

**Process Review Panel for
the Financial Reporting Council**

2010 Annual Report

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Chapter 1 : Background

1.1 The Process Review Panel for the Financial Reporting Council (PRP) is an independent and non-statutory panel established by the Chief Executive of the Hong Kong Special Administrative Region in 2008 to review cases handled by the Financial Reporting Council (FRC), and consider whether the actions taken by the FRC are consistent with its internal procedures and guidelines.

Background of the FRC

1.2 The FRC was established under the FRC Ordinance (Cap. 588) in 2006 as an independent statutory body to investigate auditing and reporting irregularities and non-compliance with accounting requirements of listed corporations and collective investment schemes in Hong Kong. The FRC plays a key role in upholding the quality of financial reporting, promoting the integrity of the accountancy profession, enhancing corporate governance and protecting investors' interest.

1.3 Under the FRC Ordinance, the FRC is empowered to conduct independent investigations into possible auditing and reporting irregularities in relation to listed entities and is assisted by the statutory Audit Investigation Board comprising officers from the FRC Secretariat. The FRC is also tasked to conduct independent enquiries into possible non-compliance with accounting requirements on the part of listed entities and is assisted by the Financial Reporting Review Committees drawn from Convenors and members of the statutory Financial Reporting Review Panel comprising individuals from a wide range of professions in addition to accountants.

The PRP

1.4 Established by the Administration in late 2008, the PRP is tasked to ensure that the FRC handles individual cases in a consistent manner, and that the actions taken and decisions made adhere to FRC's internal procedures and guidelines. It reflects the Administration's continuing commitment to enhance the accountability of the FRC.

Functions of the PRP

1.5 The terms of reference of the PRP are as follows –

- (a) to receive and consider periodic reports from the FRC on completed or discontinued cases;
- (b) to receive and consider periodic reports on investigations and enquiries lasting more than one year;
- (c) to receive and consider periodic reports from the FRC on complaints against the FRC or its staff;
- (d) to call for files from the FRC to review the handling of cases to ensure that the actions taken and decisions made adhered to and are consistent with internal procedures and guidelines and to advise the FRC on the adequacy of its internal procedures and guidelines where appropriate;
- (e) to advise the FRC such other matters relating to the FRC's performance of statutory functions as the FRC may refer to the PRP or on which the PRP may wish to advise; and
- (f) to submit annual reports to the Secretary for Financial Services and the Treasury.

1.6 The above terms of reference apply to the FRC main Council. The PRP is tasked to review and advise the FRC its case-handling and not its internal operation on administrative matters, hence the work of the committees set up under the FRC is not subject to direct review by the PRP.

1.7 The internal procedures which the PRP would make reference to in reviewing FRC's cases include guidelines on the handling of complaints, initiation and processing of investigations and enquiries, review of modified auditors' reports, working protocols with other regulatory bodies, preservation of secrecy and identity of informers and relevant legislative provisions.

Composition of the PRP

1.8 At the time of the review for the second case review cycle, the PRP comprised five members, including a lay Chairman (i.e. non-accountant) to avoid conflict of interests, the FRC Chairman as an ex-officio member and three members from the accountancy sector, the financial sector and other professions.

1.9 The membership of the PRP is at Annex.

Follow-up on the PRP's recommendation made in the 2009 Annual Report

1.10 In its 2009 Annual Report, the PRP noted that the FRC's internal procedures provided limited guidance on the handling of suspended cases and informal inquiries, hence recommended that the FRC consider providing more detailed guidance in that regard. The FRC accepted the PRP's recommendation, and subsequently amended its operating procedures in 2010 in accordance with the PRP's recommendation.

Chapter 2 : Work of the PRP in 2010

2.1 This report covers the work of the PRP from 1 January 2010 to 31 December 2010, reviewing cases completed by the FRC during 2009.

Modus operandi of the PRP

2.2 The PRP, at its first meeting held in mid-November 2008, decided that except for the first review cycle that should start from July 2007 when the FRC became fully operational until end December 2008, all case review cycles thereafter should run on a calendar year basis.

2.3 According to its terms of reference, the PRP would receive and consider periodic reports from the FRC on completed cases, investigations and enquiries lasting longer than one year as well as complaints against the FRC or its staff. Basing on the FRC's caseload during the relevant review cycle, the PRP would select cases for review at the end of the cycle, and all PRP members would join the case review session(s). The approach for case selection could be reviewed or fine-tuned as the Panel proceeds with the case review work.

2.4 PRP members are obliged to preserve secrecy in relation to information furnished to them in the course of the PRP's work, and to refrain from disclosing such information to other persons. To maintain the independence and impartiality of the PRP, all PRP members took care in declaring their interests upon the commencement of their terms of appointment, as well as, before conducting case review.

Selection of cases for review

2.5 By end December 2009, the FRC Secretariat advised the PRP that the FRC had completed 18 cases, none of which had exceeded 12 months, and had not received any complaints against the FRC or its staff during the second review cycle. The FRC Secretariat provided the PRP in May 2010 with lists and case summaries of completed cases for PRP members to select for review.

2.6 By August 2010, the PRP selected five cases for review out of the

18 completed cases –

Distribution of cases reviewed

An enquiry case arising from the review of complaints

A complaint case with both suspected accounting non-compliances and audit irregularities

A complaint case with no follow up action after review (unsubstantiated case)

A case arising from the review of modified auditors' reports

An enquiry arising from the review of modified auditors' reports

2.7 The PRP considered that the selection above reflected a good mix of the completed cases, which were of the following distribution –

| <u>Distribution of completed cases¹</u> | <u>Total no.</u> |
|---|------------------|
| Enquiry cases | 2 |
| Investigation cases | 0 |
| Unsubstantiated cases | 8 |
| Cases referred to another enforcement agency ² | 4 |
| Cases where the complaint was resolved by the complainee(s) (e.g. voluntarily corrected the suspected non-compliance) | 6 |

Case review session

2.8 After the selection of cases for review in August 2010, with the assistance of the FRC Secretariat, the PRP Secretariat made preparations for the case review meeting. The case review meeting was held in October 2010

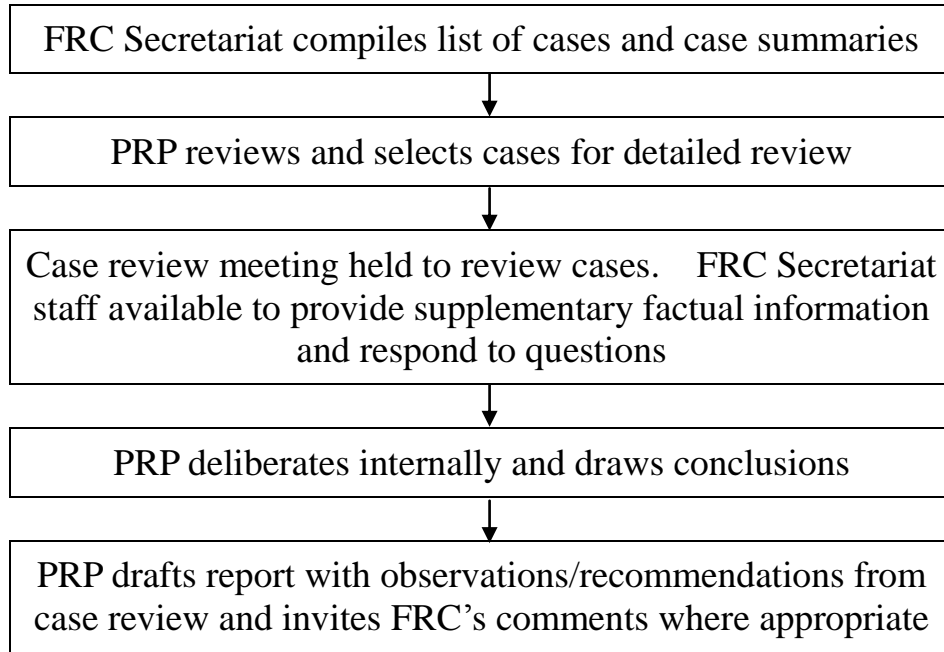
¹ Some of the completed cases resulted in a combination of follow-up actions taken by the FRC. These cases have been included under all the relevant categories.

² 2 out of the 4 cases under this category involve other different follow-up actions taken by the FRC, and have been counted under those relevant categories as well.

to review the five selected cases.

Case review workflow

2.9 The workflow of the PRP case review process is set out below –



2.10 PRP's observations and recommendations are set out in the following chapters.

Chapter 3 : PRP's review of cases completed by the FRC

3.1 On the whole, based on the cases reviewed in the second cycle, the PRP was of the view that the FRC had followed its internal procedures in handling cases.

Review of an enquiry case arising from the review of complaints

Case facts

3.2 The PRP reviewed a complaint case concerning a formal enquiry into a suspected financial reporting non-compliance of a listed entity. It was alleged that the listed entity's accounting treatment of the convertible bonds did not comply with accounting requirements, and could result in material misstatements of the entity's financial statements. This case took 10 months to complete and was one of the two cases taking the longest processing time, in addition to being one of the two enquiry cases, completed during the review cycle.

FRC actions

3.3 The FRC examined the case and decided to initiate an enquiry into the suspected non-compliance with accounting requirements, and found that the accounting treatment of the convertible bonds in the financial statements did not violate the relevant accounting requirement. Since the allegations of accounting non-compliances against the entity could not be substantiated, the FRC did not pursue the case any further.

PRP's areas of review

3.4 Based on the case facts outlined above, the PRP checked how the FRC had handled the case from –

- (a) the initial screening;
- (b) liaising with the listed entity to review the allegations;
- (c) preparing and submitting a complaint assessment report to the

Council;

- (d) initiating a formal enquiry;
- (e) appointing and working with the Financial Reporting Review Committee (FRRC) to conduct the enquiry;
- (f) preparing and issuing the enquiry report; and/to
- (g) adoption of the enquiry report by the Council.

3.5 In response to the PRP's question about the reasons for having taken a relatively longer period of time to complete the enquiry of the case, the FRC explained that some two to three months had been taken to complete the appointment to the relevant FRRC due to many candidates' possible conflicts of interests in the case under enquiry and their heavy work schedules. The complexity of the case also added to the time and efforts required for its examination.

3.6 On the process of collecting information for the compilation of the enquiry report, the FRC advised that it varied on a case-by-case basis, and that usually information would be obtained from the concerned entity and its auditor, and sometimes also from other regulators. A great deal of importance was placed on maintaining the transparency of the process, and parties under enquiry were free to voice their opinions which would be included in the subsequent report.

3.7 On the question of the schedule of preparing and submitting the relevant enquiry plan to the FRRC for consideration, the FRC clarified that enquiry plans were usually provided to FRRC members about a week before the first FRRC meeting.

Conclusion

3.8 Having reviewed FRC's handling of the case as highlighted in parts (a) to (g) in paragraph 3.4 above and obtained the above clarifications, the PRP concluded that the FRC had handled the case in accordance with its internal procedures.

Review of a complaint case with allegations of both accounting non-compliances and audit irregularities

Case facts

3.9 The PRP reviewed a case arising from complaints received, which involved allegations of both accounting non-compliances and auditing irregularities, including the concerned listed entity's failure in disclosing the reasons for losing control of its former wholly-owned subsidiary and in adopting the appropriate accounting treatment in stating the value of its assets in the financial statements, and its auditor's issuing of an opinion without modification despite the afore-mentioned possible non-compliances with accounting requirements.

FRC actions

3.10 The FRC examined the case and liaised with the listed entity in question, and established that there were in fact non-compliances with the Listing Rules and accounting requirements as well as audit irregularities. The FRC issued an advice to the listed entity on complying with the relevant accounting requirements, drawing the attention of the current year auditor and the subsequent year auditor to such non-compliance with accounting requirements, and referred two other substantiated allegations to the appropriate enforcement agencies for follow up.

PRP's areas of review

3.11 With the above background, the PRP checked how the FRC had handled the case from –

- (a) the initial screening stage;
- (b) liaising with the listed entity to review the allegations;
- (c) submitting a complaint assessment report to the Council;
- (d) following up with the listed entity with advice; and/to
- (e) referring to another enforcement agency for follow-up.

3.12 The subject case involved a number of allegations of non-compliances which the listed entity eventually resolved to the FRC's satisfaction. The only problem which fell outside FRC's remit was the entity's failure to maintain proper books and records of its subsidiary. With respect to FRC not pursuing the company for the last allegation, the FRC explained that the listed entity's failure to maintain proper books and records of its subsidiary was a violation of the Listing Rules, which fell outside FRC's remit and was hence referred to the appropriate enforcement agency for follow-up.

Conclusion

3.13 Having reviewed FRC's handling of the case as highlighted in parts (a) to (e) in paragraph 3.11 above, the PRP concluded that the FRC had handled the case in accordance with its internal procedures.

Review of an unsubstantiated complaint case

Case facts

3.14 Among the eight completed cases whose allegations were unsubstantiated, the PRP selected one for review to consider if the case had been handled in accordance with FRC's internal procedures. The chosen case involved an allegation that a listed entity did not properly account for the changes in the percentage of its shareholding in a major subsidiary in its financial statements.

FRC actions

3.15 The FRC contacted the listed entity, which clarified that the shareholding change resulted from a misunderstanding between the two shareholders of the subsidiary in question, and provided evidence to support its explanation. The entity had also rectified the relevant statutory records. The FRC was satisfied that there was no non-compliances in relation to the allegations, hence did not pursue the case any further.

PRP's areas of review

3.16 With the above background, the PRP checked how the FRC had handled the case from –

- (a) the initial screening stage;
- (b) liaising with the listed entity to review the allegations;
- (c) submitting a complaint assessment report to the Council; and/to
- (d) closing the case.

3.17 Upon enquiry by the PRP on how an anonymous complainant could learn of the result of an enquiry, the FRC explained that the relevant case summary would be posted on FRC's website for public information.

Conclusion

3.18 Having reviewed FRC's handling of the case as highlighted in parts (a) to (d) in paragraph 3.16 above, the PRP concluded that the FRC had handled the case in accordance with its internal procedures.

Review of a case arising from the review of modified auditors' reports

3.19 Aside from handling complaints received, since July 2008 the FRC also screens all modified auditors' reports of listed entities in Hong Kong, and reviewed the qualified items therein, with a view to identifying potential non-compliances. As this was a relatively new area of FRC's work, the PRP selected two such cases for examination.

Case facts

3.20 The first such case involved a number of potential non-compliance with accounting requirements including, among others, the impairment of assets.

FRC actions

3.21 Having liaised with the listed entity and having examined the case, the FRC advised the listed entity that the allegations of accounting non-compliances were substantiated, and recommended that the entity should appropriately consider the relevant accounting requirements in its future financial statements. The listed entity had undertaken to perform the required impairment exercise in its financial statements in the subsequent year. The FRC was satisfied with the proposed remedial action and did not pursue the case any further.

PRP's areas of review

3.22 With the above background, the PRP checked how the FRC had handled the case from –

- (a) the initial screening stage;
- (b) liaising with the listed entity to review the potential non-compliances;
- (c) submitting a review assessment report to the Council; and/to
- (d) concluding the review and taking follow-up action with the listed entity.

3.23 Upon enquiry as to whom the conclusion letter of the case was addressed, as the case arose from FRC's review of modified auditors' reports, the FRC advised that it was issued to the listed company. The PRP noted that the FRC had amended its internal procedures to provide for the issuance of conclusion letters to other concerned parties, in particular where there was no complainant.

3.24 On whether banks which had dealings with the listed entity under a formal enquiry would be informed of the conclusion of the case, the FRC explained that, in general, it had responsibility to notify all parties concerned in an enquiry, but it would seldom go beyond those which were directly involved in the process of enquiry, i.e., the relevant listed entity and its auditor. In any case, the enquiry report would be made available to the public via FRC's website and its publication announced via a press release.

Conclusion

3.25 Having reviewed the FRC's handling of the case as highlighted in parts (a) to (d) in paragraph 3.22 and obtained further clarifications above, the PRP concluded that the FRC had handled the case in accordance with its internal procedures.

Review of an enquiry arising from the review of modified auditors' reports

Case facts

3.26 The second case chosen by the PRP that arose from FRC's review of modified auditor's reports was one of the two enquiry cases, as well as the case taking the longest processing time (12 months). The case concerned suspected non-compliance in respect of measurement of the value in use of certain property, plant and equipment in a listed entity's financial statements.

FRC actions

3.27 The FRC examined the case and established that there was indeed non-compliance of an accounting requirement. The FRC related the findings of the enquiry to the entity, and requested that the entity should revise the relevant calculation in the financial statements, which had been done in the entity's financial statements in the subsequent year. The FRC was satisfied with the remedial action and did not pursue the case further.

PRP's areas of review

3.28 The PRP noted the issues involved in the selected case and checked how the FRC had handled the case from –

- (a) initial screening stage;
- (b) preparation of a review assessment report;
- (c) concluding the review;
- (d) initiating a formal enquiry;
- (e) appointing and working with the FRRC to conduct the enquiry;

- (f) preparing and issuing the enquiry report; and/to
- (g) adoption of the enquiry report by Council.

3.29 Upon the enquiry on the reason for having taken 12 months to complete the case, the FRC explained that time was taken to follow all necessary procedures, including receiving comments from the listed entity under enquiry and its auditor on the draft enquiry report, consulting the FRC's legal advisors on the report's compliance with the Financial Reporting Council Ordinance, and taking follow-up action with the listed entity upon the Council's adoption of the report.

Conclusion

3.30 Having reviewed the FRC's handling of the case as highlighted in parts (a) to (g) of paragraph 3.28 above, the PRP concluded that the FRC had handled the case in accordance with its internal procedures.

Chapter 4 : Recommendations and way forward

4.1 During the review, the PRP performed its functions through the examination of selected cases from the full list of completed cases, and made its observations and recommendations to the FRC, which included the following –

- (a) the PRP understood that the FRC, when considering whether an enquiry or investigation should be initiated, would take into account a number of factors which vary from case to case, including the materiality of the issues, the impact on future financial statements and the gravity of the allegations, amongst others. The PRP recommended that the FRC should explicitly lay down an assessment mechanism to determine whether an enquiry or investigation should be initiated in a particular case;
- (b) the PRP appreciated that the FRC had strived to maintain a high degree of transparency in its work, and recommended that the FRC maintain the high level of transparency;
- (c) in view of FRC's plan to widen its scope of review and introduce a new risk-based financial statements review programme in early 2011, the PRP also recommended the FRC to keep updating its internal procedures and guidelines to accommodate its new review programme.

4.2 The FRC accepted the PRP's recommendations above and will take appropriate follow-up action.

4.3 The PRP will continue its work on the review of completed cases to ensure that the FRC adheres to its internal procedures consistently. For 2011, the PRP will select cases that the FRC had completed from January to December 2010 for review.

4.4 Comments on the work of the PRP can be referred to the Secretariat of the PRP for the FRC by post (Address: Secretariat of the PRP for the FRC,

Room 1801, 18th Floor, Tower 1, Admiralty Centre, 18 Harcourt Road, Admiralty, Hong Kong) or by email (email address: frcprp@fstb.gov.hk)³.

³ For enquiries or complaints relating to non-procedural matters of the FRC, they should be made to the FRC direct –
By post : 29th Floor, High Block, Queensway Government Offices, 66 Queensway, Hong Kong
By telephone : (852) 2810 6321
By fax : (852) 2810 6320
By email : general@frc.org.hk

Chapter 5 : Acknowledgement

5.1 The PRP would like to express its gratitude to the FRC for their assistance in facilitating the review work, and their co-operation in responding to the PRP's enquiries and recommendations in the past year.

**Secretariat of the Process Review Panel
for the Financial Reporting Council
March 2011**

Process Review Panel
for the Financial Reporting Council
Membership

Chairman

Mr. Edmund K H LEUNG, SBS, JP (梁廣灝)

Members

Ms. Sophia KAO, SBS, JP (高靜芝), ex-officio member

Ms. Angelina KWAN (關蕙)⁴

Ms. Elizabeth LAW, MH, JP (羅君美)

Mr. Peter LO Chi-lik (羅志力)

Mr. Joseph PANG Yuk-wing, JP (彭玉榮)

Secretariat support by
the Financial Services and the Treasury Bureau

⁴ Ms. Angelina KWAN was appointed to the PRP on 1 November 2010, hence was not involved in the PRP's review of cases completed by the FRC in the second case review cycle for cases completed in 2009.