

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

2011 Annual Report

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Chapter 1 : Background

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

Background of the FRC

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

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

The PRP

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

Functions of the PRP

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

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

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

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

Composition of the PRP

1.8 At the time of the review for the third case review cycle covering the FRC's work in 2010, the PRP comprised six members, including a lay Chairman (i.e. non-accountant) to avoid conflict of interests, the FRC Chairman as an ex-officio member and four members from the accountancy sector, the financial sector and other professions.

1.9 The membership of the PRP is at Annex.

Follow-up on the PRP's recommendation made in the 2010 Annual Report

1.10 In its 2010 Annual Report, the PRP noted that the FRC would take into account a number of factors, which vary from case to case, when considering whether an enquiry or investigation should be initiated, and recommended that the FRC should explicitly lay down an assessment mechanism to determine whether an enquiry or investigation should be initiated in a particular case. The FRC accepted the PRP's recommendation, and subsequently amended its operating procedures in 2011 in accordance with the PRP's recommendation.

Chapter 2 : Work of the PRP in 2011

2.1 This report covers the work of the PRP in 2011 during the third review cycle. The work included the review of reports from the FRC on completed cases, an ongoing investigation lasting more than one year as well as a complaint against a FRC staff member.

Modus operandi of the PRP

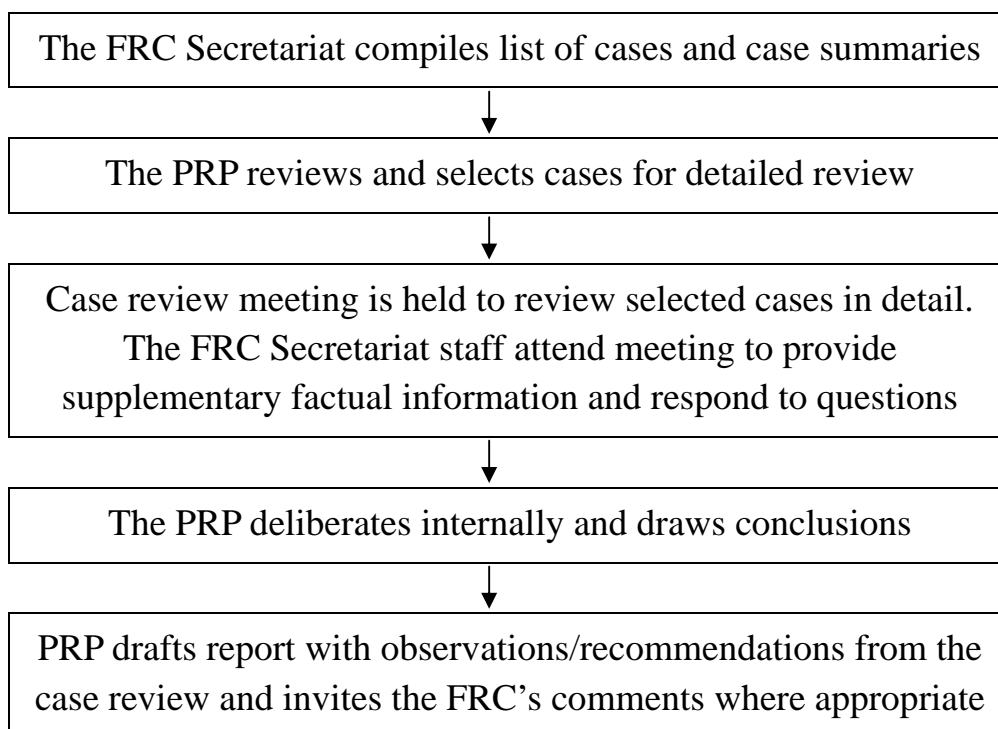
2.2 The PRP, at its first meeting held in mid-November 2008, decided that except for the first review cycle that should start from July 2007 when the FRC became fully operational until end December 2008, all case review cycles thereafter should run on a calendar year basis.

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

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

Case review workflow

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



Selection of cases for consideration/review

2.6 The FRC Secretariat advised the PRP that the FRC had completed 12 cases during the third review cycle. There was also one complaint against a FRC staff member during the cycle, and three ongoing investigations being processed by the FRC which had lasted for more than one year by the end of the cycle. The FRC Secretariat provided the PRP in May 2011 with reports on the said 16 cases for PRP members to select for review.

2.7 The distribution of the 16 cases is as follows –

<u>Distribution of cases</u>	<u>Total number</u>
Ongoing investigations lasting more than one year	3
Complaint against a FRC staff member	1
Completed investigation case	1

<u>Distribution of cases</u>	<u>Total number</u>
Completed enquiry case	1
Unsubstantiated cases	6
Cases referred to other regulatory bodies for follow-up	2
Cases that the FRC directly followed up with the listed entity/ auditor and referred to other regulatory bodies for separate follow-up	2

2.8 By July 2011, the PRP selected seven cases for review out of the 16 cases. The PRP considered that the selection of cases reflected a good mix of the cases falling within the third review cycle –

Distribution of cases reviewed

- an ongoing investigation case lasting more than one year;
- a complaint case against a FRC staff member;
- a completed investigation case arising from the review of complaints;
- a completed enquiry case arising from the review of modified auditors’ reports;
- an unsubstantiated case arising from the review of modified auditors’ reports;
- a case which was referred to other regulatory bodies for follow-up; and
- a substantiated case being directly followed up by the FRC.

Case review session

2.9 After the selection of cases for review in July 2011, with the assistance of the FRC Secretariat, the PRP Secretariat made preparations for the case review meeting. The case review meeting was held in August 2011 to review the seven selected cases.

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

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

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

Review of an ongoing investigation case lasting more than one year

Case facts

3.2 The PRP reviewed a complaint case leading to a formal investigation into a suspected auditing irregularity which was in progress and lasted for more than one year. The investigation was initiated in November 2009 in respect of the audit of accounts of a listed entity and its subsidiaries.

FRC actions

3.3 The FRC examined the case and directed the Audit Investigation Board (AIB) to investigate the suspected auditing irregularity. As the case involved multiple auditing issues in multiple years and required the examination of voluminous legal documents, expert reports and audit working papers, the FRC had taken more than one year to conduct the investigation.

PRP's areas of review

3.4 The PRP focused its review on the long time taken by the FRC to conduct the investigation. The FRC explained that apart from the voluminous working papers that it needed to examine, the change of senior management and temporary shortage of operational staff of the FRC during the year were also factors affecting the time taken to conduct the investigation.

Conclusion

3.5 Having considered FRC's handling of the case and in the light of the above clarifications, the PRP concluded that the reasons for the FRC to have taken more than one year to complete the investigation case were acceptable. As the investigation was only completed in July 2011, the whole investigation process will be subject to review by the PRP under the next review cycle.

Review of a complaint case against a FRC staff member

Case facts

3.6 The PRP reviewed a report concerning the handling of a complaint case against a FRC staff member. The complainant alleged that the staff did not handle her earlier complaint appropriately. In her previous complaint letter to the FRC, she alleged that a number of listed media companies did not report her complaint about the misconduct of certain government officials in the news. The staff replied to her previous complaint and explained that her allegations were not related to relevant non-compliance or auditing irregularity and were therefore not within the remit of the FRC. As such, the FRC did not pursue her complaint further.

FRC actions

3.7 The Chairman of the FRC reviewed the complaint and considered that the staff had handled the previous complaint appropriately. The Chairman of the FRC wrote to the complainant and explained again why her previous complaint was not within the remit of the FRC.

PRP's areas of review

3.8 This was the first complaint against its staff received by the FRC. The PRP considered the comprehensiveness of the FRC's internal guidelines for handling complaints, and whether the FRC had adhered to the guidelines in handling the case.

Conclusion

3.9 The PRP considered that the FRC's internal guidelines are comprehensive enough to handle complaints against FRC staff and concluded that the FRC had handled the complaint case in accordance with its internal guidelines.

Review of an investigation case arising from the review of complaints

Case facts

3.10 The PRP reviewed a complaint case leading to a formal investigation into a suspected auditing irregularity relating to a listed entity. The complainant alleged that there was non-compliance with accounting requirements in the relevant financial statements and questioned the issuance of an unqualified auditor's report with no modification by the auditor. The FRC took 14 months to complete this case. This is the longest processing time amongst all cases completed during the third review cycle.

FRC actions

3.11 The FRC examined the case and directed the AIB to investigate the alleged auditing irregularity. Based on its findings, the AIB was of the view that the auditor should have modified the audit opinion in its report in accordance with the relevant auditing and assurance requirements given that the non-compliances with accounting requirements identified in the financial statements of the listed entity were material. The investigation report was referred to the Hong Kong Institute of Certified Public Accountants (HKICPA) to determine if any disciplinary actions were warranted.

PRP's areas of review

3.12 Based on the case facts outlined above, the PRP reviewed the following steps taken by the 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 the AIB to conduct the investigation;
- (f) preparing and issuing the investigation report;

- (g) adoption of the investigation report by the Council; and
- (h) referring to another enforcement agency for follow-up.

3.13 In response to the PRP's question on how the HKICPA had followed up with the identified auditing irregularity, the FRC explained that the HKICPA would not conduct an investigation into the case afresh as the investigation report was admissible as evidence of facts on its production without further proof under section 35(7) of the FRC Ordinance. The PRP also noted that the HKICPA would decide if it was necessary to initiate disciplinary proceedings against the auditor based on the findings of the FRC.

3.14 In respect of the granting of extension of time for two weeks to the listed entity for complying with its request for information, the FRC said that the decision was made having regard to the fact that the listed entity's premises were under renovation when the FRC made the request. In this connection, it was noted that there was a growing tendency for listed entities and auditors to seek an extension of time shortly before the deadline set by the FRC. This had hindered the FRC from conducting investigations in a timely manner in accordance with its planned timetable. The PRP took the view that measures should be taken to prevent the parties under investigation from repeatedly seeking time extension.

Conclusion

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

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

Case facts

3.16 The PRP reviewed a formal enquiry case arising from the review of a modified auditor's report by the FRC. Potential issues identified included the inability of the auditor to obtain sufficient information and explanations from

management to form his assessments on impairment of assets. This was a case with the second longest processing time handled by the FRC within the third review cycle. The case took ten months to complete.

FRC actions

3.17 The FRC appointed a Financial Reporting Review Committee (FRRC) to examine the case. After liaising with the listed entity in question, it was established that there were in fact non-compliance issues in relation to the measurement of the value in use of the assets in the financial statements. The FRC had taken follow-up action directly with the listed entity by requesting the listed entity to make retrospective adjustments to rectify the non-compliance issues in accordance with the accounting requirements in its next set of financial statements.

PRP's areas of review

3.18 The PRP noted the issues involved in the selected case and reviewed the following steps taken by the 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 the FRRC to conduct the enquiry;
- (f) preparing and issuing the enquiry report;
- (g) adoption of the enquiry report by the Council; and
- (h) following up directly with the listed entity for the rectification of non-compliances identified.

3.19 The PRP noted that there was a three-month time gap between the first letter issued to the listed entity and the review assessment report prepared by the case officer. The FRC advised that it was due to the several rounds of follow-up requests made by the FRC for additional information from the listed entity after issuing the first letter, as well as an extension of time for 30 days

sought by the listed entity for complying with one of the requests.

Conclusion

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

Review of an unsubstantiated case arising from the review of modified auditors' reports

Case facts

3.21 Among the six completed cases whereby the allegations were unsubstantiated, the PRP selected one for review to consider if the case had been handled in accordance with the FRC's internal procedures. The chosen case involved an allegation that the auditor was unable to obtain sufficient evidence to substantiate the appropriateness of assumptions and basis used by the management to justify the full impairment of certain assets of the entity in the financial year.

FRC actions

3.22 The FRC sought clarifications from the listed entity and the audit firm regarding the full impairment of those assets. The FRC considered that the listed entity had provided reasonable explanations and that the impairment was recognized in accordance with the relevant accounting requirements. The FRC was satisfied that there was no non-compliance in relation to the allegations and hence did not pursue the case further.

PRP's areas of review

3.23 With the above background, the PRP reviewed the following steps taken by the 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 review assessment report to the Council;
and
- (d) closing the case.

3.24 The FRC advised that as only one issue was involved in the case, the review was completed in around two months. The PRP noted that the listed entity concerned had engaged different auditors in different accounting periods, and asked if there was any follow-up action taken by the FRC in that regard. The FRC said that it would inform the Stock Exchange of Hong Kong Limited if in its opinion, there was an unusual change of auditors by a listed entity.

Conclusion

3.25 Having reviewed FRC's handling of the case as highlighted in parts (a) to (d) in paragraph 3.23 above, the PRP concluded that the FRC had handled the case in accordance with its internal procedures.

Review of a case which was referred to other regulatory bodies for follow-up

Case facts

3.26 As there were a number of cases received by the FRC which included allegations outside its remit and had to be referred to other regulatory bodies for follow-up, the PRP considered it appropriate to select one of such cases for review. The selected case arose from the review of a modified auditor's report by the FRC. There was a question of whether it was proper to consolidate the results of an acquired subsidiary and deconsolidate that subsidiary and recognize a loss on deconsolidation in the financial statements of the listed entity.

FRC actions

3.27 The FRC examined the case and considered it arguable as to whether control existed at the date of acquisition of the subsidiary because the listed entity seemed to have little control over the financial and operating policies of the subsidiary. Given that the financial impact of the consolidation was

immaterial and that judgment was involved in determining whether control existed, the FRC did not pursue further on that case.

3.28 However, the FRC considered that the case might involve an element of fraud and had referred this case to the Securities and Futures Commission (SFC) for possible follow-up action.

PRP's areas of review

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

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

3.30 In response to the PRP's query on why the FRC had only requested for information from the listed entity but not the auditor concerned, the FRC explained that it would not seek information from the auditor if in its opinion, those supplied by the listed entity was sufficient and comprehensive.

3.31 On the question of whether the case involved any negligence by the auditor, the FRC advised that since the case was concerned with the acquisition of a subsidiary by the listed entity which the auditor had little control of, the auditor was not considered negligent.

3.32 The PRP noted that the FRC had decided not to further pursue some cases if it considered the non-compliance issues identified as immaterial while it referred some similar cases to other bodies for follow-up. The FRC clarified that although the non-compliance issues identified in the current case was considered immaterial and not warranting further follow-up, a possible fraud was identified and the case was therefore referred to the SFC for follow-up action.

Conclusion

3.33 Having reviewed the FRC's handling of the case as highlighted in parts (a) to (d) in paragraph 3.29 and obtained further clarifications above, the PRP concluded that the FRC had handled the case in accordance with its internal procedures.

Review of a substantiated case with the FRC taking direct follow-up actions

Case facts

3.34 The selected case resulted in both direct follow-up actions taken by the FRC with the listed entity and its auditor as well as referral to another regulatory body for follow-up. The case involved the appropriateness of recognizing an impairment loss on a project and compensation income in the financial statements of the listed entity. There was also a potential auditing irregularity in respect of the auditor's failure to identify a suspected fraudulent transaction during the course of audits of the prior years' financial statements.

FRC actions

3.35 The FRC considered that it was inappropriate to recognize an impairment loss on the project since the listed entity no longer had the title or rights of the project and no further economic benefits were expected to flow to the listed entity. Instead, the project should be derecognized from the consolidated statement of financial position and a loss on derecognition should be recognized in the consolidated income statement. However, given that the non-compliance did not have any financial impact on the net profit or loss of the listed entity, the FRC did not initiate an enquiry. The FRC had drawn the attention of the listed entity and the auditor to the non-compliance.

3.36 In respect of the suspected fraudulent transaction, the FRC considered that there was no apparent negligence on the part of the auditor but the case was referred to the SFC for follow-up actions.

PRP's areas of review

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

- (a) initial screening;
- (b) liaising with the listed entity and the auditor to review the potential non-compliance issues and auditing irregularity;
- (c) preparing and submitting a review assessment report to the Council;
- (d) following up directly with the listed entity and the auditor with advice; and
- (e) referring the case to another enforcement agency for follow-up.

3.38 During the review, the PRP noted that there was a three-month gap between the issue of the first letter to the listed entity and the auditor by the FRC, and the preparation of the review assessment report by the case officer. The FRC explained that the chairman of the listed entity was out of town when the first letter was issued, and he subsequently sought an extension of one month to reply to the letter. To prevent any similar occurrence in future, the FRC would copy its letter to the chief financial officer of the listed entity so that the entity could respond to the FRC's request without undue delay.

Conclusion

3.39 Having reviewed the FRC's handling of the case as highlighted in parts (a) to (e) of paragraph 3.37 above, the PRP concluded that the FRC had handled the case in accordance with its internal procedures.

Chapter 4 : Recommendations and way forward

4.1 During the review, the PRP performed its functions through reviewing reports from the FRC on completed cases, an ongoing investigation lasting more than one year as well as a complaint against a FRC staff member during the review cycle. Based on the discussion at the case review session, the PRP had the following observations and recommendations to the FRC –

- (a) the PRP understood that the FRC would normally accede to applications for extension of time by the listed entity, auditor or reporting accountant concerned for complying with its requests for information if the applications were made on reasonable grounds. While this could ensure that sufficient information would be furnished by the listed entity, auditor or reporting accountant, and could provide a reasonable opportunity for these parties to make representations and to be heard, the PRP noted that it had increasingly prevented the FRC from handling the cases in a timely manner. The PRP recommended that the FRC should consider laying down objective principles to determine whether an extension should be granted to the applicant in order to prevent the parties under investigation or enquiry from repeatedly seeking time extension;
- (b) the PRP noted that in handling a complaint case, the FRC would send a conclusion letter to inform the complainant that the case would not be pursued further with brief reasons if the Council decided not to initiate an investigation or enquiry. However, the complainant would not be informed if the Council decided to initiate an investigation or enquiry. The PRP recommended that the FRC should take similar actions to update the complainant on the progress of the review of complaint at an appropriate juncture if an investigation or enquiry had been initiated; and
- (c) the PRP noted that following the introduction of the new risk-based financial statements review programme by the FRC in 2011, a new chapter of internal procedures had been prepared to provide guidance for conducting such reviews. The PRP commended the FRC for the

measure and recommended that it should continue to review and modify its internal procedures and guidelines as and when new initiatives are launched in future.

4.2 The FRC accepted the PRP's recommendations above and will take appropriate follow-up action. Specifically, the FRC Secretariat would seek the endorsement of the Operations Oversight Committee to amend its operating procedures in order to implement the recommendations of the PRP.

4.3 The PRP will continue its work on the review of completed cases to ensure that the FRC adheres to its internal procedures consistently. For 2012, the PRP will select cases that the FRC had completed from January to December 2011 for review.

4.4 Comments on the work of the PRP can be referred to the Secretariat of the PRP for the FRC by post (Address: Secretariat of the PRP for the FRC, Room 1515, 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 the FRC, they should be made to the 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 The PRP would like to express its gratitude to the FRC for its assistance in facilitating the review work, and its co-operation in responding to the PRP's enquiries and recommendations in the past year.

**Secretariat of the Process Review Panel
for the Financial Reporting Council
March 2012**

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

Chairman

Mr. Edmund K H LEUNG, SBS, JP (梁廣灝)

Members

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

Ms. Angelina 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)

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