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20 November 2001

Mr. J. S. Bush
Secretary, Standing Committee on
Company Law Reform
Companies Registry
15/F, Queensway Government Offices
(High Block)
66 Queensway, Hong Kong

Dear Mr. Bush,

Corporate Governance Review
by the Standing Committee on Company Law Reform
A Consultation Paper on proposals made in Phase I of the Review

Further to our letter of 4 October 2001 requesting an extension of submission deadline, we have pleasure in providing our comments on the Consultation Paper issued by the Standing Committee on Company Law Reform ("SCCLR"). These are divided into two parts: Part A deals with those matters that have specific accounting/auditing implications and Part B contains our views on the remaining corporate governance matters.

As a general point we would emphasise that while it is important to ensure that Hong Kong's company and related legislation continues to provide a statutory framework that is appropriate to regulate and facilitate the conduct of business in a major international financial and commercial centre, it is equally important to ensure that the framework is capable of being effectively enforced. We hope that the enforcement issues will be fully considered when it comes to drafting legislation to give effect to the proposals arising from the SCCLR's findings and the subsequent consultation exercise.

Part A - Proposals with Specific Accounting/Auditing Implications

1. Filing of financial statements *(Summary paragraph 14, Chapter 4, paragraph 22.06)*

The filing of financial statements with the Companies Registry for public inspection would arguably improve transparency and enable stakeholders of private limited companies to have some access to relevant financial information relating to those companies. It should therefore help to instil greater discipline in financial reporting by private companies provided there is an effective regime of monitoring in place to enforce timely filing as well as the standard of disclosure. This should presumably include penalties for not filing. A proper assessment of the resources required for such monitoring and enforcement ought to be conducted before any such requirement is imposed. A further matter to be considered concerns whether it is appropriate to allow the impression to be given to creditors, trading partners, etc. of companies that they are entitled to place any legal reliance on financial statements that are intended for shareholders of the company. On the assumption that the SCCLR is not suggesting any change to this aspect of the company law regime, then in conjunction with the implementation of a filing requirement, the question of managing the expectations of other stakeholders ought also to be addressed.

In the longer term we understand that the Registry envisages that filing of accounts will be done electronically. Assuming this to be the case, then consideration needs to be given to

the resource implications for preparers of financial statements, particularly if the option of manual filing is withdrawn. Smaller companies may not be geared up for electronic filing and their costs will be increased if different regulators require returns in a different format. The latter problem could be alleviated if a common e-reporting standard were to be adopted by all relevant regulators. The XBRL (EXtensible Business Reporting Language) project offers this opportunity.

We understand that the proposed requirement would apply only to companies incorporated in Hong Kong. As such, if Hong Kong-incorporated companies considered the requirement to be a significant burden, then they could be prompted to re-domicile outside of Hong Kong to jurisdictions without an equivalent filing obligation. Similarly promoters of new companies starting up might be more inclined to set up overseas rather than in Hong Kong. Consideration could be given to imposing the proposed requirement on "oversea" companies registered under Part XI of the Companies Ordinance as well, but before doing so a proper assessment would need to carried out of the potential loss of business resulting from applying a blanket requirement on all companies carrying out business in Hong Kong.

2. Inconsistencies between the audited financial statements and other financial information contained in the directors' report and other sections of the annual report *(Summary para.16, Chapter 4, para.24.05)*

We support the proposal that the Companies Ordinance should be amended to enable auditors to report on any inconsistencies that they may come across between the audited financial statements and financial information contained in the directors' report. This should be a power rather than a duty.

We are of the view that qualified privilege should be extended to enable 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.

The proposed qualified privilege will provide the auditors with a defence to an action for defamation where they follow SAS 160 "Other information in documents containing audited financial statements", by including in the auditors' report a description of any material inconsistencies between the financial statements and the other information contained in the annual report or any material misstatements of fact in the other information contained in the annual report.

3. Accounting reference date *(Summary para.17, Chapter 4, para.25.07)*

We support the proposal that the Companies Ordinance should be amended to provide for an accounting reference date, an accounting reference period and financial year.

4. Standards setting process *(Summary para.18, Chapter 4, para.26.13)*

We agree with the SCCLR that Hong Kong does not need independent standards setting bodies for accounting and auditing standards and that the standards setting function should continue to be vested with the Society.

We would have no objection in principle to expanding representation on the relevant committees within the Society, namely the Auditing Standards Committee and the Financial Accounting Standards Committee, as proposed in the Consultation Paper. However, we would question why the banking industry specifically has been singled out as meriting a representative on the AuSC.

5. Body to investigate financial statements *(Summary para.19, Chapter 4, para. 27.12)*

We support the proposal to set up a body with authority to investigate financial statements and enforce any necessary changes to the companies' financial statements as this would help to enhance the standards of reporting by listed companies (preparers of financial statements). Given the long-standing role and experience of the Society in this area, we believe that the Society could be of assistance in helping to establish such a body and we would be happy to work closely with the Government to this end. We consider that it is important that the members of any such body should have sufficient expertise in the field and that the body should be chaired by someone of suitably high standing and reputation.

Our views on the associated issues raised in the Consultation Paper are as follows:-

(a) Functions of the body

i. We concur that the body should be reactive rather than proactive. It should act on significant matters referred to it that suggest that the relevant financial statements may be incorrect and require restatement.

ii. We believe that the body should carry out a fact-finding role, as the Financial Reporting Review Panel does in the UK, and that in the first instance there should be voluntary corrections of financial statements by the company concerned. In the event of a disagreement, the enforcement of any requirement to revise the financial statements should be referred to the Court.

iii. We consider that the scope of the body's work should extend not only to annual financial statements but also to complaints in relation to interim results which contain financial information that is not monitored by any other regulatory body.

iv. We suggest that apart from having the power to apply to the Court for an order to require a company to re-issue financial statements, the body should also be specifically empowered to ask the Court to consider imposing disciplinary action against directors for failing to comply with the Companies Ordinance. In taking such action, consideration could be given to distinguishing action taken against executive directors from that taken against independent non-executive directors who will not usually be involved in the daily operations of the company.

v. We note that the ultimate power of the body will be to require amendments to be made to the financial statements but a more important objective will be to create a deterrent effect to ensure that financial statements are free from material errors. This will require other appropriate regulatory provisions to be in place, such as penalties, to ensure that all financial statements issued by directors are correct the first time around. By the time the financial statements are amended and reissued, damage to shareholders' interests may already have been done.

vi. We believe that there is a need for a comprehensive review of all relevant rules and regulations to ensure that the body plays an effective part in the overall corporate governance structure and the regulatory framework in Hong Kong. Possible considerations would include introducing tighter regulatory controls to support the work of the body both prior to and after its involvement in a particular case. Such regulation might, for example, include provisions similar to those adopted overseas which provide for some legal backing for compliance with accounting standards or for a contractual

arrangement through a listing agreement. Part XI of the Companies Ordinance may also be revised to bring overseas registered companies listed in Hong Kong in line with Hong Kong-incorporated companies.

vii. As the function of the body is to assist the Government in regulating all companies incorporated in Hong Kong and those incorporated elsewhere that are listed in Hong Kong, the body should be funded by the Government.

(b) Jurisdiction of the body

i. We consider that the categories of companies falling within the remit of the body's work should include companies in which there is a significant public interest element. These would include companies listed in Hong Kong, companies in regulated industries, public companies and large private companies, such as charities.

ii. We note that since many companies listed in Hong Kong are incorporated outside Hong Kong, the body will have no jurisdiction over these companies unless the requirements to comply are incorporated into the listing agreement with the Stock Exchange or legislation is appropriately amended.

(c) Mode of establishment for the body

We have no strong view on the mode of establishment of such a body. However, we consider it important that the body should be independent and able to exercise effectively its power over those companies falling within its jurisdiction.

As indicated above, given that the body would monitor compliance with accounting standards issued by the Society under the Professional Accountants Ordinance, the Society is willing and able to assist in the formation of the body as well as in its on-going operations.

6. Quality of audit practice and monitoring of audit practice *(Summary para.20, Chapter 4, para.28.16)*

In light of experience gained in the first cycle of practice review the Practice Review Committee is currently reviewing its practice review programme and is considering a number of significant changes that will be implemented in the coming second cycle of practice reviews. Although the thrust of the first cycle was educational and time was allowed for our members to improve their practices, the objective of practice reviews has always been to provide assurance to the public that services, and especially statutory audits, are being performed properly and in accordance with the Society's professional standards. The Society welcomes any proposals that will assist in achieving this objective.

Our comments on the individual proposals contained in the Consultation Paper are as follows:

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

We understand this proposal is seeking views on whether there should be one auditing standard for "public companies" and another auditing standard to be applied to non-public companies.

The Society agrees that public companies have a wider body of shareholders who are not involved in day-to-day management and as a result, greater reliance is placed by shareholders of these companies on the role of independent third party monitoring and review to ensure their interests are properly safeguarded. For this reason failures by auditors in complying with professional standards in the audit of public companies may lead to damage to the interests of these shareholders and could also adversely affect the reputation of the accounting profession as a whole.

The Society's professional standards include accounting, auditing and ethical standards, and these standards are applicable to all members of the Society regardless of whether the member is a practising member with public company clients. The fact that a client is a public company does not alter the basic principles and objectives of an audit. The audit opinion for both public and non-public companies is the same, i.e. a "true and fair view", and the auditor is expected to appropriately plan his audit and obtain sufficient and reliable audit evidence to enable him to arrive at a reasoned opinion.

The financial statements of public companies, we believe, are differentiated from non-public companies only in that they are subject to additional disclosure requirements. For example, a public company which is also listed on an exchange, such as the Stock Exchange of Hong Kong, must comply with additional financial statement disclosures imposed under its listing agreement with the Exchange. In addition, if the company is engaged in a specialised industry, it may be subject to the disclosure requirements of legislation and/or regulation specifically applicable to that industry; e.g. a bank would need to comply with the rules of the Banking Ordinance and the disclosures required by the Hong Kong Monetary Authority.

When carrying out an audit of a public company, the auditor is required to be aware of the relevant regulations governing the company concerned and would be expected to tailor his audit work to ensure that the relevant risks associated with the company are addressed and the additional disclosures required in its financial statements are made.

The Society believes that the proposal to establish another set of auditing standards for the audit of public companies is not warranted and in fact may lead to undesirable results. It could create a misleading impression that there are two levels of auditing although the same audit opinion is given for both. It may also give rise to the impression that non-public companies are subject to lower auditing criteria and that therefore their audits have a lower level of credibility.

The Society therefore believes that the current approach of a single, uniform auditing standard for all companies is appropriate.

(b) *Should the frequency of [practice] 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?*

In the first cycle of practice reviews, the Society adopted a random basis of selection of practices for review. In its second cycle of practice reviews, the Society will adopt a risk-based approach. Under this revised approach, practices will be assessed on their risk profile and those with a higher risk profile will be assigned priority for practice review selection. This revised approach will focus on the overall risk levels of the practice and practices with audit clients in which there is a wider public interest, including listed companies, have been identified as being a higher risk category.

The Society believes this revised approach is appropriate because the overall risk level of the practice is determined after considering all relevant risk factors. We consider that the priority for selection of practices for review and the frequency of reviews of individual practices should be determined based on the overall risk profile of the audit practice. The risk factors to be considered will include, inter alia, the characteristics of the audit practice's client portfolio (e.g. whether the practice has listed company clients and the industry and financial year end concentration of the practice's clients), the partner/qualified staff and partner/client ratios, internal controls established by the practice and the results of previous practice reviews conducted on the practising member.

Although audit practices with listed clients would be more likely to be selected, we wish to emphasise that the existence of listed clients alone should not be the only factor to be taken into account. A practice may for example have additional internal control systems in place to monitor the proper performance of such audits and these will also be taken into account. Weak internal controls within a practice on the other hand may increase its overall risk level and will call for more frequent reviews or a higher priority in selection.

The revised approach will ensure that the Society makes the best use of its resources by focusing its practice reviews on those audit practices with clients whose activities or status give rise to a higher degree of public interest and also on those audit practices which are assessed as being more susceptible to possible findings of audit deficiencies and non-compliance with professional standards.

The increased frequency of practice reviews for high-risk categories of practising members will ultimately increase the burden on the business community but this is an inevitable consequence. At present, the Society's practice review programme is financed solely from members' subscriptions. As more frequent practice reviews are expected for audit practices with listed company clients, it may be appropriate that some funding from the market should be allocated to the Society for this purpose.

International developments

In addition to our internally-initiated proposals for enhancement of the practice review system, we should also like to draw your attention to developments occurring at the international level that are relevant to this discussion, with which the Society is fully in tune.

The Society is a member of the International Federation of Accountants ("IFAC"), which has an objective of ensuring the needs of the public interest are served by developing standards and ensuring accountants provide services of a consistently high quality.

IFAC's programme included the launch in January 2001 of a Forum of Firms ("FOF"), which is a grouping of international firms that perform audits of financial statements that are or may be used across national borders. The founder members include all Big Five firms and progression to full membership will be subject to an applicant firm agreeing to the FOF's Global Quality Standards and agreeing to submit its assurance work to periodic external quality assurance reviews. This global peer review programme aims to raise standards of the international practice of auditing and better serve the interests of the users of the profession's services. The review system will be managed and monitored by the executive arm of the FOF, the Transnational Auditors Committee. Oversight of the process, effectiveness and results of quality reviews will be the prime responsibility of a Public Oversight Board ("POB") to be established to oversee IFAC's public interest activities. It is intended that members of the POB will be independent of IFAC and of the FOF, will encompass a wide range of business/public sector and geographical backgrounds. They will also need to have senior level and global experience and be of the highest reputation and integrity. This development represents a significant step towards ensuring the maintenance of high quality standards amongst members at the transnational level and ultimately at the jurisdictional level.

The Society is represented on the IFAC Board and its Compliance Committee, and we are committed to aligning our own approach with international norms.

(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?

As mentioned above, the Society does not believe that there should be a separate auditing standard established for listed companies. Rather, audit practices with listed company clients are in future likely to be subject to more frequent practice reviews. Whilst we note that in the USA audit firms with listed clients require separate licensing by the Securities and Exchange Commission, in other jurisdictions the quality of audits of listed companies is addressed through more frequent practice reviews. The latter approach is regarded by the Society as being the more appropriate approach for Hong Kong.

7. Revision of audited financial statements and related matters *(Summary para. 21, Chapter 4, para. 29.10)*

We support the proposal regarding the actions to be taken by directors and auditors when there are material misstatements in the financial statements that have been laid before the company in the general meeting and subsequently filed. This will have the effect of reinforcing the requirements already contained in the Society's Statement of Auditing Standard 150 "Subsequent events".

Part B - Other Corporate Governance Proposals

(Item numbers in Part B follow the order of items in the *Summary of Proposals*)

1. Directors' duties *(paragraph 6.13, Chapter 2)*

We consider that it would be useful to include in the statute a broad statement of principles in relation to directors' fiduciary duties and standard of care and skill, as has been done in certain other common law jurisdictions, e.g. Australia,

Malaysia and Singapore. While we agree with the SCCLR's view that it would not be possible for all duties to be properly encapsulated in the statute, an express provision could be added to clarify that the statement of directors' duties contained in the Ordinance is not exhaustive.

The proposal not to recommend codifying the common law duties of directors is based on the assumptions, which believe are open to question, that case law could continue to demand higher standards of care and skill from directors and that the UK case law would be persuasive in Hong Kong. We consider that a statutory enactment would serve the following purposes:

(a) it would remind directors of the existence of a requirement to exercise fiduciary duties and an appropriate standard of skill and care, which is generally regarded as being not well understood in Hong Kong. It would also set out the required level of responsibilities in broad terms. In this respect it would create more certainty; and

(b) it would facilitate monitoring and enforcement by minority shareholders of these duties.

While codifying these common law duties would be new for Hong Kong, we note that there was previously a proposal to do this and that a bill was introduced into the Legislative Council which would have had this effect. At that time however the Bill failed to gain sufficient support. In addition, as indicated above, some other common law jurisdictions have introduced a statutory of statement fiduciary duties and the duty of care and skill.

The Consultation Paper mentioned that action is now being taken by the Securities and Futures Commission ("SFC") to draft a Code of Best Practice that would serve as a guide to directors as to their duties. It appears that this will not have statutory backing and while it may be adopted by listed companies it is not clear that it will have any impact upon directors of unlisted companies, especially small private companies.

2. <u>Voting by directors in relation to directors' self-dealing *(paragraph 7.09, Chapter 2)*</u>

We consider that the proposal to disallow interested directors from voting at a board meeting on a matter in which they have an interest should apply to listed and public companies only.

Many companies in Hong Kong, particularly small private companies, are held and managed by connected parties and the directors and shareholders are often one and the same persons. In some cases, self-dealing by directors may be in the best interests of the company as a whole. In such circumstances, the proposal may not be practicable and could impede the business process, especially for family-owned businesses. While the rationale for applying the proposal to listed and public companies is clear, it is much less obvious how it would operate in the context of small shareholder-director-run companies and what the benefits would be of extending the requirement to such companies. Furthermore, proposals have been put forward previously to allow the creation of "one-man companies" in Hong Kong and these are permitted in some jurisdictions overseas. How would a ban on voting by interested directors operate if one-man companies were to be allowed in Hong Kong in future? For similar reasons we question the

extension to private companies of several of the other proposals referred to below.

3. Shareholder approval for connected transactions of significance involving directors *(paragraph 8.22, Chapter 2)*

We consider that the proposal to a adopt 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 should apply to listed and public companies only.

For listed companies, the requirements in the Listing Rules are generally sufficient but it would be useful to introduce a statutory provision to extend the requirement to public companies. We would also suggest that shareholders who are interested in the transaction or arrangement in question should abstain from voting.

For private companies, it might in principle be preferable to provide for a mechanism for the valuation and disposal of the minority shareholders' interests in the company in cases where the minority shareholders consider that they are being disadvantaged.

4. Transactions between directors or connected parties with an associated company *(paragraph 9.08, Chapter 2)*

We consider that the proposal to require that the approval of shareholders be obtained in relation to transactions or arrangements between a director or connected person and other associated companies or corporations should apply to listed and public companies only.

With regard to the definition of "associated company", we would like to draw your attention to paragraph 2 of Statement of Standard Accounting Practice 10 "Accounting for investments in associates" which defines an "associate" as an enterprise in which the investor has significant influence and which is neither a subsidiary or a joint venture of the investor. "Significant influence" is the power to participate in the financial and operating policy decisions of the investee but is not control over those policies. "Control" is the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities.

5. Nomination and election of directors *(paragraph 10.29, Chapter 2)*

We consider that the proposal in relation to the lodging of nominations, the election procedure and the right of shareholders to elect directors should apply to listed and public companies only, except paragraph 5.04(f), which proposes to require the company to disclose in its report to shareholders any reasons given to the company for a decision on the part of a director to resign or decline re-election. This should also apply to private companies.

6. Role of independent director *(paragraph 11.12, Chapter 2)*

We consider that the general duties of independent directors are no different from those of other directors and therefore setting out the general fiduciary duties of directors, without distinguishing between executive, non-executive, independent or otherwise, would be sufficient.

In practice the function of independent directors of private companies may often be limited to giving business advice and therefore paragraph 6.02(b) of the Summary of Proposals, which proposes setting out the functions of non-executive directors under specific circumstances, may not be generally applicable to private companies.

We agree in principle that independent directors could be appointed with specific monitoring roles, but if so the issue of how this might impinge on their liabilities would need to be further considered.

7. Self-dealing by controlling shareholders *(paragraph 13.18, Chapter 3)*

We consider that the proposal to require disclosure of connected transactions and to require them to be subjected to a disinterested shareholders' vote, with interested shareholders abstaining from voting, should apply to listed and public companies only.

With respect to paragraph 7.06(f), Summary of Proposals, under which a connected transaction between a director and a connected party is voidable by the company, this could be unjust to the connected party. We note the proviso that that this is subject to *bona fide* third party rights not being affected, which could address the concern if a connected party acting in good faith is not excluded from the definition of "bona fide third party"; if, on the other hand, the connected party is to be so excluded, then we consider that other remedies should be available instead.

8. Derivative action *(paragraph 15.25, Chapter 3)*

We have no strong view on the proposal to statutorily provide for the right to bring derivative actions, rather than continuing to rely on case law.

However, we note that the practical difficulties with derivative actions identified by the SCCLR at paragraph 8.01 of the Summary of Proposals, such as the shareholders' inability to access information in order to commence a proper action and the fact that the plaintiff may be liable for the costs of the action without having a right to the potential damages, would appear to remain unresolved by the proposal for the introduction of a statutory derivative action We note however that the proposal at paragraph 12.02(b) of the Summary may help to deal partially with the issue of costs.

In practical terms therefore, and particularly where fraud may be involved, the SFC may be the most appropriate party to initiate such an action.

9. Unfair prejudice *(paragraph 16.27, Chapter 3)*

We have no strong view on the proposals.

10. Personal rights *(paragraph 17.09, Chapter 3)*

We note that the proposal to clarify the law so that an individual member can enforce all rights in the memorandum and articles of association as personal rights has already been incorporated into a Bill to be introduced into the Legislative Council.

11. Orders for inspection *(paragraph 18.05, Chapter 3)*

We support the proposal to provide a statutory method by which shareholders can obtain access to company records on application to the Court, subject to prescribed safeguards. Such safeguards should be sufficient to prevent access on the basis of frivolous or vexatious applications and in addition it may be desirable to consider specifying a minimum shareholding requirement.

12. Other powers of the court *(paragraphs 19.03, 19.05 & 19.06, Chapter 3)*

We consider that the proposal to grant additional powers to the Court to enable it to grant an injunction against any contravention of the Companies Ordinance or any breach of fiduciary duties, to grant orders as to the costs for shareholders in taking action in respect of corporate injury and unfair prejudice, and to expand of the power of the Court to all companies registered in Hong Kong, will be useful.

13. The role of regulators *(paragraph 20.09, Chapter 3)*

We note the difficulty raised by the SCCLR, that although in principle the SFC might seek an order from the court for a derivative action to be instituted against wrongdoers in relation to a public listed company, the circumstances under which the Court would order such an action are unclear. However, while it may be advantageous in some circumstances to enable the securities regulator to bring a derivative action directly against wrongdoers for breaches of duty on behalf of the company, it would be helpful if clarification could be provided as to why the SCCLR has proposed adopting this approach, rather than, for example, the alternative of specifying more clearly the grounds under which the Court should consider making the relevant order.

15. Management Discussion and Analysis *(paragraph 23.08, Chapter 4)*

We consider that the proposal to amend the Listing Rules in respect of the Management Discussion and Analysis, to include more qualitative and forward-looking disclosure, should apply to listed and public companies only.

Should you have any questions on the above recommendations or wish to discuss them further, please feel free to contact Mr. Peter Tisman at 2287 7084 or Ms. Elaine Chan at 2287 7095 in the first instance.

Yours sincerely,

WINNIE CHEUNG
SENIOR DIRECTOR
HONG KONG SOCIETY OF ACCOUNTANTS

PMT/EC/cy