

# Chapter 1:

## Why to List in Hong Kong

**W**hen your business has grown to a certain scale, listing will become an available option for you to take your business to the next level. Undoubtedly, listed companies enjoy many benefits over private companies, but these benefits come with prices. In deciding whether to list a business, the pros and cons of listing should be weighted, having regard to the specific needs of the business and objectives it strives to achieve.

In addition, whether your business is suitable and eligible for listing, where you should list your business and how to prepare for the listing are all important questions to consider.

This chapter outlines the major considerations a company should take in planning its listing. It also sets out the basic requirements for listing in Hong Kong and suggests some pre-IPO preparations which may be done to streamline the process.

### **Listing or Not – A Critical Decision to Make**

A successful listing by way of an initial public offering (IPO) is more than a capital-raising activity. It also enhances the public profile of the business and affords it a sense of prestige. However, a hasty move to list a business with poor planning and execution may result in adverse consequences. In extreme cases, companies may have to de-list their businesses as their listings do more harm than good. As a listing is an important milestone in a company's history, it should not be decided lightly and the following pros and cons of listing should be considered and weighted:

#### **Ease of Capital-Raising versus Listing Expenses**

A listed company enjoys a competitive edge over a private company in terms of ease of raising capital. An IPO is a relatively cost-effective way of raising capital when compared to financings available to private companies, such as debt financing. In addition, a listed company can raise further finance easily and cheaply by issuing more shares. Moreover, a listed company generally enjoys better terms for bank financings. Banks may release the personal guarantees given by the major shareholders for the company's bank facilities upon listing.

However, an IPO involves substantial capital outlay during the process. Careful budgeting and precise execution are required to ensure its cost-effectiveness. To control its

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cost exposure, a potential issuer may consult with professional parties involved in the IPO to agree on payment of fees by instalments. If necessary, potential issuers may consider introducing pre-IPO investors to the company for fund flow.

### **Liquidity versus Unwanted Shareholders**

A shareholder of a private company may not easily increase or decrease his or her stake in the company, as it may involve complicated business valuations and heighten the tension among the shareholders. In particular, for a family-owned business, any change to the existing shareholding structure may lead to family issues, which may in turn spark a dispute among the shareholders. By providing liquidity to the shares and affording the founders an exit option to realise their investments in the company, listing a business may mitigate the risk of shareholders' disputes.

Nevertheless, the other side of the coin with liquidity is that you cannot avoid unwanted investors from becoming shareholders of your company. Shareholdings in a listed company should be closely monitored so as to avoid takeover bids from competitors or other investors.

### **Publicity versus Market Scrutiny; Prestige versus Compliance Burden**

A listing status is a badge of quality. It generally shows that the company is adhering to higher standards of compliance and corporate governance. Also, listing a business is a means to raise its public profile and visibility, which will in turn increase the market's awareness of the company's products or services.

The price for publicity is that a listed company is subject to market scrutiny. The company will face a larger group of shareholders, regulators as well as other stakeholders; each with their own requirements and expectations. It will also be subject to a more onerous compliance burden. Hence, only those enterprises with capable and committed management which are prepared to demonstrate high standards of corporate governance and transparency should take the challenge of listing.

### **Why List in Hong Kong?**

Once an enterprise has decided to pursue a listing, the next step is to choose the most suitable market for listing. The Hong Kong Stock Exchange (HKEx) is an attractive listing venue for many local and international businesses. It is the seventh largest stock exchange in the world in terms of the total market capitalisation of all securities listed thereon.<sup>1</sup> It has also been the busiest stock exchange in the past few years in terms of its numbers of IPOs. Its popularity can be explained by a number of Hong Kong's advantages as the listing venue:

### **Gateway between Mainland China and the Rest of the World**

Strategically located in a high-growth region, Hong Kong is well-positioned to capture the opportunities offered by the booming economy of Mainland China. HKEx allows Mainland

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<sup>1</sup> Statistics for 2011 are available on [www.world-exchanges.org](http://www.world-exchanges.org)

China businesses to access capital from investors from all over the world. Meanwhile, it also allows international investors to invest in Mainland China businesses. Moreover, it has now become a trend for international brands to list on the HKEx to gain access to capital from the Mainland China and to raise their profile and visibility in the Mainland China.

### **Strategic Plan to Capture Mainland China's Growth**

Pursuant to its strategic plan for 2010-2012, HKEx is committed to attracting new listings from Greater China or with a China orientation. To capture the opportunities arising from the internationalisation of Renminbi (RMB), HKEx is also working on new products, platforms and infrastructure, aiming at becoming the exchange of choice for international investors to access RMB-denominated products.

### **Liquid Market with Free Flow of Capital**

Having access to both local and international funds, HKEx is a vibrant and liquid stock market. With numerous tax advantages, currency convertibility and free transferability of securities but no capital flow restrictions, HKEx is an attractive market for both companies and investors alike.

With its unique role as a gateway to Mainland China, coupled with a more liquid market, HKEx is expected to continue its position as the pre-eminent exchange in the region.

### **Strong Legal System and Sound Regulatory Framework**

A well-established and respected legal system is a cornerstone of Hong Kong's success. HKEx is regulated by a clear and sound regulatory framework, which is on a par with international standards. These provide a strong foundation for companies to raise funds in Hong Kong and affords investors confidence in Hong Kong's stock market.

Despite that A-share listings in Shanghai and Shenzhen generally enjoy higher profit-to-earnings (P/E) ratios, many Mainland businesses choose to list in Hong Kong because the HKEx adopts a clear set of objective listing criteria and a more guaranteed listing timetable. These would facilitate the listing preparation and provide more certainty to a listing application.

### **Is Your Business Suitable and Eligible for Listing?**

Once a decision to list in Hong Kong is made, the potential issuer should then consider if it can satisfy the HKEx's listing criteria. First of all, the company and its business must, in the HKEx's opinion, be suitable for listing.<sup>2</sup> In addition, the company must also satisfy the listing qualifications set out in the Listing Rules.

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<sup>2</sup> Rule 8.04 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (Listing Rules); Rule 11.06 of the Rules Governing the Listing of Securities on the Growth Enterprise Market (GEM) of The Stock Exchange of Hong Kong Limited (GEM Listing Rules)

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### **Suitability for Listing**

There is no definitive “suitability” test, although the HKEx may raise concerns in situations where:

- the company does not have control over its business and is unable to carry on an independent business as its main activity; for example, the company is heavily dependent on one customer/supplier<sup>3</sup> or relies heavily on the support of a related party<sup>4</sup>, the parent company or a controlling shareholder<sup>5</sup>;
- the company’s has regulatory non-compliance records<sup>6</sup>; or
- the company has deteriorating financial performance and uncertain business prospects<sup>7</sup>.

### **Regulatory Non-Compliance and Illegal Acts**

It is not uncommon for listing applicants to disclose in their listing documents incidents of regulatory non-compliance or illegal acts committed by the companies. Common incidents of regulatory non-compliance include:

- failure of Hong Kong companies to hold annual general meetings and lay accounts in accordance with the requirements of the Companies Ordinance (Cap. 32)(Companies Ordinance);
- failure of Hong Kong companies to file specified forms with the Companies Registry in accordance with the requirements of the Companies Ordinance; and
- non-payment or under-payment of social security contributions for the employees in the Mainland China.

Regulatory non-compliance or illegal acts of an applicant may not necessarily render the applicant unsuitable for listing. HKEx will consider the nature and seriousness of the breach, whether it was intentional or involved dishonesty, the impact on ongoing operations and the measures put in place to prevent further breaches.<sup>8</sup> In most of the cases, HKEx will allow listing provided that the non-compliance or illegal acts are fully disclosed in the listing documents. For serious breaches, the HKEx may require the listing to be delayed to ascertain the full effects of the breaches and the effectiveness of the preventive measures put in place.

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<sup>3</sup> Listing Decision (HKEx-LD107-1) published in October 2010

<sup>4</sup> Listing Decision (HKEx-LD92-1) published in May 2010

<sup>5</sup> Listing Decision (HKEx-LD46-1) published in July 2005; Listing Decision (HKEx-LD46-2) published in July 2005; Listing Decision (HKEx-LD51-1) published in March 2006; Listing Decision (HKEx-LD51-3) published in March 2006; and Listing Decision (HKEx-LD30-2012) published in April 2012

<sup>6</sup> Listing Decision (HKEx-LD97-1) published in July 2010; Listing Decision (HKEx-LD19-2011) published in September 2011

<sup>7</sup> Listing Decision (HKEx-LD37-2012) published in September 2012

<sup>8</sup> Listing Decision (HKEx-LD97-1) published in July 2010

### Main Board Listing Qualifications

Apart from being suitable for listing, a listing applicant must also satisfy one of the following three financial tests set out under Listing Rules: (1) profit test; (2) market capitalisation/revenue test; or (3) market capitalisation/revenue/cash flow test.

	<b>Profit Test</b>	<b>Market Capitalisation/ Revenue Test</b>	<b>Market Capitalisation/ Revenue/ Cash Flow Test</b>
Minimum profit attributable to shareholders	At least HK\$20 million recorded in the most recent financial year, and aggregate profits of at least HK\$30 million recorded in the two preceding financial years	-	-
Minimum market capitalization at the time of listing	HK\$200 million	HK\$4 billion	HK\$2 billion
Minimum revenue	-	HK\$500 million for the most recent audited financial year	HK\$500 million for the most recent audited financial year
Minimum cash flow	-	-	Aggregate positive cash flow from operating activities of HK\$100 million for the three preceding financial years

In addition, the listing applicant must also demonstrate:

- a trading record of at least three financial years with management continuity for at least the three preceding financial years and ownership continuity and control for at least the most recent audited financial year<sup>9</sup>;

<sup>9</sup> The HKEx may accept a shorter trading record period under substantially the same management if the company qualifies under the Market Capitalisation/Revenue test and can demonstrate (i) that its directors and management have sufficient and satisfactory experience of at least three years in that line of business/industry; and (ii) management continuity for the most recent audited financial year.

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- that it has enough working capital for its current needs and for at least 12 months after listing;
- that at least 25% of its total issued share capital will at all times be held by the public<sup>10</sup>, which means that the market capitalization of the public float must be at least HK\$50 million; and
- that it will have at least 300 shareholders post-listing.

A company that cannot meet the above requirements will generally be not eligible for a listing on the Main Board of HKEx, unless the HKEx agrees to relax those requirements in a particular case. Nevertheless, such a company may still be able to list on the GEM, which is an alternative stock market operated by the HKEx and is aimed at enterprises that have growth potential but are not necessarily able to meet the financial tests for the Main Board.

### **GEM Listing Requirements**

To be eligible for listing on the GEM, the listing applicant must have:

- a positive cashflow generated from operating activities in its ordinary and usual course of business of at least HK\$20 million for the two preceding financial years;
- a market capitalisation of at least HK\$100 million at the time of listing. As with the Main Board requirements, at least 25% of the company's total issued share capital must at all times be held by the public, and for GEM companies the minimum market capitalisation of the public float is HK\$30 million;
- a trading record of at least two financial years with management continuity for at least the two preceding financial years and ownership continuity and control for at least the most recent audited financial year; and
- at least 100 shareholders post-listing.

GEM is positioned as a stepping-stone to the Main Board. A GEM listed company may apply for a transfer of its listing to the Main Board at a later stage, provided that the Main Board listing criteria are met.

Due to their unique characteristics, the listings of mineral companies or newly formed “project” companies in Hong Kong are subject to specific listing qualifications and requirements. For details, please refer to Chapter 5 (Preparing for an IPO – Specific Listing Issues).

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<sup>10</sup> The HKEx may accept a lower public float percentage of between 15% and 25% in cases where a company has an expected market capitalisation of over HK\$10 billion at the time of listing.

## **How to Prepare for an IPO?**

### **Pre-IPO Diagnosis**

In formulating a listing plan, the potential issuer should consult with professional parties at an early stage for a clear understanding of the listing requirements, as well as the HKEx's current vetting attitude towards the business of the potential issuer. Legal advisers, together with accountants and/or sponsor firms, could provide pre-IPO diagnosis against the business to be listed to identify material issues in advance and propose solutions for the potential issuer. With the advice of the professional parties, the potential issuer may devise an action plan for listing, which would facilitate project management and the control of cost outlay.

### **Pre-IPO Reorganisation**

An IPO process usually involves group reorganisation, which aims at organising the group into a suitable listing structure. Such reorganisation usually commences shortly before the submission of listing application. However, in some cases, potential issuers may have to commence the group reorganisation at an earlier stage. Otherwise, the listing process may be delayed.

For example, some business partners may run a business using different entities. If they cannot prove that the entities are operated under their common control, they will not be regarded as a legal group and the reporting accountants may not be able to prepare consolidated accounts for these entities. As a result, the results, assets and liabilities of the entities may only be consolidated into the group account after the restructuring. In such case, the disregarded results may render the listing group failing to meet the listing qualifications, and the business partners may need to wait for longer time to list their business.

In addition, sometimes the existing group structure may not entail all material operating subsidiaries, assets and businesses, or may contain businesses which need to be excluded. In such cases, pre-IPO reorganisation should be commenced earlier to allow the effect of the inclusion or exclusion of businesses or assets to be reflected in the track record period results.

Pre-IPO reorganisation requires careful consideration of various aspects, including legal, tax and accounting implications as well as the requirements under the Listing Rules. Legal advisers and accountants should be consulted to ensure all aspects would have been considered.

### **Pre-IPO Financing**

Companies may have funding needs before listing. Potential issuers may consider introducing strategic investors to the company so as to obtain funding and to access the business experience of strategic investors. Many private equity, hedge funds and investment banks would invest in unlisted companies, with the aim of cashing out on eventual IPOs. In return, these investors may take the form of a straightforward investment in ordinary shares or convertible instruments. As different investment structures may have different impact on the Company's financial position, pre-IPO financing should be carefully structured.

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Pre-IPO investors are usually given large discounts because of the risk that the IPO might not be successful. Also, they may ask for some special rights to protect their exposure. These preferential treatments may not be allowed by HKEx. For details, please refer to Chapter 5 (Specific Listing Issues).

### **Disclaimer**

The law and procedure on this subject are very specialized and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

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## Chapter 2: The Role of Reporting Accountants

Under Hong Kong's listing rules, it's mandatory to engage Reporting Accountants to assess and report on the financial information in a company's Prospectus.

The contents of the Prospectus, which serves as an invitation to the public to subscribe for or purchase shares or debentures in a company, are governed by the relevant Hong Kong Stock Exchange's (HKEx) Main Board/GEM Board Listing Rules, the Hong Kong Companies Ordinance, the Securities (Disclosure of Interests) Ordinance and the Codes on Takeovers and Mergers and Share Repurchases.

These rules specify that a Prospectus must include an accountant's report. The accountants who prepare this report, known as the Reporting Accountants, must be qualified under the Professional Accountants Ordinance for appointment as an auditor. (For a list of qualified accountants in Hong Kong, refer to the Hong Kong Institute of Certified Public Accountants (HKICPA).)

According to the HKICPA Auditing Guideline AG 3.340 "Prospectus and The Reporting Accountant":

*the reporting accountant for prospectuses is required to provide an independent statement of financial information for the company and the group (if applicable) concerned. This statement, which is to be supported by an opinion together with the other information in the prospectus supplied by the company and its independent valuers may assist potential investors in making a decision on whether or not to take up the offer or invitation to invest in the company or group which issues the prospectus.*

### **What to Expect from Reporting Accountants**

The Reporting Accountants will play an integral role in a company's IPO. To ensure a smooth and efficient IPO process, it is vital to engage Reporting Accountants very early in the planning process, ideally before the board obtains shareholder approval to proceed with a listing.

The Reporting Accountants will thoroughly examine the company's books and its structure to ensure the company will be able to comply with all of Hong Kong's listing rules and regulations, generally-accepted accounting practices and the relevant financial reporting standards. In some cases, the Reporting Accountants may assist in a group restructure. In other cases, the Reporting Accountants can provide guidelines to assist the company's internal accountant to reconstruct financial details in order for the company's records to meet the rules for listed companies.

The Reporting Accountants can conduct a tax compliance review to ensure any potential tax issues are resolved in a timely manner, well before the company lists.

The Reporting Accountants also have a key role to play in the preparation of the company's Prospectus. They are required to prepare an accountant's report on the company's historical financial information and the statement of adjustments. The Reporting Accountants will comment on the company's working capital sufficiency, debt status, net tangible assets, related party transactions and any profit forecast and other financial information that is included in the Prospectus.

The Reporting Accountants need to verify the financial information set out in the other parts of the Prospectus and ensure all the information is consistent with the Accountants' Report.

To complete all these tasks, the Reporting Accountant will need to attend meetings with parties involved in the IPO process, including the sponsors, lawyers and valuers. The Reporting Accountants will also be on hand to assist management deal with any queries raised by the HKEx.

### **Reporting Accountants Will Prepare: An Accountants' Report**

The Accountants' Report must detail the issuer's historical financial information during the trade record period ("Relevant Period"). The Relevant Period should cover the financial statements from at least the three financial years immediately preceding the issue of the Prospectus for Main Board applicants and at least two financial years for GEM Board applicants. The Relevant Period must have ended six months or less before the issue of Prospectus.

In cases where the time between the end of the last reporting period and the date of the Prospectus is more than six months, financial statements for the interim period, generally referred to as the stub period, can be provided. The comparative figures of the stub period must be reviewed by the Reporting Accountants under Hong Kong Standards on Review Engagements (HKSRE) 2410 Review of Interim Financial Information.

The financial information should be prepared in accordance with the Hong Kong Financial Reporting Standards (HKFRS) or International Financial Reporting Standards (IFRS). A People's Republic of China (PRC) issuer also has the option of presenting its financial information under the China Accounting Standards for Business Enterprises (China GAAP). The financial information must include a statement of comprehensive income, financial position, cash flows and any changes in equity during the reporting periods.

### **Additional Information**

The HKEx may require additional information to be disclosed in the Accountant's Report if it is considered necessary for potential investors to understand more of the issuer's financial performance and positions. In some cases, the HKEx may request the Prospectus to include financial details and projections of newly acquired subsidiaries to give prospective investors a thorough understanding of the expected financial role of the new unit in the listed group.

Directors are responsible for the preparation of the Financial Information, and the Reporting Accountants are responsible for obtaining sufficient relevant and reliable evidence to form an opinion.

The Reporting Accountant's opinion should draw attention to the following matters:

- that the financial information is based on the audited financial statements of the company and its subsidiaries;
- that all adjustments considered necessary have been made (or that no adjustments were considered necessary);
- that work has been carried out in accordance with AG3.340 of the HKICPA Members' Handbook Volume III Auditing and Assurance Standards; and
- whether or not the financial information gives a true and fair view of the company's financial affairs and the results for the Relevant Period.

### **A Statement of Adjustments**

According to the HKEx listing rules, the Reporting Accountants are required to prepare a statement of adjustments to reconcile the figures included in the statutory audited financial statements to the figures in the Accountants' Report. This statement of adjustments, which will be available publicly, must identify each adjustment and spell out the reasons for each adjustment.

Adjustments to previous audited financial statements may be made for the following reasons:

- To ensure the financial information is presented in the Accountants' Report in a consistent and comparable basis. For example, ensuring the value of various company properties are calculated using the same method.
- Correction of material errors, reclassification of balance sheet items and other matters considered appropriate by the Reporting Accountant.

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### **Pro Forma Financial Information**

Listing rules require the Prospectus to present pro forma financial information in certain circumstances.

The pro forma financial information should show how the company's historical financial statements would appear if a transaction, such as a major acquisition, had been made at an earlier date.

A pro forma would be required if the issuer made a major acquisition after its most recent reporting period. The financial statements of the acquired subsidiary would be included in a pro forma which re-reports the financial affairs of the enlarged group as if the transaction had been in effect on the last date of the financial information. Accounting Guideline 7 of the HKICPA Members' Handbook Volume II Financial Reporting Standards, entitled "Preparation of Pro Forma Financial Information for Inclusion in Investment Circulars", has more guidance about the preparation of pro forma statements.

Hong Kong's listing regulations also require a net tangible asset statement backing for each class of security for which a listing is being sought. This statement should be prepared taking the proposed new shares into account as detailed in the Prospectus.

Where there is any pro forma information in the Prospectus, the Reporting Accountants are required to prepare a report on the pro forma financial information in accordance with Hong Kong Standards on Investment Circular Reporting Engagements (HKSIR) 300 – Accountants' Report on Pro Forma Financial Information in Investment Circulars and give an opinion as to whether:

- The pro forma financial information has been properly compiled on the basis stated;
- The basis of the pro forma information is consistent with the accounting policies of the issuer; and
- Any adjustments for the purposes of the pro forma financial information are appropriate.

The work of the Reporting Accountants primarily consists of comparing the unadjusted financial information with the source documents, considering the evidence supporting any adjustments and making enquiries of the directors regarding the process. This does not constitute an audit or review.

### **Review of Working Capital Sufficiency**

Listing rules require the directors to state in the Prospectus whether the issuer's working capital is sufficient for the group's requirements for at least 12 months from the date of the publication of the Prospectus. If the working capital is not deemed sufficient, the Prospectus should outline how the directors propose to raise additional working capital.

As a general practice, the directors would prepare a cash flow forecast to illustrate working capital sufficiency. The cashflow forecast should cover at least one year from the date of the Prospectus.

The Reporting Accountants are engaged to review the assumptions of the cashflow

forecasts by referring to existing or future facilities and resources available to the issuer, which may include existing loan facilities and credit policies of suppliers and customers.

The Reporting Accountant gives a private comfort letter to the directors to confirm whether 1) the statement of the directors on the adequacy of the working capital has been made after due and careful enquiry and 2) the persons or institutions providing finance to the issuer have stated in writing that the relevant financing facilities exist.

### **Consent Letter**

If a Prospectus contains any statement made by experts such as Reporting Accountants or legal advisors involved in the IPO process, the expert must provide a letter of consent to the issue of the Prospectus.

The Reporting Accountant must give consent to the publication of the prospectus containing his or her report and statements, include the accountant's reports and the comfort letters that address the profit forecast. These consent letters need to be filed with the Registrar of Companies and the HKEx and are available for public inspection.

### **Indebtedness**

As part of the IPO process, the issuer must disclose their level of indebtedness, including bank loans, overdrafts or similar indebtedness, hire purchase commitments, guarantees or other material contingent liabilities, as at the latest practicable date. If there are no borrowings, the issuer should record a "nil" statement in the Prospectus. This is sometimes called a negative statement.

The indebtedness statement should be dated less than two calendar months from the publication of the Prospectus. It is the responsibility of the directors to prepare this statement. The Reporting Accountants are engaged to form and provide a private letter of comfort, which may contain a negative assurance in relation to the issuer's borrowings in the form of a statement declaring "nothing has come to our attention to indicate that any adjustments should be made to the statement of indebtedness".

### **Review of Profit Forecasts**

It is not mandatory for a Prospectus to include a profit forecast. However, if the issuer chooses to include this information, the Reporting Accountants should review and report on the profit forecast.

Any profit forecasts in the Prospectus should be prepared in accordance with the profit forecast regulations that apply to listed companies. Profit forecasts should be compiled with the greatest possible care by directors and must clearly state the assumptions upon which the forecasts are based. The Reporting Accountants should examine and report on the accounting policies and calculations used in the profit forecast and indicate whether the accounting policies differ from the policies adopted in the issuer's financial statements.

The directors assume full responsibility for the profit forecast and their approval of the profit forecast should be noted in Board minutes. There is also a requirement that the sponsor

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should report whether or not they have satisfied themselves that the forecast was prepared by the directors after due and careful enquiry.

It is not the Reporting Accountants' responsibility to report upon the assumptions upon which the profit forecast is based or state whether or not the company is likely to meet the profit forecast. However, the Reporting Accountants should note in their report if there are any assumptions that appear unrealistic or if any seemingly important information has been omitted.

The issuer's directors or the sponsors decide the forecast period. The forecast period usually begins one year or less from the date covered by the most recent audited financial statements and ends at the end of the next financial year or half year.

In practice, it is unusual to provide a forecast for a succeeding period unless:

- (a) at least 10 months of the current period has elapsed; and
- (b) the company's operations lend themselves to reasonably accurate forecasting such as in the case of a property investment company.

The Reporting Accountant should review and form an opinion on the forecast in accordance with the requirements of Auditing Guideline 3.341, "Accountants' Report on Profit Forecasts" that:

*the profit forecast, so far as the accounting policies and calculations are concerned, has been properly compiled on the footing of the assumptions made by the board of directors, as set out in the prospectus, and is presented on a basis consistent with the accounting policies normally adopted by the issuer.*

As part of the review procedures, the Reporting Accountants are required to:

- Understand the nature of the business and the market conditions
- Understand the existing group structure (and any potential changes during the forecast period)
- Understand the procedures the directors used to prepare the forecast
- Assess the quality of any previous forecasts
- Compare and update the forecast with actual figures
- Enquire how the assumptions were arrived at
- Query any assumptions which appear inappropriate or unrealistic

### **Related Party Transactions**

Hong Kong Accounting Standards (International Accounting Standard 24) contains the definitions of related parties, and the HKEx's listing rules also contain requirements for the disclosure of connected party transactions. Related party transactions can include sales, purchases or advances between the issuer and companies controlled by directors, associated

companies, joint ventures, key management personnel and/or major shareholders. Over the past decade, the definition of related party has been broadened to include key management personnel.

The purpose of disclosing related party transactions is to ensure a company's financial statements draw potential investors' attention to the possibility that the company's financial position and profits or losses may have been affected by the existence of related parties and by transactions and outstanding balances with such parties.

A related party relationship could have an effect on the profits or losses and financial position of an entity. Related parties may also enter into transactions that unrelated parties would not. For example, an entity that sells goods to its parent at cost might not sell on those terms to another customer. Also, transactions between related parties may not be set at the same amounts as between unrelated parties.

Therefore, the existence of related party transactions may affect how potential investors assess a company's operations and the Prospectus should set out the risks and opportunities that these related party transactions create.

The related party disclosure requirements can present a particular problem for Mainland Chinese companies seeking to list on the HKEx. Many of these enterprises have experienced tremendous growth in business operations during the past decade and usually the structure of the organizations have not kept pace with the growth. Experience has shown us that the senior managers of these companies generally do not understand related party transactions as defined by HKFRS and Hong Kong's listing rules.

Mainland Chinese companies may not have kept complete records of related party transactions and may not have adequate internal controls for such transactions. Also, major related party transactions originating at the subsidiary level may not have been adequately reported back to the head office. It is also common for Chinese companies to have no separation of the business/cash flows between the owners' fund and the monies generated by the operations. Certain cash in and out through the owners' bank accounts may not be properly identified and recorded.

The Reporting Accountants are required to obtain an understanding of the nature and business rationale of a company's related party relationships and transactions sufficient to identify, assess and respond to the risks of material misstatement resulting from them. It is sometimes difficult to identify related party relationships and transactions if these are not identified or disclosed by management. In some circumstances, particularly in the absence of proper records, the Reporting Accountants may need to rely on the management's representation of these related party transactions.

The Reporting Accountants may need to use the following procedures to identify related party transactions:

- requesting from management personnel a list of related parties and any transactions the company has completed with those parties during the trade record period;
- reviewing the Board minutes for authorization of transactions;
- understanding and evaluating investment transactions; for example, the purchase or sale