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Red Flags Identification During Sponsors' Due Diligence

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INTRODUCTION

On October 11, 2017, the Executive Director of Enforcement Division of the Securities and Futures Commission ("SFC") of Hong Kong, Mr. Thomas Atkinson, gave a keynote speech at the 8th Pan Asian Regulatory Summit, which reiterated that "investigating large red flags have always and continue to be the duty of sponsors". "Sub-standard due diligence on the part of sponsors has resulted in billions of dollars in investment losses" and investigation into the sponsors by the SFC. Corporate fraud in an IPO reflects badly on Hong Kong's stature as an international finance center and on the regulatory standards of the SFC. The SFC "will make every effort to hold sponsors accountable, if they fail to discharge their regulatory duties". It is therefore vital for sponsors to verify disclosures of business data, including material customers and revenue information, in order to ensure that corporate fraud is not committed.

SPONSORS' "RED FLAGS" DUE DILIGENCE

Paragraph 17.4(a)(i) of the Code of Conduct for Persons Licensed by or Registered with the SFC ("Code of Conduct") requires a sponsor to have "performed all reasonable due diligence in respect of a listing application". Factors required to be taken into account by sponsors include the listing applicant's history and background; the personal and business backgrounds of the senior management and controlling shareholders; financial information; material disclosures; and the legality and compliance of the business operations. It is essential that sponsors identify and disclose any material deficiencies in relation to the above factors and see to that the listing applicant is able to address and remedy them.

In order to identify these "red flags", sponsors may pay attention to the following aspects when conducting due diligence for an IPO project:

(A) Apply "Red Flag Mindfulness" During Standard Procedures for Identification of Potential Issues

When performing checking procedures, sponsors should do so with "red flag mindfulness" on potential frauds, non-compliances and problems posing hurdles to listing and other similar public transactions.

For instance, Sponsors of IPOs should have such "red flag mindfulness" when performing the risk-related IPO checking and disclosure procedures required by standard guidance letters and checklists (see **Schedule 1** for a summary of key IPO guidance materials and checklists), to ensure the completeness and integrity of the checking and disclosure process. Taking such a perspective will reduce the likelihood of overlooking suspicious activity and evidence.

(B) Apply Forensic Accounting Checking Concepts Where Appropriate

There are several checking procedures that may aid sponsors in conducting due diligence that sets out frameworks for measuring and identifying any deficiencies of the listing applicant, such as the IRFS standards and other accounting guidelines.

IFRS 13 sets out methods to measure the fair value of the listing applicant for financial reporting. This standard was incorporated by the Hong Kong Institute of Certified Public Accounts into Hong Kong Financial Reporting Standard 13 Fair Value Measurement. Fair value is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" and applies when another standard requires fair value measurements or disclosures about such measurements. Regulatory guidance can be found in standard materials under Schedule 1 and specific guidelines such as SFC's guidance note on directors' duties in the context of valuations in corporate transactions, HKEX's guidance letter GL46-12 and listing decision LD66-1. In general, sponsors should watch out for any improper asset valuations in the form of inventocry valuation, accounts receivable, business combinations or fixed assets. These may go hand in hand with other schemes, such as those to inflate sales, deflate or defer corresponding costs, inventory provision adjustments and provision write-backs. Generally, any significant deviation from the norms of industry peers should be checked.

IFRS 3 outlines accounting procedures performed when an acquirer obtains control of a business through an acquisition or a merger. The assets acquired and liabilities assumed in such business combinations have to be measured at their fair values at the acquisition date. This "acquisition method" involves identifying the acquirer; determining the acquisition date; measuring the identifiable assets acquired and liabilities assumed; measuring the consideration transferred; and measuring goodwill or a gain.

> **Example:** A listing applicant acquired a design company during the track record period. The company does not engage in any production, meaning that most of its business is intangible. Excessive reserves from prior charges were booked, to be "released" gradually later to cover up otherwise poor performance.

Another important "red flag" is timing difference, which is the recording of revenues or expenses in improper periods. This improper practice serves the purposes of increasing and decreasing earnings by transferring revenues or expenses between different periods. There are several situations that may make due diligence by the sponsor harder with regards to timing difference, including long-term contracts, channel stuffing and sales with conditions. Long-term contracts are a challenge because it is easy to manipulate revenues and expenses as progress on a project is made by recognizing revenues prematurely. Channel stuffing may take the form of the sale of an excessively large quantity of product to distributors taking advantage of discounts or extended payment terms, often with return flexibility, in order to inflate a company's revenues. Sales with conditions are sales with incomplete terms where the rights of the goods have not been transferred to the purchaser, in which case, sales cannot be recorded as revenue before the conditions have been fulfilled.

> **Example**: A company is involved in event management where sales are not completed until the event occurs because clients are not obligated to complete payment until then. However, the company records sales revenues before the event has taken place, sometimes weeks and months before it is scheduled.

Example: A company is engaged in the manufacture and design of kitchen appliances. The company established a program to distributors involving discounts, mark-ups and the right of return or exchange on unsold products to encourage them to buy their products before the end of the financial year. The company does not disclose this practice in its financial reports.

(C) Apply Other Relevant Methodologies

In addition to financial forensic analysis skills, sponsors should also make use of relevant methodologies like computer technologies, which include data recovery, decryption, e-discovery, and data analytics, to identify red flags. These skills may be crucial in determining the hidden liabilities or any vulnerabilities of a listing applicant suspected of fraud in order to conduct a full investigation. These computer technologies can recover deleted or lost files, establish timelines of computer usage and uncover data patterns. The results can then be used to trace old transactions, locate assets and recreate lost records, which contribute to painting a full picture of a company. In a world where digital media and tools continues to evolve and expand, the accountability of digital evidence and the analysis of electronic data could be vital.

Schedule 1 - **Summary of Risk-Related IPO Guidance Materials and Checklists in Hong Kong**

1 Basic: M100 and G100 IPO Checklists
http://www.HKEX.com.hk/eng/rulesreg/listrules/listipo/Documents/M100.pdf
http://www.HKEX.com.hk/eng/rulesreg/listrules/listipo/Documents/G100.pdf

2 Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (especially paragraph 17)
http://www.sfc.hk/web/EN/assets/components/codes/files-current/web//code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission.pdf
and related Due Diligence Guidelines Adopted by the Industry

3 PN21 (Main Board) and PN2 (GEM) Checklists of HKEX:
https://www.HKEX.com.hk/eng/rulesreg/listrules/mbrules/documents/pn_21.pdf
http://en-rules.HKEX.com.hk/net_file_store/new_rulebooks/h/k/HKEX4476_1797_VER10.pdf

4. Main Disclosure Related Guidance Letters Issued by HKEX

- **GL86-16** Guide on Producing Simplified Listing Documents Relating to Equity Securities for New Applications

http://en-rules.HKEX.com.hk/net_file_store/new_rulebooks/g/l/gl8616.pdf

- **Appendix 2 to the above GL-86-16** - other relevant guidance letters:

Industry-specific guidance letters			
1	HKEX-GL26-12	01/2012	Business models with significant forfeited income from prepayments
2	HKEX-GL28-12	01/2012	Restaurant operators
3	HKEX-GL36-12	05/2012	Distributorship business
4	HKEX-GL52-13	03/2013	Mineral companies
5	HKEX-GL71-14	01/2014	Gambling activities

Other guidance letters on disclosure in a Listing Document			
6	HKEX-GL8-09	07/2009	Disclosure of statistics and data quoted in listing documents
7	HKEX-GL24-11	03/2011	Disclosure requirements for IPO cases – Formal Notice
8	HKEX-GL30-12	02/2012	Disclosure of intellectual property rights
9	HKEX-GL34-12	04/2012	Disclosure of hard underwriting
10	HKEX-GL38-12	06/2012	Latest practicable date and the latest date for liquidity disclosure
11	HKEX-GL37-12	06/2012	Indebtedness, liquidity, financial resources and capital structure disclosure
12	HKEX-GL41-12	08/2012	Disclosure of material changes in financial, operational and/ or trading position after trading record period
13	HKEX-GL63-13	07/2013	Disclosure of material non-compliance incidents
14	HKEX-GL65-13	09/2013	Disclosure of property valuation report and market
15	HKEX-GL82-15	08/2015	Disclosure of unaudited quarterly/interim financial information in the listing document where the new listing applicant or any of its subsidiaries is listed on another exchange

5. Issues Raised in Previous Reported Returned Cases and Other Reminders from Regulators: Sponsors should have their internal checklists to ensure non-recurrence of previous returned cases and similar reminders from regulators, such as those reported by SFC:

- Corporate Regulation Newsletter
- Dual Filing Update
- Enforcement Reporter
- Risk-focused Industry Meeting Series
- SFC Regulatory Bulletin: Listed Corporations
- Takeovers Bulletin

6. HKEX Reported Returned Cases

- HKEX LISTING DECISION HKEX-LD92-2015 (published in June 2015) https://www.HKEX.com.hk/eng/rulesreg/listrules/listdec/Documents/ld92-2015.pdf
- HKEX LISTING DECISION HKEX-LD101-2016 (published in April 2016) http://en-rules.HKEX.com.hk/net_file_store/new_rulebooks/l/d/ld101-2016.pdf
- HKEX LISTING DECISION HKEX-LD100-2016 (published in April 2016) http://en-rules.HKEX.com.hk/net_file_store/new_rulebooks/l/d/ld100-2016.pdf
- HKEX LISTING DECISION HKEX-LD106-2016 (published in May 2017) http://en-rules.HKEX.com.hk/en/display/display.html?rbid=4476&element_id=5068
- HKEX LISTING DECISION HKEX-LD107-2017 (published in May 2017) http://en-rules.HKEX.com.hk/en/display/display.html?rbid=4476&element_id=5069

Note: Information in this document is for general reference only and should not be relied on as legal advice.