Hong Kong Institute of
Certified Public Accountants
香港會計師公會

**By email <** bc_03_10@legco.gov.hk **> and by post**

28 June 2011

Our Ref.: C/CB, M77971

The Hon. Paul Chan Mo-po
Chairman
Bills Committee on Companies Bill
Legislative Council Secretariat
Legislative Council Building
8 Jackson Road
Hong Kong

Dear Mr. Chan,

**Re: Companies Bill**

Thank you for inviting the Hong Kong Institute of Certified Public Accountants to submit views on the Companies Bill. The Institute's comments are contained in the appendix to this letter.

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If you have any questions on our submission or wish to discuss it further, please contact me at the Institute.

Yours sincerely,

Peter Tisman
Director, Specialist Practices

PMT/ML/ay
Encl.

c.c. Companies Bill Team, Financial Services and the Treasury Bureau
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# Appendix

## Comments from Hong Kong Institute of CPAs on the Companies Bill

| Clause No. | Comments |
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| Part 9 – Division 4 – Subdivision 3 – clauses 15, 375 – 378 | **Concept of subsidiary and parent undertakings (re consolidated financial statements)**<br><br>Schedule 23 of the existing Companies Ordinance ("CO"), which deals with the concepts of "subsidiary undertaking" and "parent undertaking", appears to have been incorporated into the draft Companies Bill ("CB") as Schedule 1, largely unchanged from the existing CO wording. We believe that the concepts of "subsidiary undertaking" and "parent undertaking", together with the concept of a "true and fair override" (contained in section 126(4) of the existing CO), were introduced into the CO in 2005-6, around the time of full convergence of Hong Kong Financial Reporting Standards ("HKFRS") with International Financial Reporting Standards ("IFRS"), solely for the purpose of facilitating the preparation of consolidated financial statements which complied with the requirements of IFRS, as adopted into HKFRS, without disturbing other provisions of the CO which referred to "holding companies" and "subsidiaries".<br><br>We are concerned that retaining the wording of the existing Schedule 23 is contrary to one of the objectives of the re-write of the CO, which is to avoid including detailed accounting requirements or definitions in the legislation and to refer instead to relevant accounting standards. This approach facilitates continuing compliance of the financial statements with the relevant accounting standards as and when those accounting standards evolve, without having to reconcile those requirements with the different language in the CO and to rely on the "true and fair override", set out in section 376(6) of the CB (and currently contained in sections 123(4) and 126(4) of the CO) or to seek amendments to the legislation when differences are identified.<br><br>In the case of the preparation of consolidated financial statements required by section 375(2) of the CB, this is particularly pertinent now, as the International Accounting Standards Board ("IASB") has recently issued a replacement of IAS 27, *Consolidated and Separate Financial Statements*, in the form of a new standard IFRS 10, *Consolidated Financial Statements*, which is effective for financial years beginning on or after 1 January 2013 and which extends the scope of consolidation to include entities which are not "subsidiary undertakings", as defined in Schedule 23 of the existing CO. This new standard will be introduced in Hong Kong as HKFRS 10. We are concerned that retaining provisions similar to Schedule 23 (in Schedule 1 of the CB) in such circumstances will result in confusion and inefficiencies as companies seek to reconcile the two very-differently-worded sets of requirements. |

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| | For example, the new IFRS 10 uses the concepts of “protective rights” and “substantive rights”, whereby in order to consolidate an entity, the investor needs only to have sufficient voting power to control the exercise of “substantive rights”, even though other investors may have retained some “protective rights" (for example, the power to veto capital expenditure above a specified limit). By contrast, paragraph 2(5) of Schedule 1 in the CB refers simply to having the majority of voting rights on “all matters or on substantially all matters”, raising doubt over whether it can be argued that the two sets of requirements are the same or different. Similarly, IFRS 10 requires consolidation of an entity over which the investor has de facto control, as a result of a wide dispersal of other interests. This appears to be outside the scope of Schedule 1, as paragraph 2(2) of that schedule identifies only “the right to exercise dominant influence” held by virtue of some legal document, indicating that it would only be possible to comply with this aspect of IFRS 10 if the company could invoke the true and fair override in section 376(6) of the CB.<br><br>In this regard, a further concern arises, as it is doubtful whether section 376(6) would even permit an override of the scope of consolidated financial statements in section 376(2). We should be pleased to discuss further with the Administration our concerns on this point and to explore possible solutions. If, on a correct interpretation of section 376(6), the override would not be available in cases of differences between IFRS 10 and the scope of Schedule 1 in the CB, then in such cases, the existence of Schedule 1 would prevent an affected company from asserting full compliance with accounting standards, which in turn would prevent the company from complying with section 376(4).<br><br>In short, any differences in concepts between Schedule 1 and IFRS 10 as to the scope of consolidation could cause extensive confusion and detract from the overall objective of requiring the preparation of consolidated financial statements, which give a true and fair view and comply with the relevant accounting standards.<br><br>We, therefore, strongly recommend that Schedule 23 of the existing CO not be imported into the CB, i.e., that Schedule 1 of the CB be deleted and that, instead, the requirements as to the scope of consolidated financial statements be dealt with entirely within Part 9 of the CB, specifically sections 376 – 378 (cross-referenced in section 375(2)) and with reference to the relevant financial reporting standards. This approach would require a definition of “subsidiary undertaking” to be added to section 376(8) (since the phrase is used in section 376(2) and section 377) that is consistent with the wording in section 375(2); for example, the following (edit marks show the suggested changes): |

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| | "(8) In this Part –<br><br>(a) ***accounting standards*** means statements of standard accounting practice issued by a body prescribed by the Regulation; ~~and~~<br><br>(b) a reference to accounting standards applicable to any financial statements is a reference to accounting standards as are, in accordance with their terms, relevant to the company's circumstances and to the financial statements; and<br><br>(c) subsidiary undertakings are those undertakings which are required by the relevant accounting standards to be included in the consolidated financial statements of the holding company.<br><br>An alternative approach would be to retain the format of a "Schedule 1" for the purposes of defining "parent undertaking" and "subsidiary undertaking", but to simplify the definition of a "subsidiary undertaking" in that schedule. "Subsidiary undertakings could be defined as "those undertakings which are required by the relevant accounting standards (as defined in section 376(8)) to be included in the consolidated financial statements of the holding company" and a "parent undertaking" could be defined simply as "an undertaking which has one or more subsidiary undertakings", thus removing the need for much of the current Schedule. This approach would have the same practical effect as expanding section 376(8) and would require fewer changes to the CB as drafted, but it may be less streamlined from a users' point of view.<br><br>Given that IFRS 10 contains extensive guidance on identifying a controlled entity, which differs from the prescriptive approach contained in Schedule 1 of the CB, we consider it important that Schedule 1 be deleted or substantially simplified before the legislation is enacted. Otherwise, the new CO could already be out-of-date and inconsistent with accounting standards on the date of its enactment.<br><br>*NB. It should be noted that in recommending the above changes, we have assumed that the term "subsidiary undertakings" (as opposed to "subsidiary") is not used in the CB, other than for the purposes of determining the scope of consolidated financial statements, under Part 9). If either of the above approaches is to be adopted, this assumption will need to be verified*. |
| Part 9 – Division 2<br>clauses 358 – 362 | **More explicit text in the CB on preparation of simplified financial statements**<br><br>Sections 358 to 362 in the CB cover the eligibility of a company or a group for the "reporting exemption". Section 376(7) of Part 9 seems to be the only |

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| | place in the CB that covers the impact on the financial statements of choosing to take advantage of the reporting exemption. This subsection simply enumerates those subsections of section 376 which do not apply to such entities, leaving the reader to determine which requirements are applicable to them.<br><br>In our view, this approach could leave companies in doubt as to the impact of taking advantage of the reporting exemption, and could potentially lead companies to mistakenly assume that they are exempt from preparing financial statements altogether (as the relevance and significance of the wording in section 376(7) may be overlooked by many). We would recommend, therefore, that the requirements in the CB applicable to companies opting for the reporting exemption be made more explicit and readily identifiable for readers by, for example, including a separate section after section 376 which, for the avoidance of doubt, explicitly refers to such companies. Such a section should make it clear that:<br><br>➢ section 376 applies except for those subsections of 376 which pertain to the financial statements giving a true and fair view (namely, subsections (1), (2), (5) and (6)); and<br><br>➢ in the case of companies taking advantage of the reporting exemption, the accounting standards referred to in section 376(8) are those accounting standards issued by a body prescribed by the Regulation relevant to companies falling within the reporting exemption. |

**Comments from Hong Kong Institute of CPAs on the Draft Companies Bill Consultations that were not taken up**

| Clause No. | Comments |
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| Part 5 – Division 2 clause 200 | **Solvency test**<br><br>The Institute supports the adoption of a uniform solvency test for the transactions specified under this part of the CB to provide consistency and clarity. Nevertheless, we reiterate the view that we expressed during the second phase consultation on the draft CB consultation that the existing solvency requirement in Hong Kong, which is basically a cash flow test, should be modified by including a balance sheet solvency test, covering both current and total assets/liabilities. This would provide a more comprehensive and objective approach to the assessment of solvency and a better safeguard for creditors. In the event of financial difficulties, creditors would look not only to cash flows for repayment but also to the assets on the balance sheet of a company. |
| Part 9 – Division 4 Subdivision 4 – clause 380 | **Including an analytical and forward-looking business review in the directors' report**<br><br>Section 380(1) requires companies that do not fall within the reporting exemption to contain in the directors' report a business review that is to some extent analytical and forward-looking, non-compliance with which will carry criminal sanctions, as specified under sections 380(5) and 380(6).<br><br>Shareholders and investors will find it useful to have more analytical and substantive, and forward-looking information included in the business review in companies' annual reports. Internationally, there is a growing trend to encourage more meaningful disclosure in narrative reporting.<br><br>However, given that directors face possible criminal sanctions for failing to comply with the requirements of this section, those requirements must be expressed in terms that make it clear when they have been complied with and when they have not. In addition, achieving compliance should not be unduly onerous. There are elements of the provisions in the CB that arguably do not meet this standard.<br><br>For example, it is not entirely clear what, in section 380(5), would constitute taking "all reasonable steps to secure compliance" with subsections (1) and (2). While we note that, under subsection (7), it is a defence for a director to establish that he had reasonable grounds to believe, and did believe, that a competent and reliable person was charged with the duty of ensuring compliance and was in a position to discharge that duty, this could involve a good deal of subjective judgment. Furthermore, as subsection (7) merely provides a defence, the burden of proof will be on |

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| | the director and he or she will need to establish, not only that, objectively, there were reasonable grounds to believe that a competent and reliable person was charged with the relevant duty, but also that he or she did, in fact, believe that to be the case. It is potentially onerous for someone to have to prove what they believed.<br><br>Turning to the content of the business review itself, Schedule 5 section 1(d) requires that the business review must contain "an indication of likely future development in the company's business". As drafted, this could be interpreted as requiring the directors to take a view on what others might consider to be likely. The intention may be, and it would surely be more reasonable, for directors to give an indication what in their view is the likely future development in the company's business.<br><br>In the light of the above, we suggest that the following be considered:<br><br>(i) Retaining the principles in the primary legislation and placing the more detailed content items in a separate document or code, where the detailed wording would be more amenable to revision, and which could be given statutory recognition.<br><br>(ii) Restricting the criminal sanctions to cases of wilful or reckless conduct.<br><br>(iii) Removing the second arm of what a director needs to prove in the defence under section 380(7), i.e., so a director would only need to establish that there were reasonable grounds to believe that a competent and reliable person was charged with the duty of ensuring compliance and was in a position to discharge that duty.<br><br>(iv) We indicated in our comments on the second phase consultation on the draft CB that it is important that directors should feel comfortable with making forward-looking statements which are meaningful, and not just boiler-plate legalese to avoid possible law suits by investors if the future does not turn out as the directors envisage. In this regard, we suggested that a "safe harbour" clause be included in the CB, which would provide directors with protection from civil liability for statements or omissions in the directors' report. By way of example, the UK Companies Act ("UKCA") 2006 (section 463) contains a safe harbour, which provides that directors are liable solely to the company, and no other person, for a loss suffered by the company if statements are untrue or misleading or there is an omission of anything required to be in the report. The directors are liable if they knew a statement was made in bad faith or recklessly, or an omission was made for deliberate and dishonest concealment of material facts. The protection does not affect any other liability for a civil penalty or criminal offence. |

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| | In the consultation conclusions on the second phase consultation, the Administration appeared to accept this point and indicated (in paragraph 61 of the conclusions) that a safe harbour provision, along the lines of section 463 of the UKCA 2006, would be inserted into the bill. However, we are not able to find any such safe harbour in the CB and so we reiterate that such a provision should be included. |
| Part 9 – Division 5 Subdivision 3 – clause 399 | **<u>Offences relating to contents of auditor's report</u>**<br><br>Section 399 introduces a new criminal sanction for an auditor who knowingly or recklessly causes certain statements required to be contained in an auditor's report to be omitted from the report.<br><br>*Professional judgment*<br><br>Imposing a criminal sanction on a person for knowingly or recklessly omitting certain statements from the auditor's report may create a problem, where the inclusion or exclusion of those statements depends upon the exercise of professional judgment.<br><br>The accounting profession's adoption of a principle-based rather than a rule-based system of standards can give rise to grey areas, which a court may not be the most suitable forum to resolve. A disciplinary framework involving a mix of experts from the accounting profession, lay and legally trained persons, may be a more appropriate channel to use in the first instance.<br><br>In this regard, the Institute might be constrained to follow the decision of a criminal court regarding a professional issue, with which the profession does not agree. In the event that the matter is subsequently referred to a disciplinary committee of the Institute, the committee is not required to look at the propriety of a conviction.<br><br>*Disciplinary or criminal sanctions*<br><br>For the above and other reasons, we previously queried whether it is necessary to introduce criminal sanctions given the Institute's power to discipline auditors. Under the Professional Accountants Ordinance (Cap. 50)("PAO") any instances of serious non-compliance with professional standards, or professional misconduct, committed by an Institute member (such as tampering with the auditor's report) are subject to a complaint being raised against the auditor. |

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| | The financial penalty under the PAO, although not criminal, is potentially heavier than the proposed financial penalty under section 399. Under the CB, the maximum fine is $150,000. Sanctions under the PAO could include a maximum penalty of $500,000 and removal from the register of members or removal of a practising certificate (which is required in order to sign audit reports), either permanently, or for such period as a disciplinary committee thinks fit.<br><br>Given that the PAO sanctions are not criminal, the standard of proof required is also based on the lower threshold of the balance of probabilities.<br><br>*Time frame for prosecution*<br><br>If an offence under section 399 is a summary offence, then the prosecution must be completed within six months of the date of offence (i.e., the audit report date). It is quite possible that the criminal investigation of such matters will take more than six months. On the other hand, under the PAO there is no similar statutory limitation period (subject to any challenges for undue delay). Therefore, it may be more appropriate to pursue the misconduct stated in section 399 under the PAO.<br><br>*Persons liable to prosecution*<br><br>It is not entirely clear from the wording of section 399(2) who could be held to have committed an offence. Given that the concept of recklessness is not easy to pin down, it may not be sufficiently clear whether other persons in the audit engagement team could, by extension, be held liable for actions by an employee of the auditor. |
| Part 10 – Division 2 clause 456 | **<u>Codifying directors' duty of care, skill and diligence</u>**<br><br>It is noted that section 456(1) and (2) defines the standard of care, skill and diligence as the standard that would be exercised by a reasonably diligent person with:<br><br>(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and<br><br>(b) the general knowledge, skill and experience that the director has.<br><br>Paragraph (a) above aims to adopt an objective test as the minimum standard, while paragraph (b), adds a subjective test, which looks at the personal attributes of a particular person, which may raise the standard expected of that person above the minimum objective standard. |

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| | To reiterate a reservation that the Institute expressed during the second phase consultation, we have some concern that the present wording in paragraph (a), which supposedly reflects "a minimum objective standard of care expected of all directors", may actually go somewhat further than this when it refers to "the functions carried out by the director" (underlining added). This arguably seems to require an examination of the specific circumstances applying in the particular company in question. Further clarification on this point would be helpful. In endeavouring to codify the common law standard of care, skill and diligence, it is important that the statute does not, inadvertently, go beyond the existing common law standard or create any ambiguity. |