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

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The Hon. Audrey Eu, SC, JP
Chairwoman
Bills Committee on Companies (Amendment) Bill 2004
The Legislative Council
Legislative Council Building
8 Jackson Road
Central
Hong Kong

Dear Ms. Eu,

Companies (Amendment) Bill 2004
Proposed legislative amendments to the definition of "subsidiary"

We were pleased to have had the opportunity of attending the last Bills Committee meeting and to listen to the different opinions offered in connection with the proposed legislative amendments to the definition of subsidiary. We are most appreciative of the efforts of Administration in addressing the concerns raised either in the submissions received or at the meeting. We are in total agreement with the Administration's responses and, in particular, their responses to the concerns expressed by the securitisation industry. In this letter, we offer our further thoughts on the subject and comment on some of the major concerns raised by the securitisation industry.

The 'control-based' definition of subsidiary

We wish to emphasise that the primary objective of the proposed legislative amendments is to require (and, in fact, permit) companies incorporated under the Hong Kong Companies Ordinance to use the "control-based' definition of subsidiary when preparing their consolidated financial statements. This definition is currently used by all non-Hong Kong incorporated companies that apply Hong Kong Financial Reporting Standards (HKFRS) as well as those that apply International Financial Reporting Standards (IFRS).

The "control-based" definition of subsidiary differs from the existing legal definition of subsidiary in that it looks beyond actual shareholdings and voting power that an entity may have in respect of another entity and focuses instead on whether or not the former entity has the power to exercise control over the operating and financial policies of the latter entity.

For example, an entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or it may own other similar instruments that have the potential, if exercised or converted, to give the entity power or reduce another party's power to determine the financial and operating policies of another entity. A company may also create a Special Purpose Entity (SPE) to accomplish a narrow and well–defined objective and impose strict and sometimes permanent limits on the decision-making powers of the governing board or management over the operations of the SPE. As a result, the SPE operates on so-called "autopilot". In these cases, the shareholding or voting powers, if any, held may not reflect the true relationship between the two parties and therefore using the control-based definition of subsidiary to determine the true relationship is more appropriate.

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In our sophisticated economy, situations where an entity may have the power to control another entity in the absence of a majority shareholding or voting powers are numerous. Consolidated financial statements are the financial statements of a group presented as a single economic entity. In determining which entities should be part of the group, decisions should not be made merely on the shareholding and voting power that an entity may have in respect of another entity. All facts and circumstances should be examined. Without this ability, the consolidated financial statements would not meet the objective of providing true and fair information about the performance and financial position of the group that is useful to users of financial statements in making economic decisions. Also, the consolidated financial statements would not show the true results of the stewardship of management, or permit true accountability of management for the resources entrusted to it.

Accordingly, we believe the proposed legislative changes are necessary in that they will enhance the reliability, comparability and transparency of financial statements and improve the quality of financial reporting in Hong Kong.

Impact on securitisation industry

A constant theme in opposition to the proposed legislative change is the perceived adverse effect that changes will have on the securitisation business because they will deprive the asset securitisation market of off-balance sheet treatment in the presentation of financial statements.

We do not believe that the proposed legislative amendments to the definition of subsidiary, when implemented, will have an effect on securitisation where the originators of the receivables have made a clean sale of their receivables to a party over which they have no control. In fact, we have observed that, many, if not most, banks (major participants in the securitisation market), that have transferred their receivables to third parties without recourse for securitisation purposes have been able to remove these items from their balance sheets even when using the "control-based" definition of subsidiary.

The proposed legislative amendments will only have an impact on those companies that are now relying on the existing legal definition of subsidiary to transfer (without subsequent consolidation) their receivables and related liabilities to a SPE over which they exercise control or in respect of which they have, in substance, retained control. Often, the reason for doing this is to improve key balance sheet ratios, resulting in an ability to undertake more securitisation activities.

At the last Bills Committee meeting, the Hong Kong Mortgage Corporation (HKMC) argued that, if their SPEs were to be consolidated, credit risk would be perceived to be higher and, as a result, investors would demand a higher price in order to be compensated for taking on the higher credit risk. However, we note from the note on credit risk management in the 2003 annual report of the HKMC that the HKMC has a prudent policy for managing credit risk and adopts a five pronged approach to maintaining the high asset quality of its mortgage portfolio through: a careful selection of approved sellers; prudent mortgage purchasing criteria; prudent insurance eligibility criteria; an effective due diligence review process; and adequate protection for higher-risk mortgages. It would appear, therefore, that the quality of the mortgage portfolio plays a significant role in determining the credit risk rating and the price of their products, rather than the accounting of SPEs per se.

It should also be noted that, under the current accounting framework in Hong Kong, those entities that do not consolidate their controlled entities because they do not meet the existing legal definition of subsidiary are required to disclose in their notes to the financial statements the effect on the income statement and balance sheet had those controlled entities been

consolidated. The HKMC currently discloses this effect in their notes to the financial statements. In assessing credit risk, sophisticated investors will always take into account all of the information contained in the financial statements, including the notes.

Therefore, the principle impact of the proposed amendments would be to present the information now contained in the notes more prominently (and more accurately) in the financial statements. The new presentation is designed to provide a more appropriate reflection of the results and the state of affairs of the group. However, viewed in the whole, there would be no alteration to the amount of information provided in the financial statements.

In light of the above, we find it difficult to see that there are valid grounds to argue that the legislative changes will have an adverse effect on the securitisation business.

Effect of off-balance sheet treatments

In recent years, accounting standards have been developed to address the issues and to deal with the problems caused by the misleading effects that “off-balance sheet treatments” can have on financial statements. The most widely recognised effect of such treatment is the omission of liabilities from the balance sheet.

When off-balance sheet accounting is used, users of financial statements would be unaware of the extent of liabilities that an entity may have until those liabilities became too large and led to the eventual collapse of the entity.

In the case of Enron, significant liabilities were hidden in the SPEs and thus were omitted from the financial statements of the company. The significant losses made by the SPEs were also omitted from the results of the company. Investors only became aware of these liabilities and losses after the collapse of Enron. Enron is not an isolated case. There are many other instances, such as the Maxwell case (omission of pension liabilities), Bank of Credit and Commerce (liabilities hidden in a Cayman subsidiary) and, most recently, Parmalat.

Without this legislation, we believe that users of the financial statements of companies incorporated under the Hong Kong Companies Ordinance are subject to similar risks.

Adoption of US treatment is inappropriate

Our understanding is that the existing US GAAP accounting for Qualified SPEs (QSPE) is mainly set out in FAS140. We would like to point out that the general principles of consolidation under US GAAP are almost identical to those in IFRS. The exemption from consolidation of QSPEs under FAS 140 is an exception to the general principles and is restricted solely to QSPEs and no other entities. This exception is, however, not acceptable under IFRS.

In 2002, the US Financial Accounting Standards Board (FASB) signed a Memorandum of Understanding (the Norwalk Agreement) with the IASB that formalized their respective commitment to achieve convergence of US GAAP and IFRS. The treatment of QSPEs has been identified as one of the differences and discussion is underway to eliminate this difference.

In addition, we note that the FASB is considering a number of revisions to FAS 140, and the release of an exposure draft on revisions to FAS 140 is expected in the second quarter of 2005. Of particular significance is the reconsideration by the FASB of what constitutes "legal separation". The FASB is considering revised criteria for legal separation that would make it

consistent with what would be considered a "true sale" from a legal standpoint. In turn, the support for a legal true sale would rest on a legal opinion. Accordingly, we see that, in the near future, the exemption for QSPE will be restricted, if not completely eliminated.

The international capital markets are actively moving to apply the IASB's Standards or, at least, standards that are consistent with those issued by the IASB. In respect of the standards that apply in Hong Kong, we would submit that it is good public policy for our accounting requirements to be aligned with the IASB's Standards rather than applying selectively one jurisdiction's accounting requirements where, even there, the accounting rules are currently under review.

No longer True and Fair

We understand that the securitisation industry has indicated a preference for a "carve-out" from the proposed legislation. We are of the view that, if a "carve-out" is granted under the proposed legislation, the financial statements prepared by those entities, including the HKMC, that have unconsolidated SPEs because of the "carve-out" granted by law will not give a true and fair view as required under HKFRS even though they might satisfy all of the legal requirements. In addition, we believe that such a "carve out" would result in two similar entities presenting very different results and financial positions depending on whether or not they meet the conditions of the carve out and thereby hindering the comparability of financial statements.

We also note that the HKMC has expressed concern over the changes to the capital adequacy ratio and other ratios if the SPEs are required to be consolidated. We need to stress that financial reporting and financial regulatory functions serve different purposes. The objective of financial reporting is to present financial information that gives a true and fair view of the results and the state of affairs of the entity. The capital adequacy ratio is, however, a concept that is commonly used to regulate banks and other regulated industries. It has nothing to do with financial reporting and does not normally apply to other industries. In some cases, the law or the regulators may specify a required capital adequacy ratio for certain regulated industries and therefore consequential changes to the relevant law and regulations may be required when the legislative amendments are implemented. However, we do not believe that the maintenance of a capital adequacy ratio as required by regulations and/ or law provides a valid reason for opposing the proposed legislation.

IASB current review of the Standard on consolidation

The IASB is currently undertaking a review of the concept of control and other relevant issues concerning the accounting standard on consolidation. However, the IASB has indicated that it has no intention to change the definition of control. Their review is focused on giving more guidance on what control actually means. Accordingly, the current review of the standard on consolidation by the IASB will not have an effect on the proposed legislative changes under review.

The remaining exception under our convergence project

As you may be aware, we have a policy to adopt, on a timely basis, accounting standards that are converged with those set by the IASB. This policy has had the long-standing support of the government and other international bodies such as the International Monetary Fund, who in their June 2003 report on Hong Kong rebuked us for not having adopted certain International Accounting Standards sooner.

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Recently, we have issued a press release announcing the completion of our convergence project (copy of the press release is available at http://www.hkicpa.org.hk/professionaltechnical/accounting/pressrelease/docs/041209e.pdf). In our press release, we have noted that, while the HKFRS will be, in all respects, fully converged with IFRS as from 1 January 2005, there is one remaining exception that applies only to Hong Kong companies, being the conditions by which entities are regarded as being subsidiaries for the purpose of preparing consolidated financial statements. The issue, as regards the definition of "subsidiary" in consolidated financial statements, is the result of a different definition being applied in the Hong Kong Companies Ordinance and is the subject that is currently under review. We believe that it is a great pity for Hong Kong's international standing that we cannot eliminate this only exception at the same time as the completion of the convergence project.

We would encourage the Government, as we have on many prior occasions, to implement the proposed changes to the definition of subsidiary as early as practicable. We believe the proposed legislative amendments under review augur well for the future of financial reporting in Hong Kong and for the well being of Hong Kong as one of the world major financial centres.

We hope the above provides the Bills Committee with further insights into our views on the proposed legislative amendments. Should the Bills Committee have any questions on the above, we would welcome the opportunity to explain our comments further.

Yours sincerely,

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CHIEF EXECUTIVE & REGISTRAR
HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

WCC/EH/al

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The Hon. Mandy Tam, Legislative Councillor (Accountancy)
Ms. Connie Szeto, Clerk to Bills Committee on Companies (Amendment) Bills 2004