香港董事學會
The Hong Kong Institute of Directors

Issued on: 16 January 2012

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

This is in reply to the letter dated 6 December 2011 from the Companies Bill Team at the Financial Services and the Treasury Bureau inviting The Hong Kong Institute of Directors (HKIoD) to give written views on Clauses 358 to 362 (under Part 9) and Schedule 3 of the Companies Bill.

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HKIoD previously commented on the issue of relaxing the criteria for small companies to prepare simplified financial and directors' reports, in our 27 August 2010 submission (the "2010 submission") in connection with the Draft Companies Bill Second Phase Consultation and in our 19 August 2011 submission (the "2011 submission") in response to the Bills Committee invitation to give views on the issue.

We stand by the views presented in those submissions and restate them here:-

- As we indicated in the 2010 submission and the 2011 submission, we generally support the notion of relaxing the qualifying criteria for private companies/groups to prepare simplified financial reports and simplified directors' reports. We do, however, agree with the retention of the general notion that companies seeking simplified reporting should be entities that do not have "public accountability" concerns.

- We agree with the qualifying conditions previously put up for consultation and now included in the Companies Bill for "small private company" automatic qualification.

for companies limited by guarantees

- As we indicated in the 2010 submission and the 2011 submission, we generally support the proposal to relax the qualifying criteria for guarantee companies/groups to prepare simplified financial reports and simplified directors' reports. Guarantee companies are required to file annual return but to require all these companies to follow HKFRS could be too burdensome on many of the smaller entities. We agree with the HK$25 million annual revenue bright line test that was previously put up for consultation and is now included in the Companies Bill.

for companies not incorporated in Hong Kong

- As we indicated in the 2010 submission and the 2011 submission, we believe private companies not incorporated in Hong Kong should be permitted to qualify for or to adopt simplified reporting in the same way as companies incorporated in Hong Kong, so long as such would not be inconsistent with specific requirements imposed by the laws of the entity's place of incorporation or any applicable securities laws and regulations (to the extent applicable), or would not otherwise raises any "public accountability" concerns.

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on removing the CO section 141D(3) prohibition

- As we indicated in the 2010 submission and the 2011 submission, we welcome the move to remove the prohibition preventing a private company that owns and operates ships or aircraft engaged in the carriage of cargo between Hong Kong and a place outside Hong Kong from qualifying for or adopting simplified reporting.

three-tier accounting system

- As we indicated in the 2010 submission and the 2011 submission, we generally support the notion of a three-tier accounting system comprising full HKFRS for publicly quoted companies, simplified HKFRS-PE for private entities with no public accountability concerns, and SME-FRF&FRS for SMEs meeting threshold requirements. We acknowledge that the HKFRS-PE is intended to be applicable to all companies and businesses that do not have public accountability concerns but do not or cannot apply SME-FRF&FRS.

We remain in favour of letting more private companies/groups opt for simplified reporting.

Let more private companies/groups opt for simplified reporting

The primary question presented in this consultation is whether to further relax the criteria so that more private companies can adopt SME-FRF&FRS. Essentially, the issue is whether private companies/groups of <u>any size</u> should be permitted to opt for simplified reporting, even though the HKFRS-PE is already available to larger private companies/groups as an alternative to full HKFRS.

We note that a similar proposal was previously put up for consultation in the Draft Companies Bill, but has not been included in the Companies Bill now before the committee. The proposal there provided that private companies that do not qualify as a "small private company" can take advantage of simplified reports if members holding at least 75% of the voting rights so resolve and no other member objects. The 75% super-majority and "no other member objects" requirements are mirrored in situations where a group of companies that do not qualify as a "small group" seeks to take advantage of simplified reports.

As we indicated in the 2010 submission and the 2011 submission, we do not object to the notion of letting those private companies (including groups of private companies) which would not qualify for automatic qualification to take advantage of simplified reporting if there is super majority (75% was the proposal) support among members and no other member objects.

As we indicated in the 2010 submission and the 2011 submission, we are also in support of the notion to dispense with the "no other member objects" restriction. A super-majority of 75% is already a high threshold and we ask if the "no other member objects" provision would translate into an unnecessarily high veto power even if the aim is to protect minority interest.

Individuals who come together to do business in the form of a private company/group should have as much freedom as possible to design the way they go about their internal affairs. Private companies/groups with no public accountability concerns should have that freedom to opt for simplified reporting.

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If a private company/group is in a certain business or industry sector or otherwise conduct matters in particular circumstances that raises "public accountability" concerns, there should be targeted treatment rather than a broad brush ban for all private companies/groups. Under the Bill, a banking/deposit-taking company, an insurance company or a stock-broking company are each excluded from qualifying for simplified reporting. This is consistent with the premise we subscribe to, that those companies seeking simplified reporting should be ones that do not have "public accountability" concerns.

Opponents to relaxing the criteria for adopting simplified reporting argued that the simplified reporting under SME-FRF&FRS "generally has much simpler accounting requirements and might not be able to reflect, with the degree of transparency that would be expected, the state of affairs of sizeable companies/groups with more complex accounts."

We note that, how company owners handle the company's internal affairs among themselves ought to be considered a separate (though related) matter from how to protect outside parties the company deals with. Even if we were to let sizeable private companies/groups adopt SME-FRF&FRS, is there not a case for us to believe that their lenders and creditors, or business partners and equity investors will demand more transparency, as circumstances require? Will there not be a case for private companies/groups which opt for lesser reporting to eventually experience a higher cost of capital?

Fiddling with automatic qualification criteria to help more SMEs?
We do not object to the notion of enabling more SMEs to qualify for simplified reporting, but it is not clear to us (yet) if fiddling with the automatic qualification thresholds (i.e., the $50 million revenue, $50 million total assets and the 50 employees threshold) would actually have a significant effect at capturing more SMEs.

Even if it does, we are not too convinced there is real urgency to raise the thresholds, for if the members of private companies can opt for simplified reporting along the lines we described above, private companies of many sizes can resolve to take that option and not mire themselves into worrying which side of the thresholds they would fall from one year to the next.

Higher automatic qualification thresholds for larger private companies?
Automatic qualification thresholds are arbitrary by nature. Setting higher thresholds for larger private companies at some multiples of the ordinary set of thresholds does nothing to remove that arbitrariness. We do not believe the focus should be on trying to find some "magic" thresholds to work in every situation. We are not in favour of Option 3.

The law should rather let members of private companies decide on the risks and benefits they want to bear from simplified reporting.

Minority shareholder protection in context
Protecting minority shareholders of private companies ought to be put into context. The situation for minority shareholders in private companies/groups is not quite the same as a small investor buying a few lots into a big publicly listed company. There, the small investor

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cannot be expected to have the same kind of weight and influence as he/she might have in the internal affairs of a private company/group.

But minority shareholders in private companies have much better opportunities and already have the means. Shareholders can by agreement among themselves (shareholder agreements and then the articles of association) stipulate the type of financial information on the company that they can obtain. Anyone investing into a minority interest of a private company/group would have had ample opportunity to consider the kind of information he/she would get from the company, and could have required particular types and forms of financial and other information as a term of the investment. No one is compelled to hold a minority interest in a private company if one does not like the way it goes about its internal affairs! But in a free economy, anyone is free to "take the risk" for what might be a good financial return from investing in a private company.

A case for restoring the "signaling effect"
through fuller financial reporting practices adopted on own volition

For private companies that are by and large owner-managed, imposing fuller scale reporting framework might not serve much utility, and might just invite a formalistic approach to it using boilerplate verbiage. The "signaling effect" of a commitment to demonstrate corporate governance and internal control would have been lost if they were just barely trying to comply with the fuller reporting framework imposed on them.

Even if we were to let more private companies adopt simplified reporting, will it not be the case that these companies will find appreciable benefit in the form of a lower cost of capital if they opt for fuller reporting on their own volition?

It has indeed been our observation that many SMEs are ill-prepared to submit sound loan proposals. They need a better corporate governance scorecard to demonstrate that they have the proper level of internal control, and they need better corporate governance training in order to do. We should make it easier and make it more affordable for SME owners to obtain training to enhance their corporate governance practices.

But our company law should continue to respect the freedom of those who come together to form a business association and to allow them as much freedom as possible to design how they want to handle internal affairs. The Companies Bill does not preclude members of a private company/group to set out their respective rights and responsibilities in their own constitution and private contracts. The initiatives among private company members to make use of the freedom provided under law to strive for their own protection and to drive for their own governance is what we want to encourage.

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