Jan 2019 Legal and Regulatory Update

Top stories

HKEX review: annual reports disclosure

HKEX published a **report** on its review of issuers' **annual reports for year 2017**.

This is the first **"consolidated" review**, combining previously separate programmes: (i) review of disclosure in annual reports to **monitor rule compliance**; (ii) **financial statements review**.

It reviewed eight areas — two are new, including "material intangible assets" (accounting review theme), and review of issuers listed in 2016/7.

Regarding **"Business review in MD&A"**, it focused on some **issuers previously subject to negative market commentaries**. **Typical allegations** include overstated revenue; understated costs; undisclosed related party transactions. **Better disclosure in business model and financial performance** might reduce the likelihood of allegations based on **misinformed assumptions/ speculations.**

As regards "**annual review of continuing connected transactions**" by independent directors ("INEDs"), HKEX gave **useful examples of good practices**, including additional monitoring procedures adopted by some INEDs.

For "**update on material asset impairments" post-acquisitions,** HKEX noted that some issuers announced significant assets impairment shortly after acquisitions. It reminded directors of their duties to assess risks, referencing **SFC's Guidance on directors duties in valuations in the context of corporate transactions**.

Recommendations in certain areas, like auditors' modified opinions, better disclosure on "material other expenses/income", were **similar to last year's**. (Click here: press release, full report, our Jan 18 update for last review)

What you should know:

- **"Business review" in MD&A** (para 66)
  - Focus: issuers subject to market commentary; **recommended better disclosure**
    - (i) Business model/revenue recognition methodology of each core business
    - (ii) Unique characteristics of operation processes
    - (iii) Relationships with key customers and suppliers
    - (iv) Principal risks affecting the operations and measures to manage such risks
    - (v) Strategies (including operation strategies and treasury policies) for meeting the business objectives

(vi) Key performance drivers for each core business; why significant to its strategies and results
(vii) Other material information

- **Useful examples** (para 58-63), why better disclosure might help
- E.g. (para 60) allegation of over-stating profits by under-stating production costs, based on benchmarking industry peers. In fact, the issuer adopted different operating process to achieve lower costs — but not clearly disclosed in annual report

- **"Updates on material asset impairments and results of performance guarantees after acquisitions"** (para 16-33)
  - Reminder: **directors' fiduciary duties to conduct acquisitions in the best interest of the issuer**
  - **SFC Guidance note** on directors' duties in the context of valuations in corporate transactions

    (i) Ensure acquisition targets are properly considered and investigated
    (ii) Independent due diligence, not only relying on valuations supplied by vendors

  - **Timeliness** of disclosure stressed (e.g. profit warning, other announcements)

- Better disclosure of **significant securities investments in MD&A**: issuers with significant securities investments should note (para 56)

- **"Continuing connected transactions"** ("CCTs")
  - (Similar to last review) useful examples (para 41-46)

    (i) **Internal control procedures**
    (ii) **Review by internal audit and/or designated teams**
    (iii) **Information to independent directors** ((i) and (ii) above)

  - **Additional monitoring procedures for INED annual review** (para 47)

    (i) Monthly/ quarterly management reports to monitor ongoing compliance; utilisation status of annual caps
    (ii) Monthly management reports on exceptions and new transactions
    (iii) Review changes made to the "connected persons list" kept by management
    (iv) Meet management teams of different business lines, internal audit, legal, finance to better understand the issuer's business and nature of CCTs

- **“Material intangible assets”** (para 108-149)
  - Directors and management are responsible for performing proper analysis and exercising judgement to assess the **reasonableness of key assumptions in impairment testing** (e.g. growth rates and discount rates)
  - Should not rely solely on valuers
  - **SFC guidance note on valuations** may also apply in the context of preparing financial statements
  - **3 key disclosure areas** involving accounting judgement/estimates
  - References to accounting standards; recommended disclosure
    - (i) Reasonableness of financial budgets and assumptions used in determining “recoverable amounts”
    - (ii) Assessment of intangible assets with indefinite or long useful lives
    - (iii) Business combinations: intangible assets properly identified, separately recognized and measured? (e.g. customer relationships; contracts)
  - Reminder: the above may form **“Key Audit Matters”** in auditor’s report; **audit committee** should discuss with auditors at early stage

What you should do:

- Your forthcoming **annual INED review of CCTs** — review your list of information to be provided; consider additional monitoring procedures above
- Your forthcoming **annual results announcement/annual reports** — take into consideration HKEX’s specific recommendations, e.g. for MD+A
- Better disclosure in periodic reports also **helps reduce the need to make “inside information” disclosure**. E.g. more detailed disclosure regarding “significant securities investments” means that investors already have more background information to assess the impact of market volatilities
- Reminder of **directors’ duties** — particularly for judgment areas in financial statements (note special roles of audit committee); acquisitions

Also in this issue

Regulators

(i) HKEX published its consultation conclusions on proposed changes to the review structure for Listing Committee (“LC”) decisions. (Click: press release; consultation conclusions)

"Decisions of material significance" (e.g. imposition of certain disciplinary actions) made by the LC will be subject to only one level of review (instead of the current two levels of review).

A new independent review committee (the Listing Review Committee), consisting of 20 or more outside market participants with no current LC members/ representatives of SFC and HKEX, will be established.

The SFC may request a review of any matter, including a decision of the LC by the new Listing Review Committee.

The revised rules will take effect around mid-2019, at a date to be announced.

(ii) SFC, HKEX, and the Federation of Share Registrars Limited **jointly issued a consultation paper proposing an uncertificated securities market in Hong Kong**. (Click: press release; consultation paper)

Investors could then hold and transfer securities in their own name without share certificates or other paper documents.

The costs of new systems to support the revised model will largely be borne by HKEX and share registrars.

Further legislative amendments will be needed to implement the initiative. It may start to be implemented in early 2022, beginning with IPOs.

The consultation period will last till 27 April.

Legislation

The Companies Registry prosecuted 12 Hong Kong companies under the Companies Ordinance (s. 653M(1)) for **failing to keep the "significant controllers register".** Each of the companies was fined $8,000 to $20,000. (Click: Highlights of Prosecution Cases).

Under the Companies (Amendment) Ordinance 2018 (effective from March 2018), companies incorporated in Hong Kong need to maintain **beneficial ownership information** which may be inspected by law enforcement officers. This reflects HK's anti-money laundering efforts in line with international standards. (Click: our Jan 18 legal update)

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