

**For discussion
on 15 May 2018**

**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 5 June 2017. This paper updates the Panel on the work progress achieved by the FRC in 2017.

BACKGROUND

2. The FRC is a statutory body established in December 2006 to conduct independent investigations into possible auditing or reporting irregularities by auditors 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. Every complaint received by the FRC is carefully evaluated prior to determining whether to close the case or commence an investigation and/or an enquiry. In 2017, the FRC received a record number of 126 pursuable complaints. Together with the 14 complaints brought forward from 2016, we handled a total of 140 complaints in 2017. We completed the review of 126 out of these 140 complaints. The remaining 14 complaints were under review as at the end of 2017.

4. Of the 126 pursuable complaints received, seven related to auditing or reporting irregularities and four related to non-compliance with accounting requirements. The remaining 115 complaints involved both auditing or reporting irregularities and non-compliance with accounting requirements. Of the 126 pursuable complaints received, 101 appeared to have come from the same source and were directed at a single audit firm. While none of these 101 complaints gave rise to any investigation, they were referred to the HKICPA for follow up. We have been informed by the audit firm concerned that it has put in place relevant remedial actions. We understand that the HKICPA will consider these in conjunction with their inspection process in 2018.

Financial Statements Reviews

5. Apart from receiving complaints, the FRC proactively selects financial statements of listed entities for review. In 2016, we adopted a filtering approach to identify financial statements for review based on various filters which have been approved by the Operations Oversight Committee¹ (“the OOC”) and revisited annually.

6. In addition, a review of a selection of companies adopting Chinese Accounting Standards for Business Enterprises (“CASBE”) continued to be carried out in collaboration with the Hong Kong Exchanges and Clearing Limited (“the HKEX”) and the HKICPA. The FRC then aggregated the findings from all the three organisations and issued them to the PRC’s Ministry of Finance (“the MoF”).

7. In the past, the review of financial statements relied on the support of external reviewers in reviewing financial statements. From 2017, the financial statements review has been carried out entirely in-house, thereby bringing efficiencies to the process and affirming the FRC’s independent role. In addition, we have leveraged our financial statements review programme and our media watch activities to develop a system which enables us to better monitor the financial reporting of certain companies. This is helping us identify non-compliance with accounting standards and/or potential irregularities in the conduct of the audit on a more real-time basis.

¹ The 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 coopted members who have relevant experience and expertise in accounting and auditing related matters.

Investigations

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

9. In 2017, the FRC initiated 14 investigations and handled 37 cases brought forward from the previous year. In total, 11 investigations were completed, and 10 investigation reports have been referred to the HKICPA which will determine whether any disciplinary action is warranted. This left 40 investigations in progress as at the end of 2017³.

Enquiries

10. 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”)⁴ under the FRCO to look into the possible non-compliance. The FRRC determines the work to be carried out and makes its recommendations in a report for the 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.

11. The FRC brought forward two enquiries from last year which were still in progress as at the end of 2017.

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 The outstanding investigations include those for which we await finalisation of the Memorandum of Understanding with the MoF. In the meantime, we have not pursued these investigations and will not do so until there is an arrangement on gaining access to audit working papers in the Mainland.

⁴ 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 2018, there were seven Panel Convenors and 38 members on the FRRP.

Advice letters to listed entities and their auditors

12. When evaluating complaints or reviewing financial statements, the FRC may decide that while the complaint or review does not warrant being taken further to an investigation or enquiry, it is appropriate to issue letters to the listed entities and their auditors pointing out our findings and recommending improvement measures. The FRC issued 17 such letters of advice in 2017.

ACHIEVEMENTS

10th anniversary

13. 2017 was not only another year of achievements for the FRC but also marked the 10th anniversary of the commencement of our operations. During the past 10 years, we received and handled over 400 complaints as well as completing 56 investigations and 11 enquiries. Also in that time, we referred a total of 69 investigations and complaints to the HKICPA for possible disciplinary action. Of these referrals, 39 have resulted in sanctions being applied, while the majority of the remainder are still working through the disciplinary process. With respect to the 11 enquiries completed, eight of these led to listed issuers being requested to amend their financial statements. We also referred the 101 complaints mentioned in paragraph 4 above to the HKICPA. This summary of the FRC's achievements clearly demonstrates that we have acted firmly in the public interest since we commenced operations, and that we have continued to do so despite an increasing workload each year.

Comprehensive review of procedures

14. In pursuit of excellence in our operations, the FRC, in conjunction with external legal counsel, undertook a comprehensive review of its procedures in respect of enquiries and investigations. This involved carrying out a detailed analysis of our procedures, and linking every procedure in our operations manual with the specific requirements of the relevant legislation in the FRCO. In addition, we examined every one of our procedures individually to ensure that they each were contributing fully to the quality and effectiveness of our work, without any compromise for the sake of expediency. This exercise is now complete, and our operations manual has been updated accordingly.

AUDITOR REGULATORY REFORM

15. The FRC has been advocating for the auditor regulatory reform since the beginning of this decade. Our belief has always been that such reform is in the best interests of the investing public, and that it would bring Hong Kong's auditor regulatory regime up to date with international norms. Other auditor regulatory regimes around the world have migrated successfully from "self-regulation" to "independent oversight" as a result of legislative changes, which has enhanced audit quality and investor protection internationally.

16. Over the years, Hong Kong's capital market has grown very significantly. The number of listed entities is now approaching 2,200, and market capitalisation has risen to over HK\$30 trillion. Nevertheless, recent studies suggest that, to compete with its international rivals, Hong Kong needs to continue to attract new listings, for example by introducing more diverse types of business and company structures. In embracing this inevitable market evolution, Hong Kong must also meet the expectations of the global investing public. This means it must have an independent and robust oversight regime for auditors of listed entities in Hong Kong.

17. On the basis of our Update on Independent Audit Oversight Report, published in 2016, we believe that the Financial Reporting Council (Amendment) Bill 2018 ("the Bill") when passed will enable the FRC to become a member of the International Forum of Independent Audit Regulators ("IFIAR"). This is a forum, membership of which is open to relevant independent regulatory bodies such as the UK Financial Reporting Council and the US Public Company Accounting Oversight Board, that enables members to share their regulatory experience and inspection findings with other members from around the globe with an aim of enhancing audit quality. While IFIAR does not prescribe competence requirements for all aspects of the oversight responsibilities of its members, one of its Core Principles states that members must have stable funding that is sufficient for them to execute their responsibilities.

18. In addition, the European Commission ("EC") regulatory equivalence is regarded internationally as an endorsement of the competence of an auditor regulator across core aspects of its oversight ambit, i.e. registration, inspection, investigation, discipline, standards on professional ethics and auditing, and continued professional education. A total of 53 jurisdictions worldwide, including China, the UK and the US, currently meet the EC regulatory equivalence requirements. Obtaining EC regulatory equivalence

status would lead to enhanced global confidence in Hong Kong's auditor regulatory regime, and facilitate cross-border investment.

19. The existing EC Directive requires that the governing body of an independent auditor regulator must be comprised solely of non-practitioners (i.e. persons who in the previous three years have not been involved in statutory audits or been a partner of, or employed by or associated with an audit firm). Such composition requirement, if embedded in relevant legislation, will ensure the governing body's independence from the audit profession and does not hinder the appointment of talent with accounting and auditing expertise to that body.

20. Currently, 45 jurisdictions around the world are recognised by the EC as having regulatory equivalence, and their independent regulatory bodies are also members of IFIAR. Such dual recognition has become the international norm and if such dual recognition can be achieved by Hong Kong, the city's status and reputation as a major international financial centre will certainly be enhanced.

21. As a strategic effort in advocating for the reform, the FRC spent much time during 2017 delivering presentations on the Government's reform proposals in response to invitations from professional accounting bodies and audit firms. We found these sessions to be particularly beneficial for all parties as they enabled attendees to better understand the proposals and their benefits.

22. The Bill was introduced into the Legislative Council on 24 January 2018 and is now being discussed in the Bills Committee. The FRC will continue advocating for the enactment of the Bill which will lead to better audit quality and investor protection in Hong Kong.

REGULATORY COLLABORATION

23. In 2017, the FRC continued to reach out to, and interact with, other regulators in Hong Kong and the Mainland and in the international arena. As part of this process, we held quarterly meetings with the Securities and Futures Commission ("the SFC"), the HKEX and the HKICPA in which we shared information on cross-referrals and key findings from our respective activities, and discussed how we could improve our responses to issues arising on a timely basis.

24. The FRC also continued its dialogue with the MoF on our respective roles. These discussions included the topic of gaining access to audit

working papers in the Mainland. Recent meetings have proved very fruitful, and our discussions are now turning to include the FRC's future role once the Bill is enacted.

25. Earlier in the year, the FRC attended an ASEAN Audit Regulators Group meeting which included valuable sessions on inspection workshops and lessons learnt internationally, along with a detailed workshop on financial statements surveillance. We also attended a regional regulators meeting in Bangkok, where discussions were held on global audit quality and ways of promoting the value of an audit.

26. The FRC also maintained dialogue with IFIAR and has recently informed them of the introduction of the Bill, in which they are taking a keen interest.

27. As part of their visit to the Mainland and Hong Kong, the UK FRC delegation paid us a courtesy visit, which proved a useful opportunity for us to exchange ideas on our respective work. The UK FRC expressed a keen interest in assisting us in our transition to new responsibilities following the passage of the Bill.

FINANCIAL POSITION

28. 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 SFC.

29. The combined contribution from the four funding parties was HK\$30.83 million in 2017, 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 2017 was HK\$29.73 million.

THE STAFF

30. The staff of the FRC ("the Staff") are responsible for managing and administering the day-to-day operations of the FRC. 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.

31. As at 31 December 2017, the FRC had 22 staff, comprising a strong team of professionally qualified accountants with audit background, a legally qualified in-house General Counsel and dedicated administrative staff. There were certain vacancies in existence as at 31 December 2017 which have since been filled.

CORPORATE GOVERNANCE

32. The FRC strives to maintain corporate governance of the highest standard. Key areas are highlighted in paragraphs 33 to 45 below.

Committees established by the Council

33. The Council has established five committees, namely the 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

34. 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. Council Members come from a variety of backgrounds with diversified and relevant skills, including accountancy, law and business. Not only do Council Members attend meetings of the Council, but each member is involved in one or more of the underlying committees thus ensuring they are involved extensively in the affairs of the Council. The Council meets once every two months and holds additional meetings as necessary.

35. 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 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

36. The FRC adopts a strict audit process. The FRC's annual budget must be endorsed by the Council. The Secretary for Financial Services and the Treasury then reviews and approves the FRC's annual estimates of income and expenditure.

37. The financial statements of the FRC are audited 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. The FRC presents a progress report annually at this meeting.

Ombudsman

38. 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 2017.

Internal control

39. 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.

40. 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")

41. 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 Government, including the FRC Chairman as an ex-officio member. The PRP publishes its report annually. In its 2017 Annual Report it was concluded that

the FRC had handled the cases selected for review in the year in accordance with its internal procedures.

Code of conduct

42. 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 portfolio.

43. 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

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

45. 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

46. Riding on the historical milestones built by our team of professional and dedicated staff in the last 10 years, the FRC will continue to operate in accordance with its core principles, being independence and impartiality, accountability and transparency, integrity and proficiency. We always strive to uphold fairness, natural justice and act in the public interest.

47. In anticipation of the enactment of the Bill, the FRC is preparing to expand our operations having regard to international best practice which are appropriate in the local context and to recruit talent with relevant competencies in order to execute the new mandate in respect of inspection, discipline and

oversight. We are confident that, with adequate resources provided, the FRC is ready to bring all its professionalism to the task of tackling any challenges arising in its new role as the independent fully-fledged auditor regulator for Hong Kong.

Financial Reporting Council
May 2018