

**For discussion  
on 4 April 2011**

**Legislative Council  
Panel on Financial Affairs**

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

**PURPOSE**

The FRC last briefed this Panel on its work progress on 8 April 2010. This paper updates the Panel on the work progress made by the FRC since then.

**BACKGROUND**

2. The Financial Reporting Council (“FRC”) is a statutory body established to conduct investigation of auditing irregularities and enquiries into non-compliance with accounting requirements in relation to listed entities. In addition to responding to complaints, the FRC has taken a proactive approach since July 2008 by making reference to modified auditors’ reports on the financial statements of all listed entities to identify potential non-compliance with accounting requirements. The FRC has widened its scope of review with the introduction of a new risk-based financial statements review programme which went into effect in January 2011.

## **WORK PROGRESS**

3. The FRC entered into its fourth year of operation in 2010 and a brief account of its work in the past year is set out below.

### ***Preliminary assessment of complaints***

4. The FRC received nine complaints in 2010 and as of 28 February 2011, it has received a total of 51 complaints since establishment. The Secretariat of the FRC (the “Secretariat”) reviews information provided by complainants together with information available in the public domain and additional information collected from listed entities and auditors concerned. In respect of each complaint, the Secretariat submits a complaint assessment report for the consideration of the Members of the FRC (“the Council”). The Council would then determine if the complaint justifies the initiation of an investigation or an enquiry.

5. Among the complaints received in 2010, two related to auditing or reporting irregularities and seven involved both auditing irregularities and non-compliance with accounting requirements. The assessments of seven complaints were completed by the end of the year, one was completed after the year end and one was still under review. Amongst the eight completed review of complaints, three investigations<sup>1</sup> and one enquiry were initiated. One of these investigations was completed at the end of January 2011.

### ***Review of modified auditors’ reports***

6. The FRC screened 142 modified auditors’ reports in 2010 and as of 28 February 2011, it had screened 305 modified auditors’ reports since the

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<sup>1</sup> Two investigations were initiated in 2010 and one was initiated in 2011.

proactive review approach was adopted in July 2008. Among the modified auditors' reports issued on the financial statements of listed companies in 2010, the FRC identified eight cases of potential non-compliance with accounting requirements, two cases of potential auditing irregularities and two cases with both non-compliances and auditing irregularities, which resulted in the initiation of one enquiry and two investigations which are still in progress in the middle of March 2011.

7. For the other cases, the FRC advised the listed entities and the auditors of the review findings and suggested improvement measures or referred the cases to other regulators for possible follow-up action.

#### *New risk-based review programme*

8. The FRC has widened its scope of review by implementing a new risk-based financial statement review programme since January 2011. As a result, in addition to reviewing issues identified in modified auditors' reports, the FRC also performs comprehensive reviews of entire sets of financial statements selected from various categories.

9. Financial statements with modified auditors' reports and those with alleged non-compliance with accounting requirements or auditing irregularities based on news from the media are two of the aforesaid categories. We also select financial statements of newly listed companies and companies which have changed auditors for review. Certain financial statements are selected for review based on a specific accounting theme or an industry focus.

10. Under this review programme, any listed company can be selected for review. For the 2011 operational year, we expect to review the financial

statements of approximately 5% of the listed companies, i.e. about 70 companies.

### ***Investigations***

11. The FRC handled eight investigations of auditing or reporting irregularities in 2010, of which four were initiated in 2009 and the other four were initiated in 2010. Among those four cases initiated in 2010, two cases were initiated as a result of the review of complaints (paragraph 5 refers), and two as a result of the review of modified auditors' reports (paragraph 6 refers). The Council initiated another investigation at its Council Meeting in March 2011. Investigations were initiated as a result of potential or suspected auditing or reporting irregularities identified and the Audit Investigation Board ("AIB")<sup>2</sup> was directed by the Council to conduct the investigations in accordance with the FRC Ordinance (Cap. 588).

12. For the four investigations initiated in 2009, one was completed in 2010 which led to the publication of the second investigation report of the FRC in August 2010. This investigation was initiated in September 2009. The report was referred to the Hong Kong Institute of Certified Public Accountants ("HKICPA") in August 2010. The investigation of two further cases were completed and were awaiting comments from the named persons on the draft investigation report in accordance with the provision of the FRCO before adoption of the report by the Council. The remaining investigation is expected to be completed in the second quarter of 2011.

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<sup>2</sup> The AIB was established under section 22 of the FRC Ordinance to conduct investigation as directed by the Council. The AIB is chaired by the Chief Executive Officer of the FRC with four professional Secretariat staff appointed by the Council as members.

13. For the four investigations initiated in 2010, one was completed in January 2011 and the others are in progress.

### ***Enquiries***

14. As mentioned above, the FRC initiated two enquiries last year, both in November 2010, including one initiated as a result of the review of complaints (paragraph 5 refers) and one as a result of the review of modified auditors' reports (paragraph 6 refers). In respect of each enquiry, the Council appointed a separate Financial Reporting Review Committee ("FRRC")<sup>3</sup> under the FRC Ordinance to look into the possible non-compliances. Both of these enquiries are in progress.

15. In 2010, the FRC had also handled an enquiry which was initiated in September 2009 and completed in March 2010. Following the conclusion of the FRRC's work, the FRC had written to the listed company requesting it to rectify the non-compliance and a report on the enquiry was published in March 2010. The listed company made prior year adjustments in its financial statements for the subsequent year.

### **THE SECRETARIAT**

16. The Secretariat is responsible for managing and administering the day-to-day operations of the FRC. The current Chief Executive Officer, Dr. P.M. Kam, commenced his appointment on 1 April 2010.

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<sup>3</sup> FRRCs are appointed by the Council from the Financial Reporting Review Panel ("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 7 Panel Convenors and 34 members in the FRRP.

17. To cope with the significant increase in workload caused by the complexity of certain cases handled in 2010, as a special measure consultants and employees on short-term contracts were hired to help out. The FRC has also formed a team to execute the new risk-based financial statements review programme. In addition, the FRC has strengthened staff resources to handle a rapidly evolving corporate communications programme. In 2010, two full-time positions were added.

18. All the 15 full-time positions in the Secretariat have been filled, including one investigation officer who will report duty in May 2011. The FRC will continue to assess its workload and decide if the team needs to be further strengthened. For any short-term increase in workload, the FRC will adopt flexible short-term measures, such as the hiring of staff on short-term contracts.

#### **INCREASED INVOLVEMENT OF ADVISERS AND MEMBERS**

19. Three new Honorary Advisers joined the Advisory Panel of the FRC in August 2010 which brings the number of advisers to four. This highly experienced panel will continue to offer guidance in cases involving auditing irregularities.

20. Committees have been established to advise the Council in specific areas. During 2010, the name of the Operations Committee was changed to Operations Oversight Committee (“OOC”) to better reflect its responsibilities in providing oversight and direction to the Secretariat in the handling of cases. Moreover, the OOC’s involvement in providing advice on cases has increased. In addition to providing comments on draft investigation and enquiry reports, the OOC is also tasked with considering whether investigations and enquiries should be initiated based on results of the Secretariat’s initial review of complaints or review of modified auditors’ reports.

The experience and expertise of the Committee Members, and their greater involvement, have facilitated the Council to make decisions on cases in a more effective and efficient manner.

## **COLLABORATION WITH OTHER REGULATORS**

21. The FRC maintains close communication with other regulatory organisations in Hong Kong. In 2010, the frequency of inter-agency meetings increased and the Council has started to refine ways to coordinate reviews of financial statements with other regulators to ensure that its work is complementary and productive.

22. Mainland and Hong Kong regulators have jointly developed a scheme to provide Mainland incorporated companies listed in Hong Kong with the option to prepare their financial statements using Mainland accounting standards and have them audited by approved Mainland audit firms using Mainland auditing standards. The scheme went into effect in December 2010.

23. In relation to the above scheme, the FRC signed a Memorandum of Understanding with the Ministry of Finance in 2009, which established a framework for investigative cooperation. The FRC could investigate, through the Ministry of Finance, potential auditing irregularities in relation to Mainland auditors of Hong Kong listed companies.

## **PUBLICITY**

24. The FRC publicized its work through updating its website regularly and the distribution of annual reports and leaflets to stakeholders. Staff of the FRC Secretariat attended seminars, meetings and conferences hosted by local accounting groups and international professional associates and institutions to strengthen its network both locally and overseas, and gave talks

at universities, to raise the level of public awareness of the role and functions of the FRC.

25. The FRC developed a public communications programme in 2010 for engaging other stakeholders including listed companies, relevant regulators and the public. The programme includes presentations to listed companies and other professional bodies, radio advertising and the regular publication of e-newsletters. The radio promotion programme which highlights the role and functions of the FRC has been launched on two radio stations in Hong Kong since January 2011.

## **FINANCIAL SITUATION**

26. The FRC is jointly funded by the Companies Registry Trading Fund, the Hong Kong Exchanges and Clearing Limited (the “HKEx”), the HKICPA, and the Securities and Futures Commission (“SFC”).

27. The combined contribution from the four funding parties has increased from HK\$10 million to HK\$16 million in 2010, with a 5% upward adjustment annually from 2011 to 2014. The increase has taken into account the FRC’s assessment of its funding requirements to perform its statutory functions in the light of its operational experience in the past three years.

28. The actual expenditure of the FRC in 2010 was HK\$12 million and the approved budget of the FRC for 2011 is HK\$17 million which has taken into account the need to strengthen the professional team and an increase in the provision for legal expenses having regard to the number of investigations to be conducted in 2011.

## **CORPORATE GOVERNANCE**

29. The FRC strives to maintain corporate governance of the highest standard. Key areas are highlighted in paragraph 30 to 39 below.

### ***Independence***

30. Members of the FRC are appointed by the Chief Executive. The Council currently comprised 10 members and six of them, including the Chairman, are lay persons, i.e. 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. Committees provide advice to the Council on various matters and meet on a periodic basis and whenever necessary.

31. Members are legally bound to declare any interest they may have in a case. During 2010, the FRC reviewed its procedures in relation to the declaration of conflict of interest and refined its policy regarding cases referred by the HKEx, the HKICPA and the SFC. It was concluded that Members who were present during the deliberation by these organizations, or took part in any decision of these organizations, with respect to the referral of cases to the FRC, would be regarded as having interest in the case. These Members 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 matter, in accordance with the FRC Ordinance.

### ***Financial control***

32. 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 the SFST once a year. The 2010 Annual Report of the FRC will be tabled at the Legislative Council sitting of 30 March 2011.

### ***Internal control***

33. The Chief Executive Officer (“CEO”) is the administrative head of the FRC. He leads the administration and operation. The Council provides directions to and oversees the performance of the CEO and the Secretariat.

34. The CEO is supported by the operations team in the Secretariat. For each operational case, one director takes charge while a different director is assigned to review that case for the purpose of checks and balances and quality assurance. On top of this, the CEO oversees the work of the directors in the operations team to provide the second level of checks and balances and quality assurance, and the work of the CEO and the directors are all overseen by the Council.

### ***Process Review Panel (PRP)***

35. The PRP is an independent panel 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 including the FRC Chairman as an ex-officio member. It has published its 2010 Annual Report in late March 2011. The Report concluded that the PRP was satisfied that the FRC had handled the cases in accordance with its internal procedures. The PRP had also recommended the FRC to explicitly lay down an assessment mechanism to determine whether an enquiry or investigation should be initiated

in a particular case. The FRC welcomes and fully accepts the PRP's recommendation.

### ***Code of conduct***

36. The FRC has developed a recognized culture and a set of values that fully support effective corporate governance. All staff members strictly adhere to the FRC's Code of Conduct when undertaking any role on its behalf. The 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 regular declarations of their own and their spouse's investments and notifications in case of changes in holdings.

37. The Code of Conduct is reviewed and updated on a regular basis to ensure that it remains consistent with the best practices currently undertaken across the areas in which the FRC operates.

### ***Transparency***

38. The FRC continues to publish on its website the summary of completed complaints, statistics of its operation updates and publication of reports on investigation and enquiry on a timely basis.

39. The FRC have adopted a policy on 'Access to Information' which outlines the procedures for members of the public to access information and the limitations that need to be imposed on that access. The policy was designed to attain a balance between privacy of information and access to public records. The "Access to Information" policy is also available on our website.

## **LOOKING FORWARD**

40. The objectives set out in the Strategic Plan 2010-2012 have been further developed in 2010, focusing on four specific areas which include the adoption of a more proactive approach in the regulation of financial reporting of listed entities, increasing the effectiveness and efficiency of its operations, raising the level of understanding by the public on its role and functions, and raising public awareness of independent audit oversight regimes adopted by other major international financial centres.

41. The FRC will continue to discharge its statutory duties, in the broader interests of Hong Kong, to uphold the quality of financial reporting in Hong Kong, enhance protection for investors and increase investors' confidence.

**Financial Reporting Council  
March 2011**