

Introduction

Introduction	¶15-000
Meaning of “accounts”	¶15-020
Keeping of books of account	¶15-040
True and fair view	¶15-060
Form of books of account	¶15-080
Accounting systems and internal controls	¶15-100
Failure to keep accounting records	¶15-120
Where accounting records to be kept	¶15-140
Retention of accounting records	¶15-160
Compliance with approved accounting standards	¶15-180
Inspection	¶15-200

¶15-000 Introduction

Directors are entrusted with the administration and the management of the company's resources such as money, properties and manpower to fulfill the objectives of the company. As such, they are obligated to account for the money and resources used in generating income and profits (or losses) as well as to provide relevant, timely and material information to shareholders and stakeholders.

In lieu of the above, directors are required to oversee the account of transactions and the keeping of adequate records of all transactions entered into by the company. Besides complying with the requirements of the *Companies Ordinance* (Cap 32), such practice also serves the purpose of meeting the requirements imposed by the *Inland Revenue Ordinance* (Cap 112). The reason behind the law is to ensure that shareholders and management are informed of the results of the operations during the accounting period, and the state of affairs as at the end of that period.

For listed companies, whose financial year ends by 31 December 2012, a part of the Report must include reference to the Environmental, Social and Governance Reporting Guide.

For listed and non-listed companies, the directors of “financial institutions” should be mindful of the operation of the *Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance* (Cap 615) which came into force on 1 April 2012.

A “financial institution” means:

- an authorised institution,
- a licensed corporation,
- an authorised insurer,
- an appointed insurance agent,
- an authorised insurance broker,
- a licensed money service operator, or
- the Post Master General.

¶15-020 Meaning of “accounts”

The term “accounts” refers to profit and loss accounts, balance sheets and cash flow statements, including the notes and other statements attached, which are collectively intended to give a true and fair view of the financial position, profit or loss and cash flows of the company.

Directors are required by the *Companies Ordinance* (Cap 32) to render an annual account of their stewardship to the shareholders. This account must take the form of a financial report. A detailed report by directors referring to specific areas of activity and an auditors' report are also required to be attached with the accounts.

Accordingly, the annual reports that directors present to shareholders comprise a financial report, the directors' report and auditors' report.

¶15-040 Keeping of books of account

Every company shall cause to be kept proper books of account with respect to:

- all sums of money received and expended and the matters in respect of which receipts and expenditure takes place,
- all sales and purchases of goods by the company,
- all assets and liabilities of the company.

Proper books of account cannot be deemed to be kept unless they are kept as necessary to give a true and fair view of the state of the company's affairs and to explain its transactions from time to time.¹

¶15-060 True and fair view

In compliance with the *Companies Ordinance* (Cap 32), the accounts of a company must, above all, give a true and fair view of the state of the company's affairs as at the end of its financial year (in the case of the balance sheet) and of the profit and loss for the financial year (in the case of the profit and loss account).

The term "true and fair view" is not defined by the law, nor does the law give any real guide to its interpretation. In lieu of this, the courts have now accepted the rules laid down by the accountancy profession for its interpretation. Accounts which are in conformity with generally accepted accounting principles are accepted as being "true and fair".

In Hong Kong, the Statements of Standard Accounting Practice and the Interpretations issued by the Hong Kong Society of Accountants provide the rules for this purpose.

¶15-080 Form of books of account

The extent and range of books of account maintained will vary to suit the needs of each company and the complexity of the business. Accounting records and books are properly maintained if they exhibit and explain the transactions and financial position of the company. To achieve this end, they should explain:

- details of entries of cash received and paid daily,
- where the company deals in goods, the following statement:
 - (i) statements of the annual stocktakings from which the statements of stocks held by the company at the end of each financial year will be prepared, and
 - (ii) statements of all goods sold and purchased which are detailed enough to enable identification of the goods, buyers and sellers, and
- information to allow the company's accounting books and records to be conveniently and properly audited.

To achieve the continuing requirements that adequate maintenance of accounting records be kept at all times, a company must maintain a proper accounting system. An accounting system is defined as a series of tasks in an entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyse, calculate, classify, record, summarise and report transactions and other events.

¶15-100 Accounting systems and internal controls

An adequate accounting system usually incorporates various internal controls to the extent appropriate to the size and nature of the company's business. An internal control system is a plan of organisation methods and procedures adopted by management, as far as practicable, to assist in achieving the overall objective of ensuring:

- orderly and efficient conduct of its business, including adherence to management policies,
- safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and
- timely preparation of reliable financial information.

Thus, the need for internal control extends beyond matters which relate directly to the functions of the accounting system.

Directors are in no way relieved of their responsibility for ensuring that the accounting system adopted for recording the transactions entered into by the company is adequate even though senior managers or executives may be appointed to carry out the delegated authority of keeping accounts and preparing the annual profit and loss statement, balance sheet and cash flow statement.

To ensure proper discharge of those duties and obligations, directors should implement an adequate internal control system to ensure that policies established by the directors are in fact being followed throughout the company as well as the assets of the company are properly safeguarded. An early detection of fraud, mismanagement or errors in the recording system will mitigate the losses suffered by the company as the consequences of the malicious activities intended.

Apart from the objectives of a system of internal controls stated above, it is also to provide confidence and assurance that the accounting system provides the financial information necessary for the preparation of true and fair financial statements.

To summarise, the objectives of a system of internal controls are to enable:

- the examination of the transactions to ensure that they are in accordance with management's general and specific authorisation,
- the prompt recording of all transactions in the correct amount in quantity and value, where appropriate in the relevant accounts and within the accounting period in which the transaction has been executed so as to

permit preparation of financial information within the framework of a recognised accounting policy,

- the permission to access the assets and records in accordance with management's authorisation, and
- the ascertainment of the recorded particulars of assets by comparing and verifying with the existing assets and new assets where appropriate at reasonable intervals, and the taking of timely and appropriate action with regard to any discrepancies found during internal audit procedures.

¶15-120 Failure to keep accounting records

If any person being a director of a company fails to take all reasonable steps to secure compliance by the company with the requirement of s 121 of the *Companies Ordinance* (Cap 32) to keep proper books of account, or has wilfully caused any default by the company, he shall be guilty of an offence and be liable to imprisonment and a fine.²

¶15-140 Where accounting records to be kept

The accounting records of a company are to be kept at the registered office of a company or at a place to be decided by the directors, and shall at all times be open to inspection by the directors.

The accounting and other records of operations outside Hong Kong may be kept by the company at a place outside Hong Kong, but the accounts and returns must be sent to and kept at a place in Hong Kong and at all times be open to inspection by the directors. Such accounts and returns with respect to the business dealt with in the records so kept should enable the preparation of profit and loss account and balance sheet and any documents required to be attached thereto and reflect with reasonable accuracy the financial position at intervals not exceeding six months.³

¶15-160 Retention of accounting records

All companies are required to retain such accounting and other records as will sufficiently explain the transactions and financial position for a period of seven years after the completion of the transactions or operations to which they respectively relate.⁴

The period of retention however, defers from the tax legislation which states that where the situation warrants it, the Commissioner of Inland Revenue has the power to review tax assessments within ten years after the end of any year of assessment. In view of this, companies might consider retaining important accounting records for a period of ten years for tax purposes.⁵

¶15-180 Compliance with approved accounting standards

The directors of a company must ensure that the accounts and, if the company is a holding company, the group accounts of the company, laid before the company at its annual general meeting are made in accordance with the applicable approved accounting standards. The approved accounting standards are accounting standards which are issued or approved by the Hong Kong Society of Accountants and should be applied to the published accounts of all commercial, industrial or business enterprises in Hong Kong, including any of their overseas subsidiaries and related companies.

Where accounts or group accounts are not made in accordance with a particular set of approved accounting standards, the director must:

- disclose by way of a note in the accounts and justify their reason for not making out the accounts or consolidated accounts in accordance with the approved accounting standards, and
- give particulars in the notes of the quantified financial effect on the accounts if the relevant approved accounting standard had been complied with.

The departure from the accounting standards is subject to the assessment of an auditor who has the duty to report his/her opinion on the true and fair views of the accounts to the shareholders of the company.

Inspection

Inspection.....	¶15-200
Inspection by directors.....	¶15-210
Inspection by auditor	¶15-220
Inspection by other parties	¶15-230

¶15-200 Inspection

The accounting records are important documents of a company.

As directors are responsible for the published accounts of a company, they are entitled to the fullest information which the company is capable of giving them. The *Companies Ordinance* (Cap 32) also enables parties other than the company's directors to access a company's records for various reasons.

Application was made in *Tsai Shao Chung v Asia Television Ltd & Ors* [2011] 6 HKC 71 for access to various documents, and to allow their

Takeovers and mergers

Introduction	¶30-000
Source and purpose of Codes	¶30-020
Definitions	¶30-080
The Codes on Takeovers and Mergers	¶30-160
Offers	¶30-220
Offer document: Schedule 1	¶30-300
Offeree directors' comments	¶30-320
Independent advice circular	¶30-340
Terms of offer: Schedule 1	¶30-360
Revised offers	¶30-380
Closing of offers	¶30-400
Announcement of acceptances	¶30-420

¶30-000 Introduction

Takeovers and mergers have always been one of the main areas of concern of regulatory authorities in Hong Kong. As Hong Kong is a leading financial centre in the Far East Asian region and a prominent free-trade port, Hong Kong regulatory authorities are anxious to provide a stable and fair investment atmosphere for investors in Hong Kong. Under this general principle, the Takeovers Code (ie, the Codes on Takeovers and Mergers, but now referred to as "The Takeovers Code"); and see also the Share Repurchase Code) are the practical guidelines that the Hong Kong regulatory authorities require the market to follow as far as takeover and merger activities in Hong Kong are concerned.

Taking over control of a company involves the existing shareholders of a company transferring sufficient shares to an offeree so as to confer on the offeror control of the voting shares of the company. The normal test for whether a person is controlled by, controls or is under the same control as another person, will be by reference to the definition of control, that is by reference to holding 50% or more of the voting rights of a company. In other words, when the offeror acquires all or over 50% of the voting shares of the target company, effective control is achieved. However in reality effective control may be achieved with less shareholding – as low as 30% shareholding in the target company.

A friendly takeover occurs when the directors of the target company welcome the bid. A hostile takeover is when there is opposition from the directors, and the company may seek to take defensive action to prevent the takeover; for example by application to the Takeover Panel.

The reasons for a takeover include:

- acquisition of a competitor,
- to enable expansion into a new area or to diversify, or
- to take advantage of a favourable share price or surplus cash of the company or to acquire a valuable asset. For example the target company in the *Shanghai Land's* case (*Vivien Fan & Ors v HKSAR* (2011) FACC Nos 6-8 and 10-12 of 2010, CFA) where the target company was described as a "cash rich" entity and the acquisition was to obtain a wealthy company.

Takeovers of target companies are usually conducted in one of the following manners:

- by way of a private treaty,
- by acquisition of shares in the market,
- a combination of the above, and
- making a mandatory offer to all shareholders of the target company.

Where the takeover is that of a private company, then it is commonly referred to as a merger and acquisition ("M&A"). However, where the transaction involves a public company, whether or not listed (and the relevant listing here is that it is a primary listing in Hong Kong), then it is referred to as a takeover. An M&A involves observance of the terms of the *Companies Ordinance* (Cap 32), in particular the sections relating to "financial assistance". A takeover also involves the *Companies Ordinance* (Cap 32) and the *Takeovers Code*; if the target is a listed company, then provisions of the *Securities and Futures Ordinance* (Cap 571) will also be relevant; in particular see clauses 4.1 to 4.3 of the "Introduction to the Takeovers Code".

The documentation for an M&A usually includes:

- a confidentiality agreement, perhaps limited to the duration of the negotiations; this will be followed by certain confidentiality terms in the contract (the "Sale and Purchase Agreement"),
- an exclusivity agreement under which the target company covenants to deal only with the current, potential purchaser, usually for a limited time,
- sometimes a separate agreement containing a non-compete covenant to protect the value of the asset being purchased, and

- the formal Sale and Purchase Agreement containing several Schedules (which are expressly provided to be part of the contract) and often Appendices.

These general documents will be used whether the purchaser is seeking to buy the share capital of the target, or only selected assets (and perhaps liabilities) of the target under an Asset Purchase Agreement. Other aspects of the transaction include due diligence, a disclosure letter from the target (supported by an "entire agreement" clause in the Sale and Purchase Agreement), a share transfer, notice under the *Transfer of Businesses Ordinance (Protection of Creditors) Ordinance* (Cap 49), and relevant documents. For an Asset Purchase Agreement, various transfers, notices and others will be relevant, including notices to third parties with whom the target had contracted where those contracts are now being assigned to the purchaser.

A takeover must follow the requirements of the Takeover Code; these provisions are commented on below, and the terms of the Code are referred to in the Appendices. The underlying factors for the regulation of a takeover are:

- the identity of the offeror which should be openly disclosed,
- adequate time given to shareholders and directors of the target company to consider the offer and alternatives,
- equal opportunity for every shareholder to participate in the benefits of the scheme, and
- detailed disclosure to enable shareholders and directors of the target company to form a judgment on the merits of the scheme.

In general a takeover typically involves:

- the approach and recommendation to consider the offer,
- an irrevocable announcement of the offer,
- the offer document, and
- the closing of the offer and the compulsory acquisition. Questions of acting in concert will be relevant to the transaction.

Economic assumptions

In general, the term of "takeover" is when one company acquires control of another smaller company. "Merger" is understood to be a marriage between two companies of roughly equal size, although the word has been often taken to mean a takeover as well. It may also be defined as an arrangement whereby assets of one or more companies become vested in, or under the control of, one company. Therefore in broad terms, a takeover is:

- the acquisition or holding of, or entitlement to exercise or control the exercise of, more than 30% of the voting shares in a public company (and designated company) by a person (or company) or a group of such persons acting in concert, or
- the entering into of an agreement, arrangement or understanding by two or more persons to co-operate to act jointly or severally (eg, consolidate their voting power) for the purpose of exercising control over a company.

From the point of view of a free enterprise economy, allowing people to pursue their own economic advantage will result in the best use of limited resources. It follows from this theory that, as in the case of takeover bids, a person of substantial means who feels that the value of the assets of a company is greater than the value placed upon those assets by its existing shareholders, should be free to attempt to persuade those shareholders to transfer control to the person with substantial means. From the economic point of view the person of substantial means will put these assets to more efficient use.

Similarly, in a merger, the two business enterprises, by merging, will be regarded as the best judges of a business advantage. Nevertheless, the theory on free enterprise also recognises that a resulting enterprise may become monopolistic and abuse its position by charging higher prices, and operate with less efficiency than under competitive conditions. Further, a takeover bid may override certain considerations of public interest, particularly in industries providing public services and utilities.

There are various categories of takeovers and mergers which can be classified in the manner set out below:

- *Horizontal* – A horizontal takeover or merger involves two companies producing essentially the same products or services (or products or services competing with each other) joining together. The objective of the exercise is to reduce the number of competing firms in an industry and eliminate duplicate facilities thus giving rise to a greater scope for the economies of scale.
- *Vertical* – A vertical takeover or merger involves a firm engaged in the manufacturing of a certain product taking over the other firms engaged in the manufacture of the same product at a different stage. The takeover is called a vertical one if one of the two companies is a potential supplier of goods and services to the other so that the two companies that merge contribute to the final product manufactured. For example, a car manufacturer taking over a sheet metal maker or a car distributing firm.
- *Conglomerate* – This mode of takeover or merger involves the joining of two companies in different industries not related to each other horizontally. The objective is to merge the same or competing products

of the two companies, thus bringing together common factors in marketing, manufacturing, research and development or technology into a big group of business activities. Sometimes, such an action is also called diversification with a view to:

- (a) achieving greater stability of earnings through the spreading of activities,
- (b) employing spare resources of capital and management,
- (c) reaping the benefits of economies of scale for financial advantages,
- (d) defending itself against being an object of takeover, and
- (e) strengthening its ability to withstand economic cycles.

A leverage buy-out (LBO) has also qualified as a distinct form of takeover. It is a takeover where a substantial proportion of the acquisition price has been financed by borrowings. The bidder is usually a company formed by a consortium with the intention of acquiring control of a conglomerate. The borrowings are then repaid partly or wholly out of the proceeds of selling off parts of the group acquired.

A management buy-out (MBO) is a type of leverage buy-out popularly carried out in the 1980s. In this case, part or all of the existing management of the target company forms a prominent part of the consortium set up to acquire it. It is funded by financiers who expect that members of the management invest substantially their own net worth in the project as a show of earnestness of their commitment to the venture.

A *Competition Bill* was introduced into LegCo in 2010 and is currently with a Bills Committee. The Bill is designed to prohibit conduct that prevents, restricts or distorts competition in Hong Kong. It also prohibits mergers that have the effect of substantially lessening competition in Hong Kong. However the merger rule is to apply only in respect of carrier licences issued under the *Telecommunications Ordinance* (Cap 106). A Competition Commission will be established to investigate and enforce the prohibition against anti-competitive conduct. Further, a Competition Tribunal will also be established for proceedings in respect of such conduct.

¶30-020 Source and purpose of Codes

The Takeovers Code has been issued by the Securities and Futures Commission ("SFC") in consultation with the Takeovers Panel and its predecessor, the Committee on Takeovers and Mergers.

The Code comprises General Principles, and Rules. The General Principles apply to supplement any areas not covered expressly by the Rules.

The General Principles represent statements of good conduct in relation to takeovers and mergers. The Share Repurchase Code also contained General Principles which have the same object as those in the Takeovers Code.

Despite not being binding, the spirit and the terms of both are to be observed. However, in exceptional circumstances, the Executive and the Panel may modify or relax the application of the Rules.

The Takeovers Panel and the Executive administer the Codes.

The primary purpose of the takeover codes is to ensure fair treatment for shareholders who are affected by takeover and merger transactions. In essence, the Code seeks to achieve fair treatment by requiring equality of treatment of shareholders, mandating disclosure of timely and adequate information to enable shareholders to make an informed decision as to the merits of an offer and ensuring there is a fair and informed market in the shares of companies affected by takeover and merger transactions. It also provides an orderly framework with which all takeover and merger transactions take place.

The Codes do not have the force of law. They are written so far as possible non-technical language and should not be interpreted as statute. However, the listing rules of the Stock Exchange in Hong Kong Limited expressly require compliance with the Codes.

The Rules in each of the Codes contain detailed information about the manner of observing the terms. They are to be interpreted to achieve their underlying purpose of affording fair treatment for shareholders who are affected by takeover and merger transaction, and share repurchases.

Both the Takeovers Code and the Code on Share Repurchases share common definitions and general principals. The General Principals are essentially statements of good standards of conduct to be observed in takeovers, mergers and share repurchases.

Each of the Codes contains a series of rules. Although the rules are expressed in more detail, they are to be interpreted to achieve their underlying purpose.

From 25 June 2010, the Takeovers Code became relevant to REITS, as an example of a collective investment scheme under Part IV of the *Securities and Futures Ordinance* (Cap 571).

Definitions

Takeover offer.....	¶30-080
Acquirer	¶30-090
Persons acting in concert	¶30-100

¶30-080 Takeover offer

A "takeover offer" in relation to a company means an offer made to acquire all or part of its voting shares, or any class or classes of its voting shares. There is no definition of "takeover" in the *Companies Ordinance* (Cap 32) (see the Definitions in the Takeovers Code).

¶30-090 Acquirer

An "acquirer" means:

- a person (either a body corporate or an individual) who acquires or proposes to acquire control in a company by himself or through an agent, or
- two or more persons, who acting in concert with one another, acquire or propose to acquire control in a company by themselves or through an agent.

¶30-100 Persons acting in concert

"Persons acting in concert" are defined as persons who, pursuant to an agreement arrangement or understanding actively co-operate to obtain or consolidate "control" of a company through the acquisition by any of them of the voting rights of the company (r 26).

An agreement, arrangement or understanding means an agreement, arrangement or understanding whether formal or informal, written or oral, express or implied or whether or not having legal or equitable force.

Based on the above definition of "persons acting in concert", there can be a takeover by parties acting in concert regardless of whether there is an acquisition of shares. A takeover situation arises when an agreement, arrangement or understanding exists between two or more persons to co-operate to act jointly or severally for the purpose of exercising control over a company.

The following persons are presumed to be acting in concert unless the contrary is established:

- A company, its parent, its subsidiaries, its fellow subsidiaries, associated companies of any of the foregoing, and companies of which such companies are associated companies.
- A company with any of its directors (together with their close relatives, related trusts and companies controlled by any of the directors, their close relatives and related trusts).
- A company with any of its pension funds, provident funds and employee share schemes.
- A fund manager (including an exempt fund manager) with any investment company, mutual fund, unit trust or other person, whose investments such fund manager manages on a discretionary basis, in respect of the relevant investment accounts.
- A financial or other professional adviser, (including a stockbroker), with its client in respect of the shareholdings of the adviser and persons controlling, controlled by or under the same control as the adviser except in the capacity of an exempt principal trader).
- Directors of a company (together with their close relatives, related trusts and companies controlled by such directors, their close relatives and related trusts) which is subject to an offer or where the directors have reason to believe a *bona fide* offer for their company may be imminent.
- Partners.
- An individual (including any person who is accustomed to act in accordance with the instructions of the individual) with his close relatives, related trusts and companies controlled by him, his close relatives or related trusts.
- A person other than an authorised institution within the meaning of the *Banking Ordinance* (Cap 155) lending money in the ordinary course of business, providing finance or financial assistance (directly or indirectly) to any person (or a person acting in concert with such a person) in connection with an acquisition of voting rights (including any direct or indirect refinancing of the funding of the acquisition).

¶30-160 The Codes on Takeovers and Mergers

In Hong Kong, the scheme for a takeover bid is not governed by the *Companies Ordinance* (Cap 32) but by the Takeovers Code (ie, the Codes on Takeovers and Mergers). The Code applies to all takeovers and mergers affecting public companies in Hong Kong and listed companies with a primary listing of their equity shares. The Code is concerned with offers for and