June 18 Legal and Regulatory Update

Top stories

HKEX published its 2017 financial statements review report, monitoring issuer compliance with disclosure requirements of Listing Rules, accounting standards, and Companies Ordinance ("CO"). (Click: full report; press release)

This year's special review themes are (i) "general accounting" review theme — disclosure of impact of new / amended HKFRS in issue but not yet effective; (ii) "special review" theme — new auditors' reporting.

For Listing Rule requirements, (as in previous years) HKEX stressed the significance of providing investors with a "meaningful management commentary".

The report has a useful executive summary. We highlight below "new areas" covered in this report. e.g. specific examples of improvement areas; the above special review themes.

("Special industry" review theme: industrial engineering companies, and there are additional industry-specific findings).

What you should know:

- (Listing Rules; CO) **"Meaningful" management commentary in "MD&A" and "Business Review" to investors** (paras 11-21)

  Improvement areas, as in previous reports: (i) adequate explanation of performance; (ii) commentary on significant balances and transactions; (iii) explanation of principal risks; (iv) use KPIs.

  Examples of expected elaboration ("principal risks and uncertainties")

  - **Cyber risk and security**: how issuers considered cyber risk; what discussions about cyber risk / security held
  - **Data fraud or theft**: how internal controls were evaluated to be in place
  - **Environmental and social risks**: consider carefully whether such risks are relevant and if so, on how such risks affect businesses across different segments and geographical locations

- (Accounting) **judgments and estimates** (paras 51-57) — management should have a thorough discussion each year with the audit committee and auditors, whereby management explains the judgments of key assumptions underlying critical accounting estimates

- (Accounting) **impairment of tangible and intangible assets (including goodwill)** (paras 70-82) — stresses **responsibility of directors and management**, for proper analysis and judgment to assess the reasonableness of key assumptions applied in impairment testing. **Should not rely solely on professional valuers / experts** without due diligence

- **Accounting for acquisitions** (paras 89-102) — consider carefully whether the transaction constitutes a **"business combination"** or an **"asset acquisition"** given the very different accounting treatments

- (General accounting review theme; HKAS 8) **Impact of applying key HKFRSs in issue but not yet effective** (paras 106- 118)

  - HKFRS 9 *"Financial Instruments"* and HKFRS 15 *"Revenue from Contracts with Customers"* **effective** from 1 Jan 18. i.e. by the time annual reports for year ended 31 Dec 17 were **issued**, **though not applicable for reporting period**
  - Implementation of new standards **not only an accounting issue**: possible significant impact, particularly on **information systems**, **internal controls**, **business contracting processes**
  - **HKICPA Alert Issue 24** (Dec 16): estimated impact of new and amended standards should become more accurate closer to the effective date
  - Disclose more **entity-specific qualitative / quantitative information** (e.g. stage of implementation; accounting policy choices expected to be applied by the management; amount and nature of expected impact for financial statement line items affected
  - **Interim report 2018** (for Dec year-end companies): these standards will be applicable; note specific disclosure requirements
  - **Annual report 2018** (for Dec year-end companies): should adopt the above approach for disclosure on HKFRS 16 *"Leases"*, effective 1 Jan 2019 (i.e. by issuance of the report)

- (Special review theme) **New auditors' reporting** (paras 155-180)

  - Details on **"key audit matters" ("KAMs")**: a matter of professional judgment of auditors
  - KAMs should refer to related disclosure in financial statements
  - Issuers, in particular **audit committees**, should have discussions early with auditors regarding KAMs. Directors can then improve relevant disclosures in financial statements
  - Useful observations on **5 common KAMs** and suggested additional disclosure (para 166)

What you should do/watch out for:

- **Interim report 2018** — significant accounting standards referred to above will be **applicable for the reporting period**; readiness for **implementation** and **disclosure**?
- **Annual report 2019** — consider improvement areas like management commentary; follow above approach to disclose new accounting standards in effect (though not yet applicable to reporting period)
- **Directors' responsibilities in various areas** (e.g. judgment areas (rigour expected in reviewing assumptions for "impairment"); implementation of new accounting standards and impact on internal controls, company systems/processes)
- **Audit committee's work** — particularly regarding early interaction with the auditors on KAMs; special role in reviewing significant financial reporting judgmental areas

Hot Trends

Shareholder activism

- Activist campaign against Nestle

New York hedge fund, Third Point, launched campaign against Swiss-based Nestle (the largest global food and beverage company) …

Activist allegations include:

- Vague strategy
- Sub-optimal portfolio — late to participate in key trends e.g. organic baby foods
- Organization — no external f+b expertise on the board

Nestle responded by outlining a growth plan…

Read + get a feel of a campaign!

- Activist's website for Nestle campaign
- Letter to Nestle Board
- Presentation on its Nestle plan
- Nestle's response

Also in this issue

Regulators

(i) HKEX updated and withdrew FAQs, Guidance Letters, and Listing Decisions as a result of **Listing Rule changes on Capital Raisings**. (Background on new Rules: Click our May 18 legal update).

These are consequential updates, following the new Rules becoming effective on 3 July.

While the new Rules are not expected to affect genuine capital raisings, issuers should double-check applicable requirements if any proposed transaction falls within the broad transaction categories.

What you should do/watch out for:

The new Rules seek to address potential abuses related to **large scale deeply discounted capital raising** activities. Transactions covered include **rights issues**, **open offers**, **specific mandate placings.**

E.g. prohibition of capital raisings with a **material value dilution** (**25%** or more within a rolling **12-month** period when aggregated).

E.g. **placing of warrants** using the **general mandate** is no longer allowed. Placing of **convertible securities** under the **general mandate** is subject to **conditions** on the conversion price

(ii) HKEX published a consultation paper on backdoor listing, continuing listing criteria and other Rule amendments (Click: press release; consultation paper).

It also published **Guidance letter GL96-18** (became effective on issuance) on listed issuer's **suitability for continued listing**. It gives examples where HKEX may question an issuer's suitability for listing, in light of concerns that it may be carrying on its business for the purpose of maintaining a "listing status" only.

As noted in our previous updates, there have been concerns on **"shell companies"** in recent years. HKEX is applying a three-pronged approach: (i) tighten suitability review of new IPO applicants to address "shell creation"; (ii) enhance **continuing listing criteria** for issuers to deter the existence of listed shells; (iii) tighten "reverse takeovers" ("RTOs") Rules to prevent **"backdoor listings"** particularly those involving shell companies.

The proposals are not intended to restrict issuers from legitimate business expansion or diversification.

Issuers should, however, note changes in continuing listing criteria, including **securities trading / investment** and **disclosure** requirements.

What you should do/watch out for:

"Shell companies" do not fall within our focus area. A detailed summary of the proposed Rule amendments is set out in the attachment to the press release.

- **Continuing listing criteria** (Rule 13.24 "sufficient operations") — require an issuer to carry out a business with a sufficient level of **operations AND assets** of sufficient value (NOT "or" as currently provided)
- Some proposed Rule changes seek to codify Guidance Letters previously issued. (e.g. GL84-15 on backdoor listings through large scale securities issue). Compliance requirements for "backdoor listings" (RTOs and "extreme transactions") will be tightened
- 12-month transitional period for continuing listing criteria, but not for other "backdoor listings" amendments.
- Proposed rule changes for **"securities trading/investments"**
  - E.g. when considering "**sufficiency of operations/assets**" for continued listing, to **exclude** its securities trading / investment activities (other than a Chapter 21 investment company)
  - E.g. **disclose** in annual reports details of each securities investment that represents 5 per cent or more of total assets

Published by Practising Governance Limited

July 2018