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

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Urgent By Fax

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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"

First of all, I would like to confirm the Hong Kong Institute of CPAs' full support for the captioned Bill. The Institute advised the Administration that the proposed amendments to the Companies Ordinance to align the legal definition of "subsidiary" in the Companies Ordinance for the purpose of group accounts with the definition of "subsidiary" in the International Accounting Standard (IAS) 27 and the equivalent Hong Kong Accounting Standard (HKAS) 27 are necessary and important. This will enhance the reliability, comparability and transparency of financial statements of Hong Kong incorporated companies and bring them into line with overseas companies applying IAS and HKAS. We believe that the arguments for the amendments have been fully rehearsed by the Administration as well as the Institute's representatives and they are not repeated here.

This letter is written specifically to respond to a request from the Bills Committee and the Administration for the Institute's view on two proposals made at a recent Bills Committee, which were made with a view to reducing the impact of the Bill on the securitisation market in Hong Kong. These proposals are:

(1) providing a carve out for unlisted companies from the Bill's proposed new [control based] definition of "subsidiary" so that the new definition shall only apply to listed companies, leaving unlisted companies to continue applying the existing Company Ordinance definition;

(2) providing a separate regime for listed and unlisted companies in the Hong Kong Accounting Standard HKAS 27 'Consolidated and Separate Financial Statements' and giving unlisted companies an option to use the linked presentation method to present their securitised assets and liabilities on a net rather than gross basis in their consolidated accounts.

At our Council Meeting held on 24 May 2005, our Council considered the above proposals and unanimously agreed that they do not support them for the following reasons:

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Proposal 1 - Different definitions of subsidiary for listed and unlisted companies

(1) The "control-based" definition of subsidiary differs from the existing legal definition of subsidiary in that it looks beyond the actual shareholdings or voting power that an entity may have in respect of another entity. Instead, the "control-based" definition focuses on whether the investing entity has the power to exercise control over the operating and financial policies of the investee entity.

(2) 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 power are numerous. Group accounts would not meet the objective of providing true and fair information about the performance and financial position of the group if some companies subject to control of the group are taken off the balance sheet. These accounts would fail to show the true results of stewardship of the management, or permit true accountability by management for the resources entrusted to it. These accounts would also impede users from making informed decisions.

(3) The Institute considers that off-balance sheet treatment for a securitisation special purpose entity (SPE) by a company that has control over it would result in the group financial statements not giving a true and fair view. As a matter of principle, whether a company is listed or unlisted is irrelevant.

(4) Off-balance sheet treatments have caused many accounting scandals globally. It will harm Hong Kong's reputation if it is seen to be endorsing such treatments. The effect of a high-profile failure is equally damaging whether it is a major listed or unlisted concern.

(5) **Moreover, the provisions of the Companies Ordinance regarding the requirements to prepare group accounts that show a true and fair view apply to all companies. There is no scope nor justification under the existing Companies Ordinance framework for the creation of two separate financial reporting regimes for listed and unlisted companies.**

Proposal 2 – Allowing linked Presentation for non-listed companies

(6) Linked presentation is a special form of presentation that is permitted in UK Accounting Standards for securitised loans in that the loans can be reflected as a deduction from the gross amount of the item it finances. Linked presentation has nothing to do with the recognition of an SPE. It seeks to allow the related assets and liabilities held by an SPE to be shown together rather than separately in each side of the group balance sheet.

(7) The general principle under the IASB Financial Reporting Framework, which has been adopted as the HK Financial Reporting Framework for HKASs since 1994, is that assets and liabilities, and income and expenses, should be reported separately. Offsetting is restricted to very exceptional circumstances. Accordingly, the linked presentation method is inconsistent with the general principle established in the financial reporting framework, and the Institute is unable to permit its adoption in HKAS 27. **To do so for unlisted companies would create a contradiction between the standard and the framework which the Institute would not be able to reconcile. It would also create an inconsistency between listed and unlisted companies which is unjustifiable as they both share the same financial reporting framework.**

(8) The linked presentation method is a unique concept in the UK and we understand that it will be eliminated in due course; as UK accounting standards move to converge with the IASs.

I hope the above adequately explains why we are unable to support either of the two proposals.

The Institute is also of the view that:

(1) the primary objective of financial statements is to report to the shareholders the results and financial position. Therefore, shareholders should be provided with information reflecting the risks and rewards of the group's transactions. To do otherwise would undermine the primary objective of the financial statements;

(2) it is not appropriate for other interests to take precedence over those of the shareholders in preparing financial statements;

(3) we are of the view that the perceived problems can be overcome through education and experience. It is open to regulators to adjust capital requirements according to the nature of the assets - and shareholders and rating agencies to make up their own minds about risks - given the information provided to them.

We would encourage the Bills Committee, as we have on many prior occasions, to implement the proposed legislative changes as currently drafted as early as practicable. Hong Kong needs to maintain its reputation as the world's major financial centre and the current exemption in our accounting standard for Hong Kong incorporated companies, which is only meant to be a transitional arrangement, detract from this objective. Should the Bills Committee have any questions, we would welcome the opportunity to explain further.

Yours sincerely,

Winnie C.W. Cheung
Chief Executive & Registrar

WCC/pm

c.c. Miss Emma Lau, Deputy Secretary (Financial Services), FSTB
The Hon. Mandy Tam, Legislative Councillor (Accountancy)
Ms. Connie Szeto, Clerk to the Bills Committee on Companies (Amendment) Bill 2004