

**For discussion
on 5 May 2014**

**Legislative Council
Panel on Financial Affairs**

**Progress Report on
the work of the Financial Reporting Council**

PURPOSE

The Financial Reporting Council (“FRC”) last briefed this Panel on its work progress on 3 May 2013. This paper updates the Panel on the work progress made by the FRC in 2013.

BACKGROUND

2. The FRC is a statutory body established in 2006 to conduct independent investigations into possible auditing or reporting irregularities and enquiries into possible non-compliance with accounting requirements in relation to listed entities. Any auditing or reporting irregularities identified by the FRC will be referred to the Hong Kong Institute of Certified Public Accountants for follow-up action and initiating disciplinary actions as appropriate. On the other hand, the FRC is empowered under the Financial Reporting Council Ordinance (Cap. 588) (“the Ordinance”) to require listed entities involved in completed enquiries to remove any non-compliance with accounting requirements identified.

WORK PROGRESS

3. The FRC entered its seventh year of operation in July 2013 and a brief account of its work in the past year is set out below.

Review of pursuable complaints

4. The FRC deals with each complaint it receives (including complaints referred from other financial regulators) professionally and within the parameters of established policies and procedures. In respect of each complaint, the staff of the FRC (“Staff”) reviews information provided by complainants together with information available in the public domain and additional information collected from listed entities and auditors concerned. The Staff then submits a complaint assessment report for the deliberation by the Members of the FRC (“Council”). The Council may then decide to initiate an investigation or an enquiry under the Ordinance where appropriate.

5. At the beginning of 2013, there were five complaints brought forward from 2012 and the Council also recommenced the review of three complaints which were suspended prior to 2013. Among the 20 pursuable complaints received in 2013, five related to auditing or reporting irregularities, two related to non-compliance with accounting requirements, and 13 involved both auditing or reporting irregularities and non-compliance with accounting requirements. The FRC initiated four investigations after completing the review of six complaints in 2013. At the end of 2013, 22 complaints were under review.

6. To bring the Panel up-to-date from the figures in our 2013 Annual Report, the FRC received 24 pursuable complaints in the first quarter of 2014.

As of 31 March 2014, it has received 121 pursuable complaints since establishment.

Review of modified auditors' reports

7. The FRC proactively screened all 168 modified auditors' reports issued by listed entities in 2013. Of these, 100 contained no apparent auditing irregularities or non-compliance with accounting requirements. The FRC reviewed all other modified auditors' reports and made follow-up enquiries when appropriate. As of 31 March 2014, it has screened 766 modified auditors' reports since adoption of the proactive review approach in July 2008.

8. The FRC changed its review policy at the end of June 2013. Up until then, cases where the initial review of a modified auditor's report identified potential auditing or reporting irregularities, or non-compliance with accounting requirements, were followed up by subjecting the listed entity's full set of financial statements to external reviewers for a comprehensive review under the FRC's risk-based financial statements review programme (paragraphs 10 to 16 refer). Only one set of financial statements warranted a comprehensive review of this kind in the six months to the end of June 2013.

9. From July 2013, however, the review policy was modified. The change was made based on the FRC's previous experience in reviewing the modified auditors' reports. Under the new policy, if an audit qualification indicates prior period errors that were not identified in the prior period report, the FRC will now follow up the matter directly, without having first to send the financial statements to external reviewer for comprehensive review under the risk-based financial statements review programme. The new review policy is aimed at enhancing the efficiency of the review procedures without compromising on quality and effectiveness.

Risk-based financial statements review programme

10. The FRC's risk-based financial statements review programme has been in place since 2011. The FRC determines the selection criteria based on its assessments on prevailing risk factors before each review cycle begins. For the 2013/2014 review cycle, the programme selects accountants' reports of newly listed entities which significantly underperformed in the first year of listing, financial statements from listed entities that frequently change their directors or senior management, and those of listed entities which engage audit firms that are small in relation to the complexity of the audit. In addition, the financial statements of listed entities that have been subject to intervention by Hong Kong Exchanges and Clearing Limited ("HKEx") may be reviewed, as may those of long suspended listed entities.

11. The FRC also expanded the criteria to include financial statements with significant prior period errors, since these suggest that investors relying on these prior period financial statements may have been misled.

12. To ensure the review process is performed efficiently, the FRC asks external reviewers to review financial statements and accountants' reports of newly listed companies, financial statements prepared under ASBE, and those containing complex or contentious accounting/auditing issues. The FRC internally reviews financial statements with prior period adjustments which may indicate lack of adequate professional scepticism.

13. In 2013, the FRC completed reviews of 66 sets of financial statements out of the 75 sets of financial statements selected for the 2012/2013 review cycle, and did not initiate any investigation/enquiry cases.

14. For the 2013/2014 cycle, which began in July 2013, the FRC planned to review 75 sets of financial statements representing the financial statements of approximately 5% of all Hong Kong listed entities. The industry focus for the 2013/2014 cycle has been changed; the focus is now on entities involved in the mining industry. The programme no longer focuses on an accounting theme.

15. The first batch of financial statements for the 2013/2014 cycle was sent for external review in the second quarter of 2013. Once reviewed, the Staff will go through the comments received to ensure that all apparent non-compliances with accounting requirements have been dealt with consistently.

16. As of 31 March 2014, the FRC has fully completed the review of 10 sets of financial statements for the 2013/2014 cycle. The reviews of the remaining 65 sets of the financial statements are expected to be completed in 2014.

Investigations

17. Investigations are initiated by the FRC as a result of potential or suspected auditing or reporting irregularities identified. The Audit Investigation Board (“AIB”)¹ is directed by the Council to conduct investigations in accordance with the Ordinance.

18. In 2013, the FRC initiated seven investigations and handled eight cases brought forward from the previous year; and also completed five investigations. The auditing irregularities identified in the investigations have

¹ The AIB was established under section 22 of the Ordinance to conduct investigation as directed by the Council. The AIB is chaired by the CEO of the FRC with the Deputy CEO and four professional staff members appointed by the Council as members.

been referred to the HKICPA to determine if any disciplinary action is warranted. At the end of 2013, ten investigations were in progress, most of which are expected to be completed in 2014.

19. As at 31 March 2014, the FRC has handled 36 investigations since establishment.

Enquiries

20. Enquiries are initiated by the FRC into possible non-compliance with accounting requirements in relation to listed entities. In respect of each enquiry, the Council appoints a separate Financial Reporting Review Committee (“FRRC”)² under the Ordinance to look into the possible non-compliance. Once an enquiry is completed, the FRC will request the listed entity involved to remove the identified non-compliance with accounting requirements, and to rectify the non-compliance by making appropriate prior year adjustments in subsequent financial statements.

21. During 2013, the FRC completed two enquiries brought forward from last year. At the end of 2013, one enquiry was in progress, which was completed in the first quarter of 2014.

22. As at 31 March 2014, the FRC has handled ten enquiries since establishment.

² FRRCs are appointed by the Council from the Financial Reporting Review Panel (the “FRRP”) established under section 39 of the FRC Ordinance to conduct formal enquiries into cases of possible non-compliance with accounting requirements. At present, there are 6 Panel Convenors and 37 members in the FRRP.

Advice letters to listed entities and their auditors

23. In the course of discharging its statutory duties, the FRC offers advice to listed entities and their auditors on ways of improving the quality of their financial reporting. In some cases where potential non-compliance with accounting requirements does not compromise the presentation of the financial statements, the FRC does not initiate an investigation or enquiry. Instead, it issues a letter of advice, which includes findings and suggested improvements or remedial measures for the listed entities and/or their auditors to consider. The FRC issued 11 such letters of advice in 2013. In each case, the letters were the result of the review of complaints and of the listed entities' relevant financial statements under the risk-based financial statements review programme.

PREPARING FOR AUDITOR REGULATORY REFORM

24. A major aspect of the FRC's work over the past year was to prepare for auditor regulatory reform in Hong Kong.

25. The FRC has been assisting the Government in its efforts to develop reform proposals to enhance the independence of our auditor regulatory regime which will be conducive to Hong Kong's competitiveness and reputation as an international financial centre and capital market. To this end, the FRC had commissioned an international comparative study by Deloitte LLP (UK) on the topic of independent audit oversight, and the consultancy findings were published in October 2013. The consultancy study has also been made available on FRC's website. Given the significance of the above study for the investing public, the FRC held a special press briefing on 10 October 2013. The event was a major success, in terms both of the public interest aroused and the positive media coverage it received. The FRC's goal was to communicate

clearly to Hong Kong the pressing need for auditor oversight reform and to arouse public awareness on the available options for reform.

26. The FRC's understanding is that the Government plans to carry out a public consultation regarding the regulatory reform in the near future. The FRC is confident that the reform will provide Hong Kong with an enhanced regulatory regime that will better protect the investing public, and will also strengthen confidence in the integrity of our financial reporting. Ultimately, the reform should further entrench Hong Kong's status and reputation as a major international financial centre.

ENCOURAGING MULTI-LEVEL COLLABORATION

27. Collaboration with other regulators has continued in an open, cooperative manner. The FRC has continued holding regular liaison meetings with other Hong Kong regulators, including the Securities and Futures Commission ("SFC"), the HKICPA and the HKEx with whom we have Memoranda of Understanding.

28. The FRC shared insights and opinions on regulatory developments during regular meetings with other regulators; these meetings have also been important in achieving across-the-board efficiencies in enforcing regulations in the Hong Kong capital market. These are in addition to our regular programmes of referrals and joint reviews of individual cases.

29. One of the roles of the FRC that has been growing in importance is that of generating discussion and debate among its stakeholders, particularly on issues such as injecting new elements of independence into the regulatory framework for auditors. This has involved the FRC actively engaging in

dialogues and discussions with the Government, other regulators, professional bodies and the investing public throughout the year.

30. Around the world, there is a continuing trend towards developing consistent global principles and practices relating to the financial reporting of listed entities and their auditors, and the regulations that apply to them. The FRC has kept abreast of the debates and new developments globally by participating in a number of international conferences, seminars and workshops throughout the year. In 2013, FRC delegates attended global conferences and workshops hosted by the PCAOB in the United States, as well as meetings of the International Auditing and Assurance Standards Board and the International Forum of Independent Audit Regulators.

FINANCIAL SITUATION

31. The FRC is jointly funded by the Hong Kong Government, the HKEx, the HKICPA, and the SFC.

32. The combined contribution from the four funding parties has increased to HK\$18.5 million in 2013, after a 5% upward adjustment according to an agreed arrangement among the FRC and the four funding parties. The actual expenditure of the FRC for 2013 was HK\$20.6 million.

THE STAFF

33. The Staff is responsible for managing and administering the day-to-day operations of the FRC. The current CEO, Mr Mark Dickens, commenced his appointment on 1 April 2013. The current Deputy CEO, Ms Wincey Lam, commenced her office on 2 December 2013. This new position

was created in the light of the increasingly heavy workload of the FRC, which has arisen due to an increase in both case load and complexity of cases.

34. The FRC currently has 18 full-time members of staff and is hiring a manager to meet the increasing workload. The FRC will continue to assess its workload and decide if the team needs to be further strengthened.

CORPORATE GOVERNANCE

35. The FRC strives to maintain corporate governance of the highest standard. Key areas are highlighted in paragraphs 36 to 49 below.

Committees and panels established by the Council

36. The Council has established five committees comprising members of the Council, namely Corporate Communications Committee, Finance Committee, Independent Audit Oversight Reform Committee, Operations Oversight Committee and Remuneration Committee, with specific responsibilities. These committees provide advice to the Council on various matters and meet on a periodic basis and whenever necessary. Each committee operates according to its terms of reference.

Independence

37. Except for the FRC Chairman who is appointed by the Chief Executive, members of the FRC are appointed by the Financial Secretary under delegated authority. The Council currently comprises 10 members. The Ordinance stipulates that the number of Council Members who are lay persons is to exceed the number of those who are not. At present, seven of the Council Members, including the Chairman are non-accountants. They have all actively participated in the work of the FRC through Council meetings and committees.

The Council meets once every two months and holds additional meetings as necessary.

38. Members of the Council are legally bound to declare any interest they may have in a case. Council Members who were present during the deliberation by the HKEx, the HKICPA and the SFC, or took part in any decision of these organizations, with respect to the referral of cases to the FRC, would be regarded as having an interest in the case. Under the Ordinance, in general Council Members having interest in a case could not (a) be present during any deliberation by the Council, (b) take part in any decision of the Council, or (c) be given any documents related to the case, in accordance with the Ordinance.

Financial control

39. The annual budget of the FRC is approved by the Secretary for Financial Services and the Treasury (“SFST”). The financial statements of the FRC are audited by the Director of Audit. The FRC submits a report on its operation together with a set of financial statements and the report of the Director of Audit on the financial statements (i.e. the Annual Report) to SFST once a year. The 2013 Annual Report of the FRC was tabled at the Legislative Council sitting of 16 April 2014.

Internal control

40. The FRC maintains an effective internal control system that has a clear organizational structure, well-defined levels of authority, and proper segregation of duties. The CEO is the administrative head of the FRC. He leads the administration and operation of the FRC. The Council provides directions to and oversees the performance of the CEO and the Staff.

41. The FRC assigns a director to take charge of each case from the moment enquiries commence; at least one other person at director level or above must review the case before any decision or action is taken.

42. The FRC regularly monitors all its policies and guidelines relating to personnel administration, procurement, authorization of transactions, and the safeguarding of its assets.

Process Review Panel (“PRP”)

43. The PRP is an independent panel charged with the responsibility to undertake a review of the handling of cases by the FRC to ensure that actions taken and decisions made adhered to and were consistent with internal procedures and guidelines. The PRP comprises six members appointed by the Chief Executive, and includes the FRC Chairman as an ex-officio member.

44. It published its 2013 Annual Report on 17 April 2014. The PRP concluded that the FRC had handled cases in accordance with its internal procedures.

45. The FRC accepted the recommendation from the PRP and will set out procedural arrangements between the FRC and the HKICPA on the interpretation of professional standards in its operations manual.

Code of conduct

46. The FRC fosters a culture and set of values that underpin the effectiveness of its corporate governance. All staff members are expected to adhere strictly to our code of conduct when carrying out any role on behalf of the FRC. Our code of conduct specifies standards to be followed in areas that may involve conflicts of interest, confidentiality of information, personal

investments and data protection. This includes the need for staff members to make regular declarations of their own and their spouse's investments, and to notify any changes in their holdings.

47. FRC's code of conduct is reviewed and updated on a regular basis to ensure that it remains consistent with the best practices currently being applied across the areas in which the FRC operates.

Transparency

48. The FRC has continued promoting its role and functions through radio and web banner advertisements. It has also published annual reports and bi-annual eNews to keep stakeholders informed about the FRC's operations and new developments.

49. Operations statistics and press releases about completed cases are regularly posted on the FRC's website. A new section named "FRC Decisions", containing summaries of cases not requiring investigations or enquiries, has recently been created on the FRC website. Its aim is to enhance understanding of best practices in applying accounting and auditing standards.

LOOKING FORWARD

50. Looking forward, the FRC will continue to build on its strength and professionalism to discharge its functions effectively and efficiently over the coming year, in the interests of the investing public.