

## **Bills Committee on Companies Bill**

### **Follow-up actions for the meetings held on 18 and 25 November 2011 in relation to Part 9 of the Companies Bill**

#### **Purpose**

This paper sets out the Administration's response to the issues raised by Members at the Bills Committee meetings on 18 and 25 November 2011 relating to Part 9 (Accounts and Audit) of the Companies Bill ("CB").

#### **Administration's response**

##### Division 2 (Reporting Exemption)

2. At Members' request, we have conducted a consultation on the Qualifying Criteria for Private Companies to Prepare Simplified Financial and Directors' Reports. In particular, we consulted the public on whether larger private companies/ groups should be allowed to prepare simplified reports with their members' approval. The consultation period ended on 16 January 2012. We are considering the public views received and will revert to the Bills Committee in due course.

3. Apart from the issue covered by the consultation, Members asked the Administration to consider, taking into account overseas experience, whether members of a company which qualified for simplified reporting should be provided with a statutory right to demand the company to prepare financial reports in accordance with the full Hong Kong Financial Reporting Standards ("HKFRS"). Members also sought information on provisions offering protection to minority shareholders with respect to company records.

4. For small private companies that qualify for the reporting exemption automatically, the SME-financial reporting framework and standards ("SME-FRF and FRS"), which are self-contained but a simpler

version of the full HKFRS, are already adequate in reflecting the complexity of accounts. If there are circumstances suggesting that it is necessary for the financial statements to be prepared in accordance with the full HKFRS, the directors of the company, who owe fiduciary duties to the company, will make the decision whether to prepare full reports. We do not consider it necessary to give minority shareholders of a small company or group of small companies a statutory right to make such request. Other comparable jurisdictions (such as the UK and Singapore) which enable small companies to prepare simplified reports do not have provisions giving minority shareholders the right to request preparation of full reports.

5. For protection of minority shareholders, clauses 712 to 714 seek to restate (with modifications) the unfair prejudice remedy provisions under section 168A of the Companies Ordinance (“CO”) which allow a member of a company to petition to the court if there is any actual or proposed act or omission of the company which is or would be prejudicial to the interests of the members. In addition, clauses 728 to 731 which restate sections 152FA to 152FD of the CO enable minority shareholders meeting certain threshold requirements to apply to court for an order for inspection of the company’s records.

#### Clause 363 (Financial year)

6. Members expressed reservation on the proposal to allow a director to adjust the financial year end date by seven days. Having considered Members’ views, we will introduce Committee Stage Amendments (“CSAs”) to remove the flexibility for directors.

#### Clause 369 (Company must keep accounting records)

7. Members sought clarification on the difference between the terms “accounting records” in the CB and “books of account” in the CO and the implications of the change in terminology on contracts. In this regard, there is no difference in substance between “books of account” and “accounting records”. The change in terminology is mainly due to

the growing use of computerization which renders it desirable to make it clear that accounting records need not necessarily be kept in paper form or in books. These records, in whatever form they are kept, must be sufficient to show and explain the company's transactions and must enable the directors to carry out their duties with regard to the preparation of financial statements under the CB. The requirement in the CB makes it clear that the accounting records must disclose with reasonable accuracy, at any time, the company's financial position and financial performance.

8. If there is any contract executed prior to the commencement of the CB which contains any provision governing the parties' rights and obligations in relation to "books of account", clause 909 or section 21 of Cap 1 will be applicable to preserve the respective parties' rights and obligations if the term is used by reference to its meaning in section 121 of the CO. If the use of the term "books of account" did not make reference to section 121 of the CO, we consider that the change of terminology only will not alter the parties' rights and obligations in relation to "books of account", as it means essentially the same as "accounting records".

#### Clause 396 (Auditor's duty to report)

9. Taking into account Members' views that the Chinese heading of the provision might not reflect its contents, we will introduce a suitable CSA.

#### Clause 399 (Offences relating to contents of auditor's report)

10. Members asked the Administration to reconsider whether an officer, partner, employee and agent of the auditor, who himself is eligible for appointment as auditor of the company, should be liable for offences relating to the contents of auditor's report. In this regard, we note Hong Kong Institute of Certified Public Accountants ("HKICPA")'s submission to the Bills Committee of 21 December 2011, expressing concern about the consequences of clause 399 of the CB and the potential implications

for criminal liability of its members. HKICPA questioned whether criminal sanctions are necessary given its power to discipline auditors, and expressed concerns covering timeframe for prosecution, materiality, professional judgement, persons liable to prosecution and the primary responsibility of investigation.

11. As explained at the Bills Committee, our intention is that only a person who knowingly or recklessly causes a required statement to be omitted from the auditor's report would be liable under clause 399. It is a high threshold which, while seeking to uphold the accuracy of financial reports, avoids the provision being too onerous for auditors.

12. To better reflect this policy intention, and having taken into account Members' views, we would propose CSAs to remove the references to officer, partner, employee and agent of the auditor from the clause. It would be made clear that only the persons who are eligible for appointment as auditor of the company and knowingly or recklessly cause the required statement to be omitted from the auditor's report would be liable.

13. Regarding HKICPA's concerns, as explained in our response to deputations (LegCo Paper No. CB(1)339/11-12(01)), clause 399 is for enforcement of the duty to make two very important statements in the auditor report. These statements are part and parcel of the auditor's opinion as to whether adequate accounting records have been kept and whether the financial statements are in agreement with the accounting records which the auditor is required to state pursuant to clause 398. Having considered the severity of knowingly or recklessly causing such important statements to be omitted, and the offences under the CB in relation to other wrongdoing, we consider criminal sanction necessary under clause 399. There is no conflict between offence and the disciplinary mechanism under the Professional Accountants Ordinance.

14. As for the concern on the timeframe for prosecution of summary offences, clause 888 provides that, despite section 26 of the Magistrates Ordinance, action may be brought (a) within three years after the commission of the offence and (b) within 12 months after the date on which the supporting evidence came to the Secretary for Justice's

knowledge.

Clauses 403 (Rights in relation to information) and 404 (Offences relating to section 403)

15. Members suggested providing an express defence for a company and its officers in case they failed to obtain the information or explanation requested by the auditor concerning a non-Hong Kong subsidiary owing to restrictions imposed by overseas legislation. In this regard, as explained in paragraph 14 of LegCo Paper No. CB(1)2636/10-11(02), the requirement under clause 403(4) and (6) is for the company, if required by the auditor, to take all reasonable steps to obtain relevant information or explanation from the non-Hong Kong subsidiaries or specified persons as soon as practicable. It is clear that, if the company has taken all reasonable steps as soon as practicable but cannot obtain the information or explanation from a non-Hong Kong subsidiary, the company and its officers would not be liable under the provision.

16. Taking into account Members' concerns, and for the avoidance of doubt, we would introduce an express defence for cases where the failure to obtain the information from a non-Hong Kong subsidiary is due to restrictions imposed by overseas legislation.

Clause 406 (Avoidance of provisions protecting auditor from liability)

17. Members noted that it would be rare for a company to take out insurance for the auditor of the company or the auditor of an associated company against his liability, and asked if clause 406(4) should be deleted. In this regard, we have consulted the HKICPA. While such insurance might be rare, the HKICPA considered it useful and that the relevant provision should be retained.

18. Clause 406(4) restates section 165(3) in the CO and will not impose any obligation on a company and it is up to the company to decide whether to take out insurance for the auditor of the company or the auditor of an associated company against his liability. Subject to the

views of the Bills Committee, we are inclined to retain clause 406(4).

Clause 409 (Cessation of office)

19. Members were of the view that a period should be set out for the auditor to notify the company of his cessation of office. Taking into account Members' views, we will introduce a CSA to clause 409(1)(b) to specify a period of seven days.

Clause 413(5) (Cessation statement in relation to, and attendance at, general meeting)

20. Members asked the Administration to consider if the drafting of clause 413(5) could be simplified. We note Members' views and will review the drafting of the Bill with a view to improving its readability.

Clause 420(2) (Directors must lay financial statements etc. before company in general meeting)

21. Members were concerned that, under the current formulation of clause 420, a newly appointed director at the end of the period specified in clause 422 would be liable for the offence under clause 420(2) and (3). Taking into account Members' concern, we are prepared to review the formulation of the clause with reference to the formulation in section 122(3) of the CO, namely, that a director would be liable for an offence if he fails to take all reasonable steps to secure compliance with clause 420(1). Unless the offence is committed wilfully, it would be a defence to establish that the director had reasonable grounds to believe, and did believe, that a competent and reliable person was charged with the duty of ensuring compliance with the provision and was in a position to discharge that duty.

Clause 436(3) (Additional copy of reports etc. to be sent by company)

22. There was a view that the periods specified in clause 436(3)(a) and (b) were too short. In this regard, it should be noted that the respective periods of 7 and 14 days specified in clause 436(3)(a) and (b) are the periods allowed, after receipt of the request, for the company to send the requisite documents. We consider such periods sufficient for the company to comply with the requirement.

Clause 437(1)(b) (Company must not send summary financial report under some circumstances)

23. Members were concerned that the current drafting might not be able to distinguish the case of a strict prohibition to send a copy of the summary financial report from a prohibition to send a copy of the summary financial report instead of a copy of the reporting documents. We will introduce CSAs to address Members' concern.

Clause 440 (Voluntary revision of financial statements etc.)

24. Members noted that the role of auditors in the revision of financial statements was not apparent in the clause. In this regard, it should be noted that clause 440 seeks to empower the directors to revise financial statements and confine the scope of such revision. The role of auditors in relation to the audit report on the revised accounts, which is currently provided in sections 6(4)(b) and 10 of the Companies (Revision of Accounts and Reports) Regulation (Cap 32N), will be re-stated (with modifications) in the regulations to be made by the Financial Secretary under clause 441(2)(b).

Schedule 1 (Parent Undertakings and Subsidiary Undertakings)

25. Currently, the definitions of parent and subsidiary undertakings are set out in Schedule 1 of the CB. In its earlier submission to the Bills Committee of 28 June 2011 (LegCo Paper No. CB(1)2679/10-11(01)),

the HKICPA expressed reservation on setting out the definitions in the CB and suggested that the CB should make reference to the relevant financial reporting standards.

26. At the Bills Committee, Members were concerned about HKICPA's proposal. Members also requested for information on how overseas legislation deal with any possible overlapping between the law and relevant financial reporting standards, and how financial reporting standards are formulated in Hong Kong.

#### *Overseas legislation*

27. In the UK Companies Act 2006 ("UKCA 2006"), there are sections dealing with the meaning of parent and subsidiary undertakings as well as related expressions, which are relevant if companies are preparing accounts based on UK Generally Accepted Accounting Principles.

28. In Singapore, the Singapore Companies Act ("SCA") gives a prescriptive definition of subsidiary and holding company, which is not the same as the relevant financial reporting standards. However, in the provisions which set out the requirements for consolidated accounts, the SCA refers to the relevant financial reporting standards.

#### *Formulation of Financial Reporting Standards in Hong Kong*

29. A note on the process of formulation of financial reporting standards in Hong Kong, which was prepared in consultation with the HKICPA, is at **Annex**.

#### *Definitions of Parent and Subsidiary Undertaking in the CB*

30. We have considered further whether to set out the definitions of parent and subsidiary undertakings in Schedule 1 of the CB in the light of Members' concern. We agree with Members that the definitions of parent and subsidiary undertakings are important for the preparation of consolidated financial statements and may have implications on the operations of groups of companies. It is therefore desirable for the

definitions to be set out in the CB.

31. HKICPA's main concern about setting out the definitions in the CB is that any difference between the definitions in the CB and in the relevant financial reporting standards would cause difficulties in compliance. In this regard, the current definitions in Schedule 1 of the CB are in line with those in the relevant financial reporting standards. Should the definitions evolve in the future, the Financial Secretary may amend Schedule 1 if he considers it appropriate to do so.

32. In the light of the above, we would retain the definitions in Schedule 1 of the CB.

Section 2(4) (Provisions supplementary to this Schedule), Schedule 3 (Specified qualifying conditions for sections 359 to 362)

33. On the calculation of the average number of a company's employees during a financial year for the purpose of deciding the size of a company for adoption of simplified reporting, Members asked whether the maximum number of employees in each month rather than the number at the end of the month should be used, so that companies could not reduce the number of employees towards the end of the month for the purpose of financial reporting. Members also suggested that the drafting of the Chinese version be reviewed to see if it reflected our policy intention.

34. We have consulted the HKICPA. The current formulation, which refers to the number of employees at the end of each month, is in line with the formulation in the relevant financial reporting standard. HKICPA advised that they were not aware of any abuse. Calculations based on the maximum number or average number of employees during the month could be onerous to the reporting entities. Taking into account HKICPA's advice, we propose no substantive change to the current provision.

35. As to Members' suggestion on drafting, we will review the Chinese version of the provision.

**Financial Services and the Treasury Bureau  
Companies Registry  
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## **Formulation of Financial Reporting Standards in Hong Kong**

The HKICPA is the statutory body in Hong Kong that sets financial reporting standards. The HKICPA has adopted the policy of achieving convergence of the HKFRSs with International Financial Reporting Standard (“IFRSs”). IFRSs need to go through a formal process before they are adopted in the HKFRSs. There are also a few local standards which are developed through a similar process.

2. The due process for adoption of financial reporting standards in Hong Kong involves the HKICPA Financial Reporting Standards Committee (“FRSC”) which comprises members and member practices of the HKICPA, listed companies in Hong Kong, the stock exchange, regulatory and legal authorities, academics and other interested individuals and organisations. Due process for the development of financial reporting standards may involve any or all of the following steps –

- identifying and reviewing all the issues associated with an exposure draft or a draft interpretation issued by the International Accounting Standards Board (“IASB”) for possible adoption in Hong Kong;
- studying pronouncements of the IASB and other standard setting bodies and accepted industry practices about the issues;
- forming an advisory group to give advice to the FRSC on the project;
- publishing for public comment a discussion document, an exposure draft or a draft interpretation and, in the case of the IASB issuing those documents, issuing an invitation to comment in Hong Kong on those documents;
- publishing within an exposure draft a basis for conclusions;
- considering all comments received and, when appropriate, preparing a comment letter to the IASB;

- following publication of the finalised IFRS or Interpretation of IFRS, considering the changes made, if any, by the IASB and adopting the finalised IFRS or Interpretation of IFRS in Hong Kong;
  - approving a standard or an Interpretation, including that converged with the equivalent IFRS or Interpretation of IFRS, by the HKICPA; and
  - publishing within a standard a basis for conclusions, if appropriate, explaining how the conclusions were reached and giving background information that may help users of HKFRS to apply them in practice or, in the case of a standard that is converged with IFRS, publishing within the standard the IASB Basis for Conclusions with an explanation of the extent to which the HKICPA Council agrees with the IASB Basis for Conclusions so as to enable users to understand any changes made to the IFRS.
3. On occasion, the FRSC may consult and raise issues specific to Hong Kong proactively with the IASB.