

FINANCIAL STATEMENTS REVIEW PROGRAMME  
REPORT 2014

July 2015



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

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Report 2014**

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### EXECUTIVE SUMMARY

The Exchange has completed its review of issuers' published financial reports for compliance with the disclosure requirements of the Listing Rules and accounting standards. This is our sixth published report summarising our key observations and findings.

We reviewed 100 reports comprising of issuers' annual, interim and quarterly reports released between October 2013 and April 2015. During the review process, we issued 61 letters to issuers that contained more than 210 enquiries and observations. Our enquiries requested explanations and information about the accounting treatment adopted or clarifications of possible non-compliance or omitted disclosures.

Based on the responses to our enquiries during the review, there were no significant breaches of the Listing Rules or accounting standards that would render the financial statements misleading, 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, we received confirmations from the issuers that the required disclosures would be rectified in future financial reports.

We highlight below areas arising from our review where issuers can continue to improve their disclosures:-

- Issuers should take note that in addition to the disclosure requirements in accounting standards, the Listing Rules have disclosure requirements related to financial information. These are primarily set out in Appendix 16 to the Main Board ("MB") Rules (and equivalent Growth Enterprise Market ("GEM") Rules). Issuers should pay attention to the recent Listing Rules amendments with reference to the new Companies Ordinance (Cap. 622) (the "New CO") (effective for accounting periods ending on or after 31 December 2015), in particular paragraph 28 of Appendix 16 to the MB Rules (and equivalent GEM Rules) (see paragraphs 14 to 41);
- Issuers should ensure that additional information is presented in annual and interim reports when there are significant events or material balances and transactions (see paragraphs 19 to 21, 56 to 60, 68 and 69);
- Issuers should improve the quality of their disclosure of the judgements and estimates they made in applying the accounting policies. The information should be clear, understandable and entity-specific (see paragraphs 52 to 55);
- Issuers should note that when they are not early adopters of new or revised accounting standards that have been issued but are not yet effective, they should state this and provide the known or reasonably estimable information needed to assess the possible impact that application of the new or revised standards will have on the issuers' financial statements in the period of their initial application (in accordance with HKAS 8 "*Accounting Policies, Changes in Accounting Estimates and Errors*") (see paragraphs 61 to 64);

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- Issuers should ensure that robust asset impairment review processes are in place, and more should be done to improve the quality of disclosures under HKAS 36 “*Impairment of Assets*”, particularly where the recoverable amount was based on value in use, so that investors and other users have confidence in the reported asset values (see paragraphs 73 to 77);
- Issuers should provide entity-specific information rather than boilerplate text in preparing financial risk information under HKFRS 7 “*Financial Instruments: Disclosures*” to enable investors and other users to understand what management thinks are the key financial risks and how they have adequately managed those risks (see paragraphs 83 to 85); and
- Issuers should follow the disclosure requirements under HKFRS 13 “*Fair Value Measurement*”, which are designed to help investors and other users assess the valuation techniques and inputs used in fair value measurements, particularly those based on significant unobservable inputs, and the effect on financial statements (see paragraphs 103 to 116).

The overarching principle for financial reporting should be “information provided is relevant and material” and issuers should avoid cluttering by reducing non-relevant and non-material disclosure so that their communication through financial reports is clear and concise.

We encourage directors and other persons responsible for financial reporting to take note of the matters discussed in this report. They should review and regularly improve their financial reporting systems and explore ways to better integrate information in financial statements and other parts of the financial report such that the information provided is useful to investors and other users.

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### I. INTRODUCTION

1. As part of the Exchange's regulatory function, the Listing Division operate a Financial Statements Review Programme (the "FSRP") which reviews, on a sample basis, issuers' published periodic financial reports. The FSRP covers issuers' quarterly, interim and annual reports.
2. The objective of the FSRP is to monitor issuers' compliance with the requirements of the Listing Rules in relation to periodic financial reports and, in parallel, to monitor their compliance with the relevant disclosure requirements of the Companies Ordinance, and the applicable accounting standards: including Hong Kong Financial Reporting Standards ("HKFRS") issued by Hong Kong Institute of Certified Public Accountants (the "HKICPA"); and International Financial Reporting Standards ("IFRS") issued by the International Accounting Standards Board (the "IASB"). The review also covers a sample of issuers incorporated in the Mainland ("PRC issuers") that have elected to adopt China Accounting Standards for Business Enterprises ("CASBE") issued by the Ministry of Finance of the People's Republic of China.
3. In order to enhance transparency and help issuers improve the quality of the financial disclosures in their periodic financial reports, we regularly publish our report of key observations and findings from our review programme. The purpose of the report is to increase issuers' awareness of the possible pitfalls in the preparation of periodic financial reports so that they may learn from the experience of others and improve the quality of their future reports.

#### **Scope of financial statements review programme**

4. A risk-based approach is adopted in selecting issuers for the FSRP. The selection criteria include:-
  - Impact – where an instance of major non-compliance by an issuer might adversely affect the reputation of the Hong Kong equity market as a whole.
  - Probability – where there is a possible higher risk of misstatement or misapplication of accounting standards due to the existence of certain features, including where an issuer has any of the following characteristics:-
    - experienced significant changes in its net assets
    - newly listed
    - subject of complaints concerning compliance with the Listing Rules
    - financial statements issued with a qualified or modified auditors' report
    - engaged a smaller accounting firm as its auditors
  - Random – a number of cases are selected at random so that any issuer may be selected for review.

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5. We reviewed 100 reports released by issuers between October 2013 and April 2015 and issued 61 letters to issuers that contained more than 210 enquiries or observations.
6. Of all the cases reviewed during the period, 99 were subsequently closed after considering the responses received to our letters. One case remains outstanding, as we are awaiting further clarification and information from the relevant issuer.
7. This is our sixth published report. This report highlights our key observations and findings relating to Listing Rules disclosures (Section II of this report) and accounting standards (Section III of this report). This report highlights our key findings and does not include all areas in which we raised comments or asked questions.
8. For each year's review, in addition to monitoring compliance with the Listing Rules and accounting standards, we have different accounting and industry themes, and including a topical issue, if appropriate. For this year, we selected:-
  - “Fair value measurement”, as our accounting theme (Section IV of this report); and
  - “Issuers whose major or principal activities included automotive related businesses”, as our industry review theme (Section V of this report).
9. Key observations and findings raised in our past reports may also be relevant and useful for references. They can be accessed at:-  
<http://www.hkex.com.hk/eng/rulesreg/listrules/guidref/finrept.htm> .
10. This FSRP is separate from our Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance (the “Compliance Review”). The Compliance Review focuses on issuers' compliance with the Listing Rules and their disclosure of material events and developments. The Compliance Review Report 2014 can be accessed at:-  
<http://www.hkex.com.hk/eng/rulesreg/listrules/guidref/issuergdo.htm> .
11. We take this opportunity to thank issuers for their cooperation and assistance in the review process.
12. Unless otherwise specified, the Rule references referred to in this report apply to both MB Rules and GEM Rules. While the discussion in this report will focus on MB Rules, the discussion applies equally to GEM Rules.

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## II. FINDINGS REGARDING THE LISTING RULES

13. This section sets out a summary of key areas arising from this year’s review, many of which have been raised in our past reports, where issuers should continue to pay particular attention:-

**Table 1: Key areas relating to Listing Rules disclosures**

Area	MB Rules	GEM Rules
<b>Information required under the Listing Rules in addition to those required under accounting standards</b> <ul style="list-style-type: none"> <li>• Management Discussion and Analysis</li> <li>• Disclosures required under the Companies Ordinance</li> <li>• Credit policy and ageing analysis of accounts receivable</li> <li>• Directors’ emoluments</li> <li>• Five highest paid individuals and senior management remuneration by band</li> <li>• Distributable reserves</li> <li>• Revision of Appendix 16</li> </ul>	Appendix 16	Chapter 18
<b>Annual reporting and review of continuing connected transactions</b>	Chapter 14A	Chapter 20
<b>Financial reports using CASBE</b>	Chapter 19A	Chapter 25

**Information required under the Listing Rules in addition to those required under accounting standards**

14. Appendix 16 to the MB Rules (“Appendix 16”) specifies a number of matters that issuers are required to disclose in their annual reports in addition to the disclosures required under accounting standards. For some of these disclosures, the Listing Rules specify that they should be included in the financial statements. Otherwise, the disclosures may be presented outside the financial statements, such as in the Management Discussion and Analysis (“MD&A”) or directors’ report.
15. During our review we occasionally noted that information provided outside the financial statements appeared to contradict or was inconsistent with the information included in the financial statements. Issuers should bear in mind the requirement under MB Rule 2.13(2) that in any corporate communication *“the information contained in the document must be accurate and complete in all material respects and not be misleading or deceptive”*. Auditors, as required by ISA/HKSA<sup>1</sup> 720

<sup>1</sup> International Standards on Auditing (“ISA”) issued by the International Auditing and Assurance Standards Board (the “IAASB”) / Hong Kong Standards on Auditing (“HKSA”) issued by HKICPA.

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*“The Auditor’s Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements”* issued in 2009, should read the other information in annual reports to identify material inconsistencies, if any, with the audited financial statements<sup>2</sup>.

16. In this year’s review, we noted the following commonly omitted or incomplete disclosures which require attention and improvement:-

### Management Discussion and Analysis (paragraphs 32 and 52 of Appendix 16)

#### Minimum disclosure requirements

17. Paragraph 32(1) to 32(12) of Appendix 16 sets out the minimum areas that should be covered in the MD&A.
18. During our review we noted that some issuers had overlooked these minimum disclosure requirements. Examples of omissions include the following:-
- the currencies in which borrowings are made and in which cash and cash equivalents are held;
  - the extent to which borrowings are at fixed interest rates;
  - significant investments held, their performance during the financial year and their future prospects; and
  - comments on segmental information such as changes in the industry segment, developments within the segment and their effect on the results of that segment.

#### Significant balances and transactions

19. Paragraph 32 of Appendix 16 requires annual reports to include a statement *“containing a discussion and analysis of the group’s performance during the financial year and the material factors underlying its results and financial position. It should emphasize trends and identify significant events or transactions during the financial year under review.”*
20. As was the case last year, we continue to note that disclosures relating to significant events or material balances and transactions mentioned in some reports were brief. In some cases, the MD&A tended to repeat information available in the financial statements in narrative form without additional analysis and explanations.

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<sup>2</sup> In April 2015, the IAASB has issued ISA 720 (Revised) *“The Auditor’s Responsibilities Relating to Other Information”* (the HKICPA is expected to issue the corresponding HKSA 720 (Revised) in the third quarter of 2015), which is effective for audits of financial statements for periods ending on or after 15 December 2016. The press release of ISA 720 (Revised) is available on the IAASB’s website at:- <http://www.ifac.org/news-events/2015-04/iaasb-s-revised-standard-isa-720-enhances-auditor-focus-annual-reports-light-inc> .



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21. Issuers should bear in mind that paragraph 112(c) of HKAS 1 (Revised) *“Presentation of Financial Statements”* further requires entities to provide information which is relevant to an understanding of the financial statements by way of inclusion of necessary additional notes to the financial statements. Our observations and further guidance is detailed in paragraphs 56 to 60 of Section III *“Findings regarding Accounting Standards”*.

Disclosures required under the Companies Ordinance (paragraph 28 of Appendix 16)

22. Paragraph 28 of Appendix 16 requires an issuer (whether or not it is incorporated in Hong Kong) to include in its annual report disclosures required under certain provisions of the Companies Ordinance.
23. In this year’s review, we found there was a general improvement in disclosures in this area. However, we identified some instances where issuers incorporated outside Hong Kong did not provide some of the disclosures required under the Tenth Schedule of the predecessor Companies Ordinance (Cap. 32) (the “Old CO”). The commonly omitted disclosures in the financial statements included the holding company’s statement of financial position for the financial year, the movement in the holding company’s reserves and the auditors’ remuneration (as required under the Tenth Schedule of the Old CO, which is set out in Schedule 4 of the New CO).
24. Issuers should pay attention to the recent Listing Rules amendments with reference to the New CO (effective for accounting periods ending on or after 31 December 2015), in particular paragraph 28 of Appendix 16 (see paragraph 36 below).

Credit policy and ageing analysis of accounts receivable (paragraph 4(2)(b)(ii) of Appendix 16)

25. During our review, we noted that some issuers did not provide details of the policy regarding credit terms granted to trade customers and ageing analysis presented on the revenue recognition date, which is usually the invoice date.
26. We also noted other cases where an ageing analysis of trade debtors that were past due but not impaired as required under paragraph 37(a) of HKFRS 7 *“Financial Instruments: Disclosures”*, was not provided in financial statements.

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27. Although the Listing Rules do not specify the intervals required for the ageing analysis, the analysis “*should normally be presented on the basis of the date of the relevant invoice or demand note and categorised into time-bands based on analysis used by an issuer’s management to monitor the issuer’s financial position*”<sup>3</sup> (e.g. where the credit period is 30 days from the invoice date, the ageing analysis could be categorized into 30 days, 60 days, 90 days, 120 days, etc.). This analysis would be different from the requirement under accounting standards (e.g. paragraph 37(a) of HKFRS 7) where an analysis is required for those due but not impaired. For the latter, the analysis would be based not on the revenue recognition date but on the payment due date. Accordingly, we expect two ageing analyses to be disclosed in the financial statements.

### Directors’ emoluments (paragraph 24 of Appendix 16)

28. We noted that disclosures regarding directors’ emoluments in the financial statements continued to be incomplete. Examples included the following:-
- “discretionary” bonuses paid/payable to directors were incorrectly aggregated with the basic salaries and other allowances and benefits in kind;
  - disclosure of the contributions to pension schemes for directors or past directors for the financial year was not made;
  - disclosure of the remuneration of certain current directors and certain directors who resigned during the financial year was not made; and
  - analysis of the remuneration of supervisors (in the case of a PRC issuer) by name or a chief executive (who is not a director) was not provided.
29. Issuers should take care to ensure that they meet the requirements under notes 24.3 to 24.5 to paragraph 24 of Appendix 16:-
- in addition to discretionary bonus payments, all bonus payments to which a director is contractually entitled and which are not fixed in amount, together with the basis upon which they are determined, must be disclosed under the category of the bonuses paid or receivable by directors;
  - in the case of a PRC issuer, references to directors or past directors shall also mean and include supervisors and past supervisors (as appropriate); and
  - references to “director” include a chief executive who is not a director.

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<sup>3</sup> Following the Consultation Conclusions on the Revision of Appendix 16 (see paragraph 35 below), effective for accounting periods ending on or after 31 December 2015, the basis on which the ageing analysis is presented should be disclosed (new note 4.2 to paragraph 4 of Appendix 16).

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### Five highest paid individuals and senior management remuneration by band (paragraph 25 of Appendix 16 and Code Provision B.1.5 of Appendix 14 to the MB Rules)

30. Paragraph 25 of Appendix 16 requires that “*An issuer must disclose in its financial statements information in respect of the five highest paid individuals during the financial year ...*”. Code Provision B.1.5 of Appendix 14 to the MB Rules also requires (on a “comply or explain” basis) that “*Issuers should disclose details of any remuneration payable to members of senior management by band in their annual reports.*”
31. As was the case last year, some issuers provided information about the five highest paid individuals in their financial statements but failed to disclose in their corporate governance reports details of remuneration paid to members of senior management<sup>4</sup> or explain reason for deviation, as required under Code Provision B.1.5. Issuers should ensure that both disclosures are included in their annual reports.
32. We remind issuers that where all five of the highest paid individuals are directors (or supervisors, in the case of a PRC issuer) and the information required under paragraph 25 of Appendix 16 has been disclosed in the “emoluments of directors” (and supervisors), this must be stated in the financial statements and no additional disclosure under that paragraph is required.

### Distributable reserves (paragraph 29 of Appendix 16)

33. We noted a few cases where the issuers did not provide a statement of the reserves available for distribution to shareholders as at the date of the statement of financial position in their annual reports. There was also a case where the figure of distributable reserves in the directors’ report was inconsistent with that shown in the financial statements.
34. Hong Kong incorporated issuers should read Accounting Bulletin 4 “*Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Hong Kong Companies Ordinance*” (“AB 4”)<sup>5</sup> issued by the HKICPA which provides guidance on the determination of distributable profits. Issuers incorporated outside Hong Kong are also encouraged to read AB 4 for reference where issuers taking into account advice from their legal counsel believe that AB 4 is relevant in determining the distributable profits.

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<sup>4</sup> “Senior management” is defined in Appendix 14 to the MB Rules as the same persons whose biographical details are disclosed in the annual report under paragraph 12 of Appendix 16.

<sup>5</sup> HKICPA AB 4 can be accessed at:-  
<http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/circular/>.

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### Revision of Appendix 16

35. The Exchange published its Consultation Conclusions on “*Review of Listing Rules on Disclosure of Financial Information with Reference to the New Companies Ordinance and Hong Kong Financial Reporting Standards and Proposed Minor/Housekeeping Rule Amendments*” on 6 February 2015<sup>6</sup>. The main changes to the Listing Rules relating to the disclosure of financial information in Appendix 16 (“Revision of Appendix 16”) include:-

- aligning the requirements for disclosure of financial information in Appendix 16 with reference to the disclosure provisions in the New CO; and
- streamlining the disclosure requirements and removing duplications with HKFRS.

The Rule amendments relating to disclosure of financial information will apply to accounting periods ending on or after 31 December 2015<sup>7</sup>.

36. Following the Consultation Conclusions on the Revision of Appendix 16, paragraph 28 of Appendix 16 has been revised to require issuers to comply with the following disclosure provisions of the New CO and subsidiary legislation:-

“(1) *in financial statements*

- (a) *Section 383 - Notes to financial statements to contain information on directors’ emoluments etc.;*
- (b) *Schedule 4 - Accounting Disclosures relating to:*
  - (i) *Part 1(1) Aggregate amount of authorized loans;*
  - (ii) *Part 1(2) Statement of financial position to be contained in notes to annual consolidated financial statements;*
  - (iii) *Part 1(3) Subsidiary’s financial statements must contain particulars of ultimate parent undertaking;*
  - (iv) *Part 2(1) Remuneration of auditor; and*
- (c) *Companies (Disclosure of Information about Benefits of Directors) Regulation; and*

(2) *in directors’ report*

- (a) *Section 390 - Contents of directors’ report: general;*

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<sup>6</sup> For further details and other amendments unrelated to the Revision of Appendix 16 can be accessed at:- <http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp201408cc.pdf> .

<sup>7</sup> For Hong Kong incorporated issuers, Part 9 “*Accounts and Audit*” of the New CO comes into effect for the first financial reporting year beginning on or after 3 March 2014, the commencement date of the New CO. Accordingly, the first year ends to be impacted will be those falling in 2015. For example, for those companies with a financial year starting from 1 April 2014, the New CO first impacts the financial statements and directors’ reports for the year ended on 31 March 2015.

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- (b) *Section 470 - Permitted indemnity provision to be disclosed in directors' report;*
  - (c) *Section 543 - Disclosure of management contract;*
  - (d) *Schedule 5 - Content of Directors' Report: Business Review; and*
  - (e) *Companies (Directors' Report) Regulation."*
37. 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 New CO.
38. In view of the new requirement for a Business Review under the New CO, a question arises as to how the MD&A of an issuer's performance and the Business Review should be presented in the annual report. According to section 388 and Schedule 5 of the New CO, a Business Review must be part of the directors' report. Therefore, it cannot be part of the MD&A, unless the MD&A forms a part of the directors' report. However, the law does not mention whether cross referencing is prohibited. The Exchange does not propose to dictate the way issuers present their Business Review and MD&A, as long as the issuer provides in its periodic financial reports the disclosures required under both paragraphs 28(2)(d) and 32 of Appendix 16. If the MD&A information has been disclosed in the Business Review section of the directors' report, there is no need to repeat the disclosures in a separate section of the annual report<sup>8</sup>.
39. For further guidance on the preparation of a Business Review, issuers may refer to the HKICPA's Accounting Bulletin 5 "*Guidance for the Preparation and Presentation of a Business Review under the Hong Kong Companies Ordinance Cap. 622*" ("*AB 5*")<sup>9</sup> and the Hong Kong Institute of Directors' "*Clear and Concise: A Director's Guide to Writing the Business Review of an Annual Report*"<sup>10</sup>. Moreover, the HKICPA provides some guidance materials on its designated webpage "*New Companies Ordinance Resource Centre*"<sup>11</sup>. We encourage issuers to read practical guides, illustrative financial statements and disclosure checklists that are available from the websites of accounting firms, but it is important that issuers tailor the disclosures to reflect their specific circumstances.

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<sup>8</sup> See Question 5 of FAQ Series 31 released on 6 February 2015:-  
[http://www.hkex.com.hk/eng/rulesreg/listrules/listrulesfaq/Documents/FAQ\\_31.pdf](http://www.hkex.com.hk/eng/rulesreg/listrules/listrulesfaq/Documents/FAQ_31.pdf).

<sup>9</sup> HKICPA AB 5 can be accessed at:-  
<http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/circular/>.

<sup>10</sup> Hong Kong Institute of Directors "*Clear and Concise: A Director's Guide to Writing the Business Review of an Annual Report*" can be accessed at:-  
<http://www.hkiod.com/clear-and-concise.html>.

<sup>11</sup> HKICPA "*New Companies Ordinance Resource Centre*" can be accessed at:-  
<http://www.hkicpa.org.hk/en/standards-and-regulations/standards/new-co/>.

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40. Paragraph 52 of Appendix 16 currently encourages issuers to provide additional commentary in the MD&A section of their interim and annual reports:-
- “(i) *efficiency indicators (e.g. return on equity, working capital ratios) for the last five financial years indicating the bases of computation;*
- (ii) *industry specific ratios, if any, for the last five financial years indicating the bases of computation;*
- (iii) *discussion of the listed issuer’s purpose, corporate strategy and principal drivers of performance;*
- (iv) *an overview of trends in the listed issuer’s industry and business;*
- (v) *a discussion on business risks (including known events, uncertainties and other factors which may substantially affect future performance) and risks management policy;*
- (vi) *a discussion on the listed issuer’s environmental policies and performance, including compliance with the relevant laws and regulations;*
- (vii) *a discussion on the listed issuer’s policies and performance on community, social, ethical and reputational issues;*
- (viii) *an account of the listed issuer’s key relationships with employees, customers, suppliers and others, on which its success depends; and*
- (ix) *receipts from, and returns to, shareholders.”*
41. Issuers should bear in mind that the recent Listing Rules amendments with reference to the New CO, items (v), (vi) and (viii) of paragraph 52 of Appendix 16 will be removed and become new requirements under paragraph 28(2)(d) of Appendix 16 (see paragraph 36 above). This follows from the alignment of these provisions with similar disclosures required under Schedule 5 “*Content of Directors’ Report: Business Review*” of the New CO.

### **Annual reporting and review of continuing connected transactions**

42. MB Rules 14A.55, 14A.56, 14A.71 and 14A.72 set out the annual reporting and review requirements of continuing connected transactions, including:-
- disclosure in the annual report of details of the transactions, including the total consideration and terms, a brief description of the transactions and their purposes, the parties to the transactions and descriptions of their relationships;
  - annual review of the continuing connected transactions by the independent non-executive directors and a confirmation in the annual report that the transactions have been conducted<sup>12</sup>;
  - annual confirmation by the auditors<sup>13</sup> (“Auditors’ Confirmation”); and

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<sup>12</sup> See MB Rule 14A.55.

<sup>13</sup> See MB Rules 14A.56 and 14A.71. Issuers are also required by MB Rule 14A.57 to provide a copy of the auditors’ letters on continuing connected transactions to the Exchange.

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- when the issuer discloses in its annual report information of any related party transaction under the accounting standards (“Related Party Disclosures”) for preparing its financial statements, a statement in the annual report as to whether the transaction is a connected transaction under MB Chapter 14A and whether it has complied with the requirements in that chapter.

### Disclosure of the Auditors’ Confirmation (MB Rule 14A.71(6)(b))

43. In this year’s review, we noted a few cases where the issuers provided a brief statement in their annual reports and incorrectly stated that *“The Directors have requested the auditors of the Company to perform certain agreed upon procedures on the continuing connected transactions and have received a letter from the Company’s auditors stating their findings that the continuing connected transactions ...”*. We would like to point out that the work is an assurance engagement rather than an agreed-upon procedures engagement.
44. The HKICPA issued Practice Note 740 *“Auditor’s Letter on Continuing Connected Transactions under the Hong Kong Listing Rules”* (“Practice Note 740”) <sup>14</sup>. The purpose of Practice Note 740 is to provide guidance to auditors and issuers on their respective responsibilities and to promote consistency in annual reporting. Issuers should ensure that the annual review of continuing connected transactions complies with Hong Kong Standard on Assurance Engagements 3000 *“Assurance Engagements Other Than Audits or Reviews of Historical Financial Information”* and follows the guidance in Practice Note 740.
45. We also observed that some issuers included a clear statement on the work performed by the auditors in accordance with the illustrative example provided in Practice Note 740. We encourage issuers to provide more relevant information in their annual reports to ensure that investors and other users understand the nature of the engagement and the work performed by their auditors.

### Related Party Disclosures (MB Rule 14A.72 and paragraph 8 of Appendix 16)

46. As was the case last year, we noted a number of issuers did not provide the statement in their annual reports as to whether their related party transactions constituted connected transactions as defined under MB Chapter 14A.
47. Issuers should bear in mind that even if a related party transaction is a fully exempt connected transaction under MB Chapter 14A, they should specify that the related party transaction is a connected transaction under MB Chapter 14A and describe the exemption applicable to the transaction <sup>15</sup>. Accordingly, issuers should ensure that they include the above Related Party Disclosures in their annual reports.

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<sup>14</sup> HKICPA Practice Note 740 was developed in consultation with the Exchange and staff at the Securities and Futures Commission and can be accessed at:-

[http://app1.hkicpa.org.hk/ebook/HKSA\\_Members\\_Handbook\\_Master/volumeIII/pn740.pdf](http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeIII/pn740.pdf) .

<sup>15</sup> See Question 23 of FAQ Series 20 released on 28 February 2013/ last updated on 1 July 2014:-  
[http://www.hkex.com.hk/eng/rulesreg/listrules/listrulesfaq/Documents/FAQ\\_20.pdf](http://www.hkex.com.hk/eng/rulesreg/listrules/listrulesfaq/Documents/FAQ_20.pdf) .

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### Financial reports using CASBE

48. 40 PRC issuers elected to prepare their financial statements for the year ended 31 December 2013 under CASBE (2012: 37). The Exchange, the Financial Reporting Council (the “FRC”) and the HKICPA have agreed to collaborate in reviewing the CASBE financial statements. Financial statements prepared under CASBE, like other published financial reports, are subject to selection and review under our FSRP.
49. In this year’s review, the Exchange selected 10 sets of financial reports using CASBE. Although some disclosures were omitted, they were not material to the financial statements as a whole and the issuers confirmed that the required disclosures would be provided in their future annual reports. We would like to remind issuers using CASBE to also ensure the disclosure requirements under Appendix 16 are met.
50. Pursuant to the Joint Declarations that the HKICPA signed with the China Accounting Standards Committee and the Chinese Auditing Standards Board on 6 December 2007, there is a mechanism to ensure effective ongoing convergence of the accounting and auditing standards between Mainland and Hong Kong<sup>16</sup>. We encourage PRC issuers that elect to adopt CASBE to stay alert to the progress on convergence and work closely with their auditors.

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<sup>16</sup> Additional information is available on the HKICPA’s website at:-  
<http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/mainland-standards-convergence/> .



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### **III. FINDINGS REGARDING ACCOUNTING STANDARDS**

51. Table 2 below summarizes the key findings and observations relating to accounting standards. Unless otherwise specified, HKFRS and their paragraph numbers referred to in this section correspond to those in IFRS.

**Table 2: Key areas relating to Accounting Standards**

<b>Area</b>	<b>Accounting Standards</b>
<b>Presentation of Financial Statements</b>	HKAS 1 (Revised)
<b>Accounting Policies, Changes in Accounting Estimates and Errors</b>	HKAS 8
<b>Interim Financial Reporting</b>	HKAS 34
<b>Impairment of Assets</b>	HKAS 36
<b>Business Combinations</b>	HKFRS 3 (Revised)
<b>Financial Instruments: Disclosures</b>	HKFRS 7
<b>Investments in Associates and Joint Ventures</b> <b>Consolidated Financial Statements</b> <b>Joint Arrangements</b> <b>Disclosure of Interests in Other Entities</b>	HKAS 28 (2011) HKFRS 10 HKFRS 11 HKFRS 12

#### **HKAS 1 (Revised) “Presentation of Financial Statements”**

##### Accounting policies, judgements and estimates

52. HKAS 1 (Revised) requires an entity to disclose:-
- in the summary of significant accounting policies, the judgements that management has made in the process of applying their policies and that have the most significant effect on the amounts recognized in the financial statements (paragraph 122 of HKAS 1 (Revised)); and
  - the key assumptions the management made about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year (paragraph 125 of HKAS 1 (Revised)).

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53. The following are the observations from our review:-
- issuers' accounting policies tended to be generic, like extracts from standards and illustrative financial statements;
  - issuers' description of critical accounting judgements was simply repeated or referred to the corresponding accounting policy without reflecting the entity's facts and circumstances; and
  - it was not a common practice amongst issuers to provide the sensitivity analyses of how possible changes in key assumptions would impact the carrying amounts.
54. From the perspective of investors and other users, it is important to know how an issuer's accounting policies link to its specific business and transactions. For example, revenue recognition policies are usually considered by investors and other users to be significant and may be subject to differing interpretations. From other related work at the Exchange, we noted a case where an issuer made prior year adjustments in its subsequent financial statements to rectify improper timing of revenue recognition on transactions with a distinct group of customers. However, the issuer did not highlight in the current or prior financial statements the issue involved, and related judgement made.
55. In preparing disclosures regarding the significant accounting policies, judgements and estimates, issuers should ensure as far as possible that:-
- information provided is clear, understandable and entity-specific, rather than boilerplate text;
  - a particular accounting policy disclosure will assist investors and other users in understanding how transactions, other events and conditions are reflected in the reported financial performance and position;
  - the disclosures include the nature of the issuers' operations and the policies that investors and other users would expect to be disclosed for the specific industry that they belong to;
  - the policies disclosed are selected from accounting options allowed in HKFRSs; and
  - the disclosures include information on the sensitivity of significant carrying amounts relating to the methods, assumptions and estimates underlying the issuers' calculations, including the reasons for the sensitivity.

### Significant events, balances and transactions

56. Paragraph 112(c) of HKAS 1 (Revised) requires an entity to provide information which is relevant to an understanding of the financial statements by way of additional notes to the financial statements.

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57. We continued to identify instances where disclosure of the nature and impact of significant events or material balances and transactions was less than adequate. For example, material “other receivables”/“other payables” were often aggregated with “prepayments and deposits”/“accrued expenses” or simply disclosed without further analysis or explanation. In some cases, deposits paid for the acquisition of major assets or businesses remained on the statement of financial position for over a year, but the development and status of the investments in relation to the deposits were not updated in the financial statements or elsewhere in the annual reports.
58. During our review, we requested issuers to provide information on and explanations of the relevant significant balances or transactions to better understand their nature and impact on the issuers concerned. Based on the responses to our enquiries, we were pleased to note that there was no apparent breach of the Listing Rules or accounting standards. Issuers have confirmed that they will ensure such information and explanations are included in their annual reports, where appropriate.
59. Issuers should ensure that information in financial reports is relevant and material and avoid cluttering by reducing non-relevant and non-material disclosures. This would make communications through financial reports more clear and concise. Improving the effectiveness of disclosure is widely considered to be one of the most important and challenging tasks in financial reporting. Many other international regulators are looking at this issue.
60. The IASB is responding to this challenge through its “*Disclosure Initiative*”<sup>17</sup> – a broad-based initiative to explore how disclosures in IFRS financial reporting can be improved. The Disclosure Initiative is made up of a number of implementation and research projects. As part of the IASB's overall Disclosure Initiative, the IASB published “*Disclosure Initiative (Amendments to IAS 1)*” in December 2014<sup>18</sup>, which is effective for annual periods beginning on or after 1 January 2016. The narrow-scope amendments to IAS/HKAS 1 are designed to further encourage entities to apply professional judgement in determining what information to disclose in their financial statements. The amendments include clarifications of the materiality requirements in IAS/HKAS 1 (new paragraph 30A and revised paragraph 31 of IAS/HKAS 1 (Revised)) to emphasize that:-
- entities should not aggregate or disaggregate information in a manner that obscures useful information;
  - the materiality requirements apply to the financial statements as a whole, including the primary statements and the notes;
  - materiality should be applied to specific disclosure requirements in individual standards; and

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<sup>17</sup> For further details about the IASB's Disclosure Initiative can be accessed at: <http://www.ifrs.org/Alerts/Publication/Pages/IASB-makes-progress-on-improving-the-effectiveness-of-disclosure-in-financial-reporting-December-2014.aspx> .

<sup>18</sup> The HKICPA issued the corresponding amendments to HKAS 1 in January 2015.

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- entities should consider whether information about matters addressed by an HKFRS needs to be presented or disclosed to meet needs of users, even if that information is not included in the specific disclosure requirements of the HKFRS.

### **HKAS 8 “Accounting Policies, Changes in Accounting Estimates and Errors”**

#### New or amended HKFRS in issue but not yet effective

61. Paragraph 30 of HKAS 8 requires an entity to provide disclosures when it has not yet applied an HKFRS that has been issued but is not yet effective. The entity is required to disclose that it has not yet applied the HKFRS, and known or reasonably estimable information relevant to assessing the possible impact that initial application of the new or amended HKFRS will have on the entity’s financial statements in the period of initial application. Paragraph 31 provides further guidance on specific disclosures in complying with paragraph 30 of HKAS 8, the entity should consider including a discussion of the impact that initial application of HKFRS is expected to have on the entity’s financial statements. If the impact is not known or cannot be reasonably estimated then this should be stated.
62. A question which is often raised by preparers of financial statements is whether it is necessary for the financial statements to list every new or amended HKFRS that has been issued but is not yet effective. During our review we noted that the disclosure is diverse in practice. Some issuers adopted the approach of providing a complete list to reduce the risk that some new HKFRSs might be overlooked, while other issuers provided the nature of the impending change and discussed the possible impact of a list of selected HKFRSs that “*may be relevant to the Group*”. It may be acceptable not to mention an HKFRS that does not affect the issuer. However, in this situation we suggest that issuers include a statement that all other HKFRSs issued but not yet effective “*are not likely to have a significant impact on the Group’s financial statements*”. We have seen some issuers disclosing this statement in their financial statements.
63. The new HKFRS 15 “*Revenue from Contracts with Customers*” was issued in 2014 and comes into effect on 1 January 2017. It deals with revenue recognition and replaces the current HKAS 18 “*Revenue*” and HKAS 11 “*Construction Contracts*”, and related interpretations. From our review, we found that some issuers stated that they are “*currently assessing the impact of HKFRS 15 upon adoption*” and others commented that they “*anticipate that the application of HKFRS 15 in the future may have a material impact on the amounts reported and disclosures made in the Group’s consolidated financial statements. However, it is not practicable to provide a reasonable estimate of the effect of HKFRS 15 until the Group performs a detailed review*”. Only a few issuers stated that the adoption of HKFRS 15 “*is unlikely to have a significant impact on the consolidated financial statements*”.

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64. In May 2015, the IASB published for consultation a proposal to defer the effective date of IFRS 15 by one year to apply to accounting periods beginning on or after 1 January 2018<sup>19</sup>. We remind issuers that IFRS/HKFRS 15 may change the way they recognize revenue when it becomes effective. It will have a significant impact on issuers, particularly on their information systems, accounting processes, internal controls and business contracting processes. Issuers are encouraged to closely monitor the development on the implementation of IFRS/HKFRS 15, perform a detailed review of IFRS/HKFRS 15 at an early stage, identify areas that require attention and establish transition plans. Issuers should also stay alert to other standard-setting projects, such as IFRS/HKFRS 9 “*Financial Instruments*” (effective for accounting periods beginning on or after 1 January 2018) and “*Leases*”, amongst others.

### Correction of prior period errors

65. Financial statements containing material prior period errors indicate these prior period financial statements may be misleading. From other related work at the Exchange, we found there were occasions where prior period adjustments were made in some financial reports to correct material errors. These included mistakes made in applying accounting policies, oversights and misinterpretations of facts. During the period, we referred six cases that were triggered by the correction of prior period errors in subsequent financial reports to the FRC/HKICPA for consideration of further enquiry and investigation into possible accounting and auditing irregularities.
66. We would like to remind issuers that, as of 1 April 2015, there is a new headline category “*Prior Period Adjustments due to Correction of Material Errors*”<sup>20</sup>, which issuers must select when they submit for publication on the Exchange’s website results announcements containing prior period adjustments due to the correction of material errors. Issuers should also bear in mind their obligations under Part XIVA of the Securities and Futures Ordinance to disclose inside information. Issuers should assess the effect of any prior period adjustments due to the correction of material accounting errors on their financial performance and position, and make immediate announcements of any inside information at the time when the error is identified.

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<sup>19</sup> The main reason for the proposed deferral of the effective date is that the IASB is planning to issue an exposure draft of targeted amendments to IFRS 15, which will include clarifying some of its requirements and adding illustrative examples to aid implementation. Further details can be accessed at:- <http://www.ifrs.org/Alerts/PressRelease/Pages/IASB-calls-for-feedback-on-proposal-May-2015.aspx>.

<sup>20</sup> For further details, see Chapter III of the Consultation Conclusions on “*Review of Listing Rules on Disclosure of Financial Information with Reference to the New Companies Ordinance and Hong Kong Financial Reporting Standards and Proposed Minor/Housekeeping Rule Amendments*” published by the Exchange on 6 February 2015, as referred to in paragraph 35 above.

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67. In addition, directors of issuers are primarily responsible for the preparation of financial statements that give a true and fair view and for establishing internal control systems such that the financial statements prepared are free from material misstatement, whether due to fraud or error. An important element of internal control is the maintenance of proper books and records. We recommend that issuers take extra care at the planning stage to prevent audit qualification issues due to insufficient information and lack of proper books and records.

**HKAS 34 “Interim Financial Reporting”**

68. Similar to last year, we noted in this year’s review that the following disclosures required under HKAS 34 that may have been relevant to an understanding of the issuer’s current interim period were frequently overlooked:-
- explanation of circumstances or events that led to the recognition of material impairment loss on goodwill, trade receivables and other assets (paragraph 15B(b) of HKAS 34);
  - changes in the business or economic circumstances that led to the significant change in the fair value of financial instruments (paragraph 15B(h) of HKAS 34);
  - nature and amount of unusual items because of their nature, size, or incidence (paragraph 16A(c) of HKAS 34); and
  - effect of changes in group structure (paragraph 16A(i) of HKAS 34).
69. We reminded issuers that paragraphs 15B and 16A of HKAS 34 provides a non-exhaustive list of significant events and transactions and a list of other items that should be included in the interim financial statements respectively. HKAS 34 does not specify the level of detail required for these disclosures, but the disclosure principle should be such that “*the interim notes include primarily an explanation of the events and changes that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period*” (paragraph IN6 of HKAS 34).
70. In addition, during our review we observed some cases where the issuers experienced a significant loss (for the group as a whole or an operating segment) in the interim period, which would trigger a need to carry out an interim evaluation of goodwill for potential impairment. We requested these issuers to provide further information on whether they had performed an interim goodwill impairment analysis and explain how they arrived at the conclusion that no further impairment charge should be recognized in the interim period. Based on the responses to our enquiries, there were no apparent breaches of the accounting standards. However, we recommend that in similar cases in the future, issuers should after performing an interim impairment test, consider disclosing that they have performed this test, the event that triggered the test and the test result (even if they passed).

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71. We encourage issuers to read illustrative examples accompanying HKAS 34, which provide examples of applying the general recognition and measurement principles for an interim period. For example, HKAS 34 requires an entity to apply the same impairment testing, recognition, and reversal criteria in accordance with HKAS 36 “*Impairment of Assets*” at an interim date as it would at the end of its financial year. That does not mean, however, that an entity must necessarily make a detailed impairment calculation at the end of each interim period. Rather, an entity should consider whether there are any indications of significant impairment since the end of the most recent financial year to determine whether such a calculation is needed (paragraphs B35 and B36 of HKAS 34).
72. Issuers should also take note of the “*Annual Improvements to HKFRSs 2012-2014 Cycle*” issued by the HKICPA in October 2014, which are effective for annual periods beginning on or after 1 January 2016. These Annual Improvements include amendments to HKAS 34 that clarify the requirements relating to information required by HKAS 34 that is presented elsewhere within the interim report but outside the interim financial statements. Such information is required to be incorporated in the interim financial statements by cross-reference to the other parts of the interim report.

**HKAS 36 “Impairment of Assets”**

73. HKAS 36, which is one of the most challenging areas for issuers, prescribes the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. Entities are required to review indefinite life intangible assets and goodwill for impairment at least annually (paragraph 10 of HKAS 36) and other assets where at the end of the reporting period there is an indication of possible impairment (paragraph 9 of HKAS 36). The robustness of the impairment test and its disclosure is an important issue, particularly where the recoverable amount is based on value in use. The following highlights some of our recurring observations in relation to these disclosures:-
- explanations of 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 recognized 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 that led to the impairment;
  - key assumptions on which management had based its cash flow projections were not clearly described (paragraph 134(d)(i) of HKAS 36);
  - an explanation of why management adopted financial budgets/forecasts covering a period longer than five years was omitted (paragraph 134 (d)(iii) of HKAS 36); and
  - the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts was not disclosed (paragraph 134(d)(iv) of HKAS 36).

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74. From other related work at the Exchange, we noted a case where the issuer made prior year adjustments in its subsequent financial statements. Firstly the fair value of the identifiable intangible assets in a business combination at the acquisition date was re-assessed and substantially restated downwards. Secondly, an impairment loss on the goodwill was recognized and the remaining amount of goodwill was substantially restated downwards at the end of the first reporting period after the acquisition date. It appeared that when preparing the prior year financial statements the issuer determined the fair value and value in use based on the financial budgets that did not reflect the condition prevailing at the respective dates of valuation. As a result, the case had to be referred to the FRC to consider further enquiry and investigation of possible accounting and auditing irregularities.
75. Issuers should take note of paragraph 99 of HKAS 36 which permits the most recent detailed calculation made in a preceding period of the recoverable amount of a cash-generating unit to which goodwill has been allocated to be used in the impairment test of that unit in the current period, provided all of the following criteria are met:-
- the assets and liabilities making up the unit have not changed significantly since the most recent recoverable amount calculation;
  - the most recent recoverable amount calculation resulted in an amount that exceeded the carrying amount of the unit by a substantial margin; and
  - based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a current recoverable amount determination would be less than the current carrying amount of the unit is remote.
76. Issuers should follow the guidance included in HKAS 36 for asset impairment tests and, in particular, the need to consider the length of the period covered by the most recent financial budgets/forecasts, estimated 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 prospects. 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.
77. Based on our review, we consider that the quality of issuers' disclosures has room for improvement, for example, in relation to the sensitivity of the carrying amount and the assumptions and estimates underlying the value in use calculation (amongst other areas). We recommend that issuers refer to Section IV "*Findings regarding General Accounting Review Theme – Impairment of Assets*" of our FSRP Report 2013 for further guidance in this regard.



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**HKFRS 3 (Revised) “Business Combinations”**

Contingent consideration

78. As part of the terms of acquisition agreements, it is not uncommon that entities, are required to pay additional consideration to or are entitled to receive a return of previously transferred consideration from, the vendors of the acquirees when certain future events occur or conditions are met (such as a condition involving the target level of future earnings for the acquiree in the specified post-acquisition period). Thus, issuers should account for the obligations and rights associated with contingent consideration arrangements in accordance with the requirements of HKFRS 3 (Revised) (initial recognition – paragraphs 39 and 40 of HKFRS 3 (Revised); subsequent measurement – paragraph 58 of HKFRS 3 (Revised); and disclosures – paragraphs B64(g) and B67(b) of HKFRS 3 (Revised)).
79. In this year’s review, we found there was a general improvement in disclosures in this area. We noted that most of the issuers under review provided adequate disclosure of initial recognition as required by paragraph B64(g) of HKFRS 3 (Revised); but a few issuers overlooked the need to provide an update in their subsequent financial statements as required by paragraph B67(b) of HKFRS 3 (Revised). The latter provides that the acquirer should disclose, for each reporting period after the acquisition date until the entity collects, sells or otherwise loses the right to a contingent consideration asset, or until the entity settles a contingent consideration liability or the liability is cancelled or expires:-
- any changes in the recognized amounts, including any differences arising upon settlement;
  - any changes in the range of outcomes (undiscounted) and the reasons for those changes; and
  - the valuation techniques and key model inputs used to measure contingent consideration.
80. We remind issuers that in January 2014, the HKICPA issued an improvement of HKFRS 3<sup>21</sup>. It provides that, in respect of business combinations for which the acquisition date is on or after 1 July 2014, the contingent consideration that is classified as an asset or a liability should be subsequently measured at fair value at each reporting date, irrespective of whether the contingent consideration is a financial instrument within the scope of HKAS 39 “*Financial Instruments: Recognition and Measurement*” or HKFRS 9 “*Financial Instruments*” or a non-financial asset or liability. Changes in fair value (other than measurement period adjustments) should be recognized in profit or loss.

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<sup>21</sup> Included in “*Annual Improvements to HKFRSs 2010-2012 Cycle*”.

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81. Furthermore, paragraph 91 of HKFRS 13 “*Fair Value Measurement*” establishes that the disclosure requirements of HKFRS 13 apply to assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition. Accordingly, the acquirer should apply the disclosure requirements of HKFRS 13 to the contingent consideration after their initial recognition in the financial statements (e.g. categorisation within the fair value hierarchy).
82. In relation to an acquisition of an associate or a joint venture, issuers should take note that paragraph 26 of HKAS 28 (2011) “*Investments in Associates and Joint Ventures*” states that “*the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate or a joint venture*”. In this connection, notwithstanding HKAS 28 (2011) does not provide specific guidance on how to account for contingent consideration arising from acquisition of an associate or a joint venture, it would be appropriate for the acquirer to apply the relevant requirements set out in HKFRS 3 (Revised) by analogy.

### **HKFRS 7 “Financial Instruments: Disclosures”**

#### **Disclosure of risks associated with financial instruments**

83. The objective of HKFRS 7 is to facilitate the disclosure of qualitative and quantitative information that enables investors and other users to evaluate the nature and extent of risks arising from the financial instruments to which an entity is exposed and how the entity manages those risks. As was the case last year, many issuers only provided minimal or boilerplate disclosures on financial risk management, particularly for the qualitative disclosures (i.e. descriptions of management’s objectives, policies and processes for managing risks). In some cases, it appeared that the same template was used year after year, and consequently the disclosures did not describe the facts specific to the issuer or provide tailored information that reflected the current reporting period.
84. From the perspective of investors and other users, it is important to understand what management thinks are the key financial risks and how management thinks that they have adequately managed these risks. To this end, we encourage issuers to reconsider the nature and extent of their disclosures and enhance them where appropriate. For example, where liquidity risk has become material, issuers should consider including disclosure of the amount of undrawn banking facilities at the end of the reporting period and the latest information on renegotiated borrowings and banking facilities after the year end. Also, we remind issuers that HKFRS 7 includes mandatory application guidance (paragraphs B6 to B28 of HKFRS 7) that explains how to apply the disclosure requirements in relation to financial risk management. It is also accompanied by non-mandatory implementation guidance (paragraphs IG15 to IG40 of HKFRS 7) that describes how an entity might provide the disclosures.

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85. Moreover, HKFRS 7 provides that the disclosures may be given either in the financial statements or incorporated in the financial statements by cross-reference to other parts of the annual report, such as a risk report or a Business Review section in the directors' report. Without the information incorporated by cross-reference, the financial statements are incomplete (paragraph B6 of HKFRS 7). Therefore, if the disclosures are provided outside the financial statements, the information should be "audited" and clearly referenced as part of the financial statements.

**HKAS 28 (2011) "Investments in Associates and Joint Ventures", HKFRS 10 "Consolidated Financial Statements", HKFRS 11 "Joint Arrangements" and HKFRS 12 "Disclosure of Interests in Other Entities"**

**Classification of an investee**

86. The package of new and revised standards on consolidation, joint arrangements and disclosures in 2011 became effective for the annual periods beginning on or after 1 January 2013. The application of HKFRS 10, HKFRS 11 and HKAS 28 (2011) may be challenging in certain cases on how an investee should be classified (e.g. a subsidiary, a joint arrangement or an associate).
87. HKFRS 10 builds on existing principles by introducing a new definition of control that contains three elements (paragraph 7 of HKFRS 10). One critical element is to have "*power over an investee*" and that an investor must have existing "substantive" rights (rights that are not "protective") that give it the current ability to direct the relevant activities (i.e. "*the activities that significantly affect the investee's returns*") (paragraphs 10 and B9 of HKFRS 10).
88. From other related work at the Exchange, we noted a case that at the time of preparing the investment circular the pro forma financial information indicated that the investee was accounted for as a subsidiary, but in its subsequent annual financial statements the investee was classified as a joint venture. Then, when preparing the following interim financial statements (neither audited nor reviewed by its auditor) the issuer reclassified it as a subsidiary. However, having further considered the matter and discussion with its auditor, the issuer changed its judgement again that the investee should continue to be treated as a joint venture. In this case, it appeared that no amendment was made to the constitutional documents of the investee but changes in the interpretation of the constitutional documents on whether the veto rights held by the other shareholders are "protective" or "substantive" (that prevent the issuer from exercising control over the investee) under HKFRS 10.

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89. Different types of rights that, either individually or in combination, can give an investor power over an investee. To determine whether control exists, issuers should consider all facts and circumstances and make appropriate judgements. Issuers are reminded that HKFRS 10 includes guidance on (a) the activities that an investor must be able to direct in order to have power (i.e. those activities that significantly affect the investee's returns) (paragraphs B14 to B21 of HKFRS 10); (b) when those rights are substantive (paragraphs B22 to B25 of HKFRS 10); and (c) whether the rights held by other parties are sufficient to prevent an investor from controlling an investee (paragraphs B26 to B33 of HKFRS 10).

### Changes in the proportion held by non-controlling interests in subsidiaries

90. After control of an investee is obtained, changes in a parent's ownership interest that do not result in the parent losing control of the subsidiary are equity transactions (i.e. transactions with owners in their capacity as owners (paragraph 23 of HKFRS 10)). This means that no gain or loss from these changes should be recognized in profit or loss and no change in the carrying amounts of the subsidiary's assets (including goodwill) or liabilities should be recognized as a result of such transactions.
91. This is not a new requirement, but from other related work at the Exchange, we noted a case where the issuer acquired the remaining interest of a subsidiary from the non-controlling shareholder and recognized the difference between the amount by which the non-controlling interests were adjusted and the fair value of the consideration paid was recognized as goodwill in the pro forma financial information in the investment circular. The difference should be recorded as a reduction to the equity of the company. As a result, the case was referred to the HKICPA for investigation of possible reporting irregularities.
92. It is important that issuers should ensure that the pro forma financial information presented is not misleading. The purpose of pro forma financial information presented in the investment circulars is to provide investors with relevant information by illustrating how the transaction might affect the broad outline of the issuers' financial performance and position at the date reported. Issuers should pay particular attention to the pro forma adjustments that should be consistent with HKFRS and its accounting policies under HKFRS<sup>22</sup>. The reasons for any significant change in treatments should be also provided in the subsequent annual reports.

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<sup>22</sup> See MB Rule 4.29(3) and (7), paragraph 7(d) of HKICPA Accounting Guideline 7 "*Preparation of Pro Forma Financial Information for Inclusion in Investment Circulars*" and paragraph 11(b)(ii) of Hong Kong Standard on Assurance Engagements 3420 "*Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus*".

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### Disclosure requirements under HKFRS 12

93. HKFRS 12 requires extensive disclosures for interests in subsidiaries, joint arrangements, associates and structured entities. We would like to take this opportunity to highlight the following areas which require attention and improvement:-
- some issuers did not clearly demonstrate how they had control over an investee when they did not hold more than 50% equity interest in an investment (that was classified as a subsidiary) or have significant influence even though they held less than 20% of equity interest in an investment (that was classified as an associate) (paragraphs 9(b) and (e) of HKFRS 12); and
  - where the group has a number of non-wholly owned subsidiaries and presented a material amount in either profit or net assets attributable to the non-controlling interests (“NCIs”), but there was no disclosure of summarised financial information of individual subsidiaries that have material NCIs as required by paragraphs 12(g) and B10(b) of HKFRS 12.
94. The assessment of whether an entity controls an investee sometimes requires judgement. Paragraph 7 of HKFRS 12 requires an entity to disclose information about significant judgements and assumptions it has made in determining whether it has control, joint control or significant influence over an investee and the type of joint arrangement (i.e. joint operation or joint venture). Paragraph 8 of HKFRS 12 requires an entity to provide these disclosures when changes in facts and circumstances affect the entity’s conclusion during the reporting period. Issuers are reminded of the examples of situations in paragraph 9 of HKFRS 12 for which significant judgements might need to be applied. These examples make it clear that extra care should be taken in explaining departures from the assumed correlation between the percentages of entity interest/voting rights and level of influence over an investee.
95. We also recommend issuers to read the “*IFRIC Update for January 2015*”<sup>23</sup> issued by the IFRS Interpretations Committee, which clarified the requirements in paragraphs 12(e) to (g) of IFRS 12 to disclose information in respect of a subsidiary that has a material non-controlling interest. The Interpretations Committee observed the importance of materiality assessment in determining the required information. This Update also provided a clarification on the requirement of paragraph 21(b)(ii) of IFRS 12 to disclose summary financial information on material joint ventures and associates. When the group presents a significant amount of NCIs/joint ventures/associates but none of the NCIs/joint ventures/associates is considered as individually significant, we encourage issuers to disclose and explain this fact.

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<sup>23</sup> “*IFRIC Update for January 2015*” can be accessed at:-  
<http://media.ifrs.org/2015/IFRIC/January/IFRIC-Update-January-2015.pdf> .

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### Impact of new and revised Auditor Reporting requirements

96. Issuers should note that in January 2015, the IAASB released its new and revised ISAs that are designed to significantly enhance auditor's reports for investors and other users of financial statements<sup>24</sup>. They are effective for audits of financial statements for periods ending on or after 15 December 2016. The form and content of the auditor's report will be substantially changed.
97. The most notable enhancement of the new auditing standards is the new requirement for the auditor of a listed entity's financial statements to communicate "Key Audit Matters"<sup>25</sup> ("KAM") – *“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”*. The listed entity auditor is also required to consider (a) areas of higher assessed risks of material misstatement, or significant risks identified; (b) significant auditor judgements relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty; and (c) the effect on the audit of significant events or transactions that occurred during the period.
98. In view of the new auditor reporting requirements, issuers, in particular their audit committees, should have more in-depth conversations with their auditors. Having discussions with their auditors at an early stage about the KAM may help to minimise the risk of last minute surprises.
99. For example, KAM included in auditors' reports will include the most significant accounting judgements and estimates. Issuers should ensure that the relevant information is disclosed in financial statements in accordance with HKAS 1 (Revised). The corporate governance report should also describe how the audit committee has met its responsibilities in its review of the significant financial reporting judgements contained in periodic financial reports (Code Provision C.3.3(d) and paragraph L(d)(iv) of Appendix 14 to the MB Rules). Issuers are encouraged to link these disclosures by cross-referencing to minimise the extent to which information is repeated, but also ensure that the corporate governance report and auditor's report are more focused on the responsibilities and work done by the audit committee and auditor, respectively.

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<sup>24</sup> The HKICPA is expected to issue the corresponding set of auditing standards in the third quarter of 2015. The press release of new and revised Auditor Reporting standards is available on the IAASB's website at:-

<http://www.ifac.org/news-events/2015-01/iaasb-issues-final-standards-improve-auditors-report> .

<sup>25</sup> See paragraph 8 of new ISA 701 "Communicating Key Audit Matters in the Independent Auditor's Report".

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### Cooperation with other regulators

100. In addition to the Exchange, the FRC and the HKICPA also undertake a continuous review the published financial statements of issuers. The focus of the regulators are different. The Exchange's FSRP focuses on compliance with the Listing Rules and accounting standards and our feedback is addressed to, and attempt to help, issuers. The FRC's programme places greater emphasis on the detection of auditing irregularities<sup>26</sup>, while the HKICPA's professional standards monitoring ("PSM") programme<sup>27</sup> focuses on accounting standards and its feedback is addressed to the auditors of listed companies to monitor the quality of their audit work. To the extent legally permissible and under our separate memorandum of understanding ("MOU") with the FRC and the HKICPA respectively, the Exchange liaises, shares information and meets regularly with the two regulators to avoid duplication of work performed.
101. A joint financial reporting forum with the FRC and HKICPA, which was an annual event since 2011, was held on 19 November 2014 and is available on webcast at the HKICPA's website. The representatives of the three bodies shared common or significant observations identified from reviews of financial statements of listed companies.
102. Pursuant to the MOUs, through other related work at the Exchange, we referred nine cases to the FRC and two cases to the HKICPA during the period for consideration of further enquiry and investigation into possible accounting non-compliances and related possible auditing and reporting irregularities.

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<sup>26</sup> Further information relating to the FRC's work is available on the FRC's website at:-  
<http://www.frc.org.hk/en/index.php> .

<sup>27</sup> Further information relating to the PSM programme is available on the HKICPA's website at:-  
<http://www.hkicpa.org.hk/en/standards-and-regulations/quality-assurance/professional-standards-monitoring/> .

#### **IV. FINDINGS REGARDING GENERAL ACCOUNTING REVIEW THEME – FAIR VALUE MEASUREMENT**

103. The specific accounting standards theme chosen for this year's programme was compliance with the accounting standard dealing with the disclosure requirements in relation to fair value measurement under HKFRS 13 "*Fair Value Measurement*". Unless otherwise specified, HKFRS and their paragraph numbers referred to in this section correspond to those in IFRS.
104. We did not note any significant non-compliance for issuers reviewed regarding the disclosure requirements in HKFRS 13. There were areas of disclosure that could be improved in future reports. The key findings together with our recommendations are set out below.

##### **Our findings**

105. We observed that around two-third of the 100 issuers under review had assets and liabilities that are measured at fair value (on a recurring or non-recurring basis) in their statements of financial position.
106. Out of these issuers who had assets and liabilities that are measured at fair value in their statements of financial position, we observed that:-
- nearly all of them disclosed the fair value measurement at the end of the reporting period (paragraph 93(a) of HKFRS 13) and the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3) (paragraph 93(b) of HKFRS 13), except:-
    - three issuers had leasehold land and building and investment property measured at fair value at the end of the reporting period but did not provide any disclosure as required by HKFRS 13 in its annual report; and
    - one issuer, who had assets held for disposal that are measured at fair value less cost to sell, did not provide the required disclosure;
  - a few of them had transfers between Level 1 and Level 2 of the fair value hierarchy and had disclosed:-
    - the amounts of the transfers and the reasons for the transfers (paragraph 93(c) of HKFRS 13); and
    - the policy for determining when transfers between levels of the fair value hierarchy are deemed to have occurred (paragraph 95 of HKFRS 13);



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- around two-third of them had fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy:-
  - nearly all of them provided description of the valuation techniques and the inputs used in the fair value measurement (paragraph 93(d) of HKFRS 13); and
  - one issuer had changed the valuation technique used in the fair value measurement and had disclosed the reason for making the change (paragraph 93(d) of HKFRS 13);
  
- around one-third of them had fair value measurements categorized within Level 3 of the fair value hierarchy:-
  - nearly all of them provided the quantitative information about the significant unobservable inputs used in the fair value measurement (paragraph 93(d) of HKFRS 13);
  - nearly all of them disclosed the reconciliation from the opening balances to the closing balances disclosing separately the changes during the period (paragraph 93(e) of HKFRS 13);
  - nearly all of them disclosed the amount of the total gains or losses for the period included in profit or loss that is attributable to the change in unrealised gains or losses relating to those assets and liabilities held at the end of the reporting period, and the line item(s) in profit or loss in which those unrealised gains or losses are recognised (paragraph 93(f) of HKFRS 13);
  - nearly all of them disclosed the description of the valuation processes used (paragraph 93(g) of HKFRS 13);
  - most of them disclosed the narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs used and the description of the interrelationship, if any, among unobservable inputs used (paragraph 93(h) of HKFRS 13);
  - a few of them disclosed that for its financial assets and financial liabilities, if changing one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly and disclosed the effect of the changes (paragraph 93(h) of HKFRS 13); and
  - some of them specifically stated that the highest and best use of the non-financial assets was the current use and none of them disclosed that the highest and best use of non-financial assets differed from their current use (paragraph 93(i) of HKFRS 13).

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### **Our recommendations**

107. HKFRS 13 establishes a single comprehensive framework for measurement and disclosure of fair values which is required or permitted in other HKFRSs. The framework aims at assisting users of financial statements to understand how the fair value is measured, including the valuation techniques and the inputs used.
108. Issuers are reminded that HKFRS 13 does not specify the requirement to measure or disclose the fair value of an asset or liability. Those requirements are included in other HKFRSs. Where fair value measurement or disclosure is required or permitted in other HKFRSs, issuers should follow HKFRS 13 for the measurement and disclosure of fair value, except the scope exclusions as set out in paragraphs 6 and 7 of HKFRS 13.
109. Issuers should provide the fair value disclosures of all assets and liabilities that are measured at fair value at the end of the reporting period. We observed that there were issuers that disclosed the information in relation to fair value of financial assets and liabilities in accordance with HKFRS 13; but did not provide the disclosure for non-financial assets, such as investment property. It appeared that these issuers updated the note for investment property from previous year and omitted the disclosure requirements in HKFRS 13, which were applicable for annual periods beginning on or after 1 January 2013.
110. Paragraph 16A(j) of HKAS 34 requires the disclosures about fair value of financial instruments in the interim reports as required by paragraphs 91 to 93(h), 94 to 96, 98 and 99 of HKFRS 13 and paragraphs 25, 26, 28 to 30 of HKFRS 7. This subparagraph was added as a consequence of issuing HKFRS 13 and was applicable for annual periods beginning on or after 1 January 2013 (see paragraph 50 of HKAS 34). Issuers are reminded to provide the disclosure required by paragraph 16A(j) of HKAS 34 in their interim reports.
111. For fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy, paragraph 93(d) of HKFRS 13 requires disclosure of a description of the valuation technique and the inputs used in the fair value measurement. We recommend that the disclosure should be provided for each class of assets and liabilities individually, rather than listing out all the valuation techniques and inputs used. Where multiple valuation techniques are used to measure the fair value of a single item, it should be clearly disclosed and reasons why the use of multiple valuation techniques is considered more appropriate are encouraged. In addition, valuation techniques should be applied consistently from one period to the next unless alternative techniques provide an equal or more reliable measurement of fair value. Where there is a change of the valuation technique used, issuers should disclose details of the change and the reason for making the change, as required by paragraph 93(d) of HKFRS 13.

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112. For fair value measurements categorized within Level 3 of the fair value hierarchy, paragraph 93(g) of HKFRS 13 requires disclosure of a description of the valuation processes used by the entity (including, for example, how an entity decides its valuation policies and procedures and analyses changes in fair value measurements from period to period). Further guidance is provided in paragraph IE65 of the illustrative examples accompanying HKFRS 13 which states that:-

*“For fair value measurements categorised within Level 3 of the fair value hierarchy, the IFRS requires an entity to disclose a description of the valuation processes used by the entity. An entity might disclose the following to comply with paragraph 93(g) of the IFRS:*

- (a) for the group within the entity that decides the entity’s valuation policies and procedures:
  - (i) its description;*
  - (ii) to whom that group reports; and*
  - (iii) the internal reporting procedures in place (eg whether and, if so, how pricing, risk management or audit committees discuss and assess the fair value measurements);**
- (b) the frequency and methods for calibration, back testing and other testing procedures of pricing models;*
- (c) the process for analysing changes in fair value measurements from period to period;*
- (d) how the entity determined that third-party information, such as broker quotes or pricing services, used in the fair value measurement was developed in accordance with the IFRS; and*
- (e) the methods used to develop and substantiate the unobservable inputs used in a fair value measurement.”*

113. Fair value measurement of property, plant and equipment and investment property is a complex and judgemental area due to lack of observable inputs and the use of a range of methodologies, inputs and adjustments to reflect the differences among properties. HKICPA’s “A Plus for January 2014”<sup>28</sup> included an article “Application of fair value hierarchy to real estate” which provided further guidance in the fair value measurement of real estate. It stated that “Even in highly transparent and liquid markets it is likely that valuers will use one or more significant unobservable inputs or make at least one significant adjustment to an observable input. Accordingly, it is likely that the majority of property valuations will fall within the Level 3 category, unless there are frequent sale transactions of properties of a similar nature, location and characteristics (e.g. en bloc) such that significant adjustments are not required. ... To achieve a Level 2 classification, management and valuation experts will have to provide objective evidence that all significant assumptions are based on recent and relevant market transaction.”

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<sup>28</sup> HKICPA “A Plus for January 2014” can be accessed at:-  
[http://app1.hkicpa.org.hk/APLUS/2014/01/pdf/full\\_edition\\_2.pdf](http://app1.hkicpa.org.hk/APLUS/2014/01/pdf/full_edition_2.pdf) .

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114. Where issuers categorize the fair value measurement of properties within Level 2 of the fair value hierarchy, issuers are encouraged to provide in the annual reports further information and explanation how and why the fair value measurement of properties is categorized within Level 2 so that users of financial statements are able to understand clearly how the fair value of properties is measured and reasons why the use of unobservable inputs or adjustment to observable inputs is not needed in the fair value measurement.
115. Issuers should be aware that, although paragraph 7 of HKFRS 13 states that the disclosures required by HKFRS 13 are not required for assets for which recoverable amount is fair value less costs of disposal in accordance with HKAS 36, the amendments to paragraphs 130 and 134 of HKAS 36 has been effective for annual period beginning on or after 1 January 2014. The amendments require the disclosure of information in relation to fair value measurement where the recoverable amount is fair value less costs of disposal (see amendments to paragraphs 130 and 134 of HKAS 36).
116. Issuers should also be mindful of paragraph 97 of HKFRS 13 which requires that, for each class of assets and liabilities not measured at fair value in the statement of financial position but for which the fair value is disclosed, an entity should disclose the information required by paragraphs 93(b), 93(d) and 93(i) of HKFRS 13, but the quantitative disclosures about significant unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy is not required. Though the fair value is disclosed for information only, issuers are reminded to follow HKFRS 13 to provide the required disclosures, as such information would be useful to users of financial statements.

**V. FINDINGS REGARDING INDUSTRY REVIEW THEME –  
ACCOUNTING BY AUTOMOTIVE COMPANIES**

117. In this year's review, we chose as the industry theme issuers whose major or principal activities included automotive related businesses. Unless otherwise specified, HKFRS and their paragraph numbers referred to in this section correspond to those in IFRS.
118. The review focused on accounting and reporting issues of the industry including:-
- Revenue recognition
  - Property, plant and equipment
  - Intangible assets
  - Impairment of assets
  - Provisions
119. In total, annual reports of 15 issuers whose major or principal activities included automotive related businesses were selected for review. Around half of the 15 automotive issuers under review engaged in manufacture and sales (wholesale / retailing) of automotive. These 15 automotive issuers under review also engaged in other automotive related businesses including manufacture and sales of automotive components such as engines, ventilation systems, glass and metal castings, etc.; design of solutions that improve fuel economy and reduce emissions; etc.
120. Where potential non-compliance was noted, we have raised enquiries to issuers and they provided explanation and clarification to our enquiries. We did not note any significant non-compliance for the automotive issuers reviewed.
121. There were areas of disclosure that could be improved in future reports. The key findings together with our recommendations are set out below.

**Revenue recognition**

**Our findings**

122. The sale of automotive and automotive components and other related products and services is accounted for in accordance with HKAS 18. Revenue from sale of automotive and automotive components and other related products should be recognized when the significant risks and rewards of ownership of the goods are transferred to the buyer and the seller retains neither managerial involvement to the degree usually associated with ownership nor effective control over the goods sold. Certain arrangements, such as services associated with the sale of automotive, warranty, repurchase agreements, etc., add complexity to the revenue recognition of automotive companies.

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123. From our review, we observed that the 15 automotive issuers under review have disclosed their revenue recognition policy, but the revenue recognition policy disclosed was generic. Most of them disclosed that revenue from sale of goods is recognized “when goods are delivered to and accepted by the customers” or “when the significant risks and rewards of ownership have been transferred to the buyer”.
124. An automotive company would usually sell automotive together with certain additional services, such as after-sales services, mobility guarantees or free maintenance period, etc. However, none of the 15 automotive issuers under review disclosed in their annual reports whether the sale contracts included such arrangements and how these arrangements were accounted for.
125. Offer of discounts, sales incentives and rebates are common in automotive sector. We observed that a few of the 15 automotive issuers under review stated in their annual reports that revenue is recognized after discounts. However, no disclosure of details of discounts, sales incentives and rebates and no separate accounting policy for discounts, sales incentives and rebates were provided in the annual reports.
126. Manufacturers of automotive may sell automotive with repurchase agreements or buy-back guarantees. The automotive issuers under review that engage in manufacture and sales of automotive did not mention in the annual reports whether they have entered into such arrangements.

### **Our recommendations**

127. For users to better understand the financial statements, issuers should disclose more specific accounting policy on revenue recognition. It is expected that the transfer of significant risks and rewards of ownership of goods would be physical delivery of goods or transfer of legal title of goods to the buyer. However, the timing of revenue recognition of wholesaler and retailer of automotive would be different. We encourage issuers to enhance disclosure of the timing of revenue recognition.
128. For sale of automotive together with additional services, such as after-sales services, mobility guarantees or free maintenance period, etc., automotive issuers should consider whether these components should be identified and accounted for separately. We recommend issuers to enhance the disclosure on how these components are identified and accounted for in their annual reports.
129. Where automotive companies offer discounts, sales incentives and rebates to buyers, automotive companies should consider the uniqueness and complexity of these discounts, sales incentives and rebates and determine whether these discounts, sales incentives and rebates should be accounted for separately or with the sale of automotive as a whole.

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130. Regarding sales of automotive with repurchase agreements or buy-back guarantees, automotive issuers should carefully consider the terms and conditions of the repurchase agreements and whether the risks and rewards of ownership have been transferred to the customer or rest with the seller. This is critical as it determines whether the transaction constitutes a sale or a lease arrangement; and where the transaction is a sale, whether the revenue is deferred and when the revenue is recognized. We encourage automotive issuers who have entered into such kind of arrangements provide clear disclosure of the details of the repurchase or buy-back arrangements and how the sales with such repurchase or buy-back arrangements are accounted for.
131. As mentioned in paragraphs 63 and 64 above, HKFRS 15 may result in changes to the accounting policy for revenue recognition adopted currently by automotive issuers. Automotive issuers should study the new accounting standard at an early stage and assess the potential impact of HKFRS 15 on their financial statements.

### **Property, plant and equipment**

#### **Our findings**

132. Property, plant and equipment were generally significant to the statement of financial position of automotive companies as the automotive industry is capital-intensive with substantial manufacturing plants and equipment. All of the 15 automotive issuers under review had their property, plant and equipment stated at cost less subsequent accumulated depreciation and accumulated impairment losses. They adopted straight-line method of depreciation over the estimated useful lives of property, plant and equipment.
133. None of the 15 automotive issuers under review disclosed whether major parts or components of the manufacturing plants and equipment were identified and depreciated individually.

#### **Our recommendations**

134. Paragraph 43 of HKAS 16 “*Property, Plant and Equipment*” states that each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately. Automotive issuers should consider whether an item of property, plant and equipment consists of significant components for which different depreciation methods or depreciation rates should be applied.
135. In addition, as mentioned above, property, plant and equipment were generally significant to the statement of financial position of automotive issuers, therefore automotive issuers are reminded to perform impairment test regularly on the major assets and be mindful of the occurrence of any indication of impairment loss. Further guidance is detailed in paragraphs 142 to 146 below.

**Intangible assets**

**Our findings**

136. Entities in automotive industry often incur research and development costs internally to improve current products or develop new products and may capitalize such costs when the technical feasibility of a project can be demonstrated and the recognition criteria as set out in HKAS 38 “*Intangible Assets*” are met. Paragraph 21 of HKAS 38 states that an intangible asset is recognized if it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity and the cost of the asset can be measured reliably. Capitalizing or expensing the research and developments would have significant impact on the financial statements.
137. We observed that some of the 15 automotive issuers under review capitalized development costs as intangible assets and disclosed the accounting policy for development costs. One issuer set out in the accounting policy the criteria to capitalize development costs, which was in accordance with paragraph 57 of HKAS 38, as:-
- “Expenditure incurred on projects to develop new products is capitalised and deferred only when the Group can demonstrate the technical feasibility of completing the intangible asset so that it will be available for use or sale, its intention to complete and its ability to use or sell the asset, how the asset will generate future economic benefits, the availability of resources to complete the project and the ability to measure reliably the expenditure during the development. Product development expenditure which does not meet these criteria is expensed when incurred.”*
138. Those issuers that had capitalized development costs stated at cost less subsequent accumulated amortization and accumulated impairment losses, adopted a straight-line method of amortization over the commercial lives of the underlying products, except one issuer had the development cost of new energy vehicles amortized using the unit of production method, commencing from the date when the products are put into commercial production. However, this issuer did not explain the reason for adopting the unit of production method for amortizing the development cost of new energy vehicles.

**Our recommendations**

139. In addition to the general recognition criteria in paragraph 21 of HKAS 38, automotive issuers should consider the additional criteria for recognizing an intangible asset from development as required by paragraph 57 of HKAS 38. The accounting policy for development costs should set out the criteria for capitalizing development costs. Where there are additional industry-specific or entity-specific criteria for capitalizing development costs as intangible assets, automotive issuers are encouraged to disclose these industry-specific or entity-specific criteria as well.



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140. Paragraph 97 of HKAS 38 states that an intangible asset with a finite useful life should be amortized on a systematic basis over its useful life and the amortization method used should 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.
141. Automotive issuers should select an amortization method based on expected pattern of consumption of the expected future economic benefits embodied in the asset. We encourage issuers to disclose the reason for selecting an amortization method other than straight-line method.

**Impairment of assets**

**Our findings**

142. The automotive industry is faced with challenges from technology evolution and customer demand and changes in preference. Where the plant and equipment are not able to catch up with the latest technology or the sales of vehicles is not as expected or forecasted due to customer dissatisfaction, the related plant and equipment and the intangible assets would be impaired.
143. All of the 15 automotive issuers under review disclosed an accounting policy for impairment of assets and a few automotive issuers under review had recognized impairment loss on property, plant and equipment or intangible assets. However, they did not disclose the events and circumstances that led to the recognition of impairment loss.
144. A few of the 15 automotive issuers under review disclosed and briefly discussed impairment indicators, which included intense competition in the automotive industry and regulatory changes, e.g., the promotion of new energy vehicles and energy-saving vehicles affected the sales of traditional low-end vehicles.

**Our recommendations**

145. Automotive issuers are reminded to comply with the disclosure requirements as set out in paragraphs 126, 129 and 130 of HKAS 36 where impairment loss is recognized or reversed during the reporting period. Where significant impairment loss is recognized, narrative information should be provided and should be case-specific and closely related to the issuer's operation and activities.
146. Paragraph 9 of HKAS 36 requires an entity to assess at the end of the reporting period whether there is any indication that an asset maybe impaired. Paragraph 12 of HKAS 36 provides a non-exhaustive list of indications that an impairment loss may occur. Where any of the indications arise, automotive issuers should carry out impairment tests on the related assets or cash-generating units accordingly. Where it is concluded that no impairment is needed, automotive issuers are encouraged to disclose that impairment testing has been performed on the property, plant and equipment or intangible assets and the reason why management considered that

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property, plant and equipment or intangible assets are not impaired. In addition, automotive issuers are reminded to disclose clearly how the recoverable amounts of the assets or cash-generating units are measured together with the assumptions and estimates used in the measurement. Further guidance is detailed in paragraphs 73 to 77 above.

### **Provisions**

#### **Our findings**

147. HKAS 37 “*Provisions, Contingent Liabilities and Contingent Assets*” requires the recognition of a present obligation (legal or constructive) as a provision as a result of a past event and it is probable that an outflow of resources is required to settle the obligation. Automotive companies often offer warranty to buyers as part of the sale agreements and confront environmental obligations resulting from the manufacture of automotive which may result in recognition of provisions.
148. Around half of the 15 automotive issuers under review recognized provision for warranty, one of them had provision for environmental obligations and two recognized provisions for decommissioning. These issuers provided the accounting policy for provisions and most of them were generic.
149. Only a few of the 15 automotive issuers under review disclosed limited information of the warranty offered to buyers and how the provision for warranty was estimated, for example, “based on sales volume and past experience of the level of repairs and returns, discounted to their present values as appropriate”. The issuers who had recognized provisions for environmental obligations and decommissioning did not provide any information in relation to the environmental obligations and decommissioning.

#### **Our recommendations**

150. Automotive issuers should identify whether there is any present or constructive obligation in relation to environment and decommissioning which may be required by the terms of contracts of master supply agreements or regulatory requirements and the obligation as a result of warranty periods offered to buyers. Issuers are encouraged to disclose whether or not there are specific requirements under current relevant laws and regulations in relation to environment and decommission and whether provision should be recognized.
151. Automotive issuers are reminded that paragraph 85 of HKAS 37 requires an entity to disclose for each class of provision a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits. We recommend automotive issuers to disclose clearly when each class of provision is recognized and how the provision is estimated; and the provision should be measured at the best estimate of the costs to be incurred and time value of money should be considered where material.

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**VI. CONCLUSION**

152. The overarching principle for financial reporting should be “information provided is relevant and material” and issuers should avoid cluttering by reducing non-relevant and non-material disclosure so that their communication through financial reports is clear and concise.
153. The global economic environment is highly challenging. Accordingly, issuers should stay alert to changes to the Listing Rules, accounting and auditing standards, other local laws and regulations in different countries (where relevant). It is important that issuers consult their auditors and other professional advisers for timely insights into these changes and the implications on their periodic financial reports. We also encourage directors and other persons responsible for financial reporting to take note of the matters discussed in this report. They should review and regularly improve their financial reporting systems and explore ways to better integrate information in financial statements and other parts of the financial report such that the information provided is useful to investors and other users.

- End -

