

For discussion

**Bills Committee on
Financial Reporting Council Bill**

**Follow-up actions arising
from the meeting held on 23 January 2006**

PURPOSE

This paper sets out the Administration's responses to the follow-up actions arising from the meeting held on 23 January 2006.

PRESERVATION OF SECRECY

2. In respect of the secrecy provision of **clause 51** of the Financial Reporting Council Bill (the Bill), some Members of and the Legal Adviser to the Bills Committee have invited the Administration to clarify the following matters -

- (a) in relation to **clauses 51(3)(b)(ix)** and **51(3)(c)**, the disclosure gateway applicable to Official Receiver (OR) when acting in the capacity of a liquidator/provisional liquidator appointed under the Companies Ordinance (CO, Cap. 32) or otherwise; and
- (b) whether **clause 51(1)** is wide enough to protect the confidentiality of the auditor or reporting accountant who communicates to the FRC any information or opinion relating to an investigation or enquiry.

3. Regarding paragraph 2(a), it is intended that **clause 51(3)(b)(ix)** will be invoked when OR acts otherwise than in the capacity

of a liquidator/provisional liquidator under the CO¹, while **clause 51(3)(c)** is for the disclosure of information to a liquidator/provisional liquidator (including OR in the capacity as such liquidator/provisional liquidator)². We are reviewing the drafting of the relevant clauses with the Department of Justice and will revert to the Bills Committee during the clause-by-clause scrutiny of the Bill.

4. Regarding paragraph 2(b), we agree that it is important to uphold the confidentiality of the identity of the auditor or reporting accountant who communicates in good faith to the FRC any information or opinion regarding a matter relating to the investigation or enquiry. In this regard, **clause 51(1)** contains the secrecy prohibition whereby, except in the performance of any function under this Ordinance or the carrying out into effect the provisions of this Ordinance, a specified person³ -

- (a) shall not suffer or permit any person (“Person A”) to have access to any matter relating to the affairs of any person (“Person B”) that comes to the specified person’s knowledge in the performance of any function under this Ordinance; and
- (b) shall not communicate any such matter to any person (“Person A”) other than the person to whom such matter relates

¹ This includes the situations when OR acts as a regulator of the insolvency regime to, for example, apply to the court for a disqualification order of directors under section 168I of the CO and take cognizance of the conduct of liquidators of companies that have been wound up by the court under section 204 of the CO, etc.

² It should be noted that, when **clause 51(3)(c)** is invoked, the information can only be used for *the purpose of enabling or assisting the liquidator or provisional liquidator to perform his functions as such liquidator or provisional liquidator*. Therefore, where OR, in the capacity of a liquidator or provisional liquidator, receives information under **clause 51(3)(c)**, he can only use the information for the purpose of performing his functions as such liquidator or provisional liquidator. On the other hand, as regards the disclosure of information to OR acting otherwise than in the capacity of a liquidator/provisional liquidator under **clause 51(3)(b)(ix)**, **clause 53(4)(a)** provides that the FRC shall not disclose information under **clause 51(3)(b)** unless the FRC is of the opinion that the disclosure will enable or assist the recipient of the information *to perform his functions (i.e. functions other than those of a liquidator/provisional liquidator)*. Hence, OR cannot use the information he has received in the capacity of a liquidator/provisional liquidator for the purpose of acting otherwise than in the capacity of a liquidator/provisional liquidator, unless with the consent of the FRC under **clause 51(6)(a)**.

³ By virtue of **clause 51(13)**, a “specified person”, in essence, means the FRC and any person who performs any function under the Ordinance (including the employees of the FRC, and members of the FRC, the AIB and a FRRC).

(“Person B”).

In our view, the second reference to “person” (i.e. “Person B”) in (a) and (b) above must be able to be construed to include, among other persons, the “auditor or reporting accountant” who “blows the whistle” and is protected by the immunity under **clause 54**. With **clause 51(1)** being a “catch-all” provision⁴, we consider it not necessary to provide for separate secrecy requirements.

AVOIDANCE OF CONFLICT OF INTERESTS

5. Some Members have invited the Administration to consider the following matters –

- (a) whether it is necessary to prescribe a quorum requirement for the meetings of the AIB and a FRRC;
- (b) whether any member of the FRC, the AIB or a FRRC who has disclosed an interest in any matter will constitute the quorum required for convening the relevant meeting; and
- (c) whether a change in membership in the AIB or a FRRC at the final stage of the investigation or enquiry will breach the principles of natural justice.

6. Regarding paragraph 5(a), in response to Members’ comments, we agree to consider proposing a CSA to the effect that the quorum of any meeting of the AIB is to be two members, or half of its members, whichever is greater. As regards a FRRC, we propose that a quorum requirement is to be half of its members⁵.

⁴ We note that section 30A of the Prevention of Bribery Ordinance (Cap. 201) contains the secrecy provision to protect the identity of informers. As we consider **clause 51(1)** already sufficient for the purpose of upholding confidentiality, there is no need for the Bill to duplicate the secrecy requirements by modelling on the relevant provision under the Prevention of Bribery Ordinance.

⁵ Please refer to paragraph 6 of the Administration’s paper entitled “Follow-up actions arising from the meeting held on 12 January 2006” (LC Paper No. CB(1)866/05-06(02)).

7. Regarding paragraph 5(b), if a member of the FRC, the AIB, or a FRRC has disclosed an interest in the matter being investigated or enquired, the member is, unless the FRC determines otherwise, required not to be present during the deliberation of the FRC, the AIB or the FRRC (as the case may be) in respect of the matter under **clause 52(5)(a)**. Thus, that relevant member will, of course, not be counted, alongside other members present, for the purpose of forming a quorum at the relevant meeting. To put this beyond doubt, we agree to consider proposing a Committee Stage Amendment (CSA) to expressly state this position.

8. Regarding paragraph 5(c), the Bills Committee has noted the Administration's explanation at the meetings held on 12 and 23 January 2006 that the functions of the AIB and a FRRC are to investigate auditors' irregularities and enquire into non-compliances of a listed entity's financial report and that they are not tribunals with sanctioning powers. In this regard, while the AIB and a FRRC have to act fairly in conducting investigations/enquiries, considerable latitude is allowed as to their procedures. In this connection, a change in the membership of the AIB or a FRRC (due to, for example, the death of one of its members) at any stage of an investigation or an enquiry will not by itself constitute a breach of the principles of natural justice⁶.

RETENTION OF RECORDS

9. **Clause 34(4)** provides that any record or document removed under a magistrate's warrant may be retained for a period not exceeding six months beginning on the day of its removal, or, if the record or document is or may be required for criminal proceedings or for any proceedings under this Ordinance, for such longer period as may be necessary for the purpose of those proceedings. We agree with Members' comment that the records may be of use during the disciplinary proceedings under the Professional Accountants Ordinance (Cap. 50), and

⁶ Please refer to paragraph 8 of the Administration's paper entitled "Follow-up actions arising from the meeting held on 6 December 2005" (LC Paper No. CB(1)665/05-06(01)) and paragraph 6 of the Administration's paper entitled "Follow-up actions arising from the meeting held on 20 December 2005" (LC Paper No. CB(1)665/05-06(07)). Both papers were discussed by the Bills Committee at the meeting held on 12 January 2006.

will consider proposing a CSA to **clause 34(4)** to the effect that the records or documents removed may also be retained for such longer period as may be necessary for the purpose of such disciplinary proceedings.

REVISION OF FINANCIAL REPORTS

10. Following an enquiry into the non-compliances of a relevant financial report with the relevant accounting requirements, the FRC may, pursuant to **clause 49**, specify why in the FRC's opinion there is a relevant non-compliance, and request the listed entity to cause the relevant financial report to be revised. If a listed corporation does not comply with the request, the FRC may, pursuant to **clause 50**, apply to the court for a declaration that there is a relevant non-compliance in the relevant financial report and an order requiring the directors of the listed corporation to revise the financial report as necessary⁷. In this respect, a Member has invited the Administration to clarify, with reference to the United Kingdom (UK)'s experience, the following matters -

- (a) whether the FRC should be in a position to request the listed entity concerned to revise a financial report under **clause 49**;
- (b) whether the request made by the FRC for revision of a defective report will have implications for the listed entity and reporting accountant concerned; and
- (c) whether the court should be in a position to declare non-compliance of a financial report with the relevant accounting requirements under **clause 50**.

11. Regarding paragraphs 10(a) and (b), the proposals enshrined in **clauses 49** and **50** seek to implement the recommendations made by the Standing Committee on Company Law Reform in the context of

⁷ Please refer to paragraphs 17 to 19 of the Administration's paper entitled "Component Three: Financial Reporting Review Panel and Financial Reporting Review Committees" (LC Paper No. CB(1)420/05-06(02)), as discussed by the Bills Committee at its meeting held on 20 December 2005.

Phase I of the Corporate Governance Review. We envisage that, during an enquiry into the relevant non-compliances of a financial report of a listed entity, a FRRC may form an opinion about whether and why there are non-compliances with respect to the financial report and how these non-compliances should be rectified. We consider it appropriate to empower the FRC, having considered the findings of the FRRC⁸, to request the listed entity to revise the defective financial report as prompt remedial actions in this respect will enable the investing public to have the more reliable financial report in order to appraise the financial position of the listed entity concerned⁹. In addition, the UK Financial Reporting Review Panel (UK FRRP) follows similar *modus operandi* and has successfully caused entities concerned to accept the Panel's recommendations in revising the defective financial reports and adopting the more appropriate accounting methods¹⁰.

12. That said, if the listed entity does not agree with the FRC's opinion and does not voluntarily revise its financial report, the FRC has no authority to impose a sanction under **clause 49**¹¹. However, the FRC may apply to the court for mandatory revision of the report under **clause 50** or, if the situation warrants, the FRC may refer the case to the Hong Kong Institute of Certified Public Accountants, Hong Kong Exchanges and Clearing Limited or Securities and Futures Commission for any

⁸ Pursuant to **clause 41(1)**, members of a FRRC are drawn from the Financial Reporting Review Panel which comprises members with the expertise in financial reporting, auditing, banking, financial services and business administration. After the enquiry by a FRRC, the FRRC's findings will be considered by the FRC before the FRC makes the requests for voluntary revision of financial reports. In this regard, there will be sufficient checks and balances in the process.

⁹ It should be noted that those consultees who commented on the enquiry powers of the FRRC in the Administration's consultation in February 2005 generally supported the proposal.

¹⁰ According to the UK FRRP, where a company's financial report contains non-compliances, the Panel will attempt to secure its revision by voluntary means but, if this approach fails, the Panel is empowered to make an application to the court under section 245B of the Companies Act 1985 for an order for revision. An example of how the UK FRRP secured voluntary revision is demonstrated in the press release at **Annex**. To date, no court application has been made.

¹¹ In this regard, whether or not the voluntary revision of a financial report pursuant to FRC's request has an impact on the listed entity or preparers of the report depends on the facts of each case. If the financial report has not been properly prepared, these facts remain so whether or not it is subsequently revised voluntarily on the request of the FRC. On the contrary, if the entity continues any non-compliance with accounting requirements and does not take any remedial actions, the entity will run greater risks of repeatedly contravening relevant requirements governing the announcement and presentation of financial reports under the law, Listing Rules or accounting standards.

follow-up actions with respect to the non-compliances found.

13. Regarding paragraph 11(c), **clause 50** proposes that the FRC should only be empowered to seek a court order to mandate revision of the annual accounts of Hong Kong incorporated companies under the requirements of the CO, or any specified reports that are required under the CO to be included in a prospectus. As these non-compliances relate only to the accounting requirements as to the matters or information to be included in the financial report **as provided in the CO**, the court is in a position to declare a relevant non-compliance and order the revision of the defective report. It should be noted that the court's decision in this regard is appellable, and that the court procedures will also allow relevant parties to present relevant information as appropriate. As a point of reference, under section 245B of the UK Companies Act, the UK court is empowered to, on the application of the UK FRRP, make a declaration that the financial report of a company does not comply with the requirements of the UK Companies Act 1985 and order the directors of the company to revise the report.

Financial Services and the Treasury Bureau
February 2006

Financial Reporting Review Panel

Panel Concludes Enquiry on Royal Bank of Scotland Accounting for Joint Venture

FRRP PN 84

08 June 2005

The Financial Reporting Review Panel (the Panel) has had under consideration the report and accounts of The Royal Bank of Scotland (RBS) for the five years ended 31 December 2004.

The matter at issue was the accounting for Tesco Personal Finance Group Limited (TPFG) which RBS fully consolidated in its group accounts as a subsidiary throughout the period under review.

The Panel is of the view that, although RBS owns the majority of the voting shares, TPFG fulfils the definition of a joint venture as set out in Financial Reporting Standard (FRS) 9, 'Associates and joint ventures' and should therefore have been accounted for using the gross equity method throughout the period under review.

International financial reporting standards will apply to RBS for future accounting periods and as TPFG qualifies as a joint venture under IFRS, the company will be accounted for as such, using proportionate consolidation, in future sets of accounts.

In the light of RBS' announcement today, showing the effect of accounting for TPFG for 2004 under the gross equity method and under proportionate consolidation the Panel considers its enquiry, which commenced on 6 July 2004, as concluded.

Notes to Editors

1. The Financial Reporting Review Panel (FRRP) is part of the Financial Reporting Council (FRC), whose mission is to promote confidence in corporate reporting and governance. The FRC has five operating bodies; the Accounting Standards Board, the Auditing Practices Board, the Financial Reporting Review Panel, the Accountancy Investigation and Discipline Board and the Professional Oversight Board for Accountancy.
2. The role of the Panel is to examine the annual accounts of public and large private companies to see whether they comply with the requirements of the Companies Act 1985 ('the Act'), including applicable accounting standards. Following implementation of the Accounting Regulation (EC) No. 1606/2002, this may mean compliance with UK or International Financial Reporting Standards.
3. Where breaches of the Act are discovered the Panel seeks to take corrective action that is proportionate to the nature and effect of the defects, taking account of market and user needs. Where a company' s accounts are defective in a material respect the Panel will, wherever possible, try to secure their revision by voluntary means, but if this approach fails the Panel is empowered to make an application to the court under section 245B of the Companies Act 1985 for an order for revision. To date no court applications have been made.
4. On 6th April, the Panel published revised Operating Procedures to reflect changes in its remit and powers arising from implementation of the Companies (Audit, Investigations and Community Enterprise) Act 2004.
5. The Chairman of the Panel is Bill Knight and the Deputy Chairman Ian Brindle FCA. There are currently 22 other Panel members drawn from a broad spectrum of commerce and the professions. Individual cases are normally dealt with by specially constituted Groups of 5 or more members.
6. All Press enquiries should be directed to: Carol Page on Tel: 0207 492 2460 or email: c.page@frc-frp.org.uk