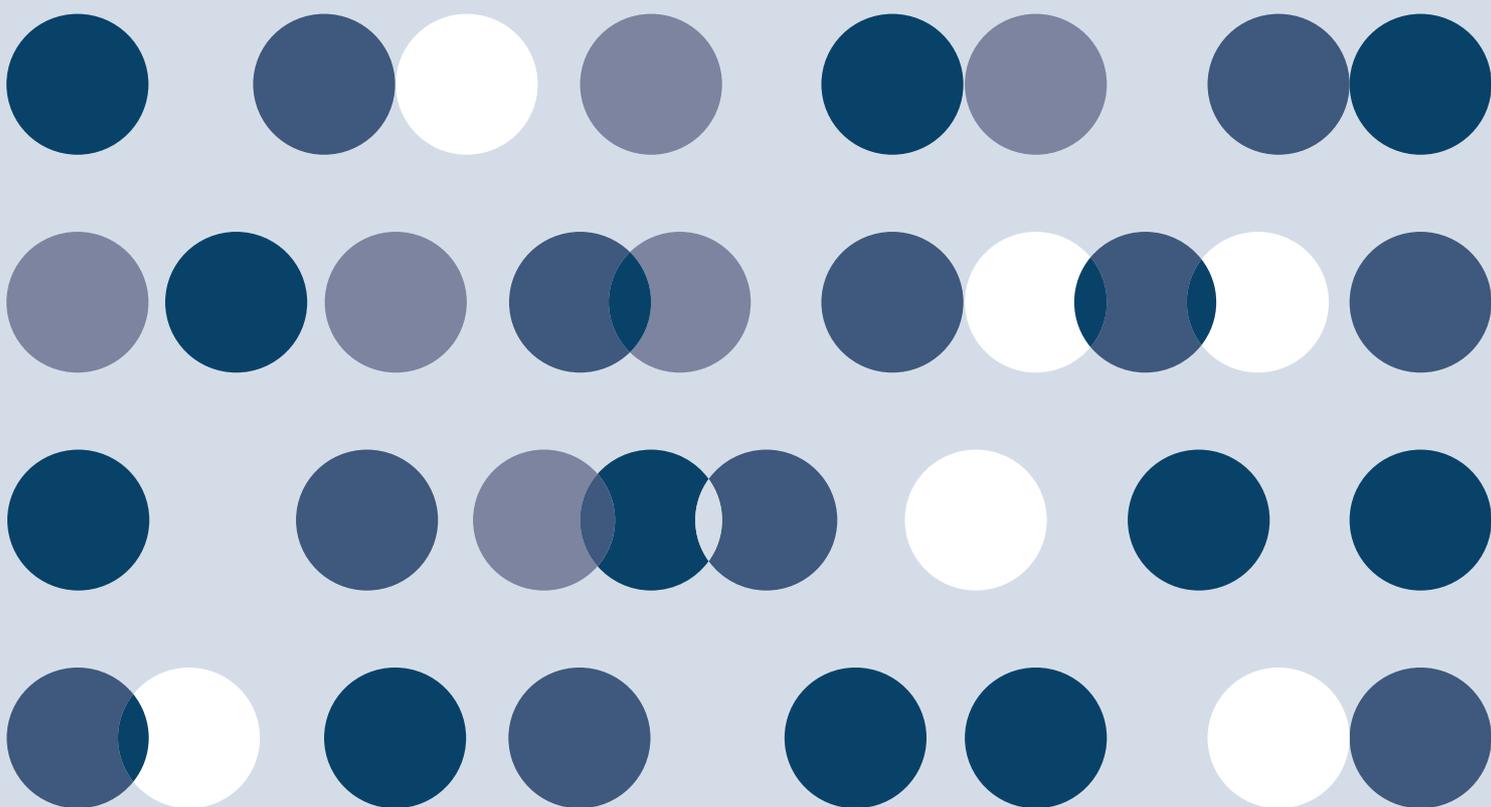


January 2017

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

REPORT 2016



Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance Report 2016

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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 fifth 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. Two new areas which were not covered by our review last year are the "Disclosure of significant securities investments" section in item (v), and item (vi).

- (i) Fundraisings 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 award schemes
- (v) Disclosure of business review and significant securities investments in the MD&A section
- (vi) Financial statements with auditors' modified opinions
- (vii) Contractual arrangements adopted by issuers
- (viii) Issuers listed in 2014 and 2015

We note that in the areas covered by our review last year, a vast majority of issuers continue to comply with the Rules, but there are some areas where issuers can improve their disclosure.

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The Exchange specifically recommends the following:

- (a) **Business review in MD&A**¹ – issuers should provide sufficient information for shareholders and other investors to make a reasonable assessment of their businesses and financial performance, and are recommended to enhance disclosure as follows:
- On principal risks and uncertainties: discuss specifically how the major risk areas would affect business operations, their potential financial impact and, where applicable, the measures taken to manage the risks.
 - On environmental policies and compliance with relevant laws and regulations: explain the material impact of the relevant laws and regulations on business operations.
 - On key relationships with employees, customers and suppliers: disclose information about the background of the major customers and length of relationship, credit terms granted, subsequent settlement of trade receivables, risks associated with reliance on major customers and measures to mitigate such risks.
 - On financial key performance indicators: explain the basis for selecting the indicators and how they are effective in measuring business performance.
- (b) **Significant securities investments in MD&A** – issuers should provide sufficient information about investment portfolios and performance during the financial year, and are recommended to disclose a breakdown of major investments held, the fair value of each major investment as at the financial year end date and its size as compared to the issuer's total assets, the performance of each major investment during the year, and a discussion of the strategy for future investments and the prospects of these investments.
- (c) **Financial statements with auditors' modified opinions** – issuers should provide more detailed and additional information to enable shareholders to better understand the modifications and their actual and potential impact on the financial position. The audit committee should critically review major judgmental areas, and ensure any disagreement with the management is disclosed in the annual reports. Issuers and audit committees should also engage in early discussions with the auditors about the audit plans and how to address the issues that gave rise to the previous year's modifications in the following financial year.

¹ Following the amendments of the Companies Ordinance that took effect in March 2014, the Rules were amended in 2015 to require a business review section that complies with Schedule 5 of the Companies Ordinance. Certain recommended disclosures in the old Rules have become mandatory disclosure requirements.

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- (d) **Continuing connected transactions** – Issuers should have in place internal control procedures to ensure that continuing connected transactions will be conducted in compliance with the connected transaction Rules. They should also ensure that their internal audits would review these transactions and the adequacy and effectiveness of the internal control procedures, and provide the findings to independent directors to assist them in performing their annual reviews. Independent directors should make appropriate enquiries with the management to ensure that they have sufficient information to review the transactions and the internal control procedures.

In our next review², we intend to continue to cover most of the areas reviewed under this report.

² Our next review will cover annual reports for the financial year ended between January and December 2016.

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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 shareholders and 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 eight areas. Our review covers the annual reports of issuers for the financial year ended between January and December 2015³:
 - (i) Fundraisings 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 award schemes (Part IID)
 - (v) Disclosure of business review and significant securities investments in the MD&A section (Part IIE)
 - (vi) Financial statements with auditors' modified opinions (Part IIF)
 - (vii) Contractual arrangements adopted by issuers (Part IIIA)
 - (viii) Issuers listed in 2014 and 2015 (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.

³ 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. Fundraisings through issue of equity / convertible securities and subscription rights

7. Under the Rules, issuers must announce details of their equity fundraisings, including the terms and size of the equity issuance and the proposed use of proceeds. They must also report to shareholders on the fundraisings conducted during the financial year in their annual reports⁴.
8. In our previous Review Reports, we reminded issuers to avoid generic descriptions and to provide meaningful updates on the actual use of proceeds during the reporting period. The updates should include details of the actual application, a breakdown of how the funds were allocated among different uses and whether the funds were applied in accordance with the intended uses previously disclosed in announcements. Issuers should also account for any unutilized proceeds and discuss their intended uses.
9. For new issue of convertible securities and warrants, issuers must disclose⁵ in their annual reports specific details of the class, number and terms of the convertible securities and warrants issued, the consideration received by the issuers, and particulars of any exercise of the conversion or subscription rights during the year. If an adjustment was made to the conversion or subscription price of convertible securities or warrants issued under a general mandate during the financial year, issuers should confirm that it has sufficient mandate to issue further shares upon conversion or subscription. In addition, issuers must obtain the Exchange's prior approval before altering the terms of the issued convertible securities or warrants⁶.

Scope

For all issuers

10. We reviewed the announcements and annual reports of all issuers that conducted equity fundraisings during the financial year, including placings under general (or specific) mandates, and pre-emptive issues. We considered whether they complied with the disclosure requirements mentioned above and, where applicable, obtained the Exchange's prior approval for alterations of the terms of issued convertible securities or warrants.

⁴ Paragraphs 11 and 32 of Appendix 16 to the MB Rules / GEM Rules 18.32 and 18.41

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

⁶ MB Rules 15.06 and 16.03 / GEM Rules 21.06 and 22.03. See our Guidance Letter [GL80-15](#).

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For large scale fundraisings

11. The cash company Rules⁷ may apply to large scale fundraisings that involved investors injecting substantial amounts of cash into the issuers (see our Guidance Letter [GL84-15](#)). Factors for determining whether the cash company Rules would apply include, among others, whether the funds raised would be used for new businesses with little or no relation to and expected to be substantially larger than the issuers' existing principal businesses. In some cases, we did not apply the cash company Rules after considering, among others, the issuer's proposals about the intended use of proceeds and its business plans (for example, where the proceeds would be applied to the issuer's existing business, or new business not expected to be substantially larger than its existing business).
12. We reviewed the annual report disclosures made by issuers conducting large scale fundraisings and considered whether their actual use of proceeds were consistent with their original plans. In particular, we looked at whether there was any change in the use of proceeds and whether the proceeds were applied according to the previously disclosed timeframe. A change in the proposed use of proceeds may raise concerns about circumvention of the cash company Rules.

Findings

For all issuers

13. Compared to last year, we noted an improvement in terms of both the number of issuers that disclosed details of the application of proceeds and the level of details disclosed. Issuers generally followed our guidance and disclosed the actual application of proceeds (including breakdowns of multiple uses where applicable), whether the funds were applied according to the original intentions, and details about proposed applications of unused proceeds. While a minority of issuers failed to make these disclosures, they would generally, upon our enquiries, make supplemental disclosures in separate announcements and/or subsequent financial reports.
14. For issuers that have issued convertible securities and warrants, we found that issuers generally complied with the disclosure and approval requirements in paragraph 9 above.

⁷ MB Rules 14.82 to 14.84 / GEM Rules 19.82 to 19.84

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For large scale fundraisings

15. All issuers applied their proceeds according to the intended uses stated in their circulars. A large majority also applied the proceeds according to the previously disclosed timelines. A few issuers who experienced delay in their business plans disclosed the reasons for the delay. We did not find concerns about possible circumvention of the cash company Rules.
16. To enhance shareholders' understanding of the progress of business expansion with the cash proceeds, some issuers disclosed detailed breakdowns of the application of proceeds in table form, comparing the actual application against each of the intended uses and the expected timeframe previously stated in their circulars. We encourage issuers that conducted large scale fundraisings to adopt a similar approach, particularly where the cash proceeds would be applied to a number of different uses involving a relatively long timeframe.

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

17. The Rules require issuers to announce material acquisitions, publish investment circulars and obtain shareholder approval for these acquisitions. Issuers should also disclose in the MD&A section of their annual reports information about the acquired businesses, including circumstances involving any material asset impairments.
18. Where an asset impairment is supported by an independent valuation, we recommended in our previous Review Reports that the issuer should disclose (a) details of the value of inputs used for the valuation 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. This enables shareholders to understand the basis for the impairments and the prospects of the acquired business.
19. Under some acquisition agreements, the vendors guarantee the performance of the acquired businesses and agree to compensate the issuers for any shortfall or adjust the consideration based on agreed formulae if the guarantees are not met.
20. The Rules set out the information required to be disclosed in an announcement and the next annual report in respect of any performance guarantee given by a connected person where the actual performance fails to meet the guarantee. In our previous Review Reports, we recommended that, irrespective of whether the performance guarantee is given by a connected person or an independent party, the issuer should publish an announcement about (and disclose in its next annual report) the performance of the acquired business and whether the performance guarantee is met. If the performance guarantee is not met, the issuer should also disclose how it would enforce the obligations of the guarantor under the acquisition agreement.

Scope

21. We reviewed the announcements, circulars and annual reports of the issuers that:
 - (a) completed material acquisitions in their last two financial years;
 - (b) recorded material impairments during the financial year under review in respect of the assets previously acquired; or
 - (c) required performance guarantees in previous acquisitions with the guaranteed periods ended in the financial year under review.

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22. For issuers which completed material acquisitions in their last two financial years, we reviewed their annual report disclosures about the developments of the acquired businesses and, in particular, any significant changes to the value of intangible assets and goodwill. We considered whether:
 - (a) the information disclosed in their original investment circulars was materially accurate;
 - (b) any material change to the acquired business was timely announced; and
 - (c) any impairment to assets was properly made and whether the annual reports discussed matters giving rise to the impairment.
23. For issuers which recorded material impairments during the financial year under review in respect of the assets previously acquired, we reviewed (a) their annual report disclosures about the developments of the acquired businesses; and (b) the valuation reports on the assets.
24. For performance guarantees where the guaranteed periods ended in the financial year under review, we reviewed the issuers' annual reports and announcements to assess whether the outcomes were disclosed, and where the performance guarantees were not met, whether and how the issuers enforced the obligations of the guarantors. We also reviewed the accounts of the acquired businesses to check whether the performance guarantees were actually met.

Findings

25. Compared to last year, there was a significant increase in the number of cases where a material impairment was made to the acquired assets. Generally, these impairments were caused by a slowdown in the market condition of the relevant industry or a decline in the trading price of the commodities produced and/or traded by the acquired businesses. All cases except one (see paragraph 26) were caused by events that occurred after completion of the acquisitions. Issuers generally announced the material developments of the acquired businesses in a timely manner and discussed in their annual reports matters giving rise to the impairments. A large majority of the issuers supported the material impairments with independent valuations and followed our recommendations (mentioned in paragraph 18) to disclose details of the valuations to enhance shareholders' understanding.

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26. One issuer recorded a material impairment shortly after the acquisition due to its failure to obtain sufficient working capital for carrying out the proposed business plan of the acquired business. The issuer's alleged reasons for the material impairment appeared inconsistent with the representation it had made in the acquisition circular. This suggested that the information in the acquisition circular might be misleading or incomplete, and raised a question about whether the directors had applied the necessary degree of skill, care and diligence in the course of the acquisition. We have taken appropriate action in this case.
27. Our review of performance guarantees indicated that:
- (a) Two-thirds of the performance guarantees were met. Of the performance guarantees that were not met, one was provided by the issuer's connected persons.
 - (b) In all cases, issuers disclosed whether the performance guarantees were met and if not, whether and how the guarantors fulfilled their obligations under the agreements.
 - (c) Where the performance guarantees were not met, issuers in most cases were compensated by the guarantors according to the terms of the agreements as set out in the acquisition circulars. In the other cases, the issuers either took legal actions to recover the compensation or extended the guarantee period after negotiation. None of these cases involved connected persons as guarantors.
 - (d) Where issuers confirmed that the performance guarantees had been met, our review of the accounts of the acquired businesses did not indicate any concern about the truthfulness of such confirmations.
 - (e) Generally, issuers continued to follow our recommendations set out in paragraph 20 above.

C. Continuing connected transactions

28. Under MB Chapter 14A / GEM Chapter 20, in each financial year:
- (a) An issuer must report its continuing connected transactions in its annual report. It must confirm whether its related party transactions (as disclosed in the financial statements) were connected transactions under the Rules and, if so, whether these transactions complied with the connected transaction requirements.
 - (b) Independent directors and auditors must review the issuer's continuing connected transactions and report their findings in the issuer's annual reports. Independent directors must also confirm whether such transactions were made (i) on terms that are fair and reasonable and in the interests of the issuers' shareholders as a whole; (ii) on normal commercial terms or better; and (iii) in the issuer's ordinary and usual course of business.
29. In our Guidance Letter [GL73-14](#), we provide guidance to issuers and independent directors on the monitoring of continuing connected transactions to ensure that they are conducted in accordance with the framework agreements and in compliance with the connected transaction Rules. In particular:
- (a) An issuer should have in place adequate internal control procedures to ensure that individual continuing connected transactions are indeed conducted in accordance with the pricing policies or mechanism under the framework agreements. It should also ensure that its internal audit⁸ will review these transactions and the internal control procedures, and provide the findings to the independent directors to assist them in performing their annual review.
 - (b) Independent directors should ensure that (i) the methods and procedures established by the issuer are sufficient to ensure that the transactions will be conducted on normal commercial terms and not prejudicial to the interests of the issuer and its minority shareholders; and (ii) appropriate internal control procedures are in place and the issuers' internal audit would review these transactions. Where appropriate, they should make enquiries with the management to ensure that they are given sufficient information to review the transactions and the internal control procedures.

⁸ Under the Corporate Governance Code, an issuer should also have an internal audit function which carries out an analysis and independent appraisal of the adequacy and effectiveness of its risk management and internal control systems.

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30. Last year, we noted that the management's reports provided to the independent directors primarily focused on whether transactions by their nature were covered by the relevant framework agreement and whether the total transaction amount during the financial year was within the annual cap. 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; and (b) the issuer's internal control procedures are adequate and effective to ensure that transactions are so conducted. Without such information, it was unclear how independent directors had assessed issuers' continuing connected transactions to conclude (a) that the transactions were conducted in compliance with the pricing policies or mechanisms under the framework agreements, and (b) the adequacy and effectiveness of the issuers' internal control procedures.

Scope

31. For the purpose of this review, we sent questionnaires to 65 selected issuers⁹ and requested information concerning their internal controls and procedures for compliance with the connected transaction Rules, and details of the annual reviews performed by independent directors.
32. In addition, for all issuers that conducted continuing connected transactions during the financial year (excluding those with specific pricing terms such as a rental agreement), we reviewed their announcements and circulars against the disclosure in their annual reports to assess their compliance with the annual reporting requirements.

Findings

33. Based on their responses to our questionnaires, the selected issuers confirmed to us that they have in place internal controls and procedures to ensure that their operation teams will conduct the continuing connected transactions according to the framework agreements. For example, they have internal procedures that require prior approval before entering into these transactions. They also have internal procedures to ensure that these transactions are conducted in accordance with the framework agreements. For example, each transaction must comply with a specific range of unit price or profit margin pursuant to the pricing terms of the framework agreements.

⁹ We sent questionnaires to 10, 31 and 24 issuers with market capitalization of more than \$10 billion, more than \$1 billion and less than \$10 billion, and less than \$1 billion respectively. These issuers were selected on a random sampling basis within the three bands of issuers categorized by size of market capitalization.

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34. A majority of the selected issuers have also taken measures to periodically counter-check whether their internal controls and procedures are effectively enforced. For example, their finance, internal audit and/or other designated team would:
- (a) sample check vouchers, quotations, invoices and/or receipts to ensure the pricing terms of transactions conducted to be compliant with the framework agreements;
 - (b) review market intelligence concerning market prices and industry trends, and/or compare pricing terms for transactions conducted with independent parties and those with connected persons, to ensure the transactions with connected persons to be on normal commercial terms; and/or
 - (c) prepare periodic reports on the total transaction amounts to ensure the annual caps not to be exceeded.
35. While a majority of issuers provided the above information to independent directors for their annual reviews, a minority of issuers only provided (a) their management confirmation on the fairness and reasonableness of the transactions; and (b) the external auditors' confirmation letter¹⁰ to the independent directors. Without additional information about the work done by the management, it is unclear whether the independent directors had sufficient information to ascertain (a) whether the transactions were actually conducted on normal commercial terms and in compliance with the pricing policies or mechanisms under the framework agreements; or (b) the adequacy and effectiveness of the issuers' internal control procedures to ensure the transactions were so conducted.
36. In light of the above, we remind issuers to take note of our recommendation in paragraph 29(a) and take adequate steps to review their continuing connected transactions and internal control procedures to ensure compliance with the Rules. Issuers should also provide sufficient information to independent directors to assist their annual reviews. Independent directors should ensure that they have sufficient information to properly review the transactions and the internal control procedures (also see our recommendation in paragraph 29(b) and our Guidance Letter [GL73-14](#)).

¹⁰ Under MB Rule 14A.56 / GEM Rule 20.54, an issuer must engage its auditors to report on the continuing connected transactions every year. The auditors must provide a letter to the issuer's board of directors confirming whether anything has come to their attention that causes them to believe that the continuing connected transactions: (1) have not been approved by the issuer's board of directors; (2) were not, in all material respects, in accordance with the pricing policies of the issuer's group if the transactions involve the provision of goods or services by the issuer's group; (3) were not entered into, in all material respects, in accordance with the relevant agreement governing the transactions; and (4) have exceeded the cap.

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Annual report disclosures

37. We found that a vast majority of issuers have continued to comply with the annual report disclosure requirements set out in paragraph 28 above.

D. Share award schemes

38. This year, we continued to review annual report disclosures about share award schemes adopted by issuers.
39. Generally, share awards are satisfied by (a) existing shares acquired or to be acquired by the trustee from the market; (b) new shares to be issued to the trustee under a general (or specific) mandate; or (c) a combination of both. The connected transaction requirements (MB Chapter 14A / GEM Chapter 20) apply to any issue of new shares to connected persons. The Model Code (Appendix 10 to the MB Rules / GEM Rules 5.46 to 5.68) applies to awards of new or existing shares to connected persons.
40. Paragraph 32(7) of Appendix 16 to the MB Rules / GEM Rule 18.41(7) requires issuers to include in their annual reports, among others, a discussion on the remuneration of employees and remuneration policies. The Hong Kong Financial Reporting Standard 2 "Share-based Payment", which requires disclosure of the nature and extent of share based payment arrangements existing during the reporting period, also applies to share award schemes. These requirements include (a) a description of each type of share-based payment arrangement, including the general terms and conditions of each arrangement; and (b) the movements of share awards during the reporting period.

Scope

41. We reviewed the annual reports of all issuers that adopted share award schemes, and considered whether they complied with (a) the disclosure requirements; and (b) the connected transaction requirements and the Model Code.

Findings

42. A large majority of issuers disclosed the major terms of their share award schemes as part of their discussions on the remuneration of employees and remuneration policies. The major terms disclosed included the purpose of the scheme, the total number of shares that can be awarded, the maximum entitlement of each awardee, whether the awards are satisfied by new or existing shares, and the identity of the trustee. Most issuers also disclosed movements in the share awards. We consider such information to be useful for shareholders, and remind issuers to disclose the same.
43. We did not identify any potential breaches of the connected transaction requirements and/or the Model Code.

E. Disclosure of business review and significant securities investments in the MD&A section

44. The MD&A section serves to provide meaningful information that enables shareholders and investors to properly appraise 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 additional disclosure for the section.
45. Following the amendments of the Companies Ordinance that took effect in March 2014, the Rules were amended to require a business review section that complies with Schedule 5 of the Companies Ordinance to be included in annual reports¹¹ (the **New Rules**). The New Rules apply to accounting periods ended on or after 31 December 2015, and require the following disclosures:
- (a) A directors' report for a financial year must contain a business review that includes:
 - (i) a fair review of the issuer's business;
 - (ii) a description of the principal risks and uncertainties facing the issuer;
 - (iii) particulars of important events affecting the issuer that have occurred since the end of the financial year; and
 - (iv) an indication of likely future development in the issuer's business.
 - (b) To facilitate a better understanding of the development, performance and position of the issuer's business, a business review must also include:
 - (i) an analysis using financial key performance indicators;
 - (ii) a discussion on the issuer's environmental policies and performance and its compliance with the relevant laws and regulations; and
 - (iii) an account of the issuer's key relationships with its employees, customers and suppliers and others on which its success depends.
46. The matters mentioned in paragraph 45(a)(ii) and (b)(ii) and (iii) above were previously recommended disclosures under paragraph 52 of Appendix 16 to the old MB Rules / old GEM Rule 18.83, and have now become mandatory disclosure requirements under the New Rules. The New Rules promote the transparency of an issuer's businesses and financial performance in the interests of shareholders and investors.

¹¹ Paragraph 28(2)(d) of Appendix 16 to the MB Rules / GEM Rule 18.07A(2)(d)

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Scope

Business review

47. We reviewed the annual reports of 35 issuers which encountered significant changes in financial position during the financial year. We assessed whether their business review sections complied with the New Rules and provided sufficient information for investors to make a reasonable assessment of their businesses and financial performance.

Significant securities investments

48. We noted that there was an increase in the number of issuers that made substantial securities investments during the financial year. We reviewed the annual reports of these issuers and assessed whether their disclosures provided sufficient information about investment portfolios and performance during the financial year.

Findings

Business review

49. Based on our review, we noted that issuers generally followed the New Rules and included a business review section that disclosed the information required in paragraph 45 above. However, as explained below, in many cases the disclosures concerning the matters mentioned in paragraph 45(a)(ii) and (b) were too generic:

(a) Principal risks and uncertainties affecting the issuer

50. Issuers generally discussed their risk exposures to areas such as exchange rate fluctuations, industry competition, changes in the government policies, and reliance on major customers/suppliers. However, most issuers neither elaborated on how these risks were related to (or would affect) their business operations and the potential impact, nor provided meaningful information about their risk management policies. For example, one issuer with business operations in different geographical locations stated that exchange rate fluctuation might adversely affect the group, but did not make a meaningful assessment of the potential financial impact and how it would manage this risk.
51. Issuers are expected to discuss specifically how the major risk areas would affect their business operations, the potential financial impact, and whether they had undertaken any measures to manage the risk areas.

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(b) Environmental policies and performance and compliance with the relevant laws and regulations

52. A vast majority of issuers confirmed their compliance with the relevant laws and regulations, but did not explain whether and how the laws and regulations would have a material implication or impact on their business operations.
53. We recommend that issuers should include more detailed disclosures, including whether and how the laws or regulations in question would have a material implication or impact on their operations and, where applicable, the historical compliance record and details of the non-compliance.

(c) Key relationships with employees, customers and suppliers

54. Most issuers provided generic descriptions about their relationships with employees, customers and suppliers. For example, they simply stated that they maintained a good or long-term relationship, or had no significant disputes, with customers and suppliers during the year, or that employees were valuable assets to the issuers. These generic descriptions do not give meaningful information to shareholders or investors.
55. As suggested in our previous Review Reports, we encourage issuers to disclose in the annual reports:
 - (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.

(d) Financial key performance indicators (KPIs)

56. Some issuers only provided the current ratio, number of turnover days over accounts receivable, accounts payable and inventory, and return on equity etc. as their KPIs. They did not explain the basis for selecting these KPIs and how they are effective in measuring their business performance. Only a minority of issuers followed our recommendation in our 2012 Review Report to disclose:
 - (a) the reasons for selecting or changing certain KPIs, and how they are linked to the issuer's objectives;

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- (b) the trend each of the KPIs represents; and
 - (c) the reasons for any differences between the KPIs and figures reported under accounting standards in the financial statements.
57. To enhance shareholders' and investors' understanding of how the management measures business performance, we remind issuers to follow our recommended disclosures.

Significant securities investments

58. Paragraph 32(4) of Appendix 16 to the MB Rules / GEM Rule 18.41(4) requires issuers to disclose their significant investments held, their performance during the financial year, and future prospects.
59. A majority of issuers did not provide adequate information about their investments in the annual reports. For example, most issuers did not provide a breakdown of their investments portfolios, and discussed only the performance of selected investments which did not represent a meaningful coverage of their investment portfolios. Following our enquiries, these issuers have made further announcements to include the information required under the Rules.
60. We recommend issuers to disclose the following:
- (a) a breakdown of major investments held, including the names and principal businesses of the underlying companies, the number or percentage of shares held and the investment costs;
 - (b) the fair value of each major investment as at the financial year end date and its size as compared to the issuers' total assets;
 - (c) the performance of each major investment during the year, including the change in fair value, gain or loss on disposal and dividends received; and
 - (d) a discussion of the strategy for future investments and the prospects of these investments.

F. Financial statements with auditors' modified opinions

61. Issuers are obliged to provide shareholders with financial statements which fairly present their financial position and performance and are free from material misstatements. Such financial information is necessary for shareholders and investors to make an informed investment decision.
62. Paragraph 3 of Appendix 16 to the MB Rules / GEM Rule 18.47 requires an issuer to provide more detailed or additional information if its financial statements do not give a true and fair view of its state of affairs, results of operations and position of cashflows.

Scope

63. We reviewed the annual reports of 65 issuers with auditors' modified opinions¹² on their financial statements. We considered whether these issuers had provided additional information about the modified opinions issued by auditors and their proposed measures to address them.

Findings

64. Based on our observation, the modified opinions can be broadly divided into the following categories:
 - (a) material uncertainty on whether the financial statements can be prepared on a going concern basis;
 - (b) modifications brought forward from previous years;
 - (c) limitation of scope to measure the value of assets and liabilities due to various reasons (e.g. uncertainty on the outcome of future events which might affect the ownership of assets, or auditors' inability to obtain sufficient audit evidence on impairment assessment);
 - (d) departure from accounting standards; and
 - (e) internal control issues (e.g. auditors' inability to access the books and records of a subsidiary due to loss of control, or obtain sufficient evidence to substantiate the substance and rationale of certain transactions and fund flows).

¹² Under paragraph 5(b) of Hong Kong Standard on Auditing 705 (Revised) "Modifications to the Opinion in the Independent Auditor's Report", the term "Modified opinion" is defined as: "A qualified opinion, an adverse opinion or a disclaimer of opinion on the financial statements".

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65. As described below, other than the modification on material uncertainty related to going concern, issuers generally did not provide additional information about the modifications or how they intended to address the issues giving rise to the modifications.
- (a) *Material uncertainty related to going concern* – Most issuers were able to disclose the basis upon which the directors considered that their financial statements could be prepared on a going concern basis (e.g. financial support from controlling shareholders or continuing financing from their principal bankers, or implementation of appropriate measures to meet the cash flow requirements).
 - (b) *Modifications brought forward from previous years* – Issuers were generally silent on whether these modifications would be removed or resolved.
 - (c) *Limitation of scope* – In most cases where auditors issued modified opinions on account balances due to failure to obtain sufficient audit evidence on an impairment assessment, the issuers did not disclose the basis on which the management considered an impairment to be unnecessary, and did not explain why the required audit evidence was not available for auditors.
 - (d) *Departure from accounting standards* – Issuers generally did not disclose whether this modification would be removed or resolved. For example, in one case where the auditor issued a modified opinion on the financial statements of the issuer that failed to consolidate a subsidiary's financial statements, the issuer did not explain the reasons for its inability to get access to the books and records or how it intended to resolve the issue.
 - (e) *Internal control issues* – Some issuers were unable to provide auditors with sufficient audit evidence to substantiate the substance and rationale of certain prepayments, thereby resulting in modifications. This may suggest that there were deficiencies in the issuers' internal controls.
66. We have followed up with the issuers to understand the nature of modifications, the reasons why the issuers could not provide sufficient information to address the auditors' concerns and the proposed plans for addressing the modifications.

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67. We highlight that under the Corporate Governance Code¹³, the board is responsible for ensuring that (a) the issuer establishes and maintains appropriate and effective internal control systems; and (b) a review of the effectiveness of internal control systems is conducted at least annually and reported in its Corporate Governance Report. Further, the audit committee should monitor the integrity of the issuer's annual reports and review any significant financial reporting judgements contained in the annual reports, the going concern assumptions and any modifications, and compliance with accounting standards. It should also give due consideration to any matters raised by the auditors and oversee the issuer's internal control systems.
68. To enable shareholders to better understand the modifications and their actual or potential impact on the issuers' financial position, we recommend issuers to enhance their disclosure in annual reports. For modifications involving major judgmental areas (such as going concern assumptions and the valuation to support the fair value of assets), the management should clearly explain their position and the basis of their views in the annual reports. Moreover, the audit committee should critically review these judgmental areas. Any disagreement by the audit committee with the management's position should be disclosed in the annual report.
69. Issuers and their audit committees should also engage in early discussion with the auditors about the audit plan and how to address the issues that gave rise to the previous year's modifications in the following financial year.

¹³ Sections C.2 and C.3 of Appendix 14 to the MB Rules / Appendix 15 to the GEM Rules

III. FINDINGS ABOUT RULE COMPLIANCE BY SPECIFIC TYPES OF ISSUERS

A. Contractual arrangements adopted by issuers

70. Issuers engaged in businesses subject to foreign ownership restrictions listed on 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.
71. Our Guidance Letter ([GL77-14](#)) sets out factors for issuers to consider when adopting Contractual Arrangements, and requires disclosures in their transaction announcements and circulars about the legality and validity of the Contractual Arrangements and subsequent changes thereto.
72. In our last Review Report, we found that a vast majority of issuers adopting Contractual Arrangements (the **VIE-Issuers**) did not follow the disclosure requirements under the Guidance Letter. We reminded the VIE-Issuers to take note of and consider the disclosure guideline when preparing their annual reports. The recommended disclosures include (a) particulars of the operating entity and its registered owners, and a summary of the major terms of the Structured Contracts; (b) a description of the operating entity's business activities and their significance to the issuer (e.g. the respective revenue and assets value); (c) the extent to which the Structured Contracts relate to requirements other than the foreign ownership restriction; and (d) the reasons for using Contractual Arrangements, the associated risks and actions taken by the issuer to mitigate the risks.
73. As set out in our Guidance Letter ([GL77-14](#)), Contractual Arrangements adopted by issuers must be narrowly tailored to address the foreign ownership restriction. For requirements other than the foreign ownership restriction (**Other Requirements**)¹⁴, the issuer should, upon advice from its legal adviser, reasonably assess the requirements under the applicable rules and take all reasonable steps to comply with them. While the issuer may not be able to fully comply with the Other Requirements before the establishment of the Contractual Arrangements, it must commit financial and other resources to achieve full compliance as soon as practicable.

¹⁴ Certain industry regulators impose certain qualification requirements which are other than the foreign ownership restriction listed in the Foreign Investment Industries Guidance Catalogue. For example:

- (a) Under the Provisions on the Administration of Foreign-Invested Telecommunications Enterprises, the major foreign investor of a foreign-invested telecommunications enterprise providing value-added telecommunications services shall have a good performance record and experiences in providing value-added telecommunications services.
- (b) Sino-foreign cooperation in operating schools or training programs in the PRC is subject to the Regulation on Sino-Foreign Cooperation in Operating Schools. The foreign investor in a sino-foreign joint venture private school must be a foreign educational institution with relevant qualification and high educational quality (subject to evaluation by the relevant authority).

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74. The issuers are also recommended to publish the Structured Contracts on their websites to promote transparency.

Scope

75. We reviewed the VIE-Issuers' annual reports and considered whether they followed our guidance on annual report disclosures. We also reviewed whether they published the Structured Contracts on their websites as recommended in our Guidance Letter ([GL77-14](#)).

Findings

76. Compared to last year, the disclosures in the VIE-Issuers' annual reports have generally improved, with over 80% of the VIE-Issuers having made disclosures in their annual reports as recommended under our guidance. A few VIE-Issuers did not disclose any information about their Contractual Arrangements but, after our follow up, have either published supplemental announcements or agreed to make the disclosures in their forthcoming annual reports.
77. We noted that about one-third of the VIE-Issuers are subject to Other Requirements in addition to the foreign ownership restriction. A majority of these VIE-Issuers disclosed in their annual reports details of the Other Requirements and their proposed course of actions or plans for fulfilling these requirements. For example, some VIE-Issuers have been gradually building up their track record of overseas business operations for the purpose of satisfying the Other Requirements applicable to their industries. We encourage all VIE-Issuers that are subject to Other Requirements to disclose the related particulars, including their action plans and the progress on compliance with the Other Requirements.
78. We found that a majority of the VIE-Issuers have published the Structured Contracts on their websites. To promote transparency, we encourage those VIE-Issuers who have not done so to follow the recommended practice.

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B. Issuers listed in 2014 and 2015

79. 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 recommendation.

Scope

80. 122 and 138 issuers were listed in 2014 and 2015 respectively (the **Newly Listed Issuers**). 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 before listing; and
 - (e) non-compliance with the Listing Rules after listing.
81. We also reviewed the post-listing developments of these issuers to examine their compliance behaviors.

Findings

(a) Profit forecasts and material changes in financial results

Profit forecasts

82. A vast majority of the Newly Listed Issuers did not publish any profit forecast in their prospectus. All profit forecasts published by Newly Listed Issuers were met.

Profit warnings / Positive profit alerts

83. Some Newly Listed Issuers published profit warning or positive profit alert announcements in respect of their first financial year performance after listing. Generally, these announcements (mostly profit warnings) were published around one month after their financial year ends.
84. Last year, we reminded issuers to observe the guidance published in the SFC Corporate Regulation Newsletter of April 2015 and our previous Review Reports. According to the guidance, profit warning or positive profit alert announcements issued under the Inside Information Provisions should disclose material developments subsequent to the date of the prospectus that have not been disclosed by the issuer. If an issuer wishes to provide the market with additional information about its

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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 the information already available in the prospectus.

85. However, Newly Listed Issuers generally did not fully observe this guidance. We noted that in most cases, the reasons given for their profit warnings had already been disclosed in the IPO prospectuses. We take this opportunity to remind new issuers again to take note of the guidance. In addition, when preparing profit warning or positive profit alert announcements, new issuers are encouraged to use clear and concise language and, to the extent possible, describe the potential impact quantitatively so that shareholders and investors can better understand the actual situation.

(b) Changes in the use of IPO proceeds

86. The disclosure in an IPO prospectus and an annual report regarding the use of the IPO proceeds demonstrates whether a Newly Listed Issuer has deployed resources to develop and expand its business as planned and, if not, what changes have been made. This information assists investors to appraise of the issuer's value and make an informed investment decision.
87. A few Newly Listed Issuers announced changes in the use of IPO proceeds within the first two years after listing. All cases (except one) properly explained the reasons for the changes. One issuer delayed in announcing the change and we have taken appropriate action. We recommend that new issuers should clearly disclose in their IPO prospectus the specific uses of proceeds commensurate with their past and future business strategy, and should timely and properly explain any subsequent material changes in the use of the IPO proceeds by way of announcement.
88. One Newly Listed Issuer conducted fundraisings (through debt and equity issues) shortly after listing, with the amount raised exceeding the IPO proceeds. This was inconsistent with the disclosure in the IPO prospectus about its funding needs after listing and we have taken appropriate action. We remind that in their IPO prospectuses, new issuers should ensure the accuracy and completeness of the disclosures about their business plan(s), use of proceeds and funding needs after listing.

(c) Undertakings provided by major shareholders

89. It is common that a Newly Listed Issuer is given a non-competition undertaking (**NCUs**) by its major shareholder in relation to the issuer's business, so as to clearly delineate the issuer's businesses from that of its major shareholder.

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90. Newly Listed Issuers which were given the NCUs before listing were normally required to disclose the fulfilment of the NCUs and the steps taken to confirm such fulfilment in their subsequent annual reports. We found that a vast majority of these issuers disclosed such information in their annual reports. For those which failed to do so, they have at our request either published supplemental announcements, or agreed to make the disclosure in future financial reports.

(d) Fulfilment of conditions or undertakings imposed before listing

91. Where the Listing Committee imposed specific conditions on, or required undertakings (other than NCU) to be provided by, a Newly Listed Issuer before listing to address particular concerns raised during the IPO vetting process, the issuer should disclose its compliance with such conditions or undertakings in their annual reports after listing.
92. We identified a few cases where the Newly Listed Issuers were specifically required by the Exchange to disclose in their annual reports whether the relevant conditions or undertakings imposed before listing are fulfilled. All these issuers properly disclosed the required information in their annual reports. These conditions or information included compliance with specific regulatory requirements, the status update of obtaining permits for properties or relocation of material operations, and updates on business exposure to sanctions risks.

(e) Non-compliance with the Listing Rules after listing

93. A small number of the Newly Listed Issuers were found to have breached the Listing Rules after listing and the extent of non-compliance warranted our follow up actions, including issuance of caution letters, guidance letters or warning letters. The breaches included:
- (a) Non-compliance with notifiable / connected transaction requirements (five cases);
 - (b) Delay in publishing financial results due to changes in auditors (two cases);
 - (c) Delay in announcing a change in the use of IPO proceeds (one case) (see paragraph 87 above); and
 - (d) Failure to disclose materially accurate and complete information about a profit warning in a timely manner (one case).

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94. Last year, we reminded new issuers to fully observe the Rule requirements to consult with their compliance advisers in a timely manner in the circumstances set out in Chapter 3A (or Chapter 6A of GEM Rules)¹⁵. Despite this reminder, we noted that some Newly Listed Issuers still failed to consult with their compliance advisers (or delayed in doing so) as required. We reiterate our guidance that Newly Listed Issuers should consult with their compliance advisers in a timely manner to ensure compliance with the Rules.

Post-listing developments of the Newly Listed Issuers

95. We reviewed the post-listing developments of the Newly Listed Issuers, in particular regarding their material transactions and change in control. Our observations included:
- (a) There was an increase in the number of cases where the controlling shareholders disposed of their shares in the issuers shortly after the lock-up periods expired (10 of these issuers were listed in 2014 and four were listed in 2015). In two cases, the disposals took place only 14 months after listing.
 - (b) Two issuers introduced new controlling shareholders after completion of a notifiable transaction and a share subscription respectively. However, we did not identify any issuers that underwent material changes in principal businesses.
 - (c) A number of issuers were identified by the SFC as having high concentration of shareholding shortly after listing (12 of these issuers were listed in 2014 and 10 issuers were listed in 2015).
96. In one isolated case involving an issuer listed in 2014, the issuer noted certain irregularities that gave rise to an issue of management integrity. This has resulted in the trading suspension of the issuer's shares.
97. We will continue to closely monitor the activities conducted by issuers to ensure their compliance with our Rules and guidance after listing.

¹⁵ The circumstances include: (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.

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IV. CONCLUSION

98. From our review of issuers' annual reports this year, we noted improvements in the disclosures in the areas which were subjects of our previous reviews, particularly in respect of disclosure about the use of proceeds from fundraisings through issue of equity securities, results of performance guarantees, and contractual arrangements. The majority of issuers have considered and adopted our guidance to enhance their disclosures in annual reports. In respect of continuing connected transactions and disclosure of business review in the MD&A section, we have highlighted in this report the aspects that issuers should further improve their practice and disclosure.
99. For the new areas covered by this review, including "financial statements with auditors' modified opinions" and "disclosure of significant securities investments", we consider that in general, issuers should improve their disclosure. We have set out our findings and recommendations on these areas in this report, and urge issuers to consider and take up our guidance.
100. 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 -

