LC Paper No. CB(1)465/04-05(03)

Companies (Amendment) Bill 2004
Administration's Responses to the Submission from Hong Kong Mortgage Corporation Limited (HKMC)

	Summary of Comments[1]	Responses
1	The mortgage-backed securitization (MBS) market in Hong Kong has great potential for growth. However, the proposed amendments will make off-balance sheet treatment, which is a major driver for some transactions, very difficult to achieve and thus have a chilling effect on Hong Kong's securitization market.	The Government attaches great importance to the development of the securitization market. In this regard, a number of initiatives have already been taken. These include the streamlining of the prospectuses requirements, the securitization of revenues from government toll tunnels and bridges, and investor education. We do not consider that the amendments would put Hong Kong in a disadvantaged position, vis-à-vis other financial centers such as London and Singapore, in the development of the securitization market. We will elaborate on our views in the responses below.
2	There is continuing controversy over the effects of IAS on the global securitization industry and the American, Australian and European Securitization Forums have made submissions to the International Accounting Standards Board (IASB) and been in discussion and negotiation with the IASB on modifications to the International Accounting Standards (IAS) to facilitate off-balance sheet treatment for genuine	The proposed amendment to the Companies Ordinance (CO, Cap. 32) follows a "control-based" approach in defining "subsidiary" for the purpose of preparing group accounts. This approach has been reaffirmed by IASB. According to its latest deliberation at the November 2004 Board meeting, the IASB has emphasized that "*the Board's intention is that the consolidation principles it develops would apply to all entities, including special-purpose entities (SPEs)*". IASB has also reaffirmed that "*consolidation should be based on the notion of control*" and that

[1] For details of the comments, please refer to the original submission of HKMC.

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	MBS transactions.	"*control of an entity is the ability to direct the strategic financing and operating policies of an entity*"[2]. The same approach is also adopted in the company law or statutorily backed accounting standards in places such as the United Kingdom (UK), Australia and Singapore. The relevant legislation/standards have run well in these jurisdictions for years. As such, the proposed amendments are in line with both the IAS and the legislation/accounting standards in places with a company law system similar to that of Hong Kong. Furthermore, Hong Kong does not adopt the United States (US) accounting standards. Indeed, in the light of the financial reporting debacles experienced in the US in recent years – most notably Enron, questions have been asked in the US about the adequacy of the financial reporting regime in relation to the off-balance sheet financing and the use of SPEs for exclusion from consolidated accounts.
3	The amendments to the CO will entrench the current IAS's definition of "subsidiary" into the CO when the relevant IAS themselves are in a state of flux and in fact quite controversial in some aspects. When any further changes are introduced and affect the	See responses to (2) above. Instead of IAS being in a state of flux, IASB has repeatedly affirmed its position regarding the need to consolidate the accounts of the SPEs in the accounts of the entity having an ultimate control of the SPEs.

[2] A paper - *Consolidation (including special purpose entities)*, issued by IASB on 23 November 2004 to reflect the decisions up to and including the November 2004 Board meeting.

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	definition of "subsidiary" or other provisions in the CO, this would require another round of legislative amendments to the CO.	Moreover, as far as we are aware, the UK, Australia and Singapore have no plan to amend their relevant legislation/accounting standards, on which our proposed amendments are modelled.
4	Entrenchment of the definition of "subsidiary" in the CO will put Hong Kong at a competitive disadvantage vis-à-vis other countries (like Singapore and Australia) that do not have entrenched definition. Notwithstanding the adoption of IAS in Australia and Singapore, these jurisdictions have no intention to amend the definition of "subsidiary" in their legislation. Moreover, the company law in Australia and Singapore does not prescribe any requirements for the contents of financial reports, instead it is stipulated that financial reports must comply with accounting standards from time to time. Accordingly, despite their respective adoption of IAS, neither Australia nor Singapore sees the need to amend its existing definitions of "subsidiary" and therefore neither has a definition of "subsidiary" which captures securitization SPEs.	Neither Singapore nor Australia amends the company law with regard to the general operation of "subsidiary" because there is no need to do so. In the two places, the company law there has given statutory backing to the financial reporting standards which follow IAS 27 with respect to the "control-based" definition of "subsidiary" and the treatment of "SPEs" in accounts consolidation. Moreover, we have made reference to the company laws in the UK, to develop the proposed legal definition of "subsidiary undertaking", which has been in force in the UK since 1990. There is no question of competitive disadvantage given that these places in effect have adopted what we propose in the Bill with respect to the definition of "subsidiary" in the preparation of group accounts.
5	Some banking regulators have already taken	We need to stress that **financial reporting** vis-à-vis **financial**

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	the view that IAS does not adequately address regulatory capital reporting requirements for banks. In relation to the consolidation of SPEs as required by the IASB/Hong Kong Institute of Certified Public Accountants (HKICPA), the Hong Kong Monetary Authority (HKMA), in discussion with banking industry associations, has indicated its view that the consolidation of SPEs does not properly reflect the risks assumed by the banks (i.e. consolidation will overstate the retained risks and understate the capital adequacy ratio). The HKMA therefore is requesting the supervised banks to continue to submit separate accounts drawn up in accordance with existing supervisory standards (i.e. without consolidating SPEs). We understand that the Australian Prudential Regulatory Authority will also implement a separate parallel reporting requirement from banks.	**regulation** serve different purposes. Financial reporting is fundamentally about presenting the financial performance in a true and fair view. As for the latter, the objective is usually more on the prudential regulation of the entities concerned or the protection of investors/depositors. In terms of general **financial reporting**, Australia has adopted in its statutorily backed financial reporting standards for years a definition for "subsidiary" similar to that proposed in the Bill. It has also announced that it would fully adopt International Financial Reporting Standards(IFRSs) in 2005. As for **financial regulation**, it is true that the Australian Prudential Regulation Authority (APRA) will adopt different standards for its regulatory work. However, this will not stand the full adoption of IFRSs by Australia in 1 January 2005 in the way. Indeed, APRA recognizes the difference of financial reporting with general financial reporting requirements. In the Overview paper issued by APRA on 3 November 2004, APRA accepts that its "*prudential framework and supervisory approach is forward-looking and primarily risk-based, while accounting standards primarily focus on verification and reporting of past transactions and events*". In addition, APRA recognizes that its "*prudential requirements are aimed at protecting the interests of beneficiaries, while general purpose financial reporting focuses on evaluating the interests of the economic owners of an institution on a going concern basis*."[3] In this connection, we also note that the HKMA will continue to

[3] An overview paper – "*Adoption of International Financial Reporting Standards: Prudential Implications*", issued by APRA on 3 November 2004.

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		apply its existing long-standing rules on whether or not an SPE needs to be consolidated for capital adequacy purposes, and this will not be affected by the current round of accounting changes.
6	In May 2004, HKICPA adopted IAS 39 as HKAS 39, which will come into effect from 1 January 2005. If the proposed legislative amendments to the CO are passed, this will mean that Hong Kong originators will not only be subject to the provisions of HKAS 39, which already greatly restrict the scope of off-balance sheet treatment, but in addition will have to deal with the effect of IAS 27 and SIC-12 (adopted as HKAS 27 and HK-Int 12), the combined effect of which will make achieving off-balance sheet treatment more difficult.	In short, IAS 39 is about the recognition and measurement of financial asset, not consolidation of accounts. HKICPA advises that IAS 39 is not particularly relevant to the proposed amendments.
7	There is authority in the UK suggesting that the effect of the "true and fair view override" provisions is limited only to matters of disclosure and does not enable a company to depart from other provisions of the Act (e.g. definitions) even though section 227A also has language that overrides other provisions of the Act. If a similar interpretation of the "true and fair view override" is adopted in Hong Kong, and if accounting standards change in a	The proposed "true and fair view override" provisions in the proposed sections 123(4), 123(4A), 126(4) and 126(5) are modelled on the previous sections 226(4)-(5) and 227(5)-(6) (which have now been newly re-enacted as sections 226A(4)-(6) and 227A(4)-(6)) of the UK Companies Act 1985. In essence, our intention is that only the Tenth Schedule and other requirements of the CO as to the matters to be included in company's accounts are subject to this "true and fair view override". To further extend the scope of the "true and fair view override" to any other sections in the CO will unnecessarily allow a much larger

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	manner which conflicts with parts of the CO other than the Tenth Schedule and other matters of disclosure, the true and fair view override will not enable a company to disregard the requirements of the CO and follow accounting standards. Accordingly, the Bills Committee may wish to consider whether the "true and fair view override" provisions should be amended to expressly extend its overriding effect over other sections in the CO, such as the definitions sections.	room for discretion beyond which is strictly required in relation to form and content of the accounts (i.e. Tenth Schedule) and other CO requirements as to the matters to be included in a company's accounts or group accounts. In this light, we consider that the current proposal, which is modelled on the UK Companies Act 1985, has provided an appropriate ring-fence for the "true and fair view override" provisions. Moreover, we will like to point out that that, as far as we are aware, no problem has arisen from the operation of the relevant provisions in the UK.
8	Even if a revised "true and fair view override" provision is implemented, there is the practical difficulty to be overcome by a company wishing to avail itself of the "true and fair view override" provision. The obligation to present accounts in the format specified by the CO is onerous, and one which is backed by criminal penalties on a company's directors for non-compliance (see sections 123(6) and 124(3) of the CO). Accordingly, to depart from the requirements of the CO is not something that can or will be lightly undertaken, and even if the directors of a company were of the view that it was necessary to make use of the "true and fair view override", it is	The gist of the proposed "true and fair view override" provisions is to ensure that accounts would always present a "true and fair view". The general requirement to present accounts giving a true and fair view has always been the objective of financial reporting, notwithstanding that the existing CO does not expressly require companies to disclose additional information or depart from the requirements of the CO to give a "true and fair view". Section 123(3) of the existing CO states that "(s)ave as expressly provided in the following provisions of this section or in Part III of the Tenth Schedule, the requirements of subsection (2) and the said Schedule shall be <u>without prejudice either to the general requirements of subsection (1) or to any other requirements of this Ordinance</u> (emphasis added)". Thus, where compliance with the Tenth Schedule does not give a true and fair view of the company's state of affairs, the company accounts should, say, disclose additional

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	questionable whether the company's auditors could be persuaded to endorse such departure. Thus whilst theoretically there might appear to be scope for painless adaptation to changes in accounting standards through the availability of the "true and fair view override" provision, it is doubtful whether the provision will prove to be easily utilized in practice.	information as may be necessary to fulfill the "true and fair view" requirement in section 123(1). We consider that the proposed *express* "true and fair view override" provisions will enhance the transparency of financial reporting hence providing further guidance to company directors in order to discharge their duties of preparing accounts that give a true and fair view. We have to stress that the "true and fair view override" provisions are not simply about "departure", but also "disclosure". When the provisions are used, additional information as may be necessary to give the true and fair view, and reasons for and particulars and effects of such departure have to be disclosed to facilitate users of the accounts to assess the implications therefor. HKMC has rightly pointed out that this provision is not intended to be used easily in practice but only in very exceptional and unforeseen circumstances with strong justification. This position is similar to that under UK Companies Act 1985. As accounts are also subject to audits by auditors who have a statutory duty to state whether in the auditors' opinion the accounts has been properly prepared and whether in their opinion a true and fair view is given, this will provide sufficient and necessary "check and balance" to avoid abuses.
9	Our preferred option is for the legislation to expressly provide a carve-out from the	IASB stresses that there "*should be no specific exceptions from consolidation on the basis of transaction types (such as for certain*

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	definition of "subsidiary" for asset securitization SPEs similar to the concept of the Qualifying SPE (QSPE) available under US accounting rules. The IASB and the Federal Accounting Standards Board (FASB) have entered into an agreement for the convergence of international and US accounting standards. However, notwithstanding concern about the abuse of SPEs following a number of financial scandals (e.g. Enron), it is significant to note that there are apparently as yet no plans to phase out the concept of QSPEs under FASB.	*types of securitization)*"[4]. In fact, IASB has always reaffirmed the Board's intention that "*the consolidation principles it develops would apply to all entities, including SPEs*"[5]. The proposed carve out will also be against the purpose of the legislation (i.e. to better reflect the financial position of a company through aligning the definition of "subsidiary" in CO more closely with IAS 27 and HKAS 27). Given IASB's confirmation, we do not see the need to propose a carve-out, in a way that is not recognized by IASB and any jurisdictions that have adopted IFRS. According to HKICPA, Hong Kong Financial Reporting Standards (HKFRSs) will be fully converged in all material aspects with IFRSs starting from 1 January 2005. IFRSs are indeed quite different with the US accounting standards in many aspects. We are not aware that other jurisdictions following IFRSs will apply the concept of QSPEs under FASB in their own local accounting standards, as the concept *per se* has been questioned in the post-Enron era. HKICPA does not consider it appropriate to adopt this concept in HKFRSs.
10	The HKICPA should consider possible amendments to the Hong Kong Accounting Standards which will enable asset securitization SPEs to use the UK's "linked presentation" format for their accounts	The linked presentation method under UK FRS 5 "Reporting the Substances of Transaction" essentially means reflecting in the balance sheet the securitized loans as a deduction from the gross amount of the item it finances. As far as we understand, this is a unique concept in the local financial reporting standards of UK

[4] A paper - *Consolidation (including special purpose entities)*, issued by IASB on 31 May 2004 to reflect the decisions up to and including the May 2004 Board meeting.
[5] Same as footnote 2.

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	which can clearly disclose the effect of the securitization transaction on the originator's balance sheet. Although "linked presentation" will no longer be available for listed companies in the UK as from 1 January 2005, unlisted companies will still have the option for the time being to make use of the rules. In our discussion with HKICPA, they are however not receptive to the proposition to introduce "linked presentation" in Hong Kong. On the other hand, there is an ongoing dialogue between IASB and the American, Australian and European Securitization Forums on possible amendments to IAS to accommodate securitization activities based on the "linked presentation" approach.	before the convergence of these standards with IFRSs. IAS 27 has not adopted similar approach of financial reporting. In fact, IASB has emphasized that "*the Board's intention is that the consolidation principles it develops would apply to all entities, including SPEs*"[6]. In this light, the HKICPA does not consider it appropriate to deviate from the international norm and to permit under accounting standards the linked presentation method which is a falling-away concept even in the UK. We want to stress that the changes introduced by the proposed amendment in the Bill lie primarily in the format of such disclosure, instead of the content or amount of the disclosure. Consolidation will present a clearer picture to users of accounts, as opposed to the linked presentation method which attempts to achieve unsatisfactorily a hybrid of the two worlds. In any case, all listed companies in the UK will be prohibited to use the linked presentation method in their group accounts starting from 1 January 2005.
11	As a result of the discussion with the trade forums, the IASB itself is undertaking a review of the IAS 27 which will consider whether or not the revisions of the "control" model for subsidiaries should also be applied to SPEs. We submit that it will not	We do not consider it appropriate to withhold the Bill given that the "control-based" definition of "subsidiary" proposed in the Bill has been adopted by IASB since 1990 and were adopted by many jurisdictions following IFRS in their company laws / accounting standards since the last decade. As far as we are aware, this definition of "subsidiary" for the purpose of group accounts has run

[6] Same as footnote 2.

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	be objectionable for a short deferral of the amendments.	well in these jurisdictions over these years. According to its most recent deliberation of the matter in November 2004 and quite contrary to HKMC's submission, IASB has repeatedly affirmed the intention that "*the consolidation principles it develops will apply to all entities including SPEs*"[7]. Given that IASB has reaffirmed this approach on many occasions before and most recently, we see it unnecessary to defer the Bill. In fact, the Bill will enhance the quality of financial reporting for Hong Kong incorporated companies and thus their corporate governance, and facilitate comparison and interpretation of accounts of Hong Kong incorporated companies vis-à-vis those in other major financial markets in the world that adopt IFRSs.

Financial Services and the Treasury Bureau
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[7] Same as footnote 2.