January 2019

REVIEW OF ISSUERS' ANNUAL REPORT DISCLOSURE

REPORT 2018

CONTENT

EXECUTIVE SUMMARY

The Listing Department reviews issuers' annual reports as part of its ongoing monitoring activities.

We undertake two on-going review programs (i) Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance (the **AR Review Program**); and (ii) Financial Statements Review Programme (the **FSRP**). Each review program has a different focus.

The AR Review Program examines issuers' annual reports with a focus on Rule compliance, issuers' corporate conduct and their disclosure of material events and developments. In our review of an issuer's disclosure, we consider not only the disclosure in the annual report, but also the consistency and materiality of disclosure in the issuer's corporate communications (such as announcements and circulars) over time.

The FSRP is operated with a view to encouraging high standards of financial disclosure and focus on compliance with applicable accounting standards. It reviews, on a risk-based approach, the issuers' published financial reports.

Both review programs are primarily to give meaningful guidance to issuers on specific areas to focus on when preparing the annual report. Where we note any particular non-compliance with any rules and regulations, we would consider appropriate disciplinary action under the Exchange Listing Rules and/or making referrals to other regulatory agencies.

In order to increase issuers' awareness of the possible pitfalls in the preparation of periodic financial reports particularly in relation to compliance with the disclosure requirements of the Listing Rules, accounting standards and relevant disclosure requirements of the Companies Ordinance (Cap. 622) (the **CO**), starting from this year, the findings from both review programs are consolidated into this Review Report.

For the purpose of this review, we have considered the findings and observations in our last review reports and the latest market trends and developments of listed issuers, and have selected specific areas for assessing listed issuers' performance and providing appropriate guidance and recommendations. In this review, we have covered eight areas:

(i) Fundraisings through issue of equity / convertible securities and subscription rights

(ii) Updates on material asset impairments and results of performance guarantees after acquisitions

(iii) Continuing connected transactions

(iv) Disclosure in business review and significant securities investments in the MD&A section

(v) Financial statements with auditors' modified opinions

(vi) Disclosures on material other expenses / income

(vii) Issuers listed in 2016 and 2017

(viii) Material intangible assets

The Exchange specifically recommends the followings:

(a) **Financial statements with auditors' modified opinion –** In previous years, we recommended issuers with auditors' modified opinions disclose in their annual reports certain information in relation to the audit modifications. In this review, we continued to note that some issuers failed to make the recommended disclosures relating to the audit committee's views towards the modifications and proposed plans to address them. We remind issuers to make appropriate disclosures on these areas. We also remind issuers, in particular those with modified opinions in repeated years, to take prompt and adequate actions to implement the plans to resolve the issues that led to the modifications.

(b) **Business review in MD&A** – We selected for review this year a number of issuers that were previously subject to negative market commentaries that questioned the credibility of the issuers' business model and published financial information. Our review of these issuers' annual reports indicated that the disclosure of certain key areas of their business model and financial performance by these issuers were limited and the descriptions were generic. We recommend issuers improve their disclosures in the MD&A section with a view to facilitating shareholders' understanding of the key aspects of their performances during the year and prospects, and also reducing the likelihood of allegations based on misinformed assumptions or speculations. Specifically, we recommend issuers enhance their disclosures about their business model / revenue recognition methodology of each core business; unique characteristics of their operation processes; relationships with key customers and suppliers; principal risks affecting the operations and measures to manage such risks; and strategies (including operation strategies and treasury policies) for meeting the business objectives. We also recommend issuers discuss the key performance drivers for each core business and why they are significant to the issuer's strategies and results.

(c) **Material intangible assets** – Issuers should aim to improve the quality of their disclosures and ascertain whether the processes for assessing impairment are sufficient and appropriate, in particular when there are significant goodwill and intangible assets with indefinite useful lives. Directors and management are responsible for performing proper analysis and exercising judgement to assess the reasonableness of key assumptions applied in impairment testing so that assumptions applied (such as growth rates and discount rates) are not overly optimistic, in particular, where issuers are loss-making or suffer material deterioration in revenue, net profits or gross profit margin. They should not rely solely on professional valuers or other experts without carrying out sufficient due diligence. Directors should also assess the competence, capabilities, objectivity and qualifications of professional valuers or other experts.

(d) **Disclosures on material other expenses** – We noted that many issuers with material "other / other operating expenses" provided no or limited disclosures on such expenses. Issuers should improve their disclosures and provide appropriate breakdown of their other expense items in their future annual reports to enhance shareholders' understanding.

Issuers are kindly reminded to take note of our observations and recommendations discussed in this report and follow the guidance in their future annual reports to improve transparency and accountability to investors.

I. INTRODUCTION

1. An annual report should provide material and relevant information about an issuer's financial results and position, and assist investors to assess its past performance and future prospects. As a general principle, disclosure in annual reports should be clear, straightforward, and provide a qualitative analysis that complements and explains quantitative information in the related financial statements. There should be a balanced discussion of all major aspects of the issuers' businesses, including both positive and negative circumstances, in the "management discussion and analysis" section (**MD&A**). Better disclosure improves transparency and promotes a fair, orderly and informed market.

2. As part of our monitoring of issuers' activities, we review annual reports with a particular focus on their Rule compliance, corporate conduct, and disclosure of material events and developments. In our review of an issuer's disclosure we consider not only the disclosure in the annual report, but also the consistency and materiality of disclosure in its corporate communications (such as announcements and circulars) over time. Our review of issuers' disclosure over time helps us identify cases of potentially misleading disclosure in corporate documents, issues on directors' role in safeguarding corporate assets, and possible corporate misconduct.

3. The Rules and applicable accounting standards set out the minimum information an issuer must include in its annual report. An issuer should provide additional information that is relevant to shareholders and investors according to its own circumstances. In our review, we also consider whether issuers adopted our guidance from our previous annual report reviews as well as guidance materials issued from time to time. Where appropriate, we have requested issuers to make further disclosures by way of announcements or in subsequent financial reports.

4. This report presents our findings and recommendations from our review of the following eight areas. Our review covers the annual reports of issuers for the financial year ended between January and December 2017. Specifically, we reviewed the disclosures in the annual reports of issuers that carried out relevant activities in the financial year, or where applicable, in the previous financial years. We conducted a review on a sample basis of disclosures in continuing connected transaction sections (item (iii) below). The scope of review for each area is described in Parts II, III and IV of this report.

   (i) Fundraisings through issue of equity / convertible securities and subscription rights (Part IIA)

   (ii) Updates on material asset impairments and results of performance guarantees after acquisitions (Part IIB)

   (iii) Continuing connected transactions (Part IIC)

   (iv) Disclosure in business review and significant securities investments in the MD&A section (Part IID)

   (v) Financial statements with auditors' modified opinions (Part IIE)

   (vi) Disclosures on material other expenses / income (Part IIF)

   (vii) Issuers listed in 2016 and 2017 (Part III)

   (viii) Material intangible assets (Part IV)

5. In this report, "Rules" refer to both Main Board (**MB**) Rules and GEM Rules.

6. Unless otherwise specified, Hong Kong Financial Reporting Standards (**HKFRSs**) and Hong Kong Standards on Auditing (**HKSAs**) and their paragraph numbers referred to in this report correspond to those in IFRSs and ISAs[1] respectively. Discussions in this report in relation to accounting and auditing standards are intended for general guidance only. Readers should read the full HKFRSs and HKSAs to fully understand the implications of HKFRSs and HKSAs.

[1] HKSAs are issued by the Hong Kong Institute of Certified Public Accountants (the **HKICPA**); while International Standards on Auditing (**ISAs**) are issued by the International Auditing and Assurance Standards Board.

II. FINDINGS ON SPECIFIC AREAS OF DISCLOSURE

A. Fundraisings through issue of equity / convertible securities and subscription rights

7. Under the Rules, issuers should announce details of their equity fundraisings, including the terms and size of the equity issuance and the proposed use of proceeds. Issuers should also report to shareholders on the fundraisings conducted during the financial year in their annual reports[2].

8. In our previous reports, we recommended issuers to provide meaningful updates on the actual use of proceeds in their annual reports during the reporting period. The updates should include (i) a detailed breakdown and description of the use of proceeds for different purposes during the financial year; (ii) if there is unutilized amount, a detailed breakdown (by different purposes) and description of the intended use of the proceeds and the expected timeline; and (iii) whether the proceeds were used, or are proposed to be used, according to the intentions previously disclosed by the issuer, and the reasons for any material change or delay in the use of proceeds. Issuers are recommended to present the above information in tabular format to show separately the amounts used and the purposes for which they are used, and compare each of the actual or intended uses against the intention and expected timeframe previously disclosed by the issuer.

Scope

<u>*For all issuers*</u>

9. We reviewed the announcements and annual reports of all issuers that conducted equity fundraisings during the financial year, including placings under general and specific mandates and pre-emptive issues. We assessed whether the issuers followed our recommended disclosures mentioned above.

[2] These disclosure requirements are set out in paragraphs 11 and 32 of Appendix 16 to the MB Rules / GEM Rules 18.32 and 18.41. With effect from 3 July 2018, the Rules were amended to codify our previously recommended disclosures, details of which are set out in paragraph 8.

For large scale fundraisings

10. In late 2015, we observed that there was an increase in listed issuers proposing large scale fundraisings that involved investors injecting substantial amounts of cash into the issuers. It raised concerns whether the proposed fundraisings would render the issuers becoming "cash companies" under the Listing Rules[3], and whether the incoming investors were in effect listing, through the listed issuer, new businesses which would not have otherwise met the new listing requirements[4]. In some cases, upon our assessment, we did not apply the cash company Rules after taking into account, among others, the issuer's intended use of proceeds and its business plans.

11. As part of our program, we reviewed the annual report disclosure of the issuers that had conducted large scale fundraisings since late 2015 for the purpose of checking whether their actual use of proceeds was consistent with their original plans, in particular, whether any material change in the use of proceeds would raise concerns about circumvention of the cash company Rules.

Findings

For all issuers

(1) Disclosures on the actual use of proceeds

12. Similar to last year, a majority of the issuers followed our recommendations in paragraph 8 above to disclose information regarding the actual application of proceeds in their annual reports. Issuers which failed to do so had generally disclosed the relevant information by way of supplemental announcements or in the subsequent financial reports after our follow up.

[3] Rules 14.82 to 14.84 / GEM Rules 19.82 to 19.84

[4] In December 2015, the Exchange published Guidance Letter GL84-15 which provides guidance on the Exchange's approach in applying the cash company Rules to cases involving large scale fundraisings by listed issuers, including relevant factors that the Exchange would take into account, e.g. whether the funds raised would be used for new businesses with little or no relation to and expected to be substantially larger than the issuers' existing principal businesses.

(2) Change of use of proceeds

13. We noted that a few issuers had disclosed changes in use of proceeds in their annual reports. The changes were mainly related to reallocation of funds among different originally intended uses disclosed in the relevant fundraising announcements, or reassignment of funds to the existing or new businesses of the issuers. The extent of these changes was not material. Most of these issuers published separate announcements disclosing the reasons for and the amounts of the change. Overall, we have not identified any major issues arising from such changes.

14. With effect from 3 July 2018, the recommended disclosures in paragraph 8 above were codified into the Listing Rules[5]. Issuers are reminded to comply with the new Rules in their next annual reports.

For large scale fundraisings

15. For issuers that conducted large scale fundraisings since late 2015, we noted that they generally applied the proceeds according to the business plans and timeframe as previously disclosed. We did not identify any major concerns about circumvention of the cash company Rules.

[5] Paragraphs 11(8), 11A and 41A of Appendix 16 to the MB Rules / GEM Rules 18.32(8), 18.32A and 18.55A

B. Updates on material asset impairments and results of performance guarantees after acquisitions

16. The Rules require issuers to announce material acquisitions, publish investment circulars and obtain shareholder approval for these acquisitions. Issuers should also disclose in the MD&A section of their annual reports information about the acquired businesses, including circumstances involving any material asset impairments.

17. Where an asset impairment is supported by an independent valuation, we recommended in our previous reports that the issuer should disclose information about the basis of the valuation, including (a) details of the value of inputs used for the valuation together with the basis and assumptions; (b) the reasons for any significant changes in the value of the inputs and assumptions from those previously adopted; (c) the valuation method and the reasons for using that method; and (d) an explanation of any subsequent changes to the valuation method adopted. This enables shareholders to understand the details of and reasons for the impairments and their amount, and the prospects of the acquired business.

18. In some acquisition agreements, the vendors guarantee the performance of the acquired businesses and agree to compensate the issuers for any shortfall or adjust the consideration based on agreed formulae if the guarantees are not met.

19. The Rules set out the information required to be disclosed in an announcement and the next annual report in respect of any performance guarantee given by a connected person where the actual performance fails to meet the guarantee. In our previous reports, we recommended that, irrespective of whether the performance guarantee is given by a connected person or an independent party, the issuer should disclose in its next annual report the performance of the acquired business and whether the performance guarantee is met. If the performance guarantee is not met, the issuer should publish an announcement to disclose how it would enforce the obligations of the guarantor under the acquisition agreement[6].

[6] In the consultation paper on Backdoor Listing, Continuing Listing Criteria and Other Rule Amendments issued by HKEX (June 2018), we proposed to codify the recommended disclosures on the outcome of performance guarantees into the Rules (paragraph 140).

Scope

Update on material impairments on acquired assets

20. We reviewed the announcements, circulars and annual reports of the issuers that:

    (a) completed material acquisitions in their last two financial years; or

    (b) recorded material impairments on the assets previously acquired during the financial year under review.

21. We reviewed their annual report disclosures about the developments of the acquired businesses or assets and any significant changes to the value of intangible assets and goodwill. We considered whether:

    (a) any impairment to the acquired businesses or assets was properly made and whether the annual reports discussed matters giving rise to the impairment;

    (b) the information disclosed in their transaction circulars and/or announcements was materially accurate, and whether the directors have properly discharged their fiduciary duties in the acquisitions in light of the developments (such as material impairments) of the acquired businesses or assets; and

    (c) any material change to the acquired businesses or assets after the acquisition was timely announced.

Results of performance guarantees

22. For issuers that were given performance guarantees in previous acquisitions and the guaranteed periods ended in the financial year under review, we reviewed their annual reports, announcements and the accounts of the acquired businesses to assess whether the outcomes of the performance guarantees were properly disclosed. Where the performance guarantees were not met, we considered whether and how the issuers enforced the obligations of the guarantors.

Update on material impairments on assets (other than the acquired assets)

23. We also reviewed the annual reports of the issuers that recorded material impairments on assets (other than the acquired assets) during the financial year under review, and considered whether the reasons for, and the circumstances leading to, the impairments were adequately disclosed in the annual reports. Where the impairment indicated material changes to the businesses of the issuers, we also considered whether such changes were timely announced.

Findings

<u>Update on material impairments on acquired assets</u>

(1) Disclosures in annual reports

24. The number of cases involving material impairments on acquired assets was comparable to last year. Generally, these impairments were caused by a downturn of the industry in which the acquisition targets operated or factors specific to the targets such as loss of significant customers or decrease in sales orders. In a few cases, the impairments in investments were resulted from the decline in share price of the targets after the acquisitions. Most of these issuers discussed the matters giving rise to the impairments in their annual reports. The remaining few issuers, upon our enquiry, had made announcements to disclose the details of and reasons for the impairments.

25. A large majority of the issuers supported the material impairments with independent valuations and followed our recommendation to disclose details of the valuations as described in paragraph 17 above. A few issuers did not disclose the reasons for adopting a particular valuation methodology or the basis of changing the value of the inputs and assumptions that led to the impairments. To enhance shareholders’ understanding, we urge issuers to make the recommended disclosures in their future annual reports.

26. In a small number of cases, issuers did not engage an independent valuer to perform the impairment tests. These issuers conducted internal assessment and evaluation to support the impairments made. All of them disclosed the bases for the impairments in the annual reports.

27. We noted two cases where the issuers recorded material impairments on the acquired assets shortly after the acquisitions. In these cases, the directors of the issuers appeared to be aware, at the time of the acquisitions, of certain business risks associated with the acquisition targets that may have material potential negative impacts on the targets. However, the directors had not properly assessed such risks and their impacts in deciding to acquire the targets and in determining the considerations, and had not made sufficient disclosures at the time of the acquisitions. Shortly after the acquisitions, such risks materialized and resulted in material impairments to the acquisition targets. This raised our concern that the directors might have failed to discharge their fiduciary duties to conduct the acquisitions in the best interest of the issuers and their shareholders. It also raised question that the disclosures at the time of acquisitions might not be complete and accurate as they lacked discussion of the relevant risks and potential negative impacts. We have taken appropriate action in these cases.

28. We remind issuers again to observe the SFC guidance[7] on directors' duties in the context of valuations in corporate transactions. This guidance note reminds directors of their duties in ensuring that acquisition targets are properly considered and investigated. Directors should carry out independent due diligence on the acquisition targets. They should not accept blindly and unquestioningly financial forecasts, assumptions or business plans provided to them typically by the target's vendor or management.

(2) Timeliness of disclosures of material changes of acquired businesses

29. Issuers generally disclosed material changes to the acquired businesses or assets that led to the material impairments in profit warning or other announcements. We did not identify any major issues about the timeliness of issuers' disclosures on material changes to the acquired assets.

Results of performance guarantees

30. Our review of performance guarantees indicated that:

(a) Generally, issuers have followed our disclosure recommendations last year as set out in paragraph 19 above. All of the issuers have disclosed (either in their annual reports or supplemental announcements in response to our enquiry) whether the performance guarantee was met and if not, whether and how the guarantors fulfilled their obligations under the agreements.

(b) A majority of the performance guarantees were met upon expiry. Of the other cases where the performance guarantees were not met, only three were provided by the issuers' connected persons.

(c) Where the performance guarantees were not met:

(i) In a large majority of the cases (including the three cases where the performance guarantees were provided by connected persons), the issuers were compensated by the guarantors according to the terms of the agreements.

[7] Guidance note on directors' duties in the context of valuations in corporate transactions (May 2017) issued by the SFC

(ii) In the remaining cases, the issuers took a variety of actions to protect their interests. They included taking legal actions to seek compensation*;* changing the compensation method (receiving cash compensation in lieu of allotment of additional shares in the target) to expedite settlement; and selling the acquisition target back to the vendor at a gain. These issuers had generally updated shareholders on the status of their actions in the announcements or annual reports.

(d) In all cases where the issuers confirmed that the performance guarantees had been met, our review of the accounts of the acquired businesses did not indicate any concern about the truthfulness of such confirmations.

Update on material impairments on assets (other than the acquired assets)

(1) Disclosures in annual reports

31. Some issuers made material impairments on assets (other than the acquired assets), including intangible assets, financial assets, property, plant and equipment and receivables, during the financial year under review. Generally, these impairments were caused by intensified competition in the relevant industry or factors specific to the issuers such as failure to collect account receivables and suspension in production. Issuers in general have disclosed and explained the matters that gave rise to the impairments in their annual reports.

32. These issuers disclosed the basis of the impairments made, for example, in determining bad debt provisions with reference to credit policy. For certain types of assets (such as intangible assets), issuers supported the material impairments with independent valuations*.* In most of these cases the issuers disclosed details of the valuations as described in paragraph 17 above. For those few issuers which had not done so, they did not disclose the bases for changes in particular valuation assumptions that led to the impairments. To enhance shareholders' understanding, we urge issuers to make the recommended disclosures in their future annual reports.

(2) Timeliness of disclosures of material changes

33. Issuers generally disclosed the circumstances that led to the material impairments on assets (other than the acquired assets) in profit warning or other announcements. We did not identify any major issues about the timeliness of such disclosures.

C. Continuing connected transactions

34. Under the Rules, shareholders may give an issuer a prior mandate to conduct continuing connected transactions, subject to the terms of the agreement which provide a framework for negotiating each individual transaction, and annual caps which limit the aggregate size of the transactions. It is important that the terms of the agreement are specific and measurable and that there are adequate internal controls in place to ensure that the individual transactions are indeed conducted within the framework of the agreement.

35. The Rules also require that, in each financial year:

    (a) An issuer must report its continuing connected transactions in its annual report. It must confirm whether its related party transactions (as disclosed in the financial statements) were connected transactions under the Rules and, if so, whether these transactions complied with the connected transaction requirements.

    (b) Independent non-executive directors (**INEDs**) and auditors must review the issuer's continuing connected transactions and report their findings in the issuer's annual reports. INEDs must also confirm whether such transactions were made (i) according to the agreement governing them on terms that are fair and reasonable and in the interests of the issuer's shareholders as a whole; (ii) on normal commercial terms or better; and (iii) in the issuer's ordinary and usual course of business.

36. Guidance Letter GL73-14 provides guidance to issuers on establishing pricing policies in agreements for continuing connected transactions and internal controls to monitor these transactions, and to INEDs on their roles in reviewing the transactions' compliance with the terms of the agreements and the connected transaction Rules. In particular:

    (a) An issuer should have in place adequate internal control procedures to ensure that individual continuing connected transactions are conducted in accordance with the pricing policies or mechanism under the framework agreements. It should also ensure that its internal audit function[8] will review these transactions and the internal control procedures, and provide the findings to the INEDs to assist them in performing their annual review.

[8] Under the Corporate Governance Code, an issuer should also have an internal audit function which carries out an analysis and independent appraisal of the adequacy and effectiveness of its risk management and internal control systems.

(b) INEDs should ensure that (i) the methods and procedures established by the issuer are sufficient to ensure that the transactions will be conducted on normal commercial terms and not prejudicial to the interests of the issuer and its minority shareholders; and (ii) appropriate internal control procedures are in place and the issuers’ internal audit function would review these transactions. Where appropriate, they should make enquiries with the management to ensure that they are given sufficient information to review the transactions and the internal control procedures.

Scope

Internal control procedures

37. We sent questionnaires to 40 selected issuers about their internal control procedures on continuing connected transactions and the annual review by their INEDs of these transactions. The 40 issuers were selected from a pool of issuers which (i) had conducted continuing connected transactions during the financial year which were material to them or (ii) had failed to comply with the continuing connected transaction Rules at some time in the past two years.

38. In the questionnaire, we requested information concerning the issuers’ compliance with the continuing connected transaction Rules in various aspects, including:-

(a) their internal control procedures for monitoring individual connected transactions and ensuring they were conducted in compliance with the agreements and the continuing connected transaction Rules;

(b) the mechanisms for regularly examining and ensuring the effectiveness of the internal control procedures for monitoring continuing connected transactions; and

(c) for issuers which had breached the continuing connected transaction Rules in the past two years and proposed remedial measures to avoid similar non-compliances, whether such measures have been implemented.

INED annual review

39. We also enquired INEDs' view of the issuers' internal control procedures for monitoring continuing connected transactions. Further, we requested information about INED's monitoring work, including:-

    (a) information provided by the management of the issuers to assist INEDs in performing the annual review of continuing connected transactions; and

    (b) INEDs' other specific role and involvement, if any, in overseeing the issuers' continuing connected transactions and the related internal control mechanism on an ongoing basis.

Annual report disclosure

40. We also reviewed the annual reports of 160 issuers selected on a sample basis from those which had conducted continuing connected transactions under framework agreements approved by independent shareholders during the financial year. We reviewed the announcements and circulars of these selected issuers against the disclosures in their annual reports to assess their compliance with the annual report disclosure requirements of the Rules.

Findings

Internal control procedures

41. Our review indicated that issuers have generally followed the specific pricing policies / mechanisms as set out in the respective continuing connected transaction agreements. Further, issuers generally have in place internal guidelines and procedures to ensure that individual transactions were conducted in accordance with the pricing policies or mechanism under the agreements. These procedures include obtaining market price or quotations from independent parties on a regular basis, comparing the pricing terms for transactions conducted with independent parties and those with connected persons to ensure the pricing terms of the continuing connected transactions are on normal commercial terms.

42. To monitor the annual caps and ensure that they will not be exceeded, issuers under review generally prepare periodical report on continuing connected transactions for directors or senior management's review. Some issuers adopt threshold reporting systems or prepare financial forecasts as additional measures to monitor the annual caps. When the transaction amounts are approaching the annual caps, issuers would take measures (e.g. requiring their business teams to reduce or suspend further transactions) to ensure compliance with continuing connected transactions requirements before the annual caps would be exceeded.

43. All issuers selected for review engaged external professional parties (e.g. their auditors or internal control professionals) to review the issuers’ internal controls to ensure that appropriate control procedures are in place and that the procedures are effective. A majority of the issuers also required their internal audit department (or other team of similar function) to review the continuing connected transactions periodically and perform sampling inspections to ensure the internal controls and procedures were followed.

44. The INEDs of all the selected issuers considered that the issuers’ internal control procedures in monitoring continuing connected transactions are properly implemented and effective.

45. Issuers who breached the continuing connected transaction Rules in the past two years generally proposed remedial measures to avoid similar non-compliances. From our review, all of these issuers have implemented their suggested measures. Their INEDs also concluded that those remedial measures were effective in preventing similar non-compliances. In some cases, the INEDs have made additional suggestions to improve the internal control procedures. Examples include recommending the issuer to appoint designated staff to oversee compliance of all continuing connected transactions on an ongoing basis, establishing internal systems to regularly update the list of connected persons, and counter-checking all material contracts to ensure proper identification of continuing connected transactions. In these cases, the relevant issuers have implemented the recommended measures.

INED annual review

46. Same as last year, we noted that issuers have generally provided their INEDs with relevant information for their annual review for the purpose of providing a confirmation on continuing connected transactions in the annual reports. These include (a) information to support that the issuer has in place adequate internal control procedures to comply with the connected transactions Rules (e.g. internal guidelines for conducting continuing connected transactions and auditors’ annual review report on these transactions); (b) information related to the assessment of effectiveness of the internal control procedures (e.g. reports on findings from internal control reviews prepared by internal audit function or external professional parties); and (c) information and supporting documents related to the underlying continuing connected transactions (e.g. agreements, quotations, invoices for the relevant transactions and related price or market trend data to support that the terms of the individual transactions were conducted in accordance with the stated pricing policies and the framework agreements).

47. A majority of the selected issuers confirmed that there was no other specific role and involvement by their INEDs in overseeing continuing connected transactions on an ongoing basis (see paragraph 39 above). However, a few issuers advised that their INEDs have performed the following additional monitoring work:

(a) review monthly or quarterly management reports to monitor issuer's ongoing compliance regarding continuing connected transactions and utilisation status of annual caps;

(b) require the management to report to the INEDs for any exceptions and new transactions on a monthly basis;

(c) review the changes made to the connected persons list kept by the issuer; and

(d) meet with the management teams of different business lines, internal audit team, legal team and finance team to facilitate the INEDs' understanding of the issuer's business and nature of its continuing connected transactions.

48. INEDs play an important role in providing checks and balance over the listed issuers' corporate affairs and transactions. The appropriate level and scope of, and specific measures required for, monitoring continuing connected transactions are expected to be commensurate with the individual circumstances of the issuers, including the type and volume of the transactions, their complexity and the risks involved. We appreciate that some issuers' INEDs (see paragraph 47 above) conduct ongoing monitoring over continuing connected transactions and encourage other issuers to consider the same, subject to their own circumstances.

Annual report disclosure

49. We noted that a vast majority of issuers continued to comply with the annual report disclosure requirements set out in paragraph 35 above. A few issuers failed to (i) confirm in their annual reports whether their related party transactions were connected transactions under the Rules; and (ii) disclose the auditors' review findings on continuing connected transactions. These issuers have subsequently disclosed the missing information in separate announcements or in their next interim reports.

D. Disclosure in business review and significant securities investments in the MD&A section

50. The MD&A section serves to provide meaningful information that enables shareholders and investors to appraise an issuer's performance and prospects. The Listing Rules require disclosures in the annual reports including[9]:

    (a) a discussion and analysis of the issuer group's performance during the financial year and the material factors underlying its results and financial position, which should emphasize trends and identify significant events or transactions during the financial year under review.

    (b) a business review of the issuer's business and its future developments, the principal risks and uncertainties facing the issuer and important events occurred during the financial year under review.

    (c) commentaries on additional areas such as a discussion of the issuer's purpose, corporate strategy and principal drivers of performance, an overview of industry and business trends.

    (d) an explanation of the basis on which the issuer generates or preserves value over longer term (the business model) and the strategy for delivering the issuer's objectives.

51. In addition, paragraph 32(4) of Appendix 16 to the MB Rules / GEM Rule 18.41(4) requires issuers to disclose their significant investments held, their performance during the financial year and future prospects. Sufficient information concerning the investments should be disclosed for shareholders to better appraise the underlying value, potential risk exposure and future prospect of such investments to the issuer.

Scope

Issuers subject to negative market commentaries

52. In recent years, some issuers were subjects of negative market commentaries by short sellers and others. These market commentators questioned the credibility of the issuers' business models and suggested poor internal control systems and/or corporate governance practices. Major allegations in these reports commonly related to overstatements of revenue, understatements of costs of sales and various expenses and undisclosed related party transactions.

[9] Paragraph 28(2)(d), paragraph 32 and paragraph 52 of Appendix 16 to the MB Rules / GEM Rule 18.07A2(d), 18.41 and 18.83 and Code Provision C.1.4 of Appendix 14 to MB Rules / Code Provision C.1.4 of Appendix 15 to GEM Rules

53. These market commentators generally used publicly available information to support their analysis and by applying a "reasonableness" test. For example, they would: (i) identify discrepancies in sales and/or profits by comparing an issuer's group consolidated results with governmental or tax filings of its PRC subsidiaries, its suppliers or major customers; (ii) suggest an overstatement in sales based on tax payments, or based on comparison with published industry statistics or import / export data; (iii) suggest questionable business processes or cost structures based on comparisons of an issuer's selling price, cost structure or other key performance indicators (**KPIs**) with those of its industry peers; or (iv) suggest fictitious cash balances based on interest income reported by an issuer and its operating cash flow. Some market commentators performed additional work to support the allegations, such as site visits or interviews with an issuer's employees, customers and/or suppliers.

54. It was also reported extensively in the media that some market commentators like to target companies with certain characteristics including (i) significantly larger earnings than industry peers; (ii) exceptionally high growth rate in absence of technological advancement; (iii) engagement of lower tier auditors or legal advisers; and/or (iv) possible undisclosed overseas borrowings or undisclosed related party transactions.

55. This year, we reviewed the MD&A disclosure in annual reports of 16 issuers that were subject to negative market commentaries in 2016 and 2017. We also reviewed the announcements made by these issuers to rebut the allegations[10], and where available, the annual reports published subsequent to the negative market commentaries.

Significant securities investments

56. In previous years, we recommended disclosures on the significant securities investments held by the issuers in order for shareholders to better appraise the underlying value, potential risk exposure and future prospects of such investments. This disclosure may include a breakdown of the major investments held, information on their fair value, their performance during the year, their investment strategy and future prospects[11].

[10] Under Guidance Letter GL87-16, the Exchange may continue to follow up with the issuer on any further disclosures, reviews or investigations it considers necessary on matters that have arisen out of the allegations. The Exchange may require the issuer to provide further information to support its denials of the allegations.

[11] In the consultation paper on Backdoor listing, Continuing Listing Criteria and Other Rule Amendments issued by HKEX (June 2018), we proposed to codify our recommended disclosures into the Rules (paragraphs 133 to 135).

57. This year, we selected 75 issuers[12] with substantial investments and considered whether they followed our recommended disclosures.

Findings

Issuers subject to negative market commentaries

58. In our review of the issuers’ MD&A disclosures, the negative market commentaries and issuers’ rebuttal announcements, we noted that issuers generally provided additional information in the rebuttal announcements to support their assertions that the market commentators’ allegations were unfounded. Common assertions made by issuers were that the assumptions made in interpreting the public data were incorrect, or that the market commentators did not understand the issuers’ business models and as a result, did not properly analyze the costs structures, or that certain comparisons to industry peers were not appropriate. We considered that more detailed disclosures in the MD&A section of issuers’ business models and/or explanations of material changes in financial performance would avert or refute these allegations. The following are some examples:

(1) Inadequate disclosure of business / operation model and competitive edge over industry peers

59. In one case a market commentator alleged overstatement of revenue as the issuer’s reported revenue was substantially higher than the publicly available statistics of government tender projects, which were assumed to be the major customers and revenue source. In its rebuttal announcement the issuer clarified that it secured projects from multiple channels and public tender projects represented a minority portion of its revenue source. However, information about the identity, background and relationship with key customers and its key performance drivers were not disclosed in its annual report.

60. In another case it was alleged that an issuer overstated its profits by understating its production costs based on benchmarking the issuer’s financial ratios with its industry peers. In its rebuttal announcement the issuer explained that it adopted a different operation process to achieve lower production costs, including the sourcing of materials, self-supply of power and lower transportation costs. However, information about KPIs, analysis of their trends, and how they were linked with the issuer’s business models and objectives were not discussed in its annual report.

[12] This represented issuers with total investments which accounted for 20% or more of their total assets as at the financial year end dates.

(2) Unclear disclosure on methodology for revenue recognition

61. In one case the market commentator alleged that the issuer had inflated its revenue based on its projections using pricing formulae from the public domain. In another case it was alleged that the issuer inflated the revenue based on the commentator's estimates using production volumes reported by the issuer. In the annual reports, these issuers did not provide sufficient information about their methodology for revenue recognition, operational processes, and breakdown of the product / geographical mix, revenue streams and pricing basis, leading to allegations based on wrong assumptions made by the market commentators.

(3) Insufficient disclosure on treasury policy

62. In one case the market commentator alleged that the issuer's cash balance was fictitious, asserting that the interest income earned should be higher had the issuer maintained the reported cash balance in RMB deposits. The issuer did not make sufficient disclosure about its treasury policy in its annual report.

(4) Insufficient disclosure on material account balances

63. In a few other cases, the analysts alleged fraudulent cash balance or profits. For example, an issuer was alleged to misstate its profits as it made a full tax provision despite the availability of preferential tax treatment. The issuer did not provide sufficient explanation in its annual report about the approval status of the preferential tax treatment and its applicability, and the basis for the calculation of its tax provision.

64. From our review we noted that disclosures by these issuers of their business model and financial performance in the annual reports were limited and the descriptions were generic. We also noted that while most issuers provided additional information regarding their business and/or financial performance in their rebuttal announcements, they did not make material enhancement to the MD&A disclosures in the next annual reports subsequent to the market commentaries.

Recommendation

65. The MD&A section serves to provide meaningful information that enables shareholders and investors to appraise an issuer's performance and prospects. Adequate disclosure by issuers is important to facilitate investors to make informed investment decisions. This would also help reduce the likelihood of allegations based on misinformed assumptions or speculations. Further, an issuer with robust disclosures would be in a better position to defend itself against negative market commentaries by making reference to its published information. An effective and swift rebuttal of unfound allegations may alleviate adverse market reactions towards the allegations and, in turn, help minimize volatility in trading of the issuer's securities.

66. Based on our observations above, we consider that there is a room for improvement in issuers' disclosures in the MD&A section. While the scope and level of disclosures may vary amongst issuers, the directors should have due regard to the Rule requirements in selecting relevant information for disclosure. We recommend issuers to disclose information that would facilitate shareholders' understanding of key aspects of their performances and prospects:

    (a) a description of the business model / revenue recognition methodology of each core business, the unique characteristics of their operation processes, relationships with key customers and suppliers, principal risks and uncertainties affecting the operations and any measures to manage the risk areas;

    (b) an overview of the issuers' strategies for meeting the business objectives for each core business, including strategies specific to business operations (e.g. measures for enhancing production capacity, customer relationships), and other strategies such as treasury policies;

    (c) a discussion on the key performance drivers for the issuers and each core business and why they are significant to an issuer's strategies and results. In particular, in our previous reports, we recommended issuers to enhance disclosures on the reasons for selecting certain KPIs, why they would be effective for the management to measure the business and financial performance as well as the industry trend and ratios; and

    (d) other material information that could facilitate shareholders' understanding of the issuer's performance during the financial year, including material changes to account balances in financial statements. For example, where there are abnormal effective tax rates or material changes in tax liabilities, a discussion on the preferential tax treatments and applicable tax rates and reasons for significant discrepancies or changes in tax balances.

Significant securities investments

67. In last year's report, we recommended issuers to enhance disclosure on the discussion of the issuer's strategy for the significant investments, including discussion on their investment objectives, industry focus and other factors that would be considered for investment decisions to facilitate shareholders' understanding of the potential exposure, benefits and risks of future investments.

68. Based on our review, we noted there was an improvement on the disclosure on the discussion of the issuer's strategy for the significant investments. However, some issuers did not disclose details of their investment costs. To enhance shareholders' understanding, we recommend that issuers follow our guidance set out in paragraph 56 above.

E. Financial statements with auditors' modified opinions

69. Issuers are obliged to provide shareholders with financial statements which fairly present their financial position and performance and are free from material misstatements. Such financial information is necessary for shareholders and investors to make an informed investment decision.

70. Paragraph 3 of Appendix 16 / GEM Rule 18.47 requires an issuer to provide more detailed or additional information if its financial statements do not give a true and fair view of its state of affairs, results of operations and position of cashflows.

71. Under the Corporate Governance Code:

    (a) The board is responsible for ensuring that (i) the issuer establishes and maintains appropriate and effective internal control systems for proper financial reporting; and (ii) a review of the effectiveness of internal control systems is conducted at least annually and is reported to shareholders in its Corporate Governance Report. Under Code Provision C.2.4 the issuer should disclose a narrative statement on its risk management and internal control processes. C.2.6 and C.2.7 recommend issuers as best practices to also disclose details of any significant areas of concern and confirmation from management of the effectiveness of the issuer's risk management and internal control systems.

    (b) Under C.3 the audit committee should monitor the integrity of the issuer's financial statements and review any significant financial reporting judgments contained in the annual reports, the going concern assumptions and any modifications, and compliance with accounting standards. It should also give due consideration to any matters raised by the auditors.

    (c) Under C.1 the board should prepare the financial statements on a going concern basis, with supporting assumptions and modifications as necessary unless it is inappropriate to assume that the issuer will continue its business. Where the directors are aware of material uncertainties relating to events or conditions that may cast significant doubt on the issuer's ability to continue as a going concern, they should be clearly and prominently disclosed and discussed at length in the Corporate Governance Report. The disclosure should contain sufficient information for investors to understand the severity and significance of matters. Issuers may refer to other parts of the annual report but should not contain only a cross-reference without any discussion of the matter.

Scope

72. This year we reviewed the annual reports of 78 issuers[13] whose auditors expressed a modified opinion on the issuers' financial statements for the financial year ended in 2017, including 44 issuers with disclaimer of opinions and 34 issuers with qualified opinions. Of these, 29, 13, 19, 7, 3, 3, and 4 issuers had modified opinions for the first, second, third, fourth, fifth, sixth and seventh years[14].

Findings

(1) 29 issuers with modified opinions for the first time

73. In prior years' report, we recommended issuers with auditors' modified opinions provide the following disclosure in their annual reports:

(a) details of the modifications and their actual or potential impact on the issuers' financial position;

(b) management's position and basis on major judgmental areas (such as basis for impairment or valuation of assets), and how the management's view is different from that of the auditors;

(c) audit committee's view towards the modifications, and whether the audit committee reviewed and agreed with the management's position concerning major judgmental areas; and

(d) issuers' proposed plans to address the modifications.

74. We have reviewed the annual reports of the 29 issuers to consider whether they have followed our recommended disclosures. We noted that most of these issuers have made disclosures in their annual reports on all of the recommended areas. The minority of issuers that did not follow the recommended disclosures generally failed to disclose the audit committee's view towards the modifications and/or the proposed actions to address the modifications.

[13] Excluding 22 issuers that were long suspended companies at the time they published the financial statements for 2017. In the prior year, there were 70 issuers (excluding long suspended issuers) that had modified opinions.

[14] Of the 70 issuers with modified opinions in 2016, 21 issuers have removed all their audit modifications in their 2017 financial statements.

75. Issuers should inform its shareholders of their intended actions to address the audit modifications and take prompt actions to implement those plans. Upon our follow up, those issuers had disclosed such information by announcements.

(2) Issuers with repeated modified opinions

76. 49 issuers had audit modifications brought forward from previous years. We reviewed the actions taken by these issuers to address the modifications. Of these, 16 issuers have resolved the underlying issues that led to the audit modifications[15]. The actions taken by these issuers to resolve the issues included (i) disposing of the problematic subsidiaries or assets; (ii) making appropriate asset impairments; (iii) providing the auditors with the requested information for audit purposes; and (iv) implementing restructuring plan such as debt restructuring and capital raising. In addition, two issuers resolved the audit issues brought forward from last year but had new audit issues which formed basis of the continued modified opinion.

77. Of the remaining 31 issuers, a majority of those issuers had not taken appropriate actions to resolve the audit modifications. A minority of the issuers resolved some (but not all) of the audit modifications. Only a few cases involve issues where the circumstances were not within the issuers' control (e.g. on-ongoing litigation, matters subject to government approvals or negotiations involving various parties). In a few extreme cases involving repeated audit modifications, there were questions whether the directors properly discharged their fiduciary duties, we have taken appropriate actions in those circumstances.

78. We noted that there remain a large number of issuers that have not taken adequate actions to resolve the audit modifications. A modified audit opinion on the financial statements indicates a risk of material misstatement, raising questions about whether investors have sufficient information about the issuer's financial positions, and/or whether the issuer has appropriate risk management and internal control systems to safeguard its assets and properly report on its financial position. We remind issuers to take prompt actions to resolve the issues that led to the audit modifications.

[15] Depending on the nature of the issue, the financial statements for the following years may continue to have modified opinions (e.g. the auditors may give a modified opinion on the opening balances in the following year).

79. In some cases the audit modifications suggested deficiencies in issuers' internal control systems (e.g. inadequate documentation or record-keeping systems for accounts receivables, deposits, or expenses, or loss of access to books and records of subsidiaries). As stated in paragraph 71(a) above, the issuer's Corporate Governance Report should have a narrative statement on its risk management and internal control processes. It is also a recommended best practice to disclose details of any significant areas of concern and confirmation from management of the effectiveness of the issuer's risk management and internal control systems. We note that a majority of issuers have made appropriate disclosures.

80. We also noted that more than half of the issuers with modified opinions relating to going concern did not discuss this in the Corporate Governance Report. We have provided guidance to these issuers in this regard.

F. Disclosures on material other expenses / income

81. Paragraph 32 of Appendix 16 to the MB Rules requires a discussion and analysis of the issuer's performance during the financial year and the material factors underlying its results and financial position. The issuer should emphasize trends and identify significant events or transactions during the financial year under review.

82. Financial statements, in particular the statement of profit or loss, present important information on the issuers' financial performance during the year. Material income and expense items in the statement of profit or loss could affect issuers' profitability and financial position significantly, and for that reason issuers should make adequate disclosures to describe the nature of, and explain the movements of these material items. Such disclosures facilitate investors in understanding the major factors contributing to the issuer's financial performance during the year.

Scope

83. This year, we reviewed the annual report disclosures of issuers which reported material other expenses or other income. For this purpose we selected all issuers which presented "other / other operating expenses" or "other / other operating income" as a line item on their statement of profit or loss and the amounts of which were material[16]. Of those, 306 issuers recorded material "other / other operating expenses" and 506 issuers recorded material "other / other operating income" in their statement of profit or loss. We reviewed the disclosures in their annual reports on these items, including notes to these expenses or income items and commentary in the MD&A section (if any).

Findings

Other expenses

84. We noted from our review of the annual reports that:

    (a) About one-third of the selected issuers with material "other / other operating expenses" provided, by way of footnotes, breakdown for most or all of such item. These expenses mainly included advertising expenses, travelling expenses, impairment losses on assets (e.g. goodwill, trade and other receivables and inventories), auditors' remuneration, legal and professional expenses and operating lease charges; and

[16] This represented issuers with "other / other operating expenses", or "other / other operating income" which accounted for over 25% of their revenue or net profits / loss and were over HK$10 million.

(b) The remaining two-third of issuers provided no or limited disclosures on "other / other operating expenses". In particular, a large majority of these issuers neither provided any breakdown, nor any qualitative analysis in their MD&A section. It is further noted that for some issuers, the unexplained "other / other operating expenses" were also material to the issuers with reference to the issuers' total costs and expenses for the year[17]. We have provided guidance to these issuers in such regard.

85. To enhance shareholders' understanding, we recommend issuers to improve their disclosures and provide appropriate breakdown of their other expense items in their future annual reports.

Other income

86. Based on our review, all the selected issuers with material "other / other operating income" have disclosed either fully the entire item or a material portion of the item by way of footnotes. We have not identified major issues on this area.

[17] This represented issuers with other / other operating expenses which accounted for more than 20% of the issuers' total costs and expenses for the year.

III. FINDINGS ABOUT RULE COMPLIANCE BY ISSUERS LISTED IN 2016 AND 2017

87. As part of the Listing Department's ongoing monitoring activities, we reviewed new issuers' Rule compliance and annual report disclosure. This section highlights our general observations and recommendation.

Scope

88. 120 and 161 issuers were listed in 2016 and 2017 respectively (the **Newly Listed Issuers**)[18]. We considered their Rule compliance and annual report disclosure in the following areas:

 (a) profit forecasts and material decline in financial results;

 (b) changes in the use of IPO proceeds;

 (c) undertakings provided by major shareholders;

 (d) fulfilment of conditions or undertakings imposed before listing; and

 (e) non-compliance with the Listing Rules after listing.

89. We also reviewed the post-listing developments of these issuers for material changes and corporate actions after listing.

Findings

(1) Profit forecasts and material decline in financial results

Profit forecasts

90. A vast majority of the Newly Listed Issuers did not publish any profit forecast in their prospectus. Those Newly Listed Issuers that published a profit forecast were able to meet the forecasted profits.

Profit warning announcements

91. Some Newly Listed Issuers published profit warning announcements in relation to their interim periods or financial years immediately after listing.

[18] Transfers of listing from GEM to Main Board are excluded.

92. In previous years, we reminded issuers to observe the guidance published in the April 2015 and December 2016 SFC Corporate Regulation Newsletters and our previous Reports. Profit alert announcement that repeats facts previously disclosed in the prospectus is not necessary and may even cause confusion. If an issuer feels that it needs to make such an announcement, it should clarify the extent to which the information in the announcement differs from those previously disclosed in the prospectus. If there has been a significant change in the facts and circumstances since the prospectus was issued, the issuer may be required to make an announcement under the Inside Information Provisions. In addition, an issuer is encouraged to quantify potential impact to the profit figure and use clear and concise language in a profit alert announcement.

93. Based on our review all profit warning announcements disclosed the expected changes to the profit or loss and the major reasons for such changes. About half of these issuers quantified such financial impact in terms of percentages or in dollar amounts. However, a small number of issuers merely repeated information that was previously disclosed in the prospectus in their profit warning announcements. We remind issuers again to observe our guidance.

94. We also made follow up enquiries with issuers whose financial results in the interim periods or financial years immediately after listing deviated materially from the profit forecast submitted to the Exchange as part of the new listing application. All (except one issuer) explained that the material changes in the financial results were due to events that took place after listing. In one case, the issuer published a profit warning announcement shortly after listing and the reasons for the decline appeared to have existed as at the date of the prospectus but were not disclosed therein. We have taken appropriate action.

(2) Changes in the use of IPO proceeds

95. The disclosure of the use of IPO proceeds in IPO prospectuses indicates how a new issuer deploys resources to develop and expand its business. This is relevant information for investors to appraise the issuer's business development and make informed investment decisions. Where there are changes to the use of IPO proceeds and/or business strategies, an issuer should timely and properly explain any material changes by way of announcement.

96. Some Newly Listed Issuers announced changes to their proposed uses of IPO proceeds within the first two years after listing. We have reviewed their disclosures and considered that these issuers had generally explained the changes on a timely basis.

(3) Undertakings provided by major shareholders

97. It remains common that a Newly Listed Issuer is given a non-competition undertaking (**NCU**) by its major shareholder(s) for the purpose of establishing a clear delineation between the issuer's business and that of the major shareholder(s). Generally the major shareholders would undertake that they would take steps to comply with their obligations under the NCUs and make annual declarations confirming such compliance in the annual reports.

98. Upon our review we noted that, notwithstanding these undertakings, some issuers failed to disclose the steps undertaken to comply with the NCUs and the annual declarations by the major shareholders. In response to our enquiry, most of these issuers published supplemental announcements or agreed to disclose such information in their forthcoming financial reports. We have also given guidance reminding these issuers to ensure disclosure of the same in the future annual reports.

(4) Fulfilment of conditions or undertakings imposed before listing

99. Where the Listing Committee imposed specific conditions on, or required undertakings to be provided by, a new issuer before listing, the issuer should disclose its compliance with such conditions or undertakings in its annual report after listing.

100. We identified a few cases where the Newly Listed Issuers were required to disclose in their annual reports whether the relevant conditions or undertakings imposed before listing were fulfilled. These included updates on business exposure to sanctions risks, disclosures on the actual use of advance mandates for asset acquisitions and report on risk management advisor's findings. All these issuers had disclosed such information in their annual reports.

(5) Non-compliance with the Listing Rules after listing

101. We identified a slight increase in non-compliances with the Listing Rules by Newly Listed Issuers. The breaches / potential breaches included:

(a) non-compliance with notifiable / connected transaction requirements (19 cases) where the issuers failed to announce notifiable/connected transactions in a timely manner and seek shareholder approval for the proposed transactions (including one case that involved repeated non-compliances with the notifiable and connected transaction Rules and possible failure by the issuer to maintain adequate internal control and/or corporate governance measures);

(b) non-compliance with the financial reporting / results announcements requirements (4 cases) where the issuers failed to dispatch / announce the financial reports / results within the prescribed period under the Rules;

(c) failure to make accurate and complete disclosure in the prospectus (see paragraph 94) and announcement (2 cases);

(d) non-compliance with the lock-up of controlling shareholders' interest (1 case); and

(e) failure to meet the minimum public float requirement (2 cases). Both cases involved core connected persons (other than controlling shareholders) acquiring shares in the issuers, resulting in breach of the minimum public float requirement.

102. We have taken disciplinary actions (including public censure or cautions) against most of these issuers. Three cases are under investigation.

103. Chapter 3A (or Chapter 6A of GEM Rules) requires an issuer to consult with its compliance adviser on a timely basis in certain circumstances, specifically (a) before the publication of any regulatory announcement, circular or financial report; (b) where a transaction which might be a notifiable or connected transaction is contemplated including share issues and share repurchases; and (c) where there is a proposed change of the use of IPO proceeds, or a proposed change in business activities, developments or results which deviated from any forecast, estimate or other information in the prospectus. We continue to remind all new issuers and sponsors to observe the Rule requirements to consult with their compliance advisers in a timely manner in the aforesaid circumstances.

(6) Post-listing developments of the Newly Listed Issuers

104. In June 2016, we issued Guidance Letter (GL68-13A) which noted our concerns that some issuers might have sought new listings for the perceived premium attached to the listing status rather than the development of the underlying business or assets. In light of this, we have reviewed the post-listing developments of the Newly Listed Issuers, particularly where they have exhibited "shell" characteristics after listing.

105. Based on our review we noted 19 issuers that have undertaken one or more of the following activities after listing: (a) disposal of controlling interests by the original controlling shareholders; (b) material acquisitions of new business and/or material disposals of original business; and/or (c) reallocation of IPO proceeds to new business:

(a) Disposal of controlling interests by the original controlling shareholders

The original controlling shareholders of 17 issuers disposed of their controlling interests in the issuers. The majority of these disposals took place within one year after the regulatory lock-up period. 13 cases involved the introduction of new controlling shareholders and mandatory general offers under the Code on Takeovers and Mergers by the new controlling shareholders. We noted that most of these new controlling shareholders are PRC individuals or entities with background unrelated to the businesses of the issuers.

(b) Material acquisition of new business and/or material disposals of original business

Two issuers proposed material acquisitions of new business that constituted major acquisitions. In one case, the issuer reallocated a material part of its IPO proceeds to finance the acquisition. In the other case, the proposed acquisition was made with the new controlling shareholder of the issuer. The new lines of business of both issuers were not disclosed in their business plans in the IPO prospectus.

There were no material disposals of original businesses by the Newly Listed Issuers[19].

(c) Reallocation of IPO proceeds to new business

Two issuers changed the use of IPO proceeds and reallocated the proceeds into new businesses (including the issuer described in paragraph 105(b) above)[20].

106. We have the following observations on these issuers:

(a) Small market capitalization

13 were Main Board issuers with median initial market capitalization of HK$480 million, and 6 were GEM issuers with median initial market capitalization of HK$270 million at the time of listing.

[19] In addition, 27 Newly Listed Issuers conducted very substantial acquisitions and major acquisitions of businesses that were part of the same line of business of the issuers. 3 Newly listed issuers conducted major disposals and very substantial disposals of assets. Such assets did not constitute the core businesses of those issuers at the time of the IPO.

[20] In addition, 45 issuers changed the use of IPO proceeds within the first two years after listing. These issuers either re-allocated the proceeds to other initiatives under the business plan disclosed in the prospectus, or applied the proceeds for existing principal businesses.

(b) Utilization status of IPO proceeds and material changes

We reviewed the utilization of IPO proceeds of these issuers. Only 4 issuers fully utilized their IPO proceeds in accordance with the plan disclosed in the prospectus. About half have not applied their IPO proceeds according to the expected timetable disclosed in their prospectuses. Some issuers explained that the failure to meet their timetable was due to delays in executing their expansion plans, and a few of these issuers also proposed changes in the use of IPO proceeds.

(c) Material decline in financial performance

16 issuers recorded material decline in net profits (excluding listing expenses) after listing[21].

107. In June 2018, we published the Consultation Paper on Backdoor Listing, Continuing Listing Criteria and Other Rule Amendments. It was noted that some issuers were engaged in "shell creation" activities and investors would acquire control of these issuers and used them as a listing platform to acquire new businesses that would bear no relationship with the issuer's original business, achieving backdoor listings of those new businesses and circumventing the new listing requirements. These backdoor listings were often conducted through a series of arrangements and transactions, including the change in control of the issuer, acquisitions (or a series of acquisitions) of new business(es) and disposals of the original businesses of the issuers. In view of these activities, we will continue to closely monitor the post-listing activities conducted by new issuers and where justified, apply the reverse takeover Rules.

[21] This represented issuers whose net profits (excluding listing expenses) decreased by 20% or more in any financial years after listing as compared to the last financial year before listing.

IV. FINDINGS REGARDING ACCOUNTING REVIEW THEME – MATERIAL INTANGIBLE ASSETS

108. Intangible assets can form part of the significant assets of issuers and this is an emerging area of investors' interest. The disclosures related to goodwill and other intangible assets are the most challenging areas for issuers, which require information about management's judgements and estimates.

109. Recognition, measurement and relevant disclosure requirements of intangible assets are primarily set out in the following three accounting standards:

(a) Hong Kong Accounting Standard (**HKAS**) 36 *"Impairment of Assets"*, which sets out the requirements to account for asset impairment, in particular goodwill and intangible assets;

(b) HKAS 38 *"Intangible Assets"*, which sets out the requirements to recognize and measure intangible assets; and

(c) HKFRS 3 (Revised) *"Business Combinations"*, which sets out the principles on the recognition and measurement of assets and liabilities in business combinations, the determination of goodwill and the necessary disclosures.

Scope

110. For this purpose, we selected all issuers whose intangible assets had accounted for over 25% of their total assets. 165 issuers fell into this category, of which 121 issuers' annual reports had a financial year-end date of 31 December 2017, and 44 issuers had other financial year-end dates in 2017.

111. We reviewed the issuers' financial statement disclosures relating to the material intangible assets to assess whether they had complied with the requirements under HKFRSs, in particular, specific disclosures required by HKAS 36 and HKAS 38, including information related to the annual impairment tests for goodwill and intangible assets with indefinite useful lives (HKAS 36.134) and general disclosure requirements for intangible assets (HKAS 38.118-123).

112. We also examined the level of detail of their disclosures, particularly information on management's judgements and estimates under HKAS 1 (Revised) *"Presentation of Financial Statements"* (HKAS 1R.122 and 1R.125), to justify whether:

(a) the financial budgets and assumptions used in determining the recoverable amounts were reasonable;

(b) the intangible assets disclosed as having indefinite or long useful lives were supportable; and

(c) the intangible assets had been properly identified, separately recognized and measured at fair value in business combinations.

Findings

113. Based on the cases reviewed, we found that the most common intangible assets were: goodwill, customer relationships, research and development costs, mining rights, software, technology know-how, trademarks, patents and licences.

114. The 165 issuers covered a wide range of industry sectors:

Industry	**No. of issuers**
Consumer Goods	33
Consumer Services	35
Energy	12
Financials	8
Industrials	16
Information Technology	17
Materials	18
Telecommunications	7
Utilities	15
Others	4
Total	**165**

115. We observed that the issuers under review generally included the required disclosures and we did not note any significant non-compliance regarding the disclosure requirements in HKFRSs, in particular HKAS 36 and HKAS 38. During our review, where disclosures were not sufficiently specific or descriptions were generic, we made enquiries with issuers to obtain additional information. Where disclosure was insufficient and not material to the financial statements as a whole, we obtained confirmations from issuers that the required information would be provided in future financial reports.

116. Based on our review and issuers' responses to our enquiries in relation to the cases under review, we had referred five cases to the Financial Reporting Council (the **FRC**) for further enquiry and investigation of possible accounting and auditing irregularities.

117. From our review, we found the following three key areas, particularly about their accounting judgements or estimates (HKAS 1R.122 and 1R.125) where enhancements could be made to provide better information to investors.

(1) Disclosures on the reasonableness of the financial budgets and assumptions used in determining the recoverable amounts

118. Many issuers under review had goodwill together with other intangible assets (with finite or indefinite useful lives), and were required to perform an annual impairment test[22]. In most of the cases, the recoverable amounts[23] of the cash-generating units (**CGUs**) to which goodwill and intangible assets were allocated were based on value in use (**VIU**) calculation.

119. We made a number of enquiries when there were indications of possible impairment without any impairment losses, in particular when (i) the group or the CGU suffered recurring operating losses or deterioration in revenue, net profit or gross profit margin, or (ii) for certain industries, the carrying amount of the issuer's net assets was substantially more than its market capitalization resulting from a recent drop. In some cases where the issuers had engaged independent professional valuers, we still observed that it was unclear why the directors believed that no impairment loss was needed or assumptions applied were reasonable.

120. Under the above circumstances, we requested additional information or clarifications from the relevant issuers for their compliance with HKAS 36, including:

(a) quantifying the key assumptions underlying the cash flow projections (such as budgeted sales, gross and net margins). This was because the descriptions of the key assumptions underlying the cash flow projections were unclear (HKAS 36.134(d)(ii)). For example, the gross margin or the terminal growth rate appeared to be overly optimistic with regard to historical cash flows and results, raising doubts as to whether the key assumptions were reasonable and supportable;

[22] HKAS 36.9-11 not only requires an annual impairment test on (i) an intangible asset with an indefinite useful life; (ii) an intangible asset not yet available for use; and (iii) goodwill acquired in a business combination, but also requires an impairment test on any non-financial assets where there is an indication of impairment.

[23] An asset should not be carried at more than its recoverable amount. If its carrying amount exceeds the amount to be recovered through use or sale, it is impaired and the issuer should recognize an impairment loss.

(b) justifying the rationale of why the management used a financial budget / forecast that covered a period greater than five years (HKAS 36.134(d)(iii));

(c) explaining why the discount rate or terminal growth rate used (HKAS 36.134(d)(iv) and (v)) was significantly changed from one year to another;

(d) clarifying whether a sensitivity analysis of the key assumptions had been performed; and confirming whether reasonably possible change in the key assumptions would cause the CGU's carrying amount to exceed its recoverable amount (HKAS 36.134(f));

(e) quantifying the recoverable amount of the CGU and the headroom available (i.e. the excess of the recoverable amount of the CGU over its carrying amount), and clarifying whether the assessment was based on a valuation carried out by an independent professional valuer and requesting for a copy of the valuation report; and

(f) explaining why no impairment loss was recognized when the group or the CGU was loss-making or suffered deterioration in revenue, gross and net profit margins (e.g. to ascertain whether there are any new business plans that had been implemented or contracts with new customers that had been entered into, which would further support the VIU calculation).

121. We observed that some issuers had enhanced their disclosures by providing additional information about their impairment tests, such as a negative statement indicating that reasonably possible change in the key assumptions would not cause an impairment loss and engagement of an independent professional valuer.

(2) <u>Disclosures on the assessment of the intangible assets with indefinite or long useful lives</u>

122. We observed that the issuers' disclosures on the determination of the indefinite or long useful life tended to be generic rather than entity-specific. In particular, the descriptions of the reasons supporting the assessment of intangible assets with indefinite useful lives were brief or omitted, including describing the factors that played a significant role in determining that the intangible assets had indefinite useful lives (HKAS 38.122(a)).

123. One issuer disclosed that its mobile application had an indefinite useful life because *"it is expected to contribute to net cash flows indefinitely"*. We noted that the disclosure was based on the text taken from HKAS 38[24] but did not explain the particular factors that resulted in the judgment made in determining the mobile application had an indefinite useful life.

124. Another issuer explained that its *"provisional"* licence had a 25-year useful life because it *"does not have a contractual term of use"*. We considered that the nature of the licence, which was temporary, appeared to contradict the explanation. It was therefore unclear how its "25-year" useful life could be justified.

(3) <u>Disclosures on the accounting for business combinations, in particular whether the intangible assets had been properly identified, separately recognized and measured at fair value</u>

125. We observed that some issuers had completed business combinations in recent years and recognized a significant amount of goodwill in the financial statements because the fair value of identifiable assets acquired was minimal. However, their MD&A or earlier announcements indicated that intangibles were purchased (e.g. customer relationships and contracts with customers and suppliers), it was unclear why the intangibles did not satisfy the asset recognition criteria under HKFRS 3 (Revised) and HKAS 38. We therefore requested these issuers to explain why there were no intangible assets (other than goodwill) recognized in the acquisition in accordance with HKFRS 3 (Revised) and HKAS 38.

126. In another case, the issuer recognized a significant gain on bargain purchase in the income statement because the fair value of the identifiable assets acquired was substantially higher than the consideration paid. However, the issuer's disclosure in relation to why the transaction resulted in a gain (HKFRS 3R.B64(n)) was unclear. We therefore requested the issuer to confirm whether it had properly carried out the steps specified under HKFRS 3R.36, including a review of the procedures used to measure the acquisition-date amounts of the identifiable assets and liabilities, before recognizing the gain.

[24] HKAS 38.88 states: *"An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity."*

Our recommendations

127. In relation to the above three key areas about accounting judgements and estimates, our recommendations are set out below.

(1) <u>Disclosures on the reasonableness of the financial budgets and assumptions used in determining the recoverable amounts</u>

128. Issuers are reminded that impairment testing is required to be performed on an annual basis irrespective of whether any indication of impairment exists for goodwill, intangible assets with indefinite useful lives and intangible assets not yet available for use (HKAS 36.10), and that the concept of materiality (HKAS 36.15) is not applicable to these assets. For other non-financial assets within the scope of HKAS 36, issuers have to assess at the end of each reporting period whether there is any indication that these assets may be impaired and, if so, estimate their recoverable amounts (HKAS 36.9).

129. For this purpose, we recommend that issuers consider, at a minimum, the non-exhaustive list of indications of impairment set out in HKAS 36.12 and 36.14:

HKAS 36.12 – a non-exhaustive list of indications of impairment	
<u>External sources of information</u>	
(a)	a significant and unexpected decline in the asset's market value
(b)	significant adverse effects in the technological, market, economic or legal environment
(c)	increases in market interest rates that are likely to affect the discount rate used in calculating an asset's VIU and decrease the asset's recoverable amount materially
(d)	the carrying amount of the net assets of the entity is more than its market capitalization
<u>Internal sources of information</u>	
(e)	obsolescence or physical damage of an asset
(f)	an asset is idle, part of a restructuring or held for disposal
(g)	internal reporting *(see HKAS 36.14 below)* that indicates that the economic performance of an asset is, or will be, worse than expected
(h)	for investments in subsidiaries, joint ventures or associates, the carrying amount is higher than the carrying amount of the investee's assets, or a dividend exceeds the total comprehensive income of the investee

HKAS 36.14 – indications from internal reporting	
(a)	cash flows for acquiring the asset, or subsequent cash needs for operating or maintaining it, that are significantly higher than those originally budgeted
(b)	actual net cash flows or operating profit or loss flowing from the asset that are significantly worse than those budgeted
(c)	a significant decline in budgeted net cash flows or operating profit, or a significant increase in budgeted loss, flowing from the asset
(d)	operating losses or net cash outflows for the asset, when current period amounts are aggregated with budgeted amounts for the future

130. Whenever there are indications of impairment, issuers should perform an impairment test, which is not necessarily performed at the year end. For example, where an issuer experienced a significant loss (for the group as a whole or an operating segment) in the interim period, it should disclose in its interim report (i) whether it has performed an interim impairment test; (ii) the event that triggered the test; and (iii) the test result (even if it does not result in impairment).

131. In addition, we strongly remind issuers that directors and management are responsible for performing proper analysis and exercising judgement to assess the reasonableness of key assumptions applied in impairment testing (HKAS 36.33) so that assumptions applied (such as budgeted sales and gross margins) are not overly optimistic. If the carrying amount exceeds the recoverable amount, an asset or a CGU is impaired and an impairment loss should be recognized.

132. We highlight the following from HKAS 36 which require issuers' attention in measuring the VIU:

HKAS 36.30-57 – VIU
HKAS 36.6 defines VIU as *"the present value of the future cash flows expected to be derived from an asset or cash-generating unit"*. Issuers are reminded of the following when estimating the future cash flows: <u>(a) Management's best estimates</u> • Cash flow projections on reasonable and supportable assumptions • Greater weight shall be given to external evidence <u>(b) Forecast period</u> • Maximum of five years, unless a longer period can be justified • Cash flow projections after the forecast period are extrapolated over the useful life of the CGU using a steady or declining growth rate that is consistent with that of the products, industry or country <u>(c) Cash flow assumptions</u> • Capital expenditure – exclude expansionary capital expenditure, unless already committed to by the entity • Restructuring – exclude restructuring plans, unless already committed to by the entity • Corporate overheads – include those for the day-to-day servicing of the asset as well as future overheads that can be attributed directly, or allocated on a reasonable and consistent basis, to the use of the asset <u>(d) Discount rate</u> Pre-tax discount rate should reflect current market assessments of: • the time value of money; and • the risks specific to the asset for which the future cash flow estimates have not been adjusted

133. HKAS 36.126-137 requires extensive disclosures in respect of the impairment tests performed and impairments recognized. In particular, issuers are reminded of the following:

HKAS 36.130(a)-(g)
Information about an individual asset (including goodwill) or a CGU, for which an impairment loss has been recognized or reversed during the period, including: • the events and circumstances that led to the recognition or reversal of the impairment loss *(Note)* • the recoverable amount of the impaired asset or the CGU • whether the recoverable amount is its fair value less costs of disposal or VIU • if the recoverable amount is fair value less costs of disposal, the corresponding information required (HKAS 36.130(f)), including the level of the fair value hierarchy within which the fair value measurement of the asset (CGU) is categorized in its entirety • if recoverable amount is VIU, the discount rate(s) used in the current estimate and previous estimate (if any) of VIU *Note: Issuers are reminded that the narrative information should be case-specific and closely related to the issuer's operations and activities.*
HKAS 36.134(a)-(f)
Information about each CGU (group of units) for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, including: • whether the CGU's recoverable amount is determined based on VIU or fair value less costs of disposal • key assumptions applied to estimate the recoverable amount and how they are determined • the period over which management has projected cash flows based on financial budgets / forecasts approved by management and reason why a period greater than five years is used • growth rate used to extrapolate cash flow projections • discount rate applied to cash flow projections • the information required by HKAS 36.134(f) if a reasonably possible change in a key assumption would cause the CGU's carrying amount to exceed its recoverable amount

134. To enhance clarity, where issuers have material goodwill and other intangible assets or there are indications of possible impairment, we recommend certain areas of disclosures could be enhanced by disclosing them in the MD&A and financial statements (where appropriate). For example:

(a) providing additional quantitative data of key assumptions (other than discount rate and terminal growth rate, e.g. gross and net margins), comparative information in the previous year and the explanation of significant changes of assumptions;

(b) providing a negative statement indicating that reasonably possible change in the key assumptions on which the management had based its determination of the CGU's recoverable amount would not cause an impairment loss (which is not required by HKAS 36.134(f));

(c) providing the recoverable amount of the CGU and the headroom available;

(d) highlighting whether the impairment assessment is based on a valuation by an independent professional valuer; and

(e) providing details of further development of the CGU or segment, such as business plan and contracts with new customers in the coming year and their impact on the revenue and margins.

(2) *Disclosures on the assessment of the intangible assets with indefinite or long useful lives*

135. Accounting for an intangible asset is based on its useful life[25]. HKAS 38.93 states: *"The useful life of an intangible asset may be very long or even indefinite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short."* Issuers are reminded to refer to HKAS 38.88-96 for details of the requirements and the Illustrative Examples accompanying HKAS 38, such as HKAS 38.90 which sets out the factors considered in determining the useful life of an intangible asset, including:

HKAS 38.90
(a) the expected usage of the asset by the entity and whether the asset could be managed efficiently by another management team (b) typical product life cycles for the asset and public information on estimates of useful lives of similar assets that are used in a similar way (c) technical, technological, commercial or other types of obsolescence *(Note 1)* (d) the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset (e) expected actions by competitors or potential competitors (f) the level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the entity's ability and intention to reach such a level (g) the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases *(Note 2)* (h) whether the useful life of the asset is dependent on the useful life of other assets of the entity *Note 1: HKAS 38.92 states: "Given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it will often be the case that their useful life is short …"* *Note 2: HKAS 38.94 states: "The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset. If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost …"*

[25] An intangible asset, if finite, is amortized; if indefinite, is not subject to amortization but mandatorily subject to an annual impairment review.

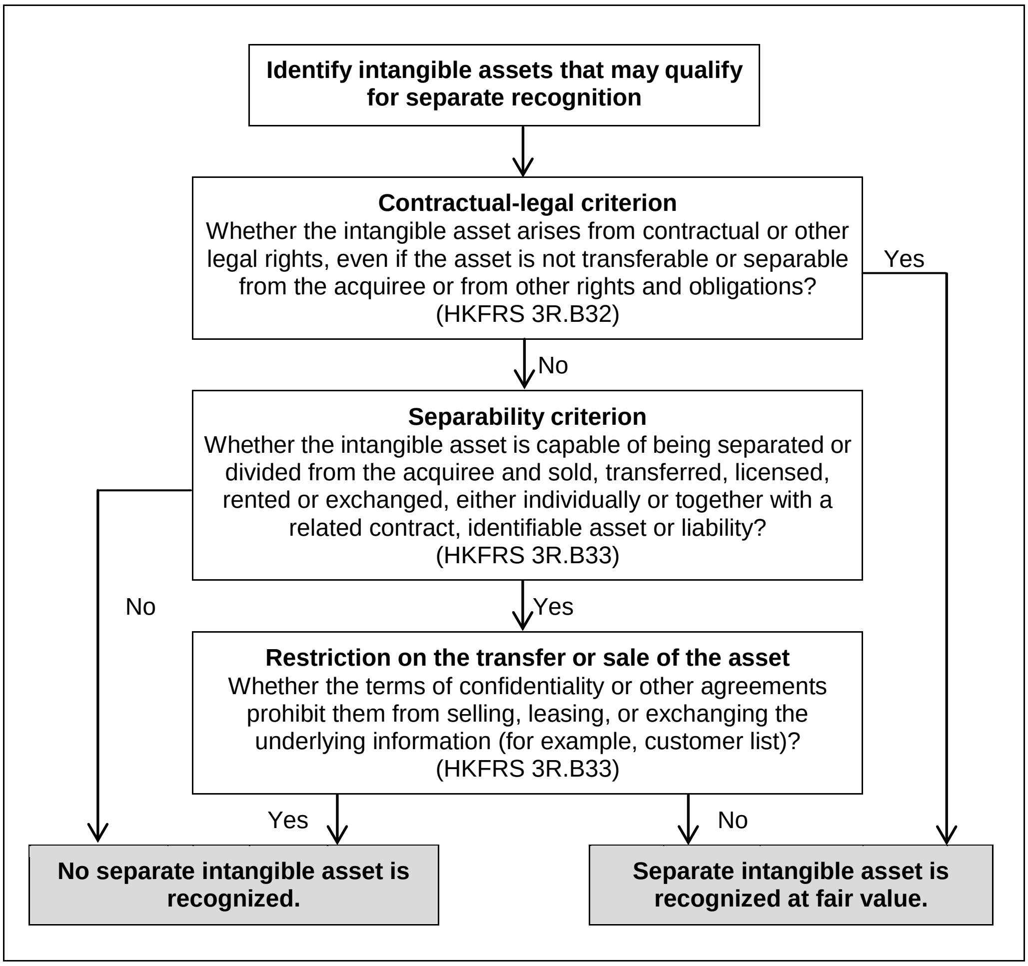
136. Issuers should take into account all of the relevant factors and disclose the key judgements made by the management in determining the useful life of an intangible asset. The disclosures should be tailored to their specific circumstances. In particular, when describing the factors that played a significant role in determining that the useful life of an intangible asset is indefinite (HKAS 38.122(a)), HKAS 38.123 requires an entity to consider the list of the factors in HKAS 38.90.

137. Issuers are also reminded that the amortization period and the amortization method for an intangible asset with a finite useful life should be reviewed at least at each financial year-end (HKAS 38.104), while the indefinite useful life of an intangible asset should be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset (HKAS 38.109). We recommend issuers to highlight in the financial statements that an annual review has been performed to determine whether events and circumstances continue to support their useful life assessment, in particular, cases where an intangible asset is classified as having an indefinite or a long useful life.

(3) *Disclosures on the accounting for business combinations, in particular whether the intangible assets had been properly identified, separately recognized and measured at fair value*

138. Issuers should note that all identifiable intangible assets acquired in a business combination are recognized separately from goodwill and are initially measured at their acquisition-date fair values (HKFRS 3R.10 and 3R.18). This often involves identifying and recognizing intangible assets not previously recognized by the acquiree in its financial statements (HKFRS 3R.13). Therefore, the identification and recognition of intangible assets is an important part of the acquisition accounting that often requires considerable time and attention.

139. Issuers having a business combination should refer to the application guidance in HKFRS 3R.B28-B40 and the Illustrative Examples 16 to 44 accompanying HKFRS 3 (Revised) to identify and recognize all identifiable intangible assets acquired. The chart below assists issuers in identifying intangible assets that may qualify for separate recognition.



140. On the other hand, issuers are reminded of the requirement of HKFRS 3R.36, which sets out the following steps before recognizing a gain on bargain purchase:

HKFRS 3R.36
Before recognizing 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 shall recognize any additional assets or liabilities that are identified in that review. The acquirer shall then review the procedures used to measure the amounts HKFRS 3 (Revised) requires to be recognized at the acquisition date for all of the following: (a) the identifiable assets acquired and liabilities assumed; (b) the non-controlling interest in the acquiree, if any; (c) for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree; and (d) the consideration transferred. The objective of the review is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date.

141. We also recommend issuers to provide additional disclosures, such as:

(a) highlighting the fact that an analysis of the intangibles in accordance with the separability criterion under HKFRS 3R.B33 has been performed; and disclosing, where relevant, the significant judgements underlying the conclusion whether separation of intangible assets from goodwill is deemed necessary; and

(b) indicating how the assets and liabilities are reassessed in accordance with HKFRS 3R.36 when disclosing the reasons why the business combination results in a gain on bargain purchase (as required by HKFRS 3R.B64(n)).

Other points to note

142. Issuers that have entered into complex business transactions can give rise to significant accounting issues, e.g. business combinations, recognition and valuation of intangible assets and goodwill. We encourage issuers to early consult with their auditors to avoid delays in releasing the annual results and prevent unintended errors due to inappropriate application of the accounting requirements. If the transaction is entered in the interim period, we would also encourage issuers to consider carefully whether a review of the interim report should be carried out by their auditors, depending on the complexity of the transactions.

143. In relation to the auditors' reporting, in most of the cases selected, the auditors reported "Impairment of goodwill and other intangible assets" and "Acquisition accounting" as the key audit matters (**KAMs**)[26] in the auditor's reports. Our observations were in line with the HKICPA's findings from its review of auditor's reports of listed issuers. For further details, see *"Second year review of enhanced auditor's reports"* published by the HKICPA in November 2018.

144. Issuers should note that reporting KAMs in the auditor's reports is not intended to be a substitute for the financial statement disclosures. This is because the directors are responsible for providing information about the group and that the financial statements should give a true and fair view. All issuers, in particular their audit committee, should have discussions with their auditors at an early stage about the KAMs. This will ensure that the directors have sufficient time to consider and make improvement to the extent of disclosures in the financial statements.

145. Issuers should bear in mind that HKFRS, which is a principles-based financial reporting framework, requires issuers to put more emphasis on the exercise of judgement in the financial reporting process. Such a process, with the involvement of the audit committee, should be rigorous and documented properly. Where similar matters such as those in (1) to (3) above arise in the future, issuers should ensure the quality and completeness of disclosures. They should:

(a) provide all information necessary for investors to understand their key judgements when concluding the appropriate accounting treatments; and

(b) use the language that is concise and explain the complex accounting issues clearly; avoid using boilerplate text (such as extracts from HKFRSs or illustrative financial statements).

146. Issuers should also ensure that their management has held a thorough discussion each year with the audit committee[27] and auditors. Audit committee should question the adequacy of disclosures on the material intangible assets because they have a responsibility to monitor the integrity of the issuer's financial statements and reports, and to review significant financial reporting judgements made by the management. Audit committee should also assess whether the management and staff have adequate skills to deal with impairment issues[28].

[26] HKSA 701 *"Communicating Key Audit Matters in the Independent Auditor's Report"* defines KAMs as *"Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance."*

[27] See the Principle C.3, Code Provisions C.3.3(d) and (e) of the Corporate Governance Code and the *"Guidance for Boards and Directors"* published on 27 July 2018.

[28] Code Provision C.2.2 states that *"The board's annual review should, in particular, ensure the adequacy of resources, staff qualifications and experience, training programmes and budget of the issuer's accounting, internal audit and financial reporting functions."*

147. Where valuation is performed with involvement of professional valuers, directors and management should still perform proper analysis and assess the reasonableness of financial budgets / forecasts and key assumptions applied. They should not leave the responsibility solely to professional valuers or other experts. It is unreasonable for directors and management to rely on valuation reports without exercising any independent judgement in assessing the reasonableness of key assumptions used. Directors should also assess the competence, capabilities, objectivity and qualifications of professional valuers or other experts.

148. The directors should exercise due care, skill and diligence in the assessing the valuation. They should also read the SFC guidance note regarding directors' duties and valuations in corporate transactions. The SFC guidance note may be applied in the context of the valuations under HKFRSs for the preparation of financial statements, such as the directors' considerations when engaging a valuer.

149. International standard-setters are reviewing the current requirements and practice for the reporting of goodwill and intangibles. We will closely monitor these international developments, and continue to assess the issuers' compliance with the disclosure requirements and adequacy of information in respect of the material intangible assets in their future annual reports.

V. Conclusion

150. From our review of issuers' annual reports this year, we noted that issuers have generally followed the Rules and, if applicable, our recommendations relating to disclosures in areas including use of proceeds from fundraising through issue of equity securities, continuing connected transactions, results of performance guarantees and significant securities in the MD&A section, and noted improvements in disclosure in the last aforesaid area.

151. In respect of disclosures in business reviews in the MD&A section and in financial statements with auditor's modified opinions, material intangible assets and other expenses, we have highlighted in this report aspects that issuers should take into account when making disclosures.

152. As a general measure to improve communications with shareholders, enhance Rule compliance and promote a fair, orderly and informed market, issuers should take note of and consider our observations discussed in this report in preparing their annual reports. Directors should ensure that their finance department has the adequate resources to perform its role in financial reporting. The Audit Committee should stay focused on financial reporting integrity as part of its core oversight responsibilities.

APPENDIX –LINKS TO USEFUL GUIDANCE MATERIALS

(a) FRC and HKICPA websites:

Regulator	Reference materials
FRC	FRC website http://www.frc.org.hk/en/index.php
HKICPA	HKICPA PSM programme https://www.hkicpa.org.hk/en/Standards-and-regulation/Quality-assurance/Professional-standards-monitoring

(b) Guidance to specific financial disclosure topics:

Topic	MB Rules / Standards	Reference materials
Valuation	HKAS 36 and HKFRS 13	• SFC guidance note regarding valuations in corporate transactions (May 2017) http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=17PR68
Accounting and auditing standards	HKFRS/IFRS and HKSA/ISA	• HKICPA Members' Handbook http://app1.hkicpa.org.hk/ebook/index.php (restricted to website visitors in Hong Kong only)
Illustrative financial reports and disclosure checklists	HKFRS/IFRS	• HKICPA Resource Centre – Illustrative financial reports and disclosure checklists from public accounting firms https://www.hkicpa.org.hk/en/Standards-and-regulation/Standards/Resource-centre/Illustrative-Financial-Reports-and-Disclosure-Checklists
New accounting standards	HKAS/IAS 8	• HKICPA New and Major Standards Resource Centre https://www.hkicpa.org.hk/en/Standards-and-regulation/Standards/New-and-major-standards/New-and-Major-Standards • HKICPA Alert Issue 24 *"Are you ready for the next wave of change in accounting standards?"* (December 2016) https://www.hkicpa.org.hk/-/media/HKICPA-Website/HKICPA/section6_standards/technical_resources/pdf-file/financial-alert/alert24.pdf?la=en&hash=4D0E8A45D3696808628342944D18F378 • ESMA *"European common enforcement priorities for 2018 annual financial reports"* (October 2018) https://www.esma.europa.eu/sites/default/files/library/esma32-63-503_esma_european_common_enforcement_priorities_2018.pdf

Topic	MB Rules / Standards	Reference materials
Accounting for acquisitions	IFRS 3/ HKFRS 3 (Revised)	• IASB *"Definition of a Business (Amendments to IFRS 3)"* (October 2018) https://www.ifrs.org/news-and-events/2018/10/iasb-amends-definition-of-business-in-ifrs-standard-on-business-combinations/
Accounting for transaction costs incurred in initial public offerings	HKAS 32	• HKICPA technical article *"Accounting for transaction costs incurred in initial public offerings"* (June 2014) http://app1.hkicpa.org.hk/APLUS/2014/06/pdf/46_Techupdate.pdf
Earnings per share	HKAS 33	• HKICPA technical article *"Earnings per share error"* (September 2017) http://app1.hkicpa.org.hk/APLUS/2017/09/pdf/44_TechUpdate.pdf
Mainland and Hong Kong standards convergence	CASBE/ HKFRS	• HKICPA Major Projects – Mainland and Hong Kong Standards Convergence https://www.hkicpa.org.hk/en/Standards-and-regulation/Standards/Major-projects/PRC-standards-convergence
New auditors' reporting	HKSA 701 and HKSA 720 (Revised)	• HKICPA New and Major Standards Resource Centre https://www.hkicpa.org.hk/en/Standards-and-regulation/Standards/New-and-major-standards/New-and-Major-Standards/New-and-Revised-Auditor-Reporting • HKICPA *"Second year review of enhanced auditor's reports"* (November 2018) https://www.hkicpa.org.hk/-/media/Document/SSD/audit/2ndar2018.pdf
Non-HKFRS financial measures	Paragraphs 28 and 32 of Appendix 16, Schedule 5 of the CO	• IOSCO *"Statement on Non-GAAP Financial Measures"* (June 2016) http://www.iosco.org/library/pubdocs/pdf/IOSCOPD532.pdf • HKICPA technical article *"Non-IFRS performance measures: the good, bad and ugly"* (February 2017) http://app1.hkicpa.org.hk/APLUS/2017/02/pdf/48_TechUpdate.pdf • The Financial Reporting Lab of the UK Financial Reporting Council *"Performance metrics – Principles and practice"* (November 2018) https://www.frc.org.uk/getattachment/cd978ef7-72ad-4785-81ee-e08bb7b7f152/LAB-Performance-metrics-FINAL.pdf

Topic	MB Rules / Standards	Reference materials
Directors' emoluments	Paragraph 24 of Appendix 16	• HKICPA Accounting Bulletin 3 (Revised) *"Guidance on Disclosure of Directors' Remuneration"* http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeII/ab3.pdf
Companies Ordinance	Paragraphs 28 of Appendix 16	• HKICPA Resource Centre – Companies Ordinance Cap.622 – Technical Resources https://www.hkicpa.org.hk/en/Standards-and-regulation/Standards/Resource-centre/Companies-Ordinance-Cap-622
Distributable reserves	Paragraph 29 of Appendix 16	• HKICPA Accounting Bulletin 4 *"Guidance on the Determination of Realised Profits and Losses in the* Context *of Distributions under the Hong Kong Companies Ordinance"* http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeII/ab4.pdf
Acting as scrutineer when a poll is called at a general meeting of an issuer	Rule 13.39(5)	• HKICPA Practice Note 720 *"Acting as Scrutineer at a General Meeting of a Listed Issuer"* http://app1.hkicpa.org.hk/hksaebk/HKSA_Members_Handbook_Master/volumeIII/pn720.pdf
Publication of preliminary results for a financial year or interim results	Rule 13.49(2), paragraphs 45 and 46 of Appendix 16	• HKICPA Accounting Bulletin 6 *"Guidance on the Requirements of Section 436 of the Hong Kong Companies Ordinance Cap.622"* http://app1.hkicpa.org.hk/hksaebk/HKSA_Members_Handbook_Master/volumeII/ab6.pdf • HKICPA Practice Note 730 (Revised) *"Guidance for Auditors Regarding Preliminary Announcements of Annual Results"* http://app1.hkicpa.org.hk/hksaebk/HKSA_Members_Handbook_Master/volumeIII/pn730rev.pdf
Review of financial information included in a circular issued in relation to a very substantial disposal	Rule 14.68(2)(a)(i)	• HKICPA Practice Note 750 *"Review of Financial Information under the Hong Kong Listing Rules for a Very Substantial Disposal"* http://app1.hkicpa.org.hk/hksaebk/HKSA_Members_Handbook_Master/volumeIII/pn750.pdf
Reporting on continuing connected transactions	Rules 14A.56 and 14A.71, paragraph 8 of Appendix 16	• HKICPA Practice Note 740 *"Auditor's Letter on Continuing Connected Transactions under the Hong Kong Listing Rules"* http://app1.hkicpa.org.hk/hksaebk/HKSA_Members_Handbook_Master/volumeIII/pn740.pdf
Notifiable and connected transaction Rules relating to lease transactions of listed issuers adopting HKFRS/IFRS 16 "Leases"	Chapters 14 and 14A	• FAQ 045-2018 to 052-2018 (released on 28 September 2018 / last updated on 7 December 2018) http://en-rules.hkex.com.hk/net_file_store/new_rulebooks/f/a/FAQ_045-2018_to_052-2018.pdf

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