

REVIEW OF DISCLOSURE IN
ISSUER'S ANNUAL REPORTS TO
MONITOR RULE COMPLIANCE

REPORT 2013

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Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2013

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EXECUTIVE SUMMARY

The Listing Division reviews issuers' annual reports as part of its ongoing monitoring and compliance activities. This is the second published report which presents our findings and recommendations.

In this review we examined annual report disclosure with a focus on issuers' Rule compliance, their corporate conduct and their disclosure of material events and developments. In our review of an issuer's disclosure we consider not only the disclosure in the annual report, but also the consistency and materiality of the issuer's disclosure in its corporate communications (e.g. announcements, circulars) over time.

We continued our review of the areas covered last year and add new areas including:

- Fund raising activities through issue of equity or convertible securities (new)
- 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 (new)
- Biological assets (new)
- Issuers listed in 2011 and 2012
- Periodic disclosure of mining or petroleum assets under Main Board Chapter 18 / GEM Chapter 18A
- Disclosure by investment companies listed under Main Board Chapter 21

While a large majority of issuers complied with the Rules, we continue to identify a small number of cases involving potential breaches of the Rules, particularly in areas relating to material acquisitions and performance guarantees. Our review of issuers' disclosure over time helped us identify cases of potentially misleading disclosure in corporate documents, and possible corporate misconduct and issues with directors' role in safeguarding corporate assets.

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In the new areas reviewed, we note that issuers can improve their disclosure in the following areas:

- (a) *Fund raising activities through issue of equity or convertible securities* – a majority of issuers did not clearly set out the proposed use of funds raised from general mandate placings in their announcements, and failed to provide an account of the actual uses of the funds raised in their annual reports. To improve their accountability to shareholders, issuers should i) where possible, avoid generic descriptions and have a specific description of the proposed use of funds in the announcements; and ii) provide meaningful updates on the actual applications of funds in annual reports, including a breakdown of how the funds were allocated among different uses.
- (b) *Significant changes to financial performance and material reliance on key customers* – in these circumstances issuers should consider additional disclosure in the “management discussion and analysis” 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.
- (c) *Biological assets* – 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. Areas of note include valuation methodology and assumptions, material inputs used in the valuation, and sensitivity analysis.

We note that issuers had taken note of some of our guidance in the 2012 Review Report¹ and enhanced their annual report disclosure. We urge issuers to review and adopt guidance in the following areas to the extent applicable:

- annual updates by Mineral and non-Mineral Companies; and
- management discussion and analysis of material changes in financial items including taxes, trade receivables and key performance indicators.

¹ See our “Review of Disclosure in Issuers’ Annual Reports to Monitor Rule Compliance – Report 2012” (<http://www.hkex.com.hk/eng/rulesreg/listrules/guidref/Documents/rdiar-2012.pdf>)

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I. INTRODUCTION

1. An annual report should provide material and relevant information about an issuer's financial results and position, and assist investors to assess its past performance and future prospects. As a general principle, disclosure in an annual report should be clear, straightforward, and provide a qualitative analysis that complements and explains quantitative information in the related financial statements. There should be a balanced discussion of all major aspects of the issuer's businesses, including both positive and negative circumstances, in the "management discussion and analysis" (MD&A) section.
2. As part of our monitoring of issuers' activities, we review annual reports with a particular focus on issuers' Rule compliance, their corporate conduct and their disclosure of material events and developments. We consider that better disclosure improves transparency and promotes a fair, orderly and informed market. In our review of an issuer's disclosure we consider not only the disclosure in annual report, but also the consistency and materiality of the issuer's disclosure in its corporate communications (e.g. announcements, circulars) over time.
3. The Rules and applicable accounting standards set out the minimum information an issuer must include in its annual report. An issuer should provide additional information that is relevant to investors according to its own circumstances. In our review, we also considered whether issuers adopted our guidance from our findings from our 2012 annual report review.
4. Our review program covers all issuers (excluding collective investment schemes listed under Main Board Chapter 20)² in the six areas that were part of our 2012 review and three new areas:
 - Fund raising activities through issue of equity or convertible securities (Part IIA) (new)
 - Updates on material changes after acquisitions (Part IIB)
 - Results of performance guarantees on acquisitions (Part IIC)
 - Connected transactions (Part IID)
 - Significant changes to financial performance and material reliance on key customers (Part IIE) (new)
 - Biological assets (Part IIIA) (new)
 - Issuers listed in 2011 and 2012 (Part IIIB)

² Including all annual reports issued for the financial year ended between December 2012 and November 2013.

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- Periodic disclosure of mining or petroleum assets under Main Board Chapter 18 / GEM Chapter 18A (Part IIIC)
 - Disclosure by investment companies listed under Main Board Chapter 21 (Part IIID)
5. This review is separate from our Financial Statements Review Program (the “**FSRP**”). The FSRP reviews the periodic financial reports published by issuers for compliance with both financial reporting standards and the disclosure of financial information requirements under the Listing Rules.
 6. In this report, Rules refer to both Main Board (“**MB**”) Rules and Growth Enterprise Market (“**GEM**”) Rules.

II. FINDINGS ON SPECIFIC AREAS OF DISCLOSURE

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

7. Issuers conducting equity fund raising activities are required under the Rules³ to announce details of their fund raisings, including the terms and size of the share issuance and the use of proceeds. Shareholders may give issuers a general mandate to issue shares subject to the Rules requirements⁴, or a specific mandate to issue shares under particular terms and for the specific uses set out in a circular. Issuers are also required to report to shareholders the fund raisings conducted during the financial year in their annual reports.

Scope

8. We reviewed announcements and annual reports of 272 issuers that conducted 280 equity fund raisings during the financial year. It included 166 share placings under general mandates, 61 share placings under specific mandates, and 53 pre-emptive issues including rights issues and open offers.
9. In our review we considered the disclosure about issuers' uses of proceeds and the dilution impact of their convertible securities on shareholders.

Update on actual use of proceeds

10. *General mandate issue* – The Rules allow issuers to seek prior mandates from their shareholders to issue shares in order to provide flexibility and facilitate smaller sized equity fund raisings. Issuers are required to make an announcement about the terms of the issue and the proposed use of proceeds at the time of the fund raising, and account for the actual use of the proceeds in their annual reports⁵.
11. We note that in only about one-fifth of the cases, issuers disclosed specifically in the announcements the proposed use of proceeds. In about four-fifths of the cases reviewed, issuers described the proposed use of the proceeds to be for general working capital or future business developments.
12. More than one-fifth of the issuers updated in their annual reports i) that the proceeds raised were utilized in accordance with the specific uses described in the announcements; or ii) where the funds were to be used for general working capital and/or future business developments, details of the actual application of the proceeds (e.g. construction of facilities, acquisition of assets, etc.).

³ MB Rule 13.28 / GEM Rule 17.30

⁴ Under a general mandate (MB Rule 13.36(2) or GEM Rule 17.41(2)) the share issuance must not exceed 20% of the issuers' share capital; the issue price may not be at a discount of 20% or more to the market price.

⁵ Paragraph 11 of Appendix 16 to the MB Rules / GEM Rule 18.32 sets out the specific disclosure requirements in an annual report, including the use of proceeds.

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13. 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.
14. We consider that issuers should be accountable to their shareholders about their use of funds raised:
 - (a) MB Rule 13.28 / GEM Rule 17.30 requires issuers to describe in their announcements the funds to be raised and the proposed use of the proceeds, and the reasons for making the issue. Issuers should avoid, where possible, generic descriptions. Where issuers intend to use funds raised for working capital or future acquisitions, they should have a clear explanation of the working capital position of the company, or their business plans and proposed acquisitions targets.
 - (b) Paragraph 11 of Appendix 16 to the MB Rules / GEM Rule 18.32 requires disclosure in the annual report about issuers' equity issues, including, among others, the use of the proceeds. To improve their accountability to shareholders issuers should provide meaningful updates on the actual use of proceeds from equity fund raising, including the details of the application and where applicable, a breakdown of how the funds were allocated among different uses.
15. *Specific mandate issue and pre-emptive offers* – In these circumstances issuers must publish a circular and/or a listing document which is pre-vetted by the Exchange. These documents must include the proposed use of proceeds to allow shareholders to make an informed investment/voting decision.
16. Under Paragraph 32 of Appendix 16 to the MB Rules / GEM Rule 18.41, an issuer should discuss in its annual report its significant events during the financial year. From our review we 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.
17. We consider any material equity fund raising to be 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. Issuers should also update in the annual report the details of how the proceeds were applied.

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

18. 78 issues involved securities convertible into ordinary shares of the issuers, including 54 issues under general mandates and 24 issues under specific mandates. We reviewed the announcements, monthly/ next day returns⁶ and annual reports of these issuers.
19. Paragraphs 10(1) and 10(2) of Appendix 16 to the MB Rules / GEM Rules 18.11 and 18.12 require an issuer to disclose in its annual report i) specific details relating to convertible securities issued during the financial year; and ii) particulars of any exercise of conversion right under convertible securities during the financial year. Our review confirmed that issuers have generally complied with the disclosure requirements.
20. A number of issuers undertook corporate actions (e.g. share consolidation or subdivision, capital distributions, further issue of securities) which triggered adjustments to the conversion price and number of conversion shares under the terms of the convertible securities. Issuers confirmed that these adjustments were made in accordance with the terms of the agreement and had been reviewed by auditors or financial advisors.
21. In four cases, 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. Following our enquiries, these issuers did not issue any conversion shares in excess of the mandate limit.
22. As corporate actions triggering the conversion adjustment mechanisms are within the issuer's control, we remind issuers that i) 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 ii) 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.

⁶ MB Rules 13.25A and 13.25B / GEM Rules 17.27A and 17.27B.

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B. Updates on material changes after acquisitions

23. The 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 year⁷.
24. In 2012, we identified a small number of cases with significant asset impairments where i) the information disclosed in the investment circulars may have been incorrect or incomplete; and ii) issuers did not timely announce the material changes to their business. We also noted disclosure could be improved in the discussion about material asset impairments. In this review, we continued to identify instances of non-compliance in these areas.

Scope

25. 255 issuers announced or completed at least one material acquisition in their last two financial years. There were 318 acquisitions, including 116 very substantial acquisitions and 202 major acquisitions, of which 78 involved acquisitions from connected persons. Of these, we identified 29 cases where material impairments were made on the acquired assets during the financial year under review. We also identified nine cases where issuers recorded a material impairment of assets acquired over two years ago. Of these 38 cases, six involved acquisitions from connected persons.
26. We 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. We 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.

⁷ See MB Chapter 14 or GEM Chapter 19 for requirements applicable to material acquisitions, and Paragraph 32 of Appendix 16 to the MB Rules or GEM Rule 18.41 for all disclosure requirements for annual reports.

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Findings

27. We identified four cases where the material write down resulted from failures to obtain working capital, licenses or sign agreements which led to material delays in the production schedules and poor financial performance in the acquired business. These were critical success factors in the acquired businesses and our review suggested that 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 circulars⁸. 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.
28. We also questioned whether the issuers in these four cases had timely informed the market about the failures to obtain key licenses and the delays in production plans. Based on our review, the issuers should have been aware of the material changes in the business prospects of the acquired businesses before they disclosed the impairments in the financial results or profit warning announcements. Failure to timely announce material information may constitute a breach of the Rules.
29. We have taken appropriate actions against the potential breaches above, depending on their nature and materiality. Incidentally, we have also made referrals to the Securities and Futures Commission where we identified cases of potential breaches of the Securities and Futures Ordinance in the course of our review.
30. In the other 34 cases, the asset impairments resulted from events arising after the acquisitions. We reviewed issuers' announcements and were generally satisfied that in all but two cases, issuers informed the market by way of business updates and/ or profit warning announcements.

Valuation

31. HKAS 36⁹ requires a reporting entity to perform an annual impairment test on its goodwill and intangible assets with an indefinite useful life. Of the 38 cases with material impairments, over 70% were supported by valuations prepared by external valuers. We reviewed these valuation reports and the disclosure in the annual report.

⁸ MB Rule 14.66(10) and Paragraphs 29(1)(b) and 30 of Appendix 1B to the MB Rules / GEM Rule 19.66(11) and Paragraphs 29(1)(b) and 30 of Appendix 1B to the GEM Rules

⁹ Hong Kong Accounting Standards 36 - Impairment of Assets

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32. Our review indicates that while issuers generally disclosed the main reasons for asset impairments (e.g. weakened demand, changes in product or commodity prices, changes of government policies), there were little discussions about the valuation methodologies used, the major assumptions and how the changes in circumstances affected the assumptions and inputs used. The investors might not have sufficient information to understand the basis for the impairments and the prospects of the business.

33. We reiterate our guidance to 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

34. Where an acquired business did not meet the performance guaranteed by a connected person, an issuer must publish an announcement¹⁰. 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.
35. In 2012, we identified that some issuers did not disclose the outcome of performance guarantees and/or enforce the obligations of the vendors under the terms of the acquisition agreements. We also recommended that there should be clarity in how the guarantees would be calculated and whether they would achieve the intended purposes, and that issuers should clearly disclose this information in the original investment circulars.

Scope

36. Our review identified 75 guarantees provided on the performance of businesses acquired by issuers where the performance period ended in the financial year under review, of which eight guarantees were provided by connected persons. 31 performance guarantees were met and 44 performance guarantees were not met.
37. We reviewed issuers' announcements, annual reports and the accounts of the acquired businesses to consider whether the outcomes of the performance guarantees were disclosed, and where the performance guarantees were not met, whether the issuers enforced the obligations of the guarantors.

Findings

38. A large majority of issuers followed our 2012 guidance and announced the outcome of these performance guarantees¹¹. Of the remaining issuers that did not initially make such an announcement, a vast majority did so following our enquiries.
39. We reviewed the accounts of the acquired businesses in the 31 cases where issuers announced that the guaranteed performances were met and except for one case, did not note exceptions.

¹⁰ Under MB Rule 14A.57 / GEM Rule 20.57, the announcement must include the shortfall and any adjustment to the consideration, whether the connected person has fulfilled its obligations, whether the issuer has exercised any option to sell the acquired business back to the connected person, and the views of independent directors as to whether the connected person has fulfilled its obligation.

¹¹ In the 2012 review report, we recommended issuers to make clear disclosure about the performance of the acquired business, whether the performance guarantee was met, and whether and, if so, how the guarantor fulfilled its obligations under the terms of the agreement where the performance guarantee was not met.

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40. 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.
41. Of the 44 cases where the acquired companies did not meet the guaranteed performances, the vendors in 31 cases compensated the issuers in accordance with the terms of acquisition agreements. However, 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.
42. In the remaining 13 cases where the performance guarantees were not met, issuers attempted to re-negotiate the compensation terms with the vendors. Common examples included extending the guarantee period, or disposing of the acquired company to the vendors. In most of these cases the issuers disclosed legitimate reasons for the amendments to the original terms. Three cases drew our attention, including:
 - (a) 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
 - (b) 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.
43. These cases (cited in paragraphs 40 to 42 above) raised questions about 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

44. In 2012, we reviewed issuers' compliance with the connected transaction requirements. Except for a few issuers which failed to announce and/or seek shareholder approval for their connected transactions, the vast majority of issuers complied with these requirements. We also noted some omissions in disclosure in the annual reports, including: i) confirmations that issuers have conducted a review of their related party transactions and are satisfied that all connected transactions are properly reported¹²; and ii) for continuing connected transactions, the results of annual reviews by the independent directors and/or auditors¹³.

Scope

45. In view of the positive findings in 2012, we reduced the scope and reviewed the disclosure of 72 issuers that had failed to comply¹⁴ with connected transaction requirements in the previous financial year. We considered whether these issuers have identified and complied with the announcement/ shareholders' approval requirements for connected transactions.

Findings

46. Based on a review of related party transactions disclosed in the issuers' financial statements, we are satisfied that all the issuers reviewed have timely announced, and/or sought shareholder approvals, for their connected transactions. However, two issuers exceeded the annual caps in respect of their continuing connected transactions. These were identified in the auditors' annual review.
47. The Rules require an issuer to announce and/or seek shareholder approval of the continuing connected transactions and a revised annual cap before the annual cap is exceeded. We remind issuers to maintain appropriate internal controls to monitor continuing connected transactions so that they can comply with this requirement.
48. We also reviewed issuers' compliance with the disclosure requirements in annual reports. We continue to note that some issuers failed to disclose: i) the results of auditors' and/or independent directors' review; and ii) confirmation that the issuers have reviewed their related party transactions and were satisfied that all connected transactions were properly reported.
49. We remind issuers again to make disclosure about the review of the connected transactions described in paragraph 48 above. These disclosures provide assurance to shareholders that the issuers have properly reviewed and identified connected transactions.

¹² Paragraph 8(3) of Appendix 16 to the MB Rules / GEM Rule 18.09(3)

¹³ MB Rules 14A.37 to 14A.39 / GEM Rules 20.37 to 20.39

¹⁴ Those non-compliance included failure to announce / seek shareholder approval for continuing connected transactions after their annual caps were exceeded, and failure to timely announce and/or seek shareholder approval for connected transactions.

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

50. The MD&A section allows shareholders to appraise an issuer's performance and prospects. The Rules set out the minimum required disclosure¹⁵ and recommended disclosure¹⁶. In addition, an issuer should include material and relevant information according to its own circumstances.
51. In our guidance letter of July 2013 (HKEx-GL59-13) on MD&A disclosure in listing documents, we recommended that new applicants should prepare 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.

These general principles also apply to the MD&A section in issuers' annual reports.

52. In March 2013, we published the 2012 review report which provides guidance for issuers on annual report disclosure about material changes in their trade receivables, effective tax rates and tax balances, and key performance indicators.

Scope

53. We 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.

¹⁵ Paragraph 32 of Appendix 16 to the MB Rules / GEM Rule 18.41.

¹⁶ Paragraph 52 of Appendix 16 to the MB Rules / GEM Rule 18.83.

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Findings

54. Based on our 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. We made enquiries but did not identify cases involving failure to disclose material information under the Rules.
55. We identified one issuer that underwent material changes in its business model since its listing and did not disclose in its annual reports up-to-date information about its new product lines and changes to its production lines. Following our enquiries, it published an announcement about its business model, which provided the necessary information to adequately explain changes to its financial performance and position.
56. As described in our last report, issuers should improve transparency through better disclosure in its corporate communications, including disclosure in their financial reports and by providing regular trading updates. Better disclosure promotes a more efficient market and discourages allegations about the credibility of issuers' accounts and business models¹⁷.
57. Based on our review, we identify below areas where disclosure may be improved.

Reliance on a small number of key customers

58. Paragraph 52(viii) of Appendix 16 to the MB Rules / GEM Rule 18.83(8) recommends an issuer to give an account of its key relationships with employees, customers, suppliers and others on which its success depends. This discussion may include:
 - (a) background of the major customers, the length of 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 and conditions of any long-term agreements;

¹⁷ In recent years some short sellers published negative research reports on individual companies, making allegations about accounting irregularities and questioning the credibility of the issuers' business models. These reports were generally prepared based on public information published by the issuers and the analysts' own modeling and assumptions, compared with the key performance measures of industry peers.

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- (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

- 59. Paragraph 32 of Appendix 16 to the MB Rules / GEM Rule 18.41 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 emphasize trends and identify significant events or transactions during the financial year under review.
- 60. 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:
 - (a) significant growth in revenue and profit was explained by generic statements, such as enhanced sales team performance and improved product recognition and market awareness; and
 - (b) significant changes in financial position which deviated from the growth trend were not properly explained. For example, a significant increase in revenue coupled with i) a significant decrease in trade receivable balances; or ii) a net operating cash outflow due to significant increases in inventories and trade receivables.
- 61. 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 our guidance letter (HKEx-GL59-13) to enhance their MD&A disclosure:
 - (a) to assist shareholders to better understand how the issuer had performed compared to its industry peers, an issuer should 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.

III. FINDINGS ABOUT RULE COMPLIANCE BY SPECIFIC TYPES OF ISSUERS

A. Biological assets

62. Paragraph 32 of Appendix 16 to the MB Rules / GEM Rule 18.41 requires an issuer to disclose in the MD&A section of the annual report material trends and significant events or transactions during the financial year.
63. Guidance letter HKEx-GL46-12 was published in December 2012 to provide guidance to IPO applicants on the disclosure requirements related to biological assets. We consider 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.
64. HKAS 41¹⁸ requires a biological asset to be measured at fair value less cost to sell (other than when its fair value cannot be measured reliably) and their financial statements to disclose the methods and significant assumptions applied in the fair value measurement.
65. HKAS 1¹⁹ requires disclosure on the major sources of estimation uncertainty at the end of the reporting period in the financial statements. Examples of the disclosure include the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity.

¹⁸ Hong Kong Accounting Standard 41 – Agriculture (“**HKAS 41**”)

¹⁹ Paragraphs 125 to 133 of Hong Kong Accounting Standard 1 – Presentation of Financial Statements (“**HKAS 1**”)

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66. Issuers engaging in agricultural activities are subject to material risks relating to the valuation of biological assets. These issuers may record significant fluctuations in their asset value and/ or profitability as a result of unrealised fair value gain/ loss arising from the valuation of biological assets. The presentation of this information should be clear to investors.

Scope

67. We identified 25 issuers with material biological assets as at the financial year end. These issuers were all engaged in agricultural and forestry activities. We reviewed these issuers' annual reports and the valuation reports and/ or expert reports on the biological assets, and considered whether they have disclosed sufficient information.

Findings

68. We note that a majority of issuers engaged valuers and experts to perform site inspections to assess the physical existence and quality of the biological assets and to prepare the valuations. In circumstances where there were material changes in the valuation from the previous year (21 cases), issuers disclosed the reasons for the material change, which were consistent with the changes to the inputs and assumptions used in the valuation reports. We have not identified any concern upon review of these valuation reports.
69. However, issuers' disclosure in the annual reports can be improved in the following areas. Issuers should consider and apply the guidance set out in paragraph 63:
- (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* - HKAS 41 states that the market approach is the preferred method to measure the fair values of biological assets. Our review identified only 11 issuers that adopted market approach. A majority of issuers adopted the income approach as they took the view that there was no active market or the market data was not readily assessable. However, 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:
 - i) 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;

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- ii) 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
 - iii) 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.

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B. Issuers listed in 2011 and 2012

70. We reviewed the annual reports of 100 issuers listed in 2011 (recently listed issuers) and 64 issuers listed in 2012 (newly listed issuers) and considered their Rule compliance and annual report disclosure in the following areas:
- (a) outcome of profit forecasts and material changes in financial results;
 - (b) use of IPO proceeds;
 - (c) fulfilment of undertakings or conditions imposed before listing; and
 - (d) conflicts of interests and competing businesses between issuers and their directors, major shareholders and their respective associates.

Outcome of profit forecasts and material changes in financial results

71. 19% of newly listed issuers reported profit forecasts in their prospectuses and all met the forecasted profits. While two issuers made profit warnings in respect of the first interim period subsequent to the forecast period due to i) change in economic factors; and ii) change in laws and regulations applicable to their businesses, they were not new developments after listing as these reasons had been described in their prospectuses.
72. Of the newly listed issuers that did not disclose profit forecasts in their prospectuses, 12 of them published profit warning announcements in the first financial year after listing. We note the underlying factors giving rise to the deterioration in results were disclosed in the prospectuses.
73. We also noted that 39% of the recently listed issuers (2012 review: 34%) announced profit warnings in respect of their second financial year after listing. Reasons given for the deterioration in financial results included: i) changes in market conditions; and ii) delays in the implementation of business plans. These were generally disclosed as risk factors in the issuers' prospectuses.

Use of IPO proceeds

74. Five newly listed issuers and six recently listed issuers announced changes in their use of IPO proceeds during the financial year under review. With the exception of one case, these revised uses were generally in line with the business developments discussed in the prospectuses, or represented a re-allocation of resources within the projects described in the prospectuses. In one case, a recently listed issuer proposed an acquisition of a new business not described in the prospectus. This issuer had announced the change with an explanation and had sought shareholder approval in accordance with the Rules²⁰.

²⁰ Under MB Rule 14.89 / GEM Rule 19.88, an issuer must not, during the period of 12 months from date of listing, enter into any acquisition(s), disposal(s) or other transaction(s) or arrangement(s), which would result in a fundamental change in its principal business as described in the prospectus.

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Other areas under review

75. We did not identify any non-compliance issues concerning i) the fulfilment of undertakings or conditions imposed before listing; and ii) disclosure of competing businesses with their directors, major shareholders and their respective associates under MB Rule 8.10 / GEM Rule 11.04.

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

76. Under MB Rules 18.14 to 18.18 / GEM Rules 18A.14 to 18A.18, Mineral Companies and non-Mineral Companies²¹ must disclose an annual update of resources and reserves. Updates should be presented in a tabular format in a manner readily understandable, and substantiated at least by internal experts with assumptions clearly disclosed. Mineral Companies²² 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) sets out recommended disclosure in these areas.

Scope

77. We reviewed the annual reports of 34 Mineral Companies and 43 non-Mineral Companies, and considered their compliance with the Rule requirements and the guidance letter.

Annual updates on resources and reserves

78. All 34 Mineral Companies and 40 non-Mineral Companies provided annual updates of resources and reserves estimates in their annual reports. Most of these updates were disclosed in a tabular format. We note that i) 30 companies either made a no material change statement or revised the estimates by deducting the production amounts; and ii) 44 companies revised the estimates based on updated exploration results (e.g. new drilling results). A majority of these issuers (over 80%) engaged internal or external experts to review the revised estimates.
79. We recommended in our 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. We note that over half of the 44 companies identified did not follow, or only partially followed this recommendation.

²¹ A non-Mineral Company refers to an issuer that publicly disclosed information about resources and / or reserves under MB Rule 18.15 / GEM Rule 18A.15.

²² Under MB Rule 18.01 / GEM Rule 18A.01, a Mineral Company refers to a new applicant whose major activity is the exploration for and/or extraction of natural resources, or an issuer that completes a material acquisition of mineral or petroleum assets (i.e. major acquisition or above).

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Exploration, development and mining production activities

80. All but one of the 34 Mineral Companies made disclosure about their exploration, development and mining production activities. A majority of Mineral Companies are in the production stage and their disclosures were generally focused on the production activities. Around one-third of these companies, which also had projects at development or exploration stages, did not disclose their exploration and development activities during the financial year.
81. Other recommendations set out in our guidance letter (HKEx GL47-13) were partially taken up:
- (a) 71% of Mineral Companies which had multiple projects disclosed details of exploration, development and mining activities on a project-by-project basis;
 - (b) 44% of Mineral Companies disclosed details of their new contracts and/or commitments; and
 - (c) some issuers experienced delays in the application process for the exploration/mining licenses or delays in the expansion plan and/or infrastructure construction. While these issuers disclosed the delays, they failed to discuss the business and financial impact of the delay and the revised business plans.

Expenditures incurred

82. A majority of the Mineral Companies disclosed information about the capital expenditures. Only a few Mineral Companies provided a summary of expenditures incurred in its exploration, development and mining production activities. Most of these disclosures were made in relatively broad categories. Mineral Companies should provide further breakdowns in order to provide more meaningful information to the shareholders and enhance the transparency.
83. In general, we consider the disclosure have slightly improved over the previous year. We have followed up with those issuers whose disclosure fell short of the Rules requirements and the guidance set out in our guidance letter (HKEx GL47-13). We remind issuers to follow the guidance letter (HKEx GL47-13). We consider issuers should further enhance the disclosure in their annual reports in the above areas.

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D. Disclosure by investment companies listed under MB Chapter 21

84. In the 2012 review, we identified some investment companies which had omitted to disclose information about their investments required under MB Rule 21.12(1), including i) an analysis of provision for diminution in the value of investments; ii) an analysis of realised and unrealised surpluses; and iii) a list of their significant investments. As investment companies are bound by their investment mandates and exempt from certain requirements under Chapter 14 of the MB Rules, the required disclosure plays an important role to provide shareholders with information about the underlying investments.

Scope

85. Our review covered the annual reports of all 25 investment companies listed on the MB. We considered whether:
- (a) the specific disclosure requirements in annual reports were met; and
 - (b) their operations complied with the general obligations under MB Chapter 21.

Findings

86. 16 investment companies have disclosed details of their investments in annual reports required under MB Rule 21.12(1). Nine investment companies omitted either one or two of the required disclosures. We have reminded these investment companies to disclose full details of their investments in annual reports.
87. All investment companies complied with the general obligations under MB Chapter 21, including conducting business activities within their investment mandates and maintaining a reasonable spread of investments. This represents an improvement over 2012 where three companies failed to comply with some of these requirements.

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IV. CONCLUSION

88. We continue to identify a small number of cases involving potential breaches of the Rules, particularly in areas relating to material acquisitions and performance guarantees. Our review of issuers' disclosure over time helped us identify cases of potentially misleading disclosure in corporate documents, and possible corporate misconduct and issues with directors' role in safeguarding corporate assets. We have taken appropriate actions against these potential breaches, depending on their nature and materiality. Incidentally, we have also made referrals to the Securities and Futures Commission where we identified cases of potential breaches of the Securities and Futures Ordinance in the course of our review.
89. We also identify areas where issuers can improve their disclosure. While disclosure in the areas of performance guarantees have improved, we note that issuers have not fully adopted our guidance in other areas, particularly the annual updates by Mineral Companies and non-Mineral Companies; and MD&A analysis of material changes in financial items including taxes, trade receivables and key performance indicators. We also identified and gave guidance in new areas including accountability of the use of proceeds from equity fund raising, and disclosure in the MD&A section about the valuations of biological assets, reliance on key customers and significant changes in financial results.

- End -

