

**Bills Committee
on Companies (Amendment) Bill 2004**

**Follow-up Actions Arising from the Discussion
at the Meeting on 13 January 2005**

PURPOSE

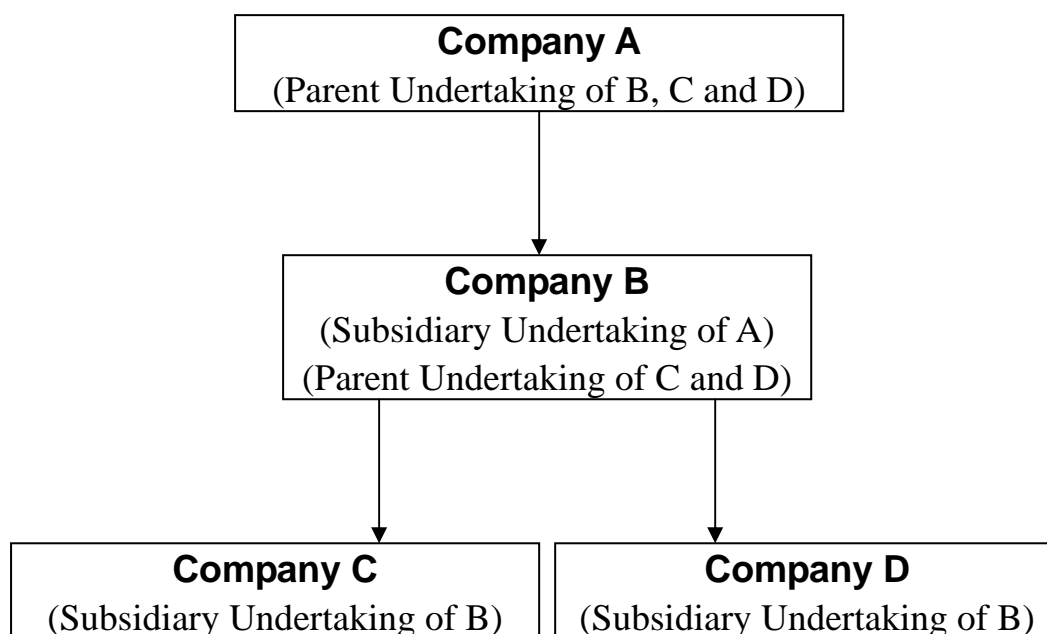
At the Bills Committee meeting held on 13 January 2005, Members requested the Administration to provide additional information on and clarify a number of matters relating to the Companies (Amendment) Bill 2004 (the Bill). We have consulted the Department of Justice and the Hong Kong Institute of Certified Public Accountants (HKICPA), and set out the relevant information in the following paragraphs.

MATTERS RELATING TO THE PROPOSED TWENTY-THIRD SCHEDULE

- (a) *The operation of the “dominant influence test” and the preparation of group accounts under various possible scenarios, with reference to the proposed definition of “undertaking” in section 1 and the proposed provisions in sections 2 and 3 of the proposed Twenty-third Schedule to the Companies Ordinance (Cap. 32) (CO). Possible scenarios include –*
- (i) *A parent undertaking (“A”) has a subsidiary undertaking (“B”), which in turn is the parent undertaking of other undertakings (“C” and “D”);*
 - (ii) *A parent undertaking (“E”) has a subsidiary undertaking (“F”), which is not a body corporate and holds certain voting rights of the parent undertaking.*

2. The scenario set out in (i) can be depicted in **Diagram 1** below -

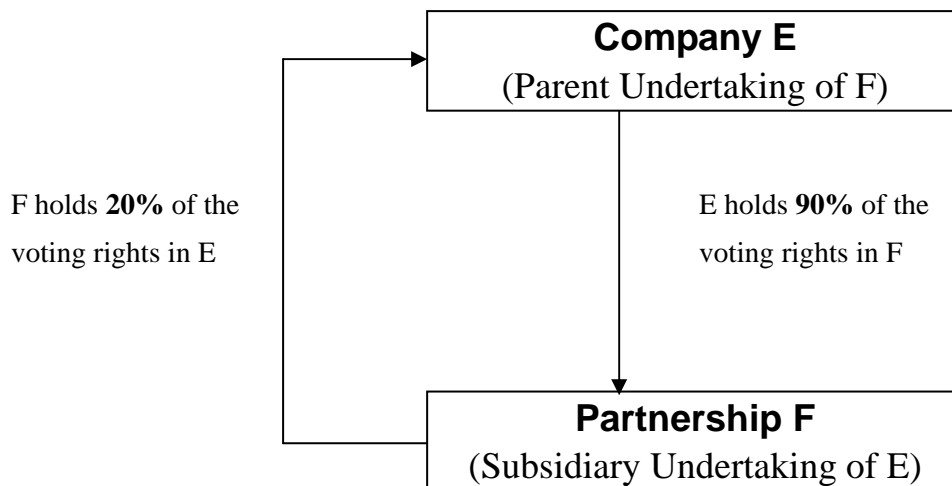
Diagram 1



3. Given that Company B is the subsidiary undertaking of Company A and the parent undertaking of both Companies C and D, section 2(3) of the proposed Twenty-third Schedule shall come into play, thus treating Company A as the parent undertaking of both Companies C and D as well. Where Companies A and B are companies subject to the accounting requirements in the CO, **both of them would need to prepare separate group accounts.** For Company A, the group accounts would consolidate the accounts of Companies A, B, C and D. For Company B, the group accounts would consolidate the accounts of Companies B, C and D. However, Company B would be exempt from preparing group accounts pursuant to section 124(2)(a) of the Ordinance, if at the end of its financial year Company B is the wholly owned subsidiary of Company A.

4. The scenario set out in (ii) can be depicted in **Diagram 2** below -

Diagram 2



5. In the above given situation, as Company E holds 90% of voting rights (i.e. a majority of voting rights) in Partnership F, Company E becomes the parent undertaking of Partnership F by virtue of section 2(1)(b)(i) of the proposed Twenty-third Schedule¹. Company E's position as Partnership F's parent undertaking remains unchanged, even though Partnership F is concurrently holding 20% of voting rights in Company E.

6. As regards whether section 3(3) of the proposed Twenty-third Schedule² will apply in this situation, we have sought further clarification from the Department of Trade and Industry (DTI) of the United Kingdom (UK) on the application of paragraph 10 of Schedule 10A to the UK Companies Act 1985³ on which section 3(3) of the

¹ Under section 2(1)(b)(i) of the proposed Twenty-third Schedule, an undertaking is a parent undertaking ("parent undertaking") in relation to another undertaking ("subsidiary undertaking") if the subsidiary undertaking is not a body corporate and the parent undertaking holds a majority of voting rights in the subsidiary undertaking.

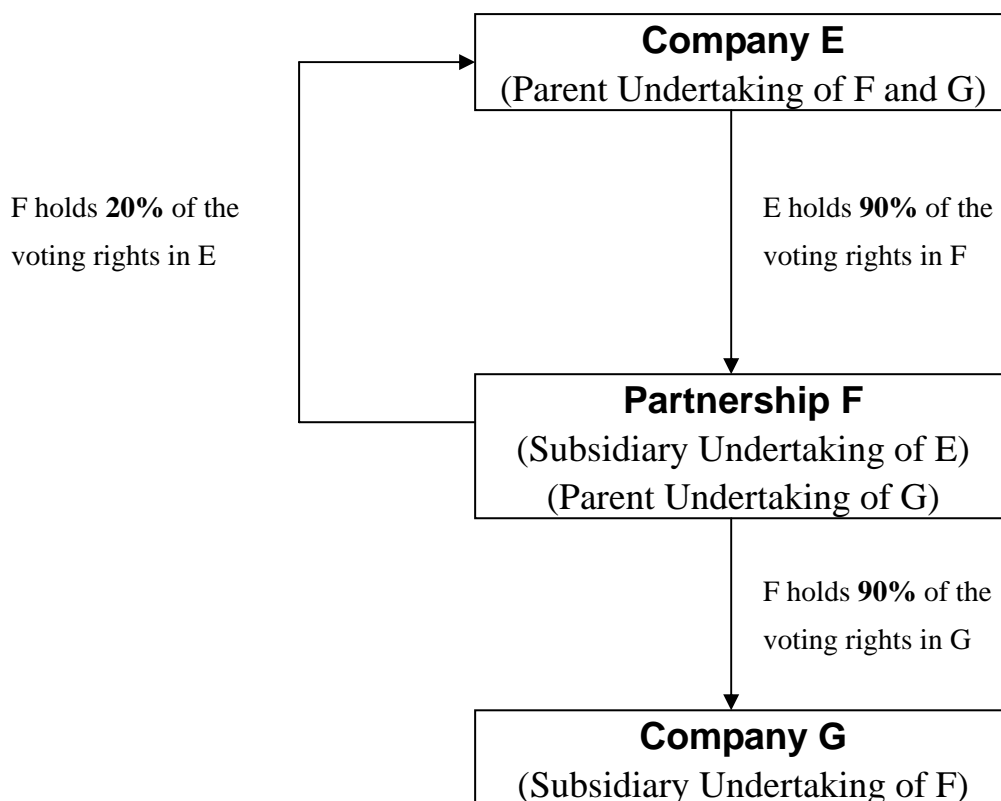
² Section 3(3) of the proposed Twenty-third Schedule reads "[t]he voting rights in an undertaking referred to in subsection (1) shall be reduced by any rights held by the undertaking itself."

³ Paragraph 10 of Schedule 10A of the UK Companies Act 1985 states that "[t]he voting rights in an undertaking shall be reduced by any rights held by the undertaking itself."

proposed Twenty-third Schedule is modelled. We have been advised that the interpretation of the relevant provisions in the Companies Act is a matter for the courts. However, subsequent to our latest enquiries with the DTI, our attention have been drawn to a number of observations. According to the observations, it is generally considered that paragraph 10 of Schedule 10A of the UK Companies Act 1985 should be read as applying to voting rights in an undertaking held by the same undertaking itself, and that the paragraph should not be taken as applying to a cross-holding of rights in a structure depicted in **Diagram 2** above. In this light, we should, when referring to **Diagram 2**, read section 3(3) to the proposed Twenty-third Schedule as “the voting rights in an undertaking (i.e. Partnership F) shall be reduced by any rights held by the undertaking (i.e. Partnership F) itself”. As Partnership F does not hold voting rights of Partnership F itself but the voting rights of Company E, section 3(3) has no application in respect of the situation illustrated in **Diagram 2**.

7. For illustrative purpose, we may vary Diagram 2 by turning it into a “grandparent-parent-subsidiary” relationship as depicted in **Diagram 3** below -

Diagram 3



8. In the above situation, Company E continues to be the parent undertaking of Partnership F. Since Partnership F is also holding 90% of voting rights in Company G, Partnership F should also be considered as the parent undertaking of Company G. Under this “grandparent-parent-subsubsidiary” situation, Company E should be treated as the parent undertaking of Company G as well, such that Company E should consolidate both Partnership F and Company G as subsidiary undertakings, as in the situation illustrated in paragraph 3 and **Diagram 1** above. The only difference is that Partnership F, being not a company, is not obliged to prepare group accounts under the CO.

(b) *Whether the proposed definition of “undertaking” in section 1 of the proposed Twenty-third Schedule to the CO is intended to cover “an individual”.*

9. According to the HKICPA, entities subject to consolidation under IAS 27 should not be interpreted to include “an individual”. Therefore, the proposed definition of “undertaking” which includes “an unincorporated body carrying on a trade or business, whether for profit or not” in section 1 of the proposed Twenty-third Schedule is not intended to cover “an individual”. To put the provision beyond doubt, we intend to propose a Committee Stage Amendment (CSA) to change the term “unincorporated body” in the definition of “undertaking” to “unincorporated **association**”, and qualify the scope of the definition by amending the word “includes” to “means”. The proposed CSA is modelled on section 259(1) of the UK Companies Act 1985.

(c) Section 2(1) of the proposed Twenty-third Schedule to the CO sets out the various criteria under which an undertaking is defined to be a parent undertaking in relation to another undertaking. Can more than one undertaking satisfy the criteria and become the parent undertakings of a subsidiary undertaking?

10. We have clarified our policy intent as set out in the Administration’s reply dated 27 January 2005 to the Assistant Legal Adviser (LC Paper No. CB(1)825/04-05(03)). In short, it is hypothetically possible for more than one undertaking to meet the relevant criteria. However, such a possibility should be remote in practice and already exists under the existing definition of “subsidiary” in section 2(4) of the CO.

(d) The policy intent of section 2(3) of the proposed Twenty-third Schedule to the CO and the need to improve the drafting.

11. As illustrated in paragraph 3 and **Diagram 1** above, the intent of section 2(3) is to cater for a “grandparent-parent-subsidiary” situation, whereby an undertaking shall be treated as the parent undertaking of another undertaking if a subsidiary undertaking of the first-mentioned undertaking is the parent undertaking of that other undertaking. We agree that the drafting could be improved. We intend

to propose a CSA to recast the drafting to clarify any doubt regarding the policy intent. It is proposed that the recast section 2(3) of the proposed Twenty-third Schedule will read as -

“An undertaking shall be treated as the parent undertaking of another undertaking if a subsidiary undertaking of the first-mentioned undertaking is, or is to be treated as, the parent undertaking of that other undertaking; and references to a subsidiary undertaking of the first-mentioned undertaking shall be construed accordingly.”

(e) *Section 3(3) of the proposed Twenty-third Schedule to the CO provides that “[t]he voting rights in an undertaking referred to in subsection (1) shall be reduced by any rights held by the undertaking itself.” The proposed provision is not clear. In particular, the following points need to be clarified –*

(i) *What is “an undertaking referred to in subsection (1)”? In the various possible scenarios under item (a) above, which of the undertakings will be covered by section 3(3)?*

(ii) *What is the meaning of “any rights held by the undertaking itself”?*

(iii) *How is the off-setting of voting rights between the concerned undertakings conducted? What would be the impact on the concerned undertakings if the result of off-setting is zero?*

12. Having regard to the latest clarification from the DTI of the UK, it is now apparent that section 3(3) of the proposed Twenty-third Schedule would not apply as an off-setting rule in a scenario of cross-holding of rights between the parent and subsidiary undertakings. We are now doing further research into the intent and application of paragraph 10 of Schedule 10A to the UK Companies Act 1985 on which section 3(3) of the proposed Twenty-third Schedule is modelled. We would revert to Members on this later.

IMPACT OF THE BILL ON THE ASSET-SECURITIZATION MARKET IN HONG KONG

13. We are in the process of collating the relevant information, and endeavour to submit it for Members' consideration at the fifth meeting of the Bills Committee.

THE CONSEQUENTIAL AMENDMENTS TO SECTION 128

(a) The policy intent for introducing the proposed amendments to sections 126 and 128(3) of the CO.

14. We propose to add the "true and fair view override" provisions as new sections 126(4) and 126(5) in relation to the preparation of group accounts. The proposed section 126(4) intends to expressly require directors to give additional information in the group accounts as may be necessary to give a true and fair view, as and when compliance of the Tenth Schedule and other requirements of the CO as to the matters to be included in a company's group accounts would not be sufficient to give a true and fair view. The proposed section 126(5) goes further in requiring directors to depart from the requirements of the Tenth Schedule and other requirements of the CO as to the matters to be included in the group accounts where compliance therewith is inconsistent with the requirement to give a true and fair view.

15. As the duty to prepare group accounts giving a true and fair view of the group's results and state of affairs rests with the directors, and given that the proposed "true and fair view override" provisions allow flexibility to cater for unforeseeable circumstances which warrants override and departure, we do not consider that it is necessary for the Financial Secretary (FS) to retain the power under section 126(3) to modify the requirements of the Tenth Schedule for the purpose of adapting them to the circumstances of the company, upon the application or with consent of the company's directors in question. In this light, we propose to repeal FS's powers under section 126(3).

16. Section 128(1) requires a company which has subsidiaries to show in the accounts of the company or the statement annexed thereto some particulars (for example, the subsidiary's name, its place of incorporation, etc.) with respect to each subsidiary. As we propose to broaden the scope of "subsidiary", in section 1 of the proposed Twenty-third Schedule, to include undertakings which are not body corporate (i.e. a partnership or an unincorporated association), it is necessary for us to make consequential amendments to the relevant disclosure requirements in section 128. The proposed amendments to section 128(3) are **purely consequential** to cater for a subsidiary which is not a body corporate. The proposed amendments in the Bill does not carry the intention to change the fundamentals of the existing section 128(3) which exempts disclosure of relevant particulars about a subsidiary which is incorporated outside Hong Kong or, being incorporated in Hong Kong but carries on business outside Hong Kong.

- (b) *On the proposed subsection 3(c) of section 128 of the CO, how could the directors of the undertaking determine whether the disclosure of information is "harmful to the business" of the undertaking or of any of its subsidiaries?*
- (c) *On the proposed subsection 3(d) of section 128 of the CO, why is the FS empowered to exempt an undertaking from the requirement of disclosing information relating to its subsidiary?*

17. Section 128(3) of the CO was enacted in 1974. So far, we are not able to trace the legislative intent then, but are aware that it was modelled on the section 3(3) of the UK Companies Act 1967 (before it was subsequently amended). The relevant UK provision then read as -

"Subsection (1) of this section shall not require the disclosure of information with respect to a body corporate which is the subsidiary of another and is incorporated outside the United Kingdom or, being incorporated in the United Kingdom, carries on business outside the United Kingdom if the disclosure would, in the opinion of the directors of that other, be harmful to the business of that

other or of any of its subsidiaries and the Board of Trade agree that the information need not be disclosed.”

18. It should be noted that the UK Companies Act 1989 has modified the disclosure requirement set out in paragraph 17 above. This disclosure exemption in relation to “disclosure harmful to the business” has been recast to refer to “disclosure seriously prejudicial to the business”, as in the present section 231(3) of the UK Companies Act 1985 (as amended in 1989). So far, we are unable to trace the policy intent with respect to the modification. That said, such non-disclosure requires the agreement of the Secretary of State. The existing UK provision is set out in the comparison table at **Annex**.

19. We wish to reiterate that the proposed amendments under the Bill, in relation to section 128 of the CO, are purely consequential to the amendments to the definition of “subsidiary”, which is the primary purpose of the Bill. Separately, we would like to inform Members that the accounting and auditing provisions of the CO including the disclosure requirements under section 128 are being considered in the context of a review conducted by the Joint Government / HKICPA Working Group. Upon the completion of the review by the Joint Working Group, we would consult the Standing Committee on Company Law Reforms and other stakeholders on the way forward in respect of any proposed amendments to those provisions.

(d) Provisions of relevant legislation in other jurisdictions

20. A comparison of the relevant legislation in relation to section 128 of the CO is at **Annex**.

Financial Services and the Treasury Bureau
January 2005

**Comparison of the Relevant Provisions in Overseas Legislation
vis-à-vis Section 128 of the Hong Kong Companies Ordinance**

<u>Hong Kong</u> Companies Ordinance (Cap. 32)	<u>Hong Kong</u> Companies (Amendment) Bill 2004 (changes to the existing Ordinance emphasized)	<u>United Kingdom</u> Companies Act 1985 (As amended by Companies Act 1989)	<u>Australia</u> Corporations Act 2001 & Accounting Standard AASB 127 – Consolidated and Separate Financial Statements	<u>Singapore</u> Companies Act & Financial Reporting Standard FRS 27 – Consolidated and Separate Financial Statements
<p>Section 128 (1) Subject to the provisions of this section, where, at the end of its financial year, a company has subsidiaries, there shall be shown in the accounts of the company laid before it in general meeting, or in a statement annexed to those accounts, the following particulars with respect to each subsidiary-</p> <p>(a) the subsidiary's name; (b) the country in which it is incorporated;</p>	<p>Section 128 (1) Subject to the provisions of this section, where, at the end of its financial year, a company has subsidiaries, there shall be shown in the accounts of the company laid before it in general meeting, or in a statement annexed to those accounts, the following particulars with respect to each subsidiary-</p> <p>(a) the subsidiary's name; (b) the country in which it is incorporated or established¹;</p>	<p>Schedule 5 to the Act 15(1) The following information shall be given with respect to the undertakings which are subsidiary undertakings of the parent company at the end of the financial year.</p> <p>15(2) The name of each undertaking shall be stated.</p> <p>15(3) There shall be stated – (a) if the undertaking is</p>	<p>Section 42.1 of the Accounting Standard AASB 127 – Consolidated and Separate Financial Statements Where a group of entities (e.g. a government and its controlled entities) is a reporting entity, but the preparation of separate financial statements for the parent for the parent is not required, the notes to the consolidated financial</p>	<p>Section 42 of the Financial Reporting Standard FRS 27 – Consolidated and Separate Financial Statements When a parent, venturer with an interest in a jointly controlled entity or an investor in an associated prepares separate financial statements, those separate financial statements shall disclose (among other things), a list of significant</p>

¹ In response to the Law Society's suggestion, we would consider proposing a CSA to require disclosure of the "address of the subsidiary's principal place of business" for

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<p>(c) in relation to shares of each class of the subsidiary held by the company, the identity of the class and the proportion of the nominal value of the issued shares of that class represented by the shares held; and</p> <p>(d) with reference to the proportion of the nominal value of the issued shares of a class represented by the shares held by the company, the extent (if any) to which it consists of shares held by, or by a nominee for, a subsidiary of the company and the extent (if any) to which it consists of shares held by, or by a nominee for, the company itself.</p>	<p>(c) in relation to shares of each class of the subsidiary held by the company, the identity of the class and the proportion of the nominal value of the issued shares of that class represented by the shares held; and</p> <p>(d) with reference to the proportion of the nominal value of the issued shares of a class represented by the shares held by the company, the extent (if any) to which it consists of shares held by, or by a nominee for, a subsidiary of the company and the extent (if any) to which it consists of shares held by, or by a nominee for, the company itself.</p>	<p>incorporated outside Great Britain, the country in which it is incorporated; (b) (repealed); (c) if it is unincorporated the address of its principal place of business.</p> <p>16(1) The following information shall be given with respect to the shares of a subsidiary undertaking held –</p> <p>(a) by the parent company, and</p> <p>(b) by the group;</p> <p>and the information under paragraphs (a) and (b) shall (if different) be shown separately.</p> <p>16(2) There shall be stated –</p> <p>(a) the identity of each</p>	<p>statements shall disclose a list of significant subsidiaries, including –</p> <p>(a) the name;</p> <p>(b) the country of incorporation or residence (where other than Australia); and</p> <p>(c) proportion of ownership interest and, if different, proportion of voting power held.</p> <p>Section 296(1) of the Corporations Act</p> <p>The financial report for a financial year must comply with the accounting standards. However, a small proprietary company's report does not have to comply with particular accounting</p>	<p>investments in subsidiaries, jointly controlled entities and associates, including the name, country of incorporation or residence, proportion of ownership interest and, if differently, proportion of voting power held.</p> <p>Section 201 of Companies Act</p> <p>(3A) Subject to subsections (14) to (14C), the directors of a company that is a holding company at the end of its financial year need not comply with subsections (1) and (3) but must cause to be made out and laid before the</p>

a subsidiary which is not a body corporate, by modelling on paragraph 15(3) of Schedule 5 to the UK Companies Act 1985 (as amended in 1989).

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<p>(3) Subsection (1) shall not require the disclosure of information with respect to a body corporate which is the subsidiary of another and is incorporated outside Hong Kong or, being incorporated in Hong Kong, carries on business outside Hong Kong if the disclosure would, in the opinion of the directors of that other, be harmful to the business of that other or of any of its subsidiaries and the Financial Secretary agrees that the information need not be disclosed.</p>	<p>(3) Subsection (1) shall not require the disclosure of information with respect to an undertaking which –</p> <p>(a) is the subsidiary of another undertaking; and</p> <p>(b) is established under the laws of a place outside Hong Kong or carries on business outside Hong Kong,</p> <p>if,</p> <p>(c) the disclosure would, in the opinion of the directors of that other undertaking, be harmful to the business of that other undertaking or of any of its subsidiaries; and</p> <p>(d) the Financial</p>	<p>class of shares held; and</p> <p>(b) the proportion of the nominal value of the shares of that class represented by those shares.</p> <p>Section 231 of the Act</p> <p>(3) The information required by Schedule 5 need not be disclosed with respect to an undertaking which –</p> <p>(a) is established under the law of a country outside the United Kingdom; or</p> <p>(b) carried on business outside the United Kingdom, if in the opinion of the directors of the company the disclosure would be seriously prejudicial to the business of that undertaking, or to the business of the company or any of its subsidiary</p>	<p>standards if:</p> <p>(a) the report is prepared in response to a shareholder direction under section 293; and</p> <p>(b) the direction specifies that the report does not have to comply with those accounting standards.</p> <p>Section 340 of the Corporations Act</p> <p>(1) On an application made in accordance with subsection (3) in relation to a company, registered scheme or disclosing entity, ASIC may make an order in writing relieving any of the following requirements of Parts 2M.2, 2M.3 and 2M.4 (other than Division 4):</p> <p>(a) the directors;</p>	<p>company at its annual general meeting –</p> <p>(a) consolidated accounts dealing with the profit or loss and the state of affairs of the company and its subsidiaries for the period beginning from the date the preceding accounts were made up to (or, in the case of first accounts, since the incorporation of the company) and ending on a date –</p> <p>(i) in a case where the holding company is a public company listed or quoted on a stock exchange in Singapore, not more than 4 months before the date of the meeting; or</p> <p>(ii) in any other case, not more than 6 months before the date of the meeting; and</p>

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	<p>Secretary agrees that the information need not be disclosed.</p>	<p>undertakings, and the Secretary of State agrees that the information need not be disclosed.</p> <p>This subsection does not apply in relation to the information required under paragraph 6, 9A, 20 or 28A of that Schedule.</p>	<p>(b) the company, scheme or entity; (c) the auditor.</p> <p>(2) The order may: (a) be expressed to be subject to conditions; and (b) be indefinite or limited to a specified period.</p> <p>(3) The application must be: (a) authorised by a resolution of the directors; and (b) in writing and signed by a director; and (c) lodged with ASIC.</p> <p>(4) ASIC must give the applicant written notice of the making, revocation or suspension of the order.</p> <p>Section 342 of the Corporations Act</p>	<p>(b) a balance-sheet dealing with the state of affairs of the holding company at the end of its financial year, each of which complies with the requirements of the Accounting Standards and gives a true and fair view of the matters referred to in paragraph (a) or (b), as the case may be, so far as it concerns members of the holding company.</p> <p>(14C) The Minister may, by order published in the Gazette, in respect of companies of a specified class or description, substitute other accounting standards for the Accounting Standards, and the provisions of this section and sections 207 and 209A shall apply</p>

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			<p>(1) To make an order under section 340 or 341, ASIC must be satisfied that complying with the relevant requirements of Parts 2M.2, 2M.3 and 2M.4 would:</p> <p>(a) make the financial report or other reports misleading; or</p> <p>(b) be inappropriate in the circumstances; or</p> <p>(c) impose unreasonable burdens.</p>	<p>accordingly in respect of such companies.</p>