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APERCU

CONTENTS

BE ON THE LOOKOUT FOR RELATED PARTY DISCLOSURES AND BUSINESS COMBINATIONS

To facilitate interpretation of financial statements, ***Frank Lam, Director of Assurance Services of BDO*** will look into two hot topics in financial reporting, namely related party disclosures and business combinations.

It isn't always easy to read the financial statements of listed companies, let alone grasp effectively the substance and context of the numbers and lengthy disclosures they contain. One thing I feel sure of is that more disclosures will appear in financial statements in the future, in order to meet the market's expectations and enhance their transparency. Yet these may create even greater difficulties for non-accountant readers. Analysts and financial reporters sometimes complain to me that understanding financial information is becoming ever more problematic.

To tackle the problems about reading financial statements and thus prepare ourselves better for the next peak financial reporting season, let's discuss two of the hottest current topics about financial reporting: related party disclosures and business combinations.

Related party disclosures

Readers often confuse related party transactions with connected transactions. Many think they are the same, but actually they are not. 'Connected transactions' are defined and regulated under the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited or the Rules Governing the Listing of Securities on the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited as applicable, whereas 'related party transactions' come under the Hong Kong Financial Reporting Standards (HKFRSs). There is one more difference: related party transactions are disclosed in a note to the financial statements of an annual report, whereas connected transactions are disclosed in an annual report but usually outside the financial statements. That is why readers should study both sections in order to fully understand both types of transactions.

A listed issuer is required to disclose certain information when it has transactions with its related parties, including the nature of their relationship, information about their transactions, outstanding balances and commitments. This is necessary for readers to understand the potential impact of the relationship on the financial statements. The definition of related parties is set out in Hong Kong Accounting Standard (HKAS) 24, 'Related Party Disclosures'.

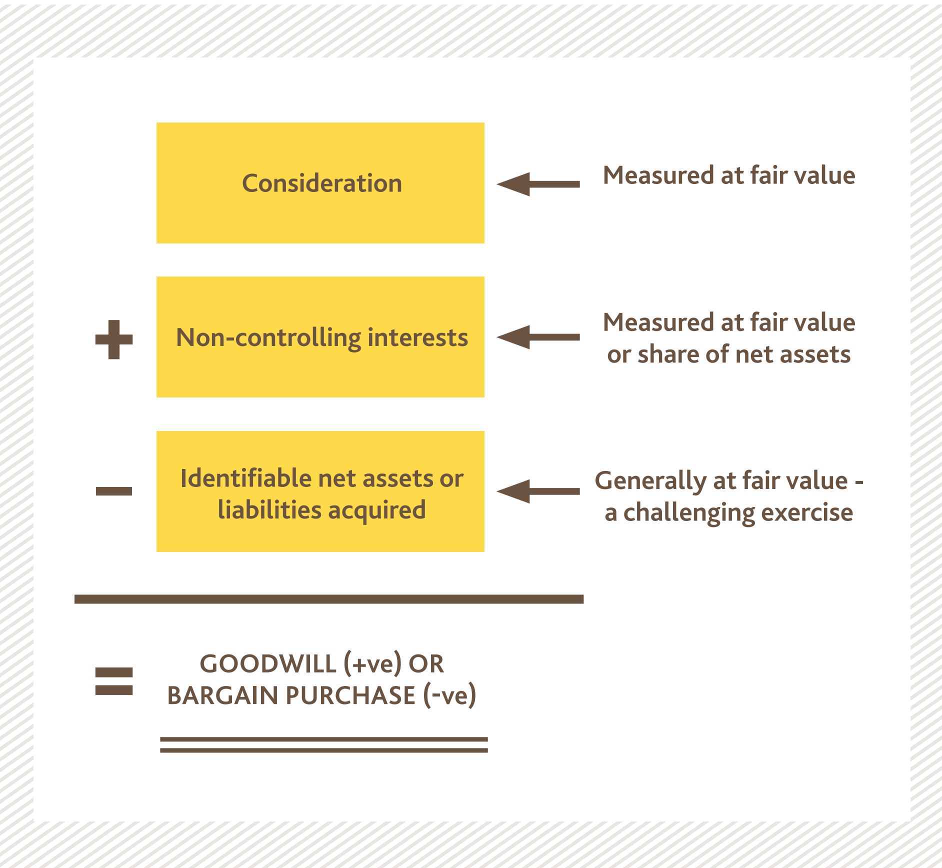
The following are examples of the types of transactions that are disclosed if they are with a related party:

(a) purchases or sales of goods (finished or unfinished);
(b) purchases or sales of property and other assets;
(c) rendering or receiving of services;
(d) leases;
(e) transfers of research and development;
(f) transfers under licence agreements;
(g) transfers under finance arrangements (including loans and equity contributions in cash or in kind);
(h) provision of guarantees or collateral;
(i) commitments to do something if a particular event occurs or does not occur in the future, including executory contracts (recognised and unrecognised); and
(j) settlement of liabilities on behalf of the entity or by the entity on behalf of that related party.

Business combinations

Business combinations may be the hottest topic in the media. Stories about acquisitions are always very interesting and attractive to investors as well as the general public. As a world-class financial centre, Hong Kong has quite a number of listed companies that seek to expand their operations and market shares by tapping the capital market in order to acquire new businesses. Accounting matters relating to such acquisitions are dealt with under HKFRS 3 'Business Combinations'. To understand the accounting implication arising from business combinations more fully, we should be aware of the formula in table 1 that is widely used in accounting for business combinations:

Table 1



The formula shown in table 1 has only four components and seems uncomplicated. However the devil is in the detail. So let's look at these four components in greater depth:

(a) Consideration

According to HKFRS 3, the consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirers to former owners of the acquiree and the equity interests issued by the acquirer. If the consideration is paid in cash or a cash equivalent, measuring the consideration is straightforward. But on many occasions, listed companies would pay the consideration in other forms, such as other assets, a business, or a subsidiary of the acquirer, contingent consideration, ordinary or preference equity instruments, options or warrants. In such cases, the acquisition date is very important, because the consideration should be measured at fair value as of that date.

The acquisition date is defined in HKFRS 3 as the date on which the acquirer obtains control of the acquiree, generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes liabilities for them – in other words, the closing date. However, the acquirer might occasionally obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date can precede the closing date if a written agreement provides for the acquirer to obtain control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

(b) Non-controlling interests

A non-controlling interest is defined in HKFRS 3 as the equity in a subsidiary not attributable, directly or indirectly, to a parent. For instance, if an acquirer purchases a 60% equity interest in an entity and thus obtains control over it, the related non-controlling interest should be the remaining 40% equity interest that is attributable to other investors.

Measurement of a non-controlling interest upon the acquisition date in a business combination is also governed under HKFRS 3. A non-controlling interest in an acquiree that is present ownership interest and entitles to a proportionate share of the entity's net assets in the event of liquidation is measured at either fair value or the non-controlling interests' proportionate share in the recognised amounts of the acquiree's net identifiable assets. All the other components of a non-controlling interest shall be measured at its acquisition-date fair value, unless another measurement basis is required by HKFRSs.

Similar to (a) above, determining the acquisition date is a crucial element in determining the initial recognition of non-controlling interests in a business combination. Moreover, HKFRS 3 also allows the acquirer to select the basis for the measurement of the non-controlling interests that are present ownership interests and entitle to a proportionate share of the entity's net assets in the event of liquidation at either fair value **or** the non-controlling interests' proportionate share in the recognised amounts of the acquiree's net identifiable assets. This is at the acquirer's discretion. Such a selection can provide quite different results from an accounting perspective, as shown in table 2.

Table 2 shows that the goodwill recognised on the same acquisition can differ by $30 million, solely because a different measurement method was chosen for the non-controlling interests upon initial recognition. Moreover, it is worth pointing out that HKFRS 3 also allows the issuer to select the method for measuring the qualifying non-controlling interests on a transaction-by-transaction basis.

Table 2

The impact on goodwill when non-controlling interests (NCI) are measured at fair value or share of net assets acquired.

Background

- Consideration for the acquisition : $800 million (m)
- 80% of shares acquired with the remaining 20% being NCI
- Net assets acquired: $750 m
- Fair value of NCI: $180 m

	NCI at fair value	NCI at share of net assets
Consideration	$800m	$800m
NCI	↑ $180m	$150m* ↓
Net assets acquired	$(750m)	$(750m)
Goodwill	↑ $230m	$200m ↓

* Being 20% of net assets acquired of $750m

(c) Identifiable net assets or liabilities acquired

Yes, this is 'challenging' – as mentioned in table 1.

Like components (a) and (b) of the formula, identifiable assets acquired and liabilities assumed as part of a business combination are usually measured at acquisition-date fair value.

While it is not difficult for readers of financial statements to understand that assets and liabilities of and recorded by the acquiree should form part of the identifiable net assets or liabilities acquired, readers should appreciate that the acquirer's application of this recognition principle and conditions may result in the recognition of some assets and liabilities that the acquiree had not previously recognised in its financial statements. Sounds amazing, doesn't it? Actually, it is due to the different perspectives of the acquirer and acquiree. For example, the acquirer may recognise the acquiree's identifiable intangible assets, such as a brand name, patent or customer relationship. The acquiree did not recognise these as assets in its own financial statements because they were developed internally by the acquiree, which charged the related costs to expenses in its financial statements. Therefore, no such 'assets' appear in the financial statements of the acquiree. Many (if not all) acquisitions give rise to the recognition of different intangible assets; so let's take a closer look at how these are recognised when an acquisition takes place.

An intangible asset is an identifiable non-monetary asset without physical substance. Although matters relating to accounting for intangible assets are dealt with in HKAS 38 'Intangible Assets', intangible assets are recognised in many acquisitions. The acquirers are normally assumed to be well aware of the commercial values of the acquisition targets when the acquirers make the offers, and these should be the starting points for the acquirers to identify the intangible assets of the acquirees. Nevertheless, in real situations, it is sometimes challenging for the management of the acquirers to identify, effectively and accurately, **all** the intangible assets of the acquirees, particularly those the acquirees did not previously recognise at all. The directors of the acquirers should fully understand the business and the relationships of the acquirees and carefully find out all its 'hidden' intangible assets. This can be achieved through a detailed due diligence exercise on the acquiree before completion of the acquisition. Sometimes, professionals – such as valuers, legal counsels and financial advisors – are appointed to assist the acquirers in this aspect.

(d) Goodwill or bargain purchase

The closing balance of the formula may give rise to a positive figure (ie goodwill, which is an asset on the financial statements of the acquirer) or a negative figure (ie a gain from a bargain purchase, which is the resulting gain recognised in the profit or loss on the acquisition date. This gain shall be attributed to the acquirer). Before recognising a gain on a bargain purchase, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed, and it shall recognise any additional assets or liabilities that are identified by that review. The acquirer shall then review the procedures used to measure the amounts for the components that HKFRS 3 requires to be recognised at the acquisition date, including (a), (b) and (c) above. The review's objective is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date.

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BDO EXECUTIVE FORUM

Staying at the forefront of ever-changing markets


BDO

BDO EXECUTIVE FORUM

Staying at the forefront of ever-changing markets

Monday, 16 July 2012

ABOUT THIS EXECUTIVE FORUM

In today's dynamic economic environment, business executives are confronted with challenges in view of growing expectations for good corporate governance as well as increasing demand for clear and thorough valuation of business assets and liabilities especially in case of financial transactions. BDO is organising this half day forum to share our knowledge and bring insight on the topics of **corporate governance and valuation of transactions** to help executives stay at the forefront of ever-changing markets.

BDO Director and Head of Risk Advisory Services Patrick Rozario will discuss the latest corporate governance requirements and guidance, which were revised by Hong Kong Stock Exchange and Clearing Limited in late 2010 and took effect in January 2012.

BDO Principal of Specialist Advisory Services Paul Williams will explain the standard valuation methodologies applied in transactions, with an overview of intangible asset valuations and how utilised in purchase price allocation exercises on completion of a transaction.

Date:	Monday, 16 July 2012
Time:	8:30am - 9:00am (Registration) 9:00am - 12:30pm (Forum session)
Venue:	CPA Australia 20/F Tai Yau Building 181 Johnston Road Wanchai, Hong Kong
Language:	English
Fee:	HK$200

TOPIC HIGHLIGHTS

- Corporate governance latest updates
  - Hong Kong corporate governance practices
  - Latest corporate governance requirements
  - Insights into the latest corporate governance trends and practices in the current economic environment
  - Corporate social responsibility highlights
  - The state and the level of compliance with corporate governance in Hong Kong
- Valuation of transactions
  - Valuation purpose and timing
  - Valuation methodologies involving income, market and asset-based valuation techniques
  - An overview of intangible asset valuations and the application in purchase price allocations

The sixth BDO Executive Forum will be held on Monday, 16 July 2012 at CPA Australia, 20/F Tai Yau Building, 181 Johnston Road, Wanchai, Hong Kong. This biannual event aims to provide clients and contacts with up-to-date information about financial reporting standards, corporate governance and finance.

In this session, two experienced speakers from BDO will share their knowledge and bring insight on the topics of **corporate governance and valuation of transactions** to help executives stay at the forefront of ever-changing markets.

BDO Director and Head of Risk Advisory Services Patrick Rozario will discuss the latest corporate governance requirements and guidance, which were revised by Hong Kong Stock Exchange and Clearing Limited in late 2010 and took effect in January 2012.

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Topic highlights

Corporate governance latest updates

- Hong Kong corporate governance practices
- Latest corporate governance requirements
- Insights into the latest corporate governance trends and practices in the current economic environment
- Corporate social responsibility highlights
- The state and the level of compliance with corporate governance in Hong Kong

Valuation of transactions

- Valuation purpose and timing
- Valuation methodologies involving income, market and asset-based valuation techniques
- An overview of intangible asset valuations and the application in purchase price allocations

For more details and registration, please visit BDO's website at www.bdo.com.hk

BDO EXECUTIVE FORUM

Date: Monday, 16 July 2012
Venue: CPA Australia, 20/F Tai Yau Building, 181 Johnston Road, Wanchai
Language: English
Fee: HK$200

08:30-09:00	Registration & tea/coffee
09:00-09:10	Welcoming remarks
09:10-11:00	CORPORATE GOVERNANCE LATEST UPDATES Patrick Rozario, Director and Head of Risk Advisory Services, BDO
11:00-11:30	Coffee break
11:30-12:20	TRANSACTION VALUATION TECHNIQUES Paul Williams, Principal of Specialist Advisory Services, BDO
12:20-12:30	Closing remarks
12:30	End of forum

SHAREHOLDER DISPUTES

Disputes are an unavoidable fact of human life. People will often disagree with one another because of different opinions or perceptions. While some ideologues may argue that disputes help generate fresh ideas, in most cases they destroy harmony, create tension and ultimately cause relationships to break down. That is a tragic but realistic description of where disputes can lead if no remedial measures are taken quickly to resolve them.

A company is only a legal person that is owned by its shareholders. It cannot get into a dispute with itself, but its shareholders can dispute among themselves. Nowadays, shareholder disputes often end up in a courtroom, where the litigants have to take the witness stand, give evidence and reveal a company's 'confidential' matters to the public. This can lead to personal humiliation and the failure of a business, neither of which is a desirable outcome. Once a dispute materialises, the best course of action is to manage it sensibly. This article aims to provide some observations about the factors surrounding shareholder disputes, as well as some simple and practical ways to mitigate or resolve them.

Causes of disputes

If we wish to analyse and identify the causes of shareholder disputes, we need to have some insights about human nature. From ancient times to the present day, people have been fighting over wealth, power and passion. While wealth and power are the most obvious causes of disputes, passion should not be overlooked. When a couple jointly own a family asset, that ownership is often served by the establishment of a corporate entity. Disputes between husbands and wives about company matters can become very heated if their relationship turns sour. Such dispute may be regarded as a kind of matrimonial disagreement. However, the possible remedy under ancillary relief during matrimonial proceedings is limited. So most aspects of such a dispute will need to be resolved under the company law regime.

Going one level further, wealth, power and passion are just the outer shell of the causes of disputes. People are unhappy if their wealth and power seem to be jeopardised. At the heart of such perceptions is the idea of fairness – the antithesis of inequity and the embodiment of equality. It goes without saying that everyone longs for equality. If a shareholder perceives some form of inequity in any matter, the first and most important element of a dispute is already present.

The most common type of shareholder dispute is triggered by a disparity in profit distributions. In essence, that does not refer to actual dividends declared to shareholders. Those are governed by the shareholding structure. A practical example of such a disparity would be if the pre-distribution profits were skewed towards the benefit of one group of shareholders, by way of management compensation such as salaries or other remuneration packages. Such arrangements might be seen by the 'disadvantaged' parties as mechanisms to syphon off significant portions of the economic benefits a company has generated, instead of fairly distributing them to all its shareholders. Another common complaint is when the management camp of shareholders gains unequal benefits by setting up related-party transactions and not trading at arm's length. Overpaying related suppliers and undercharging related customers will definitely affect a company's results, as its partners in the transaction will benefit from the price differentials.

Other than monetary issues, management authority is also a common cause of disputes. Unsurprisingly, such power is seen as an important component in an organisation. A shareholder who also plays a role in the company's daily management may choose to deny other shareholders access to information or fail to provide meaningful responses to their questions. That is usually construed as a hostile act. The 'victims' of such behaviour may perceive it to be a disparity of power and seeks ways to eliminate it. Power disparity can also come about as the result of who occupies certain key positions in the company. Finance and marketing are usually regarded as core functions that possess important information. If one group of shareholders (or its allies) occupies crucial roles in those departments for lengthy periods of time, it could easily create friction with other shareholders.

Types of disputes

It is also worth noting the common types of shareholder disputes. Although disputes between business partners are seen to be the most widespread, those between family members can sometimes turn out to be the fiercest. Of course, that includes disputes between shareholders who are married to each other.

Disputes between business partners are normally the result of disagreements about strategy, although they can also arise from different interpretations of a shareholders' agreement. Strategy disagreements can be about the direction a business is taking, the use of funds, expansion in the market, etc. Frankly speaking, such issues are likely to be profit-driven rather than emotional. Shareholder agreement disputes generally materialise as the result of a critical incident that has caused the parties to refer to the contractual agreements they previously entered into. They are primarily disputes about legal terminology.

Disputes between family members are a different kettle of fish. They are less formal or legal, and more relational and emotional. In addition to disputes between a married couple, disputes about inheritances are common. Wrangles over the next generation's succession after a senior family member who has been a company's figurehead retires can cause enormous problems. When you read about various court cases, it is often easy to identify instances where different members of the family have totally opposite management and business styles. Like their familial relationship, their shareholder status is not a matter of choice. They cannot cooperate effectively with each other when significant issues arise; instead, matters become more and more heated. Finding a practical way to resolve their differences under such circumstances is often difficult.

Disputes in action

Besides theoretical analysis and general observations, one must not overlook the practical side of the coin. Disputes can be logically divided into three categories: (i) one-on-one; (ii) one-to-many; and (iii) many-to-many. Their meanings can easily be deduced from their names. One-on-one disputes are the simplest type, but unfortunately they are often the toughest to deal with. They usually have intense emotional undercurrents. If two parties have equal equity and equal representation on a company board, it can result in complete deadlock.

One-to-many disputes normally occur when a minority shareholder raises a complaint that he/she is being oppressed and that his/her equity interest is being jeopardised. The complainant generally demands monetary compensation or wants the majority shareholder to buy out his/her equity.

Many-to-many disputes may involve complex shareholding structures and unusual circumstances that lead to a major dispute. They can be extremely complicated. Nevertheless, the fact that a number of parties are involved may mean there is actually more room for negotiation than in the other two types of disputes.

Consequences of shareholder disputes

Some may consider a courtroom to be the most appropriate place to resolve disputes. While that may be true in a legal sense, in practical terms, legal proceedings can bring about undesirable and unpleasant consequences. The parties involved should always bear in mind that legal proceedings not only consume money and time, they also entail stress and psychological discomfort. They require a lot of documentary evidence and/or witness testimony. This will definitely disturb the operations of the business concerned, and it may undermine its efficiency and morale. The firm's financial performance is likely to be seriously affected too.

Another obvious side effect of dispute proceedings on a company is the loss of its trading partners' confidence. That is obvious and understandable. Customers will worry whether the company will be able to deliver the products they have ordered. Vendors will be concerned about whether the company can pay their invoices. It is unwise to assume that business disputes and friction are private and confidential issues between the parties concerned, and that outsiders will remain unaware of them. In reality, every staff member in the company has the potential to communicate these matters to other people. Experience shows that few customers and suppliers will be willing to continue trading on the existing terms once they find out there is a dispute within their trading partner. Most likely, business will decline, sometimes to the extent where there will be serious doubts about a company's continued viability.

Suggestions and remedies

As your family doctor always tells you: precaution is better than cure. To a certain extent, that also applies to managing shareholder relationships. While it is true to say that no shareholder agreement can be perfect, having one is better than having none. In-depth discussion and participation are the keys to making a shareholder agreement a good reflection of the shareholders' intentions. A good shareholder agreement should be tailor-made and not standardised. It needs not be written in Shakespearean English, but it should take into consideration and deal with all the potential scenarios that the shareholders might face. It should at least cover management authority, representation, responsibility, remuneration and commission, as well as competition clauses, dividend policies, fundraising rules and equity disposal procedures. If a company is formed for a specific purpose, the unique circumstances surrounding the cooperative partnership should be properly and unambiguously addressed in the agreement. A well-written shareholder agreement can help reduce the likelihood of shareholder disputes.

Of course, we must accept that disputes can still occur, despite every reasonable precaution. The disputing parties should try to remain calm if that happens. Rational and sensible behaviour is a crucial factor in mitigating the fallout it might cause. Forceful attitudes and responses just add fuel to the fire, and they do not help matters. A cooling-down period is definitely a useful way to identify and seek common ground for negotiation. Aside from their dispute, the shareholders involved have common interests. Disputes are painful in the short term, but shareholders would be unwise to prolong the agony, which can eventually cause them serious financial damage.

Disputing parties should also seek proper legal advice at the first sign of trouble, not for the purpose of launching hostile actions against their partners but as a form of self-protection and a precautionary measure. Some actions taken during the daily management of a business may have prejudicial repercussions if legal proceedings later become inevitable. These can often be avoided with legal advice. Conversely, if a shareholder considers himself or herself to be unfairly treated, he or she may need to substantiate this allegation with adequate evidence. Proper legal advice can also place you on a firmer and more advantageous foundation during negotiations. Nevertheless, one should bear in mind that it might not be a good idea to let your opponents know that you are consulting a lawyer too early in the game. Doing so may have an adverse effect, and a legal confrontation should be regarded only as a last resort.

My final piece of advice is to separate your emotions from the subject of a shareholders' dispute. That may not be easy, but it is usually the best way to resolve a dispute. One must recognise that the law is different from morality. Shareholder disputes have their roots in company issues, and they are primarily legal matters. Morality is morality, and it cannot replace the law when dealing with corporate disagreements. If something is immoral, that does not necessarily make it illegal. Putting your faith in your emotions and moral justice can ultimately turn out to be an expensive way of dealing with a shareholder dispute, and it can cause a lot of regret. The best way to handle a dispute is always to seek the best possible outcome. Then put it behind you and look to the future with confidence and a smile.

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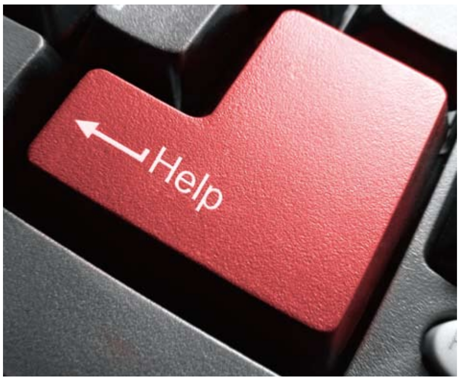


BDO RECENT ACHIEVEMENTS

1. Three awards from International Accounting Bulletin

BDO won three prestigious prizes at the inaugural International Accounting Bulletin (IAB) Awards on 8 March 2012. BDO International was named **Tax Adviser of the Year**; Trond-Morten Lindberg, managing partner of BDO Norway, was selected as **Young Accountant of the Year**; and Jeremy Newman, CEO of BDO International until September 2011, received the accolade **IAB Personality of the Year**.

Tax Adviser of the Year

In its citation, IAB said that BDO's co-ordinated, cross-border approach to tax planning had helped a major IT client identify and resolve tax risks and maximise its tax position in 60 countries. Moreover, the firm had advised on European VAT, Enterprise Resource Planning systems, R&D credits and transfer pricing – a full suite of tax services spanning the entire BDO network.

Young Accountant of the Year - Trond-Morten Lindberg

2. Two awards from Managing Partners' Forum

BDO LLP in the UK gained the top spot in two categories at the 2012 Managing Partners' Forum European Leadership Awards on 1 March 2012. These were the **Best Innovation in Client Service** and **Best Collaboration across International Frontiers awards**.

The former went to BDO UK in recognition of its clear business strategy, which is based on empowering people to deliver exceptional client service. The firm's global outsourcing team won the latter for co-ordinating in the UK and delivering in 122 countries statutory compliance for one of its largest clients, SITA, an airline technology company.

BDO UK was the only accounting firm to win two Managing Partners' Forum awards. It was also runner-up in the Best Strategic Leadership category and it appeared on the shortlist for the Best Performing Accountancy Brand Award.

BDO CONTINUES TO SUPPORT THE CHAMBER OF HONG KONG LISTED COMPANIES (CHKLC) DIRECTOR TRAINING SERIES FOR SECOND CONSECUTIVE YEAR

The CHKLC Director Training Series for 2012 is receiving BDO's support for the second consecutive year. Running from May to November, the six seminars are designed with common issues faced by directors in mind. They are equipping participants with relevant information and up-to-date knowledge about directorship, and helping them discharge their duties effectively.

BDO Directors Patrick Rozario and Kenneth Yeo, Principal Paul Williams and Managers Eric Zegarra and Vivian Chow will be among the speakers on important aspects of directorship in listed companies during the Series.

The first session, on 'Effective running of the board' by Dr Lewis Luk, senior associate of PC Woo & Co, took place at BDO's premises on 24 May 2012.

The second session, on the topic of 'Latest listing and related rules updates', was conducted by Vincent Kwan, a Consultant at Messrs Gallant YT Ho & Co, on 19 June 2012.

The schedule and topics for the other sessions are shown in table 1.

Table 1

Date	Topic
19 Jul 2012	Overview of corporate governance and its applications
13 Sep 2012	How to manage risks and effective internal control
18 Oct 2012	Managing director's responsibilities and liabilities
22 Nov 2012	Valuation of transaction and latest financial reporting standards

If you are interested in attending them, please enrol directly with the CHKLC. For more information, visit its website: www.chklc.org

香港上市公司商會
CHKLC THE CHAMBER OF HONG KONG LISTED COMPANIES

CHKLC DIRECTOR TRAINING SERIES 2012

A six-part training programme aiming at supporting directorship in Hong Kong

(Total 12 CPT Hours)

Programme Partner: BDO Limited BDO

Dates: 24 May 2012 | 19 June 2012 | 19 July 2012 | 13 September 2012 | 18 October 2012 | 22 November 2012

Company directors play a pivotal role in company success. With the increasing demand of corporate governance of listed companies both from the regulators and shareholders, coupled with the tightening of various sets of rules and regulations with more serious consequences, company directors operate in an increasingly challenging environment. In view of this, the Chamber of Hong Kong Listed Companies is launching a training programme for company directors for the second year. Designed with the common issues faced by directors in mind, the programme will equip directors with the most relevant information and updated knowledge about directorship and will help them discharge their duties effectively.

The whole programme comprises six seminars dealing with the important aspects of directorship for a listed company. These range from board effectiveness, corporate governance, internal control and risk management, valuation to rules updates. Experienced professionals as well as directors from listed companies will act as speakers to share their knowledge and first-hand experience, ensuring the practical value of this training programme. Attending this training series will fulfill the latest training requirements under the recently revised Code of Corporate Governance by the HKEx.

The Chamber is pleased to partner with BDO in offering this programme whose involvement ensures the relevance of the topics covered and adds depth to the discussion.

Time: 4:00 pm Registration
4:30 – 6:30 pm Course Session (2 CPT hours per session)
Venue: BDO Limited
25/F, Wing On Centre, 111 Connaught Road Central, Hong Kong
Language: English

REGISTRATION

	Full Course	Per Session
Members / BDO Clients & Contacts	HK$2,100	HK$420
Non-members	HK$2,750	HK$520

Enquiry: CHKLC Secretariat ☎ (852)2970 0886 (852)2970 0555 @ info@chklc.org
Online Registration: http://www.chklc.org/web/eng/events.htm

SPOTLIGHT: CHINA'S PHARMACEUTICAL INDUSTRY

Industry overview

China's pharmaceutical industry became the world's third largest in 2011, from a ranking of eight in 2006. According to IMS Health[1], China's pharmaceutical industry grew at a compound annual growth rate (CAGR) of 21.9% between 2002 and 2010 (see table 1). This fast growth has largely been the result of the booming domestic economy and aging population.

At 4.7% of GDP, China's health expenditure remains relatively low compared to other major economies. However, the government's recent RMB 850 billion[1] healthcare package will raise this figure to 5.5% of GDP. This is being supported by the comprehensive healthcare reforms of 2009, which emphasised modernising hospitals, basic healthcare and insurance coverage[2]. The below graph shows the industry's annual turnover is expected to grow from RMB 1,200 billion in 2010 to around RMB 3,000 billion by 2015. Pharmaceutical manufacturing will receive a big boost from increased government spending, as well as being supported by tax and R&D incentives and other government initiatives, such as preferential pricing for R&D-based companies.

Challenges

The Chinese pharmaceutical market is highly fragmented, which has resulted in inefficiency and a lack of innovation. 70% of the market is dominated by non-branded generic domestic pharmaceutical products, made with simple technology and production methods. Many of those products are very similar, which has led to overproduction. Consequently, many smaller domestic companies are finding it difficult to remain profitable. The top ten companies control only 20% of the market, a figure that is closer to 50% in most developed countries. A summary of the top ten listed pharmaceutical companies in China by market capitalisation is shown in table 2.

An increasing number of technologically advanced multinationals (MNCs) are attempting to strengthen their presence in the industry. Whereas domestic companies focus on non-branded generics, the MNCs are concentrating on higher-end products, such as medicine, research and distribution. However, they are finding it difficult to match the regional knowledge and low prices of domestic companies.

Price-control measures are in place to ensure that the cost of drugs does not rise too fast. Around 60% of pharmaceuticals in China are currently sold at regulated prices[3].

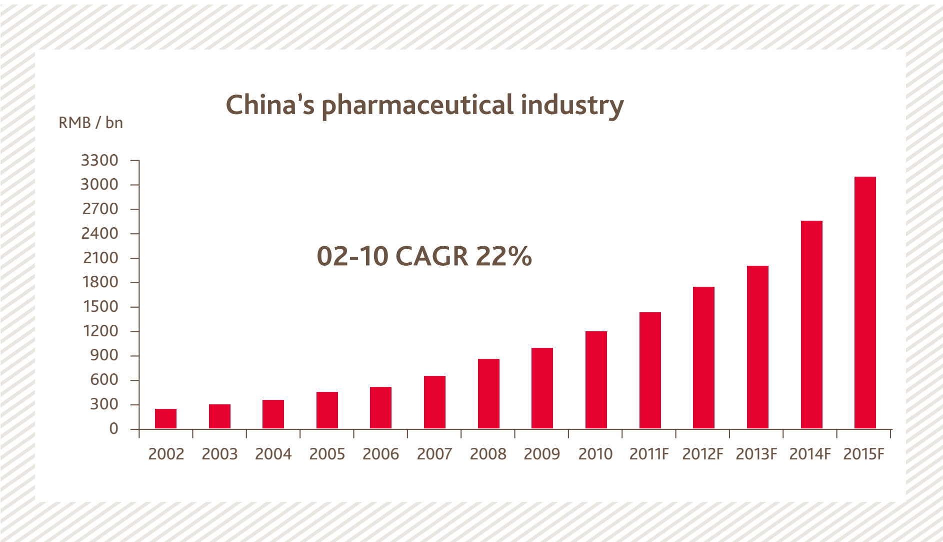
Going forward

China is taking steps forward to improve the quality of its domestic products. The 12th 5-Year Plan (5YP) was recently implemented and it included increased emphasis on quality over quantity in the healthcare sector.

The following key areas are currently being transformed:

- Good Manufacturing Practice (GMP) for drugs was promulgated by the State Food and Drug Administration (SFDA)[4] on 1 March 2010. According to the Hong Kong Trade Development Council, 'GMP is a basic requirement in drug production and quality control. It aims to lower such risks as contamination and mishandling in the process of drug production.' The SFDA hopes this will increase innovation and development strategies in the large number of manufacturers, thus raising the quality of their products and helping them to compete with foreign companies.

Table 1



Source: CEIC, Sinopac Securities

Table 2

Company name	Market capital	Growth in revenue (%)	Growth in EPS (%)	P/E
	RMB billion			
Yunnan Baiyao Group Co Ltd	36.1	13	31	28
Sinopharm Holding Co Ltd	35.3	48	25	22
Jiangsu Hengrui Medicine Co Ltd	31.5	22	21	34
Shanghai Pharmaceuticals Holding Co Ltd	29.6	42	15	11
Guangdong Kangmei Pharmaceutical Co Ltd	27.1	84	10	23
Shan Dong-E-E-Jiao Co Ltd	25.4	12	47	28
Sichuan Kelun Pharmaceutical Co Ltd	21.4	28	31	22
Shanghai Fosun Pharmaceutical (Group)	19.1	42	33	15
Beijing Tongrentang Co Ltd	19.3	24	29	41
Tasly Pharmaceutical Group Co Ltd	19.2	41	28	32

Source: Bloomberg, May 2012

- To reduce the fragmentation in the market, the government intends to create mega-pharmaceutical groups that will reduce over-production and raise the quality of goods.
- The number of retail chain pharmacies will be increased to improve the link between regional and national healthcare. That will also help improve the provision of pharmaceuticals in rural areas, where there is increasing demand for them. This trend is being reinforced by the recent convergence between the government's rural and urban healthcare spending, from a ratio of around 30:70 in 2005 to 40:60 in 2010[5].
- The government is continuing to increase its spending on drug R&D. This is reflected by the 26.5% annual growth rate in R&D between 2000 and 2007 under the 10th and 11th 5YPs[6]:
- Larger Chinese companies are now looking to expand abroad as part of their global strategy.

Potential sub-sectors for investment

The industry consists of four main sub-sectors, namely over-the-counter (OTC) drugs, traditional Chinese medicine (TCM), prescription drugs and medical devices. The OTC market currently remains the largest of these. However, the TCM and prescription drugs sub-sectors are growing the fastest, making them potentially the most attractive sub-sectors in which to invest.

TCM

China is one of the few countries where TCM is integrated within the healthcare system. China's reliance on TCM products is a major factor that differentiates its drugs market from those in western countries. Nearly one-fourth of all China's drug companies produce TCM products and the TCM market accounts for 22% of China's pharmaceutical industry by output value[7]. In 2009, China spent RMB 10.97 billion on TCM, an increase of 165% on the 2005 figure[8]. TCM is growing in popularity, and the government intends to modernise this sub-sector[9], especially in terms of TCM hospitals, R&D processes and structures.

Prescription drugs

China's prescription drug market is set to become the world's second largest by 2020. It is forecast to be worth more than RMB 695 billion by 2015, up from RMB 316 billion in 2010, according to various industry researchers[10]. Such growth can be attributed to the rise of China's middle class, combined with the government's increased commitment to invest. There is huge demand for advances in prescription drugs for chronic illnesses like cardiovascular diseases, diabetes and cancer, which in aggregate now account for the majority of all deaths in China.

Outlook

The rapid growth and potential of the Chinese pharmaceutical market plus the government's initiatives to reduce the number of smaller players will result in continued consolidation and M&A activity in this sector.

Due to the current price controls, investors should consider sub-sectors that are less affected by such controls and which align with the government's focus on innovation and drug R&D. The industry's modernisation will take time, but it will allow China to become an innovative pharmaceutical manufacturer with global brands and pricing power.

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HKEx ENHANCES CORPORATE GOVERNANCE CODE AND RELATED LISTING RULES

HKEx first introduced the Code on Corporate Governance Practices (the Code) and related Listing Rules in January 2005. No major enhancements were made to the Code until this year, when some long-overdue revisions to the Rules took effect on 1 January 2012, and an enhanced version of the Code itself and other related Rules took effect on 1 April 2012.

The changes aim to increase the accountability of issuers and directors, as well as the transparency, quality and effectiveness of corporate governance. HKEx took some years to make these enhancements to the Code, probably due to its concern about their acceptance by issuers during the period of economic instability and volatility that has prevailed in recent years. Some Code Provisions have now been elevated to Rules, and many Recommended Best Practices have been upgraded to Code Provisions. New Recommended Best Practices have also been introduced. While issuers are required to abide by the Rules, they continue to have flexibility about complying with the Provisions. If issuers decide they cannot or prefer not to adopt a Provision, they must explain the reasons in their corporate governance reports. Issuers are encouraged to adopt Best Practices, but they are not required to state whether they have done so. HKEx has merged Appendix 23 – Corporate Governance Report into Appendix 14 – Corporate Governance Code of the main board Listing Rules. Corporate governance reporting requirements are now stated in the Mandatory Disclosure Requirements and Recommended Disclosures sections in Appendix 14.

One of the new Rules is that independent non-executive directors (INEDs) must form at least one-third of an issuer's board. Our firm's annual review of the corporate governance practices of the large and mid-cap indexed companies that constitute the Hang Seng Composite Index (HSCI) last year revealed that more than 25% of HSCI companies did not satisfy this new requirement (see table 1). The 2011 Corporate Governance Review is accessible at http://www.bdo.com.hk/publications_risk.php?refresh=1&time=2012519144957.

In the 2011 Corporate Governance Review, the 232 HSCI companies that we reviewed represent the largest companies listed in Hong Kong in terms of market capitalisation. They are also Hong Kong's business leaders and representative of overseas markets. If we also considered all the other issuers, the result about the new INEDs requirement would be far worse. The number of INEDs available in the market may not be sufficient as the demand for them will increase significantly.

Other changes related to independence included the upgrading from a Best Practice to a Provision that INEDs who have served on the board for more than nine years must demonstrate their continued independence by subjecting themselves to a shareholder resolution concerning their re-election. The new Provision makes it the board's responsibility to explain how the independence of those directors has been maintained. Another new Rule requires remuneration committees to be chaired by an INED, and to have a majority of INEDs. The Best Practice that nomination committees should be chaired by an INED or the company chairman and have a majority of INEDs has been upgraded to a Provision as well.

The Code's new version further clarifies, details and emphasises the previous Rule concerning the importance of the roles of directors and their duties and ultimate responsibilities. A new Provision states that the board should reassess the time commitment of its directors and determine their ability to satisfy this. The promotion of continuous training for directors has been upgraded to a Provision. Instead of specifying the training directors must undertake, it allows issuers flexibility to tailor-make continuous development programmes that will suit their board and their needs.

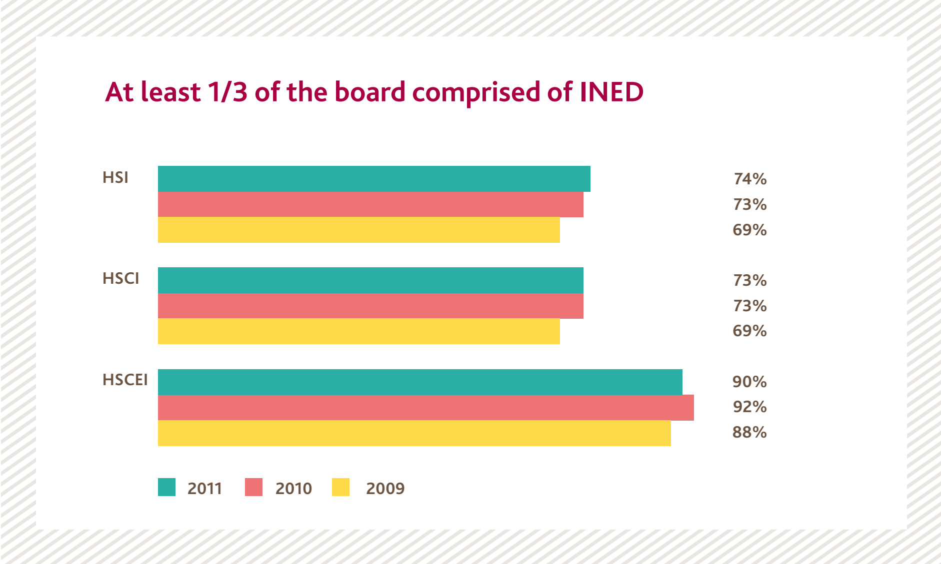
Remuneration remains an important topic as investors continue to demand greater transparency about the remuneration packages of senior corporate leaders. A new Provision and revised Rule require disclosure of the remuneration of senior management and the chief executive (a non-director) respectively.

The chairman of the board's leadership responsibilities with regard to the board and corporate governance have been upgraded to Provisions. Specifically, the Chairman's responsibility to lead the board of directors to act in the best interest of an issuer has been included as a Provision. The Chairman's roles to ensure the issuer to provide effective communication between shareholders and the board is also upgraded to a Provision. A new Best Practice was also introduced that the board should regularly evaluate its own performance.

An interesting and an important new Provision is that management should provide all members of the board with monthly updates giving a balanced and understandable assessment of the issuer's **performance, position and prospects** in sufficient detail as to enable the board as a whole and each director to discharge their duties. That means management would need to provide monthly **actual, budget and variance analysis** information to the board of directors. We are aware that not all issuers can provide such information and data in a timely manner, and we will have to wait and see how most issuers satisfy this new important Provision.

Changes concerning improved interaction between issuers and their shareholders include a Provision that independent resolutions proposed in general meetings should not be bundled together, as this practice sometimes conceals their gravity. A new Rule requires shareholders' approval for the appointment or removal of an auditor, and a new Provision specifies that issuers should establish a policy for maintaining effective communication with shareholders.

Table 1



Source: BDO Corporate Governance 2011

There are new and specific requirements about minimum standards for the competency of company secretaries. These include a new section in the Rules that specifies the minimum academic requirements and professional qualifications acceptable for company secretaries, including undergoing 15 hours of training every year to ensure their awareness of the latest issues. A new section of the Code has introduced four new Provisions concerning the responsibilities of company secretaries to the board and their position in the organisation.

Many issuers have allowed their corporate governance processes to remain static. There has been minimal improvement concerning the degree of disclosure about various components of board independence, internal control assessment, risk management and executive remuneration. The revisions to the Code and related Rules now offer issuers an opportunity to re-evaluate and enhance their corporate governance framework and disclosures.

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RECENT BDO PUBLICATIONS

BDO Annual Statement 2011

The Annual Statement 2011 of the international BDO network, covering the fiscal year ended 30 September 2011, is now available.

The Statement enables our stakeholders - businesses, investors, regulators and communities - to understand our global organisation better. It explains how BDO is run and how BDO International provides reasonable assurance of the high quality of its member firms' audit, tax and advisory services.

HKFRS/IFRS Update 2012/05: Government loans – Amendments to HKFRS 1

This newsletter summarises key amendments to IFRS 1 First-time Adoption of International Financial Reporting Standards issued by the International Accounting Standards Board in March 2012.

If you wish to obtain a copy of these publications, please visit www.bdo.com.hk

GLOBAL NETWORK DEVELOPMENT AT A GLANCE

BDO strengthens its presence in Australia

BDO's member firm in Australia and PKF East Coast Practice (PKF ECP) have completed their integration negotiations, and they will officially merge on 1 July 2012. The move will add PKF's offices in Melbourne and New South Wales to the BDO Australia network, while the two firms' offices in Brisbane will be combined. The merger will boost BDO Australia's headcount to approximately 160 partners and more than 1,300 staff members, and take its annual revenues to an estimated A$240 million.

'A key driver to this arrangement was the clear value the leadership of BDO and PKF ECP see in bringing together like-minded people striving for the same thing. Our joint focus is on demonstrating value to clients and staff and, in so doing, seeking to provide stability and success for them,' explains BDO Australia's National Chairman Tony Schiffmann.

The CEO of PKF ECP, Michael Grant, says the strength and reputation of the BDO brand in Australia and – significantly - globally proved a very attractive proposition for his firm.

BDO's CEO Martin van Roekel adds: 'The completion of this agreement within such a short timeframe is both remarkable and a testament to the strength of the BDO brand. We have always been committed to creating a truly integrated national firm in Australia for the benefit of our clients, and I am delighted that we are now able to establish a strong, vibrant and long-term presence in Sydney and Melbourne. The two firms enjoy many synergies and a cultural alignment focused on client service. I am delighted to welcome them to BDO and look forward to seeing commensurate growth in BDO Australia as a whole.'

New member firm in Barbados

Ward, Patel & Co in Barbados has become a BDO member firm. The firm primarily focuses on audit services, which accounts for approximately 73% of its revenues, as well as consulting and tax services. These are delivered mainly to a portfolio of local small and medium-sized clients that is characterised by its stability and loyalty. BDO's CEO Martin van Roekel said: 'The BDO network will give the firm an opportunity to develop and grow its business in the future.'

New member firm in Norway

Crowe Horwath International's Norwegian firm joined BDO Norway, effective from 1 July 2012, thus creating a firm similar in size to Deloitte. The merger will add more than 100 employees to BDO Norway and increase its annual revenues to about NOK 1.1bn. BDO Norway's Managing Partner, Trond-Morten Lindberg, said: 'I am delighted to welcome Crowe Horwath's highly competent employees to BDO, and I am certain they will feel at home with us from day one.'

New member firm in Puerto Rico

Scherrer Hernandez & Co in Puerto Rico has become a BDO member firm. The firm serves a range of clients from governmental public insurance entities to financial institutions, real estate, retail and distribution and construction companies. BDO's CEO Martin van Roekel said: 'BDO Puerto Rico already has a strong local reputation for delivering service levels that consistently delight their clients and I know that they will join the BDO firms across this region in bringing up to date ideas to their clients and in delivering the high quality in their market that our clients worldwide expect.'

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