Bills Committee on Companies Bill

Qualifying Criteria for Private Companies to prepare Simplified Financial and Directors' Reports

Purpose

This paper sets out the Administration's response to Members' comments on the qualifying criteria for private companies to prepare simplified financial and directors' reports.

Qualifying criteria to adopt simplified reporting

2. Section 141D of the Companies Ordinance ("CO") provides that a private company may, with the written agreement of all its members, prepare simplified accounts and simplified directors' reports in respect of one financial year at a time. Section 141D is not applicable to groups of companies. It also does not apply to banking/deposit-taking companies, insurance companies, stock-broking companies, or companies which are engaged in the carriage of cargo between Hong Kong and places outside Hong Kong.

3. To save compliance costs of private companies while maintaining an appropriate level of transparency of companies' business through financial reporting, we proposed in Part 9 of the Companies Bill ("CB") (clauses 358 to 362 and Schedule 3) that two types of private companies will automatically be qualified for simplified reporting[1]. They are set out in (a) and (b) below –

Type (a) – a single company

[1] i.e. section 141D of CO is not restated in the CB.

A private company (except for banking/deposit-taking companies, insurance companies or stock-broking companies[2]) which is a "small private company", i.e. a private company that satisfies any two of the following conditions –

(i) total annual revenue of not more than HK$50 million;
(ii) total assets of not more than HK$50 million;
(iii) no more than 50 employees.

<u>Type (b) – a group of companies</u>

A private company that is the holding company of a "group of small private companies", i.e. a group of private companies that satisfies any two of the following conditions –

(i) aggregate total annual revenue of not more than HK$50 million net;
(ii) aggregate total assets of not more than HK$50 million net;
(iii) no more than 50 employees.

4. At the Bills Committee, some Members suggested that the criteria for private companies should be further relaxed. In view of Members' concerns, the Bills Committee invited submissions from the public on the issue in July 2011. The secretariat has received a total of 23 submissions and emails expressing views on the issue.

5. At the Bills Committee meeting on 25 November 2011, Members requested the Administration to conduct further consultation, particularly on whether large private companies with members' approval should be given the flexibility to adopt simplified reporting. In response to the Bills Committee's request, the Administration launched a public consultation on 6 December 2011 to seek views on whether large private companies/groups with members' approval should be allowed to adopt simplified reporting.

6. At the same time, as the qualifying criteria for simplified reporting

[2] The prohibition of CO against companies which are engaged in the carriage of cargo between Hong Kong and places outside Hong Kong is removed. It is considered to be an anachronism which is no longer appropriate.

in CB are intended to be aligned with the size criteria in the Small and Medium-sized Entity-Financial Reporting Framework ("SME-FRF") issued by the the Hong Kong Institute of Certified Public Accountants ("HKICPA"), the Administration had invited HKICPA to review the criteria in the SME-FRF. HKICPA issued a consultation paper on 6 December 2011 proposing a relaxation to the current size criteria in the SME-FRF.

Consultation conclusions

7. The consultation conclusions of the Administration's consultation is at **Annex** for Members' reference. We recommend the following –

(a) doubling the size criteria as proposed by HKICPA (i.e. HK$100 million assets, HK$100 million revenue and 100 employees while maintaining the "two out of three" approach). A Committee Stage Amendment ("CSA") will be introduced to CB as a result;

(b) introducing a CSA to preserve the existing section 141D option for private companies (not being members of corporate groups) to adopt simplified reporting; and

(c) consulting the Bills Committee further on whether private companies/groups meeting the higher size criteria (see paragraph 18 of the consultation conclusions) should be allowed to prepare simplified report if members of the company so resolve.

Advice Sought

8. Members are invited to note the contents of the paper and provide their views.

Financial Services and the Treasury Bureau
Companies Registry
28 May 2012

Annex

Companies Bill

Consultation on the Qualifying Criteria for Private Companies to Prepare Simplified Financial and Directors' Reports

Consultation Conclusions

BACKGROUND

1. Section 141D of the Companies Ordinance ("CO") provides that a private company may, with the written agreement of all its members, prepare simplified accounts and simplified directors' reports in respect of one financial year at a time. Section 141D is not applicable to groups of companies. It also does not apply to banking/deposit-taking companies, insurance companies, stock-broking companies, or companies which are engaged in the carriage of cargo between Hong Kong and places outside Hong Kong.

2. To save compliance costs of private companies while maintaining an appropriate level of transparency of companies' business through financial reporting, we proposed in Part 9 of the Companies Bill ("CB") (clauses 358 to 362 and schedule 3) that two types of private companies will automatically be qualified for simplified reporting[1]. They are set out in (a) and (b) below –

   <u>Type (a) – a single company</u>

   A private company (except for banking/deposit-taking companies, insurance companies or stock-broking companies[2]) which is a "small private company", i.e. a private company that satisfies any two of the following conditions –

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[1] i.e. section 141D of CO is not restated in the CB.

[2] The prohibition in CO against companies which are engaged in the carriage of cargo between Hong Kong and places outside Hong Kong is removed. It is considered to be an anachronism which is no longer appropriate.

(i) total annual revenue of not more than HK$50 million;
(ii) total assets of not more than HK$50 million;
(iii) no more than 50 employees.

Type (b) – a group of companies

A private company that is the holding company of a "group of small private companies", i.e. a group of private companies that satisfies any two of the following conditions –

(i) aggregate total annual revenue of not more than HK$50 million net;
(ii) aggregate total assets of not more than HK$50 million net;
(iii) no more than 50 employees.

3. During the discussion of the Legislative Council Bills Committee on CB, some Members expressed concern that the revenue and asset criteria mentioned above are too restrictive. They suggest that the relevant criteria for automatic qualification for simplified reporting should be relaxed. Further, they are of the view that there is very little, if any, public interest at stake in the financial reporting of private companies. They therefore suggest that private companies and private companies which are holding companies of groups of private companies not meeting the size criteria ("large private companies/groups") should also be allowed to adopt simplified reporting provided that most of their members so resolve.

4. As a result, the Government launched a public consultation on 6 December 2011 to seek views on whether large private companies/groups with members' approval should be allowed to adopt simplified reporting. The consultation paper was circulated to various stakeholders, including relevant professional bodies, business organisations, market practitioners, chambers of commerce, financial regulators, etc. It has also been posted on the CO Rewrite website.

5. At the same time, as the qualifying criteria for simplified reporting in CB are intended to be aligned with the size criteria in the Small and Medium-sized Entity-Financial Reporting Framework ("SME-FRF") issued by the the Hong Kong Institute of Certified Public Accountants ("HKICPA"), the Government had invited HKICPA to review the criteria in the SME-FRF. HKICPA issued a consultation paper on 6 December 2011 proposing a relaxation to the current size criteria in the SME-FRF. In short, it proposed doubling the three size criteria about revenue, assets and number of employees.

OUTCOME OF CONSULTATION

Government Consultation

6. The Government consultation ended on 16 January 2012. A total of 47 submissions were received and their major views are summarized in this document. A list of the respondents is at Appendix I. The submissions are also available at the CO Rewrite website.

Options proposed in the consultation

7. In the consultation paper, we proposed three options, namely –

Option 1

Small private companies/holding companies of groups meeting the size criteria can automatically qualify for simplified reporting. Large private companies/groups cannot opt in.

Option 2

Small private companies/holding companies of groups meeting the size criteria can automatically qualify for simplified reporting. Large private companies/groups can opt in if members holding at least 75% of the voting rights so resolve and no other member objects.

Option 3

Small private companies/holding companies of groups meeting the size criteria can automatically qualify for simplified reporting. Large private companies/groups can opt in if members holding at least 75% of the voting rights so resolve and no other member objects, subject to their size not exceeding a higher threshold, say three/five times the revenue and assets criteria. Views were also sought on the appropriate level of the higher threshold.

Respondents' views

8. The comments received are divided.

For Option 1

9. A total of 16 submissions (including HKICPA, Financial Reporting Council, the Hong Kong Association of Banks, the Chinese General Chamber of Commerce and some accounting firms) support Option 1. The major arguments include –

(a) the SME-FRF and the Small and Medium-sized Entity Financial Reporting Standard ("SME-FRS") were developed essentially for SMEs, which generally have much simpler accounting requirements. As such, SME-FRF & FRS will not reflect, with the expected degree of transparency and consistency, the state of affairs of sizeable companies or groups of companies with more complex business and accounting environments;

(b) for large private companies/groups, they still have the option to prepare financial reports in accordance with the Hong Kong Financial Reporting Standards for Private Entities ("HKFRS for PE"), which is simpler and less onerous than the full HKFRS;

(c) when any entity exceeds certain size criteria, the entity becomes economically and socially significant and therefore attracts public interest. Apart from members, other third parties like creditors, suppliers or business partners may also need to consider the accounts of such companies. It may not be practicable for the company concerned to produce another set of accounts. As a result, third parties may have to accept simplified accounts and bear the risks;

(d) the increased size criteria proposed by HKICPA (see paragraph 13 below) would allow the substantial majority of private entities to be automatically qualified for simplified reporting. It is therefore not necessary to adopt option 2 or 3;

(e) if the proposal to allow large private companies/groups to use SME-FRF & FRS is accepted, additional accounting guidance and disclosures will need to be included in the SME-FRS. This added burden would reduce the benefits of SME-FRF & FRS; and

(f) in other jurisdictions like the Mainland of China, UK and Singapore, companies and groups may apply simplified reporting frameworks only if they meet the size criteria.

For Option 2

10. A total of 15 submissions (including the Hong Kong Institute of Directors, the Law Society of Hong Kong, the Association of Chartered Certified Accountants Hong Kong, the Federation of Hong Kong Industries, and the Chinese Manufacturers' Association of Hong Kong) support option 2. The major arguments include –

(a) Option 2 will enhance the flexibility in a company's operation and reduce compliance cost;

(b) with the size criteria incorporated into the CB, certain companies that previously qualified for simplified reporting will now be excluded[3]. It is therefore reasonable to allow these companies to adopt simplified reporting provided that most of their members resolve and no other member objects;

[3] Under section 141D of CO, a private company not being member of a corporate group, a banking company, a deposit-taking company, an insurance company, etc. may with the written agreement of all its members adopt simplified reporting, irrespective of its size.

(c) while other comparable jurisdictions like the UK and Singapore do not allow large private companies to opt for simplified reporting, it is worth noting that annual accounts are not required to be filed at the Companies Registry by private companies in Hong Kong whereas private companies in the UK and large private companies in Singapore must file their annual accounts with the local companies registry which thereby become public information; and

(d) unlike the case of listed companies, the key users of private company financial statements are the Inland Revenue Department, lenders and members. It is generally recognised that lenders will rely on security rather than on historic financial statements to protect their credit position. They can also request additional financial information as they require to support their credit decision. If a majority of members agree, the company should be able to adopt simplified reporting.

For Option 3

11. Fewer respondents support option 3 (a total of 4 submissions, including Hong Kong Bar Association and the Institute of Certified Management Accountants Hong Kong Office). The reasons quoted include striking a balance between extending the benefit of the proposal to a larger group of companies and the need to protect the interests of the shareholders, as well as taking care of the needs of SMEs without compromising the corporate governance standard of large companies.

Other or nil comments

12. At the same time, a number of submissions (12) offer other comments or do not offer any comment. These other comments include retaining the existing CO section 141D with modifications; and requiring members' approval even for those companies meeting the size criteria.

HKICPA's consultation

13. Meanwhile, HKICPA has completed its own consultation on the proposal to relax the current size criteria in the SME-FRF (doubling the current eligibility limits to HK$100 million assets, HK$100 million revenue and 100 employees, while maintaining the "two out of three" approach). HKICPA has obtained general support for the proposals to increase the size criteria.

Our response

14. Financial reporting is a key element of corporate governance. We note the view that SME reporting standards are designed for SMEs to lessen their compliance burden, and that the standards might not be able to fully reflect the state of affairs of large private companies/groups with the expected level of transparency. The volume and complexity of the financial information about a company sought by its members and third parties such as creditors and regulatory agencies is likely to increase with company size, particularly those in corporate groups. For large companies and corporate groups, more detailed financial information is also required for effective tax administration and, in the unfortunate event of a company becoming insolvent, for preliminary investigation in the administration of the winding-up process. In practical terms, compared to SMEs large companies are in a better financial position to absorb a relatively higher compliance cost. For these reasons, we do not prefer option 2.

15. The current proposal under CB is the result of extensive consultation. As far as SMEs are concerned, the proposal has already relaxed the current framework by extending the pool of eligible entities from single companies to groups of companies. In the light of the outcome of the latest round of consultations conducted by the Government and HKICPA, we are prepared to introduce further relaxation by doubling the qualifying size criteria as outlined in paragraph 13 above.

16. With the above change, it is expected that an overwhelming majority of private companies will automatically qualify for SME reporting.

According to the 2009 Annual Survey of Economic Activities conducted by the Census and Statistics Department, 97% of establishments had both business receipts not exceeding HK$100 million and number of persons engaged not exceeding 100[4].

17. We also note the concern that certain companies previously qualified for simplified reporting under the CO (i.e. those single private companies not meeting the size criteria but having obtained the written agreement of all their members) will now be excluded. After careful consideration, we are prepared to reinstate the simplified reporting provision under the existing section 141D of CO in CB, i.e. a private company which is not a member of a corporate group may still adopt simplified reporting even though its scale exceeds the revised size criteria, provided it has secured the written agreement of all its members.

18. Further, to extend the benefit of the proposal to a larger group of companies, there are merits in option 3. In particular, for those companies whose size just exceeds the size criteria, allowing them to prepare simplified financial reports as long as no member objects would facilitate them to decide the form of the report in accordance with the nature and needs of their business. While there are views that it is not appropriate for companies with $500 million in revenue or assets to adopt simplified reporting due to their size, the limit can be suitably lowered to, say, $200 million. In other words, private companies/groups satisfying any two of the following conditions. may adopt simplified reporting if members holding at least 75% of the voting rights so resolve and no other member objects –

(i) aggregate total annual revenue of not more than HK$200 million net;
(ii) aggregate total assets of not more than HK$200 million net;
(iii) no more than 100 employees.

4 For details of the survey, please refer to the Census and Statistics Department's website (www.censtatd.gov.hk).

19. We consider that the proposal can be positively considered and look forward to listening to the views of the Members of the Bills Committee on the Companies Bill.

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CONCLUSIONS

20. We therefore recommend the following –

(a) doubling the size criteria as proposed by HKICPA (i.e. HK$100 million assets, HK$100 million revenue and 100 employees while maintaining the "two out of three" approach). A Committee Stage Amendment ("CSA") will be introduced to CB as a result; and

(b) introducing a CSA to preserve the existing section 141D option for private companies (not being members of corporate groups) to adopt simplified reporting;

(c) consulting the Bills Committee on the Companies Bill further on whether private companies/groups meeting the higher size criteria (see paragraph 18 above) should be allowed to prepare simplified report if members of the company so resolve.

--------- The CSAs are attached at Appendix II (English only).

Financial Services and the Treasury Bureau
Companies Registry
28 May 2010

<u>Appendix I / 附錄 I</u>

List of Respondents / 回應者名單

1. ACCA
2. BDO Ltd
3. Best, Roger Mr
4. CCIF CPA Ltd
5. CLP Holdings Ltd
6. Computershare Ltd
7. Ernst & Young
8. Federation of Hong Kong Industries
9. Financial Reporting Council
10. Greenwood, Peter W Mr
11. Henderson Land Development Company Ltd
12. Ho, Tak-wing Mr
13. Hong Kong Bar Association
14. Hong Kong Institute of Certified Public Accountants
15. Hong Kong Investment Funds Association
16. Hong Kong Securities Professionals Association
17. Hong Kong Trustees' Association Ltd
18. Hsin Chong Construction Group Ltd
19. KPMG
20. Mandatory Provident Fund Schemes Authority
21. Mavis
22. Mazars CPA Ltd
23. PricewaterhouseCoopers
24. Securities and Futures Commission
25. Suen, Chi-wai Mike Mr
26. The British Chamber of Commerce in Hong Kong
27. The DTC Association
28. The Hong Kong Association of Banks
29. The Hong Kong Federation of Insurers
30. The Hong Kong Institute of Directors

31. The Hong Kong Shipowners Association Ltd
32. The Hong Kong Society of Financial Analysts
33. The Law Society of Hong Kong
34. The Real Estate Developers Association of Hong Kong
35. The Stock Exchange of Hong Kong Ltd
36. Tsao, Yea-tann Simon Mr
37. Wong, Patrick Mr
38. Woo, Kwan, Lee & Lo
39. Yu, Benita Ms
40. 林健根先生
41. 香港中國企業協會
42. 香港中華廠商聯合會
43. 香港中華總商會
44. 澳洲管理會計師公會 - 香港辦事處

There are three respondents who do not wish to have their names published. / 另有三名回應者不願意公開名字。

Appendix II / 附錄 II

CSA in relation to Simplified Reporting
與擬備簡明報告有關的修正案

358. Company falling within reporting exemption

(1) For the purposes of this Part, a company falls within the reporting exemption for a financial year—

(a) ~~–~~if—

(~~a~~i) it is qualified as a small private company or small guarantee company for the financial year; and

(~~b~~ii) it is not a company specified in subsection (4) at any time during the financial year~~.~~; or

(b) if—

(i) it is a private company at all times, and is not a company specified in subsection (4) at any time, during the financial year; and

(ii) all members of the company enter into a written agreement that the company is to fall within the reporting exemption for the financial year only.

(2) For the purposes of this Part, a company also falls within the reporting exemption for a financial year if—

(a) it is a private company at all times, and is not a company specified in subsection (4) at any time, during the financial year;

(b) it is the holding company of a group of companies, of which no member is a company specified in subsection (4) at any time during the financial year; and

(c) the group of companies is qualified as a group of small private companies for the financial year.

(3) For the purposes of this Part, a company also falls within the reporting exemption for a financial year if—

(a) it is a company limited by guarantee at all times, and is not a company specified in subsection (4) at any time, during the financial year;

(b) it is the holding company of a group of companies, of which no member is a company specified in subsection (4) at any time during the financial year; and

(c) the group of companies is qualified as a group of small guarantee companies for the financial year.

(4) The company specified for the purposes of subsections (1), (2) and (3) is—

(a) one that carries on any banking business and holds a valid banking licence granted under the Banking Ordinance (Cap. 155);

(b) one that is a corporation licensed under Part V of the Securities and Futures Ordinance (Cap. 571) to carry on a business in any regulated activity within the meaning of that Ordinance; or

(c) one that—

(i) carries on any insurance business otherwise than solely as an agent; or

(ii) accepts, by way of trade or business (other than banking business), loans of money at interest or repayable at a premium, otherwise than on terms involving the issue of debentures or other securities.

Schedule 3 Specified Qualifying Conditions for Sections 359 to 362

1. Qualifying conditions

(1) The conditions specified for the purposes of section 359(1), (2) and (3) are—

(a) that the amount of the company's total revenue for the financial year, as would be reflected in the company's annual financial statements for the financial year if the company is qualified as a small private company for the financial year, does not exceed $~~50~~100 million;

(b) that the amount of the company's total assets at the date of the statement of financial position for the financial year, as would be reflected in the company's annual financial statements for the financial year if the company is qualified as a small private company for the financial year, does not exceed $~~50~~100 million; and

(c) that the average number of the company's employees during the financial year does not exceed ~~50~~100.

(2) The conditions specified for the purposes of section 359(4) are—

(a) that the amount of the company's total revenue for the financial year, as reflected in the company's annual financial statements for the financial year, does not exceed $~~50~~100 million;

(b) that the amount of the company's total assets at the date of the statement of financial position for the financial year, as reflected in the company's annual financial statements for the financial year, does not exceed $~~50~~100 million; and

(c) that the average number of the company's employees during the financial year does not exceed ~~50~~100.

(3) The condition specified for the purposes of section 360(1), (2) and (3) is that the amount of the company's total revenue for the financial year, as would be reflected in the company's annual financial statements for the financial year if the company is qualified as a small guarantee company for the financial year, does not exceed $25 million.

(4) The condition specified for the purposes of section 360(4) is that the amount of the company's total revenue for the financial year, as reflected in the company's annual financial statements for the financial year, does not exceed $25 million.

(5) The condition specified for the purposes of section 361(1), (2), (3), (4) and (5) is that each company in the group is qualified as a small private company for the financial year.

(6) The conditions specified for the purposes of section 361(1), (2) and (3) are—

(a) that the aggregate amount of the group's total revenue for the financial year does not exceed $50 million;

(b) that the aggregate amount of the group's total assets at the date of the statement of financial position for the financial year does not exceed $50 million; and

(c) that the aggregate of the average number of employees of each company in the group during the financial year does not exceed 50.

(7) The conditions specified for the purposes of section 361(4) and (5) are—

(a) that the aggregate amount of the group's total revenue for the financial year does not exceed $50 million;

(b) that the aggregate amount of the group's total assets at the date of the statement of financial position for the financial year does not exceed $50 million; and

(c) that the aggregate of the average number of employees of each company in the group during the financial year does not exceed 50.

(8) The conditions specified for the purposes of section 362(1), (2) and (3) are—

(a) that each company in the group is qualified as a small guarantee company for the financial year; and

(b) that the aggregate amount of the group's total revenue for the financial year does not exceed $25 million.

(9) The conditions specified for the purposes of section 362(4) and (5) are—

(a) that each company in the group is qualified as a small guarantee company for the financial year; and

(b) that the aggregate amount of the group's total revenue for the financial year does not exceed $25 million.

(10) In subsections (1), (3), (5), (6) and (8)—

(a) a reference to a financial year of a company for the purposes of section 359(2), 360(2), 361(2) or 362(2) includes a financial year of the company for the purposes of the predecessor Ordinance that immediately precedes the company's first financial year after the coming into operation of this section; and

(b) a reference to a company's annual financial statements is, in the case of a financial year of the company for the purposes of the predecessor Ordinance, a reference to the company's accounts for the financial year.