

立法會
Legislative Council

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Legislative Council
Panel on Financial Affairs

Minutes of special meeting held on
Thursday, 14 March 2002 at 2:00 pm
in Conference Room A of the Legislative Council Building

- Members present** : Hon Ambrose LAU Hon-chuen, GBS, JP (Chairman)
Hon Henry WU King-cheong, BBS (Deputy Chairman)
Hon James TIEN Pei-chun, GBS, JP
Hon Albert HO Chun-yan
Hon Eric LI Ka-cheung, JP
Dr Hon David LI Kwok-po, GBS, JP
Hon NG Leung-sing, JP
Hon James TO Kun-sun
Hon CHAN Kam-lam
Hon SIN Chung-kai
Hon Jasper TSANG Yok-sing, JP
Hon Emily LAU Wai-hing, JP
- Non-Panel members attending** : Hon Cyd HO Sau-lan
Hon CHAN Yuen-han, JP
Hon Audrey EU Yuet-mee, SC, JP
- Members absent** : Hon LEE Cheuk-yan
Hon Bernard CHAN
Dr Hon Philip WONG Yu-hong
Hon MA Fung-kwok

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**Public officers
attending**

- : Mr Stephen IP
Secretary for Financial Services
- Miss AU King-chi
Deputy Secretary for Financial Services (1)
- Miss Susie HO
Deputy Secretary for Financial Services (2)
- Mr Gordon JONES
Registrar of Companies

**Attendance by
invitation**

- : Mr Ashley ALDER
Executive Director (Corporate Finance)
Securities and Futures Commission
- Ms Karen LEE
Executive Vice President
(Listing, Regulation and Risk Management)
Hong Kong Exchanges and Clearing Limited
- The Honourable Mr Justice ROGERS, V-P, JP
Chairman
Standing Committee on Company Law Reform
- Mr Michael W SCALES
Member
Standing Committee on Company Law Reform
- Mr William TAM Sai-ming
Member
Standing Committee on Company Law Reform
- Mr Alvin WONG Tak-wai
President
Hong Kong Society of Accountants
- Mr David SUN Tak-kei
Vice-President
Hong Kong Society of Accountants
- Mr Edward CHOW Kwong-fai
Vice-President
Hong Kong Society of Accountants

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Mr LEE Kai-fat
Registrar & Secretary-General
Hong Kong Society of Accountants

Ms Winnie CHEUNG Chi-woon
Senior Director
Hong Kong Society of Accountants

Clerk in attendance : Ms Anita SIT
Chief Assistant Secretary (1)6

Staff in attendance : Ms Pauline NG
Assistant Secretary General 1

Mr Watson CHAN
Head, Research & Library Services

Mr Jackie WU
Research Officer 1

Mr WONG Tin-yau, Anthony
Senior Assistant Secretary (1)8

I Presentation of the research report on "Practices of overseas jurisdictions in building up or maintaining their fiscal reserves"

RP04/01-02

Research report prepared by
the Research and Library
Services Division of the
LegCo Secretariat

At the Chairman's invitation, the Assistant Secretary General 1 (ASG1) briefed members on the background and process of the research on "Practices of overseas jurisdictions in building up or maintaining their fiscal reserves". She recapitulated that upon the delivery of the 2001-02 Budget by the Financial Secretary (FS) in March 2001, the Panel decided to examine the issues relating to the target level and uses of Hong Kong's fiscal reserves. After the discussion with the Secretary for the Treasury on 7 May 2001, the Panel invited academics and experts to give views on the subject at the Panel meeting on 3 July 2001. The Panel endorsed the outline of the research in September 2001. Two informal meetings were held in January and March 2002 to review the draft research report. In the light of members' views, the scope of the research was expanded to incorporate the historical levels of Hong Kong's fiscal reserves and an analysis of the relationship between the fiscal reserves and the Exchange Fund. The research had also incorporated FS's announcement in his 2002-03 Budget Speech the

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decision to revise the target level of fiscal reserves from the equivalent of 18 months to 12 months of government expenditure, and the views given by some academics on this recent revision.

2. At the Chairman's invitation, the Head, Research & Library Services took members through the research report, highlighting the similarities and differences among the jurisdictions studied with regard to the practices of maintaining and utilizing their fiscal reserves, as summarized in the Appendix of the research report. Members noted that among the six jurisdictions studied, (Singapore, Norway, New Zealand, Argentina, the United States and Hong Kong) only Hong Kong, Singapore and New Zealand possessed fiscal reserves and only Hong Kong had laid down guidelines for determining the target level of fiscal reserves.

3. In summarizing the presentation, ASG1 said that based on the practices of other jurisdictions and academics' views, the Secretariat had drawn up a list of issues, as set out in paragraph 29.1 of the research report, for further consideration by the Panel. She further elaborated some of the issues by making the following points-

- (a) Some experts and academics had queried the justification for using Hong Kong's fiscal reserves for monetary purposes, in addition to operating and contingency purposes. Although FS had announced the decision to lower the target level of the fiscal reserves to the equivalent of 12 months of government expenditure by delinking the level of fiscal reserves from money supply, the fiscal reserves would continue to be placed with the Exchange Fund and thus could still be used for monetary purposes.
- (b) While academics in general considered it acceptable to pitch setting the target level of fiscal reserves at 12 months of government expenditure acceptable, some held the view that there should be a more scientific method for setting the level of fiscal reserves. It had been suggested that the amounts of fiscal reserves that had been drawn out to meet fiscal deficits at different times in the past and the projected fiscal deficits for the current and the following four years should form the bases for determining the operating and contingency requirements for the fiscal reserves.
- (c) Some experts and academics had also suggested that where the level of fiscal reserves exceeded the target level, the excess might be used to finance relief programmes and other designated programmes for the purpose of reviving the economy.
- (d) Apart from the return to the fiscal reserves, there were other investment incomes of the Government. It was however not clear how far these other investment incomes were available for financing

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specific social services or contingent relief measures. It also appeared that apart from the return to the fiscal reserves as published by the Hong Kong Monetary Authority, details of other Government investment incomes were not readily available in the public domain.

4. Miss Emily LAU considered it necessary to follow up various issues relating to the target level and purposes of the fiscal reserves as highlighted in the research report. To facilitate further deliberation by the Panel on the subject of fiscal reserves, members should be provided with comprehensive information on the Government's investment incomes in the past years. She suggested and members agreed that the Secretariat should write to the Administration for provision of such information.

(Post-meeting note: The letter from the Secretary for the Treasury dated 16 May 2002 providing information on the investment incomes of the Government for the period from 1996-97 to 2000-01 was issued to members vide LC Paper No. CB(1)1772/01-02(01) dated 17 May 2002.)

5. Mr James TIEN queried the propriety of setting the target level of fiscal reserves at a certain fixed monetary amount or at a certain number of months of government expenditure. He remarked that although FS had revised the target level of fiscal reserves from the equivalent of 18 months to 12 months of government expenditure, it would be necessary to progressively increase the monetary amount of the fiscal reserves over time to cope with the corresponding increase in government expenditure. This would leave little room for the Government to adjust its fiscal position to respond to changing economic circumstances. He was particularly concerned that the failure to attain the target level of fiscal reserves under the current stringent guidelines would adversely affect Hong Kong's credit rating internationally and in turn create unwarranted pressure to raise taxes or introduce new taxes.

6. ASG1 responded that some academics had opined that instead of laying down a rigid formula for determining the target level of fiscal reserves, the Government should determine the objectives/purposes of the fiscal reserves in the first place and review the target level of fiscal reserves against the prevailing and projected economic conditions on a regular basis. To avoid giving wrong signals to the international community about Hong Kong's economic conditions, the target level should at all times allow flexibility whereby the fiscal reserves could fluctuate within a reasonable range in response to changing economic and social circumstances. Mr TIEN shared this view and suggested that the Panel should further examine the propriety of the current guidelines for determining the target level of fiscal reserves and other possible options in this regard.

7. Mr SIN Chung-kai expressed his view that the fiscal reserves should not be used for maintaining the stability of Hong Kong's monetary system and therefore he considered that the incumbent FS had made a right move by delinking the fiscal reserves from the money supply. He also pointed out that in most

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countries, the fiscal reserves were maintained separately from the foreign reserves and only the foreign reserves were tasked to maintain the stability of the local currency.

8. ASG1 clarified that although FS in his 2002-03 Budget Speech had announced the decision to delink the level of fiscal reserves from the M1 Hong Kong Dollar money supply, FS had not indicated that there would be any change to the purposes of the fiscal reserves (i.e. monetary, operating and contingency purposes). As the fiscal reserves would continue to be placed in the Exchange Fund, they might still be used for maintaining the stability of the Hong Kong dollar. Members agreed that the Secretariat should write to the Administration to seek clarification on this issue.

(Post meeting note: A letter dated 20 March 2002 from the Panel Clerk to the Administration requesting clarification on the above subject, and the latter's reply letter dated 12 April 2002 were issued to members vide LC Paper No. CB(1)1491/01-02 dated 15 April 2002.)

9. As regards overseas experience in maintaining foreign reserves, members agreed that the Secretariat should gather more information on whether the Singaporean government managed its fiscal reserves separately from its foreign reserves and whether it employed different strategies in investing fiscal reserves and foreign reserves.

(Post meeting note: In response to the Secretariat's enquiry, the Ministry of Finance of Singapore advised that they "do not disclose information on fiscal reserves data and the approach of managing fiscal reserves as such information is confidential". The relevant information note was issued to members vide LC Paper No. CB(1)1492/01-02(01) dated 15 April 2002.)

10. Members agreed that as the Administration would be asked to provide further information and clarification on certain issues, the Panel would decide in due course whether the Administration and other related parties should be invited to further discuss the subject.

II Initiatives to strengthen Hong Kong's corporate governance regime
LC Paper No. CB(1)1184/01-02(04) - Paper provided by the Administration

LC Paper No. CB(1)1302/01-02(01) - Note provided by Mr Anthony ROGERS, Chairman of the Standing Committee on Company Law Reform

LC Paper No. CB(1)1302/01-02(02) - Paper provided by the Hong Kong Society of Accountants

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11. The Chairman welcomed representatives of the Administration, the Standing Committee on Company Law Reform (SCCLR), the Hong Kong Society of Accountants (HKSA), the Hong Kong Exchanges and Clearing Limited (HKEx) and the Securities and Futures Commission (SFC) to the meeting. At the Chairman's invitation, they each made a presentation on the initiatives that had been and were being undertaken to strengthen Hong Kong's corporate governance regime. The respective speaking notes were circulated to members vide LC Paper No. CB(1)1330/01-02 dated 19 March 2002. The points highlighted by Mr Anthony ROGERS, Chairman of SCCLR, were as per the note circulated vide LC Paper No. CB(1)1302/01-02(01) dated 13 March 2002.

Discussion with members

Legislative requirement to regularly change a company's audit firm in overseas jurisdictions

12. Mr SIN Chung-kai said that he was aware that Singapore had recently introduced legislation which provided that banks operating within its jurisdiction should change their respective audit firms every five years, though the existing audit firms were allowed to re-tender for the business. He was aware that there were pros and cons associated with such a legislative requirement, and sought the Administration's and SFC's views on whether Hong Kong should consider similar legislation for strengthening the local corporate governance regime.

13. The Secretary for Financial Services (SFS) responded that similar legislation was being considered in other jurisdictions such as the United Kingdom and the United States (US), especially in the light of the Enron case. He considered that the crux of the matter was not so much whether companies should be required to change their audit firms within a defined period of time, as to ensure that the quality of these audit firms were maintained. SFS said that while he maintained an open mind on the matter, there was no urgency or strong reason now for Hong Kong to enact similar legislation.

14. Ms Karen LEE, Executive Vice President (Listing, Regulation and Risk Management) of HKEx expressed agreement with SFS. She said that the key consideration of HKEx in this regard was whether such a requirement, be it statutory or non-statutory, could in fact effectively ensure that the audit firms maintained quality work and were adequately regulated at different levels.

15. Mr Alvin WONG, President of HKSA pointed out that in Italy, the listed companies were required to change their audit firms every seven years. Following the winding up of a number of companies during the 1980s and the 1990s, a survey had been conducted to look into the probable causes. One interesting observation was that many of these companies wound up a year or two after new auditors took over the servicing of their businesses. It was inferred that due to the tendering process, whereby new audit firms were mostly selected on cost considerations, the

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quality of the auditing work for the listed companies might have been lowered, and this might have indirectly contributed to the collapse of the companies. He therefore suggested that changing the audit firm of a company might not be an absolutely effective measure to ensure that the financial performance of a listed company was properly audited.

Accountability of independent non-executive directors

16. Mr James TO Kun-sun noted that in the Hong Kong corporate environment, non-executive directors operated in a somewhat confined circle. These non-executive directors were acquainted with one another, and sat as directors on one another's companies. This norm might hamper the independence of non-executive directors. It was also difficult for external regulators to monitor the performance of these non-executive directors. Mr TO asked if there were measures in place to assess the performance of these directors, and if there were training programmes to equip them to perform their duties successfully. SFS replied that it was important to ensure that independent non-executive directors were truly independent and knew their responsibilities. He agreed that company directors should be given more training and guidelines. The Administration supported the initiatives of the industry bodies in this regard. He added that under SCCLR there was a subcommittee responsible for examining the issues relating to directors.

17. Mr Anthony ROGERS, Chairman of SCCLR supplemented that under SCCLR, the Sub-committee on Directors (the Sub-committee) had considered measures to ensure that independent non-executive directors performed their directorate duties effectively. The Sub-committee had discussed the possibility of statutorily encoding non-executive directors' duties. However, SCCLR had not made a final decision in this regard. Mr ROGERS was of the view that it would not be practicable to impose a general statutory duty for the independent director(s) to perform a special monitoring role. He considered that it would be more effective that non-executive directors be encouraged to perform their duties in a fit and proper manner generally, rather than attempting to specify how they should perform their duties by legislative means. In the light of the above, Mr ROGERS opined that any proposal on strengthening corporate governance should not overly rely on the monitoring role and accountability of non-executive directors.

18. Miss Emily LAU noted that preliminary results of the research projects commissioned by SCCLR revealed that more than 80% of companies listed on the Main Board of the Stock Exchange of Hong Kong were controlled by a single shareholder or a family. As such it would be difficult to appoint directors truly independent from the influence of the dominant shareholder(s). Miss LAU suggested that for companies with minority shareholders, the latter could appoint truly independent directors who were not subject to the influence of a single or a number of majority shareholders.

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19. Mr Anthony ROGERS said that while such a suggestion was worth considering, there were certain pragmatic difficulties. For example, by the time shareholders were notified of the annual general meeting of companies, it was often too late to put up any nominations for directorship. Mr ROGERS also pointed out that important considerations such as whether the minority shareholders had the best interest of the company in mind, or whether they were only concerned with making a quick profit should also be borne in mind.

The Enron case and the issue of conflict of interest

20. Miss Emily LAU said that the Enron case had cast a shadow of doubt on the integrity of the accounting industry and the audited reports of companies. The manner in which important records and documentation had been allegedly destroyed by Arthur Andersen & Company, Enron's accounting firm, revealed that there were inadequate safeguards to prevent such acts from occurring. She sought views from HKSA in this regard.

21. Mr Alvin WONG replied that the Enron incident was an isolated case, and that the alleged destruction of evidence, if proven, would constitute a criminal act. While HKSA and comparable regulatory bodies in other jurisdictions had not developed guidelines to govern the management of records and important documentation of clients' businesses by their audit firms, there were specific requirements laid down in the relevant legislation in respective jurisdictions governing the proper handling of company records and documentation. Mr WONG added that if any HKSA member were found to instigate or be involved in wrongful destruction of records or documentation, the member concerned would be censured and penalised for dishonourable conduct. Mr Eric LI added that in the Enron case, the US office of Arthur Andersen & Company would have contravened its own company guidelines in the alleged destruction of documents which could be evidence for the investigation underway. The alleged destruction of evidence in the Enron case contravened both industry guidelines and relevant legislation. The staff who allegedly committed such an act had been immediately relieved of his appointment, and in fact the alleged destruction of evidence was reported by the accounting firm to the authorities concerned. In Hong Kong there was relevant legislation in place which prohibited any destruction of evidence while an investigation was in progress, and HKSA was empowered to revoke a member's licence if the member was found in breach of the legislation.

22. Miss Emily LAU pointed out that an accounting firm simultaneously offering audit and consultancy services to companies would likely constitute a conflict of interest. She expressed concern that in the paper provided by HKSA it was said that these functions might not be separated (paragraph 39). She said that if the two functions were not separated, there would not be adequate transparency in regard to the financial positions and operation of accounting firms and their client companies to facilitate proper governance by regulators and prevent auditing firms from engaging in activities that constituted a conflict of interest.

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23. In response, Mr Alvin WONG said that in the First Report produced by the Corporate Governance Committee of the HKSA in 1995, it was recommended that the fees for non-audit services including consulting services of their respective audit firms should be disclosed in the listed companies' financial statements. Instead of adopting a rule-based approach to ban member accounting firms from providing audit and non-audit services to the same company, HKSA considered it more appropriate to require its members to exercise professional judgement and objectivity with regard to the public interest, which included, an obligation to identify and evaluate circumstances and relationships that created threats to independence, and to take appropriate action and safeguards to eliminate or reduce them to an acceptable level. Mr WONG observed that in Hong Kong, most listed companies were not inclined to engage the management consulting services of audit firms. This was particularly true for those listed companies the management of which was dominated by a single family. Mr WONG further said that HKSA had not found conflict of interest a problem among its member audit firms.

24. SFS noted that the HKEx's Consultation Paper on proposals on changes to the Listing Rules relating to corporate governance issues contained a proposal requiring the disclosure of auditors' remuneration to be broken down into those for audit services and those for non-audit services. He said that it was important for Hong Kong's arrangements for dealing with possible conflict of interests to be on a par with the international standards. He believed that HKSA would keep an eye on international developments.

Maintaining professional and ethical standards of the accountancy profession in tandem with overseas jurisdictions

25. Mr CHAN Kam-lam urged the Administration, the regulatory bodies and the relevant professional bodies to work closely to continually maintain high professional and ethical standards. He asked if HKSA continually monitored industry regulatory trends in other jurisdictions and provided training to local industry personnel, such that the latter would be kept abreast of such trends and the latest legislative development. Mr Alvin WONG replied that HKSA was a member of the International Federation of Accountants (IFAC) and therefore there was ongoing sharing of information among HKSA's members on the initiatives of overseas jurisdictions to strengthen corporate governance. The standards and practices set by HKSA were also in tandem with international standards. In 1999, HKSA introduced mandatory continuing professional education requirement and provide various workshops and training programmes aimed at enabling accountancy professional to keep abreast of the development in regulatory and professional standards.

Effectiveness of audit committees

26. Miss Emily LAU noted from HKSA's information paper that an updated "Guide for Effective Audit Committees" had been released by HKSA in February 2002, which however was not a mandatory code for compliance by listed

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companies. Miss LAU enquired about the number of listed companies in Hong Kong which had set up audit committees and how far these audit committees were effective in contributing towards strengthening corporate governance.

27. Ms Karen LEE replied that in the Stock Exchange's Code of Best Practice (the Code) published in 1998, it was recommended that companies listed in the Main Board of the Hong Kong Stock Exchange should set up audit committees. Currently over 90% of these companies had set up audit committees, while the rest, which included some H-share companies incorporated in the Mainland, had other monitoring mechanisms. The audit committees were operated with reference to the code published by HKSA. She acknowledged that the Code had no mandatory force, and its adoption was on a voluntary basis. Audit committees were effective as far as the directors understood, were committed to and dutifully discharged their responsibilities according to the Code. While it could not be ascertained how much investor and market confidence had been restored by such a measure, most corporations supported the establishment of an audit committee for their corporations. SFS supplemented that one of the proposals of HKEx's consultation paper was to make the establishment of an audit committee a mandatory requirement. The Administration supported this proposal, as this would help strengthen the corporate governance regime in Hong Kong.

28. Mr Eric LI said that the public and shareholders might have overly high expectations on audit committees, and did not realize the difficulties that audit committees were faced with. The public and investors alike should be made aware of the constraints and limitations of audit committees in performing their monitoring role. For example, audit committees were not empowered to participate in the respective companies' decision-making process and therefore should not be expected to exercise effective monitoring of a company's daily operation. Such and other difficulties that an audit committee was faced with were highlighted to corporations globally in the wake of the Enron case. Mr LI hoped that the Administration and relevant bodies would do more work to educate the public and shareholders in respect of the role and functions of audit committees.

Transparency of audited accounts

29. In response to Miss Emily LAU's request for HKSA to confirm that off-balance sheet finance arrangements through special purpose entities would not be permitted, and that there was full transparency on the audited accounts of companies, Mr Alvin WONG replied that International Accounting Standards (IASs) and the Hong Kong Accounting Standards (SSAP 32) would not permit off-balance sheet finance arrangements through special purpose entities. The Hong Kong Accounting Standards had adopted the IAS control concept for group consolidation and in particular the accounting for special purpose entities in group accounts.

30. The Chairman thanked the representatives of the Administration and industry bodies for attending the meeting.

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III Any other business

Monitoring of the financial position of authorized insurers in Hong Kong

31. The Chairman advised that Mr James TIEN had written a letter to him suggesting that the Panel discuss the monitoring of the financial position of authorized insurers in Hong Kong. Members noted that there were already three agenda items scheduled for discussion at the next regular Panel meeting on 9 April 2002 and that the subject was not time critical. Members therefore agreed to discuss Mr TIEN's proposed subject at the Panel meeting in May 2002.

32. There being no other business, the meeting ended at 4:30 pm.

Legislative Council Secretariat
19 September 2002