KPMG

BRIEFING NOTE

In this briefing note …

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New Hong Kong Companies Ordinance

Briefing Note 5

Overview of amendments introduced by the Companies (Amendment) (No. 2) Ordinance 2018 relating to financial reporting and share capital

On 1 February 2019 the Companies (Amendment) (No. 2) Ordinance 2018 came into effect. This Amendment Ordinance, (referred to here as the 2019 Amendment Ordinance, given its effective date) aimed to clarify policy intent and remove ambiguities and inconsistencies based on experience and operational feedback from stakeholders.

The amendments included a number of matters which related to the preparation of annual reports and one which related to share capital. In the vast majority of cases, none of these amendments will require an entity to change its current financial reporting practices. However, a number of them offer opportunities for change which may be of interest to some companies. The remainder of the amendments confirm or clarify existing understanding of the requirements or are housekeeping matters.

KPMG's Briefing Notes 1 to 4 on what's new for financial statements, directors' reports, share capital and the simplified reporting regime, as well as KPMG's series of information sheets, disclosure checklists and worksheets, have been updated to reflect the amendments as and where they impact on the guidance in those publications.

The purpose of this additional briefing note is to provide:

- an at-a-glance index of all of these amendments by topic; and
- a brief overview of each change, listed in the order in which the impacted sections appear in the Companies Ordinance, for reference.

Further details of the amendments and a fuller understanding of their context, can be found in the respective Briefing Notes or Information Sheets.

If you would like further assistance on any of the matters discussed, please feel free to talk with your usual KPMG contact.

Index of amendments relating to financial reporting and share capital

The following index groups the amendments by topic. The "overview item" number in this table refers to where further explanation of these amendments and their impact can be found in the "Overview" section of this Briefing Note. The Overview section lists the amendments in order of their CO section reference, consistent with the approach taken in the Amendment Ordinance.

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Overview of each amendment (listed in order of CO section reference)

1. Clarification of how to assess eligibility for the simplified reporting regime when the group includes non-Hong Kong subsidiaries: amendments to section 359 and Schedule 3

s357(1), s359(2)(b), s359(3)(b), s359(3A)(b), s359(5)

Prior to the 2019 Amendment Ordinance there was no explicit statement in the CO relating to how to apply the eligibility criteria to groups which include one or more subsidiaries incorporated outside Hong Kong, where the holding company is required to prepare consolidated financial statements. This led to some diversity in views as to how to approach this topic, ranging at one extreme to the view that these overseas companies can simply be ignored when testing the group or, at the other extreme, holding the view that their presence in the group effectively prevents the group from satisfying the criteria set out in Schedule 3, regardless of their size.

The 2019 Amendment Ordinance removed this diversity by introducing new sections which explicitly refer to a "non-Hong Kong body corporate" to make clear that the same restrictions apply whether the companies in the group are incorporated in Hong Kong or elsewhere. Specifically, if the subsidiary is incorporated outside Hong Kong, then the requirements are that

- the subsidiary would not have fallen within the meaning of public company in section 12 had it been incorporated under the Hong Kong Companies Ordinance. This clarification was added by the 2019 Amendment Ordinance in a new section, s359(5)(c);
- the subsidiary does not carry on activities that are equivalent to those that are on the restricted list for Hong Kong incorporated companies, for example, any business that, had it been carried on in Hong Kong, would be required to be carried on under a valid banking license granted under the Banking Ordinance or a licence under Part V of the Securities and Futures Ordinance. This clarification was added by the 2019 Amendment Ordinance in a new section, s359(5)(a) and (b); and
- in all other respects, the subsidiary is assessed against the relevant size tests in the same way as Hong Kong incorporated companies.

These amendments serve to create a level playing field for Hong Kong incorporated holding companies, regardless of the country of incorporation of their subsidiaries. This change will provide certainty to those companies who had assumed this was how the eligibility rules could reasonably be applied and may encourage other holding companies to take advantage of the simplified regime.

An introduction to the simplified reporting regime can be found in KPMG's Briefing Note 4, and we also have worksheets available to test whether a company or a group meets the eligibility criteria.

2. "Mixed groups" now permitted to adopt the simplified reporting regime if the relevant criteria are met: new sections 359(3A) and 366A and consequential amendments to Schedule 3

s359(3A), s366A

Prior to the 2019 Amendment Ordinance, a holding company could only be eligible to use the simplified reporting regime when preparing its consolidated annual report if all the subsidiaries in the group were of the same type as the holding company. That is, if the holding company was a private company, then the group needed to consist entirely of private companies, whereas if the holding company was a company limited by guarantee, then the group needed to consist entirely of companies limited by guarantee.

The 2019 Amendment Ordinance relaxed this rule to allow "mixed groups" i.e. groups that contain both companies limited by guarantee and private companies limited by shares, provided that these companies meet the relevant size tests. That is:

- each company in the group needs to satisfy the size tests applicable to that type of company. For example, the revenue of any company limited by guarantee is limited to $25 million, regardless of whether that company is in a group of companies limited by guarantee or is in a mixed group headed by a private company. Similarly, private companies must fall within the "2 out of 3" size tests for private companies, even if in a mixed group headed by a company limited by guarantee; and

- when testing the group as a whole, the relevant test depends on the type of holding company. This means that if the holding company in that group is a private company, then the group as a whole needs to satisfy the size tests applicable to private groups, whereas if the holding company is a company limited by guarantee, then the group as a whole needs to satisfy the size test applicable to groups of companies limited by guarantee (i.e. the group's annual revenue cannot be more than $25 million).

These amendments relax one specific aspect of the eligibility criteria which served no useful purpose and may enable more holding companies to take advantage of the simplified regime.

The appendices to KPMG's Briefing Note 4 look in depth at establishing eligibility, and we also have worksheets available to test whether a company or a group meets the eligibility criteria, depending on whether the holding company is a private company or a company limited by guarantee.

3. Relaxation of approval requirements for larger "eligible" groups: amendment to section 360(2)

s360(2)

Prior to the 2019 Amendment Ordinance, one of the eligibility criteria was that it was necessary for all companies in a group to be eligible for the reporting exemption in their own right, as well as the group as a whole passing the tests. This meant that it would be necessary to obtain shareholder approval (or at least no objection) from all the shareholders of any subsidiaries which exceeded the smaller size tests, including from the non-controlling shareholders.

The 2019 Amendment Ordinance simplified the approval process for groups, such that going forward it is only necessary for the holding company to obtain approval from its own shareholders and not from the non-controlling shareholders of any of its larger "eligible" subsidiaries.

This amendment streamlines the processes for the holding company of a larger eligible group seeking to prepare a simplified annual report for its shareholders.

However, it should be noted that the holding company's group assessment is solely for the purposes of determining whether the holding company can take advantage of the simplified reporting regime when preparing its own consolidated annual report. Regardless of what the holding company decides, each Hong Kong incorporated company within the group will be required to make its own decision as to which reporting regime to follow and, if a subsidiary wishes to use the simplified reporting regime for its own annual report, then it may still need to obtain its own shareholder approvals.

Briefing Note 4 takes a closer look at the shareholder approval requirements which apply to larger "eligible" private companies.

4. Greater flexibility around the year end date to accommodate business practices: amendment to section 367

s367(1), (2)

The new CO, as originally effective in 2014, effectively defined the reporting date as being the anniversary of the previous reporting date i.e. a date exactly one full calendar year later. Therefore, if the reporting period ended on any other day, this was regarded as a "change in the reporting date" which would be subject to the requirements which would apply whenever directors planned to change the year end date. This caused difficulties for entities that defined their reporting period as an exact 52 week period, or, for example, as ending on the last Friday in February each year.

To cater for such entities, the 2019 Amendment Ordinance amended the definition of "financial year" in sub-sections (1) and (2) of s367 to allow for the financial year end date to be any date within a period of 7 days before or after the anniversary of the previous financial year end date.

This is a minor change which is expected to have minimal impact to most companies. Further details on the requirements that continue to apply whenever a company wishes to change its year end date by more than 7 days can be found in Briefing Note 1.

5. Clarification of the definition of wholly-owned: amendments to sections 379(3)(a) and 388(3)(b)

s379(3)(a), s388(3)(b)

The CO contains certain exemptions which are available to companies which are the wholly owned subsidiary of another body corporate. Specifically, these companies are exempt from preparing consolidated financial statements and from including a business review in their directors' reports. Prior to the 2019 Amendment Ordinance, the exemption referred to companies which were a wholly owned subsidiary of another body corporate "in the financial year". This wording was inconsistent with the generally held view that it was only acceptable for an entity to take advantage of these exemptions when preparing its annual report if it was still a wholly-owned subsidiary at the year end.

The 2019 Amendment Ordinance clarified this issue by amending the wording in sections 379(3)(a) and 388(3)(b) such that the relevant date is now stated to be "at the end of the financial year".

This change is not expected to change practice, since it aligns the CO with common understanding.

Further information on the meaning of "wholly-owned" can be found in KPMG's Information Sheets on "The requirement to prepare consolidated financial statements: Which companies does it apply to and how to claim exemption?" and "Claiming exemption from the requirement to prepare a business review".

6. Exemption from preparing consolidated financial statements: new section 379(3)(c) for partially-owned holding companies

s379(3)(b), s379(3)(c)

The new CO effective in 2014 contained a new way by which partially-owned holding companies could be exempt from preparing consolidated financial statements. This involved writing to the shareholders before the end of the first half of the current financial year to notify them of the directors' plan not to prepare consolidated financial statements. If no shareholders objected then the directors were permitted to prepare company-level financial statements.

The 2019 Amendment Ordinance introduces an alternative method by which partially-owned parents can confirm the views of their shareholders later in the year. This is in a new sub-section, s379(3)(c).

In accordance with s379(3)(c), a partially-owned parent will be exempt from preparing consolidated financial statements if all of its members agree in writing before the end of the financial year that consolidated financial statements will not be prepared for that financial year.

This new alternative method provides some relief for those entities whose circumstances changed during the year or who overlooked the 6 month rule, provided that all of the shareholders are willing to confirm in writing that they are content with company-level financial statements.

However, this new method still requires action to be taken during the financial year and so will not provide relief to those parents who only consider this issue at the time of preparing their annual report.

An introduction to the requirements around who has to prepare consolidated financial statements can be found in KPMG's Briefing Note 1, with a closer look in the Information Sheet on this topic.

7. Clarification of the consequences of being exempt from preparing consolidated financial statements: new section 379(3A)

s379(3A)

Prior to the 2019 Amendment Ordinance, the wording of section 379 indicated that wholly-owned holding companies were required to prepare company-level financial statements. This raised concerns for any wholly-owned holding company that chose to prepare consolidated financial statements. Specifically, the concern was that the consolidated financial statements would be regarded as non-statutory financial statements and the company would still be required to prepare a full set of company-level financial statements in order to satisfy section 379, even though all other holding companies preparing consolidated financial statements would not be so required.

This concern was initially addressed by guidance from the Companies Registry confirming that wholly-owned holding companies do have a choice of either preparing company-level financial statements or consolidated financial statements and do not need to prepare both sets, provided that the set prepared satisfied the relevant requirements of the Companies Ordinance. This guidance has now been confirmed in a new section, section 379(3A)(a), introduced by the 2019 Amendment Ordinance.

New section 379(3A)(b) then further confirms that if the directors and shareholders of a partially-owned holding company take steps to satisfy the exemption criteria set out in section 379(3)(b) or section 379(3)(c) (as discussed above in item 6), then the directors must prepare company-level financial statements that comply with s380 and 383 as per s379(1). That is, in the case of partially-owned holding companies, the choice relates to whether or not to take steps to satisfy the exemption criteria. Once that choice has been made, then the directors should follow through with the plan according to the shareholder wishes.

This new section 379(3A) addresses technical issues with the previous wording of section 379 and is not expected to change current practice.

As mentioned above, an introduction to the requirements around who has to prepare consolidated financial statements can be found in KPMG's Briefing Note 1, with a closer look in the Information Sheet on this topic.

8. Relocation of definition of accounting standards: repeal of s380(8) and new definition in 357(1) and 357(4)(a)

s380(8) (now repealed), s357(1) and (4)(a)

As discussed in Briefing Note 1, one of the changes introduced by the new CO in 2014 was to give statutory backing to accounting standards issued by the HKICPA. This was done through the requirement in section 380(4)(b) that financial statements should comply with the accounting standards applicable to the financial statements, and the interpretations in section 380(8) of the meaning of "accounting standards" and "applicable".

The 2019 Amendment Ordinance effectively relocated those interpretations from section 380(8) to section 357. Specifically, the definition of "accounting standards" can now be found in section 357(1) and the interpretation of "applicable" can be found in section 357(4)(a), while section 380(8) has been repealed.

These amendments were a housekeeping exercise by the law draftsman and have no impact in practice.

Further details on the statutory backing for accounting standards can be found in Briefing Note 1, and an information sheet is also available on asserting dual compliance with HKFRS and IFRS® Standards.

9. Tidying up the references to disclosure of directors' transactions: amendment to section 383(1)(e)

s383(1)(e) As discussed in Briefing Notes 1 and 2, one of the changes introduced by the new CO in 2014 was to move certain of the disclosures relating to material interests of directors in transactions, arrangements or contracts from the directors' report into the financial statements, and therefore to come within the scope of the audit once the new CO became effective.

The original wording in section 383(1)(e) indicated that the Government intended to issue subsidiary legislation such that the transactions, arrangements or contracts to be disclosed in the financial statements would include those entered into either by the company or by another company in the same group of companies. However, the subsidiary legislation in question, being Cap. 622D (relating to the contents of the directors' report) and Cap.622G (relating to the disclosure in the financial statements), effectively limits the impact of section 383(1)(e) such that those material transactions, arrangements or contracts with directors entered into by another company in the same group of companies continue to be disclosed in the directors' report, and are not required to be disclosed in the financial statements.

This inconsistency has been rectified by the 2019 Amendment Ordinance deleting the redundant words "or another company in the same group of companies" from section 383(1)(e) in order to be consistent with the effective scope of that section.

> *This amendment was a housekeeping exercise by the law draftsman and has no impact in practice.*
>
> *Further details of the disclosure requirements applicable to the financial statements and the directors' report can be found in Briefing Notes 1 and 2 respectively. A disclosure checklist is also available.*

10. Relief for publication of the names of the directors of subsidiaries: new sections 390(4)-(7)

s390(4) to (7) The new CO, as effective in 2014, introduced a new requirement that if a parent company prepares consolidated financial statements, then the directors' report must be a **consolidated** report so far as the disclosure of the directors' names is concerned. This means that it is also necessary to disclose the names of any persons who are or were directors of any of the subsidiaries included in the consolidated financial statements.

In most cases, the disclosure of information relating to directors in a directors' report relates only to the directors of the company (i.e. the directors of the parent which heads up the consolidated group). For example, the disclosure of directors' remuneration only relates to the individuals who were directors of the holding company. Therefore, the new disclosure of directors' names on a consolidated basis was a surprising exception to this general approach, and concerns were soon expressed on the practical implementation of this requirement, particularly from large corporate groups.

The Companies Registry responded by publishing an FAQ on their website permitting the disclosure of the names of the directors of the subsidiaries to be omitted from the directors' report provided that the directors' report included a cross reference to an accessible location where the list of directors of the subsidiaries could be found in full (e.g. by providing a link to the relevant website location which contained a full list of the names).

This practical approach has now been reflected in the new CO by way of amendments to section 390. Specifically, as a result of new sub-sections (4) to (7), there is no need to include the list of names of the directors of the subsidiaries in the directors' report, provided the company makes this list available throughout the relevant period either:

(a) at the company's registered office, where it is made available for inspection by the members free of charge during business hours; or

(b) on the company's website.

Under s390(5), the list should contain the name of every person who was a director of the company's subsidiary undertakings during the financial year or during the period between the end of the financial year and the date of approval of the directors' report. According to s390(7), this list should be continually available throughout the period until the next directors' report is sent to the members.

This amendment provides some relief to companies in terms of the length of their annual reports. However, it does not relieve the company from maintaining this information for the whole group and this may continue to be an administrative burden, particularly for large groups.

The disclosure of directors' names is discussed in Briefing Note 2.

11. Confirmation that section 436 does not apply to summary financial reports: amendment to the definition of "non-statutory accounts" in section 436(6)

s436(6)

Prior to the 2019 Amendment Ordinance, the definition of "non-statutory accounts" in section 436(6), when read literally, appeared to include summary financial reports, and to some extent the requirements of section 436 overlapped or contradicted with the requirements of section 439 and the Cap 622E in respect of disclosures in a summary financial report and attaching an auditor's report.

This issue was previously clarified in Accounting Bulletin 6 (AB 6), issued by the HKICPA after being developed in consultation with the Companies Registry, which confirmed that section 436 was not intended to apply to summary financial reports. The 2019 Amendment confirms that position by amending the definition of "non-statutory accounts" to explicitly state that it excludes any summary financial report. AB 6 was consequently updated in June 2019.

This amendment addressed a technicality in the wording of section 436 and is not expected to have an impact in practice.

Further details on the requirements of section 436, which apply when statutory or non-statutory accounts are made available to others, and the guidance and examples in AB 6 can be found in our Information Sheet on this topic.

12. Clarification that subsidiaries of a non-Hong Kong company may amalgamate: amendments to sections 678 and 681

s678 and 681,

One of the changes introduced by the new CO effective in 2014 was a new court-free way to amalgamate companies. These amalgamations could either be an amalgamation of a holding company and one or more of its wholly-owned subsidiaries (a "vertical amalgamation") or between two or more subsidiaries wholly-owned by a common parent (a "horizontal amalgamation").

The 2019 Amendment Ordinance amended s678 and s681 to clarify the definition of a wholly-owned subsidiary for the purposes of these new requirements. As a result of these amendments, it is now clear that wholly-owned subsidiaries may horizontally amalgamate even if their common parent is not a Hong Kong incorporated company. This is indicated by the use of "body corporate" in this definition, rather than "company" as was previously the case.

This change is not expected to change practice, since it aligns the CO with common understanding.

Further details on court-free amalgamations can be found in KPMG's Briefing Note 3.

13. Alignment of the definition of subsidiary undertaking with the HKFRS control concept: amendments to Schedule 1

Sch. 1

Prior to the 2019 Amendment Ordinance, the CO took a legalistic checklist approach to defining "subsidiary undertaking" by setting out in Schedule 1 a range of different ways in which one company may be the subsidiary undertaking of another. A company needed only to satisfy one of these ways in order to be regarded as a subsidiary undertaking.

Given this, it was possible that an investee could meet the legalistic definition of "subsidiary undertaking" set out in Schedule 1 of the CO without the reporting entity meeting the control criteria set out in HKFRS 10 in respect of that investee (and vice versa). For example, if a company held more than 50% of the shares of another company, then that other company would fall within the definition of a "subsidiary undertaking", even if a shareholder agreement was in place requiring unanimous consent from the other shareholders on all key operating and financial decisions. This caused complications in practice over the scope of disclosure requirements which referred to "subsidiary undertakings" or "parent undertakings" and on occasion may have given rise to the need to use the true and fair override in section 380(6), especially in the case of joint arrangements.

The 2019 Amendment Ordinance simplifies Schedule 1 to the new CO, such that the definition of a "subsidiary undertaking" in the CO now more clearly aligns with the definition of a subsidiary in HKFRS 10 by using the control concept as the primary indicator of a subsidiary undertaking.

The old Schedule 1 was brought forward largely unchanged from the old CO (Cap. 32), and did not sit well with the statutory backing for accounting standards issued by the HKCIPA that was included as a key element of the new CO (Cap. 622). This amendment closes that gap by making it no longer necessary to consider whether or not a non-controlled entity outside the scope of HKFRS 10 might technically be regarded by the CO as a subsidiary undertaking.

An introduction to the requirements around the true and fair override can be found in KPMG's Briefing Note 1. In our Information Sheet on Investment entities, we take a closer look at using the true and fair override when an entity is an investment entity and therefore does not consolidate its subsidiary undertakings.

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