

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

2009 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 on 1 November 2008 to review cases handled by the Financial Reporting Council (FRC) and consider whether the actions taken by the FRC are fair and consistent with its internal procedures and guidelines.

Background of the FRC

1.2 The FRC was established under the FRC Ordinance (Cap. 588) on 1 December 2006 as an independent statutory body to investigate audit 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 accountancy 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 statutory Financial Reporting Review Panel comprising individuals from a wide range of professions in addition to accountants.

1.4 After the initial months to recruit staff, set up internal procedures and working protocol with other regulators, etc., the FRC came into full operation and started receiving complaints in July 2007.

Background of the PRP

1.5 Since the FRC came into full operation and started handling complaint cases in July 2007, the Administration began to prepare for the establishment of the PRP, including making reference to the operation of the Process Review Panel for the Securities and Futures

Commission (PRP for the SFC). The aim is to set up a PRP to ensure that the FRC handles individual cases in a fair and consistent manner, and actions taken and decisions made adhere to FRC's internal procedures and guidelines. The PRP for the FRC was established on 1 November 2008.

1.6 The establishment of the PRP reflects the Administration's continuing commitment to enhance the accountability of the FRC.

Functions of the PRP

1.7 The establishment of and appointments to the PRP were approved by the Chief Executive. 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 adhered 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.

1.8 The above terms of reference apply to the FRC main Council. The PRP is tasked to review and advise the FRC its case-handling and not its internal operation on administrative matters, hence the work of the committees set up under the FRC is not subject to direct review by the PRP.

1.9 The internal procedures that 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 auditor's reports, working protocols with other regulatory bodies, preservation of secrecy and identity of informers and relevant legislative provisions.

Composition of the PRP

1.10 The PRP for the FRC comprises five members, including a Chairman who should be a non-accountant to avoid conflict of interests, the FRC Chairman as an ex-officio member and three members from the accountancy sector, the financial sector and other professions.

1.11 The membership of the PRP is at Annex.

Chapter 2 : Work of the PRP in its first year (2008-09)

2.1 This report covers the work of the PRP from 1 November 2008 to 31 December 2009.

Modus operandi of the PRP

2.2 The PRP met in mid November 2008 to deliberate and agree on its modus operandi. The PRP decided that the first review cycle should start from July 2007 when the FRC became fully operational until end December 2008, i.e. the first review cycle would be of about 18 months, and thereafter 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 longer than one year as well as complaints against the FRC or its staff. In view of the short history of the FRC and taking into account its caseload, the PRP resolved to select cases for review at the end of the first review cycle, and that there would be no need to set up separate working groups, hence all PRP members would join the case review session(s).

2.4 As 2007-2008 was the inaugural year for the PRP as well as for the FRC, the PRP considered it premature to lay down a pre-set quota or criteria for future case selection. The PRP decided that the approach for case selection could be reviewed in the next review cycle or could be fine-tuned as members began the case review work.

2.5 The 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, PRP members took care in declaring their interests upon the commencement of their terms of appointment as well as before conducting case review.

Selection of cases for review

2.6 By end December 2008, the FRC Secretariat advised the PRP that the FRC had completed 25 cases and had not received any

complaints against the FRC or its staff during the first review cycle. The FRC Secretariat provided the PRP in January 2009 with lists and case summaries of completed cases and cases lasting for more than one year for the PRP members to select cases for review.

2.7 By March 2009, the PRP selected five cases for review out of the 25 completed cases –

Distribution of cases reviewed

An enquiry case

An investigation case

A case with no follow up action after review (unsubstantiated case)

A suspended/referral case

A review of modified auditor's report

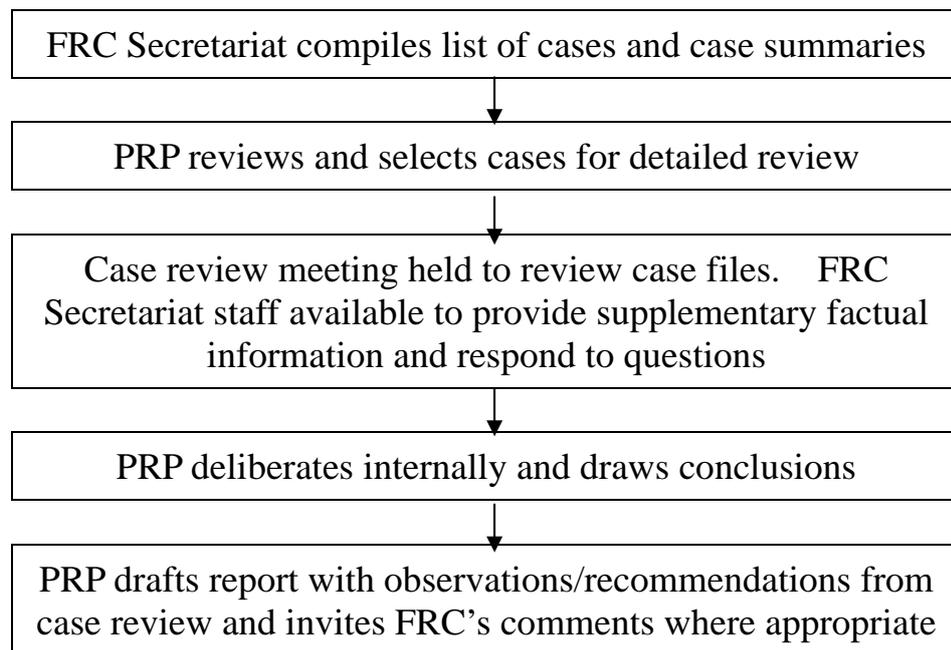
2.8 The PRP considered the selection above reflected a good mix of the completed cases, which were of the following distribution –

<u>Distribution of completed cases</u>	<u>Total no.</u>
Enquiry case	1
Investigation case	1
Unsubstantiated cases	13
Suspended cases/cases referred to another enforcement agency	7
Reviews of modified auditor's report	2
Cases where the complaint was resolved by the complainee(s) (e.g. voluntarily corrected the suspected non-compliance)	1

Case Review Process

2.9 After the selection of cases for review in March 2009, with the assistance of the FRC Secretariat, the PRP Secretariat made preparations for the case review. A case review meeting was held in May 2009 to review the five selected cases.

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



2.11 PRP's observations and recommendations are set out in the following chapter.

Chapter 3 : Observations and recommendations arising from the review of completed cases

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

Review of an enquiry case

Case facts

3.2 The PRP reviewed a complaint case concerning a formal enquiry into a suspected financial reporting non-compliance of a listed entity. The case in question was the only enquiry case completed during the review cycle. It was alleged that the financial results of a subsidiary of the listed entity were not consolidated in the quarterly and interim financial information and the information contained was misleading. It was also alleged that the management made a false statement in its clarification announcement in relation to the liquidation of a subsidiary and certain payments by the subsidiary were not properly accounted for.

FRC actions

3.3 The FRC examined the case and decided to initiate an enquiry into the suspected non-compliance with accounting requirements and did not pursue the allegations on the listed entity's quarterly financial information as they were outside the remit of the FRC. As for some other allegations that were related to the Listing Rules, the FRC resolved to refer to another enforcement agency for follow-up action.

PRP's areas of review

3.4 Based on the case facts outlined above, the PRP checked how the FRC had handled the case from –

- (a) the initial screening and sending acknowledgment to the complainant;

- (b) liaising with the listed entity to review the allegations;
- (c) submitting a complaint assessment report to the Council;
- (d) initiating a formal enquiry;
- (e) appointing and working with the Financial Reporting Review Committee to conduct the enquiry; and/to
- (f) preparing and issuing the enquiry report.

3.5 In reviewing the handling of the case, the PRP asked whether an interim report should have been prepared, given that the enquiry had lasted for an extended period of time. The FRC explained that a case-specific interim report had not been prepared as the FRC Secretariat provided updates to the FRC on the developments of the case during regular Council meetings. The PRP noted that FRC's internal procedures specified that "more than 12 months" would be seen as an example of "an extended period of time" which would warrant an interim report. The case in question only lasted for nine months, hence an interim report was not necessary.

3.6 The PRP also looked into the time lag between the preparation of the draft enquiry report and its final adoption. The FRC explained that more time was taken as its Secretariat had to seek comments from the relevant parties (including the listed entity, the Financial Reporting Review Committee, lawyers concerned, etc.) and incorporate them before submission to the FRC for adoption.

3.7 In response to the PRP's question on why the FRC did not apply to court to mandate the removal of relevant non-compliance, the FRC explained that the mandated removal of the relevant non-compliance under the FRC Ordinance would only be applicable to Hong Kong companies yet the listed entity concerned was incorporated outside Hong Kong. In this particular case, the FRC has notified the relevant enforcement agencies for follow-up.

3.8 The PRP noted that although the FRC had already decided there was indeed non-compliance with accounting requirements involved and the listed entity should be required to remove the

non-compliance, and according to FRC's internal procedures, it should issue warning letters or refer to other regulatory bodies when the listed entity did not comply with the notice to remove the non-compliance, but it was not until five months later that the FRC decided to publish the enquiry report and forward it to the relevant enforcement agencies. The PRP thus questioned whether there was a gap in FRC's internal procedures or in the follow-up action taken by the FRC.

3.9 In response, the FRC advised the PRP of the efforts taken by the FRC Secretariat to request the listed entity to remove the non-compliance. The FRC had needed some time to liaise with other parties involved in the case in and outside Hong Kong to obtain information and explore with the listed entity on how to remove the non-compliance. The listed entity subsequently issued an announcement which stated that it would remove the non-compliance concerned in the upcoming financial statements. The FRC had been kept informed of the progress by its Secretariat throughout the period.

Conclusion

3.10 Having reviewed FRC's handling of the case as highlighted in parts (a) to (f) in paragraph 3.4 above and obtained the above clarifications, the PRP concluded that the FRC had handled the case in accordance with its internal procedures.

Review of an investigation case

Case facts

3.11 The PRP reviewed the only investigation case completed during the review cycle, which was also the case with the longest processing time (14 months). It was alleged that the auditor did not follow professional standards in the audit of the financial statements of a listed entity.

FRC actions

3.12 The FRC examined the case and decided to initiate an investigation into the suspected audit irregularity. The case was completed 14 months later after concluding that there was evidence of audit irregularity. The investigation results were then referred to another enforcement agency for follow-up action.

PRP's areas of review

3.13 With the above background, the PRP checked how the FRC had handled the case from –

- (a) the initial screening stage;
- (b) liaising with the audit firm to review the allegations;
- (c) submitting a complaint assessment report to the Council;
- (d) initiating and conducting the investigation through the Audit Investigation Board;
- (e) drafting the investigation report;
- (f) consulting relevant parties; and/to
- (g) issuing the report and referring it to another enforcement agency for follow-up action.

3.14 The PRP asked why an interim report was not prepared for Council's approval even though the investigation took more than 12 months to complete. In response, the FRC advised that this was because the FRC Secretariat provided regular reports to the Council on the progress of the investigation and hence it was considered that a separate interim report was not necessary.

3.15 In response to the PRP's question on whether the FRC had any pledge to complete certain procedures within a specified period of time, FRC explained that there was no specific performance pledge as the time required to handle a case would depend on its specific circumstances. On why the case in question required some 14 months for processing,

FRC explained that the actual investigation only took about five months. However, considerable time was taken to consult relevant parties, including parties related to the complaint and FRC's honorary advisers, before the report could be finalised.

Conclusion

3.16 Having reviewed FRC's handling of the case as highlighted in parts (a) to (g) in paragraph 3.13 above and obtained the above clarifications, the PRP concluded that the FRC had handled the case in accordance with its internal procedures.

Review of an unsubstantiated case

Case facts

3.17 Given that there were many completed cases whose allegations were unsubstantiated, the PRP selected one of them for review to consider if the case was handled in accordance with FRC's internal procedures. Among the unsubstantiated cases, the case selected was the one with the longest processing time and widest range of allegations, ranging from money laundering, non-disclosure of connected party transactions, inflated reported earnings and non-compliance in accounting treatments for acquisition of assets.

FRC actions

3.18 The FRC reviewed the allegations concerning suspected non-compliance with accounting requirements but concluded that the allegations could not be substantiated and hence the case was not pursued further. As for the allegations that were outside FRC's remit, the FRC noted that the complainant had already filed a complaint with another enforcement agency in parallel.

PRP's areas of review

3.19 With the above background, the PRP checked how the FRC had handled the case from –

- (a) the initial screening stage;
- (b) liaising with the listed entity to review the allegations;
- (c) submitting a complaint assessment report to the Council;
and/to
- (d) closing the case and replying to the complainant.

3.20 Upon enquiry by the PRP on why there was a five-month gap between the Secretariat's preparation of the complaint assessment report and the FRC's decision on how to follow-up the case, FRC explained that the Council instructed the Secretariat to conduct further informal inquiry to obtain more details during this period, hence the FRC did not conclude the case until five months later when the Secretariat had obtained necessary clarifications from relevant parties indicating that the case could not be substantiated.

Conclusion

3.21 Having reviewed FRC's handling of the case as highlighted in parts (a) to (d) in paragraph 3.19 above and obtained the above clarifications, the PRP concluded that the FRC had handled the case in accordance with its internal procedures.

Review of a suspended case

Case facts

3.22 As there were a number of cases received by the FRC which were outside its remit and had to be referred to other enforcement agencies for action or were suspended to avoid duplication of efforts as another enforcement agency had already initiated investigations, the PRP considered it appropriate to select one of such cases for review. The case selected had the third longest processing time among the completed cases during the review cycle (the longest two cases being the formal investigation case and formal enquiry case). It involved multiple allegations on suspected non-compliance and fictitious conduct of the listed entity.

FRC actions

3.23 FRC examined the case in detail and concluded, after initial assessment and informal enquiry, that it would suspend the case given on-going investigation by another enforcement agency.

PRP's areas of review

3.24 With the above background, the PRP checked how the FRC had handled the case from –

- (a) the initial screening stage;
- (b) liaising with the listed entity to review the allegations;
- (c) submitting a complaint assessment report to the Council;
- (d) conducting further informal enquiry with the listed entity; and/to
- (e) concluding that the case would be suspended because of investigation by another enforcement agency.

3.25 In response to the PRP's enquiry on why the FRC took seven months to consider the case before concluding that it would suspend the case rather than initiating enquiry or investigation, FRC explained that the FRC Secretariat had conducted several rounds of informal enquiry with the listed entity and relevant authorities to obtain further information before the FRC could reach the conclusion to suspend the case.

Conclusion

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

3.27 However, the PRP noted that FRC's internal procedures provided limited guidance on the handling of suspended cases and

informal inquiries. The PRP recommended that the FRC consider providing more detailed guidance on conducting an informal inquiry in its internal procedures, e.g. whether key steps or target milestones should be set to ensure that informal inquiries were properly conducted. The FRC accepted the PRP's recommendation and is preparing to expand its internal procedures on this front.

Review of a modified auditor's report case

Case facts

3.28 The PRP noted that the FRC had adopted a more proactive approach in the regulation of financial reporting of listed entities since July 2008 to monitor and review all financial statements of listed entities in Hong Kong which have a modified auditor's report. The aim was mainly to identify potential non-compliance. Hence the PRP decided to select one of the two modified auditor's report cases completed during the review cycle for review.

FRC actions

3.29 The PRP noted the issues involved in the selected case and checked how the FRC had handled the case from –

- (a) initial screening stage;
- (b) initial inquiry;
- (c) preparation of a review assessment report;
- (d) concluding the review; and/to
- (e) referral to another enforcement agency for follow-up.

PRP's areas of review

3.30 The PRP noted that the FRC Secretariat had gone through four levels of case review, including review by a case officer, review by a director, counter checking by the CEO of FRC and review by the

Council, before reaching the conclusion that there was no non-compliance with accounting requirements that would warrant initiating a formal enquiry.

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

Chapter 4 : Way forward

4.1 Between November 2008 and October 2009, the PRP performed its functions through the review of selected cases from the full list of completed cases, and made its observations and recommendations to the FRC.

4.2 The PRP will continue its work on the review of completed cases to ensure that the FRC adheres to its internal procedures consistently. For 2010, the PRP will select cases that the FRC had completed from January to December 2009 for review.

4.3 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 1801, 18th Floor, Tower 1, Admiralty Centre, 18 Harcourt Road, Admiralty, 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 direct –

By post : 29th Floor, High Block, Queensway Government Offices,
66 Queensway, Hong Kong

By telephone : (852) 2840 9222

By fax : (852) 2521 7836

By email : general@frc.org.hk

Chapter 5 : Acknowledgement

5.1 The PRP would like to express its gratitude to the FRC for their assistance in facilitating the review work, and their 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
February 2010

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

Membership

(from 1 November 2008 – 31 October 2010)

Chairman

Mr. Edmund K H LEUNG, SBS, JP (梁廣灝)

Members

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

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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