

Bills Committee on Companies Bill
Follow-up actions to be taken by the Administration
for the meetings on 6 May and 17 June 2011
in relation to Parts 5, 6, 9 and 13

Purpose

This paper sets out the Administration's response to the following issues raised by Members at the Bills Committee meetings on 6 May and 17 June 2011 relating to Parts 5, 6, 9 and 13:-

Part 5 – Transactions in relation to Share Capital

Reasons why an auditor's report is required for buy-backs out of capital but not reduction of capital by a private company under the court-free procedure in the United Kingdom (UK) (paragraphs 2 to 6).

Part 6 – Distribution of Profits and Assets

Practice for distribution in-specie in Hong Kong (paragraphs 7 to 12).

Part 9 – Accounts and Audit

- (I) Review of qualifying criteria for simplified reporting (paragraph 13); and
- (II) Auditor's rights to information in relation to non-Hong Kong subsidiary (paragraph 14).

Part 13 – Arrangements, Amalgamation, and Compulsory Share Acquisition in Takeover and Share Buy-Back

- (I) Public views on court-free amalgamation procedure (paragraphs 15 to 17); and
- (II) Whether the solvency requirement should be relaxed to

allow for meeting the balance sheet test as an alternative (paragraphs 18 to 19).

Administration's response

Part 5 – Transactions in relation to Share Capital

Reasons why an auditor's report is required for buy-backs out of capital but not reduction of capital by a private company under the court-free procedure in the UK

Procedure for buy-backs out of capital under UK Companies Act 2006 (UKCA 2006)

2. Chapter 5 (sections 709 to 723) of Part 18 of the UKCA 2006 provides for buy-backs out of capital by private companies without having to go through a full and compulsory court procedure for a reduction of capital. Their predecessor provisions were first introduced in 1981.

3. Under section 714(3) of the UKCA 2006, directors have to make a statement about the solvency of the company to support a buy-back out of capital. The directors' solvency statement has to be accompanied by a report from the company's auditors stating their opinion that the amount of permissible payment has been properly calculated and that they are not aware of any matters which renders the directors' statement unreasonable in all the circumstances (section 714(6) of the UKCA 2006).

Procedure for reduction of capital under UKCA 2006

4. The UKCA 2006 introduces a new and simpler procedure (sections 642 to 644 of the UKCA 2006) for reduction of capital for private companies, as an alternative to the court approval procedure.

This new procedure for reduction of capital requires a special resolution of the company's members, based on a solvency statement made by the directors. There is no requirement for the solvency statement to be accompanied by an auditor's report.

Buy-backs out of capital vs reduction of capital

5. According to our study, prior to the enactment of the UKCA 2006, the original reform proposal was that the procedure for buy-backs out of capital by private companies would disappear¹, in view of the introduction of the simplified procedure for reduction of capital. However, the buy-backs procedure was subsequently retained in the UKCA 2006. This is probably because the funds available under this procedure are wider than the traditional meaning of share capital. In particular, a "revaluation reserve" can be used to fund a buy-back out of capital at above their nominal value, even if the company had no share premium account or other reserves, while the same is not possible under the capital reduction procedure².

6. We cannot ascertain from the available literature the reasons for keeping the requirement for the auditors' report for buy-backs. The fact that the procedures for buy-backs and reduction of capital are different might justify the different requirements.

Part 6 – Distribution of Profits and Assets

Practice for distribution in-specie in Hong Kong

Relevant provisions under the Companies Ordinance (CO)

7. Under section 79A (of Part IIA) of the CO, "distribution"

¹ See paragraph 7.18 in page 152 of *Modern company law for a competitive economy: completing the structure*, issued by the UK Company Law Review Steering Group in November 2000; and page 41 of the white paper *Company Law Reform* issued by the Department of Trade and Industry of the UK in May 2005.

² See paragraph 6.842 of *Palmers Company Law*.

means every description of distribution of a company's assets to its members, *whether in cash or otherwise*, with a few exceptions (e.g. bonus shares and distribution of assets to members of the company on its winding up). Consequently, a distribution can be made in the form of non-cash assets. The provision is re-enacted in the Companies Bill (CB) as clause 286.

8. Section 79L of the CO provides that where a company makes a distribution of or including a non-cash asset, and any part of the amount at which that asset is stated in the accounts relevant for the purposes of the distribution represents an unrealised profit, that profit is to be treated as a realised profit for the purpose of determining the lawfulness of the distribution in accordance with Part IIA (whether before or after the distribution takes place). The provision is re-enacted in the CB as clause 290.

Practice for distribution in-specie in Hong Kong

Articles of Association

9. It is common for a company's Articles of Association to authorise a company to distribute dividends in the form of specific assets of the company. Regulation 121 in Part 1 of Table A in the First Schedule to the CO provides that any general meeting declaring a dividend may direct payment of such dividend wholly or partly by the distribution of specific assets. It also provides that the directors may fix the value for distribution of such specific assets or any part thereof and may determine that cash payments shall be made to any members upon the footing of the value so fixed in order to adjust the rights of all parties.

Accounting practice

10. The Hong Kong Institute of Certified Public Accountants (HKICPA) issued in December 2008 the HK(IFRIC) Interpretation³ 17

³ "HK(IFRIC) Interpretation" refers to "Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) as adopted by the HKICPA".

“*Distributions of Non-cash Assets to Owners*” (the Interpretation), which relates to the distribution of non-cash assets. An entity shall apply the Interpretation prospectively for annual periods beginning on or after 1 July 2009⁴.

11. Subject to certain scope exclusions⁵, the Interpretation requires distributions of non-cash assets to be accounted for at the fair value of the assets concerned. This will often result in a profit being recognised when the distribution is paid out.

12. Prior to the issue of the Interpretation, the Hong Kong Financial Reporting Standards did not include any requirements concerning the distribution of non-cash assets. The distributions of non-cash assets were usually accounted for either at fair value or at the carrying amount of the assets concerned⁶ then.

Part 9 – Accounts and Audit

(I) Review of qualifying criteria for simplified reporting

13. We note Members’ views on the qualifying criteria for private companies falling within the reporting exemption as set out in schedule 3 of the CB. We will consider the criteria further in consultation with the Hong Kong Institute of Certified Public Accountants and revert to the Bills Committee in due course.

(II) Auditor’s rights to information in relation to non-Hong Kong subsidiary

14. At the meeting held on 6 May 2011, some Members were

⁴ See paragraph 18 of the HK(IFRIC) Interpretation 17.

⁵ For example, the Interpretation does not apply to a distribution of a non-cash asset that is ultimately controlled by the same party or parties before and after the distribution (i.e. an intra-group transfer of assets). See paragraph 5 of the HK(IFRIC) Interpretation 17.

⁶ Page 104 of *Financial Reporting in Hong Kong 2010, Deloitte and IAS Plus*, published by CCH Hong Kong Limited.

concerned that the formulation in clause 403(4) and (6) of the CB might not provide sufficient protection for a company and its officers in case the company fails to obtain the information or explanation requested by the auditor concerning a non-Hong Kong subsidiary, due to restrictions imposed by overseas legislation (see LegCo Paper No. CB(1)2132/10-11(03) dated 11 May 2011). We have further considered the relevant provisions in the light of Members' concerns. The requirement under clause 403(4) and (6) is for the company, if required by the auditor, to take all reasonable steps to obtain relevant information or explanation from the non-Hong Kong subsidiaries or specified persons. It is clear that, if the company has taken all reasonable steps as soon as practicable but cannot obtain the information or explanation from a non-Hong Kong subsidiary, the company and its officers would not be liable under the current formulation. The failure to obtain the information or explanation may be due to a variety of reasons e.g. restrictions imposed by the subsidiary's local legislation. We are therefore of the view that no amendment to the relevant provisions is needed.

Part 13 – Arrangements, Amalgamation, and Compulsory Share Acquisition in Takeover and Share Buy-Back

(I) Public views on court-free amalgamation procedure

15. In the consultation on Share Capital, the Capital Maintenance Regime and Statutory Amalgamation Procedure held between June to September 2008, a majority of the respondents supported the introduction of a court-free statutory amalgamation procedure, with some of them expressing the view that the procedure should only apply to intra-group amalgamations⁷. Most of the respondents opined that Hong Kong

⁷ Respondents who supported the introduction of a court-free statutory amalgamation procedure include Li & Fung Limited, Swire Pacific Limited; Cathay Pacific Airways Limited; Hong Kong Aircraft Engineering Company Limited, Arthur Lam & Co. CPA, KPMG, Clifford Chance, the Chinese General Chamber of Commerce, Hermes Equity Ownership Services Ltd., Hong Kong Stockbrokers Association, the Chinese Manufacturers' Association of Hong Kong, CCIF CPA Limited, Canadian Certified General Accountants Association of Hong Kong, CLP Holdings Limited, the British Chamber of Commerce in Hong Kong, Stephenson Harwood & Lo, the Society of Chinese Accountants & Auditors and the Hong Kong Institute of Certified Public

should introduce a court-free statutory amalgamation procedure which would be less complicated and costly compared with the court-sanction procedure. Some highlighted the importance of adequate protection for shareholders and creditors in the new procedure to prevent possible abuses by the management.

16. On the other hand, a few respondents⁸ queried the need for a court-free statutory amalgamation procedure. There was a concern that the procedure, particularly that for long form amalgamation (i.e. amalgamation involving companies not within the same group) could easily be abused. They considered that judicial scrutiny was necessary to ensure that an amalgamation was just and fair to shareholders, especially minority shareholders, and creditors. For more details on the public views received during the consultation, please refer to the consultation conclusions issued in February 2009⁹.

17. While there is majority support for the introduction of a court-free statutory amalgamation procedure, the protection of the interests of minority shareholders and creditors, as highlighted by some respondents, is a pertinent concern. To minimise the risk of the new court-free statutory procedure being abused, we propose to confine it only to intra-group amalgamations where minority shareholders' interests would normally not be an issue. The proposal was contained in the draft CB published for the second phase public consultation held from May to August 2010. We received no substantive comments on the proposal during the consultation.

Accountants. Those who supported a court-free procedure for intra-group amalgamations include the Chartered Institute of Management Accountants Hong Kong Division, Tricor Services Limited, the Hong Kong General Chamber of Commerce and the Hong Kong Institute of Chartered Secretaries. The Law Society of Hong Kong said that a court-free procedure for intra-group amalgamation other than listed companies may be considered.

⁸ Ho Tak Wing, the Hong Kong Chinese Enterprises Association and the Hong Kong Bar Association.

⁹ Available at http://www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/doc/cmrsap_conclusion_e.pdf.

(II) Whether the solvency requirement should be relaxed to allow for meeting the balance sheet test as an alternative

18. At the meeting held on 17 June 2011, a Member suggested that the solvency requirement under the statutory amalgamation procedure in clauses 669 and 670 should be relaxed so that a company which meets the balance sheet test but not the cash-flow test could still make use of the procedure. We consider that reliance on the balance sheet test alone may give rise to the following risks –

- (a) a balance sheet is a snapshot report of the affairs of the company as at a particular date. It is a mere mechanical and rigid application of a calculation of net asset value without considering the quality of a company's assets and liabilities and their linkage over time. The test does not reflect the assets coming into the company and equally fails to project any expected deterioration of revenues;
- (b) off balance sheet liabilities, such as contingent liabilities, and other risks, such as declining markets or order books, need to be properly assessed. The balance sheet test is not well suited to covering these important forward looking indicators of the true financial position¹⁰;
- (c) reliance on the balance sheet alone clearly has serious disadvantages in terms of the signals to directors and the dangers of undue reliance on the balance sheet, which by its nature cannot fully portray the timing and degree of certainty of future cash flows and the company's flexibility¹¹; and
- (d) other comparable jurisdictions, including the UK, Singapore, the United States and New Zealand, do not adopt a pure balance sheet test.

¹⁰ *Reforming Capital: Report on the Interdisciplinary Group on Capital Maintenance* by Jonathan Rickford [2004] EBLR 975.

¹¹ *Reforming Capital: Report on the Interdisciplinary Group on Capital Maintenance* by Jonathan Rickford [2004] EBLR 977.

19. Having considered the above factors, we consider it prudent not to relax the solvency requirement to allow using a pure balance sheet test as an alternative.

**Financial Services and the Treasury Bureau
Companies Registry
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