

New Companies Ordinance

Briefing Notes on Part 9

Accounts and Audit

INTRODUCTION

Part 9 (Accounts and Audit) of the new Companies Ordinance (“new CO”) contains the accounting and auditing requirements, namely provisions in relation to the keeping of accounting records, the preparation and circulation of annual financial statements, directors’ and auditors’ reports and the appointment and rights of auditors. New provisions are introduced to facilitate small and medium-sized enterprises (“SMEs”) to take advantage of simplified accounting and reporting, to require public and other large companies to include an analytical business review in directors’ reports, and to enhance auditors’ right to information.

POLICY OBJECTIVES AND MAJOR CHANGES

2. This Part contains initiatives that aim at business facilitation, namely –
 - (a) Relaxing the criteria for companies to prepare simplified financial and directors’ reports i.e. the “reporting exemption” (paragraphs 5 to 10 below); and
 - (b) Making the summary financial report provisions more user-friendly and extending their application to all companies (paragraphs 32 to 36 below).
3. There are also initiatives to enhance corporate governance, namely –
 - (a) Requiring public companies and other companies that do not qualify for simplified reporting to prepare a “business review” within the directors’ report, whilst allowing private companies to opt out by special resolution (paragraphs 17 to 21 below);

- (b) Empowering auditors to obtain information from a wider range of persons for the performance of their duties (paragraphs 22 to 26 below); and
 - (c) Improving transparency with regard to circumstances of cessation of office of an auditor (paragraphs 27 to 31 below).
4. This Part also modernises and improves the law by –
- (a) Clarifying the financial year of a company, requiring companies to hold annual general meetings (“AGMs”) and requiring public companies or companies limited by guarantee to file annual returns in respect of every financial year of the company (paragraphs 11 to 16 below); and
 - (b) Streamlining disclosure requirements that overlap with the accounting standards (paragraphs 37 to 41 below).

Relaxing the criteria for companies to prepare simplified financial and directors’ reports i.e. the “reporting exemption” (Sections 359 to 366 and Schedule 3 to the new CO)

Position under the Companies Ordinance (Cap. 32) (“Cap. 32”)

5. Section 141D of Cap. 32 provides that 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 in respect of one financial year at a time. According to the Small and Medium-sized Entity-Financial Reporting Framework (“SME-FRF”) issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”), a Hong Kong company qualifies for reporting based on the SME-Financial Reporting Standard (“SME-FRS”) if it satisfies the requirement under section 141D. The SME-FRF is not applicable to groups of companies or guarantee companies at all under Cap. 32.

Position under the new CO

6. The original draft Companies Bill ("CB") allowed private companies and groups of private companies meeting the size criteria that qualify for financial reporting under the current SME-FRF (i.e. two out of three of the following eligibility limits : HK\$50 million assets, HK\$50 million revenue and 50 employees) to be automatically qualified for the preparation of simplified financial and directors' reports. The Bills Committee of the Legislative Council noted the support for relaxation of the size criteria and the suggestion to extend the use of SME-FRS to private companies/groups of any size when members holding certain voting rights in the company approve and no member objects.

7. The Bills Committee supported allowing private companies/groups meeting a higher size criteria to prepare simplified reports if members of the company so resolve.

8. The criteria for simplified reporting are therefore relaxed by doubling the eligibility limits for automatic qualification, introducing a higher size criteria for private companies/groups that opt for simplified reporting and retaining the exception in section 141D of Cap. 32.

Key provisions in the new CO

9. **Sections 359 to 366 and Schedule 3** set out the qualifying conditions for companies to prepare simplified financial and directors' reports along the following lines –

(a) A private company is automatically qualified for simplified reporting if it 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\$100 million;
- (ii) total assets of not more than HK\$100 million;
- (iii) no more than 100 employees.

(sections 359(1)(a)(i), 361, Schedule 3 section 1(1), (2))

(b) A private company that is the holding company of a “group of small private companies” and that satisfies any two of the following conditions is automatically qualified for simplified reporting –

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

(sections 359(2)(a),(b) and (c)(i), 364, Schedule 3 section 1(7), (8) and (9))

(c) 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 –

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

(for eligible private company : sections 359(1)(c), 360(1), 362, Schedule 3 section 1(3) and (4)

for group of eligible private companies : sections 359(2)(a),(b) and (c)(ii), 360(2), 365, Schedule 3 section 1(10), (11) and (12))

(d) 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.

(for a small guarantee company : sections 359(1)(a)(i), 363, Schedule 3 section 1(5) and (6)

for a group of small guarantee companies : sections 359(3), 366, Schedule 3 section 1(13) and (14))

- (e) The option under section 141D of Cap. 32 available to a private company not being a member of a corporate group to adopt simplified reporting with unanimous members' written agreement is retained in **section 359(1)(b)**.

10. Companies which are qualified for simplified reporting are referred to in the new CO as companies “falling within the reporting exemption”. The reporting exemptions are in respect of the specific requirements relating to the preparation of financial statements and directors’ reports. The exemptions are set out in the following sections –

- **Section 380(3)** (no requirement to disclose auditor’s remuneration in financial statements).
- **Section 380(7)** (no requirement for financial statements to give a “true and fair view”).
- **Section 381(2)** (subsidiary undertakings may be excluded from consolidated financial statements in accordance with applicable accounting standards).
- **Section 388(3)(a)** (no requirement to include business review in directors’ report).
- **Section 406(1)(b)** (no requirement for auditor to express a “true and fair view ” opinion on the financial statements).

Under **section 380(4)(b)**, the financial statements of a company must be prepared in compliance with the applicable accounting standards. The intention is that the accounting standards that will be applicable to a company falling within the reporting exemption is the SME-FRS and FRF issued or specified by the HKICPA which is the body prescribed in the Companies (Accounting Standards (Prescribed Body)) Regulation for issuing or specifying

the applicable accounting standards under **section 380(8)(a)**. The accounting standards applicable to companies that prepare simplified financial reports are less onerous than the Hong Kong Financial Reporting Standards (“HKFRS”) applicable to listed, public or other companies not qualified for simplified reporting.

Audit of the financial statements is still required for all companies, except dormant companies (**section 447**), under the new CO.

Clarifying the financial year of a company, requiring companies to hold annual general meetings (“AGMs”) and requiring public companies or companies limited by guarantee to file annual returns in respect of every financial year of the company (Sections 367 to 371, 610, 662(3), (4))

Position under Cap. 32

11. Cap. 32 does not provide for a company’s accounting reference period. Section 122 of Cap. 32 requires accounts to be made out every year and to be laid before the company at its AGM, and 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 in section 2(1) of Cap. 32 as the period in respect of which the accounts so laid are made up. Section 111 of Cap. 32 requires every company to hold an AGM in each year and not more than 15 months is to elapse between the date of one AGM and the next but there are no rules on shorter accounting periods. In addition, there is no provision to regulate the first accounting period, except that the first AGM has to be held within 18 months of incorporation.

12. Section 109(1) of Cap. 32 provides that, except where the company is a private company having a share capital, the annual return is required to be filed within 42 days after the AGM for the year. Section 109(3) of Cap. 32 further provides that, except where the company is a private company, the annual return shall include certified copies of the company’s balance sheet and reports laid before the company in general meeting to which the return relates.

Position under the new CO

13. 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.

14. Unless exempted under sections 612 or 613, companies are required to hold an AGM within 6 months (for public companies) or 9 months (for private companies or companies limited by guarantee) after the end of the accounting reference period. With regard to the annual return of a public company or company limited by guarantee, the requirement to file the annual return within 42 days of the AGM under section 109(1) of Cap. 32 has been changed as an AGM may be dispensed with under Part 12 (section 612(2)) of the new CO. Instead, the annual return is to be filed within 42 days after the company's return date i.e. 6 months (for public companies) or 9 months (for companies limited by guarantee) after the end of the company's accounting reference period. The annual return is no longer required to be filed in each calendar year. There is no change to the requirement to file annual returns of private companies under section 109(1A) of Cap. 32 (section 662(1), (2) of new CO), which requires the annual return of a private company to be completed within 42 days after the anniversary of the date of its incorporation and filed forthwith.

Key provisions in the new CO

15. **Section 367** provides for the beginning and end of a company's first financial year after the new CO comes into operation, and that of subsequent financial years, by reference to a company's first accounting reference period. The accounting reference period is the period by reference to which the company's financial statements are to be prepared. Every subsequent accounting reference period is a period of 12 months beginning immediately after the end of the previous accounting reference period and ending on its accounting reference date, unless it is shortened or extended by alteration of the accounting reference date (**section 368(3)**). The accounting reference date is defined in **section 370**. It can be altered by a directors' resolution pursuant to **section 371**. In the case of alteration of an accounting reference date of a public company or a company limited by guarantee, notice of the new accounting reference date must be delivered to the Registrar of Companies ("the Registrar") for registration within 15 days after the date of the directors' resolution (**section 371(2)**).

16. **Sections 610 and 662(3) and (4)** respectively set out the requirements for companies to hold AGMs, and for public companies or companies limited by guarantee to file annual returns, in respect of every financial year of a company.

Requiring public companies and other companies that do not qualify for simplified reporting to prepare a “business review” within the directors’ report, whilst allowing private companies to opt out by special resolution (Section 388 and Schedule 5 to the new CO)

Position under Cap. 32

17. The directors’ report is basically a report of the company’s information that people may wish to know about but is not included in the accounts. Section 129D of Cap. 32 sets out the detailed information required. The report must be approved by the board of directors. A copy of the report must be sent to every member and debenture holder of the company together with a copy of the accounts and auditors’ report.

Position under the new CO

18. All companies (except those qualified for simplified reporting) are required to prepare, as part of the directors’ report, a business review which is more analytical and forward-looking than the information required under Cap. 32. Private companies not qualified for simplified reporting may opt out of the requirement to prepare a business review if so approved by a special resolution.

19. The business review will provide additional information for shareholders and help assess how the directors have performed their duties. In particular, the requirement to include information relating to environmental and employee matters that have a significant impact on the company is in line with international trends to promote corporate social responsibility.

Key provisions in the new CO

20. **Section 388** and **Schedule 5** provide for the directors' duty to prepare a directors' report and the detailed requirements of a business review. The business review consists of a fair review of the company's business; 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; and an indication of likely future development in the company's business. To the extent necessary for an understanding of the development, performance or position of the company's business, a business review must include an analysis using financial key performance indicators; a discussion on the company's environmental policies and performance and the company's compliance with the 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 on which the company's success depends. The exemptions from preparation of a business review are set out in **section 388(3)** which include wholly-owned subsidiary companies. The holding company of such companies will prepare the business review unless it is exempted on other grounds.

21. To encourage meaningful reporting and to limit directors' civil liability for statements or omissions in the directors' report, **section 448** provides a "safe harbour" so that directors are liable to the company only in respect of loss suffered by it as a result of any untrue or misleading statements or the omission of anything required to be included. The directors are only liable if they knew, or was reckless as to whether, a statement was untrue or misleading, or an omission was dishonest concealment of a material fact.

Empowering auditors to obtain information from a wider range of persons for the performance of their duties (Section 412)

Position under Cap. 32

22. To ensure that an auditor will be in a position to perform his oversight functions in an effective manner, it is important for him to have access to the relevant information regarding the state of affairs of the company.

The auditors' rights to information as set out in sections 133(1) and 141(5) of Cap. 32 are considered to be too restrictive.

Position under the new CO

23. The provisions under the new CO empower auditors to require a wider range of persons, including persons holding or accountable for accounting records, to provide them with information and explanation as they reasonably require for the performance of their duties.

Key provisions in the new CO

24. Under **section 412**, the persons who will be required to provide information or explanation to auditors are –

- an officer of the company;
- a Hong Kong subsidiary of the company;
- an officer or auditor of such a subsidiary;
- a person holding or accountable for any of the accounting records of the company or such a subsidiary; and
- any of the above persons or subsidiary at the time to which the information or explanation relates.

25. The auditor of a holding company may also require the company to obtain information or explanation from its non-Hong Kong subsidiary, the officers and auditor of such a subsidiary, persons holding or accountable for any of the accounting records of such a subsidiary and any of these persons at the time to which the information or explanation relates.

26. Failure to comply with the requirement to provide information or explanation to the auditors will be subject to criminal sanctions under **section 413**.

Improving transparency with regard to circumstances of cessation of office of an auditor (Sections 421 to 427)

Position under Cap. 32

27. Under section 140A(2) of Cap. 32, a resigning auditor is required to 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, and if so, a statement of any such circumstances (“statement of circumstances”). Auditors who ceased office owing to other reasons, e.g. removal or not being re-appointed after retirement, are not required to make such a statement.

Position under the new CO

28. To improve transparency and corporate governance, an outgoing auditors’ right to make a statement of circumstances is extended to an auditor who has been removed and a retiring auditor who has not been reappointed.

Key provisions in the new CO

29. **Sections 424 and 425(1)** provide for the auditor’s duty to make a statement of circumstances connected with the resignation or the termination of appointment due to removal from office or retirement without reappointment. Within 14 days of receipt of the statement, the company must send a copy of the statement to the members or apply to court for an order directing copies of the statement not to be sent to the members (**section 426(1)**). **Section 427** provides that the court may order the statement not to be sent if it is satisfied that the outgoing auditor has abused the use of the statement or is using it to secure needless publicity for defamatory matter.

30. If the outgoing auditor has not received notice of an application to the court within 21 days of the company receiving the statement, the auditor must send a copy of the statement to the Registrar for registration within a further 7 days (**section 426(5)**). The outgoing auditor is also required to do so if he /she receives notice that the court does not grant the application not to send the statement to the members (**section 427(5)**).

31. **Section 410** is new and gives an auditor qualified privilege for statements made in the course of performing duties as auditor of the 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 his or her cessation of office.

Making the summary financial report provisions more user-friendly and extending application to all companies (Sections 437 to 446)

Position under Cap. 32

32. Under sections 141CA to 141CH of Cap. 32, a listed company may send a summary financial report to the members and debenture holders in place of the accounts, directors' and auditors' reports required to be sent under section 129G of Cap. 32 provided that it has obtained the agreement of those persons. Very few listed companies have offered the alternative of providing summary financial reports to members under those sections partly due to cost considerations and partly because the company has to obtain the members' consent by complying with complex rules for sending notification to and receiving a response from the members.

33. There is also no exemption for listed companies incorporated in Hong Kong not to send out accounts and reports or summary financial reports. However, in some other jurisdictions, those documents need not be sent if the members so request.

Position under the new CO

34. 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 as in Cap. 32. Unlike Cap. 32, members' consent is not required before a company can send a copy of a summary financial report to its members.

Key provisions in the new CO

35. **Section 441** provides companies (other than those falling within the reporting exemption) with a choice of sending a copy of the summary financial report instead of a copy of the full "reporting documents" (defined in **section 357(2)** to mean the financial statements, directors' report and auditors' reports) to their members. This will avoid the complex rules which require a company to ask its members in advance before it can send them a copy of the summary financial report. Members receiving summary financial reports may request a copy of the full reporting documents from the company (**section 445**).

36. Under **section 442**, the company may at any time ascertain the wishes of its members or potential members through a “notification” which allows them to elect to receive a copy of the reporting documents, or a copy of the summary financial report in hard copy form, or electronic form, or by making it available on a website; or not to receive any copies of the documents.

Streamlining disclosure requirements that overlap with the accounting standards (Schedule 4 to the new CO)

Position under Cap. 32

37. There are certain inconsistencies between the accounting requirements under Cap. 32 and the accounting standards, particularly in respect of the simplified accounting requirements in section 141D of Cap. 32. Compared with the requirements under section 141D, the SME-FRS requires a more complete set of accounts and more disclosures. For example, pursuant to section 141D(1)(e), the auditors’ report of a company which applies section 141D covers only the balance sheet but not the profit and loss account.

38. Cap. 32 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. As accounting standards are constantly evolving, it is very difficult to keep the statutory requirements up-to-date. This can give rise to potential conflict between the two.

Position under the new CO

39. To avoid any potential conflict between the Tenth Schedule and HKFRS and between the Eleventh Schedule and SME-FRS, both Schedules are repealed, with only a small number of public interest disclosure requirements not covered by the HKFRS or SME-FRS being retained in **Schedule 4**. The HKFRS and SME-FRS will be given indirect statutory recognition, as financial statements are required to comply with the applicable accounting standards issued by a body prescribed by the Companies (Accounting Standards (Prescribed Body)) Regulation (**section 380(4)(b)**).

Key provisions in the new CO

40. **Schedule 4** includes the following public interest disclosures —
- (a) the aggregate amount of any outstanding loans to directors and employees to acquire shares in the company authorized under sections 280 and 281 of the new CO (required under paragraphs 9(1)(c) and 5 respectively of the Tenth and Eleventh Schedules to Cap. 32);
 - (b) information regarding a company's ultimate parent undertaking (required under section 129A of Cap. 32); and
 - (c) auditors' remuneration (applicable to companies not qualified for simplified reporting, required under paragraph 15 of the Tenth Schedule to Cap. 32).
41. **Section 4 of Part 1 of Schedule 4** 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.

TRANSITIONAL AND SAVING ARRANGEMENTS

42. Transitional and saving arrangements are set out in **sections 76 to 87, 107(2) to (5) and 121 of Schedule 11** to the new CO and are basically as follows —

- **Financial year and related matters**

Sections 127 and 141D of, and the Eleventh Schedule to, Cap. 32 continue to apply in relation to a financial year beginning before the commencement of Division 3 of Part 9 and ending on or after that commencement.

- **Accounts and directors' report**

(1) Sections 122, 123, 124, 125, 126, 128, 129, 129A, 129B, 129C, 129D, 129G, 141C, 161, 161A, 161B, 161BA and 161BB of, and the Tenth Schedule to, Cap. 32 continue to apply in relation to accounts for a financial year beginning before the commencement of Subdivision 3 of Division 4 of Part 9 and ending on or after that commencement.

- (2) Despite subparagraph (1) above, section 122(1B) of Cap. 32 continues to apply in relation to accounts for a financial year beginning before the commencement of Subdivision 3 of Division 4 of Part 9 and ending on or after that commencement as if paragraph (b) of subsection (1B) were omitted.
- (3) If the court makes an order under section 122(1B) of Cap. 32 under subparagraph (2) above, the accounts to be laid at the meeting concerned must be made up to the company's primary accounting reference date under section 369(1)(b) of the new CO.
- (4) Sections 129D, 129E, 129F and 141C of Cap. 32 continue to apply in relation to a directors' report for a financial year beginning before the commencement of Subdivision 4 of Division 4 of Part 9 and ending on or after that commencement.

- **Auditors' report**

- (1) Sections 141(1), (2), (3), (4), (5) and (6), 161(8) and 161B(12) of Cap. 32 continue to apply in relation to a financial year beginning before the commencement of Subdivision 3 of Division 5 of Part 9 and ending on or after that commencement.
- (2) Section 141(7) and (8) of Cap. 32 continues to apply in relation to a general meeting of which notice is given before the commencement of Subdivision 4 of Division 5 of Part 9.

- **Removal and resignation of auditor**

- (1) Sections 131(6), (7) and (10) and 132 of Cap. 32 continue to apply in relation to a removal of a person appointed as auditor for a financial year beginning before the commencement of Subdivision 6 of Division 5 of Part 9 and ending on or after that commencement.
- (2) Sections 140A and 140B of Cap. 32 continue to apply in relation to a resignation of a person appointed as auditor for a financial year beginning before the commencement of Subdivision 6 of Division 5 of Part 9 and ending on or after that commencement.

- **Summary financial report**

Sections 141CA, 141CB, 141CC, 141CD, 141CE and 141CF of Cap. 32 and the Companies (Summary Financial Reports of Listed Companies) Regulation (Cap. 32 sub. leg. M) continue to apply in relation to a summary financial report for a financial year beginning before the commencement of Division 7 of Part 9 and ending on or after that commencement.

- **Voluntary revision of accounts etc.**

Section 141E of Cap. 32 and the Companies (Revision of Accounts and Reports) Regulation (Cap. 32 sub. leg. N) continue to apply in relation to accounts for a financial year beginning before the commencement of section 449 and ending on or after that commencement.

- **Annual general meetings**

If a company is required to lay at its AGM an account or a balance sheet in accordance with section 122 of Cap. 32, section 111(1), (5) and (6) of Cap. 32 continues to apply in relation to an AGM at which the account or balance sheet is to be laid.

- **Annual return**

(1) Except where the company is a private company having a share capital, if the financial year (as defined in section 2(1) of Cap. 32) of the company begins before the commencement of section 662 and ends on or after that date, sections 107 and 109 of Cap. 32 continue to apply for that financial year.

(2) If the company is a private company having a share capital, sections 107 and 109 of Cap. 32 continue to apply in relation to the company's annual returns made up to a date before the commencement of section 662.