

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

REPORT 2012

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Hong Kong Exchanges and Clearing Limited  
香港交易及結算所有限公司

# Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2012

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### EXECUTIVE SUMMARY

The Listing Division reviews issuers' annual reports as part of our ongoing monitoring and compliance activities. This report presents our findings and recommendations.

In this review we examined annual report disclosure with a focus on issuers' Rule compliance and their disclosure of material events and developments. Areas covered included:

- Impairment of intangible assets arising from material acquisitions
- Results of performance guarantees on acquisitions
- Connected transactions
- Significant changes to financial position
- Newly listed issuers
- 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

We noted that a large majority of issuers complied with the Rule requirements, which set the minimum standard for information disclosure. In preparing annual reports, issuers should consider their own circumstances and present information that is relevant for investors' decision making and provide an unbiased, complete and well-informed view of their performances, financial positions and future prospects.

We note that the following areas merit better disclosure:

- (a) Impairment of intangible assets arising from material acquisitions* – issuers that have reported impairments to intangible assets should disclose details of the impairment. These include explanations on the events and circumstances that led to the recognition of impairment losses. Information about the valuations used to support the write downs should also be disclosed, including the assumptions used, valuation methodologies and explanations for any significant changes.
- (b) Results of performance guarantees* – issuers that have negotiated performance guarantees as part of the terms of material acquisitions should disclose the outcome of these performance guarantees, including whether they were met and whether the guarantors fulfilled their obligations under the agreements.

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- (c) *Connected transactions* – issuers are reminded to disclose in their annual reports whether or not their related party transactions were connected transactions under the Rules and whether they have complied with the specific rule requirements for such connected transactions<sup>1</sup>.
- (d) *Significant changes to financial position* – issuers with significant changes to their businesses and financial performances during the financial year should ensure the “management discussion and analysis” section adequately explains changes to the major items in the financial statements. Areas of note include trade receivables, effective tax rates and tax balances, and changes to key performance indicators. Further guidance is set out in this report.
- (e) *Main Board Chapter 18 / GEM Chapter 18A mineral companies* – issuers engaged in exploration, development and mining production activities are required by the Rules to provide updates in their annual reports. We note that some issuers that complied with the specific disclosure requirements under the Rules provided minimum disclosures which lack details. We have issued a guidance letter (GL47-13) setting out recommended disclosures.
- (f) *Main Board Chapter 21 investment companies* – the Rules set out specific disclosure requirements about issuers' investments, including a breakdown of the investment portfolio and their performances. Issuers should comply with the Rule disclosure requirements in order to present shareholders with decision-useful information about their investment portfolios.

We have also noted individual cases of non-compliance with various areas of the Rules. Appropriate actions have been taken against these breaches, depending on their nature and materiality of the non-compliances.

We will continue this review program, focusing on different thematic areas in future.

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<sup>1</sup> See requirements in Paragraph 8(3) of Appendix 16 of the Main Board Rules / GEM Rule 18.09(3)

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### I. INTRODUCTION

1. The annual report is a major corporate communication tool for an issuer to convey material and relevant information about its operating condition and financial position. It updates investors on the development of significant events and business performance during the financial year, and provides information for investors' assessment of an issuer's future prospects.
2. In recent years, scandals and negative publicity on accounting and corporate governance issues relating to some US-listed Chinese companies undermined market confidence in these companies globally and, to a certain extent, in our local market. These concerns were exacerbated by some short sellers publishing negative research reports on individual companies. We consider that as a general measure to promote a fair, orderly and informed market, issuers can improve transparency through better disclosure.
3. The Rules and the 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.
4. As part of our monitoring of issuers' activities, we review annual reports with a particular focus on issuers' Rule compliance and their disclosure of material events and developments. Our review program covers all issuers. This report presents our findings and recommendations from our review of all listed issuers' annual reports (excluding collective investment schemes listed under Main Board Chapter 20)<sup>2</sup>.
5. Our review focused on the following areas:
  - Impairment of intangible assets arising from material acquisitions (Part IIA)
  - Results of performance guarantees on acquisitions (Part IIB)
  - Connected transactions (Part IIC)
  - Significant changes to financial position (Part IID)
  - Newly listed issuers (Part IIIA)
  - Periodic disclosure of mining or petroleum assets under Main Board Chapter 18 / GEM Chapter 18A (Part IIIB)
  - Disclosure by investment companies listed under Main Board Chapter 21 (Part IIIC)

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<sup>2</sup> Includes all annual reports issued for financial year ended between December 2011 to November 2012.

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6. This review is separate from our Financial Statements Review Program (the “**FSRP**”)<sup>3</sup>. The FSRP focuses on the disclosure and accounting treatment required under the accounting standards and the disclosure requirements for annual reports under the Rules (Appendix 16 to the Main Board Rules / GEM Chapter 18)<sup>4</sup>.
7. In this report, Rules refer to both Main Board (“**MB**”) Rules and Growth Enterprise Market (“**GEM**”) Rules.

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<sup>3</sup> For the full FSRP Report 2012 issued in January 2013, please refer to <http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/Documents/frm-12.pdf>

<sup>4</sup> The FSRP involved a sample of 120 issuers' financial reports including annual, interim and quarterly reports released between May 2011 and September 2012.

## **II. FINDINGS ON SPECIFIC AREAS OF DISCLOSURES**

### **A. Impairment of intangible assets arising from material acquisitions**

8. MB Chapter 14 / GEM Chapter 19 requires an issuer to announce acquisitions and, where the acquisition is material, obtain shareholder approval and publish an investment circular. The circular provides material information about the acquiring business and its impact on the issuer for shareholders' investment and voting decisions.
9. Where the performance of the acquired business undergoes significant changes after acquisition, the issuer should timely announce these changes in accordance with its general disclosure obligations. These include, but are not limited to, profit alerts and impairments on intangible assets and/or goodwill.
10. Paragraph 32 of Appendix 16 to the MB Rules / GEM Rule 18.41 requires an issuer to disclose in the "management discussion and analysis" section of the annual report material trends and significant events or transactions during the financial year. These would include discussions on the performance and developments of the acquired business subsequent to the acquisition, as well as any significant change in the value of intangible assets and/or goodwill arising from the acquisition.

#### *Scope*

11. We identified 267 issuers that announced or completed at least one material acquisition in their last two financial years. There were 336 acquisitions, including 134 very substantial acquisitions and 202 major acquisitions, of which 87 involved acquisitions from connected persons.
12. 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, and considered whether:
  - (a) the information disclosed in the original investment circular was materially accurate;
  - (b) any material changes to the acquired business were timely disclosed in announcements; and
  - (c) any impairment to assets was properly made.

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### *Findings*

13. There were 33 cases where during the financial year, impairments were made to goodwill and intangible assets arising from the acquisition shortly after completion. Of these, there were three cases where the circumstances leading to the recognition of impairments might have existed at the time of the acquisitions.
14. In two cases, the write down and subsequent disclosure about the acquired businesses in the annual reports suggested that the values of the acquired businesses and their prospects might have been overstated in the investment circulars. In particular, disclosure of the business plans and/or the cash flow forecasts in the investment circulars might have been overstated, misleading or inaccurate.
15. The investment circular provides material information about the acquisition target and the impact of the acquisition to the issuer, and enables shareholders to decide whether or not to approve the acquisition. We remind issuers about the general principles applicable to the presentation of information (MB Rule 2.13(2) / GEM Rule 17.56(2)), which require that information presented must be accurate and complete in all material respects and not be misleading or deceptive.
16. In one case involving an impairment of intangible asset, the impairment was due to differences between the valuation methodology used to determine the consideration and that used to determine the value of the business to be acquired under the accounting standards. This was properly disclosed in the investment circular.
17. Under the Rules, financial information of the acquired business and pro forma financial information of the enlarged issuer group must be reported in the investment circular and prepared using the issuer's accounting policy consistently. Any potential significant impairment of goodwill or other assets required under the accounting standards should be considered by the issuer and the reporting accountants and disclosed in the investment circular.
18. In the other 30 cases, the asset impairments resulted from events arising subsequent to the acquisitions. We reviewed issuers' announcements and noted that in all, except two, cases where the impairments were material, issuers made appropriate profit warning announcements to alert shareholders to the impairments and the impact on their financial position.
19. In two cases the issuers published profit warning announcements and the major reasons leading to significant asset impairments were not fully disclosed, raising questions about potentially incomplete disclosure in the announcements. Issuers should ensure there is no material omission of information in their announcements.



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20. We also reviewed some of the valuation reports prepared to support the value of intangible assets in the financial statements. We noted that in some cases, the basis of the impairments and the assumptions for the valuations were not properly disclosed. The explanations on the events and circumstances that led to the recognition of impairment losses were short and generic.
21. We expect issuers to disclose relevant information about the valuation of intangible assets in the “management discussion and analysis” section of the annual report. These may include:
  - (a) the value of the inputs (e.g. projected cash flow, discount rate and growth rate) used in the valuations together with the basis and assumptions;
  - (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 and the reasons for any significant change in value.

**B. Results of performance guarantees on acquisitions**

22. From time to time issuers making acquisitions would require the vendor to guarantee the performance of the acquired business. The performance guarantee may take different forms and cover different durations. 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.
23. Where a guarantee is provided by a connected person, MB Rule 14A.57 / GEM Rule 20.57 requires an issuer to publish an announcement if the financial performance of the acquired business is less than the amount guaranteed. The announcement must include the shortfall and the adjustment of 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 the independent directors as to whether the connected person has fulfilled its obligations.
24. Where a guarantee is provided by an independent party, the Rules do not provide for specific disclosure requirements. Nevertheless, issuers are obliged to inform their shareholders about material developments. These may include the outcome of performance guarantees, whether there is a shortfall and how the issuers would enforce the compensation obligations of the guarantors.
25. In addition, MB Rule 14.36 / GEM Rule 19.36 states that if there is any material variation to the terms of a transaction previously announced under MB Chapter 14 / GEM Chapter 19, the issuer must announce this fact. If there is any change to the terms of the guarantee (for example, where the guarantee is not met and the compensation arrangement is re-negotiated), the issuer must announce the details of the revised terms under this Rule.

*Scope*

26. Our review identified 54 guarantees provided on the performance of businesses acquired by issuers where the performance period ended in the financial year under review. These include 28 cases where the acquired businesses met the guaranteed performance and 26 cases where the acquired businesses failed to meet the guaranteed performance. Seven guarantees were provided by connected persons.

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27. We reviewed issuers' annual report disclosure about the acquired business and considered whether:
- (a) the outcomes of the performance guarantees were disclosed;
  - (b) whether the performance guarantees were met in accordance with the terms of the agreement; and
  - (c) where the performance guarantees were not met, whether the issuers enforced the obligations of the guarantors.

### *Findings*

28. Issuers in 27 cases did not initially disclose the outcome of the guarantees. In 25 cases, issuers made announcements following our enquiries. In the other 27 cases, issuers announced the outcomes of the performance guarantees, including all seven cases where the guarantors were connected persons.
29. In 26 cases the performance of the acquired businesses failed to meet the guaranteed amounts, including two cases that involved connected persons.
- In 18 cases the guarantors compensated the issuers in accordance with the terms of the acquisition agreements.
  - In five cases the guarantors re-negotiated the guarantee arrangements with the issuers, including extending the periods of the guarantees and disposing the acquired business. None of these cases involved connected persons. In three cases the issuers made announcements after they re-negotiated the terms of the guarantee. In two cases, issuers made announcements about changes to the terms of the guarantees only after our enquiries.
  - In one case, the agreement did not set out a mechanism for the calculation of the compensation amount. Upon our enquiries, the issuer is negotiating with the guarantor on a settlement.
  - In two cases the compensations were waived, including one case where the issuer could not provide an adequate explanation upon our enquiry.

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30. Where the terms of an acquisition agreement include guaranteed performances or the consideration is negotiated by reference to the future performance of the acquired business, they form part of the basis upon which shareholders approved the acquisition. As a matter of accountability and transparency, the issuer should make clear disclosure about the performance of the acquired business, whether the performance guarantee was met, and whether and how the guarantor fulfilled its obligations under the terms of the agreement where the performance guarantee was not met.
31. In circumstances where issuers re-negotiated the terms of the guarantee, they should also disclose the re-negotiated terms by way of an announcement.
32. In some acquisitions, performance guarantees are part of the terms of the acquisition agreement which support the basis of the consideration. Where the guarantee is not met and the issuer does not enforce the agreement to seek compensation, or where the agreement does not specify a method to determine the compensation, there is a question about whether the guarantee was genuine, or merely used to support an overstated consideration amount (e.g. where the consideration was based on a price earnings multiple of the profit guarantee). We remind issuers that information presented in the investment circular must be materially accurate and complete, and not be misleading or deceptive. We also remind directors of their obligations under MB Rule 3.08 / GEM Rule 5.01, to act for proper purpose and in the interest of the company as a whole.
33. We also note that in isolated cases, the acquired businesses met the guaranteed performance through new businesses developed after the acquisition, or through one-off transactions. Those circumstances raise questions about whether the performance guarantees were genuinely met and whether the disclosure in the investment circular was accurate, in particular, about the expected performance of the acquired business. We recommend to issuers that in their negotiations, there should be clarity of the terms of performance guarantees and whether they would achieve the intended purposes. Further, they should be clearly disclosed in the investment circular.

**C. Connected transactions**

34. 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 announce the transaction and, where the transaction is material to the issuer, seek independent shareholder approval. The issuer is also required to report connected transactions in its annual report.
35. Continuing connected transactions must be reviewed by the issuer's independent directors and auditors annually. The issuer must also disclose the results of the reviews in the annual report.

*Scope*

36. We reviewed issuers' announcements and disclosure in annual reports (including the note to the financial statements on related party transactions and the disclosure on connected transactions required by the Rules) to consider whether:
- (a) the issuers have properly identified and reported the connected transactions at the time of the agreement through announcements (through our review of related party transactions disclosed in the annual reports and enquiries with issuers);
  - (b) the issuers have properly reported the connected transactions conducted during the financial year in their annual reports (through our review of issuers' announcements); and
  - (c) the continuing connected transactions were reviewed by independent directors and auditors and the results were reported in the annual reports.

*Findings*

37. 854 issuers conducted connected transactions or continuing connected transactions during the financial year.
38. We reviewed disclosures of related party transactions reported in the notes to the financial statements and where necessary, made enquiries with issuers, to consider whether connected transactions were properly disclosed by way of announcements at the time of the agreements. The vast majority of issuers complied with the connected transactions requirements, with a few cases where issuers failed to announce, and in some cases, seek shareholders' approvals for the connected transactions and conduct annual reviews on these unannounced transactions. These failures constituted breaches of the Rules and appropriate disciplinary actions were taken, depending on the materiality of the transactions. There were cases where the issuers disagreed with our interpretation of the Rules and took the view that exemptions under the Rules applied to their

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circumstances.

39. We recommend that if issuers are uncertain about the operation of the Rules in their particular circumstances, they should seek our guidance.
40. Paragraph 8(3) of Appendix 16 to the MB Rules / GEM Rule 18.09(3) requires an issuer to disclose in its annual reports whether or not its transactions with related parties were connected transactions under the Rules, and whether it has complied with the specific rule requirements for such connected transactions. We note about one sixth of the issuers reviewed did not make this confirmation in the annual reports. Without this statement, the shareholders do not know whether the issuers have reviewed and properly identified all connected transactions. Issuers should take note and ensure this disclosure is made.
41. We have reviewed issuers' announcements about connected transactions and considered whether those transactions were also disclosed in their annual reports. The vast majority of issuers complied with the Rules requirements and disclosed previously announced connected transactions in their annual reports.
42. For continuing connected transactions, we also reviewed issuers' annual report disclosure about the annual reviews conducted by their independent directors and auditors and considered whether they provided the confirmations in accordance with the Rules. Auditors are also required to submit a confirmation to the Exchange about the results of their review. The vast majority of issuers complied with the Rule requirements. A few issuers performed the reviews, but failed to report the results of the annual reviews in the annual reports and / or failed to submit the auditors' confirmation to the Exchange.
43. We consider that generally, issuers have complied with the Rules on connected transactions. We remind issuers to disclose in the annual reports (i) confirmations that they have conducted review of their related party transactions and are satisfied that all connected transactions are properly reported; and (ii) for continuing connected transactions, the results of the annual reviews by independent directors and auditors.

**D. Significant changes to financial position**

44. During 2012, scandals and negative publicity on accounting and corporate governance issues relating to some US-listed Chinese companies undermined market confidence in these companies globally, and to a certain extent, in our local market. These concerns were exacerbated by some short sellers publishing negative research reports on individual companies.
45. A number of published research reports made allegations about accounting irregularities and questioned the credibility of the issuers' business models, implicating poor corporate governance practices and directors' incompetence. These reports were generally prepared based on public information published by issuers and using the analysts' own modeling and assumptions. Some research houses also disclosed that they had short sold securities prior to issuing the report. We noted that while the market has, to a certain extent, discounted these allegations, these attacks raised concerns on the potential disruption to a fair and orderly market.
46. We consider that as a general measure to prevent a false market, issuers can improve transparency through disclosure and adopting better corporate governance practices. To address concerns about the creation of a false market, we published a letter to all issuers in May 2012<sup>5</sup> reminding them of the approach to handle market rumors and their obligation to disclose information necessary to avoid the establishment of a false market, and encouraging them to improve transparency through the publication of trading updates. In July 2012, we tightened the eligibility criteria for designated securities for short selling.
47. As part of our monitoring activities, we reviewed the annual reports of 34 mainland issuers with identified corporate governance issues (e.g. frequent changes in auditors, directors or senior management, persistent negative news against the directors, management and / or controlling shareholders), or histories of significant growth or changes in financial position. Our review covered issuers' annual reports and other published documents (e.g. announcements, circulars), media and research reports and other information in the public domain.

*Findings*

48. In two cases, issuers engaged independent consultants after our enquiries. In one case, as a result of high volume of cash sales and identified weaknesses in internal control, the issuer engaged an independent auditor to review the internal controls of its cash and sales cycle. In the other case, following complaints and our review of the issuer's valuation report on its biological assets, the issuer engaged an independent valuer and an expert to review the valuation of those biological assets.

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<sup>5</sup> The letter is available at <http://www.hkex.com.hk/eng/rulesreg/listrules/listletter/Documents/20120510.pdf>

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49. Based on our review and enquiries, we identified disclosures in certain areas in the annual report which can be improved. We provided guidance to those issuers.
50. We identified three areas where issuers that experienced significant change in financial position or financial results can enhance their disclosures in annual reports. These are disclosures about trade receivables, effective tax rates and tax balances and key performance indicators. The disclosures would provide shareholders with a better understanding of the issuers' business and financial performance.
51. *Trade receivables* - In a number of cases issuers experienced unusual changes in trade receivables, including significant increases in trade receivables, increases in overdue balances, debtors' turnover days, etc. We reviewed subsequent settlement of these receivables after the year end and explanations for the fluctuations. Some issuers provide minimal information and did not adequately explain the fluctuations, aging analysis and credit policy in the "management discussion and analysis" section.
52. Issuers should provide analysis and explanations about the fluctuations of trade receivables, and should not merely repeat information presented in the financial statements in narrative form. Paragraph 52(viii) of Appendix 16 to the MB Rules / GEM Rule 18.83(8) provides recommended disclosure of an issuer's key relationship with customers. Further, the analysis and explanation may include:
- the reasons for debtors' turnover days being longer than the issuer's general credit policy;
  - the length of extended credit period granted to the customers, and whether their payment patterns are in line with the industry practice;
  - a general profile of customers with longer credit periods or with substantial long outstanding balances;
  - the subsequent settlement of the trade receivables after the year end date, and how these receivables were settled (e.g. whether in cash or offset by sales return);
  - any change in the business relationship with customers, who have significant or long outstanding receivables, subsequent to the year end date; and
  - the actions taken by the issuers to follow up with the customers with long outstanding receivables.
53. *Effective tax rates and tax balances* - Some issuers disclosed abnormal effective tax rates or significant tax balances in their balance sheets and these figures were not adequately explained.



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54. To allow the readers of the annual reports to better understand the impact of a tax holiday and the reduced tax rate, we expect issuers to provide a more meaningful analysis in their “management discussion and analysis” section. The analysis may include:
- the reasons for the discrepancies and the significant changes in tax balances;
  - the range of tax rates applicable to the major operating subsidiaries and the effective period of the tax holiday and reduced tax rates; and
  - the name of major operating subsidiaries enjoying such tax benefits and their profit contributions to the group.
55. Where there is material fluctuation in the tax effect of the non-deductible expenses or exempted items in the tax reconciliation, we expect the issuers to disclose details about the reasons for such change.
56. *Key performance indicators* - Some issuers employ specific key performance indicators (“**KPIs**”) to measure their performance and publish this information on their websites or in some cases, in the “management discussion and analysis” section of the annual report. These KPIs provide a consistent benchmark for comparison of companies in the same industry.
57. Under Paragraphs 52(i) and (ii) of Appendix 16 to the MB Rules / GEM Rules 18.83(1) and (2), issuers are recommended to disclose efficiency indicators and industry specific ratios. To allow investors to better understand how the issuer’s management measures its business, we encourage issuers disclosing information about the KPIs to also include this information in the “management discussion and analysis” section of their annual reports. The disclosure may include:
- the reasons for including the KPIs and how they are linked with the issuer’s objectives;
  - the definition and calculation of the KPIs;
  - the reasons (e.g. change in strategy of the issuer, change in market environment) for any change in the use of KPIs;
  - the meaning of the trend of each KPI in the specific circumstances of the issuer (this is necessary because an improvement of a KPI may not necessarily indicate a sign of strength);
  - the reasons for the significant changes in the KPIs; and
  - the reconciliation and reasons for any differences between the KPIs and figures reported under accounting standards in the financial statements (e.g. underlying profits used in KPIs measurement and net profits used in the financial statements).

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

#### **A. Newly listed issuers**

58. A prospectus may include forward looking statements such as a profit forecast, a business plan and the intended use of IPO proceeds. Under the Rules (Paragraph 32 of Appendix 16 to the MB Rules / GEM Rule 18.41), an issuer should identify significant events or transactions during the financial year in its "management discussion and analysis" section of the annual report. For a newly listed issuer, these may include updates on the forward looking statements in the prospectus.
59. Our review covered 100 issuers which were listed in 2011. Our key observations include annual report disclosure described in items (a) to (d) below:
- (a) profit forecasts and material changes in financial results;
  - (b) changes in the use of IPO proceeds;
  - (c) fulfilment of undertakings and conditions imposed before listing; and
  - (d) conflicts of interests and competing businesses between the issuer and its directors, substantial shareholders and their respective associates.
60. A majority of newly listed issuers complied with the Rules. There were a few non-compliance cases.

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

61. Under MB Rule 13.09 / GEM Rule 17.10, an issuer must publish inside information as required by Part XIVA of the Securities and Futures Ordinance. This would normally include material changes to its financial condition or the performance of its business. MB Rule 13.24B / GEM Rule 17.26A requires that if, during the profit forecast period, an event occurs which would have caused any profit forecast assumptions to have been materially different, the issuer shall promptly announce such event and its likely impact on the profit forecast.
62. Approximately 48% of issuers reported profit forecasts in their prospectuses. Only three issuers failed to meet their profit forecasts. We noted that in two cases the size of the shortfall was small, and was attributable to foreign exchange losses from the IPO proceeds. In one case the shortfall was material and was attributable to deterioration in business performance.

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63. Around 34% of issuers published profit warning announcements; about 12% published positive profit alert announcements. With the exception of two cases, the reasons for the material changes in the issuers' results were already disclosed in the prospectuses. These include, for example, non-recurring profits, listing expenses, increase in administrative costs, intensified market competition and slowdowns in the PRC markets or negative impacts from the USA and European economic crisis.
64. In two cases we noted material deteriorations in the issuers' results shortly after listing. These issuers failed to publish profit warning announcements in a timely manner and may have breached the Rule requirement to timely update the market on material changes to its financial position.
65. An issuer's prospectus should clearly disclose its business trends and prospects. We expect this to include its expected performance for the current financial period and major factors that may affect its financial performance. It would be highly unusual to have sudden and unanticipated deteriorations in an issuer's business very shortly after its listing. We remind issuers that the prospectus should contain all material information for investors to make informed decisions. Any material omission in a prospectus, or failure to timely disclose material changes to financial performance after listing, may constitute a breach of the Securities and Futures Ordinance.

### *Changes in the use of IPO proceeds*

66. 10 issuers changed the use of the IPO proceeds shortly after listing. With the exception of one case, the changes in the use of the proceeds were properly disclosed to shareholders by way of announcement. The issuers either re-allocated the uses among the originally disclosed uses, or for business expansions disclosed in the prospectuses. We have not identified any cases with material deviations to the proposed uses of proceeds which were not in line with the issuers' business plans.
67. In one case the issuer used the IPO proceeds to make entrusted loans and structured deposits. Such uses were not disclosed in the prospectus and constituted notifiable transactions under the Rules which were not announced by the issuer. We consider the issuer's action to be a material breach of the Rules. Investors rely on information in the prospectus to assess the investment risks in making investment decisions.
68. We remind new applicants to carefully consider their business plans and make appropriate disclosures in the prospectus. Where there is a legitimate change of plans after listing, the issuers should make immediate disclosure of this change.

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### *Fulfilment of undertakings and conditions imposed prior to listing*

69. Six issuers gave undertakings to the Exchange, or were imposed conditions by the Listing Committee at the time of listing. All, except one issuer, met their undertakings or imposed conditions.
70. In one case the issuer was requested to appoint an independent director with relevant industry experience to enhance its corporate governance. The issuer is still in the process of identifying a qualified individual.
71. Two new applicants were found to have weaknesses in their internal controls during the track record periods, and implemented procedures to rectify the problems before listing. They were required to appoint independent internal control consultants to review their internal controls after listing, and to disclose the results of the reviews in subsequent annual reports. They complied with the conditions, and the results of internal control measures implemented before listing were found to be satisfactory.
72. In two cases the issuers complied with the conditions to make certain disclosures in their annual reports after listing. In one case the issuer complied with its undertaking to discontinue certain business after listing.

### *Conflicts of interests and competing businesses between the issuer and its directors, substantial shareholders and their respective associates*

73. MB Rule 8.10 / GEM Rule 11.04 states that a director must disclose details of his interests in any business which competes or is likely to compete (directly or indirectly) with the issuer. In addition, in some cases the major shareholders of listing applicants provide non-competition undertakings to delineate the listed business from their personal businesses.
74. 78 newly listed issuers were given non-competition undertakings from their major shareholders before listing.
75. Based on our review of the annual reports and enquiries, there was no compliance issue with those undertakings.

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

76. The revised MB Chapter 18 / GEM Chapter 18A became effective on 3 June 2010. The Rules govern both Mineral Companies and issuers that publicly disclose information about resources and / or reserves (“**non-Mineral Companies**”). Mineral Companies must disclose details of their exploration, development and mining production activities, expenditures incurred on those activities and updates of resources and reserves in their annual reports. Both Mining Companies and non-Mineral Companies must disclose details of their resources and reserves in their annual reports.

*Scope*

77. We identified 63 issuers that were subject to the disclosure requirements, including 25 Mineral Companies and 38 non-Mineral Companies.
78. We considered whether issuers' disclosure in the annual reports met the Rule requirements and provided relevant and reliable information about the exploration and production of natural resources.

*Findings*

79. Nine issuers complied with the disclosure requirements by providing a “no material change” statement in their annual reports. For the 39 issuers that disclosed the required information under MB Rules 18.14 to 18.18 / GEM Rules 18A.14 to 18A.18, a majority met the minimum specific disclosure requirements. A few issuers omitted material required disclosures, including details of resources and / or reserves and details of their exploration, development and mining production activities. Upon our enquiries, some issuers made announcements to disclose the omitted information.
80. A few issuers omitted minor information, such as not disclosing details of their resources and/or reserves in a table format, or the reporting standards used as required by MB Rule 18.18 / GEM Rule 18A.18. Some non-Mineral Companies took the view that those provisions only applied to Mineral Companies. We have published a FAQ (Series 20 No. 26) in February 2013<sup>6</sup> to clarify that MB Rules 18.17 and 18.18 / GEM Rules 18A.17 and 18A.18 apply to the updates in annual reports of both Mineral Companies and non-Mineral Companies.

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<sup>6</sup> The FAQ is available at [http://www.hkex.com.hk/eng/rulesreg/listrules/listrulesfaq/Documents/FAQ\\_20.pdf](http://www.hkex.com.hk/eng/rulesreg/listrules/listrulesfaq/Documents/FAQ_20.pdf)

## Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2012

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81. We note that while a majority of issuers met the minimum disclosure requirements, in some cases the disclosures were general and lacked sufficient details. The main purpose of the annual updates requirements in MB Chapter 18 / GEM Chapter 18A is to ensure that investors are provided with significant, relevant and reliable information about companies engaged in exploration and production of natural resources. We expect Mineral Companies and non-Mineral Companies to observe the following non-exhaustive guidance in their preparation of future annual reports.
82. *Exploration, development and mining production activities* - The disclosures on exploration, development and mining production activities in the annual reports should contain:
- (a) Details of exploration activities including the number, average size, and total length of holes drilled during the review period.
  - (b) Details of development activities including the progress on the mining structure or infrastructure.
  - (c) Details of mining activities including the quantity of mineral ore being mined during the period under review by project or at least a separate discussion on major projects.
  - (d) Details of the new contracts and commitments entered into during the period including those related to infrastructure projects (road and railway), subcontracting arrangements and purchases of equipment.
83. If a Mineral Company has several mineral assets/projects on hand, it should consider presenting this information on a project basis.
84. *Expenditures incurred* - The summary of expenditures incurred should not be limited to operating expenses, i.e. costs that were directly charged to income statement during the period they were incurred. A Mineral Company should also disclose the capital expenditures incurred, which could be much more significant than operating expenses.
85. Common expenses include mining costs, processing costs, transportation, royalties or fees payable to government and financing costs. A Mineral Company, depending on its own situation, should consider providing a further breakdown of expenses incurred in order to provide more meaningful information to its shareholders and enhance the transparency of its activities (e.g. separate disclosure of labour costs incurred in mining activities and processing activities).

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86. *Annual updates on resources and reserves* – Annual updates of resources and reserves should be presented in a table format and in a readily understandable manner in annual reports. In addition, issuers should disclose the assumptions adopted. For any material change of assumptions as compared with previous disclosed estimates, the reasons for the changes should also be disclosed. Both Mineral Companies and non-Mineral Companies are subject to these disclosure requirements.
87. It would also be useful for Mineral Companies and non-Mineral Companies to include the reasons for changes in the resources and reserves estimates. Examples include changes in geological confidence level, additional drilling information becoming available, amount of mineral mined during the period etc.
88. We encourage Mineral Companies and non-Mineral Companies to adopt the recommendations above. This was published in our guidance letter (GL47-13) of January 2013<sup>7</sup>.

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<sup>7</sup> The guidance letter is available at <http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/Documents/gl47-13.pdf>

**C. Disclosure by investment companies listed under MB Chapter 21**

89. MB Chapter 21 applies to investment companies. These are companies which make passive investments in accordance with their investment mandate and are required under the Rules to maintain an adequate spread of investments. These companies are exempt from certain disclosure requirements when making investment decisions (e.g. discloseable transactions), but are subject to additional disclosure in the annual report on the investments, including a breakdown and description of the major investments in their portfolio, an analysis of any provision for diminution in the value of investments and an analysis of realised and unrealised surpluses.

*Scope*

90. We have reviewed the annual reports of 25 investment companies and considered whether:
- (a) their operations complied with the general obligations under MB Chapter 21; and
  - (b) the specific disclosure requirements in annual reports were met.
91. In the course of our review, we identified one issuer that might have conducted business activities outside its investment mandate. Upon enquiries, this issuer terminated the activities in question and resolved not to undertake similar activity in future.
92. We also identified two investment companies that had portfolios with a high concentration of investments. This was likely due to the issuers' small asset sizes. We remind investment companies to closely observe their investment mandates and monitor the spread of investments in managing their investment portfolios.
93. In our review of issuers' disclosure of the details of investments, we identified one issuer that omitted all disclosures under MB Rule 21.12(1) about the breakdown and details of investments in its portfolio, and a number of issuers that omitted some of these disclosures. The most commonly omitted disclosure were the analysis of provisions for diminution in the value of investments, dividend cover or underlying earnings, dividend received, and net assets attributable to major investments.
94. Since investment companies engage only in investment activities, various provisions under MB Chapter 14 are not applicable to them. The required disclosures in annual reports play an important role to provide readers with an unbiased explanation of the performance, financial position and future prospects of the investments held by the investment companies.



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95. We remind investment companies to disclose full details of their investments in their annual reports which are material information to their shareholders. Under MB Rule 21.12(1) an investment company must set out in its annual report an analysis on the provisions for diminution in the value of, and surpluses of, each investment; an analytical and in-depth discussion of its investments including a description of business of the investee; directors' valuation or market value of the investment; dividend received (including any abnormal dividends); dividend cover or underlying earnings; and analysis and explanations about the fluctuations of value in each investment.

## **Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2012**

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### **IV. CONCLUSION**

96. From our review of issuers' annual reports, we noted a small number of cases involving potential material breach of the Rules or material omission of information which required our follow up. Our review also identified some areas of minor non-compliances which appeared to be common, and areas where disclosures can be improved with a view towards providing useful and relevant information for shareholders. We consider that as a general measure to improve shareholders communication, instil investors' confidence and promote a fair, orderly and informed market, issuers should take note and consider our observations discussed in this report in preparing their annual reports.

- End -

