Guide for Annual Reporting on Fiscal Year 2019

for Companies Listed on the Hong Kong Stock Exchange

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This update provides an overview of recent developments that will affect preparation of annual results and annual reports for companies listed on The Stock Exchange of Hong Kong Limited (HKEX).

In particular, it covers amendments to the Rules Governing the Listing of Securities on HKEX (Listing Rules) as well as announcements, guidance and enforcement-related news from HKEX and the Securities and Futures Commission (SFC). We also discuss both disclosure developments and continued areas of focus for HKEX and the SFC during this annual reporting season.

Contents

New Disclosure Requirements for Fiscal Year 2019

Profit guarantees

Previously, disclosure in an annual report regarding a financial performance guarantee given in the context of a transaction (*e.g.*, a guarantee by the vendor of a company that the company's profit would meet a certain threshold) was only required where the guarantee was given by a connected person and where the actual financial performance fell below the guaranteed expectation.

The Listing Rules now require disclosure in all circumstances involving a financial performance guarantee, including but not limited to where the financial performance guarantee is met and where the counterparty giving the guarantee is independent. Listed companies that received a financial performance guarantee need to disclose in their annual report:

- any changes to the terms of the guarantee and the reason for such changes, and whether the independent non-executive directors (**INEDs**) consider the changes fair and reasonable and in the interests of the shareholders as a whole; and
- whether the actual performance of the company or business acquired met the guarantee.

Significant investments in securities and other financial assets

Listed companies are currently required to disclose any significant investments and discuss their performance and prospects. This has been an area of focus for HKEX in the past two years, with HKEX making follow-up enquiries where it considers disclosure to be insufficient and requiring additional discussion on investment objectives, industry focus and other factors relevant to investment decisions.

The Listing Rules have now been extended to also require companies to disclose the following details of each securities investment that represents 5% or more of their total assets (even if at the time the investment was made it was less than 5%):

- details of the investment, including the name and principal business of the underlying company, the number and percentage of shares held and the investment cost;
- the fair value of the investment as at year-end and its size relative to the company's total assets;
- the performance of the investment during the year, including any realised and unrealised gain or loss and any dividends received; and
- a discussion of the company's investment strategy for these significant investments.

Recent Changes to Disclosure Requirements

Additional disclosures for pre-revenue biotech companies and high-tech, new-economy companies with dual-class share structures

On 30 April 2018, HKEX introduced a series of reforms to encourage the listing of pre-revenue biotech companies and high-tech, new-economy companies with dual-class share structures (referred to by HKEX as weighted voting rights or **WVRs**). WVR companies are subject to enhanced disclosure requirements in their annual reports in two respects. First, in relation to their WVR structure, they must disclose:

- a description of the WVR structure, the rationale for using it and the associated risks for shareholders;
- the identity of the beneficiaries of weighted voting rights;
- the impact of a potential conversion of WVR shares into ordinary shares on its share capital; and
- all circumstances in which the weighted voting rights attached to its shares will cease.

Second, in providing a summary of the work of their corporate governance committee, they must disclose:

- whether the committee fulfilled its terms of reference during the reporting period;
- the committee's actions taken to ensure effective and ongoing communication by the company with its shareholders;
- the committee's recommendations on the company's appointment of compliance advisers; and
- any significant subsequent events after the reporting period and up to the date of annual report.

Biotech companies are required to include details of their research and development activities during the reporting period, including:

- details of the key stages for each of their core products under development to reach commercialisation;
- a general indication of the likely timeframe, if the development is successful, for each core product to reach commercialisation;
- a summary of expenditure incurred on research and development activities; and
- a prominent warning that their core products may not ultimately be successfully developed and marketed.

Companies with a secondary listing in Hong Kong

Greater China and international companies seeking a secondary listing in Hong Kong under Chapter 19C benefit from certain automatic waivers, as has been the case for other secondary listings under the SFC and HKEX's 2013 joint policy statement. Most significantly, secondary issuers are exempt from:

- requirements to issue a results announcement, a corporate governance report or an environmental, social and governance (**ESG**) report;
- the Appendix 16 content requirements for financial statements;
- disclosures relating to connected transactions, option schemes, share repurchases or securities transactions by directors; and
- certain rules relating to notice and conduct of shareholder meetings.

In addition, secondary issuers that have a WVR structure are further exempt from the corporate governance committee-related disclosure obligations applicable to a WVR issuer (although they are still subject to enhanced disclosure regarding their WVR structures).

Use of proceeds

Enhanced disclosure regarding the use of proceeds from capital raises have been effective since July 2018 after serving as a significant focus of HKEX's review of annual report disclosures in both 2017 and 2018. Listed companies are required to disclose the following details until proceeds are fully utilised:

- the total funds raised;
- a detailed breakdown and description of the proceeds and the purposes for which they were used during the financial year;
- a detailed breakdown and description of the intended use and the expected timeline for unutilised amounts; and
- any material changes or delays in the use of proceeds (as compared to previous disclosure of their uses or the expected timetable) and the reasons for such changes.

Non-GAAP financial measures[1]

HKEX published guidance on the presentation of non-GAAP financial measures (measures not in accordance with generally accepted accounting principles) (GL103-19) in April 2019. This was the first authoritative statement that HKEX made on its expectations for non-GAAP measures, and the guidance will in particular affect companies in the high-tech/new-economy sector that frequently make use of such measures in their periodic financial reports.

The guidance requires non-GAAP financial measures (such as adjusted profit or EBITDA — earnings before interest, tax, depreciation and amortization, among others) to be presented in a manner that is not misleading, and to comply with the following factors in order to ensure reliability and comparability over time:

- non-GAAP financial measures should be defined, with an explanation of the basis of calculation;
- companies should have an unbiased purpose in utilizing non-GAAP financial measures;
- GAAP measures should feature more prominently compared to non-GAAP financial measures;
- a quantitative reconciliation from any non-GAAP measure to its corresponding GAAP measure should be provided;
- non-GAAP financial measures should be used consistently over time;
- companies should exercise judgment regarding what constitutes a normal, recurring operating expense;
- adjustments should be reconciled on a gross basis before tax; and
- associated information must be easily accessible.

Corporate governance disclosures

An update to HKEX's corporate governance framework took effect on 1 January 2019.[2] The key changes relevant to annual reports are as follows:

Mandatory changes:

- Companies must adopt a diversity policy and disclose that policy or a summary of it in their corporate governance report.
- Companies must disclose their director nomination policy.

"Comply or explain" matters (Code Provisions):

- When proposing an INED candidate for election, boards must set out (i) the process by which the candidate was identified, (ii) reasons why the candidate should be elected, (iii) reasons the candidate is independent, (iv) the perspectives, skills and experience the candidate brings, and (v) how the candidate will contribute to diversity of the board.
- As highlighted in HKEX's first Listed Issuers Regulatory Newsletter released in November 2019, where an INED candidate is nominated to a seventh (or more) listed company directorship, the board must explain why it believes the director will still be able to devote sufficient time to his/her role.
- Companies must adopt and disclose a dividend policy.

Recommended best practices (for which compliance is voluntary):

- Companies are encouraged to disclose INED's cross-directorships or other significant links with other directors when proposing the candidates for election.

Additionally, a more esoteric change effective since March 2019 is a requirement for inclusion of a director's former name or alias in his or her biography. Although not itself significant, this does represent a departure from the norm for most listed companies, which will not typically have requested or included such information in their prospectuses and will now need to confirm this disclosure with their directors.

[1] See our 3 July 2019 client alert "Hong Kong Regulatory Update — July 2019."

[2] See our 5 April 2019 client alert "Hong Kong Regulatory Update — April 2019."

Areas of HKEX Focus

HKEX review of 2018 annual reports[3]

Based on its review of published 2018 annual reports, HKEX raised the following as key areas with room for improvement in annual reports:

- **Business review in MD&A:** Companies should provide in the management discussion and analysis section of their annual reports sufficient disclosure of their business models and the revenue recognition methodologies of each core business; unique characteristics of their operation processes; relationships with key customers and suppliers; principal risks affecting operations and measures to manage such risks; and strategies (including operations strategies and treasury policies) for meeting their business objectives.
- **Material intangible assets:** Companies should ensure the quality of their disclosures relating to intangible assets and ascertain whether the processes for assessing impairment are sufficient and appropriate, in particular when significant goodwill and intangible assets with indefinite useful lives exist. Disclosures should address the valuation method used, reasons for applying such valuation method, inputs to the valuations, basis and assumptions of valuation and reasons for any changes to the inputs, basis and assumptions.
- **Disclosures on material "other expenses":** Companies with material "other expenses" or "other operating expenses" should provide appropriate detailed breakdowns of those items to enhance shareholders' understanding.
- **Financial statements with auditors' modified opinions:** Companies with auditors' modified opinions should disclose their audit committee's views of the modifications and proposed plans to address them.

HKEX review of 2018 ESG reports

HKEX recently published its second review of ESG reports, this time covering 400 ESG reports issued for financial years ended in 2018. HKEX reported the following as key areas with room for improvement in ESG reporting:

- **Materiality:** A lack of detail appeared regarding the existence and thoroughness of materiality assessments, the process of identifying and engaging with key stakeholders, and the criteria for assessing materiality, despite two-thirds of sampled reports disclosing that an assessment had occurred.
- **Board involvement:** Notwithstanding that disclosure of board involvement is not required for financial years beginning before 1 July 2020, HKEX noted that a majority of listed companies provided little or no description of board involvement in assessing and addressing ESG-related risks.
- **Preference to comply and reluctance to explain:** Among ESG comply-or-explain requirements, only 3% were explained, suggesting that listed companies did not sufficiently consider what is material or were reluctant to explain their determination of immaterial provisions. Moreover, even if a provision is immaterial, a statement of such is still necessary, as an omission or failure to address a comply-or-explain provision is itself technically a breach of the Listing Rules.
- **Poor disclosure regarding laws and regulations:** Disclosures on compliance with relevant laws and regulations that have a significant impact on listed companies were generally less thoroughly reported than were disclosures about company policies or disclosures of key performance indicators.

[3] See our 5 April 2019 client alert "Hong Kong Regulatory Update — April 2019."

The emphasis on materiality and relevance to a listed company's business and operations, and encouragement to use explanations (rather than compliance), are particularly relevant in light of market concerns, expressed in the process of HKEX's 2019 consultation on ESG matters, that the enhanced requirements may be burdensome and overly prescriptive for listed companies.

Mandatory disclosure on materiality (how a company determines material ESG factors) and reporting boundaries (details to identify entities or operations included in an ESG report) are expected to help companies focus their ESG reporting.

More generally, given the greater number of comply-or-explain items in the HKEX ESG reporting guide, listed companies should carefully consider when explaining why certain factors are not material or relevant, rather than unnecessarily complying with the reporting guide, is sufficient.

Connected transactions and deeds of non-competition

Connected transactions were a topic of concern to HKEX in its review of 2018 annual reports, and HKEX has since also turned its focus towards deeds of non-competition between listed companies and their controlling shareholders.

In relation to connected transactions, HKEX has particularly focused on:

- disclosure regarding whether related-party transactions (as assessed under the accounting standards) included in financial statements are also connected transactions for the purposes of the Listing Rules, and if so, whether a company has complied with the Listing Rules in such transactions;
- disclosure that a company's INEDs have reviewed and provided certain confirmations in relation to continuing connected transactions;
- disclosure that a listed company has received a letter from its auditor confirming certain matters relating to continuing connected transactions.

HKEX has continued to issue questionnaires to selected companies about their continuing connected transactions and the annual review of these by their INEDs, including with respect to:

- the information provided to INEDs to assist their annual review of continuing connected transactions;
- the work performed and enquiries made by INEDs during their review;
- INEDs views on the information provided, work performed, difficulties experienced or other aspects of their annual review; and
- any specific recommendations from INEDs for enhancing the effectiveness of the safeguard and monitoring of the continuing connected transactions.

Listed companies should maintain good internal records of the review of connected transactions performed by INEDs, as HKEX may request copies of meeting minutes and documents tabled.

More recently, HKEX has focused upon deeds of non-competition entered into by controlling shareholders. Common corporate governance features in deeds of non-competition are (i) for controlling shareholders to give an annual confirmation to a company that they have complied with their undertakings under the deed of non-competition, (ii) for INEDs to review and confirm compliance with such undertakings each year, and (iii) for both groups to provide a notice to the company where a potential competing business exists (and for the company to have a right of first refusal to acquire that business if it is sold by the controlling shareholders).

HKEX has recently placed particular emphasis on compliance with, and corresponding disclosure about, these corporate governance controls, and a number of companies have had to issue supplemental announcements to confirm that such confirmation and reviews have been conducted.

How to prepare an ESG report[4]

In November 2018, HKEX updated its guide on how to prepare ESG reports, which is required under Appendix 27 of the Listing Rules. The guide suggests that a listed company:

- establish an ESG working group, bearing in mind that the board retains overall responsibility;
- understand the ESG reporting requirements and identify the company's particular ESG risks and any gaps in data and information;
- determine the scope of business on which to report (such as particular geographical or business segments);
- engage with stakeholders potentially affected by the company's decisions on ESG matters;
- conduct internal and external assessments of the ESG issues that are material to the company; and
- prepare the ESG report.

HKEX also clarified that printed copies of the ESG report need not be sent to shareholders (unless specifically requested) if the report appears as a standalone report or is published on the company's website.

[4] See our 5 April 2019 client alert "Hong Kong Regulatory Update — April 2019."

Upcoming or Potential New Requirements

HKEX requires companies with adverse audit opinion to suspend trading[5]

Under new Listing Rule 13.50A, for financial years commencing on or after 1 September 2019, HKEX will require trading in a company's securities to be suspended if it publishes a preliminary annual results announcement and the auditor has issued, or has indicated that it will issue, a disclaimer of opinion or an adverse opinion on the company's financial statements.

Although these new rules are not yet in effect, listed companies are still subject to their existing obligation to provide enhanced disclosure if there is a disclaimer of opinion or an adverse opinion. HKEX has focused on this issue in recent months and is likely to begin expecting listed companies to provide sufficient information to enable investors to make an informed assessment of their financial position (*i.e.*, the standard under the new rules) even if automatic suspension of trading has not yet begun.

HKEX consults on codifying waivers and other rule changes

At present, a listed company must publish a results announcement and an annual report within three and four months, respectively, of the end of its financial year irrespective of when it became a listed company. Companies that were recently listed and included information with regard to the most recent financial year in their prospectus are commonly granted a waiver from these requirements. In a consultation paper released in August 2019, HKEX proposed to codify this common waiver into the Listing Rules.

In the same consultation paper, HKEX also sought views on clarifying that the requirement under LR13.51A (to prominently highlight the stock code of the company) may be fulfilled by including the stock code prominently in the corporate or shareholder information section of an annual report.

HKEX adopts enhancements to ESG reporting[5]

HKEX has adopted a number of enhancements to the existing ESG reporting regime, which will take effect for financial years commencing on or after 1 July 2020.

The new rules generally seek to strengthen and encourage board involvement in managing ESG issues, including by mandating disclosure of a statement setting out the board's consideration of ESG issues. This statement should include details of the board's oversight of ESG issues, its approach and strategy to manage them, and how progress on relevant ESG-related goals and targets is reviewed.

Other key changes include:

- mandatory disclosure requirements to include applications of relevant reporting principles (materiality, quantitative and consistency) and boundaries in the ESG report;
- disclosure (subject to "comply or explain") of significant climate-related issues that have impacted and may impact the company;
- disclosure (subject to "comply or explain") of relevant targets for "environmental" key performance indicators (**KPIs**) and steps taken to achieve them;
- disclosure (subject to "comply or explain") of "social" KPIs;

[5] See our 3 July 2019 client alert "Hong Kong Regulatory Update — July 2019."

- a requirement to publish ESG reports within five months of the financial year-end;[6]
- obligation to notify shareholders of the online location of each ESG report and to produce a printed ESG report only in response to shareholders' specific request for one;
- permission for companies to seek independent assurance to strengthen the credibility of their ESG disclosures, and where such independent assurance is obtained, the issuer should describe the level, scope and processes adopted for assurance clearly in the ESG report.

[6] By contrast, the annual report and corporate governance report are required to be published within four months of financial year-end.

In response to queries raised during the consultation process regarding the scope and application of the revised ESG reporting regime, HKEX has indicated it will update old guidance, provide further training, and publish new guidelines on the ESG reporting procedures.

The SFC has also placed increasing emphasis and developed guidance on ESG reporting, particularly climate-related disclosure, as part of its strategy to develop green finance in Hong Kong.

The momentum toward enhanced ESG disclosures is a global trend and a reflection of the their increasing importance to institutional investors, regulators and other stakeholders. Listed companies should consider making preparations to position themselves to meet these heightened requirements during the course of 2020.

Enforcement Matters

Set out below is a summary of recent enforcement matters announced by the SFC and HKEX relevant to annual reporting and related disclosures:

HKEX censures Artini for delayed publication of annual results and annual report

HKEX censured Artini Holdings Limited (**Artini**) for its delay in the publication of its annual results and annual report for the year ended 31 March 2017. The delay stemmed from material deficiencies in its internal controls, including a failure to maintain adequate supporting documents or records of its revenue or expenditures in certain businesses, which an independent internal control consultant found to be high- to medium-risk.

HKEX found the lack of or limited supporting information and documents prevented Artini's auditors from carrying out satisfactory audit procedures, resulting in both a disclaimer of opinion on Artini's annual results and annual report for the year ended 31 March 2017 and a delay in the publication of the same.

Artini had commissioned an internal control review, following discovery of the internal control deficiencies, and had since implemented measures to improve the internal control systems and financial reporting procedures.

HKEX reiterates that deadline for results announcement and annual results are not merely procedural

HKEX censured Kin Hung International Holdings Limited (**Kin Hung**) and relevant directors for their failure to (i) obtain the auditor's agreement as to Kin Hung's 2015 results announcement, and (ii) publish and dispatch Kin Hung's 2016 results announcement and annual results in a timely manner.

Kin Hung published its 2015 results announcement on 1 April 2016 in order to meet the deadline for results announcements, despite its auditors having not signed off and providing further comments shortly before publication. As a result, it needed to issue a clarification announcement on 22 April 2016 with revised financial figures.

The following year and less than a month after new auditors were appointed, Kin Hang published its 2016 results announcement on 2 April 2017 in order to meet the deadline for results announcement. As a result of the short time since appointment and inability to obtain sufficient audit evidence on 15 items, the initial results announcement contained a disclaimer of opinion. A revised 2016 results announcement (now with a qualified audit opinion relating to four items and the material uncertainty related to going concern) was made on 30 May 2017, when Kin Hung also dispatched its 2016 annual report.

Although the initial 2015 and 2016 results announcement were both published within the required time, HKEX concluded that they did not convey any meaningful information about the listed issuer's financial position and performance. The results announcements were meaningless to shareholders and investors for assessment of the company's financial performance or position as a result of the significant accounting issues. Thus the publication of such purported preliminary results, even if published within the prescribed time limit, did not amount to compliance with the relevant financial reporting obligation.

DBA Telecommunication and former CFO convicted of issuing false and misleading results announcement

In April 2019, the SFC secured the conviction of Mr. Chan Wai Chuen (**Mr. Chan**) for his role in making a false and misleading statement in relation to the results announcement for DBA Telecommunication (Asia) Holdings Limited (**DBA**) for the year ended 31 December 2012. Earlier in June 2018, DBA had pleaded guilty to the same charge.

On 28 March 2013, DBA had published its results announcement for the year ended 31 December 2012. The SFC's investigation revealed that DBA's financial statements had not been approved by the auditors, as required under the Listing Rules, and were therefore false or misleading in a material particular. As DBA's former executive director, chief financial officer and company secretary, Mr. Chan was involved in preparing and publishing the announcement, knew that audit work was outstanding, and knew that the financial statements had not been approved by the auditors.

Mr. Chan was fined HK$60,000 after DBA had been fined HK$20,000 following its earlier guilty plea. Trading of DBA shares has been suspended since 6 June 2013.

SFC seeks disqualification of former CFO of Fujian Nuoqi

The SFC commenced proceedings in June 2019 to disqualify Mr. Au Yeung Ho Yin (**Mr. Au Yeung**), former chief financial officer, company secretary and executive director of Fujian Nuoqi Co., Ltd. (**Nuoqi**). The SFC investigation uncovered withdrawals of a substantial portion of the net proceeds of Nuoqi's 2014 global offering. The withdrawals were made without proper approval from Nuoqi's board of directors and did not serve any genuine commercial purpose.

The SFC alleges that despite knowledge of red flags regarding the withdrawals, Mr. Au Yeung failed to discharge his duties as the chief financial officer or executive director of Nuoqi in that, among other missteps, he did not ensure that the disclosure of information about the use of the global equity offering proceeds in Nuoqi's 2013 annual report was accurate.

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