

NEW HKCO: REPORTING EXEMPTION FOR GROUPS - 2 CRITICAL QUESTIONS

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“The New HKCO offers two new doors to simplified reporting for companies with subsidiaries but which one can be opened or how to open it remains under debate.”

BACKGROUND

The new Hong Kong Companies Ordinance (Cap. 622) (the “**New HKCO**”) replaces the simplified-reporting route under section 141D (“**section 141D**”) of the predecessor Hong Kong Companies Ordinance (Cap. 32) (the “**Predecessor HKCO**”) with a new one called “**reporting exemption**” under section 359 of the New HKCO (“**section 359**”). By falling within the reporting exemption, a HK company can take a number of advantages in relation to the preparation of the directors’ report and the financial statements – a concept similar to section 141D. Unlike section 141D, however, the gateway under section 359 is opened for companies limited by guarantee as well as private companies or companies limited by guarantee having subsidiaries. In this article, we will look at 2 critical questions concerning the assessment of whether companies having subsidiaries fall within the reporting exemption.

QUESTION 1: COMPANY OR GROUP BASIS ?

Section 359 sets out the conditions that a company must satisfy in order to fall within the reporting exemption. In particular, section 359(1) (the “**Company Basis**”) deals with the cases where the company concerned is a company while section 359(2) and (3) (the “**Group Basis**”) are applicable to the cases where the company is the holding company of a group of companies. Intuitively, there is a concept of dichotomy behind the legislation intent between companies with and without subsidiaries because it is more difficult to satisfy the conditions under the Group Basis (for simplicity of comparison, ignoring the route of section 141D brought forward from the Predecessor HKCO). Unfortunately, the legislation does not reflect such intent. Section 359(1) says: “*For the purposes of this Part, a company falls within the reporting exemption for a financial year*”. Interestingly, section 359(2) and (3) specify: “*For the purposes of this Part, a company also falls within the reporting exemption for a financial year if*”. The word “also” emphasizes the lack of a mutually-exclusive relationship between (A) the Company Basis and (B) the Group Basis – although the interpretation will not be different even without it.

In order to solve the above puzzle, an attempt has been made to find a hint in the provisions in the New HKCO which govern the preparation of consolidated financial statements, particularly section 379 (“**section 379**”) thereof. Putting the two pieces together (i.e. sections 359 and 379), one will find that there is a sequential linkage between them. Sadly, this linkage is not in the direction as we expect: the application of section 359 will affect that of section 379 (by means of section 380 of the New HKCO) but not the other way round. This linkage further highlights the importance of the correct interpretation of section 359. In a nutshell, when a holding company assesses whether it can fall within the reporting exemption under section 359, in our opinion, two independent paths are available: the Company Basis and the Group Basis.

Section 379 does not play a role in this process. It follows that all holding companies are expected to select the Company Basis given that, in general, the Group Basis is stricter and this renders the Group Basis redundant.

In respect of this matter, we submitted our enquiries to the HK Companies Registry (the “**HKCR**”) in August 2014. The HKCR replied that for companies having subsidiaries, section 379 requires the preparation of consolidated financial statements unless the exemptions apply. Therefore, those companies, which are required to prepare consolidated financial statements under the New HKCO, have to follow the Group Basis instead of the Company Basis in order to fall within the reporting exemption.

As explained above, in our view, neither could we find a legal provision to dictate the sequential application of section 379 first and then section 359 nor did the HKCR quote one in its replies. On 19 March 2015, the HKICPA updated its Q&As¹:

“Question D6 – Interaction between the eligibility for the reporting exemption (s.359) and the exemption from preparing consolidated financial statements (s.379(3)²)

Answer

There is no clear link stated in the new CO between the requirements in section 379(3) (on the eligibility for not preparing consolidated financial statements) and section 359 (on the eligibility for the reporting exemption). However it would seem reasonable to assume that a correlation is intended.

Based on such assumption, if a holding company is required to prepare consolidated financial statements, then the group needs to qualify for the reporting exemption under section 359(2) before it is qualified for simplified reporting (i.e. qualified for preparing consolidated financial statements under the SME-FRF & SME-FRS (Revised 2014)); whereas if the holding company does not need to prepare consolidated financial statements, then it may qualify for simplified reporting as a stand-

(1) <http://www.hkicpa.org.hk/en/standards-and-regulations/standards/new-co/qa-index/pd-sme-frf-frs/#QD6>

(2) Although the question is written in the context of section 379(3), the discussion of the HKICPA actually extends to section 379(1) and (2).

alone company under section 359(1) and thus, qualify for preparing company-level financial statements only under the SME-FRF & SME-FRS (Revised 2014).”

In the absence of a legal ground, the reasonable assumption advocated by the HKICPA is, at best, a voluntary practice. It seems that holding companies have done nothing wrong if the Company Basis, which is generously offered by the New HKCO, is chosen. Further, if the reasonable assumption is valid which implies that the Company Basis and the Group Basis are mutually exclusive, as elaborated in our enquiries made to the HKCR, a consequential problem will be created when a company switches from a company without subsidiaries to a holding company and vice versa because the continuance of the reporting exemption status will be inevitably broken given the provisions set out in sections 361 to 366 of the New HKCO. On the other hand, if the so-called presumed sequential application were the legislation intent, it should have been put under the spotlight during the legislation process and reflected in the New HKCO rather than leaving it to companies to make a reasonable assumption. For the benefit of the public and the members, the HKCR and the HKICPA are recommended to take prompt actions to address this matter.

QUESTION 2: “GROUP OF COMPANIES” OR GROUP OF “COMPANIES”?

The relevance of this second question hangs on the resolution of the first question above and therefore the following discussion assumes the application of the Group Basis.

The Group Basis lays down a number of conditions as set out in sections 359 to 366 of and Schedule 3 to the New HKCO (the “**Conditions**”) that must be satisfied for companies to fall within the reporting exemption including, as the case may be:

- Type of company: private company or company limited by guarantee;
- Restriction of business: those businesses or

- activities set out in section 359(4);
- Size-related threshold: the qualification as a group of small private companies, a group of eligible private companies or a group of small guarantee companies; and
- Approval of shareholders: the approval set out in section 360.

The Conditions are imposed on “each company” in “a group of companies”, where applicable. Given that the Group Basis is applied when the company concerned is the holding company of a group of companies, one may think that it is far beyond doubt that all companies in the group should fall into the scope of the Conditions. Unfortunately, the wording in the legislation tells a different story. Before proceeding further, let’s look at the following important definitions which are building blocks of the Conditions:

- (1) “a group of companies”
Section 2 of the New HKCO (“**section 2**”) defines this term as “any 2 or more bodies corporate one of which is the holding company of the other or others”, where “body corporate” generally includes HK and non-HK companies.
- (2) “company”
It is defined by section 2 as HK companies.

The definitions in section 2 are applicable to the whole Ordinance unless a different meaning is ascribed by a specific section – which does not happen to the case of the Conditions. With these definitions in mind, it will be clear that the Group Basis is applicable to a group of HK and/or non-HK companies, provided that the holding company concerned is a HK private company or company limited by guarantee. Second, the Conditions specified by the Group Basis only cover HK companies in the group.

In respect of this matter, we submitted our enquiries to the HKICPA in April 2014 and the HKCR in August 2014. The HKICPA has not yet given its reply as of the date of this article while the HKCR replied that “As each company in the group is required to be a “company” as defined in section 2 of the new CO, it follows that only HK companies

are considered for calculation of the group's revenue or assets. A HK holding company having PRC subsidiaries is not qualified for the reporting exemption". In simple terms, the HKCR reads "a group of companies" as a group of "companies" where "companies" refers to HK companies and therefore, the Group Basis is applicable only to a group in which all companies are HK companies. If this is the case, given the local circumstances, the applicability of the Group Basis and in turn the reporting exemption status for groups of companies will be very limited. On the other hand, if our interpretation is the correct one, a group of companies with giant non-HK subsidiaries could fall within the reporting exemption by the route of the Group Basis – which may move in the opposite direction of the re-write initiative of "facilitating SMEs to prepare simplified financial and directors' reports". Making it further complicated and problematic, for the purpose of assessing the size-related threshold, the "set-offs and other adjustments for transactions between companies in the group", as stipulated in Schedule 3, to the New HKCO could effectively require companies to prepare another set of financial statements after elimination of transactions among HK-companies in the group when the group also has transactions between HK-companies and non-HK companies or among non-HK companies in the group – which is a set of financial statements different from the consolidated financial statements in which, generally, all intra-group transactions are eliminated. Again, for the benefit of the public and the members, the HKCR and the HKICPA are recommended to take prompt actions to address this matter.

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