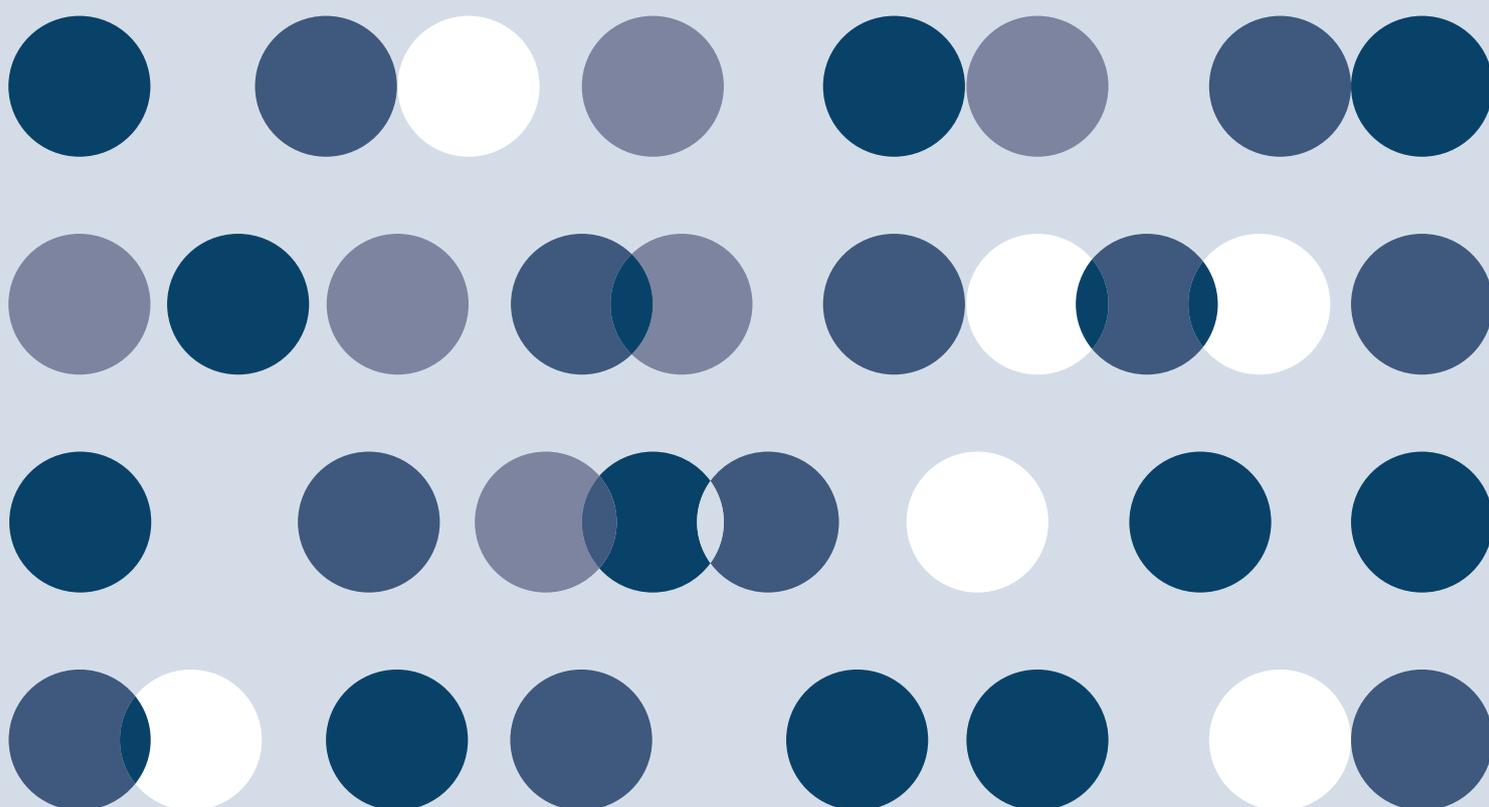


January 2020

REVIEW OF ISSUERS'  
ANNUAL REPORT DISCLOSURE

REPORT 2019



### CONTENT

Executive summary	1
I. Introduction	4
II. Findings on specific areas of disclosure	
A. Fundraisings through issue of equity / convertible securities and subscription rights	6
B. Updates on material asset impairments and results of performance guarantees after acquisitions	8
C. Continuing connected transactions	13
D. Disclosure of business review and significant investments in the MD&A section	18
E. Financial statements with auditors' modified opinions	23
F. Disclosure on material other expenses / income	28
G. Issuers listed under the new listing regime for weighted voting rights and biotech companies	30
III. Issuers listed in 2017 and 2018	34
IV. Findings regarding accounting review themes	
A. Material intangible assets	39
B. Disclosure relating to the implementation of HKFRS 9	49
C. Disclosure relating to the implementation of HKFRS 15	56
D. Disclosure of possible impact of applying a new or amended HKFRS in issue but not yet effective	63
E. Using non-GAAP financial measures	66
V. Conclusion	71

### EXECUTIVE SUMMARY

The Listing Division reviews issuers' annual reports as part of its ongoing monitoring activities.

We undertake two on-going review programmes (i) Review of Disclosure in Issuers' Annual Reports to monitor Rule compliance (the **AR Review Programme**); and (ii) Financial Statements Review Programme (the **FSRP**). Each review programme has a different focus.

The AR Review Programme examines issuers' annual reports with a focus on Rule compliance, issuers' corporate conduct and their disclosure of material events and developments. In our review of an issuer's disclosure, we consider not only the disclosure in the annual report, but also the consistency and materiality of disclosure in the issuer's corporate communications (such as announcements and circulars) over time.

The FSRP is operated with a view to encouraging high standards of financial disclosure and is focused on compliance with applicable accounting standards. As in previous year, we adopted a risk-based approach in selecting our cases for review. In 2019, the sample size was increased to 300 cases.

Both review programmes are primarily to give meaningful guidance to issuers on specific areas to focus on when preparing their annual reports. Where we noted any particular non-compliance with any rules and regulations, we would consider appropriate remedial and / or disciplinary action under the Exchange Listing Rules and / or making referrals to other regulatory agencies.

This report presents our findings and recommendations from both review programmes. For the purpose of this review, we have considered the findings and observations in our previous reports and the latest market trends and developments of issuers, and have selected specific areas for assessing issuers' performance and providing appropriate guidance and recommendations. In this review, we have covered 13 areas:

- (i) Fundraisings through issue of equity / convertible securities and subscription rights
- (ii) Updates on material asset impairments and results of performance guarantees after acquisitions
- (iii) Continuing connected transactions
- (iv) Disclosure of business review and significant investments in the MD&A section
- (v) Financial statements with auditors' modified opinions
- (vi) Disclosure on material other expenses / income

- (vii) Issuers listed under the new listing regime for weighted voting rights and biotech companies
- (viii) Issuers listed in 2017 and 2018
- (ix) Material intangible assets
- (x) Disclosure relating to the implementation of Hong Kong Financial Reporting Standard (**HKFRS**) 9 “Financial Instruments”
- (xi) Disclosure relating to the implementation of HKFRS 15 “Revenue from Contracts with Customers”
- (xii) Disclosure of possible impact of applying a new or amended HKFRS in issue but not yet effective
- (xiii) Using non-GAAP financial measures

The Exchange specifically recommends the following:

- (a) **Amended Rules on annual report disclosure** – Issuers should take note that the Rules have been amended to codify some recommended disclosure from our previous reports, including amendments effective from 3 July 2018 requiring disclosure of the use of proceeds from fundraisings, and amendments effective from 1 October 2019 requiring disclosure relating to (i) information about any guarantee regarding the financial performance of a business acquired; and (ii) a breakdown of significant investments. The amended Rules on disclosure of the use of proceeds from fundraisings have taken effect. However, we noted that the level of compliance by issuers has not improved compared to last year. We remind issuers to fully comply with the amended Rules.
- (b) **Business review in MD&A** – We reviewed the MD&A disclosure of issuers with major operations in the pharmaceutical or education industries in the PRC in view of changes in PRC regulations and / or government policies in the past financial year. We recommend that issuers improve their MD&A disclosure by making clear disclosure about any risk areas such as major regulatory or governmental policy changes, and an assessment on the impact to their business operations and previously announced business plans. Issuers should highlight the principal risks and uncertainties arising from such changes. Where applicable, issuers should also discuss the impact of the policy changes to their financial performance during the financial year.

- (c) **Financial statements with auditors' modified opinions** – We encourage issuers with audit modifications to actively engage their auditors on their action plans with a view towards taking appropriate and effective actions to remove the modifications. This year, we noted an increase in the number of audit modifications on asset valuations of receivables and deposits, and recommend issuers maintain a credit loss policy supported by historical loss information and adjusted by forward looking economic factors, and make impairments according to such policy. To enhance transparency to shareholders, we urge issuers to follow our previous recommendations to discuss management's position and audit committee's view towards the modifications, and plans (including an update of plans for repeated modifications) to address them.
- (d) **Disclosure on material "other expenses"** – Approximately one-half of the issuers under review provided no or limited disclosure on "other expenses". We remind issuers to provide appropriate breakdown of their "other expenses" to enhance shareholders' understanding of their financial performances.
- (e) **Material intangible assets** – In relation to intangible assets, including goodwill, directors and management should be responsible for performing proper analysis and exercising judgment to assess the reasonableness of key assumptions applied in impairment testing such that assumptions applied were not overly optimistic. In addition, sufficient information about key assumptions should be provided as investors rely on it to understand how management determined the values assigned to the key assumptions and assess the reliability of the impairment testing.
- (f) **Using non-GAAP financial measures** – Issuers should ensure that the non-GAAP financial measures should be unbiased, presented with no greater prominence than GAAP measures, clearly defined, reconciled to the relevant amounts in the financial statements and presented consistently over time. Issuers should also avoid describing the adjusting items as non-recurring, infrequent or unusual without sufficient explanation, when such items are reasonably likely to recur in the foreseeable future, or are activities that affected the entity in the recent past.

Issuers are reminded to take note of our observations and recommendations discussed in this report and follow the guidance in their future annual reports to improve transparency and accountability to investors.

### I. INTRODUCTION

1. An annual report should provide material and relevant information about an issuer's financial results and position, and assist investors to assess its past performance and future prospects. As a general principle, disclosure in annual reports should be clear, straightforward, and provide a qualitative analysis that complements and explains quantitative information in the related financial statements. There should be a balanced discussion of all major aspects of the issuers' businesses, including both positive and negative circumstances, in the "management discussion and analysis" (**MD&A**) section. Better disclosure improves transparency and promote a fair, orderly and informed market.
2. As part of our monitoring of issuers' activities, we review annual reports with a particular focus on issuers' Rule compliance, corporate conduct, and disclosure of material events and developments. In our review of an issuer's disclosure we consider not only the disclosure in the annual report, but also the consistency and materiality of disclosure in its corporate communications (such as announcements and circulars) over time. Our review of issuers' disclosure over time helps us identify cases of potentially misleading disclosure in corporate documents, issues on directors' role in safeguarding corporate assets, and possible Rule non-compliances and / or corporate misconduct.
3. The Rules and applicable accounting standards set out the minimum information issuers must include in their annual reports. Issuers should provide additional information that is relevant to shareholders and investors according to their own circumstances. In our review, we also consider whether issuers adopted our guidance from our previous annual report reviews as well as guidance materials issued from time to time. Where appropriate, we have requested issuers to disclose the omitted information by supplemental announcements or in subsequent financial reports.
4. This report presents our findings and recommendations from our review of the following 13 areas. Our review covered the annual reports of issuers for the financial year ended between January and December 2018. Specifically, we reviewed the disclosure in the annual reports of issuers that carried out relevant activities in the financial year, or where applicable, in the previous financial years. We conducted a review, on a sample basis, of disclosure in continuing connected transaction section (item (iii) below). The scope of review for each area is described in Parts II, III and IV of this report:
  - (i) Fundraisings through issue of equity / convertible securities and subscription rights (Part IIA)
  - (ii) Updates on material asset impairments and results of performance guarantees after acquisitions (Part IIB)

- (iii) Continuing connected transactions (Part IIC)
  - (iv) Disclosure of business review and significant investments in the MD&A section (Part IID)
  - (v) Financial statements with auditors' modified opinions (Part IIE)
  - (vi) Disclosure on material other expenses / income (Part IIF)
  - (vii) Issuers listed under the new listing regime for weighted voting rights and biotech companies (Part IIG)
  - (viii) Issuers listed in 2017 and 2018 (Part III)
  - (ix) Material intangible assets (Part IVA)
  - (x) Disclosure relating to the implementation of HKFRS 9 (Part IVB)
  - (xi) Disclosure relating to the implementation of HKFRS 15 (Part IVC)
  - (xii) Disclosure of possible impact of applying a new or amended HKFRS in issue but not yet effective (Part IVD)
  - (xiii) Using non-GAAP financial measures (Part IVE)
5. In this report, "Rules" refer to both Main Board (**MB**) Rules and GEM Rules.
6. Unless otherwise specified, HKFRSs and Hong Kong Standards on Auditing (**HKSAs**) and their paragraph numbers referred to in this report correspond to those in International Financial Reporting Standards (**IFRSs**) and ISAs<sup>1</sup> 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.

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<sup>1</sup> HKSAs are issued by the Hong Kong Institute of Certified Public Accountants (the **HKICPA**); while International Standards on Auditing (**ISAs**) are issued by the International Auditing and Assurance Standards Board.

**II. FINDINGS ON SPECIFIC AREAS OF DISCLOSURE**

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

7. The Rules require issuers to disclose in their annual reports details of their equity fundraisings, including the terms and size of the equity issuance and the use of proceeds<sup>2</sup>.
8. With effect from 3 July 2018, the Rules were amended to codify our previously recommended additional disclosure. Under the amended Rules, issuers should disclose in their annual reports the following information:
  - (a) a detailed breakdown and description of the proceeds for each issue and the purposes for which they are used during the financial year;
  - (b) if there is any amount not yet utilised, a detailed breakdown and description of the intended use of the proceeds for each issue and the purposes for which they are used and the expected timeline; and
  - (c) whether the proceeds were used, or are proposed to be used, according to the intentions previously disclosed by the issuer, and the reasons for any material change or delay in the use of proceeds<sup>3</sup>.

Issuers are recommended to present the above information in tabular format.

**Scope**

9. We reviewed the announcements and annual reports of all issuers that conducted equity fundraisings during the financial year and the annual reports of issuers that had unutilised proceeds brought forward from equity fundraisings conducted in previous financial year(s).
10. A vast majority of the issuers under review published their annual reports after the Rule amendments took effect. We assessed whether they complied with the amended Rules. For the issuers that published annual reports before the Rule amendments, we assessed whether they followed our recommended disclosure.

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<sup>2</sup> Paragraphs 11 and 32 of Appendix 16 to the MB Rules / GEM Rules 18.32 and 18.41.

<sup>3</sup> Paragraphs 11(8) and 11A of Appendix 16 to the MB Rules / GEM Rules 18.32(8) and 18.32A.

### **Findings**

#### *(1) Disclosure on use of proceeds*

11. Similar to last year, a majority of the issuers fully disclosed the required information<sup>4</sup>. Issuers that did not fully disclose the required information generally omitted the description of the intended use of the unutilised proceeds and / or the expected timeline. These issuers, in response to our follow up, disclosed the omitted information by supplemental announcements or in subsequent financial reports.
12. We noted that despite the recent Rule amendments to codify our previously recommended disclosure, the level of compliance has not improved compared to last year. Issuers are reminded to fully comply with the Rules.

#### *(2) Change in use of proceeds*

13. We noted that a small number of issuers disclosed changes in the use of proceeds in their annual reports. The changes were mainly related to reallocation of funds among different intended uses initially disclosed in the fundraising announcements, or reassignment of funds to the existing businesses of the issuers. The extent of these changes was not material. Most of these issuers also published supplemental announcements disclosing the reasons for the change and the amounts involved. We have not identified any major issues arising from such changes.

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<sup>4</sup> Our recommended disclosure on issuers' use of proceeds from fundraisings has been codified into the Rules with effect from 3 July 2018 (see paragraph 8 above). Accordingly, in determining issuers' level of compliance with the required disclosure, we have considered issuers' compliance with (i) our recommended disclosure as set out in previous reports for annual reports published prior to 3 July 2018 and (ii) the required disclosure under the amended Rules for annual reports published on or after 3 July 2018.

### **B. Updates on material asset impairments and results of performance guarantees after acquisitions**

14. The Rules require issuers to announce material acquisitions, publish circulars and obtain shareholder approval for these acquisitions. Issuers should also disclose in the MD&A section of their annual reports information about the acquired businesses, including circumstances involving any material asset impairments.
15. Where an asset impairment is supported by an independent valuation, we recommended in our previous reports that the issuer should disclose information about the basis of the valuation, including (i) details of the value of inputs used for the valuation together with the basis and assumptions; (ii) the reasons for any significant changes in the value of the inputs and assumptions from those previously adopted; (iii) the valuation method and the reasons for using that method; and (iv) an explanation of any subsequent changes to the valuation method adopted. This enables shareholders to understand the details of and reasons for the impairments and their amounts, and the prospects of the acquired business.
16. In addition, the SFC issued in May 2017 a [“Guidance note on directors’ duties in the context of valuations in corporate transactions”](#). The guidance note reminds directors of their duties in ensuring that acquisition targets are properly considered and investigated. It states that directors should carry out independent due diligence on the acquisition targets, and should not accept blindly and unquestioningly financial forecasts, assumptions or business plans provided to them typically by the target’s vendor or management.
17. In some acquisition agreements, the vendors guarantee the performance of the acquired businesses and agree to compensate the issuers for any shortfall, adjust the consideration based on agreed formulae or take specific action (such as buying back the business from the issuer) if the guarantees are not met.
18. Before 1 October 2019, the Rules set out the information required to be disclosed in an announcement and the next annual report in respect of any performance guarantee given by a connected person where the actual performance fails to meet the guarantee. In our previous reports, we recommended that, irrespective of whether the performance guarantee is given by a connected person or an independent party, the issuer should disclose in its next annual report the performance of the acquired business and whether the performance guarantee is met. If the performance guarantee is not met, the issuer should publish an announcement to disclose how it would enforce the obligations of the guarantor under the acquisition agreement.

19. With effect from 1 October 2019, our recommended disclosure on performance guarantees have been codified into the Rules<sup>5</sup>.

### **Scope**

#### Update on material impairments on acquired assets

20. We reviewed the announcements, circulars and annual reports of the issuers that:
- (a) completed material acquisitions in their last two financial years; or
  - (b) recorded material impairments during the financial year under review on assets acquired in previous financial years.
21. We reviewed their annual report disclosure about the developments of the acquired businesses or assets and any significant changes to the value of intangible assets and goodwill. We considered whether:
- (a) any impairment to the acquired businesses or assets was properly made and whether the annual reports discussed matters giving rise to the impairment;
  - (b) the information disclosed in their circulars and / or announcements was materially accurate, and whether the directors have properly considered the terms of the acquisition and properly discharged their fiduciary duties in the acquisitions in light of the developments (such as material impairments) of the acquired businesses or assets; and
  - (c) any material change in relation to the acquired businesses or assets after the acquisition was timely announced.

#### Results of performance guarantees

22. For issuers that were given performance guarantees in previous acquisitions and the guarantee period ended in the financial year under review, we reviewed the issuers' annual reports, announcements and the accounts of the acquired businesses to assess whether the outcomes of the performance guarantees were properly disclosed. Where the performance guarantees were not met, we considered whether and how the issuers enforced the obligations of the guarantors.

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<sup>5</sup> MB Rule 14.36B / GEM Rule 19.36B and paragraph 6.3(i) of Appendix 16 to the MB Rules / note 4(h) to GEM Rule 18.07.

### Update on material impairments on assets (other than acquired assets)

23. We also reviewed the annual reports of issuers that recorded material impairments on assets (other than acquired assets) during the financial year under review, and considered whether the reasons for, and the circumstances leading to, the impairments were adequately disclosed in the annual reports. Where the impairment indicated material changes to the businesses of the issuers, we also considered whether such changes were timely announced.

### *Findings*

#### Update on material impairments on acquired assets

##### (1) Disclosure in annual reports

24. The number of cases<sup>6</sup> involving material impairments on acquired assets was comparable to last year. Issuers generally attributed the impairments to economic slowdown arising from geopolitical factors (e.g. trade tensions and Brexit), downturn in the industries in which the acquisition targets operated, changes in government policies or industry regulations, or factors specific to the targets (e.g. departure of key management staff or decrease in sales order). Most issuers discussed the matters giving rise to the impairments in their annual reports. The remaining few issuers, in response to our enquiry, disclosed the details of and reasons for the impairments by supplemental announcements.
25. A large majority of the issuers engaged independent valuers to perform valuations and disclosed details of the valuations as described in paragraph 15 above. A few issuers that did not disclose all the recommended information generally omitted the reasons for adopting or changing a particular valuation methodology. These issuers, in response to our enquiry, disclosed the omitted information by supplemental announcements.
26. In a few cases, the issuers did not engage an independent valuer to perform the impairment tests. These issuers conducted internal assessment and evaluation to support the impairments made. In response to our enquiry, they disclosed the bases for the impairments by supplemental announcements or in subsequent financial reports. To enhance shareholders' understanding of the basis of the impairments, we urge issuers to make the recommended disclosure in their annual reports.

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<sup>6</sup> This review excluded cases where the auditors expressed a modified opinion in respect of the impairment of assets. For those cases, please refer to part IIE - Financial statements with auditors' modified opinions.

### (2) Timeliness of disclosure of material changes to the acquired businesses

27. Issuers generally disclosed material changes to the acquired businesses or assets that led to the material impairments in profit warning or other announcements. We did not identify any major issues about the timeliness of issuers' disclosure on material changes to the acquired assets.

### Results of performance guarantees

#### (1) Performance of acquired businesses under performance guarantees

28. In slightly over one-half of the cases, the issuers confirmed that the performance guarantees were met upon expiry of the guarantee period. We have reviewed the accounts of the acquired businesses and did not identify issues about such confirmations.
29. Where the guarantees were not met, a large majority of the issuers were compensated by the guarantors according to the terms of the agreements. The remaining cases involved guarantees provided by independent third parties. In one case the issuer decided to revise the terms of the compensation arrangement and entered into a supplement agreement with the vendor. In the other cases, the issuers took actions against the vendors, including withholding the issuance of consideration shares to the vendors or taking legal actions against the vendors. The issuers had generally updated shareholders on the rationale and status of their actions in announcements or annual reports.

#### (2) Disclosure of results of performance guarantees

30. A large majority of issuers have followed our recommendations to disclose in their annual reports whether the performance guarantee was met and if not, whether and how the guarantors fulfilled their obligations under the agreements. The other issuers, in response to our enquiry, made the above recommended disclosure by supplemental announcements.

31. Our previous recommended disclosure on details about the fulfilment of performance guarantees (see paragraph 18 above) have been codified into the Rules since 1 October 2019. We remind issuers to comply with these Rules in their future annual reports.

### Update on material impairments on assets (other than acquired assets)

#### (1) Disclosure in annual reports

32. Some issuers made material impairments on assets (other than acquired assets), including intangible assets, financial assets, property, plant and equipment and receivables, during the financial year under review. Generally, these issuers attributed the impairments to intensified competition in the relevant industry or factors specific to the issuers, such as failure to collect account receivables and suspension in operation. They generally have disclosed and explained the matters that gave rise to the impairments in their annual reports.
33. These issuers<sup>7</sup> also disclosed the basis of the impairments made, for example, by referring to credit policies for determining bad debt provisions. For certain types of assets (such as intangible assets), issuers supported the material impairments with independent valuations. In most of these cases the issuers disclosed details of the valuations as described in paragraph 15 above. A few issuers that did not do so omitted information about the bases for adopting a particular valuation methodology and changes in particular valuation assumptions that led to the impairments. These issuers, in response to our enquiry, disclosed the omitted information by supplemental announcements. To enhance shareholders' understanding of the basis of the valuations and impairments, we urge issuers to make the recommended disclosure in their future annual reports.

#### (2) Timeliness of disclosure of material changes

34. Issuers generally disclosed the circumstances that led to the material impairments on assets (other than acquired assets) in profit warning or other announcements. We did not identify any major issues about the timeliness of such disclosure.

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<sup>7</sup> This review excluded cases where the auditors expressed a modified opinion in respect of the impairment of assets. For those cases, please refer to part IIE - Financial statements with auditors' modified opinions.

### C. Continuing connected transactions

35. Under the Rules, shareholders may give an issuer a prior mandate to conduct continuing connected transactions (**CCTs**), subject to the terms of the agreement which provide a framework for negotiating each individual transaction, and annual caps which limit the aggregate size of the transactions. It is important that the terms of the agreement are specific and measurable and that there are adequate internal controls in place to ensure that the individual transactions are conducted within the framework of the agreement.
36. The Rules also require that, in each financial year:
- (a) An issuer must report its CCTs in its annual report. It must confirm whether its related party transactions (as disclosed in the financial statements) were connected transactions under the Rules and, if so, whether these transactions complied with the connected transaction requirements; and
  - (b) Independent non-executive directors (**INEDs**) and auditors must review the issuer's CCTs and report their findings in the issuer's annual report. INEDs must also confirm in the annual report on whether such transactions were made (i) according to the agreement governing them on terms that are fair and reasonable and in the interest of the issuer and its shareholders; (ii) on normal commercial terms or better; and (iii) in the issuer's ordinary and usual course of business.
37. Guidance Letter [GL73-14](#) provides guidance to issuers on establishing pricing policies in agreements for CCTs and internal controls to monitor these transactions, and to INEDs on their roles in reviewing the transactions' compliance with the terms of the agreements and the CCT Rules. In particular:
- (a) An issuer should have in place adequate internal control procedures to ensure that individual CCTs are conducted in accordance with the pricing policy or mechanism under the framework agreements. It should also ensure that its internal audit function<sup>8</sup> will review these transactions and the internal control procedures, and provide the findings to the INEDs to assist them in performing their annual review; and

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<sup>8</sup> Under the Corporate Governance Code, an issuer should also have an internal audit function which carries out an analysis and independent appraisal of the adequacy and effectiveness of its risk management and internal control systems.

- (b) INEDs should ensure that (i) the methods and procedures established by the issuer are sufficient to ensure that the transactions will be conducted on normal commercial terms and not prejudicial to the interests of the issuer and its minority shareholders; and (ii) appropriate internal control procedures are in place and the issuer's internal audit function would review these transactions. Where appropriate, they should make enquiries with the management to ensure that they are given sufficient information to review the transactions and the internal control procedures.

### **Scope**

#### Internal control procedures

38. We sent questionnaires to selected issuers about their internal control procedures on CCTs and the review by their INEDs of these transactions. This year, we selected 40 issuers from issuers that had conducted CCTs under framework agreements approved by independent shareholders during the financial year and had also failed to comply with the CCT Rules<sup>9</sup> in the past three financial years.
39. We requested information in the questionnaire on, among others, the following:
- (a) issuers' internal control procedures to monitor individual CCTs and ensure they were conducted in compliance with the agreements and the CCT Rules;
  - (b) issuers' mechanisms to examine these internal control procedures regularly to ensure their effectiveness;
  - (c) INEDs' view on the effectiveness of these procedures and recommendations, if any, to strengthen them; and
  - (d) issuers' implementation of remedial measures (if any) to prevent recurrence of previous non-compliances with the CCT Rules.

#### INED's review

40. We also requested information about INED's monitoring work, including:
- (a) information provided by issuers' management to assist INEDs in their annual review of CCTs and INEDs' view on the sufficiency of such information;

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<sup>9</sup> These non-compliances mainly related to delay in announcement of CCTs under MB Rule 14A.35 / GEM Rule 20.33 and / or exceeding of annual caps without timely re-compliance with the announcement and / or shareholders' approval requirements under MB Rule 14A.54 / GEM Rule 20.52.

- (b) any major challenges or difficulties encountered by INEDs in the annual review, and how they were resolved; and
- (c) any additional work performed by INEDs to oversee existing CCTs on an ongoing basis.

### Annual report disclosure

41. We reviewed issuers' compliance with the disclosure requirements set out in paragraph 36 above. This year, we selected and reviewed the annual reports of 148 issuers, comprising (i) all those issuers that had failed to comply with the disclosure requirements under last year's review; and (ii) those issuers, selected on a sample basis, which had conducted CCTs under framework agreements approved by independent shareholders during the financial year. We also reviewed the announcements and circulars of those selected issuers against the disclosure in their annual reports to assess their compliance with the annual report disclosure requirements of the Rules.

### **Findings**

#### Internal control procedures

42. The selected issuers had generally put in place reasonable internal control procedures to monitor CCTs:
- (a) They had mechanisms to identify connected persons through, for example, maintaining a list of connected persons with regular updates or conducting background checks before entering into transactions;
  - (b) They had formulated and followed internal guidelines and procedures to ensure the pricing terms of individual CCTs were in line with the specific pricing policies or mechanisms under the framework agreements, for example, by obtaining market prices or quotations from independent parties on a regular basis and comparing the pricing terms of the CCTs with the terms of the transactions with independent parties; and
  - (c) They monitored transaction amounts regularly to ensure the annual caps would not be exceeded. Some issuers adopted threshold reporting systems or prepared financial forecasts to monitor the annual caps.
43. All selected issuers engaged external professional parties (e.g. their auditors or internal control professionals) to review their internal controls to ensure their effectiveness. A majority of them also required their internal audit function (or another team of similar function) to review the CCTs periodically and perform sampling inspections to ensure the internal control procedures were followed.

44. The INEDs of all selected issuers considered that the issuers' internal control procedures were properly implemented and effective. Some INEDs made further recommendations to enhance the procedures, including (i) providing more frequent updates to INEDs (such as the status on utilisation of annual caps; (ii) making clearer delineation of responsibilities between different departments of the issuers to monitor CCTs and setting up or enhancing internal audit roles to regularly review internal control procedures; and (iii) providing regular training for the issuers' senior management and employees on the CCT Rules.
45. Some selected issuers had previously proposed measures to remedy their non-compliances with the CCT Rules. Our review indicated that all of these issuers have implemented the proposed measures, and their INEDs have concluded that those measures were effective. We have not noted further non-compliances by these issuers.

### INED's review

46. The selected issuers generally provided their INEDs with relevant information for their annual review, including (i) findings of internal control reviews by internal audit or external professional parties to support the adequacy of the internal controls; (ii) agreements and invoices of the relevant transactions, quotations and related price or market trend data to demonstrate that the individual transactions were conducted on normal commercial terms; and (iii) comparisons of actual transaction amounts with annual caps to substantiate compliance with the annual cap. The INEDs of the selected issuers confirmed that such information was sufficient for their review purpose.
47. The majority of the INEDs reported that they did not encounter any major challenges or difficulties in performing the annual review. A few issuers' INEDs noted some delays in obtaining relevant information to review the CCTs due to ineffective communication among the issuers' different departments. They recommended appropriate internal guidelines and timetables be formulated to improve effectiveness.
48. Apart from reviewing CCTs on an annual basis, the INEDs of some selected issuers performed additional work to oversee the CCTs. These included (i) attending periodic meetings with the audit committee, management and internal auditors to review the transactions and the related internal controls; (ii) reviewing quarterly management reports on the status of the transactions and the utilisation of annual caps; and (iii) reviewing the updated lists of connected persons.

49. INEDs play an important role in providing checks and balance over the issuers' corporate affairs and transactions. The appropriate level and scope of, and specific measures required for, monitoring CCTs are expected to be commensurate with the individual circumstances of the issuers, including the type and volume of the transactions, and their complexity and the risks involved. We appreciate and note that some issuers' INEDs (see paragraph 48 above) conduct ongoing monitoring of CCTs and encourage other issuers to consider adopting similar processes, subject to their own circumstances.

Annual report disclosure

50. We noted that a vast majority of issuers continued to comply with the annual report disclosure requirements set out in paragraph 36 above. A small number of issuers failed to (i) confirm in their annual reports whether their related party transactions were connected transactions under the Rules and if so, whether these transactions complied with the connected transaction requirements; and / or (ii) disclose the auditors' and / or INEDs' review findings on CCTs. These issuers, in response to our enquiry, disclosed this information by supplemental announcements.

### **D. Disclosure of business review and significant investments in the MD&A section**

51. The MD&A section serves to provide meaningful information that enables shareholders and investors to appraise an issuer's performance and prospects. For this purpose, the Rules<sup>10</sup> require, among others, an issuer to include in its annual report a review<sup>11</sup> of its business, the principal risks and uncertainties facing the issuer, important events occurred during the financial year under review and an indication of likely future business developments.
52. The Rules also require an issuer to disclose its significant investments held, their performances during the financial year and future prospects. With effect from 1 October 2019, the Rules were amended to codify a number of our previously recommended disclosure to allow shareholders to better appraise such investments. They included a breakdown of the issuers' significant investments as at the financial year end date, including (i) the names and principal businesses of the underlying companies, the number and percentage of shares held and the investment costs; (ii) the fair value of each significant investment as at the financial year end date and its size relative to the issuers' total assets; (iii) the performance of each significant investment during the year, including any realised and unrealised gain or loss and any dividends received; and (iv) a discussion of the issuers' investment strategy for these significant investments<sup>12</sup>.

### **Scope**

#### *Issuers subject to the recent changes in the PRC regulations*

53. Issuers face industry related risks and uncertainties which may have significant impact on their financial performances and future business developments. For example, issuers operating in highly regulated industries may be affected by changes in regulatory requirements or government policies, and such changes may impact their business operations and profitability, market position and / or development prospects. Our previous reports recommended that issuers should discuss specifically how these major risk areas or uncertainties would affect their business operations, the financial impact, and what measures they may have taken to manage those risks.

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<sup>10</sup> Paragraphs 28(2)(d), 32 and 52 of Appendix 16 to the MB Rules / GEM Rules 18.07A(2)(d), 18.41 and 18.83.

<sup>11</sup> Paragraph 28(2)(d) of Appendix 16 to the MB Rules / GEM Rule 18.07A(2)(d) and Schedule 5 of the Companies Ordinance.

<sup>12</sup> Paragraph 32(4A) of Appendix 16 to the MB Rules / GEM Rule 18.41(4A).

54. We reviewed the MD&A disclosure<sup>13</sup> of 46 issuers with major operations<sup>14</sup> in the pharmaceutical or education industries in the PRC in view of the following changes in PRC regulations and / or government policies during the financial year under review:

- (a) A pilot scheme for pharmaceutical tendering with minimum procurement quantities was launched and applicable to specific drugs in 11 selected PRC cities, which together represented a material share of the PRC drug market. Under the previous tendering system, public hospitals must procure a particular drug at the bid price from the successful bidder but without making a minimum purchase commitment. The new pilot scheme stipulates an intended quantity commitment for each specific drug, and public hospitals must prioritise their purchases from the successful bidder until the quantity commitment has been satisfied. Market commentaries suggested that PRC pharmaceutical manufacturers may be more willing to cut their prices to win a tender and as a result, the new pilot scheme may cause a sharp decline in prices for selected drugs.

Of the 30 PRC pharmaceutical issuers under review, 22 issuers disclosed that their major customers included hospitals and accordingly, might be affected by the new pilot scheme.

- (b) A draft revised PRC private education law was published for consultation and would, among others, prohibit entities from taking effective control of non-profit private schools through contractual agreements. The proposed change, if implemented, might affect PRC education issuers that employ contractual arrangements to hold their non-profit private schools.

Of the 16 issuers operating private schools, 10 issuers operated non-profit private schools through contractual arrangements.

- (c) Policies relating to preschool education in the PRC were issued by the relevant PRC authority which stipulated that: (i) private kindergartens are not allowed to form the whole or part of business for listing purpose; and (ii) issuers are prohibited from investing in for-profit kindergartens by means of issuing new shares or cash payment.

Of the 16 issuers operating private schools, five<sup>15</sup> issuers are engaged in preschool education.

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<sup>13</sup> This includes chairman's statement, management discussion and analysis and business review.

<sup>14</sup> This represented issuers with over 50% of their revenue generated from the pharmaceutical or education industries in the PRC during the financial year.

<sup>15</sup> This includes four issuers that also operated non-profit private schools through contractual arrangements

55. We assessed whether these selected issuers made disclosure regarding the following areas:
- (a) the major changes in regulations and / or government policies. The issuers should elaborate on the key changes and how such changes might apply to their operations;
  - (b) the impact of the changes in regulations and / or government policies on the issuers' operations and profitability during the financial year, if any. The issuers should make a meaningful assessment of the business / financial impact; and
  - (c) the principal risks and uncertainties arising from the major changes and an assessment of the potential risks to their business operations and the potential impact on their future business developments.

### Significant investments

56. In previous years, we noted that issuers' disclosure of their significant investments varied, and some issuers did not fully follow our recommended disclosure set out in paragraph 52. This year, we continued our review in this area and selected 106 issuers with significant investments for review. These issuers' total investments accounted for 20% or more of their total assets as at the financial year ends.

### **Findings**

#### Issuers subject to the recent changes in the PRC regulations

57. We noted that a few issuers have provided detailed disclosure on the major regulatory and / or governmental policy changes, their potential impact and measures they have taken or will take to manage the risks and uncertainties in the business review section. For example,
- (a) A few issuers principally engaged in manufacture and sales of pharmaceutical products disclosed in their annual reports that their major products are not covered under the pilot scheme and accordingly, their sales would not be affected by the new regulations.
  - (b) An issuer providing private education in the PRC disclosed that in view of the consultation proposals to restrict the use of contractual arrangements to hold non-profit private schools, it may transform some of its non-profit private universities into for-profit private universities. The issuer also disclosed the estimated additional capital required for such changes.

- (c) Five issuers operating kindergartens as part of their principal businesses (paragraph 54(c) above) disclosed in their prospectuses that they would allocate part of their IPO proceeds to further expand through acquiring or setting up new kindergartens. In view of the new policies issued in 2018, three issuers disclosed in their annual reports the details of the policies and the potential impact to their operations. These issuers disclosed uncertainties about their operations of private kindergartens through a listed company and quantified the number of kindergartens potentially affected. To manage uncertainties arising from the prohibition from investing in for-profit kindergartens under the new policies, one issuer disclosed that it would continue to monitor the relevant regulatory developments and might adjust its business focus and the use of the IPO proceeds where appropriate.
58. However, a large majority of the issuers under review did not disclose the major changes in regulations and / or government policies relevant to their operations. These issuers also did not assess the potential impact arising from changes to their operations.
- (a) A large majority of the selected pharmaceutical manufacturers only referred to the pilot scheme for pharmaceutical tendering but did not explain the key changes under the pilot scheme, and how such changes would affect their operations. These issuers did not disclose whether they currently operated in the 11 selected cities or whether their drugs fell under the pilot scheme. While the pilot scheme was published in late 2018 and might not have affected the financial performances for the financial year under review, we noted that these issuers did not highlight the changes in regulation as potential risks to their operations.
- (b) Most of the selected issuers that operated non-profit private schools through contractual arrangements mentioned the consultation proposal to disallow the holding of non-profit private schools through contractual arrangements and that it has yet to be promulgated. However, these issuers did not disclose the extent of their holdings of non-profit private schools under contractual arrangements to alert shareholders of the potential risk exposures.
- (c) An issuer engaged in preschool education in the PRC did not discuss whether the new policy restricting investments in for-profit kindergartens by cash would apply and affect its plan to acquire kindergartens with IPO proceeds.

### Recommendation

59. We recommend issuers to improve their disclosure by making clear disclosure about any risk areas such as major regulatory or governmental policy changes, and an assessment on the impact to their business operations and previously announced business plans. Issuers should highlight the principal risks and uncertainties arising from such changes. Where applicable, issuers should also discuss the impact of the policy changes to their financial performances during the financial year.

### Significant investments

60. We noted that a majority of the issuers disclosed information on their significant investments covering all or substantially all of the areas we recommended. Issuers who did not fully follow our recommended disclosure generally omitted information about the performance of the investments and their overall investment strategies. This year's findings represented a notable improvement from last year's as we noted a smaller proportion of issuers that did not follow any or part of our recommendations.
61. Following our enquiries, most issuers had disclosed the omitted information by supplemental announcements or in the subsequent financial reports. For the few issuers that did not make the supplemental disclosure, we have provided guidance to them.
62. Our recommended disclosure on significant investments have been codified into the Rules effective from 1 October 2019. Issuers are now required to disclose details of each investment that represents 5% or more of their total assets as at the financial year end date. We remind issuers to make proper disclosure of their significant investments in full compliance with the new Rules in their next annual reports.

### **E. Financial statements with auditors' modified opinions**

63. Issuers are obliged to provide shareholders with financial statements which fairly present their financial position and performance and are free from material misstatements. Such financial information is necessary for shareholders and investors to make an informed investment decision.
64. The Rules<sup>16</sup> require an issuer to provide more detailed or additional information if its financial statements do not give a true and fair view of its state of affairs, results of operations and cashflows.
65. Under the Corporate Governance Code<sup>17</sup>:
- (a) The board is responsible for ensuring that (i) the issuer establishes and maintains appropriate and effective internal control systems for proper financial reporting; and (ii) a review of the effectiveness of internal control systems is conducted at least annually and is reported to shareholders in its Corporate Governance Report. An issuer should disclose a narrative statement on its risk management and internal control processes<sup>18</sup>. It should, as best practice, disclose details of any significant areas of concern and confirmation from management of the effectiveness of the issuer's risk management and internal control systems<sup>19</sup>;
  - (b) The audit committee should monitor the integrity of the issuer's financial statements and review any significant financial reporting judgments contained in the annual reports, the going concern assumptions and any modifications, and compliance with accounting standards. It should also give due consideration to any matters raised by the auditors<sup>20</sup>; and
  - (c) The board should prepare the financial statements on a going concern basis, with supporting assumptions and modifications as necessary unless it is inappropriate to assume that the issuer will continue its business. Where the directors are aware of material uncertainties relating to events or conditions that may cast significant doubt on the issuer's ability to continue as a going concern, they should be clearly and prominently disclosed and discussed at length in the Corporate Governance Report. The disclosure should contain sufficient information for investors to understand the severity and significance of matters. The issuer may refer to other parts of the annual report but should not make cross-references only without any discussion of the matter<sup>21</sup>.

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<sup>16</sup> Paragraph 3 of Appendix 16 to the MB Rules / GEM Rule 18.47

<sup>17</sup> Appendix 14 to the MB Rules and Appendix 15 to the GEM Rules

<sup>18</sup> Code Provision C.2.4

<sup>19</sup> Code Provisions C.2.6 and C.2.7

<sup>20</sup> Code Provision C.3.3

<sup>21</sup> Code Provision C.1.3

66. In May 2019, we published the [Consultation Conclusions on the Proposal Relating to Listed Issuers with Disclaimer or Adverse Audit Opinion on Financial Statements](#) and introduced new Rules<sup>22</sup> that will normally require suspension of trading in an issuer's securities if it publishes a preliminary results announcement for a financial year and the auditor has issued, or indicated it would issue, a disclaimer or adverse opinion on the issuer's financial statements<sup>23</sup>. The suspension will normally remain in force until the issuer has addressed the issues giving rise to the disclaimer or adverse opinion. If the issuer fails to resolve the underlying issues that led to the disclaimer or adverse opinion during the remedial period, it may be delisted.
67. The new Rules will apply to financial years commencing on or after 1 September 2019.
68. In prior years' reports, we recommended that issuers with modified opinions disclose the following in their annual reports:
- (a) details of the modifications and their actual or potential impact on the issuers' financial position;
  - (b) management's position and basis on major judgmental areas (such as basis for impairment or valuation of assets), and how the management's view is different from that of the auditors;
  - (c) audit committee's view towards the modifications, and whether the audit committee reviewed and agreed with the management's position concerning major judgmental areas; and
  - (d) issuers' plans to address the modifications.

### Scope

69. This year, we reviewed the annual reports of 92 issuers<sup>24</sup> whose auditors expressed a modified opinion on the issuers' financial statements for the financial year ended in 2018. Of these 92 issuers, 29, 22, 9, 15, 8, 2, 2 and 5 issuers had modified opinions for the first, second, third, fourth, fifth, sixth, seventh and eighth year.

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<sup>22</sup> MB Rules 13.50A and 13.50B / GEM Rules 17.49B and 17.49C

<sup>23</sup> Suspension will normally not be required for (i) disclaimer or adverse opinion relating to going concern issue only; or (ii) the underlying issues giving rise to the disclaimer or adverse opinion have been addressed before the issuer publishes the preliminary results announcement.

<sup>24</sup> Excluding 19 issuers that were long suspended companies at the time they published the financial statements for 2018. Last year, there were 78 issuers (excluding long suspended issuers) that had modified opinions.

70. Our review focused on the adequacy of disclosure on the audit modifications, and actions taken by the issuers to address them.

### **Findings**

#### *(1) 29 Issuers with modified opinions for the first time*

71. Of the 29 issuers, seven issuers received modified opinions solely due to material uncertainties about their abilities to remain as going concerns; 19<sup>25</sup> issuers received modified opinions on the valuation of assets, a majority of which were related to the recoverability of receivables and deposits; and the remaining three issuers received modified opinions due to insufficient audit evidence to support a recognised income or the commercial substance of certain transactions, or disagreement on the application of accounting standards.
72. Compared to last year, the annual report disclosure of modified audit opinions by these issuers were less satisfactory. Only about one-third of the issuers made the recommended disclosure in full. Whilst the audit opinion included details of the audit modifications, the remaining issuers failed to discuss the audit modifications as recommended in paragraph 68 above. All these issuers, in response to our enquiry, disclosed the omitted information by supplemental announcements.
73. The action plans disclosed by issuers with only going concern modifications mainly included (i) obtaining new equity and / or debt financing; (ii) extending the maturity of existing loans or converting loans into shares; and (iii) implementing cost control measures. For issuers with modifications on the recoverability of receivables and deposits, the modifications were mainly due to insufficient objective evidence or failure by the management to justify the extent of impairment for the receivables and deposits. In such circumstances, we recommend that issuers should establish a credit loss policy supported by historical loss information and adjusted by forward looking economic factors, and make impairments according to such policy. Where issuers encounter unusual provisions or losses, they should engage their auditors at the earliest instance to discuss the impairment assessment.

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<sup>25</sup> Some of these issuers also have other modifications on, such as, going concern, limited access to books and records of subsidiaries or associates and disagreement on application of accounting standards.

### *(2) 63 Issuers with repeated modified opinions*

74. Of the 63 issuers, 32 issuers<sup>26</sup> resolved all underlying issues that led to the audit modifications, six issuers resolved the previous audit issues but received modified opinions on new issues, and 25 issuers were unable to resolve any, or only resolved some, of the issues.
75. Of the 38 issuers that had resolved all underlying issues that led to the previous year's audit modifications, nine issuers had modifications on the opening balances and comparative figures only as the audit issues were resolved in the previous financial year. For the remaining 29 issuers, most of them had audit modifications related to the valuation of various assets (including equity investments, goodwill and intangible assets, receivables and deposits) due to (i) limited access to financial information of investees; (ii) forecast without proper assumptions; and (iii) insufficient documents to support the recoverable values of aged receivables and deposits. These issuers resolved the issues mainly by (i) obtaining independent valuation on the assets; (ii) making appropriate and justifiable forecast assumptions; and (iii) disposing of the underlying assets. Compared to last year, considerably more issuers were able to resolve their audit issues.
76. Nine of the remaining 25 issuers have shown progress towards removing the modified audit opinion during the year, albeit still unable to resolve all the audit issues. 16 issuers were unable to resolve any of the underlying issues brought forward from last year. In particular:
- (a) most of the issuers with going concern issues took actions according to their action plans (which were similar to those set out in paragraph 73 above) during the financial year, but such actions did not significantly improve the issuers' financial conditions and the audit modifications remained;
  - (b) issuers with audit issues related to valuation of assets were unable to resolve those issues mainly because their plans to deal with the assets, in particular disposals of the assets or attempts to gain access to books and records of investees, failed to materialise. In other cases, the actions taken were considered inappropriate by the auditors. For example, some issuers prepared valuation reports using inappropriate valuation methodologies or unsubstantiated assumptions; and
  - (c) some issuers were unable to resolve the audit issues due to disagreement with auditors on the application of accounting standards / treatments. For example, an issuer proposed to enter into sales contracts with customers to support its recognition of sales revenue, but it failed to sign the contracts.

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<sup>26</sup> The audit modifications of these 32 issuers were not related to material uncertainties about going concerns.

77. A modified audit opinion on the financial statements indicates a risk of material misstatement and compromises the quality of financial information provided to shareholders. We noted that some issuers have made progress towards resolving audit modifications, however, in view of a significant number of issuers with unresolved audit issues, we encourage these issuers to actively engage their auditors on the action plans at the earliest instance. For issuers with audit issues related to valuation of assets, they should discuss with the auditors on the valuation methodologies and assumptions to be adopted.

### Disclosure in the annual reports

78. Issuers generally followed our recommendations to disclose information on the modified opinion in their annual reports, including the management position, audit committee's view and the action plans to resolve the audit issues. However, we noted that most of the issuers with repeated modified opinions did not disclose the actions taken and whether they had followed their action plans towards resolving the audit issues during the current financial year. We recommend that issuers update shareholders on their actions taken and the action plans to address the audit issues.

### (3) Other disclosure – Corporate Governance Report

79. In a few cases where the audit modifications arose from inadequate documentation or loss of access to books and records of subsidiaries, we noted that those issuers did not discuss the internal control deficiencies or confirmed that there were no deficiencies in their Corporate Governance Reports. This is despite the requirements for issuers to include in their Corporate Governance Reports a narrative statement on its risk management and internal control processes and, as a recommended best practice, disclose details of any significant areas of concern about their internal control systems. These issuers, in response to our enquiry, clarified the discrepancies and disclosed their remedial actions taken (or to be taken) by supplemental announcements.
80. This year, a large majority of issuers with audit modifications on going concerns have made the required disclosure in their Corporate Governance Reports. This is a significant improvement compared to less than one-half last year.
81. We remind issuers that had internal control issues and / or going concern modifications to have due regard to the requirements under the Corporate Governance Code and make appropriate disclosure.

### F. Disclosure on material other expenses / income

82. Under the Rules<sup>27</sup>, issuers should present in their annual reports a discussion and analysis of their performances during the financial year and the material factors underlying their results and financial positions. Issuers should emphasise trends and identify significant events or transactions during the financial year under review.
83. The statement of profit or loss presents important information on an issuer's financial performance during the year. Material income and expense items in the statement of profit or loss could affect an issuer's profitability and financial position significantly, and for that reason the issuer should make adequate disclosure to describe the nature of, and explain the movements of these material items. Such disclosure facilitate investors in understanding the major factors contributing to the issuer's financial performance during the year.

#### Scope

84. Last year, we reviewed for the first time issuers' disclosure of material other expenses and other income in their annual reports. We found that about two-thirds of the issuers that reported material "other / other operating expenses" provided no or limited breakdown of such expenses.
85. This year, we continued to review issuers' disclosure in this area. Applying the same criteria adopted last year, we selected 352 issuers that recorded material "other / other operating expenses" and 318 issuers that recorded material "other / other operating income" as a line item in their statements of profit or loss<sup>28</sup>. We reviewed disclosure in the annual reports on these expenses or income, including notes to the financial statements and commentaries in the MD&A section (if any).

#### Findings

##### Other expenses

86. About one-half of the selected issuers provided breakdown for all or most of the reported "other / other operating expenses" in the notes to the financial statements. This represents an improvement compared to only about one-third last year. The "other / other operating expenses" items were mainly advertising expenses, travelling expenses, impairment losses on assets (e.g. goodwill, trade and other receivables, inventories), auditors' remuneration, legal and professional expenses and operating lease charges.

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<sup>27</sup> Paragraph 32 of Appendix 16 to the Main Board Rules / GEM Rule 18.41

<sup>28</sup> The "other expenses / other operating expenses" or "other income / other operating income" accounted for over 25% of these issuers' revenue or profit or loss and were over HK\$10 million.

87. The remaining issuers provided no breakdown of the “other / other operating expenses” or a breakdown of only a minor portion of the “other / other operating expenses”. In a small number of cases, the unexplained “other / other operating expenses” were also material with reference to the issuer’s total costs and expenses for the year<sup>29</sup>. We have provided guidance to these issuers in respect of the above.
88. To enhance shareholders’ understanding, we urge issuers to disclose meaningful information by providing appropriate breakdown of their other expenses items in their future annual reports.

### Other income

89. All the selected issuers with material “other / other operating income” disclosed a breakdown of all or a material portion of the “other / other operating income” in the notes to the financial statements. We did not identify issues in this area.

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<sup>29</sup> The “other / other operating expenses” accounted for more than 20% of those issuers’ total costs and expenses for the year.

### **G. Issuers listed under the new listing regime for weighted voting rights and biotech companies**

90. In April 2018, the Exchange introduced Chapter 8A for the listing of issuers with weighted voting right (**WVR**) structure and Chapter 18A for the listing of biotech companies that do not meet any of the financial eligibility tests under Rule 8.05. To date, there are two WVR issuers listed under Chapter 8A and 14 biotech companies listed under Chapter 18A. Among them, the two WVR issuers and six biotech companies have published their annual reports for the financial year ended in 2018<sup>30</sup>.
91. In view of the potential risks associated with non-standard governance features of WVR issuers and early stage biotech companies, the Rules require the following post-listing safeguards to protect shareholders and prospective investors.

#### WVR issuers

92. Issuers listed under Chapter 8A are permitted to maintain a class of shares with WVR entitling the beneficiaries of such shares to have voting power greater than or superior to that attached to an ordinary share. In this connection, the Rules set out certain restrictions on WVR shares and enhanced corporate governance requirements for WVR issuers:
- (a) The beneficiary's WVR in the issuer must cease if the individual ceases or becomes unsuitable to be a director<sup>31</sup>, or transfers their interests in the WVR shares, or control over the WVR attached to such shares, to another person<sup>32</sup>;
  - (b) A WVR issuer must not increase the proportion of WVR shares after listing. It can only issue new WVR shares under a pre-emptive offer to all shareholders, or other pro-rata arrangements such as scrip dividends or stock splits<sup>33</sup>. Also, if it reduces the number of shares in issue (e.g. by a share repurchase) resulting in an increase in the proportion of the WVR shares, the WVR beneficiaries must reduce their WVR shares proportionately by, for example, converting some WVR shares to ordinary shares<sup>34</sup>; and

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<sup>30</sup> The remaining eight biotech companies were listed in 2019.

<sup>31</sup> MB Rules 8A.11 and 8A.17.

<sup>32</sup> MB Rule 8A.18.

<sup>33</sup> MB Rule 8A.14.

<sup>34</sup> MB Rule 8A.15.

- (c) The WVR beneficiaries can only vote on a “one-share one-vote” basis on material corporate matters including changes to the issuer’s constitutional documents, variation of rights attached to any class of shares, appointment or removal of independent non-executive directors or auditors, and voluntary winding-up of the issuer<sup>35</sup>.
93. A WVR issuer must establish a Corporate Governance Committee (the **CG Committee**) comprising entirely independent non-executive directors to provide oversight and discharge the following additional duties specific to WVR issuers under its term of reference<sup>36</sup>:
- (a) confirm annually whether the requirements described in paragraph 92 above have been complied with throughout the year;
  - (b) review and monitor whether the issuer is operated for shareholders’ benefits;
  - (c) review and monitor the management of conflicts of interests with WVR beneficiaries and all risks related to the WVR structure (including connected transactions with WVR beneficiaries) and make recommendation to the board on any such matter or transaction;
  - (d) make recommendation to the board on appointment or removal of compliance adviser; and
  - (e) seek to ensure effective and on-going communication between the issuer and its shareholders, in particular in using shareholders’ meetings and encouraging participation in such meetings.
94. The Rules also set out enhanced annual reporting requirements for WVR issuers. In particular, a WVR issuer must disclose a summary of the work of the CG Committee with regard to its terms of reference in the Corporate Governance Report.
95. In its annual reports, a WVR issuer must also include a warning that the issuer is a company controlled through weighted voting rights and describe the WVR structure, rationale and associated risks for shareholders. Further, it must disclose the identities of the WVR beneficiaries, impact of a potential conversion of WVR shares into ordinary shares, and all circumstances in which the WVR will cease<sup>37</sup>.

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<sup>35</sup> MB Rule 8A.24.

<sup>36</sup> Rules 8A.30 and 8A.31

<sup>37</sup> Rules 8A.37, 8A.39, 8A.40 and 8A.41

### Biotech companies

96. Rule 18A.08 requires a biotech company to disclose in its annual and interim reports:
- (a) the details of key stages for each of their core products under development to reach commercialisation, and a general indication of the likely timeframe, if the development is successful, for the core product(s) to reach commercialisation;
  - (b) a summary of expenditure incurred on their research and development activities; and
  - (c) a prominently disclosed warning statement that their core product(s) may not ultimately be successfully developed and marketed.

### **Scope**

97. We have reviewed the annual reports of the two WVR issuers and six biotech companies which have published their annual reports for the financial year ended in 2018, and assessed whether these issuers and their annual reporting have complied with the relevant Rules.

### **Findings**

#### WVR issuers

98. Both WVR issuers made the required disclosure in their annual reports. We did not identify issues in this area:
- (a) *Enhanced corporate governance and reporting* - Both WVR issuers have established a CG Committee comprising independent non-executive directors to provide oversight. The issuers have disclosed a summary of the work performed by the CG Committees with regard to their terms of reference in the Corporate Governance Report. They have also disclosed the information set out in paragraph 95 above.
  - (b) *Restrictions on WVR shares* – The CG Committees of both WVR issuers have confirmed that the WVR issuers complied with the Rules described in paragraph 92. One issuer had made a number of share repurchases during the year and consequently converted some of its WVR shares into ordinary shares in accordance with the Rules to maintain the proportion of WVR shares. In addition to the disclosure required under the Rules, the issuer made additional disclosure of the details of these share repurchases and the conversion of WVR shares into ordinary shares in its annual report.

### Biotech companies

99. All six biotech companies made the required disclosure in their annual reports and we did not identify issues in this area:
- (a) *Key stages of research and development* - All six biotech companies updated the progress of their research and development activities (e.g. patient enrollment, first dosage to patients, updates on response rate, treatment duration and / or safety and efficacy data based on clinical trials) relating to their core products in the annual reports. Such disclosure is consistent with the business update announcements (including inside information and voluntary updates) made by the biotech companies from time to time. They also included a summary table illustrating the stage of developments of the core products and the expected timeframe for the next stage of clinical trial or obtaining the relevant regulatory approvals for commercialisation.
  - (b) *Summary of research and development expenditures* - All six biotech companies included a summary of their research and development expenses in their annual reports. They provided a breakdown of their research and development expenses by nature of activities, such as contracting costs, clinical trial expenses, licensing fees, staff costs, and depreciation and amortisation, and / or discussed the key items driving the year-to-year fluctuations of their research and development expenses.
  - (c) *Warning statement* - All six biotech companies included the requisite warning statement in their annual reports.
100. Some biotech companies further disclosed material developments to their drug portfolio in addition to the required disclosure of core products under development. These included the post-commercialisation developments (e.g. information about the revenue generated, market coverage, and status of enrollment into insurance programme and eligibility for government subsidies), as well as the major developments of their products which were newly in-licensed or considered non-core at the time of IPO (e.g. progress to the next stage of clinical trial and / or obtaining the relevant regulatory approvals). The additional disclosure provides investors with relevant and material information to appraise the biotech companies' business development.

### III. ISSUERS LISTED IN 2017 AND 2018

101. As part of the Listing Division's ongoing monitoring activities, we reviewed new issuers' post-listing corporate activities, Rule compliance and annual report disclosure. This section highlights our general observations and recommendations.

#### **Scope**

102. 161 and 208 issuers were listed in 2017 and 2018 respectively (the **Newly Listed Issuers**)<sup>38</sup>.

103. In last year's report, we noted concerns<sup>39</sup> that some issuers might have sought new listings for the perceived premium attached to the listing status rather than the development of the underlying business or assets. In light of this, we reviewed the post-listing developments of the new issuers, particularly where they have exhibited "shell" characteristics after listing. This year, we continued this review.

104. In addition, we monitored the post-listing activities of the Newly Listed Issuers, including their compliance with the Rules and their disclosure in announcements and annual reports in the following areas:

- (a) profit forecasts and material decrease in financial results;
- (b) changes in the use of IPO proceeds;
- (c) non-compliance with the Rules after listing; and
- (d) fulfilment of conditions or undertakings imposed or provided before listing.

#### **Findings**

##### *(a) Post-listing developments of the Newly Listed Issuers*

105. Similar to last year, we reviewed whether the Newly Listed Issuers had undertaken one or more of the significant corporate actions after listing, including: (i) disposals of controlling interests by the original controlling shareholders; (ii) material acquisitions of new businesses and / or material disposals of original businesses; and / or (iii) reallocation of IPO proceeds to new businesses.

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<sup>38</sup> Transfers of listing from GEM to Main Board are excluded.

<sup>39</sup> See our Guidance Letter [GL68-13A](#).

106. We noted 20 Newly Listed Issuers that have undertaken these significant corporate actions, including (a) 15 issuers where their controlling shareholders disposed of their controlling interests in the issuers; (b) five issuers that proposed material acquisitions of new businesses; and (c) two issuers that re-allocated part of their IPO proceeds to finance the acquisitions of new businesses.
107. In addition to the significant corporate actions, we have also noted a few issuers proposed transactions and / or arrangements that would have the effect of circumventing the new listing requirements. We have applied the reverse takeover requirements to those proposed transactions. For example:
- (i) In one case, the issuer proposed a very substantial acquisition of a business that was excluded from the issuer's group at the time of listing. It disclosed in the prospectus that the excluded business would face more intense market competition and have different risk profile with lower profit margin. Shortly after listing, the issuer proposed to acquire the excluded business. That excluded business might not in itself meet the eligibility requirements for a new listing, and represented a significant part of the issuers' enlarged group and a fundamental change of the issuer's business as at the time of listing.
  - (ii) In another case, shortly after the expiry of the lock-up period, the issuer underwent a change in control and all the directors resigned. The revenue of the IPO business declined significantly. Shortly thereafter, the issuer proposed to provide the new controlling shareholder with new services that were unrelated to its original business, and the size of which would be significant to the issuer. The proposed transactions raised concerns that the issuer business would change fundamentally, and that it would result in a listing of the new service business. This service business had no track record and would not have met the new listing requirements.
108. As part of our initiatives to deter "shell" activities, we published the [Consultation Conclusions on Backdoor Listings, Continuing Listing Criteria and Other Rule Amendments](#) in July 2019, and the new Rules became effective on 1 October 2019. We will continue to closely monitor the post-listing activities conducted by new issuers and take appropriate actions to deter potential shell activities.
- (b) Profit forecasts and material decrease in financial results*
109. A vast majority of the Newly Listed Issuers did not publish any profit forecast in their prospectus. Those Newly Listed Issuers that published a profit forecast were able to meet the forecasted profits.

### Profit warning announcements

110. Some Newly Listed Issuers published profit warning announcements in respect of their first interim periods or financial years immediately after listing.
111. One-third of these issuers reported post-listing financial results that were largely consistent with the profit forecasts submitted to the Exchange as part of the new listing applications. A majority of these issuers forecasted decline in financial results due to increases in listing expenses. Of the remaining two-third of issuers reviewed, their financial results deviated materially from the profit forecast previously submitted. These deviations mainly resulted from increases in expenses or market downturns after listing. Most of the issuers explained the material changes in the financial results in the profit warning announcements. A few cases continue to be under our review.
112. In previous years, we reminded issuers to observe the guidance set out in the SFC Corporate Regulation Newsletters<sup>40</sup> and our previous reports that they should not issue profit alert announcement that merely repeats facts previously disclosed in the prospectus, and the issuers should quantify the potential impact to the profit figure and use clear and concise language in the profit alert announcement. Despite this reminder, we noted that about half of the issuers under review did not quantify the financial impact in terms of percentages or in dollar amounts in their profit warning announcements, and a small number of issuers merely repeated information that was previously disclosed in the prospectus. We remind issuers again to observe our guidance.

### (c) Changes in the use of IPO proceeds

113. The disclosure of the use of IPO proceeds in prospectuses and annual reports indicates how a new issuer deploys resources to develop and expand its business. This is relevant information for investors to appraise the issuer's business development and make informed investment decisions. When assessing a new listing applicant's suitability for listing, we focus on a qualitative review of its commercial rationale for listing, including whether a listing of the applicant is consistent with the proposed use of proceeds<sup>41</sup>. Where a newly listed issuer changes its use of IPO proceeds and / or business strategies shortly after listing, we would assess whether the issuer has timely and properly explained any material changes by way of announcement.

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<sup>40</sup> These refer to the [April 2015](#) and [December 2016](#) SFC Corporate Regulation Newsletters. According to the guidance, profit alert announcement that repeats facts previously disclosed in the prospectus is not necessary and may even cause confusion. If an issuer feels that it needs to make such an announcement, it should clarify the extent to which the information in the announcement differs from those previously disclosed in the prospectus. If there has been a significant change in the facts and circumstances since the prospectus was issued, the issuer may be required to make an announcement under the Inside Information Provisions.

<sup>41</sup> [Guidance Letter GL68-13A](#)

114. Some Newly Listed Issuers announced changes to their proposed uses of IPO proceeds within the first two years after listing, the number of such cases were comparable to last year. For a vast majority of these issuers, the changes related to reallocation of funds among different originally intended uses disclosed in the prospectus, or reassignment of funds to the existing businesses of the issuers. Generally, the reasons for the changes related to failures to identify acquisition targets, unexpected declines in the businesses that were originally planned for expansion, and changes in market or regulatory policy. We have reviewed their disclosure and noted that all these issuers (except one) had explained the changes on a timely basis. One issuer delayed announcing the changes for about one year until the publication of the annual report and may have made inaccurate disclosure in its quarterly and interim result announcements / reports (see paragraph 115(iii) below). This case is under review.

(d) Non-compliance with the Rules after listing

115. We noted an increase in the number of new issuers that did not comply with the Rules shortly after listing. The breaches / potential breaches included:
- (i) non-compliance with notifiable / connected transaction requirements (29 cases) where the issuers failed to announce notifiable / connected transactions in a timely manner and seek shareholders' approval for the proposed transactions (including one case that involved repeated non-compliances with the notifiable and connected transaction Rules and possible failure by the issuer to maintain adequate internal control and / or corporate governance measures);
  - (ii) non-compliance with the financial reporting / results announcements requirements (8 cases) where the issuers failed to dispatch / announce the financial reports / results within the prescribed period under the Rules;
  - (iii) failure to make accurate and complete disclosure in the announcements and / or financial reports (2 cases) (including the issuer described in paragraph 114 above);
  - (iv) failure to meet the minimum public float requirement (2 cases). Both cases involved connected persons (other than controlling shareholders) acquiring shares in the issuers, resulting in failure to comply with the minimum public float requirement;
  - (v) non-compliance with the lock-up requirement on controlling shareholders' interest (1 case);
  - (vi) non-compliance by directors with the dealing restrictions during the black-out period (2 cases); and
  - (vii) failure to cancel the repurchased shares in a reasonably practicable period of time (1 case).

116. We have taken appropriate actions (including disciplinary actions) against these issuers. Chapter 3A (or Chapter 6A of GEM Rules) requires an issuer to consult with its compliance adviser on a timely basis in certain circumstances, specifically (i) before the publication of any regulatory announcement, circular or financial report; (ii) where a transaction which might be a notifiable or connected transaction is contemplated including share issues and share repurchases; and (iii) where there is a proposed change of the use of IPO proceeds, or a proposed change in business activities, developments or results which deviated from any forecast, estimate or other information in the prospectus. We continue to remind all new issuers to observe the Rule requirements to consult with their compliance advisers in a timely manner in the aforesaid circumstances.

(e) Fulfilment of conditions or undertakings imposed or provided before listing

117. For some Newly Listed Issuers, the Listing Committee required them to provide undertakings to take certain actions and disclose in their subsequent annual reports whether the relevant undertakings were fulfilled. These included updates on the latest regulatory developments and report on independent advisor's findings on implementation of risk management systems. All these issuers had disclosed such information in their annual reports.

118. The major shareholders of some Newly Listed Issuers also provided a non-competition undertaking (**NCU**) to the issuers to establish a clear delineation between the issuer's business and that of the major shareholders. In a majority of the cases, the major shareholders undertook that they would take steps to comply with their obligations under the NCUs and make annual declarations confirming such compliance in the annual reports. However, we noted that, notwithstanding these undertakings, a few issuers failed to disclose the annual declarations made by the major shareholders and the steps undertaken by them to comply with the NCUs. All these issuers, in response to our enquiry, disclosed the omitted information by supplemental announcements or agreed to disclose such information in their forthcoming financial reports. We have also given guidance reminding these issuers to ensure disclosure of the same in their future annual reports.

#### IV. FINDINGS REGARDING ACCOUNTING REVIEW THEMES

##### A. Material intangible assets

119. Intangible assets including goodwill are often significant assets of an issuer and impairment of these assets remains an ongoing key area of focus for investors. It is critical for issuers to make sufficient disclosure with reference to HKFRSs, particularly information on management's judgements and estimates in the preparation of the financial statements.
120. Recognition, measurement and relevant disclosure requirements of intangible assets are primarily set out in Hong Kong Accounting Standard (HKAS) 36 "Impairment of Assets", HKAS 38 "Intangible Assets" and HKFRS 3 (Revised) "Business Combinations".
121. In previous year's review, we found the following three key areas, particularly about their accounting judgements or estimates under HKAS 1 (Revised) "Presentation of Financial Statements" (HKAS 1R.122 and 1R.125), where enhancements could be made to provide better information to investors and made the following recommendations:

Area	Our recommendations
(1) Disclosure on the reasonableness of the financial budgets and assumptions used in determining the recoverable amounts	<ul style="list-style-type: none"> <li>• Directors and management should be responsible for performing proper analysis and exercising judgement to assess the reasonableness of key assumptions applied in impairment testing so that assumptions applied are not overly optimistic.</li> <li>• Provide the following additional information in the MD&amp;A and financial statements (where appropriate):               <ul style="list-style-type: none"> <li>(a) providing additional quantitative data of key assumptions (other than discount rate and terminal growth rate, e.g. gross and net margins), comparative information in the previous year and the explanation of significant changes of assumptions;</li> <li>(b) providing a negative statement indicating that reasonably possible change in the key assumptions on which the management had based its determination of the CGU's recoverable amount would not cause an impairment loss;</li> <li>(c) providing the recoverable amount of the CGU and the headroom available;</li> <li>(d) highlighting whether the impairment assessment is based on a valuation by an independent professional valuer; and</li> <li>(e) providing details of further development of the CGU or segment, such as business plan and contracts with new customers in the coming year and their impact on the revenue and margins.</li> </ul> </li> </ul>

## Review of Issuers' Annual Report Disclosure – Report 2019

Area	Our recommendations
(2) Disclosure on the assessment of the intangible assets with indefinite or long useful lives	<ul style="list-style-type: none"> <li>• Issuers should take into account all of the relevant factors and disclose the key judgements made by the management in determining the useful life of an intangible asset. The disclosure should be tailored to their specific circumstances.</li> <li>• Highlight in the financial statements that an annual review has been performed to determine whether events and circumstances continue to support their useful life assessment, in particular, cases where an intangible asset is classified as having an indefinite or a long useful life.</li> </ul>
(3) Disclosure on the accounting for business combinations, in particular whether the intangible assets had been properly identified, separately recognised and measured at fair value	<ul style="list-style-type: none"> <li>• Issuers should recognise all identifiable intangible assets acquired in a business combination separately from goodwill and measure the identifiable intangible assets at their acquisition-date fair values initially. In addition, before recognising a gain on bargain purchase, issuer should reassess whether it had correctly identified all of the assets acquired and all of the liabilities assumed and recognised any additional assets or liabilities that were identified.</li> <li>• Provide additional disclosure, such as:               <ul style="list-style-type: none"> <li>(a) highlighting the fact that an analysis of the intangibles in accordance with the separability criterion under HKFRS 3R.B33 has been performed; and disclosing, where relevant, the significant judgements underlying the conclusion whether separation of intangible assets from goodwill is deemed necessary; and</li> <li>(b) indicating how the assets and liabilities are reassessed in accordance with HKFRS 3R.36 when disclosing the reasons why the business combination results in a gain on bargain purchase (as required by HKFRS 3R.B64(n)).</li> </ul> </li> </ul>

### Scope

122. For this purpose, we selected the review cases from issuers whose intangible assets had accounted for over 25% of their total assets and excluded the 165 cases that were reviewed under this review theme in last year's review.
123. Out of 300 cases reviewed under the FSRP this year, we selected 70 issuers under this review theme, of which 45 issuers newly fell into this category and 25 issuers were follow-up review from the FSRP last year.
124. We continued to review the issuers' financial statement disclosure relating to the material intangible assets to assess whether they had complied with the requirements under HKAS 36, HKAS 38 and HKFRS 3 (Revised). We also examined the level of detail of their disclosure, particularly information on management's judgements and estimates (HKAS 1R.122 and 1R.125), to justify whether:
- (a) the financial budgets and assumptions used in determining the recoverable amounts were reasonable;
  - (b) the intangible assets disclosed as having indefinite or long useful lives were supportable; and

- (c) the intangible assets had been properly identified, separately recognised and measured at fair value in business combinations.
125. Regarding the follow-up review cases, in last year's review, we raised enquiries in relation to the details of impairment assessment of intangible assets and goodwill and / or suggested these issuers to provide additional information about impairment assessment. This year, we continue to focus on the review area set out in paragraph 124 above; and review whether these issuers provided the recommended disclosure set out in paragraph 121 above.

### **Findings**

126. We observed that the issuers under review generally included the required disclosure. Based on our review and issuers' responses to our enquiries, we did not note any significant non-compliance regarding the disclosure requirements in HKAS 36, HKAS 38 and HKFRS 3 (Revised)<sup>42</sup>.
127. We set out below our observations and recommendations in relation to the above-mentioned three key areas.
- (1) Disclosure on the reasonableness of the financial budgets and assumptions used in determining the recoverable amounts
128. A majority of issuers under review had goodwill and intangible assets with indefinite useful lives, which were subject to annual impairment test. Most of these issuers determined the recoverable amounts<sup>43</sup> of the cash-generating units (**CGUs**) to which goodwill and intangible assets were allocated based on value in use (**VIU**) calculation.
129. Same as previous years, we noted many cases where there were indications of possible impairment but no impairment losses were recognised, in particular when (i) the group or the CGU suffered recurring operating losses or deterioration in revenue, net profit or gross profit margin, or (ii) for certain industries, the carrying amount of the issuer's net assets was substantially more than its market capitalisation.
130. Under the above circumstances, we made enquiries to request additional information and explanations from the relevant issuers, including:

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<sup>42</sup> Based on our review of other cases under FSRP, we noted strong impairment indicators of assets in two cases but no impairment loss was recognised where (i) the change of key management of the group resulted in the group being unable to continue production from the facilities leased from a group of lessors and this caused a significant deterioration in the group's performance; and (ii) a study report indicated that the reconstruction of a piece of land was not commercially feasible and the group did not harvest any produce from the land for over five years. We had referred these two cases to the Financial Reporting Council for their further consideration.

<sup>43</sup> HKAS 36.6 defines the recoverable amount of an asset or a CGU as the higher of its fair value less costs of disposal and its VIU.

- (a) quantifying key assumptions underlying the cash flow projections (such as budgeted sales, gross and net margins) and explaining why directors and management considered them reasonable and supportable;
  - (b) justifying the rationale of why the management used a financial budget / forecast that covered a period greater than five years (HKAS 36.134(d)(iii));
  - (c) explaining why the discount rate or terminal growth rate used (HKAS 36.134(d)(iv) and (v)) was significantly changed from one year to another;
  - (d) clarifying whether a sensitivity analysis of the key assumptions had been performed; and confirming whether reasonably possible change in the key assumptions would cause the CGU's carrying amount to exceed its recoverable amount (HKAS 36.134(f));
  - (e) quantifying the recoverable amount of the CGU and the headroom available (i.e. the excess of the recoverable amount of the CGU over its carrying amount), and clarifying whether the assessment was based on a valuation carried out by an independent professional valuer and requesting for a copy of the valuation report; and
  - (f) explaining why no impairment loss was recognised when the group or the CGU was loss-making or suffered deterioration in revenue, gross and net profit margins.
131. Regarding the follow-up review cases, we noted that in some of these cases, the group or the CGUs continued to suffer loss, turned loss making or the actual performance did not meet the forecast (which was obtained during our enquiry in last year's review) without recognising an impairment loss. Therefore, we raised enquiries in this year's review and requested these issuers to provide details of the impairment assessment, such as whether they revised the forecast future cash flows underlying the VIU calculation.

132. In relation to the recommended disclosure set out in previous report, we observed that many issuers under review, including the follow-up review cases, provided the recommended disclosure, including:
- (a) around one-third of the issuers provided quantitative data of key assumptions (other than discount rate and terminal growth rate, e.g. revenue growth rate, gross and net margins);
  - (b) around one-third of the issuers provided a negative statement indicating that reasonably possible change in the key assumptions on which the management had based its determination of the CGU's recoverable amount would not cause an impairment loss; and a few issuers disclosed a sensitivity analysis.

However, one issuer disclosed that there would be a “downside” effect on the carrying amount of a CGU if the discount rate increased or growth rate decreased by a certain percentage. The disclosure did not indicate clearly whether the change in key assumptions would cause an impairment loss. The issuer has confirmed to us that it will enhance the relevant additional disclosure in its future annual reports;

- (c) around one-tenth of the issuers quantified the recoverable amounts of the CGUs or the headroom available; and
- (d) around one-third of the issuers disclosed that the impairment assessment was based on a valuation by an independent professional valuer. Some of them also disclosed the identity and qualification of the independent professional valuer engaged.

### Recommendation

133. Disclosure about the key assumptions made by management is highly critical as investors rely on it to understand how management determines the values assigned to the key assumptions and assess the reliability of the impairment testing.
134. Therefore, we reiterate that directors and management should be responsible for performing proper analysis and exercising judgement to assess the reasonableness of key assumptions applied in impairment testing (HKAS 36.33) so that assumptions applied (such as budgeted sales and gross margins) are not overly optimistic. Moreover, we recommend the audit committee<sup>44</sup> ensure that it is satisfied that sufficient analysis (including the sensitivity analysis on key assumptions) had been performed.

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<sup>44</sup> See the “[Guidance for Boards and Directors](#)” published on 27 July 2018.

135. More and more issuers engage independent professional valuers to determine the recoverable amount. However, issuers are reminded that 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<sup>45</sup>.
136. We highlight the following from HKAS 36 which require issuers' attention in determining the key assumptions used in the VIU calculation:

HKAS 36.30-57 – VIU
<p>HKAS 36.6 defines VIU as “the present value of the future cash flows expected to be derived from an asset or cash-generating unit”.</p> <p>Issuers are reminded of the following when estimating the future cash flows:</p> <p><u>(a) Management's best estimates</u></p> <ul style="list-style-type: none"><li>• Cash flow projections on reasonable and supportable assumptions</li><li>• Greater weight shall be given to external evidence</li></ul> <p><u>(b) Forecast period</u></p> <ul style="list-style-type: none"><li>• Maximum of five years, unless a longer period can be justified</li><li>• Cash flow projections after the forecast period are extrapolated over the useful life of the CGU using a steady or declining growth rate that is consistent with that of the products, industry or country</li></ul> <p><u>(c) Cash flow assumptions</u></p> <ul style="list-style-type: none"><li>• Capital expenditure – exclude expansionary capital expenditure, unless already committed to by the entity</li><li>• Restructuring – exclude restructuring plans, unless already committed to by the entity</li><li>• Corporate overheads – include those for the day-to-day servicing of the asset as well as future overheads that can be attributed directly, or allocated on a reasonable and consistent basis, to the use of the asset</li></ul> <p><u>(d) Discount rate</u></p> <p>Pre-tax discount rate should reflect current market assessments of:</p> <ul style="list-style-type: none"><li>• the time value of money; and</li><li>• the risks specific to the asset for which the future cash flow estimates have not been adjusted</li></ul>

<sup>45</sup> Issuers should read the following guidance notes issued by the SFC in relation to valuations in corporate transactions:

- [“Statement on the Conduct and Duties of Directors when Considering Corporate Acquisitions or Disposals”](#) (issued in July 2019); and
- [“Guidance on corporate transactions and the use of valuations”](#) (issued in May 2017).

137. In addition, issuers are reminded to provide the information required by HKAS 36.126-137, in particular the key assumptions applied to estimate the recoverable amount and how they are determined and the reason why financial budget period greater than five years is used, and the recommended disclosure in relation to impairment assessment in their annual reports, where appropriate, as set out in paragraph 121 above.
138. We also set out some further points to note when disclosing the headroom available and sensitivity analysis. The purpose of disclosing the sensitivity analysis is to indicate how imminent is a possible impairment loss and allow investors to understand what changes in the values of key assumptions would reduce the headroom to nil. Therefore, issuers are recommended to disclose:
- the headroom available and / or the recoverable amount of the asset or CGU;
  - explanation of what changes in key assumptions management thinks are “reasonably possible” and the judgments and estimates involved (HKAS 1R.122 and 1R.125); and
  - information required by HKAS 36.134(f) where the reasonably possible change in the key assumptions would reduce the headroom to nil and cause the recognition of an impairment loss; or a negative statement indicating that reasonably possible change in the key assumptions would not cause the recognition of an impairment loss.
- (2) *Disclosure on the assessment of the intangible assets with indefinite or long useful lives*
139. We continued to note that the issuers' disclosure on the determination of the indefinite or long useful life tended to be generic rather than entity-specific and some issuers omitted the disclosure of the factors that played a significant role in determining that the intangible assets had indefinite useful lives (HKAS 38.122(a)). One issuer under our follow-up review confirmed that it would disclose this required information upon our enquiry in last year's review but continued to omit this information in its annual report for the year ended 31 December 2018. Upon further enquiry in this year's review, the issuer explained why it had overlooked this disclosure and confirmed that it would disclose the information in its future annual reports.
140. We observe that a few issuers under review mentioned in the accounting policy that they would review annually to determine whether events and circumstances continue to support the indefinite useful life assessment.

141. Moreover, a few issuers under review enhanced the disclosure according to our recommendations and clearly stated in the notes of accounting judgments and estimates or intangible assets that they had performed an annual review and concluded that the intangible assets continued to have indefinite useful lives.

Recommendation

142. As the accounting for an intangible asset is based on its useful life, it is critical for issuers to take into account all of the relevant factors in order to determine the useful life of an intangible asset. Issuers are reminded to refer to HKAS 38.88-96 and the Illustrative Examples accompanying HKAS 38 for details of the requirements. In particular, HKAS 38.90 sets out the factors that should be considered in determining the useful life of an intangible asset, including:

<b>HKAS 38.90</b>
<p>(a) the expected usage of the asset by the entity and whether the asset could be managed efficiently by another management team</p> <p>(b) typical product life cycles for the asset and public information on estimates of useful lives of similar assets that are used in a similar way</p> <p>(c) technical, technological, commercial or other types of obsolescence (<i>Note 1</i>)</p> <p>(d) the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset</p> <p>(e) expected actions by competitors or potential competitors</p> <p>(f) the level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the entity's ability and intention to reach such a level</p> <p>(g) the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases (<i>Note 2</i>)</p> <p>(h) whether the useful life of the asset is dependent on the useful life of other assets of the entity</p> <p><i>Note 1: HKAS 38.92 states: "Given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it will often be the case that their useful life is short ..."</i></p> <p><i>Note 2: HKAS 38.94 states: "The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset. If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost ..."</i></p>

143. Issuers are also reminded to disclose the reasons supporting the assessment of an indefinite useful life and the key judgements made by the management in the assessment. The disclosure should be tailored to their specific circumstances.

144. In addition, we reiterate our recommendation that issuers should highlight in the financial statements that an annual review has been performed to determine whether events and circumstances continue to support their useful life assessment, in particular, cases where an intangible asset is classified as having an indefinite or a long useful life.

(3) Disclosure on the accounting for business combinations, in particular whether the intangible assets had been properly identified, separately recognised and measured at fair value

145. In this year's review, we also noted a few cases where issuers recognised significant amount of goodwill in business combinations completed during the year. However, their MD&A or earlier announcements indicated that intangibles were purchased (e.g. customer relationships and contracts with customers and suppliers), but it was unclear why the intangibles did not satisfy the asset recognition criteria under HKFRS 3 (Revised) and HKAS 38. We therefore requested these issuers to explain why there were no intangible assets (other than goodwill) recognised in the acquisition in accordance with HKFRS 3 (Revised) and HKAS 38.

146. We did not note any cases where the business combination resulted in a material gain on bargain purchase in this year's review.

147. Other than the above, we noted one case where the fair value of the consideration for an acquisition completed in prior year was reassessed in current year after reconsideration of all terms and conditions and the requirements of HKFRS 3 (Revised). As a result, prior year adjustments were made to adjust certain comparative figures, including goodwill.

### Recommendation

148. Identification and recognition of intangible assets separately from goodwill in an acquisition is an important part of the acquisition accounting as it provides an insight on why an entity acquired the acquiree and it helps in understanding the components of the acquired business.

149. Issuers should note that all identifiable intangible assets acquired in a business combination should be recognised separately from goodwill and initially measured at their acquisition-date fair values (HKFRS 3R.10 and 3R.18). This often involves identifying and recognising intangible assets not previously recognised by the acquiree in its financial statements (HKFRS 3R.13).

150. We reiterate that before recognising a gain on a bargain purchase, issuers should follow the requirements in HKFRS 3R.36 to reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and recognised any additional assets or liabilities that are identified in the review. We believe that these requirements might also be applicable to the cases where issuers would recognise a significant amount of goodwill in an acquisition.
151. Issuers are reminded to provide the disclosure required by HKFRS 3 (Revised), in particular the factors that make up the goodwill recognised (HKFRS 3R.B64(e)) and reasons why the acquisition resulted in a gain on a bargain purchase (HKFRS 3R.B64(n)). The disclosure should be clear and specific. In addition, issuers are reminded to provide the recommended disclosure set out in paragraph 121 above.
152. In addition, issuers should note that the HKICPA published “Definition of a Business (Amendments to HKFRS 3)” in January 2019. It clarified the minimum requirements to be a business, removed the assessment of a market participant’s ability to replace missing elements, and narrowed the definition of outputs. The amendments will be applicable to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2020 and to asset acquisitions that occur on or after the beginning of that period.

### **B. Disclosure relating to the implementation of HKFRS 9**

153. HKFRS 9 “Financial Instruments”, effective for annual periods beginning on or after 1 January 2018, replaced HKAS 39 “Financial Instruments: Recognition and Measurement” and HKFRS 7 “Financial Instruments: Disclosures” introduced extensive disclosure requirements for classification and measurement, impairment of financial assets and hedge accounting. In addition, entities are required to apply the transition requirements in HKFRS 9 and HKAS 8 “Accounting Policies, Changes in Accounting Estimates and Errors” at the date of initial adoption of HKFRS 9.
154. Where applicable, entities need to update their disclosure of significant estimates and judgements under HKAS 1 (Revised) to take into account the different judgements and estimates applied under HKFRS 9. Further, to the extent more financial assets are measured at fair value on a recurring basis subsequent to the adoption of HKFRS 9, entities are expected to provide more extensive disclosure required under HKFRS 13 “Fair Value Measurement”.

#### **Scope**

155. Out of 300 cases reviewed under the FSRP, 230 issuers, with a financial year-end date of 31 December 2018, adopted HKFRS 9. Of which, 204 issuers were non-financial sector entities and 26 issuers were in the financial sector. Our review focused on the adequacy of the disclosure against the requirements of HKFRS 9 and HKFRS 7 in the first year of adoption, where applicable, the judgements and estimates and fair value requirements under HKAS 1 (Revised) and HKFRS 13 respectively.

#### **Findings**

156. Most issuers, other than those in the financial sector, reported that the adoption of HKFRS 9 did not have a material impact. Our review indicated that issuers had generally complied with the disclosure requirements. In particular, most of the issuers reviewed provided a reconciliation of the key line items to highlight the key changes in classification between HKAS 39 and HKFRS 9, and disclosed detailed information explaining the effect of adopting HKFRS 9.
157. Although this is the first year of adoption and disclosure will continue to develop over time, our key findings indicated the following two areas where disclosure could be improved.

### (1) Impairment of financial assets

158. HKFRS 9 introduced a new impairment model based on expected credit losses (**ECLs**)<sup>46</sup>, resulting in the recognition of a loss allowance before the credit loss is incurred. Under the ECL model, entities should consider reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions (HKFRS 9.5.5.17). Hence, this evaluation requires considerable judgements and estimates. HKFRS 9 establishes a three-stage general approach for measuring impairment and a simplified approach for certain financial assets such as trade receivables with no significant financing component<sup>47</sup>.
159. In relation to trade receivables and contract assets, many issuers stated that the application of the ECL model had generally no material effect. We also noted the following:
- Most issuers applied the simplified approach, calculating lifetime ECLs for trade receivables and contract assets;
  - Only a few issuers had applied the general approach for their long-term loan and receivable balances; and
  - Some issuers had provided additional loss allowance as at the beginning of 2018 upon adoption of HKFRS 9.
160. In addition, most issuers provided the reconciliation of loss allowance from the opening to the closing balances and the qualitative credit risk information such as the credit risk concentrations on their major customers. However, the following disclosure was sometimes omitted or incomplete:
- Many issuers identified the determination of ECLs as a key source of estimation uncertainty but the descriptions tended to be generic rather than entity-specific, without an explanation on how the provision of ECLs was sensitive to changes in estimates.
  - Quantitative credit risk information was sometimes inadequate. For example, some issuers reported that they measured the ECLs based on the provision matrix or expected loss rates but did not disclose the relevant matrix or rates.

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<sup>46</sup> ECL model is different from the previous HKAS 39 where an incurred loss model was used. The incurred loss model only required the recognition of credit losses to the extent that there was objective evidence of impairment, i.e. a loss event need to occur before an impairment loss could be made.

<sup>47</sup> Under the general approach, impairment is generally measured as either 12-month ECLs or lifetime ECLs. The measurement basis depends on whether there has been a significant increase in credit risk since initial recognition. ECLs are measured as lifetime ECLs if, at the reporting date, the credit risk on the financial instrument has increased significantly since its initial recognition. Under the simplified approach, the loss allowance is always equal to lifetime ECLs.

161. In relation to other receivables, the level of detail of their disclosure varied considerably. Most issuers explained in the accounting policy how they applied the general approach in measuring the loss allowances. However, we observed that some issuers had made loss allowance but did not disclose their reconciliations during the year and both qualitative and quantitative credit risk disclosure was sometimes brief or omitted.

*Recommendation*

162. The new impairment requirements of HKFRS 9 affect almost all issuers and not just issuers in the financial sector. Issuers should ensure that appropriate systems and processes are put in place to measure the ECLs and capture the quantitative information for the required disclosure. Even if the ECLs are determined to be negligible, it is important that issuers should demonstrate that they have done enough work to ascertain that result.
163. Issuers should provide sufficient qualitative and quantitative information to enable investors to evaluate the ECLs recognised and to understand the assumptions used and judgements made in estimating the ECLs as well as any changes from the prior reporting period. HKFRS 7.35F-35N requires extensive disclosure about issuers' credit risk management practices and how they relate to the recognition and measurement of ECLs. In particular, issuers are reminded of the following:

<b>ECL calculations (HKFRS 7.35G)</b>
<p>Explain the basis of the inputs, assumptions and the estimation techniques used when:</p> <ul style="list-style-type: none"> <li>• measuring 12-month and lifetime ECL;</li> <li>• determining whether the credit risk of financial instruments has increased significantly since initial recognition; and</li> <li>• determining whether financial assets are credit-impaired.</li> </ul> <p>Explain also:</p> <ul style="list-style-type: none"> <li>• how forward-looking information has been incorporated into the determination of ECL, including the use of macro-economic information; and</li> <li>• changes in estimation techniques or significant assumptions made during the reporting period and the reasons for those changes.</li> </ul>

164. When issuers reported that they measured the ECLs based on the provision matrix or expected loss rates, they should disclose such information and make reference to the example of a provision matrix for trade receivables (HKFRS 9.B5.5.35 and Illustrative Example 12), which is summarised below:

CU'000	Trade receivables days past due					Total
	Current	1-30 days past due	31-60 days past due	61-90 days past due	More than 90 days past due	
Expected credit loss rate	0.3%	1.6%	3.6%	6.6%	10.6%	-
Gross carrying amount	15,000	7,500	4,000	2,500	1,000	30,000
Lifetime ECL	45	120	144	165	106	580

165. Where issuers have material balances on trade and other receivables, they should provide additional information in the MD&A or in the financial statements (where appropriate), e.g. if extended credit policy is given to specific customers, discussing the actions that have been taken to recover the debts that were significantly impaired, and subsequent settlement of those trade and other receivables.

(2) Fair value measurement of equity investments

166. HKFRS 9 has three financial asset classification categories: (i) amortised cost, (ii) fair value through other comprehensive income (**FVOCI**) and (iii) fair value through profit or loss (**FVTPL**). Classification is based on the entity's business model for managing the financial assets and their contractual cash flow characteristics (HKFRS 9.4.1.1). Investments in equity instruments are always measured at fair value<sup>48</sup>. However, management may make an irrevocable election to present changes in fair value in other comprehensive income, provided the equity investment is not held for trading (HKFRS 9.4.1.4 and 9.5.7.5). If the equity investment is held for trading, changes in fair value are presented in profit or loss.
167. From our review, it was not uncommon that the issuers made investments in equity instruments and some of the investments were stated at cost under previous HKAS 39. Upon adoption of HKFRS 9, most of them had re-measured their equity investments at fair value at the beginning of 2018, and their unquoted equity investments were always designated at FVOCI.

<sup>48</sup> HKFRS 9 does not permit the use of cost as the measurement objective but acknowledges that, in limited circumstances, cost may be an appropriate estimate of fair value, although not for quoted equity instruments. That may be the case if insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range (HKFRS 9.B5.2.3 to B5.2.6). In contrast, previous HKAS 39 allowed cost to be used and subject to a review for impairment when the equity instruments without a quoted market price and whose fair value could not be reliably measured.

168. Only a few issuers reported that the costs of certain unquoted equity investments at FVOCI were approximate their fair values. In one case, the reason stated was that “*there is insufficient more recent information available to measure fair value*”, which was based on boilerplate text taken from HKFRS 9 and was not sufficiently tailored to the issuer’s specific circumstances.
169. During our review, we observed the following:
- Issuers under review invested in a wide range of sectors, such as start-up companies and companies involved in property development and investment, mining and financial businesses, etc.
  - The fair value measurements were always categorised within Level 3 of the fair value hierarchy and their disclosure generally complied with the requirements under HKFRS 13. Most of the issuers provided the description of the valuation techniques and the inputs used (HKFRS 13.93(d)). However, the following disclosure was sometimes omitted:
    - Quantitative information about the significant unobservable inputs used in the fair value measurement (HKFRS 13.93(d)); and
    - Narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement (HKFRS 13.93(h)(i)).
  - Different valuation techniques had been used in determining the Level 3 fair values, such as comparable company valuation multiples (market approach), discounted cash flow (income approach) and adjusted net asset method. Some issuers disclosed that they had engaged the independent valuers to perform the valuations.
  - Where the fair value was material, the auditors reported the Level 3 fair value measurement as a key audit matter<sup>49</sup> and disclosed how such matter was addressed in the audit and what the audit procedures had been performed.
170. We also raised enquiries with some issuers to request additional information or clarifications, including an explanation why there was a material fair value change during the year; justifying the appropriateness of using a specific valuation technique; and how they monitor the investees’ performance and obtain the financial data in determining the fair values.

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<sup>49</sup> HKSA 701 “Communicating Key Audit Matters in the Independent Auditor’s Report”.

### Recommendation

171. Investments in equity instruments should be stated at fair value under HKFRS 9, therefore, issuers should determine the fair values on an ongoing basis at each reporting period and prepare extensive disclosure on recurring fair value measurements as required by HKFRS 13.91-99, particularly, the following information on Level 3 fair value measurements:

<b>Key disclosure requirements under HKFRS 13.93</b>
<ul style="list-style-type: none"><li>• Description of the valuation techniques and inputs used in the fair value measurement.<ul style="list-style-type: none"><li>- If there has been a change in valuation technique (eg changing from a market approach to an income approach or the use of an additional valuation technique), that change and the reason(s) for making it.</li></ul></li><li>• Quantitative information about significant unobservable inputs used in the fair value measurement.</li><li>• A narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement.<ul style="list-style-type: none"><li>- If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, a description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement.</li></ul></li><li>• If changing one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly, that fact and the effect of those changes and how they were calculated.</li><li>• A description of the valuation processes and policies.</li></ul>

172. Valuing financial instruments is complex and may require the assistances from independent professional valuers. In relation to the investments in equity instruments, depending on the percentage of interest held, issuers may have limited access to information needed to measure their fair values, such as latest financial data, updates about operations and major projects, recent share transactions. Therefore, issuers should establish procedures for fair value measurements and have discussions with their audit committee, auditors and valuers at an early stage. This will ensure that issuers have sufficient time to make arrangements to obtain information from relevant investees for measuring fair value and preparing the necessary disclosure.
173. We remind issuers again to read the SFC [guidance note](#) regarding directors' duties and valuations in corporate transactions. Directors should exercise due and reasonable care, skill and diligence in assessing the valuations of financial instruments, and they should not rely solely on professional valuers or other experts.

174. Issuers are also encouraged to read the IFRS Foundation's [educational material](#) "Measuring the fair value of unquoted equity instruments within the scope of IFRS 9 Financial Instruments", which provides high level valuation guidance to support the personnel responsible for measuring fair value when measuring the fair value of unquoted equity instruments of an investee within the scope of IFRS 9.

### **C. Disclosure relating to the implementation of HKFRS 15**

175. Revenue is an important number to investors in assessing an issuer's financial performance and position. HKFRS 15 "Revenue from Contracts with Customers", which has been effective for annual periods beginning on or after 1 January 2018, replaced HKAS 18 "Revenue" and HKAS 11 "Construction Contracts", and related interpretations and outlines a single comprehensive model of accounting for revenue arising from contracts with customers.
176. The disclosure requirements of HKFRS 15 are set out in HKFRS 15.110-129, of which the objective is to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers (HKFRS 15.110). HKFRS 15.111 states that issuers should consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements of HKFRS 15, and aggregate or disaggregate disclosure so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics.

#### **Scope**

177. Out of 300 cases reviewed under the FSRP, 230 issuers, with a financial year-end date of 31 December 2018, adopted HKFRS 15.
178. We reviewed the issuers' financial statement disclosure relating to revenue to assess whether they had complied with the requirements under HKFRS 15, including but not limited to information related to disaggregation of revenue (HKFRS 15.114-115), contract balances (HKFRS 15.116-118) and remaining performance obligations (HKFRS 15.120-122).
179. We also examined the level of detail of their disclosure on management's judgements in the application of HKFRS 15 (HKFRS 15.123), in particular to justify whether the issuer is a principal or an agent under the contract.

### *Findings*

180. We observed that the issuers under review generally included the required disclosure and we did not note any significant non-compliance regarding the disclosure requirements in HKFRS 15. During our review, where disclosure was not sufficiently specific or descriptions were generic, we made enquiries with issuers to obtain additional information. 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. From our review, we found the following four areas where issuers are required to consider the level of detail of disclosure in order to satisfy the disclosure objective.

#### *(1) Disaggregation of revenue*

181. Many issuers under review disaggregated revenue into categories. We observed that the most commonly selected categories included type of market, type of good or service and timing of transfer of goods and services to customers.

182. One issuer disclosed in the accounting policies that revenue was recognised both at point in a time and over time but revenue was not disaggregated on this basis. It raised doubt over whether the disclosure objective of the disaggregation disclosure requirement in HKFRS 15.114 had been met.

183. We observed that some issuers provided disaggregated revenue for each of the reportable segments in a matrix format to clearly present the relationship between disaggregated revenue and segment revenue.

#### *Recommendation*

184. Issuers are required to disclose disaggregated revenue information to illustrate how the nature, amount, timing and uncertainty about revenue and cash flows are affected by economic factors (HKFRS 15.114). Issuers should make reference to the application guidance on the disaggregation of revenue disclosure set out in HKFRS 15.B88-B89 and the example of the disclosure provided in HKFRS 15 Illustrative Example 41:

## Review of Issuers' Annual Report Disclosure – Report 2019

Segments	Consumer products CU	Transport CU	Energy CU	Total CU
<u>Primary geographical markets</u>				
North America	990	2,250	5,250	8,490
Europe	300	750	1,000	2,050
Asia	700	260	-	960
	<u>1,990</u>	<u>3,260</u>	<u>6,250</u>	<u>11,500</u>
<u>Major goods / service lines</u>				
Office supplies	600	-	-	600
Appliances	990	-	-	990
Clothing	400	-	-	400
Motorcycles	-	500	-	500
Automobiles	-	2,760	-	2,760
Solar panels	-	-	1,000	1,000
Power plant	-	-	5,250	5,250
	<u>1,990</u>	<u>3,260</u>	<u>6,250</u>	<u>11,500</u>
<u>Timing of revenue recognition</u>				
Goods transferred at a point in time	1,990	3,260	1,000	6,250
Services transferred over time	-	-	5,250	5,250
	<u>1,990</u>	<u>3,260</u>	<u>6,250</u>	<u>11,500</u>

### (2) Contract balances

185. Many issuers under review provided the relationship between the timing of satisfying a performance obligation and the timing of payment and the effect that those factors have on the contract asset and contract liability balances in accounting policies. However, we observed that explanations of significant changes in the contract asset and contract liability balances during the year tended to be brief or omitted in the financial statements or MD&A.
186. We observed that a few issuers under review did not provide the amount of revenue recognised in the period that was included in the contract liability balance at the start of the year even though the amounts were material.
187. Only a few issuers under review disclosed revenue recognised in the period from performance obligations satisfied, or partially satisfied, in previous periods, which may be because the amounts of other issuers were not material although this was not specified.

### Recommendation

188. Issuers are reminded of the following disclosure requirements from HKFRS 15 for contract asset and contract liability balances:

<b>HKFRS 15.116-118</b>
<ul style="list-style-type: none"><li>• The opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers (if they are not otherwise separately presented or disclosed);</li><li>• The amount of revenue recognised in the current period that was included in the opening contract liability balance;</li><li>• The amount of revenue recognised in the current period from performance obligations satisfied (or partially satisfied) in previous periods: e.g. changes in transaction price;</li><li>• An explanation of how the timing of satisfaction of entity's performance obligations relates to the typical timing of payment and the effect that those factors have on the contract asset and the contract liability balances; and</li><li>• An explanation of the significant changes in the balances of contract assets and contract liabilities, which should include both qualitative and quantitative information, such as:<ul style="list-style-type: none"><li>- changes due to business combinations;</li><li>- cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, including adjustments arising from a change in the measure of progress, a change in an estimate of the transaction price (including any changes in the assessment of whether an estimate of variable consideration is constrained) or a contract modification;</li><li>- impairment of a contract asset;</li><li>- a change in the time frame for a right to consideration to become unconditional (i.e. for a contract asset to be reclassified to a receivable); and</li><li>- a change in the time frame for a performance obligation to be satisfied (i.e. for the recognition of revenue arising from a contract liability).</li></ul></li></ul>

189. Significant changes in contract balances may arise from changes in judgements and estimates in determining the timing of satisfaction of performance obligations and the transaction price and amounts allocated to performance obligations, such as revisions to the estimated percentage of completion. Issuers should take into account all of the relevant factors and disclose the key judgements and estimates made by the management required by HKFRS 15.124 and 15.126. The disclosure should be tailored to their specific facts and circumstances.

### (3) Remaining performance obligations

190. Some issuers under review disclosed the amount of the transaction price allocated to the remaining performance obligations with an explanation of when the issuer expects to recognise this revenue using time bands or qualitative information, while some issuers explained it has applied the practical expedient to not disclose the information required by HKFRS 15.120. The remaining issuers did not provide such information, where it appeared to be irrelevant and immaterial in view of the sectors those issuers are in.

### Recommendation

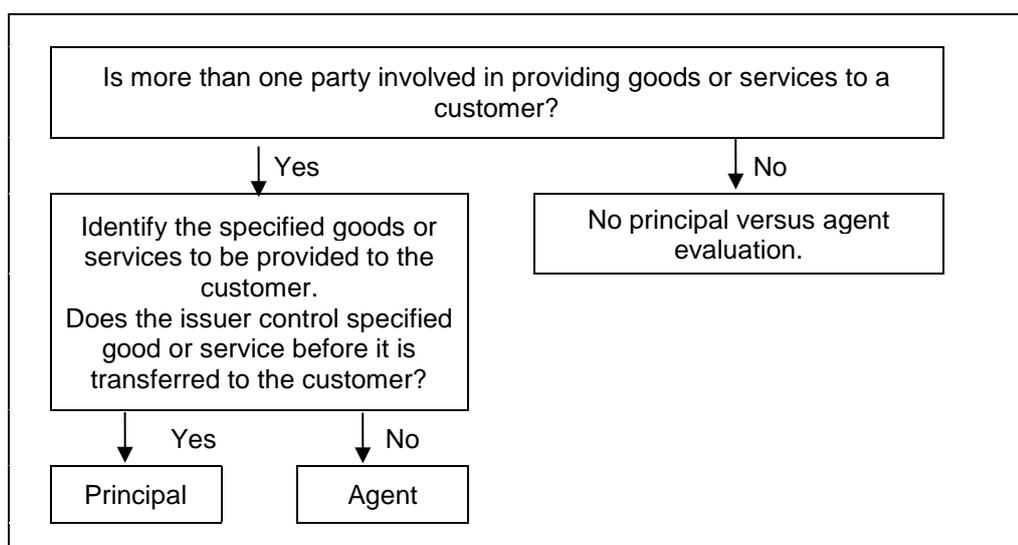
191. Issuers are reminded that HKFRS 15.120 requires the aggregate amount of the transaction price allocated to the remaining performance obligations to be disclosed. It also requires an explanation of when the issuer expects to recognise this revenue. This explanation can be either disclosed quantitatively, using time bands that would be most appropriate for the duration of the remaining performance obligations (such as between one and two years and between two and three years), or disclosed using qualitative information.
192. As a few issuers may also disclose “backlog” (that is, an estimate of contract value of work that remains to be completed as of a certain date) information in the MD&A section, we would like to reiterate that MD&A should be consistent with information disclosed in the financial statements.
193. As a practical expedient, HKFRS 15.121 states that an issuer need not disclose the information in HKFRS 15.120 for a performance obligation if either of the following conditions is met: (a) the performance obligation is part of a contract that has an original expected duration of one year or less; or (b) the issuer applies the practical expedient in HKFRS 15.B16 such that it recognises revenue at the amount to which it has a right to invoice, which corresponds directly with the value to the customer of the issuer’s performance completed to date (e.g. a service contract in which the entity bills a fixed amount for each hour of service provided).
194. In accordance with HKFRS 15.122, issuers are required to explain qualitatively whether it has applied the practical expedient in HKFRS 15.121 in providing the information required by HKFRS 15.120. This practical expedient should be applied consistently to similar contracts in similar circumstances.

### (4) A principal or an agent under the contract

195. We observed that a few issuers' disclosure of the accounting policy on determining whether they are a principal or an agent in sale transactions tended to be generic rather than entity-specific, where the descriptions of the reasons supporting the assessment of a principal or an agent were also brief or omitted.
196. We made a number of enquiries when it was unclear why directors determined the issuers were acting as a principal or an agent based on the business model. In particular, two issuers did not disclose the significant judgement that it was acting as a principal or an agent where we might expect there to be a significant judgement required based on their business models.

### Recommendation

197. The revenue of the agent is the amount of fee or commission earned to arrange for the provision of the specified goods or services by another party; and the revenue of the principal is the gross amount of consideration to which the issuer expects to be entitled in exchange for the specified good or service transferred (HKFRS 15.B35B and 15.B36).
198. Issuers are reminded that determining whether the issuer is acting as an agent or principal is complex and highly judgmental. An issuer should determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (i.e. the issuer is a principal), or to arrange for them to be provided by the other party (i.e. the issuer is an agent) (HKFRS 15.B34).
199. The following flow chart illustrates the process for performing a principal versus agent evaluation:



200. Issuers should refer to the prescriptive guidance and examples under HKFRS 15 on how to determine the nature of its promise and how to assess control of a specified good or service in different scenarios. In particular, indicators in relation to principal versus agent considerations are set out in HKFRS 15.B37:

<b>HKFRS 15.B37</b>
Indicators that the entity is a principal include, but not limited to: <ul style="list-style-type: none"><li>• the entity is primarily responsible for fulfilment of the promise to provide the specified goods or service;</li><li>• the entity has inventory risk; and</li><li>• the entity has discretion in establishing prices.</li></ul>

201. Issuers are reminded to clarify in accounting policies whether the revenue is presented gross or net and adequately disclose the specific nature of performance obligations. We also recommend issuers clearly disclose the significant judgements applied as required by HKFRS 15.123, including the evaluation of whether the issuers are acting as a principal or an agent in providing any goods and services by reference to the indicators of control in HKFRS 15.

**D. Disclosure of possible impact of applying a new or amended HKFRS in issue but not yet effective**

202. HKAS 8.30 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.”*
203. HKAS 8.31 states that an issuer should consider disclosing the nature of the impending changes in accounting policy and the date as at which it plans to apply the new standard initially.
204. HKFRS 16 “Leases”, one of the major new HKFRSs issued by the HKICPA, has become effective and is applicable to annual periods beginning on or after 1 January 2019.
205. Investors expect high-quality disclosure of the expected impact on the financial statements in the period of initial application of new standards. The disclosure should include entity-specific qualitative and quantitative information about the expected impact. In this regard, in previous years, we reminded issuers to disclose in their interim and annual reports:
- 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.
206. When adopting a new or amended standard initially in a financial period or year, issuers should make disclosure in their interim and annual reports in accordance with HKAS 8.28 and HKAS 34 “Interim Financial Reporting” (HKAS 34.16A(a)). In this regard, we recommended in previous years:
- any key judgements made by management in applying the requirements of the new or amended standard 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 the new standards and the requirements of HKAS 8; and
- issuers should ensure that the application and implementation of the new standards are in accordance with the accounting requirements. To avoid unintended errors due to inappropriate application of 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.

### **Scope**

207. We reviewed the disclosure of expected impact of HKFRS 16 in the annual reports of 300 issuers, of which 230 issuers' annual reports had a financial year-end date of 31 December 2018 and 70 issuers had other financial year-end dates in 2018. In the review, we focused on whether issuers provided useful disclosure for investors to understand the potential impact of adopting HKFRS 16 and the level of details of the disclosure.

### **Findings**

208. We noted that a majority of the issuers under review had followed the requirements of HKAS 8 and our recommendations to disclose in their annual reports of the expected impact of adopting HKFRS 16, including:

- a brief description of the requirements of HKFRS 16 and the nature of the impending change of accounting policy for leases;
- the date at which they planned to adopt HKFRS 16 initially and the transition provisions they planned to choose;
- a cross reference to the note to financial statements regarding the operating lease commitments; and
- qualitative information of the impact of adopting HKFRS 16 on the financial statements. Most of them disclosed that certain amounts included in the operating lease commitments met the definition of a lease and they would recognise right-of-use assets and lease liabilities. Some of them briefly described how the right-of-use assets would be measured.

209. In addition to the qualitative information in paragraph 208 above, some issuers under review had disclosed quantitative information of the impacts of adopting HKFRS 16. Most of these issuers disclosed the amounts of right-of-use assets and lease liabilities that would be recognised as at 1 January 2019. Some of them also disclosed the quantitative impact on other line items of the statement of financial position, such as retained earnings, non-controlling interests and net assets.
210. One issuer under review has early adopted HKFRS 16 in its annual report for the year ended 31 December 2018. This issuer provided the disclosure in relation to change in accounting policy in accordance with HKAS 8, including the new accounting policy for leases, the transition approach applied and the impact of adopting HKFRS 16 on the financial statements.

### Recommendation

211. We reiterate the importance of disclosing the expected impact of adopting a new or amended standard as it enables investors to gain an early understanding of the impacts that such new standards will have on the financial position and performance of the entity and how the change in presentation may affect key performance ratios and debt covenant.
212. Issuers are reminded of the recommended disclosure in paragraph 205 above to disclose potential impact of a new or amended standard issued but not yet effective and the recommended disclosure in paragraph 206 above to disclose the effect upon adoption of a new or amended standard. In addition, issuers should provide entity-specific information and avoid generic boilerplate disclosure, in particular when disclosing a description of the changes introduced by the new standards.
213. The recommendations discussed above may also be relevant in considering the implementation and disclosure of other new standards that are issued but not yet effective, such as HKFRS 17 “Insurance Contracts” (issued in January 2018 and will be effective for annual periods beginning on or after 1 January 2021<sup>50</sup>). Issuers are also encouraged to read the guidance materials published by other regulators and organisations<sup>51</sup>.

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<sup>50</sup> The International Accounting Standards Board is currently discussing to defer the effective date by one year so that entities would be required to apply IFRS 17 “Insurance Contracts” for annual periods beginning on or after 1 January 2022.

<sup>51</sup> Issuers should read the following guidance materials published by other regulators and organisations:

- HKICPA [New and Major Standards Resources Centre](#); and
- The International Organization of Securities Commissions’ [Statement on Implementation of New Accounting Standards](#) (issued in December 2016).

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

214. A non-GAAP financial measure is a numerical measure of an issuer's historical or future financial performance, financial position or cash flow that is not specified, defined or determined under the issuer's GAAP<sup>52</sup>. Non-GAAP financial measures are often used in the annual reports, including in the business review or MD&A<sup>53</sup>, to supplement information prepared in accordance with GAAP. There is generally no standardised definition and method for calculating the non-GAAP financial measures.
215. In recent years, there is an increasing market focus on the use of non-GAAP financial measures. In April 2019, the Exchange published the Guidance Letter [GL103-19](#) which provides guidance on the presentation of the non-GAAP financial measures in any documents pursuant to the Rules (such as financial reports, announcements and circulars), including the following:

<b>Key elements for presenting non-GAAP financial measures</b>	
(a)	<b>Definitions</b> – Each non-GAAP financial measure presented should be defined and a clear explanation of the basis of calculation should be provided. Also, they should be clearly labelled in such a way that they are distinguished from GAAP measures. Labels should be meaningful and should reflect the composition of the measure.
(b)	<b>Prominence</b> – Non-GAAP financial measures should not be presented with more prominence than the most directly comparable measure calculated and presented in accordance with GAAP.
(c)	<b>Explanations for using non-GAAP financial measures</b> – Issuers should set out the reasons for presenting the non-GAAP financial measures including explanations of why the information is useful to investors, and for what additional purposes, if any, management uses the measures.
(d)	<b>Reconciliation and nature of adjusting items</b> – Issuers should provide a clear and concise quantitative reconciliation from the non-GAAP financial measure to the most directly comparable GAAP measure presented in the financial statements. The adjustments should be explained. This helps to enhance transparency so that investors can understand how significant the variances are between GAAP and non-GAAP figures.
(e)	<b>Comparatives</b> – Issuers should present comparatives and disclose non-GAAP financial measures consistently over time.

<sup>52</sup> GAAP as referred in this report includes HKFRS, IFRS or other accounting standards that are accepted by the Exchange.

<sup>53</sup> Paragraphs 28(2)(d) and 32 of Appendix 16 to the MB Rules / GEM Rules 18.07A(2)(d) and 18.41.

### **Scope**

216. Out of 300 cases reviewed under the FSRP, 89 issuers used the non-GAAP financial measures in their annual reports. We examined how these issuers presented, explained and reconciled the non-GAAP financial measures.
217. The review aimed to establish the extent to which the selected annual reports were consistent with our Guidance Letter [GL103-19](#). This enables us to promote specific points which issuers need to take into account when preparing their upcoming annual reports.

### **Findings**

218. Although we did not identify any major issues from the 89 cases reviewed, there is room for improvement in certain areas of disclosure. Our observations are set out below.

#### *(a) Definitions*

219. The issuers under review used a number of non-GAAP financial measures, for example: operating income that excludes one or more expense items, EBITDA (earnings before interest, taxes, depreciation, and amortisation), adjusted EBITDA, free cash flow and net debt. EBITDA is the most commonly used non-GAAP financial measures. We are pleased to note that many issuers provided definitions for their non-GAAP financial measures, by way of a footnote or including in a glossary.
220. The labels generally reflected their content or basis of calculation. However, we identified a few cases where non-GAAP financial measures had been labelled as “core operating profit” and “underlying profit”, which appeared to be similar to the description used for GAAP measures. In these cases, the issuers disclosed the non-GAAP adjustments that were not part of “core operating profit” and “underlying profit” and / or explained why these measures were useful in understanding their performance during the year. We also observed that some issuers labelled the non-GAAP financial measures as “adjusted” EBITDA or “non-GAAP” operating profit to avoid investors’ confusion with traditional definition of EBITDA and GAAP measures.

### (b) Prominence

221. During our review, we considered various factors in determining whether non-GAAP financial measures gives greater prominence to GAAP measures, such as:
- Manner in which GAAP and non-GAAP figures were presented (e.g. using bold letters, larger font size, italic for non-GAAP financial measures);
  - Location of non-GAAP financial measures (e.g. providing non-GAAP financial measures preceding their comparable GAAP measures); and
  - Whether the non-GAAP financial measures were accompanied by their comparable GAAP measures.
222. We observed that in most of the cases the non-GAAP financial measures were presented equal or not more prominent than the GAAP measures. The GAAP information or measures were always presented as the starting point when discussing the issuers' performance in the MD&A section. Some issuers also presented both non-GAAP and GAAP measures side by side (either in tables or graphs) in their financial highlights or chairman statement section, but a few issuers did not include the comparable GAAP measures. We would emphasise that non-GAAP financial measures should not precede their comparable GAAP measures, even though such comparable GAAP measures were disclosed in later sections of the annual reports.

### (c) Explanations for using non-GAAP financial measures

223. From our review, we noted that the disclosure varied considerably. Reasons why the issuers used the non-GAAP financial measures included the following:
- The measures were used internally (e.g. to manage the business, to monitor segment performance and / or to determine the incentive compensations);
  - Issuers believed the measures provided supplemental information to assess the issuers' performance by excluding the impact of certain non-cash items and one-off expenses; and
  - The measures were commonly used in the issuers' industries or peers.

224. While some issuers provided full explanations, other issuers provided reasons that tended to be short and generic or were omitted, for example, stating the non-GAAP financial measures were believed “*to be effective in measuring the development, performance or position of the business of the Group*”. In our view, boilerplate and generic disclosure should be avoided, and the level of detail depends on the complexity of the non-GAAP financial measures and how familiar the investors are with the measures. A good explanation should explain why a non-GAAP financial measure is useful, helpful or more meaningful rather than stating whether it is used internally.
225. Some issuers also included a “caution statement” to remind investors that non-GAAP financial measures were not defined under GAAP and were not intended as a substitute for GAAP measures, and might not be comparable to similar titled measures presented by other companies. We consider that such statement is helpful in alerting investors to the limitations of non-GAAP financial measures.

(d) Reconciliation and nature of adjusting items

226. During our review, except for the traditional non-GAAP financial measures (such as EBITDA), most of the issuers provided the reconciliation that began with the GAAP figures and reconciled to the non-GAAP figures. 37 issuers under review used “adjusted” measures of profit. We noted that different terms were used, for example, adjusted EBITDA, adjusted net profit and underlying profit. The reconciliations were always presented in table form with comparatives. We noted the following common adjusting items:
- Fair value gains or losses (e.g. investment properties)
  - Impairment charges (e.g. property, plant and equipment and trade receivables);
  - Share-based payment expenses (equity-settled);
  - Restructuring charges;
  - Gains or losses on disposals (e.g. subsidiaries and associates); and
  - Listing expenses.
227. Some adjusting items were made since they were non-cash in nature, but a few issuers described the adjusting items as “non-recurring, infrequent or unusual” and their explanations did not provide adequate justification. For example, one issuer described its share-based payment expenses as unusual and non-recurring item even though such expenses had been incurred in each of the past years, and stated that they were not indicative of the issuer’s business performance.

228. We strongly remind issuers that they should be careful when describing the adjusting items as “non-recurring, infrequent or unusual”, in particular for items that are reasonably likely to recur in the foreseeable future, or are activities that affected the entity in the recent past. In such circumstances, issuers should not describe the items as “non-recurring, infrequent or unusual”, and select more accurate labels. Also, the explanations on each adjusting item should be specific enough to the issuer’s facts and circumstances (such as the item is commonly adjusted for by the issuers’ peers).

(e) Comparatives

229. The majority of the reports under review provided comparatives, and the calculation basis was generally consistent with that used in prior year.

Recommendation

230. Issuers should take note of the requirement under MB Rule 2.13(2) / GEM Rule 17.56(2) such that any corporate communication (including financial reports) should be accurate, complete and not misleading. Issuers are also reminded that Code Provision C.1.5 requires that the board should present a balanced, clear and understandable assessment in annual and interim reports and other financial disclosure required by the Rules.

231. Non-GAAP financial measures are neither prohibited nor required. It is important that their use does not replace or obscure GAAP measures. Issuers should consider the Guidance Letter [GL103-19](#) as an opportunity to step back and take a holistic view of their current non-GAAP financial measures and consider revising their disclosure.

232. In addition, issuers should establish written policies that provide guideline to follow when preparing and presenting non-GAAP financial measures. This would help promote consistency in the presentation of non-GAAP financial measures and the way they are calculated. Also, having policies in place can help in making judgments on the treatment of a one-time transaction in non-GAAP financial measures and avoid giving the appearance of “cherry picking” to achieve a positive measure.

233. Audit committee is recommended to assess management’s reasons for presenting non-GAAP financial measures; evaluate the sufficiency of the related disclosure that is consistent with the Rules and guidance; and determine whether the measures present a fair and balanced view of the issuer’s performance and position.

**V. CONCLUSION**

234. From our review of the 13 selected areas in issuers' annual reports this year, we noted that issuers have generally followed the Rules and, where applicable, our previously recommended disclosure in the following areas: continuing connected transactions, material asset impairments and results of performance guarantees, significant investments in the MD&A section and disclosure required for issuers listed under the new listing regime for WVR and biotech companies. In relation to the implementation of HKFRS 9 and HKFRS 15, we noted that issuers have generally complied with the disclosure requirements in the relevant HKFRSs.
235. We have highlighted in this report aspects that issuers should take into account when making disclosure in the following areas: amended Rules on annual report disclosure, business review in the MD&A section, financial statements with auditor's modified opinions, material other expenses, material intangible assets and non-GAAP financial measures.
236. We encourage directors and other persons responsible for financial reporting to take note of the matters discussed in this report and be apprised of changes in the Rules, accounting and auditing standards, and other relevant laws and regulations. They should review and regularly improve their financial reporting systems and explore ways to better integrate information in financial statements and other parts of the annual report such that the information provided is useful to investors. The audit committee<sup>54</sup> should stay focused on financial reporting integrity as part of its core oversight responsibilities.

- End -

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<sup>54</sup> See the "[Guidance for Boards and Directors](#)" published on 27 July 2018.

