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2867 2820
2869 1007

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edwardlau@cr.gov.hk

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

BY FAX: 2869 6794

Dear Ms SZETO,

**Re : Bills Committee on Financial Reporting Council Bill
Invitation for submissions**

Thank you for your letter of 27 July 2005 inviting the Standing Committee on Company Law Reform (“SCCLR”) to give views on the Financial Reporting Council (“FRC”) Bill. As the legislative proposals to establish the FRC were only recently discussed by the SCCLR at its 189th meeting on 2 April 2005, no further meeting has been called to go through the clauses in the Bill on this particular occasion. Instead, members have been invited to give comments by way of circulation. The majority of the members have no comments on the Bill. Two of the members have, however, specifically replied and their comments are as set out below.

(1) ***The remit of the AIB and the FRRC should be expanded to cover all situations where financial reports would be required to be prepared and widely circulated***

This is the only recommendation made by the SCCLR at its 189th meeting which has not been adopted by the Administration. The Administration is of the view that the present definition of the remit is wide enough to enable the AIB and the FRRC to focus on the audit and reporting of key financial information that is published under the relevant statutory or regulatory requirements and involves a greater degree of public interest.

The commenting member remains, however, of the view that, under the current drafting of the definitions of “specified report” and “listing document”, many financial reports required to be prepared and widely circulated in accordance with both the Main Board and the GEM Listing Rules (the “Listing Rules”) will fall outside the coverage of the Bill.

First of all, the definition of “listing document” in the Bill does not cover the listing documents prepared in connection with applications for listing by way of introduction (i.e. introduction documents) whereby no offers of securities are made in the primary market. These introduction documents (which count as listing documents for the purpose of the Listing Rules) are considered by investors in the secondary markets to be as important as prospectuses. Under the Listing Rules, introduction documents are expressly included in the definition of “listing document”.

Secondly, the definition of “specified report” does not cover financial reports included in circulars required to be prepared and circulated by listed companies in connection with major transactions, very substantial acquisitions and very substantial disposals (as such terms are defined in the Listing Rules). As these financial reports are not audited financial statements or “specified reports” as defined in the Bill, they are also not covered by the Bill. However, the fact remains that they are of no less significance to the investing public.

For the reasons stated above, consideration should be given to appropriately expand the definitions of “specified report” and “listing document”.

(2) **The FRC should be empowered to consult with the HKICPA as to the proper interpretation of Financial Reporting Standards**

The commenting member agrees with the conclusion stated in paragraph 7 of the Legislative Council Brief that there is no need to set up a separate body to hear appeals against the decisions of the FRC, but only in so far as the FRC is performing its investigatory/enquiry role against suspected irregularities concerning auditors, which if established, would be further referred to an appropriate regulatory authority for follow-up action. As regards investigations/enquiries into suspected non-compliance with financial reporting standards, the lack of some sort of appeal tribunal provisions (other than judicial review) may not be appropriate. In addition, there is no provision in the Bill which confers power on the FRC to consult with the HKICPA, as the Financial Reporting Standards setting body, in cases of revision of accounts under the proposed sections 49 and 50 of the Bill when the directors or auditors of the listed entities do not agree with the FRC’s interpretation of the

relevant Financial Reporting Standards. The absence of such a consultation process may result in the FRC interpreting certain Financial Reporting Standards differently from the standard setters themselves, although the likelihood of this is remote. Safeguards in this respect should therefore be introduced to ensure that, where the matter under investigation involves the interpretation of financial reporting standards, the HKICPA, as the standard setting body, should be consulted. Even though the proposals in respect of the functions, power and composition of the FRRC are modelled on a similar set-up in the UK, the commenting member believes that the situation is in fact different because in the UK, the FRC plays the combined role of enforcer and standard setter through the Accounting Standards Board whereas, in Hong Kong, the proposed FRC is a body independent from the standard setting body, namely the HKICPA.

(3) **The FRC's power to take proactive investigations should be carefully exercised**

Section 9 of the Bill sets out that the functions of the FRC include investigating or enquiring “in response to a complaint or otherwise.” This provides the FRC with the power to adopt a proactive approach to its work, rather than solely relying on referrals and other information received. Whilst it is important to allow the FRC flexibility in the performance of its duties, its scope should remain primarily reactive upon receipt of referrals from other regulators and complainants. In the case of proactive investigations, it is important that there should be checks and balances to ensure that, before any investigation is commenced, due consideration is given to the costs and benefits of carrying out the investigation, taking into account the estimated costs, resources and demands that such an investigation is likely to impose on all the parties concerned, including the FRC and those individuals and entities which may be involved in the investigation. Furthermore, it is important to take note of any new developments in corporate financial reporting when carrying out any such cost-benefit analysis giving weight to any revision or proposed revision to the Financial Reporting Standards or interpretations which are likely to come into effect shortly.

When the SCCLR discussed the Consultation Paper on “the Legislative Proposals to Establish the Financial Reporting Council” at its 189th meeting on 2 April 2005, members were generally in support of the proposals to establish the FRC, an AIB and a FRRC for the purposes stated in the Consultation Paper. They emphasised particularly the importance of providing adequate funding for the FRC and the need for the new body to gain public recognition and acceptance through achieving demonstrable results in good time. They also raised concerns and recommendations on a number of specific issues which have all been taken on by the Administration and reflected in the Bill apart from the one to expand the remit of the AIB and the FRRC.

These concerns and recommendations include :-

Recommendations

- The remit of the AIB and the FRRC should be expanded to cover all situations where financial reports would be required to be prepared and widely circulated.
- A legal cost reclaim mechanism should be established to enable the HKICPA to recover costs in relation to cases referred to them by the FRC for taking disciplinary proceedings.
- There should be clear provisions in the FRC Ordinance
 - ✧ giving a FRRC the discretion to decide whether to take “pro-active approach” in performing its functions.
 - ✧ permitting cross referral of cases between the AIB and a FRRC.
 - ✧ enabling the FRC to engage full time staff to assist in the work of the AIB and a FRRC.
 - ✧ enabling the FRC to refer those matters beyond its remit to other relevant authorities for appropriate follow-up action.

Concerns

- Whether it be appropriate to empower the FRC to publish AIB/FRRC investigation reports.
- Whether liquidators should be included as a “relevant body” to whom the FRC would refer a case or disclose the relevant information obtained.

Yours sincerely,

(Edward Lau)
Secretary

Standing Committee on Company Law Reform