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

By e-mail <co_rewrite@fstb.gov.hk> and by fax (2869 4195)

3 July 2007

Our Ref.: C/SSD

Companies Bill Team
Financial Services and the Treasury Bureau
15/F, Queensway Government Offices
66 Queensway
Hong Kong.

Dear Sirs,

Comments on the Consultation Paper on the Rewrite of the Accounting and Auditing Provisions in the Companies Ordinance

The Hong Kong Institute of Certified Public Accountants (the Institute) welcomes the opportunity to comment on the captioned Consultation Paper published by the Financial Services and the Treasury Bureau in March 2007.

We are fully supportive of the Government's efforts to rewrite the Accounting and Auditing Provisions of the Companies Ordinance (CO) to make the company law more user-friendly and provide Hong Kong with a modernized legal infrastructure commensurate with its status as a major international business and financial centre. We have demonstrated our commitment through working with the Government since 2002 on this important project through the Joint Government/Institute Working Group to Review the Accounting and Auditing Provisions of the CO.

--- Please find attached the Institute's answers to the specific questions raised in the Consultation Paper. In preparing our responses, we have consulted our members generally and have specifically requested the views of those Committees at the Institute with a specific interest in various provisions of the CO.

We look forward to working with you further as this project develops and trust that our comments are of assistance. If you require any clarifications on our comments, please do not hesitate to contact me or Steve Ong, Deputy Director, Standard Setting (ong@hkicpa.org.hk).

Yours faithfully,

Patricia McBride
Executive Director

PM/SO/jc
Encl.

37th Floor, Wu Chung House,
213 Queen's Road East, Wanchai, Hong Kong
香港灣仔皇后大道東213號胡忠大廈37樓

Tel電話: (852) 2287 7228
Fax傳真: (852) 2865 6776
(852) 2865 6603

Website網址: www.hkicpa.org.hk
Email電郵: hkicpa@hkicpa.org.hk

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

ATTACHMENT

CONSULTATION PAPER ON THE REWRITE OF THE COMPANIES ORDINANCE – ACCOUNTING AND AUDITING PROVISIONS

HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS' ANSWERS TO THE 22 QUESTIONS FOR CONSULTATION

Question 1 : (a) Should the right of inspecting a company's accounting records be extended beyond directors to other officers of the company (such as managers and secretaries)?

We do not believe that the right of inspecting a company's accounting records should be extended beyond directors to other officers of the company unless those other officers (however defined) have legal responsibilities with respect to the company's accounting records. We do not see any need to provide for officers without specific legal responsibilities to have a general right in law as the extent of these other officers' duties and responsibilities concerning the financial records will have arisen from their terms of engagement with the company. Access to the books and records is therefore a matter to be dealt with on a case by case basis when the company assigns these persons their responsibilities.

(b) Do you agree that the court may, on application by a director, allow a person to inspect a company's accounting records on behalf of the director on such terms and conditions as the court may think fit?

We agree with the proposal which is aimed at ensuring that a director, including an independent non-executive director, would be able to received necessary support in discharging his/her duties which have become more extensive and demanding in recent years.

We consider that this inspection should be subject to the following constraints:

- The person authorised to inspect records may use the information obtained during the inspection only for the specific purpose approved by the court
- A person authorised to inspect records may not disclose the information acquired by him during his inspection to anyone except the appointing director
- Making copies of the records is not permitted unless the court orders state otherwise.

Question 2 : (a) Do you agree that the CO should be amended to require each company to have a fixed accounting reference period?

We agree with the proposal, as there is currently no provision to regulate the first accounting period except that the first AGM has to be held within 18 months of incorporation, and accounts are required to be laid before the company at its AGM.

IF YES, do you agree that:

For a newly incorporated company:

(i) it should be allowed to appoint a day as its accounting reference date through a directors' resolution, provided that the first accounting reference period should be (counting from its incorporation date) as mentioned in paragraph 3.8(a):

- **not less than six months?**
- **not more than 18 months?**

We agree with having a maximum period of 18 months for the first accounting period. However, we do not support the proposal to mandate a minimum initial period of not less than six months. We do not see the need for this requirement and consider it unnecessarily restrictive.

For example, if a company was incorporated in September 2007 and wished to adopt a December year end, we do not see the need to prohibit that company from preparing financial statements for the three month period ended 31 December 2007. If the company chooses to prepare such financial statements this would enable the entity to prepare its 2008 financial statements on a calendar year basis, with comparative amounts covering the initial three month period, rather than covering an initial 15 month period with no comparatives. In our view, such financial statements would be more informative for the reader and should not be prohibited.

(ii) if there is no appointed date under (i) above, the accounting reference date should be the last day of the month of its incorporation anniversary as mentioned in paragraph 3.8(a)?

We agree.

(iii) in either case, the subsequent successive accounting reference periods should be 12 months each?

We agree, subject to our comments below concerning ability to change the accounting reference date.

For any other company:

(iv) the accounting reference date should be the anniversary of the end-date of the company's most recent accounts laid at its AGM?

We agree, subject to our comments below concerning ability to change the accounting reference date.

(v) the first and subsequent successive accounting reference periods should be 12 months each?

We agree, subject to our comments below concerning ability to change the accounting reference date.

(b) Do you agree that each company should be allowed to alter its accounting reference date through a directors' resolution?

We agree that each company should be allowed to alter its accounting reference date through a directors' resolution.

IF YES, do you agree that:

(i) the accounting reference period should not be extended to more than 18 months?

We agree with this restriction.

(ii) such alteration should not occur within five years since the last extension of the accounting reference period, save for the purpose of aligning the accounting reference date with that of its holding company?

We do not agree with this restriction. We do not see the need to restrict the alteration to being only every five years, on the basis that in our experience companies will only change their accounting reference date for sound operational reasons and not arbitrarily.

In our experience such reasons are not restricted to a subsidiary aligning with its holding company. For example, if a Hong Kong incorporated holding company acquired significant subsidiaries in a jurisdiction where the accounting reference date was determined by statute, the holding company may decide to amend its own reporting date to align with that of its subsidiaries, as it is not legally able to amend the subsidiaries' reporting date. Other reasons may include a shift in the seasonality of its operations (for example, as a result of expansion into the Southern hemisphere), which result in a change in the most efficient reporting date for cut-off purposes.

We consider that it would be a sufficient safeguard to require the directors' resolution and directors' report to state the reason for the change in reporting date, with the added proviso (as proposed) that the resulting accounting period is no longer than 18 months.

(iii) in the case of a public company, the resolution should be filed with the Registrar of Companies for public information?

We agree.

(c) Do you agree that the CO should be amended to require each company to have a fixed financial year, i.e. the same as the accounting reference period, except that directors may alter the last day of the financial year by plus or minus seven days?

We agree with this proposal, provided that directors will be permitted to alter the last day of the financial year by any number of days up to and including seven days (i.e. it need not be exactly "plus or minus seven days"), for example, to enable them to end their financial year on a Friday each year.

Question 3 : (a) Should a holding company be relieved from the obligation to prepare its own accounts, provided that it has prepared group accounts and has included its own balance sheet as a note to its group accounts?

Although we are aware that many jurisdictions do not require the preparation of "parent" accounts, we are also aware of concerns that full parent account are necessary in Hong Kong. We recommend that the Companies Ordinance include a provision for shareholders of the "parent" to be able to require full "parent" accounts.

(b) Do you agree that the conditions under which a subsidiary is not required to prepare group accounts should be refined as proposed in paragraph 3.13?

We agree with the conditions as are set out in paragraph 3.13, except that we consider that it is unduly burdensome for a non-wholly owned holding company to be required to obtain the consent of all its shareholders. In our view, it would be sufficient to make the condition that "the other members have been informed about and do not object to the parent not presenting consolidated financial statements" i.e. to mirror the wording in paragraph 10(a) of Hong Kong Accounting Standard 27 *Consolidated and Separate Financial Statements*.

If there are concerns that this concession may be abused, we would support introducing de-minimus limits, for example stipulating that the company need not prepare consolidated financial statements if it has obtained the consent of the shareholders holding at least 75% in nominal value of the shares agree, provided those holding the remaining 25% have been informed about and do not object to the parent not presenting consolidated financial statements, following a similar approach as is proposed in paragraph 7.6(c). Furthermore, this concession could be restricted to private companies.

Question 4 : Should companies (unless otherwise exempted as proposed in paragraphs 4.6, 7.9 and 7.11) be required to prepare a more analytical and forward-looking business review along the lines of paragraph 4.3?

We consider that this information is generally only of relevance in the case of companies which have raised funds publicly. We consider that the information may not be of interest for shareholders of small private companies and welcome the proposed exemption for "section 141D companies".

We note that jurisdictions requiring such disclosures generally provide some form of "safe harbour" to support directors in making appropriate disclosures. We recommend that consideration be given to introducing such support in Hong Kong.

Question 5 : Do you have any suggestions on the information that should be included in the financial and non-financial key performance indicators, a generic term which is intended to refer to factors by reference to which a company's business can be measured effectively?

For listed companies, we recommend that any requirements relating to specific key performance indicators be included in the Listing Rules. Such requirements would need to be very general as it is hard to identify indicators that are relevant to the circumstances of all listed companies.

For non-listed companies, in our view a knowledgeable reader should be able to identify key financial information which reflects the business from the financial statements provided and there is no need for the directors' report to contain further financial information.

With respect to non-financial information, in order for such information to be meaningful, it should be tailored from one business to another. We therefore do not think it is practicable or appropriate to further define the information that should be disclosed as a "non-financial key performance indicator" in the CO.

Question 6 : Do you have any other suggestions on matters that should be covered in the business review?

We recommend that the requirements be kept at a very high level, to discourage "boiler plate" reporting.

Question 7 : Should directors' reports (unless otherwise exempted) be required to include information on:

(a) any significant difference in valuation between the market value of the company's non-current operating assets shown on the balance sheet as consist of interests in land and buildings and its book value to the extent practicable and, if so, what should be the appropriate information sources?

We have some reservations about this proposal. In our view, such market information should only be disclosed by directors if it is placed in its proper context. That is, the reader needs to be told:

(a) the source of the market information; and

(b) further information concerning the relevance of that market information to the company's property, for example, any differences in age, location, size, use etc. which could materially contribute to a difference in valuation between the properties which were the subject of the market information obtained and the company's own properties.

We consider that to make meaningful disclosure of information with respect to (b) could well be onerous on the directors and may result in the need to involve professional experts. And yet without disclosing this information, the reader of the directors' report could be materially misled by any market information disclosed. On balance, we would therefore not recommend introducing this new disclosure requirement.

The above issues, if important enough, should be addressed by financial reporting standards.

(b) equity linked agreements which subsist at the end of the financial year or which the company has entered into in the financial year, if the issue of shares under such agreements has a potential to dilute existing shareholders' interests?

We support this proposal. However, if the company entered into such agreements during the year, but they no longer subsist at the year end, then presumably they no longer have any potential to dilute existing shareholders' interests. We therefore consider that extending the proposal to those "which the company has entered into in the financial year" is not necessary.

Question 8 : **Should directors' reports contain a statement to the effect that, so far as each director knows, there is no relevant audit information of which the auditors are unaware, and that each director has taken all the steps he should have taken to make himself aware of such information and to establish that the auditors are aware of it?**

We support the proposal that directors' reports contain a statement to the effect that "so far as each director knows there is no relevant audit information of which the auditors are unaware". We agree that it is important that each director is made aware of his/her personal responsibility for the omission if he/she is aware that material information has been withheld from auditors.

However, we have reservations about extending that requirement to require that "each director has taken all the steps he should have taken to make himself aware of such information and to establish that the auditors are aware of it". We are concerned that this requirement may not be practicable as it appears to extend in effect to all "relevant audit information". Given this broad scope, we are concerned that the proposed requirement will leave directors unclear as to the extent of the "steps [they] should have taken" to inform themselves of all the information that the auditors need to know and then to establish the extent to which auditors are aware of all of this information.

Therefore, while we support the proposal to make each director personally responsible if they are aware that material information has been withheld from auditors or misrepresented to them, we do not support requiring each director to state in the directors' report that he/she has taken all steps necessary to ensure completeness of the auditors' knowledge in respect of all relevant audit information. At the very most, directors should only be required to take "all reasonable steps".

Question 9 : **Do you agree that a separate directors' remuneration report should be prepared by:**

(a) listed companies incorporated in Hong Kong; and

(b) unlisted companies incorporated in Hong Kong where holders of not less than 5% of the issued share capital or, in the case of a company not having a share capital, members representing not less than 5% of the total voting rights of all the members so request?

IF YES, do you agree that the remuneration report should disclose full details of various types of benefits given to the individual directors by name, including basic salary, fees, housing and other allowances, benefits in kind, pension contributions, bonuses, compensation for loss of office and long-term incentive schemes including share options?

We do not support this proposal. We consider that so far as listed companies are concerned, the matter is adequately and appropriately dealt with in the Listing Rules. So far as other companies are concerned, we consider that while directors' contracts should be open to inspection by shareholders, we consider

that including such personal information by name in the directors' report or financial statements is an unnecessary infringement of personal privacy.

Question 10 : We aim to revise the provisions regarding summary financial reports to make them more user-friendly from the company's as well as the members' viewpoints. Would you support amending the provisions along the lines as suggested in paragraph 5.4? Do you have any specific suggestions as to the form or contents of the summary financial reports?

We support the proposals in paragraph 5.4 as we consider that these offer a range of practical solutions to encourage the use of summary reports and will help provide information to shareholders that they find useful.

We recommend that a summary financial report include, as a minimum:

- the statement of recognised income and expense, or statement of changes in equity, as presented in the full financial statements;
- the balance sheet as presented in the full financial statements;
- the statement of cash flows, as presented in the full financial statements; and
- a basis of preparation note, which would include, as a minimum:
  - an explanation of the basis of preparation of the summary financial statements; and
  - a statement setting out the extent of compliance of the source financial statements with the applicable accounting framework.

Question 11 : Should auditors be given qualified privileges for statements made in the course of their duties as auditors and in respect of their resignation as auditors under the CO?

IF YES, do you agree that the proposed privileges should be extended to persons who publish any document prepared by the auditors in the course of their duties as auditors and in respect of their resignation under the CO?

We support the proposals given the increasingly important functions that auditors are required to perform on the corporate governance front. The new provision should ensure that auditors, will not, in the absence of malice on their part, be liable to any action for defamation at the suit of any person in respect of any oral or written statement which they make in the course of their duties as auditors and in respect of their resignation as auditors under the CO.

Question 12 : Should the auditors' rights to information be enhanced so that they can require "specified persons", as mentioned in footnote 51, to provide them with information, explanations or other assistance as they think necessary for the performance of their duties as auditors?

We have serious reservations about broadening the category of persons who are compelled by law to provide any information that the auditors may consider they need to know as auditors. For example, we do not consider it appropriate that predecessor auditors should be compelled by law to provide all and any information to the incoming auditors may request, as incoming auditors are required to form their own opinions concerning the financial affairs of the company. In addition, the specified persons may include individuals who are not Hong Kong residents (and may never have been), raising jurisdictional concerns over the extent to which such individuals should be held to have committed an offence under Hong Kong law, simply by failing to comply with a request for information from a Hong Kong incorporated company or its auditors.

We therefore consider that the question of auditors obtaining information from the broader group of specified persons identified in footnote 51 should be dealt with in the same manner as is proposed in paragraph 6.5. That is, such requests should be made through the company, and it will be the company (and every officer of it who is in default) who will commit an offence if they fail to take all steps reasonably open to them to obtain the information.

Question 13 : Where a holding company has a subsidiary undertaking which is not a body corporate incorporated in Hong Kong, should the auditor have the right to require the holding company to obtain from the relevant persons or parties such information, explanations or other assistance as the auditor may reasonably require for the purposes of his duties as auditor?

We support the proposal that the auditor should have the right to require the holding company to obtain the information and the holding company and every officer of it who is in default will commit an offence if the holding company fails to take all steps reasonably available. However, the Working Group may need to be mindful of difficulties when:

- the interest in the subsidiary undertaking is less than 100%, potentially leading to legal issues; or
- the local laws of some countries do not permit the subsidiary undertaking to provide the required information.

Question 14 : Should an outgoing auditor be allowed to give the incoming auditor information that he became aware of in his capacity as auditor without seeking permission of the company?

We support this on the premise that this will ensure an effective and continuous oversight of any changes in the auditor of a company.

Question 15 : Should all outgoing auditors (i.e. auditors who cease to hold office for any reasons) be required to provide a statement of any circumstances connected with his ceasing to hold office that he considers should be brought to the attention of the members or creditors of the company or a statement of no such circumstances?

We support the proposal. This would extend the section 140A of the current CO whereby a resigning auditor is required to make a statement in the notice of resignation as to whether there are any circumstances or not in relation to his resignation that he considers should be brought to the notice of the members or creditors of the company.

Question 16 : Do you agree with the proposed amendments to the auditing provisions as set out in paragraph 6.9?

We support the proposals in paragraph 6.9 to improve the clarity and operation of the auditing provisions in the CO.

Question 17 : (a) Do you agree that the qualifying criteria for exemptions from certain accounting provisions for private companies under section 141D should be relaxed along the lines as suggested in paragraph 7.6?

We agree that the qualifying criteria should be relaxed along the lines suggested in paragraph 7.6.

(b) Specifically, do you agree that the size criteria set out in paragraphs 7.3 and 7.6(e), i.e. (aggregate) total annual revenue, (aggregate) total assets and number of employees are the right criteria? IF YES, do you agree with the proposed thresholds?

We agree.

Question 18 : Should section 141D be amended to require a private company applying the section to prepare a full set of accounts dealing with the state of affairs and profit or loss of the company as required under the SME-FRS and, in the case of a holding company, also to prepare a full set of group accounts?

We support the proposal. We presume that the propose exemptions from the preparation of group accounts would apply to "section 141D companies" if the conditions set out in paragraph 3.13 are met.

Question 19 : Should "section 141D companies" be required to produce only simplified directors' reports along the lines of paragraph 7.9?

We agree that "section 141D companies" should be permitted to produce a simplified directors' reports along the lines of paragraph 7.9.

Question 20 : Do you agree that guarantee companies should be allowed to take advantage of the simplified reporting and disclosure requirements similar to those proposed to be applied to section 141D private companies (including simplified accounts and simplified directors' reports) if they are able to meet certain qualifying criteria?

IF YES,

(i) do you agree that the size criteria set out in paragraphs 7.3 and 7.6(e), i.e. (aggregate) total annual revenue, (aggregate) total assets and number of employees, are the right criteria for guarantee companies?

(ii) should the thresholds outlined in paragraphs 7.3 and 7.6(e) be applied to guarantee companies or should they be modified?

(iii) should any additional information be required from those guarantee companies which take advantage of the simplified reporting and disclosure requirements?

We consider that primary consideration for guarantee companies should be deciding which accounting framework more appropriately suits their circumstances.

In this respect it should be noted that full HKFRSs have been developed primarily to assist investors and/or analysts in capital markets to assess the financial performance and future potential of companies that have or are seeking to raise capital from those markets, in order to make investment decisions such as whether to buy or sell their interests in those entities.

In our view, such a framework is not designed to be adopted by companies limited by guarantee when these companies have been set-up for non-profit making purposes such as educational, charitable, religious or community-related projects. It may also be an unnecessarily onerous burden on those companies to require them to employ or engage accountants with sufficient knowledge of HKFRSs to prepare their financial statements.

By contrast, the SME framework is an historical cost framework, i.e. a framework which is backward-looking in its focus on recording the resources obtained by an entity and how management of entity has preserved or used those resources in their activities. In our view, it is an appropriate basis for reporting, where assessment of the stewardship of management is the primary function of the financial statements. It is therefore particularly suited to companies which have been set-up for non-profit making purposes such as educational, charitable, religious or community-related projects.

Therefore, in our view, all such guarantee companies should be permitted to prepare financial statements in accordance with the SME framework, irrespective of size as determined by the SME criteria.

Question 21 : (a) Among the three options listed in paragraph 8.2, which option do you favour? What are the reasons for your choice?

We consider Option (3) more appropriate as it will retain a few of the disclosure requirements in the Tenth Schedule which are not presently covered by the HKFRSs but with a significant public interest or corporate governance dimension (e.g. auditors' remuneration) and repeal the rest of the Schedule. Companies are required to continue to follow the overriding principle that their accounts must give a true and fair view of their state of affairs.

(b) If Option (3) is chosen, do you also favour giving statutory recognition to the HKFRSs by requiring companies to state in their accounts as to whether the accounts have been prepared in accordance with applicable accounting standards, and particulars of any material departure from those standards and the reasons?

We favour this form of statutory recognition of HKFRSs. This may however beg the question on the status of those financial statements prepared using other financial reporting frameworks like IFRSs.

(c) If you do not favour any of the three options, do you have any other suggestion for dealing with possible conflicts between the Tenth Schedule and accounting standards?

Not applicable.

Question 22 : (a) Do you agree that the Eleventh Schedule in its present form should be repealed while retaining those disclosure requirements concerning section 141D companies with a significant public interest or corporate governance dimension and which are not presently covered by the SME-FRS?

We agree.

(b) <u>IF YES</u>, do you agree that statutory recognition should be given to the SME-FRS by requiring section 141D companies to state in their accounts as to whether the accounts have been prepared in accordance with applicable accounting standards, and particulars of any material departure from those standards and the reasons?

We agree. However, similar to Question 21(b) above, this may beg the question on the status of those financial statements prepared using other financial reporting frameworks like the IASB's IFRSs for SMEs if it is issued in Hong Kong after the exposure draft stage.

(c) <u>IF NOT</u>, do you have any other suggestion for dealing with possible conflicts between the Eleventh Schedule and the SME-FRS?

Not applicable.

- END-