

Hong Kong Capital Markets Update

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HKEx Publishes 2015 Report on Reviews of Disclosures in Issuers' Annual Reports to Monitor Rule Compliance

On 29 January 2016, The Stock Exchange of Hong Kong Limited (the "Exchange") published a report entitled "[Review of Disclosure in Issuer's Annual Reports to Monitor Rule Compliance - Report 2015](#)" (Report). This is the fourth report published by the Listing department of the Exchange as part of its ongoing monitoring and compliance activities. The review focuses on issuer's compliance with the listing rules (the "Rules") and disclosure of material events and developments. The 2015 review program involves issuers' annual reports with financial year ended in December 2014.

Overall, the Exchange noted that a majority of issuers comply with the Rules and that there was room for improvement with disclosure and in following the Exchange's guidance on best practices.

The themes covered in the 2015 review program include four areas brought forward from last year's review and three new areas:

THREE NEW AREAS	<ul style="list-style-type: none"> Continuing connected transactions Share option / award schemes Contractual arrangements adopted by issuers
FOUR AREAS FROM LAST YEAR	<ul style="list-style-type: none"> Fundraisings through issue of equity/convertible securities and subscription rights Updates on material changes and results of performance guarantees after acquisitions Disclosure of significant changes to issuers' financial performance and reliance on key customers in the MD&A section Newly listed issuers in 2013 and 2014

The best practices and guidance for disclosures in annual reports set out in the 2015 Report are summarised in the Quick Reference Card at the end of this publication. The key findings and areas for improvement noted in the 2015 Report are highlighted below.

1. Continuing Connected Transactions (CCTs) –

It is unclear how the independent non-executive directors (INEDs) assessed the CCTs and concluded that they had been conducted in accordance with the terms of the framework agreements with connected persons

In addition to reviewing issuers' announcements, circulars and disclosure in annual reports of all issuers that conducted CCTs during the financial year, the Exchange also obtained copies of the minutes of audit committees or appropriate committees of selected issuers to consider whether sufficient information had been given to the INEDs for them to discharge their duties. The findings indicated that the reports provided to the INEDs primarily focused on whether the CCTs by their nature were covered by the framework agreement and did not cover the work done by the management to check that the transactions were conducted according to the pricing policies or mechanisms under the framework agreement and whether the relevant internal control procedures are adequate and effective.

The new Code Provision C.2.5 (the "New Code") of Appendix 14 to the Rules/ Appendix 15 of the GEM Rules which requires issuers to have (i) an internal audit review of risk management and internal control systems and (ii) an internal audit function. The New Code is first effective for financial years beginning on or after 1 January 2016. Issuers are expected to have their internal audits to carry out effective review of the internal control procedures governing CCTs and provide the findings to INEDs in connection with their annual review. The Exchange has indicated that CCTs will continue to be a review area for rule compliance in next year's review.

2. VIE arrangements –

Issuers adopting contractual arrangements (VIE-Issuers) did not fully comply with the disclosure requirements set out by the Exchange

A vast majority of the VIE-Issuers did not follow the guidance on disclosures in [GL 77-14](#) “Guidance on listed issuers using contractual arrangements for their businesses” which requires full disclosure of the business activities of the relevant operating entities and a summary of the major terms of the structured contracts and their significance to the issuers. Issuers are reminded to keep investors informed of the material development in their business operations subject to structured contracts and unwind the structured contracts as appropriate to comply with the relevant laws and regulations (i.e. the consultation draft of the new Foreign Investment Law by the People’s Republic of China’s Ministry of Commerce from January 2015 or the revised Foreign Investment Industries Guidance Catalogue from March 2015).

3. Management discussion and analysis (MD&A) –

Issuers should provide more in-depth discussion in the “management discussion and analysis” section (MD&A) about their compliance with the relevant laws and regulations, their capital requirements and the related financing plan, and their key relationships with customers

The Exchange noted that while improvements had made by issuers in discussing significant changes in their revenue, profit margin and tax positions following the prior year’s recommendations, only a few issuers discussed their compliance with laws and regulations that have a significant impact on their business. Updates on material changes to the issuers’ operations were not provided by a majority of the issuers (e.g. product mix and business model) and only few issuers provided an analysis of performance using key financial performance indicators, and comparisons of results with industry peers.

Whilst many issuers disclosed their liquidity position, debt portfolio and gearing ratios in their annual reports, Exchange encourages issuers to provide discussion and disclosures on their financing plans to meet future capital commitments/requirements and whether there are any fund-raising activities in the upcoming year.

4. Use of IPO proceeds –

Issuers are reminded to provide meaningful updates on the actual use of proceeds from equity fundraising

Issuers generally disclosed the basic information required under the Rules and the level of details disclosed was similar to last year’s findings. Issuers that conducted equity fund raisings (including IPO) during the financial year should provide meaningful updates in their annual reports on the actual use of the proceeds including details of the application and a breakdown of how the funds were allocated among different uses.

Newly listed issuers are required to explain any material changes in the use of IPO proceeds by way of an announcement.

Reminder on 2015 Annual Report Disclosure Requirements



As many Hong Kong listed issuers with a 31 December financial year end are preparing their 2015 annual reports for despatch to shareholders by 30 April 2016, we would like to remind them of some of the new disclosure requirements. Following the effectiveness of the new Companies Ordinance, the Rules were amended in February 2015 to align with the requirements for financial information disclosures with reference to the disclosure provisions in the new Companies Ordinance (“New Rules”). The New Rules align the requirement for a business review in the new Companies Ordinance for both Hong Kong incorporated and non-Hong Kong incorporated listed issuers. For annual reports with the financial year ended on or after 31 December 2015, non-Hong Kong incorporated listed issuers will also need to include the following required disclosures that were previously recommended disclosures:

- (a) a discussion on business risks
- (b) a discussion on the issuer’s environmental policies and performance, including compliance with the relevant laws and regulations: and
- (c) an account of the issuer’s key relationship with employees, customers, suppliers and others.

Where the information is already disclosed in the new business review section, no additional information is required in the MD&A section. Issuers may consider including a cross reference to the business review section.



If you have any questions about the matters discussed in this publication, please feel free to contact the following partners in our Capital Markets Advisory Group.

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Quick Reference Card

2015 Review Area	Rule reference	Rules, guidance and best practices
Fundraising through issue of equity (including IPO)	MB ¹ Rule, Appendix 16, paragraph 11/GEM ² Rule 18.32	<ul style="list-style-type: none"> Provide details of application and a breakdown of allocation and whether the funds raised were applied according to the specific uses previously disclosed Avoid generic descriptions and provide meaningful updates in the annual report on actual use of proceeds
Fundraising through issue of convertible securities and subscription rights	MB Rule 13.280/GEM Rule 17.30	<ul style="list-style-type: none"> Disclose by way of announcement: <ul style="list-style-type: none"> the maximum number of shares to be issued upon exercise of the conversion of subscription rights a summary of the provisions for adjustments of the price and/or number of shares to be issued and other material terms
	MB Rules, Appendix 16, paragraph 10(1) & (2)/GEM Rules 18.11 & 18.12	<ul style="list-style-type: none"> Disclose: <ul style="list-style-type: none"> specific details of the class, number and terms of the convertible securities and warrants issued together with the consideration received particulars of any exercise of conversion rights during the year
	MB Rules 15.06 & 16.03/GEM Rules 21.06 & 22.03	<ul style="list-style-type: none"> Announce details of general mandate, if applicable, and disclose whether the mandate was sufficient after any adjustments of conversion or subscription price
	GL80-15	<ul style="list-style-type: none"> Seek prior approval of the Exchange for any alterations of terms after issue
Updates on material changes and results of performance guarantees after acquisitions	2014 Review recommendation	<p><i>Asset impairment</i> Where the asset impairment is supported by independent valuation, issuers should disclose details of the value of inputs, basis and assumptions of valuation, the valuation method, and an explanation to any significant change to any of them from those previously used</p> <p><i>Performance guarantees</i> Publish an announcement and disclose in the next annual report:</p> <ul style="list-style-type: none"> whether or not the performance guarantee has been met the performance of the acquired business how the issuer enforces the obligations of the guarantors under the acquisition agreements where the performance guarantee is not met
Continuing connected transactions	Code Provision C.2.5 of Appendix 14, MB Rule/ Appendix 15, GEM Rule	<ul style="list-style-type: none"> Coming into effect for financial years beginning on or after 1 January, 2016, Code Provision C.2.5 requires an issuer to have an internal audit function that generally carries out the analysis and independent appraisal of the adequacy and effectiveness of the issuer's risk management and internal control systems
	2015 Review recommendation	<ul style="list-style-type: none"> Implement internal control procedures to check that CCTs have been conducted in accordance with the pricing policies or mechanisms under the framework agreement Test the relevant internal controls over CCTs for adequacy and effectiveness The internal audit function should review the CCTs and internal control procedures and provide the findings to the INEDs to assist them in performing their annual review

Share option / award schemes	MB Chapter 17/ GEM Chapter 23	<ul style="list-style-type: none"> MB Chapter 17/GEM Chapter 23 governs the disclosure of share options or any schemes involving the grant of options over new shares or other new securities of the issuer or its subsidiaries
	MB Chapter 14A/ GEM Chapter 20	<ul style="list-style-type: none"> Share awards granted to connected persons involving issue of new shares are governed by MB Chapter 14A/GEM Chapter 20
	Model Code requirements	<ul style="list-style-type: none"> Share awards satisfied by issue of new shares or on-market acquisition of existing shares are governed by Model Code requirements (Appendix 10, MB Rules/GEM Rules 5.46 to 5.68)
	Hong Kong Financial Reporting Standard 2 "Share-based Payment" (HKFRS 2)	<ul style="list-style-type: none"> HKFRS 2 sets out the disclosure requirements for the nature and extent of share based payment arrangements and are applicable to both share option schemes and share award schemes
Disclosure of significant changes to issuers' financial performance reliance on key customers in the MD&A section	MB Rule, Appendix 16, paragraph 28(2)(d)/GEM Rule 18.07A(2)(d) (New Rules)	<ul style="list-style-type: none"> Include in the business review section (first effective for financial year ended 31 December 2015): <ul style="list-style-type: none"> a discussion on business risks (including known events, uncertainties and other factors which may substantially affect future performance) and risks management policy; a discussion on the issuers' environmental policies and performance, including compliance with the relevant laws and regulations; and an account of the issuer's key relationships with employees, customers, suppliers and others, on which its success depends
	MB Rule, Appendix 16, paragraph 52/ GEM Rule 18.43/ GL59-13	<ul style="list-style-type: none"> Recommend to enhance the MD&A disclosure to provide meaningful explanation of the factors causing the material changes in revenue, profit margin and tax positions during the financial year under review
	MB Rule, Appendix 16, paragraph 32(1)/ GEM Rule 18.41(1)	<ul style="list-style-type: none"> Disclose liquidity and financial resources such as comments on the level of borrowings as at the date of the statement of financial position, the seasonality of borrowing requirements, and the maturity profile of borrowings and committed facilities Consider to include reference to funding requirements for capital expenditure commitments and authorisations where appropriate Discuss the capital expenditure requirements for the business operations and the related financing plans where appropriate
	2013 Review recommendation/ New Rules	<ul style="list-style-type: none"> Disclose key relationships with customers in the annual report and include: <ul style="list-style-type: none"> the background of the major customers and their length of relationship with the issuer the credit terms granted to major customers and whether they are in line with those granted to other customers details of the subsequent settlement of accounts receivables with major customers, and whether any provisions are necessary; and the risks associated with reliance on major customers, and measures undertaken by issuers to mitigate such risks Discuss the exposure to substantial risks resulting from any key customer relationships

<p>Contractual arrangements adopted by issuers</p>	<p>GL77-14</p>	<ul style="list-style-type: none"> ● Disclose in the annual report: <ul style="list-style-type: none"> (i) particulars of the operating entity and its registered owners, and a summary of the major terms of the structured contracts (ii) a description of the operating entity's business activities and their significance to the issuer (iii) quantitative information including revenue and assets subject to the structured contracts (iv) the extent to which structured contracts relate to requirements other than the foreign owner restriction (v) the reasons for using contractual arrangements, the associated risks and actions taken by the issuer to mitigate the risks (vi) any material change in the contractual arrangements and/or the circumstances under which they were adopted, and its impact on the issuers (vii) any unwinding of structured contracts or failure to unwind when the restrictions that led to the adoption of structured contracts are removed (viii) include an update on the regulatory developments affecting the contractual arrangements and unwind the structured contracts as soon as practicable when the restrictions are lifted
<p>Newly listed issuers in 2013 and 2014</p>	<p>General observations and recommendations</p>	<ul style="list-style-type: none"> ● Profit warning announcements should disclose material developments subsequent to the date of the prospectus that has not been disclosed by the issuer. The information should be meaningful and specific and not a restatement of information already available in the prospectus ● Disclose any material changes in the use of IPO proceeds and explain the reasons by way of an announcement on a timely basis ● Disclose major shareholders' compliance with the non-competition undertaking in the annual report or by way of announcement ● Disclose issuer's compliance with conditions or undertakings imposed prior to listing ● Consult with the compliance advisors in a timely manner in those circumstances set out in MB Rule 3A.23/GEM 6A.23

¹ Main Board Listing Rules of The Hong Kong Stock Exchange Limited

² Growth Enterprise Market Listing Rules of The Hong Kong Stock Exchange Limited