



Clerk to Bills Committee  
Legislative Council Building  
8 Jackson Road  
Central  
Hong Kong

Attn: Ms Connie Szeto

9 September 2005

Dear Madam

**Financial Reporting Council Bill**

We refer to your letter dated 27 July 2005 inviting us for comments on the above Bill. On behalf of ACCA (the Association of Chartered Certified Accountants), we present our response as attached.

If you or any of your colleagues wish to discuss with us the contents of our submission, please feel free to contact Ms Sonia Khao, Head of Technical Services (Hong Kong) at 2524 4988.

Yours faithfully

A handwritten signature in black ink, appearing to read 'May Law', is written over a light blue horizontal line.

May Law  
Head of ACCA Hong Kong

Enclosures



## **RESPONSE TO INVITATION TO COMMENT ON THE FINANCIAL REPORTING COUNCIL BILL**

### **Introduction**

1. ACCA is pleased to submit its comments on the Financial Reporting Council Bill (the “Bill”). ACCA is the largest and fastest-growing international accountancy body in the world, with over 345,000 members and students in 160 countries, including over 33,000 in Hong Kong. It has an extensive network of over 75 staffed offices and other centres around the world.

ACCA’s unrivalled access to companies, governments, regulators and practitioners across the world gives it a unique perspective on the needs of modern accounting and financial management. ACCA has helped to develop professional bodies and regulatory structures in a wide range of countries including the UK, Canada, Cyprus and South Africa. It has therefore, both a global perspective and a distinct interest in developments in Hong Kong.

2. In assessing the proposals set out in the Consultation Paper issued in February 2005, we recognised that balance is required between serving the needs of Hong Kong and having regard to international trends. A solution derived simply from other jurisdictions may not be appropriate, and may even be counter-productive; however, a solution which focuses too narrowly on domestic considerations and ignores clear signals about international best practice is unlikely to achieve the goals of rebuilding confidence.

These further comments have been formulated in the light of the objective set out in the consultation paper issued by the Administration in September 2003, namely *“to ensure an effective, transparent and accountable regulatory regime for the auditing profession that is in line with international developments”*.

3. In this document, we first compare the principles embodied in the Bill with our recommendations set out in our previous response (Part A). We then consider the detailed wording of the Bill (Part B).

## **Part A: The Principles**

### ***Overall structure***

4. We welcome the establishment of a Financial Reporting Council (FRC) to oversee both the Audit Investigation Board (AIB) and the Financial Reporting Review Committees (FRRCs).

### ***Financial Reporting Council***

5. Section 7 of the Bill sets out the proposed composition of the FRC. This includes “not fewer than 4, and not more than 6, other members appointed by the Chief Executive”. Our proposal in response to the consultation paper – that these members of the FRC should represent the stakeholder groups that the FRC is intended to protect – has not been incorporated into the Bill. Therefore, certain stakeholders such as listed companies, investors etc may not be adequately represented amongst these four to six members.
6. Section 2 of Schedule 2 to the Bill states that appointments to the FRC should be for a term not exceeding three years, although members can be reappointed. We stated in our response to the consultation paper that, as a good corporate governance practice, there should be a maximum term for any member reappointed. The Bill is silent in this respect.
7. One of the specific issues for consultation listed in the February 2005 consultation paper was whether the proposed accountability measures were appropriate in ensuring that the FRC would perform its functions independently, fairly, properly, efficiently and with due propriety? In response, we expressed our belief that the proposal to include in the Bill a provision allowing the Chief Executive to give the FRC written directions as he thinks fit as to the performance of any of its functions may be perceived as a lack of independence. Nevertheless, the provision has been included in the Bill without moderation.

According to an IMF Country Report on HKSAR’s securities regulation, it states that “the power of the Chief Executive of HKSAR to give a direction to the SFC about any matter relevant to the performance of its functions is inconsistent with its statutory role as an independent securities regulator”.

8. Section 10 (1) empowers the FRC to “do all such things as are necessary for, or incidental or conducive to, the performance of its functions”. This includes referring a case or complaint to a specified body and providing assistance to a specified body. Beyond this, the FRC is not vested with enforcement or disciplinary powers to sanction anyone or to impose a penalty. We strongly feel that the current situation – that the function of the FRC should remain purely investigatory – are inappropriate for two main reasons:
  - The Bill, as it stands, is inconsistent with the IOSCO Principles for Auditor Oversight. To be consistent with these Principles, there should be a mechanism to make auditors subject to discipline by an oversight body that is independent of the profession. If cases are referred to HKICPA or other professional bodies for disciplinary proceedings, the FRC should act in the monitoring role to ensure proper follow up actions take place.
  - The Bill is inadequate to meet the objectives of transparency and accountability summarised in paragraph 2 of this response, particularly when the case is to be referred to a professional accountancy body. The regulatory process is undermined if public interest disciplinary action remains in the hands of a professional accountancy body, giving rise to a lack of independence (or at least a perceived lack of independence) at the end of the regulatory process.
9. If cases are referred to a professional accountancy body for disciplinary proceedings, the FRC should act in a monitoring role to ensure that appropriate actions are taken. This recommendation is consistent with our proposals, set out in paragraphs 7 and 24 of our previous response, that there should be provision for the accountancy bodies regulating its members who are authorised to conduct audit work in Hong Kong to report on their activities to the FRC for cases referred for disciplinary proceedings, and for the FRC to inspect/investigate such activities of these accountancy bodies.
10. On the assumption that the FRC is finally vested with the necessary disciplinary powers, the need for a separate appeal tribunal (discussed in paragraphs 4.5 to 4.8 of the February 2005 consultation paper) becomes stronger.

11. Where the FRC does not possess any disciplinary power, it should at least have the power to refer cases that are warranted of disciplinary action directly to the Disciplinary Committee of the local statutory professional accountancy body, and act as the complainant to present the case in front of the Disciplinary Committee. This will avoid duplication of resources of the FRC and the local statutory accountancy body.
12. Although the Bill includes (in section 67) an amendment to the Professional Accountants Ordinance to allow the HKICPA to contribute to the FRC “such amount, as the Institute thinks fit, of the costs and expenses reasonably incurred by the FRC for the performance of the FRC’s functions”, the full funding arrangements are not set out in the Bill. It is important that the funding arrangements demonstrate the independence of the FRC, and that funding is adequate to allow the FRC to perform its functions fully.

In our previous response, we stated that the proposed funding arrangement was one of our areas of major concern. The proposal included an annual contribution of \$2.5 million by each of the four parties concerned, totalling \$10 million. This appeared to be inadequate to facilitate the whole set-up, including the Board, the FRC employees, the FRRP members and other consultants, agents or advisers engaged. Budget is an important issue to avoid a public perception that inadequate resources will lead to the ineffectiveness of the whole set-up.

This budget will be even tighter if the scope extends to all “public interest entities”. (See our comments below under “miscellaneous matters”.)

13. Section 52 of the Bill sets out the provisions in respect of the avoidance of conflicts of interest. Apart from these provisions, internal guidelines (possibly in the form of a staff code of conduct) should also be released. These should provide for a sufficient “cool down period” for any members and other persons performing any function of the FRC. This should stipulate a period after they leave the FRC during which they may not work for an employer with whom they had involvement through the FRC.
14. Section 52 does not explain what is meant by an “interest” in a listed entity. The Bill should refer to a “direct or indirect interest”, thereby

including the interests of a spouse, a trust of which a member is a trustee, or any other person included within subsection (3)(b).

### ***Audit Investigation Board***

15. The meaning of “relevant irregularity”, which sets out the scope of investigation by the AIB is set out in section 4 of the Bill, and in particular, the “specified events” are described in subsection (3). These extend beyond the public interests (such as doing or omitting to do something that is likely to bring discredit upon the auditor). The scope of investigation should be limited to cases where public interests are jeopardised.
16. With the objectives set out in the introduction to this response in mind, the AIB must be seen to be investigating irregularities and possible irregularities where there is public interest. “Public interest entities” and “listed entities” have a high degree of overlap, but are not identical: the former also includes unlisted public companies, large charities, insurance companies and pension funds. Consistent with previous representations made by ACCA, we strongly feel that the AIB should address cases which raise issues affecting the public interest, whenever they arise. There is currently no provision within the Bill to extend the scope of investigation of the AIB to other public interest entities.

### ***Financial Reporting Review Panel and Committees***

17. As stated above in respect of the AIB, enquiries must be capable of being extended to all public interest entities, rather than just listed entities as stipulated under section 40 of the Bill.
18. Section 39 of the Bill states that the Chief Executive appoints the members of the FRRP as he considers will be suitable for appointment to FRRCs. Section 41 gives no further detail of the expertise required of members of a Review Committee. The February 2005 Consultation Paper stated the intention that “members of the Panel should come from a wide range of financial reporting, auditing, banking, financial services and commercial expertise”. However, ACCA responded that, due to the technical nature of the duties of the FRRP and FRRCs, members should possess relevant accounting expertise to ensure their duties are properly discharged.

The Bill is currently silent regarding the expertise of members of the FRRP. However, ACCA maintains that, in view of the technical expertise required, the FRRP and each FIRC should consist of a majority of accountants, who should be drawn from a variety of backgrounds, and bring to the Panel and the Committees experience in a variety of sectors.

19. The Bill does not refer to the speed of the FRC's action to request the removal of any non-compliance, or the period within which the operator of the entity must take the remedial action (although it states that the period must be specified in the notice). It may be that these details are not required in the legislation, and it is the intention that the FRC publishes more detailed operational procedures in due course. If this is the case, these detailed operational procedures should be referred to in the Bill.

#### ***Miscellaneous matters***

20. The focus throughout the Bill is on listed corporations and listed collective investment schemes. The February 2005 Consultation Paper identified stakeholders (ie the "public") in terms of the bodies that represent them, namely:
  - the HKICPA (representing its member accountants),
  - the SFC (representing investors),
  - HKEx (representing listed entities), and
  - the Administration (representing the above and other members of the public).

Included within the categories of "investors" and "other members of the public", would be individuals with interests in unlisted public companies, large charities, insurance companies and pension funds. Therefore, if the objective of the FRC is to investigate cases involving "public interest", the functions of the FRC should be defined more broadly.

21. Whilst protecting the public interest with reference to those entities with a broad public interest, the "public" should also include those individuals and organisations with an interest in less public entities (including, for example, private companies). Regulation of audit work in this respect will remain with the professional accountancy bodies.

The principles for audit regulation developed by the International Organisation of Securities Commissions (included as an appendix to the September 2003 consultation document) clearly spell out that auditors should be subject to discipline by an oversight mechanism which is independent of the profession and operates in the public interest. Although the IOSCO principles recognise that a professional body may act as the oversight body, they state that, in such instances, it must itself be overseen by an independent body. Therefore, there should be provision for the accountancy bodies regulating its members who are authorised to conduct audit work in Hong Kong to report on their activities to the FRC on the cases referred for disciplinary proceedings, and for the FRC (through the AIB) to inspect/investigate such activities of these accountancy bodies.

22. Section 9 states that the FRC may refer a case or complaint to a “specified body”, being a “specified authority” or “specified enforcement agency”. The interpretation of a “specified authority” includes an accountancy body that is a member of the International Federation of Accountants (IFAC). In view of the different categories of IFAC membership possible (including affiliate membership), this requirement should refer to current full membership of IFAC.

## **Part B: The Detailed Wording of the Bill**

1. The objective of the FRRCs and the FRRP (as set out on paragraph 6.3 of the February 2005 Consultation Paper) is to consider whether the provision of financial information complies with relevant legal and accounting requirements. Therefore, the review should cover the whole set of annual accounts wherever financial information is presented. If this is not the case, there will be an inconsistency between the objectives of the FRRCs and the FRRP and the scope of their reviews.

The definition of “relevant requirement”, set out in Parts 1 and 2 of Schedule 1 to the Bill, is in relation to an “accounting requirement”, and therefore does not include compliance of other information issued with financial statements (eg directors’ reports) with relevant legal requirements. Rather, the definition should be in relation to an “accounting or reporting requirement”.



Similarly, the definition of “relevant financial report” set out in Parts 1 and 2 of Schedule 1 to the Bill, is in relation to a balance sheet and accounts annexed to it in accordance with section 129C(1) of the Companies Ordinance. Therefore, the directors report (required to be attached by section 129D of the Companies Ordinance) is not included within the definition of “relevant financial report”. We strongly recommend that this also be changed in order to remove the inconsistency between the objectives of the FRRCs and the FRRP and the scope of their reviews.

2. Section 49(1)(b) of the Bill permits the Council to *request* the operator of a listed entity, by written notice, to cause the relevant financial report to be revised or take other remedial action; section 50 of the Bill enables the Council to apply to the Court for an order *requiring* the directors of a listed *corporation* to revise, as the Court considers necessary, the relevant financial report, or take other necessary remedial action. (We note in the February 2005 consultation document that this provision is modelled on section 245B of the UK Companies Act 1985.) Section 49 of the Bill refers to a listed entity which includes both a listed corporation and a listed collective investment scheme as stipulated in section 3 of the Bill. Therefore we consider that the scope of section 50 of the Bill should not be limited to a listed corporation, but should refer to a listed entity as interpreted under section 3 of the Bill.