

## Financial Reporting-related Matters and Preparation of Directors' Reports under the new Companies Ordinance, Chapter 622 – an Overview

One of the objectives of re-writing the Companies Ordinance, Cap.32 (the old Ordinance) was to modernise the provisions to enhance business efficiency and corporate governance. Among other aspects, financial reporting and directors' report requirements are the areas where material changes have been made. In this newsletter, we give an overview of these changes in order for you to have a general idea of in what aspects your companies may need to get ready for the new provisions in the Companies Ordinance, Cap.622 (the new CO). In our coming issues, we will look into these changes in greater detail to give you some insights into the new CO provisions.

In this newsletter we talk about the following financial reporting and directors' report requirements:

- Keeping of accounting records
- Financial year
- General provisions on preparation of financial statements
- Preparation of consolidated financial statements
- Summary financial reports
- Preparation of directors' reports
- Reporting exemption
- Effective date of the new CO provisions

### Keeping of accounting records

The provisions in the new CO on keeping accounting records are close to those in the old CO, ie the accounting records must contain:

- a) *daily entries* of all sums of money received and expended by the company, and the matters in respect of which the receipt and expenditure takes place; and
- b) a record of the company's assets and liabilities (s.373(3)).

What is new in the new CO is the introduction of the "sufficiency" requirement in s.373(2). In particular, the accounting records must be sufficient to disclose with reasonable accuracy, *at any time*, the company's financial position and financial performance. Another new requirement is that if a company has a non-Hong Kong incorporated subsidiary undertaking, directors of the company must take all reasonable steps to ensure that the subsidiary undertaking keeps accounting records that are sufficient to enable the company's directors to ensure that the company's financial statements (company level or consolidated) give a true and fair view and comply with other requirements of the new CO (s.373(4)).

## Financial year

The new CO introduces the concept of "financial year". For each financial year, a company's directors must prepare financial statements that comply with the new CO (s.379). Under the old CO, there was no specific requirement on the length of period covered by the annual financial statements of a company. The length was determined with reference to the frequency of its annual general meeting. The introduction of "financial year" makes the requirement more straightforward.

In short, for most companies incorporated under the old CO (ie existing companies) the introduction of "financial year" will not have any impact on the frequency of preparing their financial statements and the length of period covered. For example, an existing company (Co. A) has a 31 March financial year-end. Its last annual accounts prepared under the old CO ended on 31 March 2014 (see the section "Effective date of the new CO provisions" below). Co. A's first financial year determined under the new CO commences on 1 April 2014 covering a 12-month period.

In respect of companies incorporated under the new CO, the new CO requires the directors of the company to specify a date as the company's financial year-end date and the company's first financial year-end date must fall within 18 months after the company's date of incorporation. If the company's directors fail to specify such a date, the company's first financial year-end date would be taken as the last day of the month in which the company's first anniversary of incorporation falls (s.368(2), s.369(5) & (6)).

For example, Co. B is incorporated under the new CO on 10 April 2014 and its directors decide to adopt 30 June as its financial year-end date. Co. B may specify 30 June 2014 or 30 June 2015 as its first financial year-end date. However, if Co. B decides to adopt 31 December as its financial year-end date, it must specify 31 December 2014 as the end date of its first financial year. Otherwise its first financial year-end date would exceed 18 months after its date of incorporation. On the other hand, if the directors of Co. B fail to specify such a date, 30 April 2015 would be taken as the first financial year-end date of Co. B.

## General provisions on preparation of financial statements

The new CO retains the requirement of financial statements giving a true and fair view (s.380(1) & (2)). S.380(3) & (4) further stipulates that the financial statements must comply with the accounting standards applicable to the financial statements, the accounting disclosures detailed in Schedule 4 of the new CO, and other provisions in the ordinance relating to financial statements, subject to the true and fair view overriding provision (see below).

As contained in the old CO, the true and fair overriding provision applies,

- if compliance with the requirements set out in s.380(3) & (4) of the new CO (see the paragraph immediately above) is insufficient for the financial statements to give a true and fair view. The financial statements must contain all additional information necessary for the purpose of giving a true and fair view; or
- if compliance with all these requirements would be inconsistent with the requirement to give a true and fair view. The financial statements must depart from these requirements to the extent such that the financial statements give a true and fair view.

Notwithstanding these similarities of financial statement requirements under the old and new CO, there are some salient changes introduced by the new CO. For example:

- the new CO gives statutory backing to the HKICPA by stating that companies must prepare annual financial statements that comply with the accounting standards issued or specified by the HKICPA.
- the terminologies used are modernised and more in alignment with those used in accounting standard.
- disclosure requirements previously set out in the Tenth Schedule of the old CO are generally considered burdensome and out of date. To a certain extent, these disclosures do not fit well with the HKFRS. The Tenth Schedule is repealed now. Other than disclosures relating to directors' emoluments and other benefits, Schedule 4 of the new CO contains all the financial statement disclosure requirements. The matters required to be

disclosed are greatly simplified. In total there are only five sections in Schedule 4 of the new CO.

- the new CO expands the scope of directors' emoluments which are subject to disclosure. For example, the old CO required the disclosure of directors' pensions but now the scope is extended to directors' retirement benefits. Relevant benefits received by a connected entity (as defined in the new CO) of a director are also caught by the new CO (s.10 of the Companies (Disclosures of Information about Benefits of Directors) Regulation).
- disclosures of material interests of directors in contracts entered into by the company or another company in the same group of companies was previously disclosed in directors' reports under the old CO. Such disclosures are now to be made in the annual financial statements. Also the scope of matters subject to disclosure is extended from contracts to include transactions and arrangements (s.383(1)(e)).

### Preparation of consolidated financial statements

The new CO defines a subsidiary and a subsidiary undertaking in the same way as the old CO. Consistent with the requirement under the old CO, if a company is a holding company at the end of a financial year under the new CO it must prepare consolidated financial statements (s.379(2)) unless it meets the exemption conditions in the ordinance (s.379(3)).

A change introduced by the new CO is that if a company prepares consolidated financial statements, its company-level statement of financial position and company-level movements in reserves are presented in the notes to the consolidated financial statements (s. 2(1) of Schedule 4) and there is no need for the company to include notes supporting its company-level statement of financial position (a.2(2) of Schedule 4).

The new CO tightens up the consolidation exemption conditions. A holding company may decide not to prepare consolidated financial statements if:

- it is a wholly-owned subsidiary of another body corporate in the financial year; or

- it is a partially-owned subsidiary of another body corporate in the financial year,
  - at least 6 months before the financial year-end date, the directors notify the members in writing of the directors' intention not to prepare consolidated financial statements for the financial year, and
  - at least 3 months before the financial year-end date, the directors have not received a written request from the members for the preparation of consolidated financial statements for the financial year (s.379(3)).

Notwithstanding the requirements set out above, a holding company may exclude one or more than one subsidiary undertaking from its consolidated financial statements if the inclusion is not material for the purpose of the financial statements to give a true and fair view (s. 381(3)). This exemption condition is new and in alignment with the general principle of materiality used in HKFRS and HKFRS for Private Entities.

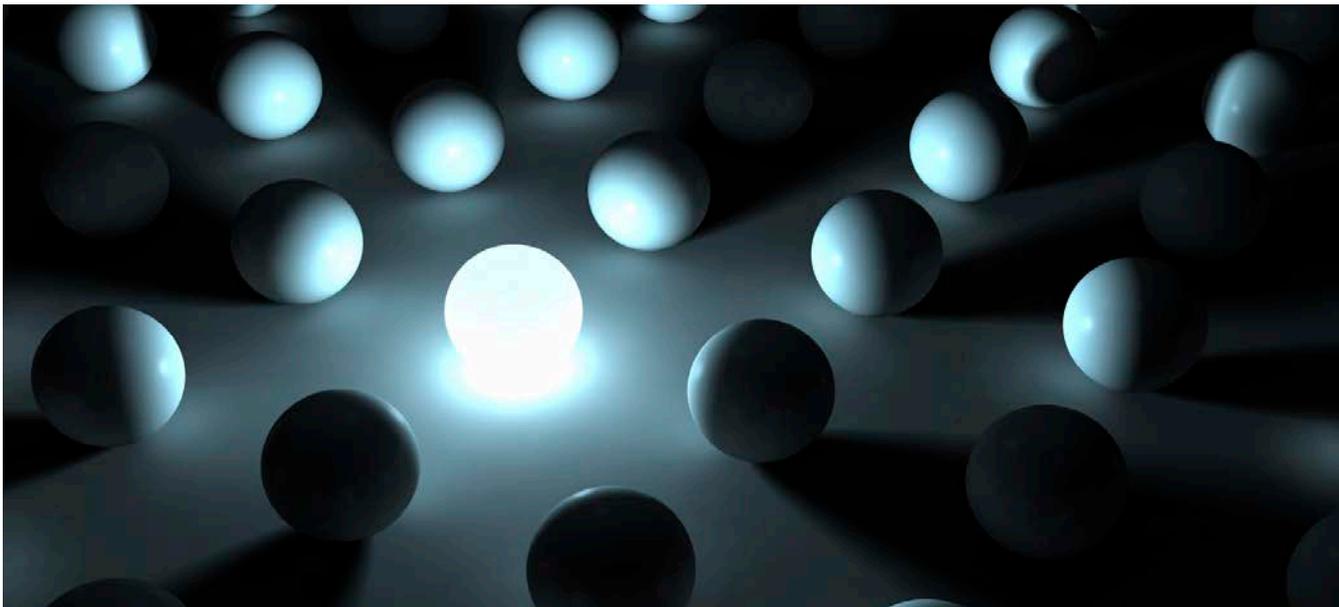
Please note that the above "not material to give a true and fair view" exemption is not applicable to companies that fall within the reporting exemption under the new CO and prepare their financial statements under HKFRS for Small and Medium-sized Entities Financial Reporting Standard (SME-FRS). For these companies, they may exclude one or more of their subsidiaries from consolidated financial statements in compliance with the conditions set out in the SME-FRS (s.381(2)). Further details about the reporting exemption under the new CO are set out in the section "Reporting exemption" below.

### Summary financial reports

A summary financial report is a financial report in summary form which is derived from a company's Reporting Documents which are its:

- financial statements,
- directors' report, and
- auditor's report.

A company may opt to send a summary financial report to its members instead of its Reporting Documents. However, note that this option does not release the company from the obligation to prepare Reporting Documents.



The summary financial report is not a new option for companies in respect of information to be communicated to their members. The old CO also allowed companies to send summary financial reports to their members. However the option was available to listed companies only. The new CO extends this option to all companies unless:

- The company falls within the reporting exemption (see the section “Reporting exemption” of this newsletter) for the year (s.438), or
- The company's articles require the sending of reporting documents to its members (s.446(1)(a)), or
- The company's articles prohibit the sending of summary financial reports to its members (s.446(1)(b)).

A company which desires to send a summary financial report to its members must obtain its members' intent on receiving a summary financial report or Reporting Documents. The form and contents of

- a) notification to members seeking their intent, and
- b) summary financial report

must comply with the requirements of the Companies (Summary Financial Reports) Regulation, Cap 622E.

### **Preparation of directors' reports**

One of the more significant changes introduced by the new CO is the requirement to include a business review in a directors' report (s.388(1) & Schedule 5). Schedule 5 of the new CO sets out the required contents of a business review. The review must consist 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 the likely future development of 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 of
  - 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 and on which the company's success depends.

However the business review requirement does not apply to a company if:

- the company falls within the reporting exemption (see the following section "Reporting exemption" of this newsletter) for the financial year;
- the company is a wholly-owned subsidiary of another body corporate in the financial year; or
- the company is a private company (as defined by the new CO) that does not fall within the reporting exemption for the financial year, and a special resolution is passed by the members to the effect that the company will not prepare a business review for the financial year. This special resolution must be passed at least 6 months before the end of the financial year to which the directors' report relates. (s.388(3) & (4))

In addition to business review-related information, other new disclosures in a directors' report include:

- information about equity-linked agreements<sup>7</sup> entered into by the company in the financial year and/or that subsist at the end of the financial year;
- a summary of the reasons (if related to the company's affairs) given by directors for resignation or not seeking re-appointment; and
- a statement that an indemnity provision as permitted under the new CO for the benefit of directors of the company, or its associated company, is in force when the directors' report is approved or was in force in the financial year.

## Reporting exemption

The new CO introduces the reporting exemption with the objective of relaxing certain companies' reporting burden but at the same time taking into consideration their members' information needs. Under the old CO regime, companies meeting the requirements of s.141D could prepare their annual financial statements using HKFRS for Small and Medium-sized Entities Financial Reporting Standard (SME-FRS). These companies had to be private companies as defined in the ordinance and could not be in a group (ie have no subsidiary or

not be a subsidiary of another company). All shareholders of these companies had to agree in writing that the Company would not prepare financial statements for the year which give a true and fair view.

The new CO retains the exemption under the previous s.141D and extends the exemption to a wider scope of companies including group companies and guarantee companies. The exemption conditions are a combination of size test and members' approval. Private companies of a size not exceeding the specified threshold fall within reporting exemption without the need for obtaining members' approval. However, larger private companies can only fall within reporting exemption if:

- a) their size does not exceed the higher threshold; and
- b) their members holding at least 75% of the voting rights support the resolution to the effect that the company falls within reporting exemption; and
- c) the remaining members do not vote against this resolution.

The new CO does not stipulate when the company must obtain its members' resolution. However if the resolution is passed more than 6 months before the company's financial year-end date, its members may object to the company falling within reporting exemption by giving notice in writing to the company at least 6 months before the end of the financial year (s.360(3)).

Companies falling within reporting exemption enjoy the following relaxed requirements:

- Directors' reports need not include:
  - a business review;
  - certain disclosures relating to directors; and
  - disclosure of donations made.
- Financial statements
  - may be prepared using HKFRS for SME-FRS (s.380(7));
  - need not disclose auditor's remuneration (s.380(3), Part 2 of Schedule 4); and
  - need not disclose certain information about directors' transactions with the Company

<sup>7</sup> An equity-linked agreement is defined by the Companies (Directors' Report) Regulation as (a) an agreement that will or may result in the company issuing shares; or (b) an agreement requiring the company to enter into an agreement which will or may result in the company issuing shares.

## Effective date of the new CO provisions

The new CO provisions on accounts and directors' reports came into operation on 3 March 2014 but subject to the transitional provisions in Schedule 11 of the new CO. For existing companies (ie companies

incorporated under the old CO), 3 March 2014 generally refers to annual financial statements and directors' reports of periods beginning on or after 3 March 2014. The table below shows the effective date applicable to companies with more common financial year-end dates.

Financial year-end date	The first set of annual financial statements and directors' report that must comply with the new CO
31 March	Financial year: 1 April 2014 - 31 March 2015
30 June	Financial year: 1 July 2014 - June 2015
30 September	Financial year: 1 October 2014 - 30 September 2015
31 December	Financial year: 1 January 2015 - 31 December 2015

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