

**For discussion
on 5 June 2017**

**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 23 May 2016. This paper updates the Panel on the main work progress achieved by the FRC in 2016.

BACKGROUND

2. The FRC is a statutory body established in December 2006 to conduct independent investigations into possible auditing or reporting irregularities in the audited financial statements of listed entities, and to conduct enquiries into possible non-compliance with accounting requirements by 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 including initiating disciplinary actions where appropriate. In addition, the FRC is empowered under the Financial Reporting Council Ordinance (“the FRCO”) (Cap. 588) to require listed entities to remove any non-compliance with accounting requirements identified in an enquiry, which can include re-stating their financial statements.

WORK PROGRESS

Handling of Complaints

3. We received and handled an unprecedented number of pursuable complaints in 2016. After averaging 25 a year over the previous five years, the number of complaints rose to a total of 118 last year. Together with the 24 complaints brought forward from 2015, we handled a total of 142 complaints in 2016. We completed the review of 128 out of these 142 complaints. The remaining 14 complaints were under review as at the end of 2016.

4. In order to manage the increased level of activity effectively, we focused our resources on enhancing the operational efficiency. With the approval of our Operations Oversight Committee (“the OOC”)¹, we made several amendments to our operations manual. In particular, we streamlined our complaints handling process so that we could better meet our goal of evaluating complaints within three months of receiving them. This means that we are now able to evaluate each complaint more quickly to decide whether an investigation is warranted, an enhancement that has led to a rise in the number of investigations initiated during the year. We also amended the relevant procedures in the operations manual to deal with vexatious and nuisance complaints in the future.

Financial Statement Reviews

5. Apart from receiving complaints, the FRC proactively selects financial statements of listed entities for review. In 2016, we have reconsidered the financial statements review programme. We revised the programme to introduce “filters” to more effectively identify areas of likely non-compliance and/or irregularity. The filters focus on the following attributes:

- Companies with change of auditors due to disagreements or unresolved issues;
- Companies whose audit firm is small in relation to the complexity of the audit;
- Financial statements with alleged non-compliance with accounting requirements and/or auditing or reporting irregularities based on media reports/companies subject to intervention by the Hong Kong Exchanges and Clearing Limited (“the HKEX”);
- Financial statements with significant prior period errors suggesting investors relying on prior period financial statements could have been misled; and
- Financial statements with modified auditor’s reports.

¹ The Operations Oversight Committee (“OOC”) assists the Council in formulating policies, strategies, guidelines and procedures for the operation of the FRC, provides advice to the Council and the FRC operational staff on technical and business issues, and considers, *inter alia*, enquiry, investigation and complaint/review assessment reports before submission to the Council. It is appointed by the Council and comprises a number of members from the Council (one of whom would be the chair of the OOC) and co-opted members who have relevant experience and expertise in accounting-related matters.

Our work on modified auditors' reports is now no longer a separate exercise, but is now part of the filter mechanism.

6. Amongst the financial statements selected for review, there were 12 financial statements of companies reported using Chinese Accounting Standards for Business Enterprises ("CASBE"). The HKEX and the HKICPA also selected some other financial statements of companies using CASBE for review. The FRC collated and summarised the results of all these reviews and provided a report to the PRC's Ministry of Finance ("MoF").

Investigations

7. Investigations are initiated by the FRC as a result of potential or suspected auditing or reporting irregularities identified. The Audit Investigation Board ("the AIB")² is directed by the Council to conduct investigations in accordance with the FRCO.

8. In 2016, the FRC initiated 18 investigations and handled 30 cases brought forward from the previous year. In total, 11 investigations were completed, which was the highest number in one year since we commenced operations, and all of the investigation reports have been referred to the HKICPA which will determine whether any disciplinary action is warranted. This leaves 37 investigations in progress at the end of 2016. In addition, arising from our review under the financial statements review programme mentioned in paragraph 6 above, we referred one case concerning suspected auditing irregularity in respect of a Mainland audit firm to the MoF for investigation according to the Memorandum of Understanding between the MoF and the FRC.

Enquiries

9. Enquiries are initiated by the FRC into possible non-compliance with accounting requirements by listed entities. In respect of each enquiry, the Council appoints a separate Financial Reporting Review Committee ("the FRRC")³ under the FRCO to look into the possible non-compliance. The FRRC determines the kind of work to be carried out and makes its

² The AIB was established under section 22 of the FRCO to conduct investigations as directed by the Council. The AIB is chaired by the Chief Executive Officer ("CEO") of the FRC.

³ 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 30 April 2017, there were eight Panel Convenors and 40 members on the FRRP.

recommendations for Council to consider. The FRRC is supported by staff of the FRC. Once an enquiry is completed, the FRC may request the listed entity involved to remove any identified non-compliance with accounting requirements, and to rectify the non-compliance either by re-issuing existing financial statements or by making appropriate prior year adjustments in subsequent financial statements.

10. The FRC brought forward two enquiries from last year, initiated one new enquiry and completed one enquiry during 2016. As at end of 2016, two enquiries were still in progress.

Advice letters to listed entities and their auditors

11. When evaluating complaints, the FRC may decide that while the potential non-compliance/irregularity does not have material impact which warrants being taken further to an investigation or enquiry, it is appropriate to issue a "letter of advice" as an educational reminder to the company and the auditor so that the company's financial reporting and the auditor's audit process can be improved in future. The FRC issued five such letters of advice in 2016.

AUDIT REGULATORY REFORM

12. In 2013, the FRC commissioned a report on independent audit oversight that identified the areas in which Hong Kong did not meet the requirements for membership of the International Forum of Independent Audit Regulators ("IFIAR") and fell short of achieving regulatory equivalence with the European Commission ("EC"). That report helped provide an impetus for the Government to closely examine the existing audit regulatory regime in Hong Kong, following which it published its "Proposals to Improve the Regulatory Regime for Listed Entity Auditors" for public consultation in June 2014.

13. In June 2015, the Government published the Consultation Conclusions, which took into account feedback received from the public including the FRC's own written submission. Under the proposals and conclusions, the FRC will become Hong Kong's audit oversight body, vested with direct powers of inspection, investigation and discipline with regard to auditors of listed entities. The FRC will also be vested with oversight power over the HKICPA in relation to registration, the setting of standards in professional ethics, auditing and assurance, and the setting of continuing professional development requirements for auditors of listed entities.

14. The global audit regulatory environment has continued to evolve. In order to keep abreast of international norms and expectations, in October 2016 the FRC published an Update on Independent Audit Oversight Report (“the 2016 Report”). The 2016 Report shows clearly that an audit regulator should be operationally independent of the audit profession in the exercise of its functions and powers.

15. The 2016 Report reiterates the fact that audit regulators of major jurisdictions such as the United Kingdom and the United States all have three key characteristics; they are (1) independent of the profession and have authority over auditors of listed entities; (2) members of IFIAR; and (3) in compliance with the EC requirements. Currently, 41 jurisdictions around the world are both IFIAR members and recognised by the EC as having regulatory equivalence.

16. The FRC firmly believes that there are no impediments to Hong Kong joining the world of independent audit regulators in the near future, and meeting the requirements for both IFIAR membership and EC equivalence. In this way, Hong Kong will become integrally connected with the audit regulatory regime worldwide, and stand alongside other capital markets at the forefront of global audit regulatory best practice.

17. 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

18. In 2016, the FRC continued to hold regular liaison meetings with other regulators in Hong Kong to discuss matters of mutual interest, the status of referred cases, and the progress of the respective financial statements review programmes. The FRC also made use of these meetings to discuss how to improve efficiencies between the parties and how to improve our responses collectively.

19. The FRC continued to be involved in constructive discussions with the MoF on the arrangements for our access to audit working papers in the Mainland in the course of performing our statutory functions. The FRC believes that the Mainland authorities recognise the importance of our access to

audit working papers, and are considering suitable measures to enhance cross-border cooperation in this area.

20. 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

21. Under the existing funding arrangement, the FRC is jointly funded by the Government (via the Companies Registry Trading Fund), the HKEX, the HKICPA, and the Securities and Futures Commission (“the SFC”).

22. The combined contribution from the four funding parties was HK\$29.36 million in 2016, which was based on a 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 2016 was HK\$27.33 million.

THE STAFF

23. The staff of the FRC (“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.

24. The FRC has recently reassessed its manpower requirements in response to an increasing caseload. One investigation director and an associate investigation director took up their positions in the first quarter of 2016. We are currently recruiting three additional professional staff in response to the increasing workload and in order to support the work in conducting financial statement reviews. The FRC will continue to assess its workload and decide if the team needs to be further strengthened.

CORPORATE GOVERNANCE

25. The FRC strives to maintain corporate governance of the highest standard. Key areas are highlighted in paragraphs 26 to 39 below.

Committees established by the Council

26. The Council has established five committees, namely the Corporate Communications Committee, Finance Committee, Independent Audit Oversight Reform Committee, OOC 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

27. 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.

28. 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 or 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. 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

29. 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.

30. The financial statements of the FRC are subject to an official audit by the Government's Director of Audit. The Annual Report is submitted to the Secretary for Financial Services and the Treasury and tabled at the Legislative Council each year. The FRC attends the meeting of the Legislative Council Panel on Financial Affairs and presents a progress report annually. The 2016

Annual Report of the FRC was tabled before the Legislative Council sitting of 10 May 2017.

Ombudsman

31. 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 2016.

Internal control

32. 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.

33. 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”)

34. 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, including the FRC Chairman as an ex-officio member.

35. The PRP published its 2016 Annual Report on 28 April 2017, which concluded that the FRC had handled the cases selected for review in the year in accordance with its internal procedures.

Code of conduct

36. 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 spouses.

37. 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

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

39. 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 a specified period, are regularly published on the FRC website (www.frc.org.hk).

LOOKING FORWARD

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

41. 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 hope the auditor regulatory reform will enable the FRC to become a member of IFIAR and Hong Kong's auditor regulatory regime will be recognised as EC equivalent.

**Financial Reporting Council
May 2017**