Views on the Impact of the Companies (Amendment) Bill 2004 on the Asset-securitization Market in Hong Kong

After reviewing the various papers and documents on the "definition of a subsidiary", we concur with HKICPA (letter to LEGCO dated 12 January 2005) in that we should support the captioned Bill. The "control-based" definition of a subsidiary is definitely an improvement over the existing definition currently stated in the Hong Kong Companies Ordinance because it presents better a "true and fair view" of the group accounts. This definition is also used by IAS and many other countries. In particular, the "control-based" definition of subsidiary supports the purpose of consolidated financial statements. Besides, the major concerns raised by the securitization industry are not imperative.

Also, in general we should not allow firms to remove liabilities off the balance sheet simply to improve some important accounting ratios on paper to "gain" more business. Sophisticated investors are not naive (they will check the relevant footnotes to recalculate these ratios any way). This kind of off-balance financing and reporting actually stands for poor corporate governance and less corporate (financial report) transparency.

We think that the Bill should be supported and implemented without further delays.

Purpose of consolidated financial statements

Underlying the preparation of consolidated financial statements is the notion that the consolidated financial statements present the financial position and the results of operations of a parent and its subsidiaries as if the related companies actually were a single company.

Without consolidated statements it often is very difficult for an investor to gain an understanding of the total resources controlled by a company. A consolidated balance sheet provides a much better picture of both the total assets under the control of the parent company and the financing used in providing those resources.

A parent company has the ability to exercise control over one or more other entities. Under the existing Companies Ordinance, a company is considered to be a parent company when it has direct or indirect control over a majority of the common stock or voting power of another company. The proposed amendment is to adopt a broader definition of control that would not be based exclusively on stock ownership.

Creditors of the parent company have primary claim to the assets held directly by the parent. Short-term creditors of the parent are likely to look only at those assets. Because the parent has control of the subsidiaries, the assets held by the subsidiaries are potentially available to satisfy parent company debts. Long-term creditors of the parent generally must rely on the soundness and operating efficiency of the overall entity, which normally is best seen by examining the consolidated statements.

To achieve this purpose of preparing consolidated financial statements, all assets and liabilities of those companies under the control of the parent should be consolidated and assets and liabilities of those companies that the parent cannot control should be excluded. Business issues or impact on particular industry are not to be considered basically.

Negative impact on the development of the asset-securitization market in Hong Kong

According to the industry, the "proposed bill will have an adverse effect on securitization business because it will deprive the off-balance sheet treatment in the presentation of financial statements."

Indeed, the "control-based" definition of subsidiary will have no impact on the asset securitization arrangement if it is a true sale that the originator does not retain control. The asset will be removed from the balance sheet if it is a transfer of assets without recourse.

There are concerns to address the problems caused by misleading "off-balance-sheet" treatments, such as that in the case of Enron. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

In fact, the US GAAP – FAS 140 specifically states its application of a financial-components approach that focuses on control, thus an entity recognizes the assets it controls and derecognizes when control has been surrendered. The emphasis on the control reinforces the "control-based" definition of subsidiary.

Besides, the FASB Interpretation No. 46 (FIN 46) has required the preparers to look beyond the legal form and use the term "variable interest", i.e. the substance, to consider whether consolidation is required, though it is not applicable to the qualifying SPE under FASB 140.

Addressing to industry's concern in terms of credit risk, I believe that the quality of the financial assets to be securitized is more important for assessment of credit risk than the financial ratios of the originator.

In conclusion, we support the proposed changes to the definition of subsidiary to improve the quality of financial reporting in Hong Kong.

Dr Ben-Hsien Bao & Mr Kam-Por Yuen
For and on behalf of
Prof. Ferdinand A. Gul
Head and Chair Professor of Accounting and Corporate Governance
School of Accounting and Finance
Faculty of Business
The Hong Kong Polytechnic University

2 February 2005