

### Relevance

Information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events, or confirming or correcting their past evaluations. The predictive and confirmatory roles of information are interrelated. By applying the concept of relevance, we should consider both materiality and timeliness. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations. Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, security price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the income statement is enhanced if unusual, abnormal and infrequent items of income or expense are separately disclosed. There are some accounting concepts to be considered:

- *Materiality*—the relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of the risks and opportunities facing the enterprise irrespective of the materiality of the results achieved by the new segment in the reporting period. In other cases, both the nature and materiality are important; for example, the amounts of inventories held in each of the main categories that are appropriate to the business. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic that information must have if it is to be useful.
- *Timeliness*—represents constraints on relevant and reliable information. If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or another event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the economic decision-making needs of users.

### Reliability

Moreover, information must also be reliable. Information has the quality of reliability when it is free from material error and bias, and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent. Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action are disputed, it may be inappropriate for the enterprise to recognise the full amount of the claim in the balance sheet, although it may be appropriate to disclose its amount and circumstances. To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date that meet the recognition criteria. The concept of reliability is further divided into the following five areas.

- *Faithful presentation*—most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured, or in devising and applying measurement and presentation techniques that can convey messages corresponding with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.
- *Substance over form*—if the information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality, and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an enterprise may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure the enterprise continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there were a transaction).
- *Neutrality*—in addition, the information contained in financial statements must be neutral; that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgment in order to achieve a predetermined result or outcome.
- *Prudence*—the preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the

What would be the pros and cons of IFRSs to investors, especially after most of the countries adopted the standards? IFRSs generally are high-quality standards when compared to the legalistic, politically and tax-influenced standards that historically have typified Continental Europe. IFRSs are designed to reflect economic substance more than legal form, reflect economic gains and losses in a more timely fashion, and make IFRS earnings more informative.

The advantages of direct IFRSs for investors would include (provided the standards are implemented consistently):

- more accurate (efficient) valuation in the equity markets
- reduced cost of being informed in a timely fashion
- reduced cost of processing financial information (no Generally Accepted Accounting Principles (GAAP) adjustments needed cross countries)
- increased comparability and hence reduced information costs and information risk to investors.

The advantages of indirect IFRSs for investors:

- more efficient contracting in debt markets means lower capital costs
- better corporate governance, due to greater transparency.

The disadvantages of IFRSs for investors:

Immediate:

- Fair value accounting—IFRSs heavily emphasise fair value accounting that provides investors with insight into prevailing market values, further helping to ensure the usefulness of financial reports. However, fair value accounting could be problematic.
- Implementation—despite some regulatory coordination, the incentives of preparers (managers) and enforcers (auditors, courts, regulators, politicians) remain primarily local. Political and economic forces will lead to inconsistency in implementation.

Longer term:

- One global brand name—allowing all countries to use the IFRS label discards information about reporting quality differences among countries.
- 'Free rider' problem—essentially costless for low-quality countries in financial reporting to use the IFRS 'brand name'. These countries can claim they use IFRSs, but their financial reports could be of low quality due to poor implementation.
- Lack of competition—competition among alternative financial reporting systems is healthy and innovative while imposing worldwide standards could be risky on centralisation.
- Politicisation and bureaucracy: the IASB and International Financial Reporting Standards (IFRS) currently have strong 'common law' orientation due to the strong influence of common law countries like the UK and US. Over time, the IASB risks becoming a politicised and bureaucratic UN-style body.

## Understanding Company Financial Statements

Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the income statement are income and expenses. The statement of changes in financial position usually reflects income statement elements and changes in balance sheet elements; accordingly, this framework identifies no elements that are unique to this statement.

The presentation of these elements in the balance sheet and the income statement involves a process of sub-classification. For example, assets and liabilities may be classified by their nature or function in the business of the enterprise in order to display information in the manner most useful to users for purposes of making economic decisions. Section 123(1) of the Companies Ordinance requires that the balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year, and the profit and loss account shall give a true and fair view of the profit or loss of the company for the financial year. Section 126(1) of the Companies Ordinance imposes the same requirement in relation to the company and subsidiaries included in-group accounts so far as members of the company are concerned.

### Balance Sheet—Statement of Financial Position

The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:

- An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.
- A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
- Equity is the residual interest in the assets of the enterprise after deducting all its liabilities.

The definitions of an asset and a liability identify their essential features, but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition. In particular, the

- payment of cash
- transfer of other assets
- provision of services
- replacement of that obligation with another obligation
- conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights. Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods and the use of services give rise to trade payables (unless paid for in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan. An enterprise may also recognise future rebates based on annual purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.

Some liabilities can be measured only by using a substantial degree of estimation. Some enterprises describe these liabilities as provisions. In some countries, such provisions are not regarded as liabilities because the concept of a liability is defined narrowly, so as to include only amounts that can be established without the need to make estimates. Thus, when a provision involves a present obligation and satisfies the rest of the definition, it is a liability even if the amount has to be estimated. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations.

## Equity

Although equity is defined as a residual, it may be sub-classified in the balance sheet. For example, in a corporate enterprise, funds contributed by shareholders, retained earnings, reserves representing appropriations of retained earnings, reserves representing capital maintenance adjustments and dividend payout and its movement may be shown separately. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an enterprise have differing rights in relation to the receipt of dividends or the repayment of capital.

## Capital Maintenance Adjustments

The revaluation or restatement of assets and liabilities gives rise to an increase or decrease in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the income statement under certain concepts of capital maintenance. Instead, these items are included in equity as capital maintenance adjustments or revaluation reserves.

The creation of reserves is sometimes required by statute or other law in order to give the enterprise and its creditors an added measure of protection from the effects of losses. Other reserves may be established if national tax law grants exemptions from, or reductions

in, taxation liabilities when transfers to such reserves are made. The existence and size of these legal, statutory and tax reserves is information that can be relevant to the decision-making needs of users. Transfers to such reserves are appropriations of retained earnings rather than expenses. The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the enterprise or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the enterprise as a whole on a going concern basis.

Commercial, industrial and business activities are often undertaken by means of enterprises such as sole proprietorships, partnerships and trusts, and various types of government business undertakings. The legal and regulatory framework for such enterprises is often different from that applying to corporate enterprises. For example, there may be few, if any, restrictions on the distribution to owners or other beneficiaries of amounts included in equity. Nevertheless, the definition of equity and the other aspects of this framework that deal with equity are appropriate for such enterprises.

## Concepts of Capital and Capital Maintenance

A financial concept of capital is adopted by most enterprises in preparing their financial statements. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the enterprise. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day. The selection of the appropriate concept of capital by an enterprise should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the enterprise, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

## Concepts of Capital Maintenance and the Determination of Profit

The concepts of capital give rise to the following concepts of capital maintenance:

- Financial capital maintenance—under this concept a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

First, the company could be expected to grow revenue and earnings much more quickly in the future than companies with a PE of 20, thus commanding a higher price today for the higher future earnings. Second, suppose the estimated (trailing) earnings of the 40-PE company are very certain to materialise, whereas the 20 P/E companies' future earnings are somewhat uncertain, indicating a higher investment risk. Investors would of course incur less risk by investing in more certain earnings instead of less certain ones, so the company producing those affirmative earnings again commands a higher price today.

It must also be noted that average P/E ratios tend to vary from industry to industry. Typically, P/E ratios of companies in very stable, mature industries that have more moderate growth potential have lower P/E ratios than companies in relatively young, quick-growing industries with more robust future potential. Thus, when an investor is comparing P/E ratios from two companies as potential investments, it is important to compare companies from the same industry with similar characteristics. Otherwise, if an investor simply purchased stocks with the lowest P/E ratios, they would likely end up with a portfolio full of utilities stocks and similar companies, which would leave them poorly diversified and exposed to more risk than if they had diversified into other industries with higher-than-average P/E ratios.

However, this does not mean that stocks with high P/E ratios cannot be regarded as good investments. Suppose the same company mentioned earlier with a 40 P/E ratio (stock at \$40, earned \$1/share last year) was widely expected to earn \$4/share in the coming year. This would mean (if the stock price didn't change) the company would have a P/E ratio of only 10 in one year's time (\$40 price/\$4 earnings), making it appear very inexpensive. The procedure is that when looking at P/E ratios as part of your stock analysis, consider what premium you are paying for a company's earnings today and determine if the expected growth warrants the premium; compare it with its industry peers to see its relative valuation and try to determine overall if the premium is worth the cost of the investment.

## Relation between Expected Return and Risk of Investment

For a company share investment, the focus is placed on risk as well as the expected return. The risk perceived is not replicated in terms of the asset class volatility. While it is true that the equities have the highest volatility and the government bill has the lowest, the bond volatilities appear out of order. That is, the corporate bond has a higher return and a lower volatility than the government bond.

Figure 2.2, which will become a common tool, graphs the expected return  $E(r)$ , ( $y$ -axis), against volatility or risk, ( $x$ -axis). It is sometimes called a mean-standard deviation graph (also mean-variance, or reward to risk). Risk-averse investors prefer more return to less and less risk to more. That is, the risk-averse investors would prefer to be as high as possible and to the left (preferences in the northwest direction) on the graph. Notice that portfolio A has higher expected return and lower volatility than portfolio B. It dominates an investment in portfolio B in terms of mean and standard deviation.

## The Risk/Return Trade-off in Financial Analysis

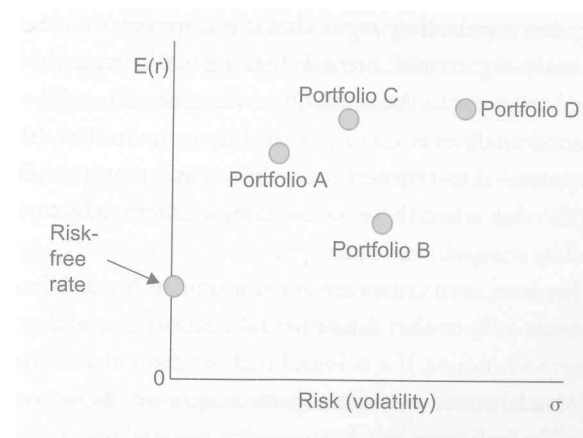
It is widely accepted that the major determinant of the required return on the asset (or the rate to be applied to a stream of receipts to capitalise its value) is its degree of risk. Risk refers to the probability that the return and therefore the value of an asset or security may have alternative outcomes. Risk is the uncertainty (today) surrounding the eventual outcome of an event that will occur in the future. In financial analysis, the risk/return trade-off states that financial decisions that subject stockholders to more risk must offer a higher expected return. Risk aversion is the tendency to try to avoid risky situations unless adequate compensation is offered. For example, the risk-averse individual faced with two events each having the same expected outcome will choose the outcome with the lower level of risk.

## Categories of Risk and Leverage Faced by the Firm and by Shareholders

### Operating Leverage

This type of risk is magnified by the degree to which the firm relies on fixed operating expenses in producing sales. In many cases there is not much the firm that can do about this type of risk; some industries have more volatile sales and higher fixed operating expense

FIGURE 2.2 Expected Return Against Volatility or Risk



It is a simple measure that estimates whether the business can pay debts due within one year from assets that it expects to turn into cash within that time frame. A ratio of less than one is often a cause for concern, particularly if it persists for any length of time.

### Quick Ratio (or 'Acid Test' Cash and Near Cash)

Not all assets can be turned into cash quickly or easily. Some—notably raw materials and other stocks—must first be turned into final product, then sold and the cash collected from debtors. The quick ratio therefore adjusts the current ratio to eliminate all assets that are not already in cash (or near-cash) form. Once again, a ratio of less than one would start to send out danger signals.

## Stability Ratios

These ratios concentrate on the long-term health of a business—particularly the effect of the capital/finance structure on the business:

### Gearing Borrowing

(all long-term debts + normal overdraft)/bet assets (or shareholders' equities)

Gearing (otherwise known as *leverage*) measures the proportion of assets invested in a business that are financed by borrowing. In theory, the higher the level of borrowing (gearing) the higher are the risks to a business, since the payment of interest and repayment of debts are not optional in the same way as dividends. However, gearing can be a financially sound part of a business's capital structure, particularly if the business has strong, predictable cash flows.

### Interest Cover

operating profit before interest/interest

This measures the ability of the business to service its debt. Are profits sufficient to be able to pay interest and other finance costs?

## Return on Shareholders' Equity:

Return on equity (ROE) stands for earnings before extraordinary items, less preferred-share dividends, divided by shareholders' equity. ROE shows the rate of return on the investment for the company's shareholders, the only providers of capital who do not have a fixed return.

$$\text{ROE} = \frac{\text{net income}}{\text{sales}} \times \frac{\text{sales}}{\text{total assets}} \times \frac{\text{total assets}}{\text{average stockholders equity}} = \frac{\text{net income}}{\text{average stockholders equity}}$$

$$\text{ROE} = (\text{profit margin}) \times (\text{asset turnover}) \times (\text{equity multiplier}) = (\text{net profit/sales}) \times (\text{sales/assets}) \times (\text{assets/equity})$$

ROE can be seen as a measure of how well a company used reinvested earnings to generate additional earnings, equal to a fiscal year's after-tax income (after preferred stock dividends, but before common stock dividends) divided by total equity, expressed as a percentage. There are other measures of return on equity; for example, return on capital employed (ROCE).

ROCE is a measure of the returns calculated as profit before interest and tax divided by the difference between total assets and current liabilities. The resulting ratio represents the efficiency with which capital is being utilised to generate revenue. A different way to calculate ROCE is ROACE, return on average capital employed. Instead of using the capital as reported, it uses the average of opening and closing capital for the time period.

## Usefulness and Limitation of Ratio Analysis

When we look at the balance sheet we need to know how to assess the numbers. Financial ratios can be calculated from the balance sheet, and these help the investor understand the state of liquidity and growth potential of the company in question. One example is the current ratio (current assets/current liabilities), which reveals a company's ability to pay its short-term obligations. If a company's current ratio is 1.5, this could be showing us that the company is not only liquid but also healthy enough to pay off its debts without taking out a loan. It also shows that a company is financing itself through a larger amount of reinvested earnings rather than through debt. When comparing companies in the same industry, the investor can determine which company is the best investment. When compared against the industry's average, a lower ratio may indicate possible liquidity problems.

Another useful ratio is leverage (long-term debt/total net worth), which displays how assets are financed by the company; that is, whether by debt or retained earnings. If a company has a high amount of leverage, or debt, it may be a sign that the company will have difficulty finding any future financing and is therefore headed towards bankruptcy.

The notes to the financial statements (sometimes called footnotes) are also an integral part of the overall picture. If the income statement, balance sheet and statement of cash flow are the heart of the financial statements, then the footnotes are the arteries that keep everything connected. If you are not reading the footnotes you are missing out on a lot of information, especially on the rationale of the meanings behind the ratios. The footnotes list important information that could not be included in the actual ledgers. Could you imagine if the company listed out individual expenses on the income statement instead of putting them under one or two neat headings? The income statement would be 20 pages long! The notes will list relevant things like outstanding leases, the maturity dates of outstanding debt, and even details on where the revenue actually came from. Generally speaking, there are two types of footnotes we should take a closer look at:

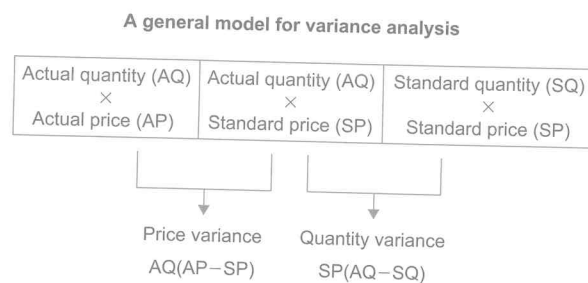
turned into a dollar value. To do this we turn again to the standard cost per unit. Having dealt with any difference in the price per kilogram in the price variance, we can use the standard cost per kilogram to translate this value into a monetary one (see Table 3.6).

**TABLE 3.6 Material usage (quantity) variance continued**

Variance = 500 kg adverse  $\times$  \$3/kg = \$1,500 adverse

The approach of actual and projected numbers, can be applied to all of the variance calculations that are required at this level.

We can follow a general model to calculate price and quantity variances:



The general model can be used to calculate material, labour and variable (production) overhead variances.

## Labour Variances

Now let us consider the labour variances. The standard cost per unit is made up of the standard hourly rate of \$8/hour and a standard production time of two hours. Thus we will need to consider whether the labour was paid \$8/hour (the rate variance) and if it took two hours per unit (the efficiency variance). In Table 3.7, the labour was paid more than expected and this will lead to an unfavourable (adverse) variance. Applying the general model of price variance, or rate variance for labour variances, we derive the labour rate variance:

**TABLE 3.7 Labour rate variance**

	\$
Paid labour for 8,250 hours ( <i>actual</i> )	68,500
Should have paid labour for 8,250 hours ( $8,250 \times \$8$ )	66,000
	2,500 unfavourable

Having focused on the monetary value, we can now turn our attention to the non-monetary value, the labour hours. In Table 3.2, there is a difference between the hours that have been paid and the hours that were worked. We are told that 150 hours were lost due to delivery problems. This means that although labour was paid for 8,250 hours they could not have worked for that many hours due to this loss of production time. The hours in which labour produced 4,150 units were 8,250 hours—150 hours = 8,100 hours. It is this figure that will be used to see how efficient labour has been. However, we do need to consider this loss of production time. In this example it was expected that labour were productive for all the time that it worked. As we have seen, 150 hours were lost due to delivery problems so the amount of time that labour was productive for was 8,100 hours (see Table 3.8).

As the variance is stated in a non-monetary value, we need to convert it to a monetary value using the standard rate per hour of \$8 (see Table 3.9).

The final labour variance (see Table 3.10) deals with how efficiently labour has worked to produce the 4,150 units. We have already calculated that it did take labour 8,100 hours to make this many units. Should it have taken the labour force that long to produce them?

Since labour took less time to make the 4,150 units than expected, there is a favourable variance that needs to be converted into dollars (see Table 3.11).

**TABLE 3.8 Labour idle time variance**

	Hours
No. of productive labour hours ( <i>actual</i> )	8,100
No. of hours that labour should be used	8,250
	150 unfavourable

**TABLE 3.9 Labour idle time variance continued**

Variance = 150 hours adverse  $\times$  \$8/hour = \$1,200 adverse

**TABLE 3.10 Labour efficiency variance**

	Hours
Time taken to produce 4,150 units ( <i>actual</i> )	8,100
Time it should take to produce 4,150 units ( $4,150 \times 2$ hours/unit)	8,300
	200 favourable

**TABLE 3.11 Labour efficiency variance continued**

Variance = 200 hours favourable  $\times$  \$8/hour = \$1,600 favourable

of its nature; for example, a highly structured product, which is the result of a repackaging many times removed from the original underlying assets? On the other hand, how to distinguish between market data, which are indicative of fair value, and market data which relate to fire sale values achieved in a distressed or inactive market? In other words, liquidity could be an issue in practice. Bid-ask spreads can be large and companies have correlated positions and cannot all cash out simultaneously at the bid price, let alone the ask price.

### Model noise

Model noise could be introduced due to imperfect models and parameter estimates when liquid market prices are not available. This could also provide opportunities for managers to manipulate the mark-to-market value.

### Volatility

Volatility due to the use of fair value should not be the concern. Volatility could be an advantage when it reflects timely incorporation of new information (contrast with the smoothing of accounting numbers), especially after managers and users of the financial information get accustomed to it. However, volatility is a disadvantage when it reflects noise or manipulation.

As mentioned above, fair value accounting rules have been part of GAAP for many years. However, recently it has drawn a lot of attention due to the financial downturn and received many calls for change. No doubt, the dramatic falls in the market value of certain financial instruments as a result of the adverse changes to the fundamentals underlying those assets, and the entities holding those assets, are averse to booking these losses by using fair value accounting. As Lynn Turner, the former US Securities and Exchange Commission chief accountant, has been quoted as saying in response to banks' assertions that fair value accounting is the cause of the problem, 'the only thing fair value accounting did is force you to tell investors you made a bunch of very bad loans'.

## Restructuring Company Capital

### Issuance and Redemption of Shares

In Hong Kong, private and listed companies that wish to raise further capital by issuing shares traditionally underwrite that issuance. This involves appointing a lead underwriter who agrees to subscribe to any shares, at the issue price, which are not taken up by shareholders or other offerees. The lead underwriter will normally arrange with sub-underwriters to absorb the risk of having to subscribe to the underwritten shares. The arrangement is made by agreement with the company itself and its advisers.

### Deep Discount Issue

This method of issuing shares has often been shunned by the listed companies as it has a number of perceived disadvantages; for example, lack of certainty of proceeds, adverse impact on share price, an unwillingness of the company to adjust its dividend per share, and a belief that deep discounted share issues give a signal to the market that the company is weak. The guidance notes point out that, depending slightly on the size of the issue discount, it would not involve a cost to the existing shareholders provided they all receive a pro rata allocation of the new shares as a right. This way, the net assets of the company before and after the issue are owned in the same proportion by each shareholder. Even if a shareholder sells their nil-paid rights before being obliged to take up the subscription, the nil-paid rights will have a value very close to the size of the discount at the time of sale. There is a need to adjust earnings, assets and dividends per share accordingly, and this need is becoming widely accepted by institutional investors.

A deep discount issue need no longer be associated with weakness. Corporate rescues have often been structured to include a deep discount issue. This has encouraged a market perception that discounted issues are indicative of a company being in financial difficulty. However, a company with a good, strong track record and a supportive shareholder base should seriously consider a deep discount for the whole issue if the purpose is to raise additional investment capital, rather than for a specific acquisition. This will do away with the need for underwriting completely and lower the cost to the company. In any case, even a partially discounted issue will invariably alleviate some of the risk to a lead underwriter and should consequently reduce the standard underwriting fee incurred by the company.

### Share Repurchase

This is a universally popular practice, with stalwarts such as Coca-Cola, Intel, Chrysler and so on having carried out this exercise very successfully. Share buybacks are a way to compensate shareholders with a company's excess cash, as well as to enhance shareholder value in many ways. So why do companies increasingly show a preference for share buybacks and how does it really enhance shareholder value? One of the reasons companies are opting for share repurchases over dividends is that shareholders often prefer capital gains over the current income that comes from dividends. In addition, dividends are double taxed since all the profits a company earns are taxed at the corporate level. If a company wishes to pay out some of its profits in the form of a dividend, the overseas shareholders or institutional investors also have an income tax liability. In such an environment, it makes sense to go in for share repurchase activity.

Share repurchases by their very nature decrease the number of shares outstanding. Having fewer shares outstanding not only increases the relative percentage ownership of the remaining shareholders, but also the percentage claim on the company's profits. In another way, buying back shares increases the earnings per share (EPS) assuming that net income is at least steady. If a company can manage to increase earnings at the same time it is retiring shares, the growth in EPS is compounded. If a stock's price is its market-assigned

equity treats the beneficiaries as the real owner of the trust property by reference to the parties' real intention.

- It created the concept of *equity of redemption*, which is an equitable right of the mortgagor to redeem his land even after the date of redemption had passed because equity looks to the intent rather than form.
- It modified the existing common law rules. For instance, in the law of contract, equity would assist the party subject to undue influence to avoid the contract, or to rectify the contract if there were a mistake, or to rescind a contract if there were undue influence.
- It introduced new remedies where the common law remedy of damages was inadequate. They included *specific performance*, which was a court order requiring that the terms of a contract or trust must be complied with or carried out, and *injunction*, which was a court order forbidding or compelling the person subject to injunction to do or abstain from doing certain acts.

## Definition of Common Law and Equity

It is obvious that in one wider sense common law can be defined as that part of the law common to the whole of England, but which was not statute, local custom or royal prerogative. When the common law (in a restrictive sense) is contrasted with *equity*, it represents those rules of law that developed out of the old Common Law Courts before the Judicature Acts 1873–75. In a general sense, equity means fairness. In a legal context, equity means that body of rules applied by the Court of Chancery before its abolition by the Judicature Acts 1873–75. Common law, in its generic sense, means the common law and rules of equity in force in Hong Kong (section 10C(2) of the Interpretation and General Clauses Ordinance).

The main effects of the Acts were to transfer the jurisdiction of all the superior courts of common law and equity to a new Supreme Court of Judicature, such that there was fusion of the administration of common law and equity (that is, amalgamation of both the Common Law Courts and the Courts of Chancery in respect of their jurisdiction), but with their distinct body of rules and principles remaining unfused. Furthermore, it was enacted that in cases of conflict, the rules of equity shall prevail. The procedural rules were also simplified by the Judicature Acts by the creation a single set of rules to apply throughout the Supreme Court.

## Similarities between Common Law and Equity

Both common law and equity are law. In a wider sense, equity forms part of the common law. In a restrictive sense, they were separate systems of law applying different rules and principles by different courts of law before the Judicature Acts.

Both systems of common law and equity were developed by the doctrine of judicial precedent. Both systems of common law and equity have been partly embodied and codified in statute law; for example, the *Bills of Exchange Ordinance* (common law) and the *Trustee Ordinance* (equity).

As a result of the Judicature Acts 1873–75, both systems of law have been administered in the same courts. The Judicature Act applied to Hong Kong by virtue of section 5 of the old *Supreme Court Ordinance 1873*.

## Difference between Common Law and Equity

Common law is a complete and independent system, whereas equity only developed to remedy the defects of common law. It cannot exist in isolation. Its existence presupposes the existence of common law.

Equity 'acts *in personam*', while common law 'acts *in rem*'. It has two different meanings. First, common law rights are enforceable against anyone, whereas equitable reliefs are enforceable only against those whose consciences are affected. For example, persons (such as trustees) having knowledge that the right (for instance, beneficiary's interest) exists, but not against a third party (for example, those who have acquired trust property in good faith from the fraudulent trustee). Second, common law remedies are given against property by ordering the wrongdoer to pay monetary compensation to the persons who have suffered, in the form of damages, whereas equitable remedies of injunction and specific performance are awarded against the person, and if they are not complied with, are enforceable ultimately by imprisonment of that person for contempt of court.

Common law remedies of damages and/or *quantum meruit* are available 'as of right' as long as the plaintiff proves his claim. However, equity will only provide a remedy where the court is satisfied that it is required to achieve justice. In other words, the court would have discretion whether or not a particular equitable remedy will be granted.

At common law, a person must exercise his right of action within the time limits laid down in the *Limitation Ordinance*, whereas under equity, equitable remedies must be sought without undue delay, and it is a question of fact in each case whether this has been done. This is an equitable maxim that states, 'delay defeats equity', and this is usually referred to as the doctrine of laches.

If there is a conflict between common law and equity, then equity must prevail.

## The Common Law and the Rules of Equity under the Basic Law

The common law and the rules of equity are to be found primarily in the judgments of the superior courts in Hong Kong and other common law jurisdictions. In historical terms,



in writing). They derive their legal status entirely from the law of contract. It is with this kind of contract that we are primarily concerned.

A *void* contract is one that the law holds to be no contract at all. A contract is void when it is destitute of all legal effect. A contract is *voidable* when the law allows one of the contracting parties to withdraw from the contract if he so wishes. The distinction between void and voidable contracts is crucial where the interests of a third party are involved. A voidable contract remains effective unless and until the innocent party chooses to avoid it. For instance, in case of a contract for the sale of goods, if the buyer resells the goods before the contract is avoided, the sub-buyer becomes the owner and can retain the property provided that he purchased the goods in good faith. When a contract is void, ownership of the property that has been sold will not pass to the buyer, whom will not be able to sell it to anyone else. The original seller will be able to recover the property from whomever has it. A contract is *unenforceable* when, although it is valid if the parties perform it, it cannot be enforced in the courts of law if either party fails to do so. Property or money that has passed from one party to the other under the contract can be retained by that party. The contract can be used as a defence if the party brings a claim to recover the property or money. Therefore, the contract has some life and it is not void.

## The Essentials of a Valid Contract

A valid and enforceable contract must be formed on the following basis:

- There must be an offer and acceptance: the agreement.
- There must be consideration (unless the agreement is under seal).
- Certain types of agreement are only valid if made in a particular form; for example, in writing.
- The contracting parties must have the intention to create legal relations.
- The parties must have the appropriate capacity to contract.
- There must be genuine consent by the parties to the terms of the contract and the terms shall be clear and certain.
- The contract must not have been concluded as a result of undue influence, duress or misrepresentation.
- The contract must not be contrary to public policy or be otherwise illegal.
- The contract must be capable of being performed.
- The contract must not be frustrated by an intervening event.

## Offer and Acceptance

### Offer

An offer is a proposal made by one party (called the offeror) to another (called the offeree) with the intention that it shall become binding as soon as it is accepted. For example, A offers to sell a car to B with the intention that it shall become binding as soon as it is accepted. If

A offers to sell a car to B for HK\$20,000 and B accepts the offer, A cannot escape liability merely by showing that his actual intention was to offer the car to B for HK\$50,000.

An offer must be clear and certain; it may be made orally or in writing or by conduct.

An offer can be made to a particular individual or to a group of persons, or to the world at large. The offer remains open until it is terminated in one of the following ways:

By *revocation*—withdrawal of the offer and it will only be effective if it is communicated to the offeree before he accepts the offer. A promise to keep an offer open for a fixed period does not prevent its revocation within that period unless the offeree buys an option to keep the offer open for a fixed period.

However, if the offeree is aware that the offer is no longer open, this will operate as a revocation, no matter how he became aware of it, say from a third party. This rule, 'communication of revocation need not come from the offeror', can be a regrettable source of uncertainty and might not apply to Hong Kong as it is arguable that communication of acceptance must be either from the offeror himself or his authorised agent, and there is no reason why a similar principle should not apply to revocation of offer.

By *rejection* by the offeree: this causes the offer to lapse (but a promise to keep an offer open for a certain period is not binding unless under seal or given for consideration). Rejection is expressed when the offeree refuses the offer, or it may be implied; for instance, when the assent made by the offeree is subject to conditions or he makes a counteroffer. A counteroffer must be distinguished from a mere request for information. Similarly, if an offer is made for the sale of a home at a specified price, an inquiry whether the intending vendor is prepared to reduce the price will not amount to a rejection of the enquiry as 'merely exploratory'.

By *lapse of time*:

- An offer will expire after the expiration of a fixed time limit specified in the original offer.
- An offer that stipulates for acceptance 'by return' must normally be accepted either by a return post communication or by some other no less expeditious method.
- An offer that contains no express provision limiting its duration will lapse after a reasonable time. What is a reasonable time will depend on the nature of the offer.

By *death of either party*:

- death of offeror before acceptance—except where the offer is personal to the offeror, the offer remains valid until the news of death is communicated to the offeree
- death of offeree before acceptance—once the offeree is dead, the offer cannot be accepted
- death of parties after acceptance—death after acceptance usually has no effect unless the contract is for personal services.

By *failure* of a condition subject to which the offer was made. If the offer was made subject to a condition and that condition is not fulfilled, the offer is incapable of acceptance.

## Certainty of Terms

A contract will be void for uncertainty unless the parties make their contract in terms that are certain.

Moreover, there cannot be a contract to make another contract. The parties cannot, in other words, reach an agreement to keep in the future. The parties must agree on the terms that are definite or capable of being made definite without further agreement.

There cannot be a binding *lock-in* (an agreement where one is compelled to deal with a specific party in good faith); a binding *lock-out* agreement under which one promises not to deal with others for a fixed period is possible; that is, a collateral contract not to deal with others.

If the parties have agreed to a procedure whereby the terms could be determined either by conferring on a court of law or an arbitrator the power to fill in a term in their agreements, then the contract is binding.

If the whole contract consists of meaningless terms the contract is void. However, if the meaningless terms are secondary, the contract may be held valid and the meaningless term will be disregarded in law.

## Implied Terms

Implied terms may be divided into three groups:

- terms implied in fact; that is, which are not expressly set out in the contract, but which the parties intended to include
- terms implied in law; that is, terms imported by operation of law, although the parties may not have intended to include them
- terms implied by custom.

### Terms Implied in Fact

One test for a term to be implied in fact is the *officious bystander* test, by which the courts decide whether, if it had been suggested at the time the contract was made that the clause should be included, the parties would have readily agreed; that is, the parties would respond with a common 'of course'. For a term to be implied into a contract it must be obvious and essential. It is not sufficient that the term should be reasonable.

A second test for the implication of a term in fact is that of *business efficacy*, the judge regarding himself as doing merely what the parties themselves would have done in order to cover the situation if he had addressed themselves to it, and to make the contract workable; that is to say, to give them *business efficacy*.

### Terms Implied in Law

#### *Terms Implied in Court*

While the basic objective of the courts is to give effect to the intentions of the parties, there are areas where the question of implied terms has arisen so frequently that a set of implied

terms has been established by case law that the court will apply wherever this type of contract arises. Thus there are, for example, a series of rights and duties implied into contracts of agency, employment and tenancy.

There are also a number of implied duties owed by a banker to his customers that include the duty to accept money and collect cheques; to honour cheques or orders drawn on them by his customers; to keep secrecy about his customers' affairs. In return the customers have implied duties to exercise reasonable care in drawing cheques so as not to mislead the bank or facilitate forgery.

Under a contract of employment, an employer owes an implied duty to take reasonable care for the safety of his employees, not to endanger the employees' health and not to require the employee to do any unlawful act; and an employee owes a duty to act in good faith, to exercise reasonable care and skill in the performance of his duties, to obey the employer's lawful and reasonable instructions, not to act against the employer's interest, and to indemnify his employer against liabilities incurred as a result of his wrongful acts.

There is an implied term in a tenancy agreement of a furnished house that the house is 'reasonably fit for human habitation'. In the case of a multi-storey building consisting of undivided shares allocated to individual flat owners, there is an implied term imposed on the developer or the management company that has been appointed to take care of the management of the building to maintain common areas.

#### *Term Implied by Statute*

For some types of contract, the terms are implied by statute irrespective of the intention of the parties. Examples can be found in the *Sales of Goods Ordinance*, the *Supply of Services (Implied Terms) Ordinance* and the *Personal Data (Privacy) Ordinance*.

Some of the duties imposed by the *Sales of Goods Ordinance* can be freely altered by the parties. Therefore, unless there is a contrary agreement, delivery of the goods and payment of the price are concurrent conditions. However, the parties may agree to depart from this rule so that the buyer is allowed credit and takes possession of the goods before payment.

Other sections of this Ordinance impose duties irrespective of the wishes of the parties, and these may only be excluded in certain circumstances provided the exclusions are reasonable. They are appropriately set out in sections 14 to 17 of the Ordinance, which are primarily concerned with the title of goods; whether the goods are free from encumbrance; whether the goods correspond with the contractual description; whether the goods are of merchantable quality and fit for the purpose for which they are bought; and whether the goods correspond with the samples provided. Exclusion from the operation of these provisions is invalid where a consumer is involved.

The *Supply of Services (Implied Terms) Ordinance* imposed the following three implied terms:

- service will be carried out with reasonable skills and care
- if the parties have not agreed when the services will be carried out they will be carried out within a reasonable time
- the party contracted with the supplier will pay a reasonable price for service rendered.

## The Meaning of Representation

A representation is a statement made by one party to another to induce him to enter a contract. It must be a positive statement of some existing facts or past events, and so the following are excluded:

- statements of law—unless they are:
  - wilful misrepresentations of the law
  - statements of mixed law and fact; for example, the content of a piece of legislation is law whereas the content of a legal document is fact
  - representations as to the nature or effect of private rights
  - where the maker has superior knowledge and he believes that the other party will rely on his opinion.

Promises should be referred to *Future Behaviour or Conduct* as follows:

- statements of intention—unless it can be proved as a matter of fact that there was no such intention
- statements of opinion—unless it can be proved as a matter of fact that the speaker does not have any such opinion
- mere *puffing*, as for example, any statement used in advertising.

Silence does not normally amount to representation, except in the following cases:

- where it distorts a positive representation—a half-truth may have the same effect as a lie
- where a statement, true when it is made, subsequently becomes false before the conclusion of the contract
- as regards contracts where statute requires disclosure
- as regards contracts *uberrimae fidei* (of the utmost good faith), such as contracts of insurance and family settlements where full and frank disclosure must be made
- in cases of concealed fraud.

## Type of Actionable Misrepresentation

A misrepresentation may be (i) fraudulent, (ii) innocent or (iii) negligent.

### Fraudulent Misrepresentation

This occurs when the statement is known to be false, or made without belief in its truth, or recklessly and without caring as to whether it is true or false. Fraud is a serious charge that must be clearly and distinctly proved by the misled party. The burden of proof on the misled party is a heavy one.

### Innocent Misrepresentation

The statement is made with reasonable grounds to believe that it is true, but turned out to be untrue.

### Negligent Misrepresentation

There have been no reasonable grounds for believing the statement is true, but it was made honestly. It is made carelessly and in breach of a duty owed by the representor to the representee to take reasonable care that the representation is accurate.

## Undue Influence

Undue influence—that is, the influence of one mind over another—is an equitable doctrine under which a contract may be voidable as if the contract is made under pressure or there is an element of control by force. The test is whether free judgment has been exercised or whether the weaker party is able to freely consent to the contract. There are two types of undue influence: actual and presumed. The party who claims relief on the ground of actual undue influence must prove that such influence existed and had been exerted by the other contracting party, and that the transaction resulted from that influence. There is no longer a prerequisite in cases of this kind that the transaction must be shown to be to the manifest disadvantage, meaning a clear and obvious disadvantage, of the party seeking to set it aside.

In some situations, where there is a fiduciary relationship between the parties, undue influence is presumed; such influence will prevail unless rebutted by the party benefiting from the transactions. The presumption arises in relationship between, for example, parent and child; trustee and beneficiary; solicitor and client; doctor and patient; priest and communicant; teacher and pupil. Thus, in these situations, there is no need to show that undue influence existed and had been exerted. Undue influence may also arise from a long relationship of confidence and trust between the parties; for example, between husband and wife, employer and employee, or where one party had been accustomed to rely for guidance and advice on the other. Where undue influence is presumed to have been exercised, the weaker party must also suffer a real and obvious disadvantage. The presumption of undue influence is rebutted if the party benefiting from the transaction shows that there was 'free exercise of independent will'.

## Effect on the Contract

A contract induced by undue influence is voidable, and confers a right to rescission. Like the remedy for misrepresentation, the claim for right of rescission of the contract may be refused where:

- the plaintiff's conduct has been tricky or unfair
- the plaintiff has delayed unreasonably in seeking relief.

Trusts originated in medieval times when the settlor wanted to avoid the obligations imposed on him by feudalism. Nowadays they are used in the following situations:

- to enable land to be held for the benefit of persons who cannot hold it themselves; for example, a minor
- to enable two or more persons to hold land jointly; for example, a couple
- to enable the settlor to make secret dispositions of his property; for example, to a mistress
- to enable the settlor to benefit persons in succession
- to enable the settlor to benefit non-human objects; for example, animals
- to enable the setting up of provident fund and pension schemes
- to facilitate estate duty and income tax planning
- for the purpose of asset protection.

Trust law is mainly concerned with the relationship between trustee and the beneficiary. The trustee is the legal owner of the trust property whose duty is to manage the trust that has been established. He is also the equitable owner of the trust property. The essence of the trust relationship is the separation of legal ownership of the property from its enjoyment. The settlor no longer owns the assets that he has put into the trust but, in a way, he retains certain control therein. The way the settlor normally retains control is by establishing a series of rules and regulations in a legal document known as the trust deed, which governs how the assets are to be dealt with. The trustee owns the property but he has no right to enjoy it. The beneficiary has the right to enjoy the property but has no control over it. For example, a settlor may tell a trustee:

‘You are to hold this property on terms that my widow gets the benefit during her life, after that my son gets the income. When my son is 25 years old, you should distribute to my son all remaining capital and income in the trust.’

## Classification

The concepts of trust can be classified in the following manner by reference to the purpose and the way in which it is created:

- *Express trusts* whether public or private are set up expressly by the settlor and they are the most common form of trust.
- A *charitable trust (public trust)* is created for the benefit of the community at large.
- A *private trust* is created for the benefit of an individual or a group of individuals.
- A *statutory trust* is one where the trust is regulated by legislation; for example, a statutory trust for sale on behalf of the children of a deceased under the *Intestates' Estates Ordinance*.
- A *resulting trust* is a non-express trust based on the presumed or inferred intention of the settlor. In resulting trusts the beneficial interests result (that is, go back) to the settlor and, if he dies, his estate.

- A *constructive trust* arises by operation of equity, irrespective of the expressed or implied intentions of the parties. Equity will impose the constructive trust whether when justice requires or to avoid unfair results, and is based on what good conscience demands.

## Express Private Trusts

These are trusts that are formed by the stated (*expressed*) wish of the settlor. He may either make a gift *inter vivos* during his lifetime or in his will; or he may declare himself to hold as trustee, property of which he is already the legal owner. For such a trust to arise, the settlor must clearly spell out his intention to create a trust. Three certainties are essential for the creation of an express trust.

### Three Certainties

*Certainty of intentions (or words)*—the person who is attempting to establish the trust must make it clear by the words he uses that the holder or transferee of the property is under mandatory legal obligation to carry out the wishes of the settlor in so far as the law allows. If A wishes to convey land to B on trust for C, he must use words that clearly spell out his intention for a trust to arise, and that he does not wish B to take the property beneficially. Use of the word *trust* is not absolutely necessary since other words may be constructed as equally imperative in substance. *Precatory*, or praying words (that is, words beseeching or hoping) do not generally have this effect. In some instances, however, precatory words used by the settlor have been held to establish a trust. Occasionally the courts are able to deduce the material intention to create a trust from a combination of words and conduct, or by having regard to surrounding circumstances, where words alone would be indecisive.

*Certainty of subject matter*—not only the settled property must be certain but also the beneficiaries' interest in the property must be certain. Uncertainty regarding the trust property most commonly arises:

- where the terms used to define or describe it are ambiguous or imprecise
- where the property is given to one person with an imprecise gift over the surplus in favour of another.

Unless the interests to be held by the beneficiaries are certain, the trust is also liable to fail.

*Certainty of objects*—a private trust must be for the benefit of persons and not for abstract impersonal purposes. The trust is judged to be valid only where such persons are certain.

To determine whether the objects of a trust are sufficiently certain, the courts look at whether the trust is non-discretionary or discretionary. There is a non-discretionary trust where the settlor prescribes the interests of the beneficiaries. A trust is discretionary when a settlor declares a trust in favour of a class, but confers a discretion on the trustee to

- The drawee of a cheque is a banker.
- The drawee of a cheque is not liable to the holder for payment, since the banker never accepts the cheque.
- The rules on acceptance do not apply to cheques.
- As most cheques are usually not negotiated, the rules on negotiation have little significance.
- Delay in presenting a cheque for payment does not discharge the drawer, unless he suffers actual loss through the delay.
- The rules concerning crossings are confined to cheques and certain other instruments and not to other bills of exchange.
- Payment of an order cheque with a forged or unauthorised endorsement discharges the paying banker (though certain statutory exemptions apply), but, in the same situation, the acceptor of a bill of exchange would not be discharged.
- Based on the contractual relationship between a banker and a customer, a number of implied obligations are imposed on them towards one another by law. This applies to cheques accounts generally.

## Negotiation of Cheques

Generally, the holder of a cheque may negotiate it to another person in the manner considered below. The exception to this general rule is that a cheque which contains words prohibiting transfer, or indicating an intention that it should not be transferable, is incapable of negotiation though it is perfectly valid 'as between the parties thereto'. Hence, if a cheque is drawn payable to a specified person followed by the word *only*, it is incapable of negotiation though it is valid as between the drawer and the payee; cheques drawn in this manner are seldom encountered in practice. However, a cheque that is payable simply to a specified person without the addition of the words *or order* is negotiable in the normal way. Further, even if a cheque is crossed *Account payee*, it is still negotiable.

### How Cheques are Negotiated

A cheque is negotiated when it is transferred from one person to another in such a manner as to constitute the transferee as the holder of the cheque (section 31(1) of BOEO). A cheque payable to bearer is negotiated by delivery alone, whereas a cheque payable to order is negotiated by the endorsement of the holder completed by delivery. If the holder of a cheque payable to his order transfers it for value without indorsing it, the transfer gives the transferee such title as the transferor had in the instrument and, in addition, the transferee acquires the right to have the endorsement of the transferor.

## Meaning of Endorsement

Endorsement means 'an endorsement completed by delivery'. Endorsement of cheque may be defined as the signature on a cheque, usually on the back, by the holder or by his duly authorised agent, followed by delivery of the instrument, whereby the holder of a cheque payable to his order negotiates it to another person who takes it as a new holder.

### Blank and Special Endorsement

An endorsement may be either in blank or special. An endorsement in blank specifies no endorsee and its effect is to make the instrument payable to bearer. A cheque endorsed in blank may be negotiated by delivery.

A special endorsement specifies the person to whom, or to whose order, the instrument is to be payable. Thus a cheque endorsed 'Pay to X' or 'Pay to the order of X' is specially endorsed, and X, the endorsee, may further negotiate it by endorsement and delivery.

When a cheque has been endorsed in blank, any holder may convert the blank endorsement into a special endorsement by writing above the endorser's signature a direction to pay the cheque to, or to the order of, himself or some other person. If the holder writes a direction to pay some other person and delivers the cheque to that person, the holder has negotiated the cheque by special endorsement, but without himself endorsing the instrument or assuming liability thereon as an endorser. Nevertheless, he may be liable as a transferor by delivery.

There is one case where a special endorsement does not have the effect of making a cheque payable to the named endorsee or his order; namely, where the cheque was originally drawn payable to bearer. This is because the BOEO provides that a bill or cheque is payable to bearer, which is expressed to be so payable, or on which the only or last endorsement is an endorsement in blank. So, if a cheque is drawn payable to bearer, it remains a bearer cheque during the rest of its life and no special endorsement can ever make it payable to order.

However, if a cheque that was originally drawn payable to order is endorsed in blank and is then specially endorsed, it would seem that the special endorsement is fully effective, and that it *controls* the previous endorsement in blank. Thus, the cheque becomes payable to the named endorsee or order.

### Requisites of Valid Endorsement

The signature of the cheque holder or of his duly authorised agent is essential for the validity of an endorsement.

A signature by procuration operates as notice that the agent has but a limited authority to sign. His principal will then only be bound by such a signature if the agent in so signing was

Thus, if a drawee bank sees no evidence of the above and pays the cheque as it appears to him to warrant, he will not be responsible for any loss that may be sustained by the true owner as a result of the unauthorised tampering with the crossing.

Section 78 further provides that crossing is a material part and may not be cancelled.

It should be noted that any cheque holder may do the following:

- cross an uncrossed cheque
- change a general crossing to a special one
- add the words 'Not negotiable.'

## Not Negotiable

When this is added to a crossed cheque, it has the effect that if transferred, the transferee gets no better title than the transferor. Section 81 of the BOEO provides that:

Where a person takes a crossed cheque which bears on it the words 'not negotiable', he shall not have, and shall not be capable of giving, a better title to the cheque than that which the person from whom he took it had.

This section points out that the negotiability of a crossed cheque is destroyed by adding the words 'Not negotiable' to the crossing. These words do not affect the transferability of the cheque, but prevent a transferee from acquiring a better title to the cheque than that of his transferor.

A 'Not negotiable' crossed cheque can circulate just as freely as an ordinary, negotiable cheque, and so long as no defect of title arises in the circulation of the former the position is exactly the same as with the latter. But once a defect of title occurs in relation to a 'Not negotiable' cheque, then all subsequent holders take subject to that defect.

Hence, the use of 'Not negotiable' on a crossed cheque is beneficial to the drawer of the cheque, which is why some drawers always add the words when making out cheques, and cheque books specially printed at the request of company customers often include them. The reason is that a subsequent holder for value after a defect of title has arisen cannot set himself up as a holder in due course so that if, for example, the drawer has already stopped payment of the cheque, he cannot be successfully sued by the holder, however innocent the latter may be.

## 'A/C Payee' or 'A/C Payee Only'

These words have no statutory significance because the BOEO does not mention them. They are not binding on the paying bank and do not affect the transferability or negotiability of the cheque. However, a collecting bank would disregard them at its peril. It is the collecting bank and not the paying bank that is in a position to see that the direction is obeyed.

In collecting a cheque cross 'A/C payee' for someone other than the specified payee, the collecting bank would be negligent and liable to the true owner if the collecting bank disregards the direction and pays the money into a third party account without first making an enquiry with the payee.

## A Banker's Duty to Honour Cheques

The banker is obliged to honour a customer's cheques up to the amount of his credit balance or agreed overdraft. The banker's duty to honour the cheque ends:

- on countermanding of payment by the customer—commonly known as 'stop'
- on receiving notice that the customer has died or is insolvent
- on receiving notice of bankruptcy or liquidation of the customer
- if a receiving order is made against the customer
- on receiving notice of mental disorder of the customer
- on receiving a garnishee order against the customer's account
- on receiving a court order freezing the customer's account.

Section 75 of the Ordinance provides that:

The duty and authority of a banker to pay a cheque drawn on him by his customer are determined by:

- countermand of payment
- notice of the customer's death.

A banker will pay without mandate if he overlooks or ignores notice of countermand of payment by the customer and he cannot debit the customer's account. A banker is justified in paying a cheque after the customer's death, but before he receives notice thereof.

## The Cheque Clearing System

In practice, banking payment involves two basic steps:

- The person paying the money gives a payment order to the bank holding the funds.
- The bank transfers the fund to an account of the recipient with the same or another bank or financial institution.

These steps remain valid regardless of whether the procedures adopted are paper-based or electronic—transfer—operated.

Traditional payment methods include negotiable instruments such as cheques and bills of exchange. These are ways by which one person orders another to pay to a beneficiary

- there are sufficient funds
- there is no legal bar.

In paying any crossed cheques, protection of the paying bank is available under section 80 of the Ordinance, which requires that cheques must be paid in good faith, without negligence and in accordance with the crossing.

Although the banker enjoys statutory protection, this does not entitle the person who has been paid by the banker to retain the money he has received, and the true owner can sue him to recover the money in an action for conversion.

There is no statutory protection for the paying banker where the drawer's signature is forged, or where a cheque is void as a result of material alteration. Under such circumstances, the banker cannot generally debit his customer's account. However, the customer must bear any loss caused by breaching his duty to carefully draw a cheque in such a way that no alteration could have been made. Sometimes the customer is stopped, for example, if the banker suffers detriment from the customer's failure to notify him promptly after discovering that his signature has been forged.

## Protection of Collecting Banker

There are three possible kinds of protection for a collecting banker; namely, those concerned with:

- holder for value/holder in due course
- section 86 of BOEO
- contributory negligence.

A collecting banker can act as a holder for value or a holder in due course under the following situations:

- Where a bank has cashed or exchanged a cheque for a customer or any other holder. In this case, the bank has bought the cheque and when it collects the cheque it is doing so on its own behalf.
- If a cheque is paid in for the express purpose of reducing the customer's overdraft.
- If there is a definite authority or agreement between the bank and its customer that the customer may draw against uncleared items.
- Where the bank has paid cheques against uncleared items as a regular practice.

As a holder in due course, a banker can obtain an indefeasible title to the cheque. But this defence is not open to him if the cheque is not transferable.

Section 86(1) of the BOEO provides that:

Where a banker, in good faith and without negligence—

Receives payment for a customer of an instrument to which this section applies; or

Having credited a customer's account with the amount of such an instrument, receives payment thereof for himself,

And the customer has no title, or a defective title, to the instrument, the banker does not incur any liability to the true owner of the instrument by reason only of having received payment thereof.

In order to qualify for protection under this section, a banker must act:

- in good faith
- for a customer
- without negligence.

1. *Good faith* means things done honestly, whether negligently or not (section 96).
2. *Customer* means an account holder, whether current, savings or deposit account. It covers the position where a person opens an account by paying in a cheque.
3. *Without negligence* means whether the transaction of paying in any given cheque, coupled with the circumstances antecedent and present was so out of the ordinary course that it ought to have aroused doubts in the bankers' minds, and caused them to make enquiry and to have received a satisfactory answer that would satisfy a businessman. The onus is on the bank to prove the absence of negligence. Courts have tended to call for a very high standard of care from banks in this respect. The following are examples of *negligence* as emanating from case law:

## Negligence Cases when Opening Account

- failure to make proper enquiries concerning a new customer on opening an account; for example, not to require identification such as the Hong Kong Identity Card, and proof of residence at the given address
- failure to take up a reference
- failure to ask for the customer's employment
- failure to ascertain the occupation of the customer's husband of a married woman customer.

## Negligence Cases when Collecting Cheques

- collecting without enquiry for the private account of a cheque payable to the firm
- collecting without enquiry for the private account of an official of a cheque payable to the company and endorsed by that official
- collecting for the private account of an official cheque payable to the holder in his official capacity