

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

2012 Annual Report

Table of Contents

<u>Chapter 1</u> Background	P. 1 – 4
<u>Chapter 2</u> Work of PRP in 2012	P. 5 – 7
<u>Chapter 3</u> PRP’s review of cases handled by FRC	P. 8 – 18
<u>Chapter 4</u> Recommendations and way forward	P. 19 – 20
<u>Chapter 5</u> Acknowledgement	P. 21
<u>Annex</u> Membership list	P. 22

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 to consider whether actions taken by FRC are consistent with its internal procedures and guidelines.

Background of FRC

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

1.3 Under the FRC Ordinance, 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 (AIB) comprising officers from the FRC Secretariat. 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 (FRRC), whose members are drawn from the statutory Financial Reporting Review Panel comprising individuals from a wide range of professions in addition to accountants.

PRP

1.4 Established by the Administration in late 2008, PRP is tasked to ensure that 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 FRC.

Functions of PRP

1.5 The terms of reference of PRP are as follows –

- (a) to receive and consider periodic reports from FRC on completed or discontinued cases;
- (b) to receive and consider periodic reports from FRC on investigations and enquiries which have lasted for more than one year;
- (c) to receive and consider periodic reports from FRC on complaints against FRC or its staff;
- (d) to call for files from FRC to review the handling of cases to ensure that the actions taken and decisions made adhere to and are consistent with internal procedures and guidelines and to advise FRC on the adequacy of its internal procedures and guidelines where appropriate;
- (e) to advise FRC such other matters relating to FRC's performance of statutory functions as FRC may refer to PRP or on which 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 main Council of FRC (the Council). PRP is tasked to review and advise FRC on its handling of cases and not its internal operation or administrative matters. Therefore, the work of the committees set up under FRC is not subject to direct review by PRP.

1.7 The internal procedures which 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 auditor's reports and financial statements under its risk-based financial statements review programme, working protocols with other regulatory bodies, preservation of secrecy and identity of informers, and relevant legislative provisions.

Modus operandi of PRP

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

1.9 Based on FRC's caseload during the relevant review cycle, 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.

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

Composition of PRP

1.11 At the time of the present review, PRP comprised six members, including the Chairman who is a lay person (i.e. non-accountant) to avoid conflict of interests, the FRC Chairman as an ex-officio member, a member from the accountancy sector, and three other members from the financial sector.

1.12 The membership of PRP is at Annex.

Follow-up on PRP's recommendation made in the 2011 Annual Report

1.13 In its 2011 Annual Report, PRP recommended that FRC should consider laying down objective principles to determine whether time extension should be granted to the applicant to furnish information requested by FRC so as to prevent the parties under investigation or enquiry from repeatedly seeking such extension. In response to PRP's recommendation, FRC had introduced a new procedure requiring that any application for time extension which exceeded one month had to be endorsed by the Chairman of the Operations

Oversight Committee established under FRC.

1.14 In the Report, PRP also recommended FRC to inform the complainant of the progress of the review at an appropriate juncture if an investigation or enquiry had been initiated. In response to the recommendation, FRC amended its operating procedures requiring complaint officers to update complainants on the latest progress of cases which had taken more than one year to complete.

1.15 Moreover, in light of increasing co-operation with Mainland regulatory authorities, FRC had laid down new procedures on investigations which might require assistance from these authorities.

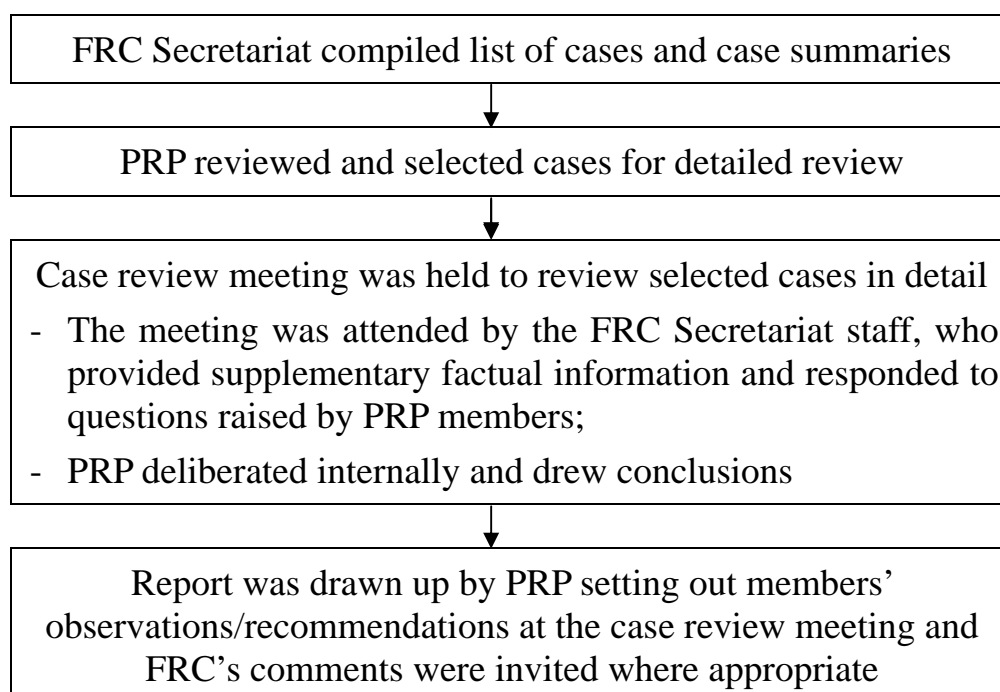
1.16 PRP noted the follow up actions taken by FRC in the light of its recommendation made in the 2011 Annual Report.

Chapter 2 : Work of PRP in 2012

2.1 This report covers the work of PRP in 2012. This included the review of reports from FRC on cases completed during the fourth review cycle (i.e. from January to December 2011) as well as an ongoing investigation which had lasted for more than one year by the end of the cycle.

Case review workflow

2.2 The workflow adopted by PRP in reviewing the cases is set out below –



Selection of cases for consideration/review

2.3 The FRC Secretariat advised PRP that FRC had completed 20 cases during the fourth review cycle. There were also three ongoing investigations being processed by FRC which had lasted for more than one year by the end of the cycle. The PRP members were provided with summaries of the 23 cases for review. The distribution of the 23 cases is as follows –

<u>Distribution of cases</u>	<u>Total number</u>
Ongoing investigations which had lasted for more than one year	3
Completed investigation case	5
Completed enquiry case	2
Unsubstantiated cases	9
Cases referred to other regulatory bodies for follow-up	1
Cases that FRC directly followed up with the listed entity/auditor	3

2.4 In June 2012, PRP selected six cases for review out of the 23 cases –

- (a) an ongoing investigation case which had lasted for more than one year;
- (b) a completed investigation case arising from the review of complaints;
- (c) a completed case which was referred to another regulatory body for follow-up;
- (d) an unsubstantiated case arising from the proactive review of financial statements;
- (e) a completed case directly followed up by FRC with the auditor; and
- (f) a completed enquiry case arising from the proactive review of modified auditor's reports.

PRP considered that the selection of these six cases reflected a good mix of the cases falling within the fourth review cycle.

Case review session

2.5 After the selection of cases for review in June 2012, with the assistance of FRC Secretariat, PRP Secretariat made preparations for the case review meeting. A case review meeting was held in July 2012 to review the six selected cases.

2.6 Before the review session began, the PRP Chairman invited members to declare any possible conflict of interest in the cases to be reviewed. Three members declared their potential conflict of interests with regard to the cases under review. The meeting agreed that in the case of two of the members, since neither they nor their relatives had been personally involved in the cases concerned, there was no apparent conflict of interest and it was not necessary for them to withdraw from the review. While another member who was also not personally involved in the cases concerned, she volunteered to withdraw from the review of one case to avoid any perceived conflict of interests since her relative was associated with the parties involved in the case.

2.7 PRP's observations in respect of the selected cases and its recommendations to FRC are set out in the following chapters.

Chapter 3 : PRP's review of cases handled by FRC

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

Review of an ongoing investigation case which had lasted for more than one year

Case facts

3.2 PRP reviewed a complaint case leading to a formal investigation into a suspected auditing irregularity which was in progress and had lasted for more than one year. The investigation was initiated in November 2009 in respect of the audits of the financial statements of a former listed entity conducted in 2001 and 2002.

FRC actions

3.3 FRC examined the case and directed AIB to investigate the suspected auditing irregularity. Given the complexity of issues involved and the lapse of time, FRC had granted time extensions to the auditor concerned for complying with its requests for information during the investigation. The investigation was completed in January 2012.

PRP's areas of review

3.4 PRP focused its review on the long time taken by FRC to complete the investigation. FRC explained that it had needed to spend a long period of time to examine the voluminous working papers provided by the auditor. Besides, since the case involved multiple issues which happened over a decade ago, it had granted time extensions to the auditor for complying with its requests for information. FRC also explained that it had spent some time to seek legal advice in response to the auditor's challenge to the legality of FRC to conduct the investigation, as the investigation was concerned with financial statements published before the establishment of FRC and the entity had been

de-listed at the time of the investigation. The change in the senior management and the temporary shortage of operational staff of FRC at the time had also affected to some extent its progress in completing the investigation.

Conclusion

3.5 Having considered FRC's handling of the case and in the light of the above clarifications, PRP concluded that the reasons for FRC to have taken more than one year to complete the investigation case were acceptable. PRP also accepted that it was reasonable for FRC to grant time extensions to the auditor for complying with its requests for information in the circumstances.

3.6 As the investigation was completed in January 2012, the investigation process of the case will be subject to review by PRP under the next review cycle.

Review of a completed investigation case arising from the review of complaints

Case facts

3.7 PRP reviewed a complaint case leading to a formal investigation into a suspected auditing irregularity in respect of the audits of the financial statements over three years of a former listed entity and its subsidiaries. The complainant alleged that the auditor had not obtained sufficient and appropriate audit evidence to support its audit opinion. FRC took 20 months to complete this case. This is the longest processing time amongst all cases completed during the fourth review cycle.

FRC actions

3.8 FRC examined the case and directed AIB to investigate the alleged auditing irregularity. Based on its findings, AIB was of the view that the auditor had not obtained sufficient and appropriate audit evidence and had not prepared sufficient and appropriate audit documentation in relation to the audit procedures performed. FRC referred the investigation report to the Hong Kong Institute of Certified Public Accountants (HKICPA) to determine if any disciplinary actions were warranted. During the investigation, FRC noted that the auditor concerned had appointed a law firm as its internal investigator.

PRP's areas of review

3.9 Based on the case facts outlined above, PRP reviewed the following steps taken by FRC in handling the case –

- (a) initial screening;
- (b) liaising with the listed entity and the audit firm to review the allegations;
- (c) preparing and submitting a complaint assessment report to the Council;
- (d) initiating a formal investigation;
- (e) directing AIB to conduct the investigation;
- (f) preparing and issuing the investigation report by AIB;
- (g) adoption of the investigation report by the Council; and
- (h) referring to another regulatory body for follow-up.

3.10 In response to PRP's question on the reason for the auditor concerned to appoint a law firm as an investigator and whether there was any conflict between the roles of FRC and the law firm, FRC advised that the law firm was appointed by the auditor to investigate its own affairs and there was no conflict since FRC did not consider any of the law firm's findings in its investigation report. PRP also noted that FRC had granted a time extension to the auditor for furnishing the information requested since the auditor required internal technical clearance before giving a reply to FRC.

3.11 PRP noted that an overseas consultant was appointed by FRC to assist in its investigation, and asked if it was a normal practice for FRC to seek assistance from an external party. FRC replied that the consultant was appointed having regard to the complexity of the case and the temporary shortage of operational staff of FRC at the time of investigation. It was the first time FRC had done so and FRC did not envisage the need to make a similar appointment in the foreseeable future. PRP took the view that it was reasonable for FRC to engage an external party for providing consultancy services in this case since FRC did not have the relevant regulatory experience

in handling a case of comparable complexity. In response to a PRP member's question on the means of communication between the overseas consultant and FRC, FRC said that the consultant had travelled to Hong Kong on a regular basis for this assignment.

Conclusion

3.12 Having reviewed FRC's handling of the case as highlighted in parts (a) to (h) in paragraph 3.9 and obtained the above clarification, PRP concluded that FRC had handled the case appropriately and in accordance with its internal procedures.

Review of a completed case which was referred to another regulatory body for follow-up

Case facts

3.13 PRP reviewed a complaint case received by FRC which alleged that the disclosure in the financial statements in relation to the acquisition of subsidiaries might not be in accordance with the applicable financial reporting standard and that the auditor had failed to identify the non-compliance with accounting requirements.

FRC actions

3.14 FRC had examined the complaint and issued informal requests to the listed entity for information. In response to FRC's first informal request, the listed entity asked FRC to provide a Chinese translation of the request. FRC subsequently provided the listed entity with a translated version of the request.

3.15 Given that the listed entity had corrected the non-compliance issue in the subsequent financial statements on its own initiative before FRC formally started handling the complaint, FRC did not pursue further on that allegation of non-compliance.

3.16 However, FRC considered that the auditor had not acted diligently and in accordance with applicable technical and professional standards when providing professional services in respect of its audit. Therefore, the identified irregularity was referred to HKICPA for follow-up action.

PRP's areas of review

3.17 With the above background, PRP reviewed the following steps taken by FRC in handling the case –

- (a) initial screening;
- (b) liaising with the listed entity to review the potential non-compliances and with the auditor on the potential irregularity;
- (c) preparing and submitting a complaint assessment report to the Council; and
- (d) concluding the review and referring the case to another regulatory body for follow-up.

3.18 In response to the question raised by PRP on whether it was a normal practice for FRC to send a Chinese translation of an informal request for information to the listed entity, FRC replied that it was the first and only time for FRC to issue a request in Chinese to a listed entity. PRP further noted that the translation was done by the FRC Secretariat internally.

3.19 FRC also clarified that it had granted a time extension to the entity for complying with its request for information since the listed entity had appointed a legal adviser to represent it on the case and more time was required by the listed entity to provide a formal response to FRC's request. FRC supplemented that progress reports were submitted to the Council at its meetings held every two months to keep it posted of the latest developments of the case.

Conclusion

3.20 Having reviewed FRC's handling of the case as highlighted in parts (a) to (d) in paragraph 3.17 and obtained the further clarifications above, PRP concluded that FRC had handled the case in accordance with its internal procedures.

3.21 On the other hand, PRP suggested that FRC might consider outsourcing its translation work to relevant professionals in future. PRP noted that it was not uncommon for financial regulators, e.g. the Securities and Futures Commission, to outsource its translation work on the condition that the translator was contractually required to observe confidentiality regarding the information handled by it. PRP also invited FRC to consider whether it would be necessary to invite an appropriate person with relevant expertise to vet the translation work done by the FRC subject officers/outside contractors.

Review of an unsubstantiated case arising from the proactive review of financial statements

Case facts

3.22 Among the nine completed cases whereby the allegations were unsubstantiated, PRP selected one for review to consider if the case had been handled in accordance with FRC's internal procedures. The chosen case involved possible non-compliance in recognising revenue in the financial statements and loss on cancellation of sales in the subsequent interim report of the listed entity, as well as possible auditing irregularity by the auditor in issuing an unqualified auditor's report on the financial statements of the listed entity.

FRC actions

3.23 FRC sought clarification from the listed entity and the auditor regarding the accounting treatment used in the financial statements and the interim report. FRC considered that the listed entity had provided reasonable explanations to support the recognition of revenue in the financial statements and the loss on cancellation of sales in the subsequent interim report, and there was no evidence to suggest that there was apparent non-compliance with

accounting requirements, or insufficiency or inappropriateness in the audit work performed by the auditor. FRC was satisfied that there was no non-compliance or auditing irregularity in relation to the allegations and hence did not pursue the case further.

PRP's areas of review

3.24 With the above background, PRP reviewed the following steps taken by FRC in handling the case –

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

3.25 PRP noted that there was a two-month gap between the receipt of information from the listed entity and the submission of the review assessment report by the officer-in-charge of the case to the Council, and asked if there was any particular reason hindering the completion of the report by the officer at an earlier time. FRC explained that some time had been spent to seek clarification from the listed entity on the information provided and to consult an honorary adviser on the interpretation of the relevant financial reporting standards, which resulted in the officer-in-charge having spent more than two months to complete the case assessment report.

Conclusion

3.26 Having reviewed FRC's handling of the case as highlighted in parts (a) to (d) in paragraph 3.24 and the clarification above, PRP concluded that FRC had handled the case in accordance with its internal procedures.

Review of a completed case directly followed up by FRC with the auditor

Case facts

3.27 The case involved a potential auditing irregularity in relation to the disclaimer of opinion on the financial statements of a listed entity and the qualified opinion on the revised financial statements issued by the auditor.

FRC actions

3.28 FRC considered that the auditor's report should only quantify those balances that were the subject of limitation of scope or disagreement with management, and the possible resulting adjustments to the financial statements that would be material. FRC sent a letter to the auditor drawing its attention to the auditing irregularity.

3.29 In respect of the issue related to the qualified opinion on the revised financial statements, FRC considered that the auditor's explanation was not unreasonable and there was no apparent auditing irregularity. This issue was not pursued further.

PRP's areas of review

3.30 PRP noted the issues involved in the selected case and reviewed the following steps taken by FRC in handling the case –

- (a) initial screening;
- (b) liaising with the listed entity and the auditor to review the potential auditing irregularity;
- (c) preparing and submitting a review assessment report to the Council;
and
- (d) following up directly with the auditor with advice.

3.31 During the review, a PRP member noted that the auditor concerned had repeatedly failed to provide information requested by FRC before the deadlines. However, since the case had not reached the investigation stage,

FRC could not use its statutory powers to request the auditor to comply with the requests. FRC clarified that the auditor was unable to comply with its requests for information before the deadlines because there were more than 10 issues involved in the disclaimer of opinion and the subject auditor was out of town when the requests were made. It also advised that the auditor had appointed a legal adviser to represent it on the case and it had taken more time for the auditor to provide formal response to FRC's requests.

3.32 While acknowledging FRC's explanation, PRP suggested FRC to put down a marker when it made informal requests for information before the investigation stage in future, to the effect that if the party concerned was unable to provide the requested information by the deadline, FRC may consider initiating an investigation to compel the party to provide the information by law.

Conclusion

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

Review of a completed enquiry case arising from the proactive review of modified auditor's reports

Case facts

3.34 PRP reviewed a formal enquiry case arising from FRC's proactive review of modified auditor's reports. The case involved a potential non-compliance as no deferred tax liabilities were recognised in respect of the fair value gains on intangible assets arising from two business combinations (fair value gains). The case took ten months to complete.

FRC actions

3.35 FRC appointed a FRRC to conduct an enquiry into the case. Based on the results of the enquiry, FRC concluded that there was non-compliance in

the financial statements. The relevant non-compliance was the non-recognition of deferred tax liabilities in respect of the fair value gains in the financial statements and its consequential financial impact on the subsequent financial statements. Although the listed entity agreed that there was relevant non-compliance in the financial statements, such non-compliance would be removed following a prior period adjustment in its subsequent financial statements, i.e. a reversal of the fair value gains previously recognised. Accordingly, FRC recommended no further action on the relevant financial statements.

PRP's areas of review

3.36 PRP noted the issues involved in the selected case and reviewed the following steps taken by FRC in handling the case –

- (a) initial screening;
- (b) preparing and submitting a review assessment report to the Council;
- (c) concluding the review;
- (d) initiating a formal enquiry;
- (e) appointing and working with FRRC to conduct the enquiry;
- (f) preparing and issuing the enquiry report by FRRC; and
- (g) adoption of the enquiry report by the Council.

3.37 In response to PRP's query on the reasons for granting time extensions to the auditor twice for complying with its request for information, FRC explained that the auditor concerned was out of town when the information was requested and he needed more time to look into his own working papers before providing the requested information.

3.38 PRP also noted that FRC had held a pre-meeting with the chairman of FRRC, and asked whether it was a normal practice to do so. FRC advised that while there was no such requirement under the present procedures, it was reasonable for the FRRC chairman to request for a pre-meeting with the FRC Secretariat in order to better understand the background information of the case and the handling procedures, especially when it was the first time for the

FRRC chairman to conduct an enquiry. FRC also advised that a progress report was submitted to the Council at every Council meeting until the case was completed so that the Council was posted of the latest developments of the enquiry.

Conclusion

3.39 Having reviewed FRC's handling of the case as highlighted in parts (a) to (g) in paragraph 3.36 and obtained clarification above, PRP concluded that FRC had handled the case in accordance with its internal procedures.

Chapter 4 : Recommendations and way forward

4.1 During the review, PRP performed its functions through reviewing reports from FRC on completed cases and an ongoing investigation which had lasted for more than one year during the review cycle. Based on the discussions at the case review session, PRP made the following observations and recommendations –

- (a) PRP recommended FRC to consider the need to outsource its translation work to relevant professionals in future if internal resources and capabilities are challenged and to invite an appropriate person with relevant expertise to vet the translation work; and
- (b) PRP noted that for cases that had not reached the investigation stage, FRC could not use its statutory powers to compel the auditors concerned to comply with its request for information in a timely manner. PRP recommended that if there was a need for FRC to make informal requests for information before a formal investigation was initiated, it should put down a marker in its requests to the effect that if the party concerned was unable to provide the requested information by the deadline, the Council may consider initiating an investigation to compel the party to provide the information by law.

4.2 FRC accepted PRP's recommendations above and will take appropriate follow-up actions. Specifically, for paragraph 4.1(b), FRC Secretariat would seek the endorsement of the Operations Oversight Committee to amend the language in its request for information in order to implement the recommendation of PRP.

4.3 PRP will continue its work on the review of completed cases to ensure that FRC adheres to its internal procedures consistently. For 2013, PRP will select cases that FRC had completed during the period between January and December 2012 for review.

4.4 Comments on the work of PRP can be referred to the Secretariat of PRP for FRC by post (Address: Secretariat of PRP for FRC, Room 1512, 15th Floor, Queensway Government Offices, 66 Queensway, Hong Kong) or by email (email address: frcprp@fstb.gov.hk)¹.

¹ For enquiries or complaints relating to non-procedural matters of FRC, they should be made to FRC directly –

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

**Secretariat of the Process Review Panel
for the Financial Reporting Council
March 2013**

Process Review Panel
for the Financial Reporting Council
Membership

Chairman

Mr. Edmund K H LEUNG, SBS, JP (梁廣灝)

Members

Ms. Angelina Agnes KWAN (關蕙)

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)

Mr. John POON, JP (潘祖明), ex-officio member²

Secretariat support by
the Financial Services and the Treasury Bureau

² Ms. Sophia KAO (高靜芝) resigned from the position as the Chairman of Financial Reporting Council with effect from 3 October 2012. The new Chairman of Financial Reporting Council, Mr John POON, became the ex-officio member of the Process Review Panel on the same date. The fourth case review session was attended by Ms. KAO in July 2012.