JUNE 2012 SUPPLEMENT

Qualification Programme

Module B
Corporate Financing

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Changes at a glance

Introduction

This Supplement has been produced for those candidates preparing for the June 2012 examination session of the HKICPA Qualification Programme.

It is designed to be used in conjunction with the 2011 edition of the Learning Pack, and it will bring you fully up to date for developments that have occurred in the period since publication of the Learning Pack.

The supplement contains two sections:

Part A contains a list of any notified errors in the material in the current edition of the Learning Pack. These are identified in chapter order, therefore as you start a new chapter in the Learning Pack you are advised to refer to the list to see whether there is anything relevant.

Part B comprises a technical update on developments that will be examinable in June 2012 that are not currently covered in the Learning Pack. The topics covered are listed on the contents page, and again are covered in chapter order.

In each case the text in the supplement explains how the Learning Pack is affected by the change, for example whether the new material should be read in addition to the current material in the Learning Pack, or whether the new material should be regarded as a replacement.

Careful study of both the Learning Pack and this supplement should ensure that you are fully prepared for the June 2012 examination session.

Good luck with your studies!

Part A: Identified Errata

At the time of writing an identified error in the Module B Learning Pack or Flashcards is in Chapter 17, page 626.

In the dividend based valuation model example (which starts on page 625) the annuity to infinity is shown as:

$$\left(\frac{1}{K_e} - g\right)$$

This should be shown as:

$$\frac{1}{(K_e - g)}$$

Part B: Technical Update

Chapter 1 **Ethics in business**

Corporate social responsibility and sustainability reporting

These sections provide additional information on corporate social responsibility and reporting by companies on their Corporate Social Responsibility (CSR) policies and performance. CSR reporting is also called 'social and environmental reporting' and 'sustainability reporting'. 'Sustainability reporting' may also be used more specifically for 'triple bottom line' reports, in which companies report on three aspects of their performance: economic, environmental and social aspects. Triple bottom line reporting is advocated by the Global Reporting Initiative (GRI) and is used by a number of global companies.

There is growing awareness of social and environmental issues in business, particularly among large international investors as well as the general public, but also among the board of directors of some major companies. Environmental concerns are mainly about pollution, global warming and unsustainable use of the world's natural resources. Social concerns relate to employees of companies and also to communities in which companies operate: safety at work is a particular issue.

Some companies have strategies for CSR issues, and most of these choose to publish reports (at least annually) about their strategies and on their progress towards achieving the strategic objectives.

- It is important to recognise that currently CSR reporting is voluntary in most countries.
- Some countries have laws or regulations that require the disclosure of some aspects of environmental performance, such as carbon dioxide (CO_2) emissions, but they do not require companies to publish CSR reports.
- CSR reporting is currently more common in countries where institutional investors are major shareholders, and it is less common in countries where many large companies are family-owned or family-controlled, so that shareholder pressure for CSR reporting is much less.

What should CSR reports contain?

Corporate social responsibility reports are voluntary and there are no rules about what they should contain or what their format should be.

- CSR reports may contain quantified measures of social and environmental performance, but many reports are mainly narrative reports with some quantified measurements.
- Companies may choose to report the favourable aspects of their social and environmental performance, but exclude the unfavourable aspects of performance. For example, a company may report on its success in reducing its emissions of carbon dioxide (CO_2) but fail to report a large increase in accidents and deaths among employees at work.
- Without external auditing, there is no way of judging whether the performance figures in a CSR report are true or false. For this reason, many companies now arrange for an independent external organisation to carry out an audit of their social and environmental performance figures and provide a certification of their reliability in the CSR report.

The environmental concerns of companies can differ widely, according to the nature of their business. For example the environmental concerns of a bank and a coal mining company or chemicals company are very different. This means that the information provided in CSR reports will differ according to the nature of the industry in which the company operates.

There are also different ways of measuring environmental performance. For example, CO_2 emissions can be measured by the amount of energy a company consumes, the volume of gas emissions at its manufacturing sites or the amount of fuel consumed by its motor vehicles. A method of simplifying measures of performance is required, to make comparisons between companies easier.

There has been some progress towards standardisation of CSR reports, so that reports of different companies can be compared more easily – especially reports of companies in the same industry. The Global Reporting Initiative (GRI) has developed reporting standards based on triple bottom line reporting.

Sustainability reporting: an example

Only a few Hong Kong companies produce CSR reports/sustainability reports. One of these is the energy company CLP Group, which publishes on-line sustainability reports based on the Global Reporting Initiative. These reports are mainly narrative in form, but contain some quantified performance statistics on economic, environmental and social performance that are independently verified by an external auditing agency.

CLP Group is a major company with operations in many countries in the Asia-Pacific Region, and it is aware of differing expectations about the social and environmental aspects of its operations in the different countries where it operates. For example, industry in China and India still relies heavily on the use of coal for energy, even though the use of coal creates large emissions of CO_2, but Australia is a country where concerns about the use of coal have been increasing. Many people in the Asia Pacific region do not yet have any access to electricity, and providing them with electricity will have implications for the future – providing important social benefits but at the same time creating environmental damage.

CLP Group recognises that it needs to plan for the company's future as well as its short-term success, and that it also needs to find a balance between the economic, environmental and social aspects of its business. Its 2010 sustainability report commented on the principles of sustainable development, 'balancing social, environmental and economic dimensions of business and considering needs of future as well as current generations'.

It went on to state: 'A sustainable business must be one which meets the needs of its stakeholders today, while looking ahead and positioning itself to meet the needs of shareholders and stakeholders in the years to come.'

Sustainability policies: commercial risks and opportunities

Although the management of CLP Group believe that there is an ethical dimension to sustainability, they are also well aware of the commercial aspects of sustainability policies. At some time in the future, developments in technology may improve the economics of alternative energy sources such as wind power. There may also be new legislation by governments against high-polluting energy sources such as coal. There are risks, but there are also opportunities to develop new business, and companies should be strategically placed to respond to these risks and opportunities. To do this, they need well-developed environmental policies.

The CLP Group's 2010 sustainability report commented: 'We believe conducting our business in a socially and environmentally responsible way is both an ethical obligation and good for business. Minimising environmental impact and contributing to the societies in which we operate is all part of a sustainable business that produces long-term returns on our investments.'

Examples of CSR policies

CSR policies (sustainability policies) vary between companies according to their circumstances and business environment. The policies of CLP Group are fairly typical of a company in a high-polluting industry.

- In 2010, CLP introduced a group-wide policy that all its operationally-controlled facilities (such as power stations) should certify within two years that their environmental management systems (EMS) comply with international standards.
- The Group has targets for reductions in emissions of carbon dioxide (CO_2), sulphur dioxide (SO_2) and nitrous oxides (such as NO_2).
- The Group has policies for minimisation of accidents and fatalities at work.

CSR performance measures

When targets can be quantified for CSR policies, it should also be possible to quantify actual performance and compare this with the target. Users of a CSR report/sustainability report can then assess the success of the company in achieving progress over time towards its policy targets. Many companies that produce sustainability reports state their policy targets for a year in the future (say, 2020) and report each year on progress towards the target.

Quantified environmental performance measures may therefore include figures for:

- CO_2 emissions (compared with target or previous year)
- emissions of other toxic gases and chemicals
- the amount of waste produced in operations (toxic and non-toxic waste) and the amount of waste recycled

- the amount of water used/water recycled.

Social performance measures relating to employment may include:

- the number of accidents at work and the number of fatalities
- training days
- employee numbers

Chapter 15 Regulatory environment

Amendments to the Main Board Listing Rules

These sections provide updating notes about recent changes to the Main Board Listing Rules, which were announced in October 2011 and which come into operation during 2012 (most changes should be implemented by April 2012).

How are the Listing Rules changed?

The Listing Rules may be amended by the Hong Kong Stock Exchange from time to time, subject to approval by the Securities and Futures Commission, under the terms of the Securities and Futures Ordinance.

The significant rule changes introduced in 2012 are mostly concerned with corporate governance, and measures to promote a higher level of corporate governance in Hong Kong.

The Listing Rules and Corporate Governance Code

Corporate governance requirements for listed companies in Hong Kong are applied within the Listing Rules at three levels: Listing Rules, code provisions and recommended best practices.

Some corporate governance requirements are imposed by the Listing Rules themselves. All listed companies must comply with these Rules. The Rules include a requirement for companies to include a Corporate Governance Report in their annual report.

The Corporate Governance Code (previously called the Code on Corporate Governance Practices) is an Appendix to the Listing Rules. The Listing Rules require companies to apply the Corporate Governance Code.

The Corporate Governance Code contains some general principles but also:

- code provisions, and
- recommended best practices

Listed companies are normally expected to comply with the **code provisions**, but compliance is not a regulatory requirement. However, if a listed company fails to comply with any code provision, it must explain the reason for non-compliance in its Corporate Governance Report. This requirement to apply code provisions or explain non-compliance is called ‘comply or explain’.

Recommended best practices (RBPs) are practices that listed companies are encouraged to apply, but compliance with RPBs is not a regulatory requirement, and companies are not required (although they are encouraged) to explain any non-compliance in their Corporate Governance Report.

Comply or explain

The requirement for ‘comply or explain’ is set out in the Listing Rules (Rule 13.89) as follows:

‘The Corporate Governance Code … sets out the principles of good corporate governance and two levels of recommendations: (a) code provisions; and (b) recommended best practices. Issuers are expected to comply with, but may choose to deviate from, the code provisions. The recommended best practices are for guidance only.

Issuers must state whether they have complied with the code provisions set out in the Corporate Governance Code for the relevant accounting period…. Where the issuer deviates from the code provisions, it must give considered reasons: for annual reports … in the Corporate Governance Report….

For recommended best practices, issuers are encouraged, but are not required, to state whether they have complied with them and give considered reasons for any deviation.'

Governance changes in the Listing Rules and Corporate Governance Code

The changes introduced from 2012 are described here briefly. The changes are a combination of:

- new Listing Rules and some amendments to existing Listing Rules
- new code provisions, some amendments to existing code provisions and some re-classification of recommended best practices as code provisions
- some new recommended best practices and amendments to existing RPBs.

Changes in the Listing Rules

Some of the changes in the Listing Rules are as follows.

- A Rule about the delegation of authority by directors is strengthened. Directors are allowed to delegate authority, but they remain responsible and must satisfy the required levels of skill, care and diligence. Directors do not satisfy these requirements if they do nothing more than attend formal meetings. 'At a minimum they must take an active interest in the issuer's affairs and obtain a general understanding of its business. They must follow up anything untoward that comes to their attention.'
- At least one third of the members of the board of directors of an issuer must be independent non-executive directors (from December 2012).
- An issuer must establish a remuneration committee consisting of a majority of independent non-executive directors and chaired by an independent non-executive director. (Previously the requirement for a remuneration committee was not compulsory.)
- The term of office of an issuer's auditor ends at the annual general meeting. The auditor cannot be removed from office before the end of this term without the approval of the shareholders in a general meeting.

Changes in the Corporate Governance Code

The main changes in the Corporate Governance Code are as follows.

- An addition to a general principle in the Code is that the board should regularly review whether each director is spending sufficient time performing his or her required duties. However an addition to a code provision states that a director may attend a meeting by electronic means (such as telephone or videoconferencing).
- Management should provide all directors with monthly updates 'giving a balanced and understandable assessment of the issuer's performance, position and prospects in sufficient detail to enable the board as a whole and each director to discharge their duties'. This requirement is linked to the Listing Rule change that directors are required to take an active interest in the issuer's affairs and obtain a general understanding of its business.

- A note to the Code states that an issuer should have a corporate strategy and a long-term business model. A new code provision requires the directors to include a statement in the annual report that contains a 'discussion and analysis of the group's performance, an explanation of the basis on which the issuer generates value over the longer term (the business model) and the strategy for delivering the issuer's objectives.'

You can read the full text of the Corporate Governance Code and the required contents of a Corporate Governance Report. These are contained in Appendix 14 of the Listing Rules, which can be found at:

www.hkex.com.hk/eng/rulesreg/listrules/mbrules/listrules.htm