

**For discussion
on 23 May 2016**

**Legislative Council
Panel on Financial Affairs**

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

PURPOSE

The Financial Reporting Council (“the FRC”) last briefed this Panel on its work on 4 May 2015. This paper mainly updates the Panel on the work progress made by the FRC in 2015.

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 ninth year of operation in July 2015 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 2015, there were 14 complaints brought forward from 2014. The FRC received a further 46 pursuable complaints in 2015, amongst which, 25 related to auditing or reporting irregularities, three related to non-compliance with accounting requirements, and 18 involved both auditing or reporting irregularities and non-compliance with accounting requirements. In 2015, the FRC completed the review of 36 out of these 60 complaints and initiated six investigations and/or enquiries as a result. The remaining 24 complaints were under review as at the end of 2015 and were brought forward to 2016.

6. To bring the Panel up-to-date from the figures in the FRC’s 2015 Annual Report, the FRC received four pursuable complaints in the first quarter of 2016. The FRC completed the review of 11 complaints and initiated one investigation during the same period. 17 complaints were under review as at 31 March 2016.

Review of modified auditors’ reports

7. The FRC screened all 174 modified auditors’ reports issued by auditors of Hong Kong listed entities in 2015. Of this total, 95 did not include any apparent auditing irregularities or non-compliance with accounting requirements, as the auditors issued an “emphasis of matter” opinion in their auditors’ reports. These modified auditors’ reports did not require further review. The FRC reviewed all the other 79 modified auditors’ reports with other modified opinions (such as “Qualified opinion”, “Disclaimer of opinion” and “Adverse opinion”) in order to consider follow-up action. In the first quarter of 2016, the FRC screened 31 modified auditors’ reports. Of these, 13 contained no apparent auditing irregularities or non-compliance with accounting requirements.

8. 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 9-13 refer). In 2015, four modified auditors’ reports required such direct follow-up action by the FRC.

Risk-based financial statements review programme

9. The FRC selects financial statements for review based on the risk factors currently prevailing in the market. The specific criteria for selecting financial statements for review are determined before each review cycle begins.

10. To ensure the review process is carried out as efficiently as possible, the FRC engages external reviewers to review some of the financial statements under the programme. Those handled by external reviewers include (a) financial statements and accountants' reports of newly listed entities; (b) financial statements prepared under the Accounting Standards for Business Enterprises; and (c) financial statements containing complex or contentious accounting/auditing issues. All financial statements reviewed by external reviewers are re-examined by the Staff to ensure that any cases of apparent non-compliance with accounting requirements have been dealt with consistently.

11. Internally, the FRC itself reviews financial statements with prior period adjustments which might suggest a lack of adequate professional skepticism on the part of auditors in the prior year.

12. At the beginning of 2015, the review of 62 financial statements was brought forward from 2014. The FRC initiated the review of another 61 financial statements in 2015. Out of these financial statements, 32 of them have been reviewed with no follow-up action; eight required follow-up review; and two have been reviewed with letters of advice issued. 81 financial statements were still under review as at 31 December 2015.

13. To bring the Panel up-to-date from the figures in the FRC's 2015 Annual Report, in the first quarter of 2016, the FRC initiated the review of 14 financial statements. The review of 15 financial statements was completed, out of which 11 required no follow-up action, two were completed with letters of advice issued, and two financial statements required follow-up review. 80 financial statements were still under review as at 31 March 2016.

Investigations

14. Investigations are initiated by the FRC as a result of potential or suspected auditing or reporting irregularities identified. The Audit

Investigation Board (“the AIB”)¹ is directed by the Council to conduct investigations in accordance with the FRCO.

15. In 2015, the FRC initiated 11 investigations and handled 28 cases brought forward from the previous year. In total, nine investigations were completed, and the investigation reports have been referred to the HKICPA, which will determine whether any disciplinary action is warranted.

16. By the end of 2015, 30 investigations were in progress. The majority of these were initiated in the second half of 2014 and in 2015. Some of the investigations still outstanding involve highly complex issues and require study of financial statements across several years, and these have required more time for evidence to be collected and information to be reviewed. We are confident that the majority of these outstanding investigations can be completed in 2016.

17. In the first quarter of 2016, the FRC initiated one investigation and completed two investigations. 29 investigations were still in progress as at 31 March 2016.

Enquiries

18. 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.

19. The FRC brought forward one enquiry from last year and initiated one new enquiry during 2015. As at 31 March 2016, 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 Chief Executive Officer (“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 2016, there were six Panel Convenors and 41 members in the FRRP.

20. The time taken to complete an enquiry depends on the circumstances and complexity of individual cases. Documents, explanations and information from related persons have to be obtained, all of which can take considerable time. The FRC is aiming at completing the outstanding enquiries during 2016.

Advice letters to listed entities and their auditors

21. In cases where potential non-compliance with accounting requirements does not affect 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 four such letters of advice in 2015.

DEVELOPMENT OF AUDITOR REGULATORY REFORM

22. The FRC commissioned Deloitte LLP (UK) to carry out a detailed comparative study of international best practice in auditor regulation, which was published in October 2013. The study considered auditor regulatory practices in different countries in the light of the European Commission (“EC”) and the International Forum of Independent Audit Regulators (“IFIAR”) requirements, and noted that over 40 jurisdictions, including China, were already members of the IFIAR and/or an EC equivalent on the basis of their auditor regulatory regimes.

23. In June 2014 the Government issued its consultation paper containing proposals to improve the regulatory regime for listed entity auditors in Hong Kong. As part of that process the FRC submitted its own responses to the consultation paper.

24. The Government’s consultation conclusions on proposals to improve the regulatory regime for listed entity auditors (“Consultation Conclusions”) are a major step towards bringing auditor regulatory reform to Hong Kong. At the broadest level, the Consultation Conclusions made it clear that the concept of self-regulation by the profession must now be firmly left behind. The overwhelming trend in recent years has been for international financial centres to move away from allowing the audit profession to self-regulate towards adopting a much more transparent and impartial system with an independent regulator performing regulatory functions. This is the shift that needs to take place in Hong Kong too in the best interest of the investing public.

25. Since the FRC already operates independently from the audit profession, it is a reasonable move for the FRC to take up the role as the independent auditor regulator in Hong Kong. This would bring Hong Kong into line with other major jurisdictions.

26. A core part of the Government's proposals as reflected in the Consultation Conclusions is to vest the FRC with powers to carry out direct inspections and investigations of auditors of listed entities, as well as to take disciplinary action against them as required. In addition, the FRC would be vested with oversight powers in relation to registration, the setting of standards on professional ethics, auditing and assurance, and the setting of requirements for continuing professional development for auditors of listed entities. The FRC would also be empowered to require relevant information from the HKICPA for the purpose of exercising the oversight powers, and upon being satisfied that it is in the public interest to do so, to give written directions to the HKICPA in relation to the performance of the oversight functions.

27. The Government's Consultation Conclusions are a major step towards bringing auditor regulatory reform to Hong Kong. We continue to hold regular liaison meetings on the topic with the Government and other stakeholders, and keep abreast of developments in international auditor regulation. All this is helping the FRC prepare for changes in the local auditor regulatory regime as and when they are implemented.

MULTI-LEVEL COLLABORATION

28. In 2015, the FRC continued to hold regular liaison meetings with other regulators in Hong Kong to discuss matters of mutual interest. The FRC also made use of these occasions to discuss with other regulators the status of referred cases, and the progress of the respective financial statements review programmes.

29. The FRC continued to be involved in constructive discussions with the PRC's Ministry of Finance and the China Securities Regulatory Commission on ways to overcome the difficulties experienced by regulators and auditors in gaining access to audit working papers under current Mainland regulations. The FRC believes that the Mainland authorities recognise the importance of allowing the FRC access to audit working papers, and are considering suitable measures to enhance cross-border cooperation in this area.

30. Further afield, the FRC sent representatives to various international conferences and related events where they were able to share insights with regulators from other major capital markets.

FINANCIAL SITUATION

31. Under the existing funding arrangement, the FRC is jointly funded by the Government, the Hong Kong Exchanges and Clearing Limited (“the HKEX”), the HKICPA, and the Securities and Futures Commission (“the SFC”).

32. The combined contribution from the four funding parties was HK\$28.0 million in 2015, which was based on a new Memorandum of Understanding signed among the FRC and the four funding parties in November 2014 setting out the funding arrangements for the next five years (from 2015 to 2019). The actual expenditure of the FRC for 2015 was HK\$23.2 million.

THE STAFF

33. The Staff is responsible for managing and administering the day-to-day operations of the FRC. The former CEO, Mr Mark Dickens, commenced his appointment on 1 April 2013 and retired on 31 March 2016. The current CEO, Mr Paul F. Winkelmann, commenced his appointment on 1 April 2016. The current Deputy CEO, Ms Wincey Lam, commenced her office on 2 December 2013.

34. The FRC has recently reassessed its manpower requirements in response to an increasing caseload. It hired an investigation director and an associate investigation director in the fourth quarter of 2015, and they took up their positions in the first quarter of 2016. 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 50 below.

Committees established by the Council

36. 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

37. 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. All members have 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. Council Members 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 organisations, with respect to the referral of cases to the FRC, would be regarded as having an interest in the case. In general, Council Members having an 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

39. The FRC adopts a strict audit process. The FRC's annual budget must be endorsed by the Council and submitted to the Secretary for Financial Services and the Treasury for approval.

40. The financial statements of the FRC are subject to an official audit by the Government's Director of Audit; annual reports are submitted to the Secretary for Financial Services and the Treasury and tabled at the Legislative Council. The FRC attends the meeting of the Legislative Council Panel on Financial Affairs and presents a progress report annually. The 2015 Annual

Report of the FRC was tabled before the Legislative Council sitting of 11 May 2016.

Ombudsman

41. The Ombudsman also indirectly oversees the work of the FRC by dealing with any public complaints regarding alleged maladministration made against the FRC and its staff. The FRC did not receive any enquiries from the Ombudsman in 2015.

Internal control

42. The FRC maintains an effective internal control system that includes a clear organisational 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 investigations/enquiries commence; at least one other person at director level or above must review the case before any decision or action is taken.

43. The FRC regularly reviews all its policies and guidelines relating to personnel administration, procurement, authorisation of transactions, and the safeguarding of its assets.

Process Review Panel (“PRP”)

44. 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.

45. The PRP published its 2015 Annual Report on 5 April 2016, which concluded that the FRC had handled the cases selected for review in the year in accordance with its internal procedures.

Code of conduct

46. The Staff 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 the Staff to make regular declarations of their own and their spouse's investments, and to notify any changes in their holdings.

47. 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

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

49. Information disseminated by the FRC is user-friendly and easily accessible. The FRC publishes annual reports and bi-annual eNews publications to keep stakeholders informed about the progress of its work and its development. Statistics relating to its operations and handling of information requests, as well as press releases concerning cases completed in specified period, are regularly published on the FRC website (www.frc.org.hk).

50. To improve the transparency of its work, the FRC has revamped its official website to make navigation easier and to increase the amount of practical and timely information available on it. The FRC has also set up official pages on some social media channels to allow interested parties to connect in a more interactive manner.

LOOKING FORWARD

51. Looking forward, the FRC will build on its proven experience and professionalism as it performs its core functions. In doing so, it will continue making a vital contribution to the integrity of the Hong Kong capital markets as a whole.

52. The FRC will continue to assist the Government in the legislative process and provide input regarding the ongoing listed entity auditor regulatory reform process. We are hopeful that the Government's reform proposals will lead to the FRC being mandated with additional responsibilities and transformed into a fully-fledged auditor regulator in the near future. The successful implementation of the reform proposals will further enhance the professional standards and conduct of the audit profession, benefit the profession itself and investors, and elevate and reinforce the status of Hong

Kong as an international financial centre. We hope the auditor regulatory reform will bring the FRC to become a member of the IFIAR and Hong Kong's auditor regulatory regime will be recognised as EC equivalent.

Financial Reporting Council
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