The Legislative Council
Panel on Financial Affairs

Continuous Efforts to Strengthen Corporate Governance : Review of Listing Rules and Other Initiatives

PURPOSE

This paper outlines the major initiatives to enhance Hong Kong's corporate governance regime and reflects on the lessons to be drawn from recent happenings in other financial markets.

BACKGROUND

Importance of Corporate Governance

2. Good corporate governance is a key factor in building and sustaining any successful financial market. It is a matter of investor protection and credible corporate behaviour. It holds the key to the reputation of a financial market. The global community has therefore in recent years focused on standards of corporate governance as a concern, especially in light of increasing globalization of financial services and financial markets.

3. We are committed to the same efforts in Hong Kong. We have made it our prime objective "to establish Hong Kong as a paragon of corporate governance, ensuring that those investing in Hong Kong are afforded the best protection and that our listed companies are managed with excellence"[1].

4. Our work on enhancing standards of corporate governance involves many aspects and on-going efforts. Major developments are taking place through the updating of the Listing Rules, reviews by the Standing Committee on Company Law Reform (SCCLR), and modernization of our overall regulatory regime for the securities market as embodied in the Securities and Futures Bill (SF Bill).

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[1] Paragraph 68, 2001-02 Budget Speech.

5. Recent cases of corporate failure elsewhere, in particular the Enron case, highlight again the critical importance of corporate governance. The picture revealed so far raises concerns over issues such as the accountability of the audit committee and independence of auditors and quality of their audits in relation to a listed company. We believe the initiatives we have embarked on will help fortify our corporate governance regime to keep pace with other international financial centres.

Public Consultation on Proposed Changes to the Listing Rules

6. Corporate governance of issuers in Hong Kong is mainly governed by common law, statute law, non-statutory rules and codes of practices. Statute law includes the Companies Ordinance and the various securities legislation now being consolidated into the SF Bill. Non-statutory rules include the Listing Rules, the Code on Takeovers and Mergers and the Code on Share Repurchases (Takeovers Code).

7. The Listing Rules are a major source of regulatory requirements for companies listed in Hong Kong. Our objective is to enhance the corporate governance-related sections of the Stock Exchange's Listing Rules to ensure that they are on a par with international standards and practices having regard to the circumstances in Hong Kong.

8. Under the above principle, the Hong Kong Exchanges and Clearing Limited (HKEx) published in January 2002 a Consultation Paper on a set of proposals on changes to the Listing Rules relating to corporate governance issues. The consultation will last for three months and covers three main areas-

- Protection of shareholders' rights;
- Directors' and board practices; and
- Corporate reporting and disclosure of information.

9. HKEx's proposals in each of these areas are summarized at Annex A. The key considerations are -

(a) *Protection of shareholders' rights* is to be enhanced through tighter voting mechanism for connected transactions and by interested shareholders, stricter rules against the dilution of shareholders' interests through placing of shares, rights issues and share repurchases, higher notification requirements for very substantial transactions and introduction of similar requirements for "very substantial disposal", tighter rules for connected transactions and disposal of controlling shareholders interests.

(b) To establish *good directors' and board practices* so that directors and their boards are responsible for the governance of issuers and accountable to shareholders for asset and resources entrusted to them. To this end, HKEx will issue further guidance on the independent role of Independent Non-Executive Directors (INEDs). At least one of the INEDs will be required to have appropriate professional qualifications. Issuers will also be required to appoint INEDs representing not less than one-third of the members of their boards or not less than 2 in any event.

The establishment of Audit Committees will be made mandatory and that of remuneration committees and nomination committees will be recommended good practices. Audit Committees will be required to play a proactive role in ensuring the independence of auditors. In this connection, issuers are proposed to disclose the nature and amount of audit and non-audit fees separately in their annual reports.

It is further recommended that the roles of chairman and chief executive officers should be segregated as a good practice and issuers should regularly review the effectiveness of their internal control. Issuers will also be required to disclose directors' remuneration and compensation packages for individual directors. There will also be stricter rules on the disclosure of securities transactions by directors.

(c) *Disclosure of quality information in a timely manner* will enhance transparency of issuers' businesses and operations and facilitate investment decisions. It is essential to good corporate governance. The Consultation Paper requires companies to publish quarterly reports and issue quarterly results announcement within 45 days after the quarter-end. Issuers will be required to publish their half year results announcements within 2 months of the relevant financial period. The publication deadline for annual reports will be 3 months after the end of the company's financial year.

SCCLR Review and the Accounting Standards-setting process

10. The HKEx's Consultation Paper is part of our overall efforts to enhance Hong Kong's corporate governance regime in the light of the needs of our economy and investors. Such efforts started two years ago in 2000 when the SCCLR was tasked by the Financial Secretary to conduct a comprehensive corporate governance review.

11. SCCLR set up three Sub-committees on Directors, Shareholders and Corporate Reporting respectively to take forward the review and a Consultation Paper with specific proposals in respect of directors' duties, shareholders rights, corporate reporting enhancement was issued in July 2001. A summary of the proposals which span over 20 areas is at Annex B.

12. As reflected in recent international events, having a sound, transparent and effective disclosure and financial reporting system is of paramount importance. Towards this end, SCCLR's corporate reporting sub-committee examined and made specific proposals on the following issues.

(a) The Accounting Standards-setting process

13. The Hong Kong Society of Accountants (HKSA) is responsible for promulgating accounting and auditing standards in Hong Kong. Under the HKSA, the Financial Accounting Standards Committee (FASC) and Auditing Standards Committee (AuSC) are responsible for

setting the accounting and auditing standards respectively. Since 1993, it has been the HKSA's policy to harmonize its accounting and auditing standards respectively with the International Accounting Standards (IASs) and the International Standards on Auditing (ISAs). It is only under rare circumstances, e.g., conflicts with local legal requirements, that departures from IASs and ISAs would be accommodated.

14. Having examined the present Accounting and Auditing Standards setting process in Hong Kong and in other jurisdictions, SCCLR believes that Hong Kong does not need an independent standard setting body given that the Hong Kong accounting and auditing standards are closely modeled on the well-recognised IASs and ISAs. However, SCCLR recommends that the composition of FASC and AuSC should be widened to cater for greater involvement of the public.

(b) The Quality of audit practice and monitoring of audit practice

15. The HKSA is the regulator of company auditors in Hong Kong. To monitor compliance with auditing standards, the HKSA has regular programmes such as the Professional Standards Monitoring Committee programme and the Practice Review Programme which monitors the quality of all audit practices.

16. Having examined the present monitoring process, SCCLR invited public views on whether a higher standard should be required for firms auditing public companies, and whether firms performing audits of listed companies or companies with significant public interests should be subject to additional scrutiny or a separate regulatory regime.

(c) The adequacy and quality of information in Hong Kong listed companies' Management Discussion and Analysis (MD&A) section of the Annual Reports

17. The Listing Rules require listed companies to prepare a MD&A, which comprises a statement containing a discussion and analysis of the group's performance during the financial year and the material factors underlying its results and financial position. SCCLR is of the view that there is merit in providing shareholders of listed

companies with qualitative and forward-looking corporate information and proposals to expand the scope of the information to be covered in the MD&A section.

(d) Establishing a body to investigate financial statements

18. SCCLR considered how the compliance with accounting standards be better enforced. At present there is no mechanism in our regulatory regime to provide for the making of enquiries into the financial statements of companies on their compliance with the accounting requirements in the Companies Ordinance, including the accounting standards and the true and fair view requirement. Neither is there any mechanism whereby directors may be required to revise and re-issue financial statements. Auditors of a company may at best issue a qualified audit opinion if they find that the company's financial statements do not comply with the accounting requirements either in the Companies Ordinance or in the accounting standards.

19. In the light of the above and having examined the practice in other jurisdictions, SCCLR proposes that a body with authority to investigate financial statements and enforce any necessary changes to the companies' financial statements should be set up.

(e) Auditors to report on any inconsistencies between the audited financial statements and financial information contained in the directors' report

20. The present provision in the Companies Ordinance confines the scope of the statutory audit to financial statements of a company. Auditors have no statutory responsibility in respect of financial information in other documents such as directors' reports and other financial information contained in the annual reports of listed companies. The SCCLR proposes that the Companies Ordinance should be amended to enable auditors to report on any inconsistencies between the audited financial statements and financial information contained in the directors' report.

(f) The revision of audited financial statements and related matters

21. Under the Companies Ordinance, the directors of a company are responsible for ensuring that a company's financial statements give a 'true and fair' view of the state of affairs and profit or loss of the company. Auditors of a company are required to report to the members on the financial statements audited by them. There are no statutory provisions at present for the revision of the financial statements after they have been laid before the company in general meeting or delivered to the Registrar of Companies. It is possible that information may come to light or become known to directors or auditors after the financial statements have been issued that suggest that the financial statements had been incorrectly prepared based on wrong or omitted information unknown at the time.

22. To prevent further reliance on misstated financial statements, SCCLR proposes that directors and auditors should be allowed to prepare and file revised financial statements and a revised auditors' report, in the event that material misstatements in the financial statements are found after the financial statements being laid before the company in the general meeting and filed with the Registrar.

(g) The filing of financial statements by private companies with limited liability

23. At present, every company incorporated in Hong Kong is required by law to prepare a set of financial statements and every public company is required to file with the Companies Registry an annual return which contains certain basic company information including its financial statements. Private companies are not required to file any company financial statements with the Registry. To enhance corporate transparency and accountability, SCCLR proposes that private companies with limited liability should file their financial statements with the Companies Registry for public inspection.

24. The comments received from the professional bodies, trade associations, academia and individuals during the consultation period indicated general support for most of the above proposals. In relation to the quality of auditing practice and the monitoring of such practice, the

public comments indicated general content with the present arrangement and did not favour having a separate monitoring regime in respect of the audits of public companies. SCCLR has just completed its scrutiny of the comments and the Administration would consider the SCCLR's views including how best to take forward those recommendations.

25. The corporate governance review is a continuous process. SCCLR has now forged ahead with the second phase of the review and in respect of corporate reporting, the following issues will be tackled-

(a) Examining the roles and functions of Audit Committees;

(b) Developing a framework setting out the financial reporting standards for different categories of companies e.g., listed, unlisted public and private companies;

(c) Undertaking a complete review of the accounting and audit provisions in Part IV and the 10th Schedule to the Companies Ordinance;

(d) Further reform and strengthening of the non-statutory disclosure requirements in respect of listed companies in the SEHK's listing rules including director's remuneration;

(e) Strengthening the internal controls in companies with particular reference to internal audit functions;

(f) Examining the responsibilities, liabilities and independence of external auditors.

26. As indicated above, issues pertaining to accounting and auditing standards, monitoring of the work of auditors, and the efficiency of our present corporate reporting regime have been or are being examined by SCCLR in the context of the corporate governance review. In the process, SCCLR would also have regard to the lessons to be learnt from the Enron case.

The Hong Kong Society of Accountants

27. The HKSA, the self-regulatory body for the accountancy profession, has been active in studying and making recommendations on increasing transparency, better disclosure and improving the quality of financial reports. Since 1995, HKSA has published six substantive guides/research papers on the subject covering matters like business review in annual report, audit committees formation and directors' remuneration. In February this year, HKSA issued 'A Guide for Effective Audit Committees' as part of its continuing efforts to improve standards of corporate governance.

28. Apart from adopting international accounting and auditing standards, HKSA also seeks to adopt the recently updated Code of Ethics for Professional Accountants by the International Federation of Accountants (IFAC). HKSA will issue a draft Hong Kong Code of Ethics for consultation later this year. The updated IFAC code features new rules on auditors' independence by setting out a conceptual framework that focuses on the factors that pose a threat to independence of auditors and the safeguards that auditors should put in place to preserve their independence. Issuing a Code of Ethics for Hong Kong auditors along the lines of the IFAC Code would ensure that the professional ethics standard in Hong Kong is on par with the international standard, it will also address the concern over the independence, or perceived independence, of accountants.

29. The HKSA is closely involved in the SCCLR's corporate governance review and we would continue to work closely with HKSA to enhance our corporate disclosure/reporting regime.

The Securities and Futures Bill (the Bill)

30. The Bill, currently in the final stage of the legislative process, contains a number of proposals that would contribute towards better corporate governance.

(a) Enhancing transparency of listed companies

31. The Bill seeks to enhance transparency of listed companies by improving the extent and timeliness of disclosure of price sensitive information. The more important proposals are to lower the initial shareholding disclosure threshold for substantial shareholders from 10% to 5%; and to shorten the disclosure notification period from 5 to 3 business days. The new disclosure regime will bring the level of market transparency in Hong Kong in line with international standards.

(b) Combating market misconduct

32. We propose to set up a Market Misconduct Tribunal (MMT) under the Bill to deal with a wider range of market misconduct, including the disclosure of false or misleading information inducing transactions in securities or futures contracts. The MMT would be able to impose a range of civil sanctions, such as disgorgement of profits made or loss avoided, disqualification of a person from being a director or otherwise involved in the management of a listed company for up to 5 years, and referral of a person found to have engaged in market misconduct to a body to which that person is a member for disciplinary action by that body. The same market misconduct may also constitute a criminal offence attracting a maximum penalty of $10 million and 10 years' imprisonment.

33. We believe that the above proposals will send a clear signal to the market that disclosure of false or misleading information inducing transactions and other types of market misconduct would not be tolerated.

(c) Enhancing SFC's investigatory powers

34. The Bill seeks to strengthen the SFC's power to inquire into possible misconduct of listed companies by allowing it to obtain documents and explanations from the parties closely connected with the listed companies concerned and its group corporations. These parties include their bankers, auditors and those who have done business with them. This is intended to enable the SFC to verify with these parties the information it obtains from the listed companies under inquiry and its

group corporations. Specifically, the SFC may, subject to necessary statutory safeguards, obtain from the auditor of a listed company the record or document in the nature of audit working papers, which could be any record or document prepared, obtained or retained by the auditor for or in connection with the performance of any of his functions relating to the conduct of any audit of the accounts of the listed company. The enhanced powers of the SFC would serve as a more effective tool for conducting inquiries into the misconduct of listed companies prejudicing the interest of shareholders.

(d) Providing immunity in respect of communication by auditors of listed companies

35. The Bill seeks to provide auditors of listed companies who report to the SFC any suspected fraud or misconduct in the management of a listed company with statutory immunity from civil liability under the common law, if such reports are made in good faith. This, we believe, would encourage auditors who may identify possible fraud or irregularity in conducting an audit of a listed company to protect the public interest by reporting their concerns to the SFC.

(e) Empowering investors with a private cause of action

36. The Bill seeks to provide expressly for a private cause of action for a person to seek compensation for pecuniary losses suffered as a result of relying on any public communication relating to securities or futures contracts, which is false or misleading. The intention is to ensure that persons responsible for issuing public communications, such as listed companies, should exercise all due care and diligence in doing so.

37. The Bill further creates an express private right of civil action for a person to sue another person for recovery of pecuniary losses resulting from the latter's market misconduct. It allows the court hearing on such a private action to admit findings of the MMT and criminal convictions as evidence that market misconduct has been committed. This would help facilitate the investors in establishing their claims without having to prove the existence of certain market

misconduct ab initio.

38. The above proposals have been carefully considered by the Bills Committee set up to scrutinise the Bill. Resumption of the Second Reading and the Third Reading of the Bill is scheduled for 13 March 2002. We hope to bring the new law into operation later in the year when the necessary subsidiary legislation, codes and guidelines are in place.

THE ENRON LESSONS

39. It is much too soon to identify the truth of what has happened in Enron prior to its collapse and to determine the causes of its failures. It is worth pointing out that the full range of corporate governance practices are designed to ensure adequate transparency and checks and balances to ensure that directors and senior managers, who should act as agents for shareholders, do so properly. However, Enron shows that even when these are in place in the most highly developed market, there can still be failure. Part of the problem is the need to ensure that governance standards are adhered to by the company: it is all too easy to pay lip service. An example from Enron is the audit committee, which consisted of widely dispersed members who met infrequently and may not have received sufficient information to operate effectively. In other words, corporations must recognise that good corporate governance is good for them, and is worth any necessary additional costs. Results of research on the lower cost of capital for well-governed companies clearly demonstrate this. However widespread acceptance may take some time after new rules are introduced and all involved must be prepared to educate and enforce with credibility.

40. Improving corporate governance is a continuing exercise, which success relies on the concerted efforts of the regulators, market operators and professionals in the enforcement and compliance of corporate disclosure standards; the stakeholders, in particular the shareholders, company directors and senior management in exercising their rights and performing their duties; and the government in ensuing that the legislative framework is developing in tandem with market needs and international trend. More importantly, improving corporate

governance requires not only compliance with the letter, but also the spirit, of the law. As unveiled by the Enron case, this must be promoted with a cultural change amongst the stakeholders to enhance their awareness of the importance of good corporate governance. The various measures outlined in this paper are in the right direction and we shall keep these measures under review and continue to develop new measures having regard to the local market circumstances and overseas developments.

Financial Services Bureau
26 February 2002

Annex A

Consultation Paper on Proposed Amendments to Listing Rules relating to Corporate Governance Issues : Briefing Notes

Introduction

1. Hong Kong Exchanges and Clearing Ltd ("HKEx") reviews the Listing Rules of the Stock Exchange of Hong Kong ("Listing Rules") from time to time to ensure that they are on par with best international market practices and standards. We published a consultation paper on 21 January 2002 to seek views from the market on proposed amendments to the Listing Rules relating to corporate governance issues ("Consultation Paper"). The consultation period will end on 22 April 2002.

Background

2. Corporate governance of issuers in Hong Kong is mainly governed by common law, statute law, non-statutory rules and codes of practices. Statute laws include Companies Ordinance, the Securities (Disclosure of Interests) Ordinance and Securities (Insider Dealing) Ordinance. Non-statutory rules include the Listing Rules, the Code on Takeovers and Mergers and the Code on Share Repurchases of the Securities and Futures Commission ("SFC").

3. The Listing Rules include detailed provisions on corporate governance matters, such as board practices, protection of shareholders' rights in material or connected transactions and timely disclosure of information to the public. They embody the Code of Best Practice which serves as a guide to issuers to assist them in deciding their own board practices.

The Consultation Paper

4. The Consultation Paper focuses on the following 3 main areas of corporate governance :

a) protection of shareholders' rights;
b) directors' and board practices; and
c) corporate reporting and disclosure of information.

A) Protection of shareholders' rights

5. A characteristic of the Hong Kong market is that many issuers have controlling or majority shareholders who in turn tend to dominate the respective boards of directors. It is therefore necessary to have explicit provisions in the Listing Rules to ensure that there is sufficient protection of shareholders' rights, particularly their right to participate in making decisions on matters that have a significant impact on the companies and their interests.

6. The general principle is that all shareholders have the same right to vote as long as they do not have different interests from other shareholders. However, in those circumstances where the interest of controlling or majority shareholders may not be identical to that of minority shareholders or where there have been significant previous cases of abuse of minority shareholders' rights, an exception to the principle of equal voting right would be justified. These exceptional circumstances include :

   a) voluntary withdrawal of primary listing on the Exchange;
   b) material changes in the business nature of issuers shortly after listing; and
   c) rights issues or open offers that will increase the issued share capital or market value of a listed company by more than 50%.

   In these exceptional circumstances, controlling shareholders are required to abstain from voting at general meetings approving the relevant resolutions.

7. To enhance transparency and fairness of voting procedures of issuers, the Consultation Paper proposes to require voting by way of poll for those exceptional circumstances and connected transactions that require shareholders' approval.

8. Other principal proposals in the Consultation Paper relating to the protection of shareholders' rights include:

   a) to generally cap the discount to the benchmarked price to 20% for the issue of shares under a general mandate;
   b) to require shareholders' approval for a placing and top-up arrangement if the number of new securities subscribed by a

connected person would exceed the number of securities he had before placing of securities to an independent third party;

c) to amend the definition of "very substantial acquisition" and introduce "reverse takeover" transactions to the Main Board Listing Rules and amend the definition in the GEM Listing Rules;

d) to introduce "very substantial disposal" as a new category of transactions

e) to replace the "net assets test" by the "total assets test" and to adopt the "turnover test" in place of the "profits test" when the "profits test" produces anomalous results due to exceptional circumstances;

f) to adjust the threshold levels for categorising notifiable transactions under all size tests and *de minimis* thresholds for connected transactions;

g) to amend the GEM Rules to follow the definition of "connected person" in the Main Board Rules, which includes persons who are connected by virtue of their relationship at the subsidiary level;

h) to expand the definition of "connected person" under the Listing Rules to cover any associated companies over which the listed group together with the connected person(s) of a listed company have control;

i) to treat transactions between connected persons of a listed company and an associated company of the listed company in which the listed group together with the connected person(s) of such listed company have control as connected transactions; and

j) to expand the definition of "subsidiary" under the Listing Rules to include any entity which is accounted in the audited consolidated accounts of a listed company as a subsidiary under applicable accounting principles under SSAP 32 or IAS 27.

B) <u>Directors and Board Practices</u>

9. Directors and their boards are responsible for implementing good corporate governance practices within their companies. The "check and balance" role of independent directors and their independent state of mind are particularly important for enhancing the effectiveness and objectivity of the board's decision-making process, particularly when:

a) shareholders have different interests in a transaction;

b) connected persons are involved;

c) the transaction has a significant impact on the listed company and its shareholders; and

d) it relates to internal control and financial reporting system of the listed company.

10. To enable independent directors to contribute their independent views and perform their functions effectively, the Consultation Paper proposes the inclusion of more detailed guidelines in the Listing Rules to describe independence of independent directors. In addition, it proposes to require issuers to appoint independent directors representing not less than one-third of the members of the board to ensure that their views will carry significant weight in the board's decision, irrespective of the size of the board. In any event, the number of independent directors shall not be less than 2.

11. Taking into account the fact that issuers vary in size, business nature and operational structure, the Consultation Paper proposes to amend the Code of Best Practice which sets out the recommended minimum standards of board practices. While compliance with the Code of Best Practice is not mandatory, issuers will be required to disclose in their annual reports any deviations of their board practices from the standards set out in the Code.

12. Issuers will also be required to include a report on corporate governance in their annual reports. These reports shall include details of the issuers' corporate governance practices and any deviation from the minimum standards in the Code of Best Practice. This disclosure is intended to enable shareholders and investors to make an informed assessment of the companies' corporate governance practices and status.

13. As an audit committee plays an important role in overseeing companies' financial reporting process, the Consultation Paper proposes to make establishment of an audit committee mandatory. An audit committee shall have at least 3 non-executive directors, and a majority of independent directors. At least one of those independent directors shall have appropriate qualification or experience in financial reporting.

14. In relation to the role of auditors, it is noted that it has become quite common for an auditor to provide both audit and non-audit services to the same issuer. We acknowledge that auditors may provide professional advice to their listed clients and this may benefit the company as well as the shareholders as a whole. However, we consider it important that auditors should maintain their independence and audit committees should play a proactive role in ensuring that independence. Also, to assist shareholders in assessing the independence of their auditors, the Consultation Paper

proposes that issuers should disclose the audit and non-audit fees separately in their annual reports.

15. The existing Listing Rules do not make any reference to establishment of remuneration committee and nomination committee. To improve corporate governance standard, the Consultation Paper proposes to include in the Code of Best Practice a recommendation that issuers should establish a remuneration committee and a nomination committee. To avoid conflicts of interests, the remuneration committee should only comprise independent directors and the nomination committee should comprise a majority of independent directors.

16. Other principal proposals relating to directors and board practices are:

a) to recommend segregation of the roles of chairman and chief executive officer as a good practice;
b) to recommend issuers to regularly conduct a review of effectiveness of the group's internal control systems;
c) to shorten the "black out" period of directors' securities transactions for quarterly reporting from 1 months to 2 weeks;
d) to require shareholders' approval for directors' service contracts of more than 3 years or directors' service contracts that require issuers to give a period of notice of more than 1 year or to pay compensation of more than 1 year's remuneration (other than solely on account of an early termination by the issuer of a fixed term contract); and
e) to require issuers to disclose directors' remuneration and compensation packages by individual director showing the name of each director and his remuneration and compensation.

C) <u>Corporate reporting and disclosure of information</u>

17. HKEx is of the firm view that timely disclosure of quality of information by issuers is essential for good corporate governance. This would enable the public to make informed investment decisions and ensure that the affairs of issuers are conducted with transparency. In this regard, the Consultation Paper focuses on the frequency of and timeliness in the disclosure of financial information, and the adequacy and quality of information disclosed in issuers' documents including financial reports, announcements and circulars.

18. The Consultation paper proposes to require Main Board companies to publish quarterly reports and issue quarterly results announcements within 45 days after the quarter-end. Issuers will be required to publish their half-year results announcements and despatch their half-year reports within 2 months of the relevant financial period end. The publication deadline for annual reports will be 3 months after the end of the companies' financial year.

19. The Consultation Paper also proposes to amend the disclosure requirements for quarterly reports and results announcements of the GEM Rules to align them with those for the Main Board.

20. In addition, the Consultation Paper proposes certain refinements to the disclosure requirements for half-year and annual results announcements.

Conclusion

21. The recent Enron case has raised concerns about the quality and adequacy of corporate governance, among other issues. As set out in the foregoing paragraphs, HKEx is of the view that we must constantly review and update our Listing Rules to ensure that they are on par with best international market practice and standards. Publication of the Consultation Paper is timely as it has set out detailed proposals to improve the corporate governance standards of the Hong Kong market. Indeed, a number of the issues that have been raised in the wake of the Enron case have been addressed in the Consultation Paper, e.g. the treatment of connected transactions, the role of independent non-executive directors, the role of audit committees, disclosure of non-audit fees paid to auditors, and the quality and timeliness of financial and related reporting by issuers. We will be organizing a series of seminars and discussions with different sectors of the market to brief them on the proposals and to encourage them to respond to the consultation exercise. We would, of course, welcome comments and suggestions on corporate governance issues brought up in the wake of the Enron case even if they do not relate directly to the specific proposals in the Consultation Paper.

22. The consultation period will end on 22 April 2002. We would collate and analyze the response thereafter and finalize the rule amendments in consultation with the SFC.

Hong Kong Exchanges and Clearing Limited

Annex B

CORPORATE GOVERNANCE REVIEW BY THE SCCLR

SUMMARY OF PROPOSALS

1. Directors' duties

1.01 The SCCLR reviewed the law on directors' duties in Hong Kong as well as other common law jurisdictions. The SCCLR found the current state of law on fiduciary duties and the standards of care and skill in Hong Kong expected of directors generally acceptable. However, this is on the assumption that it is open for case law to demand higher standards of care and skill from directors, as evidenced in developments internationally.

1.02 In the absence of any great uncertainties in the law with regard to the duties of directors, the SCCLR did not see the need to enact these duties into statute for the following reasons: -

(a) Because the finding of a breach of duty would also depend on the complexities of the facts, it would not be possible for all duties to be properly encapsulated in the law;

(b) As a broad statement of principles would have to be framed in very general terms, it would have to be supplemented by detailed guidelines in non-statutory form;

(c) A broad statement of principles may not necessarily assist directors to clearly identify the extent of their duties nor would it help directors to determine how they should behave in any given set of circumstances;

(d) Statutory enactment would tend to be regarded as exclusive, would be inflexible and would not accommodate judicial developments to take into account changing standards;

(e) A broad statement of principles is unlikely to be of any additional assistance to shareholders;

(f) There is no intention to create criminal penalties for breach of directors' duties generally.

2. Voting by directors in relation to directors' self-dealing

2.01 General law on self dealing by directors does not prohibit an interested director voting on a matter in which he has a material interest if a company's constitution so permits. This position is also reflected in the existence of exceptions to this rule appearing in the default articles of association (Table A) in the Companies Ordinance.

2.02 However, the SCCLR considered that the current provisions under the Companies Ordinance and Table A could be improved in order to give effect to the general principle that a director should abstain from voting on a transaction in which he has an interest.

2.03 The SCCLR proposes the following amendments to the law: -

(a) The law should set out that the general position which is that an interested director should not vote at a board meeting on a matter in which he has an interest. The extent to which the articles of a company should be permitted to allow a director to be exempted from his duty to abstain from voting should be statutorily amended. Exceptions to the general prohibition will be set out in the law;

(b) Subsection 162(2) of the Companies Ordinance should be amended so that the interested director should make a disclosure of his interest on an *ad hoc* basis in addition to the general notice in advance. This is to ensure that directors are reminded of the possible conflict of interest and duty of the interested director at the time the proposal is put forward for consideration;

(c) Contracts, transactions or arrangements in which the director or connected persons have an interest should in any event be disclosed to shareholders. Where these are significant, they should also be referred to the shareholders for their approval;

(d) The law should also be amended to clarify the civil consequences of a breach of the general rule;

(e) The ambit of section 162 of the Companies Ordinance should be widened to cover 'transactions', 'arrangements' and 'connected persons'.

3. Shareholder approval for connected transactions of significance involving directors

3.01 The listing rules of the SEHK include a number of provisions dealing with connected transactions. The SCCLR found, however, that, other than in relation to the payments to directors in connection with the loss of office, the Companies

Ordinance does not require that shareholders' approval should be sought for transactions with the company involving directors or persons connected with directors under Hong Kong law. This is in contrast with the position in the other jurisdictions surveyed.

3.02 The SCCLR recommends the adoption of a statutory provision so that the approval of shareholders should be obtained in relation to transactions or arrangements of a requisite value involving directors or persons connected with directors. The relevant arrangement would not be limited to non-cash assets only but would apply to the acquisition or disposition of all assets and other arrangements potentially benefiting the director or connected person.

3.03 The SCCLR seeks the views of the public on: -

(a) Whether the test for determining the requisite value should be by reference to a net asset value test or a value which is the gross value less intangibles and less current liabilities in order to get to a longer view of the invested value of a company or some other appropriate test;
(b) The requisite percentage which would trigger the requirement for shareholders' approval for the purposes of legislation;
(c) Whether there should be a *de minimis* absolute figure which would be excluded from this requirement, and if so, what amount would be appropriate?

3.04 This requirement would extend to the directors of unlisted public companies or persons connected to them as well as to the directors of private companies. In the case of private companies where no quorum of disinterested directors can be constituted, the transaction or arrangement should be referred to shareholders for their unanimous approval.

3.05 The proposal is intended to set out more clearly, the circumstances under which shareholders' approval should be obtained for arrangements involving directors, or in relation to persons connected to directors and the consequences of the breach of such rules.

4. Transactions between directors or connected parties with an associated company

4.01 The SCCLR considered whether the approval of the shareholders be obtained in relation to transactions or arrangements between (i) a director or connected person and (ii) other "associated companies or corporations".

4.02 Currently Chapter 14 of the listing rules regulates "connected transactions". Relevant arrangements and transactions include arrangements and transactions between "connected persons" and the listed company itself or its subsidiary. The

SCCLR found, however, that the listing rules do not currently address arrangements and transactions entered into between: -

(a) a director of a listed company (or connected person); and
(b) a company that does not fall within the definition of a "subsidiary" of the listed company, i.e. where the listed company or its subsidiary holds less than 51% of the company in question (referred to, for ease of reference, as an "associated company").

4.03 Since the definition of "subsidiaries" does not extend to such companies, neither the approval of shareholders, nor disclosure or notification to shareholders will be necessary in relation to the transaction in question. Accounting principles, on the other hand, would take into account the possible influence that the company would have in relation to companies in which it has less than 51% share ownership.

4.04 The SCCLR proposes that:-

(a) The listing rules relating to connected party transactions should be extended to an "associated company" and not limited to "subsidiaries". The SCCLR considers that the "associated company" for these purposes, should be defined as one in which the listed company controls the exercise of 20% or more of the voting rights of the equity share capital;

(b) The Companies Ordinance should require the approval of disinterested shareholders in relation to transactions involving directors or connected persons and an associated company;

(c) The proposed provision under the Companies Ordinance (as discussed in section 2 above) would in addition equally apply to arrangements between: -

- the associated company of the company; and
- directors of the company or directors of its holding company or other persons connected with the director.

5. Nomination and election of directors

5.01 The SCCLR considered that the current requirements in relation to nomination and election of directors do not provide all shareholders with a meaningful procedure by which to nominate and elect directors.

5.02 Under common law principles, the right to vote for directors may belong to the shareholders. The SCCLR found that, in practice, even though the shareholder has in theory the right to nominate shareholders, the provisions in articles of association generally mean that:-

(a) the time frame within which a shareholder may leave a notice of nomination can be extremely small; and

(b) details of the nominee may not be circulated among the shareholders as a whole and he may need to bear the costs of circulating the details himself prior to the meeting.

5.03 The SCCLR found also that, in practice, because of the control that management has over the procedure for nomination, it is *management* that would be in the position to determine or influence the composition of the board through the nomination process. In Hong Kong, where in some of the public companies there is generally little separation between the board and the controlling shareholder, it is the *controlling shareholder* that would in many cases be in the best position to control the ultimate composition of the board.

5.04 The SCCLR makes the following recommendation, subject to the results of the further studies and consultations with the Universities :-

(a) There should be a statutory requirement for the effective circulation of notices relating to a nominee proposed by shareholders in time for the date fixed for election. The existing period during which the shareholders can lodge a proposal for a candidate for the position should also be amended so that shareholders will have a realistic time frame within which to effectively lodge their nominations;

(b) There should be a requirement that the biographical details of a candidate for a directorship must be set out for shareholders' information. Private companies may, however, be able to exclude this requirement by unanimous agreement in writing;

(c) For the time being, the use of formal procedures for the nomination of directors should be encouraged as a matter of best practice. Any such procedures should be fair and disclosed to the shareholders. The manner of selection of nominees should therefore be set out in the notices to shareholders of the proposed AGM;

(d) Companies should be encouraged to adopt the cumulative voting procedure if they wish to, without, however, making such a voting procedure mandatory;

(e) The right of the shareholders to elect directors should be clearly set out in legislation so that it cannot be excluded by the articles of association of the company;

(f) If any director has resigned or declined to stand for re-election since the last annual general meeting and has set out his reasons for disagreement to

the company, the company should also set out a summary of this disagreement in its report to shareholders.

6. Role of the independent director

6.01 Should the role of the independent director differ from the role of other directors in law? On the whole, the SCCLR finds that the *duties* of an independent director in law are not different from those of an executive director. The SCCLR concluded that:-

(a) The law sets out the principle of the collective duty of the board of directors and their core obligations;

(b) Jurisdictional studies show that the courts should be able to accommodate the standards expected of directors within the principle of the collective duties of directors. This is done by reference to various factors including the tasks or functions a person under those circumstances or position is to perform.

6.02 In the Hong Kong context, the SCCLR does not believe, at this stage, that it would be practicable to impose a general statutory duty for the independent director(s) to perform a special monitoring role to represent the interests of minority shareholders. The SCCLR therefore recommends that:-

(a) The role of the non-executive director, independent or otherwise, should not be set out in statute;

(b) Functions of the non-executive directors under specific circumstances may be found in Codes of Best Practices or roles specifically assigned to them. In the case of public listed companies, the functions of the non-executive and independent directors under specific circumstances may be set out in a Code of Best Practices. This may include, for example, the functions of such directors in situations where executive directors or other directors might have conflicts of interest;

(c) Independent directors or advisors could be appointed with specific monitoring roles, for instance, where the existing board has breached its obligations to comply with the listing rules.

PROPOSALS IN CHAPTER 3 ON SHAREHOLDERS

7. Self-dealing by controlling shareholders

7.01 Should shareholders or persons connected to the shareholders be under a duty to

abstain from voting in a transaction in which they have an interest, which is an interest that is different from other shareholders?

7.02 In Hong Kong, as in other common law jurisdictions such as the United Kingdom and Singapore, fiduciary principles apply to a *director* so that he may be prohibited from voting in a transaction in which he has an interest. However, unlike the director, there is support for the view that the shareholder, in his capacity as a shareholder, is not subject to the rule that he must avoid conflicts of interest. This applies even where the shareholder is a director of the company.

7.03 Chapter 14 of the listing rules of the SEHK prescribes in considerable detail how connected transactions in Hong Kong are to be dealt with. For significant "connected transactions", shareholders deemed to be "interested" persons are not permitted to vote.

7.04 The SCCLR found that the issue of whether or not the majority shareholder has the right to vote in his own selfish interest is also relevant to the discussion as to whether or not a transaction can be ratified, and therefore whether a derivative action can be taken.

7.05 Apart from *de minimis* and defined exemptions, the laws of jurisdictions such Australia and the States require disinterested shareholder voting in relation to transactions in which controllers have an interest. Malaysia is also proposing to adopt this approach in the law. While the United Kingdom and Singapore have not incorporated this requirement into the law (to the extent that the controlling shareholder is not connected to the director or a connected person of the director), the requirement nevertheless applies in relation to listed companies and their subsidiary undertakings under their respective listing rules.

7.06 The SCCLR proposes that:-

(a) For commercial certainty, shareholders should be normally be bound by their approval of a self-dealing transaction in which the director or substantial shareholder or other connected person has an interest. However, these should be subject to the exceptions in relation to transactions involving dishonesty, bad faith and "misappropriation of company assets". The exceptions reflect the current position under general law where such transactions cannot be ratified at all, whether by unanimous shareholder resolution or otherwise;

(b) To ensure procedural fairness, connected transactions must be disclosed and subject to a disinterested shareholders' vote, with interested shareholders abstaining from voting;

(c) This rule would be subject to certain exceptions such as transactions entered into by liquidators during the course of compulsory winding up or on a general reduction of capital, and, in the case of listed companies, the

limited exemptions allowed under the listing rules. The rule would also be subject to other *de minimis* exceptions, along the lines of any proposal (after the consultation referred to in paragraph 3.03 above) in relation to director-related transactions;

(d) In order to ensure that the views of all disinterested shareholders are properly reflected, voting must, under such circumstances, take place on a poll. This is in contrast to the current position where shareholders must first demand for a poll;

(e) The court's power to determine whether or not the transaction constitutes a waste of corporate assets should be nevertheless specifically preserved;

(f) A failure to follow this rule of procedural fairness, i.e. disclose and obtain the approval of the disinterested shareholders, means that the transaction should be voidable at the instance of the company, provided that *bona fide* third party rights are not affected, or if restitution is not lost. Transactions (not constituting a waste of corporate assets or involving dishonesty or in bad faith or illegal acts) should remain capable of being ratified by disinterested shareholders within a reasonable time;

(g) The liability of the interested shareholder to compensate the company should arise where the transaction is found by the court to be a waste of corporate assets and the interested shareholder has benefited from the transaction. Certain presumptions will apply :-

(i) If there is no disclosure and approval of the disinterested shareholder has not been obtained, the burden falls on the interested shareholder to show that the transaction is not a waste of corporate assets or a transaction in bad faith from which he has benefited. Otherwise the burden still lies with the plaintiff;

(ii) If the company goes into liquidation within one year from which the transaction was entered into, the burden also falls on the interested shareholder to show that the transaction is not a waste of corporate assets or a transaction in bad faith from which he has benefited. If he fails to discharge this burden, criminal sanctions may be imposed. The extent of his civil and criminal liability will need to be set out under statute.

8. Derivative action

8.01 The SCCLR has found that, particularly in the case of listed companies, where a secondary market exists, there are few incentives and considerable practical difficulties for minority shareholders to take action on behalf of the company. The SCCLR identified practical difficulties with derivative actions in Hong Kong, including the following: -

(a) The shareholder bringing the action is potentially liable for the costs of the action even though he has no corresponding right to the potential damages. The court has a general power to order the company to provide the plaintiff an indemnity as to the costs of the action, although the precise circumstances are not clear;

(b) Damages are attributable to the company and not to the individual minority shareholder;

(c) Shareholders (who are not insiders) are likely to find that they are effectively prevented from taking action because they are unable to access information or the wrongdoers in order to commence a proper action;

(d) Apart from winding up proceedings or actions under section 37A of the Securities and Futures Ordinance, the SCCLR found that it is not entirely clear whether shareholders' remedies for corporate injury to companies incorporated outside the jurisdiction of Hong Kong would be entertained;

8.02 To the extent that the unfair prejudice remedy may not be currently available for corporate injuries, the SCCLR considers that the derivative action procedure should be maintained. It also proposes the introduction of a statutory derivative action to make it clear that: -

(a) There will be no 'trial within a trial' for the purpose of determining the standing of an applicant to commence a derivative action on behalf of the company. Shareholders, at the time the cause of action arose, directors and officers of the company, past or present, may commence the action in the court;

(b) The court's power to ensure that there has been no illegal or fraudulent transactions or those that constitute a waste of corporate assets (non-"ratifiable" transactions) or which affect the personal rights of shareholders should be specifically preserved. Where the approval of disinterested shareholders has not been secured, the burden should fall on the controlling shareholder to show that the transaction was fair and not to the detriment of the company;

(c) Ratification by general meeting would, however, not be a bar to the commencement of the proceedings. Where there is apparent wrongdoer involvement in a "ratifiable" transaction (i.e. where the wrongdoer appears to have profited from the transaction in breach of his duties or a director is also a controlling shareholder or related to a controlling shareholder), only "independent" shareholders can ratify the transaction;

(d) The derivative action is intended to allow shareholders or directors of the company to bring an action on behalf of the company for a wrong done to the company where the company is unwilling or unable to do so. The grounds for such action would include the following :-

- fraud;
- negligence;
- default in relation to any laws or rules;
- breach of any duty, whether fiduciary or statutory.

9. Unfair prejudice

9.01 The SCCLR reviewed and considered the usefulness and adequacy of the unfair prejudice remedy. The SCCLR found that the difficulties faced by a petitioner in relation to the application of the remedy under section 168A of the Companies Ordinance might be as follows: -

(a) In relation to listed companies, it is not clear that the remedies available under this section are necessarily adequate, since it may not be practicable in all circumstances, for instance, for the court to require a buy-out of minority shareholders. It is not clear that the shareholder bringing the action has a right to the damages;

(b) As with the derivative action, it does not appear that legal aid is available to a petitioner seeking an unfair prejudice remedy. The court might grant such an order as to costs, but again the circumstances under which it would do so are not entirely clear;

(c) Apart from section 37A of the Securities and Futures Ordinance, the remedy is not available in relation to shareholders of oversea companies;

(d) As with derivative actions, shareholders (who are not insiders) are likely to find that they are effectively prevented from taking action because they are unable to access information or the wrongdoers in order to commence a proper action;

(e) The SCCLR also concluded that section 168A is inconsistent with section 147(2)(b) in relation to oversea companies and needs to be rectified.

9.02 The SCCLR proposes that: -

(a) The powers in section 168A should be amended to make it clear that the court has the power to award damages by way of a remedy to shareholders or former shareholders (as shareholders at the time the cause of action arose) in circumstances of unfair prejudice. The court should also have the

power to award interest on damages on such terms as the court shall think fit;

(b) Subsection 168A(2)(c) should be expanded to allow an order for compensation of costs to be paid to the shareholders undertaking representative actions;

(c) Subsection 168A(2)(c) should be expanded to allow the court to require controlling shareholders to buy out the minority shareholders;

(d) Section 168A of the Companies Ordinance should also be amended to allow members of oversea companies, as well as Hong Kong incorporated companies, to commence an action for unfair prejudice;

10. Personal rights

10.01 The SCCLR has recommended previously that the law should be clarified so an individual member can enforce all rights in the memorandum and articles of association as personal rights. The recommendations are contained in the Companies (Amendment) (No. 2) Bill 2001.

11. Orders for inspection

11.01 If such rights of inspection are not incorporated into the articles of the company, shareholders may find it difficult to sue in the event of breach of their rights or injury to the company. On the other hand, the SCCLR found that the rights of minority shareholders should be balanced against the possibility of harassment by shareholders seeking access to the company's accounts, books or papers for without proper grounds.

11.02 In line with other jurisdictions, the SCCLR proposes that a statutory method by which shareholders can obtain access to company records should be provided, subject to the prescribed safeguards, on application to the court.

12. Other powers of the court

12.01 The SCCLR also considered whether additional powers of the court might be useful to help address current practical difficulties in enforcing the duties of directors, connected persons or controlling shareholders under statute or case law.

12.02 The SCCLR proposes that :-

(a) The court should have a general power, on application by an affected person or, a relevant authority, to grant an injunction against any contravention of the Companies Ordinance or any breach of fiduciary duties. This should extend to any attempt to contravene such provisions or attempted breach of any of the directors' duties. The court should be entitled on the application of any person whose interests have been, are or would be affected by the conduct, to grant an injunction. This should be on such terms as the court thinks appropriate, restraining the person from engaging in the conduct and, if in the opinion of the court it is desirable to do so, requiring that person to do any act or thing;

(b) The court should at least have a clear general power to grant orders as to costs for shareholders for the purposes of taking action in respect of corporate injury as well as for unfair prejudice actions. This is subject to the requirement that the court will be satisfied that there is no evidence of bad faith on the part of the plaintiff and that the plaintiff has reasonable grounds on which to commence an action;

(c) The powers of the courts to make these orders should be expanded to all companies registered in Hong Kong including companies incorporated outside Hong Kong but registered under Part XI of the Companies Ordinance.

13. The role of regulators

13.01 The SCCLR proposes that it should be made clear that the securities regulator is able, without court approval, to bring derivative actions against wrongdoers in relation to a public company including an oversea company listed on the SEHK for breaches of duty on behalf of the company. This is subject to the proviso that (a) the regulator shall exercise its power in the public interest as well as in the interest of the company, and (b) it shall not be entitled to indemnities as to costs from the company.

13.02 The grounds on which the SFC should be able to commence proceedings should be wide and should include the following: -

- fraud;
- negligence;
- default in relation to any laws or rules;
- breach of any duty, whether fiduciary or statutory; or
- any other misconduct committed in connection with a matter to which any investigation or examination relates, or the recovery of property of any person including the property of the company.

PROPOSALS IN CHAPTER 4 ON CORPORATE REPORTING

14. Filing of financial statements

14.01 The SCCLR proposes that private companies with limited liability should file their financial statements with the Companies Registry (CR) for public inspection. The SCCLR considers that the proposal is conducive to good corporate governance. It would enable parties such as the suppliers and creditors of private companies with limited liability to have better access to financial information on private companies and have a better assessment of the risks inherent in their dealings with these companies.

15. Management discussion and analysis

15.01 The Hong Kong listing rules require listed companies to prepare a Management Discussion and Analysis (MD&A), which comprises a statement containing a discussion and analysis of the group's performance during the financial year and the material factors underlying its results and financial position. It should emphasize trends and identify significant events or transactions during the financial year under review.

15.02 The review includes: -

(a) Comments on segmental information. This may cover changes in the industry segment, developments within the segment and their effect on the results of that segment;
(b) Prospects for new business including new products and services introduced or announced; and
(c) Details of material acquisitions and disposals of subsidiaries and associated companies.

15.03 The MD&A also contains details of the number and remuneration of employees, remuneration policies, bonus and share option schemes and training schemes, information about its major customers, information about its major suppliers, brief biographical details of the directors and senior managers, and information about financial risks.

15.04 In the United Kingdom, it is proposed that each listed company should include an Operating and Financial Review (OFR) in its annual report. The OFR requires disclosure on the following areas :-

(a) A fair review of the development of the company's and/or group's business over the year and position at the end of it, including material post year end events, operating performance and material changes;
(b) The company's purpose, strategy and principal drivers of performance;
(c) An account of the company's key relationships with employees, customers, suppliers and others, on which its success depends;
(d) Corporate governance – values and structures;
(e) Dynamics of the business – i.e. known events, trends, uncertainties and other factors which may substantially affect future performance, including investment programmes;
(f) Environmental policies and performance, including compliance with relevant laws and regulations;
(g) Policies and performance on community, social, ethical and reputational issues; and
(h) Receipts from, and returns to, shareholders.

15.05 The SCCLR proposes that the listing rules on MD&A should be amended to include more qualitative and forward looking disclosure on areas as shown in paragraph 15.04.

16. Inconsistencies between the audited financial statements and other financial information contained in the directors' report and other sections of the annual report

16.01 The SCCLR proposes that the Companies Ordinance should be amended to enable auditors to report on any inconsistencies between the audited financial statements and financial information contained in the directors' reports. As it is in the public interest for auditors to be tasked with reporting any abnormalities found in directors' reports, it would be unreasonable for auditors to be penalized for doing so. Views are also sought as to whether such qualified privilege should be extended to enable the auditors to report inconsistencies between the audited financial statements and financial information contained in other sections of the annual reports normally distributed by listed companies.

17. Accounting reference date

17.01 The Companies Ordinance does not provide for a company's financial year and accounting reference periods. Section 122 of the Ordinance requires accounts to be made out in every calendar year, to be laid before the company's annual general meeting, and those accounts shall be made up to a date falling not more than certain months before the date of the meeting. Section 111 of the Companies Ordinance requires that not more than 15 months shall elapse between the date of the one annual general meeting and the next. Section 111 indirectly requires accounts to be made up for a period of not more than 15 months, but there are no rules on shorter accounting periods. In addition, there is no provision to regulate the first accounting period, except that the first annual general meeting has to be held within 18 months of incorporation, and accounts are required to be laid at the annual general meeting.

17.02 The SCCLR proposes that the Companies Ordinance should be amended to provide for an accounting reference date, an accounting reference period and financial year. The SCCLR considers that there may be merit in tackling the question of an accounting reference date in the context of a major review of the accounting and auditing provisions in Part IV of the Companies Ordinance. However, the SCCLR is prepared to deal with the question of the accounting reference date ahead of the review if this is supported by public opinion.

18. Standards setting process

18.01 The SCCLR considered the extent to which the accounting and auditing standards setting process may be improved. The SCCLR believes that Hong Kong does not need independent standard setting bodies for accounting and auditing standards, given that they are very closely modeled on IASs and ISAs. The standard setting function should continue to be vested in the HKSA but the composition of the Financial Accounting Standards Committee (FASC) and Accounting Standards Committee (AuSC) of the HKSA should be widened to cater for more involvement of the public.

18.02 The SCCLR proposes that wider representation on the FASC and AuSC would increase the credibility of the standards set by these committees. The SCCLR thus proposes that:-

(a) The FASC should comprise 10 to 15 persons drawn from :-
- the accountancy profession;
- the users of financial statements;
- the preparers of financial statements;
- the business community;
- the regulators of the securities and banking industries;
- academia;
- the investment community;
- members of the public

(b) The AuSC should comprise 10 to 15 persons drawn from :-
- the accountancy profession;
- the preparers of financial statements;
- the regulators of the securities, banking and insurance industries;
- the relevant Government departments;
- the banking industry;
- academia;
- members of the public.

(c) The Chairmen of the FASC and AuSC should be members of the Council of the HKSA;

(d) The HKSA should approach relevant organisations for nominations with regard to their representatives instead of appointing individuals;

(e) Where the appointment of lay members is concerned, the HKSA should adopt the following means –

(i) approaching the Consumer Council for representatives; or
(ii) conducting a public recruitment exercise to select persons with a good public service track record; or
(iii) seeking nominations from the members of the FASC and AuSC;

(f) Alternates of members should be allowed.

19. Body to investigate financial statements

19.01 The SCCLR finds that there is no body in Hong Kong tasked with making enquiries into the accounts of companies on their compliance with the accounting requirements in the Companies Ordinance, accounting standards and the true and fair view requirement. Neither is there a mechanism whereby directors may be required to revise and re-issue accounts.

19.02 The SCCLR seeks the views of the public on the proposal, as a means of strengthening our regulatory framework for financial reporting, to set up a body similar to the Financial Reporting Review Panel (FRRP) in the United Kingdom. Such a body would be is responsible for formulating general policy for the maintenance and improvement of financial reporting practices. The FRRP's function is to examine apparent departures from the accounting requirements of the Companies Act 1985, including applicable accounting standards, and its jurisdiction is confined to the accounts of public listed companies and large private companies. However, the FRRP does not proactively review accounts for non-compliance but reacts to matters that come to its attention, mainly through complaints and press reports.

19.03 The views of the public are also sought on associated issues as follows: –

(a) The functions of the body, i.e. to respond to complaints by enquiring into the financial statements of companies where there may be a failure to comply with the accounting requirements of the Companies Ordinance, including the compliance with applicable accounting standards and the true and fair view requirement, to have the power to apply to the court for an order to require a company to re-issue accounts that do not comply with the requirements in the law;

(b) The jurisdiction of the body; i.e. should the body's work be confined to certain categories of companies, for example, public companies and/or large private companies only?

(c) The mode of establishment for the body, i.e. there are different modes for establishing the body, including an independent body similar to that in the United Kingdom, parking the body with a regulator, or a self-regulating professional body.

20. Quality of audit practice and monitoring of audit practice

20.01 In Hong Kong, the HKSA is the regulator of company auditors. To monitor compliance with auditing standards by auditors, the HKSA has regular

programmes such as the Professional Standards Monitoring Committee Programme and the Practice Review Programme under Part IVA of the Professional Accountants Ordinance, which monitors the quality of all audit practices. In addition to the regular monitoring programmes, the HKSA also has the power to conduct formal investigations under Part VA of the Professional Accountants Ordinance into specific complaints on specific acts or omissions of all HKSA members that have attracted public concern. Among these measures, the SCCLR considers that the Practice Review is the key element to monitor compliance with auditing standards and to ensure quality of audit practice. Now that the Practice Review has been in operation for eight years, the SCCLR would like to invite the public's comments on possible further improvements to the Practice Reviews undertaken by the HKSA.

20.02 In 1992, the HKSA introduced the Practice Review under Part IVA of the Professional Accountants Ordinance. The Practice Review empowers the HKSA to perform on-site reviews of the audit procedures and working papers of certified public accountants' practices in order to monitor compliance with auditing standards. The Practice Review goes beyond just the presentation of the financial statements and actually looks at the underlying auditing process regarding the data contained in the financial statements and cover audits of not only listed companies but also private companies.

20.03 The SCCLR would like to ask the public to comment as to whether there are possible improvements to the HKSA's Practice Review and in particular -

(a) Whether the current "one standard fits all" approach is appropriate? Should a higher standard be required for firms auditing public companies ?

(b) Should the frequency of reviews be higher for those audit firms that audit public companies, bearing in mind the additional costs that might be involved and be borne by the audit firms, and eventually, the business community?

(c) Whether audit firms performing audits of listed companies or companies with significant public interest should be subject to additional scrutiny or a separate regulatory regime?

21. Revision of audited financial statements and related matters

21.01 There are no statutory provisions at present for the revision of the financial statements after they have been laid before the company in general meeting or delivered to the registrar. This has created an undesirable uncertainty for companies and their auditors as to the proper legal steps to be taken to correct financial statements when they are found to be defective after they have gone through the due process of being approved at the AGM and filed with the CR.

Furthermore, there is no statutory mechanism to allow the company or its auditors to prevent the public from further reliance on the filed financial statements.

21.02 It is, however, not uncommon that information may come to light or become known to the directors or the auditors after the financial statements have been issued that suggest that the financial statements had been incorrectly prepared based on wrong or omitted information unknown at the time.

21.03 The SCCLR proposes that -

(a) Where it comes to the directors' attention that there are material misstatements in the financial statements that have been laid before the company in the general meeting and filed (in case of public companies), they should file a warning document with the CR to prevent further reliance on that set of financial statements at the earliest possible opportunity. In the meantime, the directors should work with the auditors to prepare and file revised financial statements and a revised auditors' report;

(b) If the auditors find that there are material misstatements in the financial statements that have been laid and filed (in case of public companies), they should report this to the directors. The directors should be required to respond to the auditors as to whether the company will file a warning document with the CR to prevent further reliance on the financial statements;

(c) If the directors agree with the auditors, this will trigger the mechanism set out in (a) above. If the directors refuse to file a warning document, the law should allow the auditors to file such a document; and

(d) The Companies Ordinance should be amended so that the directors would be required to work with the auditors with a view to revising the financial statements in question.