



Hong Kong

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EXCHANGE'S REVIEW OF DISCLOSURE IN ISSUERS' ANNUAL REPORTS TO MONITOR RULE COMPLIANCE REPORT 2016

In January 2017, the Hong Kong Stock Exchange (**Exchange**) released its "Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance" ("**Review**") covering annual reports with financial years ending between January and December 2015. The Exchange reviews issuers' annual reports as part of its monitoring and compliance responsibilities, with a focus on compliance with the Listing Rules, corporate conduct, and disclosure of material events and developments.

Introduction

An annual report must contain material and relevant information about an issuer's financial results and position, and assist investors to assess its past performance and future prospects. The annual report should contain a balanced discussion of all significant matters of the issuers' businesses, including both positive and negative circumstances, in the "management discussion and analysis" section ("**MD&A**").

The minimum information that an issuer must include in its annual report is set out in the Listing Rules and applicable accounting standards. An issuer should also supply additional information that is relevant to shareholders and investors in accordance with its own circumstances.

Issuers may also be requested by the Exchange to make further disclosures by way of announcements or in subsequent financial reports, where appropriate.

Disclosure of business review and significant securities investment in the MD&A section

The MD&A section of an annual report is designed to provide meaningful information that enables shareholders and investors to properly appraise an issuer's performance and prospects. The minimum required disclosures and recommended additional disclosures for the MD&A section are set out in paragraphs 32 and 52 of Appendix 16 to the Listing Rules, respectively.

For accounting periods ended on or after 31 December 2015, an annual report must include a business review section that complies with Schedule 5 of the Companies Ordinance. Under these new rules, the following disclosures are required:

- a) A directors' report for a financial year must contain a business review that consists of:
 - i) a fair review of the issuer's business;
 - ii) a description of the principal risks and uncertainties facing the issuer;
 - iii) particulars of important events affecting the issuer that have occurred since the end of the financial year; and
 - iv) an indication of likely future development in the issuer's business.

¹ <https://www.hkex.com.hk/eng/rulesreg/listrules/guidref/Documents/rdiar-2016.pdf>

- b) To facilitate a better understanding of the development, performance and position of the issuer's business, a business review must also include:
- i) an analysis using financial key performance indicators;
 - ii) a discussion on the issuer's environmental policies and performance and its compliance with the relevant laws and regulations; and
 - iii) an account of the issuer's key relationships with its employees, customers and suppliers and others on which its success depends.

Findings

Business Review

The Exchange noted that issuers generally followed the new rule of including a business review section and made the relevant disclosures. However, in many cases, the disclosures were too generic, and the Exchange made several recommendations in its Review.

Principal risks and uncertainties affecting the issuer

The Exchange expects issuers to discuss specifically how the major risk areas would affect their business operations, the potential financial impact, and whether they had implemented any measures to manage the risk areas.

Environmental policies and performance, and compliance with the relevant laws and regulations

The Exchange recommended that issuers should include more detailed disclosures in relation to the environment, including whether and how the relevant laws or regulations would have a material impact on their operations, and, where applicable, the historical compliance record and details of the non-compliance.

Key relationships with employees, customers and suppliers

The Exchange recommended issuers to disclose in their annual reports information concerning major customers, including length of relationship, credit terms, details of the subsequent

settlement of trade receivables and whether any provisions are necessary, and the risks associated with reliance on major customers, as well as measures to mitigate such risks.

Financial key performance indicators ("KPIs")

The Exchange recommended issuers to explain the reason for selecting or changing the key performance indicators ("KPIs") and how they are effective in measuring their business performance and how they are linked to the issuer's objectives, the trend each of the KPIs represents, and the reasons for any differences between the KPIs and figures reported under accounting standards in the financial statements.

Significant Securities Investments

Pursuant to paragraph 32(4) of Appendix 16 to the Listing Rules, issuers are required to disclose their significant investments held, their performance during the financial year and their future prospects.

The Exchange reviewed annual reports of issuers with significant securities investment, and found that a majority did not include sufficient information about their investments in their annual reports.

The Exchange recommended issuers to disclose the following:

- a) a breakdown of major investments held, including the names and principal businesses of the underlying companies, the number or percentage of shares held and the investment costs;
- b) the fair value of each major investment as at the financial year end date and its size as compared to the issuers' total assets;
- c) the performance of each major investment during the year, including the change in fair value, gain or loss on disposal and dividends received; and
- d) a discussion of the strategy for future investments and the prospects of these investments.

Financial statements with auditors' modified opinions

Issuers are required to provide shareholders with financial statements which fairly present their financial position and performance and do not contain material misstatements.

Issuers are required under paragraph 3 of Appendix 16 to the Listing Rules to provide more detailed and/or additional information if their financial statements do not give a true and fair view of the statement of affairs, results of operations and cash flows.

Findings

Issuers generally did not provide additional information in relation to the modifications or how they intended to address the issues giving rise to the modifications.

- *Material uncertainty on whether the financial statements can be prepared on a going concern basis* – Most issuers were able to disclose the basis upon which the directors considered that their financial statements could be prepared on a going concern basis.
- *Modifications brought forward from previous years* – Issuers were generally silent on whether these modifications would be removed or resolved.
- *Limitation of scope to measure the value of assets and liabilities due to various reasons* – Where auditors issued modified opinions on account balances due to failure to obtain sufficient audit evidence on an impairment assessment, the issuers generally did not disclose the basis on which the management considered an impairment to be unnecessary, and did not explain why the required audit evidence was not available for auditors.
- *Departure from accounting standards* – Issuers generally did not disclose whether this modification would be removed or resolved.
- *Internal control issues* – Some issuers were unable to provide auditors with sufficient audit evidence to substantiate the substance and rationale of certain prepayments, thereby resulting in modifications, which may suggest deficiencies in their internal controls.

The Exchange in its Review emphasised that pursuant to the Corporate Governance Code, the board is responsible for ensuring that (a) the issuer establishes and maintains appropriate and effective internal control systems, and (b) a review of the effectiveness of these systems is conducted at least annually and is reported to shareholders in its Corporate Governance Report.

The audit committee should monitor the integrity of the annual reports and review any significant financial reporting judgements included in the annual reports, the going concern assumptions and any modifications, and compliance with accounting standards. It should also give due consideration to any issues raised by the auditors and oversee the issuer's internal control systems.

The Exchange recommended that issuers should provide more detailed and additional information so as to enable shareholders to better appreciate the modifications and their actual or potential impact on the issuers' financial position.

Management should clearly explain their position and the basis for such position in relation to major judgmental areas (for example, going concern assumptions and the valuation to support the fair value of assets) in the annual reports. The audit committee should critically review these areas, and ensure that any disagreement with management's position is disclosed in the annual report.

Issuers and their audit committees should engage in early discussions with the auditors regarding the audit plan and how to address the issues that gave rise to the previous year's modifications in the following financial year.

Continuing connected transactions

Under Chapter 14A of the Listing Rules, in each financial year, an issuer must report its continuing connected transactions ("CCTs") in its annual report, and the independent directors and auditors are required to review the issuer's CCTs and report their findings in the annual report.

The Exchange, in its Guidance Letter GL73-14, offers guidance to issuers and independent directors regarding the monitoring of CCTs so as to ensure that they are conducted in accordance with the framework agreements and in compliance with the connected transaction rules.

Findings

Issuers confirmed to the Exchange that they have in place internal controls and procedures to ensure that CCTs are conducted in accordance with the framework agreements. A majority of issuers also confirmed that they have taken measures to periodically counter-check whether their internal controls are effectively enforced. Although a majority of issuers provided supporting documents and verification records to independent directors for their annual reviews, a minority

of issuers only provided their management confirmation on fairness and reasonableness of the transactions, and external auditors' confirmation letter to the independent directors.

In its Review, the Exchange reminded issuers that they should have in place adequate internal control procedures so as to ensure that CCTs are conducted in accordance with the pricing policies or mechanism under the framework agreements and in compliance with the Chapter 14A connected transaction rules. Issuers should also take steps to review their CCTs and internal control procedures to ensure compliance with the Listing Rules. They should further ensure that their internal audits review these transactions and the adequacy and effectiveness of internal control procedures, and provide sufficient information to the independent directors to assist them in performing their annual review.

Independent directors should ensure that the methods and procedures established by the issuer are sufficient so that the transactions are conducted on normal commercial terms and are not prejudicial to the interests of the issuer and its minority shareholders. The independent directors should also ensure that appropriate internal control procedures are in place, and that the issuers' internal audit reviews CCT transactions. The independent directors should make appropriate enquiries with the management in order to ensure that they are given sufficient information to properly review the transactions and the internal control procedures.

Fundraisings through issue of equity / convertible securities and subscription rights

Under the Listing Rules, issuers are required to report on their fundraisings carried out during the financial year in their annual reports. The Exchange reminded issuers in its previous review reports to avoid generic descriptions and to provide meaningful updates on the actual use of proceeds. Issuers should also account for any unutilized proceeds and discuss their intended uses.

In regards to new issue of convertible securities and warrants, issuers are required to disclose in their annual reports specific details of the class, the number and terms of the convertible securities and warrants issued, the consideration received by the issuers, and particulars of any exercise of the conversion or subscription rights during the year.

Where adjustment is made to the conversion or subscription price of convertible securities or warrants issued under a general mandate, the issuer is required to confirm whether it

has sufficient mandate to issue further shares upon conversion or subscription. Further, Exchange approval is required prior to the alteration of the terms of the issued convertible securities or warrants.

In relation to large scale fundraisings, the Cash Company Rules may apply where the fundraisings involve investors injecting substantial amounts of cash into the issuers. Concerns regarding circumvention of the Cash Company Rules may be raised where there is a change in the proposed use of proceeds.

Findings

All issuers

The Exchange noted an improvement in comparison to last year in the number of issuers that disclosed details of the application of proceeds, as well as the level of details disclosed. In relation to issuers that have issued convertible securities and warrants, issuers generally complied with the disclosure and approval requirements.

Large scale fundraisings

The Exchange found that all issuers applied their proceeds according to the intended uses stated in their circulars, and did not find concerns about possible circumvention of the Cash Company Rules.

The Exchange encourages issuers with large scale fundraisings to disclose detailed breakdowns of the application of proceeds in table form, comparing the actual application against each of the intended uses and the expected timeframe previously stated in their circulars.

Updates on material changes and results of performance guarantees after acquisition

Information regarding acquired businesses, including circumstances concerning any material asset impairments, should be disclosed in the MD&A section of annual reports.

The Exchange recommended in its previous review reports that where an asset impairment is supported by an independent valuation, the issuer should disclose details of the value of inputs, the reasons for any significant changes in the value of the inputs, as well as any assumptions underlying the value of

inputs and reasons for any changes, the valuation method and the reasons for using that method, and an explanation of any subsequent changes in the valuation method.

Acquisition agreements may include performance guarantees of the acquired business with the vendor agreeing to compensate the issuer for any shortfall or adjust the consideration based on agreed formulae if the guarantees are not met.

The Listing Rules set out the disclosures required in an announcement and the annual report regarding any performance guarantee given by a connected person where the actual performance fails to meet the guarantee. The Exchange, in its previous review reports, recommended that, regardless of whether the performance is guaranteed by a connected person or an independent party, the issuer should publish an announcement and disclose in its annual report the acquired business' performance, whether the performance guarantee has been met, and where the performance guarantee is not met, how it would enforce the obligations of the guarantor under the acquisition agreement.

Findings

Material impairment to acquired assets

The number of cases where a material impairment was made to acquired assets significantly increased in 2016 compared to 2015. Generally, these impairments were caused by a slowdown in the market condition of the relevant industry or a decline in the trading price of the commodities produced and/or traded by the acquired businesses. The Exchange found that a large majority of issuers adhered to its recommendations in its previous review reports.

Performance guarantees

The Exchange found that in all cases of performance guarantees, issuers disclosed whether the performance guarantees were met, and if not, whether and how the guarantors fulfilled their obligations under the agreements. Two-thirds of the performance guarantees were met, and where they were not met, the guarantors compensated issuers usually according to the terms of the agreements as set out in the acquisition circulars. Where the issuers did not receive compensation, they either took legal action or the guarantee period was extended following negotiations.

Share award schemes

Generally, share awards are satisfied by (a) existing shares acquired or to be acquired by the trustee from the market; (b) new shares to be issued to the trustee under a general (or specific) mandate; or (c) a combination of both.

The requirements of Chapter 14A (Connected Transactions) apply to any issue of new shares to connected persons, and the Model Code for Securities Transactions by Directors of Listed Issuers (Appendix 10 to the Listing Rules) applies to awards of new or existing shares to connected persons.

Under the Listing Rules, issuers are required to include in their annual reports a discussion on the remuneration of employees and remuneration policies.

The Hong Kong Financial Reporting Standard 2 "Share-based Payment" applies to award schemes. This standard requires disclosure of the nature and extent of share-based payment arrangements existing during the reporting period, including a description of each type of share-based payment arrangement (including terms and conditions) and the movements of share awards during the reporting period.

Findings

The Exchange found that a large majority of issuers disclosed the major terms of their share award schemes in their discussions on the remuneration of employees and remuneration policies, and that most issuers disclosed movements in the share awards.

The Exchange did not identify any potential breaches of the connected transaction listing rule requirements.

Contractual arrangements adopted by issuers

The Review also covered contractual arrangements adopted by issuers engaged in businesses subject to foreign ownership restrictions listed on the PRC's Foreign Investment Industries Guidance Catalogue. These issuers use contract-based arrangements or structures, commonly known as VIE structures, to indirectly own and control such businesses and the operating entities.

In its last review, the Exchange found that a vast majority of issuers with such contractual arrangements did not follow the disclosure requirements as set out in Guidance Letter GL77-14. These disclosures include: (a) particulars of the operating

entity and its registered owners, and a summary of the major terms of the structured contracts; (b) a description of the operating entity's business activities and their significance to the issuer; (c) the extent to which the structured contracts relate to requirements other than the foreign ownership restriction; and (d) the reasons for using contractual arrangements, the associated risks and actions taken by the issuer to mitigate the risks.

In relation to requirements other than the foreign ownership restriction, the issuer should, upon legal advice, reasonably assess the requirements under the applicable rules and take all reasonable steps to comply with them. Where they are unable to fully comply with such requirements before the establishment of the contractual arrangements, they are required to commit financial and other resources to ensure full compliance.

The Exchange encourages issuers to publish the Structured Contracts on their websites in order to promote transparency.

Findings

Disclosure of VIE structures improved in 2016, with more than 80% of VIE-issuers making disclosures in their annual reports in accordance with the guidance.

The Exchange found that around one-third of VIE-issuers are subject to requirements other than the foreign ownership restriction, and that a majority of them disclosed in their annual reports details of these other requirements and their plans for fulfilling these requirements.

A majority of VIE-issuers published the structured contracts on their website, as recommended by the Exchange.

Issuers listed in 2014 and 2015

The Exchange reviewed new issuers' Listing Rule compliance and annual report disclosure, and made the following findings and recommendations:

Profit forecasts and material changes in financial results

All profit forecasts published by newly listed issuers were met.

Newly listed issuers who issued profit warnings or positive profit alert announcements generally did not fully observe the guidance that such announcements should disclose material developments following the prospectus date that have not been

disclosed by the issuer. The reasons for most profit warnings were already disclosed in the prospectus. The Exchange also encourages issuers when preparing profit warning or positive profit alert announcements to describe the potential impact quantitatively so as to allow investors to better understand the actual situation.

Changes in the use of IPO proceeds

All cases (except one) properly explained the reasons for changes in the use of IPO proceeds, if applicable. The Exchange in its Review recommended that new issuers should clearly disclose in their prospectus the specific uses of proceeds in line with their past and future business strategy, and should properly explain in a timely manner any subsequent material changes in the use of the IPO proceeds through an announcement.

Undertakings provided by major shareholders

A vast majority of issuers who were required to disclose in their annual reports the fulfilment of non-competition undertakings by their major shareholders and the steps taken to confirm such fulfilment, did make such disclosures.

Fulfilment of conditions or undertakings imposed before listing

Issuers should disclose in their annual reports their compliance with conditions or undertakings imposed by the Listing Committee, if any. All issuers made proper disclosure in their annual reports.

Non-compliance with the Listing Rules after listing

A small number of newly listed issuers breached the Listing Rules following listing to the extent that warranted the Exchange's follow up actions, including caution letters, guidance letters or warning letters. The Exchange reiterated its guidance that newly listed issuers should consult with their compliance advisers in a timely manner in the circumstances set out in Chapter 3A.

Post-listing developments of newly listed issuers

The Exchange reviewed the post-listing developments of newly listed issuers, in particular in relation to their material transactions and change in control. The Exchange made the following observations:

- there was an increase in the number of cases where the controlling shareholders disposed of their shares in the issuers shortly after the lock-up periods expired;
- two issuers introduced new controlling shareholders after completion of a notifiable transaction and a share subscription respectively; and
- the SFC identified a number of issuers as having high concentration of shareholding shortly after listing.

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