FINANCIAL STATEMENTS REVIEW PROGRAMME REPORT 2013

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

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EXECUTIVE SUMMARY

The 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 fifth published report summarising our key observations and findings.

We reviewed 120 reports of issuers covering the annual, interim and quarterly reports released between October 2012 and September 2013. During the review process, we issued 81 letters to issuers that contained more than 240 enquiries and observations. Our enquiries requested explanations and information about the accounting treatment adopted or clarifications on possible non-compliance or omitted disclosures.

Based on the responses to our enquiries made during our 2012/2013 review, except for two cases which have been referred to the Financial Reporting Council to consider further enquiry and investigation of possible accounting and auditing irregularities and one case which is being considered for further appropriate enforcement action, there were no significant breaches of the Listing Rules or accounting standards that would render the financial statements false or misleading or would require a restatement or reissue of financial statements or warrant disciplinary action by the Listing Committee. Where the omitted disclosures were regarded as less significant or material, we requested issuers to confirm in writing that the required disclosures will be rectified in future financial reports.

During the year, from other related work at the Exchange, we referred 12 cases to the Financial Reporting Council for consideration of further enquiry and investigation into possible accounting and auditing irregularities.

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

The major findings and recommendations from our review are:-

- Issuers are still omitting certain disclosures required under Appendix 16 to the Main Board Rules (and equivalent GEM Rules). We remind issuers that in addition to the disclosure requirements in respect of accounting standards, the Listing Rules also have disclosure requirements relating to financial information, in particular additional information should be presented in financial reports to provide a better understanding of the nature and impact of significant events or material balances and transactions. These are primarily set out in Appendix 16 to the Main Board Rules (see paragraphs 13 to 15);

- Issuers that have entered into a complex or material transaction should ensure that the transaction is properly accounted for in accordance with the accounting requirements. To avoid unintended errors due to inappropriate application of the accounting requirements, they are encouraged to early consult their auditors. If the transaction was entered in the interim period, they should consider whether a review of the interim report should be carried out by their auditors (see paragraph 42);

- Issuers should pay special attention to the key areas of financial reporting that involve significant management judgements and provide the best possible disclosure in their financial reports. The key accounting standards includes HKFRS 3 (Revised) *"Business Combinations"*, HKAS 36 *"Impairment of Assets"* and HKAS 39 *"Financial Instruments: Recognition and Measurement"*. Issuers should demonstrate their assessments and knowledge to substantiate their conclusions that the transaction and accounts balance are properly accounted for and disclosed. For example, issuers should:-

  - ensure all identifiable assets in an acquisition of a business that existed at the acquisition date, in particular intangible assets, have been properly identified and recognized separately from goodwill in accordance with HKFRS 3 (Revised) and HKAS 38 *"Intangible Assets"* (see paragraphs 48 to 54);

  - consider whether there is any indication that asset values may be impaired and the reasonableness of underlying assumptions in accordance with HKAS 36. Adequate disclosure relating to impairment of assets should be made to enable users of financial statements to fully understand the events and circumstances that led to the recognition or reversal of the impairment loss (see paragraphs 67 to 84); and

  - review the accounting treatment for financial instruments containing embedded derivatives in accordance with HKAS 39, e.g. investment in a convertible bond is classified as available-for-sale investment, so its embedded conversion option should be separated (see paragraphs 31 to 34); and

- Issuers should follow good practices when providing non-IFRS/HKFRS financial information to ensure that the information is clearly distinguished from the financial information prepared in accordance with accounting standards (see paragraphs 111 to 113).

The current global economic environment and the regular changes to accounting standards provide challenges to persons involved in the financial reporting process. Therefore, we encourage directors and other persons responsible for financial reporting to take note of the matters discussed in this report and stay alert to changes to the Listing Rules, accounting standards and other disclosure requirements. It is important that issuers should consult their auditors and other external professional advisers for timely insights into any changes to the above requirements and the implications on their periodic financial reports. They should also aim to continue improving their internal control systems for financial reporting to ensure that they comply with all the accounting requirements. The information in their periodic financial reports should be entity specific, relevant, consistent and coherent such that the information will be useful in making investment decisions.

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 compliance with the requirements of the Main Board Rules and GEM Rules and, in parallel, to monitor compliance with the relevant disclosure requirements of the Companies Ordinance, and the applicable accounting standards, including Hong Kong Financial Reporting Standards ("HKFRS") issued by the 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 samples to check compliance by issuers incorporated in the Mainland 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 improve the quality of financial disclosures in 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 to 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:-

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

   (b) Probability – issuers where there is a possible higher risk of misstatement or misapplication of accounting standards due to the existence of features that may indicate higher risk including where an issuer has any of the following characteristics:-

   - experienced significant changes in its net assets
   - newly listed
   - subject to complaints concerning compliance with the Listing Rules
   - issued with a qualified or modified auditors' report
   - engaged a smaller accounting firm as its auditors

   (c) Random – a number of cases are selected at random so that any issuer may be selected for review.

5. We reviewed 120 reports released by issuers between October 2012 and September 2013 and issued 81 letters to issuers that contained more than 240 enquiries or observations.

6. Of all the cases reviewed during the period, 119 were subsequently closed after considering the responses received to our letters and 1 case remains outstanding awaiting further clarification and information of the issuer. Two cases were referred to the Financial Reporting Council (the "FRC") and one case is being considered for further appropriate enforcement action.

7. This is our fifth published report which summarizes our key observations and findings. It is important to note that the findings do not include all areas in which we raised comments or asked questions.

8. For each year's review, we have different accounting and industry themes and including a topical issue, if appropriate. For this year, we selected:-
   - Accounting for impairment of assets, as our accounting theme (Section IV of this report);
   - Issuers whose major or principal businesses are power and utilities services, as our industry review theme (Section V of this report); and
   - Non-IFRS/HKFRS financial information in financial reports, as a topical issue (Section VI of this report).

9. Key observations and findings raised in our past reports may also be relevant and are useful references and 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 focused on issuers' compliance with the Listing Rules and their disclosure of material events and developments. The Compliance Review Report 2012 can be accessed at:-
    http://www.hkex.com.hk/eng/rulesreg/listrules/guidref/issuergdo.htm

II. FINDINGS REGARDING THE LISTING RULES

11. 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: Findings relating to Listing Rules disclosures

Area	MB Rules	GEM Rules
Additional information in annual reports required under the Listing Rules	Appendix 16	Chapter 18
Corporate Governance Reports	Appendix 14	Appendix 15
Disclosures relating to annual review of continuing connected transactions	Chapter 14A	Chapter 20
Mineral companies	Chapter 18	Chapter 18A
Financial reports using CASBE	Chapter 19A	Chapter 25

12. Unless otherwise specified, the Rule references referred to in this section apply to both Main Board Rules and GEM Rules. While the discussion in this section will focus on Main Board Rules, the discussion applies equally to GEM Rules.

Additional information in annual reports required under the Listing Rules

13. Appendix 16 to the Main Board Rules specifies a number of matters that issuers are required to disclose in their annual reports in addition to those required under accounting standards. For certain 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 & Analysis ("MD&A") or directors' report.

14. We would like to remind issuers about the general principles applicable to the presentation of information under Main Board Rule 2.13(2), which require:-

"the information contained in the document must be accurate and complete in all material respects and not be misleading or deceptive. In complying with this requirement, the issuer must not, among other things:-

(a) omit material facts of an unfavourable nature or fail to accord them with appropriate significance;

(b) present favourable possibilities as certain or as more probable than is likely to be the case;

(c) present projections without sufficient qualification or explanation; or

(d) present risk factors in a misleading way."

15. The most common omitted or incomplete disclosures which issuers should be alerted to are:-

    (a) <u>Management Discussion & Analysis (paragraph 32 of Appendix 16 to the Main Board Rules)</u>

        (i) Minimum disclosure requirements

        Paragraph 32(1) to 32(12) of Appendix 16 to the Main Board Rules sets out the minimum areas that should be covered in the MD&A.

        During our review we noted that some issuers had overlooked these minimum disclosure requirements. Examples of omissions include the following:-

        - funding and treasury policies and objectives in terms of the manner in which treasury activities are controlled;
        - 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;
        - comments on segmental information such as changes in the industry segment, developments within the segment and their effect on the results of that segment;
        - details of the number and remuneration of employees, remuneration policies, bonus and share option schemes and training schemes; and
        - gearing ratio and the basis on which the gearing ratio is computed.

        (ii) Significant balances and transactions

        Paragraph 32 of Appendix 16 to the Main Board Rules requires annual reports to include a separate 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."*

        Moreover, IAS 1/HKAS 1 (Revised) *"Presentation of Financial Statements"* requires entities to provide information which is relevant to an understanding of the financial statements by way of additional notes to the financial statements.

Although we highlighted the issue in our past reports, we continued to identify instances where disclosure of the nature and impact of significant events or material balances and transactions were less than expected. Examples included the following:-

- significant amounts were simply described as "other receivables/payables" in the financial statements without further details in the financial statements or elsewhere in the periodic financial reports;
- MD&A tended to repeat information available in the financial statements in narrative form without additional analysis and explanations; and
- apparent inconsistencies between matters reported in MD&A and financial statements.

The absence of information on significant events leading to material balances and transactions in periodic financial reports may be viewed as non-compliance with the relevant Listing Rules or accounting standards.

Effective presentation of information is an essential element for high-quality MD&A. We recommend that issuers should challenge past practices of how key information is structured and conveyed. MD&A should:-

- be balanced (coverage of good as well as bad news), clear and concise;
- be consistent with information disclosed elsewhere in the reports, particularly the information in the financial statements, and not misleading; and
- where appropriate, comment on material transactions reported in the financial statements. Conversely, matters discussed in the MD&A to be suitably highlighted in the financial statements.

Auditors also have a responsibility under Hong Kong Standard on Auditing 720 (Clarified) *"The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements"* which requires that the auditors review information accompanying the audited financial statements to identify material inconsistency, if any.

(b) Related party disclosures (paragraph 8(3) of Appendix 16 to the Main Board Rules)

Paragraph 8(3) of Appendix 16 to the Main Board Rules requires issuers to:-

- state whether or not the related party transactions disclosed in their annual financial statements in accordance with IAS 24/HKAS 24 (Revised) *"Related Party Disclosures"* fall under the definition of connected transactions or continuing connected transactions in Chapter 14A of the Main Board Rules; and
- confirm whether or not they have complied with the disclosure requirements in accordance with Chapter 14A of the Main Board Rules.

During our review we noted a number of issuers did not make the above confirmations in their annual reports.

In addition, we identified a case where the connected transactions were not announced nor approved by independent shareholders as required under Chapter 14A of the Main Board Rules. It was only after our enquiry that the issuer made an announcement to disclose the transactions and the corresponding remedial measures. This case is being considered for further appropriate enforcement action.

Issuers should ensure that the above confirmations are made in their annual reports. If a related party transaction is a fully exempt connected transaction under Chapter 14A of the Main Board Rules, the issuer should specify that the related party transaction is a connected transaction under Chapter 14A and describe the exemption applicable to the transaction (Question 23 of FAQ Series 20 released on 28 February 2013 http://www.hkex.com.hk/eng/rulesreg/listrules/listrulesfaq/Documents/FAQ_20.pdf).

Issuers are also reminded that directors are primarily responsible for ensuring the completeness and accuracy of disclosures made on connected transactions in their annual reports and for compliance with the Listing Rules in respect of such transactions. It is important that directors and persons responsible for financial reporting should familiarize themselves with the connected transaction Rules and regularly update their existing internal control procedures to ensure connected parties are properly identified and that all transactions with these parties are captured.

(c) Independent non-executive directors (paragraph 12B of Appendix 16 and Section I(g) of Appendix 14 to the Main Board Rules)

Paragraph 12B of Appendix 16 to the Main Board Rules requires an issuer to confirm in the annual report *"whether it has received from each of its independent non-executive directors an annual confirmation of his independence pursuant to rule 3.13 and whether it still considers the independent non-executive directors to be independent."*

We noted a few issuers omitted to include this confirmation in their corporate governance report or elsewhere in the annual reports. Without this confirmation, users of annual reports would not know whether the independent non-executive directors are considered to be independent. Issuers should take note and ensure the required disclosures are made.

(d) Directors' emoluments (paragraph 24 of Appendix 16 to the Main Board Rules)

We observed that there were incomplete disclosures regarding the directors' emoluments. Examples included the following:-

- "discretionary" bonus paid/payable to the director was wrongly aggregated with the basic salaries and other allowances and benefits in kind;
- no disclosure of the contributions to pension schemes for directors or past directors for the financial year; and
- no disclosure of the remuneration of certain current directors and supervisors and certain directors and supervisors who resigned during the financial year.

Issuers are reminded of the requirements of Note 24.3 to paragraph 24 of Appendix 16 to the Main Board Rules that 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. Moreover, where the directors have not received any emoluments during the financial year, a statement of that fact should be disclosed.

(e) 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 Main Board Rules)

Paragraph 25 of Appendix 16 to the Main Board Rules 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 Main Board Rules requires that *"Issuers should disclose details of any remuneration payable to members of senior management by band in their annual reports."*

During our review, some issuers provided information about the five highest paid individuals in their financial statements but omitted disclosure concerning details of remuneration paid to members of senior management as required under Code Provision B.1.5 in their corporate governance reports. Issuers should ensure that two disclosures are provided in their annual reports.

(f) Disclosures required under the Hong Kong Companies Ordinance (paragraph 28 of Appendix 16 to the Main Board Rules)

Paragraph 28 of Appendix 16 to the Main Board Rules 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, including the holding company's statement of financial position for the financial year and the movement in the holding company's reserves (as required under the Tenth Schedule of the existing Companies Ordinance, which is set out in the Fourth Schedule of the new Companies Ordinance).

We are pleased to note improvements in this area as the number of omissions was less than that observed in the samples reviewed in previous years' review. We also observed that non-Hong Kong incorporated issuers presented their company level balance sheet as a separate primary financial statements together with their consolidated financial statements, or as a note to their consolidated financial statements.

(g) Major suppliers and customers (paragraph 31 of Appendix 16 to the Main Board Rules)

Paragraph 31 of Appendix 16 to the Main Board Rules requires an issuer to disclose information in respect of its major suppliers and customers. Where the issuer's five largest suppliers/customers combined comprise equal or more than 30% of the total purchases/turnover or sales, paragraph 31(5) of Appendix 16 to the Main Board Rules further requires an issuer to disclose:-

- a statement of the interests of any of the directors; their associates; or any shareholder (which to the knowledge of the directors own more than 5% of the listed issuer's share capital) in these major suppliers/customers; or
- if there are no such interests a statement to that effect.

In this year's review, we identified that a few issuers did not make this statement in the annual reports. Upon our enquiries, they have confirmed that the required disclosures will be made in future annual reports.

Corporate Governance Reports

16. The Code became effective in 2005, and on 1 April 2012 substantial amendments were implemented resulting in the addition of 30 new Code Provisions (CPs). The disclosure requirements for the corporate governance report in previous Appendix 23 to the Main Board Rules were merged into Appendix 14 to the Main Board Rules for ease of reference.

17. In this year's review, the majority of the reports reviewed complied with most of the mandatory disclosure requirements under Appendix 14 to the Main Board Rules. We would like to take this opportunity to highlight the following areas which require attention and improvement:-

    (a) Financial statements with modified auditor's reports

    CP C.1.3 and Note 1 to Section M of Appendix 14 to the Main Board Rules require that the directors should acknowledge in the corporate governance report their responsibility for preparing the financial statements.

    Paragraph 2 of Appendix 16 to the Main Board Rules requires that *"Each set of financial statements presented in an annual report … shall provide a true and fair view of the state of affairs of the listed issuer and of the results of its operations and its cashflows …"*

    In this year's review, we noted a case where the issuer's financial statements included a qualified auditor's report because of an audit scope limitation. The issuer was required to use the equity method of accounting for an investee, and as at the date of the annual report the auditor was unable to obtain sufficient appropriate audit evidence about the investee's financial information to evaluate whether the equity method had been appropriately applied. In response to our enquiry the issuer informed that it has already been working with its auditor to address the qualified issue and expected its future financial statements will not be qualified in this respect. We strongly encourage other issuers with qualified auditor's report to take proactive steps to resolve the issues identified.

    We believe that extra care and attention at the planning stage could prevent audit qualification issues due to insufficient information and lack of proper books and records. For example, if an issuer plans to dispose of a material business or a subsidiary it should make early arrangements so that its auditors are able to verify the disposal transaction before the books and records of the business or subsidiary disposed of are released to the buyer. This should prevent the annual financial statements of the issuer from being qualified because of the non-availability of audit evidence. Issuers should ensure that they are in a position to respond to queries on whether arrangements have been put in place to enable that the transaction can be properly audited.

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. The reliability of financial reporting is dependent on the effectiveness of the internal control systems that an issuer has put in place. Issuers are also reminded of the CPs concerning the internal controls in Section C.2 of Appendix 14 to the Main Board Rules. CPs C.2.1 and C.2.2 require that *"The directors should at least annually conduct a review of the effectiveness of the issuers' and its subsidiaries' internal control systems … in particular, consider the adequacy of resources, staff qualifications and experience, training programmes and budget of the issuer's accounting and financial reporting function."*

(b) Going concern assessments

Going concern is one of the underlying assumptions of financial reporting. CP C.1.3 of Appendix 14 to the Main Board Rules states that *"Where the directors are aware of material uncertainties relating to events or conditions that may cast significant doubt on the issuer's ability to continue as a going concern, they should be clearly and prominently disclosed and discussed at length in the Corporate Governance Report. The Corporate Governance Report should contain sufficient information for investors to understand the severity and significance of matters. To a reasonable and appropriate extent, the issuer may refer to other parts of the annual report. These references should be clear and unambiguous and the Corporate Governance Report should not contain only a cross-reference without any discussion of the matter."*

Note 2 to Section M of Appendix 14 to the Main Board Rules requires an issuer to include a *"report on material uncertainties, if any, relating to events or conditions that may cast significant doubt upon the issuer's ability to continue as a going concern (C.1.3 of the Code)"* in the corporate governance report.

IAS 1/HKAS 1 (Revised) also requires that when management is aware of material uncertainties relating to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, those uncertainties should be disclosed in the financial statements.

We noted that a few issuers included a discussion in the note to the financial statements on the issue of going concern. Furthermore, their auditors included an emphasis of matter in the auditor's report. However, those issuers omitted to include the discussion in their corporate governance reports of the existence of material uncertainties that may cast significant doubt upon their ability to continue as a going concern as required under the above Rules.

In addition, during our review we observed a case where the issuer had net current liabilities with significant losses incurred and other deteriorating factors, which indicated a potential going concern issue. However, there was no further discussion in the annual report, including its corporate governance report and financial statements, explaining this uncertainty and why the directors consider the entity to be a going concern. Disclosure about the liquidity risk, as required under HKFRS 7 *"Financial Instruments: Disclosures"*, was short and generic. Based on the response to our enquiry, the management confirmed that the adoption of going concern basis is appropriate for preparing the financial statements and would take steps to enhance the liquidity position of the company and provide better disclosures in future.

Issuers are reminded that early discussions with their auditors about going concern issues may help to minimize the risk of last minute surprises. It is also likely to be helpful if a draft of the relevant disclosures about going concern and liquidity risk is prepared and discussed with the auditors well before the end of the reporting period.

Disclosures relating to annual review of continuing connected transactions

18. Issuers conducting continuing connected transactions should disclose the results of the annual reviews by their independent non-executive directors and the auditors in the annual reports as required under Main Board Rules 14A.37 and 14A.39. Auditors are also required by Main Board Rule 14A.38 to provide a letter to the Exchange about the results of their review.

19. In this year's review, we noted that the majority of reports reviewed had provided the confirmations as required under the above Rules. However, we noted a few cases where issuers had provided the Exchange with a copy of the auditors' letters on continuing connected transactions but overlooked the need to disclose the results of the auditors' review in their annual reports.

20. We also observed a case where the issuer provided a brief statement in its annual report which stated that *"The Board engaged ... the auditor of the Company to perform certain agreed upon procedures in respect of the continuing connected transactions of the Group for the year ended 31 December 2012. The auditors confirmed that these transactions ..."*

21. We would like to point out to issuers that they should ensure 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 follow the guidance in Practice Note 740 *"Auditor's Letter on Continuing Connected Transactions under the Hong Kong Listing Rules"* ("Practice Note 740") issued by the HKICPA which was developed in consultation with the Exchange and staff at the Securities and Futures Commission. Moreover, the work is an assurance engagement rather than an agreed-upon procedures engagement. Issuers are also encouraged to provide more information in their annual reports to ensure that users understand the nature of the engagement and the work performed by their auditors. Paragraph 102 of Practice Note 740 provides an illustrative example of the disclosure under Main Board Rule 14A.39. Practice Note 740 can be accessed at:- http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeIII/pn740.pdf

Mineral companies

22. The revised Chapter 18 of Main Board Rules became effective on 3 June 2010. Main Board Rules 18.14 to 18.18 set out the continuing obligations of disclosures in financial reports for "Mineral Companies" that are newly listed or completed a Relevant Notifiable Transaction (as defined in Main Board Rule 18.01) after 3 June 2010 and issuers that publicly disclose details of Resources and/or Reserves (as defined in Main Board Rule 18.01) (the "R18.15 Companies").

23. Similar to the findings of the Compliance Review Report 2012, we continue to note that most of cases reviewed under our programme complied with most of the minimum disclosures requirements. However, some findings included:-

    - disclosure of the exploration, development and mining production activities and related expenditure incurred tended to be short and general, in particular when the Mineral Company had several mining projects on hand and those projects were under different phases of operations.
    - details of Resources and/or Reserves were not presented in a table format.
    - reporting standard and assumptions used were not disclosed.

24. Mining activities begin with the exploration and evaluation of an area. If the exploration and evaluation is successful, a mine can be developed, and commercial mining production can commence. The phases before commercial production begins can be prolonged and involving significant capital expenditures and commitments. Therefore, the quality of disclosures for these activities is essential. To assist Mineral Companies and R18.15 Companies in better discharging their continuing obligations under Chapter 18 of the Main Board Rules, the Exchange has published a Guidance Letter 47-13 in January 2013:- http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/iporq/Documents/gl47-13.pdf

Financial reports using CASBE

25. 37 Mainland incorporated issuers elected to prepare their financial statements for the year ended 31 December 2012 under CASBE (2011: 28). Financial statements prepared under CASBE, like other published financial reports, are subject to selection and review under our FSRP. The Exchange, the FRC and the HKICPA have together agreed to allocate the review of these CASBE financial reports among the three parties.

26. For the cases reviewed by the Exchange in this year, although some disclosures were omitted, they were not material to the financial statements as a whole and the issuers confirmed that the required disclosures will be provided in their future annual reports. We would like to remind issuers using CASBE to also ensure the disclosure requirements under Appendix 16 to the Main Board Rules as mentioned above are met.

27. Pursuant to the Joint Declarations between the HKICPA and 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. We encourage Mainland incorporated issuers that elect to adopt CASBE to stay alert to the progress on convergence and work closely with their auditors. Useful information is available on the HKICPA's website at:-
http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/mainland-standards-convergence/

III. FINDINGS REGARDING ACCOUNTING STANDARDS

28. 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: Findings relating to Accounting Standards

Area	Accounting Standards
Related party disclosures	HKAS 24 (Revised)
Financial instruments **- Presentation** **- Recognition and measurement** **- Disclosures**	 HKAS 32 HKAS 39 HKFRS 7
Interim financial reporting	HKAS 34
Business combinations	HKFRS 3 (Revised)
Operating segments	HKFRS 8

HKAS 24 (Revised) "Related Party Disclosures"

29. Financial statements should contain information necessary to draw users' attention to the possibility that an entity's financial position and results may have been affected by the existence of, and transactions and outstanding balances with, related parties. The following are disclosures that are sometimes omitted or incomplete:-

   - the name of its parent and, if different, the ultimate controlling party; and if neither the entity's parent nor the ultimate controlling party produces consolidated financial statements available for public use, the name of the next most senior parent that does so, irrespective of whether there have been transactions between the related parties (paragraph 13 of HKAS 24 (Revised) and paragraph 138 of HKAS 1 (Revised)); and
   - key management personnel compensation in total and divided into the categories of (a) short-term employee benefits; (b) post-employment benefits; (c) other long-term benefits; (d) termination benefits; and (e) share-based payment (paragraph 17 of HKAS 24 (Revised)).

30. Under HKAS 24 (Revised), key management personnel are defined as *"those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity"*. Issuers are reminded that all directors, including non-executives, are considered by HKAS 24 (Revised) to be key management personnel and therefore, should be included in the disclosures required under HKAS 24 (Revised). We also recommend that clarity is provided when identifying other employees who are considered to satisfy the criteria of key management personnel.

HKAS 32 "Financial Instruments: Presentation", HKAS 39 "Financial Instruments: Recognition and Measurement" and HKFRS 7 "Financial Instruments: Disclosures"

Accounting for investment in a convertible bond

31. Under HKAS 39, available-for-sale ("AFS") investments are those "non-derivative" financial assets that are designated as AFS, or that are not classified as loans and receivables or held-to-maturity investments, are not held for trading and are not designated as fair value through profit or loss on initial recognition.

32. An embedded derivative is separated from its host contract and accounted for separately as a stand-alone derivative when all the criteria specified in paragraph 11 of HKAS 39 are met, including the criterion where the hybrid (combined) instrument is not measured at fair value with changes in fair value recognized in profit or loss. If a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss, it is not separated.

33. From other related work at the Exchange, we noted a case where the issuer made several prior year adjustments in its subsequent financial statements to rectify incorrect accounting treatments for AFS investments. Firstly, the investments in convertible bonds were classified as AFS investments, and the embedded conversion options were not separately recognized as financial assets at fair value through profit or loss. Secondly, the release of investment revaluation reserve upon disposal of AFS investments was not presented as reclassification adjustment in the consolidated statement of comprehensive income. Instead, such amount was presented as other equity movement in the consolidated statement of changes in equity.

34. Issuers are encouraged to read section C.3 of Implementation Guidance accompanying HKAS 39, which states that if the bond is classified as AFS, the equity conversion option should be separated. The amount paid for the bond is split between the debt instrument without the conversion option and the equity conversion option. Changes in the fair value of the equity conversion option are recognized in profit or loss unless the option is part of a cash flow hedging relationship. If the convertible bond is measured at fair value with changes in fair value recognized in profit or loss, separating the embedded derivative from the host bond is not permitted.

Reclassification of investment revaluation reserve

35. Paragraph 55(b) of HKAS 39 requires that fair value changes on AFS investments are recognized and accumulated in other comprehensive income ("OCI") and subsequently reclassified to profit or loss upon impairment or disposal.

36. In addition to improper reclassification within equity as mentioned in paragraph 33 above, during our review we noted some cases where the reclassification adjustments concerning AFS investments were appropriately presented in OCI, but these amounts were simply described as "gain/loss on disposal" or "impairment loss". It was therefore difficult to understand or trace fair value movements of AFS investments and whether they had been previously recognized in OCI and recycled to profit or loss in the current period.

37. Issuers are reminded that the HKICPA issued amendments to HKAS 1 (Revised) relating to presenting comprehensive income in July 2011. It becomes effective for annual periods beginning on or after 1 July 2012. One of the amendments to HKAS 1 (Revised) requires additional disclosures to be made in the OCI section such that items of OCI are grouped into the following two categories:-

    - items that will not be reclassified subsequently to profit or loss (e.g. revaluation surplus on property, plant and equipment under HKAS 16 *"Property, Plant and Equipment"*); and
    - items that may be reclassified subsequently to profit or loss when specific conditions are met (e.g. fair value changes on AFS investments and fair value changes on hedging instruments in cash flow hedges under HKAS 39).

Disclosure of risks associated with financial instruments

38. All issuers reviewed that had financial instruments provided a risk analysis of the financial instruments as required under paragraphs 31 to 42 of HKFRS 7 and it was normally disclosed in the note to financial statements under the heading of "financial risk management". In this year's review, we noted that some issuers only provided minimal or boilerplate disclosures on financial risk management without tailoring to the entity's circumstances which have been reported in our past reports.

39. Issuers are reminded that investors and other users want better disclosures. They need to understand what management thinks are the key financial risks and why management thinks that they have adequately managed. For example, disclosures about liquidity risk should be enhanced. In addition to the disclosure of maturity analysis for financial liabilities that shows the remaining contractual maturities, it is recommended that management should disclose amount of undrawn banking facilities and their covenant requirements. Latest information on renegotiated borrowings and banking facilities after the year end would also be relevant. Issuers should refer to paragraphs B6 to B28 of HKFRS 7 for additional application guidance on financial risk management.

HKAS 34 "Interim Financial Reporting"

40. As with last year, we noted that less than adequate disclosures were made in the notes to interim reports on the following areas:-

    - explanation of circumstances or events that led to the significant write-down of inventories to net realizable value or recognition of material impairment loss on trade receivables (paragraphs 15B(a) and (b) of HKAS 34);
    - acquisitions and disposals of items of property, plant and equipment (paragraph 15B(d) of HKAS 34);
    - capital commitments for significant construction projects or purchase of property, plant and equipment (paragraph 15B(e) 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);
    - related party transactions (paragraph 15B(j) of HKAS 34);
    - statement that the same accounting policies and methods of computation were followed in the condensed interim financial statements as compared with the most recent annual financial statements (paragraph 16A(a) 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).

41. Issuers are reminded of the requirement of paragraph 38 of Appendix 16 to the Main Board Rules which states that *"a listed issuer must prepare its interim report in accordance with the same accounting standards that it adopted in the preparation of its most recent published annual financial statements or for a newly listed company in its prospectus"*. Moreover, paragraph 3 of HKAS 34 states that if an entity's interim report is described as complying with HKFRSs, it must comply with all of the requirements of HKAS 34. Paragraph 19 of HKAS 34 further requires that *"If an entity's interim financial report is in compliance with this Standard* [HKAS 34]*, that fact shall be disclosed. An interim financial report shall not be described as complying with HKFRSs unless it complies with all the requirements of HKFRSs."*

42. Issuers that have entered into a complex or material transaction should ensure that the transaction is properly accounted for in accordance with the accounting requirements. To avoid unintended errors due to inappropriate application of the accounting requirements, they are encouraged to early consult their auditors. If the transaction was entered in the interim period, they should consider whether a review of the interim report should be carried out by their auditors under Hong Kong Standard on Review Engagements 2410 *"Review of Interim Financial Information Performed by the Independent Auditor of the Entity"*.

HKFRS 3 (Revised) "Business combinations"

43. During our review, we regularly identified a number of findings in relation to accounting for business combinations. We consider that there is a need to remind issuers of a few key observations on this topic.

Accounting for acquisition of a subsidiary as a "business" or an "asset"

44. Issuers should take note of the application of HKFRS 3 (Revised) concerning when there is an acquisition of a "business" and when there is an acquisition of an "asset". It is important to understand at the outset and differentiate between the two as the accounting treatments for acquisition of a business or an asset are very different. The key differences in accounting requirements to note are as follows:-

	Acquisition of a business/Business combination	**Acquisition of an asset**
Applicable HKFRS	HKFRS 3 (Revised)	HKASs 2[1], 16[2], 38[3], 40[4] etc.
Initial measurement of assets acquired	At fair value	At cost
Goodwill/Gain on a bargain purchase	Yes	No
Deferred tax	Required	Not permitted
Acquisition related costs	Expensed	Can be capitalized

1 HKAS 2 *"Inventories"*
2 HKAS 16 *"Property, Plant and Equipment"*
3 HKAS 38 *"Intangible Assets"*
4 HKAS 40 *"Investment Property"*

45. Paragraph 122 of HKAS 1 (Revised) requires issuers to disclose significant judgements involved in preparing their financial statements. Therefore, we recommend that issuers should disclose the basis as to how they reach the conclusion on the accounting treatment adopted.

46. Issuers are also reminded to recognize and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in a business combination in accordance with HKAS 12 *"Income Taxes"* (paragraph 24 of HKFRS 3 (Revised)). In particular, paragraph 18(a) of HKAS 12 states that temporary differences arise when *"the identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values in accordance with HKFRS 3 Business Combinations, but no equivalent adjustment is made for tax purposes"* and paragraph 19 further states that *"Temporary differences arise when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently. For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability. The resulting deferred tax liability affects goodwill (see paragraph 66* [of HKAS 12]*)"*. Issuers should also take note that paragraph 15 of HKAS 12 does not permit the recognition of a deferred tax liability for taxable temporary difference if it arises from the initial recognition of an asset in a transaction which is not a business combination and does not affect accounting profit or taxable profit at the time of the transaction.

47. Issuers should take note of the *"Annual Improvements to HKFRSs 2011-2013 Cycle"* issued by the HKICPA in January 2014. These Annual Improvements include amendments to HKAS 40 that clarify HKFRS 3 and HKAS 40 are not mutually exclusive and the separate application of both standards is required. Consequently, when an entity acquiring a property, judgement is needed to determine whether (a) the property meets the definition of investment property; and (b) the transaction meets the definition of a business. The amendments will apply prospectively for acquisitions of investment property in periods commencing on or after 1 July 2014.

Recognizing and measuring fair value of identifiable assets acquired

48. Paragraphs 10 to 31 and B28 to B45 of HKFRS 3 (Revised) set out the basic principles and criteria for the recognition and measurement of identifiable assets acquired, liabilities assumed and non-controlling interests in the acquiree.

49. We noted that there appear to be inappropriate application of HKFRS 3 (Revised) concerning "recognition" and "measurement" of assets on acquisition, in particular identification of intangible assets. Our enquiries were sometimes prompted by a reference in the MD&A or earlier announcements and investment circulars, which indicated a range of valuable intangible assets were purchased and would appear to satisfy the recognition and measurement criteria on acquisition, were not found to be recognized in the balance sheet.

50. There was often a balance of goodwill recognized when businesses were acquired. In this year's review, we noted a case where there was a significant balance of goodwill recognized at the acquisition date because the fair value of identifiable assets acquired was minimal and no intangible assets were shown in the balance sheet. We questioned whether all identifiable assets, in particular intangible assets, that existed at the acquisition date have been properly identified and recognized separately from goodwill. As a result, the case was referred to the FRC to consider further enquiry and investigation of possible accounting and auditing irregularities. The case is still under review by the FRC.

51. From other related work at the Exchange, we noted a case where the issuer made several prior year adjustments in its subsequent financial statements to rectify the incorrect accounting treatments of business combinations, including identifiable intangible assets in business combinations that were not separately recognized and initially measured at fair value at the acquisition dates.

52. Issuers are also reminded to pay attention to paragraphs 33 to 41 of HKAS 38 which prescribe the accounting for intangible assets acquired in a business combination. In respect of the "identification" criteria, reviewing the financial statements of the acquiree may not be sufficient to identifying all the assets and liabilities that existed at the acquisition date. According to paragraph 13 of HKFRS 3 (Revised) and paragraph 34 of HKAS 38, identifiable assets and liabilities may include assets and liabilities not previously recognized in the acquiree's financial statements.

53. In respect of the "measurement" criteria, paragraph 33 of HKAS 38 considers that if an asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information always exists to measure reliably the fair value of the asset. Paragraph 35 of HKAS 38 further states that when, for the estimates used to measure an intangible asset's fair value, there is a range of possible outcomes with different probabilities, and uncertainty enters into the measurement of the asset's fair value. Therefore, the uncertainty about timing or amount of expected cash flows is not a reason for an inability to measure fair value reliably. Instead, the relevant factors of uncertainties should be reflected in the calculation of fair value.

54. Issuers are also recommended to read the Illustrative Examples accompany HKFRS 3 (Revised). Although the examples of identifiable intangible assets are not intended to be all-inclusive, they can help issuers have a better understanding of the recognition and measurement requirements.

Contingent consideration

55. During our review, we noted that some issuers disclosed details of contingent consideration arrangements relating to an acquired business in their investment circulars and financial statements in the year of acquisition. However, the issuers did not update in their subsequent financial statements in post-acquisition periods whether these performance indicators were met and related impact on the financial statements.

56. In this regard, issuers should pay particular attention to the disclosure requirements on initial recognition and subsequent measurement of a contingent consideration under paragraphs B64(g) and B67(b) of HKFRS 3 (Revised) respectively, in particular 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. The following information should be disclosed:-
    - 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.

57. Issuers should take note that the HKICPA issued the *"Annual Improvements to HKFRSs 2010-2012 Cycle"* in January 2014. These Annual Improvements include amendments to HKFRS 3. These amendments clarify that the contingent consideration that is classified as an asset or a liability should be measured at fair value at each reporting date, irrespective of whether the contingent consideration is a financial instrument within the scope of HKAS 39 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. The amendments will apply prospectively to business combinations for which the acquisition date is on or after 1 July 2014.

58. In addition, during our review of Rules compliance in 2012, we identified certain areas concerning disclosures of "results of performance guarantees on acquisitions" could be improved. Issuers are encouraged to read Part IIB of the Compliance Review Report 2012 for further guidance.

HKFRS 8 "Operating Segments"

59. The core principle of HKFRS 8 is that an entity should disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates. As also highlighted in our past reports, there were always some minor omissions in disclosures such as:-
    - description of factors used to identify reportable segments and reasons for aggregation of segments (paragraph 22(a) of HKFRS 8);
    - the basis of accounting for transactions between reportable segments (paragraph 27(a) of HKFRS 8); and
    - entity-wide information, which applies to all entities including those entities that have a single reportable segment (paragraphs 31 to 34 of HKFRS 8). For example, information about the extent of their reliance on the major customer when the revenue from transactions with a single external customer amounted to 10% or more of the entity's total revenue.

60. In addition, we noted a few cases where segment disclosures were apparently inconsistent with the MD&A. For example, where a single segment was reported although the group had a range of businesses disclosed in MD&A.

61. Issuers are reminded that HKFRS 8 requires operating segment information to be reported on the same basis as the information used internally for evaluating operating segment performance and deciding how to allocate resources to operating segments. Issuers are also encouraged to provide clear explanations in support of any decision to aggregate segments.

Cooperation with other regulators

62. 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 various regulators is different. The Exchange's FSRP focuses on compliance with the Listing Rules and accounting standards and our letters are addressed to, and attempt to help, issuers.

63. The FRC has the power to enquire into issuers on financial reporting matters. In addition to looking into complaints received from the public and other regulators, it commenced the proactive screening and review of audit reports since July 2008 in order to identify reports with modified opinion. Commencing 2011 the FRC also undertakes a financial statements review programme. Its current programme places greater emphasis on the detection of auditing irregularities. Further information relating to the FRC's work is available on the FRC's website at:-
http://www.frc.org.hk/en/index.php

64. The HKICPA's professional standards monitoring programme ("PSM programme") focuses on accounting standards and its letters are addressed to the auditors of listed companies to monitor the quality of their audit work. HKICPA publishes its findings in its Quality Assurance Department's annual report. 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/

65. To the extent legally permissible and under our separate Memorandum of Understanding 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.

66. In addition, a joint financial reporting forum with the FRC and HKICPA, which was an annual event since 2011, was held on 20 November 2013 which was fully subscribed. The representatives of the three bodies shared common or significant observations identified from reviews of financial statements of listed companies.

IV. FINDINGS REGARDING GENERAL ACCOUNTING REVIEW THEME – IMPAIRMENT OF ASSETS

67. The specific accounting standards theme chosen for this year's programme was compliance with the accounting standard dealing with impairment of assets under HKAS 36 *"Impairment of Assets"*. Unless otherwise specified, HKFRS and their paragraph numbers referred to in this section correspond to those in IFRS.

68. We did not note any significant non-compliance for issuers reviewed regarding impairment of assets. However, there were areas of disclosure that could be improved upon in future reports. The key findings and observations together with our recommendations are set out below.

Recognition of impairment losses and reversal of impairment losses

Our observations

69. We observed that from our review 50 issuers recognized impairment losses and six issuers recorded reversal of impairment losses for the reporting periods.

70. Out of the 50 issuers who recognized impairment losses for the reporting periods, we observed that:-

   - two-third of them disclosed the events and circumstances that led to the recognition of impairment losses (paragraph 130(a) of the HKAS 36);

   - nearly all of them disclosed the nature of the impaired assets or description of the cash-generating units and the segmental information of the impairment losses recognized (paragraphs 130(c) and 130(d) of HKAS 36);

   - nearly all of them disclosed whether the recoverable amount of the assets or cash-generating units were fair value less costs to sell or value in use (paragraph 130(e) of HKAS 36). However, only half of them disclosed the basis used to determine the fair value less costs to sell (if recoverable amount is fair value less costs to sell) or the discount rate used in the estimation of value in use (if recoverable amount is value in use), which is required under paragraphs 130(f) and 130(g) of HKAS 36; and

   - around one-third of them disclosed certain assumptions used to determine the recoverable amounts of the assets or cash-generating units, which is encouraged under paragraph 132 of HKAS 36.

71. Out of the six issuers who recorded reversal of impairment losses for the reporting periods, we observed that around half of the six issuers disclosed:-

   - the events and circumstances that led to the recognition of the reversal of impairment losses (paragraph 130(a) of the HKAS 36);

- the nature of the assets or the description of the cash-generating units and the segmental information of the reversal of impairment losses recognized (paragraphs 130(c) and 130(d) of HKAS 36); and

- whether the recoverable amount of the assets or cash-generating units were fair value less costs to sell or value in use (paragraph 130(e) of HKAS 36).

Our recommendations

72. 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.

73. We believe that the quality of narrative information should be improved in describing the events and circumstances that led to the recognition or reversal of impairment losses. In order to enhance users of financial statements to understand the reason for the recognition or reversal of impairment losses, the narrative information should be case-specific and closely related to the issuer's operation and activities. In addition, separate narrative information should be provided for each significant impairment loss recognized or reversed.

74. Issuers are reminded to disclose the basis used to determine the fair value less costs to sell (if recoverable amount is fair value less costs to sell) or the discount rate used in the estimation of value in use (if recoverable amount is value in use), which is required under paragraphs 130(f) and 130(g) of HKAS 36. Separate disclosure should be made for each significant impairment loss recognized or reversed. In addition, where there are changes in the basis used to determine the fair value less costs to sell or the discount rate used in the estimation of value in use, explanation justifying the changes should be provided.

Disclosures of the estimates used to measure of recoverable amounts of cash-generating units containing goodwill or intangible assets with indefinite useful lives under paragraph 134 of HKAS 36

Our observations

75. We observed that out of the 120 issuers, 71 issuers recorded goodwill as at the end of the reporting periods.

76. Out of these 71 issuers, around three-fourth of the issuers provided adequate disclosures in relation to goodwill (paragraphs 134 and 135 of HKAS 36).

77. The remaining one-fourth of the issuers provided inadequate disclosures and most of them omitted the disclosure required where the recoverable amount of cash-generating units is based on value in use (paragraph 134(d) of HKAS 36).

Our recommendations

78. We emphasize that the estimates used to measure of recoverable amounts of cash-generating units containing goodwill or intangible assets with indefinite useful lives should be disclosed under paragraph 134 of HKAS 36. Quality disclosure would enhance the confidence of users of financial statements in the assessment of recoverability of the cash-generating units containing goodwill or intangible assets with indefinite useful lives.

79. Issuers are reminded to provide the disclosure as set out in paragraph 134 of HKAS 36, in particular, paragraphs 134(d) and 134(e).

(a)	Description of key assumptions and management's approach to determine the values assigned to each key assumptions	− Key assumptions are those to which the cash-generating unit or group of cash-generating units' recoverable amount is most sensitive. Description of key assumptions and management's approach to determine the values assigned to each key assumptions should be entity-specific and related clearly to the issuer's activities. If various cash-generating units are of different characteristics or risk profile, separate disclosure should be made.
(b)	Period over which management has projected cash flows	− The period over which management has projected cash flows should be based on the financial budgets or forecast approved. If the period is over five years, disclosure of an explanation justifying the longer period is required. The explanation is expected to demonstrate how the projection exceeding five years is reliable and relevant.
(c)	Growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets or forecasts	− The growth rate should be determined based on the country/area and the business sector to which the cash-generating unit is related. The growth rate used must be realistic and not be too-optimistic. In addition, the growth rate should not exceed the long-term average growth rate for products, industry or countries. If a higher growth rate is applied, issuers should disclose the reason for using a higher growth rate. − For various cash-generating units of different characteristics or risk profile, growth rate used should be separately disclosed.

(d)	Discount rates	− Paragraph 55 of HKAS 36 states that the discount rate should be a pre-tax rate that reflects current market assessment of the time value of money and the risk specific to the asset for which the future cash flow estimates have not been adjusted. Appendix A of HKAS 36 provides additional guidance on estimating the discount rate.
		− For various cash-generating units of different characteristics or risk profile, the discount rates applied should be separately disclosed. Disclosure of a range of discount rates applied or the average discount rate does not provide meaningful and relevant information to users of financial statements.

Discussion on indications of asset impairment

Our observations

80. In the review this year, we identified some indications of asset impairment with reference to paragraph 12 of HKAS 36 and looked into issuer's annual reports to observe whether issuers provided relevant and meaningful discussion or information in relation to asset impairment. Our observations are set out below.

(a)	Decline of asset's market value	− We observed that one issuer mentioned that some assets' market value declined during the reporting period and recognized impairment with reference to the estimated sales value at reporting period end.
(b)	Negative changes in technology, markets, economy, or legal environment	− We observed that 73 issuers provided discussion on negative changes in technology, markets, economy, or legal environment in which the issuers operated in MD&A. However, most of the discussions were brief, generic and not entity-specific.
		− Few issuers provided specific and detailed discussions on negative changes in technology, markets, economy, or legal environment which resulted in recognition of impairment losses on assets. Examples included:-

- One issuer disclosed that there were technical problems of its electric plants as a result of the usage of coal of poor quality and hence recognized impairment losses.

- One issuer disclosed that impairment loss was recognized on certain land drill equipment due to the civil disorder in the area in which the equipment was located.

- One issuer recognized impairment losses on its mining rights due to diminishing demand and the downward pressure of market prices of magnesium products.

(c)	Effect from increase in interest rates	− We observed that two issuers mentioned that the interest rates applicable to their bank deposits and bank loans increased during the reporting period but did not discuss how the increase in interest rates affected the discount rates used in the calculation of assets' recoverable amounts. − Another one issuer stated that changes in discount rates used would affect the result of the impairment assessment of property, plant and equipment and provided a brief sensitivity analysis on the amount of impairment loss if the discount rate increased by 1%.
(d)	Carrying amount of net assets being larger than market capitalization	− We observed that 53 issuers' net asset values were larger than their market capitalization at the end of the reporting periods. Out of the 53 issuers, only two issuers mentioned in their annual reports that their market capitalization declined and were below their net asset value which was an indication of impairment and conducted impairment tests on their assets accordingly.
(e)	Obsolescence or physical damage of assets	− We observed that five issuers stated that they had assets which became obsolescent during the reporting periods and provided impairment losses on those assets.
(f)	Restructure plans or asset disposal plans	− We observed that eight issuers had plans to dispose certain assets or reclassified certain assets as held for sale and disclosed whether impairment was necessary on the assets to be disposed.

(g) Loss making for consecutive years − We observed that 18 issuers suffered losses for consecutive three years or more during the most recent five years' period. Out of the 18 issuers, seven issuers briefly explained the reasons for suffering losses for consecutive three years or more.

Our recommendations

81. 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. If any such indication exists, the entity should estimate the recoverable amount of an asset.

82. Paragraph 12 of HKAS 36 provides a non-exhaustive list of indications that an impairment loss may occur and issuers are reminded to consider, at a minimum, the indications listed in paragraph 12 of HKAS 36. Where any of the indications arise, issuers should carry out impairment tests on the related assets or cash-generating units accordingly. An entity may identify other indications that are not listed in paragraph 12 of HKAS 36 and in these cases an impairment review should be performed.

83. We emphasize the importance of providing adequate disclosure to enhance users of financial statements to understand the reasons that assets are impaired and how the recoverable amounts are determined. Issuers are reminded to comply with paragraph 130(a) of HKAS 36 to disclose the events and circumstances that led to the recognition or reversal of the impairment loss. The narrative information should be case-specific and entity-specific. In addition, for each significant impairment loss recognized or reversed, separate disclosure of the events and circumstances that led to the recognition or reversal of the impairment loss should be provided.

84. Issuers are reminded to be aware of the release of new or revised accounting standards. HKFRS 13 *"Fair Value Measurement"*, which was issued in June 2011 and has been effective for annual periods beginning on or after 1 January 2013, contains disclosure requirements in relation to fair value disclosures and also amendments to other accounting standards, including HKAS 36 (see Appendix D to HKFRS 13). In addition, amendments to HKAS 36 *"Amendments to HKAS 36 – Recoverable Amount Disclosures for Non-Financial Assets"* contain amendments to the disclosure requirements in HKAS 36 (see Appendix D to HKAS 36) and will become effective for annual periods beginning on or after 1 January 2014.

V. FINDINGS REGARDING INDUSTRY REVIEW THEME – ACCOUNTING BY POWER AND UTILITIES COMPANIES

85. In this year's review, we chose as the industry theme issuers whose major or principal activities included power and utilities businesses. Unless otherwise specified, HKFRS and their paragraph numbers referred to in this section correspond to those in IFRS.

86. The review focused on accounting and reporting issues of the industry including:-
    - Revenue recognition
    - Property, plant and equipment
    - Emission trading schemes and certified emission reductions
    - Decommissioning obligations and provisions
    - Service concession arrangements
    - Operational aspects

87. In total, annual reports of 18 issuers whose major or principal activities included power and utilities businesses were reviewed. The businesses cover generation of electricity, water supply, gas supply, provision of alternate energy and sewage treatment.

<u>Revenue recognition</u>

Our observations

88. The sale of power and utilities products and services is accounted for in accordance with HKAS 18 *"Revenue"*. An important consideration for power and utilities companies typically is whether revenue can meet the HKAS 18 criterion of being estimated reliably. Revenue estimations are important for many power and utilities issuers because meter readings do not necessarily coincide with reporting periods. Power and utilities issuers must develop models to estimate revenue within acceptable bounds of accuracy.

89. From our review, we noted all 18 power and utilities issuers have disclosed their revenue recognition accounting policy. However, only four issuers mentioned revenue estimation in the revenue recognition accounting policy. Below were some good examples with the basis of revenue estimation being set out in the financial reports of these issuers:-

    "on the basis of periodic cycle meter readings and include an estimated accrual for the value of the commodity consumed from the meter reading date to the end of the reporting period. The unbilled revenue is calculated at the end of the reporting period based on estimated daily consumption after the meter reading date to the end of the reporting period. Estimated daily consumption is derived using historical customer profiles adjusted for weather and other measurable factors affecting consumption."

"Determination of the revenue for the distribution and sale of water may include an estimation of the water supplied to customers for whom actual meter reading is not available. The estimation is done mainly based on the past consumption records and the recent consumption pattern of individual customers."

Our recommendations

90. We recommend that for users to better understand the financial statements, issuers should disclose more specific accounting policy on revenue recognition for each kind of revenue which is significant to the issuer. We would encourage issuers to enhance disclosure of revenue estimations and the basis they adopt in future financial statements as required under paragraph 125 of HKAS 1 (Revised). This estimate generally is based on historical consumption trends, seasonal and weather factors, actual generation for the period and existing tariff schedules.

Property, plant and equipment

Our observations

91. Property, plant and equipment were generally significant to the statement of financial position of power and utilities issuers. All the 18 power and utilities 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.

92. Regarding contributions from governments towards infrastructure and transmission facilities, such as government subsidies and government grants, seven power and utilities issuers received government contributions. These issuers recognized government subsidies and government grants towards property, plant and equipment separately as deferred income that was subsequently recognized as revenue on a systematic basis over the useful life of the related asset.

93. Regarding overhaul expenses, only one power and utilities issuer recorded overhaul expense which in substance, represented repairs and maintenance work on its power plants. The accounting policy disclosed that expenditure on overhauls, repairs and maintenance was charged to profit or loss as it was incurred and the amounts of overhaul expenses were separately shown under operating expenses in the consolidated statement of comprehensive income.

94. Regarding impairment on assets related to power and utilities activities, 12 issuers disclosed impairment indicators and some of these issuers recognized impairment on the assets related to power and utilities activities. Impairment indicators that were disclosed in the annual reports of these 12 issuers included the following types:-

- falling retail prices (e.g. suppressed electricity price, decline in unit price of certified emission reduction);

- rising fuel costs (e.g. increase in coal price);
- technological obsolescence and physical damage to assets (e.g. power generators were damaged or obsolete that ceased operation, encountered technical problems);
- regulatory changes (e.g. impact of national and international regulations, impact of the policy of energy saving and pollutant reduction); and
- performance of an asset or group of assets that is below that expected by management in operational and financial plans (e.g. poor performance of hydro power plants in China due to lower than average rainfall).

Our recommendations

95. In relation to property, plant and equipment, we recommend power and utilities issuers to enhance the disclosure on the accounting treatment of major overhaul expenses as overhaul shutdowns of facilities such as power stations may occur in the power and utilities industry, and are essential to ensure the efficient and safe running of plants. Major overhaul expenses would be recognized as part of the property, plant and equipment only if it meets the general asset recognition criteria under paragraph 7 of HKAS 16, while costs associated with routine repairs and maintenance are expensed as incurred. In addition, 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 Section IV "Findings regarding general accounting review theme – Impairment of assets".

<u>Emission trading schemes and certified emission reductions</u>

Our observations

96. HKFRS does not have any specific guidance on accounting for emission trading schemes and trading of certified emission reductions. The general requirements of HKFRS applied include HKAS 2, HKAS 20 *"Accounting for Government Grants and Disclosure of Government Assistance"* and HKAS 38.

97. From our review, we noted that six power and utilities issuers generated income from sales of Certified Emission Reductions ("CERs"). They disclosed the related accounting policy that revenue from sales of CERs was recognized when following conditions were met:-

    - the counterparties have committed to purchase the CERs;
    - the sales prices have been agreed and are fixed or could be reliably estimated; and
    - relevant electricity has been generated.

98. However, the initial recognition of CERs as to whether they were at a nominal amount or at market value was not disclosed.

Our recommendations

99. Issuers are reminded to provide clear accounting policy on the recognition and measurement of emission rights and CERs, in particular, initial recognition and measurement and the subsequent measurement of emission rights and CERs, revenue recognition from sales of emission rights and CERs and whether any expense is recognized.

Decommissioning obligations and provisions

Our observations

100. Decommissioning obligations and provisions are covered by HKAS 37 *"Provisions, Contingent Liabilities and Contingent Assets"*. The power and utilities industry can have a significant impact on the environment. Decommissioning or environmental restoration work at the end of the useful life of a plant or other installation may be required under the terms of operating licences, or an entity's stated policy and past practice, or by law. An entity that promises to remediate damage, even when there is no legal requirement, may have created a constructive obligation and thus a liability under relevant accounting standards.

101. From our review, power and utilities issuers generally did not mention whether there were any decommissioning obligations and provisions. Through enquiries with these issuers under review, two issuers explained that there were decommissioning requirements under current relevant laws and regulations governing the power and utilities activities that they engaged in but the estimated obligations were not material. The rest of the issuers explained that there were no specific and clear decommissioning requirements under current relevant laws and regulations governing the power and utilities activities that they engaged in.

Our recommendations

102. Issuers are highly recommended to identify whether there is any present or constructive obligation for decommissioning and site restoration which may be required by law, the terms of operating licences or regulatory requirements. The costs associated with the decommissioning or site restoration work can be significant and therefore recognition and measurement of such costs in the financial statements are critical. We recommend issuers to disclose clearly when the provision for decommissioning and site restoration is recognized and how the provision is estimated. Issuers are reminded that 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. Issuers are also reminded to reassess the estimates of the provisions regularly.

<u>Service concession arrangements</u>

Our observations

103. HK(IFRIC) Interpretation 12 *"Service Concession Arrangements"* gives guidance on the accounting by operators for public-to-private service concession arrangements. In relation to the recognition of the arrangement consideration within the scope of HK(IFRIC) Interpretation 12, paragraph 15 requires the operator to recognize the arrangement consideration either as a financial asset or an intangible asset. The operator shall recognize a financial asset to the extent that it has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor for the construction services. The operator shall recognize an intangible asset to the extent that it receives a right (a licence) to charge users of the public service.

104. There are seven power and utilities issuers under review had service concession arrangements. All of these issuers properly disclosed the accounting policy of service concession arrangements. They all recognized the concession rights as intangible assets where they had a right to charge the users of the public service and payments are contingent on usage. Two of these issuers recognized service concession receivables as financial assets where a contractual and unconditional right to receive specified or determinable amounts of cash from the grantor based on individual contract terms.

Our recommendations

105. Issuers should take note that there are two accounting models under HK(IFRIC) Interpretation 12 that an operator applies to recognize the rights received under a service concession arrangement, as financial asset or intangible asset, as explained in paragraph 103 above. The Illustrative Examples accompanying HK(IFRIC) Interpretation 12 provide some guidance on applying financial asset model or intangible asset model. In addition, paragraph 13 of HK(IFRIC) Interpretation 12 requires the operator to recognize and measure revenue and costs relating to constructions in accordance with HKAS 11 *"Construction Contracts"* and revenue and costs relating to operation of the infrastructure in accordance with HKAS 18. Issuers are reminded to provide clear accounting policy on how revenue from service concession arrangements are measured and recognized and provide the disclosure required by HK(SIC) Interpretation 29 *"Service Concession Arrangements: Disclosures"*.

Operational aspects

Our observations

106. From our review, we noted some power and utilities issuers disclosed operational information in their annual reports to enhance users' understanding of their core businesses and performances. Below were operational information disclosed in the annual reports of these issuers (list of items were not mutually exclusive):-

- nine issuers disclosed the applicable laws and regulations under which the industry was governed;
- seven issuers disclosed the price controls on their power and utilities businesses;
- eight issuers mentioned the terms of licenses for operating power and utilities activities;
- nine issuers mentioned safety, maintenance and environmentally related laws and regulations;
- 14 issuers disclosed areas serviced by power and utilities networks;
- 13 issuers disclosed plant generation and actual utilization;
- nine issuers disclosed network capacity and actual usage;
- five issuers disclosed environmental performance; and
- five issuers mentioned technological advancements or innovative business models, for example, renewable energy to cope with challenges.

Our recommendations

107. Issuers who engage in power and utilities industry are encouraged to disclose and discuss the effect on its operations by regulatory matters and government policy. Industry specific operational data are useful for users to understand the financial performance. Operational data on quality of services are useful to users of financial statements to evaluate the performance and future outlook of issuers. Some examples include frequency of network failures reported, compliance of rules and regulations governed the industry, grid congestion risk, climatic risk and industry and competition risk, etc.

108. We recommend that issuers should be aware of international development of financial reporting issues on rate-regulated entities. Rate regulation can have a significant impact on the timing and amount of an entity's revenue. Existing HKFRS/IFRS does not provide any specific guidance for rate regulated activities.

109. The European Financial Reporting Advisory Group and the IASB and the IFRS Interpretations Committee have received requests for guidance on whether rate-regulated entities can or should recognize, in their IFRS financial statements, the balances of "regulatory deferral (or variance) accounts", often called "regulatory assets" and "regulatory liabilities". In some types of rate-regulatory schemes, these regulatory deferral account balances arise because of timing differences between the recognition of various costs (or income) for the purposes of IFRS financial reporting and for the rate-setting mechanism.

110. In January 2014, the IASB published IFRS 14 *"Regulatory Deferral Accounts"*, which is effective for annual period beginning on or after 1 January 2016. We encourage issuers to monitor the development of this project and to carefully consider how their financial reporting of power and utilities businesses may be affected.

VI. FINDINGS REGARDING DISCLOSURE OF NON-IFRS/HKFRS FINANCIAL INFORMATION

111. As in the previous year, we performed a review on disclosure of non-IFRS/HKFRS financial information, based on a specifically designed programme.

Our observations

112. Our observations are set out below:-

(a)	Disclosure of non-IFRS/HKFRS financial information	− Out of the 120 cases, about one-fifth presented non-IFRS/HKFRS financial information in the MD&A and financial review/highlights in their annual or interim reports. − Most commonly presented non-IFRS/HKFRS financial information included earnings before interest, taxes, depreciation and amortisation ("EBITDA"), EBITDA margin (being EBITDA divided by revenue/turnover), adjusted EBITDA, adjusted EBITDA margin, underlying profit and adjusted net income.
(b)	Disclosure of the reason for disclosing non-IFRS/HKFRS financial information	− Only a few issuers provided a brief explanation on the purpose or reason for disclosing the non-IFRS/HKFRS financial information.
(c)	Presentation of non-IFRS/HKFRS financial information	− Most of the disclosure was clearly labelled and distinguished from the financial information prepared under accounting standards. − The disclosure of non-IFRS/HKFRS financial information was generally presented with no greater prominence when compared to the financial information prepared in accordance with accounting standards.
(d)	Disclosure of the calculation basis or formula of the non-IFRS/HKFRS financial information	− Most of these issuers disclosed the calculation basis or formula of the non-IFRS/HKFRS financial information and the calculation basis or formula was generally consistent with that used in prior years. − However, even though the non-IFRS/HKFRS financial information was named in the same terms, the calculation basis or formula varied between issuers.

(e) Disclosure of a reconciliation between non-IFRS/HKFRS financial information and IFRS/HKFRS financial information	− Only half of these issuers provided such reconciliation. − The adjusting items included, for example, depreciation and amortization on property, plant and equipment, unrealized fair value gain/losses, share of profit or loss of associates and jointly controlled entities. − However, there was no explanation of the reason why the directors believe the "adjustments" should be made.

Our recommendations

113. Issuers who choose to present non-IFRS/HKFRS financial information should ensure that the non-IFRS/HKFRS financial information reflects the critical components of the financial performance and are accurate. We emphasize that the adequate explanation of the definition of the non-IFRS/HKFRS financial information, how they are computed and what they are supposed to indicate should be elaborated so that users of financial statements would not be confused or misled. Further guidance is detailed in the section "Findings regarding Disclosure of Non-IFRS/HKFRS Financial Information" in the FSRP Report 2012 at http://www.hkex.com.hk/eng/rulesreg/listrules/guidref/Documents/frm-12.pdf.

VII. CONCLUSION

114. We encourage directors and other persons responsible for financial reporting to take note of the matters discussed in this report. It is the primary responsibility of the directors to prepare accurate and complete financial reports. In this regard, directors and other persons responsible for financial reporting should stay alert to changes to the Listing Rules, accounting standards and other disclosure requirements. It is important that issuers should consult their auditors and other external professional advisers for timely insights into any changes to the above requirements and the implications on their periodic financial reports. They should also review and regularly improve their existing financial reporting systems to ensure that information contained in financial reports provide entity specific, relevant and material information that will be useful in making investment decisions.

\- End -