June 2018

HKEX
香港交易所

FINANCIAL STATEMENTS REVIEW PROGRAMME REPORT 2017

CONTENTS

		Page No.
EXECUTIVE SUMMARY		1
I.	INTRODUCTION	3
II.	FINDINGS REGARDING THE LISTING RULES	5
III.	FINDINGS REGARDING ACCOUNTING STANDARDS	14
IV.	FINDINGS REGARDING GENERAL ACCOUNTING REVIEW THEME – DISCLOSURE OF POSSIBLE IMPACT OF APPLYING A NEW OR AMENDED HKFRS IN ISSUE BUT NOT YET EFFECTIVE	27
V.	FINDINGS REGARDING INDUSTRY REVIEW THEME – ACCOUNTING BY INDUSTRIAL ENGINEERING COMPANIES	31
VI.	FINDINGS REGARDING SPECIAL REVIEW THEME – NEW AUDITORS' REPORTING	37
VII.	CONCLUSION	44
APPENDIX A –	LIST OF ACCOUNTING AND INDUSTRY REVIEW THEMES IN PAST YEARS	45
APPENDIX B –	LINKS TO USEFUL GUIDANCE MATERIALS FROM THE EXCHANGE AND OTHER REGULATORS	46

EXECUTIVE SUMMARY

The Exchange has completed this year's Financial Statements Review Programme (the "FSRP") for compliance with the disclosure requirements of the Listing Rules, accounting standards and relevant disclosure requirements of the new Companies Ordinance (Cap. 622) (the "CO"). This is our ninth published report summarizing our key findings from the review of 100 reports comprising issuers' annual and interim reports.

Based on our review and issuers' responses to our enquiries, except for six cases which were referred to the Financial Reporting Council (the "FRC") and the Hong Kong Institute of Certified Public Accountants (the "HKICPA") for further enquiry and investigation of possible accounting and auditing irregularities, there were no significant breaches of the Listing Rules, accounting standards or relevant disclosures requirements of the CO that would render the financial statements misleading, require their restatement or warrant disciplinary action. Where disclosure was insufficient and not material to the financial statements as a whole, we obtained confirmations from issuers that the required information would be provided in future financial reports.

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

The review found several key areas in issuers' financial disclosures and related matters where there is room for improvement and special focus is required, where appropriate:

- ***Providing investors with a meaningful management commentary*** – The Management Discussion and Analysis ("MD&A") and Business Review should provide a meaningful commentary for the benefit of investors so that shareholders' value can be enhanced (see paragraphs 11 to 21). In addition to remaining mindful of what the previous report said about (i) *Adequate explanation of performance*; (ii) *Commentary on significant balances and transactions*; (iii) *Explanation of principal risks facing the businesses*; and (iv) *Using key performance indicators*, issuers should note the following in this report:

    - *Cyber risk and security*: Issuers should elaborate on how they have considered cyber risk and what discussions about cyber risk and security were held;

    - *Data fraud or theft*: Issuers should elaborate on how they have evaluated the internal controls in place to prevent critical information from being misused through data fraud or theft; and

    - *Environmental and social risks*: Issuers should consider carefully whether such risks are relevant and if they are, elaborate on how such risks affect their businesses across different segments and geographical locations.

- ***Judgements and estimates*** – Issuers should ensure that their management has held a thorough discussion each year with the Audit Committee and auditors, whereby the management explains the judgements of key assumptions underlying critical accounting estimates. This is because each judgement or estimate can significantly impact the key balances in an issuer's financial statements (see paragraphs 51 to 57);

- ***Assessing impairment of tangible and intangible assets (including goodwill)*** – Issuers should ascertain whether the processes for assessing impairment are sufficient and appropriate. Directors and management are responsible for performing proper analysis and exercising judgement to assess the reasonableness of key assumptions applied in impairment testing so that assumptions applied (such as growth rates and discount rates) are not overly optimistic, in particular, where issuers are loss-making or suffer material deterioration in revenue, net profits or gross profit margin. They should not rely solely on professional valuers or other experts without carrying out sufficient due diligence (see paragraphs 70 to 82);

- ***Accounting for acquisitions*** – Issuers should consider carefully after an acquisition whether the transaction constitutes a business combination or an asset acquisition. This is because the accounting treatments for a business combination and for an asset acquisition are very different. Moreover, issuers should ensure that all identifiable assets are properly identified and recognized so that goodwill or a gain on bargain purchase is accurately measured (see paragraphs 89 to 102);

- ***Impact of applying key HKFRSs in issue but not yet effective*** – Issuers should note that the two major standards, Hong Kong Financial Reporting Standard ("HKFRS") 9 *"Financial Instruments"* and HKFRS 15 *"Revenue from Contracts with Customers"* were already effective when they issued their annual reports for the year ended 31 December 2017 but did not apply to those reports. Nevertheless, issuers should have disclosed in those reports more entity-specific qualitative and quantitative information, such as the stage of implementation they are at; accounting policy choices expected to be applied by the management; and the amount and nature of expected impacts for financial statement line items affected. Issuers that have not yet done so should now consult their professional advisers and perform a detailed review of these key HKFRSs as they need to apply these standards in their next interim financial statements (see paragraphs 106 to 118); and

- ***New auditors' reporting*** – Issuers should communicate early with their auditors about which documents comprise the annual reports and will be within the scope of "Other Information", as defined by Hong Kong Standard on Auditing ("HKSA") 720 (Revised) *"The Auditor's Responsibilities Relating to Other Information"*. Issuers should ensure that such information is available to their auditors for consideration, so that the auditors can complete the necessary procedures required by HKSA 720 (Revised) prior to the date of the audit report and investors are kept fully informed (see paragraphs 174 to 180).

A financial report provides an opportunity for issuers to explain their performance, financial position and future prospects clearly to investors and enhance shareholders' value. Issuers should include "information that is relevant, material and entity-specific" and present them in an effective way; and should consider removing irrelevant and immaterial disclosures. Issuers should take note that financial reports and all other corporate communication should be accurate, complete and not misleading.

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 in the Listing Rules, accounting and auditing standards, and other relevant laws and regulations; and capitalize on opportunities to provide better disclosure. Directors should ensure that their finance department has the adequate resources and training to perform its role in financial reporting. The Audit Committee should stay focused on financial reporting integrity as part of its core oversight responsibilities.

I. INTRODUCTION

1. As part of the Exchange's regulatory function, the Listing Department operates a FSRP with a view to encouraging high standards of financial disclosure. We publish a report of key findings and recommendations from the FSRP annually. The objective is to increase issuers' awareness of the possible pitfalls in the preparation of periodic financial reports particularly in relation to compliance with the disclosure requirements of the Listing Rules, accounting standards [1] and relevant disclosure requirements of the CO so that issuers may learn from the experience of others and improve the quality of their future reports.

2. We adopt a risk-based approach in selecting issuers for the FSRP. The selection criteria are set out in the table below:

Criteria	Details
Impact	Cases where an instance of major non-compliance by an issuer might adversely affect the reputation of the Hong Kong equity market as a whole.
Probability	Cases where there is a possible higher risk of misstatement or misapplication of accounting standards due to the existence of certain features, including where an issuer: • experienced significant changes in its net assets; • was newly listed; • was the subject of complaints concerning compliance with the Listing Rules; • issued financial statements with a qualified or modified audit report; and/or • engaged a smaller accounting firm as the auditors.
Random	Cases are selected at random so that any issuer may be selected for review.
Industry	Accounting by industrial engineering companies.

3. We reviewed 100 reports released by issuers between February 2017 and April 2018. The number of issuers that we sent letters was 90 (2016: 81) which contained more than 540 enquiries or observations (2016: 260)[2]. Of all the cases reviewed during the period, 98 cases were subsequently closed after considering the responses received to our letters. Two cases remain outstanding, as we are awaiting further clarification and information from the relevant issuers. Based on our review and issuers' responses to our enquiries, we identified possible non-compliances with accounting and auditing standards in six cases and had referred five cases to the FRC and one case to the HKICPA.

---

[1] Applicable accounting standards include:
- HKFRSs issued by the HKICPA;
- International Financial Reporting Standards ("IFRSs") issued by the International Accounting Standards Board (the "IASB"); and
- China Accounting Standards for Business Enterprises ("CASBE") issued by the Ministry of Finance of the People's Republic of China, for those issuers incorporated in the Mainland ("PRC issuers") that have elected to adopt it.

[2] The increase in number of enquiries was primarily due to more questions were raised on significant balances relating to (i) impairment and valuation of assets; (ii) intangible assets including goodwill and intangible assets with indefinite useful life; (iii) nature of balances included in other operating expenses, other receivables and other payables; and (iv) recoverability of receivables and inventory utilization. In addition, enquiries were also raised on progress of assessing the impact of adopting new accounting standards in issue but not yet effective. Based on our review and issuers' responses to our enquiries, other than six cases which were referred to the FRC and the HKICPA for further enquiry and investigation of possible accounting and auditing irregularities, there were no significant issues identified.

4. This is our ninth published report. It highlights our key findings and recommendations relating to disclosures under the Listing Rules (Section II of this report) and accounting standards (Section III of this report), but does not include all the areas in which we raised comments or asked questions.

5. For each year's review, we include specific accounting and industry themes (and, where appropriate, topical issues). For this year, we selected:

   - as our accounting theme, "Disclosure of possible impact of applying a new or amended HKFRS in issue but not yet effective" (Section IV of this report);

   - as our industry review theme, "Issuers whose major or principal activities include industrial engineering businesses" (Section V of this report); and

   - as our special review theme, "New auditors' reporting" (Section VI of this report).

6. Details of accounting themes and industry review themes of our past reports are set out in Appendix A to this report. Links to our FSRP past reports and useful guidance materials from other regulators on the areas covered in this report are set out in Appendix B to this report.

7. This FSRP is separate from our Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance, which focuses on issuers' compliance with the Listing Rules and their disclosure of material events and developments.

8. Unless otherwise specified, the Rule references referred to in this report apply to both Main Board ("MB") Rules and GEM Rules. While the discussion in this report will focus on the MB Rules, the discussion applies equally to the GEM Rules.

9. Unless otherwise specified, HKFRSs and HKSAs and their paragraph numbers referred to in this report correspond to those in IFRSs and ISAs[3] respectively. Discussions in this report in relation to accounting and auditing standards are intended for general guidance only. Readers should read the full HKFRSs and HKSAs to fully understand the implications of HKFRSs and HKSAs.

[3] Being International Standards on Auditing ("ISAs") issued by the International Auditing and Assurance Standards Board.

II. FINDINGS REGARDING THE LISTING RULES

10. Appendix 16 *"Disclosure of Financial Information"* to the MB Rules ("Appendix 16") specifies a number of matters that issuers are required to disclose in their financial reports in addition to the disclosures required under accounting standards. This section sets out the most common omitted or incomplete disclosures we observed in this year's review, including:

- the management commentary;
- ageing analysis of accounts receivable and accounts payable;
- directors' emoluments;
- auditors' remuneration;
- distributable reserves; and
- financial reports using CASBE.

The management commentary

11. Paragraph 32 of Appendix 16 requires an issuer to include in its annual report a discussion and analysis of the group's performance during the financial year and the material factors underlying its results and financial position. The MD&A should emphasize trends and identify significant events or transactions during the financial year under review. Paragraph 32(1) to 32(12) of Appendix 16 sets out the minimum areas that should be covered in the MD&A.

12. Paragraph 28(2)(d) of Appendix 16 requires an issuer (whether or not it is incorporated in Hong Kong) to include a Business Review in accordance with Schedule 5 of the CO ("Schedule 5") in its directors' report.

Our findings

Minimum disclosure requirements under paragraph 32(1) to 32(12) of Appendix 16

13. During our review, we noted that there was a general improvement in this area. However, we continued to note that some issuers omitted the minimum required disclosures, in particular, significant investments held, their performance during the financial year and their future prospects, gearing ratio and the basis on which it was computed.

Business Review under Schedule 5 of the CO

14. In this year's review, we observed that:

- disclosures required by Schedule 5 appeared to be subsumed within the MD&A/other sections with most issuers showing an improvement in providing a cross-reference in the directors' report to the MD&A/other sections. However, there were some issuers that did not include such a cross-reference; or where a cross-reference to the MD&A/other sections had been included, the MD&A/other sections did not contain the information required by Schedule 5, in particular, principal risks and uncertainties facing the issuers;

- descriptions of principal risks and uncertainties facing the issuer tended to be generic rather than entity-specific; and

- key performance indicators ("KPIs") and non-HKFRS financial measures were sometimes used to discuss and analyze the performance, financial position and cash flows (such as "Earnings before interests, income tax, depreciation and amortization", return on equity and free cash flow), but the reasons why KPIs and non-HKFRS financial measures were used and reconciliations between KPIs/non-HKFRS financial measures and HKFRS financial information were not disclosed.

Significant balances and transactions

15. We still noted that significant events or material balances and transactions were not sufficiently disclosed and analyzed. We have identified cases where issuers:

- merely repeated the financial information available in the financial statements in narrative form without additional analysis and explanation in the MD&A;

- did not adequately discuss key items in the statement of profit or loss and other comprehensive income. For example, there was no further analysis of "Other expenses" that were significant; and

- did not adequately discuss key items in the statement of financial position. For example: there were no further analyses of "Other receivables" and "Other payables" that were significant; no explanations were provided on why deposits paid for the acquisition of major assets or businesses remained on the statement of financial position for over a year.

Our recommendations

16. The management commentary is receiving growing focus from investors and thus delivering a useful and effective narrative reporting is an opportunity for issuers to explain clearly to investors and enhance shareholders' value, as appropriate. It should provide the information necessary for investors to assess the issuer's performance, financial position and future prospects.

17. Issuers should consider all key aspects of performance, identify major components of growth or profit or reasons for incurring losses, and provide an adequate explanation of performance (such as elaborate on the underlying causes of the changes instead of only reciting the figures). Information disclosed in the MD&A should be relevant and material, prioritized appropriately and presented in a clear and simple manner[4]. We would like to reiterate that MD&A should:

   - be fair, balanced and understandable, such that both good and bad news are presented and reported clearly and evenly, without glossing over or omitting any material facts[5];
   - be focused and avoid obscuring material disclosures with unnecessary immaterial information[6]; and
   - be consistent with information disclosed elsewhere in the reports, particularly the information in the financial statements.

<u>Minimum disclosure requirements under paragraph 32(1) to 32(12) of Appendix 16 and Business Review under Schedule 5 of the CO</u>

18. Issuers should ensure that the minimum disclosure requirements under paragraph 32(1) to 32(12) of Appendix 16 are included in their annual reports, in particular, significant investments held, their performance during the financial year and their future prospects, gearing ratio and the basis on which it was computed.

19. Schedule 5 states that a directors' report for the year must "contain" a Business Review and issuers should ensure that the Business Review includes the information required by Schedule 5. When preparing the Business Review, issuers should consider the following points[7]:

   - *Cross-referencing* – Where issuers provide a cross-reference[8] in the directors' report to the MD&A or other sections, the cross-reference must be clear and it is stated that the cross-referenced part of the annual report "forms part of the directors' report". Issuers should ensure that the cross-referenced sections contain the disclosure required by Schedule 5.

---

4 Issuers are encouraged to read a case study report *"Better Communication in Financial Reporting – Making disclosures more meaningful"* published by the IASB in October 2017 to have insights on ways to improve communication in financial statements.

5 Issuers should take note of the requirement under MB Rule 2.13(2) such that any corporate communication (including financial reports) should be accurate, complete and not misleading.

6 In relation to financial statements, paragraphs 30A and 31 of HKAS 1 (Revised) *"Presentation of Financial Statements"* emphasize that an entity should not aggregate or disaggregate information in a manner that obscures material information.

7 For further guidance on the preparation of a Business Review, issuers may refer to: (i) the HKICPA Accounting Bulletin 5 *"Guidance for the Preparation and Presentation of a Business Review under the Hong Kong Companies Ordinance Cap. 622"*; and (ii) the Hong Kong Institute of Directors *"Clear and Concise: A Director's Guide to Writing the Business Review of an Annual Report"*.

8 According to the response to Question A8 in the HKICPA Q&A relating to the new Companies Ordinance (Cap. 622) – other than those relating to transition from the predecessor Ordinance (Cap. 32): Part A – Directors' report, the requirement to include a Business Review in the directors' report can be met by including a cross-reference in the directors' report to other sections of an annual report in which the information required by Schedule 5 is located.

- *Principal risks and uncertainties* – "Principal" risks and uncertainties are the risks and uncertainties that issuers are genuinely concerned about[9] (such as risks of non-compliance with relevant laws and legislation, foreign exchange exposure, concentration of customers, cyber security, environmental and social risk). Issuers are reminded that:

  - The disclosure should include a description of the principal risks, likelihood of the risks, potential impact on the issuer, how these risks are being managed and mitigated, why the assessment of principal risks changed (if any). The description should be clear, comprehensive and entity-specific.

  - When identifying the principal risks and uncertainties, directors should consider a broad range of circumstances, including the environment in which the issuers operate. For example:

    - *Cyber risk and security*: Issuers should elaborate on how they have considered cyber risk and what discussions about cyber risk and security were held;

    - *Data fraud or theft*: Issuers should elaborate on how they have evaluated the internal controls in place to prevent critical information from being misused through data fraud or theft; and

    - *Environmental and social risks (such as climate change and natural disasters, environmental regulations, outbreak of contagious diseases, staff attraction and retention)*: Issuers should consider carefully whether such risks are relevant and if they are, elaborate on how such risks affect their businesses across different segments and geographical locations.

- *KPIs* – Issuers that choose to present KPIs and non-HKFRS financial measures should ensure that they are not misleading; and neither obscure their financial results and financial position, nor provide an incomplete description of their financial results based on accounting standards[10]. When disclosing KPIs and non-HKFRS financial measures, issuers should:

  - define the KPIs and non-HKFRS financial measures clearly and give accurate and meaningful labels; and explain the reason for using the KPIs and non-HKFRS financial measures;

  - use KPIs and non-HKFRS financial measures in an unbiased way, so that they are not used to avoid presenting adverse information to the market;

  - avoid displaying KPIs and non-HKFRS financial measures with more prominence than the HKFRS measures;

---

[9] In section B of Appendix 1 to our guidance letter HKEX-GL86-16 (published in February 2016 and updated in May 2016, September 2016 and August 2017), when preparing listing documents, we recommend that the "Risk Factors" section should include all the material risks associated with investing in an applicant and its securities, and explain why these risks are material from investors' perspective. This guidance can also be applied to the Business Review in issuers' annual reports.

[10] For further guidance in providing clear and useful disclosure of KPIs and non-HKFRS financial measures, issuers are encouraged to read *"Statement on Non-GAAP Financial Measures"* which was issued by the International Organization of Securities Commissions ("IOSCO") in June 2016.

- reconcile the KPIs and non-HKFRS financial measures to the relevant comparable HKFRS measures in the financial statements and ensure that any adjustments are clearly explained; and

- present comparatives, disclosing KPIs and non-HKFRS financial measures consistently over time.

Significant balances and transactions

20. Where issuers have any balances or transactions reported in the financial statements that are unusual or material because of their nature, size or incidence[11], they should provide adequate information in the MD&A such that investors understand those balances and transactions. For example, issuers are suggested to include an analysis and explanation of the nature and fluctuation of balances in "other expenses", "other receivables" or "other payables", discuss the actions that have been taken to recover the deposits when the potential investment was delayed or terminated.

21. Issuers should assess materiality in the context of disclosure. Information is likely material if its omission or misstatement would likely influence or change the investment decision of a reasonable investor. Management's determination of materiality applies not only to financial statement disclosures but also to all information, qualitative and quantitative, disclosed in the MD&A.

Ageing analysis of accounts receivable and accounts payable

22. Paragraph 4(2) of Appendix 16 requires an issuer to disclose in its financial statements the ageing analyses of accounts receivable and accounts payable. Note 4.2 to paragraph 4 of Appendix 16 further requires disclosure of the basis on which the ageing analysis is presented and states that the ageing analysis should normally be presented on the basis of the date of the relevant invoice or demand note and categorized into time-bands based on analysis used by an issuer's management to monitor the issuer's financial position.

23. Certain disclosures as required by HKFRS 7 *"Financial Instruments: Disclosures"* are relevant to the evaluation of accounts receivable, including the policies for managing the credit risk (paragraph 33(b) of HKFRS 7) and analysis of accounts receivable that are past due but not impaired (paragraph 37(a) of HKFRS 7).

Our findings

24. During our review, we noted that some issuers omitted to disclose the basis upon which the ageing analyses of accounts receivable and accounts payable were presented (as required under Note 4.2 to paragraph 4 of Appendix 16).

25. Some issuers provided the description of the policies for managing credit risk which tended to be generic and some did not disclose the ageing analysis of accounts receivable that were past due but not impaired (as required under paragraph 37(a) of HKFRS 7).

[11] Issuers are reminded that paragraph 112(c) of HKAS 1 (Revised) requires that an entity should provide information which is relevant to an understanding of the financial statements by way of inclusion of necessary additional notes to the financial statements.

26. We also identified a few cases where the issuers experienced substantial increase in the accounts receivable balance or had significant accounts receivable that were past due but not impaired. However, those issuers did not adequately explain the fluctuations or reason why they had significant accounts receivable that were past due but no impairment was considered necessary.

Our recommendations

27. Issuers are reminded of the requirement of Note 4.2 to paragraph 4 of Appendix 16 to disclose in their financial statements the basis on which the ageing analyses of accounts receivable and accounts payable are presented.

28. We reiterate that the ageing analysis of accounts receivable as required by paragraph 4(2) of Appendix 16 and the analysis of the age of accounts receivable that are past due but not impaired as required under paragraph 37(a) of HKFRS 7 are separate and distinct. Paragraph 37(a) of HKFRS 7 requires an analysis of the age of accounts receivable that are past due[12] but not impaired, which would be based on the payment due date instead of the revenue recognition date. Issuers should ensure that both disclosures are included in their financial statements.

29. In order to communicate with investors on how management manages credit risk[13], issuers should provide entity-specific information and avoid generic boilerplate disclosures. We also encourage issuers to provide additional information in the MD&A or in the note to financial statements that enable investors to understand significant fluctuations in accounts receivable, for example, if extended credit policy is given to specific customers, subsequent settlement of accounts receivable, or actions taken or to be taken to recover accounts receivable that were past due for over one year.

<u>Directors' emoluments</u>

30. Paragraph 24 of Appendix 16 requires an issuer to disclose in its financial statements details of director's and past director's emoluments, by name.

Our findings

31. We continued to note that disclosures regarding directors' emoluments in the financial statements were sometimes incomplete. For example, in some cases, issuers:

- incorrectly aggregated "discretionary" bonuses to directors with the basic salaries and other allowances and benefits in kind;

- did not separately disclose the contributions to pension schemes for directors or past directors for the financial year; and

[12] The term "past due" is defined in Appendix A to HKFRS 7 as: *"A financial asset is past due when a counterparty has failed to make a payment when contractually due."*

[13] Paragraphs 33 to 38 of HKFRS 7 require both qualitative and quantitative disclosures about exposure to credit risk. HKFRS 7 also includes mandatory application guidance in paragraphs B6 to B10 and is accompanied by non-mandatory implementation guidance in paragraphs IG15 to IG29 to assist entities in applying and providing the disclosures required by HKFRS 7.

- did not provide an analysis of the remuneration of supervisors (in the case of a PRC issuer) by name or a chief executive (who is not a director).

Our recommendations

32. Issuers should ensure that they follow paragraph 24 of Appendix 16 to disclose directors' emoluments[14], including separate disclosure of contributions to pension schemes. In relation to bonus payments, issuers should note that different kinds of bonus payments are disclosed under different categories as below[15]:

Category	Bonus payment
Disclose under "Directors' basic salaries"	• bonus payments to which the directors are contractually entitled and are fixed in amount
Disclose under "Bonuses paid or receivable by directors" and the basis upon which the bonus are determined	• discretionary bonus payments • bonus payments to which the directors are contractually entitled but are not fixed in amount

33. Moreover, issuers are reminded of the following requirements:

- In the case of PRC issuers, "directors" and "past directors" include supervisors and past supervisors and issuers should include the remuneration of supervisors by name[16].

- "Directors" include a chief executive who is not a director and issuers should provide an analysis of the remuneration of their chief executive if he/she is not a director[17].

<u>Auditors' remuneration</u>

34. Paragraph 28(1)(b)(iv) of Appendix 16 requires issuers (whether or not it is incorporated in Hong Kong) to comply with Schedule 4 Part 2(1) of the CO, which requires disclosure of the amount of the remuneration of the auditors under a separate heading in the financial statements.

35. Section M of Appendix 14 to the MB Rules ("Appendix 14") requires issuers to include an analysis of remuneration in respect of audit and non-audit services provided by the auditors to the issuers in their corporate governance reports. The analysis must include, in respect of each significant non-audit service assignment, details of the nature of the services and the fees paid.

36. The purpose of these disclosures is to give some insight into the degree of independence of the auditors.

---

[14] Paragraph 28(1)(a) of Appendix 16 requires an issuer (whether or not it is incorporated in Hong Kong) to disclose directors' remuneration in financial statements as required by section 383 of the CO. HKICPA published in November 2017 Accounting Bulletin 3 (Revised) *"Guidance on Disclosure of Directors' Remuneration"*, which provides guidance in this area.

[15] Set out in notes 24.2 and 24.3 to paragraph 24 of Appendix 16.

[16] Set out in note 24.4 to paragraph 24 of Appendix 16.

[17] Set out in note 24.5 to paragraph 24 of Appendix 16.

Our findings

37. A few issuers that are incorporated outside Hong Kong did not disclose the auditors' remuneration in their financial statements as required by Schedule 4 Part 2(1) of the CO. We also observed that in some cases the amount of fees relating to audit services stated in corporate governance reports could not be reconciled to the related amount disclosed in the financial statements.

38. Most issuers provided the analysis of audit and non-audit fees in the corporate governance reports. However, in a few instances, the nature of non-audit services was not disclosed in the corporate governance reports where fees for non-audit services were relatively high as compared to the audit fee.

Our recommendations

39. Issuers are reminded to provide the disclosure in relation to auditors' remuneration required by Schedule 4 Part 2(1) of the CO and Section M of Appendix 14 in their annual reports. The analysis as required by Section M of Appendix 14 is different from the amount as required by the CO. Schedule 4 Part 2(1) of the CO requires the disclosure of the sum of audit fee and the related expenses associated with the audit of the financial statements but excluding amounts for non-audit services. If the details of auditors' remuneration in the corporate governance reports are different from information on audit fees disclosed in the financial statements, issuers should provide an explanation or a reconciliation.

40. In respect of each significant non-audit service (for example, fee for preparing an accountants' report for an investment circular), details of the nature of the service and the fee paid should be disclosed separately in the corporate governance reports. For any amount paid/payable not recognized in profit or loss, a separate disclosure is expected.

41. Code Provision C.3.3 of Appendix 14 emphasizes the need for the Audit Committee to play a key role in overseeing the audit process and in ensuring that the independence of the auditors is maintained. We encourage issuers to enhance their disclosures in annual reports where the auditors are engaged to perform significant non-audit services. For example, when describing the work performed by the Audit Committee in discharging its responsibilities, issuers should include an explanation of what significant non-audit work was undertaken by the auditors and why such services provided would not impair the auditors' independence. Moreover, issuers should have a policy in relation to non-audit services, and should disclose the policy in the corporate governance reports.

Distributable reserves

42. Paragraph 29 of Appendix 16 requires an issuer to provide a statement of the reserves available for distribution to shareholders as at the reporting date in its annual report.

Our findings

43. Some issuers omitted the disclosure of the statement of the reserves available for distribution to shareholders as at the reporting date.

Our recommendations

44. Issuers are reminded to disclose the amount of their distributable reserves as at the reporting date. For Hong Kong incorporated issuers, the amount should be calculated with reference to the requirements of sections 291, 297 and 299 of Part 6 *"Distribution of Profits and Assets"* of the CO. For issuers incorporated outside Hong Kong, the amount should be calculated in accordance with any statutory provisions applicable in the listed issuers' place of incorporation or, in the absence of such provisions, with generally accepted accounting principles.

45. Hong Kong incorporated issuers should read HKICPA Accounting Bulletin 4 *"Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Hong Kong Companies Ordinance"* ("AB 4") [18] which provides guidance on the determination of distributable profits. Issuers incorporated outside Hong Kong are also encouraged to read AB 4 for reference.

Financial reports using CASBE

46. 52 PRC issuers elected to prepare their financial statements for the year ended 31 December 2016 under CASBE (2015: 48). The Exchange, the FRC and the HKICPA have agreed to collaborate in reviewing the CASBE financial statements. Financial statements prepared under CASBE, like other published financial reports, are subject to selection and review under our FSRP.

Our findings

47. In this year's review, the Exchange selected and reviewed 14 sets of financial reports using CASBE. From the review, although some disclosures under the Listing Rules and/or CASBE were omitted, they were not material to the financial statements as a whole. The issuers confirmed that the required disclosures would be provided in their future annual reports.

Our recommendations

48. We would like to remind issuers using CASBE to ensure the disclosure requirements of both the Listing Rules and CASBE are met.

49. Pursuant to the Joint Declarations between the HKICPA, 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 the Mainland and Hong Kong. We encourage PRC issuers that elect to adopt CASBE to stay alert of the progress on convergence and work closely with their auditors.

[18] AB 4 was issued by the HKICPA in May 2010. As the requirements in distributable profits under the predecessor Companies Ordinance have been brought forward largely unchanged to the CO, the guidance in AB 4 continues to be applicable under the CO.

III. FINDINGS REGARDING ACCOUNTING STANDARDS

50. This section sets out the findings in relation to accounting standards arising from this year's review.

<u>HKAS 1 (Revised) "Presentation of Financial Statements"</u>

<u>Accounting policies, judgements and estimates</u>

51. HKAS 1 (Revised) requires an entity to disclose significant accounting policies and measurement basis used (paragraph 117 of HKAS 1 (Revised)), judgements made in applying the entity's accounting policies (paragraph 122 of HKAS 1 (Revised)) and assumptions about the future and other major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year (paragraph 125 of HKAS 1 (Revised)).

Our findings

52. From this year's review, we continued to note that in some issuers' financial statements:

- accounting policies tended to be generic and were extracted from accounting standards and illustrative financial statements; and

- critical accounting judgements were simply repeated or referred to the corresponding accounting policy without elaboration of the issuer's specific facts and circumstances.

Our recommendations

53. Disclosure of accounting policies enables investors to understand how the amounts presented in the financial statements were recognized and measured. Therefore, the accounting policies disclosed should be clear, understandable and sufficiently tailored to the entity's circumstances, as well as comply with the relevant accounting standards. Issuers are reminded to include accounting policies for all material transactions conducted in both current and comparative reporting periods. In addition, industry-specific accounting policies should be explained in plain language without the use of industry jargon.

54. Issuers should ensure that their management has held a thorough discussion each year with the Audit Committee and auditors, whereby the management explains the judgements of key assumptions underlying critical accounting estimates[19]. This is because each judgement or estimate can significantly impact the key balances in an issuer's financial statements.

[19] The International Ethics Standards Board for Accountants ("IESBA") issued a revamped *"International Code of Ethics for Professional Accountants (including International Independence Standards)"* in April 2018 (the HKICPA is expected to issue the corresponding pronouncement soon). It includes new and revised sections dedicated to professional accountants in business relating to preparing and presenting information (see Section 220 *"Preparation and Presentation of Information"*).

55. Issuers should disclose the judgements (other than estimates) that have the most significant effect on the amounts that they recognize in their financial statements. This enables investors to understand the basis in applying accounting standards, where management has to exercise judgements in situations where a different judgement might lead to a materially different accounting treatment (for example, whether an acquisition is a business combination or an acquisition of assets).

56. The assumptions and other major sources of estimation uncertainty to be disclosed should relate to the estimates that require management's most difficult, subjective or complex judgements that have a significant risk of resulting in material adjustments in the next financial year. These disclosures are intended to help investors understand these judgements and the extent of estimation uncertainty. Examples might include discounted cash flow projections, utilization of tax losses and measurement of defined benefit obligations.

57. Issuers should make sure that the judgements and estimates disclosed are clear and entity-specific and do not simply repeat their accounting policies, or use extracts of the text from accounting standards or illustrative financial statements.

<u>Waiver of amount due to holding company</u>

58. A capital contribution would arise from the waiver of a debt due to holding company in accordance with paragraph 4.25 of *"Conceptual Framework for Financial Reporting 2010"* and paragraphs 106(d)(iii) and 109 of HKAS 1 (Revised).

Our findings

59. From this year's review, we noted that one issuer recognized waivers of amounts due to holding company as gains in the statement of profit or loss and other comprehensive income in recent years which significantly reduced the issuer's net losses for those financial years. Based on the disclosure made, it appeared that such waivers should be recognized as a capital contribution.

Our recommendations

60. Issuers should note that changes in an entity's equity between the beginning and the end of the reporting period reflect the increase or decrease in its net assets during the period. Except for changes resulting from transactions with owners in their capacity as owners (such as equity contributions, reacquisitions of the entity's own equity instruments and dividends) and transaction costs directly related to such transactions, the overall change in equity during a period represents the total amount of income and expense, including gains and losses, generated by the entity's activities during that period (paragraphs 106(d) and 109 of HKAS 1 (Revised)).

61. Where an entity has an amount due to its shareholder, a liability should be recognized if there is any possibility of having to repay the amount. If there is no requirement to repay the amount under any circumstances and any repayment would be entirely at the discretion of the entity that receives the contribution, the economic substance will normally be a capital contribution.

62. If a shareholder forgives the debt, it is likely that the shareholder is acting in the capacity of a shareholder and that the forgiveness of debt should be treated as a capital transaction. The outstanding financial liability should be reclassified to equity and no gain or loss should be recognized. If there is clear evidence that the shareholder is acting as a lender, i.e. in the same way as an unrelated lender, a gain or loss should be recognized in profit or loss (with accompanying related party disclosures under HKAS 24 (Revised) *"Related Party Disclosures"*).

HKAS 18 "Revenue" / HKFRS 15 "Revenue from Contracts with Customers"

63. Revenue is an important number to investors in assessing an issuer's financial performance and position. HKAS 18 outlines the requirements for the recognition and measurement of revenue and is replaced by HKFRS 15 which is effective for accounting periods beginning on or after 1 January 2018.

Our findings

64. From this year's review, we noted a case where an issuer appeared to be acting as an agent under the sourcing and trading arrangements (without bearing inventory risk) as disclosed by the issuer and therefore should recognize revenue on a net basis. However, the issuer accounted for revenue on a gross basis as if it acted as a principal.

Our recommendations

65. In an agency relationship, amounts collected on behalf of and passed on to the principal are not revenue of the agent. Under HKAS 18, the revenue of the agent is the amount of commission, plus any other amounts charged by the agent to the principal or other parties; and the revenue of the principal is the gross amount charged to the ultimate customer (paragraph 8 of HKAS 18). Under HKFRS 15, the revenue of the agent is the amount of commission or fee earned for facilitating the transfer of the specified goods or services; and the revenue of the principal is the gross amount of consideration to which the entity expects to be entitled in exchange for the specified good or service transferred (paragraphs B35B and B36 of HKFRS 15).

66. Determining whether an entity is acting as an agent or principal is inherently judgmental. Indicators in relation to principal versus agent considerations under HKAS 18 and HKFRS 15 are summarized below:

HKFRS 15 paragraph B37	HKAS 18 Illustrative Example 21
Indicators that the entity is a <u>principal</u> include, but not limited to: • the entity is primarily responsible for fulfilment of the promise to provide the specified goods or service; • the entity has inventory risk; and • the entity has discretion in establishing prices.	Indicators that the entity is a <u>principal</u> include: • the entity has the primary responsibility for providing the goods or services to the customer or for fulfilling the order; • the entity has latitude in establishing prices, either directly or indirectly; • the entity bears the risk associated with inventory; and • the entity bears the credit risk.

67. Although the indicators in HKFRS 15 are similar to those in HKAS 18, the purpose of the indicators is different. The guidance in HKAS 18 focuses on assessing whether the entity has the risks and rewards of a principal. In contrast, HKFRS 15 requires an entity to assess whether it controls the specified good or service and the indicators are intended to support the control assessment. Therefore, issuers need to reassess their arrangements through the lens of the control principle.

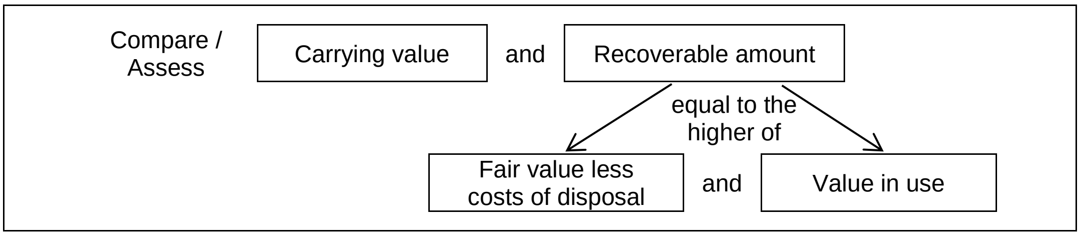
68. Under HKFRS 15, an entity determines whether the nature of its promise is a performance obligation to provide the specified goods or services itself (i.e. the entity is a principal), or to arrange for them to be provided by the other party (i.e. the entity is an agent). The entity should first identify the specified goods or services to be provided to the customer (which, for example, could be a right to a good or service to be provided by another party); and then assess whether it controls each specified good or service before that good or service is transferred to the customer (paragraphs B34 and B34A of HKFRS 15). If an entity obtains control of the specified good or service, more than momentarily, in advance of transferring those goods or services to the customer, the entity is acting as a principal (paragraph B35 of HKFRS 15). An entity is an agent if its performance obligation is to arrange for another party to provide the specified good or service (paragraph B36 of HKFRS 15).

69. Issuers should note that because an entity evaluates whether it is a principal or an agent for each specified good or service to be transferred to the customer, it is possible for the entity to be a principal for one or more specified goods or services and an agent for others in the same contract (paragraph B34 of HKFRS 15).

<u>HKAS 36 “Impairment of Assets”</u>

70. Investors continue to express concerns about impairment of assets in a volatile market. In this environment, robust impairment testing is critical.

71. HKAS 36 sets out the requirements to account for asset impairment. Impairment testing involves comparing the carrying amount of an asset with its recoverable amount, which is the higher of its fair value less costs of disposal and its value in use.



Our findings

72. We found in this year’s review that most issuers provided the disclosures required by HKAS 36. However, we still noted some areas that need further improvement in issuers’ financial statements, for example:

- the explanations of the events and circumstances that led to the recognition and reversal of impairment losses tended to be short and generic or were omitted (paragraph 130(a) of HKAS 36);

- key assumptions on which management based its cash flow projections for the period covered by the most recent budgets/forecasts or its determination of fair value less costs of disposal were not clearly described and the description of management's approach to determining the values assigned to each key assumption was brief or omitted (paragraphs 134(d)(i), 134(d)(ii), 134(e)(i) and 134(e)(ii) of HKAS 36); and

- a few issuers omitted the disclosure of growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts and the discount rate applied to cash flow projections (paragraphs 134(d)(iv), 134(d)(v), 134(e)(iv) and 134(e)(v) of HKAS 36).

73. We also noted some cases where revenue growth rates and other assumptions (such as profit margin) used in the calculation of recoverable amounts may not be reasonable and supportable when compared with their financial performance, such as loss-making or suffering deterioration in revenue, net profits or gross profit margin.

Our recommendations

74. Issuers should ascertain the need and adequacy of asset impairment testing and ensure assets are carried at no more than their recoverable amounts in accordance with the requirements in HKAS 36. Impairment testing is required:

- at each reporting date for an asset or cash-generating unit when there is an indication of possible impairment (a triggering event) (paragraph 9 of HKAS 36). For this purpose, issuers should consider, at a minimum, the non-exhaustive list of indications of impairment set out in paragraph 12 of HKAS 36; and

- annually for the following assets, regardless of whether there is a triggering event (paragraph 10 of HKAS 36):

  - intangible assets with an indefinite useful life;

  - intangible assets not yet available for use; and

  - cash-generating units to which goodwill has been allocated.

75. One of the indications of impairment is when the carrying amount of the reporting entity's net assets is more than its market capitalization (paragraph 12(d) of HKAS 36). Issuers are reminded to compare their net assets with their market capitalization in order to ascertain whether further impairment testing is considered necessary.

76. HKAS 36 requires extensive disclosures in respect of the impairment tests performed and impairments recognized. When an impairment loss is recognized or reversed, issuers should provide the disclosures required by paragraph 130 of HKAS 36. In particular, issuers are reminded to explain the events and circumstances that led to the recognition or reversal of the impairment loss (paragraph 130(a) of HKAS 36). The narrative information should be case-specific and closely related to the issuer's operations and activities. Issuers should also disclose the recoverable amount of the impaired asset or the cash-generating unit and whether the recoverable amount is its fair value less costs of disposal or value

in use (paragraph 130(e) of HKAS 36), together with the corresponding information required (paragraphs 130(f) and 130(g) of HKAS 36).

77. In addition, for each cash-generating unit for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that cash-generating unit is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, issuers should provide the information required by paragraph 134 of HKAS 36, in particular:

- whether the cash-generating unit's recoverable amount is determined based on value in use or fair value less costs of disposal;
- key assumptions applied to estimate the recoverable amount and how they are determined;
- the period over which management has projected cash flows based on financial budgets/forecasts approved by management and reason why a period greater than five years is used;
- growth rate used to extrapolate cash flow projections;
- discount rate applied to cash flow projections; and
- if a reasonably possible change in a key assumption would cause the cash-generating unit's carrying amount to exceed its recoverable amount, the information required by paragraph 134(f) of HKAS 36 should be disclosed so that investors can understand what the magnitude of change in values of key assumptions is used in impairment testing that would cause the carrying amount of the cash-generating unit to exceed the recoverable amount (i.e. how imminent is a possible impairment loss).

Where there is a change in the basis of calculation of the recoverable amount, issuers are encouraged to disclose the details of the change together with the reasons for the change.

78. Assumptions used should be reasonable and supportable, and represent their best estimate of the economic circumstances that will prevail over the remaining life of the asset or the cash-generating unit (paragraph 33(a) of HKAS 36). Assumptions should not be overly optimistic with regard to historical cash flows and results, particularly where issuers are loss-making or suffer deterioration in revenue, net profit or gross profit margin. The growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts should be a steady or declining rate and should not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified (paragraph 33(c) of HKAS 36).

79. The discount rate should be a pre-tax rate that reflects current market assessment of the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted (paragraph 55 of HKAS 36). Paragraphs A15 to A21 of HKAS 36 provide further guidance in estimating the discount rate.

80. Directors and the Audit Committee should question the need for, and adequacy of, asset impairment; ascertain whether the processes for assessing impairment are sufficient and appropriate; and assess the reasonableness of the assumptions used in impairment testing.

81. In addition, directors should critically assess and ensure that management and staff responsible for financial reporting has sufficient qualifications, experience, expertise and time to perform impairment testing and consider the need for engaging external experts, such as professional valuers.

82. Where impairment testing is performed with involvement of professional valuers, directors and management should perform proper analysis and assess the reasonableness of key assumptions applied and should not leave the responsibility solely to professional valuers or other experts. It is unreasonable for directors and management to rely on valuation reports without exercising any independent judgement in assessing the reasonableness of key assumptions used[20].

HKAS 39 "Financial Instruments: Recognition and Measurement" / HKFRS 9 "Financial Instruments"

Financial liabilities measured at amortized cost

83. HKAS 39 outlines the requirements for the recognition and measurement of financial liabilities and is replaced by HKFRS 9 which is effective for accounting periods beginning on or after 1 January 2018.

Our findings

84. From this year's review, we noted a case that for certain loans and payables which were interest-free and repayable over one year, their carrying amounts at initial recognition were the same as the contractual undiscounted amounts. This casted doubt on whether the issuer recognized the carrying amounts at fair value initially and measured them at amortized cost subsequently, as required by HKAS 39.

Our recommendations

85. On initial recognition, a financial liability is measured at fair value minus directly attributable transaction costs, unless the financial liability is classified as at fair value through profit or loss (paragraph 43 of HKAS 39). Subsequent to initial measurement, financial liabilities, other than those that are designated as at fair value through profit or loss upon initial recognition and held for trading, are measured at amortized cost calculated using the effective interest method (paragraph 47 of HKAS 39).

86. HKFRS 9 largely retains the existing requirement in HKAS 39 for the classification of financial liabilities. Under HKFRS 9, all financial liabilities are initially recognized at fair value, minus (in the case of a financial liability that is not at fair value through profit or loss) transaction costs that are directly attributable to the issue of the financial liability (paragraph 5.1.1 of HKFRS 9).

[20] Issuers should read a guidance note regarding valuations in corporate transactions issued by the Securities and Futures Commission ("SFC") in May 2017.

87. After initial recognition, an entity should classify all financial liabilities as subsequently measured at amortized cost using the effective interest method, except for:

- financial liabilities at fair value through profit or loss;
- financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies;
- financial guarantee contracts;
- commitments to provide a loan at a below-market interest rate; and
- contingent consideration recognized by an acquirer in a business combination to which HKFRS 3 (Revised) *"Business Combinations"* applies (paragraph 4.2.1 of HKFRS 9).

88. When recognizing financial liabilities which are subsequently measured at amortized cost, issuers should follow these requirements to consider whether the effect of discounting is material.

<u>HKFRS 3 (Revised) "Business Combinations"</u>

89. A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses. HKFRS 3 (Revised) sets out the principles on the recognition and measurement of acquired assets and liabilities, the determination of goodwill and the necessary disclosures.

Our findings

90. From this year's review, some issuers had completed acquisitions of businesses. We noted a few cases where there were doubts on whether the acquisition was a business combination or an acquisition of assets. In some other cases, significant goodwill was recognized which casted doubts on whether all identifiable assets that existed at the acquisition date had been properly identified and recognized separately from goodwill.

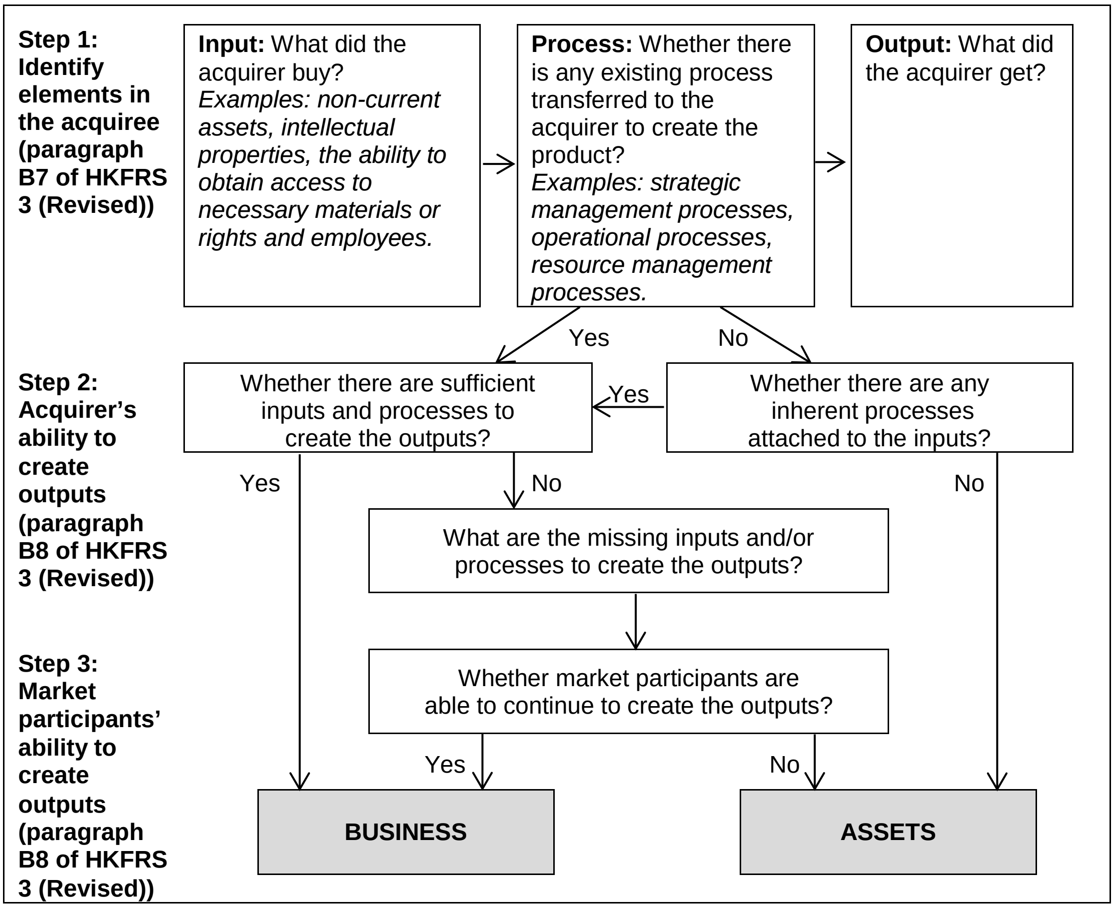
91. A few issuers omitted certain information as required by HKFRS 3 (Revised), such as a qualitative description of the factors that make up the goodwill recognized or the reasons why the business combination results in a gain on bargain purchase, the amounts of revenue and profit or loss of the acquiree since the acquisition date and the revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period.

Our recommendations

Whether an acquisition is a business combination

92. When issuers complete an acquisition, they should determine whether the transaction or event is a business combination. For a transaction or event to be a business combination, the activities and assets over which the acquirer has obtained control is required to constitute a business[21] (paragraph 3 of HKFRS 3 (Revised)). Issuers should follow the application guidance in paragraphs B5 to B12 of HKFRS 3 (Revised) in this area.

93. The chart below assists issuers in determining whether an acquisition is a business combination or an acquisition of assets.



94. If the transaction is determined as a business combination, issuers should account for it by applying the acquisition method (paragraph 4 of HKFRS 3 (Revised)). If an issuer acquires an asset or a group of assets (including any liabilities assumed) that does not constitute a business, the transaction is outside the scope of HKFRS 3 (Revised) and should be accounted for as an asset acquisition (paragraphs 2(b) and 3 of HKFRS 3 (Revised)). The key differences in accounting requirements to note are set out below:

[21] In June 2016, the IASB proposed amendments to IFRS 3 *"Business Combinations"* to provide clearer application guidance to help distinguish between a business and a group of assets when applying IFRS 3. Issuers should closely monitor the development of the proposed amendments.

	Business combination	Acquisition of an asset
Applicable HKFRS	HKFRS 3 (Revised).	HKAS 2 *"Inventories"*, HKAS 16 *"Property, Plant and Equipment"*, HKAS 38 *"Intangible Assets"*, HKAS 40 *"Investment Property"*, etc.
Goodwill / gain on bargain purchase	Recognized.	Not recognized.
Initial measurement of assets and liabilities	At their fair value.	Assets and liabilities acquired are assigned a carrying amount based on relative fair value.
Transaction costs	Expensed.	Capitalized.
Deferred taxes	Deferred tax assets and liabilities arise if tax base is different from the accounting base.	No deferred tax assets and liabilities arise if the tax base is different from the accounting base (initial recognition exemption in paragraphs 15(b) and 24 of HKAS 12 *"Income Taxes"*).
Contingent liabilities assumed	Recognized if represents present obligation that arises from past events and its fair value can be measured reliably, with subsequent changes to profit or loss.	Not recognized; subject to HKAS 37 *"Provisions, Contingent Liabilities and Contingent Assets"*.
Contingent consideration	Recorded at fair value on the date of acquisition. Subsequent changes in the fair value of contingent consideration not classified as equity are recorded in profit or loss until settled.	Generally recorded at fair value on the date of purchase. An accounting policy election could be made to record the subsequent changes in fair value against the asset's cost (HKAS 16) or in profit or loss (HKAS 39).

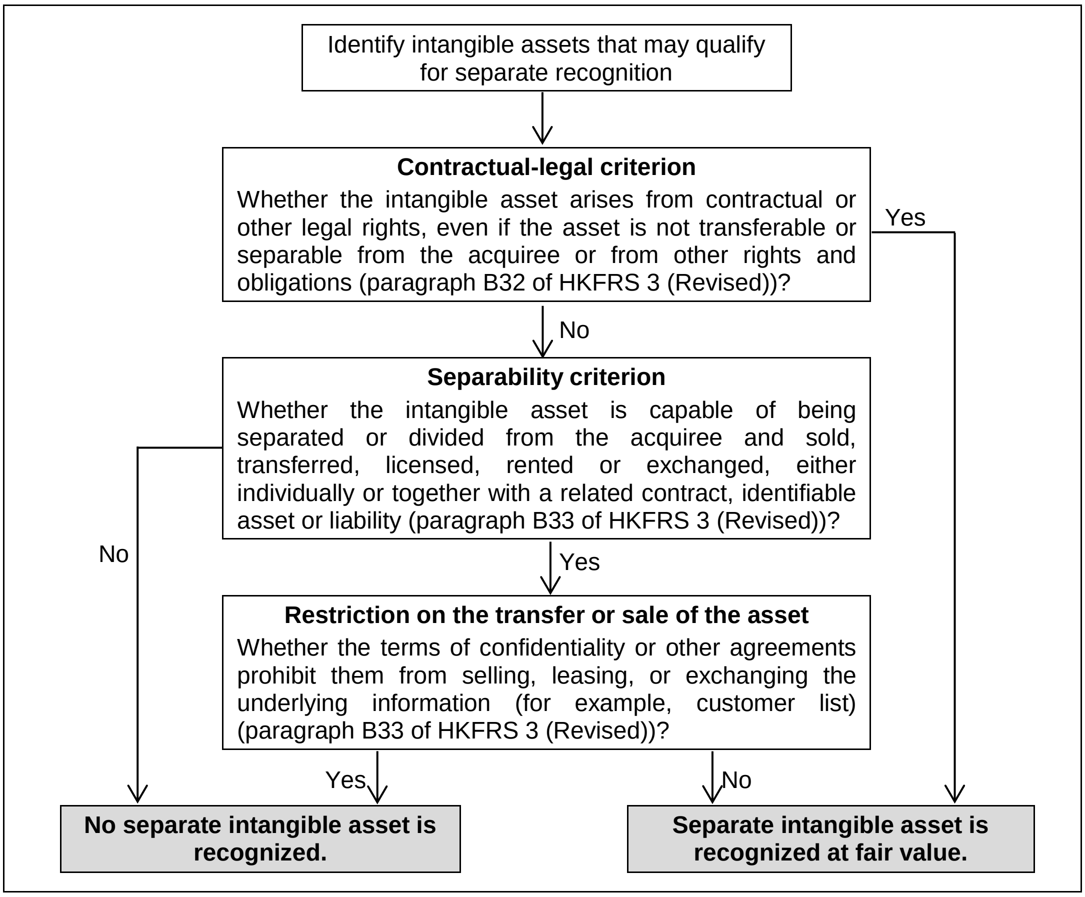
95. For investors to better understand the transaction, issuers should disclose the judgement applied in determining the transaction is a business combination or an asset acquisition (paragraph 122 of HKAS 1 (Revised)).

<u>Identification and recognition of all identifiable assets that exist at the acquisition date separately from goodwill</u>

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

97. Paragraphs B28 to B40 of HKFRS 3 (Revised) provide application guidance on identifying and recognizing assets that are not previously recognized by the acquiree and Illustrative Examples 16 to 44 of HKFRS 3 (Revised) provide examples of identifiable intangible assets acquired in a business combination. Issuers having a business combination should read these application guidance and illustrative examples to identify and recognize all identifiable intangible assets acquired.

98. The chart below assists issuers in identifying intangible assets that may qualify for separate recognition.



99. Goodwill is recognized and is measured at the date of acquisition as the excess of (a) over (b):

(a) the aggregate of:

(i) the consideration transferred measured, which generally requires acquisition-date fair value;

(ii) the amount of any non-controlling interest in the acquiree; and

(iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

(b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed (paragraph 32 of HKFRS 3 (Revised)).

A gain on a bargain purchase arises when (b) is greater than (a).

100. As a result, before recognizing a significant amount of goodwill or a gain on bargain purchase, issuers should reassess whether they have correctly identified all of the assets acquired and the liabilities assumed. In addition, issuers should also reassess whether they have correctly identified any non-controlling interests in the acquiree, any previously held equity interest in the acquiree, and the consideration transferred.

101. Issuers are reminded to disclose the factors that make up the goodwill recognized and explain the reasons why the business combination results in a gain on bargain purchase (paragraphs B64(e) and B64(n) of HKFRS 3 (Revised)). In addition, issuers are reminded of the requirement to disclose the amounts of revenue and profit or loss of the acquiree since the acquisition date and the revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period (paragraph B64(q) of HKFRS 3 (Revised)).

102. The HKICPA published *"Annual Improvements to HKFRSs 2015-2017 Cycle"* in February 2018. It includes amendments to HKFRS 3 (Revised) and HKFRS 11 *"Joint Arrangements"*, which will be effective for annual periods beginning on or after 1 January 2019. The amendments clarify how an entity accounts for increasing its interest in a joint operation that meets the definition of a business.

Should an entity remeasure its previously held interest after increasing its interest?		
Entity's interest in joint operation		**Remeasure previously held interest at fair value?**
Before transaction	**After transaction**	
Party to joint operation	Obtain joint control	No
Joint control	Maintain joint control	No*
Party to joint operation	Obtain control	Yes
Joint control	Obtain control	Yes

* Existing requirement under paragraph B33C of HKFRS 11

Cooperation with other regulators

103. In addition to the Exchange, the FRC and the HKICPA also undertake a continuous review of issuers' published financial statements. However, the focuses of the reviews are different. The Exchange's FSRP focuses on compliance with the Listing Rules and accounting standards and our feedback is addressed to, and attempt to help, issuers. The FRC's programme places greater emphasis on the detection of auditing irregularities, while the HKICPA's professional standards monitoring ("PSM") programme focuses on accounting standards and monitoring the quality of the work of listed companies' auditors. Under our memorandums of understanding ("MOUs") 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[22].

104. Pursuant to the MOUs, from this year's review under our programme, we identified possible non-compliances with accounting and auditing standards in six cases (2016: three cases) and had referred five of them to the FRC and one to the HKICPA. Moreover, through other related work at the Exchange, we referred two cases to the FRC.

[22] Links to the FRC website and HKICPA PSM programme are set out in Appendix B to this report.

105. On 22 November 2017, we held a joint financial reporting forum together with the FRC and the HKICPA. The representatives of the three bodies shared the significant observations identified from reviews of financial statements of listed companies. The financial reporting forum is held annually since 2011. A webcast of the event is available on the HKICPA's website.

IV. FINDINGS REGARDING GENERAL ACCOUNTING REVIEW THEME – DISCLOSURE OF POSSIBLE IMPACT OF APPLYING A NEW OR AMENDED HKFRS IN ISSUE BUT NOT YET EFFECTIVE

106. The specific accounting standards theme selected for this year's FSRP was compliance with the disclosure requirements in relation to the possible impact of applying a new or amended HKFRS in issue but not yet effective under HKAS 8 *"Accounting Policies, Changes in Accounting Estimates and Errors"*.

107. The three major new HKFRSs which have been issued by the HKICPA and have become or will soon become effective. They are:

HKFRS	Effective for annual periods beginning on or after
HKFRS 9 *"Financial Instruments"* (issued in September 2014)	1 January 2018
HKFRS 15 *"Revenue from Contracts with Customers"* (issued in July 2014)	1 January 2018
HKFRS 16 *"Leases"* (issued in May 2016)	1 January 2019

108. Paragraph 30 of HKAS 8 requires that when an entity has not applied a new or amended HKFRS in issue but is not yet effective, it should disclose this fact and *"known or reasonably estimable information relevant to assessing the possible impact that application of the new HKFRS will have on the entity's financial statements in the period of initial application."*

109. Our review focused on the level of detail disclosed in annual reports in accordance with disclosure requirements in paragraph 30 of HKAS 8, and whether the issuers had provided entity-specific information to investors.

Our findings

110. In relation to the disclosure pursuant to paragraph 30 (and guidance in paragraph 31) of HKAS 8, we noted from our review that:

- most of the issuers disclosed a full list of HKFRSs that have been issued but are not yet effective and the fact that they had not yet applied those HKFRSs; and

- some issuers disclosed a list of selected HKFRSs issued but not yet effective that they considered relevant to their financial statements, with few of these issuers stating the impact of other HKFRSs not in the list was not expected to have a material impact on their financial statements.

111. Many issuers under review stated that they were still assessing the impact of these three major new standards upon initial application and it was not practicable to provide a reasonable estimate of the effect, in particular for HKFRS 16. Many issuers managed to provide a brief description of these standards. When describing the possible impacts of HKFRS 16, some issuers cross referenced to the note on operating leases commitments.

112. As the annual reports for the year ended 31 December 2017 were published after HKFRS 9 and HKFRS 15 have become effective, we selected and reviewed some annual reports for the year ended 31 December 2017 which were expected to be affected by HKFRS 9 and HKFRS 15. While we observed that a few issuers were still *"assessing the impact of the new standards"* (see paragraph 111 above), some other issuers have enhanced the disclosure by providing entity-specific qualitative and quantitative information arising from the initial application of these major new standards, which was an improvement from last year. Below are some examples:

- provided the information about the accounting policy choices that are to be taken upon initial application of the new standards;
- provided quantitative assessment of the impact of HKFRS 9 and HKFRS 15 on the financial statements as of 1 January 2018;
- highlighted that the new expected credit loss model under HKFRS 9 may result in early provision of credit loss in relation to the Group's financial assets measured at amortized cost; and
- commenced work on the designing and building of models, systems, processes and controls related to the implementation of the new standards.

Our recommendations

113. The HKICPA Alert Issue 24 published in December 2016 states that information about the estimated impact of new and amended standards should become more accurate closer to the effective date. Issuers should avoid generic boilerplate disclosures and provide more tailored and granular information on the impact of new or amended HKFRSs.

114. HKFRS 9 and HKFRS 15 are effective for annual periods beginning on or after 1 January 2018. Impacts of the initial application of HKFRS 9 and HKFRS 15 should be reasonably estimable when issuers prepared and published their annual reports for the year ended 31 December 2017. Issuers that are significantly impacted by HKFRS 9 and HKFRS 15 should have disclosed the following information:

- the fact that they have substantially completed their implementation analyses and stage of implementation they are at;
- the accounting policy choices expected to be applied by the management, including those relating to the transition approach and the use of practical expedients, if any; and

- the amount and nature of the expected impacts for financial statement line items affected.

The above recommendations are in line with those expected by other regulators[23].

115. At the issuers' next reporting period, i.e. year ending 31 December 2018, when describing the application of HKFRS 16 which will be effective for annual periods beginning on or after 1 January 2019, issuers are recommended to follow the abovementioned approach of HKFRS 9 and HKFRS 15 to progressively provide more entity-specific qualitative and quantitative information.

116. Issuers are also reminded that implementation of new standards is not just an accounting exercise, but is expected to have a significant impact on some issuers, particularly on their information systems, internal controls and business contracting processes. For example, issuers which are involved in leasing of major assets should consider whether the change in accounting models arising from the implementation of HKFRS 16 may affect key performance ratios, debt covenants and structure or pricing of transactions.

117. Issuers with a financial year-end date of 31 December are required to apply HKFRS 9 and HKFRS 15 in their interim financial statements for the six-month period to 30 June 2018. Where the application involves a change of accounting policy, the nature and effect of the change should be disclosed (paragraph 16A(a) of HKAS 34 *"Interim Financial Reporting"*). In this regard, we recommend:

- any key judgements made by management in applying the new requirements under HKFRS 9 and HKFRS 15 to be clearly provided;
- quantitative disclosure with informative and detailed explanation of the changes, tailored to the issuers' specific circumstances and transactions;
- an explanation on how the transition has been implemented, after careful consideration of the transitional disclosure requirements under these new standards and the requirements of HKAS 8; and
- issuers should ensure that the application and implementation of these standards are in accordance with the accounting requirements. To avoid unintended errors due to inappropriate application of the new standards, they are encouraged to early consult their auditors. In particular they should consider whether a review of the interim financial statements should be carried out by their auditors.

[23] European Securities and Markets Authority ("ESMA") published *"European common enforcement priorities for 2017 IFRS financial statements"* in October 2017.

118. As mentioned in our previous year report, we would like to reiterate that where issuers discuss the possible impact of HKFRSs, they should consider providing a complete list of HKFRSs and discussing their impact on the financial statements to reduce the risk of overlooking any new HKFRSs. To fulfil the objective of paragraph 31(b) of HKAS 8, i.e. disclosing *"the nature of the impending change or changes in accounting policy"*, issuers should:

- avoid boilerplate disclosures;
- not merely repeat the requirements of the new standards; and
- disclose an entity-specific description of the changes introduced by the new standards.

V. FINDINGS REGARDING INDUSTRY REVIEW THEME – ACCOUNTING BY INDUSTRIAL ENGINEERING COMPANIES

119. For this year's FSRP, we selected as the industry theme issuers whose major or principal activities include industrial engineering business.

120. The review focused on accounting and reporting issues of the industry including:

- revenue recognition;
- property, plant and equipment;
- inventories; and
- research and development.

121. We reviewed the annual reports of 22 issuers whose major or principal activities include industrial engineering business. These issuers engaged in the manufacturing and sales of industrial and engineering products, such as electric vehicles, construction equipment, electrical and power-generating equipment and industrial machineries.

122. Where potential non-compliance was noted, we raised enquiries with the issuers involved. In each case, the issuers confirmed that improvements would be made and the required disclosures would be provided in their future financial reports. We did not note any significant non-compliance amongst the issuers reviewed.

123. We noted certain areas of disclosure where there was room for improvement. Our key findings and recommendations are set out below.

Revenue recognition

124. The revenue from industrial engineering business is accounted for in accordance with HKAS 18. Revenue is measured at the fair value of the consideration received or receivable for the sales of goods in the industrial engineering business. It is recognized on the transfer of risks and rewards of ownership, which generally coincides with the point of time when the manufactured goods are shipped or delivered to the customer. Revenue is shown net of value-added tax, returns, rebates and discounts.

125. It is worth noting that under HKFRS 15, an issuer recognizes revenue when it transfers control over a product or service to a customer. The timing of revenue recognition could change under HKFRS 15 as the focus shifts from transfer of risks and rewards to the transfer of control of the goods.

Our findings

126. We found that the industrial engineering issuers under review separately disclosed the revenue generated from their businesses and the accounting policy adopted for revenue recognition for each major type of revenue. All of the 22 issuers under review disclosed that revenue from the sales of goods was usually recognized on transfer of risk and rewards of ownership which was at the time when the goods were delivered and title has been passed to the customer.

127. Offer of discounts and sales rebates and provision of warranties are common in industrial engineering sector. We found that around half of the 22 issuers under review stated in their annual reports that revenue is recognized after discounts. However, no disclosure of details of discounts and sales rebates and no separate accounting policy for discounts and sales rebates were provided in the financial statements. In addition, a few of these 22 issuers recognized provision for warranties and disclosed that warranties were estimated and provided for at the time of sale based on past experience. Among these issuers, one of them did not provide the separate accounting policy for warranties in the financial statements.

Our recommendations

128. For investors to better understand the financial statements, issuers should disclose more specific accounting policy on revenue recognition. It is expected that the transfer of significant risks and rewards of ownership of goods would be physical delivery of goods or transfer of legal title of goods to the customer. We encourage issuers to enhance disclosure of the timing of revenue recognition. Robust internal controls and processes should be in place to ensure revenue is properly recognized and in compliance with the relevant accounting standards.

129. Where industrial engineering issuers offer discounts and sales rebates or provide warranties, they should consider the uniqueness and complexity of these components and provide separate disclosures and accounting policies.

130. In addition, HKFRS 15 is expected to have impacts on accounting processes, internal controls and business contracting processes. Issuers need to carefully evaluate all of their contracts and exercise more judgement than they do under HKAS 18. Issuers should read HKFRS 15 and make reference to the application guidance in Appendix B. For example:

- *Sales return* – HKFRS 15 requires the refund liability to be presented gross as a refund liability. An asset and corresponding adjustment to cost of sales are also recognized for the right to recover goods from customers on settling the refund liability, rather than the current presentation of allowances for returns on a net basis on the statement of financial position (paragraphs B20 to B27 of HKFRS 15);

- *Warranties* – Under HKFRS 15, warranties will be distinguished into service-type (warranty that provides a separate service) and assurance-type (warranty that provides assurance that the product will function as promised). Warranties that the customer has the option to purchase or those that provide the customer with a service such as specified tasks or longer than usual coverage periods are separate performance obligations when they are distinct from other promised goods and services. Revenue is allocated to the service-type warranty on a relative stand-alone selling price basis, which may differ from the contract price of the warranty. Assurance-type warranties continue to be accounted for as a cost accrual in accordance with HKAS 37 (paragraphs B28 to B33 of HKFRS 15);

- *Performance obligations satisfied over time* – Under HKFRS 15, revenue is required to be recognized over time as manufacturing occurs if the customized goods have no alternative use to an issuer, and the issuer has an enforceable right to payment for performance completed to date. When evaluating whether the customized goods have an alternative use, the issuer considers the goods that will ultimately be transferred to the customer. An enforceable right to payment exists if the industrial engineering issuer would be entitled to payment of costs plus a reasonable margin on the work performed to date if the customer were to terminate the contract early for reasons other than the industrial engineering issuer's failure to perform as promised (paragraphs B6 to B13 of HKFRS 15); and

- *Bill-and-hold arrangement* – Industrial engineering issuers may have bill-and-hold arrangements with their customers in which the issuers bill the customer for a product, but do not ship the product until a later date. HKFRS 15 focuses on when control of the goods transfers to the customer and the criteria for a bill-and-hold arrangement are specified in the paragraph B81 of HKFRS 15. Issuers should also note that an obligation to warehouse the goods after control has transferred to the customer may be a separate performance obligation and revenue would be allocated and recognized as warehousing service is provided (paragraphs B79 to B82 of HKFRS 15).

Property, plant and equipment

131. Property, plant and equipment were generally significant to the statement of financial position of industrial engineering issuers as the industrial engineering industry is capital-intensive with substantial manufacturing plants and equipment, which often comprise multiple parts that need to be periodically replaced or overhauled during their useful life.

132. Industrial engineering industry is faced with challenges from technology evolution and customer demand and changes in preference. Where the plant and equipment are not able to catch up with the latest technology or the sales of products are not as expected or forecasted due to customer dissatisfaction, there is indication that the plant and equipment may be impaired.

Our findings

133. Most of the 22 industrial engineering issuers had their property, plant and equipment stated at cost less subsequent accumulated depreciation and accumulated impairment losses, except for a few of them adopted both cost model and revaluation model for different classes of property, plant and equipment. All of these 22 issuers adopted straight-line method of depreciation over the estimated useful lives of property, plant and equipment.

134. None of the 22 industrial engineering issuers under review disclosed whether major parts or components of the manufacturing plants and equipment were identified and depreciated individually.

135. In addition, a few of the 22 issuers under review disclosed the accounting policy adopted in capitalizing the cost of major inspection or replacement. None of these issuers disclosed the details of the cost of major inspection or replacement capitalized in the carrying amount of property, plant and equipment.

Our recommendations

136. Paragraph 43 of HKAS 16 states that each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately. Industrial engineering issuers should consider whether an item of property, plant and equipment consists of significant components for which different depreciation methods or depreciation rates should be applied.

137. Issuers are reminded to recognize in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria in paragraph 7 of HKAS 16 are met (i.e. it is probable that future economic benefits associated with the item will flow to the entity and the cost of the item can be measured reliably). Issuers are also reminded that the carrying amount of those parts that are replaced should be derecognized (paragraph 13 of HKAS 16).

138. When each major inspection or overhaul is performed, issuers should capitalize the actual cost of the inspection or overhaul, provided that it is probable that future economic benefits will flow to the entity and the cost can be measured reliably. This inspection or overhaul cost is then depreciated over the period to the next inspection or overhaul. Any remaining carrying amount relating to the previous inspection or overhaul is derecognized. The remainder of the asset is depreciated over the full useful life of the asset, on the basis that the appropriate overhauls will be carried out as they are due (paragraph 14 of HKAS 16).

139. As mentioned above, property, plant and equipment were generally significant to the statement of financial position of industrial engineering issuers, therefore industrial engineering issuers should be mindful of the occurrence of any indication of impairment loss. For details, please also see paragraphs 70 to 82 of Section III *"Findings regarding accounting standards".*

140. In June 2017, the IASB published an exposure draft *"Property, Plant and Equipment — Proceeds before Intended Use (Proposed amendments to IAS 16)"*[24]. The proposed amendments in the exposure draft include amendments to prohibit deducting from the cost of an item of property, plant and equipment any proceeds from selling items produced while bringing that asset to the location and condition necessary for it to be capable of operating in the manner intended by management; and to require the entities to recognize the proceeds from selling such items, and the cost of producing those items, in profit or loss. The IASB believes that this is a simple and effective way of removing the identified diversity in practice in a manner that would improve financial reporting. Issuers should closely monitor the developments on the proposed amendments to IAS/HKAS 16.

[24] The IASB's consultation ended on 19 October 2017. The IASB's exposure draft is available at: http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/exposure-drafts/fin-report-archives/2017ar/.

<u>Inventories</u>

141. Industrial engineering issuers normally have significant balance of inventories and measurement of inventories would have material impact on the financial statements.

Our findings

142. All the industrial engineering issuers under review disclosed the accounting policy for inventories. We noted that most of the industrial engineering issuers adopted the weighted average cost formula to account for inventories and the rest of them adopted the first-in, first-out formula.

143. We found that a few industrial engineering issuer recognized significant write-down of inventories due to obsolescence. In addition, most of the industrial engineering issuers under review disclosed how they assessed the net realizable values of inventories at the financial year-end.

144. We also observed that a few of the 22 issuers recognized reversal of write-down of inventories. However, half of these issuers did not disclose the circumstances or events that led to the reversal of a write-down of inventories.

Our recommendations

145. Issuers are required to disclose the accounting policies adopted in measuring inventories, including the cost formula used (paragraph 36(a) of HKAS 2), and the amount of any write-down of inventories recognized as an expense in the year (paragraph 36(e) of HKAS 2). When reversal of write-down of inventories is recognized, issuers are reminded that they should disclose the circumstances or events that led to the reversal of a write-down of inventories (paragraph 36(g) of HKAS 2).

146. Issuers are reminded to perform regular reviews of the carrying amounts of inventories with reference to aged inventories analyses, projections of expected future saleability of goods and, management experience and judgement. Issuers are reminded that the cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale have increased (paragraph 28 of HKAS 2).

147. Issuers should carefully reassess the net realizable values of inventories at each financial year-end. The underlying estimates of assessment on net realizable values of inventories may change significantly as a result of changes in customer preference and competitor actions in response to industry cycles.

148. In addition, as mentioned above, industrial engineering issuers normally have significant balance of inventories; therefore, industrial engineering issuers are encouraged not only to discuss the year’s performance but also include the discussion in relation to inventories and other significant items in the statement of financial position in the MD&A to assist investors in understanding the performance and financial position of industrial engineering issuers.

Research and development

149. Industrial engineering issuers often incur research and development costs internally to improve current products or develop new products and may capitalize such costs when the technical feasibility of a project can be demonstrated and the recognition criteria as set out in HKAS 38 are met. Capitalizing or expensing the research and developments would have significant impact on the financial statements.

Our findings

150. More than half of the industrial engineering issuers under review mentioned that they had research and development activities in the MD&A. However, one of them did not disclose the amount of research and development expenditure and the accounting policy for research and development. All the remaining of these issuers either had the research and development expenses capitalized in the intangible assets or expensed in the profit or loss.

151. All those issuers under review had their capitalized development costs stated at cost less subsequent accumulated amortization and accumulated impairment losses. They adopted straight-line method of amortization over its estimated useful lives.

Our recommendations

152. Industrial engineering issuers are reminded that the accounting treatment for research costs and development costs is different. Research costs are expensed as they are incurred, while development costs should be capitalized if certain criteria are met, or expensed if these criteria are not met. In determining whether the development cost should be capitalized, issuers should consider (i) whether the activities qualify as development activities (as defined in paragraph 8 of HKAS 38); (ii) whether the general criteria for an intangible asset have been met (paragraphs 9 to 17 of HKAS 38); (iii) whether the recognition criteria for an intangible asset have been met (paragraph 21 of HKAS 38); and (iv) whether the recognition criteria have been substantiated by specific indications of an internally generated intangible asset (paragraph 57 of HKAS 38). Where there are additional industry-specific or entity-specific criteria for capitalizing development costs as intangible assets, industrial engineering issuers are encouraged to disclose these industry-specific or entity-specific criteria.

153. Industrial engineering issuers should disclose the amount of research and development expenditure recognized as an expense during the period (paragraph 126 of HKAS 38).

154. Paragraph 97 of HKAS 38 states that an intangible asset with a finite useful life should be amortized on a systematic basis over its useful life and the amortization method used should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method shall be used. Issuers should review the amortization method of the capitalized development costs at least at each annual reporting date and be reminded that a change in the method applied is accounted for prospectively as a change in estimate.

VI. FINDINGS REGARDING SPECIAL REVIEW THEME – NEW AUDITORS' REPORTING

155. A number of new and revised HKSAs on auditors' reporting[25] issued by the HKICPA in August 2015 became effective for audits of financial statements for periods ended on or after 15 December 2016. The form and content of the audit report for issuers have been substantially extended. The key enhancements to the new audit reports include requirements to:

- HKSA 701 – Include a new section to communicate key audit matters;
- HKSA 570 (Revised) – Include enhanced auditors' reporting on going concern; and
- HKSA 720 (Revised) – Report on the auditors' work related to other information (other than financial statements and the audit report thereon) included in issuers' annual reports.

156. The review, covering 89 auditors' reports of issuers, focused on the above key enhancements to new audit reports and consistency of disclosures between audit reports and financial statements and other parts of annual reports[26].

Key audit matters ("KAMs")

157. Reporting KAMs is mandatory for the audits of financial statements of listed entities. HKSA 701 defines KAMs as *"Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance."* In describing each KAM in the audit reports[27], the auditors are required to include:

- why the matter was considered to be one of most significance in the audit and therefore determined to be a KAM;
- how the matter was addressed in the audit; and
- a reference to the related disclosure(s), if any, in the financial statements.

158. It is important to note that the purpose of reporting KAMs is to provide greater transparency about the audit that was performed. KAMs do not affect the audit opinion and only provide additional information about the audit.

---

25 These included HKSA 701 *"Communicating Key Audit Matters in the Independent Auditor's Report"*, HKSA 570 (Revised) *"Going Concern"* and HKSA 720 (Revised) *"The Auditor's Responsibilities Relating to Other Information"*.

26 Issuers should also read the HKICPA *"Revised Auditor's Reports – First year review of experience"*, which observed how auditors implemented HKSA 701 based on a review of audit reports issued on Hong Kong listed entities.

27 See paragraph 13 of HKSA 701.

Our findings

159. All the audit reports reviewed contained at least one KAM. The majority of the audit reports included one to three KAMs. A few reported either four or five KAMs.

160. KAMs were referred to the related disclosures in the financial statements. The majority of KAMs focused on the valuation of items in the statement of financial position, with very few income statement items (other than revenue recognition) being included as a KAM. These KAMs reflected the areas that typically involved significant management judgement, and therefore typically required significant auditors' attention. The five most common KAM topics reported by the auditors included:

- Impairment of assets – goodwill, intangible assets and property, plant and equipment;
- Revenue recognition – timing of recognition and allocation of fair value among each separable component;
- Properties valuation – fair values of investment properties and net realizable values of properties under development and properties held for sale;
- Inventories – valuation and impairment; and
- Trade and other receivables – valuation and recoverability.

161. The description of KAMs always provided a brief overview of explaining how the KAMs were addressed in the audits. However, the amount of detail in the description of each KAM was a matter of the auditors' professional judgement, and varied depending on the specific facts and circumstances of the particular issuer. Examples of the procedures performed by the auditors over KAMs included the following:

- Impairment of goodwill
  - performing a retrospective review of the forecast prepared in prior years by comparing the forecast results with the current year's actual results, discussing material variances with management and considering the impact of these variances on the current year's forecast; and
  - performing sensitivity analyses of the key assumptions adopted in the discounted cash flow forecasts (including the discount rates and future revenue growth rates), and considering the resulting impact on the impairment assessments and whether there were any indications of potential management bias;
- Revenue recognition – inspecting key customer contracts to identify terms and conditions relating to goods acceptance and the right of return and assessing the Group's revenue recognition policies with reference to the requirements of the prevailing accounting standards; and
- Valuation of inventories, trade and other receivables – reviewing the adequacy of the allowances made by the management with reference to the

subsequent sales and latest unit selling prices of products, usage of raw materials and settlement of receivables after year-end.

162. Some of the audit reports voluntarily included the outcome of the audit procedures, which is not required by HKSA 701. The following are some examples of the outcome of the audit procedures:

- *"In our professional judgement, we found the assumptions made by the management in relation to the value in use calculations to be reasonable based on available evidence."*
- *"We found the Group's revenue has been appropriately recognized and in the relevant accounting period."*
- *"We found that the results of our evaluation of the Group's allowance for impairment of trade and other receivables to be consistent with management's assessment."*

Our recommendations

163. HKSA 701 provides flexibility for the auditors to describe more broadly "how the matter was addressed in the audit"[28], rather than specifically requiring a description of the auditors' responses, findings, procedures or outcomes. The amount of detail necessary is a matter of the auditors' professional judgement.

164. Issuers are reminded that reporting KAMs in the audit reports is not intended to be a substitute for the financial statement disclosures, because the directors are responsible for providing information about the Group and the financial statements[29]. The descriptions of KAMs in the audit reports should always refer to related disclosures in the financial statements, which enable investors to further understand how the directors have addressed the matters in preparing the financial statements and why the matters are determined as KAMs by the auditors.

165. All issuers, in particular their Audit Committee, should have discussions with their auditors at an early stage about the KAMs. This will ensure that the directors have sufficient time to consider and make improvement to the extent of disclosures in the financial statements.

166. In view of the above five most common KAM topics, issuers are encouraged to enhance their disclosures, where appropriate, for example:

- quantifying the key assumptions (such as revenue growth or margin, operating costs and capital expenditure) applied in estimating the recoverable amount of the cash-generating unit;
- providing more specific accounting policy in describing how revenue is recognized for each significant business stream; and
- disclosing the subsequent sales or usage of inventories and settlement of receivables after year-end.

[28] See paragraph A46 of HKSA 701.
[29] HKSA 701 points out that it is inappropriate for the auditors to be the providers of "original information" about the entities and such information is the responsibility of the entities' management and those charged with governance (see paragraphs A34 to A39 of HKSA 701).

<u>Going concern ("GC")</u>

167. HKSA 570 (Revised) enhances the auditors' focus on GC issues, including disclosures in the financial statements. When events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a GC but the audit opinion is unmodified[30], the auditors have different approaches in reporting the GC matter, which depend on whether the auditors conclude that there is a material uncertainty or not:

- When a material uncertainty exists:
  - The auditors are required to report the GC matter in a separate section of the audit reports under the heading "Material Uncertainty Related to Going Concern" and draw attention to the note in the financial statements that describes the material uncertainty[31].
- When no material uncertainty exists (often referred to as "close call" situations):
  - No separate section is required in the audit report but the auditors should evaluate whether, in view of the requirements of HKFRS, the financial statements provide adequate disclosures about these events or conditions[32].
  - The GC matter may be further determined as a KAM and reported under the KAM section[33].

Our findings

168. In our review, we noted six cases where the auditors concluded that there was a material uncertainty and reported the matter in a separate section under the heading "Material Uncertainty Related to Going Concern".

169. On the other hand, two cases were identified where the GC matter was determined as a KAM and reported under the KAM section, including what the audit procedures had been performed. In one case, the audit report did not clearly indicate whether the auditors concluded that there was a material uncertainty or not. Upon enquiry, the issuer clarified that after taking into account the Group's availability of banking facilities and costs saving measures, the auditors concluded no material uncertainty existed and complied with the requirements of HKSA 570 (Revised) and HKSA 701.

---

[30] Alternatively, the auditors may modify the audit opinion where (i) there is a lack of evidence to support management's GC assessment (see paragraph 21 of HKSA 570 (Revised)); or (ii) disclosures in the financial statements are inadequate or omitted (see paragraph 23 of HKSA 570 (Revised)).
[31] See paragraphs 19, 22, A22 and A23 of HKSA 570 (Revised).
[32] See paragraphs 20, A24 and A25 of HKSA 570 (Revised).
[33] See paragraph A1 of HKSA 570 (Revised), and paragraphs 15 and A41 of HKSA 701.

Our recommendations

170. HKSA 701 highlights that a material uncertainty related to GC is, by its nature, a KAM. However, reporting on GC when a material uncertainty exists should not be included in the KAM section but is done in accordance with HKSA 570 (Revised). HKSA 701 also states that the GC matter may be determined to be a KAM in "close call" situations when it requires significant auditors' attention, but the auditors ultimately conclude that a material uncertainty does not exist.

171. GC is a fundamental aspect of financial reporting. Issuers are reminded that the assessment of the Group's ability to continue as a GC and related disclosures are primarily the responsibility of the directors and management. The disclosure requirements related to GC are set out in paragraphs 25 and 26 of HKAS 1 (Revised). In addition, paragraph 122 of HKAS 1 (Revised) would apply where they have made significant judgements in reaching a conclusion that no material uncertainty exists[34].

172. Issuers should also pay attention to the guidance provided to the auditors in the following HKSAs:

- Paragraph A24 of HKSA 570 (Revised) – When evaluating whether the GC disclosures are adequate in "close call" situations, the financial reporting frameworks (such as HKFRS/IFRS) may address disclosures about:

  - principal events or conditions;

  - management's evaluation of the significance of those events or conditions in relation to the entity's ability to meet its obligations;

  - management's plans that mitigate the effect of these events or conditions; or

  - significant judgements made by management as part of its assessment of the entity's ability to continue as a GC.

- Paragraph A41 of HKSA 701 – When the GC matter is determined as a KAM in "close call" situations, the description in the KAM section could include aspects of the identified events or conditions disclosed in the financial statements, such as substantial operating losses, available borrowing facilities and possible debt refinancing, or non-compliance with loan agreements, and related mitigating factors.

173. In this regard, issuers, particularly for those that have "close call" situations, should ensure that the GC disclosures are sufficiently specific that enable investors to understand the Group's future viability. It is also likely to be useful if a draft of the GC disclosures will be available to the auditors earlier, so that both issuers and their auditors can assess whether additional disclosures are necessary.

[34] See IFRIC agenda decision on IAS 1 *"Presentation of Financial Statements – Disclosure requirements relating to assessment of going concern"* published in July 2014, available at: http://media.ifrs.org/2014/IFRIC/July/IFRIC-Update-July-2014.pdf.

<u>Other information</u>

174. HKSA 720 (Revised) defines "Other Information" as *"Financial or non-financial information (other than financial statements and the auditor's report thereon) included in an entity's annual report."* In addition to reading the Other Information, HKSA 720 (Revised) now requires the auditors to report in a separate section whether there is any finding on a material misstatement between the Other Information and the financial statements or the auditors' knowledge obtained in the audit.

175. For the audits of financial statements of listed entities[35], the auditors are required to report regarding the identification of Other Information:

- obtained prior to the date of the audit report; and
- expected to be obtained after the date of the audit report.

Our findings

176. We noted that many cases indicated that the Other Information comprises *"all the information included in the annual report, other than the consolidated financial statements and our auditor's report thereon"*. In the other cases, a more specific description of the Other Information was provided, such as *"the directors' report"* and *"management discussion and analysis"* were used to identify the Other Information.

177. In most of the cases, the auditors had obtained all of the Other Information in the annual report before the date of the audit report, and concluded that there was no material misstatement of the Other Information and included a statement in their audit reports that they *"have nothing to report"* in this area.

178. We also noted that there were four cases where "all" of the Other Information was not available to the auditors until after the date of the audit report. Upon our enquiries, these issuers had confirmed that in future audits, all of the Other Information will be provided to their auditors before the date of the audit report, so that the auditors are able to read and report on all of the Other Information in accordance with HKSA 720 (Revised).

Our recommendations

179. Issuers should take note of the requirement under MB Rule 2.13(2) such that any corporate communication (including financial reports) should be accurate, complete and not misleading. Therefore, they should ensure that information provided in other parts of annual reports should be consistent with the financial statements.

[35] See paragraphs 21 and 22 of HKSA 720 (Revised).

180. HKSA 720 (Revised) envisages there may be cases where not all the Other Information is provided to the auditors prior to their report dates. However, we are of the view that both issuers and their auditors should first use their best endeavours to meet the objectives and reporting requirements of HKSA 720 (Revised). It is, therefore, important for issuers to early communicate with their auditors about:

- which documents comprise the annual report and will be within the scope of Other Information, therefore within the scope of the auditors' responsibilities; and

- a detailed timetable of when Other Information will be available to the auditors for reading and consideration, so that the auditors can complete the procedures as required by HKSA 720 (Revised) prior to the date of the audit report.

VII. CONCLUSION

181. A financial report provides an opportunity for issuers to explain their performance, financial position and future prospects clearly to investors and enhance shareholders' value. Issuers should include "information that is relevant, material and entity-specific" and present them in an effective way; and should consider removing irrelevant and immaterial disclosures. Issuers should take note that financial reports and all other corporate communication should be accurate, complete and not misleading.

182. 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 in the Listing Rules, accounting and auditing standards, and other relevant laws and regulations; and capitalize on opportunities to provide better disclosure. Directors should ensure that their finance department has the adequate resources and training to perform its role in financial reporting. The Audit Committee should stay focused on financial reporting integrity as part of its core oversight responsibilities.

\- End -

APPENDIX A – LIST OF ACCOUNTING AND INDUSTRY REVIEW THEMES IN PAST YEARS

FSRP Year	Accounting Theme	Industry Review Theme
2016	Disclosure of possible impact of applying a new or amended HKFRS in issue but not yet effective (HKAS 8)	Retail and consumer goods companies
2015	Accounting for consolidation, associates and joint arrangements, and disclosure of interests in other entities (HKFRSs 10, 11 and 12)	Hotels, gaming and leisure companies
2014	Fair value measurement (HKFRS 13)	Automotive companies
2013	Impairment of assets (HKAS 36)	Power and utilities companies
2012	Goodwill and intangible assets (HKAS 38)	Telecommunications and internet companies
2011	Segment reporting (HKFRS 8)	Property companies
2010	Financial instruments (HKAS 39 and HKFRS 7)	Mining activities
2009	Business combinations (HKFRS 3 (Revised))	Toll road infrastructure facilities

APPENDIX B – LINKS TO USEFUL GUIDANCE MATERIALS FROM THE EXCHANGE AND OTHER REGULATORS

Publications for corporate reporting from the Exchange:

Publication	Link
Financial Statements Review Programme	http://www.hkex.com.hk/Listing/Rules-and-Guidance/Other-Resources/Listed-Issuers/Exchange-Review-of-Issuer-Annual-Disclosure/Financial-Statements-Review?sc_lang=en
Review of disclosure in issuers' annual reports to monitor Rule compliance	http://www.hkex.com.hk/Listing/Rules-and-Guidance/Other-Resources/Listed-Issuers/Exchange-Review-of-Issuer-Annual-Disclosure/Review-of-Disclosure-in-Annual-Reports?sc_lang=en
Review of implementation of Corporate Governance Code	http://www.hkex.com.hk/Listing/Rules-and-Guidance/Other-Resources/Listed-Issuers/Exchange-Review-of-Issuer-Annual-Disclosure/Review-of-Implementation-of-Code-on-Corporate-Governance-Practices?sc_lang=en
Environmental, Social and Governance reporting	http://www.hkex.com.hk/Listing/Rules-and-Guidance/Other-Resources/Listed-Issuers/Environmental-Social-and-Governance?sc_lang=en

FRC website and HKICPA PSM programme:

Regulator	Reference materials
FRC	FRC website http://www.frc.org.hk/en/index.php
HKICPA	HKICPA PSM programme http://www.hkicpa.org.hk/en/standards-and-regulations/quality-assurance/professional-standards-monitoring/

Guidance to specific topics covered in this report:

Topic	MB Rules / accounting standards	Reference materials
Management commentary	Paragraphs 28 and 32 of Appendix 16, Schedule 5 of the CO	• IASB case study report *"Better Communication in Financial Reporting – Making disclosures more meaningful"* http://www.ifrs.org/-/media/project/disclosure-initative/better-communication-making-disclosures-more-meaningful.pdf?la=en&hash=801789DBF05F1AF50CA3E1701060E7A612A037CF • HKICPA Accounting Bulletin 5 *"Guidance for the Preparation and Presentation of a Business Review under the Hong Kong Companies Ordinance Cap. 622"* http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeII/ab5.pdf

Topic	MB Rules / accounting standards	Reference materials
		• Hong Kong Institute of Directors *"Clear and Concise: A Director's Guide to Writing the Business Review of an Annual Report"* http://www.hkiod.com/clear-and-concise.html • HKICPA New Companies Ordinance Resource Centre http://www.hkicpa.org.hk/en/standards-and-regulations/standards/new-co/ • HKEX-GL86-16 *"Guide on Producing Simplified Listing Documents Relating to Equity Securities for New Applications"* http://en-rules.hkex.com.hk/net_file_store/new_rulebooks/g/l/gl8616.pdf • IOSCO *"Statement on Non-GAAP Financial Measures"* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD532.pdf
Directors' emoluments	Paragraph 24 of Appendix 16	• HKICPA Accounting Bulletin 3 (Revised) *"Guidance on Disclosure of Directors' Remuneration"* http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeII/ab3.pdf
Distributable reserves	Paragraph 29 of Appendix 16	• HKICPA Accounting Bulletin 4 *"Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Hong Kong Companies Ordinance"* http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeII/ab4.pdf
Illustrative financial reports and disclosure checklists	HKFRS/IFRS	• HKICPA Technical Resources – Illustrative financial reports and disclosure checklists from public accounting firms http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/fsdlist/
Mainland and Hong Kong standards convergence	CASBE/HKFRS	• HKICPA Technical Resources – Mainland and Hong Kong Standards Convergence http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/mainland-standards-convergence/
Preparing and presenting information by professional accountants in business	IAS 1/HKAS 1 (Revised)	• IESBA *"International Code of Ethics for Professional Accountants (including International Independence Standards)"* http://www.ifac.org/news-events/2018-04/global-ethics-board-releases-revamped-code-ethics-professional-accountants
Disclosure of possible impact of applying a new or amended HKFRS/IFRS in issue but not yet effective	HKAS/IAS 8	• HKICPA New and Major Standards Resource Centre http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/newmajor/ • HKICPA Alert Issue 24 http://www.hkicpa.org.hk/file/media/section6_standards/technical_resources/pdf-file/financial-alert/alert24.pdf • ESMA *"European common enforcement priorities for 2017 IFRS financial statements"* https://www.esma.europa.eu/sites/default/files/library/esma32-63-340_esma_european_common_enforcement_priorities_2017.pdf

Topic	MB Rules / accounting standards	Reference materials
Impairment testing involving valuers	HKAS 36	• SFC guidance note regarding valuations in corporate transactions http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=17PR68
Business combinations	IFRS 3/HKFRS 3 (Revised)	• IASB proposed amendments to IFRS 3 http://www.ifrs.org/projects/work-plan/definition-of-a-business/
New auditors' reporting	HKSA 701, HKSA 570 (Revised), HKSA 720 (Revised)	• HKICPA New and Major Standards Resource Centre http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/newmajor/auditreport/ • HKICPA *"Revised Auditor's Reports – First year review of experience"* http://www.hkicpa.org.hk/file/media/section6_standards/standards/Audit-n-assurance/kamrp1017.pdf

Other guidance not specifically covered in this report:

Topic	MB Rules / accounting standards	Reference materials
Acting as scrutineer when a poll is called at a general meeting of an issuer	Rule 13.39(5)	• HKICPA Practice Note 720 *"Acting as Scrutineer at a General Meeting of a Listed Issuer"* http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeIII/pn720.pdf
Publication of preliminary results for a financial year or interim results	Rule 13.49(2), paragraphs 45 and 46 of Appendix 16	• HKICPA Accounting Bulletin 6 *"Guidance on the Requirements of Section 436 of the Hong Kong Companies Ordinance Cap.622"* http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeII/ab6.pdf • HKICPA Practice Note 730 (Revised) *"Guidance for Auditors Regarding Preliminary Announcements of Annual Results"* http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeIII/pn730rev.pdf
Review of financial information included in a circular issued in relation to a very substantial disposal	Rule 14.68(2)(a)(i)	• HKICPA Practice Note 750 *"Review of Financial Information under the Hong Kong Listing Rules for a Very Substantial Disposal"* http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeIII/pn750.pdf
Reporting on continuing connected transactions	Rules 14A.56 and 14A.71, paragraph 8 of Appendix 16	• HKICPA Practice Note 740 *"Auditor's Letter on Continuing Connected Transactions under the Hong Kong Listing Rules"* http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeIII/pn740.pdf