

30 August 2018

**BY HAND AND BY EMAIL**

Hong Kong Exchanges and Clearing Limited  
10<sup>th</sup> Floor, One International Finance Centre  
1 Harbour View Street  
Central  
Hong Kong

Dear Sirs,

**Consultation Paper on Backdoor Listing, Continuing Listing Criteria and Other Rule Amendments**

Ernst & Young is pleased to respond in this letter to the request of The Stock Exchange of Hong Kong Limited for feedback on the captioned consultation paper. Terms used in this letter shall have the same meanings as defined in the consultation paper.

We welcome the Exchange's continued efforts to tackle problematic corporate behaviour with a view to maintaining the quality and reputation of the Hong Kong market. In general, we support the Exchange's proposals to codify its anti-avoidance measures and to make Rule amendments to address backdoor listing issues in a more effective manner. We also welcome any additional provisions/procedures that the Exchange may consider to put in place to protect the interests of minority shareholders, e.g., the Exchange's discretion to relax the rules for rescue proposals and/or an exit mechanism in the event the issuer is likely to be delisted.

We have focused our detailed review on those proposed Rule amendments which are more relevant to our role as auditors/reporting accountants. In particular, we would like to share with you our observations and comments on the proposals involving the inclusion of accountants' reports and pro forma income statements in the circulars of an extreme transaction or a RTO that involves a series of transactions and/or arrangements.

Under the proposed Rule 4.30, the pro forma income statement will be presented by combining the historical income statements of all the acquisition targets in the entire series of acquisitions (and, where applicable, would include any new business developed by the issuer that forms part of the series) as if they had been operated as a single group on an aggregated basis since the commencement of the track record period. To demonstrate their compliance with the requirements of Rule 8.05, a pro forma income statement must be published for each of the three financial years of the track record period.

The proposed Rule 4.30 would also require that the unadjusted information must be derived from the acquisition targets' accountants' reports, and the pro forma financial information must be reported on by the auditors or reporting accountants. Accordingly, the issuer must also produce accountants' reports for each of the acquisition targets for the track record period.

Regarding the above proposals, we have the following comments:

#### **Accountants' reports on new businesses developed by the issuer**

We note that the proposals effectively require the compilation of accountants' reports on new businesses developed by the issuer. There may be practical difficulties if the new business is not undertaken under separate legal entities and the compilation of accountants' report would involve a carve-out of a business segment. It may be not possible to produce an accountants' report with a clean opinion should there be difficulties in performing the carve-out.

#### **Publication of three-year pro forma income statement**

Paragraph 35 of Accounting Guideline 7 "Preparation of Pro Forma Financial Information for Inclusion in Investment Circulars" ("AG 7") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") states that:

"The selection of the periods or dates used for presenting pro forma financial information depends on the situation under consideration and the specific purpose of the information. Requirements set out in paragraph 33 allow the presentation of pro forma financial information for more than one period or at more than one date. For example, an issuer could present pro forma financial information for the last completed period and the most recent interim period. In practice, however, it will be difficult to envisage situations where the presentation of pro forma net asset statements or balance sheets at more than one date will serve a useful purpose. The prohibition on presenting pro forma financial information for any period preceding the most recently completed financial period also prevents issuers from presenting a three year record on a pro forma basis as this may frustrate the purpose of the pro forma financial information and give a false impression of its precision and reliability."

The proposal to publish pro forma income statement for each of the three financial years of the track record period contradicts paragraph 35 of AG 7 above.

We understand that the purpose of the proposed three-year pro forma income statement is to demonstrate compliance with the requirements of Rule 8.05. Under the proposed Rule 4.30, the pro forma income statement will be presented by combining the historical income statements of all the acquisition targets in the entire series of acquisitions (and, where applicable, would include any new business developed by the issuer that forms part of the series) as if they had been operated as a single group on an aggregated basis since the commencement of the track record period.

The Exchange may wish to consider whether it would be sufficient to publish the accountants' reports only and to present the three-year pro forma income statement (combining the acquisition targets only) to the Exchange as a private submission, given the highly hypothetical nature of such pro forma income statement and the rationale stated in paragraph 35 of AG 7. The pro forma income statement for the enlarged group (combining the listed issuer and the acquisition targets) for the final financial year will need to be published under the current Listing Rules in any case.

Furthermore, the profit mentioned in the profit test in Rule 8.05 excludes any income or loss of the issuer, or its group (excluding any associated companies and other entities whose results are recorded in the issuer's financial statements using the equity method of accounting), generated by activities outside the ordinary and usual course of its business. The profit as shown in the accountants' reports and pro forma income statements may include items that should be excluded when determining whether the profit test under Rule 8.05 can be fulfilled.

#### **Financial periods with different lengths and non-coterminous financial periods**

Paragraphs 39 to 41 of AG 7 states that:

"Where pro forma profit and loss or cash flow information is presented for two or more entities or businesses, such as may be the case in a very substantial acquisition, the unadjusted information about the issuer and the adjustments in respect of the other entity or entities would cover periods of the same length and would normally be for a full financial year of the issuer. This is to ensure that there is no distortion due to seasonal factors and that the estimated contribution of the transaction to a full year's results of the issuer can be assessed by the investors.

Whilst desirable, it is not normally necessary to use coterminous accounting periods when preparing pro forma profit and loss or cash flow information for two or more entities or businesses. For example, an issuer may be preparing a pro forma income statement based on its latest 31 December year end results for inclusion in a circular for a very substantial acquisition. If 12 month income statement information is only available for the business to be acquired up to the preceding 30 June, that information could generally be used for the purpose of making an adjustment to derive a pro forma income statement.

Even where businesses are seasonal, the use of non-coterminous accounting periods would not usually distort pro forma profit and loss and cash flow information so long as all the information covers a complete year. Nevertheless, where pro forma interim information is presented and seasonal factors are significant, coterminous accounting periods may be required to prevent the information from being misleading."



There may be situations where one (or more) of the targets have a financial year longer or shorter than 12 months. Whilst the Listing Rules recognise the fact that a financial year may be longer or shorter than 12 months, the proposed Rule 4.30 may create a situation where the unadjusted information for one (or more) of the financial years covered in the track record period would cover periods of different lengths. Combining periods of different lengths may not be in compliance with paragraph 39 of AG 7. We question whether the pro forma combined income statement for that particular period would be meaningful.

AG 7 caters for pro forma financial information compiled for the purpose of illustrating the effect of a transaction and specifically allows the use of non-coterminous periods when presenting pro forma income statements. However, the purpose of the proposed Rule 4.30 is to demonstrate compliance with the requirements of Rule 8.05 (or Rule 8.05A or 8.05B). We question whether pro forma combined results of non-coterminous periods throughout the track record period would present meaningful information to investors.

Given the above, the Exchange may wish to consider whether it would be sufficient to publish the accountants' reports only and to present the three-year pro forma income statement (combining the acquisition targets only) to the Exchange as a private submission, given the highly hypothetical nature of such pro forma income statement.

### **Modified reports**

Rule 4.19 states that:

"Where the accountants' report relates to a very substantial disposal or an acquisition which is a reverse takeover, a very substantial acquisition or a major transaction and the report is expected to be qualified ["be qualified" proposed by the Exchange to be changed to "include a modified opinion"], the Exchange must be consulted at an early stage."

As the Exchange proposes to add a new category of transaction known as "extreme transaction", Rule 4.19 may need to be revised to include extreme transactions. There is no proposed revision set out in Appendix I to the consultation paper.

The Exchange may wish to consider whether it should also explicitly request early consultation if the report by the auditors or reporting accountants on the pro forma income statement required under the new Rule 4.30 is expected to be modified. Given that the purpose of the three-year pro forma income statement is to demonstrate compliance with the requirements of Rule 8.05 (or Rule 8.05A or 8.05B), the Exchange may need to make it clear whether a modified report would bring into question the feasibility of the RTO or extreme transaction and hence necessitate early consultation with the Exchange.

#### **Cross references to pro forma financial information requirements in Chapter 4**

The purpose of pro forma financial information under the existing Rule 4.29 is to provide investors with information about the impact of the transaction on the issuer and to assist investors in analysing the future prospects of the issuer. The purpose of the proposed Rule 4.30 is for the issuer to demonstrate that the acquisition targets that form the series of acquisitions can meet the requirements of Rule 8.05 (or Rule 8.05A or 8.05B).

There are cross references in Rules 14.67(6)(b)(ii) and 14.69(4)(b)(ii) to the requirements of pro forma financial information in Chapter 4:

“The pro forma financial information must comply with Chapter 4 of the Exchange Listing Rules.”

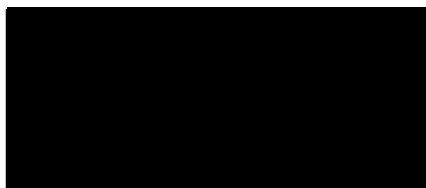
We suggest that, for the sake of clarity, the Exchange should make amendments to the above rules to specify that the required pro forma financial information of the enlarged group must comply with Rule 4.29 of the Listing Rules.

#### **Related HKICPA pronouncements and effective date**

In the event that the Exchange adopts the proposals relating to the pro forma income statement, we suggest that the Exchange liaise with the HKICPA to make the necessary amendments and include related guidance to AG 7 as well as Hong Kong Standard on Assurance Engagements 3420 “Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus”, such that these revised HKICPA pronouncements will be effective at the same time as Rule 4.30.

Should you have any questions on the above comments, please do not hesitate to contact our Professional Practice Partner in Hong Kong, [REDACTED]

Yours faithfully,



*Certified Public Accountants*  
Hong Kong