

**STATEMENT 3.406
INDUSTRY GUIDELINE
BANKS AND DEPOSIT-TAKING COMPANIES –
THE AMENDED SECTION 161B AND SECTION 161BA
OF THE COMPANIES ORDINANCE**

(Issued May 1989; revised September 2004 (name change))

Introduction

1. The Companies (Amendment) Ordinance 1988 was gazetted on 12 February 1988 and contains amendments relating to the financial statements of authorized institutions incorporated in Hong Kong and their holding companies and to the annual general meetings of authorized institutions.
2. The amendments have immediate effect which means that all financial statements approved by the directors and annual general meetings which are held after 12 February 1988 are affected.
3. This guideline should be read in conjunction with the Companies (Amendment) Ordinance 1988, copies of which are available in the Hong Kong Institute of Certified Public Accountants' (HKICPA) library.
4. The term "loans" used in this guideline refers to loans, guarantees and security provided within the meaning of Section 161B.

Background

5. The amendments were made in response to concern expressed by authorized institutions regarding the requirements of Section 161B of the Ordinance for disclosure of detailed information concerning loans to officers. Financial institutions, whose main business is lending, considered those requirements to be:
 - (a) onerous because of the volume of data to which they give rise;
 - (b) not helpful as the bulk of the disclosure is of routine loans; and
 - (c) confusing because of the implication that there is something special about these loans when in reality most are a routine part of the bank's/deposit-taking company's business.

Scope

Transactions:

6. The amendments refer to the transactions covered by Section 161B which are:
 - (a) loans (Section 161B(1));
 - (b) guarantees and security provided (Section 161B(2))

by the company to officers of the company or to directors of its holding company. Section 161B and the amendments refer to "loans" meaning any of these transactions. For simplicity this guideline uses the same term with the same meaning.

The term "directors" is used loosely in this guideline and may, in certain instances, refer to officers other than directors and to connected persons. This matter is addressed in paragraph 16 below.

Companies:

7. The amendments affect:

- (a) authorized institutions: - being banks and deposit-taking companies licensed or registered under the Banking Ordinance; and in most provisions,
- (b) the Hong Kong incorporated holding company of such an authorized institution.

The provisions which do not apply to holding companies are those relating to the statement of directors' loans and the notification of the annual general meeting date (see paragraphs 19 or 25 below).

8. The amendments actually refer to "a company which is an authorized financial institution" and a company is defined in the new Section 161B(7A) as a company formed and registered under the Companies Ordinance or any other Hong Kong incorporated corporation (e.g. The Hongkong and Shanghai Banking Corporation which is incorporated under its own statute). Thus, the amendments cover all Hong Kong incorporated entities which have banking or deposit-taking company licences or are registered deposit-taking companies. Unincorporated banks, oversea companies, their local branches and local representative offices are not affected by the amendments.

In conformity with other statements the term "financial statements" is used in this guideline whilst the Ordinance refers to "accounts". For the purposes of this guideline the two terms are used with the same meaning.

Detailed provisions

Exemptions

9. The main effect of the Amendment Ordinance is to exempt certain loans made by an authorized financial institution to its directors or those of its holding company from the disclosure requirements of Section 161B, which are that certain particulars of these loans are reported in the financial statements of the company and the group.

Instead, detailed information on these loans is carried in a register and, in the case of authorized institutions, the Section 161B particulars are reproduced in a publicly available statement - referred to in this guideline as "the statement" - rather than the financial statements.

10. The loans to directors which are exempt are all such loans which:
- (a) are not concessionary - defined as being not greater or made on terms which are not more favourable than could be reasonably expected to be made to another person of the same financial standing who is unconnected with the authorized institution;
 - (b) are concessionary but do not exceed a specified limit to any one person.

For the purposes of this second test, the amount of the loan is defined as the total of:

- (i) all loans made to the person by the authorized institution on concessionary terms, measured at their maximum point, including interest due in the financial year.

plus

- (ii) all liabilities incurred by the authorized institution on guarantees and security provided on concessionary terms in respect of loans to that person measured at their maximum point during the financial year.

This sum is then measured against a specified limit of:

the lower of \$10 million; or
10% of the paid up capital and reserves of the authorized institution.

All concessionary loans which exceed this limit are not exempt and thus need to be disclosed in the financial statements but not in the statement.

11. The HKICPA made representations that the exemption limits on the amendments should specify that the reserves include "inner" or "secret" reserves. However, the Government indicated that they see no need for a specific reference to inner reserves. This apparently means that it is explicitly understood that inner reserves are to be considered in the calculation of the limit.
12. In summary, loans to directors of an authorized institution or its holding company made by that authorized institution, are now exempt from the disclosure requirements of Section 161B of the Companies Ordinance if:
 - (a) they are not concessionary, as defined by Section 161B(4A) (a); or
 - (b) if, being concessionary, do not exceed a limit set for each person as specified in Section 161B(4A)(b); but

all other loans which do not qualify for exemption under either of these amendment sub-sections will continue to be disclosed in the statutory financial statements of the authorized institution and its holding company and thus will be subject to audit as prior to the enactment of the amendments.

New Provisions

13. The amendments include three sets of requirements which are designed to provide information on either total or exempt loans to directors in an alternative medium.

These provisions require:

- (a) disclosure in the financial statements of both the authorized institution and its holding company of aggregate information on all loans to directors whether individually exempt or otherwise;
- (b) the particulars of the exempt loans to be carried in registers which have to be kept by both the authorized institution and its holding company; and
- (c) a statement to be prepared by the authorized institution containing Section 161B information on exempt loans which is to be audited and made available at the authorized institution's Annual General Meeting and to the public at specified times and place.

These requirements are examined in more detail below.

Disclosures in the financial statements

14. The amendments require disclosure in the financial statements of both the authorized institution and its holding company of aggregate data on all loans to directors/officers of the respective companies whether exempt or not.
15. The authorized institution is required to disclose in its statutory financial statements
 - (a) the *total* at year end of:
 - (i) the balance including interest due on all loans to directors made after 31 August 1984 (when the last major Amendment Ordinance became law); plus
 - (ii) the maximum amount the authorized institution is liable for under guarantees or security provided for directors since 31 August 1984; and
 - (b) the maximum at any time during the year of the total loans, guarantees and securities referred to under (a) above.

16. The data to be provided by the authorized institution and by its holding company is the same except that:
- (a) for the authorized institution the relevant borrower is its *officer* or a *director* of its holding company or a *company* in which its director has a controlling interest; whilst
 - (b) for its holding company the relevant borrower is an *officer* of the holding company.

It is important to note that:

- (i) the borrower need not have been an officer or director at the time of the loan; and
- (ii) the requirement only applies to loans made after 31 August 1984.

The other two sets of provisions both occur in Section 161BA as described below.

The Register

17. The first provision is in Section 161BA(1) and requires that the authorized institution and its holding company each keep a register of all loans which but for exemption under Section 161B(4A) (paragraphs 9 - 12 above) would have been shown in the financial statements.
18. The register is to contain either:
- (a) a copy of any agreements under which a relevant loan to a director is granted; or
 - (b) a written memorandum setting out the terms of any relevant loan.

The other detailed requirement is that each entry must be retained in the register for 10 years.

The Statement

19. The second provision is in sub-section (2) of Section 161BA and requires that all authorized institutions should make available a statement:
- (a) containing details of exempted loans;
 - (b) the details being those which would have been shown in the financial statements under Section 161B but for the exemption; or
 - (c) if there were no such loans, a "nil statement" to that effect; and
 - (d) the statement be made available at the annual general meeting of the authorized institution for the shareholders alone; and
 - (e) to the members of the public at the same place as its register of members for a minimum of 14 days before and 7 days after the annual general meeting.
20. The point to note is that:
- (a) both the authorized institution and its holding company must keep a register; but
 - (b) only the authorized institution need produce the statement.

Auditor's Report

21. The auditors of the authorized institution are required to examine the statement and report on whether it contains the particulars required by Section 161BA(2) (see paragraphs 19 and 20 above). The auditors' report must be annexed to the statement.

It is important to note that the auditor must also report on nil statements i.e. where there are no exempt loans and thus a report to that effect is made in the statement by the directors.

22. Where the statement does not, in the auditor's opinion, contain the Section 161BA information, the auditor should provide the correct or missing information so far as is reasonably possible. The responsibilities of the auditor are considered further below.

Inspection

23. There are a number of provisions giving the shareholders and the public rights of inspection at the annual general meeting and during the 21 day period around the annual general meeting as noted in paragraph 19 above.

In particular, it should be noted that the statement is to be available:

- (a) during business hours or for any period set by the annual general meeting subject to a minimum of 2 hours per day;
- (b) free to shareholders; and
- (c) to the public for a fee set by the company up to a maximum of \$5.

Copying Fees

24. The authorized institution must allow shareholders and members of the public to have copies of part or all of the statement. It may charge fees for this service subject to a statutory limit of 25 cents per 100 words or part thereof.

The authorized institution has to send the requested copy within 10 days after receiving the request.

Notification

25. In order to ensure that the public are aware of the dates of annual general meetings of authorised institutions, the amendments require announcements of the date of the annual general meeting in a recognized English and a recognized Chinese newspaper in the Territory, at least 28 days before the meeting. (Section 161BA(5) and (6)). The newspapers regarded as recognized are those gazetted under Section 71A.

Status of exempting amendments

26. The actual wording of the lead-in to the relevant exemption in Section 161B(4A) is - "this section shall not require" - which is permissive rather than mandatory. Thus it appears that authorized institutions may choose not to take advantage of the exemption allowed by the amendments and disclose details of all loans including those which would be exempt under the amendments.

However the wordings of Section 161BA dealing with the register and the statement are not permissive and thus the register (Section 161BA(1)), the statement (Section 161BA(2)) and the auditor's report (Section 161BA(3) and (4)) are not optional and must be maintained or prepared in all circumstances.

In this regard it should be remembered that Section 161BA(2) requires a nil statement if there are no loans which would be exempt under Section 161B(4A).

Audit considerations

Procedures

27. The audit procedures required to deal with the new arrangements for disclosure of loans are not markedly different to those applied to the audit of the Section 161B information in the financial statements.

The information being audited is essentially the same, except that it now appears in a different medium (the register and statement) and slightly different format.

Auditors' Reports

28. The auditor of the authorized institution or its holding company has no direct responsibility for the contents of the register required to be kept by Section 161BA(1).

As noted above (paragraph 21) the auditor's responsibility is restricted to reporting on the statement required by Section 161BA(2). He is required to examine this statement and report whether in his opinion the statement contains the information required by Section 161BA(2) (see paragraphs 19 to 22 above). An example of a clean auditors' report is attached as Appendix I, Example 1.

Qualified Reports

29. As in the audit of the Section 161B information included in the financial statements, if the auditor is of the opinion that the statement does not comply with Section 161BA(2), he must provide the information he believes is required by that Section.
30. Closer examination of this requirement reveals that there are also ramifications for the statutory audit report on the financial statements. These arise because the information in the statement is required as a substitute for disclosure of essentially the same information in the audited financial statements.

One possible situation is that the statement may contain information which the auditor feels should be disclosed in the financial statements.

In such a situation the auditor will have to consider the effect on both his audit report on the statement and his audit report on the statutory financial statements.

31. A disagreement which gives rise to this situation will usually relate to an interpretation of the criteria regarding concessionary loans granted on "favourable terms" (see paragraphs 10 - 12 above). For example, the authorized institution may feel that a particular loan to a director is no more favourable, either in amount or terms, than would be granted to an unconnected person and thus wishes to regard it as exempt and to carry the particulars of that loan in the statement rather than in the financial statements. If the auditor disagrees and feels that the loan is favourable, he will see the financial statements as incomplete and thus will qualify his audit report on those statements and supply the required information on the loan in dispute in that report.
32. At the same time the statement will contain information which the auditors believe should be in the financial statements. Thus the statement will not comply with Section 161BA(2) because it will contain information on loans which should not be in the statement because they would not "but for Section 161B(4A) be required by Section 161B to be included in the accounts" (see Section 161BA(2)). Hence the auditors' report on the statement will also be qualified.

Examples of both types of auditors' report in this situation are attached in Appendix I as Examples 2a and 2b respectively.

Engagement letters

33. Normally the audit procedures will be undertaken and auditor's report described above will be issued in conjunction with the statutory audit of the annual financial statements.

However as the nature of the audit of and the auditor's report on the Section 161BA statement is different to that of the statutory audit and audit report, it is important that the client be made aware of this difference. At the same time the client should be asked to take reasonable steps to ensure that the company complies with the requirements concerning the register, the statement, inspection and copying of the statement and public notification of the date of the annual general meeting.

An example of the relevant section of a specimen engagement letter is attached as Appendix II.

Members should also consult SAS 140 "Engagement letters".

Representation letters

34. As the maintenance of the register and the preparation and publication of the statement are the responsibility of the directors it is important that they acknowledge this responsibility.

The acknowledgement should be provided in the letter of representation from management and members are referred to SAS 440 "Representations by management".

An example of a paragraph for insertion in a management representation letter is attached as Appendix III.

Appendix I

SPECIMEN AUDITORS' REPORTS

Example 1. Unqualified Report

AUDITORS' REPORT TO THE MEMBERS OF AUTHORIZED FINANCIAL INSTITUTION LIMITED

We have audited the financial statements of Authorized Financial Institution Ltd. for the year ended 31 December 19.... in accordance with approved Auditing Standards and have issued a report thereon dated

We have also examined the annexed statement of loans to officers for the year ended 31 December 19.... pursuant to the requirements of Section 161BA(3) of the Companies Ordinance.

Based on the foregoing, in our opinion, the statement contains the particulars required by Section 161BA(2) of the Companies Ordinance.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
Hong Kong
Date

Notes:

1. The report is also applicable to a "NIL" statement.
2. It is preferable for the report to be signed and thus dated the same day as the audit report on the statutory financial statements.

Example 2. Qualified Auditors' Reports

The statement contains loans which should be in the financial statements

a. Report on the Section 161BA statement

**AUDITORS' REPORT TO THE MEMBERS
OF AUTHORIZED FINANCIAL INSTITUTION LIMITED**

We have audited the financial statements of Authorized Financial Institution Ltd. for the year ended 31 December 19.... in accordance with approved Auditing Standards and have issued a report thereon dated

We have also examined the annexed statement of loans to officers for the year ended 31 December 19.... pursuant to the requirements of section 161BA(3) of the Companies Ordinance.

The statement contains particulars of a loan to Mr. H. Kong on 1st July 19.... for \$12 million which, in our opinion, the company has made on terms more favourable than those which it is reasonable to expect the company to have offered to a person of the same financial standing who is not connected to the company. Consequently we are of the opinion that particulars of this loan should not be included in this statement under Section 161BA of the Companies Ordinance.

Except for the foregoing, in our opinion, the statement contains the particulars required by Section 161BA(2) of the Companies Ordinance.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
Hong Kong
Date

b. Report on the statutory financial statements

Disagreement - except for: information not disclosed

**AUDITORS' REPORT TO THE MEMBERS OF
AUTHORIZED FINANCIAL INSTITUTION LIMITED**

We have audited the financial statements set out on pages to in accordance with approved Auditing Standards.

The financial statements do not disclose all the information required by Section 161B of the Companies Ordinance relating to loans to officers. In our opinion a loan to a director of the company was made on terms more favourable than those which it is reasonable to expect the company to have offered to a person of the same financial standing who is not connected to the company. Particulars of this loan are shown in the following paragraph.

The loan was made to Mr. H. Kong on 1 July 19.... for \$12 million on an unsecured basis repayable in monthly installments over 20 years at 2% interest per annum. The sum outstanding at 31 December 19.... was \$X million including accrued interest of \$Y,000, the maximum sum outstanding during the year was \$Z million and no provision has been made against the loan or accrued interest.

In our opinion, the financial statements give a true and fair view of the state of affairs of the company at 31 December 19.... and of its profit/loss/results for the year then ended and except for the omission of the disclosure referred to in the previous paragraph have been properly prepared in accordance with the Companies Ordinance.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
Hong Kong
Date

Note:

The lack of disclosure in this case does not impair the true and fair view shown by the financial statements.

Appendix II

SPECIMEN INSERT IN AN ENGAGEMENT LETTER

Statement of loans to directors

- [].1 As the company is an authorized financial institution within the meaning of the Companies Ordinance we are required by Section 161BA of that Ordinance to examine and report on the statement of loans prepared by the company under that Section.
- [].2 The statement is to contain the stipulated particulars of loans which are not required to be disclosed in the statutory financial statements by reason of Section 161B(4A) and if there are no such loans a statement to that effect.
- [].3 In discharge of our duties we shall
 - (a) examine the statement in order to express an opinion on whether the statement contains the particulars of relevant loans required by Section 161BA(2) of the Ordinance;
 - (b) report that opinion; and
 - (c) where in our opinion the statement does not contain the particulars required by the Ordinance we shall include these particulars in our report so far as we are reasonably able to do so.
- [].4 As directors of the company you are responsible for taking reasonable steps to ensure compliance with Section 161BA as regards this statement and the associated register.
- [].5 You should also ensure that
 - (a) our audit report is annexed to the statement;
 - (b) the statement is made available for inspection by members and the public; and
 - (c) a public notice of the date of the annual general meeting of the company is made in a recognized English and a recognized Chinese newspaper.

Note:

This specimen is written as an insert in the example engagement letter provided as an Appendix to SAS 140 "Engagement letters".

Appendix III
SPECIMEN INSERT IN A LETTER OF
REPRESENTATION BY MANAGEMENT

[]. We acknowledge our responsibility for the statement of loans to officers/directors prepared by the company as an authorized financial institution under Section 161BA of the Companies Ordinance.

The statement contains the particulars required by Section 161BA of all loans, guarantees and security provided by the company to its officers and to directors of its holding company which but for Section 161B(4A) would be included in the financial statements of the company.

Note:

This specimen is written as an insert in the example representation letter provided as an Appendix to SAS 440 "Representations by management".