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Hong Kong Law

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KEY CHANGES UNDER THE NEW COMPANIES ORDINANCE

PART FIVE – FINANCIAL REPORTING

Introduction

The New Companies Ordinance (Cap. 622) (the **New CO**) will come into force on 3 March 2014. Following commencement of the New CO, the current Companies Ordinance (Cap. 32) (the **Old CO**) will be retitled as the “Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)”. The core provisions affecting the operation of companies under the Old CO will be repealed, except those provisions relating to winding-up and insolvency of companies and prospectuses.

Charltons is preparing a series of newsletters summarizing the key changes to the company law framework under the New CO. In this fifth newsletter, we discuss key changes impacting on financial reporting by Hong Kong companies.

Simplified Financial Reporting for SMEs

New CO references: sections 359 to 366, schedule 3

Position under the Old CO

Under the Old CO, a private company (other than a company which is a member of a corporate group and certain companies specifically excluded, such as insurance and stock-broking companies) may, with the written agreement of all its shareholders, prepare simplified accounts and simplified directors’ reports (the **s141D exception**).

Key changes under the New CO

Full financial statements compared with simplified financial statements

Full financial statements are required to give a true and fair view of a group’s financial position and performance, generally accepted to require compliance with Hong Kong Financial Reporting Standards (**HKFRS**) issued by the Hong Kong Institute of Certified Public Accountants (**HKICPA**), as well as the disclosure requirements of the Companies Ordinance and, for listed companies, the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the **Listing Rules**).

Companies that avail of simplified reporting under the New CO will still need to prepare a directors' report and annual financial statements, and have their financial statements audited. However, simplified financial statements are exempt from the requirement to give a true and fair view and are prepared under the HKICPA's Small and Medium-sized Entity-Financial Reporting Framework (**SME-FRF**) and Small and Medium-sized Entity-Financial Reporting Standard (**SME-FRS**), rather than HKFRS. Simplified financial statements are usually prepared on a simplified historical cost basis, and do not include any assets or liabilities at fair value, or deferred tax. The disclosure notes also contain less information on the company's affairs compared to full financial statements. Other benefits of simplified financial reporting include the following:

- no requirement for the auditor to express a "true and fair view" opinion on the financial statements;
- no requirement to disclose auditor's remuneration in the financial statements;
- subsidiary undertakings may be excluded from consolidated financial statements in accordance with applicable accounting standards;
- no requirement to include a business review in the directors' report¹;
- exemption from certain disclosures in the directors' report, such as arrangements to enable a director to acquire benefits from shares in or debentures of the company, donations made for charitable or other purposes, and reasons for a director resigning or not seeking re-election in certain circumstances.



Eligibility for simplified reporting

Under the New CO, the criteria for simplified reporting have been broadened so that more companies can avail of simplified reporting. Certain small companies will also automatically qualify for simplified reporting, without the need for unanimous written consent from shareholders. The s141D exception has also been carried over from the Old CO.

The types of companies that qualify for simplified reporting are described below.

Small private company

A "small private company" or a private company that is the holding company of a "group of small private companies" is automatically qualified for simplified reporting if it satisfies any two of the following conditions:

- total (or aggregate total) annual revenue of not more than HK\$100 million;
- total (or aggregate total) assets of not more than HK\$100 million;
- no more than 100 employees.

Small guarantee company

A "small guarantee company" or a guarantee company that is the holding company of a "group of small guarantee companies" is also automatically qualified for simplified reporting if its total annual revenue or aggregate total annual revenue (as the case may be) does not exceed HK\$25 million.

¹ See below for a discussion on the New CO requirement for a business review.

Eligible private company

An “eligible private company”, or an eligible private company that is the holding company of a “group of eligible private companies”, that satisfies any two of the following conditions and has the approval of members holding at least 75% of the voting rights with no other members objecting, is qualified for simplified reporting:

- total (or aggregate total) annual revenue of not more than HK\$200 million;
- total (or aggregate total) assets of not more than HK\$200 million;
- no more than 100 employees.

The below table summarises the various tests to qualify for simplified reporting:

	Small private company or group <i>(Note 1)</i>	Small guarantee company or group	Eligible private company or group <i>(Note 1)</i>	s141D private company
Annual revenue	HK\$100m or less	HK\$25m or less	HK\$200m or less	No maximum
Total assets	HK\$100m or less	No maximum	HK\$200m or less	No maximum
Number of employees	100 or less	No maximum	100 or less	No maximum
Shareholder approval	Not required	Not required	Required (75%, with no objections)	Required (100%)

Note 1: Must satisfy two out of the three tests for annual revenue, total assets and employees

Banks, deposit taking companies, SFC-licensed corporations and insurance companies

Banking or deposit-taking companies, corporations licensed under the Securities and Futures Ordinance, or insurance companies cannot benefit from the simplified reporting exemption.

Audit requirements

Under the New CO, audit of financial statements is still required for all companies (except dormant companies).

Practical considerations and recommended steps

Timing

The changes under the New CO will come into effect for the first financial reporting year beginning on or after 3 March 2014 (the commencement date of the New CO), meaning that the first full year statements that will be effected will be those falling in 2015. For example, for companies whose financial year ends on 31 December, the New CO will first impact on financial statements for the year ending 31 December 2015.

Deciding whether to adopt simplified reporting

Qualifying or eligible companies are not required to adopt simplified reporting, so will need to decide whether or not to switch. Simplified financial reporting will appeal to many companies looking to cut down on compliance costs. However, management should carefully consider all pros and cons of switching to simplified reporting. For example, contractual obligations to third parties, such as banks or investors, may require a company to prepare full financial statements. If the company is part of a listed group that has to prepare consolidated full financial statements, it may increase time and costs to consolidate simplified financial statements. If the company (or group) is borderline with respect to the annual revenue or asset tests, so that there is a risk that it will exceed the thresholds at some point in the near future, then the company may not consider it worthwhile to switch for a short period to simplified reporting.

Shareholder approval requirements for eligible private companies or groups

“Eligible” private companies can only switch to simplified reporting with the approval of shareholders holdings at least 75% of the total voting rights of the company, with none objecting. In the case of a group of eligible private companies, all the companies individually must obtain the requisite shareholder approval (except for subsidiaries that qualify as “small private companies”) (section 360(2) of the New CO).

Business Review in Directors’ Report

New CO references: sections 388, 390 and 448, schedule 5

Position under the Old CO

The Old CO sets out the information required to be included in the directors’ report, which must be approved by the board of directors and sent to every member and debenture holder of the company together with a copy of the accounts and auditors’ report.

Key changes under the New CO

All companies (except those qualified for simplified reporting) are required to prepare, as part of the directors’ report, a “business review”. Private companies not qualified for simplified reporting may opt out of the requirement to prepare a business review by way of special resolution. Wholly-owned subsidiary companies are exempt from the requirement to prepare a business review: their holding company will prepare the business review unless it is exempted on other grounds.

The business review consists of a fair review of the company’s business, including:

- a description of the principal risks and uncertainties facing the company;
- particulars of important events affecting the company that have occurred since the end of the financial year;
- an indication of likely future development in the company’s business;

- if necessary for an understanding of the development, performance or position of the company's business:
 - an analysis using financial key performance indicators;
 - a discussion on the company's environmental policies and performance and the company's compliance with relevant laws and regulations that have a significant impact on the company; and
 - an account of the company's key relationships with its employees, customers and suppliers and others that have a significant impact on the company or on which the company's success depends.

Director liability for statements in directors' reports

Section 448 of the New CO provides a "safe harbour", so that directors are liable to the company only in respect of loss suffered by the company as a result of untrue or misleading statements or the omission of anything required to be included. The directors are only liable if they knew, or were reckless as to whether, a statement was untrue or misleading, or an omission was dishonest concealment of a material fact. Furthermore, directors are not subject to any liability to another person other than the company resulting from reliance on any information contained in the report, unless such person is entitled to be granted a civil remedy or to rescind or repudiate an agreement (section 448(4) and (5) of the New CO).

Practical considerations and recommended steps

Guidance on contents

Smaller companies looking for guidance on the contents of the new business review can review annual reports of listed companies in the same sector or industry. These companies are already required to include a management discussion and analysis in their annual reports (see below).

Excluding business review even if company is preparing full financial statements

A company that qualifies for simplified reporting can elect to exclude the business review from its business report, even if it otherwise decides to prepare full financial statements (for example, because a lender requires full financial statements).

Shareholder approval requirement for business review exclusion

The shareholder approval requirement for the exclusion of the business review is less strict than the shareholder approval requirement for eligible private companies to switch to simplified reporting. The business review exclusion only needs to be approved by a 75% majority vote in a general meeting. By contrast, the eligible private company reporting exemption needs to be approved by shareholders holding at least 75% of the total voting rights of the company (with no shareholders objecting).

Impending developments and negotiations

Under paragraph 3 of schedule 5 to the New CO, a company is not required to disclose any information about impending developments or matters in the course of negotiation, if such disclosure would, in the directors' opinion, be seriously prejudicial to the company's interests.

Impact on listed companies

Companies listed on the Hong Kong Stock Exchange are required to include in their annual reports a management discussion and analysis (**MD&A**) of the group's performance during the financial year and the material factors underlying its results and financial position. There will be substantial overlap between the contents of the business review and the minimum contents of the MD&A as specified in paragraph 32 of appendix 16 to the Listing Rules, and the "recommended additional disclosures" in paragraph 52 of the appendix 16. However listed companies should ensure the scope of their MD&A covers the requirements of schedule 5 of the New CO.

Financial Year

New CO references: sections 367 to 371

Position under the Old CO

The Old CO requires accounts to be made out every year and to be laid before the company at its annual general meeting (**AGM**). Those accounts must be made up to a date falling not more than a specified number of months before the date of the AGM. The financial year is defined as the period in respect of which such accounts are made up.

Key changes under the New CO

The New CO provides for the determination of the financial year of a company, which is the same as the accounting reference period. It also provides for alteration of the accounting reference period.

For companies formed under the Old CO, the first accounting reference period commences on the date immediately following the date to which its previous accounts were made up and ending on the anniversary of that date.

For companies formed under the New CO, the accounting reference period will begin on the company's date of incorporation and end on a date specified by the directors or, failing that, the anniversary of the company's incorporation.

The accounting reference period can be altered by a resolution of the directors. For public companies and companies limited by guarantee, any change in the accounting reference date must be notified to the Registrar of Companies in Hong Kong (**Registrar**).

New Criminal Offence for Auditors

New CO references: sections 407 to 408

Position under the Old CO

Section 407 of the New CO provides that an auditor must state in its auditor's report if:

- it is of the opinion that the company's financial statements are not in agreement with its accounting records in a material respect (section 407(2)(b)); or
- the auditor fails to obtain all the information or explanations that, to the best of the auditor's knowledge and belief, are necessary and material for the purpose of the audit (section 407(3)).

The Old CO has similar requirements in section 141, but does not provide any sanction for breach of the requirement.



Position under the New CO

Section 408(1) of the New CO creates a new criminal offence for an auditor who knowingly or recklessly causes a statement required under section 407(2)(b) or section 407(3) to be omitted from an auditor's report. Any of the following persons who commits the offence may be liable:

- if the auditor is a natural person, the auditor and every employee and agent of the auditor who is eligible for appointment as auditor of the company;
- if the auditor is a firm, every partner, employee and agent of the auditor who is eligible for appointment as auditor of the company;
- if the auditor is a body corporate, every officer, member, employee and agent of the auditor who is eligible for appointment as auditor of the company (section 408(2)).

Eligibility to act as a company's auditor is covered in section 393(1) of the New CO. This provides that only a "practice unit" is eligible for appointment as a company's auditor, the term "practice unit" being defined as:

- a firm of certified public accountants (practising) practising accountancy pursuant to the Professional Accountants Ordinance (Cap 50) (**PAO**);
- a certified public accountant (practising) practising accountancy on his own account pursuant to the PAO; or
- a corporate practice registered under the PAO.

The sanction for the offence under section 408(1) is a fine not exceeding HK\$150,000.

Guidance on the general principles applicable to determining whether an offence under section 408 should be prosecuted is set out in the Companies Registry's External Circular No. 10/2014.

Auditors' Rights of Information

New CO references: section 412

Position under the Old CO

The Old CO gives auditors rights of access to the books and accounts of a company, as well as a right to require officers of the company to provide information and explanations necessary for the performance of the auditor's duties. Auditors' rights of access and information also extend to Hong Kong incorporated subsidiaries (and the auditors of such subsidiaries).

Key changes under the New CO

Under the New CO, auditors are empowered to require a wider range of persons, including persons holding or accountable for accounting records, to provide them with information and explanations as they reasonably require for the performance of their duties.

Under section 412, the persons who will be required to provide information or explanation to auditors include:

- an officer of the company;

- a Hong Kong subsidiary of the company;
- an officer or auditor of such a subsidiary; and
- a person holding or accountable for any of the accounting records of the company or such a subsidiary.

The auditor of a holding company may also require the company to obtain information or explanation from its non-Hong Kong subsidiaries, the officers and auditors of such subsidiaries, and persons holding or accountable for any of the accounting records of such subsidiaries.

Failure to provide any information or explanation required by the auditors under section 412 is an offence for which the person may be liable to a fine not exceeding HK\$25,000, and in the case of a continuing offence, a daily fine not exceeding HK\$700 (section 413(1) of the New CO). It is a defence to establish that it was not reasonably practicable for the person to provide the information or explanation.

If a company fails to take reasonable steps to obtain the required information or explanation in respect of its non-Hong Kong subsidiary, the company and its responsible persons commit an offence, and each is liable to a fine not exceeding HK\$25,000, and in the case of a continuing offence, a daily fine not exceeding HK\$700 (section 413(5) of the New CO). It is a defence for the holding company's failure to obtain the information or explanation in respect of its non-Hong Kong subsidiary if it would be an offence under the law of the relevant jurisdiction for the subsidiary to provide the information or explanation.

If in response to an auditor's request for information or an explanation, a person provides information which is misleading, false or deceptive in a material particular, and the person knows that, or is reckless, as to whether that is the case, the person commits an offence. The offence is punishable on conviction on indictment by a fine of HK\$150,000 and 2 years' imprisonment, and on summary conviction to a fine of HK\$50,000 and 6 months' imprisonment.

Voluntary Revision of Financial Statements

New CO references: section 449 and the Companies (Revision of Financial Statements and Reports) Regulation (as amended by the Companies (Revision of Financial Statements and Reports) (Amendment) Regulation 2013

Position under the Old CO

Section 141E of the Old CO allows the directors of a company to revise the accounts and make necessary consequential revisions to the summary financial report or directors' report after the accounts have been provided to the members. Revisions are allowed only to aspects of the accounts which do not comply with the Old CO and necessary consequential revisions. The detailed requirements applicable to revision of accounts are set out in the Companies (Revision of Accounts and Reports) Regulation (Cap.32N) (**Cap. 32N**).

Position under the New CO

As in the Old CO, the New CO provides in section 449 that the directors of a company may revise the financial statements to the extent necessary to ensure their compliance with the New CO after these have been sent to the company's members and make necessary consequential amendments to the summary financial report or directors' report. The detailed requirements for revision of financial statements are now set out in the Companies (Revision of Financial Statements and Reports) Regulation as amended by the Companies (Revision of Financial Statements and Reports) (Amendment) Regulation 2013 (the **Regulation**).

The Regulation largely re-enacts Cap. 32N. The major changes include:

- alignment of accounting terminology with the New CO – i.e. the term “accounts” is replaced by “financial statements” and “balance sheet” by “statement of financial position”;
- alignment of requirements prescribed in respect of the signing and distribution of the revised statements and reports with those under the New CO; and
- alignment of provisions on the auditor’s report on revised financial statements and auditor’s rights and privileges with the relevant provisions under the New CO, including the provisions and offences relating to the contents of an auditor’s report in sections 407 and 408 of the New CO. Except for companies eligible for simplified financial reporting, Section 14(1) of the New CO requires the auditor’s report on revised financial statements to state the auditor’s opinion as to whether the revised financial statements give a true and fair view. Section 15 applies the section 407 requirement for an auditor to include in its report its opinion if the financial statements are not in agreement with the company’s accounting records or the fact that it has not obtained all the information or explanations that are necessary and material for the purposes of the audit. Section 16 of the Regulation creates a new offence, in the same terms as section 408 of the New CO, for knowingly or recklessly causing a statement required under section 15 of the Regulation to be omitted.

Auditor’s Statement on Termination of Appointment

New CO references: sections 410, 424 to 427

Position under the Old CO

Under the Old CO, a resigning auditor must make a statement in the notice of resignation as to whether there are any circumstances connected with his resignation that he considers should be brought to the notice of the members or creditors of the company. If there are, the auditor must make a statement of such circumstances. However, an auditor whose office has ceased owing to other reasons, for example, removal or not being re-appointed after retirement, is not required to make such a statement.

Key changes under the New CO

An outgoing auditor’s duty to make a statement of circumstances is extended to:

- an auditor who has been removed; and
- a retiring auditor who has not been reappointed.

Sections 424 and 425(1) of the New CO provide for the auditor’s duty to make a statement of circumstances connected with the auditor’s resignation or the termination of the auditor’s appointment due to removal from office or retirement without reappointment.

Section 426(1) requires the company to send a copy of the auditor’s statement to its members within 14 days of receipt, unless it is applying to court for an order that the statement not be sent on the grounds that the outgoing auditor has abused the use of the statement, or is using it to secure needless publicity for defamatory matter. If the outgoing auditor has not received notice of any such court application within 21 days of the company receiving the statement (or the court does not grant the application), the auditor must send a copy of the statement to the Registrar for registration within a further 7 days (sections 426(5) and 427(5)).

Privilege for statements

Section 410 of the New CO gives an auditor qualified privilege for statements made in the course of performing duties as auditor of a company. In particular, in the absence of malice, an auditor is not liable for defamation in respect of any statement given by the auditor connected with its cessation of office.

Summary Financial Reports

New CO references: sections 437 to 446

Position under the Old CO

The Old CO allows a listed company to send a summary financial report to its members and debenture holders in place of the accounts, directors' and auditors' reports normally required to be sent, provided it has obtained the agreement of such members and debenture holders.

There is no exemption for non-listed companies incorporated in Hong Kong not to send out accounts and reports or summary financial reports.

Key changes under the New CO

The summary financial report provisions in the New CO are applicable to all companies (other than those qualified for simplified reporting) rather than being only applicable to listed companies. Members' consent is not required before a company can send a summary financial report to its members.

Section 441 gives companies (other than those qualifying for simplified reporting) the choice of sending a copy of the summary financial report instead of a copy of the full "reporting documents" (i.e. the financial statements, directors' report and auditors' reports) to their members. Members receiving summary financial reports may request a copy of the full reporting documents from the company (section 445).



Under section 442, the company may at any time require its members or potential members to make an election whether to receive a copy of the reporting documents or the summary financial report (or neither), and whether or not to receive such documents in hard copy form, or electronic form, or by the making them available on a website.

Statutory Backing for Accounting Standards

New CO references: section 380(4)(b), schedule 4

Position under the Old CO

Under the Old CO, there is a general requirement for accounts to give a true and fair view, which has generally been accepted to mean such accounts need to comply with HKFRS (which are issued by the HKICPA). However, there is no specific requirement in the Old CO to follow HKFRS.

The Old CO also provides for certain disclosure requirements as to the contents of the accounts in the Eleventh Schedule (for companies that apply section 141D) and the Tenth Schedule (for other companies), which overlap with the disclosure requirements in the SME-FRS and HKFRS respectively. However, there are certain inconsistencies between the accounting requirements under the Old CO and the applicable accounting standards. For example, compared with the requirements under section 141D, the SME-FRS requires a more complete set of accounts and more disclosures.

Key changes under the New CO

The HKFRS and SME-FRS are given indirect statutory recognition under the New CO. Section 380(4)(b) provides that financial statements must comply with the applicable accounting standards issued by a body prescribed by the Companies (Accounting Standards (Prescribed Body)) Regulation (**ASPBR**). The body prescribed under the ASPBR is the HKICPA.

Section 4 of part 1 of schedule 4 of the New CO further requires a statement to be made in the financial statements as to whether they have been prepared in accordance with the applicable accounting standards, and to give the particulars of, and the reasons for, any material departure from those standards.

Only a small number of public interest disclosure requirements not covered by the HKFRS or SME-FRS will be retained in schedule 4 of the New CO, namely:

- the aggregate amount of any outstanding loans to directors and employees to acquire shares in the company;
- information regarding a company's ultimate parent undertaking; and
- auditor's remuneration (applicable to companies not qualified for simplified reporting).

Amendments have also been made to the accounting terminology used in the New CO to align with terminology in the HKFRS. Accordingly, "financial statement" replaces "accounts" and "consolidated financial statement" replaces "group accounts". "Statement of financial position" and "statement of comprehensive income" replace "balance sheet" and "profit and loss account", respectively.

Practical considerations and recommended steps

Most of the information to be included in a Hong Kong company's financial statements relating to financial performance and position will now be determined in accordance with HKFRS (as well as the Listing Rules, in the case of listed companies).

Companies will remain free to disclose more than the prescribed minimum content, meaning it will not be necessary to review the financial statements in order to delete disclosures that are no longer required. It is likely that some legacy disclosures will continue to be included in Hong Kong financial statements. At the same time, companies will now have the opportunity to streamline disclosures with HKFRS requirements.

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