FINANCIAL STATEMENTS REVIEW PROGRAMME REPORT 2010

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Hong Kong Exchanges and Clearing Limited
香港交易及結算所有限公司

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EXECUTIVE SUMMARY

The Listing Division has completed its 2008/2009 annual review of listed issuers' published financial reports for compliance with the disclosure requirements of the Listing Rules and accounting standards. This is our second published report which summarises our key observations and findings noted during our 2008/2009 review.

During the review process, we selected and reviewed 100 published periodic financial reports of issuers covering annual, interim and quarterly reports released between October 2008 and September 2009.

We issued 98 letters to issuers that contained more than 400 enquiries and observations. Our enquiries requested explanations and information about the accounting treatment adopted or clarifications on possible non-compliance or omitted disclosures.

Based on the responses to our enquiries made during our 2008/2009 review, except for four cases which have been referred to the Financial Reporting Council to consider further enquiry and investigation of possible accounting and auditing irregularities and one caution letter to an issuer, there were no significant breaches of the Listing Rules or accounting standards that would render the financial statements false or misleading or would require a restatement or reissue of financial statements or warrant disciplinary action by the Listing Committee. Where the omitted disclosures were regarded as less significant or material, issuers were requested to confirm in writing that the required information will be provided in their future financial reports.

As part of our regulatory function, we will continue to undertake a financial statements review programme and release our findings and observations on a regular basis.

We take this opportunity to thank issuers for the cooperation and assistance provided in the review process.

The major findings and recommendations arising from the review are set out below:-

- Disclosure of significant "other" account balances were simply described as "other gains/expenses" or "other receivables/payables" without further details;

- Performance indicators (e.g. "EBITDA" or "adjusted EBITDA") were used without adequate explanation of their meaning, how they are computed and what they were supposed to indicate;

- Where going concern is an issue, adequate information on going concern assessment should be included in the corporate governance report and other relevant sections of the annual report;

- Clearer explanations of the assessment of the effectiveness of internal controls should be made in corporate governance reports where there is a matter which indicates a weakness in internal controls;

- Robust asset impairment review processes should be in place so that shareholders and investors have confidence on the reported asset values;

- Disclosures of the amortisation/depreciation method adopted for mining assets, in particular, the measurement basis and key assumptions used in the estimation of proven and probable reserves, should be improved;

- Disclosure of assumptions and methods to arrive at fair values of financial instruments, including the assumptions and valuation techniques used, should be more detailed.

We encourage directors and other persons responsible for the financial reporting function to review and continuously improve their existing financial reporting systems and take note of the matters discussed in this report to ensure that useful information is presented to readers of financial statements.

BACKGROUND

1. To discharge part of the Exchange's regulatory function, the Listing Division continuously conducts a Financial Statements Review Programme (the "FSRP") which reviews, on a sample basis, issuers' published periodic financial reports, including quarterly, interim and annual reports (the "Reports").

2. The objective of the FSRP is to monitor compliance with the requirements of the Main Board Rules and GEM Rules and, in parallel, to monitor compliance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants (the "HKICPA") or International Financial Reporting Standards ("IFRSs") issued by the International Accounting Standards Board (the "IASB"), and the relevant disclosure requirements of the Companies Ordinance.

3. In order to enhance transparency and encourage high standards of financial disclosure, we publish an annual report of key observations and findings. The purpose of the report is to increase awareness of the possible pitfalls in the preparation of periodic financial reports so that issuers may learn from the experience of others and to improve the quality of their future reports. This report includes the findings arising from our 2008/2009 FSRP.

Scope of financial statements review programme

4. We adopted a risk-based approach and selected issuers for the FSRP based on the following criteria:-

   (a) Impact - issuers where an instance of major non-compliance might adversely affect the reputation of the Hong Kong equity market as a whole.

   (b) Probability - issuers where is a possible higher risk of misstatement or misapplication of financial reporting standards due to the existence of features that may indicate higher risk. Features include where an issuer has been subject to complaints concerning compliance with the Listing Rules, the auditor's report of the issuer was qualified or modified, the issuer experienced frequent changes of its independent non-executive directors, or was subject to a frequent change of auditors, or experienced significant changes in its net assets.

   (c) Random - a number of cases selected at random so that all issuers may be selected for review.

5. We included an industry theme and for this review period we chose companies whose major or principal businesses involved mining activities.

6. We also included a general accounting theme for the 2008/2009 FSRP and the theme chosen this year was accounting for financial instruments.

7. In the course of our 2008/2009 review, we reviewed 100 Reports released by issuers between October 2008 and September 2009 and issued 98 letters to issuers that contained more than 400 enquiries or observations. Of all the cases reviewed during the period, 96 were subsequently closed after considering the responses received to our letters and four cases remain outstanding awaiting further clarifications and information from the issuers.

8. The Division has referred four cases to the Financial Reporting Council (the "FRC") for consideration of further enquiry or investigation.

FINDINGS

9. This is our second published report which summarises our key observations and findings noted during our 2008/2009 review. The findings do not cover all areas in which we raised comments or asked questions.

10. We wish to remind issuers that it is the primary responsibility of the directors to prepare accurate and complete financial reports. As accounting standards are consistently being developed and revised, directors and persons responsible for accounting and financial reporting function should keep themselves abreast of the latest changes to accounting standards and other regulatory requirements including the Listing Rules, to determine their impact on the company. They should also review their financial reporting systems and procedures to ensure all revised financial disclosures are made in compliance with the new requirements.

FINDINGS REGARDING THE LISTING RULES

11. Table 1 below sets out key areas where issuers need to pay particular attention:-

Table 1: Findings relating to Listing Rules disclosures

Area	MB Rules	GEM Rules	No. of issuers
Disclosures relating to significant events, balances and transactions	Rule 2.13	Rule 17.56	54
Disclosures required under the Hong Kong Companies Ordinance	Appendix 16	Chapter 24 Chapter 25	18
Management discussion and analysis	Appendix 16	Chapter 18	16
Connected and related party disclosures	Chapter 14A Appendix 16	Chapter 20 Chapter 18	15
Going concern	Appendix 14 Appendix 23	Appendix 15 Appendix 16	5
Review of effectiveness of internal controls	Appendix 14 Appendix 23	Appendix 15 Appendix 16	4

Disclosures relating to significant events, balances and transactions

12. Although we highlighted the issue in our report last year, we continue to identify instances where significant account balances were simply described as "other gains/expenses" or "other receivables/payables" without further details. Issuers did not provide a breakdown of the balances by nature and did not disclose whether any of the balances were with related parties or connected parties.

13. During our review, we requested issuers to provide information and explanations on the relevant significant balances or transactions identified and based on the responses to our enquiries we noted that there was no apparent breach of the Listing Rules relating to notifiable, connected and related party disclosures. Nevertheless, this is an area which requires further improvement. Issuers are reminded to provide more information in their reports to ensure that readers of financial statements understand the nature and impact of significant events and material balances and transactions.

14. Main Board Rule 2.13(2) (and its GEM Rules equivalent) requires that *"the information contained in the documents must be accurate and complete in all material respects and not be misleading or deceptive"*. Moreover the *"Framework for the Preparation and Presentation of Financial Statements"* issued by the HKICPA states that the objective of financial statements is to provide financial information that is useful to users in making economic decisions and Hong Kong Accounting Standard (HKAS) 1 *"Presentation of Financial Statements"* requires companies to provide information which is relevant to an understanding of the financial statements by way of additional notes to the financial statements. The absence of information on significant events leading to material balances and transactions in periodic financial reports may be viewed as non-compliance with the relevant Listing Rules or accounting standards.

Disclosure required under the Hong Kong Companies Ordinance

Our observations

15. From our review, 18 issuers overlooked some of the disclosure requirements of the Tenth Schedule to the Companies Ordinance, in particular, the Company's balance sheet, investments in subsidiaries and amounts due from subsidiaries in their annual financial statements.

16. We continue to note that there appear to be divergent practices in the interpretation of the Listing Rules. Some interpret the Listing Rules to only require the presentation of consolidated financial statements without the presentation of the financial statements of the issuer itself. In its reply to our enquiry one issuer stated that *"the Company is a limited company incorporated in Cayman Islands and no disclosure of the Company's individual balance sheet, investments in subsidiaries and amounts due from subsidiaries was considered to be disclosed in the Annual Report. Also, the Company itself is only an investment holding company and all the investments held and the amounts due from subsidiaries will be full[y] eliminated on consolidation. The financial position of the Company together with its subsidiaries is well reflected in the Group's consolidated financial statements disclosed in the Annual Report. The Company is in [of] the opinion that sufficient information regarding the operations has already included in the consolidated financial statements for the accounts readers to evaluate the overall financial position of the Group"*. The apparent reason for this interpretation is that under the current accounting standards the presentation of separate financial statements of the company itself is not normally required unless the company elects to present them or it is required by local regulations.

Our recommendations

17. We would emphasise that the disclosure of the issuer's company level balance sheet is an important piece of information which may indicate possible impairment for investments in subsidiaries and amounts due from subsidiaries in the financial statements.

18. Paragraph 28 of Appendix 16 to the Main Board Rules (and its GEM Rules equivalent) requires that an issuer (whether or not it is incorporated in Hong Kong) shall include in its annual report disclosures required under certain provisions of the Companies Ordinance, including information required under the Tenth Schedule. In addition, Main Board Rule 13.46(2) (and its GEM Rules equivalent) states that *"In the case of an overseas issuer or a PRC issuer … Such issuer shall send to … every member of the issuer … a copy of … its annual report including its annual accounts <u>and</u>, where the issuer prepares group accounts, its group accounts, together with a copy of the auditors' report thereon …, not less than 21 days before the date of the issuer's annual general meeting and in any event not more than four months after the end of the financial year to which they relate"*.

19. Issuers that are not incorporated in Hong Kong should ensure they prepare financial statements that comply with the requirements of both the Listing Rules and the relevant sections of the Companies Ordinance.

Management Discussion and Analysis (MD&A)

Our observations

20. Similar to our 2007/2008 review, instances were noted where issuers experienced substantial fluctuations in turnover, operating results and net asset values during the period reported on but little explanation or discussion was provided regarding the reasons for the fluctuations. Most issuers simply explained that the significant fluctuations were attributable to the global financial crisis or the result of the recent adverse economic environment.

21. Some issuers presented financial and industry-specific "key performance indicators" (KPIs) in their MD&A and five years financial summary. Some companies provided financial and operation statistics in their financial reports, for example, the company's sales and distribution networks, number of stores/factories by location, production capacity, gearing ratio, interest coverage, profit margin, return on equity, net earnings, dividends and net asset value per share. Some companies operating in specialised industry sectors provided information which was of particular relevance to their industry, for example, companies engaged in mining activities disclosed the location of mines, contractual period of exploration/mining rights, and their mineral reserves.

22. We also observed that there was an increasing use of financial measures such as Earnings before interest, taxes, depreciation, and amortisation ("EBITDA"). Sometimes, issuers also presented performance indicators with meanings that were not defined (for example, "adjusted EBITDA") and we noted that an issuer used the same term but with a different meaning in different periods so it was difficult to make a comparison between periods.

23. Without adequate explanation of their meaning, how they are computed and what they are supposed to indicate, shareholders and other users of financial statements may be confused or even misled by the performance indicators. Some cases indicated that the performance indicators were derived from financial statements prepared in accordance with financial reporting standards after adjusting some selected items (e.g. excluding unrealised fair value gain/losses) but there was no explanation of what the specific adjustments were and why the directors believe the "adjustments" should be made.

Our recommendations

24. We emphasise the important role the MD&A has to guide readers through the financial statements and provide an unbiased explanation of the performance, financial position and future prospects of the company to assist readers to make informed decisions. Issuers should consider expanding their MD&As by indicating "how" as well as the "extent" to which their reported financial position, liquidity and future operations will be affected by the current market conditions and the directors' view of the future.

25. Issuers should bear in mind that Main Board Rule 2.13(2) (and its GEM Rules equivalent) requires that the information contained in documents "*must be accurate and complete in all material respects and not be misleading or deceptive*". Issuers should pay particular attention when presenting performance indicators in their financial reports. It is not appropriate to produce such information in order to present a more favourable picture of financial performance.

26. If performance indicators are presented in financial reports, they should be clearly described. Recommended disclosures include:-
    - state clearly the title of the performance indicator;
    - demonstrate the purpose of the performance indicator and its usefulness to users;
    - provide a definition and calculation formula;
    - reconcile figures to the financial statements and explain reasons for any adjustments made;
    - explain and justify with reasons any changes to the definition and calculation formula compared to those disclosed in previous financial reports; and
    - alert users to the fact that the indicators presented may not be comparable to similarly titled measures published by other issuers.

Connected and related party transactions

Our observations

27. Although there was some slight improvements from last year, six cases were noted where issuers omitted to include a narrative statement on whether their auditors had issued their confirmation on continuing connected transactions (Main Board Rule 14A.39 / GEM Rule 20.39). There were six cases where issuers did not disclose whether their related party transactions constituted connected transactions as defined under the Listing Rules (paragraph 8(3) of Appendix 16 to the Main Board Rules and its GEM Rules equivalent). We also noted that there were a further three cases that omitted to disclose both. In response to our enquiries, these 15 issuers acknowledged the omission and agreed to fully comply with the disclosure requirement and provide the information in subsequent annual reports.

28. Main Board Rule 14A.38 / GEM Rule 20.38 requires that each year the auditors must provide the issuer with a letter confirming that issuer's continuing connected transactions:-
    - have received the approval of the issuer's board of directors;
    - are in accordance with the pricing policies of the issuer if the transactions involve the provision of goods or services by the issuer;
    - have been entered into in accordance with the relevant agreement governing the transactions; and
    - have not exceeded the cap disclosed in previous announcement(s).

29. Paragraph 8(3) of Appendix 16 to the Main Board Rules (and its GEM Rules equivalent) requires companies to:-

    - state whether or not the related party transactions disclosed in their annual financial statements in accordance with HKAS 24 *"Related Party Disclosures"* fall under the definition of connected transactions or continuing connected transactions in Chapter 14A of the Main Board Rules (Chapter 20 of the GEM Rules); and

    - confirm whether or not they have complied with the disclosure requirements in accordance with Chapter 14A of the Main Board Rules (Chapter 20 of the GEM Rules).

Our recommendations

30. Issuers are reminded of the need to comply with the above Rules. Issuers should also note that the Exchange in May 2010 announced the amendments to the connected transaction Rules. The amended Rules, including relaxed exemptions and a reduced scope of who is regarded as a connected person, are effective from 3 June 2010. Further details are available at:-
http://www.hkex.com.hk/eng/newsconsul/hkexnews/2010/100520news.htm

31. Issuers should familiarise themselves with the revised connected transaction Rules and, where necessary, update their existing control procedures to ensure connected parties are properly identified and that all transactions with these parties are captured.

32. To promote consistency in annual reporting on continuing connected transactions disclosed in annual reports, after consultation with the market, the HKICPA in June 2010 issued a new Practice Note 740 "Auditor's Letter on Continuing Connected Transactions under the Hong Kong Listing Rules" ("Practice Note") which was developed in consultation with the Exchange and staff at the Securities and Futures Commission. Issuers and their auditors should familiarise themselves with the new Practice Note, which is effective for reporting on continuing connected transactions disclosed in annual reports for periods ending on or after 31 December 2010. Early adoption is permitted. The Practice Note is available on the HKICPA's website at:-
http://app1.hkicpa.org.hk/ebook/index.php.

33. In meeting their disclosure obligations on the annual review of relevant continuing connected transactions, an issuer should bear in mind the following:-

    - Directors are primarily responsible for ensuring the completeness and accuracy of disclosures made on continuing connected transactions in their annual reports and for compliance with the Listing Rules in respect of such transactions;

    - Issuers should have appropriate internal controls in place over the identification, recording, authorisation and reporting of all continuing connected transactions;

    - Directors are responsible for ensuring that the auditor is provided with all the information needed to enable him to submit his letter in accordance with the Exchange's timeline; and

- If an issuer has reason to believe that the auditor will not be able to provide an unqualified letter, it should promptly notify the Exchange and publish an announcement.

Going Concern

Our observations

34. In our review of the auditors' reports, five issuers included an emphasis of matter or a disclaimer of opinion on the issue of going concern. However, the issuers omitted to include disclosure in their Corporate Governance Reports of the existence of material uncertainties that may cast significant doubt upon their ability to continue as a going concern as required under paragraph C.1.2 of Appendix 14 and Note 2 to paragraph 2 of Appendix 23 to the Main Board Rules and their GEM Rules equivalent.

35. The Corporate Governance Code under paragraph C.1.2 of Appendix 14 to the Main Board Rules (and its GEM Rules equivalent) states that *"When the directors are aware of material uncertainties relating to events or conditions that may cast significant doubt upon the issuer's ability to continue as a going concern, such uncertainties should be clearly and prominently set out and discussed at length in the Corporate Governance Report. The Corporate Governance Report should contain sufficient information so as to enable investors to understand the severity and significance of the matters at hand. To the extent that it is reasonable and appropriate, the issuer may refer to the other relevant parts of the annual report. Any such references should be clear and unambiguous and the Corporate Governance Report should not only contain a cross-reference without any discussion of the matter"*.

36. HKAS 1 *"Presentation of Financial Statements"* also requires that when management is aware of material uncertainties relating to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, those uncertainties should be disclosed in the financial statements.

Our recommendations

37. Disclosures on going concern assessment are required by both the Listing Rules and accounting standards and adequate information should be included in corporate governance reports and other relevant sections of annual reports. In providing going concern disclosures in corporate governance reports, a balanced and clear disclosure can be achieved by a brief analysis and explanation together with:-

    - Making a cross-reference to the notes to the financial statements; for example, to the basis of preparation of financial statements note and the audit report; and
    - Cross-referencing to other risk disclosures in financial statements required by accounting standards, for example, information of liquidity risk (paragraphs 31 to 42 of HKFRS 7 *"Financial Instruments: Disclosures"*) and undrawn borrowing facilities and their covenant requirements (paragraph 50(a) of HKAS 7 *"Statement of Cash Flows"*).

38. Going concern is one of the underlying assumptions of financial reporting and is also applicable to interim reporting. If there is a going concern issue, merely disclosing a statement in the interim report that the same accounting policies and presentation as adopted in the most recent annual financial statements is not adequate. The interim report should disclose the material uncertainties and an explanation on why the directors believe preparing the interim report on a going concern basis is appropriate. Latest information on renegotiated borrowings and banking facilities would be relevant.

Review of Effectiveness of Internal Controls

Our observations

39. Of all the cases reviewed during the period, eight financial statements included modified auditors' reports because of an audit scope limitation and the non-availability of books and records. The scope limitations included no proper books and records available for subsidiaries, no assess to books and records for subsidiaries sold and insufficient audit evidence available in respect of certain intra-company account balances and transactions.

40. In these cases, the matter giving rise to the audit qualification indicates a possible breakdown in internal control but some issuers did not provide clear explanations of their assessment of the effectiveness of internal controls in their Corporate Governance Reports. We noted that for one issuer although its auditor's report was qualified on the issue of books and records, it stated in its corporate governance report that *"The Board maintains a sound and effective internal control system to safeguard shareholders' investment and the Company's assets. The internal control system is designed to provide reasonable assurance on the effectiveness and efficiency of operations, reliability of financial and management reporting, and compliance with applicable laws and regulations"*.

41. In addition, there were two cases where issuers omitted to include in their annual Corporate Governance Reports *"a statement that the board has conducted a review of the effectiveness of the system of internal control of the issuer and its subsidiaries (C.2.1 of the Code)"* as required under Note 3 to paragraph 2 of Appendix 23 to the Main Board Rules and its GEM Rules equivalent.

Our recommendations

42. Corporate governance is not simply a matter of having in place adequate procedures and effective internal control systems. The quality of disclosures in corporate governance reports is also essential as it provides information to shareholders and other stakeholders the state of the issuer's culture, control awareness, the control environment and systems put in place. We strongly encourage issuers to follow the recommended disclosures set out in paragraph 3(d)(i) of Appendix 23 to the Main Board Rules (and its GEM Rules equivalent) which include:-

    - explanation of how the system of internal control has been defined by the issuer;

- how often internal controls are reviewed;
- procedures and internal controls in place for the handling and dissemination of price sensitive information;
- whether the issuer has an internal audit function and explain its role and activities;
- review the need for an internal audit function;
- a statement that the directors have reviewed the effectiveness of the issuer's system of internal control and whether they consider the internal control systems are effective and adequate, including:-
    - criteria used by the directors to assess the effectiveness of the system of internal control;
    - the period covered by the review;
    - details of any significant areas of concern which need rectification;
    - significant views or proposals on internal controls put forward by the audit committee;
- where an issuer has not conducted a review of its internal controls during the year, an explanation why it has not done so and when one is expected to be done.

43. Issuers are also reminded that a basic feature of internal controls over financial reporting is that proper books and records are kept. In addition, extra care and attention at the planning stage of a significant transaction will prevent an audit qualification. For example, if an issuer plans to dispose of a business or a subsidiary it should make early arrangements so that its auditors are able to verify the disposal transaction at the time or immediately after the disposal. This should prevent subsequent financial statements from being qualified due to the inability of the auditors to get access to the books and records of the disposed business or subsidiary. When the Exchange vets circulars for major or very substantial disposals, issuers should expect and be in a position to respond to queries on whether the arrangements have been put in place to ensure that the disposal transaction can be readily and properly audited.

FINDINGS REGARDING ACCOUNTING STANDARDS

44. Table 2 below highlights the key findings and observations relating to disclosure requirements under accounting standards. Based on the responses to our enquiries made during our 2008/2009 FSRP, except for four cases which were referred to the FRC, no significant breach of the accounting standards arose that would render the financial statements false or misleading that would require a restatement or reissue of financial statements or warrant disciplinary action by the Listing Committee. Unless otherwise specified, HKFRSs and their paragraph numbers referred to in this section correspond to those in IFRSs.

Table 2: Findings relating to Accounting Standards

Area	Accounting Standards	No. of issuers
Impairment of assets	HKAS 36	32
Presentation of financial statements	HKAS 1	18
Interim financial reporting	HKAS 34	17
Investments in associates and interests in joint ventures	HKAS 28 HKAS 31	13
Business combinations	HKFRS 3	9
The effects of changes in foreign exchange rates	HKAS 21	4
Related party disclosures	HKAS 24	3

Our observations

45. During our review we noted the following common omitted disclosures which require attention and improvement:-

<u>HKAS 36 *"Impairment of Assets"*</u>

46. We noted 20 cases where there were no detailed explanations on why no impairment of a significant asset was made when there were indications of possible impairment (paragraph 9 of HKAS 36); for example, where subsidiaries, associates and joint venture suffer recurring operating losses this raises the issue of whether the carrying value of those investments need to be impaired.

47. We also noted that 10 issuers recognised material impairment losses on goodwill or other assets. However, explanations on the events and circumstances that led to the recognition of impairment losses (paragraph 130(a) of HKAS 36) tended to be short and generic. In some cases material impairment losses on goodwill or assets were recognised shortly after the related assets were acquired but there was no disclosure or explanation of what specific event or changes in circumstances subsequent to the acquisition led to the impairment.

48. Seven issuers had performed discounted cash flow calculations in determining their recoverable amounts of the assets based on "value-in-use" or "fair value less costs to sell". However, the key assumptions, particularly the discount rate and growth rate, and explanations of the methodology used by the management, were not disclosed in the financial statements as required under paragraphs 134(d) and 134(e) of HKAS 36.

HKAS 1 *"Presentation of Financial Statements"*

49. Six cases were noted where there was no description of the nature and purpose of reserves within equity; for example, capital reserve, special reserve, unrealised gain/loss reserve and statutory reserve funds (paragraph 76(b) of HKAS 1 (equivalent to paragraph 79(b) of HKAS 1 (Revised))).

50. 14 instances were noted where disclosure of the nature and impact of significant events or material balances and transactions were less than expected (e.g. deposits paid for the acquisition of major assets or businesses that remained on the balance sheet for over a year) (paragraph 103(c) of HKAS 1 (equivalent to paragraph 112(c) of HKAS 1 (Revised))).

HKAS 34 *"Interim Financial Reporting"*

51. Less than expected disclosures were made in the notes to interim reports on the nature and amount of unusual items because of their nature, size, or incidence (paragraph 16(c) of HKAS 34), and in some cases no commentary was made on the effects of changes in the group structure (paragraph 16(i) of HKAS 34). Although HKAS 34 sets out minimum line item disclosures for condensed interim financial statements, preparers are encouraged to follow disclosure requirements of other HKFRSs to explain the impact of significant transactions and balances in their interim reports.

HKAS 28 *"Investments in Associates"* and HKAS 31 "*Interests in Joint Ventures"*

52. 13 companies did not disclose whether the financial information of their associates and jointly controlled entities was prepared using accounting policies in conformity with the accounting policies adopted by the group. To provide a better understanding of how associates and joint ventures are reflected in their financial statements, issuers should also disclose whether adjustments are made to conform to the group's accounting policies (paragraph 26 of HKAS 28 *"Investments in Associates"* and paragraph 28 of HKAS 31 *"Interests in Joint Ventures"*).

HKFRS 3 *"Business combinations"*

53. During our review we noted that two issuers did not allocate the cost of acquisition to the acquiree's identifiable assets at fair value and a significant amount of goodwill was recognised (paragraph 36 of HKFRS 3 (equivalent to paragraphs 10, 18, 32 of HKFRS 3 (Revised))). We requested additional information about the accounting treatment adopted and following our enquiries, the issuers admitted the errors and subsequently made prior year corrections in their subsequent financial statements.

54. We also requested an issuer to provide information and explanations on whether an intangible asset met the recognition criteria, namely, whether its cash flows were independent from other identifiable assets. Based on the responses to our enquiries, there was no apparent breach of the accounting standards, but the case indicated that the issuer should have disclosed additional information on why the amount recognised in the financial statements was separable from other related income generating assets.

55. Four issuers did not use the published price of the company's shares at the date of exchange for determining the fair value of the company's shares issued as the cost of a business combination as required under paragraph 67(d) of HKFRS 3 (equivalent to paragraph 37 and related paragraph B64(f) of HKFRS 3 (Revised)), and no explanation was given on why the published price was not used.

56. Three issuers did not provide the following information:-

    (i) the issuer's share of the acquiree's post acquisition profit/losses (Paragraph 67(i) of HKFRS 3 (equivalent to paragraphs 59 and 60 and related paragraph B64(q)(i) of HKFRS 3 (Revised))); and

    (ii) the revenue and profit or loss of the combined entity for the period "as if" the acquisition date for all business combinations effected during the period had been at the beginning of that period (Paragraph 70 of HKFRS 3 (equivalent to paragraphs 59 and 60 and related paragraph B64(q)(ii) of HKFRS 3 (Revised))).

HKAS 21 *"The Effects of Changes in Foreign Exchange Rates"*

57. No detailed explanations on the choice of the functional currency. The functional currency should be the currency of the primary economic environment in which the issuer operates (i.e. the one which the issuer normally generates and expends cash). Issuers are reminded that paragraphs 8 to 14 of HKAS 21 provide a definition and guidance on determination of the functional currency.

58. One issuer did not explain the reason for using a presentation currency different from the functional currency (paragraph 53 of HKAS 21).

HKAS 24 *"Related Party Disclosures"*

59. Paragraph 17 of the standard requires that if there are transactions between related parties, there should be disclosure of the nature of relationship, the amount of the transactions, outstanding balances, and the related provisions for doubtful debts. Some issuers provided the terms and conditions of the transactions but omitted disclosure of any related provisions for doubtful debts on the outstanding balances. Some companies omitted disclosure of key management personnel compensation by category (e.g. short-term employee benefits, post-employment benefits, other long-term benefits, termination benefits, and share-based payment) (paragraph 16 of HKAS 24).

Our recommendations

60. We encourage directors and others responsible for the financial reporting function to review and continuously improve their systems and checklists to ensure the quality of disclosures in their periodic financial reports.

61. It is important that issuers have robust asset impairment review processes so that shareholders and investors have confidence on the reported asset values and that the values are not overstated. Issuers should follow the guidance included in accounting standards for asset impairment tests and, in particular, the need to consider the length of the period covered by financial budgets, estimating growth rates and discount rates used in determining value-in-use or fair values. Key assumptions used should be reasonable and not overly optimistic having regard to historical cash flows, available market information and future expectations. Directors should also consider whether there are sufficient in-house skills and experience to perform the impairment calculations. Where deemed necessary, they should seek external professional advice.

62. HKFRS 3 and HKAS 27 *"Consolidated and Separate Financial Statements"* have been revised substantially and the revised standards become effective for financial statements beginning on or after 1 July 2009. Issuers should review the revised standards and requirements and take appropriate steps at an earlier stage to ensure proper compliance in future interim and annual financial statements. We also encourage issuers who are planning an acquisition to consider the impact of these revised standards before entering into the transaction.

63. The HKICPA also undertakes a continuous review of published financial statements of listed companies and publishes its educational points and observations in its Quality Assurance Department's annual report and provides further guidance by publishing financial reporting and auditing alerts. The publications are useful reference materials of common pitfalls encountered by others and are available on the HKICPA's website at:-
http://www.hkicpa.org.hk/en/standards-and-regulations/quality-assurance/professional-standards-monitoring/publications-reference/

64. Moreover the FRC, which is an independent statutory body set up under the Financial Reporting Council Ordinance, has the power to enquire into issuers on financial reporting matters. In addition to looking into complaints received from the public and other regulators, the FRC monitors and reviews all listed companies which have a modified or qualified auditor's report soon after it is published. Further information relating to the FRC's procedures, investigation and enquiry reports are available on the FRC's website at:-
http://www.frc.org.hk/en/index.php

FINDINGS REGARDING SPECIAL REVIEW THEME – ACCOUNTING FOR MINING ACTIVITIES

65. In this year's review, our industry theme was the review of issuers whose major or principal activities included mining activities. The review focused particularly on the accounting treatment adopted for exploration and mining rights and related assets to determine whether there was compliance with applicable accounting standards. Unless otherwise specified, HKFRSs and their paragraph numbers referred to in this section correspond with those in IFRSs.

Our observations

66. Paragraph 97 of HKAS 38 *"Intangible Assets"* allows issuers to account for intangible assets by using either the cost model or the revaluation model. Paragraph 97 of HKAS 38 requires that *"The amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method shall be used."*

67. We observed that the requirements of HKAS 38 and HKFRS 6 *"Exploration for and Evaluation of Mineral Resources"* were in general complied with.

68. In total, 13 mining companies were selected for review and our observations are summarised below:-

    Exploration rights

    - Five issuers held "Exploration rights" and appropriately presented and recognised them separately. These issuers adopted the cost model and amortised the rights using the straight-line method over the period of the rights.
    - Two issuers re-capitalised the amortisation of "Exploration rights" back into the cost instead of charging the amount to the income statement.

    Exploration and evaluation assets

    - Six issuers had "Exploration and evaluation assets", including costs of topographical and geological surveys and technical feasibility studies. The issuers appropriately presented and separately recognised them, and the common practice was to state them at cost less impairment losses without amortisation.

    Mining rights

    - 11 issuers held "Mining rights" and adopted the cost model to account for the rights.
    - Four issuers amortised the rights using the straight-line method over the license period of the rights and seven issuers used the unit of production method based on the total proven and probable reserves of the mines.
    - Most issuers presented "Mining rights" as a separate item in the statement of financial position or included them as a sub-category under "Intangible assets". We however noted that one issuer presented "Mining rights" under "Property, plant and equipment".

    Mining structures

    - 11 issuers recognised "Mining structures", including mining shafts, mining related machinery and equipment, and these were normally included under "Property, plant and equipment".

- Seven issuers depreciated "Mining structures" using the unit of production method while three issuers used the straight-line method to depreciate the assets over the life of the mine. The remaining one issuer used the straight-line method to depreciate the buildings at the mining sites and adopted the unit of production method for other assets included in "Mining structures".

Our recommendations

69. We noted that disclosure of the amortisation/depreciation method adopted for mining assets was sometimes incomplete. To enable readers to fully understand the accounting policy adopted, details on the practices in applying the method, in particular, the measurement basis and key assumptions used in the estimation of proven and probable reserves should be disclosed.

70. During our review, we requested the issuers to provide further explanations in order to obtain a clearer understanding of the method adopted and encouraged them to provide such information in future financial reports. Based on replies to our enquiries, we were pleased to note that most issuers have procedures for estimating proven and probable reserves on a regular basis. They used independent professional valuers or the issuers' employees who were competent and experienced in undertaking such work.

71. Two issuers re-capitalised the amortisation of "Exploration rights" back into the cost instead of charging the amortisation to the income statement. The issuers explained that they accounted for "Exploration rights" in accordance with HKFRS 6 to state the rights at cost less impairment loss and so re-capitalised the amortisation back into the cost. The re-capitalisation had the effect that the disclosed cost was no longer the original cost and the movement of the "Exploration rights" account was confusing. We recommend that if an issuer chooses to account for "Exploration rights" in accordance with HKFRS 6, it should simply state that "Exploration rights" are carried at cost less impairment loss.

72. We observed that in general only minimal information on the exploration/mining rights held was disclosed in financial reports. Only two issuers provided useful additional information on exploration/mining rights to indicate their relative significance to the company's operations, such as number, name and location of the exploration/mining rights held, year of commencement of exploration/mining, contractual period of exploration/mining rights, quantity of proved and probable reserves, actual annual production volume, remaining unexcavated volume and carrying value for each mine. We encourage issuers to disclose such information in their future financial reports.

73. We also noted that contractual periods of some exploration/mining rights had expired. Based on replies to our enquiries, the issuers clarified that they expected that they would be able to renew the exploration/mining rights without significant cost. To justify that exploration/mining rights were not impaired, issuers normally took the view that they could renew the exploration/mining rights and continue to carry out exploration/mining operations. This was in compliance with paragraph 94 of HKAS 38 which states that *"The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset. If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost."* We recommend issuers to make appropriate disclosures, where applicable, on their ability to extend exploration/mining rights, to facilitate a better understanding of how they have determined the estimated life of their exploration/mining rights.

74. Mining companies are expected to have environmental restoration and rehabilitation obligations. However, we noted that disclosures in respect of provisions for environmental restoration were limited and could be improved. Some issuers had such provisions but did not provide details on the accounting policy adopted for recognising and measuring such provisions. We encourage issuers to expand their disclosure on provisions for environmental restoration and rehabilitation costs in their financial reports.

75. On 6 April 2010, the IASB published a Discussion Paper on Extractive Activities which sets out proposals on how to account for and measure mineral, oil and gas assets, estimation of their quantities and proposed disclosures in financial reports. Issuers engaged in mining businesses are encouraged to contribute their comments and thoughts and to monitor developments as any proposals for a change in the standards on reporting may have a significant impact on disclosures made in their future financial reports.

76. In June 2010, the Exchange introduced new Listing Rules for Mineral Companies which became effective from 3 June 2010. A "Mineral Company" is defined under Main Board Rule 18.01 / GEM Rule 18A.01 as *"a new applicant whose Major Activity (whether directly or through its subsidiary) is the exploration for and/or extraction of Natural Resources, or a listed issuer that completes a Relevant Notifiable Transaction involving the acquisition of Mineral or Petroleum Assets"*.

77. The new rules introduce new disclosure requirements for issuers listed prior to 3 June 2010 which have existing exploration or mining operations or those that intend to enter into such business in the future.

Types of issuers	Disclosure requirements
(i) Existing issuers who have publicly made a statement concerning mineral or petroleum resources and/or reserves after 3 June 2010	Although these issuers are not regarded as "Mineral Companies" as defined under Main Board Rule 18.01 / GEM Rule 18A.01, if they make such statements, they are required to update such statements in their annual reports. (Main Board Rules 18.15 and 18.17 / GEM Rules 18A.15 and 18A.17)
(ii) Existing issuers who have completed major or very substantial acquisitions of mineral or petroleum assets (i.e. a "Relevant Notifiable Transaction") after 3 June 2010	Once these issuers have completed the "Relevant Notifiable Transaction", they became a "Mineral Company" as defined under Main Board Rule 18.01 / GEM Rule 18A.01 and they are required to comply with the disclosure requirements of Chapter 18 of Main Board Rules and Chapter 18A of the GEM Rules. The issuer is required to include in its *"interim (half-yearly) and annual reports details of its exploration, development and mining production activities and a summary of expenditure incurred on these activities during the period under review"* (Main Board Rule 18.14 / GEM Rules 18A.14). They must also *"include an update of its Resources and/or Reserves in its annual report"* (Main Board Rules 18.16 and 18.17 / GEM Rules 18A.16 and 18A.17).

78. Newly listed issuers that are listed after 3 June 2010 as a "Mineral Company" are required to comply with the disclosure requirements of Chapter 18 of Main Board Rules / Chapter 18A of GEM Rules.

79. A list of Frequently Asked Questions in relation to the new Listing Rules for Mineral Companies is available on the HKEx's website at:- http://www.hkex.com.hk/eng/rulesreg/listrules/listrulesfaq/Documents/FAQ_12.pdf.

FINDINGS REGARDING GENERAL ACCOUNTING REVIEW THEME – ACCOUNTING FOR FINANCIAL INSTRUMENTS

80. The accounting standards review theme chosen for this year's programme was compliance with the accounting standards dealing with financial instruments. Unless otherwise specified, HKFRSs and their paragraph numbers referred to in this section correspond with those in IFRSs.

81. We were encouraged that the level of compliance for issuers reviewed was generally satisfactory. The key findings and observations together with our recommendations are set out below.

Reclassification of financial instruments effective from 1 July 2008

82. In light of the financial crisis in 2008, the IASB amended IAS 39 *"Financial Instruments: Recognition and Measurement"* and IFRS 7 *"Financial Instruments: Disclosures"* in October 2008 to allow the reclassification of certain financial instruments. The amendment allows an entity, which no longer intends to hold a non-derivative financial asset for its original purpose, to reclassify the asset to:-

(i) "available for sale" (measured at fair value through equity);

(ii) "held to maturity" (measured at cost or amortised cost); or

(iii) to "loans and receivables" (measured at amortised cost).

The reclassification could be made retrospectively to 1 July 2008 if the election was made before 1 November 2008.

83. Included in the companies selected for review, there were two issuers that took advantage of retrospective reclassification of their financial instruments. One entity reclassified financial assets held at "fair value through profit and loss" to "available for sale" and the reason for the reclassification was properly disclosed in the notes to the financial statements. The other entity reclassified "available for sale" financial assets to "other receivables" but did not disclose the reason for the reclassification. Issuers should note that the reasons for reclassification should be disclosed under paragraph 12 of HKFRS 7 *"Financial Instruments: Disclosures"*.

Disclosure of the accounting policy and types of financial instruments

84. All issuers reviewed disclosed the accounting policy and the types of financial instruments held as required under paragraph 21 of HKFRS 7.

Purpose for entering into financial instruments

85. We noted that most issuers used financial instruments as an integral part of their normal business operations and they did not appear to be used for speculative purposes. For example, convertible bonds were issued to finance the acquisition of a business or a company, and derivative instruments were used to hedge against fluctuations in foreign currency or commodity prices.

86. We recommend that where issuers make use of financial instruments they should disclose the purpose of entering into these financial instruments and include additional disclosures as further discussed below.

Disclosure of key terms of financial instruments

87. All issuers categorised their financial instruments by appropriate classes as required under paragraph 8 of HKFRS 7. However, we recommend that issuers should disclose more information to enable users of financial statements to understand and evaluate the nature of the risk exposures arising from holding the financial instruments. We recommend the following disclosures: -

    (i) name of counterparty but if this is commercially sensitive, disclosure of the type of organisation;

    (ii) date on which the financial instruments were entered into;

    (iii) expiry or maturity date of the financial instruments;

    (iv) market rates or prices to which the financial instruments are linked; and

    (v) whether the profits or losses that may arise from exposure to the financial instruments is non-linear or directly proportional to the performance of the market rates or prices to which the financial instruments are linked.

88. The above would be appropriate where the number of financial instruments are both significant and few. However, if there are numerous financial instruments, disclosure by portfolios of similar types of financial instruments would be appropriate.

Disclosure of assumptions and methods to arrive at fair value

89. Same as last year, there were less than expected disclosures on the assessment of fair value where the financial instruments were stated at fair value, including the assumptions and valuation techniques used which is required under paragraphs 25 to 30 of HKFRS 7.

90. It was not always clear what method and assumptions were applied by management in determining the fair value of their unlisted investments, which were normally categorised under available-for-sale financial assets or financial assets at fair value through profit or loss. Issuers should comply fully with HKAS 39 *"Financial Instruments: Recognition and Measurement"* which states that the best evidence of fair value is quoted prices in an active market. However, if the market for a financial instrument is not active, issuers should use a valuation technique to establish what the transaction price would have been on the measurement date in an arm's length exchange.

91. Valuation techniques suggested in HKAS 39 include: -

    (i) using recent arm's length market transactions between knowledgeable and willing parties;

    (ii) reference to the current fair value of another instrument that is substantially the same as the financial instrument;

    (iii) discounted cash flow analysis and option pricing models.

92. Paragraph 48A of HKAS 39 also states that if there is a valuation technique commonly used by market participants to price the instrument, and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, that technique should be used.

Disclosure of risks associated with financial assets

93. All issuers reviewed that had financial instruments provided a risk analysis of the financial instruments as required under paragraphs 32 to 42 of HKFRS 7 and it was normally disclosed in the note to financial statements under the heading of "financial risk management". However, same as last year, there were incomplete or an absence of entity specific disclosures of the risks associated with holding financial instruments and how the directors managed the exposures. Some issuers only provided minimal or boilerplate disclosures on the nature and types of financial instruments held and their related risks.

Market risk

94. 54 issuers did not disclose the assumptions used in preparing the "sensitivity analysis" of market risk. Issuers should note that under paragraph 40 of HKFRS 7, the methods and assumptions used in preparing the sensitivity analysis and any changes in the methods and assumptions used from the previous period, and the reasons for changes are required to be disclosed.

Liquidity risk

95. It is important that management should disclose the liquidity risks that arise from financial liabilities and how they have been managed. Issuers should disclose a maturity analysis to enable readers to obtain a better understanding of the timing of the cash flows which is required under paragraph 39 of HKFRS 7.

Credit risk

96. We observed that issuers often only made general disclosures on credit risks that were not specific to the company. We recommend that entity specific credit risk disclosures by class of financial instrument should be made and would also remind issuers that paragraph 36 of HKFRS 7 requires disclosures by class of financial instrument of the following:-

(i) maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements;

(ii) a description of collateral held as security and other credit enhancements;

(iii) information about the credit quality of financial assets that are neither past due nor impaired; and

(iv) the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

Disposals of financial instruments before expiry

97. We noted one case where an issuer disposed of its financial instruments before the expiry date. The issuer sold held-to-maturity investments prior to their maturity date as the value of the investments dropped substantially as a result of the deepening global financial crisis in 2008. We encourage issuers to disclose the reason for disposals of financial instruments before their expiry and their impact.

Convertible bonds

98. We noted that some issuers held financial instruments in the form of convertible bonds and we noted that strict compliance with HKAS 39 may result in significant volatility in reported results especially where there is significant movement in the share price of the shares included in the equity conversion option. The total fair value of convertible bonds, comprising both the liability and equity elements, may be significantly different from the initial nominal loan amount which is counter-intuitive. If the convertible bonds are redeemed on maturity, the previously recognised unrealised fair value gains or losses are reversed.

99. Issuers are reminded of the need to monitor developments on HKAS 39 which is in the process of being changed substantially. The changes may have a significant impact on an issuer's current accounting treatment and disclosures provided and its financial statements.

Profit warning announcement arising from fair value changes to financial instruments

100. Main Board Rule 13.09(1) (GEM Rule 17.10) requires that: -

"Generally and apart from compliance with all the specific requirements in this Chapter, an issuer shall keep the Exchange, members of the issuer and other holders of its listed securities informed as soon as reasonably practicable of any information relating to the group (including information on any major new developments in the group's sphere of activity which is not public knowledge) which:—

(a) is necessary to enable them and the public to appraise the position of the group; or

(b) is necessary to avoid the establishment of a false market in its securities; or

(c) might be reasonably expected materially to affect market activity in and the price of its securities."

101. 32 issuers issued profit warning announcements of which seven were due to significant losses arising from fair value changes on their financial instruments caused by the 2008 global financial crisis.

102. We observed that some of the profit warning announcements were only released some time after the release of the annual, interim or quarterly results announcements. Issuers are reminded of the requirements of Main Board Rules and GEM Rules referred to in paragraph 100 above which state that issuers should inform the Exchange and the public of any price sensitive information as soon as reasonably practicable. Further guidance is included in the announcement issued by the Exchange on 11 September 2006 which is available at:-
http://www.hkex.com.hk/eng/newsconsul/hkexnews/2006/060911news.htm.

103. In March 2010, the Financial Services and the Treasury Bureau published a "Consultation Paper on the Proposed Statutory Codification of Certain Requirements to Disclose Price Sensitive Information by Listed Corporations", which proposes to introduce statutory backing for obligations of issuers to disclose price sensitive information in a timely manner. Issuers should monitor developments of the proposed changes to legislation and the consequential changes that may be made to the Listing Rules.

104. Main Board issuers are also reminded that the shortened reporting deadlines for interim and annual results announcements by one month are effective for half-year accounting periods ending on or after 30 June 2010 (Main Board Rule 13.49(6)) and for annual accounting periods ending on or after 31 December 2010 (Main Board Rule 13.49(1)).

CONCLUSION

105. The current global economic environment and the regular changes to accounting standards provide challenges to persons involved in the financial reporting process. We encourage all persons responsible for preparing financial information for issuers and their auditors to take note of the matters discussed in this report. Issuers are encouraged to consult early with their external auditors and other external professional advisers to provide them with insights into the changes and their implications on annual audits or reviews of financial statements. Extra care and attention at the planning stage and other stages during the process leading to publication of financial information will ensure that useful information is presented to readers of financial statements.

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