LC Paper No. CB(1)1655/04-05(02)

Bills Committee on
Companies (Amendment) Bill 2004

Follow-up Actions Arising from the Discussion
at the Meeting on 23 May 2005

PURPOSE

At the Bills Committee meeting held on 23 May 2005, Members requested the Administration to explore options to address Members' concerns on any possible impact of the Companies (Amendment) Bill 2004 (the Bill) on the asset-securitization market and refine the drafting of clause 19 of the Bill. After consulting the Hong Kong Institute of Certified Public Accountants (HKICPA) and the Department of Justice (D of J), we set out our responses in the ensuing paragraphs.

IMPACT OF THE BILL ON THE SECURITIZATION MARKET IN HONG KONG

2. We note that Members have no objection in principle to the Administration's proposal to amend the definition of the term "subsidiary" in the Companies Ordinance (CO, Cap. 32) for the purpose of group accounts to make it more closely aligned with the definition adopted in the International Accounting Standard (IAS) 27, which provides for, among other things, the criteria in determining parent-subsidiary relationship for the purpose of group accounts.

I: International Experience

3. We note that Members are concerned about whether the proposed amendments in the Bill, in particular the scope of its application, are in line with the practices adopted by other major jurisdictions. In this respect, we would like to draw Members' attention to our findings set out in paragraphs 4 and 14 below.

(A) <u>European Union</u>

4. While, as we mentioned at the Bills Committee meeting held on 23 May 2005, only listed companies in the European Union (EU) are required to prepare their accounts in accordance with ***all*** the relevant IAS starting from 1 January 2005, we would like to point out that the focus of the discussion concerning the Bill should be made on IAS **27**, namely the IAS with which we aim to align more closely.

5. In this regard, our latest research reveals that the EU had indeed issued as early as in 1983 a Directive[1] requiring Member States to require in their national laws consolidation of accounts if one of the following criteria is fulfilled, namely (i) the control of voting rights; (ii) the control of the rights to appoint or remove the board of directors; or (iii) the right to exercise "dominant influence"[2]. The relevant extract of the Directive is at <u>Annex A</u>**.** In the UK, on top of the conventional "voting rights" or "rights to appoint or remove the board of directors" tests, the "dominant influence" test has been subsequently incorporated in the UK Companies Act 1985 (amended in 1989) <u>on which the Bill is modelled</u>. Thus, ***EU countries shall require, in their national laws, companies (both listed and unlisted) to follow the "dominant influence" test in determining a "subsidiary" and preparing group accounts for years***[3]. In other words, when it is said that unlisted companies in the EU do not need to follow the IAS, the "IAS" here means the "whole set of IAS" which had been adopted for application in the EU. However, as the "dominant influence" test (which is consistent with the definition of "subsidiary" under IAS 27) had been effective by virtue of the aforesaid 1983 EU Directive, it is fair to say that the proposals in the Bill have been put in place in the EU for years, for both listed and unlisted companies.

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1 Seventh Council Directive 83/349/EEC of 13 June 1983.

2 The introduction of the "dominant influence" test is subject to whether the national law governing the subsidiary undertaking permits its being subject to dominant influence by virtue of a control contract or provisions contained in the subsidiary undertaking's memorandum or articles of association. The Bill has adopted a similar provision in sections 2(1) and 5(b) of the proposed 23rd Schedule.

3 See footnote 2 above.

(B) <u>United Kingdom</u>

The Companies Act 1985

6. As mentioned in paragraph 5 above, the UK Companies Act 1985 (as amended in 1989) had introduced the "dominant influence" test which had, since then, been applied to both listed and unlisted companies. The proposed amendments provided under the Bill are modelled on the similar provisions in the UK Act. In 2004, the UK passed the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulation 2004 to give effect to a EU directive for application of all relevant IAS adopted by the EU to listed companies starting from 1 January 2005. Hence, as regards the preparation of group accounts, the current position of the UK Companies Act is that UK listed companies must follow the relevant IAS[4] *directly*, whereas other companies may prepare group accounts in accordance with *either* the UK Companies Act requirements *or* the relevant IAS. In this respect, the "dominant influence" test, which has already been enshrined in the UK Companies Act, continues to apply to unlisted companies which do not choose the IAS. As such, ***there is no question of unlisted companies in the UK exempt from the requirements to prepare group accounts on the basis of the "dominant influence" test in the Companies Act on which the Bill is modelled.***

Linked Presentation

7. The UK Companies Act 1985 does not expressly provide that accounts must comply with the domestic accounting standards, although we are advised by the HKICPA that it is widely accepted that such standards should be given due regard in the preparation of accounts for the achievement of a "true and fair view" presentation. The UK's linked presentation method in accounting standards essentially means reflecting on the balance sheet the securitized loans as a deduction from the gross amount of the item it finances, hence ***it is not an off-balance sheet treatment***. Also, it does **not** affect the operation of the "dominant influence" test enshrined in the Act.

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[4] The relevant IAS includes the definition of "subsidiary" in IAS 27, which is consistent with the definition of "subsidiary" under the UK Companies Act which contains the "dominant influence" test.

8. As advised by the HKICPA, it should be stressed that the linked presentation method is a unique concept in the UK. This accounting method is not prescribed under the Companies Act, nor is it adopted in any other places of the world. For UK listed companies, as they are required to comply with all relevant IAS adopted by the EU since 1 January 2005, this method can no longer be used. Furthermore, the UK Department of Trade and Industry has advised that the linked presentation method would be withdrawn altogether in due course.

(C) <u>Australia</u>

9. Australia adopted the "control-based" definition under IAS 27 since the last decade, and there is no separate regime for listed or unlisted companies. The market growth in the past few years has demonstrated that the off-balance sheet treatment should not be equated to the "oxygen" for the asset securitization market.

(D) <u>Singapore</u>

10. According to our enquiry with the Accounting and Corporate Regulatory Authority of Singapore through Hong Kong's Economic and Trade Office there, Singapore adopted the "control-based definition" in IAS 27 since the last decade as well. We are advised that there have not been any market comments suggesting that the definition of IAS 27 has had a negative impact on the securitization market in Singapore. Likewise, we are not aware of any separate regimes for listed and unlisted companies in Singapore insofar as the adoption of IAS 27 is concerned.

(E) <u>The US and Japan</u>

11. Hong Kong's company laws have a much closer origin to those in common law jurisdictions such as the UK, Australia and Singapore. The same position is true with respect to the accounting standards. On this basis, we consider that the experience of the US and Japan should be viewed in the proper context, particularly where Japan is not a common law jurisdiction.

12. According to the HKICPA, under the US's accounting standard FASB 140, securitization companies meeting the very restrictive criteria of "sale accounting" and "qualifying special purpose entity (QSPE)" would be allowed to use "off-balance sheet treatment" to account for securitization transactions. This means that such a treatment is not available to companies (both listed and unlisted) not engaging in securitization transactions. Any proposals to confine the proposed amendments under the Bill to listed companies would go beyond, and indeed deviate, from the US's practice, even if the relevance of the US's practice (see paragraph 11 above) is put aside.

(F) <u>The Various Securitization Forums in Australia, US and Europe</u>

13. As regards Hong Kong Mortgage Corporation's suggestion that the various Securitization Forums in Australia, US and Europe have kicked off a global project to develop a revised model for accounting for securitization transactions, our enquiry with the staff of the International Accounting Standards Board (IASB) reveals that ***this is not the case***. The Australian Accounting Standards Board (AASB) has also advised us that it has no knowledge about such a "global project". According to our understanding from IASB and AASB, the relevant bodies had just sought clarification on the application of the IAS on matters such as the accounting for financial instruments, which is a matter different from the determination of parent-subsidiary relationship.

14. To sum up, the international experience demonstrates that -

(a) There is no comparable jurisdiction in the world maintaining separate regimes (listed vis-à-vis unlisted) for the application of IAS 27 or the control/dominant influence test set out therein; and

(b) Nor do we find any sound arguments to justify such separate regimes for the purpose of group accounts.

II: Hong Kong

(A) <u>The Position of the HKICPA</u>

15. In Hong Kong, by virtue of section 18A of the Professional Accountants Ordinance (PAO, Cap. 50), the HKICPA issued HKAS 27, which has been effective since 1 January 2005 and is in all material terms the same as IAS 27, to govern the preparation of group accounts. Pursuant to the same section under the PAO, the accounting standards issued by the Council of the HKICPA are required to be observed, maintained or otherwise applied by any certified public accountants. Any companies (including listed or unlisted companies) in Hong Kong preparing accounts in accordance with HKAS 27 shall consolidate subsidiaries in the manner prescribed therein. Moreover, the Listing Rules require companies primarily listed in Hong Kong to adopt HKAS or IAS in preparing financial statements.

16. The HKICPA considers that off-balance sheet treatment for securitization special purpose entities (SPE) by the group company that has control over them would result in the financial statements of that group not giving a true and fair view. Currently, however, financial statements of Hong Kong incorporated companies are not qualified by their auditors, who are certified public accountants (practising) or corporate practices registered with the HKICPA, because HKAS 27 contains certain *interim* provisions for such companies to consolidate accounts in accordance with the CO's definition before it is amended by the Bill and to disclose the information of SPE under footnotes.

17. The HKICPA has put forward to the Administration that the proposed amendments to the CO 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. The HKICPA is of the view that it is not appropriate to adopt a phased approach or maintain a separate regime for listed or unlisted companies in connection with the implementation of IAS 27. Doing so would run the risk of creating inconsistency in the financial reports, as two companies with the same substance (except for one being listed and the other not) may have different financial reports. The confusion caused to users, not only

investors but also other parties such as creditors, could be considerable.

(B) <u>The Administration's View</u>

18. The Administration has considered the subject very carefully. We wish to reiterate that there is no convincing evidence to suggest that the Bill will have an adverse implication for the development of asset-securitization market in Hong Kong. Instead, the Government Economist advises that the Bill will have a positive impact on the asset-securitization industry, as it will enhance the quality of corporate governance and hence the status of Hong Kong as an international financial centre.

19. Despite the reservation of some members of the securitization industry, the Bill has received very favourable support from various sectors / bodies including the Securities and Futures Commission, the Stock Exchange of Hong Kong Limited, the Standing Committee on Company Law Reform, the Association of International Accountants, Hong Kong Institute of Company Secretaries, etc. None of the chambers of commerce has raised any objection to or adverse comments on the Bill.

20. Nor are we convinced that there is a justifiable case for pursuing the proposal of prescribing two different definitions of "subsidiary" for listed vis-à-vis unlisted companies. As a matter of principle, whether a company is listed or unlisted should not be relevant to the determination of a "subsidiary". As shown above, there is also no comparable international jurisdiction which has introduced such separate regimes to define "subsidiary". Members may wish to note that not even the securitization industry has suggested that IAS 27 should not apply to unlisted companies not engaging in securitization transactions.

21. In the final analysis, the Administration takes the view that the amendments to the CO as proposed by the Bill should apply to both listed and unlisted companies and that no "carve out" should be introduced for any particular sector. Nor do we find it justifiable to propose any phased approach with respect to the commencement of the Bill. In this connection, the Administration invites Members to support

the Bill which is pertinent to the upgrade of financial reporting quality in Hong Kong as an international financial centre.

CLAUSE 19 – TRANSITIONAL PROVISIONS

22. Separately, in response to Members' suggestions at the meeting on 23 May 2005, the Law Draftsman has refined the drafting of clause 19 as shown in the mark-up version of the Bill (extract) of Annex B.

Financial Services and the Treasury Bureau
May 2005

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SEVENTH COUNCIL DIRECTIVE

of 13 June 1983

based on the Article 54 (3) (g) of the Treaty on consolidated accounts

(83/349/EEC)

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Article 54 (3) (g) thereof,

Having regard to the proposal from the Commission [1],

Having regard to the opinion of the European Parliament [2],

Having regard to the opinion of the Economic and Social Committee [3],

Whereas on 25 July 1978 the Council adopted Directive 78/660/EEC [4] on the coordination of national legislation governing the annual accounts of certain types of companies; whereas many companies are members of bodies of undertakings; whereas consolidated accounts must be drawn up so that financial information concerning such bodies of undertakings may be conveyed to members and third parties; whereas national legislation governing consolidated accounts must therefore be coordinated in order to achieve the objectives of comparability and equivalence in the information which companies must publish within the Community;

►C1 Whereas, in the determination of the conditions for consolidation, account must be taken not only of cases in ◄ which the power of control is based on a majority of voting rights but also of those in which it is based on agreements, where these are permitted; whereas, furthermore, Member States in which the possibility occurs must be permitted to cover cases in which in certain circumstances control has been effectively exercised on the basis of a minority holding; whereas the Member States must be permitted to cover the case of bodies of undertakings in which the undertakings exist on an equal footing with each other;

Whereas the aim of coordinating the legislation governing consolidated accounts is to protect the interests subsisting in companies with share capital; whereas such protection implies the principle of the preparation of consolidated accounts where such a company is a member of a body of undertakings, and that such accounts must be drawn up at least where such a company is a parent undertaking; whereas, furthermore, the cause of full information also requires that a subsidiary undertaking which is itself a parent undertaking draw up consolidated accounts; whereas, nevertheless, such a parent undertaking may, and, in certain circumstances, must be exempted from the obligation to draw up such consolidated accounts provided that its members and third parties are sufficiently protected;

Whereas, for bodies of undertakings not exceeding a certain size, exemption from the obligation to prepare consolidated accounts may be justified; whereas, accordingly, maximum limits must be set for such exemptions; whereas it follows therefrom that the Member States may either provide that it is sufficient to exceed the limit of one only of the three criteria for the exemption not to apply or adopt limits lower than those prescribed in the Directive;

Whereas consolidated accounts must give a true and fair view of the assets and liabilities, the financial position and the profit and loss of all the undertakings consolidated taken as a whole; whereas, therefore

[1] OJ No C 121, 2. 6. 1976, p. 2.
[2] OJ No C 163, 10. 7. 1978, p. 60.
[3] OJ No C 75, 26. 3. 1977, p. 5.
[4] OJ No L 222, 14. 8. 1978, p. 11.

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consolidation should in principle include all of those undertakings; whereas such consolidation requires the full incorporation of the assets and liabilities and of the income and expenditure of those undertakings and the separate disclosure of the interests of persons outwith such bodies; whereas, however, the necessary corrections must be made to eliminate the effects of the financial relations between the undertakings consolidated;

Whereas a number of principles relating to the preparation of consolidated accounts and valuation in the context of such accounts must be laid down in order to ensure that items are disclosed consistently, and may readily be compared not only as regards the methods used in their valuation but also as regards the periods covered by the accounts;

Whereas participating interests in he capital of undertakings over which undertakings included in a consolidation exercise significant influence must be included in consolidated accounts by means of the equity method;

Whereas the notes on consolidated accounts must give details of the undertakings to be consolidated;

Whereas certain derogations originally provided for on a transitional basis in Directive 78/660/EEC may be continued subject to review at a later date,

HAS ADOPTED THIS DIRECTIVE:

SECTION 1

Conditions for the preparation of consolidated accounts

Article 1

1. A Member State shall require any undertaking governed by its national law to draw up consolidated accounts and a consolidated annual report if that undertaking (a parent undertaking):

(a) has a majority of the shareholders' or members' voting rights in another undertaking (a subsidiary undertaking); or

(b) has the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another undertaking (a subsidiary undertaking) and is at the same time a shareholder in or member of that undertaking; or

(c) has the right to exercise a dominant influence over an undertaking (a subsidiary undertaking) of which it is a shareholder or member, pursuant to a contract entered into with that undertaking or to a provision in its memorandum or articles of association, where the law governing that subsidiary undertaking permits its being subject to such contracts or provisions. A Member State need not prescribe that a parent undertaking must be a shareholder in or member of its subsidiary undertaking. Those Member States the laws of which do not provide for each contracts or clauses shall not be required to apply this provision; or

(d) is a shareholder in or member of an undertaking, and:

(aa) a majority of the members of the administrative, management or supervisory bodies of that undertaking (a subsidiary undertaking) who have held office during the financial year, during the preceding financial year and up to the time when the consolidated accounts are drawn up, have been appointed solely as a result of the exercise of its voting rights; or

(bb) controls alone, pursuant to an agreement with other shareholders in or members of that undertaking (a subsidiary undertaking), a majority of shareholders' or members' voting rights in that undertaking. The Member States may introduce more detailed provisions concerning the form and contents of such agreements.

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The Member States shall prescribe at least the arrangements referred to in (bb) above.

They may make the application of (aa) above dependent upon the holding's representing 20 % or more of the shareholders' or members' voting rights.

However, (aa) above shall not apply where another undertaking has the rights referred to in subparagraphs (a), (b) or (c) above with regard to that subsidiary undertaking.

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2. Apart from the cases mentioned in paragraph 1 the Member States may require any undertaking governed by their national law to draw up consolidated accounts and a consolidated annual report if:

(a) that undertaking (a parent undertaking) has the power to exercise, or actually exercises, dominant influence or control over another undertaking (the subsidiary undertaking); or

(b) that undertaking (a parent undertaking) and another undertaking (the subsidiary undertaking) are managed on a unified basis by the parent undertaking.

19. Transitional provisions

(1) The amendments made by this Ordinance shall not apply in relation to a company (including a company which is an insurer within the meaning of section 2(1) of the Insurance Companies Ordinance (Cap. 41)) until the start of the company’s first financial year beginning after the expiration of the 30 days immediately following the commencement of this section.

(2) For the avoidance of doubt, it is hereby declared that any provision of the principal Ordinance amended by this Ordinance shall, as it is in force from time to time apart from that amendment, apply ~~to and~~ in relation to a company until that amendment~~subsection (1)~~ applies in relation to the company.