

Clerk to the Bills Committee
(Attn: Ms May Leung)
Legislative Council Secretariat
3rd floor Citibank Tower
3 Garden Road
Central
Hong Kong

Our ref CT/20
Your ref CB1/BC/13/04

5 September 2005

Dear Madam

Financial Reporting Council Bill (“the Bill”)

We refer to your invitation to give views on the above Bill for submission to the Bills Committee and thank you for this opportunity to comment.

We are generally supportive of the proposals contained in the Bill. In our view, these proposals will enhance the regulatory regime governing the quality of financial reporting by listed issuers, as well as the accountability of their auditors.

We have the following specific comments in respect of the above proposals:

- *Referral of cases to specified bodies*

We support the establishment of the FRC and its subsidiary bodies, the Audit Investigation Board and the Financial Reporting Review Panel and its Committee(s) (“FRRC”). We further support the proposed functions of the FRC as set out in section 9 of the Bill, of investigating instances of irregularities and non-compliance and then referring cases or complaints on to the relevant specified bodies.

We note the comments made in paragraph 15 of the Legislative Council Brief, which highlight that under such a model, the FRC would refer cases of auditors’ irregularities to the HKICPA for disciplinary proceedings where appropriate. We would, however, recommend that the sections 9 and 12 of the Bill should be clarified as to whether the FRC will act in the capacity of complainant or whether it will be purely referring the case to the HKICPA for its further action. Whilst we would agree with the comment made in the footnote to that paragraph that, with the commencement of the Professional Accountants (Amendment) Ordinance 2004, the independence and transparency of the disciplinary proceedings of the HKICPA have been substantially enhanced, it would facilitate the disciplinary process if the FRC was to act as the complainant.

Given that the Disciplinary Committee of the HKICPA must now consist of a majority of lay persons, we consider that the Committee is sufficiently independent of the members of the HKICPA, to avoid the need for the FRC to set up its own disciplinary body in respect of auditors.

- *Concern over powers of the FRC to opine on financial reporting matters without consultation with the HKICPA as to the proper interpretation of Financial Reporting Standards*

We agree with the conclusion discussed in paragraph 7 of the Legislative Council Brief that where the role of the FRC is to investigate a complaint, and then refer the case to the appropriate regulatory authorities for their further consideration, there is no need for the FRC itself to be subject to an appeal tribunal process. However, we have the following concerns about the lack of appeal provisions where the matter under investigation is a question of non-compliance with financial reporting standards.

We note that in accordance with section 49 of the Bill, the FRC will be empowered to request the directors of a listed entity to revise the financial statements where it appears to the FRC that there is non-compliance. We further note that in accordance with section 50 of the Bill, the FRC will be empowered to seek a court order directing the directors of the listed entity to rectify defects, if they do not agree to do so voluntarily, having received a request made under section 49.

Given these powers to be made available to the FRC, we are concerned that the proposals do not include a requirement for the FRC to consult with the HKICPA, as the financial reporting standards setting body, where the directors of the listed entity and/or the listed entity's auditors do not agree with the FRC's interpretation of the relevant Financial Reporting Standards.

Without such a process of consultation, there is the risk that the interpretations of the financial reporting standards made by the FRC may not be consistent with the interpretations that the standard setters themselves would have made in the circumstances of the listed entity under investigation. In such cases it would be unfair to the listed entity under investigation for the FRC to find that that their treatment was a non compliance with the standards. It would also undermine the authority of the HKICPA to set and interpret financial reporting standards, as, in practical terms, the findings of the FRC will no doubt be given the status of Interpretations by the market place.

We therefore strongly recommend that safeguards be introduced to ensure that where the matter under investigation involves the interpretation of financial reporting standards, the HKICPA, as the standard setting body, is consulted as to their views on the acceptable interpretations of the accounting principles in question.

In this regard, we note that paragraph 14 of the Legislative Council Brief mentions that the proposals in respect of the functions, powers and composition of the FRRC are modelled on a similar set-up in the United Kingdom. While supporting this overall approach, we draw to your attention that the UK FRC combines the role of enforcer with the role of standard setter (through the Accounting Standards Board). By contrast, under the proposed Hong Kong regime, the proposed FRC is independent from the standard setting body (the HKICPA), by design. Therefore, while the UK model may operate successfully without a specific requirement for its FRC to consult with its standard setters, this does not alter our view that such a requirement is necessary for the Hong Kong model.

- *Qualified support for the FRC's power to be proactive in its investigations*

Section 9 of the Bill sets out that the functions of the FRC include investigating or enquiring "in response to a complaint or otherwise". This provides the FRC with the power to be proactive in its work, rather than solely acting on referrals and other information received.

Whilst we agree that it is important to allow the FRC flexibility in order to carry out its duties, we believe the FRC's scope should primarily remain reactive upon receipt of referrals from other regulators and complaints. In addition, particularly in the case of proactive investigations, we consider it desirable that there should be checks and balances to ensure that, before the investigation is allowed to proceed beyond a very preliminary stage, due consideration is given to whether the benefits of the investigation and its outcome are likely to outweigh the significant cost and resources the investigation may entail. This analysis should take into account the costs and resource demands that would likely be required from all parties that would be involved i.e. from both the FRC and those individuals and entities that would be asked to respond to the investigation.

Furthermore, it is important to take account of other developments that should help enhance corporate governance and financial reporting in Hong Kong, such as any new or revised financial reporting standards or Interpretations which had not yet come into effect in the period under review but will do so shortly. This is particularly the case when considering whether the benefits of proactively undertaking an investigation into past practices or information already reported would outweigh the costs.

We trust that our comments are helpful to the Bills Committee. If you have any questions on any of our comments, please do not hesitate to contact our Carlson Tong at 2826 7235.

Yours faithfully