



THE HONG KONG INSTITUTE OF CHARTERED SECRETARIES
香港特許秘書公會

12 September 2005

Your reference: CB1/BC/13/04

Clerk to Bills Committee
(Attn: Ms May Leung)
Legislative Council Secretariat
3rd Floor, Citibank Tower,
3 Garden Road,
Central,
Hong Kong
(Fax No: 28696794)

Dear Sirs,

Re: **Financial Reporting Council Bill**

Thank you for inviting The Hong Kong Institute of Chartered Secretaries to comment on the Financial Reporting Council Bill. Attached please find our submission.

Thank you very much for your attention to this matter.

Yours faithfully,

Neil M McNamara
President

Encl.

SUBMISSION BY
THE HONG KONG INSTITUTE OF CHARTERED SECRETARIES

1. We are in full support of the Financial Reporting Council Bill (“Bill”), the principal objective of which is to establish a Financial Reporting Council (“FRC”) under which an Audit Investigation Board (“AIB”) and a Financial Reporting Review Committee (“FRRC”) shall, subject to the relevant provisions of the Bill, be set up to investigate irregularities of auditors and reporting accountants of listed entities and to enquire into non-compliance with legal, accounting or regulatory requirements in the financial reports of listed entities respectively.

2. A submission has been made by us to the Financial Services and the Treasury Bureau (“FSTB”) on 18 April 2005 in which we have expressed our views in relation to the establishment of the FRC. A copy of the submission to FSTB is enclosed herewith for your easy reference. Apart from confirming our views stated therein, we would like to put forward some further comments on the Bill by way of elaboration on some of the points previously raised as well as making several additional comments.

3. **Composition of the FRRC**

As stated in our submission to FSTB, we support the proposal that the majority of the FRC should be lay persons. Such proposal is in line with the international trend towards making the oversight of auditors and financial reporting of listed entities more independent from the accounting profession. However, we are very concerned about the criteria for the choice of lay members of the FRC. It is of paramount importance that such persons shall possess relevant, personal, specific experience and expertise which are essential for conducting effective investigations and making sound and fair judgment in relation to financial reporting of listed entities. Their background, experience and expertise have direct bearing on whether they are able to comprehend the framework of auditing which is conducted basically on a sampling basis and to a certain extent allows flexibility and personal judgment of auditors (based on the evidence and information given by the listed entity at the

relevant time) to come into play. Inevitably, there is a serious concern within the auditing industry that lay members lacking the requisite knowledge and experience in auditing and financial reporting of listed entities may not be able to fully understand the nature of auditors' work and therefore might be more inclined to conclude that problems with financial reporting of listed entities are always a result of fault or negligence of auditors. Hence, we take the view that the FRC should be both cautious and demanding in its choice of lay members whom we suggest can be drawn from other professional bodies.

4. **Communication with relevant authorities**

To avoid any wastage of resources resulting from parallel investigations, it is critical to ensure that there is no duplication of or confusion about the respective roles of the FRC and other authorities such as Securities and Futures Commission ("SFC") and The Stock Exchange of Hong Kong Limited ("HKEX") which shall be responsible for the follow up actions after the investigation is over. Having said that, while such authorities should not conduct investigations themselves once the FRC has taken over the case, we suggest that there should be communication between the FRC and the police or the relevant authorities throughout the investigations such that the FRC is advised on the kind of information or evidence which it should collect for an offence or disciplinary action to be established. It will again be a great waste of efforts of the FRC if an investigation report is subsequently found to be lacking in some crucial evidence rendering any legal or disciplinary action impossible to proceed on the ground of technical failures.

5. **Guidelines regarding the trigger off of powers**

According to Section 23 of the Bill, if there are "**circumstances suggesting** that there is an auditing irregularity in relation to a listed entity, and the Council (FRC) certifies in writing to that effect...", then the FRC may exercise the powers under Sections 25 and 27 and Division 3. Likewise, if there are "**circumstances suggesting** that there is a reporting irregularity in relation to a listed entity, and the Council (FRC) certifies in writing to that

effect...”, then the FRC may exercise the powers under Sections 26 and 27 and Division 3. Section 23 further provides that if the FRC has “**reasonable cause to believe**, and certifies in writing that it has reasonable cause to believe, that there is or may be a relevant irregularity in relation to a listed entity...”, then it may exercise the powers under Section 28 and Division 3. While several specified events amounting to “irregularity” on the part of auditors and reporting accountants, such as falsification of documents, negligence and professional misconduct, are set out in Section 4, it is not clear what “circumstances suggesting” and “reasonable cause to believe” mean. It is our view that uncertainties should be minimized as to what constitutes “circumstances suggesting” and “reasonable cause to believe” that there is auditing and reporting irregularity under the Bill. We suggest that FRC should issue guidelines (with examples given) under Section 13 in this regard so that the auditors and reporting accountants of listed entities will have a clearer picture as to what circumstances will put them into the arena of irregularities under the Bill. Clear guidelines may also minimize the risk, however slight, of the FRC succumbing to pressure of media or otherwise, which in the normal course of events should not be taken into account when deciding whether to initiate an investigation under the Bill. We suggest the FRC providing guidance to assure that the use by the auditors of a top-down, risk-based approach employing reasonable judgment in the auditing of accounts under the generally accepted accounting principles, will be recognized and respected by the FRC. Such view is in line with recent guidance issued by the Securities and Exchange Commission and the Public Company Accounting Oversight Board in the United States on audits of internal control when they evaluated their implementation experience of Section 404 of the Sarbanes-Oxley Act. This approach ensures that resources will be devoted to areas of greatest risk thereby avoiding spending excessive time on the low-risk areas. As a result, auditing can be performed at a controlled cost.

6. **Delineation of duties between AIB and FRRC**

In our opinion, the division of duties between AIB and FRRC are clear. The former is responsible for the investigation into irregularities of auditors and reporting accountants of listed entities

while the latter deals with non-compliance of financial reports of listed entities with the relevant laws and requirements. In most cases, we believe that the body in charge can be easily identified. However, we can envisage that there are circumstances which may fall under the scope of duties of both AIB and FRRC. Take for example, if a listed entity has failed to comply with the Listing Rules in preparing its financial statements, such non-compliance is obviously something which the FRRC may enquire into and exercise certain powers including without limitation to requiring for voluntary rectification by the listed entity. However, the non-compliance may also be due to the negligence of the auditor of the listed entity which can trigger off the power of investigation by AIB. Are the powers of AIB and those of FRRC to be exercised on a mutually exclusive basis? Will the consequence of the non-compliance be the major consideration in deciding which should be the body in charge i.e the cases with more serious consequences will be handled by AIB while the less serious ones will be dealt with by the FRRC even if negligence of auditors is suspected? It is our view that clarification should be made as to how the duties of the AIB and FRRC will be delineated in such kind of situation taking into account that the powers of AIB is much more extensive than those of FRRC.

7. **Consultation with other bodies**

Section 29 of the Bill provides that consultation with the Monetary Authority, Insurance Authority, Securities and Futures Commission or the Mandatory Provident Fund Schemes Authority, as the case may be, should be made if the person on whom a requirement is proposed to be imposed under Section 25, 26 or 28, is within the jurisdiction of any of the aforesaid bodies. Likewise, Section 43 also stipulates the same requirement in relation to exercise of powers for the purpose of enquiry into non-compliance. While the plain meaning of “consultation” certainly does not equate to consent, it can be foreseen that a dilemma or deadlock will arise if the consulted body is not agreeable to the proposed exercise of the power by AIB or FRRC. It is therefore in our view advisable to provide how the matter will proceed in such kind of situation.

8. **Funding**

Regarding the funding issue, we support the idea of having a review in three years time since what level of expenditure and funding would be most appropriate is still unclear before the operation of the FRC. However, we find the present funding arrangement which only provide for the initial three years of operation is based on a very short term plan. We appreciate that the FRC intends to have a lean structure, however, it is very probable that the annual funding of HK\$10 million together with the reserve of HK\$10 million, to be equally shared by HKEX, The Hong Kong Institute of Certified Public Accountants, SFC and the Government, is not sufficient for the running of the FRC, especially in times of large scale investigations which usually demand a lot of resources or when it is challenged by judicial review in which case considerable amount of legal costs will have to be incurred. Though we agree on the timing of funding review, it is in our view necessary for the long term funding plan to be set out at this stage.

9. **Publication of investigation report**

Under Section 35, the FRC has the power to cause the investigation report to be published. In deciding whether to do so, it shall take into account several factors such as whether or not the publication (i) may adversely affect any proceedings before the court or other relevant authorities; (ii) may adversely affect any person named in the report; or (iii) is in the interest of investing public or public. Apart from the above factors, we find the timing of the publication of great importance and extreme care should be taken in determining the timing. Every investigation report will in one way or the other and to a certain extent implicate persons involved with the case and thus publication of the same can be highly damaging to the reputation of the persons concerned. Besides, everyone involved in the investigation should be presumed innocent until they are convicted. It will be unfair to those persons whose identities have been disclosed in the investigation report but for whatever reasons, no charge or disciplinary action has been pursued against them by the relevant authority subsequently. We suggest that the FRC should issue guidelines on the circumstances and timing of the publication of

the investigation report with a view to balance the need for transparency and protection of privacy. Subject to other considerations, we propose that an investigation report shall only be published after the relevant authority or the police have confirmed that it will take up and pursue the case. Consideration may also have to be given as to whether investigation reports relating to closed or suspended cases should be published. While they may have high educational value, it is not fair to the persons involved with the investigations if they are named or can easily be identified in the reports.

12 September 2005



THE HONG KONG INSTITUTE OF COMPANY SECRETARIES (Attachment)
香港公司秘書公會

18 April, 2005

Financial Services and the Treasury Bureau
(Consultation Paper on Legislative Proposals to
Establish Financial Reporting Council)
18/F, Admiralty Centre Tower 1
18 Harcourt Road
Admiralty
Hong Kong

(Fax : 2527 0292)

Dear Sirs,

Re : FSTB Consultation Paper on Legislative Proposals to Establish Financial Reporting Council

Thank you for inviting The Hong Kong Institute of Company Secretaries to comment on the Legislative Proposals to Establish Financial Reporting Council. Attached please find our submission.

Thank you very much for your attention to this matter.

Best regards,

Neil M McNamara
President

CONSULTATION PAPER
ON LEGISLATIVE PROPOSALS TO ESTABLISH
FINANCIAL REPORTING COUNCIL

SUBMISSION BY

THE HONG KONG INSTITUTE OF COMPANY SECRETARIES

1. The importance of good corporate governance in promoting a fair and proper functioning of the financial markets has long been and continues to be advocated by the Institute. Therefore, we welcome the consultation proposal to establish a new statutory body to be named the Financial Reporting Council (FRC) to oversee an Audit Investigation Board (AIB) and Financial Reporting Review Committee(s) (FRRC) which will further enhance the corporate governance regime on matters of financial reporting for listed companies and listed collective investment schemes. Indeed the implementation of the proposal in the Institute's view would be better sooner rather than later.

2. In respect of the specific issues raised in the consultation paper for which public comments were invited, we generally support the suggestions stated in the consultation paper (subject of course to further consultation when the actual wordings of the proposed legislation are put forward) and would like to put forward our additional comments in paragraphs below.

(a) Composition and Operational Structure of the FRC

3. The Institute supports the establishment of FRC as an independent statutory body, rather than a company limited by guarantee like the Financial Reporting Council in the UK. In the UK, there are many accounting bodies, whilst in Hong Kong, the HKICPA is a statutory body (and indeed the only body granting licences to accountants practising in Hong Kong) established under the Professional Accountants Ordinance.

Since the intended FRC is to take up part of the investigatory role for the accounting profession in Hong Kong and to be accountable to the public for its work, it would be more sensible to incorporate the same as an independent statutory body.

4. The proposed structure is appropriate and the duties divided amongst AIB and FRRC are clear. Whilst AIB would investigate suspected irregularities concerning auditors of listed corporations and listed corporative investment schemes, FRRC would deal with suspected non-compliance of the financial reports of listed corporations and listed collective investment schemes with the relevant law, SFC Codes, Listing Rules and Financial Reporting Standards.
5. As regards the composition of the FRC, the Institute supports the proposal that majority of the members should be lay persons. Indeed, the criteria for these

majority lay persons should be from other professional bodies with experience on matters concerning listed companies and/or securities market with sufficient understanding about financial reporting, such as members of our Institute.

(b) Jurisdictions of the AIB and FRRC

6. Because of the enhanced powers to investigate upon "circumstances suggesting the occurrence of auditors irregularities" or "reasonable cause to believe" the involvement of the same, that may cause unnecessary concerns or anxiety of auditors on how to strike the balance of maintaining client's confidentiality and compliance with statutory supervision. The Institute would like to stress the importance of issuing proper and detailed guidelines or examples on what those suspicious circumstances are (with the caveat that the list is not exhaustive and may be modified in response to market situation). By so doing, auditors and/or listed corporations would know their positions well in advance and would have no or few excuses not to comply with any request made by AIB and FRRC.

(c) Modus Operandi of the FRC

7. As both the AIB and FRC are to perform the role of investigation, leaving the issues of enforcement of irregularities found to relevant bodies such as police, SFC and/or HKICPA (or other accountancy bodies), the Institute agrees with the approach stated in the proposal that there is no need to set up an appeal tribunal on top of the FRC. However, a further check and balance mechanism may be built in for the FRC to review its decision to enhance fairness of the

procedures/findings. Such procedure is not uncommon. Although a tribunal will rarely overturn its decision and the defendant in these proceedings should not be given another chance to argue the whole case again, a review is often particularly apt to rectify some slips, minor omissions and/or clarifications of certain matters. Of course completion of the review should be the end of the matter under investigation.