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# Hong Kong Stock Exchange Publishes Report On Issuers’ Annual Report Disclosure

As an ongoing effort to monitor issuers’ compliance with the Listing Rules in relation to their disclosures in annual reports, the Exchange has published its [first report](http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/Documents/rdiar-2012.pdf) [[archived copy](rdiar-2012.pdf)] on the findings and recommendations from a review exercise of all listed issuers’ annual reports issued for the financial year ended between December 2011 and November 2012 (excluding those for collective investment schemes listed under Main Board Chapter 20) (the **Report**).

The Report identifies areas where issuer disclosure can be improved. It also identifies areas of minor non-compliance and cases involving material breaches of the Listing Rules. The Exchange commented that a large majority of issuers complied with the Listing Rule requirements in preparing annual reports and encouraged issuers to go beyond the minimum disclosure standard and to disclose additional information according to the circumstances and the nature of their business.

The Report focuses on the following areas:

* Disclosure by investment companies under Chapter 21 of the Main Board Rules;
* Impairment of intangible assets arising from material acquisitions;
* Results of performance guarantees on acquisitions;
* Connected transactions;
* Significant changes to financial positions;
* Newly listed issuers; and
* Periodic disclosure of mining or petroleum assets under Chapter 18 of the Main Board Rules (Chapter 18A of the GEM Rules)

## 1. Disclosure by investment companies

Investment companies which make passive investments in accordance with their investment mandate are governed by Chapter 21 of the Main Board Rules. They are required to maintain an adequate spread of investments and are exempt from certain disclosure requirements when making investment decisions, but are required to make additional disclosures in their annual reports on their investments. The Exchange reviewed the annual reports of 25 investment companies.

### Issues

* 1 issuer might have conducted business activities **outside its investment mandate**. Following enquiries, the activities were terminated;
* 2 investment companies had portfolios with **a high concentration of investments** which was probably due to the issuers’ small asset sizes;
* 1 issuer omitted all, and some issuers omitted some, of the disclosure requirements under Main Board Rule 21.12(1), including the analysis of provisions for diminution in the value of investments, dividend cover or underlying earnings, dividend received, and net assets attributable to major investments.

### Recommendations

The Exchange reminded investment companies to closely observe their investment mandates and monitor the spread of investments in managing their investment portfolios.

As regards disclosure requirements under Main Board Rule 21.12(1), the Exchange commented that the required disclosures play an important role in providing investors with an unbiased explanation of the performance, financial position and future prospects of the investments held by the investment companies.

The Exchange reminded investment companies to disclose full details of their investments in annual reports including,

* An analysis on the provisions for diminution in the value of, and surpluses of, each investment;
* An analytical and in-depth discussion of investments, including a description of the business of the investee;
* Directors’ valuation or market value of the investment;
* Dividend received (including any abnormal dividends);
* Dividend cover or underlying earnings; and
* Analysis and explanations about the fluctuations of value in each investment.

## 2. Impairment of intangible assets from material acquisitions

An issuer is required to **announce** acquisitions and for material acquisitions, to **obtain shareholder approval** and **publish an investment circular** which provides material information about the business to be acquired and its impact on the issuer for shareholders’ investment and voting decisions. Under the Listing Rules, an issuer is required to announce in a timely manner any significant changes in the performance of the acquired business following the acquisition in accordance with its general disclosure obligations. Significant changes would include, but are not limited to, profit alerts and impairments of intangible assets and/or goodwill.

Paragraph 32 of Appendix 16 to the Main Board Rules (GEM Rule 18.41) requires an issuer to disclose in the “management discussion & analysis” section (**MD&A section**) of the annual report material trends and significant events or transactions during the financial year.

These would include discussions on the performance and developments of the acquired business subsequent to the acquisition, as well as any significant change in the value of intangible assets and/or goodwill arising from the acquisition. The Exchange reviewed 336 acquisitions by 267 issuers which announced or completed at least one material acquisition in their last two financial years, out of which 134 were substantial acquisitions and 202 were major acquisitions.

### Issues

From its review of annual report disclosure about the development of the acquired businesses, the Exchange identified the following issues:

* There were cases where impairments of goodwill and intangible assets arising from acquisitions were made shortly after completion, leading to the recognition that **the impairments might have existed at the time of the acquisitions**;
* In some cases, the write down and subsequent disclosure about the acquired businesses in the annual reports suggested that the values of the acquired businesses, their prospects, business plans and/or the cash flow forecasts might have been **overstated, misleading or inaccurate in the investment circulars**;
* In 1 case, the impairment of an intangible asset was due to **differences between the valuation methodology** used to determine the consideration and that used to determine the value of the business to be acquired under the accounting standards;
* In 2 cases, the issuers’ **profit warning announcements failed to fully disclose** the major reasons leading to significant asset impairments raising issues of potentially incomplete disclosure in the announcements; and
* From a review of the valuation reports supporting the value of intangible assets in the financial statements, it was noted that in some cases, **the basis of the impairments and the assumptions for the valuations** were not properly disclosed, while the explanations on the events and circumstances that led to the impairment losses were **short and generic**.

### Recommendations

The Exchange reminded issuers that the investment circular in relation to material acquisitions serves to provide material information about the business to be acquired and the impact of the acquisition on the issuer to enable shareholders to decide whether to approve the acquisitions. Under the Listing Rules, all information presented by issuers must be accurate and complete in all material respects and not be misleading or deceptive.

Further, financial information of the acquired business and pro forma financial information of the enlarged issuer group, they must be reported and prepared in the investment circular **using the issuer’s accounting policy consistently**.

The Exchange expects issuers to include discussions on the performance and developments of the acquired business after the acquisition and significant changes in the value of intangible assets and/or goodwill arising from the acquisition in the MD&A section of the annual report. Issuers are also expected to include in annual reports’ MD&A section disclosure of relevant information about the valuation of intangible assets, including:

1. the value of the inputs (e.g. projected cash flow, discount rate and growth rate) used in the valuations together with the basis and assumptions;
2. the reasons for any significant changes in the value of the inputs and assumptions from those previously adopted;
3. the valuation method and the reasons for using that method; and
4. an explanation for any subsequent changes in the valuation method used and the reasons for any significant change in value.

## 3. Results of performance guarantees on acquisitions

Issuers making acquisitions sometimes require the vendor of a business to guarantee the performance of the acquired business. The Exchange reviewed 54 guarantees provided on the performance of businesses acquired by issuers. These included 27 cases where the acquired businesses met the guaranteed performance and 26 cases where the acquired business failed to meet the guaranteed performance. Seven guarantees were provided by connected persons.

The Listing Rules require an issuer to publish an announcement if the **financial performance of the acquired business is less than the guaranteed amount** where a guarantee is provided by a connected person (Main Board Rule 14A.57/GEM Rule 20.57). Where a guarantee is provided by an independent party, the Listing Rules do not provide for specific disclosure requirements but require issuers to inform their shareholders in case of material developments (e.g. **the outcome of performance guarantees** and **how compensation obligations would be enforced**).

### Issues

* In 27 cases issuers did not disclose the outcome of the guarantees until after the Exchange made enquiries;
* In cases where the performance of the acquired businesses failed to meet the guaranteed amounts:
  + issuers did not make announcements that they re-negotiated the guarantee arrangements with the guarantors until after the Exchange made enquiries;
  + in one case, the agreement between the issuer and the guarantor did not set out a mechanism for the calculation of the compensation amount and the issuer only negotiated with the guarantor on a settlement after the Exchange made enquiries;
  + in some cases the compensations were waived, including a case where the issuer could not provide an adequate explanation for the waiver upon the Exchange’s enquiry;
  + In some cases, the acquired businesses met the guaranteed performance through new businesses after the acquisition or through one-off transactions.

### Recommendations

The Exchange reiterated that where the terms of an acquisition agreement [[1]](#footnote-34) include guaranteed performances or the consideration is negotiated by reference to the target’s future performance, these terms form an integral part of the basis upon which shareholders approve the acquisition. The issuer should therefore clearly disclose the performance of the acquired business, whether the performance guarantee is met, and if not, whether and how the guarantor fulfilled its obligations under the guarantee agreement.

Where issuers re-negotiate the terms of the guarantee, they should announce the re-negotiated terms.

If the performance guarantee is not met and the issuer does not enforce the agreement to seek compensation, or the agreement does not specify a way to determine the compensation, the Exchange comments that this could raise questions about whether the guarantee was genuine, or merely used to support an overstated consideration amount. [[2]](#footnote-35)

Where acquired businesses meet the guaranteed performance through new businesses developed after the acquisition or through one-off transactions, the Exchange commented that this raises questions as to whether the performance guarantees were genuinely met and whether the disclosure in the investment circular was accurate. It recommended that the terms of performance guarantees and whether they would achieve the intended purposes should be clarified in the negotiations of the acquisitions and should be clearly disclosed in the investment circular.

## 4. Connected transactions

Transactions between an issuer and its connected persons [[3]](#footnote-37) are governed by Chapter 14A of the Main Board Rules (Chapter 20 of the GEM Rules). Issuers should properly identify and report connected transactions through announcements and in their annual reports. Continuing connected transactions should be reviewed by independent directors and auditors and the results should be reported in annual reports. The Exchange reviewed a number of issuers’ announcements and disclosure in annual reports.

### Issues

* A few issuers failed to **announce connected transactions** at the time of the agreements, **seek shareholders’ approvals** for the connected transactions and **conduct annual reviews** on these unannounced transactions. These failures constituted breaches of the Listing Rules and disciplinary actions were taken, depending on the materiality of the transactions;
* One sixth of the issuers did not disclose in their annual reports whether or not transactions with related parties were connected transactions and whether they had complied with the specific rule requirements for such connected transactions; and
* For continuing connected transactions, a few issuers **(i) failed to report the results of the annual reviews** conducted by their independent directors and auditors in the annual reports and/or **(ii) failed to submit the auditors’ confirmation** as to the annual reviews to the Exchange as required under the Listing Rules.

### Recommendations

In general, the issuers the subject of the review had complied with the Listing Rules on connected transactions. The Exchange reminded issuers to disclose in annual reports:

* Confirmations that they have conducted review of their related party transactions and are satisfied that all connected transactions are properly reported; and
* For continuing connected transactions, the results of the annual reviews by independent directors and auditors.

## 5. Significant changes to financial positions

During 2012, the Exchange noted that there were scandals and negative publicity on accounting and corporate governance issues relating to some US-listed Chinese companies. As part of the ongoing monitoring activities to prevent the development of a false market, improve transparency of issuers and maintain market confidence in the local securities market, the Exchange reviewed the annual reports, announcements, circulars, media and research reports of 34 mainland issuers with identified corporate governance issues such as frequent changes in and persistent negative news regarding directors, senior management and controlling shareholders.

### Issues

* In 2 cases, issuers were required by the Exchange to **engage independent consultants**. In one of these, the consultant was engaged to review the issuer’s internal controls of the cash and sales cycle as a result of a high volume of cash sales and identified weaknesses in internal controls. The other issuer was required to engage **independent valuers** and an expert to review its valuation of biological assets following complaints;
* Issuers which have experienced significant change in financial position or financial results often recorded unusual changes in **trade receivables** and provided only minimal information as to explanations for the fluctuations, aging analysis and credit policy in the MD&A section;
* Those issuers often disclosed **abnormal effective tax rates** or **significant tax balances** in their balance sheets without adequate explanations.

### Recommendations

The Exchange suggested 3 areas of disclosure in the annual report which can be improved, namely, trade receivables, effective tax rates and tax balances and key performance indicators (**KPI**s).

#### Trade receivables

* Unusual changes in trade receivables identified included significant increases in trade receivables, increases in overdue balances and debtors’ turnover days, etc. The Exchange expects issuers to provide analysis and explanations for fluctuations in trade receivables, aging analysis and credit policy in the MD&A, rather than merely repeat information presented in the financial statements in narrative form;
* Issuers are encouraged to disclose their **key relationships with customers** (Appendix 16 to the Main Board Rules or GEM Rule 18.83(8)), including:
  + the reasons for debtors’ turnover days being longer than the issuer’s general credit policy;
  + the length of extended credit period granted to the customers, and whether their payment patterns are in line with the industry practice;
  + a general profile of customers with longer credit periods or with substantial long outstanding balances;
  + the subsequent settlement of the trade receivables after the year end date, and how these receivables were settled (in cash or offset by sales return);
  + any change in the business relationship with customers, who have significant or long outstanding receivables, subsequent to the year end date; and
  + the actions taken by the issuers to follow up with the customers with long outstanding receivables.

#### Effective tax rates and tax balances

* Issuers should provide a meaningful analysis in the MD&A section in relation to the impact of **a tax holiday** and **the reduced tax rate**, potentially including:
  + the reasons for the discrepancies and the significant changes in tax balances;
  + the range of tax rates applicable to the major operating subsidiaries and the effective period of the tax holiday and reduced tax rates; and
  + the name of major operating subsidiaries enjoying such tax benefits and their profit contributions to the group.
* Issuers should disclose details about the reasons for material fluctuation in the tax effect of the non-deductible expenses or exempted items in the tax reconciliation.

#### KPIs

* Under Appendix 16 to the Main Board Rules or Chapter 18 of the GEM Rules, issuers are encouraged to disclose information about KPIs such as efficiency indicators and industry specific ratios in the MD&A section. The disclosure may include:
  + the reasons for including the KPIs and how they are linked with the issuer’s objectives;
  + the definition and calculation of the KPIs;
  + the reasons for any change in the use of KPIs (e.g. change in strategy of the issuer, change in market environment);
  + the meaning of the trend of each KPI in the specific circumstances of the issuer (necessary since an improvement in KPI isn’t necessarily a sign of strength);
  + the reasons for significant changes in the KPIs; and
  + the reconciliation and reasons for any differences between the KPIs and figures reported under accounting standards in the financial statements.

## 6. Newly listed issuers

The Exchange reviewed 100 issuers which were listed in 2011 focusing on 4 key disclosure areas in the annual reports. Under Appendix 16 to the Main Board Rules (GEM Rule 18.41), an issuer should identify significant events or transactions during the financial year in its MD&A section. For a newly listed issuer, these may include updates on the forward looking statements such as a profit forecast and the intended use of IPO proceeds contained in a prospectus.

### Issues

#### Profit forecasts and material changes in financial results

* Out of 48% of issuers which reported profit forecasts in their prospectuses, 3 issuers failed to meet the profit forecasts. In 2 cases the size of the shortfall was small and due to foreign exchange losses from the IPO proceeds, while in 1 case, the shortfall was material and was attributable to deterioration in business performance.
* In 2 cases, issuers recorded material deteriorations in their results shortly after listing but **failed to publish profit warning announcements** in a timely manner and may have breached the Listing Rule obligation to update the market on material changes to financial position in a timely manner.

#### Changes in the use of IPO proceeds

* In 1 case, the issuer changed the use of the IPO proceeds shortly after listing **without properly disclosing this to shareholders** by way of announcement.
* In 1 case, the issuer used the IPO proceeds to make entrusted loans and structured deposits which **had not been disclosed in the prospectus**. Such uses constituted notifiable transactions under the Listing Rules but were not announced by the issuer, which the Exchange considered to be a **material breach of the Listing Rules**.

#### Fulfilment of undertakings and conditions imposed before listing

* Out of the 6 issuers which gave undertakings to, or had conditions imposed by the Exchange, 5 met their undertakings or imposed conditions;
* In 1 case, the issuer did not fulfill the condition to appoint an independent director with relevant industry experience to enhance its corporate governance.

#### Conflicts of interests and competing businesses

* The Exchange found no compliance issues with non-competition undertakings given by issuers’ major shareholders before listing).

### Recommendations

In relation to profit forecasts, the Exchange reminded issuers that Main Board Rule 13.24B (GEM Rule 17.26A) requires that if, during the profit forecast period, an event occurs which would have caused any profit forecast assumptions to have been materially different, the issuer should promptly announce the event and its likely impact on the profit forecast.

A prospectus should clearly disclose **an issuer’s business trends and prospects**, including the expected performance for the current financial period and major factors that may affect the issuer’s financial performance. As a result, the Exchange expects that it would be highly unusual to have sudden and unanticipated deteriorations in an issuer’s business shortly after the listing. Failure to include all material information in a prospectus or failure to timely disclose material changes to financial performance after listing, may constitute a breach of the Securities and Futures Ordinance.

As regards changes in the use of IPO proceeds, the Exchange reminded new applicants to carefully consider their business plans and make appropriate disclosures in the prospectus. Where there is a legitimate change of plans after listing, the issuers should make immediate disclosure of the change.

## 7. Periodic disclosure of mining or petroleum assets

Chapter 18 of the Main Board Rules (Chapter 18A of the GEM Rules) governs Mineral Companies [[4]](#footnote-54) and issuers that publicly disclose information about resources and/or reserves (**non-Mineral Companies**). Mineral Companies must disclose details of their exploration, development and mining production activities, expenditures incurred on those activities and updates of resources and reserves in their annual reports. Both Mineral Companies and non-Mineral Companies must disclose details of their resources and reserves in their annual reports.

The Exchange reviewed 63 issuers that were subject to the disclosure requirements, including 25 Mineral Companies and 38 non-Mineral Companies.

### Issues

* A few issuers omitted material disclosures, including details of resources and/or reserves and details of their exploration, development and mining production activities. Announcements to disclose the omitted information were made only after the Exchange’s enquiries;
* While a majority of issuers met the minimum disclosure requirements, the disclosures were often general and lacked sufficient details.

### Recommendations

The following recommendations by the Exchange are non-exhaustive for both Mineral Companies and non-Mineral Companies. The recommendations were published in the Exchange’s guidance letter [GL47-13](http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/Documents/gl47-13.pdf) [[archived copy](gl47-13.pdf)].

#### Exploration, development and mining production activities

* The disclosures on these activities should contain:
  + details of exploration activities including the number, average size, and total length of holes drilled during the review period;
  + details of development activities including the progress on the mining structure or infrastructure;
  + details of mining activities including the quantity of mineral ore being mined during the review period by project or at least a separate discussion on major projects;
  + details of the new contracts and commitments entered into during the review period, including those relating to infrastructure projects, subcontracting arrangements and purchases of equipment.

#### Expenditures incurred

* The summary of expenditures incurred should not be limited to operating expenses, i.e. costs that were directly charged to income statement during the period they were incurred. A Mineral Company should disclose the **capital expenditures** incurred, which could be much greater than operating expenses alone;
* Common expenses include mining costs, processing costs, transportation, royalties or fees payable to government and financing costs. A Mineral Company should consider providing a **further breakdown of expenses** in order to give more meaningful information to shareholders (e.g. separate disclosure of labour costs incurred in mining activities and processing activities);

#### Annual updates on resources and reserves

* Annual updates of resources and reserves should be presented in a **table format** and in a readily understandable manner in annual reports;
* Both Mineral and non-Mineral Companies should disclose **the assumptions adopted** with the reasons for any material change as compared with previous disclosed estimates;
* Both Mineral and non-Mineral Companies are encouraged to include the reasons for changes in the resources and reserves estimates (e.g. changes in geological confidence level, additional drilling information becoming available, amount of mineral mined during the period etc.)

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1. Including the guaranteed performances or the consideration negotiated by reference to the future performance of the acquired business. [↑](#footnote-ref-34)
2. In some acquisitions, performance guarantees are part of the basis of the consideration of the acquisition agreement e.g. where the consideration is based on a price earnings multiple of the profit guarantee. [↑](#footnote-ref-35)
3. Connected person is defined in the Listing Rules as a director, chief executive or substantial shareholder of a non-PRC issuer or any of its subsidiaries or an associate of any of them and a director, supervisor, chief executive or substantial shareholder of a PRC issuer or any of its subsidiaries or an associate of any of them. [↑](#footnote-ref-37)
4. Defined as an issuer whose major activity is the exploration for and/or extraction of natural resources, or an issuer that completes a relevant notifiable transaction involving the acquisition of mineral or petroleum assets. [↑](#footnote-ref-54)