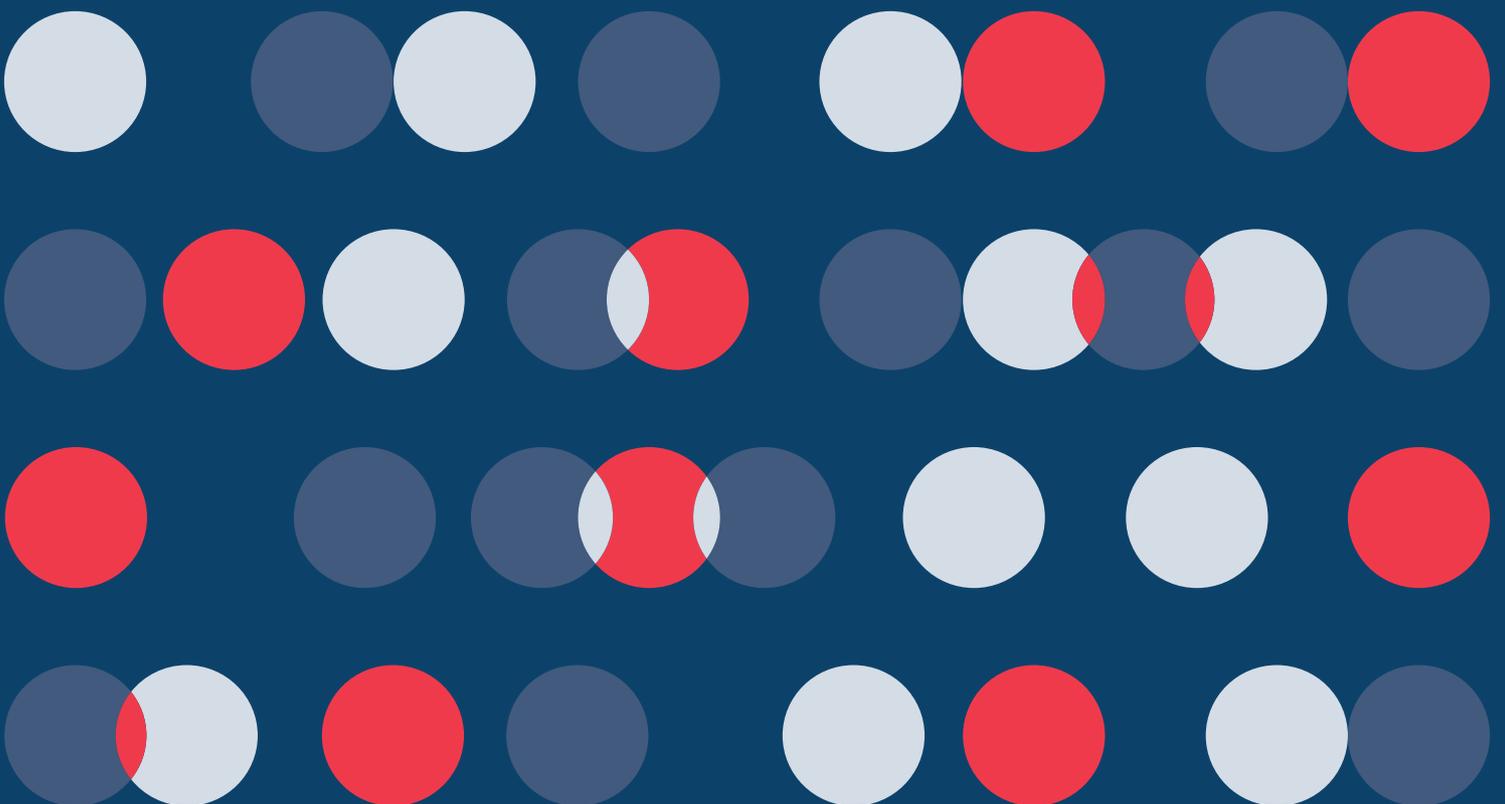


January 2016

REVIEW OF DISCLOSURE IN  
ISSUERS' ANNUAL REPORTS TO  
MONITOR RULE COMPLIANCE

REPORT 2015



# Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2015

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# Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2015

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## EXECUTIVE SUMMARY

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

We have examined issuers' annual reports with a focus on Rule compliance, issuers' 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 disclosure in its corporate communications (for example, announcements and circulars) over time.

Our review covered the following areas. Items (iii), (iv) and (vi) are new areas of review not covered last year.

- (i) Fundraising through issue of equity / convertible securities and subscription rights
- (ii) Updates on material changes and results of performance guarantees after acquisitions
- (iii) Continuing connected transactions
- (iv) Share option / award schemes
- (v) Disclosure of significant changes to issuers' financial performance and reliance on key customers in the MD&A section
- (vi) Contractual arrangements adopted by issuers
- (vii) Issuers listed in 2013 and 2014

We note that in areas we reviewed last year, a vast majority of issuers continue to comply with the Rules, but there are some areas where issuers can improve their disclosure. In new areas of review, we note that some issuers did not fully follow our guidance on best practices.

We specifically draw issuers' attention to the following areas where they should improve their practices:

- (a) *Continuing connected transactions* – independent directors have an important role in monitoring issuers' continuing connected transactions, and are required under the Rules to review these transactions annually. However, based on the documents provided by issuers' management to independent directors for review, it is unclear how the independent directors assessed and concluded that the transactions were conducted according to the terms of the framework agreements between the issuers and their connected persons. With the new Code Provision C.2.5 of

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Appendix 14 to the MB Rules / Appendix 15 to the GEM Rules requiring internal audit review of risk management and internal control systems, issuers should ensure that their internal audits review continuing connected transactions and the relevant internal control procedures, and provide the findings to independent directors to assist them in performing their annual review.

- (b) *Contractual arrangements adopted by issuers* – Our Guidance Letter ([GL77-14](#)) recommends that issuers keep their shareholders informed of their material business operations through these arrangements. A vast majority of issuers adopting contractual arrangements did not disclose details of their business activities or a summary of the major terms under the relevant structured contracts and their significance to the issuers. Given the potential risks associated with these arrangements, issuers should take note of and consider the guidance in preparing their future annual reports.
- (c) *Disclosure of significant changes to issuers' financial performance and reliance on key customers in the MD&A section* – there is general improvement in the MD&A disclosures in the areas reviewed. Many issuers have provided more discussions relating to significant changes in their revenue, profit margin and tax positions. However, issuers should provide more in-depth discussion about their compliance with the relevant laws and regulations, their capital requirements and the financing plan for such capital requirements, and their key relationships with customers. Issuers should note that some of these items were previously recommended commentaries and are now disclosure requirements for business reviews under the Rules, which apply to annual reports of financial periods ended on or after 31 December 2015. Issuers may also refer to the guidance materials issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Institute of Directors for the preparation of a business review.
- (d) *Equity fundraising* – to provide accountability to shareholders, issuers conducting equity fundraising should provide meaningful updates in their annual reports on the actual use of proceeds from equity fundraising, including details of the application and a breakdown of how the funds were allocated among different uses.

In our next review<sup>1</sup>, we intend to cover most of the areas reviewed under this report, in particular continuing connected transactions will continue to be an area of focus.

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<sup>1</sup> Our next review will cover annual reports for the financial year ended between January and December 2015

## Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2015

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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 annual reports 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 issuers' businesses, including both positive and negative circumstances, in the "management discussion and analysis" section (**MD&A**). Better disclosure improves transparency and promotes a fair, orderly and informed market.
2. As part of our monitoring of issuers' activities, we review annual reports with a particular focus on their Rule compliance, corporate conduct and 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 disclosure in its corporate communications (for example, announcements and circulars) over time. Our review of issuers' disclosure over time helps us identify cases of potentially misleading disclosure in corporate documents, issues on directors' role in safeguarding corporate assets, and possible corporate misconduct.
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 previous annual report reviews as well as guidance materials issued from time to time. Where appropriate, we have requested issuers to make further disclosures by way of announcements, or in subsequent financial reports.

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4. This report presents our findings and recommendations from our review of the following seven areas. Our review covers the annual reports of issuers with the financial year ended in December 2014<sup>2</sup>:
  - (i) Fundraising through issue of equity / convertible securities and subscription rights (Part IIA)
  - (ii) Updates on material changes and results of performance guarantees after acquisitions (Part IIB)
  - (iii) Continuing connected transactions (Part IIC)
  - (iv) Share option / award schemes (Part IID)
  - (v) Disclosure of significant changes to issuers' financial performance and reliance on key customers in the MD&A section (Part IIE)
  - (vi) Contractual arrangements adopted by issuers (Part IIIA)
  - (vii) Issuers listed in 2013 and 2014 (Part IIIB)
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 the 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.

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<sup>2</sup> The scope of review for each area is set out in parts II and III of this report

**II. FINDINGS ON SPECIFIC AREAS OF DISCLOSURE**

**A. Fundraising through issue of equity / convertible securities and subscription rights**

7. Under the Rules, issuers may issue securities under a general mandate on terms permitted by the Rules, or under a specific mandate on particular terms and for specific uses set out in a circular and approved by shareholders. In both cases, issuers are required under the Rules to announce details of their equity fundraising, including the terms and size of the equity issuance and the proposed use of proceeds. They are also required to report to shareholders on the fundraising conducted during the financial year in their annual reports.
8. In our previous Review Reports, we recommended that, to provide accountability to shareholders, issuers should avoid generic descriptions and provide meaningful updates in their annual reports<sup>3</sup> on the actual use of proceeds, including details of the application and where applicable, a breakdown of how the funds were allocated among different uses and whether the funds raised were applied in accordance with the specified uses previously disclosed.
9. For issue of convertible securities and warrants, issuers must also comply with other specific Rule<sup>4</sup> requirements. These include disclosure in the announcement of the maximum number of shares to be issued upon exercise of the conversion or subscription rights, a summary of the provisions for adjustments of the price and/or number of shares to be issued and other material terms. Further, the Rules<sup>5</sup> require issuers to disclose in their annual reports specific details of the class, number and terms of the convertible securities and warrants issued together with the consideration received by the issuers, and particulars of any exercise of conversion rights during the year. Where a general mandate is used, the Rules require issuers to announce details of the mandate. Issuers should also disclose in their annual reports whether the mandate was sufficient after any adjustments of the conversion or subscription price.
10. In addition, the Rules<sup>6</sup> require an issuer to seek prior approval of the Exchange before it proposes any alterations in the terms of convertible securities or warrants after issue, unless the alterations take effect automatically under their existing terms.

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<sup>3</sup> 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 proceeds. 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.

<sup>4</sup> MB Rule 13.28 / GEM Rule 17.30

<sup>5</sup> Paragraphs 10(1) and (2) of Appendix 16 to the MB Rules / GEM Rules 18.11 and 18.12

<sup>6</sup> MB Rules 15.06 and 16.03 / GEM Rules 21.06 and 22.03

## Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2015

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### *Scope*

11. We reviewed the announcements and annual reports of all issuers that conducted equity fundraising during the financial year, including placings under general mandates and specific mandates, and pre-emptive issues.
12. We reviewed the disclosures about these issuers' proposed and actual use of proceeds in the announcements and the annual reports. For convertible securities and subscription rights, we also reviewed whether the issuers had complied with the disclosure requirements in paragraph 9 and had sought the Exchange' prior approval for alterations of terms in paragraph 10 above.

### *Findings*

#### For all issues

13. In general, issuers disclosed the basic information required under the Rules. Approximately half of them disclosed specific details of the use of proceeds in annual reports. They either confirmed the specific uses as described in the announcements or, where the funds were proposed to be used for general working capital or future business developments, disclosed details of the actual application. A majority of issuers that repeatedly conducted equity fundraising during the year also disclosed specific details of the actual use of proceeds from previous fundraising in their announcements and/or circulars. The level of details disclosed was similar to that of the last year.
14. As recommended in our last report, issuers should provide meaningful updates in their annual reports on the actual use of proceeds from equity fundraising, including details of the application and a breakdown of how the funds were allocated among different uses.

#### For convertible securities and warrant issues

15. Our review indicates that issuers have generally complied with the disclosure requirements in paragraph 9 above.
16. We identified two cases of placing of convertible securities under general mandates where the mandate limits were slightly exceeded as a result of issuers' corporate actions which triggered the adjustment provisions of the convertible securities. Issuers should have appropriate procedures in place to keep track of the number of conversion shares issued and issuable under the terms of the convertible securities, and to take this into account before taking any corporate actions that would trigger the adjustment provisions. The above guidance was reiterated in our guidance letter ([GL80-15](#)) of May 2015.

## **Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2015**

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17. We also identified one case of placing of warrants where the issuer amended the terms of the warrants without our approval. As set out in paragraph 10 above, issuers are reminded to seek our prior approval for any alterations in the warrant terms after issue.

**B. Updates on material changes and results of performance guarantees after acquisitions**

18. The Rules require issuers to announce material acquisitions, publish investment circulars and seek shareholder approvals for these acquisitions. In addition, issuers should disclose in the MD&A section information about the acquired businesses, including circumstances involving any material asset impairments.
19. Where the asset impairment is supported by independent valuation, we recommended in our previous Review Reports that issuers should disclose details of the value of inputs, basis and assumptions of valuation, the valuation method and the reasons for using that method, and where there is any significant change to any of them from those previously used, an explanation of such change. This will enable shareholders to understand the basis for the impairments and the prospects of the acquired business.
20. Some issuers would require the vendors to guarantee the performance of the acquired business as part of the terms of the acquisition agreements. Where the guarantee is not met, the shortfall might be returned to the issuer in the form of compensation or as an adjustment to the consideration based on an agreed formula.
21. The Rules set out the information required to be disclosed in an announcement and the next annual report where the performance is guaranteed by a connected person and the actual performance fails to meet the guarantee. In our previous Review Reports, we recommended that, no matter whether the performance is guaranteed by a connected person or an independent party, issuers should publish an announcement and disclose in their next annual report whether or not the performance guarantee has been met, the performance of the acquired business, and where the performance guarantee is not met, how the issuers would enforce the obligations of the guarantors under the acquisition agreements.

*Scope*

22. We reviewed the announcements, circulars and annual reports of the issuers that had (a) completed material acquisitions in their last two financial years; (b) recorded a material impairment on the acquired assets in the financial year under review; or (c) required performance guarantees in previous acquisitions and the guaranteed period ended in the financial year under review.
23. For cases of material impairments, we also reviewed (a) the annual report disclosure about the development of the acquired businesses; and (b) the valuation reports on the assets.

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24. For cases of performance guarantees, we also reviewed issuers' annual reports and announcements to assess whether the outcomes had been disclosed, and where the performance guarantees were not met, whether and how the issuers enforced the obligations of the guarantors. For cases where the performance guarantees were met, we also reviewed the accounts of the acquired businesses to assess whether the performance guarantees were genuinely met.

### *Findings*

25. Compared to the same period last year, there was a decrease in the number of cases where material impairment was made on the acquired assets. In all these cases, we noted that the material impairments generally resulted from a slowdown in the market condition of the relevant industry and decline in the trading price of the commodities which the acquired businesses produced and/or traded. These material developments occurred after the completion of the acquisitions. Issuers generally announced such material developments to the acquired business in a timely manner and discussed in their annual reports matters that gave rise to the impairments. All such material impairments were supported by independent valuations. Issuers generally disclosed the details as recommended in paragraph 19 above.
26. Approximately half of the acquisitions where issuers required performance guarantees were completed in 2014; while the remaining acquisitions were completed in 2013 or earlier. Our review indicates that:
- (a) In all cases, issuers disclosed whether or not the performance guarantees were met, and if not, whether and how the guarantors fulfilled their obligations under the agreement terms.
  - (b) Where the performance guarantees were not met, issuers in most cases had been compensated by the guarantors in accordance with the terms of the original agreements as set out in the acquisition circulars. In the other cases, issuers took legal actions to recover the compensation.
  - (c) Where the performance guarantees were met, we did not note any exceptions from the review of the accounts of the acquired businesses and were satisfied that the performance guarantees were genuinely met.
27. Our review shows that issuers have continued to follow our recommendations set out in paragraph 21 above.

**C. Continuing connected transactions**

28. MB Chapter 14A / GEM Chapter 20 governs transactions between an issuer and its connected persons by providing safeguards against connected persons taking advantage of their positions in the issuer. An issuer is required to (a) announce the transaction and, where the transaction is material to the issuer, seek independent shareholder approval; and (b) report connected transactions in its annual report.
29. The Rules provide additional safeguards on continuing connected transactions by requiring, among others, independent directors to perform an annual review of the transactions, and confirm in the annual report that they have been conducted in accordance with the terms of the framework agreement, on normal commercial terms or better, and in the issuer's ordinary and usual course of business.
30. In March 2014, we published Guidance Letter ([GL73-14](#)) to provide guidance on complying with the continuing connected transactions Rules. The terms of the framework agreement should be specific, for example, an issuer should agree on specific pricing terms with its connected persons. Where this is not commercially practical, it should conduct the transactions in accordance with the pricing policies and guidelines that apply equally to transactions with independent customers. Such policies and guidelines may include:
  - (a) For sales of off-the-shelf goods or standard services, an indicative range of prices for the goods/services, or the minimum/maximum mark-up rate for transactions charged on a cost-plus basis.
  - (b) For sales of proprietary goods or services, the process for estimating and approving selling prices for the goods or services.
  - (c) For purchases of goods or services, the procedures for obtaining quotations or tenders from the connected persons and a sufficient number of independent suppliers, the assessment criteria and the approval process.
31. The issuer should also put in place appropriate internal control procedures to ensure that the transactions are conducted in accordance with the above pricing mechanism, and hence they are on normal commercial terms and in the interests of the issuer.

## Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2015

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32. For the purposes of performing an annual review, independent directors should consider whether:
- (a) the transactions have been conducted on normal commercial terms or better and according to the agreement governing them on terms that are fair and reasonable and in the interests of the issuer; and
  - (b) the internal control procedures put in place by the issuer are adequate and effective.

### *Scope*

33. This year we reviewed issuers' announcements, circulars and disclosure in annual reports to consider whether:
- (a) the issuers have properly identified and announced their continuing connected transactions at the time of the agreements (through our review of related party transactions disclosed in notes to financial statements and enquiries with issuers); and
  - (b) continuing connected transactions were reviewed by independent directors and auditors<sup>7</sup>, and the review results were reported in the annual reports.
34. Our review covered the annual reports of all issuers which conducted continuing connected transactions during the financial year (excluding those with specific pricing terms agreed at the time of framework agreement). We also obtained copies of the minutes of audit committee (or appropriate committee) of selected issuers to consider whether independent directors were given sufficient information to discharge their duties. These minutes were normally attached with reports on the review of continuing connected transactions prepared by the issuers' management and/or external auditors.

### *Findings*

35. From our review, we noted that:
- (a) A vast majority of issuers disclosed in their annual reports whether their related party transactions are connected transactions under the Rules, and whether they have complied with the relevant connected transaction requirements. Our follow-up action against omitted disclosures did not reveal any breach of the announcement and/or shareholder approval requirements.

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<sup>7</sup> Issuers are also required to submit the auditors' confirmation letter to the Exchange about the results of the auditors' reviews.

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- (b) A vast majority of issuers also disclosed their continuing connected transactions and the results of reviews by independent directors and auditors. A few issuers omitted to disclose the results of reviews in the annual reports. In only one case, the auditor identified that the annual cap was exceeded during the financial year.
36. Based on our review of the management/external auditors' reports provided to the independent directors, we note that these reports primarily focused on whether the transactions by their nature were covered by the framework agreement and whether the total transaction amount during the financial year was within the annual caps. However, they did not cover the work done by the management to ascertain whether:
- (a) the transactions have been conducted in accordance with the pricing policies or mechanisms under the framework agreement, including the pricing range, the process for estimating the selling prices for the goods or services, and the procedures for obtaining quotations or tenders, as appropriate; and
- (b) the issuer's internal control procedures are adequate and effective to ensure that transactions are so conducted.
37. In light of this, it is unclear how the independent directors had assessed the transactions to conclude (a) that they were indeed conducted in accordance with the terms of the framework agreements and on normal commercial terms; and (b) the adequacy and effectiveness of the issuer's internal control procedures (as described in paragraph 32 above).
38. We remind independent directors of their roles in monitoring the issuers' continuing connected transactions and the importance of the above assessments. They should ensure that their review properly covers all these assessments and, where appropriate, make enquiries with the management to ensure that they have sufficient information to properly review the transactions and the internal control procedures.
39. Issuers are also reminded that the new Code Provision C.2.5 of Appendix 14 to the MB Rules / Appendix 15 to the GEM Rules becomes effective for accounting periods beginning on or after 1 January 2016. It provides that an issuer should have an internal audit function which generally carries out the analysis and independent appraisal of the adequacy and effectiveness of its risk management and internal control systems. We recommend that issuers should ensure that their internal audits review these transactions and internal control procedures (as described in paragraph 36 above), and provide the findings to the independent directors to assist them in performing their annual review.

**D. Share option / award schemes**

40. MB Chapter 17 / GEM Chapter 23 governs the share option schemes adopted by issuers and their subsidiaries. It provides a framework for share option schemes adopted by issuers (e.g. scheme limit, discount limit on exercise price, circumstances where grant of options requires shareholder approval) and disclosure requirements in annual / interim reports to update the shareholders on the movement of share options under such schemes during the financial year / period.
41. Some issuers adopted other forms of share based compensation schemes such as a share award scheme, which is similar to a share option scheme but without the option element. MB Chapter 17 / GEM Chapter 23 is not applicable. Share awards may be satisfied by acquiring existing shares on market, issuing new shares under a general mandate or specific mandate, or a combination of both. For share awards granted to connected persons, the connected transaction requirements (MB Chapter 14A / GEM Chapter 20) apply to share awards satisfied by issue of new shares, and the Model Code requirements (Appendix 10 to the MB Rules / GEM Rules 5.46 to 5.68) apply to share awards satisfied by issue of new shares or on-market acquisition of existing shares.
42. HKFRS 2<sup>8</sup> also sets out disclosure requirements on the nature and extent of share based payment arrangements that existed during the period, how to calculate the fair value of equity instruments granted, and the effect of share based payments to the issuer's profit for the period and on its financial position. These disclosure requirements are applicable to both share option schemes and share award schemes.

*Scope*

43. We reviewed the annual report disclosures about the details of share option / awards schemes adopted and movements of share options / awards during the financial year, and considered whether:
- (a) for share option schemes, issuers have complied with the disclosure requirements under the Rules; and
  - (b) for share award schemes, issuers have complied with the connected transaction requirements and/or the Model Code requirements, as the case may be.

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<sup>8</sup> Hong Kong Financial Reporting Standard 2 – Share-based Payment

## Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2015

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### *Findings*

44. Based on our review, issuers generally complied with the specific disclosure requirements for their share option schemes. A vast majority of issuers:
- (a) included the particulars of options outstanding, granted, exercised, cancelled and lapsed during the financial year, categorized by five groups: (i) each director, chief executive and substantial shareholder, and their respective associates; (ii) each participant with options granted in excess of individual limit; (iii) aggregate figures for employees; (iv) aggregate figures for suppliers; and (v) aggregate figures for all other participants;
  - (b) provided the value of options granted during the financial year, or the reasons for non-disclosure of the value of options granted in their annual reports; and
  - (c) disclosed the particulars of the terms of share options schemes adopted (including the purpose, eligible participants, maximum entitlement per participant, basis of determining the exercise price, etc.). That said, there is a common omission in relation to the total number of securities available for issue under the schemes together with the percentage of issued shares that it represents as at the date of annual report (under MB Rule 17.09(3) / GEM Rule 23.09(3)).
45. While the share option scheme requirements are not applicable to share award schemes, a majority of issuers under review disclosed the particulars of their share award schemes and movements in share awards under such schemes in accordance with HKFRS 2. Based on our review, issuers generally complied with the connected transaction requirements and/or the Model Code requirements.

**E. Disclosure of significant changes to issuers' financial performance and reliance on key customers in the MD&A section**

46. The MD&A is important as it serves to provide the shareholders and investors with information regarding an issuer's performance and prospects. Paragraphs 32 and 52 of Appendix 16 to the MB Rules / GEM Rules 18.41 and 18.83 set out the minimum required disclosure and recommended disclosure to be covered in the MD&A.
47. Based on our reviews of the MD&A in previous years, we recommended areas where disclosures could be improved: these areas included (a) significant changes in revenue, profit margin and tax positions during the financial year under review; and (b) reliance on a small number of key customers.
48. In February 2015, we published the consultation conclusions on "*Review of Listing Rules on Disclosure of Financial Information with Reference to The New Companies Ordinance and Hong Kong Financial Reporting Standards and Proposed Minor/Housekeeping Rule Amendments*". Under the new Companies Ordinance, a business review must form part of a directors' report in the company's annual report.
49. Following the amendments of the Companies Ordinance, a business review section was introduced in the annual report disclosure requirement under Paragraph 28(2)(d) of Appendix 16 to the MB Rules / GEM Rule 18.07A(2)(d) (**New Rules**). Moreover, the following three recommended commentaries under Paragraph 52 of Appendix 16 to the old MB Rules / old GEM Rule 18.83 have been removed and are now included in the New Rules:
- (a) a discussion on business risks (including known events, uncertainties and other factors which may substantially affect future performance) and risks management policy;
  - (b) a discussion on the issuer's environmental policies and performance, including compliance with the relevant laws and regulations; and
  - (c) an account of the issuer's key relationships with employees, customers, suppliers and others, on which its success depends.

The New Rules apply to accounting periods ended on or after 31 December 2015.

## Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2015

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### *Scope*

50. As mentioned in 2014 Review Report, in recent years we noted occasions where the media, analysts and/or short sellers published negative reports on individual companies, making allegations about accounting irregularities and questioning the credibility of the issuer's business models. This year, we reviewed the annual reports of 38 issuers who either have encountered significant changes in financial position or are reliant on a small number of key customers. We considered if their MD&A disclosures provided sufficient analysis and explanations about the fluctuation of their performance and allowed investors to understand their business models, and identified areas which could be improved.

### *Findings*

51. We noted general improvement in the MD&A disclosures in the areas reviewed.

#### *Significant change in revenue, profit margin and tax positions*

52. 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 material factors underlying its results and financial position. It should emphasize trends and identify significant events or transactions during the financial year under review. In previous reports, we noted that issuers repeated information available in the financial statements in a narrative form without additional analysis and explanations. We suggested issuers to refer to the recommended disclosure under Paragraph 52 of Appendix 16 to the MB Rules / GEM Rule 18.83 and our guidance letter ([GL59-13](#)) to enhance their MD&A disclosure to provide more meaningful explanation of the factors causing the material changes in revenue, profit margin and tax positions during the financial year under review.
53. We noted many issuers provided more in-depth discussions on significant changes in their revenue, profit margin and tax positions from the current review.
54. Many issuers have adopted our suggestion in the previous reports and included an industry overview covering changes to laws and regulations and market conditions relating to their businesses, and explained how these changes have led to the fluctuation of their financial performance during the financial year. However, only a few issuers have discussed their compliance with the relevant laws and regulations that have a significant impact on their businesses. We remind issuers that this is now a disclosure requirement under the New Rules.

## Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2015

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55. We also noted that a majority of the issuers have not provided updates on material changes to their operations (such as product mix and business model), management's objectives and corporate strategies, nor described how these changes have contributed to their business performance during the financial year. Further, only a few issuers have provided an analysis of their performance using financial key performance indicators, and compared their results with industry peers. We consider that this information would enable shareholders and investors to better understand how management intends to address market trends and the threats and opportunities within the market, and provides an indication of the issuer's future business developments.
56. Under Paragraph 32(1) of Appendix 16 to the MB Rules / GEM Rule 18.41(1), issuers should disclose their liquidity and financial resources. This may include comments on the level of borrowings as at the balance sheet date, the seasonality of borrowing requirements, and the maturity profile of borrowings and committed borrowing facilities. Reference may also be made to the funding requirements for capital expenditure commitments and authorisations.
57. Based on our review, we noted that many issuers have disclosed their debts profiles (such as outstanding balances, maturity and interest rate) and gearing ratios in the annual reports. However, there was little discussion on their capital expenditure requirements and financing plan for meeting such capital requirements. Issuers are encouraged to:
- (a) lay out the capital expenditure requirements for their business operations (such as the expected construction costs for projects under development and/or new production factories and plants, budget plan to increase land banks, expected research and development costs for new technology and products mix, etc.); and
  - (b) include a discussion on their financing plans to meet the capital commitments, repay the current debt and whether there are any fundraising activities in the upcoming year.

### *Reliance on a small number of key customers*

58. In our previous reviews, we encouraged issuers to disclose details of those key customers and their relationships as recommended under Paragraph 52(viii) of Appendix 16 to the old MB Rules / old GEM Rule 18.83(8). Based on our review this year, we noted that only a minority of issuers have followed our recommendation and provided detailed discussion of their relationships with key customers in the annual reports.

## Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2015

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59. We remind issuers of our suggested disclosures set out in the 2013 Review Report, including:
- (a) the background of the major customers and their length of relationship with the issuer;
  - (b) the credit terms granted to major customers and whether they are in line with those granted to other customers;
  - (c) details of the subsequent settlement of trade receivables with major customers, and whether any provisions are necessary; and
  - (d) the risks associated with reliance on major customers, and measures undertaken by issuers to mitigate such risks.
60. Under the New Rules, an issuer must include in its annual report an account of its key relationships with customers. This may also include a discussion on whether such relationships expose the issuer's business to any substantial risks.
61. For further guidance on the preparation of a business review, issuers may refer to the Hong Kong Institute of Certified Public Accountants' Accounting Bulletin 5 *"Guidance for the Preparation and Presentation of a Business Review under the Hong Kong Companies Ordinance Cap. 622"* and the Hong Kong Institute of Directors' *"Clear and Concise: A Director's Guide to Writing the Business Review of an Annual Report"*.

### III. FINDINGS ABOUT RULE COMPLIANCE BY SPECIFIC TYPES OF ISSUERS

#### A. Contractual arrangements adopted by issuers

62. Issuers engaged in businesses subject to foreign ownership restrictions listed in the Foreign Investment Industries Guidance Catalogue commonly use contract-based arrangements or structures (**Contractual Arrangements** or **Structured Contracts**) to indirectly own and control such businesses and the operating entities. Guidance Letter ([GL77-14](#)) sets out factors for issuers to consider when adopting Contractual Arrangements, and requires disclosures in issuers' transaction announcements and circulars about the legality and validity of the Contractual Arrangements and subsequent changes thereto.
63. The Guidance Letter states that any Contractual Arrangements adopted by issuers must be narrowly tailored to achieve their business purposes and to minimize the conflicts with the relevant PRC laws and regulations. Issuers should unwind the Structured Contracts and comply with all relevant PRC laws and regulations as soon as the law allows those businesses to be operated without the Structured Contracts.
64. The Guidance Letter recommends that issuers keep their shareholders informed of their material business operations through Contractual Arrangements in its annual report. These disclosures should include (i) particulars of the operating entity and its registered owners, and a summary of the major terms of the Structured Contracts; (ii) a description of the operating entity's business activities and their significance to the issuer (e.g. the respective revenue and assets value); and (iii) the reasons for using Contractual Arrangements, the associated risks and actions taken by the issuer to mitigate the risks.

#### *Scope*

65. We reviewed the annual reports of the issuers that use Contractual Arrangements to operate businesses subject to foreign ownership restrictions (the **VIE-Issuers**). We reviewed whether they had considered our guidance on annual report disclosures in paragraph 64 above and made the relevant disclosures in their annual reports. These businesses include valued-added telecommunication services (e.g. online/mobile games, information services, etc.), internet cultural related services, broadcasting and media publications.

### *Findings*

66. A vast majority of the VIE-Issuers did not fully disclose the operating entities' business activities or a summary of the major terms under the Structured Contracts and their significance to the VIE-Issuers (e.g. the respective revenue and assets value). They also omitted disclosure about the associated risks and reasons for using the Contractual Arrangements for their businesses.
67. In light of the potential risks associated with these arrangements, the VIE-Issuers should take note of and consider our guidance in paragraph 64 above in preparing their future annual reports.

### *Latest regulatory development in using Contractual Arrangements*

68. In January 2015, the PRC's Ministry of Commerce published a consultation draft of the new PRC Foreign Investment Law (the **Draft Law**). Following the publication of the Draft Law, concerns over the legality and validity of Structured Contracts to hold interests in PRC businesses which are subject to foreign ownership restrictions may be heightened. Issuers should closely monitor any changes in the laws and regulations that govern Contractual Arrangements, and timely announce any material developments that may have an impact on the legality and validity of their Contractual Arrangements and the issuers' actions in response to these regulatory changes. Issuers should also keep investors informed of details of their business operations subject to Structured Contracts and any material developments so that investors can make an informed assessment.
69. In March 2015, the PRC government published a revised Foreign Investment Industries Guidance Catalogue which releases certain businesses from the foreign ownership restrictions. As the Contractual Arrangements adopted by issuers must be narrowly tailored to achieve their business purposes, issuers should assess the implications arising from the revised Catalogue and, where their businesses are no longer subject to the foreign ownership restrictions, should unwind the Structured Contracts and comply with the relevant PRC laws and regulations as soon as practicable.

## Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2015

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### B. Issuers listed in 2013 and 2014

70. In recent years, there were market commentaries on the quality of newly listed issuers. As part of the Listing Department's ongoing monitoring activities, we reviewed new issuers' Rules compliance and annual report disclosure. This section highlights our general observations and recommendations.

#### *Scope*

71. 100 issuers were listed in 2014 (the **Newly Listed Issuers**) and 79 issuers were listed in 2013 with the financial year end in December. We considered their Rule compliance and annual report disclosure in the following areas:
- (a) profit forecasts and material changes in financial results;
  - (b) changes in the use of IPO proceeds;
  - (c) undertakings provided by major shareholders;
  - (d) fulfilment of conditions or undertakings imposed prior to listing; and
  - (e) material non-compliance with the Listing Rules.
72. We also reviewed the post-listing developments of issuers listed in 2013 and 2014 to examine their compliance behaviors.

#### *Findings*

##### *(a) Profit forecasts and material changes in financial results*

###### Profit forecasts

73. A majority of the Newly Listed Issuers did not publish any profit forecast in their prospectus. For those who published profit forecasts, all the forecasts were met.

###### Profit warnings

74. Some of the Newly Listed Issuers published profit warning announcements in respect of their first financial years after listing. Such announcements were on average published one month after their year ends. In most cases, the information disclosed in profit warning announcements was already disclosed in their prospectus.

## Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2015

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75. We reiterate our guidance set out in the previous Review Reports that profit warning announcements under the Inside Information Provisions should disclose material developments subsequent to the date of the prospectus that has not been disclosed by the issuer. Where an issuer wishes to provide the market with additional information about its financial position after listing and this information is not inside information, it should ensure that such information is meaningful and specific, and not a restatement of information already available in the prospectus.

### *(b) Changes in the use of IPO proceeds*

76. The disclosure in a prospectus and an annual report regarding the use of the IPO proceeds indicates how the new issuer deploys resources to develop and expand its business. This is relevant information for investors to appraise of the issuer's value and make an informed investment decision.

77. An issuer should timely and properly explain any material changes in the use of IPO proceeds by way of announcement. Some issuers are required under the respective articles of association to obtain shareholder approval for the material change in the use of IPO proceeds.

78. We identified a few Newly Listed Issuers which had announced changes in the use of IPO proceeds within two years after listing. Most of them re-allocated the IPO proceeds among the originally disclosed uses in the prospectus, and their reasons were justified.

### *(c) Undertakings provided by major shareholders*

79. It is common that new issuers were given non-competition undertakings (**NCUs**) by their major shareholders in relation to the issuers' business such that the businesses of each of the issuer and its major shareholders would be clearly delineated.

80. A majority of the Newly Listed Issuers were given NCUs by their major shareholders prior to listing. A minority of these issuers did not voluntarily disclose in their annual reports information regarding the compliance with the NCUs by the major shareholders. After our follow up, those issuers either published supplemental announcements or agreed to make the disclosure in future financial reports. In general, a majority of the Newly Listed Issuers disclosed adequate information in their annual reports about the compliance with the NCUs.

## Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2015

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### *(d) Fulfilment of conditions or undertakings imposed prior to listing*

81. In some cases, the Listing Committee imposed specific conditions on or required undertakings to be provided by new issuers prior to listing. These conditions/ undertakings include: confirmation of no breach of regulatory requirements, disclosure of business exposure in certain specified locations, status update on rectification of properties title defects, etc. The compliance with such conditions/ undertakings should be disclosed in their annual reports after listing.
82. We noted six cases where the Newly Listed Issuers were required to disclose in their annual reports the fulfilment of the relevant conditions/ undertakings imposed prior to listing. All of the issuers concerned had properly disclosed the required information in their annual reports.

### *(e) Material non-compliance with the Listing Rules*

83. A small number of the Newly Listed Issuers breached the Listing Rules and warranted our issuance of warning letters. Such breaches generally include a failure or delay to comply with notifiable and/or connected transaction requirements during the Fixed Period<sup>9</sup> (as defined under MB Rule 3A.19 / GEM Rule 6A.19).
84. MB Rule 3A.23 / GEM Rule 6A.23 requires that, during the Fixed Period, an issuer must consult with its compliance adviser on a timely basis in certain circumstances including:
  - (a) before the publication of any regulatory announcement, circular or financial report;
  - (b) where a transaction, which might be a notifiable or connected transaction, is contemplated including share issues and repurchases; and
  - (c) where there is a proposed change of the use of IPO proceeds, or a proposed change in business activities, developments or results which deviated from any forecast, estimate or other information in the prospectus.
85. From our review, we noted that certain Newly Listed Issuers either failed to consult or delayed in consulting with their compliance advisers in accordance with the above Rules. The findings indicate that some new issuers were not aware of their continuous obligation to comply with the above Rules.

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<sup>9</sup> Fixed Period is defined under MB Rule 3A.19 / GEM Rule 6A.19 as the period commencing on the date of initial listing of the issuer's equity securities and ending on the date on which the issuer complies with MB Rule 13.46 / GEM Rule 18.03 in respect of its financial results for the first full financial year (for Main Board)/ the second full financial year (for GEM) commencing after the date of listing.

## Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2015

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86. We remind new issuers to fully observe the Rule requirements to consult with their compliance advisers in a timely manner in those circumstances under MB Rule 3A.23 / GEM Rule 6A.23. The compliance advisers are also expected to properly discharge their responsibilities with due care and skill under MB Rule 3A.24 / GEM Rule 6A.24 to facilitate new issuers to comply with the Rules.

### *Post-listing developments of issuers listed in 2013 and 2014*

87. Media recently reported that some newly listed companies were involved in shell<sup>10</sup> activities and would undergo material changes in ownership and businesses shortly after listing.
88. We reviewed the post-listing developments of issuers listed in 2013 and 2014, in particular material transactions and change in control (e.g. general offers, disposals of shares by controlling shareholders, subscriptions that introduced a new major shareholder). We identified isolated cases involving changes in the major shareholders of issuers after the lock-up period<sup>11</sup>, but we did not identify any issuers that underwent material changes in principal businesses.
89. The level of these activities conducted by the newly listed issuers was not disproportionate to the level of such activities conducted by all issuers generally. However, we will continue to monitor this area to ensure the issuers' compliance with our Rules and guidance<sup>12</sup>.

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<sup>10</sup> The media categorises "shell" with the following common features: (a) the company's market capitalization is below certain threshold; (b) its business is simple and asset-light; and (c) there is a high concentration of shareholding, with a large majority of shares being held by a major shareholder.

<sup>11</sup> MB Rule 10.07 / GEM Rule 13.16A

<sup>12</sup> Including our guidance letter on reverse takeovers rules ([GL78-14](#)), guidance letter on cash company rules ([GL84-15](#)), listing decision on significant distribution of unlisted assets ([LD75-4](#)) and listing decisions on significant disposal ([LD35-2012](#) and [LD88-2015](#)).

## Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2015

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### IV. CONCLUSION

90. From our review of issuers' annual reports, we note that while a vast majority of issuers have complied with the Rules, there are some areas where issuers can improve their disclosure. Our review also identifies areas where some issuers did not fully follow our guidance on best practices. These areas include continuing connected transactions and contractual arrangements. We urge issuers to review and adopt the guidance.
91. As a general measure to improve communications with shareholders, enhance Rule compliance and promote a fair, orderly and informed market, issuers should take note of and consider our observations discussed in this report in preparing their annual reports.

- End -

