

**For discussion
on 6 May 2019**

**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 15 May 2018. This paper updates the Panel on the work progress achieved by the FRC in 2018.

BACKGROUND

2. The FRC is a statutory body established in December 2006 under the Financial Reporting Council Ordinance (Cap. 588) (“FRCO”) 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 FRCO 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 commence an investigation and/or an enquiry or to close the case. In 2018, the FRC received 85 pursuable complaints. Together with the 14 pursuable complaints brought forward from 2017, we had in our caseload a total of 99 pursuable complaints during 2018. Out of these 99 complaints, we completed the review of 88 including the 14 brought forward

from 2017. The remaining 11 complaints were under review as at the end of 2018 and brought forward to 2019.

4. Of the 85 pursuable complaints received, three related to auditing or reporting irregularities and four related to non-compliance with accounting requirements. The remaining 78 complaints involved both auditing or reporting irregularities and non-compliance with accounting requirements. Of the 85 pursuable complaints received, 50 appeared to have come from the same complainant and were directed at the same audit firm. While none of these 50 complaints gave rise to any investigation, 34 of which were referred to the HKICPA for follow up in relation to possible non-compliance with standards regarding the quality control system of the firm. We have been informed by the audit firm concerned that it has put in place relevant remedial actions, which we considered appropriate. We understand that the HKICPA will consider these in conjunction with their inspection process of the audit firm concerned in 2019.

Financial statements reviews

5. Apart from receiving complaints, the FRC has in place a programme called “Financial Statements Review Programme” under which we proactively select financial statements of listed entities for review. In 2018, we continued with the Programme to identify financial statements for review based on various criteria¹ which have been approved by the Operations Oversight Committee (“the OOC”)² and reviewed annually. To optimise efficiency and affirm the FRC’s independent role, this Programme was conducted entirely in-house from 2017 rather than relying on the support of external reviewers. Together with our media watch activities, we have been able to identify

¹ The criteria include: (a) companies undertaking significant changes in business activities or undertaking new non-core business activities; (b) companies having significant assets which are subject to complex valuations; (c) companies raising funds through issuing complex financial instruments; (d) companies involved in major acquisitions or disposals during the year; (e) financial statements with significant prior period adjustments other than those reflecting a change in accounting policy or resulting from an adoption of newly introduced financial reporting standards; (f) financial statements with modified auditor’s report where there are indications of auditing irregularities in prior year’s audit; and (g) financial statements with alleged non-compliance with accounting requirements and/or auditing irregularities based on media reports/companies subject to intervention by the HKEX (e.g. to require the appointment of forensic accountants) / long-suspended companies other than shells.

² 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’s 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 and auditing related matters.

possible non-compliance with accounting requirements and/or potential auditing or reporting irregularities on a more real-time basis.

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. Together, a total of 27 financial statements were reviewed, of which 11 were conducted by the FRC in 2018. The FRC then aggregated the findings from all the three organisations and issued them to the PRC’s Ministry of Finance (“the MoF”) for their consideration of follow-up actions.

Investigations

7. Investigations are initiated by the FRC as a result of identified potential or suspected auditing or reporting irregularities. The Audit Investigation Board (“the AIB”)³ is directed by the Council to conduct investigations in accordance with the FRCO.

8. In 2018, the FRC initiated 19 investigations and handled 40 investigations brought forward from the previous year which were in our caseload due to an increased number of investigations initiated and the limited manpower in the previous year. A total of 16 investigations were completed, and the investigation reports have been referred to the HKICPA which will determine whether any disciplinary action is warranted. This left 43 investigations in progress as at the end of 2018⁴. During the year, we focused on investigations that were outstanding for longer and succeeded in clearing all but three investigations that were initiated prior to 2016. These three are complicated investigations involving multiple years’ audits. The increase in the number of outstanding cases in 2018 was mainly due to the significant increase in the number of investigations initiated during the year.

Enquiries

9. Enquiries are initiated by the FRC into possible non-compliance with accounting requirements by listed entities. In respect of each enquiry, the

³ 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.

⁴ The outstanding investigations include those for which we await finalisation of the Memorandum of Understanding with the Ministry of Finance. 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.

Council appoints a specific Financial Reporting Review Committee (“the FRRC”)⁵ 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.

10. In 2018, the FRC brought forward two enquiries from last year and initiated two enquiries. One enquiry was completed and three were still in progress as at the end of 2018.

Recommended improvements for listed entities and their auditors

11. 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 write to the listed entities and their auditors highlighting certain issues for their attention and suggesting improvement measures. The FRC issued 47 such letters in 2018⁶.

A challenging year

12. As reflected above, the FRC had a challenging year in 2018 in respect of the number of investigations and enquiries completed. This encouraging result could be attributed to our effective target and progress monitoring system. An ageing analysis and the average age since inception are monitored by the case management team and reported to the Council and the OOC every two months at their regular meetings. We also had a full complement of 27 staff in 2018. These measures have ensured that our cases are handled with efficiency without compromising the quality.

⁵ 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 2019, there were eight Panel Convenors and 38 members on the FRRP.

⁶ Details of the recommended improvements are set out on page 41 of the FRC Annual Report 2018.

AUDITOR REGULATORY REFORM

13. On 24 January 2018, the Government introduced the Financial Reporting Council (Amendment) Bill 2018 (“the Bill”) to the Legislative Council (“LegCo”). A Bills Committee was formed and seven Bills Committee meetings were held to examine the Bill culminating with their final meeting on 17 December 2018. During that period, the FRC supported the Government by preparing various research and analysis papers in relation to audit oversight system of overseas regulators and practice of pecuniary penalty that helped clarify certain important issues in relation to the Bill.

14. We also spent a considerable amount of time reaching out to different stakeholders. We gave nine presentations to all 46 audit firms that audited listed corporations/companies to explain in detail not only the provisions of the Bill but also our views on how the legislation should be implemented in practice. We also met with the media and the academic community, and gave updates to the accountancy professional bodies and other regulatory bodies in Hong Kong.

15. Our efforts in advocating for the Bill had proved effective by an increased level of awareness of the Bill among the profession and extensive media coverage about the Bill (84 clippings in total) and the FRC. The Bill was successfully passed on 30 January 2019 and the Financial Reporting Council (Amendment) Ordinance 2019 (“the Amendment Ordinance”) was gazetted on 15 February 2019. The commencement date of the Amendment Ordinance is to be announced by the Government.

16. We are developing appropriate policies, procedures and guidelines in anticipation of the commencement of the Amendment Ordinance. In April 2019, we conducted a consultation in relation to the proposed sanctions guidelines (“the guidelines”) which are required under the Amendment Ordinance to be published for the FRC to impose any pecuniary penalty. We arranged 15 meetings and briefings with different stakeholders including audit firms and professional bodies to explain the guidelines in detail and listen to their views. Comments received during the consultation are currently being evaluated.

REGULATORY COLLABORATION

17. In 2018, the FRC continued to connect and collaborate with other regulators in Hong Kong and the Mainland as well as in the international arena. Locally, we held quarterly liaison 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 emerging issues on a timely basis. We also took the opportunity to update each of them on the progress of the Bill by reference to the materials made public during the Bills Committee meetings.

18. The FRC also engaged in regular and constructive dialogue with the MoF in respect of strengthening future collaboration upon the passage of the Bill. In 2018, in anticipation of our expanded roles of inspection, investigation and discipline, we provided a draft of the Memorandum of Understanding (“MOU”) to the MoF that aims to facilitate closer cross-boundary collaboration and gaining access to audit working papers located in the Mainland. Our discussion with the MoF has been positive so far. The MOU is expected to be finalised shortly and a signing ceremony will be arranged in May 2019.

19. During the year, the FRC attended a number of regional meetings which included a roundtable discussion in Singapore on “strengthening the governance and oversight of the audit-related standard setting in the public interest” in January 2018. This was followed up by a second meeting in Hong Kong in June 2018. The FRC directly provided its views and comments on this topic on both occasions. In addition, the FRC held a meeting with the International Auditing and Assurance Standards Board in April 2018 to discuss their proposed new and updated standards on quality control, which would impact the audit firms and their regulators. These meetings not only enabled the FRC to keep abreast of the latest development in relation to international auditing and assurance standards but also raised our profile among international regulators.

20. The FRC also hosted a meeting with International Forum of Independent Audit Regulators (“the IFIAR”) in June 2018 in which we updated them on the progress of the Bill and discussed the requirements and procedures of application for the IFIAR membership. We also notified them when the Amendment Ordinance was enacted in January 2019.

FINANCIAL POSITION

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 SFC.

22. The combined contribution from the four funding parties was HK\$32.37 million in 2018, 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 2018 was HK\$35.20 million, resulting in a deficit for the year of HK\$1.30 million⁷, which was covered by the accumulated reserve.

STAFF MATTERS

23. The staff of the FRC, led by a chief executive officer, are responsible for managing and administering the day-to-day operations of the FRC.

24. As at 31 December 2018, the FRC had 27 staff, comprising a strong team of professionally qualified accountants with audit background, a legally qualified in-house General Counsel and committed administrative staff.

CORPORATE GOVERNANCE

25. The FRC strives to maintain corporate governance of the highest standard. Key areas are highlighted in paragraphs 26 to 38 below.

Committees established by the Council

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

⁷ Apart from the contribution from the four funding parties, the FRC also had income from interest and costs recovered from investigations, which amounted to a total of around HK\$1.5 million in 2018.

Council Members. The FRCO stipulates that the number of Council Members who are lay persons is to exceed the number of those who are not⁸. 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 when 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 had taken 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

29. The FRC adopts a strict audit process. The FRC's annual budget is reviewed firstly by the Finance Committee and then 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.

30. 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 LegCo. The FRC presents a progress report annually at a meeting of the LegCo Panel on Financial Affairs.

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 2018.

⁸ Under the new regulatory regime, the Council will comprise non-practitioners (i.e. a person who is not, or has not within the previous three years been a certified public accountant (practising) or a partner, director, agent or employee of a practice unit) only. Nevertheless, amongst the members of the FRC, at least one-third must be appointed because of their knowledge and experience in public interest entity engagements.

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 who has no conflict to the case to take charge of each case from the moment investigations/enquiries commence.

33. The FRC regularly reviews 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 established by the Chief Executive and charged with the responsibility to undertake a review of the handling of cases by the FRC to ensure that actions taken and decisions made 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 2018 annual meeting 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

35. 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 annual declarations of their own and their spouse’s investments in January each year, and to notify any changes in their portfolio within two weeks of the transactions.

36. 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

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

38. The FRC publishes annual reports and bi-annual eNews to keep the public informed about the progress of its work and its development. Operations statistics and press releases about cases are regularly posted on the FRC website (www.frc.org.hk), which has recently been revamped to provide the public a user-friendly way to search for updated information and to include information that reflects our expanded roles in future.

LOOKING FORWARD

39. When the Amendment Ordinance takes effect, the FRC will become the independent listed entity auditor regulator for Hong Kong with the direct powers of inspection, investigation, discipline concerning auditors of public interest entity (“PIE auditors”) and oversight of the performance of the HKICPA in respect of their functions for registration, standards on professional ethics and auditing and assurance, and continuing professional development requirements in relation to PIE auditors.

40. The FRC is fully committed to making preparations for our expanded roles which include, among others, developing various policies and guidelines, recruiting professional and competent staff and making an application for the IFIAR membership. The FRC is ready to embrace the challenges and opportunities arising in the new era.

Financial Reporting Council
May 2019