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Report of the Bills Committee on
Companies (Amendment) Bill 2004

Purpose

This paper reports on the deliberations of the Bills Committee on Companies (Amendment) Bill 2004.

Background

2. The Companies Ordinance (CO) (Cap. 32) is one of the largest and most complex pieces of legislation in Hong Kong. Since its last major review in 1984, continuous efforts have been made to update the Ordinance to keep it attuned to business needs. In June 2003, the Administration introduced the Companies (Amendment) Bill 2003 (the 2003 Bill) into the Legislative Council (LegCo). Four main groups of proposed legislative amendments were set out in Schedules 1 to 4 of the 2003 Bill, including Schedule 2 which sought to make the meaning of "subsidiary" in the CO more closely in alignment with that in the International Accounting Standards (IASs) in the context of group accounts. A Bills Committee was formed to scrutinize the 2003 Bill. At the later stage of the Bills Committee's deliberation, the Administration advised members that in view of time and resource constraints, it had decided to delete Schedule 2 and the related consequential amendments from the 2003 Bill. The 2003 Bill with Schedule 2 and the related consequential amendments removed was subsequently passed in July 2004.

3. On 13 October 2004, the Administration introduced the Companies (Amendment) Bill 2004 (the Bill) into LegCo in order to implement the proposals relating to group accounts. According to the Administration, apart from some textual amendments of minor nature, the Bill is the same in substance as the relevant proposals in the 2003 Bill.

The Bill

4. Section 124 of the CO requires a company having subsidiaries to lay before the company in general meeting accounts dealing with the state of affairs and the profit or loss of the company itself and its subsidiaries. These accounts are known as group accounts. The definition of the term "subsidiary" in section 2(4) which applies to accounting and other provisions in the CO is narrower than that adopted in the IASs. The Administration considers it necessary to amend the statutory definition for the purposes of group accounts to make it more closely in alignment with the IASs. This would ensure that under the law, the group accounts would better reflect the financial position of the company. The definition of "subsidiary" for purposes other than the preparation of group accounts would not be affected.

5. The Bill covers the following major proposed amendments –

(a) To introduce new terms of "subsidiary undertaking", "parent company" and "parent undertaking";

(b) To add "the right to exercise a dominant influence over another undertaking" test (defined as the right to give directions with respect to the operating and financial policies of that other undertaking which its directors will be obliged to comply with) to the existing tests of determining the existence of a parent-subsidiary relationship; and

(c) To introduce "true and fair view override" provisions to the effect that if compliance with the relevant requirements of the CO does not result in a true and fair view of the state of affairs of the company or the group, the directors should provide additional information or depart from these requirements to the extent necessary to give a true and fair view.

The Bills Committee

6. The House Committee agreed at its meeting on 15 October 2004 to form a Bills Committee to study the Bill. The Bills Committee first met on 8 November 2004 and Hon Audrey EU Yuet-mee was elected Chairman. The membership list of the Bills Committee is in **Appendix I**.

7. The Bills Committee held a total of 11 meetings. It received submissions from 25 organizations/individuals/academics and met with six of them. The list of the organizations/individuals/academics concerned is in **Appendix II**.

Deliberations of the Bills Committee

8. The Bills Committee has no objection to the Administration's proposal to amend the definition of the term "subsidiary" in the CO for the purposes of group accounts to make it more closely in alignment with the definition adopted in IAS 27. However, the Bills Committee notes that while some of the organizations/individuals/academics who have given views on the Bill support the proposed amendment, the asset-securitization industry has expressed grave concern about the possible negative impact of the proposed amendment on the development of the asset-securitization market in Hong Kong. In this connection, the Bills Committee has examined the Bill in detail, in particular the impact of the Bill on the requirements on companies to prepare group accounts and the development of the asset-securitization market in Hong Kong.

Definition of "subsidiary"
(Clauses 2 and 18 — Proposed new section 2B and 23rd Schedule to the CO)

9. The Bills Committee notes that there are two major proposed changes under the Bill which would broaden the scope of the term "subsidiary". The two major proposed changes, which are provided in the proposed new section 2B of the CO and the proposed new 23rd Schedule to the CO, are summarized as follows:

(a) Determination of "parent-subsidiary" relationship
Under the existing section 2(4)(a) of the CO, a company, say Company B, shall be deemed to be a "subsidiary" of another company, say Company A, if:
- Company A controls the composition of the board of directors of Company B; or
- Company A controls more than half of the voting power of Company B; or
- Company A holds more than half of the issued share capital of Company B.

However, in both IAS 27 and Hong Kong Accounting Standard (HKAS) 27, a subsidiary is defined as "an entity that is controlled by another entity", where the control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. To align more closely with IAS 27, it is proposed under the Bill that the "right to exercise a dominant influence over another undertaking" test (defined as the right to give directions with respect to the operating and financial policies of that other undertaking which its directors will be obliged to comply with) would be added to the three existing tests of determining the existence of a "parent-subsidiary" relationship mentioned above.

(b) Scope of "subsidiary"
Under the existing CO, only a body corporate subsidiary is subject to consolidation in group accounts. To better reflect the financial

position of a group, it is proposed under the Bill that the term "undertaking" be defined to include body corporate, partnership or other unincorporated body so that a subsidiary which is a body corporate, partnership or other unincorporated body is subject to consolidation in group accounts. In this connection, the Administration points out that IAS 27 also defines a subsidiary as "an entity, including an unincorporated entity such as a partnership that is controlled by another entity".

10. The Bills Committee's major deliberations on these two proposed changes and related issues are set out in paragraphs 11 to 22 below.

Scope of "subsidiary"

11. Whilst having no objection to the Administration's proposal to define the term "undertaking" to cover "partnership or other unincorporated body" so as to broaden the scope of "subsidiary", members of the Bills Committee consider it unclear from the drafting of the proposed provision as to whether the term "unincorporated body" is intended to cover "an individual". Given the Administration's advice that it is not intended to cover "an individual", members support the Administration's proposal to move a Committee Stage amendment (CSA) to section 1 of the proposed new 23rd Schedule 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".

12. Under the proposed new section 2B(2)(b) of the CO, a reference to a "subsidiary" shall be deemed to include a subsidiary undertaking. Given the Administration's policy intent that a reference to a "subsidiary company" shall also be deemed to include a subsidiary undertaking, members support the Administration's proposal to move a CSA to the English text of the proposed subsection (2)(b) to reflect its policy intent.

Determination of "parent-subsidiary" relationship

13. The Bills Committee notes that section 2(1) of the proposed new 23rd 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. It appears from the proposed provision that more than one undertaking can satisfy the criteria and become the parent undertakings of a subsidiary undertaking. The Bills Committee is advised by the Administration that the existing section 2(4)(a) of the CO may result in a hypothetical possibility, whereby a parent company controls the composition of the board of directors of a subsidiary while another parent company controls more than half of the voting power of or hold more than half of the issued share capital of the same subsidiary. In the Administration's view, occurrence of this possibility is remote, because in reality it is unlikely that an undertaking would, say, hold more than half of the issued share capital of the subsidiary but give up its right to appoint a majority of its board of directors of the subsidiary or its control of the voting power of

the subsidiary. The Administration has not come across any precedent case whereby two companies claim to be the parent company of a subsidiary under the existing section 2(4)(a) of the CO.

14. As regards section 2(1) of the proposed new 23rd Schedule, the Administration confirms that the proposed provision does not alter the status quo. While it is also hypothetically possible under section 2(1) of the Schedule that more than one undertaking can satisfy the various criteria under which an undertaking is defined to be a parent undertaking in relation to another undertaking (i.e. subsidiary undertaking), it is unlikely that an undertaking would, say, hold a majority of voting rights in the subsidiary undertaking but give up its right to appoint a majority of its board of directors or its right to exercise a dominant influence over the subsidiary undertaking. The Administration also points out that section 258 of the United Kingdom (UK) Companies Act 1985, which sets out the criteria to determine the "parent-subsidiary" relationship, contains no provision excluding or dealing with the occurrence of the above hypothetical possibilities. The Administration is not aware of any difficulties in the actual operation of the relevant provisions in the company laws of the UK.

15. The Bills Committee notes that under sections 2(1)(c)[1] and 5 of the proposed new 23rd Schedule, "parent-subsidiary" relationship is determined through the rights of an undertaking to exercise a "dominant influence" over another undertaking (i.e. the subsidiary undertaking) by virtue of the provisions contained in the subsidiary undertaking's constitutional documents or a "control contract". On the concern whether more than one entity can exercise "dominant influence" over another undertaking in the Hong Kong context, e.g. through joint control, the Bills Committee is advised by the Administration that, according to the Hong Kong Institute of Certified Public Accountants (HKICPA), only one undertaking can have dominant influence or control over another undertaking under IAS/HKAS 27. It is a question of fact to determine which undertaking ultimately has a dominant influence over another. If two undertakings concurrently but independently exert influence or control over another undertaking but each fails to demonstrate that it is a parent undertaking under the test for the "parent-subsidiary" relationship under the CO or IAS/HKAS 27, the two undertakings will be regarded under the relevant IAS as having a joint control over what the financial reporting standards call the "jointly controlled entity" (i.e. not "subsidiary"). An undertaking having a joint control together with others over a "jointly controlled entity" does not need to prepare group accounts, as the undertaking cannot satisfy any of the tests (including the "dominant influence" test) which determines "parent-subsidiary" relationship under the CO and IAS/HKAS 27.

16. On Linklaters' concern that "control contracts" do not appear to be common in Hong Kong, the Bills Committee notes the Administration's advice that in determining whether or not an undertaking is a subsidiary undertaking in relation to another undertaking under the existing provisions of the CO and the proposed new 23rd Schedule, the subsidiary undertaking's place of incorporation, formation or registration

[1] To be renumbered as section 2(1)(b) under a CSA.

is not relevant. Even though "control contracts" may not appear to be very common in Hong Kong, it can still be relevant in certain cases to identify the source document providing for the right to exercise a dominant influence over the subsidiary undertaking. The Administration considers that sections 2(1)(c)(ii)[2] and 5(b) of the proposed new 23rd Schedule, modelled on section 258(2)(c) of the UK Companies Act 1985 and section 4(2) of Schedule 10A to the same Act, adequately reflect its policy intent.

17. The Bills Committee notes that "control contract" is defined in section 5(b)(ii) of the proposed new 23rd Schedule as a contract in writing conferring a right which is "permitted by the law under which that undertaking is established". In this connection, the Law Society of Hong Kong (Law Society) is concerned that there may not be a readily identifiable jurisdiction in which the undertaking is considered to have been established. Take partnership as an example, it is formed by contract and does not require registration to come into existence. A partnership may have a presence in one or more jurisdictions in which it carries on business, but it cannot be said that in every case the partnership is established in the jurisdiction where it operates. The law under which the undertaking is established may be silent on whether a control contract is permissible. On the other hand, the law does not prohibit the entering into of such contracts. The use of the word "recognized" could perhaps clarify the intention of the provision.

18. The Bills Committee is advised by the Administration that the proposed definition of "control contract" is modelled on section 4(2) of Schedule 10A to the UK Act. Although it is possible that an unincorporated body or a partnership may not be invariably established in the place where it operates, it should be noted that section 5(b)(ii) of the proposed 23rd Schedule refers to the "the law under which that undertaking is established" but not "the law of the place where that undertaking is established". In the Administration's view, the crux of the issue is how to ascertain the governing law of the constitutional document in relation to the establishment of the undertaking (for example, a partnership agreement). Usually, such a document will contain a governing law clause. If so, "the law under which that undertaking is established" will be the governing law as expressly provided in the document. If there is no express governing law clause, there will be legal rules governing the law that should apply. For example, in the case of a partnership, where the partners are all domiciled in Hong Kong, it is likely that the partnership agreement will be governed by the laws of Hong Kong. Where the partners are domiciled in different jurisdictions, there are rules in private international law to determine the governing law of the partnership agreement. As regards the Law Society's suggestion of using the word "recognized", instead of "permitted", in the phrase "permitted by the law under which that undertaking is established", the Administration considers that the original wording "permitted" has sufficiently reflected its intent, i.e. that which is not prohibited by law is permitted.

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[2] To be renumbered as section 2(1)(b)(ii) under a CSA.

"Grandparent-parent-subsidiary" situation

19. On the determination of the "grandparent-parent-subsidiary" relationship, the Bills Committee is advised by the Administration that under the existing section 2(4)(b) of the CO, a company shall be deemed to be a subsidiary of another company if the first-mentioned company is a subsidiary of any company which is that other company's subsidiary. Section 2(3) of the proposed new 23rd Schedule preserves the status quo whereby "a parent undertaking shall be treated as the parent undertaking of undertakings in relation to which any of its subsidiary undertakings are, or are to be treated as, parent undertakings". Given the Administration's confirmation that the intent of section 2(3) is to cater for a "grandparent-parent-subsidiary" situation, members suggest that the drafting of the proposed provision be improved to reflect the policy intent. The Administration accepts members' suggestion and proposes a CSA to recast the drafting.

Consequential amendments to section 128 of the CO

20. Section 128(1) of the CO 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 the Administration proposes to broaden the scope of "subsidiary" to include undertakings which are not body corporate (i.e. a partnership or an unincorporated association), it is necessary to make consequential amendments to the relevant disclosure requirements in section 128. The Administration's original proposal is to amend subsection (1)(b) to the effect that particulars to be shown in the group accounts in respect of a subsidiary include "the country in which it is incorporated or established". The Bills Committee notes the Law Society's concern that there may not be a readily identifiable jurisdiction in which an undertaking is considered to have been established, and that it would be more meaningful to require the disclosure of the country in which the undertaking carries on business. To address this concern, the Bills Committee supports the Administration's proposal to move a CSA to subsection (1) of section 128 to require the disclosure of "the country in which it is incorporated" for a subsidiary which is a body corporate, and to require, by modelling on paragraphs 1(3) and 15(3) of Schedule 5 to the UK Companies Act 1985, the disclosure of the "address of its principal place of business", instead of the "country in which it is established", for a subsidiary which is not a body corporate.

21. The Bills Committee notes that it is proposed under the Bill that the existing subsection (3) of section 128 be repealed and substituted by a new subsection (3) to cater for a subsidiary which is not a body corporate. In this connection, the Administration confirms that the proposed amendment does not carry the intention to change the fundamentals of the existing subsection (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. However, the Bills Committee notes that under both the existing and proposed subsection (3), the exemption would apply if the disclosure of information would, in the opinion of the directors of the parent undertaking, be harmful to the business of the

parent undertaking or of any of its subsidiaries, and the Financial Secretary (FS) agrees that the information need not be disclosed. Members are concerned how the directors could determine whether the disclosure is "harmful to the business" and why FS is empowered to exempt an undertaking from the requirement of disclosing information relating to its subsidiary.

22. The Bills Committee is advised by the Administration that the existing section 128(3) of the CO was enacted in 1974. While the Administration is not able to trace the legislative intent then, it is aware that the subsection was modelled on section 3(3) of the UK Companies Act 1967 (before it was subsequently amended). The UK Companies Act 1989 has modified the disclosure requirement set out in the UK Companies Act 1967. 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). The Administration is unable to trace the policy intent with respect to the modification. However, such non-disclosure requires the agreement of the Secretary of State. Given 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, the Administration undertakes that it would, upon the completion of the review by the Joint Working Group, consult the Standing Committee on Company Law Reform and other stakeholders on the way forward in respect of any proposed amendments to those provisions.

Impact of the broadened scope of "subsidiary"

23. The Bills Committee notes that the broadened scope of "subsidiary" would have impact on the requirements on companies to prepare group accounts, including the requirement for a parent company to consolidate in its group accounts the accounts of Special Purpose Entities (SPEs) controlled by the company for the purpose of asset-securitization. This requirement has given rise to the grave concern expressed by the asset-securitization industry about the possible negative impact of the proposed amendment on the development of the asset-securitization market in Hong Kong. The Bills Committee has examined the relevant issues, and its major deliberations are set out in paragraphs 24 to 42 below.

Impact on the requirements to prepare group accounts
(Clause 4 — Section 124 of the CO)

24. The Bills Committee is advised by the Administration that at present, the requirement under section 124 of the CO to lay group accounts in general meeting applies to a "company" which has subsidiaries. As defined under section 2(1), the term "company" means a company formed and registered under the CO or an existing company[3]. The definition essentially refers to a "Hong Kong incorporated company".

[3] In short, an "existing company" means a company formed and registered under the Companies Ordinance 1865, or the Companies Ordinance 1911.

Therefore, as far as the application of the CO is concerned, whether or not the "company" is listed in Hong Kong or any other places is not relevant. The Bill will not change the status quo that only Hong Kong incorporated companies are required to prepare group accounts in accordance with the requirements of the CO. Unless a parent company is a wholly owned subsidiary of its grandparent company and is thus exempt from preparing group accounts under section 124(2)(a) of the CO, both the parent company and grandparent company are required to prepare group accounts in respect of a subsidiary undertaking under the CO.

25. As regards a non-Hong Kong company that establishes a place of business in Hong Kong, the Bills Committee notes the Administration's advice that although such company, including a company incorporated in the Mainland, is required to be registered under section 333(1) of the CO, it is not formed or incorporated in Hong Kong and therefore falls outside the definition of "company" under section 2(1). Thus, a non-Hong Kong parent company does not need to comply with the relevant requirements of preparing group accounts under section 124. Nevertheless, section 336(1) of the CO requires a non-Hong Kong company to deliver to the Registrar of Companies a certified copy of the latest published accounts of the company that comply with the law of the place of incorporation of the non-Hong Kong company. Separately, listed companies in Hong Kong are required to comply with the Listing Rules of the Stock Exchange of Hong Kong Limited (SEHK). The Listing Rules require listed companies to prepare group accounts in accordance with either the Hong Kong Financial Reporting Standards[4] (HKFRSs) or the International Financial Reporting Standards (IFRSs), including IAS 27.

26. As regards subsidiary undertakings, the Bills Committee notes the Administration's advice that accounts of all subsidiary undertakings falling within the criteria set out in section 2(1) of the proposed new 23rd Schedule to the CO, be they incorporated or registered or formed in Hong Kong or otherwise, are still subject to consolidation in the group accounts prepared by the relevant Hong Kong incorporated parent undertaking. On the Administration's proposal to add the new subsection (2A) in section 124 of the CO to specify the basis on which a subsidiary may be excluded from the group accounts of a company (clause 4), the Bills Committee notes that the latest IAS 27 no longer permits exclusion from the group accounts under the two conditions set out in the proposed new subsection (2A). The Administration advises that the proposed new subsection (2A) is modelled on the previous section 229(3) of the UK Companies Act 1985, which has recently been amended by the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004 in November 2004. In the light of the latest changes in IAS and latest legislative changes in the UK, the Administration agrees to move a CSA to delete clause 4.

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[4] The HKICPA is empowered, pursuant to section 18A of the Professional Accountants Ordinance (Cap. 50) to issue accounting standards required to be observed, maintained or otherwise applied by any certified public accountants. These accounting standards are referred to as the "Hong Kong Financial Reporting Standards (HKFRSs)" collectively. Hong Kong Accounting Standard (HKAS) 27 "Consolidated and Separate Financial Statements" is one of the HKFRSs and is equivalent in all material aspects, including the definition of "subsidiary", with IAS 27 "Consolidated and Separate Financial Statements".

27. At the request of the Bills Committee, the Administration elaborates on the obligation of parent undertakings in preparing group accounts under three different scenarios involving "grandparent-parent-subsidiary" or "parent-subsidiary" situation, as set out in **Appendix III**.

28. On the consolidation of subsidiary undertakings' accounts in the parent company's group accounts, the Bills Committee notes that at present, given the "gap" between the definition of "subsidiary" under the CO and that under HKAS 27, an interim arrangement has been set up under HKAS 27 whereby Hong Kong incorporated companies are required to disclose financial information of subsidiary undertakings, which fall outside the scope of the CO and therefore excluded from consolidation but fall within that of HKAS 27, in the "notes to accounts". However, with the introduction of the "dominant influence" test under the Bill for the determination of "parent-subsidiary" relationship, a parent company will be required to consolidate the financial information of its subsidiary undertakings in its group accounts as and when it has the right to give directions with respect to the operating and financial policies of its subsidiary undertakings.

29. To illustrate the impact of the change introduced by the Bill on the financial reporting requirements on companies, in particular those which have set up SPEs, HKICPA has provided the Bills Committee with samples of group accounts (extract) of a hypothetical Hong Kong incorporated parent company (Company H) which engages in securitization business and sets up a SPE (falling within the proposed definition of "subsidiary") which is not a body corporate *per se*. The samples, which are set out in **Appendix IV**, are summarized as follows:

(a) The first set of accounts shows the financial position of Company H before setting up the SPE;

(b) The second set of accounts shows the position after the establishment of the SPE under the existing CO, where Company H makes a disclosure in a note to the accounts in respect of the SPE; and

(c) The third set shows the position after the establishment of the SPE under the provisions of the Bill. The financial information of the SPE, which fulfills one of the criteria determining "a subsidiary undertaking" as proposed in the Bill, has been consolidated in the balance sheet of Company H.

30. The Bills Committee notes that both the Administration and HKICPA are of the view that the changes introduced by the Bill lie primarily in the format of presentation, instead of the content or amount of the disclosure in the accounts, as Hong Kong incorporated parent companies are already required under HKAS 27 to disclose the financial information of their subsidiary undertakings in the form of "notes to accounts". However, the Hong Kong Mortgage Corporation Limited (HKMCL) and

Hong Kong Capital Markets Association (HKCMA) hold different views. Their views are set out in paragraph 31 below.

Impact on the development of the asset-securitization market in Hong Kong

31. The Bills Committee notes that as indicated by HKMCL and HKCMA, the asset-securitization industry is gravely concerned about the requirement for group accounts to consolidate accounts of SPEs established and controlled dominantly by a company for the purpose of asset-securitization. The industry considers that such consolidation would deprive the asset-securitization market of the off-balance-sheet treatment in the presentation of financial statements. As a result, this would discourage securitization transactions and hamper the development of the asset-securitization market in Hong Kong, thus putting Hong Kong in a disadvantaged position vis-à-vis other international financial centres. Moreover, HKMCL disagrees with the Administration and the HKICPA that the changes introduced by the Bill lie primarily in the format of presentation, instead of the content or amount of the disclosure in the accounts. HKMCL considers that the proposed changes would also affect the financial ratios and analysts' perception of the risks retained on the originator's balance sheet and could lead to investors shunning a company with "poor" financial ratios.

32. The Bills Committee notes the Administration's view that there is no evidence supporting that the Bill would have negative impact on the development of the asset-securitization market in Hong Kong. The Administration explains that whether the accounts of a SPE is required to be consolidated in the group accounts depend on whether the parent company has control over the SPE. Even though the title, ownership and risks may have been substantially transferred from the parent company to the SPE, the parent company may still retain the control[5] over the operating and financial policy of the SPE hence the need for consolidation of the SPE as part of the group. If the parent company retains no control at all over the SPEs, the "control-based" definition of subsidiary will have no impact on the asset securitization arrangement as the asset will be rightly removed from the balance sheet in the group accounts of the company.

33. On HKMCL's concern that consolidation of the accounts of securitization SPEs may affect the financial ratios of an originator engaged in securitization transactions, thereby affecting the credit rating of the originator, the Bills Committee notes the Administration's view that it has difficulties in accepting this line of argument, as it implies that information disclosed in notes to group accounts would be ignored in credit rating assessments. This argument also misses the point that ratios should not be, and are not, viewed in isolation. Compared to notes disclosure, consolidation will present a clearer picture to all users of the statements (including ordinary investors) as regards the company's leverage hence facilitating interpretation of financial information pertinent to an informed investment decision. From the

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[5] Control may still exist even though a SPE may operate in a predetermined way (i.e. operate on "autopilot") whereby the financial and operating policies of the SPE are predefined and limited by the parent company at the inception of the SPE.

overseas experience of adopting IAS 27, the Administration is unable to see how such a clearer presentation of the group's financial information would make the issue of securities under a securitization transaction less attractive.

34. To address the concern of the asset-securitization industry, the Bills Committee requests the Administration to consider the following three alternative options put forward by HKMCL:

(a) To provide a carve-out under the Bill for securitization SPEs similar to the concept of the Qualifying SPEs (QSPEs) available under the United States (US) accounting rules; or

(b) To amend HKAS which would enable securitization SPEs to use the UK's "linked-presentation" format for their accounts which could clearly disclose the effect of the securitization transaction on the originator's balance sheet; or

(c) To defer the Bill until the International Accounting Standards Board (IASB) has completed its review of IAS 27.

35. The Administration has consulted the HKICPA on these options. On the first option suggested by HKMCL, the Administration considers that any proposed carve-out would lead to an inconsistent approach in preparation of group accounts thereby derogating from the purpose of the Bill. It also points out that IASB recommends against any carve-out. In fact, no other jurisdictions following IFRS have adopted a carve-out in relation to the securitization industry. The concept of QSPEs under the US accounting standards has been questioned in the wake of Enron.

36. On the second option suggested by HKMCL, the Administration points out that the "link-presentation" method in the UK essentially means reflecting in the balance sheet the securitized loans as a deduction from the gross amount of the item it finances. As advised by the HKICPA, this is a unique concept in the domestic financial reporting standards of UK. The IFRSs have not adopted a similar approach for financial reporting. The HKICPA does not consider it appropriate, for the purpose of presenting the "true and fair view" of the group's results and states of affairs, to deviate from the IFRSs and to permit under accounting standards the linked-presentation method which is a concept unique to the UK. In fact, starting from 2005, all listed companies in the UK are required to abandon the linked-presentation method when preparing their group accounts.

37. As regards the third option suggested by HKMCL, the Administration does 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 the Administration is aware, this definition of "subsidiary" for the purpose of group accounts has run well in these jurisdictions over these years. According to its most recent deliberation of the matter

in November 2004, IASB has affirmed the intention that "the consolidation principles it develops will apply to all entities including SPEs". Given that IASB has reaffirmed this approach on many occasions before and most recently, the Administration sees it unnecessary to defer the Bill. As regards the review on IAS 27 being undertaken by IASB, the focus of the review is more concerned about the application of the "control-based" approach in practice.

38. Given the grave concern reiterated by the asset-securitization industry, the Bills Committee requests the Administration to provide information on the existing size of the asset-securitization market in Hong Kong and its expected growth, and to re-assess the impact of the Bill on the growth of the market. The Bills Committee is advised by the Administration that, according to market sources, the asset-backed securities issued in Hong Kong have increased from US$0.84 billion in 2003 to US$1.27 billion in 2004[6]. While the Administration does not have information on the projection of the future growth of the asset-securitization industry, it has consulted the Government Economist who is of the view that the Bill will have a positive impact on the asset-securitization industry, as it would enhance the quality of corporate governance and hence the status of Hong Kong as an international financial centre.

39. The Bills Committee has also studied whether the proposed amendment in the Bill is in line with the practices adopted by other major international financial centres. The Bills Committee notes that New York and Japan have not adopted IAS 27. All European Union (EU) members require only listed companies to prepare group accounts on the basis of relevant IAS starting from 1 January 2005. As regards Australia, HKMCL has pointed out that it is expected that the adoption of IAS/IFRS from 1 January 2005 will cause all traditional securitization vehicles to be consolidated by the sponsor. As a result, the Australian Securitization Forum has recently kicked off a global project, with the endorsement of IASB, to develop a revised model for accounting for securitization transactions. There are four co-chairs of the project, including two from the American Securitization Forum and one from the European Securitization Forum. In the light of the overseas practices, the Bills Committee is concerned whether it is justified for Hong Kong to achieve full compliance with IAS 27 at this stage ahead of other major international financial centres and the impact of such on the development of the local asset-securitization market. The Administration is therefore requested to consider offering different treatment to listed and non-listed companies in Hong Kong or achieving full compliance with IAS 27 in two phases with the listed companies in Hong Kong covered by the first phase and the non-listed companies by the second phase.

40. The Bills Committee is advised by the Administration that:

(a) Hong Kong's company laws have a much closer origin to those in common law jurisdictions such as the UK, Australia and Singapore. The same position is true with respect to the accounting standards. On this basis, the Administration considers that the experience of the

[6] In May 2004, the Government has successfully launched a HK$6 billion (US$769 million) bond programme that securitized the revenues of Government-owned toll tunnels and bridge.

US and Japan should be viewed in the proper context, particularly where Japan is not a common law jurisdiction. According to the HKICPA, under the US's accounting standard FASB 140, securitization companies meeting the very restrictive criteria of "sale accounting" and "QSPE" would be allowed to use "off-balance sheet treatment" to account for securitization transactions. This means that such a treatment is not available to companies (both listed and unlisted) not engaging in securitization transactions. Any proposals to confine the proposed amendments under the Bill to listed companies would go beyond, and indeed deviate, from the US's practice, even if the relevance of the US's practice is put aside;

(b) all EU members require all listed companies to prepare group accounts based on relevant IAS from 1 January 2005 onwards. So far, the Administration has not received any information suggesting any adverse impact on the securitization markets there. Moreover, the EU has issued as early as in 1983 a Directive requiring member States to require in their national laws consolidation of accounts if one of the following criteria is fulfilled, namely (i) the control of voting rights; (ii) the control of the rights to appoint or remove the board of directors; or (iii) the right to exercise "dominant influence". As the "dominant influence" test (which is consistent with the definition of "subsidiary" under IAS 27) has been effective by virtue of the aforesaid 1983 EU Directive, it is fair to say that the proposals in the Bill have been put in place in the EU for years, for both listed and unlisted companies;

(c) in the UK, on top of the conventional "voting rights" or "rights to appoint or remove the board of directors" tests, the "dominant influence" test has been subsequently incorporated in the UK Companies Act 1985 (amended in 1989) on which the Bill is modelled. Hence, as regards the preparation of group accounts, the current position of the UK Companies Act is that UK listed companies must follow the relevant IAS directly, whereas other companies may prepare group accounts in accordance with either the UK Companies Act requirements or the relevant IAS (including IAS 27). As such, there is no question of unlisted companies in the UK being exempted from the requirements to prepare group accounts on the basis of the "dominant influence" test in the Companies Act on which the Bill is modelled;

(d) Australia adopted the "control-based" definition under IAS 27 since the last decade, and there is no separate regime for listed or unlisted companies. The market growth in the past few years has demonstrated that the off-balance sheet treatment should not be equated to the "oxygen" for the asset securitization market; and

(e) Singapore adopted the "control-based definition" in IAS 27 since the last decade as well. There have not been any market comments suggesting that the definition of IAS 27 has had a negative impact on the securitization market in Singapore. Likewise, the Administration is not aware of any separate regimes for listed and unlisted companies in Singapore insofar as the adoption of IAS 27 is concerned.

41. As regards HKMCL's view that the various Securitization Forums in Australia, US and Europe have kicked off a global project to develop a revised model for accounting for securitization transactions, the Bills Committee is advised by the Administration that according to its understanding from IASB and Australian Accounting Standards Board, the relevant bodies have just sought clarification on the application of the IAS on matters such as the accounting for financial instruments, which is a matter different from the determination of parent-subsidiary relationship. Moreover, the Administration advises that according to its understanding with IASB staff, the so-called "global project" does not have the endorsement of IASB. However, the Bills Committee notes from HKMCL's response that the American Securitization Forum, Bond Market Association, European Securitization Forum and Australian Securitization Forum have together set up a joint working group, the "Global Securitization Accounting Convergence Committee" (GSACC), to develop a global accounting framework for securitization transactions. The GSACC is conducting a survey to ascertain the views of their constituent members on certain accounting standards in each jurisdiction with an aim of developing a common preferred approach to global securitization accounting. According to HKMCL, IASB is aware of the GSACC and its goals.

42. The Bills Committee notes that the Administration maintains its view that the amendments to the CO as proposed by the Bill should apply to both listed and unlisted companies and that no carve out should be introduced for any particular sector. The Administration does not find it justifiable to propose any phased approach with respect to the commencement of the Bill. Nevertheless, the Administration undertakes that it would continue to watch international developments closely, in particular those in relation to IASs. Where necessary and justified, refinements to the legislation will be considered to ensure that Hong Kong's market development and corporate governance needs are adequately catered for and that the disclosure regime is in line with international standards and practices.

<u>True and fair view override</u>
(Clauses 3 and 5 — Sections 123 and 126 of the CO)

43. Section 123 of the CO provides that the balance sheet and profit and loss account ("the accounts") of a company shall give a true and fair view of the state of affairs and profit or loss of the company. So far as applicable, the accounts shall comply with the Tenth Schedule to the CO. Compliance with the Tenth Schedule is without prejudice to the requirement to give a true and fair view or any other requirements of the CO unless expressly provided. FS may modify any requirement of

the CO in relation to a particular company as to the matters to be stated in the accounts, except the requirement to give a true and fair view, for adapting them to the circumstances of the company (section 123(4)). Similarly, section 126 provides that the group accounts of a company shall give a true and fair view of the state of affairs and profit or loss of the company and the subsidiaries. So far as applicable, the group accounts shall comply with the Tenth Schedule. FS may modify the requirements of the Tenth Schedule in relation to the company for adapting them to the circumstances of the company (section 126(3)).

44. The Bills Committee notes that it is proposed under the Bill that "true and fair view override" provisions (proposed new subsections (4) and (4A) of section 123, and proposed new subsections (4) and (5) of section 126) be introduced to the effect that if compliance with the requirements of the CO does not give a true and fair view of the state of affairs and profit or loss of a company or a group, the directors should depart from these requirements to the extent necessary to give a true and fair view. Additional information in order to present a true and fair view should be given in the accounts or in a statement annexed to the accounts. Particulars of any such departure, the reasons for it and its effect should be given in the accounts or statement. The Bills Committee is advised by the Administration that the "true and fair view override" provisions will help cater for the evolving nature of accounting reporting requirements. They would help negate attempts to find ways around the standards or the law to avoid inclusion of vehicles, such as SPEs, into the group accounts.

45. Members are however concerned that the drafting of the existing subsections (1), (2), (3) and the proposed new subsections (4) and (4A) of section 123 does not set out clearly the Administration's policy intent, as follows:

(a) A company's balance sheet and profit and loss account shall comply with the "true and fair view" requirement and the requirements of the Tenth Schedule of CO, and the former requirement is overriding; and

(b) Where compliance with the requirements of the Tenth Schedule and other requirements of the CO would not be sufficient to give a true and fair view of the state of affairs or the profit or loss of the company, then:
   (i) additional information as may be necessary to give a true and fair view thereof shall be given in the company's accounts or statement; or
   (ii) the directors shall depart from the requirements to the extent as may be necessary to give a true and fair view, and give the reasons for and particulars and effects of such departure in the company's accounts or statement.

46. Members therefore request the Administration to review and simplify the drafting of section 123 to clearly reflect its policy intent, and to consider the need to retain the existing subsection (3). Upon review, the Administration simplifies the drafting of section 123 by consolidating the proposed new subsections (4) and (4A) in

the revised proposed new subsection (4). Members are content with the drafting of the revised provision.

47. As regards subsection (3) of section 123, the Administration agrees that, to a certain extent, subsection (3) may become redundant with the addition of the new subsection (4). However, the Administration is concerned that the repeal of subsection (3) will open up other questions in relation to the existing operation of this subsection. As subsection (3) refers to Part III of the Tenth Schedule (concerning the accounting requirements for banking and insurance companies) and any other requirements of the CO, the repeal of subsection (3) will have implications far beyond the purpose of the Bill. In this light, the Administration proposes to maintain the status quo, i.e. retaining subsection (3), and consider proposing a CSA to remove the words "in the following provisions of this section or" in subsection (3). The Administration would separately invite the Standing Committee on Company Law Reform and the Joint Government/HKICPA Working Group, which is tasked to review the accounting and auditing provisions of the CO, to examine the wider implications for the operation of subsection (3).

48. In the light of the above changes to section 123, members request the Administration to review the drafting of the proposed amendments to section 126. Upon review, the Administration simplifies the drafting of section 126 by consolidating the proposed new subsections (4) and (5) in the revised proposed new subsection (4). Members are content with the drafting of the revised provision.

49. The Bills Committee also notes the Administration's proposal to repeal the existing powers of FS under sections 123(4) and 126(3) to modify the requirements of the CO as to the matters to be stated in a company's accounts or group accounts, which would no longer be appropriate when the "true and fair view override" provisions are in place. In this connection, the Administration confirms that according to its records, the powers of FS under sections 123(4) and 126(3) have never been used. Nor have there been any existing criteria for FS to exercise these powers. Members have no objection to the Administration's proposal of deleting the two subsections.

50. The Bills Committee notes that the "true and fair view override" provisions in the Bill are derived from sections 226A and 227A of the UK Companies Act 1985. In this connection, HKMCL points out that in the UK, there is authority which suggests that the effect of the 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. Therefore, if such interpretation is adopted in Hong Kong, then if accounting standards change in a manner which conflict with parts of the CO other than the Tenth Schedule and other matters of disclosure, the "true and fair view override" provisions will not enable a company to disregard the requirements of the CO and follow accounting standards. To address the above concern, HKMCL proposes that amendments be made to expressly extend the overriding effect of the "true and fair view override" provisions to cover other sections in the CO, such as the definition section.

51. The Administration points out that the gist of the proposed "true and fair view override" provisions is to ensure that accounts would always present a "true and fair view". Its 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 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, the Administration considers 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. As far as the Administration is aware, no problem has arisen from the operation of the relevant provisions in the UK.

52. HKMCL also points out that there will be practical difficulties in using the "true and fair view override" provisions as company directors will not make a decision to use the provisions lightly because they are obliged to present accounts in the format specified by the CO and would face heavy criminal liability for non-compliance. Moreover, even if company directors consider it necessary to use the provisions, it is questionable whether the company's auditor could be persuaded to endorse such departure from the requirements of the CO.

53. The Administration points out that 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 without prejudice either to the general requirements of subsection (1) or to any other requirements of this Ordinance". 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 information as may be necessary to fulfill the "true and fair view" requirement in section 123(1). The Administration considers 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.

54. The Administration also stresses 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. 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 the 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.

55. The Bills Committee notes the views of Linklaters that in the absence of more specific guidance, the discretion for directors to apply the "true and fair view override" provisions may create problems or uncertainties on how such discretion should be exercised. It would be helpful if HKICPA could provide practical guidelines on the application of the provisions before the implementation of the Bill. The Administration envisages that the "true and fair view override" provisions will be used only in an exceptionally rare occasion to cater for the unforeseen circumstances of a company. If necessary, HKICPA will promulgate guidelines and interpretations as to the application to the "true and fair view override" provisions, taking into account the experience in the application of the provisions and the development of IFRS.

56. As regards members' concern about directors' liability relating to non-compliance with the proposed provisions, the Administration advises that according to the existing section 124(3) of the CO, the primary duty of preparing group accounts rests with company directors. The existing section 126(1) prescribes that the group accounts shall give a "true and fair view" of the state of affairs and profit or loss of the company and the subsidiaries dealt with thereby as a whole. Failure to take all reasonable steps to secure compliance in this respect is an offence under the existing section 123(6).

<u>Miscellaneous issues</u>

Voting rights in an undertaking

57. The Bills Committee notes that section 3(3) of the proposed new 23rd 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". Members consider the proposed provision unclear, in particular the meaning of "any rights held by the undertaking itself". The Law Society also considers that the objective and intended effect of section 3(3) is not at all apparent. Members therefore seek clarification from the Administration on the purposes and operation of the proposed provision.

58. According to the Administration, section 3(3) was modelled on paragraph 10 of Schedule 10A to the UK Companies Act 1985. The hitherto intention was to cater for a situation where a subsidiary undertaking, vis-à-vis other right holders, acquired voting rights in itself. The Administration believed then that this meant the case when the subsidiary undertaking held certain voting rights in the parent undertaking, hence indirectly holding voting rights in itself. After further research, the Administration advises the Bills Committee that paragraph 10 of Schedule 10A to the UK Act should be read as applying to voting rights in an undertaking held by the same undertaking itself. The relevant UK provision is not taken to apply to a cross-shareholding scenario between parent and subsidiary undertakings, but shall apply to

such a company with the result that rights held by the company itself shall be reduced for the purpose of determining the parent-subsidiary relationship. Moreover, in Hong Kong, a company cannot be a member of itself except where statute otherwise provided. Even sections 49A and 49B of the CO permit a company to redeem or purchase its own shares, such shares have to be cancelled on redemption or purchase. Consequently, voting rights in respect of theses shares would be extinguished. The Administration is not aware of any real life situation where a subsidiary undertaking which is not a body corporate holds voting rights in the same undertaking itself. Moreover, the existing tests of determining parent-subsidiary relationship of two companies under section 2(4) to (7) of the CO do not contain a reduction rule of voting rights equivalent to section 3(3) of the proposed new 23rd Schedule. Hence, section 3(3) appears to have little relevance in Hong Kong. In view of the above considerations, the Bills Committee supports the Administration's proposal to move a CSA to remove section 3(3) from the proposed new 23rd Schedule.

Power to amend section 2B(3) and 23rd Schedule to the CO

59. The proposed new section 2B(3) specifies the provisions of the CO to which the new terms "parent company, "parent undertaking" and 'subsidiary undertaking" are applicable. The Bills Committee notes the Law Society's concern that under the proposed new section 2B(4), the Secretary for Financial Services and the Treasury (SFST) may, by notice published in the Gazette, amend subsection (3), and that under the proposed section 360(5) of the CO, FS may, by order published in the Gazette, amend the 23rd Schedule. The Law Society considers that any changes to the meaning of "subsidiary" and the 23rd Schedule could have significant consequences and should require legislative oversight, and should not be left to the Administration. The Bills Committee is advised by the Administration that the "notice published in the Gazette" referred to in the proposed section 2B(4) and section 360(5) of the CO is subsidiary legislation, hence subject to the vetting by the Legislative Council.

Committee Stage amendments

60. The Bills Committee supports the CSAs proposed by the Administration. The Bills Committee has not proposed any CSAs.

Recommendation

61. The Bills Committee supports the Administration's proposal that the Second Reading debate on the Bill be resumed on 29 June 2005.

Consultation with the House Committee

62. The House Committee, at its meeting on 10 June 2005, supported the recommendation of the Bills Committee in paragraph 61 above.

Council Business Division 1
Legislative Council Secretariat
21 June 2005

附錄I
Appendix I

《2004年公司(修訂)條例草案》委員會
Bills Committee on
Companies (Amendment) Bill 2004

委員名單
Membership List

主席 **Chairman**	余若薇議員, SC, JP	Hon Audrey EU Yuet-mee, SC, JP
委員 **Members**	何俊仁議員	Hon Albert HO Chun-yan
	呂明華議員, JP	Dr Hon LUI Ming-wah, JP
	陳鑑林議員, JP	Hon CHAN Kam-lam, JP
	單仲偕議員, JP	Hon SIN Chung-kai, JP
	劉健儀議員, GBS, JP	Hon Miriam LAU Kin-yee, GBS, JP
	石禮謙議員, JP	Hon Abraham SHEK Lai-him, JP
	黃定光議員, BBS	Hon WONG Ting-kwong, BBS
	湯家驊議員, SC	Hon Ronny TONG Ka-wah, SC
	詹培忠議員	Hon CHIM Pui-chung
	譚香文議員	Hon TAM Heung-man
	(總數：11名委員) (Total : 11 members)	

秘書 **Clerk**	陳美卿小姐 Miss Salumi CHAN
法律顧問 **Legal Adviser**	黎順和小姐 Miss Monna LAI
日期 **Date**	2004年11月8日 8 November 2004

Appendix II

Bills Committee on
Companies (Amendment) Bill 2004

List of organizations, individuals and academics submitted views on the Bill

Organizations

* 1. W H Lam & Company

* 2. The Hong Kong Mortgage Corporation Limited

* 3. The Hong Kong Capital Markets Association

4. The Chinese General Chamber of Commerce

5. Securities and Futures Commission

6. The Association of Chartered Certified Accountants (Hong Kong)

7. The Association of International Accountants (Hong Kong Branch)

8. The Standing Committee on Company Law Reform

9. The Hong Kong Institute of Company Secretaries

10. The Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies

11. Company & Financial Law Committee, The Law Society of Hong Kong

12. Linklaters

* 13. Hong Kong Institute of Certified Public Accountants

14. The Asian Securitization Network

15. ACI – The Financial Markets Association of Hong Kong

16. Heller Ehrman White & McAuliffe LLP

Individuals

17. Mr John Brewer

18. Mr David M Webb

19. Ms Ann Rutledge, a partner of R & R Consulting

Academics

* 20. Professor Kalok CHAN
Head and Professor of Department of Finance
Hong Kong University of Science and Technology

* 21. Professor Raymond SO
Associate Professor
Director, M. Sc. Programme in Finance
The Chinese University of Hong Kong

22. Dr Bao Ben-Hsien for and on behalf of Professor Ferdinand Akthar Gul
Head and Chair Professor of Accounting and Corporate Governance
School of Accounting and Finance
The Hong Kong Polytechnic University

23. Mr Yuen Kam-Por for and on behalf of Professor Ferdinand Akthar Gul
Head and Chair Professor of Accounting and Corporate Governance
School of Accounting and Finance
The Hong Kong Polytechnic University

24. Dr Maurice K S TSE
Associate Dean
School of Economics & Finance
The University of Hong Kong

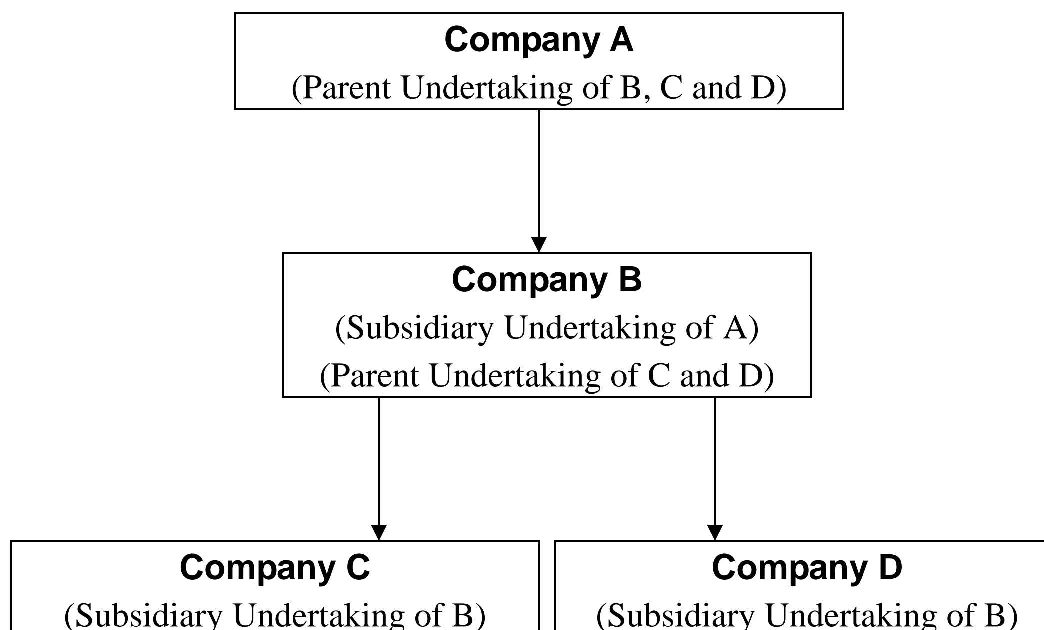
25. Dr Frederik Pretorius
Associate Professor
Department of Real Estate and Construction
The University of Hong Kong

Remark:
"*" denotes those organizations the representatives of which or academics who have attended Bills Committee meeting(s).

Appendix III

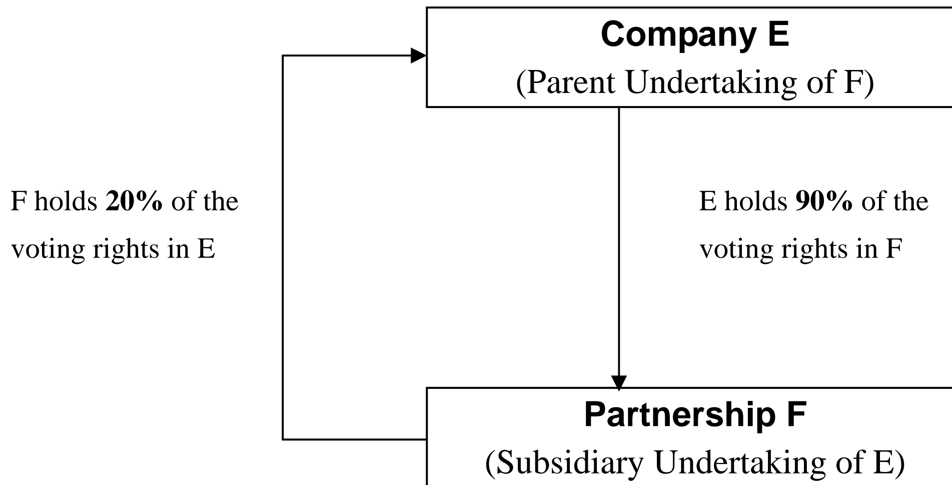
Preparation of group accounts

Scenario 1



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 new 23rd 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 CO, if at the end of its financial year Company B is the wholly owned subsidiary of Company A.

Scenario 2



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 new 23rd Schedule[7]. 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.

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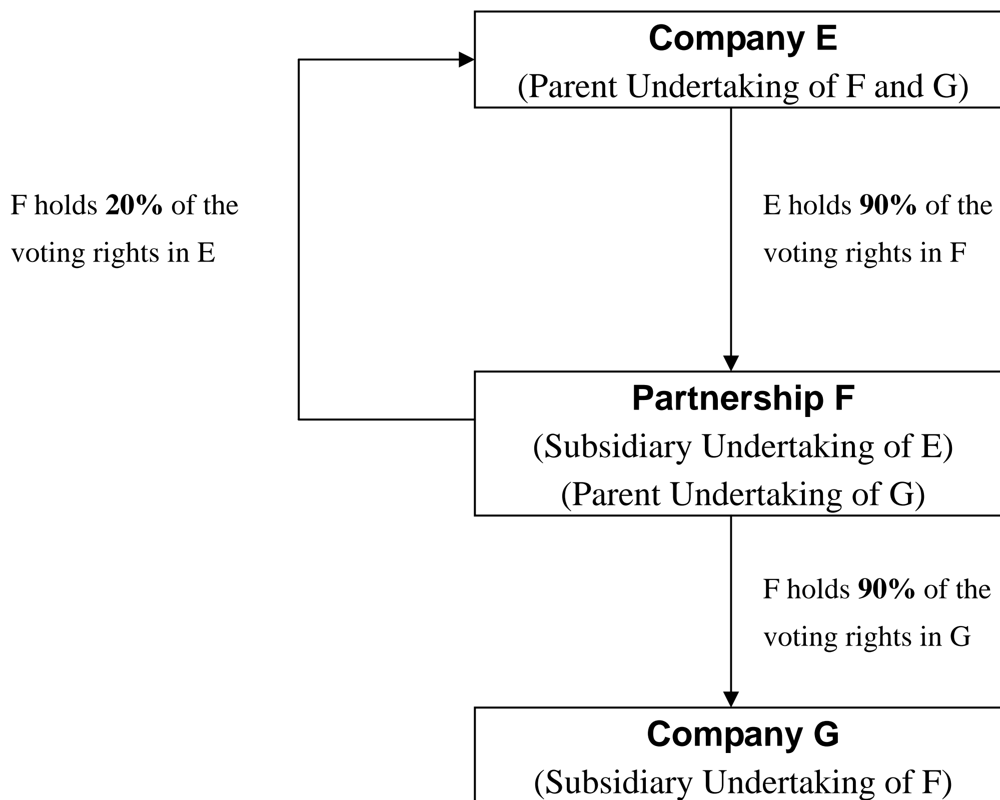
[7] Under section 2(1)(b)(i) of the proposed Twenty-third Schedule, an undertaking is a parent undertaking ("parent undertaking") in relation to another undertaking ("subsidiary undertaking") if the subsidiary undertaking is not a body corporate and the parent undertaking holds a majority of voting rights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

Scenario 3



Company E is 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-subsidiary" 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 Scenario 1 above. The only difference is that Partnership F, being not a company, is not obliged to prepare group accounts under the CO.

(Source: Paper provided by the Administration on "Follow-up Actions Arising from the Discussion at the Meeting on 13 January 2005" (LC Paper No. CB(1)825/04-05(02))

Appendix IV

Sample of group accounts (extract)
provided by the Hong Kong Institute of Certified Public Accountants
to illustrate the impact of the changes introduced by the Bill

Scenario

Company H is a hypothetical Hong Kong incorporated company holding a portfolio of receivables it securitizes.

2. **Column (1)** shows the balance sheet of Company H before the receivables are "sold" to a special-purpose entity (SPE) set up for the purpose of securitization.

3. **Column (2)** shows the balance sheet of Company H after the receivables are "sold" to the SPE for $100. With cash generated from the sale of receivables, Company H pays off the bank loan of $50. An unincorporated SPE is set up, with Company H holding an interest which is worth $1, to issue securitization bonds totalling $100. In the context of section 2(4) of the CO, the SPE, due to the way it is structured, is not construed as the Group's subsidiary. However, as required under the existing HKAS 27, Company H makes a disclosure in a note to the accounts in respect of the SPE that are excluded from consolidation by virtue of statutory requirements but would have been consolidated by virtue of the accounting standard requirements.

4. **Column (3)** shows the consolidated balance sheet of Company H after the receivables are "sold" to the SPE for the purpose of securitization. The financial information of the SPE, which fulfills one of the criteria determining "a subsidiary undertaking" as proposed in the Bill, has been consolidated in the balance sheet of Company H.

Sample Accounts

Company H
(Consolidated) Balance Sheet (Extract)
As at 31 December 200X

	(1)	(2)	(3)
	$	$	$
Assets:			
Cash at hand	-	49	50
Receivables	100	-	100
Other assets	20	20	20
Investment in SPE	**-**	**1** (Note 1)	**-**
Total Assets	120	70	170
Liabilities:			
Bonds	-	-	100
Bank loan	50	-	-
Other liabilities	20	20	20
Total Liabilities	(70)	(20)	(120)
Net assets	50	50	50
Financed by:			
Share capital	10	10	10
Retained earnings	40	40	40
Total Equity	50	50	50

Note 1 [relevant to column (2) only]

In 200X, the Company launched a securitization programme, under which a special-purpose entity (SPE) was set up to issue securitization bonds. With regard to the receivables totalling $100 sold by the Company to the SPE, this would be effected by way of a "clean sale" of such receivables to the SPE. All the receivables sold to the SPE would no longer be recognized as an asset in the balance sheet of the Group.

(Note 1 continued)

The major assets and liabilities of the SPE as at 31 December 200X are set out below -

	$
Cash	1
Receivables	100
Total Assets	101
Bonds	100
Total Liabilities	100

In accordance with HKAS 27, the Group has set out below the significant items of the consolidated balance sheet of the Group and the SPE as at 31 December 200X -

	$
Cash	50
Receivables	100
Total assets	170
Bonds	100
Total liabilities	120

(Source: The sample accounts were prepared by HKICPA and attached as Annex B to the paper provided by the Administration on "Follow-up Actions Arising from the Discussion at the Meeting on 8 November 2004" (LC Paper No. CB(1)453/04-05(16))