

**For discussion
on 4 May 2015**

**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 5 May 2014. This paper updates the Panel on the work progress made by the FRC in 2014.

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 (“the HKICPA”) for follow-up action and initiating disciplinary actions as appropriate. On the other hand, the FRC is empowered under the Financial Reporting Council Ordinance (“the FRCO”) (Cap. 588) to require listed entities involved in completed enquiries to remove any non-compliance with accounting requirements identified.

WORK PROGRESS

3. The FRC entered its eighth year of operation in July 2014 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 (“the 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 deliberation by the Members of the FRC (“the Council”). The Council may then decide to initiate an investigation and/or an enquiry under the FRCO where appropriate.

5. At the beginning of 2014, there were 22 complaints brought forward from 2013 and the Council also recommenced the review of two complaints which were suspended prior to 2014. The FRC received a further 33 pursuable complaints in 2014, amongst which, five related to auditing or reporting irregularities, three related to non-compliance with accounting requirements, and 25 involved both auditing or reporting irregularities and non-compliance with accounting requirements. The FRC completed the review of 43 out of these 57 complaints in 2014, and initiated 15 investigations and/or enquiries as a result. The remaining 14 complaints were under review as at the end of 2014 and were brought forward to 2015.

6. To bring the Panel up-to-date from the figures in the FRC’s 2014 Annual Report, the FRC received six pursuable complaints in the first quarter of 2015. The FRC completed the review of eight complaints and initiated two investigations/enquiries during the same period. As at 31 March 2015, 12 complaints were under review.

Review of modified auditors’ reports

7. The FRC proactively screened all 171 modified auditors’ reports issued by listed entities in 2014. Of these, 94 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. In the first quarter of 2015, the FRC screened 29 modified auditors’ reports. Of these, 17 contained no apparent auditing irregularities or non-compliance with accounting requirements.

8. As reported to the Panel in May 2014, starting from July 2013, the FRC would follow up directly on cases where an audit qualification in a modified auditor’s report indicates prior period errors that were not identified in the prior period report, without having the need to send the financial statements to external reviewer for comprehensive review under the risk-based financial statements review programme (paragraphs 9-12 refer). In 2014, five modified auditors’ reports required such direct follow-up action by the FRC.

Risk-based financial statements review programme

9. The FRC's risk-based financial statements review programme has been in place since 2011. The criteria for selecting financial statements for review are determined by the FRC based on its assessment of prevailing risk factors before each review cycle begins. Under the 2013/2014 review cycle (from July 2013 to December 2014), 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 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") or the Securities and Futures Commission ("SFC") may be reviewed, as may those of long suspended listed entities. The selection criteria also include those financial statements containing significant prior period errors, since these suggest that investors relying on these prior period financial statements may have been misled.

10. To ensure the review process is carried out as efficiently as possible, the FRC asks external reviewers to review financial statements and accountants' reports of newly listed companies, financial statements prepared under Accounting Standards for Business Enterprise, and those containing complex or contentious accounting/auditing issues. Internally, the FRC reviews financial statements with prior period adjustments suggesting a lack of adequate professional skepticism.

11. In 2014, the FRC completed the reviews of 25 of the 87 sets of financial statements selected in the 2013/2014 review cycle. In the first quarter of 2015, the FRC further completed the reviews of 11 sets of financial statements selected in the 2013/2014 review cycle and expected to complete the reviews of the remaining 51 sets of financial statements by the middle of 2015.

12. All financial statements reviewed by external reviewers are re-examined by staff of the FRC to ensure that all apparent non-compliance with accounting requirements have been dealt with consistently.

Investigations

13. 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 FRCO.

14. In 2014, the FRC initiated 22 investigations and handled 10 cases brought forward from the previous year; and also completed four investigations. The auditing irregularities identified in the investigations have been referred to the HKICPA to determine if any disciplinary action is warranted. By the end of 2014, 28 investigations were in progress, most of which are expected to be completed in 2015.

15. In the first quarter of 2015, the FRC initiated two investigations and completed two investigations. As at 31 March 2015, 28 investigations were still in progress.

Enquiries

16. 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 FRCO 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.

17. During 2014, the FRC completed one enquiry brought forward from last year, and initiated one new enquiry.

18. The FRC initiated one enquiry in the first quarter of 2015. As at 31 March 2015, two enquiries were still in progress.

¹ The AIB was established under section 22 of the FRCO 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 accounting staff members appointed by the Council as members.

² FRRCs are appointed by the Council from the Financial Reporting Review Panel (the “FRRP”) established under section 39 of the FRCO to conduct formal enquiries into cases of possible non-compliance with accounting requirements. As at 31 March 2015, there were 6 Panel Convenors and 37 members in the FRRP.

Advice letters to listed entities and their auditors

19. As one of its statutory duties, the FRC offers advice to listed entities and their auditors on ways of improving the quality of their financial reporting. This is generally offered in cases where potential non-compliance with accounting requirements does not compromise the presentation of the financial statements. In such cases, rather than initiating an investigation or enquiry, the FRC issues a letter of advice which generally includes findings and suggested improvements or remedial measures for the listed entities and/or their auditors to consider.

20. The FRC issued nine such letters of advice in 2014. In each case, the letters were issued in response to complaints and/or the result of a review of the listed entities' financial statements under the risk-based financial statements review programme.

FRC'S SUBMISSION TO THE CONSULTATION PAPER FOR AUDITOR REGULATORY REFORM

Independence: Paramount to Audit Regulation

21. In June 2014, the Government published the Consultation Paper on Proposals to Improve the Regulatory Regime for Listed Entity Auditors ("the Consultation Paper"). The FRC submitted its response to the Government on 18 September 2014, along with some key recommendations. On the same day the FRC held a press briefing, sharing the FRC's recommendations with the media and the public. The press briefing was very well received, and as a result the FRC's position in relation to the Consultation Paper has been widely and clearly disseminated.

22. In its submission, the FRC made it clear that any reform should at the least make Hong Kong eligible for membership of the International Forum of Independent Audit Regulators ("IFIAR") and give it a status of regulatory equivalence with the European Commission ("EC"). This would then enable the FRC to enter into reciprocal arrangements with overseas regulators, and develop workable arrangements for cross-border regulatory cooperation. The result would not only enhance international recognition of our auditors, but would also bring Hong Kong into line with some 40 jurisdictions around the world that currently already meet the regulatory or equivalence requirements of the EC, and are also members of the IFIAR.

Future Role of the FRC

23. The Consultation Paper proposed enlarging the regulatory remit of the FRC in different areas, and this is a proposal the FRC supports in its submission. Apart from its existing investigatory powers under the FRCO, FRC believes that it should be given direct responsibility for the inspection and discipline of auditors of public interest entities (“PIEs”). The FRC also supports the proposal to give the FRC the role of overseeing the statutory functions proposed for the HKICPA, by which it would handle registration, setting of continuing professional development requirements and setting of standards on professional ethics, auditing and assurance related to PIEs.

24. The Consultation Paper proposed that the new regulatory regime would cover auditors of PIEs, but that these would initially be defined in a way that included only listed entities. The FRC is generally supportive of this proposal, but has highlighted in its submission that the European Statutory Audit Directive requires oversight of the regulation of all statutory auditors. Indeed, some larger capital markets around the world already define PIEs more broadly, and it is thought that the International Ethics Standards Board for Accountants is also likely to extend the scope of its definition of PIEs sometime in the future. The FRC’s recommendation on this point is therefore that any new legislation should be flexible enough so that, in future, the definition of PIEs can be easily amended if required. This will enable us to benchmark the new auditor regulatory regime adopted by Hong Kong against international standards, and minimize the risk of it failing to meet EC equivalence requirements.

25. These comments encapsulate the heart of the FRC’s response to the Consultation Paper. In essence, the FRC’s submission encouraged the Government to vigorously pursue the establishment of an auditor regulatory regime for Hong Kong that is at least on par with those of other major international financial centres.

MULTI-FACETED COLLABORATION

26. Throughout the year, the FRC has been proactive in meeting and communicating with stakeholders. Particularly important were a number of tripartite meetings with the Government and the HKICPA, at which the FRC put forward its views on ways of improving the regulatory regime for auditors of listed entities. These views were based on the international comparative study on independent audit oversight commissioned by the FRC, and on

discussions held at meetings of the Independent Audit Oversight Reform Committee and the Council.

27. Representatives of the FRC made visits to the Ministry of Finance (“MoF”) and the China Securities Regulatory Commission in the Mainland during the year, whereby they updated the Mainland counterparts on regulatory developments for auditors in Hong Kong and on the FRC’s submission in response to the Consultation Paper, and shared ideas about cross-border cooperation. In particular, issues discussed included gaining of access to audit working papers for Mainland companies listed in Hong Kong and the MoF’s exposure draft relating to provisional regulations covering those certified public accountant practices in Hong Kong that carry out cross-border audit services in the Mainland. Generally, the FRC has remained abreast of debates and new developments globally by participating in a number of international conferences, seminars and workshops throughout the year. The FRC will continue to pursue cross-border cooperation initiatives to enhance the performance of its investigative function.

FINANCIAL SITUATION

28. Under the existing funding arrangement, the FRC is jointly funded by the Hong Kong Government, the HKEx, the HKICPA, and the SFC.

29. The combined contribution from the four funding parties has increased to HK\$19.4 million in 2014, 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 2014 was HK\$21.6 million.

30. The Memorandum of Understanding (“MoU”) setting out the funding arrangements between the FRC and its four funding parties expired on 31 December 2014. After liaison with these funding parties, a new MoU was signed with the same four parties in November 2014. The new MoU, which covers a period of five years (from 2015 to 2019), commits the four funding parties to contributing on an “equal share” basis. It also stipulates that their contributions will increase by a fixed percentage of 5% every year, to cater for inflation. The FRC budget for 2014 as approved by the Secretary for Financial Services and the Treasury (“SFST”), which amounts to HK\$26.6 million, has been used as the baseline for determining the contribution. In addition, the Reserve Fund of HK\$20 million will continue to be rolled over in a separate account.

THE STAFF

31. 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.

32. All the 19 full-time positions in the FRC have been filled. The FRC will continue to assess its workload and decide if the team needs to be further strengthened.

CORPORATE GOVERNANCE

33. The FRC strives to maintain corporate governance of the highest standard. Key areas are highlighted in paragraphs 34 to 49 below.

Committees and panels established by the Council

34. The Council has established five committees, 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

35. Except for the FRC Chairman who is appointed by the Chief Executive, Council Members of the FRC are appointed by the Financial Secretary under delegated authority. The Council currently comprises 11 Council Members. The FRCO stipulates that the number of Council Members who are lay persons is to exceed the number of those who are not. At present, six 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.

36. Council Members are legally bound to declare any interest they may have in a case. Council Members who were present during the deliberation by 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 FRCO, 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 FRCO.

Accountability and Audit

37. The FRC has adopted a strict audit process. The FRC's annual budget is endorsed by the Council and submitted to the SFST for approval. 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 2014 Annual Report of the FRC was tabled before the Legislative Council sitting of 15 April 2015.

38. The CEO and the Deputy CEO of the FRC attend the meeting of the Legislative Council Panel on Financial Affairs and present a progress report each year.

Ombudsman

39. The work of the FRC is also subject to the oversight by the Ombudsman on public complaints against the FRC and its staff relating to allegations of maladministration.

Internal control

40. The FRC maintains an effective internal control system that includes a clear organizational structure, well-defined levels of authority, and proper segregation of duties. The FRC assigns a director to take charge of each case from the moment cases commence; at least one other person at director level or above must review the case before any decision or action is taken.

41. 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”)

42. 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 five members appointed by the Chief Executive, with the FRC Chairman as an ex-officio member.

43. The PRP published its 2014 Annual Report on 30 March 2015, which concluded that the FRC had handled the cases selected for review in accordance with its internal procedures.

Code of conduct

44. FRC staff members are required to adhere to the code of conduct of the FRC when carrying out any role on behalf of the FRC. The code of conduct of the FRC 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.

45. The 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.

Communications with Stakeholders

46. The FRC actively communicates with stakeholders, including its funding parties, the accounting and auditing industry, its regulatory counterparts, and the general investing public.

47. Annual reports and bi-annual eNews publications are issued to keep stakeholders informed about the FRC’s operations and any new developments arising. Operations statistics and press releases about completed cases are regularly posted on the FRC website (www.frc.org.hk).

48. The FRC actively participates in industry-related initiatives. In 2014, the FRC submitted its response to the Consultation Paper together with its recommendations, which are available on the FRC website.

49. To improve the transparency of its work, the FRC is in the process of revamping its official website to make it more informative and user friendly. The FRC has also revised its Access to Information Policy, which is available for public's information on its website. Starting from 1 January 2015, the progress of the FRC in handling information requests is reported at the Council meetings, and such statistics are published on the FRC's website.

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.

51. Effective auditor oversight continues to play a crucial part in ensuring the reliability and integrity of the financial reporting process. This assurance is in turn fundamental to the successful operation of any financial market, and an essential part of sustaining investor confidence. Given Hong Kong's status as a major international financial centre, it is vital that it has an auditor regulatory regime that is considered to be independent and robust by major international bodies such as the International Monetary Fund, and that fully safeguards the interests of the investing public. At this stage, it is important to finalize an independent and robust regulatory framework for auditors of publicly listed entities. Such a framework should be both appropriate for Hong Kong and able to be benchmarked against international standards and best practices.