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20 September 2005

The Clerk to the Bills Committee  
Bills Committee on the Financial  
Reporting Council Bill  
Legislative Council Building  
8 Jackson Road  
Central  
Hong Kong

Dear Sir / Madam,

### **SUBMISSION ON FINANCIAL REPORTING COUNCIL BILL**

Thank you for your letter of 28 July 2005 inviting Ernst & Young to give views on the Financial Reporting Council ("FRC") Bill ("the Bill"). We make the following submissions:

1. A degree of proportion, materiality and context needed in approach to FRC enquiries and investigations

We submit that the wording in the Bill dictating the situations which require the FRC's enquiry or investigation should reflect the proviso that FRC enquiries and investigations should be launched only when a significant public interest exists. Some degree of proportion, materiality and context should be brought to bear in a decision to launch an enquiry or investigation.

The equivalent system of regulation which has been successfully operated in the United Kingdom is based on such scope parameters.

A consideration of proportion, materiality, context and public interest should particularly be reflected in the wording of section 4, which explains the meaning of a "relevant irregularity", and section 5, which does likewise for a "relevant non-compliance". These terms outline the situations where the FRC is required to enquire or investigate.

An example of wording which does not enshrine a consideration of proportion, materiality, context and public interest is included in section 4(4)(a)(vi) and 4(6)(b), which seems unnecessarily wide-ranging in referring to refusal or neglecting to comply with the provisions of:

"any bylaw or rule made or any direction lawfully given by the HKICPA Council".

A similar degree of proportion, materiality and context seems to be absent from the subsection which addresses a situation where an auditor or reporting accountant is deemed to be "negligent in the conduct of his profession". We have set out our submission on this point under 2 below.

- 2 -

2. Negligence, by itself, should not necessarily be sufficient to constitute automatic grounds for an investigation, without consideration of materiality and the public interest

Section 4(3) sets out the situations in which a “specified event” would be deemed to have occurred in relation to an auditor or reporting accountant of a listed entity. Included in the list at 4(3)(c) is:

“If the auditor or reporting accountant has been negligent in the conduct of his profession”.

In our submission, sub-section 4(3)(c) should not be included in the Bill on the grounds that:

- (i) it does not state a proviso that negligence should have had a material or public interest effect in order to warrant consideration by the FRC.

The fact of the occurrence of a negligent act should not, by itself, automatically be grounds for an investigation. For example, minor acts, omissions or “careless mistakes” could be termed “negligent”, but may have no overall or discernable impact or effect on the quality or effectiveness of an audit; and

- (ii) a material negligent act, or one with a public interest effect or a course of negligent behaviour is already addressed by sub-section 4(3)(d) which deals with professional misconduct, as explained below.

Sub-section 4(3)(d) lists a further specified event as:

“If the auditor or reporting accountant has been guilty of professional misconduct”.

The provisions of sub-section 4(3)(d) already sufficiently cover the requirement for negligence to be investigated, while addressing materiality and the public interest. While an act of negligence, by itself, in the conduct of an auditor’s profession is not necessarily sufficient to constitute professional misconduct, negligence does constitute professional misconduct if the significance or effect is material or in the public interest. Accordingly, sub-section 4(3)(d) adequately accommodates the need for material negligence to be investigated in appropriate circumstances. There is, therefore, no requirement for sub-section 4(3)(c), which could otherwise potentially give rise to investigations being carried out in situations where the negligence involved has not been material.

3. Production of documents located outside Hong Kong

Sections 25, etc require an auditor or reporting accountant to produce records or documents in his possession to the investigator. An issue may arise, however, in respect of such documents physically located in countries or jurisdictions outside Hong Kong.

Although the Hong Kong auditor or reporting accountant of a company listed in Hong Kong is required to take overall responsibility for the audit of the company’s financial statements, which include the contribution of the company’s subsidiaries wherever they are located, certain of the audit documents are likely to remain at the location of the subsidiary auditor who actually performed the audit work on a particular subsidiary.

.../3

- 3 -

3. Production of documents located outside Hong Kong (continued)

Under the regulations of that other country or jurisdiction, including those relating to state secrets and other sensitive matters, legal impediments may exist with respect to providing these documents to the investigator.

Recognition of this potential difficulty should be provided through relief from the obligation of production if the same is prohibited by reason of legal impediments arising under the laws of a relevant foreign jurisdiction.

4. Potential publication of investigation reports by the FRC

Sections 35(3), (4) and 47(3), (4) deal with the power of the FRC to cause the publication of an investigation report produced by its Audit Investigation Board ("AIB") or one of its Financial Reporting Review Committees ("FRRC") (an "FRC investigation report").

- (i) Sections 35(4) and 47(4) address the considerations that the FRC is required to take into account in deciding whether or not to cause such a publication.

35(4)(a)(i) and 47(4)(a)(i) require the FRC's consideration of whether or not the publication of an FRC investigation report may adversely affect "any criminal proceedings before a court or magistrate". To "any criminal proceedings" should also be added "any civil proceedings" – an example illustrating the necessity for this additional wording being proceedings commenced by liquidators.

(Submission 6 below addresses our concerns about the Bill's current provisions regarding the access by liquidators to an FRC investigation report).

- (ii) It is imperative that provisions dealing with the possible publication of an FRC investigation report be added to the Bill to include a requirement that the FRC informs the affected auditor, reporting accountant, persons, etc (the "affected parties") of an intention to publish the report.

Further provisions should be added to the Bill to provide the affected parties with a right of representation and an entitlement to make submissions to the FRC in respect of such a situation. The FRC should then be required to take these submissions into account in deciding whether or not to cause publication of such an FRC investigation report.

The various reasons necessitating the addition of such provisions, include, but are not restricted to, our concerns over the nature of the contents of FRC investigation reports – our comments on the nature of such contents in submission 5 below are relevant.

.../4

- 4 -

5. FRC investigation reports admissible as evidence in court or certain other disciplinary proceedings

Sections 35(5) & 47(5) state that a signed copy of an FRC investigation report “is admissible as evidence of the facts stated in the report” in any disciplinary proceedings before a court or magistrate, the Market Misconduct Tribunal, or the HKICPA under Part V or VA of the Professional Accountants Ordinance.

However, by their nature, FRC investigation reports are likely to include expressions of opinion from the FRC, from any expert advisers that have been consulted and from those that have been required to provide information under the investigation.

Furthermore, many of the detailed auditing and accounting areas investigated by the FRC are likely to relate to issues and situations that required the exercise of experienced judgement by the auditors or reporting accountants. The new auditing and accounting requirements are complicated in places.

For these reasons outlined above, while an FRC investigation report could be used as the basis for initiating court or disciplinary proceedings, it should not have the status of being “admissible as evidence of the facts stated in the report” in such proceedings. The party subject to the proceedings should not be put in the situation of having to challenge the FRC investigation report’s contents as being fact.

The court or disciplinary body should use the FRC investigation report as it deems appropriate in implementing its normal procedures, and such procedures should be conducted in accordance with their usual rules, requiring (if necessary) the calling of witnesses as to fact and expert witnesses as to expressions of opinion.

6. FRC investigation information able to be disclosed to a liquidator and the Official Receiver

Section 51(3)(c) permits the FRC to disclose information to:

“a person who is a liquidator or provisional liquidator appointed under the Companies Ordinance, or a person who acts in a similar capacity under any law of a place outside Hong Kong, for the purpose of enabling or assisting the person to perform his functions as such liquidator or provisional liquidator or in such similar capacity”.

Section 51(3)(b)(ix) permits the FRC to disclose information to the Official Receiver.

The disclosure of FRC investigation information or reports to a liquidator or provisional liquidator is wholly inappropriate. The purpose of an FRC investigation, which includes the disciplining of auditor or reporting accountant irregularities, is quite different from a liquidator’s purpose. A liquidator’s purpose includes seeking monetary re-dress, a process which tends to focus on parties with the deepest pockets or most comprehensive insurance, such as the auditor. It is inequitable that the investigative and other powers of the FRC should be available to liquidators in the pursuit of litigation against auditors.

.../5

- 5 -

6. FRC investigation information able to be disclosed to a liquidator and the Official Receiver (continued)

Liquidators have their own specific statutory means under the Companies Ordinance for accessing the information and documents that they require, such as an auditor's working papers. It is wrong to pass information and reports obtained under the "draconian" and wide-ranging powers of the FRC to a liquidator whose information gathering powers are already extensive and well established, and supported comprehensively through the ability to invoke the assistance of the Court system. Furthermore, an FRC investigation report may contain information, and may be prepared with access to people, to which a liquidator may not be permitted access. Such a report is also likely to include opinions, including those of experts – the FRC should not be performing the liquidator's job for him.

The operation of the FRC and its investigations is open to potential misuse by liquidators for the purpose of enhancing their own prospects of success in later civil proceedings against auditors. Should the proposed provisions of the Bill be enacted, auditors, reporting accountants and their insurers may have no alternative but to defend and challenge an FRC investigation, in a similar manner as they would deem appropriate in the case of a liquidator's investigation, in order to legitimately preserve and protect their legal interests.

Where parties, such as liquidators, have existing specific access of their own – through statute and the courts, with the safeguards enshrined in this process – to the underlying documentation of an auditor or reporting accountant, it should remain a requirement that these existing procedures are followed. Liquidators should not be permitted to by-pass this process.

Similarly, reports should not be sent to the Official Receiver who is essentially in the position of a liquidator and / or would be able to make such FRC investigation information or reports available to a liquidator.

7. FRC members' conflict of interest notification requirements worded widely

Section 52(2) requires an FRC member, etc, if he is required to consider a matter in which he has an interest, to immediately disclose the nature of the interest to the FRC.

Given the nature of the type of investigations undertaken by the FRC, which may be complex, or involve an ongoing widening of focus and ongoing clarification of the situations and relationships being investigated, in some circumstances it may not immediately be apparent to an FRC member that a conflict of interest exists.

We suggest that the wording of section 52(2) be extended to include wording along the lines of "when the FRC member becomes aware, or reasonable grounds exist for him to become aware" that he is required to consider a matter in which he has an interest.

8. Clarification of specific Bill wording

Section 2 ("associated undertaking" in 2 instances; and "relevant undertaking" in 2 instances) and Schedule 1 Part 1 ("relevant requirement" in 2 instances) all include similar lists of the relevant accounting standards requirements and the Listing Rules.

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- 6 -

8. Clarification of specific Bill wording (continued)

Our understanding of the Listing Rules relating to such requirements (section 2 of Appendix 16 to the HKEx "Rules governing the listing of securities on The Stock Exchange of Hong Kong Limited") and the intended logic of the Bill wording, is that the following accounting standards are *mutually exclusive* alternative options in the circumstances they are referred to in the Bill:

- "the standards of accounting practices issued ... under section 18A of the Professional Accountants Ordinance";
- "the International Financial Reporting Standards issued by the International Accounting Standards Board"; or
- "any generally accepted accounting principles allowed for usage under the Listing Rules".

Our opinion is that the drafting of these sections of the Bill should therefore set out these options in a similar logic format to that illustrated below, rather than under the existing four points of equivalent weighting:

"(a) *the following accounting standards:*

- (i) the standards of accounting practices issued ... under section 18A of the Professional Accountants Ordinance;
- (ii) the International Financial Reporting Standards issued by the International Accounting Standards Board; *or*
- (iii) any *other* generally accepted accounting principles allowed for usage under the Listing Rules; *and*

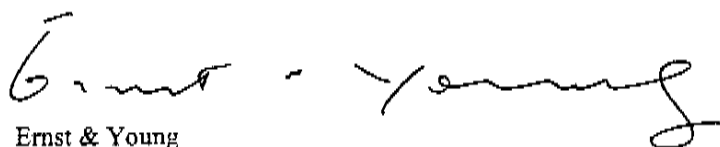
(b) the Listing Rules."

9. Potential for duplicate investigations

There should be some mechanism inserted in the Bill for confidential communication and agreement between the FRC and, for example, the HKICPA and the SFC when an enquiry or investigation is planned by the FRC, to ensure that those entities do not implement parallel enquiries, in order to avoid the inconvenience, oppression and costs to affected parties of duplicate investigations.

Again, we thank you for the invitation to make submissions regarding the Bill. We trust that the Bills Committee will address our concerns.

Yours faithfully,



Ernst & Young