responsible for the preparation of consolidated financial statements that give a true and fair view accordance with International Financial Reporting Standards and the disclosure requirements of the Hong Kong Companies Ordinance. . . . In our opinion, the consolidated financial statements give a true and fair view of the state of affairs of the Company and of the Group as at 31st March 2012, and of the Group's profit and cash flows for the year then ended in accordance with International Financial Reporting Standards and have been properly prepared in accordance with requirements of the Hong Kong Companies Ordinance." More details about audit opinion are discussed in Chapter 2, whilst the responsibilities of directors and auditors are further discussed in Chapters 2 and 8 respectively.

Audited financial statements of a public company must be presented to the shareholders at the annual general meeting (AGM) and the financial statements should be made up to a date falling not more than 6 months before the AGM.[10] A copy of the audited financial statements, auditors' report and directors' report in the company's annual return should be filed to the Registrar of Companies within 42 days following the AGM.[11] In the case of a private company, the financial statements should be made up to a date falling not more than 9 months before the date of the AGM.[12] A private company is not required to include the audited financial statements, auditors' report or directors' report in the annual return to the Registrar of Companies.[13]

Where the shareholders of a private company agree to apply Section 141D, the financial statements do not need to follow certain sections of the CO.[14] In particular, the financial statements are required to show a true and correct view (instead of a true and fair view) of the state of the company's affairs at the financial year-end and of its profit or loss for that financial year, and the Eleventh Schedule (rather than the Tenth Schedule) of the CO is required to be complied. Accordingly, Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) instead of HKFRS may be followed.

Overseas Companies

Companies incorporated overseas may operate in Hong Kong. In fact, many companies listed on the Stock Exchange are incorporated in the

Mainland China, Bermuda and the Cayman Islands, i.e. overseas (or China) companies subject to Part XI of the CO. For example, AAC and CMMB are incorporated in the Cayman Islands. If an overseas company is also a private company, it is largely exempt from the CO. However, audited financial statements are generally required for taxation purposes under the IRO.

General Book-Keeping Requirements under the Inland Revenue Ordinance

The IRO requires a person carrying on business in Hong Kong to keep sufficient records of the income and expenditure so as to readily ascertain the assessable profits.[15] Large multinational corporations usually have their own tax departments in supporting and giving advice on the tax planning and compliance issues. Some other corporations may outsource these functions to tax representatives. To ensure compliance, business records should include:

- the books of account recording receipts and payments, or income and expenditures;
- the underlying documentation necessary to verify the entries in the books of account;
- a record of the assets and liabilities of the business; and
- a daily record of all sums of money received and expended by the trade together with supporting details.

However, all these requirements relate to record-keeping rather than financial reporting. In fact, the IRO does not cover the preparation basis or disclosure items of financial statements. Nevertheless, corporations' tax returns must be supported by appropriate tax computations and audited financial statements.

Stock Exchange of Hong Kong Limited

In accordance with the Securities and Futures Ordinance (SFO), Hong Kong Exchanges and Clearing Limited (HKEx) owns and operates the Stock Exchange and Hong Kong Futures Exchange Limited (Futures Exchange) and three clearing houses which are wholly-owned subsidiaries of HKEx.[16]

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The Stock Exchange is the primary regulator of companies listed on the Main Board and the Growth Enterprise Market (GEM) Board regarding trading matters. Companies listed on the Main Board follow the Listing Rules, whereas companies listed on the GEM Board are required to comply with the GEM Rules. The Futures Exchange operates and maintains a futures market in Hong Kong, and regulates participants with respect to trading matters. The three clearing houses provide services for the clearing and settlement of securities, stock option transactions and transactions on the Futures Exchange. While the Stock Exchange remains the frontline regulator of listed companies, matters regarding takeovers, share repurchase and privatization are the responsibilities of the SFC.

General Financial Reporting Requirements for Companies Listed on the Main Board

Other than those requirements set out in the CO, the IRO and HKFRS, there are additional disclosure requirements for companies listed on the Main Board, both in respect of annual financial reporting and half-yearly financial reporting.[17] According to the HKEx's statistics,[18] there are 1,355 listed companies on the Main Board in the third quarter of 2012. Companies listed on the Main Board are required to send their annual reports (including audited financial statements) to every member within three months (or four months applicable to financial reporting periods ending on or after 31 December 2010) after the year-end, and not less than 21 days before the date of the AGM.

The Listing Rules require the presentation of certain financial information disclosures in the notes to financial statements including:

- maturity profile of borrowings;
- directors' emoluments on a named basis;
- employees' emoluments by bands;
- pension schemes;
- credit policy and aged analysis of accounts receivable; and
- aged analysis of accounts payable.

Companies listed on the Main Board are required to publish their final results in the newspapers on the next business day after the approval by the board of directors and to submit electronic copies of announcements for parallel publication on the HKEx website.

A Main Board listed company is required to issue an interim report (for the first six months of a financial year) not later than two months after the interim period end in accordance with HKFRS.[19] All companies with a primary listing on the Main Board are required to prepare financial statements in accordance with HKFRS or IAS. Listed companies adopting IAS are required to explain the relevant financial effect of material differences between IAS and HKFRS which is becoming largely irrelevant due to the harmonization between the two sets of standards (except for those incorporated in the Mainland China before 1 April 2001). Overseas companies with a secondary listing on the Main Board are permitted to use the GAAP in the USA (US-GAAP).

The Stock Exchange has recently amended the Listing Rules allowing Mainland China incorporated issuers to prepare their financial statements using the accounting standards of Mainland China; and allowing the audit firms of Mainland China vetted, nominated and endorsed by the Ministry of Finance of China and the China Securities Regulatory Commission to service these issuers using the auditing standards of Mainland China. Compliance costs for Mainland China companies listed in Hong Kong are expected to reduce.

According to page 42 of AAC's 2011 annual report, ". . . the company was incorporated and registered as an exempted company with limited liability, the Cayman Islands under the Companies Law of the Cayman Islands with its shares listed on The Stock Exchange of Hong Kong Limited (the 'Stock Exchange')." Page 45 states that "The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRSs) and include applicable disclosures required by the Rules Governing the Listing of Securities on the Stock Exchange and by the Hong Kong Companies Ordinance."

Page 40 of One Media's 2011/2012 annual report states that "The consolidated financial statements of the Group have been prepared in accordance with International Financial Reporting Standards ('IFRSs') issued by the International Accounting Standards Board ('IASB'), requirements of the Hong Kong Companies Ordinance and applicable disclosure requirements of the Listing Rules."

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General Financial Reporting Requirements for Companies Listed on the GEM Board

The financial reporting requirements for companies listed on the GEM Board are principally set out in the GEM Rules[20] which are tighter but similar to the Listing Rules. There are some specific disclosures only applicable under the GEM, such as the amount of disclosure of directors' emoluments by each director on an anonymous basis. The deadlines to publish annual and quarterly/six-monthly reports are within three months and 45 days after the respective year-/period-end on the Stock Exchange's website. All companies listed on the GEM Board are allowed to prepare financial statements in accordance with HKFRS or IAS. Companies except for property development investment companies listed on the New York Stock Exchange or Nasdaq of the USA are permitted to use US-GAAP.

According to the HKEx's statistics,[21] there are 178 listed companies on the GEM Board in the third quarter of 2012. Unfortunately, the GEM Board has not been a very active market, and its liquidity is low compared to other second-tier stock markets such as AIM in London and Nasdaq in New York.

Securities and Futures Commission

The SFC was established by the Securities and Futures Commission Ordinance (SFCO) as an independent statutory body outside the civil service, responsible for regulating the securities and futures markets in Hong Kong. In 2003, the SFCO and nine other securities and futures related ordinances were consolidated into the Securities and Futures Ordinance (SFO). To avoid conflict of interest and to ensure a level playing field, HKEx (and the Stock Exchange) is regulated by the SFC. The SFC is also responsible for handling investigations and disciplinary matters, including complaints and disputes, and is empowered to inspect the books and records of any registered person and to conduct special investigations as regard to any person involved with securities.

The SFC has six operational divisions (Corporate Finance, Enforcement, Intermediaries Supervision, Licensing, Investment Products and Supervision of Markets) and two supporting divisions (Legal Services

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Division and Corporate Affairs Division). The duties of the six operational divisions are as follows:[22]

- Corporate Finance Division is responsible for the dual filing functions in relation to listing matters, administrating the Takeovers and Mergers Code and Share Repurchases Code, overseeing the Stock Exchange's listing-related functions and responsibilities, and administrating securities and company legislation.
- Enforcement Division is responsible for conducting market surveillance to identify market misconduct, undertaking inquiry into alleged breaches of relevant ordinances and codes, and instituting disciplinary procedures for misconduct.
- Intermediaries Supervision Division is responsible for devising and administrating licensing requirements for securities and futures, and leveraged foreign exchange trading intermediaries, supervising and monitoring intermediaries' conduct and financial resources, and regulating the public marketing of investment products.
- Licensing Division is responsible for license corporations and individuals seeking to conduct business in Hong Kong in regulated activities requiring a licence under the SFO, issue codes and guidelines concerning the competence and suitability of corporations and individuals to be licensed, monitor ongoing compliance with licensing requirements by licensees and related parties.
- Investment Products Division is responsible for liaising with other divisions in doing so, with particular emphasis on the Mainland China and market development, developing and implementing codes and guidelines to set up a platform for authorization applications of investment products so as to facilitate market growth and product innovation, regulating and approving investment products offered to the public, monitoring disclosures and continuing compliance of authorized investment products.
- Supervision of Markets Division is responsible for supervising and monitoring activities of the exchanges and clearing houses, encouraging development of the securities and futures markets, promoting and developing self-regulation.

turnover is not often desirable because of the extra liquidity deriving from the time being taken by the corporation to pay.

Creditor turnover may be expressed in numbers of days, as follows:

$$\text{Creditor Turnover Days} = \frac{\text{Average Creditors}}{\text{Purchases}} \times 365 \text{ days}$$

According to AAC's 2011 annual report, the creditor turnover days for 2011 and 2010 are 128.66 days (= 365 × RMB878,067 / RMB2,491,110) and 125.26 days (= 365 × RMB669,676 / RMB1,951,392) respectively. The above numbers of days indicate that on average AAC takes 129 days to pay its trade creditors, while there was 125 days in the previous year.

Creditor turnover days may sometimes be known as average payment period or days purchases outstanding. Divide the average balance of creditors or trade payables by purchases and multiply it at 365 days to give the creditor turnover days. Similar to debtor turnover days, this ratio indicates the effectiveness of working capital management. Unfortunately, purchases are not normally shown on statement of comprehensive income, so some analysts use cost of sales (with or without adjustment of inventory movements during the year) as an approximation to purchases. Some analysts may look at creditors in relation to sales because of the complication in the composition of cost of sales which may well include or exclude certain relevant costs, such as capitalized development costs. Regardless of the exact composition of cost of sales, a consistent comparison over the years still shows the trend (unless profit margins fluctuate wildly during the period).

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Liquidity Ratios

When we look at a corporation, one of our first concerns is whether the corporation is likely to go bust in the near future. If so, any further analysis would seem irrelevant. A corporation is regarded as solvent when:

- its assets exceed its total liabilities (i.e. it has a positive net worth); and
- it can pay its debts when they fall due.

Solvency may be viewed in two time frames:

- Could the corporation pay all its short-term liabilities when they fall due (i.e. liquidity ratios)?
- Will the corporation be able to meet its long-term obligations (i.e. leverage or gearing ratios which are considered in the subsequent section)?

Short-term solvency analysis is especially important to lenders, suppliers, employees, regulators and those who are concerned with the ability to meet demands for cash in the near future. Bear in mind that it is often insolvent businesses rather than unprofitable ones that go into liquidation. Liquidity ratios answer questions of whether a corporation pays its debts when they fall due and measure the short-term solvency of a corporation, i.e. its ability to continue in the short term by paying its current obligations. They may include ratios that measure the efficiency of the usage of current assets and current liabilities.

Current Ratio

In considering short-term solvency, analysts try to see if the corporation can meet all its short-term debts. Analysts need to look at the statement of financial position and the relationship between current assets and current liabilities. In other words, the current ratio compares the corporation's assets which can be realized within a year with the liabilities it has to repay in the next year. In general, the higher the current ratio, the more liquid the corporation is.

The current ratio is represented by:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Following on from AAC's 2011 annual report, the current ratio for 2011 and 2010 are 1.82 times (= 3,425,305 / 1,887,066) and 2.42 times (= 3,402,371 / 1,407,928) respectively. These ratios indicate that AAC's current assets comfortably exceed current liabilities by around two times over the two years.

Current ratio is less than one when current liabilities exceed current assets. On the other hand, current ratio is more than one when current assets exceed current liabilities. For most industries, 1.5 is a comfortable current ratio. A low number of the current ratio, say less than 1, indicates

that a corporation may have difficulty meeting current obligations. However, a user should also take note of a corporation's operating cash flow in order to get a better sense of its liquidity. A low current ratio can often be supported by a strong operating cash flow. If the current ratio is too high, say higher than 2, then the corporation may not be managing its working capital efficiently. All other things being equal, creditors consider a high current ratio to be better than a low current ratio, because a high current ratio means that the company is more likely to meet its liabilities which are due over the next 12 months.

In considering solvency, analysts generally adopt information from statement of financial position which shows a snapshot of a corporation's assets and liabilities. An average figure may be more representative, and computing an average based on opening and closing figures gives an approximation. Ratios for two years, therefore, require three years of statement of financial position figures. However, such calculation does not consider the timing of intra-year changes in assets which may be subject to seasonal factors, and working out an average based on opening and closing amounts requires two figures.

Acid-Test (or Quick) Ratio

In some cases, analysts need to check for the instant solvency, i.e. a more immediate position than the current ratio. Instant solvency takes the most pessimistic view of solvency as we assume that all the corporation's current creditors ask for immediate payment. To calculate this ratio, we need to identify those assets that the corporation could turn into cash within a day. It is largely dependent on the type of business in question. Analysts might question that most corporations are unable to sell their inventories in a day (particularly as part of it would be in work-in-progress). Analysts need to look at the corporation and determine its liquid assets—those which could be quickly sold to generate cash. Retailers would normally be able to realize all of their current assets; most manufacturers would only be able to realize debtors (e.g. through factoring), short-term investments and cash. Acid-test ratio (or quick ratio) attempts to measure the degree of immediate solvency and is represented by:

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$$\text{Acid-Test Ratio} = \frac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}}$$

As noted from AAC's 2011 annual report, the acid-test ratios for 2011 and 2010 are 1.52 times (= RMB2,866,525 / RMB1,887,066) and 2.17 times (= RMB3,059,428 / RMB1,407,928) respectively. These ratios indicate that AAC's "quick" current assets comfortably exceed current liabilities by two times over the two years.

Inventories are removed from current assets when computing acid-test ratio due to the risks that inventories are slow-moving, damaged, obsolete or otherwise impaired to the extent that their book value cannot be realized at sale. If the ratio is one or above, the corporation has liquid assets more than it owes for repayments within a year. As long as there are no large customers going bust, the corporation should have no difficulties in meeting its immediate obligations.

If the ratio is less than one, the corporation in question might not have enough assets to cover its current expenses if its inventories could not be sold close to its book value. Acid-test ratio is the same as everyone is asking for their money back immediately and may not really be appropriate for most ongoing corporations.

Leverage Ratios

Leverage ratios measure the long-term solvency of a corporation, i.e. its ability to continue in the long term by meeting the trade debts and other financial obligations. There are a number of different indicators of a corporation's long-term solvency:

- gearing;
- interest coverage;
- net worth; and
- debt maturity profile and cash position.

Ratios relating to capital structure and long-term solvency include an evaluation of the amount and proportion of debt in a corporation's capital structure as well as the ability to service debt. If debt financing is skillfully used, the returns to owners or shareholders can be enhanced. However, debt comes with risk because debt commitments must be met in order for

the corporation to continue operations.

Leverage ratios often form parts of the financial covenants. A fall in asset price (or recurring operating losses) weakens the corporation's statement of financial position possibly placing it in default of its loans. When the loans are called up, the solvency (or survivability) of the corporation becomes doubtful.

Gearing (or Debt-to-Equity) Ratio

In the event of a financial meltdown, funding corporations with high level of debt are more vulnerable than corporations with lower debt. To measure how much debt a corporation has taken on, gearing ratio looks at how the business and operation are financed. Placing total liabilities over total equity gives the gearing ratio and is represented by:

$$\text{Gearing (or Debt-To-Equity) Ratio} = \frac{\text{Total Liabilities}}{\text{Total Equity}}$$

Following on from AAC's 2011 annual report, the gearing ratios for 2011 and 2010 are 39.55% (= RMB1,902,804 / RMB4,811,422) and 33.72% (= RMB1,407,928 / RMB4,175,891) respectively which indicate that AAC's liabilities are increased to 40% of its total equity, compared to 34% in 2010. This ratio reflects the degree of protection for lenders and investors and is often included in loan covenants.

Gearing ratio is an attempt to quantify a corporation's financial leverage, i.e. an indication of the extent to which a corporation's activities are financed by owner's capital against lender's funds. In other words, gearing ratio is used mainly for analysing a corporation's capital structure and thus assessing the corporation's financial position in the long run.

The gearing ratio is significant to a corporation and the potential investors because it affects the corporation's ability to maintain a consistent dividend policy in difficult times and reveals the suitability of capitalization of a corporation.

Interest Coverage Ratio

Interest coverage ratio measures how "safe" the corporation's profit is in terms of meeting interest payments and is represented by:

$$\text{Interest Coverage Ratio} = \frac{\text{Profit before Interest and Tax}}{\text{Interest}}$$

According to AAC's 2011 annual report, the interest coverage ratios for 2011 and 2010 are 208.07 times (= RMB1,147,072 / RMB5,513) and 336.92 times (= RMB1,102,410 / RMB3,272) respectively which indicate that AAC's reported profits are well above the interest charges over the two years. In fact, if the ratio is above one, it is "safe" in fulfilling the interest payment requirement. However, this ratio does not address the repayment of principal. If it falls below one, the corporation is probably in trouble.

In general, a lower interest coverage ratio indicates a higher debt burden of the corporation and the greater the possibility for it to go under. A lower interest coverage ratio means less profits are available to meet interest payments and that the business is more vulnerable to increases in interest rates. When a corporation's interest coverage ratio is only 1.5 or lower, its ability to meet interest expenses may be questionable. An interest coverage ratio below 1.0 indicates the business is having difficulties generating the cash necessary to pay its interest obligations (i.e. interest payments exceed its earnings [EBIT]). A higher ratio indicates a better financial health as it means that the corporation is more capable of meeting its interest obligations from operating earnings. However, a high interest coverage ratio may suggest a corporation has been neglecting business opportunities and expansions through leverage.

Net Worth, Debt Maturity Profile and Cash Position

Corporations may collapse when it fails to meet its maturing obligations (e.g. failing to redeem a loan). This kind of insolvency becomes apparent when the corporation's liabilities exceed the assets, i.e. the corporation has a net deficit (or negative equity). Net worth is a simply measurement of whether or not the corporation's assets exceed the liabilities and it is represented by:

$$\text{Net Worth (or Deficit)} = \text{Assets} - \text{Liabilities}$$

As noted from AAC's 2011 annual report, AAC's net worth for 2011 and 2010 are RMB4,811,422 and RMB4,175,891 respectively. Many corporations with net deficits remain in operation for a long time because

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Responsibilities of Directors

As a corporation is not a natural person, it is necessary to have someone in charge of its operation and direction, and be held accountable for its actions. The board of directors takes on these equal and collective responsibilities. While the chairman is the leader of the board, his/her responsibilities should not be singled out because he/she is only the board's servant and may be removed by other directors. In addition, the chairman's functions are all delegated by the board, which include organizing board meetings, chairing general meetings, liaising between the board and the Chief Executive Officer (CEO), and handling public relations for the board.

As the board is the governance body of a corporation, the calibre and commitment of each director have a direct impact on a corporation's performance. Directors are responsible for the corporation's compliance with laws and regulations as well as the business direction and operation. Directors are also responsible for the financial reporting of a corporation, and directors' responsibilities may be delegated to the senior management or other officers of a corporation depending on the role they occupy, such as CEO and general manager. Every corporation shall have at least one director who must be over 18, and a corporation cannot have a corporate body as a director apart from a private corporation which is not a member of a group of corporations which includes a listed corporation.[2]

In fact, directors' responsibilities are set out clearly in corporations' annual reports. Pages 38–39 of Neo-Neon's 2012 annual report states that "**Internal controls**—The Board has overall responsibility for maintaining an adequate system of internal controls of the Company and for reviewing its effectiveness. The Board is committed to implementing an effective and sound internal control system to safeguard the interest of shareholders and the Company's assets. . . . The Directors have reviewed the need for an internal audit function and are of the view that it would be more cost effective to recruit professionals to perform internal audit functions for the Group. . . . **Respective responsibilities of directors and auditors**—The Directors are responsible for the preparation of the financial statements, which give a true and fair view of the state of affairs of the company and comply with the requirement of the Hong Kong Companies Ordinance and the applicable disclosure provisions of the Listing Rules. . . ."

According to page 33 of Neo-Neon's 2012 annual report, "**Board**

composition—As at the date of this report, the Board has three executive Directors ('ED') and four independent non-executive Directors ('INED'), as shown on page 2 of this annual report. . . . INEDs ensure the Board accounts for the interest of all shareholders and subject matters are considered objectively. The Board has received from each INED an annual confirmation of his independence pursuant to Rule 3.13 of the Listing Rules. . . . The Board considers all of the INEDs to be independent. INEDs has accounted for more than 50% of the full Board. The Board focuses on the overall strategic direction, development, performance and risk management through their contribution at Board meetings and committee work. . . ." According to page 34 of Neo-Neon's 2012 annual report, "**Role and responsibilities of the Board**—The Board delegates appropriate aspects of its management and administration functions to management. It also gives clear directions as to the powers of management, in particular, with respect to the matters that management commitment on behalf of the Company. The Board determines on regular basis which functions are reserved to the Board and which are delegated to management. The Board exercises a number of authorities which include: formulation of the Group's long-term strategy, approving major acquisitions, disposals and capital investment, reviewing operational and financial performance, authorizing material borrowings, setting dividend policy, any issue or repurchase of the Company's securities under general mandate, approving appointment to the Board and senior management, setting the Group's remuneration policy. . . ."

Shareholders' participation in management is very common in Hong Kong. Power separation is often vague, but power concentration within family members or with an individual owner-manager has advantages in efficiency and growth. In some cases, the roles of chairman and CEO are difficult to distinguish where both functions are executed by the same person, resulting in the authority of board and management concentrated at one position. However, analysts should be aware that having combined the two roles of chairman and CEO in small corporations does not necessarily equate to poor governance.

As noted from page 28 of AAC's annual report, "Under the code provision A.2.1 of the CG Code, the roles of Chairman and chief executive officer ('CEO') should be separated and should not be performed by the

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same individual. The posts of chairman and CEO are taken up by different persons. . . ." Similarly, as noted from page 29 of One Media's 2011/2012 annual report, "**The division of responsibilities between the chairman and the chief executive office**—With a view to maintaining an effective segregation of duties, the positions of the Chairman and the Chief Executive Officer are split and each plays a distinctive role. The Chairman is mainly responsible for the leadership and effective operation of the Board of Directors and ensuring that all key and appropriate issuers are discussed by the Board of Directors in a timely and constructive manner, and the Chief Executive Officer is delegated with the authority and is mainly responsible for the operation of the Group's business and the implementation of the approved strategies with a view to achieving the corporate objectives."

As noted from page 13 of CMMB's 2011 annual report, "The Board considers that good corporate governance of the Company is central to safeguarding the interests of the Shareholders and enhancing the performance of the Group. The Board is committed to maintaining and ensuring high standards of corporate governance. The Company has applied the principles and complied with all the applicable Code Provisions of the CG Code throughout the year ended 31 December 2011 except that the Company has been deviated from the Code Provision A.2.1 of the CG Code. . . . According to the Code Provision A.2.1 of the CG Code, the roles of a chairman and a chief executive officer should be separate and should not be performed by the same individual. Given [the CEO] has had extensive experience in the business of the Group and has performed satisfactorily since his joining of the Company in 2007, particularly in soliciting for possible new business opportunities and deducing the overall strategic plan for the future development of the Company, the Board considers that it would be beneficial of the Group if [the CEO] is also in charge of overseeing the Company's operations as the Chairman. The Board considers that this structure will not impair the balance of power and authority between the Board and the management of the Group. The Board will regularly review the effectiveness of this arrangement."

Many small corporations without such separation perform very well. Nevertheless, over-concentration of power may lead to possible abuse, therefore the Code recommends segregation of the two roles and requires

reporting by exception where chairman and CEO are not separated.[3]

In general, there is no basis for executive powers to be exercised by a chairman in the corporation. The CEO is the visible leader of the corporation, and the board entrusts the care of the corporation to the CEO. A chairman is generally paid more for the extra time he/she spends in comparison with other directors and for the special skills his/her role requires. The chairman may face greater risk exposure as a result of seeing more of the corporation's business and operation, and may be liable if he/she fails to bring some of the problems to other directors' attention. In essence, the chairman manages the board, whilst the CEO manages the corporation.

The responsibilities and liabilities of directors derive from various sources, including the corporation's constitutional documents (i.e. the memorandum and articles of association) and the applicable laws and regulations. Any departure from the directors' duties may make the person liable to civil or criminal proceedings and disqualified from acting as a director. Directors' duties arising from case laws or statute laws can be classified as fiduciary duty, duty to exercise skill and care, and statutory duty.

Fiduciary Duty

Directors must act honestly and in good faith for the best benefits of the corporation. Corporations' interests may generally be aligned with the interests of their members as a whole, thus directors must not act only for the advantage of the majority shareholders without the consideration for the interests of the minority shareholders. The interests of the corporation's employees, suppliers, customers and bankers must also be considered, particularly for matters involving solvency, product safety and safety at work.

Directors must act for a proper purpose without abusing the powers for purposes other than those for which they have been conferred. Directors must not obtain a personal profit from any of the transactions relating to the corporation without the shareholders' prior approval, otherwise such profits are regarded as being held in trust for the corporation. Directors must avoid any conflict between personal interests and corporation interests and must not use the property, information or opportunity of the corporation for any purpose other than in its best interests.

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Directors must not concede to any limitation over the scope of their discretion. As the powers delegated to directors by the memorandum and articles are held in trust by them for the corporation, they must not restrict their exercise of future discretion.

Duty to Exercise Skill and Care

There are no precise standards of skill and care due to the wide range of skills required of directors. A director must exercise the care, skill and diligence as reasonably expected, i.e. what would be exercised by a reasonable person with the knowledge, skill and experience reasonably expected of a director in the position.

In general, directors should display the degree of skill and care which may reasonably be expected from a person with that director's knowledge and experience. That means a director with higher seniority and relevant qualification is expected to perform at a higher standard.

Statutory Duty

Various statute laws, such as the CO, impose a number of duties on directors, such as the preparation of finance statements in accordance with the applicable laws and regulations, and the establishment of adequate internal controls to safeguard the corporation's assets.

In respect of directors' liabilities, directors are subject to fines and penalties under the CO or other regulations and, in the event of legal proceedings, may be personally sued for negligence by investors, shareholders or other parties affected by their actions.

The Role of Independent Non-Executive Directors

The Listing Rule required that the appointment of at least three independent non-executive directors (INEDs). There is a risk of power abuse or corruption if the power in a corporation is too concentrated among too few people who have interests in conflict with other stakeholders. Preventing power abuse or corruption can be achieved by separating powers and authorities amongst directors as well as shareholders

and senior managers in the corporation. Accordingly, the concept of INEDs is introduced. Power can be decentralized by expanding the board of directors and by having INEDs as an independent, but internal, monitoring and sounding mechanism. Analysts should check the quality and quantity of INEDs in their evaluation of corporations' governance because of their balancing role to enhance the quality of corporate governance so as to protect shareholders' and other stakeholders' interests.

To maintain impartial judgement, INEDs should therefore have no prior or present interests in the corporation's business, and have no connection to any personnel in the corporation. The Listing Rule requires the appointment of three INEDs in a listed corporation, one of which must have qualified financial and accounting knowledge and experience. Analysts should check the compositions of boards for an appropriate mix of executive and non-executive directors with the right knowledge and experience.

As noted from page 14 of CMMB's 2011 annual report, "The independent non-executive Directors also serve the important function of ensuring and monitoring the basis for an effective corporate governance framework. The Board considers that each independent non-executive Director is independent in character and judgment and that they all meet the specific independence criteria as required by the Listing Rules. The company has received from each independent non-executive Directors an annual confirmation of their independence pursuant to Rule 3.13 of the Listing Rules and the Board considers such Directors are independent. . . ."

Similarly, according to page 32 of Ka Shui's 2011 annual report, "The Board comprises eight directors, including four executive directors and four independent non-executive directors. Biographical details of the directors of the Company as at the date of this report are set out on pages 15 to 18 of this annual report. The Board members have no financial, business, family or other material/relevant relationships with each other. Each of the independent non-executive directors has confirmed in writing his independence from the Company in accordance with the guidelines on director independence of the Listing Rules. On this basis, the Company considers all such directors to be independent. All the independent non-executive directors were appointed for a specific term of two years and subject to retirement by rotation and re-election at the annual general meeting. . . ."

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the same amounts as between unrelated parties.

The HKFRS also acknowledges that profit or loss and financial position of a corporation may be affected by a related party relationship even if related party transactions do not occur.[5] The mere existence of the relationship may be sufficient to affect the transactions of the corporation with other parties. For example, a subsidiary may terminate relations with a trading partner on acquisition by the parent of a fellow subsidiary engaged in the same activity as the former trading partner. Alternatively, one party may refrain from acting because of the significant influence of another, e.g. a subsidiary may be instructed by its parent not to engage in research and development. For these reasons, knowledge of a corporation's transactions, outstanding balances, including commitments, and relationships with related parties may affect assessments of its operations by users of financial statements, including assessments of the risks and opportunities facing the corporation.

A related party transaction as required to be disclosed in financial statements represents a transfer of resources, services or obligations between a corporation and its related party, regardless of whether a price is charged. Examples of related party transactions include the disposal of a luxurious yacht or limousine to the corporation's owner or parent company, the payments of rents to close family members of the corporation's owners and the settlement of the tripartite liabilities on behalf of a related party. Reading the related party transaction disclosures can help analysts to draw their own inferences and conclusions about the transactions and terms.

Tipping-off

There are plenty of descriptive materials in annual reports which discuss plans of significant investments and research and development projects, future sales target, employee relations (such as minority hiring or union negotiations), as well as the dividend policy of the corporation. Together with trade periodicals and industry commentaries often provide an indication of the corporation's trend.

Analysts and stock commentators often receive exclusive insights or even "leakage" of commercially sensitive information on an anonymous

basis. Exclusive insights may be done in the form of press release or press conference by those responsible for the information or incident in question. "Leakage", on the other hand, tends to be selective, fragmented and possibly unfounded. Even if analysts can establish a sound basis for the "leakage", the contents may be quoted out of context with an evil motive. Sometimes, analysts are seen as a kind of supine letterbox for embargoed press releases and corporate announcements. The relationship between analysts and corporations is so delicate and should be well maintained. Some critics argue that corporation's selective briefing to analysts is not ethical or professional. However, the test for analysts is whether or not to dig deeper to find out what is really going on.

Concluding Remarks

By reading through the financial statements and other parts of the annual report, analysts should have a general impression about the corporation in question, how well it appears to have performed, whether its position seems to have improved over the years and how much cash it had at the year-end. Financial analytical tools and techniques involve number-crunching and judgements. The preparation of common-size financial statements, the calculation of accounting ratios and BE points and the application of common sense are all important, but what matters most is the integration of all these other information. Combining all these techniques produce a more balanced approach in financial analysis. Judgement is normally required for analysts to use all the information about a corporation that can be collected and experience should help to improve the quality of an analyst's judgement. Analysts must not neglect the influences from the corporate macro environment, including economic and industry factors, which are discussed in Chapter 10.

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Some may rearrange the five letters of PESTE into STEEP. Over the last ten to fifteen years, various academics, executives and business consultants have further developed their own versions of macro environment scanning models. One common terminology is PESTLE (or PESTEL) Analysis which refers to an extension of PESTE by adding the legal dimension which is understandable given the increasing regulations, deregulations and litigious culture around the world. Other variations of macro environment scanning models include STEEPLED (which evaluates social, technological, economic, environmental, political, legal, ethical and demographical factors) and STEER (which evaluates socio-cultural, technological, economic, ecological, and regulatory factors).

Whatever terminology is used, PESTE Analysis seeks to give an overview of the overall macro environment and can be completed at different levels, ranging from a page of some key points to a comprehensive survey with detailed findings. Useful data exists everywhere, but the trick is to identify the relevant bits and to convert them to knowledge relevant to the underlying business. In the context of financial analysis in the corporation's macro environment, analysts tend to focus on the economy and industry.

To compete in the macro environment, a corporation may generally adopt three generic strategies[2] allowing it to obtain a competitive advantage. There are two basic types of competitive advantage that a corporation may possess—low cost and differentiation—depending on the industry and market structure and other external factors. Along with these two generic strategies, there is a third generic strategy—focus—which aims at cost advantage or differentiation in a narrow market segment than the pure low cost or differentiation strategies. Therefore, analysts may find out the type of strategies adopted by the corporation under review and how well the chosen strategies match with the macro environment, particularly relating to the economy and industry.

Economy Analysis

An economy is generally characterized by growth, inflation, interest rate, exchange rate as well as size of population, workforce and unemployment. Analysing the local economy in which the corporation under review situates may no longer be adequate because of the impact of globalization.

Changes in the local economy does not necessarily give an equivalent impact on corporations situated locally because most of today's corporations operates on a global basis in the sense that the materials are sourced worldwide, and their products are being sold to local as well as overseas markets.

An economy is basically made up of three core elements: labour, capital and natural resources. Combining all three elements is the function of entrepreneurial management so that individual corporations and the economy as a whole can prosper. In economics, these three elements are known as factors of production, referring to the resources used as factor input in producing goods or services.

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Labour

Financial analysis often reveals objective data concerning the nature, quantity and ability of labour. Tracking the volume of production or sales generated by each worker can indicate the changes in the labour's productivity. Monitoring the sick leave and punctuality of the workforce can indicate the degree of absenteeism and staff motivation. Unfortunately, such data relating to individual corporations is generally not available to anyone other than the management, but relevant data relating to the entire economy published by the government can provide a general indication of the quality of labour in the territories in which the corporation under review situates.

China, for example, has been commonly known as having a large pool of diligent production workforce, and a substantial portion of products being consumed by us nowadays are manufactured in China. India which has been widely acknowledged as having a large pool of IT-literate and English-speaking workers, and many multinational corporations have set up their back offices (e.g. call centres of some USA and European banks) in India, benefiting from lower costs of telecommunication in recent years.

The quality and availability of appropriate labour in the territories in which a corporation operates have significant influences over its performance and position. Accordingly, one of the assessments by analysts in this respect would be to determine whether or not, and to what extent, the corporation under review possesses the appropriate pool of labour.

Capital

The second core element, capital, involves two main aspects as follows:

- whether or not, and to what extent, adequate funding can be raised by corporations at the right time and at the right place; and
- whether or not, and to what extent, surplus funding can be invested into appropriate assets generating reasonable returns to investors.

As discussed in the last few chapters, financial analysis tends to relate closely with capital out of the three core elements in the economy. Many accounting ratios seek to measure capital from different aspects, such as gearing ratios which indicate the effectiveness of capital structure whereas ROCE measures the return to investors. The quality of governance indicates how well the capital invested in corporations is being guarded and managed.

Analysts should have a general awareness of the fiscal policies of the territories in which the corporation under review operates. Fiscal policies of governments generally cover two main aspects: revenue and spending. For the Government of the Hong Kong Special Administrative Region, the main revenue comprises taxation and land premium proceeds from land sales. Taxation may be levied by governments on corporations' sales, profits and capital gains. Taxation on individuals' income, wealth or capital gains also has an indirect impact on corporations due to the varied amount of disposable income and the types of distributions preferred by investors. Government spending may be perceived as a way of income redistribution and certain "preferred" activities or industries are often encouraged by governments through direct pubic investment or subsidies to corporations involved in those activities. Analysts therefore need to study the fiscal policies and identify the applicable assistance or support by governments to the corporations under review.

Natural Resources

Natural resources, as the third core element of our economy, refer to the contribution by land and basic raw material commodities. Land and other natural resources may have various degrees of impacts on different corporations, such as a land developer's financial performance predominately depends on the price of land, whereas the financial

performance of an e-commerce business may largely depend on labour costs rather than land prices.

Land and natural resources may not appear falling into the ambit of financial analysis, but a brief understanding of how they interact with the corporation under review is necessary. The economic impact of land on corporations and the economy as a whole are well documented in economics and surveying textbooks, and we focus our discussion in the subsequent paragraphs on natural resources. Commodities extracted from natural resources form our life's basic necessities that are used in manufacturing just about everything that is consumed every day. Accordingly, the demand and supply of commodities have substantial influences on corporations and economies.

Commodities are often regarded as a shield against unexpected rises in inflation, and may be categorized into three groups as follows:

- agriculture (e.g. rice, wheat, corn, beef, coffee, cocoa and cotton);
- energy (e.g. oil, natural gas, heating/fuel oil and gasoline, as well as alternative energy sources such as uranium and solar power); and
- metals (e.g. base metals of aluminium, tin, iron ore, lead, copper and zinc, as well as precious metals of gold, silver and platinum).

Demand across all commodities has been rising over time. Both newly industrialized and developed economies are fuelling a rising demand, particularly for energy commodities. Agricultural commodities have a benefit of being a natural hedge against event risks, such as climate change, geo-political events and extreme weather. Supply of commodities is constrained by the world's limited natural reserves. Climate change, severe weather patterns and unforeseen environmental disasters around the globe have a further impact upon commodity supplies. Energy prices are volatile due to increasing geo-political risk, e.g. a significant proportion of oil supplies are extracted in some politically unstable countries.

There are alternative energies such as renewable energy sources which create less environmental damage and pollution than fossil fuels, and offer an alternative to non-renewable resources, such as solar, wind, tides, waves, biomass and geothermal heat. The emission of greenhouse gases, primarily CO_2, is a major contributory factor towards global warming. Many developed countries have pledged to reduce CO_2 emissions in the

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upcoming decades. Accordingly, analysts may check the carbon footprints of corporations and look for those which can capture the opportunities presented by these regulatory changes. However, massive investments are required in research and development (R&D) in an effort to conform to the tougher emission rules and regulations, e.g. hybrid electric vehicles have the potential to reduce CO_2 emissions by up to 50% as compared with today's automobile engines. A reduction in CO_2 emissions can also be achieved by a more efficient use of energy in the design, production and employment of lighting, electronic and computer products as well as construction materials and techniques.

Industry Analysis

An industry consists of corporations selling products or services that are competing with each other and may be featured in terms of the number of sellers and the extent of differentiation in products or services, such as:

- monopoly, which is regarded as an extreme and possibly unrealistic scenario consisting of a single seller in the industry;
- oligopoly, which is regarded as an industry consisting of a few large corporations;
- monopolistic competition, which refers to numerous sellers offering differentiated products or services; and
- pure competition, which is regarded as extreme and possibly unrealistic in which differentiation is absent and the same prices are charged by all sellers in the industry.

Another way to characterize an industry is by reference to its entry, exit and mobility barriers as follows:

- entry barriers, which refer to the requirements of capital investment, economies of scales, licences, raw materials, locations and distribution channels for entering into the industry;
- exit barriers, which are regarded as to the legal and moral obligations, regulatory restrictions, high vertical integration and low residual value of assets in the event of withdrawing from the industry; and
- mobility barriers, which refer to the restrictions of movements within an industry distinguishing it from others.

In general, high entry barriers, high mobility barriers and low exit barriers often result in an industry with higher profitability. There are other ways to characterize an industry, such as the industry growth rate, the cost structure, the degree of automation in production process and the degree of vertical integration.

For the purpose of industry analysis, analysts look into a particular industry and its surrounding factors by using techniques such as:

- SWOT Analysis;
- Competitive Forces Analysis; and
- Market Analysis / Customer Profiling.

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SWOT Analysis

SWOT Analysis is a process of scanning a corporation's internal and external factors. Internal factors can be classified as strengths (S) or weaknesses (W), and those external to the corporation can be classified as opportunities (O) or threats (T). Analysts may use SWOT Analysis as a way of summarizing the corporation's current and future positions. SWOT Analysis in a tabular format helps matching the corporation's resources and capabilities to the competitive environment in which it operates. An example of SWOT Analysis is set out in Table 10.1.

Table 10.1 An example of SWOT Analysis

Strengths	Weaknesses
• economies of scale • strategic location • access to natural resources • patents or strong brand name	• poor location • high-cost structure • weak distribution channels • lack of patent protection or weak brand name
Opportunities	**Threats**
• emerging new markets • unfulfilled demands • new technologies • loosening of rules or regulations	• price war • new regulations • new competitors • new taxation

According to Table 10.1 and as part of the identified strengths, a corporation's economies of scale can provide a low cost base and financial muscles in combating against the threats of price war or new competitors. A strategically good location can help to gain from pro-business legislation