

Summary of SEHK Review of Disclosure in Issuers' Annual Reports 2015

I. Overview: focus and improvement areas

(Note: significant improvement areas identified by SEHK marked in bold)

- **Fundraising through issue of equity / convertible securities and subscription rights**
- Updates on material changes and results of performance guarantees after acquisitions
- **“Continuing Connected Transactions”**
- Share option / award schemes
- Disclosure of significant changes to issuers' financial performance and reliance on key customers in the **MD&A** section
- **“Contractual arrangements” adopted by issuers**
- Issuers listed in 2013 and 2014

II. Continuing Connected Transactions (“CCTs”)

(1) Background- SEHK Guidance Letter on CCTs

SEHK refers to a **Guidance Letter** ([GL 73-14](#)) and reminds independent directors of their obligations in conducting the annual review of CCTs:

14. The INEDs should ensure that:

- (i) the pricing mechanism and the terms of the transactions set out in the agreement [*note: for CCTs*] are clear and specific;
- (ii) the annual caps are reasonable taking into account historical transactions and management projections;
- (iii) 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;
- (iv) appropriate internal control procedures are in place, and its internal audit would need to review these transactions; and
- (v) they are provided by the management with sufficient information for the discharge of their duties.

Source: paragraph 14, GL 73-14

(2) SEHK Findings

While compliance with the annual report disclosure requirements regarding CCTs are generally in place, SEHK went deeper and obtained minutes of selected audit committees and reviewed the management/external auditors' reports provided to the independent directors. It made the following observations, relating to requirements (iii) to (v) GL 73-14 extracted above:

(a) On reports by management/external auditors (paragraph 36)

- primarily focused on whether (i) the transactions were by nature covered by the framework agreement; (ii) total transaction amount was within the annual caps
- did not cover work done by management to ascertain: (i) whether the transactions have been conducted in accordance with the pricing policies or mechanisms under the framework agreement, including the pricing range, process for estimating selling prices, procedures for obtaining quotations or tenders; and (ii) adequacy and effectiveness of the issuer's internal control procedures to ensure that transactions are so conducted

(b) On independent directors (paras 37-8)

- unclear how they had assessed the transactions to conclude (i) that they were conducted in accordance with the terms of the framework agreements and on normal commercial terms; and (ii) the adequacy and effectiveness of the issuer's internal control procedures

(c) Recommendations regarding internal audit (para 39)

- to review (i) the relevant transactions and (ii) the internal control procedures
- to provide its findings to independent directors to assist them in performing their annual review

(3) Practising Governance's suggested management actions:

- to improve on reporting by management/auditors, addressing the above areas
- appropriate involvement of internal audit
- board/audit committee processes---(i) to put in place, then (ii) properly minute, the process taken by the independent directors in reviewing the CCTs, including considering appropriate reports by management, auditors, and internal audit

III. Contractual arrangements adopted by issuers

This applies to issuers engaged in businesses subject to foreign ownership restrictions (e.g. in PRC), which use contract-based arrangements or structures (“Contractual Arrangements” or “Structured Contracts”) to indirectly own and control such businesses and the operating entities.

SEHK Findings (paras 62-69):

- SEHK **Guidance Letter (GL77-14)** recommends that issuers keep their shareholders informed of their material business operations through these arrangements, with specific disclosures
- A vast majority of issuers adopting Contractual Arrangements did not disclose the operating entities’ their business activities, a summary of the major terms under the relevant Structured Contracts, their significance to the issuers, or the associated risks and reasons for using the “contractual arrangements”
- Relevant issuers are reminded to note the latest regulatory developments in using Contractual Arrangements — e.g. Jan 2015 consultation draft of the new PRC Foreign Investment Law published by the PRC Ministry of Commerce; March 2015 revised Foreign Investment Industries Guidance Catalogue

IV. Disclosure of significant changes to issuers’ financial performance and reliance on key customers in the MD&A section

(1) SEHK findings (paras 54-61):

SEHK identified the following improvement areas. Some of these were “recommended disclosures” only, but are now requirements under the new “Business review” requirements (made applicable to all listed issuers pursuant to Listing Rule amendments):

Required under existing Listing Rules

- (para 55) updates on “material changes to operations (e.g. product mix and business model), management’s objectives and corporate strategies, and how these changes have contributed to business performance during the financial year”
- (para 57) capital requirements and the financing plan for such capital requirements

(Previously as recommended disclosure) now required under “Business review”

- compliance with the relevant laws and regulations
- key relationships with customers

(2) Practising Governance’s suggested management actions:

Issuers should note useful guidance on disclosure for two “new” Business Review” items:

(a) “compliance with the relevant laws and regulations”:

- There is further SEHK guidance under (updated) [FQ+A series 18](#) Q11— “should assess which laws and regulations have a significant impact on it in the context of its own specific circumstances, bearing in mind recent legislative and/or regulatory changes”
- the new competition law was highlighted as a possible area for issuers with HK operations

(b) “key relationships with customers (para 59):

Disclosure guidance given:

- 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 trade receivables with major customers, and whether any provisions are necessary
- the risks associated with reliance on major customers, and measures undertaken by issuers to mitigate such risks

V. Fundraising through issue of equity / convertible securities and subscription rights

(1) SEHK Findings (paragraph 14):

Issuers should “avoid generic descriptions and provide meaningful updates” in their annual reports on:

- the actual use of proceeds from equity fundraising
- including details of the application and a breakdown of how the funds were allocated among different uses

(2) Practising Governance’s suggested management actions:

Impact on preparing your AGM circular? — this is a related area, given recent investor sensitivity over the general issuance mandate to be considered at AGMs. Similarly, issuers should avoid using generic descriptions (e.g. “for general working capital”) in disclosing actual use of proceeds of past issuances, or as regards proposed use of proceeds for future issuances.

VI. Share option schemes

SEHK Findings (para 44c):

- a common omission in disclosure: the total number of securities available for issue under the schemes together with the percentage of issued shares that it represents as at the date of annual report (MB Rule 17.09(3) / GEM Rule 23.09(3))