

# Review of Issuers' Annual Reports 2021



## Review of Issuers' Annual Reports – 2021

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### CONTENT

Executive Summary	1
I. Introduction	3
II. Thematic review on selected areas and related disclosure	
A. Auditors' modified opinions	4
B. Material asset impairments	8
C. Material lending transactions	10
D. Business review in the MD&A section	12
III. Thematic review on selected types of listed issuers	
A. Newly listed issuers (listed in 2019 and 2020)	13
B. Issuers listed under the new listing regime for biotech companies	17
IV. Thematic review on issuers' financial statement disclosure under accounting standards	
A. Material intangible assets	20
B. Material Level 3 financial assets	22
C. Expected credit losses and credit risk disclosure	24
D. Revenue	25
E. Leases	26
F. Using non-GAAP financial measures	27
G. Auditor reporting and related financial disclosure	28
V. Issuers' compliance with annual report disclosure requirements	
A. Continuing connected transactions	31
B. Share schemes and pension schemes	32
C. Fundraisings through issue of equity / convertible securities and subscription rights	34
D. Significant investments	35
E. Results of performance guarantees after acquisitions	35
F. Material other expenses / income	36
G. Other annual report disclosure	36
<b>Appendix I: Summary of recommendations in previous reports</b>	<b>38</b>
<b>Appendix II: Scope of review</b>	<b>42</b>

### EXECUTIVE SUMMARY

The Listing Division undertakes an on-going programme to review issuers' annual reports as part of its monitoring activities. We adopt a thematic approach, selecting a number of specific areas for review based on the results of previous years as well as areas considered to be of higher risks. In our thematic review of selected areas we consider the actions taken by the issuers and their directors to safeguard company's assets and their corporate conduct, in addition to the adequacy of their disclosure. We also assess issuers' compliance with specific accounting standards in financial statements.

In addition, we review issuers' compliance with annual report disclosure requirements under the Rules and our recommended disclosure in previous reports.

### *Findings and Recommendations*

We highlight below material findings and recommendations from our thematic reviews and our review of issuers, details of which are set out in Sections II, III and IV of this Report:

- (a) **Auditors' modified opinions** (Section IIA) – The major audit modifications reported by auditors on the issuers' financial statements continued to be about the fairness of the reported values of the issuer's assets.

Issuers should develop supportable estimates for the valuation of their major assets, extensively document the key judgments made and consider retaining experts to perform asset valuations where necessary. Issuers should also engage in early discussions with auditors to agree on the timing, form and approach relating to the assessment of these estimates as early as practicable. Audit committees should assess and challenge the reasonableness of management's assumptions and valuation methods adopted. Before the audit commences, they should discuss and agree with the auditors on any higher risk areas and the corresponding audit approach, timetable and form of reporting on audit findings.

- (b) **Material lending transactions** (Section IIC) – We identified a few cases where loans were not properly authorised, or the subsequent impairments pointed to weaknesses in internal controls. We remind issuers to establish proper internal controls to monitor lending transactions, and where activities are conducted outside an issuer's ordinary course of business, the board of directors should exercise their oversight over these transactions.

We also noted that money lenders generally provided very limited information in their annual reports about their loan portfolios, client base and risk measures and controls over their money lending business. We recommend these issuers disclose in future annual reports details of this business segment including: (i) business model and credit risk assessment policy; (ii) major terms of loans granted, size and diversity of clients and concentration of loans on major clients; (iii) management's discussion on the movements in, and reasons for, loan impairments; and (iv) other key internal controls.

- (c) **Disclosure on use of proceeds by newly listed issuers** (Section IIIA) – The disclosure in prospectuses on use of IPO proceeds indicates how a new issuer intends to deploy resources and implement its business plans. We identified a few issuers that invested a material part of their IPO proceeds in private entities or wealth management products associated with the initial listing professional parties or their associates, or made payments for consultancy arrangements to these parties shortly after listings. These investments or arrangements were not disclosed in the prospectuses, inconsistent with their business plans and lacked clear commercial rationale. We consider the directors may have breached their fiduciary duties, and have also referred these cases to the SFC for their investigations.
- (d) **Material intangible assets reported on issuers' financial statements** (Section IVA) – There is substantial uncertainty as COVID-19 continues to evolve. Issuers should ensure that financial forecasts and key assumptions used in impairment tests are reasonable and not overly optimistic, having regard to historical cash flows, available market information and future prospects. They should continuously review the clarity and transparency of their disclosure of impairment tests.

We are generally satisfied with issuers' compliance with annual report disclosure requirements under the Rules and our recommended disclosure in previous reports, as issuers continued to achieve a high rate of compliance this year. Details of commonly omitted items are set out in Section V.

Issuers should 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 and straightforward, and provide qualitative analysis that complements and explains quantitative information in the 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" (**MD&A**) section. Better disclosure improves transparency and promotes a fair, orderly and informed market.
2. We adopt a thematic approach, selecting specific areas for review based on the results of previous years as well as areas considered to be of higher risks. We consider the consistency of issuers' disclosure in annual reports with that in their other corporate communications (such as announcements, circulars and prior years' annual reports), reviewed the substantive reasons disclosed by the issuers related to the subject matters and where applicable, actions taken by the issuers and their directors to address the subject matters. Such reviews aimed to identify cases of potentially misleading disclosure in issuers' corporate communications, failure by directors in safeguarding corporate assets, and possible Rule non-compliance and/or corporate misconduct. We also assess issuers' compliance with specific accounting standards in financial statements.
3. The Rules<sup>1</sup> set out specific annual report disclosure requirements. In prior years' report we also provided recommendations on annual report disclosure. In this review we also consider issuers' compliance with the Rule disclosure requirements for annual reports and our recommendations.
4. This review covered the annual reports of issuers for the financial year ended between January and December 2020.
5. Sections II and III of this report (**Report**) cover our thematic reviews on material areas and on specific types of issuers. Section IV sets out findings from our review of issuers' financial statement disclosure under accounting standards. Section V sets out findings from our review of issuers' compliance with annual report disclosure requirements under the Rules. **Appendices I and II** set out our recommendations provided in previous Reports and the scope of this year's review respectively.

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<sup>1</sup> In this report, "Rules" refer to both Main Board (**MB**) Rules and GEM Rules.

### II. THEMATIC REVIEW ON SELECTED AREAS AND RELATED DISCLOSURE

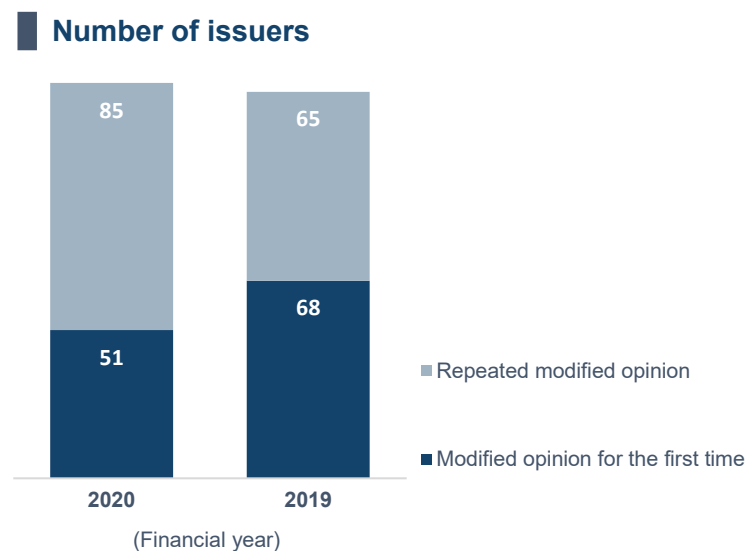
6. In this section we report on our thematic review on selected areas including modified audit opinions, material asset impairments, material loans and advances, and selected MD&A disclosure on the impact of COVID-19.
7. These are higher risk areas which warrant additional disclosure. In our review we considered the consistency of disclosure in issuers' annual reports with previous disclosure in issuers' announcements and circulars related to the subject matter. In certain thematic reviews involving the performance of the issuers (including modified audit opinions and material asset impairments) we reviewed the substantive reasons disclosed by the issuers related to the matter. Such review aimed to identify cases of potentially misleading disclosure in issuers' corporate communications, issues on directors' role in safeguarding corporate assets, and possible Rule non-compliance and/or corporate misconduct.
8. We set out below our findings and recommendations.

#### A. Auditors' modified opinions

9. Issuers are obliged to present financial statements that give a true and fair view of their state of affairs, results of operations and cash flows to allow investors to make informed investment decisions. In our previous Reports, we recommended issuers that received modified audit opinions disclose additional information about the audit modifications and their impact on the issuers' financial position, management's position, its basis on major judgmental areas and how they differ from the auditors' position, and the audit committee's view (see **Appendix I**).
10. Issuers should timely resolve the underlying issues giving rise to the audit modifications. In this regard they should also disclose in the annual reports their plans to address the modifications. The audit committee has a role in monitoring the integrity of the issuer's financial statements and annual report, and to review significant financial reporting judgments contained in them. As regards any audit modifications, the audit committee should monitor and ensure the management is implementing its plans to resolve the underlying issues in a timely manner.

**Findings**

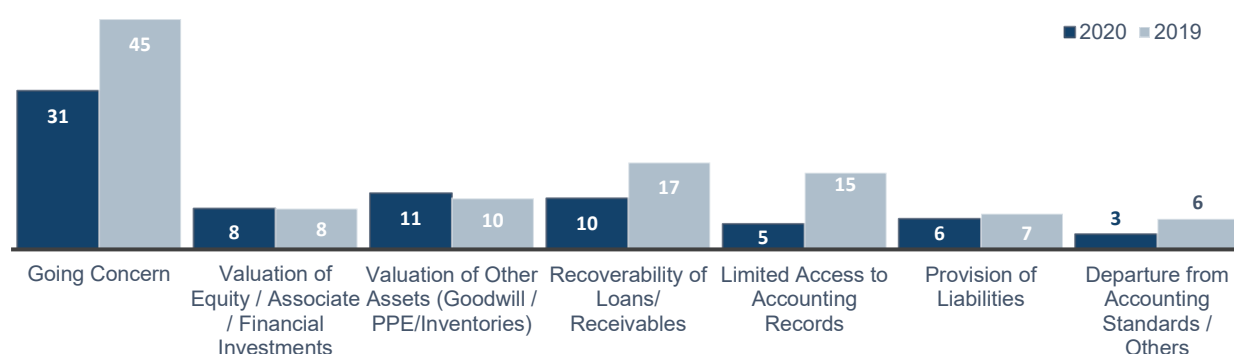
11. For the 2020 financial year, 136 issuers received a modified audit opinion on their published financial statements (2019: 133), including 51 issuers with modified opinions for the first time. This represents a reduction from last year (68):



*Note: Excluding 19 issuers that were long suspended companies at the time they published the financial statements for the 2020 financial year.*

**51 issuers with modified opinions for the first time**

12. This year, there is a notable decrease in audit modifications arising from going concern and limited access to accounting records, as COVID-19 related situations stabilised. A breakdown is shown below:



*Note: Some issuers had more than one audit issue cited in their modified opinions.*

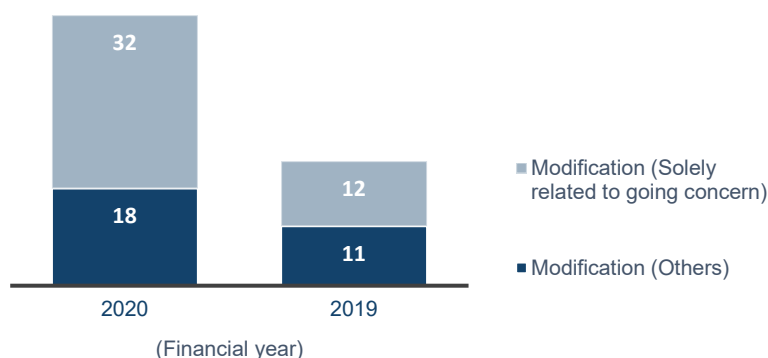
13. Similar to last year, the major area of concern raised by auditors was the fairness of the reported value of the issuer's assets. These modifications were mainly related to:
- (a) *Valuation of assets* – modified opinions were expressed on the valuation of goodwill and property, plant and equipment due to insufficient documentation to justify the assumptions adopted in the asset valuations due to, for example, insufficient funds to support the development plans in the forecasts, or lack of historical financial information on the newly acquired business or assets to support the assumptions used in the forecasts. In some cases, the auditors expressed modified opinions despite significant or full impairments having been made as the issuers failed to supply sufficient evidence and facts to support such impairments.
  - (b) *Recoverability of loans / receivables* – some issuers failed to support the expected credit losses assessment on loans and receivables with proper documentation due to, for example, lack of internal control and management oversight over the businesses that generated the loans and receivables. In other cases, the auditors questioned the commercial substance and the authenticity of the lending transactions and in turn the fairness of the related balances of loans, other receivables, deposits and prepayments being reported. See also Part C of this section below for a further discussion on loans and advances.
14. As recommended in our last year's Report, issuers should develop appropriate and supportable estimates for the financial reporting items. They should extensively document key judgments made, and consider retaining experts to perform asset valuations where necessary. They should also engage in early discussions with auditors and agree in advance the timing, form and approach of the assessment of these estimates as early as practicable. Audit committees have responsibilities to oversee the issuers' financial reporting system and the audit planning process. They should assess and challenge the reasonableness of management's estimates, assumptions and valuation methods adopted. Before the audit commences, they should discuss with the auditors and agree on the areas with higher risk, the corresponding audit approach, and the timetable and form of reporting on audit findings.
15. The audit committees have oversight of the issuers' internal control and risk management systems. They should periodically review and ensure the adequacy of the internal control on financial reporting systems.



### 85 issuers with repeated modified opinions

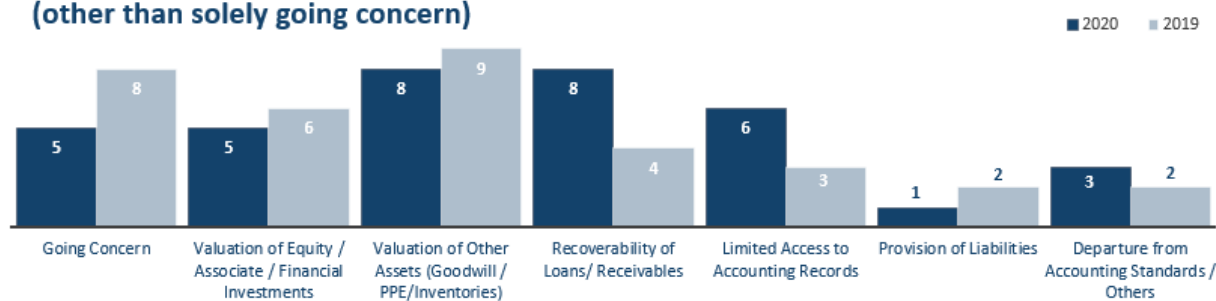
16. Of the 85 issuers with repeated modified opinions (2019: 65), 35 issuers had resolved all the underlying issues that led to the audit modifications in the prior year. The graph below illustrates the number of issuers with unresolved modified opinions.

#### **No. of issuers with repeated unresolved audit issues**



17. 50 issuers were unable to resolve all the issues underlying the audit modifications brought forward from previous year(s) (2019: 23), including 32 issuers with going concern modifications only (2019:12), and 18 issuers with audit modifications arising from a variety of issues (2019:11). The following graph illustrates the unresolved issues:

#### **Unresolved issues underlying repeated modified opinions (other than solely going concern)**

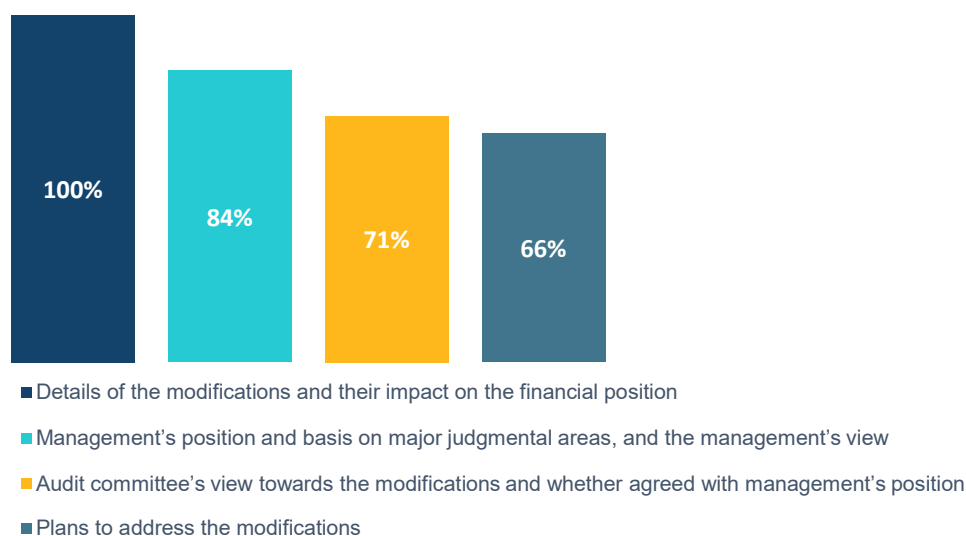


*Note: Some issuers had more than one audit issue cited in their modified opinions*

18. Compared to last year, we note that many issuers have taken appropriate actions and resolved the underlying issues. Of the 18 issuers with repeated audit modifications, only four issuers received repeated audit modifications for over two years<sup>2</sup>.
19. We also remind issuers with going concern modifications to follow our previous recommendation to continuously review their current liquidity position and expected financial resource needs to allow their businesses to operate normally, and to formulate actions to address their funding needs in a timely manner, and to take concrete actions to implement those plans.

<sup>2</sup> Including three issuers currently suspended for various reasons.

### Disclosure in annual reports



20. A large majority of issuers followed our recommendations to disclose information about modified opinions (see **Appendix I** on recommended disclosure). Some issuers omitted disclosure about the audit committee's view and action plans to address the modification, and were required to publish supplemental announcements on the disclosure.

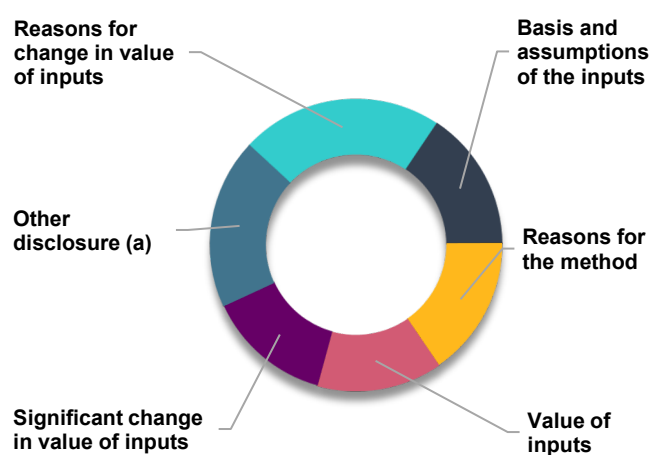
### **B. Material asset impairments**

21. The Rules require an issuer to include in its annual report a discussion and analysis of material factors underlying its financial results and position and significant events during the year. Where an issuer recorded a material impairment on its assets, it should discuss the circumstances that led to the impairment. Where an asset impairment is supported by a valuation, we recommended that the issuer should disclose the valuation method and the reason for using that method; details of the value of inputs used for the valuation together with the basis and assumptions; and explanations on any change of valuation method or significant changes in the value of the inputs or assumptions (see **Appendix I**, and also paragraphs 65 and 68 for key assumptions used in impairment tests and the recommended disclosure).
22. We reviewed the adequacy of the annual report disclosure on material impairments reported by selected issuers. Where the impairment related to recently acquired assets or businesses, we also reviewed the previously disclosed information about the acquisition (e.g. announcements and circulars) and considered the reasons giving rise to the impairments; whether the previous disclosure was materially accurate; and whether the directors had properly considered the terms of the acquisition and discharged their fiduciary duties in reviewing the acquisitions in light of the developments of the acquired businesses or assets.

### Findings

#### Impairment on acquired assets

23. Issuers generally discussed the circumstances that led to the material impairments. A large majority this year attributed the impairments to COVID-19 which had caused a material deterioration of business, delay in progress of projects and/or diminution in property value of the acquired assets. These issuers represented that these negative factors were unforeseen at the time of the acquisitions which took place before the outbreak of the pandemic.
24. Most issuers supported the impairment amounts with valuations. A large majority followed our recommendations (see **Appendix I**) to disclose details of the valuations. The information omitted is as follow:

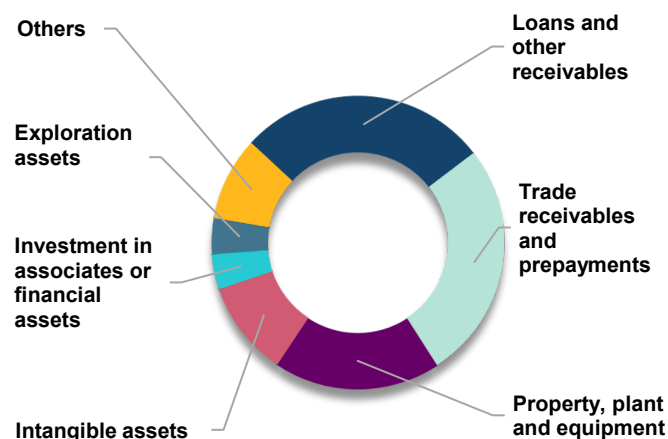


(a) Other disclosure included the valuation method, any change in the method and reasons for the change in method.

25. We identified one case where an impairment was made of most of the reported value of a business acquired about a year ago. The timing of the impairment and the rationale provided by the issuer raised a question about whether the directors had properly considered the terms of the acquisition at the material time and acted in the interest of the issuer and its shareholders as a whole. The case is currently under our investigation.

### Impairment on assets (other than acquired assets)

26. Compared to last year, the number of issuers that reported material impairments on assets other than acquired assets reduced by more than half. These assets related to the following:



27. Similar to last year, we identified a number of cases involving material impairments in loans and receivables. Our findings are further discussed in Part C of this section below.
28. In general, the impairments were properly made and supported by valuations or other evidence, except in one case where the auditors questioned the basis of the impairment and issued a modified opinion on the issuers' financial statements.
29. We were generally satisfied with the disclosure about the asset impairments. Issuers generally engaged experts to prepare asset valuations to support the impairment amounts. A large majority of issuers disclosed the valuation details we recommended in previous Reports (see **Appendix I**, and also paragraph 24 for areas of common omissions in disclosure).

### **C. Material lending transactions**

30. Following our identification of cases involving material impairments in loans and advances last year, we conducted a thematic review this year on issuers' material lending transactions and related disclosure. We selected 211 issuers<sup>3</sup> that reported material loan receivables, prepayments, deposits and other receivables in their 2020 financial statements. Approximately three-quarters were issuers that provide loans as part of their money lending business.

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<sup>3</sup> See **Appendix II** for a discussion on selection basis.

### ***Findings***

31. Our review identified a number of cases where the loans were made outside the ordinary and usual course of the issuers' businesses, and in a few of these cases the issuers reported material impairments, or the auditors questioned the commercial substances of the issuers' lending transactions and/or recoverability of the loan balances, and modified their audit opinions on the such balances. There were also a few isolated cases involving loans to other parties that were not properly authorised by the board of directors, or were purportedly upfront payments to suppliers and/or service providers and subsequently became unrecoverable.
32. We also identified a few cases (including lending transactions that were part of the issuers' principal business) where, in light of the material write downs, raised questions about whether there were material deficiencies in the issuers' internal control systems, and whether the directors had performed proper due diligence on the borrowers or subsequently, taken adequate actions to recover the loans. These cases are currently under our investigation and/or referred to the SFC for their investigation.
33. While these cases are isolated, they raised concerns about the possible dissipation of assets through these lending transactions, and whether funds were applied in a manner that was in the interest of the company and shareholders as a whole. We remind issuers to establish proper internal controls to monitor lending transactions generally, and where activities are conducted outside of an issuer's ordinary course of business, the board of directors should exercise their oversight over these transactions.
34. *Recommendation to money lenders:* We also noted that money lenders generally provided very limited information in their annual reports about their loan portfolios, client base and risk measures and controls over their money lending business. The management discussions on the performance of the business and material changes in the provision of loans and related impairments were also generic. Issuers should improve their disclosure on how they operate their money lending business. We recommend issuers include the following information in their future annual reports:
  - (a) the issuers' business model and credit risk assessment policy;
  - (b) major terms of loans granted (including details of the collaterals), size and diversity of clients and concentration of loans on major clients;
  - (c) management's discussion on the movements in loan impairments (and write-offs) and the underlying reasons; and
  - (d) other key internal controls in terms of, for example, credit approval, ongoing monitoring of loan recoverability and loan collection.

### D. Business review in the MD&A section

35. The MD&A section serves to provide investors with meaningful information to appraise an issuer's performance and prospects. In its annual report, the issuer should include a review of its business, principal risks and uncertainties facing the issuer, important events occurred during the financial year and an indication of likely future business developments.
36. Last year, we reviewed issuers' MD&A disclosure on the principal risks arising from COVID-19, its impact on the issuers and the measures they took to manage the risks. We noted that some issuers' disclosure was generic. In this regard, we provided some recommendations to help issuers enhance their disclosure in the next annual reports.
37. This year, we selected 50 issuers<sup>4</sup> and reviewed their disclosure related to the impact of COVID-19.

### **Findings**

38. We are generally satisfied with the findings of our review this year:
- (a) *Disclosure about the effect of COVID-19 on the issuer's operations and the risks or uncertainties that would materially affect their future performance (including quantitative measures)* – All of the issuers reviewed have provided assessments of the effect of COVID-19 on their operations and the relevant risks or uncertainties that might affect their future performance. They have also provided quantitative information to illustrate how the pandemic has affected their financial performance and position, such as the percentage of reduction in flight passenger capacity, hotel room occupancy rate and revenue per room, and same store sales;
  - (b) *Assessments of the liquidity positions and working capital sufficiency with reference to the operations and capital commitments* – A large majority of the issuers reviewed have discussed their liquidity position and working capital sufficiency. Issuers generally disclosed that they would have sufficient funds to finance their operations for the next 12-month period, and disclosed the factors they took into account in making this assessment, including operating cash flow, funds raised, bank borrowing and credit facilities; and
  - (c) *Measures such as cost control, funding and adjustments to business plans taken or to be taken to manage the impact of the pandemic* – A vast majority of the issuers reviewed disclosed measures taken or to be taken to manage the impact of the pandemic, such as business diversification; application of technology to expand product and service offerings; and adoption of costs saving measures. A few issuers did not disclose specific measures and they operated in industries heavily hit by the pandemic (e.g. gaming, travel and tourism) and faced with uncertainties in the environment in which they operated.

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<sup>4</sup> See **Appendix II** for the scope of our review.

### III. THEMATIC REVIEW ON SELECTED TYPES OF LISTED ISSUERS

39. We also performed reviews on A) newly listed issuers and their post-listing activities, Rule compliance and annual report disclosure, and B) annual report disclosure by Chapter 18A biotech companies. This section highlights our general observations and recommendations.

#### A. Newly listed issuers (listed in 2019 and 2020)

40. 163 and 146 issuers were listed in 2019 and 2020 respectively. In our review, we monitored the post-listing activities of the newly listed issuers, including their Rule compliance and disclosure in announcements and annual reports in the following areas:
- (a) Changes in the use of IPO proceeds;
  - (b) Profit alerts and material changes in financial results;
  - (c) Non-compliance with the Rules after listing; and
  - (d) Fulfilment of conditions or undertakings imposed or provided before listing.
41. In 2019, we amended the continuing obligations Rules to address market concerns about “shell” creation through new listings. In recent years we noted some issuers sought listing status and shortly thereafter, underwent a series of corporate activities leading to material changes in businesses, management and controllers (i.e. backdoor listing). In light of this we continued to closely monitor the post-listing developments of newly listed issuers.

#### ***Findings***

##### *Post-listing developments*

42. Similar to previous years, we reviewed whether the newly listed issuers conducted one or more of the following corporate activities, including (i) disposals of controlling interests by the original controlling shareholders; (ii) material acquisitions of new businesses and or material disposals of original businesses; and/or (iii) reallocation of IPO proceeds to new businesses.
43. 15 issuers conducted one or more of the above mentioned corporate activities (last review: 16), representing a slight decrease from last year. This included: (i) the controlling shareholders of 11 issuers disposed of their controlling interests in the issuers (last review: 10); (ii) one issuer acquired a new business (last review: four); and (iii) three issuers reported material changes in their IPO proceeds (last review: four).

44. We reviewed these corporate activities and with the exception of one case<sup>5</sup>, were generally satisfied that these corporate activities did not give rise to concerns about shell creations. Nevertheless, backdoor listing activities commonly involve a series of arrangements and transactions, we will continue to closely monitor these issuers and will take a robust approach to address shell activities.

### Changes in use of IPO proceeds

45. The disclosure in prospectuses on use of IPO proceeds indicates how a new issuer intends to deploy resources and implement its business plans. This is relevant information for investors to appraise the issuer's business development. Where an issuer changes its proposed use of proceeds or business strategies shortly after listing, the changes should be timely announced and the reasons for such changes clearly explained.
46. About 16% of newly listed issuers reallocated funds among different intended uses disclosed in the prospectuses, or reallocated funds to their existing businesses (last review: 25%). Compared to last year, the number of such cases has decreased significantly. The changes were generally attributed to the changes in business strategies or current business needs; or delays in expansion plans due to COVID-19 or China-U.S. trade war. We noted that a majority of these issuers were listed in 2019, before the outbreak of the pandemic. We were generally satisfied that the disclosure as timely and the changes adequately explained.
47. We also identified through our monitoring activities a few issuers that invested a material part of their IPO proceeds in private entities or wealth management products associated with the initial listing professional parties or their associates, or made payments for consultancy arrangements to these parties shortly after listings. These investments or arrangements were not disclosed in the prospectuses, inconsistent with their business plans and lacked clear commercial rationale. We consider the directors may have breached their fiduciary duties, and have also referred these cases to the SFC for their investigations.

### Profit alerts and material changes in financial results

48. The prospectus should contain historical and forward looking information that materially reflects the issuers' financial position and outlook. In our previous Reports we reminded newly listed issuers (i) not to publish profit alert announcements that merely repeats facts previously disclosed in the prospectus, and (ii) where material events after its listing led to material changes in its financial performance, quantify the potential impact to the profit figure and use clear and concise language in its profit alert announcements (see **Appendix I** for recommended practices).

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<sup>5</sup> In one case the issuer proposed to reallocate a substantial part of its IPO proceeds to acquire a new business, raising a concern about a fundamental change in the issuer's principal business activities within the first year of listing under MB Rule 14.89. The issuer subsequently terminated the proposed acquisition and changed in its IPO proceeds.



## Review of Issuers' Annual Reports – 2021

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49. We reviewed issuers' profit alert announcements and results announcements to consider the consistency of disclosure, in particular whether the prospectus disclosure is materially consistent with the post-listing financial performance, and where profit alert announcements are published, whether they follow our disclosure guidance.
50. Overall, we are satisfied that newly listed issuers disclosed material changes to their financial results on a timely basis. Most issuers quantified the financial impact in percentages or dollar amounts in their profit alert announcements, representing a significant improvement from last year.
51. About 25% of newly listed issuers reported material declines in their financial results, primarily attributable to factors such as COVID-19 and the China-U.S. trade war, or in some cases, delays in business developments. These factors generally emerged after the listing of these issuers (listed in 2019 or early 2020). With the exception of a few isolated cases<sup>6</sup>, we have not identified major issues having considered these issuers' explanations and circumstances related to the declines.

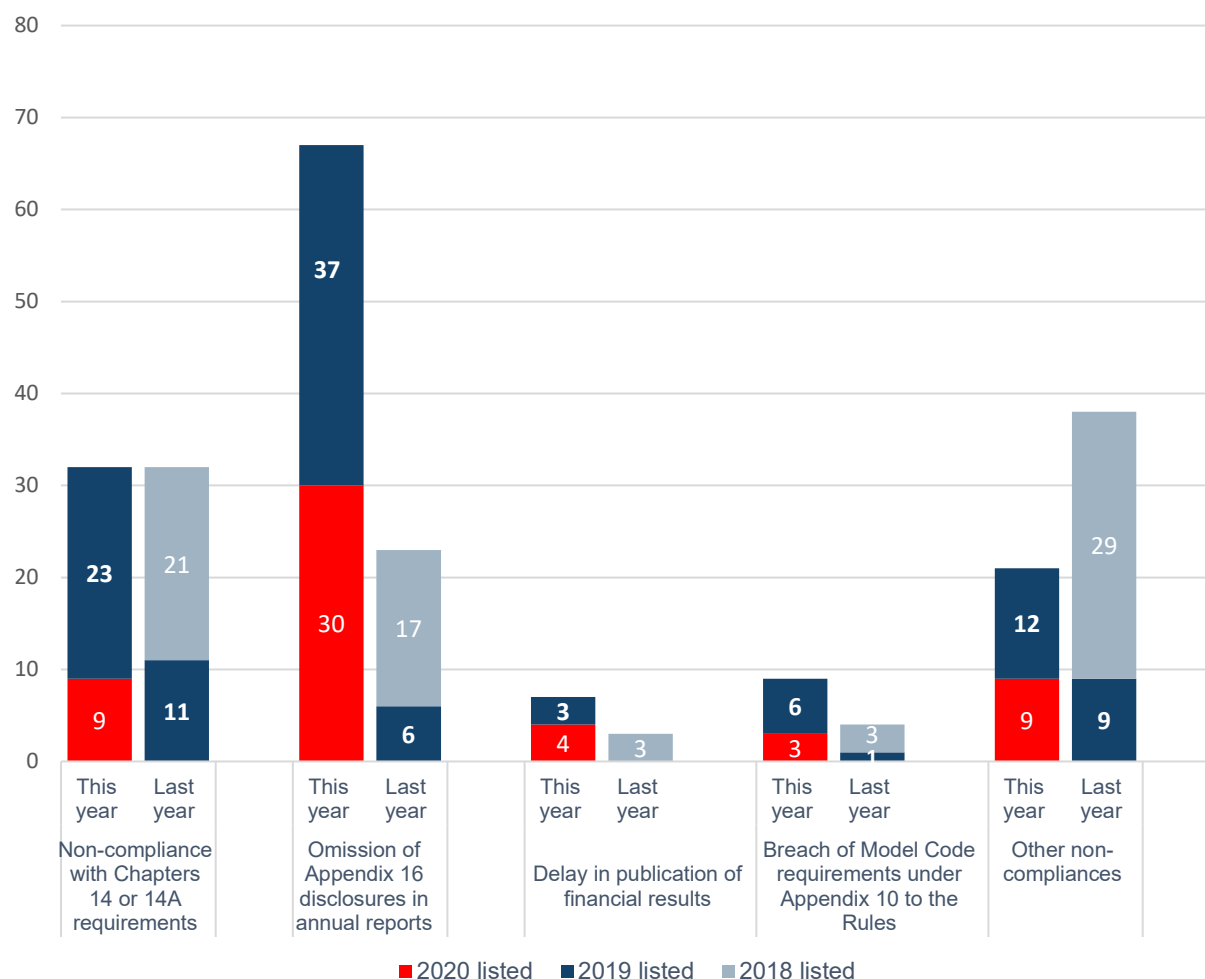
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<sup>6</sup> In a few cases, the deviations appeared to be due to matters arisen before listing, raising a question whether the issuers' prospectuses and profit forecasts were materially accurate and free from material omissions. For example, one issuer's net profits fell materially short of its forecast due to a decrease in revenue caused by promotional price discounts offered during a period before listing. We are considering whether the prospectus disclosure is materially accurate. These cases are under our consideration for possible enforcement actions, and were also referred to the SFC for their investigation.

### Non-compliance with the Rules

52. We identified 136 non-compliances with the Rules by newly listed issuers (last review: 100). Issuers should note the common non-compliances set out below for reference. We also remind newly listed issuers to consult its compliance adviser in circumstances cited in Chapter 3A of the MB Rules<sup>7</sup>, including (i) before the publication of any regulatory announcements, circular or financial report; (ii) before any proposed notifiable or connected transactions or share issuances and repurchases, and (iii) before any changes to its use of IPO proceeds.

#### Newly listed issuers with non-compliance with the Rules



53. Similar to last year, a majority of cases related to non-compliances with the notifiable or connected transaction Rules. Issuers should take note of the following:
- (a) Some issuers failed to announce their subscriptions of wealth management products issued by banks or investments in investment funds due to misinterpretation of the notifiable transaction Rules or inadvertent oversight. Issuers should refer to our [FAQ\\_057-2019](#) for guidance;

<sup>7</sup> Chapter 6A of GEM Rules.

- (b) Some issuers failed to properly monitor their continuing connected transactions and exceeded the annual caps approved by shareholders. We refer issuers to our guidance in **Appendix I** on the roles of INEDs to oversee internal controls and compliance with the connected transaction Rules; and
- (c) Some issuers failed to announce their leasing of properties. They should note that leasing activities constituted an acquisition of assets by the lessee under HKFRS 16 “Leases” (effective since 1 January 2019) and also a notifiable transaction (see [FAQ 045-2018](#)).

### Fulfilment of conditions imposed or undertakings provided before listing

- 54. In specific cases the Listing Committee required newly listed issuers to make disclosure in their annual reports about updates on regulatory developments or restrictions on the use of their IPO proceeds to finance sanctioned activities. We note that all issuers fulfilled their undertakings. We also reviewed, and were satisfied that all Chapter 19C secondary listed issuers fulfilled their undertakings to seek and obtain shareholders' approval in general meetings to amend their constitutional documents to provide the shareholder protection standards required under MB Rule 19C.07.
- 55. Some major shareholders of newly listed issuers provided non-competition undertakings to the issuers to establish a clear delineation between the issuers' businesses and the major shareholders' businesses, and to make annual declarations to that effect in the issuers' annual reports. Based on our review of annual report disclosure, we were satisfied that, with a few exceptions, these undertakings were fulfilled and disclosed.

### **B. Issuers listed under the new listing regime for biotech companies**

- 56. We reviewed Chapter 18A issuers' compliance with the annual report disclosure of the research and development (**R&D**) and the progress of their core products:
  - (a) All biotech companies provided updates on the R&D progress of their core products. They disclosed the current stage of development and/or status of regulatory applications, expected timeframe to proceed to the next stage of clinical trial and/or apply for regulatory approval. Their R&D progress was consistent with the disclosure in the IPO prospectuses and/or previously published documents;
  - (b) All except three biotech companies<sup>8</sup> disclosed a summary of the R&D expenditure incurred. These companies were required to make supplemental announcements; and
  - (c) All disclosed a warning statement that a core product may not ultimately be successfully developed and marketed.

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<sup>8</sup> These three biotech companies only stated the amount of R&D expenses incurred in the current and previous year without any discussion, breakdown or analysis of these expenses.

57. These biotech companies disclosed additional information about their products for investors information:
- (a) some issuers that successfully commercialised their core products during the 2020 financial year provided additional information about the commercialisation of those products, including competition, marketing strategy, composition of the responsible teams for commercialisation, market coverage and/or admission into the National Reimbursement Drug List in respect of these products; and
  - (b) information about non-core products, including the development stages, clinical trial status, and regulatory approval status.

### IV. THEMATIC REVIEW ON ISSUERS' FINANCIAL STATEMENT DISCLOSURE UNDER ACCOUNTING STANDARDS

58. The Rules<sup>9</sup> require issuers to prepare their financial statements in conformity with accounting standards. Our review focused on the quality of financial reporting against the requirements under the applicable accounting standards, with a view to encouraging high standards of financial disclosure.
59. Except for four cases which were referred to the Financial Reporting Council (the **FRC**) for consideration, there were no significant issues identified. Where disclosure was insufficient but 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.
60. Our review identified several key areas where issuers can continue to improve their financial disclosure, which are set out in this section to serve as reminders for issuers in their upcoming financial reporting period. Please note that the observations below are summarised based on our review and therefore are not exhaustive:
- Material intangible assets
  - Material Level 3 financial assets
  - Expected credit losses and credit risk disclosure
  - Revenue
  - Leases
  - Using non-GAAP financial measures
  - Auditor reporting and related financial disclosure
61. Unless otherwise specified, Hong Kong Financial Reporting Standards (**HKFRSs**) and Hong Kong Standards on Auditing (**HKSAs**) and their paragraph numbers referred to in this section correspond to those in IFRSs and ISAs<sup>10</sup> respectively. Discussions in this section 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.

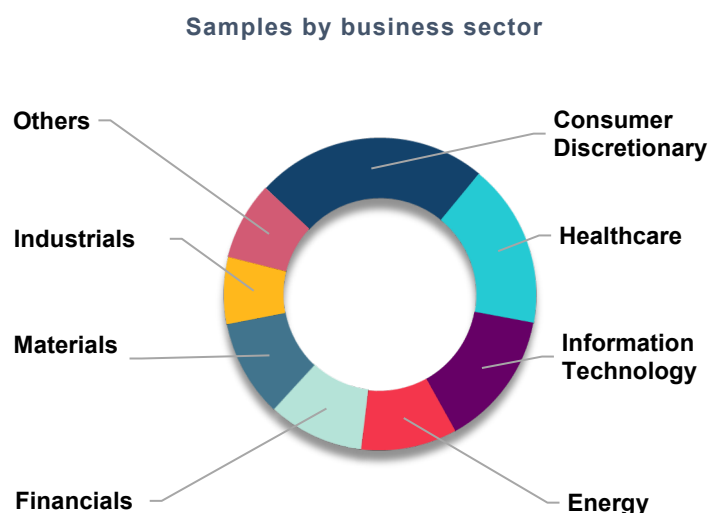
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<sup>9</sup> Notes 2.1 and 2.6 to paragraph 2 of Appendix 16 to the MB Rules / GEM Rules 18.04 and 18.06.

<sup>10</sup> HKFRSs and HKSAs are issued by the Hong Kong Institute of Certified Public Accountants (the **HKICPA**); International Financial Reporting Standards (**IFRSs**) are issued by the International Accounting Standards Board and International Standards on Auditing (**ISAs**) are issued by the International Auditing and Assurance Standards Board.

### A. Material intangible assets

62. The impact of COVID-19 heightens the focus on how issuers have addressed the potential uncertainties in their impairment tests. In this regard, material intangible assets is our ongoing key area of review. This year, the selected issuers were across different business sectors:



63. Many issuers had goodwill, together with other intangible assets (with finite or indefinite useful lives), which were required to perform an annual impairment tests. Examples of other intangible assets were customer relationships, capitalised development costs, mining rights, software, technology know-how, trademarks, patents and licences.
64. We are pleased to note that most issuers provided the required disclosure under Hong Kong Accounting Standard (**HKAS**) 36 “Impairment of Assets” and HKAS 38 “Intangible Assets”. We have the following observations about the disclosure:
- (a) **Events and circumstances that led to the recognition of impairment losses** – Out of the cases reviewed, about 60% of the issuers recognised impairment losses in the current year. They had disclosed the events and circumstances triggering the impairment losses, most of which were due to external factors such as impact of COVID-19, adverse mineral or product price fluctuations, drop in market demand and changes in government policies and regulations.
  - (b) **Determination of recoverable amounts of cash-generating units (CGUs)** – Value in use (**VIU**) was commonly used in measuring recoverable amounts of the CGUs to which goodwill and intangible assets were allocated. Only a few issuers used fair value less costs of disposal (**FVLCD**).

(c) **Estimates used to measure recoverable amounts of CGUs**

- The discounted cash flow (**DCF**) method was most frequently used to measure the recoverable amounts. Most issuers disclosed the forecast periods, discount rates and long-term growth rates. We observed that the level of detail about the description of the key assumptions and management's approach to determine such assumptions varied among issuers. In some cases the disclosure tended to be generic, for example, stating those assumptions reflected their "past experience" or were consistent with "external sources of information" without further elaborating in the context of the CGU's business activities. Some other issuers specifically discussed how the cash flow projections and assumptions had been revised to include the expected impact of COVID-19.
- We encouraged issuers to provide recommended disclosure in our previous Reports (see **Appendix I**), such as budgeted revenue growth rate, headroom<sup>11</sup> available, whether professional valuer was engaged to perform the assessment and negative statement indicating that reasonably possible change in the key assumptions would not cause an impairment loss. We noted that many issuers had enhanced their disclosure and provided one or more recommended items.

(d) **Determination of intangible assets' useful lives** – In most cases, the issuers disclosed whether the useful lives were finite or indefinite and, if indefinite, explained the factors that played a significant role in determining that the intangible assets had indefinite useful lives. A few issuers further disclosed that they had performed an annual review and concluded that their intangible assets continued to have indefinite or long useful lives.

(e) **Judgment and estimate disclosure**<sup>12</sup> – Nearly all issuers provided a separate note to disclose the assumptions used in the impairment tests as a key source of estimation uncertainty, while a few issuers involved critical judgments in determining their intangible assets' useful lives. We observed that the disclosure sometimes repeated the corresponding accounting policy or the information available in the note of the impairment tests. It would be helpful if the disclosure could be more entity-specific, such as disclosing the assumptions that requires an issuer's most difficult, subjective or complex judgment, which depends on its specific circumstances (e.g. the jurisdiction and industry in which it operates).

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<sup>11</sup> The excess of the recoverable amount of the CGU over its carrying amount.

<sup>12</sup> HKAS 1 (Revised) "Presentation of Financial Statements" paragraphs 122 and 125 set out the overarching requirement for judgments and estimates disclosure, including those that are not in the scope of another HKFRS standard.

65. Issuers should ensure that financial forecasts and key assumptions used in impairment tests are reasonable and not overly optimistic, having regard to historical cash flows, available market information and future prospects.
66. We strongly remind issuers that there is substantial uncertainty as COVID-19 continues to evolve. HKAS 36 sets out the non-exhaustive list of external and internal impairment or reversal “indicators”. Issuers should assess at each reporting date where there is any indication that an asset may be impaired, or an impairment loss recognised in prior periods for an asset (other than goodwill) may no longer exist or may have decreased (HKAS 36.9 and 36.110).
67. They should note that any impairment or reversal indicators may indicate that the remaining useful life, amortisation / depreciation method or the residual value for an asset may need to be reviewed and adjusted, even if no impairment loss is recognised or reversed (HKAS 36.17 and 36.113).
68. It is important for issuers to continuously review the clarity and transparency of their disclosure of impairment tests, in particular to provide our recommended disclosure in previous Reports set out in **Appendix I**.

### **B. Material Level 3 financial assets**

69. Material financial assets at Level 3 measurement remains to be our focus area. Classification, measurement and relevant fair value disclosure requirements are primarily set out in HKFRS 9 “Financial Instruments” and HKFRS 13 “Fair Value Measurement”. Our key findings are highlighted below:

#### **(a) Classification**

- The issuers under review had made different types of investments, such as unlisted equities, debt instruments, funds and wealth management products. Most of them were classified at fair value through profit or loss (**FVTPL**). In relation to the unlisted equity investments that were not held for trading, some issuers had elected to present subsequent changes in fair value through other comprehensive income (**FVOCI**).
- In one case, the issuer had made a prior year adjustment to reclassify its equity investments from FVOCI to FVTPL in the current year, because the investments with embedded “put options” did not meet the definition of equity instruments and could not be designated at FVOCI. This indicates that, in addition to the business model for managing financial assets, issuers should carefully understand the terms and conditions of the financial assets and ensure the accounting treatment is appropriate.



### (b) ***Disclosure of valuation techniques and significant unobservable inputs***

- Most issuers complied with HKFRS 13 disclosure requirements. In a few cases, the issuers omitted to disclose the quantitative information about the significant unobservable inputs and the reasons for the change in valuation technique used in the current year (HKFRS 13.93(d)).
- Based on the issuers' disclosure, a wide range of valuation techniques had been used in determining Level 3 fair value, such as comparable company valuation multiples (market approach), DCF method (income approach) and adjusted net asset method<sup>13</sup>. Many issuers disclosed that they had engaged the professional valuers to perform the valuations.
- From our review, we referred two cases to the FRC for consideration. In one case, the price-to-book ratio and the discount for lack of marketability appeared to be overly optimistic relative to the investees' historical performance and future prospects. In another case, the fair value of equity investments significantly decreased by over 80% in the current year, which raised doubt on whether the prior year's valuation was properly performed in accordance with HKFRS 13.

70. Directors should exercise due and reasonable care, skill and diligence in assessing the valuations of financial instruments, and they should not rely solely on professional valuers. Fair value is a market-based measurement. Issuers should ensure that the valuation technique and the underlying inputs<sup>14</sup> reflect the current market conditions at the measurement date. It is important for issuers to continuously develop robust disclosure on Level 3 measurement in accordance with HKFRS 13, in particular to provide the qualitative and quantitative information to the extent necessary for an understanding of the valuation techniques and the underlying unobservable inputs.

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<sup>13</sup> This method involved the simultaneous use of various valuation techniques to measure the fair values of the individual assets and liabilities recognised in the investees' statements of financial position as well as the fair values of any unrecognised assets and liabilities at the measurement date.

<sup>14</sup> Issuers are also encouraged to read the IFRS Foundation's educational material "Measuring the fair value of unquoted equity instruments within the scope of IFRS 9 Financial Instruments", which provides a non-exhaustive list of the common oversights when applying the valuation techniques.

### C. Expected credit losses (ECL) and credit risk disclosure

71. Assessing recoverability of receivables was one of the most challenging areas for issuers in the 2020 financial year. During our review, we have the following observations:
- Most issuers applied the simplified approach<sup>15</sup> in calculating lifetime ECL for trade receivables. The quantitative credit risk information was generally improved. Many issuers provided the provision matrix specifying provision rates by the past due time-band (e.g. “within 30 days”, “31-90 days”, “91-180 days” and “over 180 days”), while the other issuers assessed the ECL according to the groupings of customer bases (e.g. internal credit rating). A few issuers further explained that they had increased the provision rates due to greater financial uncertainty triggered by COVID-19.
  - In some cases where there was a material receivable balance but with relatively low provision rate, issuers could enhance their disclosure by justifying the extent of ECL provision and quantifying the subsequent settlement.
  - On the other hand, general approach was applied to the long-term loan receivables, other receivables and related party balances (e.g. amounts due from associates and joint ventures). As in previous years, we observed that the ECL and credit risk disclosure about these balances was relatively less detailed than their analyses of trade receivables. In light of different risk profiles, issuers are reminded to consider the credit risk of these balances separately and enhance the disclosure where necessary.
72. Under the current economic conditions, issuers should ensure that appropriate systems and assessment processes are put in place to measure the ECL. No matter which impairment approach is adopted, they need to reconsider the appropriateness of the past methods and ensure up to date inputs are used at each reporting date.
73. Issuers are strongly encouraged to enhance their ECL and credit risk disclosure under HKFRS 7 “Financial Instruments: Disclosures” paragraphs 35A to 35N, which aim to enable investors to better understand the issuers’ credit risk management practices, their credit risk exposure and ECL estimates.

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<sup>15</sup> HKFRS 9 establishes a three-stage general approach for measuring impairment and a simplified approach for certain trade receivables, contract assets and lease receivables.

### D. Revenue

74. Based on our review, we highlight below areas that require particular attention to the disclosure under HKFRS 15 “Revenue from Contracts with Customers”:
- Most issuers included the required disclosure. In particular, according to their own specific business characteristics, some issuers enhanced the disclosure of the disaggregated revenue information by selecting more than one type of category (e.g. by geographical markets, major goods or service lines and timing of revenue recognition (at a point in time or over time)).
  - However, in a few cases, the disclosure in relation to the contract assets and liabilities was incomplete, without providing an explanation of the significant changes (HKFRS 15.118) and the amount of revenue recognised during the year that was included in the contract liabilities at the beginning of the year (HKFRS 15.116(b)). Also, a few issuers omitted to disclose the fact that they had applied the practical expedient to not provide the amount of the transaction price allocated to the remaining performance obligations that were unsatisfied as at the end of the year, because they expected to recognise that amount as revenue within one year or less (HKFRS 15.120-122).
  - Issuers should avoid generic disclosure about their judgments made in applying HKFRS 15 that significantly affects the timing and amount of revenue recognition (HKFRS 15.123-126). For example, we observed a case where the issuer concluded that the revenue from its trading business was recognised on a gross basis (i.e. it was acting as a principal but not an agent) but the disclosure was relatively brief. It could provide better explanations on how the principal-versus-agent indicators in HKFRS 15.B37 (i.e. primary responsibility to provide goods, bearing of inventory risk, discretion to establish prices for goods) were linked to its business model for arranging the sales transactions.
75. Issuers should continue to improve the disclosure under HKFRS 15 and tailor information to their own circumstances to enable investors to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Under the current economic environment, issuers might have changed or will change the way in which they contract with customers (e.g. timing to deliver goods or services, offering incentives and rights of return), they should carefully consider and sufficiently disclose the implications on revenue recognition in accordance with HKFRS 15.

### E. Leases

76. We did not identify any significant issues in relation to HKFRS 16 “Leases”. Most issuers complied with the lessee and lessor disclosure requirements. Since 2020 was only the second year that issuers adopted HKFRS 16, issuers should continue to improve their disclosure, in particular the lessee disclosure as its accounting changed substantially under HKFRS 16. We observed the following disclosure:
- Many issuers, as lessees, had recognised right-of-use (**ROU**) assets and lease liabilities in their financial statements. They disclosed the quantitative information as required by HKFRS 16.53 (e.g. depreciation charges, additions to ROU assets, interest expenses on lease liabilities). Some of them provided additional information under HKFRS 16.59 (e.g. variable lease payments, extension options or termination options, restrictions or covenants imposed by leases).
  - Some issuers disclosed significant judgments and key estimates (HKAS 1R.122 and 1R.125) in applying HKFRS 16, particularly in the areas of (i) determination of the lease term with extension and termination options; and (ii) estimation of the incremental borrowing rate when measuring the lease liabilities at the present value of lease payments. Issuers are reminded that, depending on their own circumstances, the judgment and estimate disclosure should be entity-specific to enable investors to fully understand the effect that the leases had on the issuers' financial position, financial performance and cash flows.
  - A number of issuers with a December financial year end had early adopted the 2020 Amendment in relation to the COVID-19-related rent concessions<sup>16</sup>. Some of them stated that the adoption did not have a material impact on their financial statements, while the other issuers had applied the practical expedient in the 2020 Amendment that elected not to assess whether the COVID-19-related rent concessions were lease modifications and, instead, disclosed the amount recognised in profit or loss to reflect the changes in their lease payments that arose from those rent concessions.
77. Issuers should note that in April 2021, the HKICPA issued the 2021 Amendment<sup>17</sup> that has extended, by one year, the 2020 Amendment regarding the application period of the practical expedient to help lessees accounting for the COVID-19-related rent concessions. Issuers should provide adequate disclosure on the application and, where applicable, disclose the significant judgment made in determining whether rent concessions qualify for the practical expedient.

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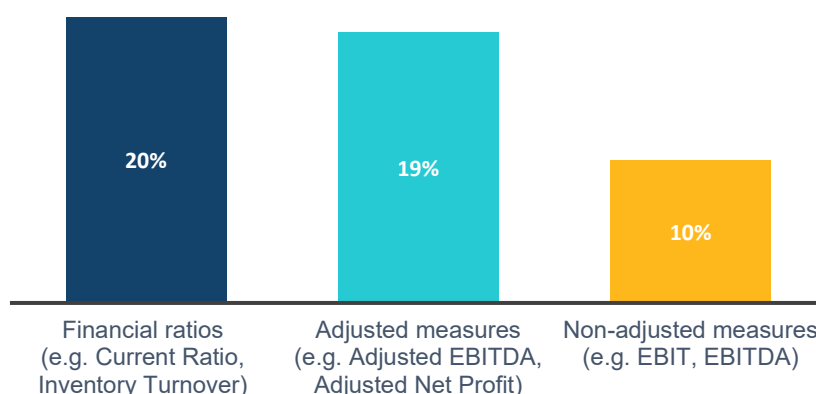
<sup>16</sup> In June 2020, the HKICPA issued the amendment to HKFRS 16 “Covid-19-Related Rent Concessions” (**2020 Amendment**), which applied to the COVID-19-related rent concessions that reduced lease payments due on or before 30 June 2021. It was effective for annual reporting periods beginning on or after 1 June 2020 (earlier application was permitted).

<sup>17</sup> The amendment to HKFRS 16 “Covid-19-Related Rent Concessions beyond 30 June 2021” (**2021 Amendment**) extended the date to permit lessees to apply the practical expedient to the COVID-19-related rent concessions that reduced lease payments due on or before 30 June 2022. It was effective for annual reporting periods beginning on or after 1 April 2021 (earlier application was permitted).

**F. Using non-GAAP financial measures**

78. This year, a number of issuers provided the non-GAAP financial measures<sup>18</sup> as a complement to the financial information reported under the GAAP in their annual reports. They followed the guidance in our Guidance Letter [GL103-19](#) when presenting the non-GAAP financial measures.

**Use of non-GAAP financial measures**



79. We highlight below areas that require particular attention:

- Some issuers used “adjusted” non-GAAP measures with different terms (e.g. adjusted EBITDA, adjusted net profit and adjusted operating losses). In a few cases, the label “adjusted” was omitted. It is important to provide appropriate labels and definitions to avoid investors’ confusion with traditional definition of EBIT (Earnings Before Interest and Taxes), EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortisation) and GAAP information.
- A few issuers newly included adjusted measures in the current year when discussing their financial performance but did not disclose the reasons for using such measures.
- Many issuers provided the reconciliations in table form with comparatives when presenting the adjusted performance measures. We observed that the items being excluded (e.g. fair value losses, listing expenses, share-based payment expenses) appeared to be justifiable but had not been clearly explained. In some cases, issuers described the adjusting items, taken as a whole, as “non-cash, non-recurring, infrequent or unusual” in nature. It would be helpful if the issuers select more accurate description and provide an explanation on each adjusting item (such as the adjustment is commonly adopted by the industry peers).

<sup>18</sup> A non-GAAP financial measure is a numerical measure of an issuer’s historical or future financial performance, financial position or cash flow that is not specified, defined or determined under the issuer’s GAAP. GAAP as referred in this report includes HKFRS, IFRS or other accounting standards that are accepted by the Exchange.

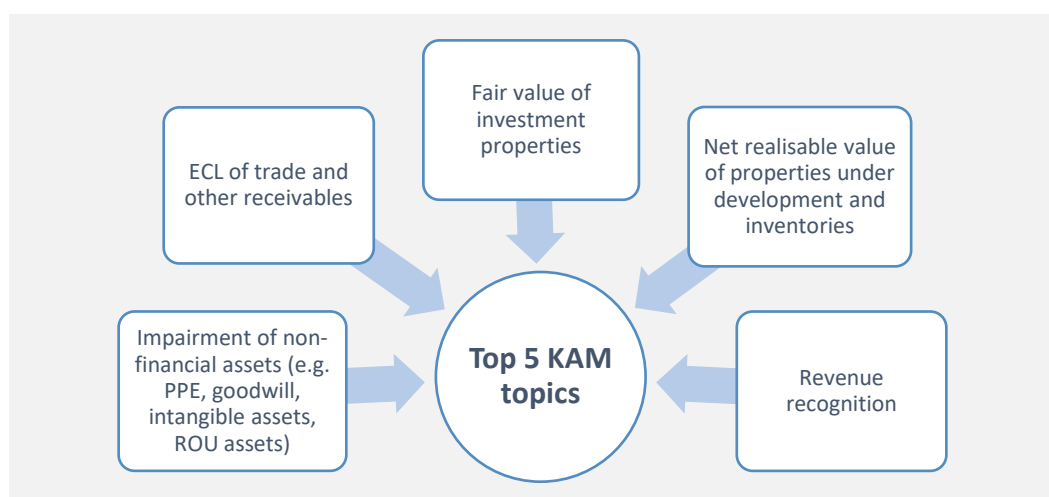
80. We remind issuers that in order to explain how COVID-19 impacted their financial performance, it is more appropriate to improve or expand their narrative information in the MD&A, rather than including new non-GAAP financial measures or adjusting the existing non-GAAP measure calculations. They should take note of the IOSCO's statement<sup>19</sup> on reporting in the time of COVID-19, which highlights that non-GAAP financial measures should not be presented inconsistently from period-to-period, defined inadequately, or are used to obscure rather than supplement GAAP information. Issuers should carefully evaluate the appropriateness of their non-GAAP financial measures and follow our guidance in GL103-19 (see **Appendix I**).

## G. Auditor reporting and related financial disclosure

81. The impact of COVID-19 on issuers' financial performance and position has posed unprecedented challenges for directors and management, as well as for their auditors. In our review, we focused on the consistency of disclosure in the financial statements and auditors' reports. We have the following observations:

### (a) **Key audit matters (KAM)**<sup>20</sup>

- In the 2020 audits, the majority of KAM were related to the asset impairment and valuation as they involved significant issuers' judgments and therefore typically required auditors' attention. The KAM disclosure was generally on the basis that those matters were already provided in the issuers' financial statements. To provide greater transparency, auditors in a few cases disclosed that they had performed additional audit procedures to evaluate the issuers' estimation of the impact of COVID-19 on future cash flows in determining the recoverable amounts of the CGUs.



<sup>19</sup> See the "IOSCO Statement on Importance of Disclosure about COVID-19" published by the International Organization of Securities Commissions (the **IOSCO**) on 29 May 2020.

<sup>20</sup> HKSA 701 "Communicating Key Audit Matters in the Independent Auditor's Report" defines KAM 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."

- In some cases, the financial statement disclosure was relatively brief. For example, the major assets of some issuers included ROU assets and property, plant and equipment (**PPE**) that were likely susceptible to impairment under the current economic environment and were identified as KAM. However, the impairment tests did not result in any impairment, and the issuers did not disclose the test methodology and key assumptions applied. We encourage issuers to disclose more and in greater depth relating to those areas covered by KAM to assist investors in better understanding of the risky areas.
- (b) **Going concern** – In some cases, auditors expressed a clean audit opinion and their auditors' reports had drawn investors' attention to the issuers' disclosure on the material uncertainty related to going concern (HKAS 1R.25-26). On the other hand, a few auditors included a "close call" KAM where there was a significant doubt about going concern but the issuers determined no material uncertainty existed. In these cases, the financial statements had disclosed the issuers' judgments (HKAS 1R.122) to support their determination, including the judgment on that mitigating actions were sufficient to make going concern appropriate. Under the current market conditions, it is important for issuers to continuously examine and provide clear and robust disclosure on going concern and liquidity risk under HKAS 1 (Revised) and HKFRS 7 at each reporting date<sup>21</sup>.
- (c) **Other Information**<sup>22</sup> – In most cases, the issuers provided the Other Information to their auditors in a timely manner, and their auditors reported in the auditors' reports that there was no material misstatement of the Other Information. There were only a few cases where the Other Information was not available to the auditors until after the date of the auditors' report. We recommend both issuers and their auditors to use their best endeavours to meet the objectives and reporting requirements of HKSA 720 (Revised), so that investors are kept fully informed.
82. The current economic environment highlights the importance of financial disclosure and audit quality more than ever. In this regard, issuers and their audit committees should maintain regular dialogue and have in-depth conversations with the auditors regarding the audit timeline, areas of audit focus, going concern and other emerging issues and financial statement disclosure at an early stage. Doing so may help to minimise the risk of last minute surprises.

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<sup>21</sup> Issuers should take note that the FRC issued a newsletter in November 2021 to remind issuers, audit committees and auditors of the important role each plays in going concern assessment and reporting. Moreover, in light of the current economic environment arising from COVID-19, the IFRS Foundation published the educational material "Going concern – a focus on disclosure" in January 2021 to support companies to implement the IFRS requirements related to the preparation of financial statements on a going concern basis.

<sup>22</sup> HKSA 720 (Revised) "The Auditor's Responsibilities Relating to Other Information" defines "**Other Information**" as "*Financial or non-financial information (other than financial statements and the auditor's report thereon) included in an entity's annual report*". HKSA 720 (Revised) requires the auditors to report in a separate section whether there is any finding on a material misstatement between the Other Information and the financial statements or the auditors' knowledge obtained in the audit.

### V. ISSUERS' COMPLIANCE WITH ANNUAL REPORT DISCLOSURE REQUIREMENTS

83. Appendix 16 of the MB Rules<sup>23</sup> sets out the minimum financial information that a listed issuer shall include in its annual report. It supplements other sections of the Rules (for example, connected transactions and share option schemes) which set out specific annual report disclosure requirements. In addition, we have in our previous Reports recommended certain disclosure items which are summarised in **Appendix I** to this report.
84. In this section, we report on issuers' compliance with specific Rule disclosure requirements in annual reports and our recommended disclosure. In our review we also considered the consistency of issuers' disclosure in annual reports with that in their announcements and prior year's annual reports.
85. Overall, issuers continued to achieve a high compliance rate. We followed up on identified omissions and, where appropriate, requested issuers to make supplemental disclosure. We noted that most issuers that omitted disclosure in last year's annual reports have made the required disclosure this year, with a few exceptions to which we have provided further guidance. We also identified isolated cases of potentially misleading disclosure, material non-compliances with the Rules or transactions that raised questions about whether the directors have acted in the interests of the issuers and their shareholders. These cases are under investigation.
86. We set out in the following sections the commonly omitted disclosure. We also highlight other observations from our review and recommendations:
- A) Continuing connected transactions
  - B) Share schemes and pension schemes
  - C) Fundraisings through issue of equity / convertible securities and subscription rights
  - D) Significant investments
  - E) Results of performance guarantees after acquisitions
  - F) Material other expenses / income
  - G) Other annual report disclosure

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<sup>23</sup> Chapter 18 of GEM Rules.



**A. Continuing connected transactions**

87. About 90% of the issuers reviewed fully complied with the annual reporting requirements for continuing connected transactions (**CCTs**). The graph below sets out commonly omitted disclosure:



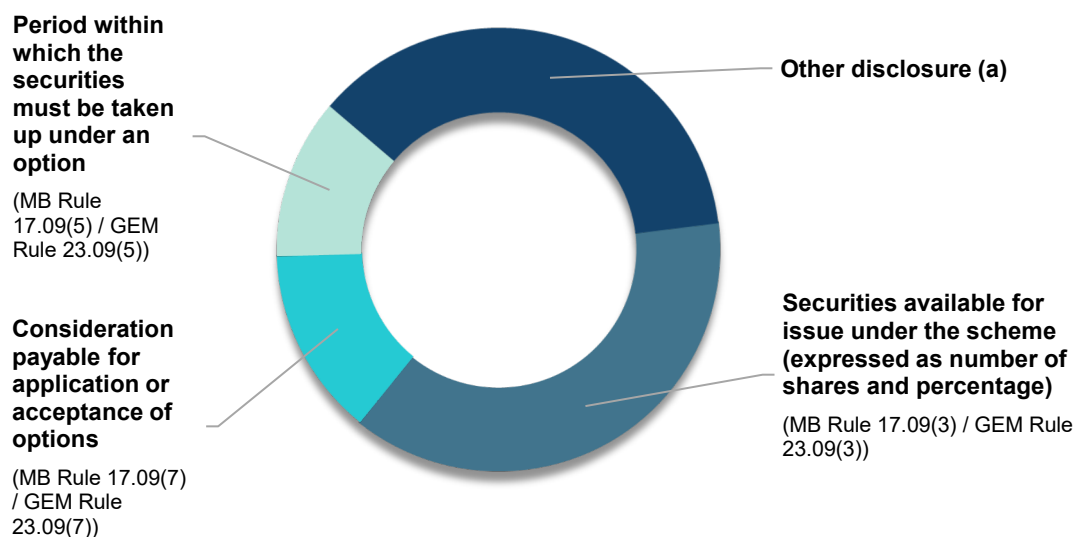
88. The most common omission continued to be a confirmation on whether the reported related party transactions were connected transactions under the Rules. In a few cases, the transactions were subject to the connected transaction Rules and the issuers also failed to announce and/or seek prior approval by independent shareholders at the relevant time. Issuers should ensure there are appropriate internal controls to review the related party transactions to ensure connected transactions are properly reported and the connected transaction Rules are complied with.
89. The Rules require independent non-executive directors (**INEDs**) and the auditors to review and confirm that the CCTs were conducted according to the agreements that governed them, were fair and reasonable to shareholders and in compliance with the connected transaction Rules. This year, we continued to identify isolated cases where the INEDs / auditors reported that the issuers exceeded the annual caps approved by independent shareholders for the CCTs, and/or failed to comply with the annual reporting requirements. We recommend issuers follow our guidance (see **Appendix I**) and put in place appropriate internal controls and mechanisms to monitor CCTs, and their INEDs review the adequacy of these internal control procedures from time to time.

**B. Share schemes and pension schemes**

(1) Share option schemes

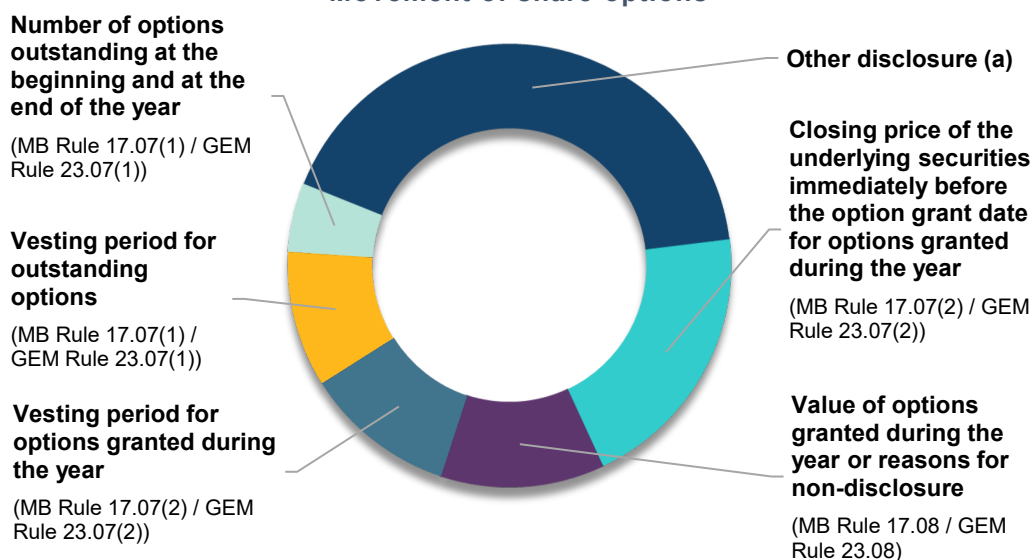
90. Similar to last year, a large majority of the issuers reviewed fully disclosed the information required under the Rules. The graphs below set out commonly omitted disclosure:

**Terms of share option schemes**



(a) Other disclosure included remaining life of the scheme, minimum option holding period before exercise, scheme purpose, scheme participants, maximum entitlement of each participant under the scheme and basis of determining the exercise price.

**Movement of share options**



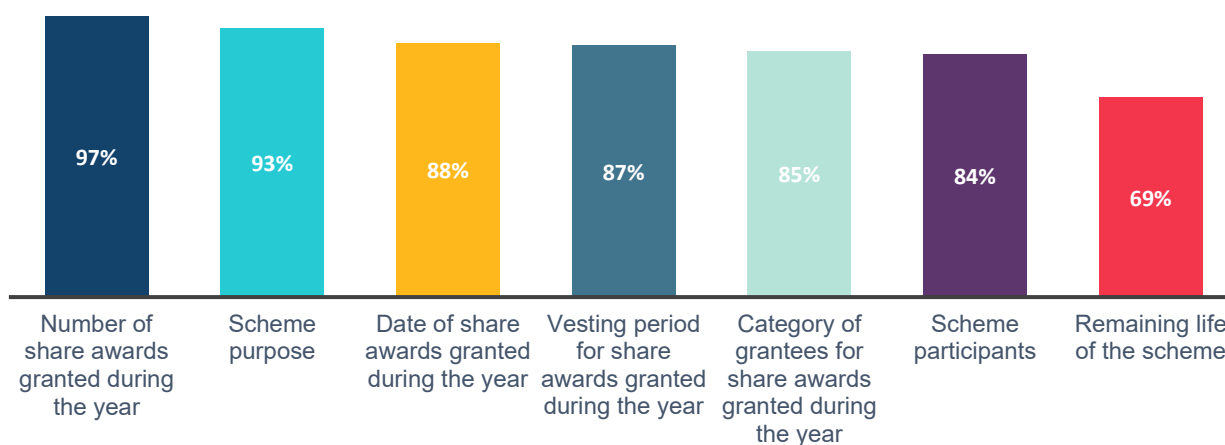
(a) Other disclosure included date of grant, exercise price, exercise period for options granted during the year and outstanding options, number of options granted and lapsed during the year, number of options, exercise price and closing price of options exercised during the year, number of options and exercise price of options cancelled during the year, and accounting policy adopted for the options.

91. This year, we noted that about one-third of issuers reviewed granted share options to non-employee participants, and a majority of these issuers did not disclose the identities of the grantees and rationale for the grants. Share option schemes are a form of incentive to scheme participants and align their interests with those of the issuers and the shareholders and as such, share option grants should encourage grantees to enhance shareholder value. We remind issuers of our recommendation in last year's Report to disclose information on the identities of the grantees, terms of the options and the rationale for making the grants. This would provide accountability to shareholders on the alignment of the grants with the objectives of the schemes.

(2) Share award schemes

92. Last year we also recommended issuers with share award schemes make disclosure consistent with the share option schemes disclosure requirements under Chapter 17 of the MB Rules<sup>24</sup>, given these schemes are also a form of share based payment arrangements. This year, a large majority of the issuers operating share award schemes disclosed the major terms of the schemes and the movements of share awards granted during the year with reference to Chapter 17. Their disclosure benchmarked with the Chapter 17 disclosure requirements is set out below:

**Disclosure of major terms and movements of share award schemes in annual reports**



<sup>24</sup> Chapter 23 of GEM Rules.

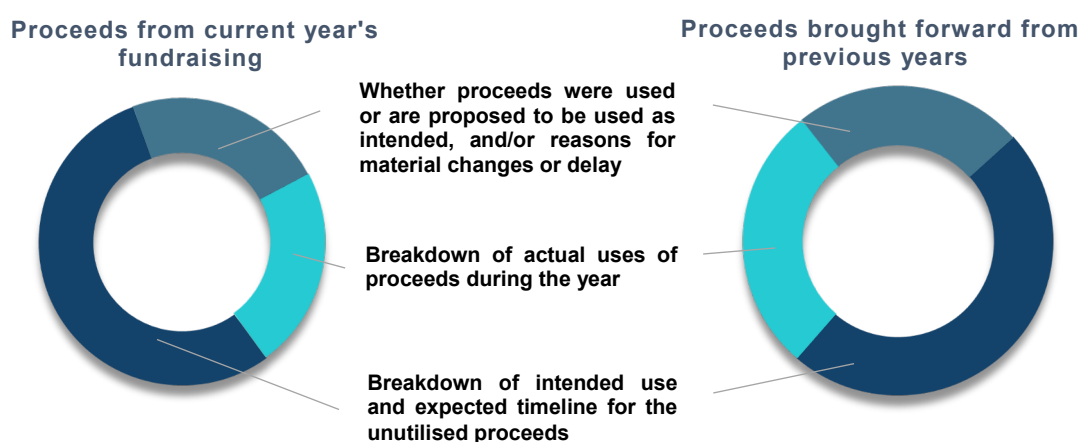
(3) Pension schemes

93. Issuers should take note of the following commonly omitted disclosure:

- (a) *Defined contribution plans*: (i) details of whether forfeited contributions may be used by the employer to reduce the existing level of contributions<sup>25</sup>. Where there was no such reduction arrangement, issuers should make a negative statement to that effect, and (ii) how the contributions or expenses were calculated<sup>26</sup>.
- (b) *Defined benefit plans*: (i) level of funding expressed in percentage terms<sup>27</sup>; and (ii) comments on material surplus or deficiency in funding<sup>28</sup>.

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

94. There was a notable increase in compliance with the disclosure requirements this year. The graphs below set out commonly omitted disclosure:



95. The most common omission was a plan for the unused proceeds including a breakdown and expected timeline. Issuers should align their proposed use of proceeds with their business plans and disclose such plans in their annual reports.

96. Over 10% of issuers reported material changes in the use of proceeds in their annual reports due to unexpected changes in market conditions or regulatory policies, or poor outlook in the businesses originally planned for expansion. These issuers generally made adequate disclosure on reasons for the changes, or reported on the reallocation of funds (generally to existing businesses, or redistributed among different uses stated in the fundraising announcements). We have not identified issues arising from these changes (see separately our review of newly listed issuers in section IIIA of this report).

<sup>25</sup> Paragraph 26(2) of Appendix 16 to MB Rule / GEM Rule 18.34(2).

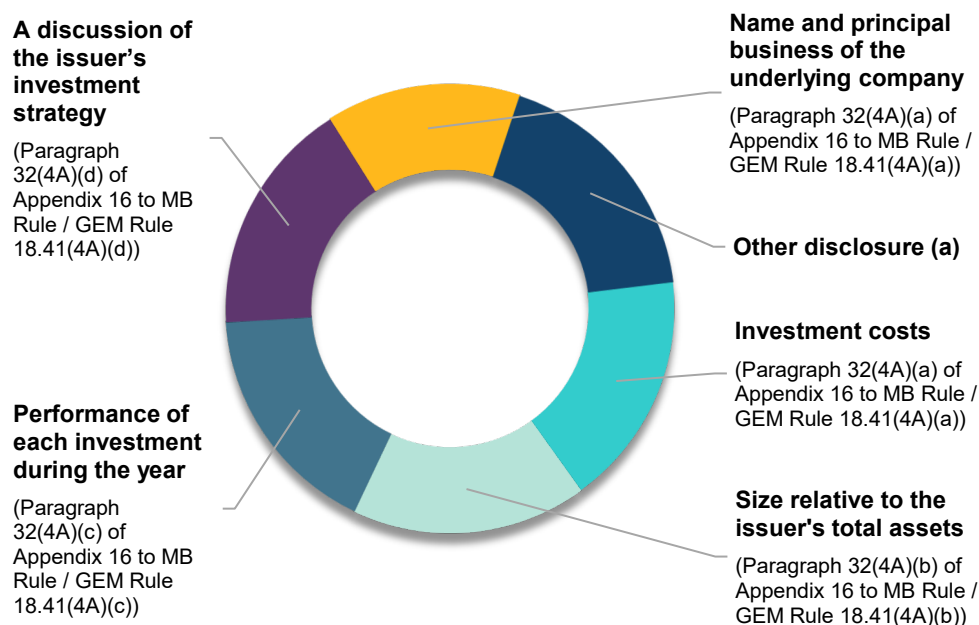
<sup>26</sup> Paragraph 26(1) of Appendix 16 to MB Rule / GEM Rule 18.34(1).

<sup>27</sup> Paragraph 26(3)(c) of Appendix 16 to MB Rule / GEM Rule 18.34(3)(c).

<sup>28</sup> Paragraph 26(3)(d) of Appendix 16 to MB Rule / GEM Rule 18.34(3)(d).

## D. Significant investments

97. Over 70% of the issuers fully disclosed information on their significant investments as required by the Rules. The graph below sets out commonly omitted disclosure:



(a) Other disclosure included number or percentage of shares held and fair value of each investment as at the year end.

98. In our monitoring we also identified isolated cases where issuers failed to comply with the notifiable transaction Rules when acquiring securities and investment products. Issuers should refer to [FAQ\\_057-2019](#) for guidance.

## E. Results of performance guarantees after acquisitions

99. In some acquisitions, the vendors guaranteed the performance of the acquired businesses and agreed to compensate the issuers for any shortfall. To provide accountability to shareholders, the Rules require issuers to report on the results of these performance guarantees.
100. We have reviewed issuers' disclosure and in cases where the performance of the acquired business fell short of the guarantee, whether the issuers have taken appropriate actions. In all but one case<sup>29</sup>, we were satisfied that the issuers had taken appropriate actions to enforce the guarantees and updated shareholders.

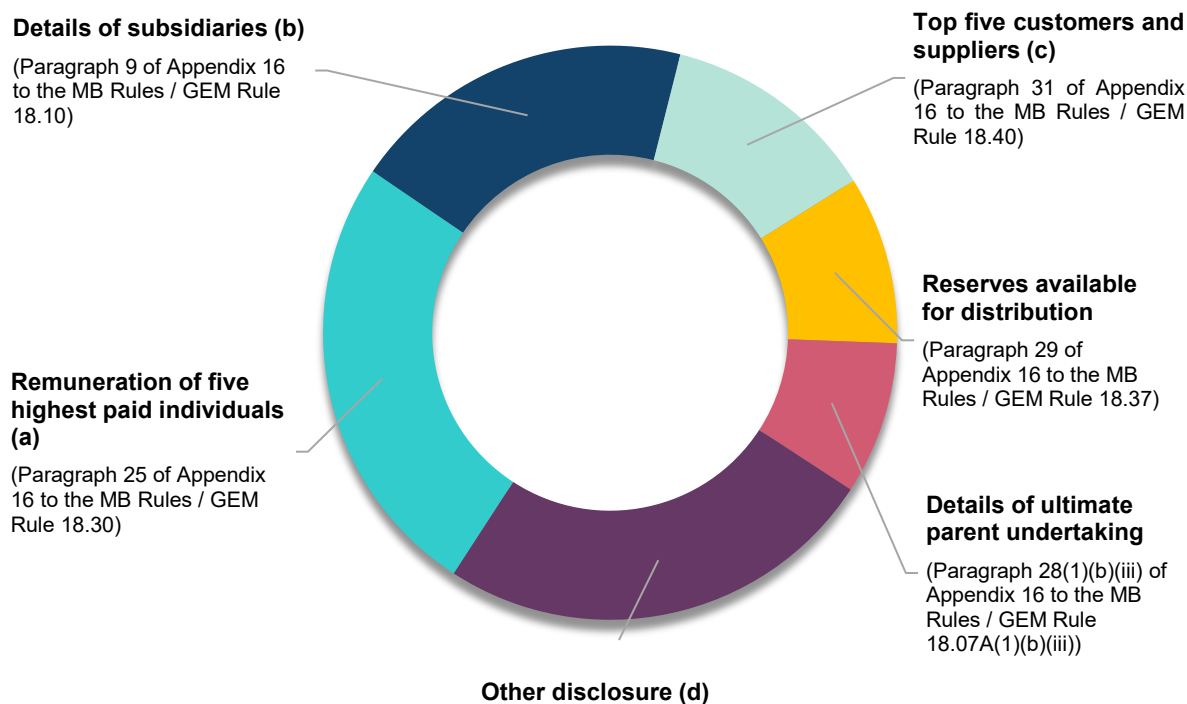
<sup>29</sup> In one case, the issuer did not enforce the terms of the guarantee to request a return of the consideration from the vendor. This raised a concern whether the directors have taken proper actions to safeguard the issuer's assets. The case is under our investigation.

**F. Material other expenses / income**

101. Over 95% of the issuers reviewed<sup>30</sup> provided additional breakdowns of material other expenses or other income in the notes to financial statements or explanations in the MD&A section.
102. In determining the appropriate level of disclosure, we recommend that issuers should have regard to the overriding principle that information disclosed must be meaningful, accurate and complete in all respects. Where the other expenses / income are material, they should provide additional information to facilitate investors' understanding of their cost structure and their financial performance.

**G. Other annual report disclosure**

103. This year, we continued to review issuers' compliance with other disclosure provisions for annual reports under Appendix 16 to the MB Rules<sup>31</sup> using our artificial intelligence model<sup>32</sup>.
104. Issuers continued to achieve a very high compliance rate this year (over 99% of the disclosure records). The graph below sets out common disclosure omissions:



<sup>30</sup> See **Appendix II** for the scope of our review.

<sup>31</sup> Chapter 18 of the GEM Rules.

<sup>32</sup> For more information, please refer to [A RegTech AI Case Study: Assessing the Annual Reports of Listed Companies](#) for details.

105. Our observations on the non-disclosure:
- (a) Certain emoluments details of the five highest paid individuals were omitted, in particular, basic salaries, housing allowances, other allowances and benefits in kind were aggregated with the discretionary bonus.
  - (b) A number of issuers did not disclose (i) the principal country of operation of the subsidiaries and (ii) the legal form of subsidiaries established in the PRC, such as whether they are wholly owned foreign enterprises, contractual joint ventures or cooperative joint ventures.
  - (c) A number of issuers omitted disclosure of (i) the percentages of revenue/purchases attributable to the largest customer/supplier; (ii) the percentages of revenue/purchases attributable to the five largest customers/suppliers combined; and (iii) the interests of any of the directors; their close associates; or any shareholder (who owns more than 5% interests in the issuers) in the five largest customers/suppliers.
  - (d) Other disclosure mainly include non-disclosure relating to (i) emoluments of directors<sup>33</sup>; (ii) change of auditors<sup>34</sup>; (iii) gear ratios<sup>35</sup>; (iv) pre-emptive rights<sup>36</sup>; and (v) public float<sup>37</sup>.
106. These common omissions were similar to last year. We recommend all issuers take note of these common pitfalls to ensure complete disclosure as required by the Rules.

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<sup>33</sup> Paragraph 24 of Appendix 16 to the MB Rule / GEM Rule 18.28.

<sup>34</sup> Paragraph 30 of Appendix 16 to the MB Rule / GEM Rule 18.42.

<sup>35</sup> Paragraph 32(10) of Appendix 16 to the MB Rule / GEM Rule 18.41(10).

<sup>36</sup> Paragraph 20 of Appendix 16 to the MB Rule/ not applicable to GEM issuers.

<sup>37</sup> MB Rule 13.35 / GEM Rule 17.38A.

## APPENDIX I: SUMMARY OF RECOMMENDATIONS IN PREVIOUS REPORTS

1. This appendix summaries our recommendations in previous Reports on issuers' annual report disclosure.

### ***Auditors' modified opinions***

2. An issuer is obliged to provide shareholders with financial statements that fairly present its financial position and performance and are free from material misstatements. The board is responsible for ensuring that the issuer establishes and maintains effective internal control systems for proper financial reporting. 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.
3. Where the issuer's financial statements do not give a true and fair view of its state of affairs, results of operations and cashflows, it is recommended to disclose the following 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' plans to address the modifications.

### ***Material asset impairments***

4. The Rules<sup>38</sup> require an issuer to include in its annual report a discussion and analysis of, among others, material factors underlying its financial results and position and significant events during the year.
5. Where an issuer recorded a material impairment on its assets, it should discuss the circumstances that led to the impairment. Where the impairment is supported by a valuation, we recommend the issuer disclose information about the basis of the valuation, including:
  - (a) details of the value of inputs used for the valuation together with the bases and assumptions;

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<sup>38</sup> Paragraph 32 of Appendix 16 to the MB Rule / GEM Rule 18.41.



- (b) reasons for any significant changes in the value of the inputs and assumptions from those previously adopted;
- (c) the valuation method and 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 amounts, and the prospects of the acquired business.

### ***Profit alert announcements published by newly listed issuers***

6. Profit alerts / warnings are normally published to alert investors to a significant change in the expected profitability of a listed issuer for the current period. A newly listed issuer is expected to disclose information about any material change (or expected change) to its financial position since the track record period in the prospectus. The prospectus forms the basis for investors to make an informed assessment about the issuer, and should contain all material information about the issuer up to the date of the prospectus. Accordingly, where subsequent to listing, a newly listed issuer publishes a profit warning announcement (under the Inside Information Provisions) about a deterioration in its financial position, that information should represent material developments subsequent to the date of the prospectus that have not been disclosed by the issuer.
7. Where an issuer wishes to provide the market with additional information about its financial position after listing and this information is not inside information, it should ensure that such information is meaningful and specific and not a restatement of information already available in the prospectus.
8. In addition, an issuer is encouraged to quantify the potential impact to the profit figure and use clear and concise language in a profit alert announcement.
9. See also guidance published in the [April 2015](#) and [December 2016](#) SFC Corporate Regulation Newsletters.

### ***Material intangible assets***

10. In addition to the disclosure requirements under accounting standards, we encourage issuers to provide the following additional information in the MD&A and financial statements (where appropriate) that may help investors' better understand their impairment tests:
  - (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;

- (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.

### ***Using non-GAAP financial measures***

11. Guidance Letter [GL103-19](#) provides guidance on the presentation of the non-GAAP financial measures in any documents pursuant to the Rules (such as financial reports, announcements and circulars). We highlight the following key elements for presenting non-GAAP financial measures:
- (a) ***Definitions*** – Each non-GAAP financial measure presented should be defined and a clear explanation of the basis of calculation should be provided. Also, they should be clearly labelled in such a way that they are distinguished from GAAP measures. Labels should be meaningful and should reflect the composition of the measure.
  - (b) ***Prominence*** – Non-GAAP financial measures should not be presented with more prominence than the most directly comparable measure calculated and presented in accordance with GAAP.
  - (c) ***Explanations for using non-GAAP financial measures*** – Issuers should set out the reasons for presenting the non-GAAP financial measures including explanations of why the information is useful to investors, and for what additional purposes, if any, management uses the measures.
  - (d) ***Reconciliation and nature of adjusting items*** – Issuers should provide a clear and concise quantitative reconciliation from the non-GAAP financial measure to the most directly comparable GAAP measure presented in the financial statements. The adjustments should be explained. This helps to enhance transparency so that investors can understand how significant the variances are between GAAP and non-GAAP figures.
  - (e) ***Comparatives*** – Issuers should present comparatives and disclose non-GAAP financial measures consistently over time.

### ***Continuing connected transactions***

12. Under the Rules, shareholders may give an issuer a prior mandate to conduct CCTs, 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 conducted within the framework of the agreement.
13. To monitor the issuer's compliance with the framework agreement, the Rules require that, in each financial year:
  - (a) An issuer must report its CCTs 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) INEDs must review the issuer's CCTs and confirm in the annual report whether such transactions were made (i) according to the agreement governing them, on terms that are fair and reasonable and in the interest of the issuer and its shareholders; (ii) on normal commercial terms or better; and (iii) in the issuer's ordinary and usual course of business; and
  - (c) The auditors must review the issuer's CCTs and provide the board of directors with a confirmation whether anything has caused them to believe that the CCTs (i) had not been approved by the board; (ii) were not in accordance with the issuer's pricing policies; (iii) were not entered into in accordance with the agreement governing them; and (iv) had exceeded the annual cap. The board should state in the annual report whether the auditors have provided such confirmation.
14. See also Guidance Letter [GL73-14](#) for details.

**APPENDIX II: SCOPE OF REVIEW**

<b>Issuers selected</b>	<b>Area reviewed</b>
<b><i>Auditors' modified opinions</i></b>	
<p>All issuers whose auditors expressed a modified opinion on the issuers' financial statements for the financial year ended in 2020 (136 issuers<sup>39</sup>).</p>	<p>Issuers' disclosure in annual reports about the modified audit opinions, with reference to our recommendations.</p> <p>Follow up actions taken by issuers to address the audit modifications.</p>
<b><i>Material asset impairments</i></b>	
<p>All issuers that recorded material impairments during the financial year on their assets or businesses, including assets or businesses previously acquired (62 issuers) and assets other than acquired assets (76 issuers).</p>	<p>Issuers' annual report disclosure about the developments of the businesses or assets and any significant changes to the value of the relevant assets (including intangible assets and goodwill).</p> <p>Whether the impairment was properly made and the matters giving rise to the impairment were discussed in the annual reports.</p> <p>Timeliness of disclosure for any material changes in the businesses or assets.</p> <p>For impairments related to acquisitions, we reviewed, in light of the impairment, (i) whether information disclosed in the shareholder circulars and/or announcements on the acquisitions was materially accurate at the relevant time, and (ii) whether the directors have properly considered the terms of the acquisition and discharged their fiduciary duties in the acquisitions in light of the developments.</p>
<b><i>Material lending transactions</i></b>	
<p>All issuers (excluding banks and insurance companies) that reported loan receivables, prepayments, deposits and other receivables that in aggregate exceeded 8% of their total asset value based on the 2020 annual reports (211 issuers (including 147 issuers that provide loans as part of their money lending business segment and 64 other issuers)).</p>	<p>Issuers' disclosure in annual reports on lending transactions, including the notes to the financial statements and commentaries in the MD&amp;A section (if any), and enquiries with the issuers on the nature and terms of the loans.</p>
<b><i>Business review in the MD&amp;A section</i></b>	
<p>Selected 50 issuers including (i) issuers reviewed last year whose disclosure about COVID-19 was generic, and (ii) issuers operating in industries materially affected by COVID-19 (e.g. airlines, hotel, restaurant, retail, gaming, pharmaceutical, education and building construction).</p>	<p>Issuers' disclosure on COVID-19 in annual reports, with reference to our recommendations.</p>

<sup>39</sup> Excluding 19 issuers (2019: 20) that were long suspended companies at the time they published the financial statements for 2020.

## Review of Issuers' Annual Reports – 2021

Issuers selected	Area reviewed
<b><i>Newly listed issuers (listed in 2019 and 2020)</i></b>	
All issuers that were listed in 2019 and 2020, excluding transfers of listing from GEM to Main Board (309 issuers).	Issuers' post-listing activities, Rule compliance and annual report disclosure.
<b><i>Issuers listed under the new listing regime for biotech companies</i></b>	
All biotech companies listed under Chapter 18A that had published annual reports for the financial year ended in 2020 (31 issuers).	Issuers' compliance with the Rule disclosure requirements in annual reports for biotech companies.
<b><i>Issuers' financial statement disclosure under accounting standards</i></b>	
<p>A total of 300 issuers, based on a risk-based approach, were selected for review. The key selection criteria included where an issuer:</p> <ul style="list-style-type: none"> <li>(i) had material intangible assets together accounted for 25% or more of its total assets;</li> <li>(ii) had material level 3 financial assets together accounted for 20% or more of its total assets;</li> <li>(iii) experienced significant changes in net assets;</li> <li>(iv) was newly listed; and/or</li> <li>(v) was the subject of complaints concerning compliance with the Rules.</li> </ul>	Issuers' financial statement disclosure in accordance with the requirements under the applicable accounting standards.
<b><i>Continuing connected transactions</i></b>	
All issuers that (i) failed to fully comply with the CCT Rules in the last two financial years (111 issuers) or (ii) were listed in 2019 or 2020 and reported CCTs in their annual reports (131 issuers).	<p>Issuers' compliance with the Rule disclosure requirements in annual reports for CCTs, with reference to their announcements and circulars.</p> <p>INEDs and auditors' annual confirmations.</p>
<b><i>Share schemes and pension schemes</i></b>	
<p><i>Share option schemes</i> – all issuers that operated share option schemes and granted options in the financial year (279 issuers).</p> <p><i>Share award schemes</i> – all issuers that operated share award schemes (424 issuers).</p> <p><i>Pension schemes</i> – all issuers that (i) had disclosure omissions identified in last year's review or (ii) had possible disclosure omissions based on initial screening / assessment by the artificial intelligence model (481 issuers).</p>	<p><i>Share option schemes</i> – issuers' compliance with the Rule disclosure requirements in annual reports for share option schemes.</p> <p><i>Share award schemes</i> – issuers' compliance with the disclosure requirements under the accounting standards and our recommended disclosure to follow the Rule disclosure requirements in annual reports for share option schemes under Chapter 17.</p> <p><i>Pension schemes</i> – issuers' compliance with the disclosure requirements in annual reports for pension schemes.</p>

## Review of Issuers' Annual Reports – 2021

Issuers selected	Area reviewed
<b>Fundraisings through issue of equity / convertible securities and subscription rights</b>	
All issuers that (i) conducted equity fundraisings during the financial year (395 issuers) or (ii) reported unutilised proceeds brought forward from equity fundraisings conducted in previous financial years (627 issuers).	Issuers' compliance with the Rule disclosure requirements in annual reports, with reference to their fundraising announcements.
<b>Significant investments</b>	
All issuers that (i) had securities investments reported in their financial statements which in aggregate accounted for 20% of more of their total assets as at the financial year end date and (ii) had an investment in an investee company with a value of 5% or more of their total assets as at the financial year end date (138 issuers).	Issuers' compliance with the Rule disclosure requirements in annual reports for significant investments, with reference to their announcements and circulars.
<b>Results of performance guarantees after acquisitions</b>	
All issuers that were provided with performance guarantees by vendors in previous acquisitions of businesses and the guarantee period ended in the financial year under review (46 issuers).	<p>Issuers' compliance with the Rule disclosure requirements in annual reports for the outcome of the performance guarantees, with reference to their announcements and the accounts of the acquired businesses.</p> <p>Issuers' enforcement of the obligations of the guarantors where the performance guarantees were not met.</p>
<b>Material other expenses / income</b>	
<p><i>Other expenses</i> – all issuers that recorded “other expense” / “other operating expenses” as a line item in their statements of profit or loss which (i) accounted for over 25% of the issuers' revenue or profit or loss and (ii) were over HK\$10 million (449 issuers).</p> <p><i>Other income</i> – all issuers that recorded “other income” / “other operating income” as a line item in their statements of profit or loss which (i) accounted for over 25% of the issuers' revenue or profit or loss; and (ii) were over HK\$10 million (388 issuers).</p>	<p><i>Other expenses</i> – issuers' disclosure of breakdown of other expenses in annual reports</p> <p><i>Other income</i> – issuers' disclosure of breakdown of other income in annual reports</p>
<b>Other annual report disclosure</b>	
All issuers	<p>Issuers' compliance with the Rule disclosure requirements for annual reports that were not covered by our thematic review.</p> <p>Reviewed by an artificial intelligence model<sup>40</sup> covering more than 360,000 disclosure records and involving more than 145 disclosure Rules.</p>

<sup>40</sup> For more information, please refer to [A RegTech AI Case Study: Assessing the Annual Reports of Listed Companies](#) for details.

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