



Hong Kong Law

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EXCHANGE REVIEWS DISCLOSURE IN ANNUAL REPORTS TO MONITOR RULE COMPLIANCE

The Exchange has published its second report on findings and recommendations from a review of disclosure in issuers' annual reports issued for the financial years ended between December 2012 and November 2013.

This newsletter will focus on areas where the Exchange has identified deficiencies in disclosure and set out the findings and recommendations provided by the Exchange as appropriate.

The following areas of disclosure are covered by the Exchange under the review:

- Fund raising activities through issue of equity or convertible securities;
- Updates on material changes after acquisitions;
- Results of performance guarantees on acquisitions;
- Connected transactions;
- Significant changes to financial performance and material reliance on key customers;
- Biological assets;
- Periodic disclosure of mining or petroleum assets under Main Board Chapter 18 / GEM Chapter 18A; and
- Disclosure by investment companies listed under Main Board Chapter 21

A. Fund raising activities through issue of equity or convertible securities

1. Issue of equity securities

Listing Rule requirements

Issuers conducting equity fund raising activities pursuant to mandates from shareholders are required under the Listing Rules to publish announcements containing details of their fund raisings, including the terms and size of the share issuance and the proposed use of proceeds. Issuers are also required to report to shareholders the fund raisings conducted during the financial year and the actual use of the proceeds in their annual reports.

MB Rule 13.28 / GEM Rule 17.30; Paragraph 11 of Appendix 16 to the MB Rules / GEM Rule 18.32

Findings

In only about one-fifth of the cases reviewed, issuers disclosed specifically in the announcements the proposed use of proceeds. In about four-fifths of the cases, issuers described the proposed use of the proceeds to be for general working capital or future business developments.

After reviewing the annual reports, the Exchange noted that the vast majority of issuers did not report the actual use of proceeds, or confirmed that the proceeds were applied for general working capital and/or business development without providing details.

In cases where issuers conducted equity fund raising activities pursuant to specific mandates, the Exchange noted that all except three issuers disclosed in their annual reports that the proceeds were applied in the manner described in the circulars. Only about one-third of the issuers disclosed details on the application of such proceeds.

Recommendations

The Exchange commented that equity fund raising is a significant event and issuers should disclose in the annual report whether the proceeds had been applied in accordance with the specific uses described in the circulars.

To improve their accountability to shareholders, issuers should:

- a) where possible, avoid generic descriptions and include a specific description of the proposed use of funds in their announcements. Where issuers intend to use funds raised for working capital or future acquisitions, they should include a clear explanation of the working capital position of the issuer, or their business plans and proposed acquisition targets; and
- b) provide meaningful updates in annual reports on the actual applications of funds, including a breakdown of how the funds were allocated among different uses.

2. Adjustment in the number of shares that can be converted from convertible securities

Listing Rule requirements

An issuer should disclose in its annual report:

- a) specific details relating to convertible securities issued during the financial year; and
- b) particulars of any exercise of conversion right under convertible securities during the financial year.

Paragraphs 10(1) and 10(2) of Appendix 16 to the MB Rules / GEM Rules 18.11 and 18.12

Findings

Issuers generally complied with the disclosure requirements. However, the Exchange noted in four cases that the adjusted number of conversion shares exceeded the general mandate and as a result, the issuers did not have a proper mandate from shareholders to issue a portion of the conversion shares.

Recommendations

In the event of corporate actions triggering conversion adjustment mechanisms, the Exchange reminded issuers that:

- a) they should take this into account before undertaking the corporate actions, and ensure that they have sufficient mandate to issue conversion shares under the terms of the convertible securities; and
- b) they must adopt appropriate procedures to keep track of the number of conversion shares approved for listing, and the number of conversion shares issued and issuable under the terms of the convertible securities.



B. Updates on material changes after acquisitions

Listing Rule requirements

The Listing Rules require issuers to announce material acquisitions, publish an investment circular and seek shareholders' approvals for these acquisitions. In addition, issuers should disclose in the MD&A information about the acquired businesses, including material trends and significant events during the year.

Findings

The Exchange reviewed the annual report disclosure about the development of the acquired businesses, in particular, any significant changes to the value of intangible assets and goodwill. The Exchange also reviewed the valuation reports on the assets, and considered whether:

- a) the information disclosed in the original investment circular was materially accurate;
- b) any material change to the acquired business was timely disclosed in the announcement; and
- c) any impairment to assets was properly made.

The Exchange identified four cases where a material write down resulted from failures to obtain working capital, licences or sign agreements. The information might have been available at the time of the acquisition, or formulated part of the business plan material to the success of the acquired business and should have been discussed in the investment circular. The disclosure in the investment circulars, or the failure by the issuers to discuss these matters in the investment circulars, might have resulted in the information in the circulars being misleading or incomplete.

In the four cases, the Exchange also commented that the issuers had not timely informed the market about the failures to obtain key licenses and the delays in production plans. This failure to timely announce material information may constitute a breach of the Listing Rules. The Exchange noted that it had taken appropriate action in respect of potential Listing Rule breaches identified and had referred potential breaches of the Securities and Futures Ordinance to the SFC.

Valuation

Hong Kong Accounting Standards 36 - Impairment of Assets requires a reporting entity to perform an annual impairment test on its goodwill and intangible assets with an indefinite useful life.

The Exchange commented that while issuers generally disclosed the main reasons for asset impairments, there was little discussion about the valuation methodologies used, the major assumptions and how the changes in circumstances affected the assumptions and inputs used.

The Exchange reminded issuers to disclose relevant information about the valuation of assets in the MD&A section of the annual report. This includes:

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

C. Results of performance guarantees on acquisitions

Listing Rule requirements

Where an acquired business did not meet the performance guaranteed by a connected person, an issuer must publish an announcement. For a performance guarantee provided by an independent party, the issuer is obliged to inform shareholders about the material developments of its acquired businesses. These would include the outcome of any performance guarantees and how the issuer would enforce the compensation terms in the acquisition agreement.

Findings

- In one case the issuer considered the guaranteed profit provided by a connected person was met by adding back certain recurring expenses of the acquired company.
- In two cases the issuers were compensated for the shortfall in guaranteed profits, whereas the considerations were based on a multiple of the guaranteed profits. The compensation could not cover the impairments on the acquired assets as it did not take into account the price-to-earnings multiples.
- In cases where the performance guarantees were not met and the issuers attempted to re-negotiate the compensation terms with the vendors:

- two issuers that announced they were re-assessing whether to exercise the compensation terms after realising that the acquired companies could not meet the guaranteed performances; and
- one issuer that resolved to waive the profit guarantee before the end of the guarantee period, without adequate explanation why it would be in the interest of the issuer to do so.

Based on the findings, the Exchange raised the following questions:

- whether the terms of the transaction (including the compensation arrangements) were in the interests of shareholders;
- whether the compensation arrangement served its purpose and the intention of the arrangement was properly disclosed in the investment circulars;
- the conduct of the issuers and their directors in safeguarding the assets of the issuers; and
- whether they properly discharged their fiduciary duties as directors of listed companies.

D. Connected transactions

Findings

1. Omission in annual reports

The Exchange noted some omissions in disclosure in the annual reports, including:

- a) confirmations that issuers have conducted a review of their related party transactions and are satisfied that all connected transactions are properly reported; and
- b) for continuing connected transactions, the results of annual reviews by the independent directors and/or auditors

2. Continuing connected transactions

Two issuers exceeded the annual caps in respect of their continuing connected transactions, which were identified in the auditors' annual review.

E. Significant changes to financial performance and material reliance on key customers

Listing Rule requirements

Paragraph 32 of Appendix 16 to the MB Rules / GEM Rule 18.41 set out the minimum disclosure requirements while Paragraph 52 of Appendix 16 to the MB Rules / GEM Rule 18.83 set out the recommended disclosure in the MD&A section. An issuer should include material and relevant information according to its own circumstances.

In guidance letter HKEx-GL59-13, the Exchange recommended that new applicants should prepare the MD&A section in their listing documents following the general principles that:

- a) the disclosure should be clear, straightforward, consistent with its related financial statements and focused on the most important and material information. In addition, there should be a balanced discussion of all major businesses and segments (both existing and planned) including both the positive and negative circumstances of a new applicant. Generic discussions that do not provide insight into a new applicant's past performance and prospects should not be included;
- b) integrated information should be provided to create a context to interpret a new applicant's financial position, financial performance and cash flows; and
- c) presenting information using tables, charts and diagrams is recommended to promote clear, concise and precise disclosure.

The above principles are also applicable to the MD&A section in issuers' annual reports.

Findings

The Exchange reviewed annual reports of 41 Mainland issuers with the following characteristics: reliance on a small number of key customers, or significant growth in revenue and/or profit margin during the financial year under review.

- A majority of the issuers did not adequately explain reasons for the material fluctuations in their financial results, or provide material information about their key customers, material risks associated with the reliance and the impact on their operations;

- One issuer underwent material changes in its business model after its listing but did not disclose in its annual reports up-to-date information about its new product lines and changes to its production lines; and
- A majority of the issuers did not provide meaningful explanation of the factors causing the material changes in revenue and/or profit margin. For example, significant growth in revenue and profit was explained by generic statements, such as enhanced sales team performance and improved product recognition and market awareness.

Recommendations

Reliance on a small number of key customers

- It is recommended that an issuer should give an account of its key relationships with employees, customers, suppliers and others on which its success depends (*Paragraph 52(viii) of Appendix 16 to the MB Rules / GEM Rule 18.83(8)*). Matters which this discussion may include are:
 - a) background of the major customers; the length of the relationship with the issuer and the percentage of revenue from these customers during the financial year and its comparative period;
 - b) detailed description of the products and/or services sold to the major customers;
 - c) credit terms granted to major customers and whether these are in line with, or more favourable than, the other customers, and detailed terms of any long-term agreements;
 - d) subsequent settlement of trade receivables with major customers after the year end date, and if the balances have not yet been settled, whether any provisions are necessary or the reasons why no provisions have been made; and
 - e) risks associated with reliance on major customers, and measures undertaken by issuers to mitigate such risks.

Significant changes to revenue and/or profit margin

- An issuer should refer to paragraph 32 of Appendix 16 to the MB Rules / GEM Rule 18.41 which requires a discussion and analysis of the issuer's performance during the financial

year and the material factors underlying its results and financial position. It should emphasise trends and identify significant events or transactions during the financial year under review;

- Issuers should consider additional disclosure in the MD&A section. The disclosure should provide shareholders with an understanding of the issuers' business model, the material risks to the issuers' operations and reasons for material fluctuations in the issuers' financial results and position; and
- Issuers should refer to the recommended disclosure under Paragraphs 52(i) and (ii) of Appendix 16 to the MB Rules / GEM Rules 18.83(1) and (2) and guidance letter (HKEx-GL59-13) to enhance their MD&A disclosure. An issuer should:
 - a) include an overview of its industry and business: the discussion should focus on the trends and analyze the impact on the issuer's future performance;
 - b) provide an update of material changes to the issuer's operation (e.g. product mix, business model), and how these changes have contributed to the issuer's performance during the financial year; and
 - c) provide integrated information about an issuer's financial results and position, such as analysis and explanation of any unusual movements in account balances (e.g. trade receivables) and/or key performance indicators, particularly areas where the movements deviated from the issuer's financial results.



FINDINGS ABOUT RULE COMPLIANCE BY SPECIFIC TYPES OF ISSUERS

F. Biological assets

Listing Rule requirements

Exchange guidance letter HKEx-GL46-12 contains guidance to IPO applicants on the disclosure requirements for biological assets. The Exchange considers that the following disclosure is also applicable to issuers to provide material information about the agricultural activities, biological assets and their valuations in their annual reports:

- a) the relevant qualifications, experience, and independence of the valuer, and how the directors are satisfied that the valuer is independent and competent to determine the fair value of biological assets;
- b) the bases or reasons for using the specific technique in valuing biological assets and if the discounted cash flow method is adopted, a discussion of why it is considered that there are no market prices that can be used for the fair value measurement;
- c) the material inputs, including bases and assumptions used in the valuation techniques, historical yield of the biological assets and commentary on the material fluctuation during the financial year;
- d) sensitivity analysis on changes in material inputs used in the valuation techniques, including the discount rate and key assumptions and variables; and
- e) full details of the issuer's licences/ rights/ permits to carry out the agricultural activities

The Hong Kong Accounting Standards also require, *inter alia*, a biological asset to be measured at fair value less cost to sell and disclosure on the major sources of estimation uncertainty at the end of the reporting period in the financial statements.

Findings and Recommendations

The Exchange noted that issuers' disclosure in the annual reports can be improved in the following areas.

a) **Qualifications of valuers** – There was no disclosure in issuers' annual reports on the qualifications and experience of the valuers engaged, and how the directors were satisfied that they were independent and competent to determine the fair value of biological assets;

b) **Valuation methodology and assumptions** – the bases for using the chosen valuation methods were not disclosed;

c) **Material inputs, including bases and assumptions used in the valuation** – there was little or no disclosure in the following areas which supported the valuation:

1. the work done to verify the physical existence and quality of the biological assets, the coverage and sampling basis on-site inspections were not disclosed in the annual reports;
2. some reports stated that the valuers adopted the prevailing market data (such as yield of the biological assets, selling prices and production costs) in the valuation, but details about the market data were not disclosed; and
3. some issuers disclosed qualitative descriptions on the inputs and assumptions, such as political, legal and economic conditions, the calculation basis of the discount rates, selling prices and costs in the cash flow projections. However, there was no quantitative disclosure on key assumptions and those specific to the type of biological assets, such as their yield rate and estimated life of the assets.

d) **Sensitivity analysis** – Only two issuers disclosed sensitivity analysis based on the possible changes in key inputs adopted in the valuation.

In general, valuation of biological assets is usually subject to higher uncertainty due to subjective and complex assumptions adopted. Issuers should discuss any material fluctuations in their asset value.

G. Periodic disclosure of mining or petroleum assets under MB Chapter 18 / GEM Chapter 18A

Under MB Rules 18.14 to 18.18 / GEM Rules 18A.14 to 18A.18, Mineral Companies and non-mineral companies must disclose an annual update of resources and reserves. Mineral Companies must also disclose details of their exploration,

development and mining production activities, and a summary of expenditures incurred in such activities in their annual reports (guidance letter HKEx GL47-13).

Findings

1. Annual updates on resources and reserves

The Exchange noted that 44 companies revised the resources and reserves estimates based on updated exploration results (e.g. new drilling results). However, over half of the 44 companies did not follow, or only partially followed the recommendation in guidance letter HKEx GL47-13 that companies should provide a discussion to support any revisions in the estimated resources and reserves, including changes in geological confidence level, additional drilling information, etc.



2. Exploration, development and mining production activities

Around one-third of the companies which are in the production stage, which also had projects at development or exploration stages, did not disclose their exploration and development activities during the financial year.

The recommendations set out in guidance letter HKEx GL47-13 were only partially taken up:

- 71% of Mineral Companies which had multiple projects disclosed details of exploration, development and mining activities on a project-by-project basis;

- 44% of Mineral Companies disclosed details of their new contracts and/or commitments; and
- Where the issuers disclosed delays in the application process for exploration/mining licences or delays in the expansion plan and/or infrastructure construction, they failed to discuss the business and financial impact of the delay and the revised business plans.

3. Expenditures incurred

Mineral companies should provide further breakdowns of expenditures incurred in its exploration, development and mining production activities in order to provide more meaningful information to shareholders and enhance transparency.

H. Disclosure by investment companies listed under MB Chapter 21

Nine investment companies omitted either one or two of the required disclosures under MB Rule 21.12(1).

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