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Welcome to the April 2013 issue of KPMG China's Hong Kong Capital Markets Update. In this issue, we highlight the regulatory developments during the first quarter of 2013 with a focus on matters of importance to directors, management and other persons who are responsible for regulatory reporting and compliance. These include:

- The new statutory regime on disclosure of inside (price sensitive) information came into effect on 1 January 2013 and the number of corporate announcements on inside information took a noticeable hike in the first quarter of 2013.
- The Hong Kong Stock Exchange ('the Exchange') published (i) the 2012 report on reviews of listed issuers' published periodic financial reports under the Financial Statements Review Programme (FSRP) and (ii) its first report on reviews of disclosures in listed issuers' annual reports.
- The Exchange published one Guidance Letter and a series of Listing Decisions in respect of the continuing disclosure requirements of mineral companies and other listed issuers that publicly disclose details of resources and/or reserves, and various other compliance issues.

# 1 New statutory regime and a rise in listed issuers' announcements on disclosure of inside information

The new statutory regime on disclosure of inside information came into effect on 1 January 2013. As reported in a recent Securities and Futures Commission (SFC) [press release](#), the total number of corporate announcements on inside information in the first quarter of 2013 was up 43 percent compared to the corresponding period last year.

The Exchange also published the consultation conclusions on the consequential changes to the Listing Rules in November 2012, which took effect on 1 January 2013. The amendments focus on false market situations and impose obligations on listed issuers to avoid establishment of a false market. For instance, a listed issuer is required to issue an announcement e.g., a profit warning to avoid the establishment of a false market in its listed securities. According to the information available from the Exchange, there was a 22 percent surge in the total number of profit warning announcements issued in the first quarter of 2013 compared to the corresponding period last year (2013: 393; 2012: 323). A new series of [frequently asked questions](#) on the consequential changes to the Listing Rules is published by the Exchange in April 2013 to help issuers understand and comply with the amended rules.

# 2 The Exchange reports on reviews of periodic financial statements and compliance with Listing Rules in issuers' annual reports

In the first quarter of 2013, the Exchange published two review reports. The first one published in January 2013 was the [2012 FSRP Report](#) on its review of listed issuers' periodic financial statements ('2012 FSRP Report'). In March 2013, the Exchange's first [report](#) on its review of listed issuers' annual reports to monitor compliance with the Listing Rules ('Report on Rule Compliance') was published.

## **2012 FSRP report**

Under the FSRP, the Exchange reviews, on a sample basis, listed issuers' published periodic financial reports for compliance with the disclosure requirements of the Listing Rules and accounting standards. The 2012 FSRP report covered 120 periodic financial reports released by listed issuers between May 2011 and September 2012.

For this review period, the Exchange chose telecommunications and internet related businesses as its industry theme with a focus on revenue recognition policy and extent of disclosures for users to understand how companies in the industry recognise revenue. For a specific accounting theme, accounting for goodwill and intangible assets was selected. The review also focused on disclosures of "non-HKFRS/IFRS" financial information in the financial reports.

The major findings highlighted in this report were as follows:

- Certain financial statement disclosures required by the Listing Rules, such as the issuer's credit policy and an ageing analysis of accounts receivable, a statement on whether a related party transaction constitutes a connected transaction, etc., were omitted. Listed issuers were reminded to pay more attention to ensure full compliance.
- Generally, the Exchange considered that listed issuers were not forthcoming in their explanation of significant events and transactions in annual and interim reports. The Exchange specifically reminded listed issuers that Hong Kong Accounting Standard / International Accounting Standard ('HKAS/IAS') 34, *Interim Financial Reporting*, requires an explanation of such matters.
- Listed issuers were urged to become familiar with the requirements of Hong Kong Financial Reporting Standard / International Financial Reporting Standard ('HKFRS/IFRS') 3, *Business Combinations*, concerning when there is an acquisition of a 'business' and when there is an acquisition of an 'asset'. An inappropriate application in this regard could have a major impact on the financial statements, for example in respect of goodwill and deferred tax.
- The Exchange suggested that listed issuers improve and further enhance disclosures relating to the impairment assessment of goodwill and intangible assets. In particular, management should ensure that the assumptions for the growth rate applied in the discounted cash flows analysis are achievable over the period under consideration.
- Listed issuers were reminded to follow good practices when providing "non-HKFRS/IFRS" financial information, to ensure that such information is clearly distinguished from the financial information prepared in accordance with HKFRS/IFRS.

### **Report on Rule Compliance**

On 22 March 2013, the Exchange published its first report on its review of disclosures in listed issuers' annual reports focusing on compliance with the Listing Rules and the disclosures of material events and developments. The report identifies several areas where disclosures by issuers could be improved and instances of non-compliance, including cases involving material breaches of the Listing Rules. The key findings were:

- *Impairment of intangible assets arising from material acquisitions*

The Exchange found cases where impairments of goodwill and intangible assets were made shortly after the completion of acquisitions. The Exchange noted that, in three cases, impairments may have existed at the time of the acquisition, and

in two of these cases, the values of the acquired business and their prospects may have been overstated in the circulars.

- *Results of performance guarantees on acquisitions*

The Exchange noted that, occasionally, listed issuers making acquisitions require the vendor to guarantee the performance of the acquired business. In some cases, the performance guarantee is part of the terms of the acquisition agreement that support the basis of the consideration. Such a performance guarantee should be clearly disclosed in the circular. In addition, the Exchange noted that there would be a question about whether a performance guarantee was genuine or merely used to support an overstated consideration amount if the guaranteed performance is not met and the issuer does not enforce the agreement to seek compensation or the agreement does not specify a method to determine the compensation.

- *Connected transactions*

A few listed issuers failed to announce or, in some cases, seek shareholder's approval for connected transactions and conduct annual reviews on these unannounced transactions. These failures constituted breaches of the Listing Rules and disciplinary action was taken.

- *Significant changes to financial position*

The Exchange identified trade receivables, effective tax rates and balances, and key performance indicators as the three areas where listed issuers with significant changes in financial position or financial results, can enhance disclosures in the management discussion and analysis section ('MD&A').

- *Newly listed issuers*

The key observations for newly listed issuers related to their compliance with the requirements in the Listing Rules to promptly announce any event occurring during the profit forecast period which would have caused the profit forecast assumptions to be materially different from those disclosed in the profit forecasts included in the IPO prospectuses, and to disclose the likely impact on the profit forecast. In addition, newly listed issuers were reminded to make immediate disclosure of changes in the intended use of IPO proceeds after listing. Failure to promptly disclose material changes to financial performance after listing may constitute a breach of the Securities and Futures Ordinance (SFO).

#### ***Our observations:***

While the Exchange's review of disclosures in listed issuers' annual reports is separate from the FSRP, a common objective of the two reviews is to monitor compliance with the disclosure requirements of the Listing Rules. Both reports include findings from the Exchange in relation to the impairment of goodwill and other intangible assets.

When an issuer makes a material acquisition, the transaction will be classified according to the notifiable transaction rules in Chapter 14 of the Main Board Listing Rules ('Chapter 14') and a circular to shareholders is generally required to be published. In the circular, the unaudited pro forma financial information ('pro forma financial information') is presented to illustrate the financial impact of the acquisition on the issuer's latest published financial statements using the issuer's accounting policies. In preparing the pro forma financial information, issuers should assess whether there are impairment indicators on goodwill or acquired assets at the time of acquisition and illustrate the financial impact of any such impairments in the pro forma financial information.

Consistent accounting treatment for the transaction is expected in the preparation of the pro forma financial information in the circular and in the preparation of the listed issuer's historical financial statements. As such, any change in the application between the publication of the circular and the subsequent annual financial statements raises concerns. Given the complexity in the area of accounting for business combinations and the assessment of impairments, an issuer should consult with its auditors/reporting accountants on a timely basis to determine the appropriate accounting treatment.

## **3 Disclosure guidance for mineral companies**

### **Continuous disclosure requirements for listed mineral companies**

The Exchange published certain Listing Decisions and a Guidance Letter in relation to the applications of the Listing Rules by mineral companies. Those Listing Decisions discussed a number of cases reviewed by the Exchange on mineral companies and also illustrated the analysis the Exchange makes when considering the granting of waivers to mineral companies.

<b>Guidance Letter</b>	<b>Particulars</b>
<a href="#">GL47-13</a>	Guidance on continuous disclosures under Chapter 18 (Chapter 18A of GEM Rules)
<b>Listing Decision</b>	<b>Particulars</b>
<a href="#">LD39-13</a> , <a href="#">LD40-13</a> , <a href="#">LD42-13</a> , <a href="#">LD45-13</a> , <a href="#">LD49-13</a>	Various cases on whether the Exchange would waive the requirement to produce or disclose a competent person's report (CPR), valuation report (VR) or other disclosures under Chapter 18 (Chapter 18A of GEM Rules) on mineral resources by

	listed issuers
<a href="#">LD41-13</a> , <a href="#">LD43-13</a> , <a href="#">LD44-13</a> , <a href="#">LD50-13</a> , <a href="#">LD51-13</a> , <a href="#">LD53-13</a>	Various cases on whether the Exchange would consider certain requirements under Chapter 18 (Chapter 18A of GEM Rules) had been fulfilled

### Disclosure guidance for listing applicants

The Exchange also published Guidance Letter [GL52-13](#), which is intended to assist new applicant mineral companies by giving guidance for better preparation of listing documents under Chapter 18 of the Main Board Rules. The Guidance Letter illustrated some of the disclosures in listing documents for new applicant mineral companies that the Exchange normally expects, and discussed disclosures to address comments raised by the Exchange and the SFC when vetting previous listing applications.

## 4 Listing decisions on issuance of, or investments in, convertible instruments

In March 2013, the Exchange published Listing Decisions [LD54-13](#), [LD55-13](#) and [LD56-13](#) which set out guidance on certain matters associated with listed issuers' issuance of, or investment in, convertible instruments.

In LD54-13, the listed issuer had issued convertible bonds under a general mandate to issue new shares given by the shareholders. As a result of a change in market conditions thereafter, the listed issuer subsequently proposed to either reduce the conversion price of the bonds or extend their conversion period and maturity. The Exchange considered that each of these proposals would constitute a material change to the terms of the convertible bonds and accordingly, the listed issuer should obtain shareholders' approval for issuing the conversion shares under the revised terms of the bonds before the Exchange was prepared to approve the change in term of the bonds.

The Exchange concluded in LD55-13 that where a listed issuer subscribes for convertible notes to be issued by another company, the subscription is considered a provision of financial assistance to the note issuing company for the purpose of classifying the transaction under Chapter 14 (as discloseable transaction, major transaction or very substantial acquisition). It was not necessary for the listed issuer to classify the subscription as if the notes were fully converted at the time of subscription.

In LD56-13, a listed issuer proposed to issue convertible notes, a conversion of which could possibly result in the public float of the listed issuer falling below the minimum requirement of 25 percent. To address the possibility of an insufficient public float upon conversion of the notes, the listed issuer proposed to either undertake to the Exchange that it would take appropriate measures to ensure compliance with the public float requirement at all times, or to limit the maximum number of conversion shares to 25 percent of the issuer's share capital at the time of subscription of the convertible

notes. The Exchange did not consider either alternative proposal acceptable, and to address this issue, the listed issuer revised the terms of the notes such that conversion could not take place if it would result in the listed issuer failing to meet the minimum public float requirement.

#### ***Our observations:***

From time to time, listed issuers may issue convertible instruments or amend the terms of such instruments similar to the cases illustrated in the abovementioned Listing Decisions. Conversion terms and conditions of such instruments may affect their classification and measurement under HKFRS/IFRS. Assessment of the accounting often requires a detailed review of all such terms and conditions, in particular, whether the instruments will be converted into 'a fixed number of shares for a fixed price'. Changes in the terms of such instruments after their issuance may also affect the accounting. Issuers are encouraged to consult with their auditors and/or other advisors when considering the issuance and/or revisions in convertible instruments.

## 5 Listing Rule implications arising from adoption of new accounting standard for consolidation

On 1 March 2013, the Exchange issued a [letter](#) to issuers (the 'Letter') to discuss the practical implications for compliance with the Listing Rules upon adoption of HKFRS/IFRS 10, *Consolidated Financial Statements*. The Listing Rules govern the activities of the issuer and its subsidiaries, including any new subsidiary identified under the new accounting standard, which is effective for annual periods beginning on or after 1 January 2013.

The Letter discussed the following implications from the perspectives of compliance with the Listing Rules and financial statements disclosures.

- *Financial statements* – The Exchange expects the issuer to disclose in the financial statements the result of its assessment of the impact of HKFRS/IFRS 10 adoption.
- *Inside information* – The issuer should assess the effect of the consolidation and deconsolidation of entities on its financial position or performance and make immediate announcements of any inside information arising from these changes.
- *Public float* – Connected persons of any newly consolidated subsidiary are also connected persons of the group and as a result, shares held by the expanded group of connected persons will not count towards satisfying the public float requirement.
- *Continuing obligations* – Activities carried out by the new subsidiary are subject to the Listing Rules including those

governing disclosure of inside information, notifiable transactions, connected transactions, spin-off, share option schemes, dealings of issuer's shares by associates of directors and corporate meetings.

#### ***Our observations:***

HKFRS/IFRS 10 is applicable for annual reporting periods commencing on or after 1 January 2013. The new standard introduces a single consolidation model applicable to all investees, which differs from the two previous consolidation models: one for special purpose entities and another for all other investees. The new model states that an investor consolidates an investee when it has power to direct the relevant activities of the investee, exposure to variability in returns and a linkage between the two. The implementation of HKFRS/IFRS 10 will require significant judgement. Changes in the consolidation conclusion under the new standard generally will call for retrospective application.

In addition to the regulatory considerations set out in the Exchange's Letter, a listed issuer should also assess how changes to the group entities resulting from the adoption of HKFRS/IFRS 10 will impact the group's financial performance indicators and other key metrics (such as EBIT and EBITDA), and the related implications on loan covenant compliance and/or other financial ratio requirements.

## 6 Other market and regulatory matters

### **Consultation conclusions**

- The Exchange published the consultation conclusions on trading halt in March 2013**

The original consultation paper in July 2012 proposed a model for implementing a [trading halt](#) in an issuer's shares during the trading hours to allow issuers to publish inside information announcements. The Exchange will not implement the proposal earlier than mid-2014, taking into account concerns raised by some respondents on the change efforts required and to provide sufficient lead time to the market for preparation. The implementation date and schedule will be announced in due course.

- SFC published its consultation conclusions on the proposal to enhance regulation of non-corporate listed entities in March 2013**

The SFC published the [consultation conclusions](#) on proposals to bring under the regulatory regime non-corporate entities that are listed on the Exchange, to make the rules more consistent with that of listed entities. These non-corporate entities include collective investment schemes (CIS) (including real estate investments trusts (REITs)), business trusts and partnerships. The SFC will proceed with the proposals and make appropriate recommendations on the legislative amendments to the Hong Kong government.

For more details on the proposals, please refer to the article entitled "Consultation Paper to Enhance the Regulatory Regime for Non-corporate Listed Entities" in our [Capital Markets Update – Issue 1, 2013](#).

## Guidance letters

- In [Guidance Letter 51-13](#) (February 2013), the Exchange sets out the principles on which placings to **cornerstone investors** are permitted in an IPO. The principles are: (a) the placing must be at IPO price; (b) the IPO shares are subject to a lock-up period of at least six-months after listing; (c) the cornerstone investor will have no board representation and is independent from the applicant, its connected persons and their associates; (d) disclosure of the placing arrangements in the listing document; and (e) the shares will be part of the public float. Any direct or indirect benefits by a side letter or otherwise, other than a guaranteed allocation, will not be allowed and may lead to the reclassification of the cornerstone investors to pre-IPO investors and as such, the requirements under the Guidance on Pre-IPO Investments in [GL29-12](#) will apply.
- The Exchange published three Guidance Letters in January 2013 to provide guidance on the **simplification of disclosures in listing documents**. These Guidance Letters aim to ensure that the relevant sections in listing documents are concise, easy to read and use plain language to provide sufficient information for investors to understand. The Exchange expects applicants to follow the Guidance Letters when preparing listing applications. Any non-compliance may result in the listing documents not being considered in an advance state.

[GL48-13](#) gives guidance on the disclosure in the **Industry Overview** section. The Exchange considered that this section should provide investors with up-to-date and concise information specific to the applicant's business and industry, and only to the extent it affects the applicants' business model and the investor's investment decision.

In [GL49-13](#), the Exchange provides guidance on the disclosure in the **History and Development** section in the listing document. The Exchange noted that applicants often included information which was not material and took up excessive pages. As a result, it clarified that the section should only include material information on the applicant's establishment, development, corporate structure and shareholding, presented in plain language.

The Exchange issued [GL50-13](#) to set out guidance on the disclosure in the **Business** section, which should only explain the material components of the applicant's business model. Disclosure should be specific rather than generic, and should reference other sections of the listing document by avoiding duplication of information within the document.

## Listing decisions

- The Exchange published [LD46-13](#) (January 2013) and [LD47-13](#) (January 2013) to give guidance on the **qualifications of company secretary**.
- In [LD48-13](#) (January 2013), the Exchange provided guidance on **why certain listing applications were returned**. In particular, the Exchange expects to receive an advanced proof of the prospectus with the listing application in order to commence its review. Otherwise, the documents including Form A1 are returned to the sponsor. The matters highlighted in the guidance include deficiencies in disclosures, non-compliance with the requirements of the Listing Rules for early filing under [GL6-09](#), failure to bring to the Exchange's attention of convictions of directors, failure to address the Exchange's previous comments when re-submitting listing applications, inability to satisfy the financial requirements for listing, lack of sponsor's final draft letter on issuer's working capital sufficiency, failure to disclose significant adverse impacts on an issuer's operations and financial position in the foreseeable future as required in [GL27-12](#).
- In [LD52-13](#) (March 2013), the Exchange considered that it was acceptable for a company listed on a PRC stock exchange to convert its entire **B shares into H shares** and list the H shares on the Main Board of the Exchange by way of introduction. The Exchange also granted certain waivers requested by the listing applicant in relation to the minimum public float requirements, financial statements requirements and the residency of the independent non-executive directors. The Exchange noted that the waivers were granted based on the applicant's particular facts and circumstances and should not be treated as precedents for other companies seeking to convert their B shares to H shares.

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