HKEX 香港交易所

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Review of Issuers' Annual Report Disclosure

Report 2020

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EXECUTIVE SUMMARY

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

We undertake an on-going review programme comprising two parts with different focuses: (i) to examine issuers' annual reports with a focus on Rule compliance, issuers' corporate conduct and their disclosure of material events and developments; and (ii) to review issuers' financial statements with a view to encouraging high standards of financial disclosure. The review is focused on compliance with applicable accounting standards.

The review programme aims to give meaningful guidance to issuers on specific areas when preparing annual reports. We adopted a thematic approach and selected specific areas for review as a result of the findings in our previous reports and latest market trends.

This report presents our findings and recommendations from the review programme, some of which are highlighted below:

(a) **Disclose the impact of the Covid-19 pandemic in issuers' business review and MD&A section** – To allow shareholders to reasonably assess how the Covid-19 pandemic has affected issuers and their business prospects, issuers should consider disclosure in the following areas:

  (i) disclosure about the effect of the Covid-19 pandemic on the issuers' operations, and the relevant risks or uncertainties that will materially affect their future performance;

  (ii) quantitative measures of the financial or operational impact of the Covid-19 pandemic;

  (iii) assessments of the liquidity positions and working capital sufficiency with reference to issuers' operations and capital commitments; and

  (iv) measures such as cost control, funding and adjustments to business plans taken or to be taken to manage the impact of the Covid-19 pandemic.

(b) **Financial statements with auditors' modified opinion** – We identified the major issues giving rise to audit modifications to be the existence of material uncertainty on issuers' ability to continue as a going concern, valuation of assets, recoverability of loans and receivables and issues arising from limited access to accounting books and records. Issuers should continuously review their current liquidity positions and expected financial resource needs to allow their businesses to operate normally. We urge issuers, in particular those issuers whose previous auditors' report highlighted on the existence of material uncertainty on the issuer's ability to continue as a going concern, to formulate action plans to address their funding needs in a timely manner, and to take concrete actions to implement those plans.

Where there are material changes in the reporting items, issuers should develop appropriate and supported estimates for these items. They should also document key judgments made, and consider retaining experts where necessary. Issuers should engage in early discussions with their auditors and agree in advance the timing, form and approach of the assessment of these estimates as early as practicable.

(c) **Continuing connected transactions** – Independent non-executive directors (**INEDs**) play an important role in providing checks and balance over the issuers' corporate affairs, business operations and transactions, and in particular, in the monitoring of connected transactions. Issuers should have in place appropriate internal controls and mechanisms to monitor, and assist INEDs in overseeing their continuing connected transactions (**CCTs**), and their INEDs should review the appropriateness of these internal control procedures. Issuers should also make reference to best practices adopted by other issuers set out in our last year's report.

(d) **Disclosure on share option and award schemes** – Chapter 17 of the Rules requires disclosure of share option schemes in annual reports, but does not apply to share award schemes. We consider such disclosure useful for shareholders' evaluation of the use of share award schemes generally, and whether the objectives of the schemes are served. We recommend issuers with share award schemes to follow the Rule disclosure requirements for all their share options and award schemes.

(e) **Material intangible assets** – Issuers should perform proper analysis and exercise judgment to assess the reasonableness of key assumptions applied in impairment testing such that assumptions applied are not overly optimistic, in particular where issuers are loss-making or suffer material deterioration in revenue, net profits or gross profit margin. They should carefully consider the impact of Covid-19 pandemic on impairment test and update the assumptions used to reflect the latest available information and evidence.

(f) **Material level 3 financial assets** – We remind issuers to develop robust disclosure on level 3 fair value measurements, in particular providing the qualitative and quantitative information to the extent necessary for an understanding of the valuation techniques and the underlying unobservable inputs. Issuers should get sufficient and timely information from investees (such as latest financial data, updates about operations and business plans, recent share transactions) for measuring fair value and preparing the disclosure. In addition, they should not rely solely on professional valuers without exercising any judgement in assessing the reasonableness of the valuation techniques and the underlying unobservable inputs.

This year, we applied artificial intelligence technology to review issuers' annual reports and their compliance with the Rules governing annual report disclosure. This enhanced the breadth and reach of our existing annual report review by helping us identify whether issuers have disclosed in their annual reports information required under the Rules. We have highlighted in this report common areas of omission, including:

(i) details about pension schemes;

(ii) details about top five customers and suppliers;

(iii) details about issuers' subsidiaries such as their principal country of operation and the legal form;

(iv) issuers' gearing ratios;

(v) remuneration of the five highest paid individuals; and

(vi) issuers' reserves available for distribution.

Issuers should 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 and straightforward, and provide qualitative analysis that complements and explains quantitative information in the 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 promotes 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 areas. Our review covered the annual reports of issuers for the financial year ended between January and December 2019. The scope of review for each area is described in Parts II, III, IV and V of this report:

   (i) Disclosure of business review and significant investments in the MD&A section (Part IIA)

   (ii) Financial statements with auditors' modified opinions (Part IIB)

   (iii) Updates on material asset impairments and results of performance guarantees after acquisitions (Part IIC)

   (iv) Continuing connected transactions (Part IID)

   (v) Disclosure on share option and award schemes (Part IIE)

   (vi) Disclosure on material other expenses / income (Part IIF)

(vii) Fundraisings through issue of equity / convertible securities and subscription rights (Part IIG)

(viii) Issuers listed under the new listing regime for biotech companies (Part IIH)

(ix) Issuers listed in 2018 and 2019 (Part III)

(x) Application of artificial intelligence in review of annual reports (Part IV)

(xi) Material intangible assets (Part VA)

(xii) Material level 3 financial assets (Part VB)

(xiii) Findings regarding other accounting areas and key reminders for the upcoming financial reporting period (Part VC)

5. In this report, "Rules" refer to both Main Board (**MB**) Rules and GEM Rules.

6. Unless otherwise specified, Hong Kong Financial Reporting Standards (**HKFRSs**) and Hong Kong Standards on Auditing (**HKSAs**) and their paragraph numbers referred to in this report correspond to those in IFRSs and ISAs[1] 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.

[1] HKFRSs and HKSAs are issued by the Hong Kong Institute of Certified Public Accountants (the **HKICPA**); International Financial Reporting Standards (**IFRSs**) are issued by the International Accounting Standards Board (the **IASB**) and International Standards on Auditing (**ISAs**) are issued by the International Auditing and Assurance Standards Board.

II. FINDINGS ON SPECIFIC AREAS OF DISCLOSURE

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

7. 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[2] require, among others, an issuer to include in its annual report a review[3] 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.

8. The Rules also require an issuer to disclose its significant investments held, their performances during the financial year and future prospects. To enhance transparency of an issuer's investment activities, the Rules were amended in October 2019 to codify a number of our previously recommended disclosure on significant investments. They include a breakdown of the issuer's significant investments (representing 5% or more of its total assets 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 issuer's investment strategy for these significant investments[4].

Scope

<u>*(1) Disclosure on impact of the Covid-19 pandemic*</u>

9. The recent Covid-19 pandemic has caused severe disruption to the operations of many issuers. It has significantly impacted the financial performance and positon, and affected the business development plans of issuers across different industries.

10. This year, we reviewed issuers' annual report disclosure on the principal risks and uncertainties arising from the Covid-19 pandemic, its impact on the issuers and the measures they took to manage the risks. We reviewed the MD&A disclosure of 50 issuers with a 31 December financial year end to consider whether adequate disclosure had been made along the following areas:

    (a) Discussion about the effect of the Covid-19 pandemic on the issuer's operations, and the relevant risks or uncertainties that will materially affect their future performance. Examples may include suspension of operations, disruption to supply chains or distribution channels, change in customers' demands, etc.;

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[2] 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.

[3] Paragraph 28(2)(d) of Appendix 16 to the MB Rules / GEM Rule 18.07A(2)(d) and Schedule 5 of the Companies Ordinance.

[4] Paragraph 32(4A) of Appendix 16 to the MB Rules / GEM Rule 18.41(4A).

(b) Quantitative measures of the financial or operational impact to allow shareholders to gauge the materiality of the impact, with reference to, for example, percentage of revenue or profit, operating capacity, and impairments to assets, loans and receivables;

(c) Assessments of the liquidity positions and working capital sufficiency with reference to the operations and capital commitments; and assessments of the ability to fulfill financial obligations or meet debt covenants; and

(d) Measures such as cost control, funding and adjustment to business plans taken or to be taken to manage the impact of the Covid-19 pandemic.

(2) Follow up on last year's review of issuers' disclosure on regulatory changes in the pharmaceutical and education industries in the PRC

11. Last year, we reviewed the MD&A disclosure of 46 issuers with major operations in the pharmaceutical or education industries in the PRC in view of the recent changes in related regulations or government policies. We noted that a large majority of the issuers under review did not discuss the major regulatory changes relevant to their operations and their assessment on the potential impact arising from such changes to their operations. This year, we reviewed these issuers' MD&A disclosure to assess whether they have followed our recommendations.

(3) Significant investments

12. We reviewed whether issuers have complied with the amended Rules to disclose details of their significant investments in annual reports[5].

Findings

(1) Disclosure on impact of the Covid-19 pandemic

13. A majority of the selected issuers made qualitative disclosure on how the Covid-19 pandemic affected their operations and the relevant risks and uncertainties that might affect their future performance. For example:

- A PRC manufacturer disclosed the delay in the productions of certain business segments since January 2020, resulting in a decrease in sales volume. As a result it anticipated an adverse impact on its financial results for the first quarter of 2020. The issuer also disclosed in the annual report that its production and operation had returned to normal in April 2020, as the Covid-19 pandemic in Mainland China gradually became under control.

[5] We selected 118 issuers whose securities investments reported in their financial statements together accounted for 20% or more of the issuers' total assets as at the financial year end date.

14. Some issuers were able to quantify the financial impact. For example:

    - A hotel operator disclosed that government travel restrictions, quarantines and lockdowns had negatively affected its hotel operations in the PRC since late January 2020 and subsequently worldwide, resulting in the cancellation of hotel room reservations and closure of restaurants. The issuer disclosed the percentage decrease in revenue for the first two months of 2020 and projected losses in the first quarter, taking into account cost control measures.

15. A number of issuers provided assessments of their liquidity positions and working capital sufficiency with reference to their operations and capital commitments. For example:

    - An airline operator disclosed that it had reviewed its cash flow forecast for the 18 months after the year end date having taken into account its actual performance in early 2020, contingent measures put in place and available banking facilities. It disclosed the directors' assessment that, based on the latest forecast, the issuer would have sufficient funds to satisfy its working capital and capital expenditure requirements for the 18-month period.

16. Some issuers disclosed measures taken or to be taken amid the Covid-19 pandemic to inform shareholders of how the issuers endeavored to manage the impacts and risks. For example:

    - A gaming operator disclosed that it had agreed with its lenders to waive certain financial covenants (including the leverage ratio and interest coverage ratio) for a specified period to prevent default of its credit facilities, and to extend the due date for the submission of its audited financial statements to the lenders.

    - An education service provider disclosed that, in spite of school suspension and other restrictions, it had put up measures to continue its operation, including implementation of on-line modules and website distance learning activities. The issuer also disclosed the management's assessment that there had been no significant impact on its financial position up to the publication of its annual report in April 2020.

17. For the remaining selected issuers, the disclosure was relatively generic. These issuers briefly mentioned the Covid-19 pandemic and that it might have an adverse impact to their businesses due to reduced consumer sentiment or compulsory precautionary measures implemented by governments. These issuers did not disclose how the Covid-19 pandemic had or would affect their business operations specifically, the risks and uncertainties encountered and their future prospects.

18. We acknowledge that the Covid-19 pandemic was only at an incipient stage when the selected issuers prepared their 2019 annual reports. As issuers are navigating through the current environment, they would be in a better position to make more informed assessment and disclosure. For the next annual report, we recommend that issuers make appropriate disclosure about the impact of the Covid-19 pandemic on their operations, financial performance and financial position, and an assessment of the risks and impact on their future performance as mentioned in paragraph 10 above.

19. As the Covid-19 pandemic situation continues to evolve, we also recommend that issuers continuously evaluate the situation and, where appropriate, announce material business developments to keep shareholders and investors timely informed.

(2) Follow up on last year's review of issuers' disclosure on regulatory changes in the pharmaceutical and education industries in the PRC

20. We are pleased to note that, in our follow up review this year, most of the issuers reviewed this year have improved their MD&A disclosure. In this year's annual reports, they disclosed details of the changes in relevant regulations and government policies and whether the changes would affect their businesses. Where applicable, the issuers discussed how the regulatory changes would affect their financial performance, including the impact on the selling price, sales volume and/ or profitability. The disclosure provided shareholders with specific information on the impact of new regulations to the issuers.

(3) Significant investments

21. A large majority of the issuers disclosed the required information in full. This represented a material improvement in disclosure compared to last year.

22. Issuers who did not fully follow the required information disclosure generally omitted information about the investment costs and the size of particular investments relative to their total assets. We recommend issuers to ensure full disclosure of all requirements under the Rules.

B. Financial statements with auditors' modified opinions

23. Issuers are obliged to provide shareholders with financial statements which fairly present their financial positions and performance and are free from material misstatements. Such financial information is necessary for shareholders and investors to make an informed investment decision.

24. The Rules[6] 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. 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;

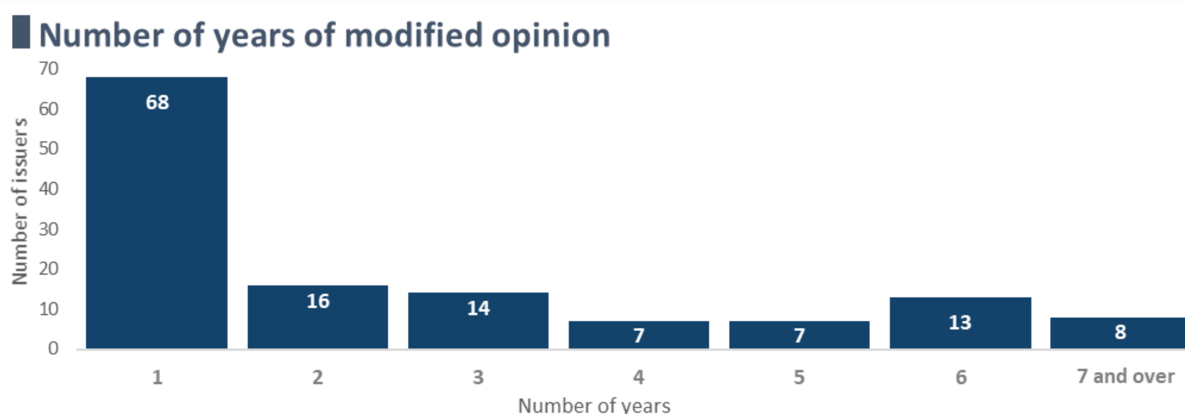
    (b) management's position and basis on major judgmental areas (such as basis for impairment or valuation of assets), and how the management's view is different from that of the auditors;

    (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

25. We reviewed the annual reports of 133 issuers[7] whose auditors expressed a modified opinion on the issuers' financial statements for the financial year ended in 2019. This included 68 issuers with modified opinions for the first time and 65 issuers with repeated modified opinions.



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6 Paragraph 3 of Appendix 16 to the MB Rules / GEM Rule 18.47

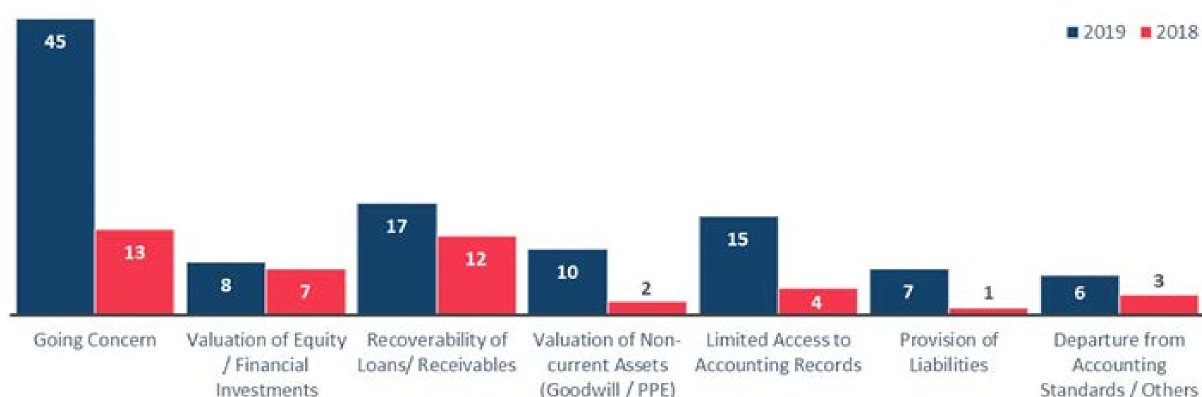
7 Excluding 20 issuers that were long suspended companies at the time they published the financial statements for 2019. Last year, there were 92 issuers (excluding long suspended issuers) that had modified opinions.

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

Findings

<u>*(1) 68 issuers with modified opinions for the first time*</u>

27. This number of issuers with modified opinions for the first time increased significantly compared to last year (29 issuers). The chart below provides a breakdown of the audit issues which gave rise to modified opinions in the 2019 financial year, with comparative figures for the 2018 financial year. The increase was primarily due to the existence of material uncertainty on those issuers' ability to continue as a going concern. Other audit modifications included valuation of assets and recoverability of loans and receivables, and issues arising from limited access to accounting books and records.



Note: some issuers had more than one audit issues cited in their modified opinions.

28. *Going concern modifications*: A majority of the issuers attributed their going concern modifications to the impact of the recent macro environment, including the Sino-US trade disputes and outbreak of the Covid-19 pandemic, on their financial performance and financial positions. While this may be the case, we noted that in a majority of cases, their liquidity and financial issues had developed over a period of years, as many of these issuers had incurred losses for over three years and/or their auditors, despite expressing an unmodified opinion, had highlighted the existence of material uncertainty on the issuers' ability to continue as a going concern in the previous year auditors' report.

29. It is important for issuers to continuously review their current liquidity position and expected financial resource needs to allow their businesses to operate normally. We urge issuers, in particular those issuers whose auditors' report highlighted on the existence of material uncertainty on the issuers' ability to continue as a going concern, to formulate action plans to address their funding needs in a timely manner, and to take concrete actions to implement those plans.

30. *Valuation of assets and recoverability of loans / receivables*: We noted that auditors generally attributed the audit modifications to insufficient evidence provided by the issuers' management to justify their estimates used to support the assets value. For example, where there were material changes in the reporting items, the issuer did not perform valuations to support the reported assets value, or failed to provide concrete evidence to support the inputs used in the valuations. We recommend that issuers should develop appropriate and supportable estimates for the financial reporting items. They should also document key judgments made, and consider retaining experts where necessary. Issuers should engage in early discussions with their auditors and agree in advance the timing, form and approach of the assessment of these estimates as early as practicable[8].

31. *Limited access to accounting records*: Issuers generally attributed this audit modification to restricted access to the books and records of entities that were disposed of, or the departure of key personnel of the issuers or their subsidiaries. These reflect weaknesses in internal controls and we recommend that issuers put in place adequate internal control measures to ensure that (i) during the course of negotiations, they make adequate arrangements to allow them to fulfil their financial reporting obligations; and (ii) there is sufficient segregation of duties and they should refrain from undue reliance on a few employees.

Disclosure in the annual reports

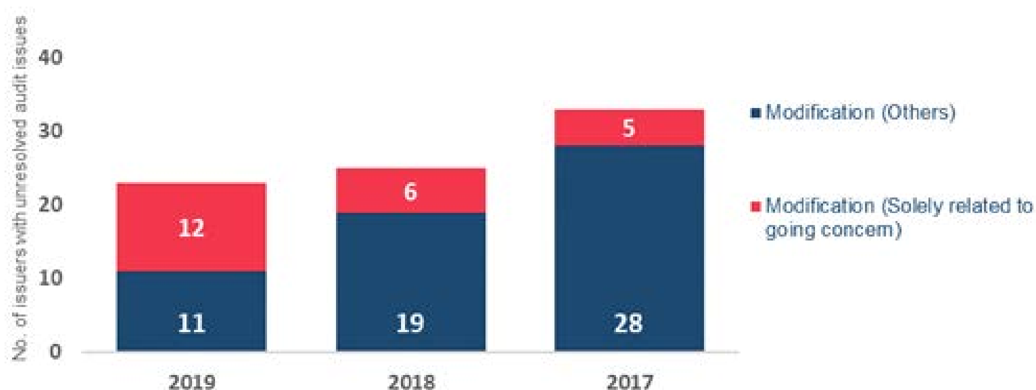
32. Compared to last year, the annual report disclosure of modified audit opinions by these issuers has improved. About one-half of the issuers made the recommended disclosure in full (last year: one-third). Whilst the audit opinion included details of the audit modifications, the remaining issuers failed to discuss the audit modifications as recommended in paragraph 24 (b) and (c) above. Most of these issuers made supplemental announcements to disclose the omitted information.

(2) 65 issuers with repeated modified opinions

33. Of the 65 issuers with repeated modified opinions, 42 issuers had resolved all underlying audit issues that led to the audit modifications in previous year(s)[9]. This represented an improvement compared to last year (38 issuers). The chart below illustrates the number of issuers with unresolved modified opinions.

[8] In its Interim Inspection Report dated 11 December 2020, the Financial Reporting Council highlighted this as an areas of concern and commented that it was the responsibility of management and the audit committee to develop appropriate and supportable estimates for all areas of the financial statements independently of the auditors, who should agree with the management the timing and form of such assessment.

[9] Four of these 42 issuers had new audit modifications in the 2019 financial year.



34. Actions taken by the 42 issuers to resolve audit modifications included (i) performing proper valuation on assets with justifiable forecast assumptions and (ii) disposing of the underlying problematic assets. These actions were similar to the cases observed last year**.**

35. The remaining 23 issuers were unable to resolve their audit modifications brought forward from previous year(s). This included 12 issuers with audit modifications related solely to going concern, and 11 issuers with audit modifications related to various matters:

Note: some issuers had more than one audit issues cited in their modified opinions.

36. Similar to issuers with first time modified opinions, the most common audit modifications related to going concern and the fairness of the reported value of material assets. In most cases, the repeated audit modifications were due to issuers' inability to provide information or evidence to satisfy auditors on the validity of their assumptions or estimates in reporting the relevant assets. We urge these issuers to formulate concrete plans to resolve these issues immediately and take note of our recommendations in paragraph 30 above. Where the issuers held material divergent views from their auditors in the last audit, they should communicate with auditors early and work closely to explore ways for reconciliation and resolution.

Disclosure in the annual reports

37. 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 modifications.

(3) New Rules relating to disclaimer or adverse opinion on financial statements

38. Under the new Rules[10], where an issuer publishes its preliminary results announcement for a financial year and its auditor has issued, or indicated it would issue, a disclaimer or adverse opinion (other than one relating solely to going concern) on the issuer's financial statements, the issuer will normally be required to suspend trading in its securities. The suspension will normally remain in force until the issuer has addressed the issues giving rise to the disclaimer or adverse opinion[11]. 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.

39. 74 issuers received a disclaimer of opinion. 48 issuers had audit modifications related to issues that had been resolved or were solely related to going concern, and the remaining 26 issuers (including 17 issuers receiving the disclaimer of opinion for the first time) had unresolved audit modifications related to various matters. We urge these issuers to take prompt and appropriate actions to resolve the underlying issues and avoid possible trading suspension.

Note: Some issuers had more than one audit issues cited in their modified opinions.

[10] MB Rules 13.50A and 13.50B / GEM Rules 17.49B and 17.49C

[11] Suspension will normally not be required if the underlying issues giving rise to the disclaimer or adverse opinion have been addressed before the issuer publishes the preliminary results announcement.

C. Updates on material asset impairments and results of performance guarantees after acquisitions

40. The Rules require issuers to announce material acquisitions, publish circulars and obtain shareholders' 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[12].

41. Where an asset impairment is supported by a 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 bases and assumptions; (ii) reasons for any significant changes in the value of the inputs and assumptions from those previously adopted; (iii) the valuation method and 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.

42. In some acquisitions, 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. Under the Rules, 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, among others, the shortfall and whether the vendor has fulfilled its obligations under the guarantee[13].

Scope

(1) Update on material impairments on acquired assets

43. We reviewed the 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.

[12] Paragraph 32 of Appendix 16 to the MB Rules / GEM Rule 18.41.

[13] 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.

(2) Results of performance guarantees

44. For issuers that were given performance guarantees in previous acquisitions and the guarantee period ended in the financial year under review, we reviewed whether the issuers have properly disclosed the outcome of the performance guarantees in announcements and annual reports, and where the performance guarantees were not met, whether and how the issuers enforced the obligations of the guarantors.

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

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

Findings

(1) Update on material impairments on acquired assets

(i) Disclosure in annual reports

46. The number of issuers reporting material impairments on acquired assets was comparable to last year. The vast majority of issuers disclosed the circumstances that led to the impairments, and engaged independent valuers to perform valuations and disclosed details of the valuations as described in paragraph 41 above. A few issuers omitted some information, including reasons for adopting a particular valuation method and/or basis of the valuation input. These issuers, in response to our enquiry, disclosed the omitted information by supplemental announcements.

47. We identified one case where the issuer recorded material impairment in its acquired equity interest in a business shortly after its acquisition, as the issuer was unable to obtain financial information on the acquired investment. We remind issuers that they should have in place appropriate internal control measures to monitor the status of, and safeguard its investments and assets.

(ii) Timeliness of disclosure of material changes to the acquired businesses

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

(2) Results of performance guarantees

49. Over one-half of the issuers with performance guarantees that ended in the financial year confirmed that the performance guarantees were met. Where the performance guarantees were not met, most issuers were compensated by the guarantors according to the terms of the agreements. In the few remaining cases, the issuers took legal actions against the vendors or unwound the transactions. We reviewed these arrangements and were satisfied that the issuers had taken appropriate actions to safeguard their assets and had updated shareholders on the rationale and status of their actions in their announcements and annual reports.

50. A large majority of the issuers made the required disclosure in their annual reports and, where the performance guarantees were not met, published announcements to disclose the shortfall and whether the vendors had fulfilled their obligations under the guarantees. Only a few issuers failed to comply with the Rule disclosure requirements. These issuers made supplemental announcements following our enquiries.

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

(i) Disclosure in annual reports

51. 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. This year, the number of issuers that made such impairments increased considerably compared to last year. Generally, these issuers attributed the impairments to macroeconomic factors, such as the Sino-US trade disputes or the general economic downturn in Hong Kong, or factors specific to the relevant industry.

52. These issuers generally disclosed the circumstances that led to the impairments in their annual reports. Where the impairments related to intangible assets, properties, plant and equipment, most of the issuers supported the impairment amounts with independent valuations and disclosed details of the valuations as described in paragraph 41 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.

53. This year, we noted an increase in cases involving material impairments on loans and receivables. These issuers generally attributed the impairments to defaults in repayment, recoverability issues and/or increased credit risk due to economic slowdown.

54. We noted that in a small number of cases, the impairments revealed potential deficiencies in the issuers’ internal controls over the grant of loans and raised concerns about the directors’ role in overseeing these lending transactions and safeguarding assets. In a few cases, the circumstances of the loan grants raised questions about the commercial rationale of the loan transactions and whether they were made in the interest of the issuers. These cases are under investigation.

55. We recommend that issuers and their audit committees should ensure that effective internal control systems are put in place to manage the issuers' credit risk exposure and to monitor repayment of the relevant loans and receivables to safeguard the issuers' assets. Issuers should also be responsive to changes in economic conditions and assess whether the current internal control procedures are adequate and reflect such changes.

(ii) Timeliness of disclosure of material changes

56. Issuers generally disclosed the circumstances that led to the material impairments on assets in profit warning or other announcements. We have not identified any major issues about the timeliness of such disclosure.

D. Continuing connected transactions

57. Under the Rules, shareholders may give an issuer a prior mandate to conduct 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.

58. To monitor the issuer's compliance with the framework agreement, the Rules 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;

    (b) INEDs must review the issuer's CCTs and confirm in the annual report 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; and

    (c) The auditors must review the issuer's CCTs and provide the board of directors with a confirmation whether anything has caused them to believe that the CCTs (i) had not been approved by the board; (ii) were not in accordance with the issuer's pricing policies; (iii) were not entered into in accordance with the agreement governing them; and (iv) had exceeded the annual cap. The board should state in the annual report whether the auditors have provided such confirmation.

Scope

59. We reviewed issuers' compliance with the CCT requirements set out in paragraph 58 above. This year, we selected and reviewed the annual reports of approximately 200 issuers that (i) had failed to comply with the CCT Rules in the past two financial years; or (ii) were listed in 2018 or 2019 and reported CCTs in their annual reports for the first time. We also reviewed the announcements and circulars of the selected issuers against the disclosure in their annual reports to assess their compliance with the annual report disclosure requirements.

60. In addition, we reviewed the INEDs and auditors' confirmations on their review of the CCTs.

Findings

61. Similar to last year, a vast majority of the selected issuers fully complied with the CCT disclosure requirements in their annual reports. A few issuers omitted disclosure in one or more of the following areas: (i) certain terms of the CCTs announced in the year; (ii) confirmation from the issuers as to 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 (iii) confirmations from the INEDs and auditors of the issuers on matters described in paragraph 58 (b) & (c) above. Upon our enquiries, all the issuers disclosed the omitted information by supplemental announcements.

62. We noted a few cases of non-compliance with the CCT Rule requirements:

    (a) In three cases, the INEDs and/or the auditors found the CCTs to have exceeded the annual caps approved by independent shareholders;

    (b) In three cases, the issuers announced that their CCTs exceeded the annual caps approved by independent shareholders. This was despite confirmations made by the INEDs and the auditors in the annual reports that the CCTs were in compliance with the Rule requirements and the terms of the framework agreements; and

    (c) Nine issuers announced failures to comply with the Rule requirements (including publication of announcements and disclosure in annual reports, and in some cases, independent shareholders' approval) on CCTs. This is despite confirmations made by the INEDs and the auditors in the annual reports that these issuers complied with Rule requirements.

63. INEDs play an important role in providing checks and balance over the issuers' corporate affairs, business operations and transactions, and in particular, in the monitoring of connected transactions. Issuers should have in place appropriate internal controls and mechanisms to monitor, and assist INEDs in overseeing their CCTs. While the specific measures required for monitoring CCTs are expected to be commensurate with the individual circumstances of the issuers, we recommend issuers and their INEDs to review the appropriateness of their internal control procedures. Issuers should also make reference to best practices adopted by other issuers set out in our last year's report.

E. Disclosure on share option and award schemes

64. Chapter 17[14] governs issuers' share option schemes, including requirements on establishment of and certain terms of the scheme, restrictions on the scheme mandate limit and on the grant of share options. The Rules also mandate disclosure of the terms of the scheme and details of the grants in annual reports to provide transparency and accountability to shareholders. Such disclosure include[15]:

    (a) the terms of the scheme;

    (b) details of the share options granted, the terms (including the number, date of grant, vesting period, exercise period and exercise price), and the closing price of the underlying securities immediately before the date of grant; and

    (c) movements of outstanding share options.

65. Separate disclosure is required for different categories of participants: (i) director, chief executive and substantial shareholder (or their respective associates); (ii) employees; (iii) suppliers of goods or services; and (iv) other participants. Disclosure by individual is required for category (i) participants and individuals with grants over the 1% individual limit.

66. Some issuers adopted share incentive schemes to incentivise scheme participants and provide compensation. While share award schemes that do not involve share options are not subject to the requirements in Chapter 17, these schemes are a form of share-based payment arrangements and a summary disclosure is required under HKFRS 2 "Share-based Payment".[16]

Scope

67. We reviewed the annual reports of 266 issuers that granted options under their share option schemes during the 2019 financial year and assessed their compliance with the disclosure requirements described above. We also reviewed the disclosure of 326 issuers with share award schemes.

Findings

(1) Share option schemes

68. A vast majority of the issuers reviewed fully disclosed the required information on the terms of their share option schemes. The remaining issuers omitted specific information, such as the securities available for issue under the share option schemes (expressed as number of shares and percentage), and the remaining life of the schemes.

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[14] Chapter 23 of the GEM Rules.

[15] MB Rules 17.07 and 17.09/ GEM Rules 23.07 and 23.09.

[16] HKFRS 2 requires a description of each type of share-based payment arrangements including the general terms and conditions of each arrangement, and disclosure on movements of share based payments during the reporting period.

69. A large majority of the issuers reviewed also fully complied with the Rules to disclose the movements and details of share options granted during the financial year for each category of participants. The remaining issuers omitted specific information, such as the closing price of the underlying securities immediately before the option grant date, the vesting period for the outstanding options, and the value of options granted during the year or the reasons for non-disclosure. A few issuers failed to separately disclose the details of share options granted to their employees and other participants.

70. About one-third of the issuers reviewed granted share options during the year to participants who were not their directors, chief executives, substantial shareholders or employees. While there is no Rule requirement, we noted that a majority of these issuers disclosed the background of the grantees, who were mainly consultants and advisers.

71. Share option schemes are a form of compensation to incentivise scheme participants and to align their interests with those of the issuers and shareholders. Accordingly, share option grants should serve to encourage the grantees to protect and improve shareholder value. Where share options are granted to non-employees, we recommend that issuers disclose information on the identities of the grantees, terms of the share options granted and the rationale for making the grants. This disclosure would provide accountability to shareholders on the alignment of the share option grants with the objective of the schemes[17].

(2) Share award schemes

72. We noted that the vast majority of issuers with share award schemes made reference to the Chapter 17 disclosure requirements and disclosed the major terms of their share award schemes. A large majority of these issuers also disclosed the movements of share awards granted during the financial year in detail, following Chapter 17 requirements. We consider such disclosure useful for shareholders' evaluation of the use of share award schemes and recommend issuers to follow the Chapter 17 disclosure requirements in their future annual reports.

[17] In its Report on the Securities and Futures Commission's review of the Exchange's performance in its regulation of listing matters issued in June 2020, the Securities and Futures Commission highlighted that while there were no requirement under the Rules to disclose the identity of non-employee grantees, issuers' disclosure of option grants to these grantees was often unsatisfactory.

F. Disclosure on material other expenses / income

73. Under the Rules[18], 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.

74. 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. For that reason, an issuer should make adequate disclosure to describe the nature of, and explain the movements of these material items. Such disclosure would facilitate investors in understanding the major factors contributing to the issuer's financial performance during the year.

Scope

75. In our review of issuers' disclosure of material other expenses and income last year, we found that issuers generally provided adequate breakdown of material other income, but about one-half of the issuers reviewed provided no or limited breakdown of other expenses.

76. This year, we continued to review issuers' disclosure in this area. We selected 374 issuers that recorded "other / other operating expenses" and 514 issuers that recorded "other / other operating income" as a line item in their statements of profit or loss[19]. 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

(1) Other expenses

77. Over 60% of the selected issuers provided breakdowns for all or most of the reported "other / other operating expenses" in the notes to the financial statements. The "other / other operating expenses" items were mainly advertising costs, travelling expenses, asset impairment, auditors' remuneration, legal and professional expenses and operating lease charges.

78. We followed up with the remaining issuers and were satisfied that, in a number of these cases, the "other / other operating expenses" were not material in relation to the financial figures in the issuers' profit and loss statement (including the revenue and/or total costs and expenses).

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[18] Paragraph 32 of Appendix 16 to the MB Rules / GEM Rule 18.41

[19] 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.

79. In determining the appropriate level of disclosure of expenses, issuers should have regard to the overriding principle that information disclosed must be meaningful, accurate and complete in all material respects[20]. They should consider their own circumstances and provide sufficient information to facilitate investors' understanding and assessment of their cost structure and their financial performance.

(2) Other income

80. Similar to previous years, issuers that reported material other income generally disclosed a breakdown of all or a material portion of such income in the notes to the financial statements. We have not identified issues in this area.

[20] MB Rule 2.13 / GEM Rule 17.56.

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

81. The Rules[21] require issuers to disclose in their annual reports details of their equity fundraisings during the year, and unutilised funds brought forward from previous year(s), including 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.

82. The disclosure promotes issuers' accountability for funds raised from equity issues. Issuers are also recommended to present the above information in tabular format.

Scope

83. We reviewed the announcements and annual reports of all issuers that conducted equity fundraisings during the financial year and the annual reports of all issuers that had unutilised proceeds brought forward from equity fundraisings conducted in previous financial years.

Findings

(1) Disclosure on use of proceeds

84. A majority of issuers fully disclosed the required information. Compared to last year, there was a general improvement in issuers' compliance with the Rule disclosure, and in particular, a vast majority of issuers that failed to fully disclose the required information last year complied with the required disclosure this year.

85. Commonly omitted information included (i) the expected timeline for the use of unutilised proceeds, and (ii) disclosure on unutilised proceeds from initial public offerings and their uses. Upon our enquiries, some issuers attributed the omissions to uncertainties in their business developments and thus difficulties in fixing a timeline.

86. The Rules[22] require issuers to disclose their future business developments in their annual reports. In line with this disclosure, issuers should also provide appropriate disclosure of the expected use of proceeds from fund raisings to support these business developments and the expected time frame. Recently listed issuers should also take note to make continual disclosure on the application of their unutilised IPO proceeds.

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21 Paragraphs 11, 11A and 32 of Appendix 16 to the MB Rules / GEM Rules 18.32, 18.32A and 18.41.

22 Paragraph 28(2)(d) of Appendix 16 to MB Rules / GEM Rule 18.07A(2)(d).

(2) Change in use of proceeds

87. A few issuers disclosed changes in use of proceeds in their annual reports. The changes were mainly related to reallocation of funds among different stated purposes in the fundraising announcements, or reassignment of funds to existing businesses. The extent of changes was not material. We have not identified any major issues arising from such changes.

H. Issuers listed under the new listing regime for biotech companies

88. In April 2018, the Exchange introduced Chapter 18A to permit listing of biotech companies that do not meet any of the financial eligibility tests under Rule 8.05. As these biotech companies are generally at a pre-revenue stage, the Rules require additional disclosure to provide information to investors. In particular, Rule 18A.08 requires biotech companies to disclose in their annual and interim reports:

    (a) 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

89. We reviewed the annual reports of 15 bio-tech companies that have published their annual reports for the financial year ended in 2019, and assessed whether these issuers have complied with the relevant Rules[23].

Findings

90. All 15 biotech companies disclosed information as required under Rule 18A.08 in their annual reports.

91. In last year's report, we noted that some biotech companies disclosed additional information on their major business developments. This year, we noted that a majority of companies made similar disclosure, including:

    (a) market information on post-commercialisation core products such as revenue generated, commercialisation strategy, market coverage and competition (e.g. market share of other drugs targeting the same disease); and

    (b) development of newly in-licensed or non-core products including stages of development; status of clinical trial and regulatory approval; expected timeframe towards commercialisation; and/or collaborations with other parties.

92. The additional disclosure provided investors with useful information to appraise biotech companies' business developments. We encourage biotech companies to continue this practice in future.

[23] Up to 31 December 2020, there were 28 biotech companies listed on the Exchange under Chapter 18A.

III. ISSUERS LISTED IN 2018 AND 2019

93. 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

94. 208 and 163 issuers were listed in 2018 and 2019 respectively (the **Newly Listed Issuers**)[24].

95. In recent years, the Exchange noted concerns over "shell" creation activities through initial listings on the Exchange. There were concerns that some issuers might have sought listings for the perceived premium attached to the listing status rather that for the development of the listed business[25]. In light of this, we continued to review the post-listing developments of the new issuers, particularly where they have exhibited "shell" characteristics after listing.

96. 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

97. Similar to previous years, we reviewed whether the Newly Listed Issuers had undertaken one or more of the significant corporate actions after listing, including (i) disposal 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.

98. We noted that 16 Newly Listed Issuers (last year: 20 issuers) had undertaken one or more of the above significant corporate changes or actions, including (i) 10 issuers where their controlling shareholders disposed of their controlling interests in the issuers; (ii) four issuers that proposed material acquisitions of new businesses; and (iii) four issuers that re-allocated part of their IPO proceeds to finance the acquisitions of new businesses.

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[24] Transfers of listing from GEM to Main Board are excluded.

[25] See our Guidance Letter GL68-13A.

99. In addition, two Newly Listed Issuers proposed acquisitions that appeared to be circumventions of the new listing requirements:

    (i) In one case, the controlling shareholder proposed to inject a substantial business shortly after listing. At the time of its new listing application, the controlling shareholder explained, upon our enquiries, that it decided not to list the substantial business as the IPO business would have better prospect and be more profitable. The proposed injection of this substantial business shortly after listing was considered an attempt to list the substantial business without going through the due diligence required for an IPO. The proposed transaction was ruled as an extreme transaction subject to additional due diligence and disclosure requirements.

    (ii) In the second case, the Newly Listed Issuer proposed to acquire a target business that was itself previously an IPO applicant. There were unresolved issues during the IPO vetting process that raised questions about the suitability of listing of the IPO applicant. There were concerns that the proposed acquisition of the target business was an attempt to circumvent the new listing requirements. The proposed transaction was subsequently terminated.

100. In October 2019, we amended our reverse takeover Rules to address issues about backdoor listings and shell activities. Since then, we continue to identify backdoor listing activities, and are closely monitoring this area. We will continue to take a robust approach to address shell activities. As part of this initiative, we issued a consultation paper in November 2020 proposing amendments to the eligibility criteria for new listing applicants to address concerns about shell manufacturing activities through new listings[26].

(b) Profit forecasts and material decrease in financial results

Profit forecasts

101. A vast majority of the Newly Listed Issuers did not publish any profit forecast in their prospectuses. Those Newly Listed Issuers that published a profit forecast were able to meet the forecasted profits.

Profit warning announcements

102. About a quarter of the Newly Listed Issuers published profit warning announcements in respect of their first interim periods or financial years immediately after listing, which was comparable to last year.

[26] See also the Listed Issuer Regulation Newsletter of December 2020 on our review of RTO activities in the last year.

103. 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 mainly due to matters arising after listing. We have considered these issuers' explanations and circumstances related to the deviations and have not identified issues with Rule compliance. A few cases continue to be under our review.

104. In our previous reports and the SFC Corporate Regulation Newsletters[27], it was recommended that issuers should (i) quantify the potential impact to the profit figure and use clear and concise language in the profit alert announcement; and (ii) not issue profit alert announcement that merely repeats facts previously disclosed in the prospectus.

105. We noted that about three-quarter of the profit warning announcements quantified the financial impact in terms of percentages or in dollar amounts, this represented a notable increase compared to last year (about a half). We have not identified any announcement that merely repeated information already disclosed in the issuer's prospectus. The issuers generally announced the relevant post-listing developments on a timely basis.

(c) Changes in the use of IPO proceeds

106. 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. 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.

107. Some Newly Listed Issuers announced changes to their proposed uses of IPO proceeds within two years after listing, the number of these cases are comparable to last year. In the vast majority of these cases, the changes related to reallocation of funds among different intended uses disclosed in the prospectus or reassignment of funds to the existing businesses of the issuers. The reasons for the changes generally related to unexpected declines in the businesses that were initially planned for expansion, or changes in market or regulatory policy.

108. We have reviewed these issuers' disclosure and noted that all issuers (except one) had explained the changes on a timely basis. One issuer delayed announcing the changes for about one year in its first year after listing (this case was reported in last year's report).

[27] Please refer to the issue No.2 April 2015 and issue No.4 December 2016 of the Corporate Regulation Newsletters published by the SFC.

(d) Non-compliance with the Rules after listing

109. 44 Newly Listed Issuers failed to comply with the Rules shortly after listing, this number was comparable to last year.

110. A majority of the cases related to non-compliances with the notifiable or connected transaction Rules (32 cases) where the issuers failed to timely announce and/or obtain prior shareholders' approval on the relevant transactions. These non-compliances were mainly attributable to misunderstanding on the application of the Rules or oversight. For example,

    (i) Nine issuers failed to announce acquisitions of wealth management products issued by banks, as they were unaware the acquisition of those products would constitute notifiable transactions under the Rules;

    (ii) Seven issuers failed to properly monitor their continuing connected transactions and exceeded the annual caps; and

    (iii) Three issuers failed to announce leasing of properties, which constituted an acquisition of assets by the lessee under HKFRS 16 "Leases" (effective since 1 January 2019) and would be notifiable transactions.

111. Other Rule non-compliances included: failure by directors to comply with the Model Code applicable to directors' dealings in the issuers' shares during blackout period; share disposal by controlling shareholders during lock-up period; delay in cancelling repurchased shares; grant of share options during prohibited period; failure to maintain minimum public float; and delays in publishing accounts.

112. Chapter 3A[28] 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.

113. In our investigation, we noted that about 40% of the above issuers failed to consult with their compliance advisers on the relevant transactions as required by the Rules. 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. We also recommend that compliance advisers take note of the above non-compliance pitfalls when advising listed issuers on Rule compliance.

[28] Chapter 6A of GEM Rules.

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

114. For a few 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 restrictions on use of IPO proceeds to finance or facilitate sanctioned activities. All these issuers had fulfilled their undertakings and made the relevant disclosure in their annual reports.

115. In addition, some major shareholders of Newly Listed Issuers provided non-competition undertakings (**NCU**) to the issuers to establish a clear delineation between the issuer's business and the major shareholders' businesses. In a large 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, some 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 in their subsequent interim results announcements or financial reports.

IV. Application of artificial intelligence in review of annual reports

116. We applied artificial intelligence technology to review issuers' annual reports and their compliance with the Rules governing annual reporting disclosure[29]. This enhanced the breadth and reach of our existing annual report review by helping us identify whether issuers have disclosed in their annual reports information required under the Rules.

117. Our developed artificial intelligence model[30] checked more than 300,000 disclosure records (covering over 140 disclosure Rules) in issuers' annual reports for the financial year ended in 2019.

118. We are pleased to find that issuers achieved a very high compliance rate (over 99% of disclosure records). Common disclosure omissions mainly related to the following areas:

(a) Paragraph 26 of Appendix 16 to the MB Rules[31] - Pension schemes

Common omissions included: (i) whether the forfeited contributions under the defined contribution schemes may be used by the employer to reduce the existing level of contributions and (ii) details of the defined benefit plans, such as the name and qualifications of the actuary; actuarial methods and assumptions; market value of the scheme assets; level of funding; and comments on any material surplus or deficiency.

(b) Paragraph 31 of Appendix 16 to the MB Rules[32] - Top five customers and suppliers

Issuers omitted disclosure of (i) the percentages of revenue/purchases attributable to the largest customer/supplier; (ii) the percentages of revenue/purchases attributable to the five largest customers/suppliers combined; and (iii) the interests of any of the directors; their close associates; or any shareholder (who owns more than 5% interests in the issuers) in the five largest customers/suppliers.

(c) Paragraph 9 of Appendix 16 to the MB Rules[33] - Details of subsidiaries

A number of issuers did not disclose (i) the principal country of operation of the subsidiaries and (ii) the legal form of subsidiaries established in the PRC, such as whether they are wholly owned foreign enterprises, contractual joint ventures or cooperative joint ventures.

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[29] Appendix 16 to the MB Rules and Chapter 18 of GEM Rules.
[30] For more information, please refer to A RegTech AI Case Study: Assessing the Annual Reports of Listed Companies for details.
[31] GEM Rule 18.34.
[32] GEM Rule 18.40.
[33] GEM Rule 18.10.

(d) Paragraph 32(10) of Appendix 16 to the MB Rules[34] - Gearing ratios

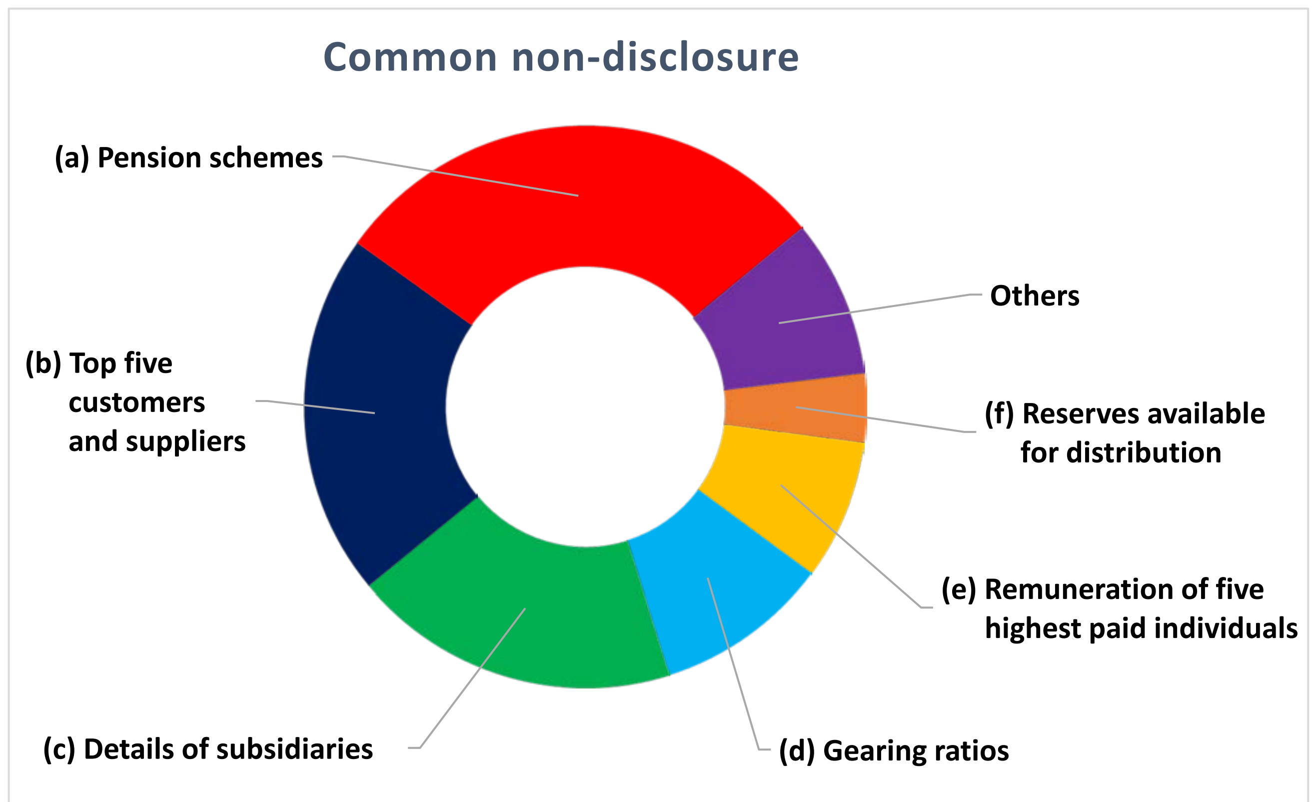
Some issuers did not disclose the gearing ratios, or basis for calculation of these ratios.

(e) Paragraph 25 of Appendix 16 to the MB Rules[35] - Remuneration of five highest paid individuals

Certain emoluments details of the five highest paid individuals were omitted, in particular, the distribution of the five highest paid individuals (non-directors) among the different remuneration bands.

(f) Paragraph 29 of Appendix 16 to the MB Rules[36] - Reserves available for distribution.

Some issuers did not make a statement of the reserves available for distribution to shareholders as at the financial year end date.



119. We invite issuers to take note of the above common non-disclosure items when preparing their next annual reports.

[34] GEM Rule 18.41(10).
[35] GEM Rule 18.30.
[36] GEM Rule 18.37.

V. FINDINGS REGARDING ACCOUNTING REVIEW THEMES

A. Material intangible assets

120. Intangible assets, including goodwill, can form part of the significant assets of issuers. Investors continue to pay special attention to impairment issues in such challenging times under the impact of Covid-19 pandemic and therefore robust impairment testing is important.

121. The 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".

122. In previous years, in addition to reminding issuers of the required disclosure, we recommended issuers to provide additional disclosure about their accounting judgements or estimates under HKAS 1 (Revised) "Presentation of Financial Statements" (HKAS 1R.122 and 1R.125), in particular on the reasonableness of the financial budgets and assumptions used in determining the recoverable amounts:

Disclosure on the reasonableness of the financial budgets and assumptions used in determining the recoverable amounts
Provide the following additional information in the MD&A and financial statements (where appropriate): (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; (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; (c) providing the recoverable amount of the CGU and the headroom available; (d) highlighting whether the impairment assessment is based on a valuation by an independent professional valuer; and (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.

Scope

123. For this purpose, we selected the review cases from issuers whose intangible assets had accounted for over 25% of their total assets. Out of 300 cases under the financial statements review this year, we selected 51 issuers under this review theme, of which 19 issuers were follow-up review from previous years' review.

124. In this year's review, we focused on 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).

125. We reviewed the disclosure in relation to indication of impairment, including whether impairment test had been performed when there was indication of impairment. We also examined the level of detail of disclosure on impairment assessment, particularly the information on management's judgements and estimates (HKAS 1R.122 and 1R.125), to justify whether the financial budgets and assumptions used in determining the recoverable amounts were reasonable. In addition, we reviewed whether the issuers under review provided the recommended disclosure set out in paragraph 122 above.

Findings

126. A majority of the issuers under review had goodwill, intangible assets with indefinite useful lives and intangible assets not yet available for use and had performed annual impairment test. Most of these issuers determined the recoverable amounts[37] of the cash-generating units (**CGUs**) to which goodwill and intangible assets were allocated based on value in use (**VIU**) calculation.

127. We are pleased to note that many issuers enhanced the disclosure of how the key assumptions used in the impairment tests were determined and disclosed quantitative data of additional key assumptions (other than discount rate and terminal growth rate), which is one of the recommended disclosure in paragraph 122 above.

128. However, in some cases, the key assumptions applied in the impairment tests (such as revenue growth rate during the forecast period, gross profit margin) appeared to be overly optimistic when compared with historical results and cash flows of the group or CGU. These raised doubts as to whether the key assumptions were reasonable.

129. We also observed some cases where there were indications of impairment but no impairment losses were recognised, in particular when (i) the group or the segment suffered recurring operating losses or deterioration in revenue, net profit or gross profit margin or had operating cash outflows, or (ii) for certain industries, the carrying amount of the issuer's net assets was substantially more than its market capitalisation.

130. In addition, regarding the follow-up review cases, we noted that in a few 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 previous years' review) without recognising an impairment loss.

[37] HKAS 36.6 defines the recoverable amount of an asset or a CGU as the higher of its fair value less cost of disposal and its VIU.

131. In relation to these cases, we made enquiries to request additional information and explanations from the relevant issuers in order to justify that directors and management had properly assessed impairment indication and performed impairment test accordingly; and that the key assumptions underlying the cash flow projections were considered reasonable and supportable, including the calculation of the recoverable amount which contained the quantitative information of key assumptions (such as budgeted sales, gross profit margin) and the relevant valuation report, explaining why assumptions were considered reasonable, 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), providing a sensitivity analysis of the key assumptions.

132. Based on our review and issuers' responses to our enquiries, we did not note any significant non-compliance regarding the requirements in HKAS 36, HKAS 38 and HKFRS 3 (Revised). We also observed that issuers under review generally included the required disclosure. Where disclosure was insufficient but was 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.

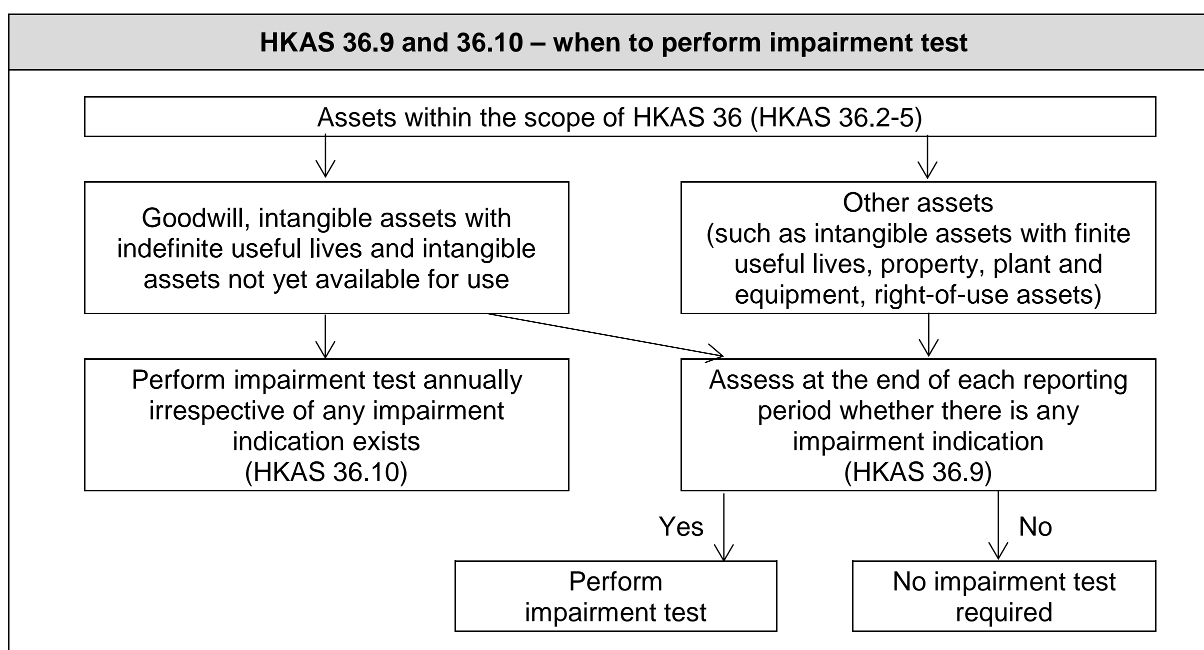
133. In respect of the recommended disclosure set out in paragraph 122 above, we observed that over half of the issuers under review (including the follow-up review cases) provided one or more items of the recommended disclosure, in particular a few of them quantified the recoverable amounts of the CGUs and the headroom available.

Recommendation

134. Based on the findings of this year's review, we set out our recommendations in the following two aspects.

(1) Timing of impairment assessment and indications of impairment

135. HKAS 36.9 and 36.10 set out the requirements of when to perform impairment test on assets within the scope of HKAS 36, which is illustrated below:



136. To assess whether there is any indication of impairment, issuers should consider, at a minimum, the non-exhaustive list set out in HKAS 36.12 and 36.14, in particular the carrying amount of the net assets being more than the market capitalisation, increase in market interest rates that are likely to affect the discount rate used in calculating an asset's VIU and decrease the asset's recoverable amount materially, actual net cash flows or operating profit or loss flowing from an asset being significantly worse than the budgeted amounts.

137. When there are indications of impairment, issuers should perform an impairment test. As illustrated in paragraph 135 above, issuers may need to perform impairment test of goodwill, intangible assets with indefinite useful lives and intangible assets not yet available for use if impairment indication exists at the end of a reporting period, including an interim period[38]. In addition, issuer are recommended to enhance the disclosure, such as whether an impairment test has been performed, the event that triggered the test and the test result (even though it does not result in impairment).

138. The Covid-19 pandemic is expected to be a strong indication of impairment because of the adverse impact on issuers' businesses, market capitalisation and the markets in which they operate. It is important that issuers provide specific disclosure of the impact on their performance and financial position and how the impact was reflected in the impairment assessment of intangible assets.

[38] Issuers should note that the principles for recognising and measuring impairments in an interim period are the same as those that an entity would follow if it prepared annual financial statements in accordance with HKAS 34 "Interim Financial Reporting" (HKAS 34.30).

(2) Disclosure on the reasonableness of the financial budgets and assumptions used in determining the recoverable amounts

139. We reiterate that directors and management are 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 that the audit committee[39] ensures it is satisfied that sufficient analysis (including the sensitivity analysis on key assumptions) had been performed. It is unreasonable for directors and management to rely solely on valuation reports without exercising any independent judgement in assessing the reasonableness of key assumptions used[40].

140. With the uncertainty on the duration and impact of Covid-19 pandemic, the estimation of future cash flows and the determination of key assumptions are particularly challenging. Issuers should carefully consider the impact of Covid-19 pandemic on impairment test and update the assumptions used to reflect the latest available information and evidence.

141. When determining the key assumptions used in the VIU calculation, issuers should follow the requirements of HKAS 36.30-57. We highlight that cash flow projections should be based on reasonable and supportable assumptions with greater weight given to external evidence, and the forecast period should cover a maximum period of five years, unless a longer period can be justified.

142. Sufficient disclosure about the key assumptions is of great importance 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. Issuers are reminded to disclose in their annual reports the information required by HKAS 36.126-137, in particular the key assumptions applied and how they are determined, and the reason why forecast period greater than five years is used, and the recommended disclosure as set out in paragraph 122 above.

143. In addition, issuers should consider enhancing disclosure of the impact of Covid-19 pandemic on impairment test that provides value to investors, including how the cash flow projections and assumptions have changed to reflect the impact, details of scenarios (such as number of scenarios, probability weightings) used under expected cash flow approach[41], disclose sensitivity analysis and widen the reasonably possible changes in key assumptions factoring in the impact of Covid-19 pandemic.

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[39] See the "Guidance for Boards and Directors" published on 27 July 2018.

[40] Issuers should read the "Guidance note on directors' duties in the context of valuations in corporate transactions" issued by the SFC in May 2017 in relation to valuations in corporate transactions.

[41] There are two cash flow approaches under HKAS 36: (i) traditional cash flow approach which uses a single set of estimated cash flows and a single discount rate; and (ii) estimated cash flow approach which uses multiple probability-weighted scenarios of estimated cash flows (HKAS 36.A4-A14).

144. Regarding intangible assets' useful lives assessment and identification of intangible assets in a business combination, although no significant issue was noted this year, issuers are reminded of the following recommendations, which had been set out in previous year's report:

Assessment of the Intangible assets with indefinite or long useful lives
(a) 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 (HKAS 38.88-96 and the Illustrative Examples accompanying HKAS 38). The disclosure should be tailored to their specific circumstances.
(b) 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.

Accounting for business combinations, in particular whether the intangible assets had been properly identified, separately recognised and measured
(a) Highlight 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.
(b) Indicate 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)). This might also be applicable to cases where issuers would recognise a significant amount of goodwill in an acquisition.

145. In addition, issuers should take note of the amendments to HKFRS 3 (Revised) in "Definition of a Business (Amendments to HKFRS 3)" which clarify the minimum requirements to be a business, remove the assessment of a market participant's ability to replace missing elements, and narrow the definition of outputs. The amendments are 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. Material level 3 financial assets

146. HKFRS 9 requires an entity to apply the requirements of HKFRS 13 "Fair Value Measurement" when measuring the fair values of financial assets. Issuers may find it challenging to measure their financial assets (e.g. unquoted equity investments) under the level 3 fair value hierarchy[42], because level 3 fair value measurement includes significant unobservable inputs, which are management's estimates, assumptions and inputs that cannot be corroborated with observable market data.

147. Classification, measurement and relevant fair value disclosure requirements of financial assets are primarily set out in HKFRS 9 and HKFRS 13. In particular, more extensive disclosure is required for level 3 fair value measurements than level 1 and level 2 and those requirements are set out in HKFRS 13.93.

Scope

148. For this purpose, we selected 71 issuers whose level 3 financial assets had accounted for over 20% of their total assets. We reviewed the issuers' financial disclosure regarding the level 3 financial assets to assess whether they had complied with the requirements of HKFRS 9 and HKFRS 13, in particular, to consider whether the qualitative and quantitative information provided to the extent necessary for an understanding of the valuation techniques and the unobservable inputs used.

Findings

149. Based on our review and issuers' responses to our enquiries, except for four cases which were referred to the Financial Reporting Council (the **FRC**) for further enquiry and investigation of possible accounting and auditing irregularities, we observed that the issuers under review generally complied with the requirements under HKFRS 9 and HKFRS 13. Where there was omitted disclosure, it was not material to the financial statements as a whole and we obtained confirmation from issuers that the required information would be provided in future financial reports.

150. Our findings are summarised in the following three key areas:

- Classification of level 3 financial assets
- Valuation of level 3 financial assets
- Fair value disclosure of level 3 financial assets

[42] HKFRS 13 sets out a fair value hierarchy that prioritises the inputs to the valuation techniques used to measure fair value into three levels: unadjusted quoted price (level 1), observable inputs (level 2) and unobservable inputs (level 3).

(1) Classification of level 3 financial assets

151. We noted that the most common investments in level 3 financial assets were unquoted equities, unlisted funds, wealth management products, derivatives and debt instruments. These financial assets were always classified at either fair value through other comprehensive income (**FVOCI**) or fair value through profit or loss (**FVTPL**).

152. In relation to the unquoted equity investments, some issuers determined the investments were held for trading and measured them at FVTPL. For those that were not held for trading, many issuers had elected to present subsequent changes in fair value in other comprehensive income in accordance with HKFRS 9.5.7.5, with no recycling of gains or losses to profit or loss on derecognition.

153. During our review, where the disclosure indicated that certain terms and conditions of the level 3 financial assets added complexity to the investments and to their classifications, we raised enquiries with issuers to request additional information or clarifications where necessary. We noted a case where the financial statements disclosed that the unquoted equity investments at FVOCI included "put options" in which the issuer had a right to request investees to repurchase the equity shares in certain situations. It was unclear whether the investments with embedded put options met the definition of equity instruments and could be designated at FVOCI (IFRS 9.BC5.21). This case was referred to the FRC for consideration.

Recommendation

154. Under HKFRS 9, on initial recognition, issuers should classify financial assets as subsequently measured at amortised cost, FVOCI or FVTPL. The classification should be based on the business model for managing the financial assets and their contractual cash flow characteristics (HKFRS 9.4.1.1). Investments in equity instruments are generally measured at FVTPL[43], except for those investments not held for trading for which issuers have made an irrevocable election to present subsequent changes in fair value in other comprehensive income (HKFRS 9.5.7.5). The above requirements should be applied to an entire financial asset, even if it contains an embedded derivative (HKFRS 9.4.3.2).

155. Since the classification model for financial assets under HKFRS 9 is more principle-based, issuers need to carefully review the contract terms and conditions of the financial assets and all other relevant facts and circumstances in order to determine the proper accounting treatments. It is also important for issuers to provide sufficient information on the critical judgement used to determine the classification of financial assets (HKAS 1R.122).

[43] Investments in equity instruments that cannot pass the SPPI (solely payments of principal and interest) test and are therefore measured at FVTPL.

(2) Valuation of level 3 financial assets

156. HKFRS 13 does not contain a hierarchy of valuation techniques. Based on the issuers' financial disclosure, we noted that the most common techniques used in the valuation of level 3 financial assets included:

- Income approach: Discounted cash flow (**DCF**) method.
- Market approach: Comparable company valuation multiples (e.g. price/book value (**P/B**) and price/earnings) and transaction price paid for an identical or a similar instrument of an investee.

157. Some issuers used the adjusted net asset method in determining the fair values of their investments, which involved the simultaneous use of various valuation techniques to measure the fair values of the individual assets and liabilities recognised in the investees' statements of financial position as well as the fair values of any unrecognised assets and liabilities at the measurement date.

158. A wide range of the unobservable inputs were significant to the level 3 measurements such as the projected cash flows used in the DCF calculations, earnings/book value/revenue multiples, long-term growth rates, expected interest rates, weighted average costs of capital and discounts for lack of marketability, etc.

159. Many issuers engaged independent valuers to perform the valuations. Most of the issuers' auditors determined the level 3 fair value measurement as a key audit matter[44] and reported how such matter was addressed in their audit and what the audit procedures had been performed.

160. Based on our review and issuers' responses to our enquiries, we referred three cases to the FRC for consideration. This was because the matters under consideration raised doubts on whether the valuations were performed in accordance with HKFRS 13, details of which are generally described below:

- The projected cash flows used in the DCF calculation appeared to be inconsistent with the business plan and development of the investee as disclosed in the MD&A.
- A substantial projected revenue and cash flows were included in the financial forecast but the investee did not generate any revenue and incurred recurring losses over the past years, and was not able to solicit any sizable customers for its products.

[44] HKSA 701 "Communicating Key Audit Matters in the Independent Auditor's Report".

- The net assets value, which was based on the investee's management accounts without any adjustments, appeared to be an unreasonable basis as the book value (B) in the P/B multiple computation since the investee incurred significant loss and impairments during the year based on its audited figures.

Recommendation

161. Fair value is a market-based measurement. The Covid-19 pandemic has widespread impacts on economics, markets and businesses in 2020, giving rise to significant volatility and uncertainty. Issuers should ensure that the valuation technique and the underlying inputs[45] reflects the current market conditions at the measurement date (HKFRS 13.15 and 13.24).

162. Depending on the percentage of interest held, issuers may have limited access to information needed to measure the fair value, such as latest financial data, updates about operations and major projects, recent share transactions. Therefore, issuers should conduct regular reviews and updates of existing valuation policies and procedures, and have discussions with their audit committee[46], 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.

163. 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. They should also read the SFC's "Guidance note on directors' duties in the context of valuations in corporate transactions", which may be applied in the context of the valuations under HKFRSs for the preparation of financial statements.

(3) Fair value disclosure of level 3 financial assets

164. We noted that many issuers under review generally complied with the disclosure requirements of HKFRS 13. We also observed that the qualitative disclosure regarding the level 3 measurement (HKFRS 13.93) could be enhanced if the issuers provided more entity-specific information, such as the reasons for the change of valuation technique used and the descriptions of the valuation processes and policies.

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[45] 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 a non-exhaustive list of the common oversights when applying the valuation techniques.

[46] See the "Guidance for Boards and Directors" published on 27 July 2018.

Recommendation

165. The fair value hierarchy in HKFRS 13 and the related disclosure are to increase consistency and comparability in fair value measurements. In view of the uncertainty and volatility in the current economic environment, issuers should consider whether unobservable inputs have become significant in the measurements, which would result in a level 3 categorisation and require more disclosure as required by HKFRS 13.

166. We encourage issuers to develop robust disclosure on fair value measurements as required by HKFRS 13.91-99, particularly, the information on level 3 fair value measurements under HKFRS 13.93:

Key level 3 disclosure requirements under HKFRS 13.93
• Description of the valuation techniques and inputs used in the fair value measurement. - If there has been a change in valuation technique (e.g. 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. • Quantitative information about significant unobservable inputs used in the fair value measurement. • Information about transfers in and out of level 3, including reasons and policies for transfer. • 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. - 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. • 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. • A description of the valuation processes and policies.

167. Issuers should take note of HKSA 540 (Revised) "Auditing Accounting Estimates and Related Disclosures", which are effective for audits of financial statements for periods beginning on or after 15 December 2019. The revisions are to establish more requirements and detailed guidance to enable auditors to appropriately deal with increasingly complex accounting estimates and disclosure.

168. HKSA 540 (Revised) requires the auditors to evaluate whether the accounting estimates and related disclosure are "reasonable" in the context of the applicable financial reporting framework, or are misstated (HKSA 540R.9), including the following areas:

- The making of the accounting estimate, including the selection of the method, assumptions and data in view of the nature of the accounting estimate and the facts and circumstances of the entity;

- The selection of management's point estimate (i.e. the amount selected by management for recognition or disclosure in the financial statements as an accounting estimate); and

- The disclosure about the accounting estimate, including disclosure about how the accounting estimate was developed and that explain the nature, extent, and sources of estimation uncertainty.

169. In applying HKSA 540 (Revised), issuers, in particular their audit committees[47], can expect to have an enhanced dialogue on the fair value measurements with their auditors. Issuers should put more emphasis on the exercise of significant judgements in the valuation process. Such a process, with the involvement of the audit committees, should be rigorous and documented properly.

[47] See HKSA 540 (Revised) paragraphs 38, A146-A148, and Appendix 2 that includes matters specific to accounting estimates that the auditor may consider communicating to those charged with governance.

C. Findings regarding other accounting areas and key reminders for the upcoming financial reporting period

170. From our review of 300 cases under the financial statements review, we noted several areas of disclosure where there is room for improvement and have set out in this part to act as reminders for issuers for their upcoming financial reporting period. Please note that the observations below are summarised based on our review and therefore are not exhaustive:

- Accounting policies, judgements and estimates
- Going concern and liquidity risk disclosure
- Capital disclosure
- Expected credit losses and credit risk disclosure
- Revenue
- Leases
- Events after the reporting period
- Using non-GAAP financial measures

171. Based on our review and issuers' responses to our enquiries, there were no significant issues identified. 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.

(1) <u>Accounting policies, judgements and estimates</u>

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

Findings

173. During our review, we noted the following:

- Accounting policies tended to be generic, with repetition of text in accounting standards and illustrative financial statements;

- Accounting policies for unusual or non-recurring transactions in current year were sometimes omitted (e.g. acquisition of a subsidiary constituting as an asset acquisition instead of a business combination);

- Descriptions of critical accounting judgements were sometimes repeated or referred to the corresponding accounting policies without elaboration of the issuers' specific facts and circumstances; and

- It was not a common practice amongst issuers to provide the sensitivity analyses of how possible changes in key assumptions would impact the carrying amounts of key balances in the statement of financial position.

Recommendation

174. When reporting regarding uncertainties about future economic and market conditions, issuers need to challenge underlying judgements and assumptions. In preparing the disclosure, issuers are reminded that:

- Information provided should be clear, understandable and entity-specific, rather than boilerplate text;

- Where there were unusual or non-recurring transactions carried out during the reporting period, the accounting policies for these transactions should be included; and

- Disclosure should help investors to understand the judgements made about the future and about other sources of estimation uncertainty. HKAS 1R.129 gives the following examples of the types of disclosure:

HKAS 1R.129 – Examples of the types of disclosure of sources of estimation uncertainty in HKAS 1R.125	
(a)	the nature of the assumption or other estimation uncertainty;
(b)	the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;
(c)	the expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and
(d)	an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.

(2) Going concern (GC) and liquidity risk disclosure

175. When preparing financial statements, an entity is required to make an assessment of its ability to continue as a GC for at least 12 months from the end of the reporting period. This assessment needs to be performed up to the date on which the financial statements are authorised for issue. When the issuer is aware of material uncertainties related to events or conditions that may cast significant doubt upon its ability to continue as a GC, these uncertainties should be disclosed (HKAS 1R.25-26 and HKAS 10 "Events after the Reporting Period" paragraphs 14-16)[48].

176. HKFRS 7 "Financial Instruments: Disclosures" requires an entity to disclose qualitative and quantitative information about exposure to liquidity risk arising from financial instruments. The qualitative disclosure should describe its objectives, policies and processes for managing the liquidity risk. The quantitative disclosure should provide information about the extent to which the entity is exposed to the risk, based on information provided internally to its key management personnel (HKFRS 7.31-35 and 7.39).

Findings

177. Some issuers included a discussion in the notes to the financial statements on the GC matter in accordance with HKAS 1R.25. Among these issuers, most of their auditors also concluded that there was a material uncertainty and reported the matter in a separate section under the heading "Material Uncertainty Related to Going Concern". On the other hand, a few auditors determined and reported the GC matter as a key audit matter when no material uncertainty existed.

178. For the liquidity risk disclosure, nearly all issuers under review provided a description of their objectives, policies and processes for managing their liquidity risk and the maturity analysis showing the remaining contractual maturities for their non-derivative financial liabilities. It would be helpful if issuers clearly explained how they manage the liquidity risk portrayed by the contractual maturity analysis (HKFRS 7.39).

Recommendation

179. The assessment of an issuer's ability to continue as a GC and related disclosure is primarily the responsibility of the directors and management. When events or conditions have been identified that may cast significant doubt on an issuer's ability to continue as a GC, no matter its conclusion as to whether a material uncertainty exists or not, its financial statements should provide adequate disclosure[49] that enables investors to understand:

- Principal events or conditions;

[48] Issuers should take note of the requirement (subject to "comply or explain") in Appendix 14 to the MB Rules to disclose in the corporate governance report material uncertainties relating to events or conditions that may cast significant doubt on the issuer's ability to continue as a GC (Code Provision C.1.3).

[49] Under such circumstances, HKSA 570 (Revised) "Going Concern" also requires auditors to evaluate adequacy of related disclosure in the financial statements (HKSA 570R.19-20, A22-A25).

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

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

- Significant judgements[50] made by management as part of its assessment of the issuer's ability to continue as a GC.

180. The liquidity risk disclosure should also be consistent with their assessment of the GC assumption. Liquidity risk in the current economic environment is likely increased, therefore, we encourage issuers to reconsider and enhance their disclosure rather than merely repeat previously published information. They should clearly explain the relationship between quantitative and qualitative disclosure about the liquidity risk as required by HKFRS 7.39, so that investors can understand the nature and extent of the risk and the timing of cash flows associated with the financial liabilities. Issuers are recommended to read HKFRS 7.B10A-B11F for the application guidance on the liquidity risk disclosure.

(3) Capital disclosure

181. HKAS 1R.134-135 require an entity to make qualitative and quantitative disclosure regarding its objective, policies and processes for managing capital.

Findings

182. Many issuers provided a general description of their objectives, policies and processes for managing their capital. Most of them mentioned that their overall capital management strategy remained unchanged in 2019 and will consider to adjust the dividend payments to shareholders, issue new shares or change the level of debts in order to balance their capital structures.

183. It was a common practice amongst issuers to use financial ratios (e.g. debt-to-equity ratio) to analyse their capital structures.

Recommendation

184. The level of issuers' capital and how they manage capital are important factors for investors to assess the issuers' risk profile and their ability to withstand unexpected adverse events. The level of capital might also affect the issuers' ability to pay dividends. Therefore, we encourage issuers to provide the capital disclosure reflecting their own facts and circumstances, including an explanation of the changes to their capital management in response to the current economic environment.

[50] HKAS 1R.122 would apply where an issuer has made significant judgements in reaching a conclusion that there remain no material uncertainty in relation to GC. See the IFRIC agenda decision on International Accounting Standard (**IAS**) 1 "Presentation of Financial Statements – Disclosure requirements relating to assessment of going concern" in IFRIC Update July 2014.

185. HKAS 1R.135 requires the capital disclosure to be based on the information provided internally to their key management personnel. Issuers may refer to the illustrative examples IG10 and IG11 of capital disclosure accompanying HKAS 1 (Revised) for better understanding of the disclosure requirements.

HKAS 1R.135
To comply HKAS 1R.134, the entity discloses the following: (a) qualitative information about its objectives, policies and processes for managing capital, including: (i) a description of what it manages as capital; (ii) when an entity is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into the management of capital; and (iii) how it is meeting its objectives for managing capital. (b) summary quantitative data about what it manages as capital. Some entities regard some financial liabilities (e.g. some forms of subordinated debt) as part of capital. Other entities regard capital as excluding some components of equity (e.g. components arising from cash flow hedges). (c) any changes in (a) and (b) from the previous period. (d) whether during the period it complied with any externally imposed capital requirements to which it is subject. (e) when the entity has not complied with such externally imposed capital requirements, the consequences of such non-compliance. The entity bases these disclosures on the information provided internally to key management personnel.

(4) Expected credit losses (ECLs) and credit risk disclosure

186. Under the impairment approach in HKFRS 9, an entity is required to measure ECLs that should be based on an unbiased, probability-weighted amount that is determined by evaluating a range of possible outcomes and reflecting time value of money. It should exercise judgement and its best efforts to consider all reasonable and supportable information available about past events, current conditions and forecasts of future economic conditions (HKFRS 9.5.5.17). HKFRS 9 establishes a three-stage general approach for measuring impairment and a simplified approach for certain trade receivables, contract assets and lease receivables.

187. HKFRS 7.35A-35N require extensive disclosure about ECLs and credit risk, which aims to enable investors to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows (i.e. the disclosure objective in HKFRS 7.35B).

Findings

188. Same as last year, most issuers under review applied the simplified approach in calculating lifetime ECLs for trade receivables by using a provision matrix grouped by past due dates. They disclosed the relevant matrix and expected loss rates and the reconciliation of loss allowances from the opening to the closing balances, which was an improvement from last year.

189. On the other hand, the issuers applied the general approach for the long-term loan and receivable balances, other receivables and related party balances (e.g. amounts due from associates and joint ventures). We observed that the ECL disclosure in these balances was relatively less detailed than their analyses of trade receivables.

190. No matter which impairment approach was adopted, many issuers briefly described about the basis of inputs, assumptions and the estimation techniques used to measure the ECLs as required by HKFRS 7.35G. It would be helpful to explain how forward-looking information was incorporated into the determination of ECLs.

Recommendation

191. The impact of Covid-19 on measuring ECLs is particularly challenging and significant for all entities. Low probabilities of default and no material ECLs in the past may no longer be the case, given the increased weighting to negative economic scenarios and exposures to specific industries that are most significantly affected by the Covid-19 pandemic. Therefore, no matter which impairment approach is adopted, issuers need to reconsider the appropriateness of the past methods and ensure up to date inputs are used and, where necessary, engage external experts to assist their estimates.

192. Given the uncertainties about future economic conditions and the significant judgement involved in estimating ECLs, disclosure of key assumptions and estimation techniques used is particularly important for investors to understand the impact of Covid-19 on ECL estimation. Issuers should take note of the disclosure requirements under HKFRS 7.35G:

ECL estimation (HKFRS 7.35G)
An entity shall explain the inputs, assumptions and estimation techniques used to apply the requirements in HKFRS 9 Section 5.5. For this purpose an entity shall disclose: (a) the basis of inputs and assumptions and the estimation techniques used to: (i) measure the 12-month and lifetime expected credit losses; (ii) determine whether the credit risk of financial instruments has increased significantly since initial recognition; and (iii) determine whether a financial asset is a credit-impaired financial asset. (b) how forward-looking information has been incorporated into the determination of expected credit losses, including the use of macroeconomic information; and (c) changes in the estimation techniques or significant assumptions made during the reporting period and the reasons for those changes.

(5) Revenue

193. HKFRS 15 "Revenue from Contracts with Customers" establishes a single comprehensive model of accounting for revenue arising from contracts with customers. The core principle underlying the model is that an entity should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services (HKFRS 15.2).

194. HKFRS 15 also requires an entity to disclose sufficient qualitative and quantitative information (HKFRS 15.110-129) to enable investors to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers (i.e. the standard's objective in HKFRS 15.1).

Findings

195. Since 2019 was only the second year that issuers adopted HKFRS 15, issuers should continue to improve their disclosure. During our review, we observed that:

- Most issuers disclosed one or two types of category to disaggregate revenue (HKFRS 15.114-115) by using the examples of categories in HKFRS 15.B89 (e.g. by major product lines and by at a point in time or over time).

- Many issuers provided the reconciliation from the opening balances to the closing balances of the contract liabilities and the revenue recognised during the year that was included in the contract liabilities at the beginning of the year (HKFRS 15.116). However, the explanations of the significant changes in the contract liabilities (HKFRS 15.118) were generally brief.

- In some cases, the accounting policies could be improved by providing more entity-specific information (HKFRS 15.119), e.g. how the timing of revenue recognition was linked to their business models and the impact on revenue recognition arising from the customer incentives provided to the customers.

- A few issuers omitted to disclose the fact that they had applied the practical expedient to not provide the amount of the transaction price allocated to the remaining performance obligations that were unsatisfied (i.e. had not recognised as revenue) as at the end of the year, because they expected to recognise that amount as revenue within one year or less (HKFRS 15.120-122).

- A few issuers provided entity-specific information about their significant judgments made in applying HKFRS 15 that affected the timing and amounts of revenue recognition (HKFRS 15.123-126), e.g. determining whether an issuer was acting as a principal or an agent in providing goods or services.

Recommendation

196. In light of Covid-19 pandemic, issuers might have changed or will change the way in which they contract with customers. Therefore, they should look into its implications on revenue recognition, e.g. assessing the enforceability of contract terms and the collectability of consideration (HKFRS 15.9-16), determining whether the customer incentives (e.g. sales discounts, rebates and rights of returns) is a contract modification (HKFRS 15.20-21) or a change in the estimate of the variable consideration (HKFRS 15.50-59). Issuers are reminded that HKFRS 15 provides a comprehensive application guidance and illustrative examples to clarify how the principles in HKFRS 15 should be applied for specific transactions (HKFRS 15.B1-B89 and 15.IE1-IE327).

197. It is important for issuers to improve the descriptions of accounting policies and ensure that these are tailored to their own particular circumstances, and disclose sufficient information about the judgements and estimates to enable investors to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. They should consider how to reflect the implications arising from the Covid-19 pandemic in their disclosure.

(6) Leases

198. HKFRS 16 "Leases" became effective for annual period beginning on or after 1 January 2019, and replaced HKAS 17 "Leases" and the related interpretations. Under HKFRS 16, lessee accounting has changed substantially. Distinctions of operating leases and finance leases are removed, and is replaced by a single accounting model for lessees, which requires a lessee to recognise a right-of-use asset and a lease liability for all leases (i.e. reported on balance sheet), except for short-term leases and leases of low-value assets. The lessor accounting, which is brought forward from HKAS 17, is substantially unchanged[51].

199. HKFRS 16 contains both qualitative and quantitative disclosure requirements for lessees and lessors, which aim to enable investors to assess the effect that leases have on the financial position, financial performance and cash flows of an entity (i.e. the disclosure objective in HKFRS 16.51 and 16.89).

[51] Lessors continue to classify leases as finance and operating leases under HKFRS 16.

Findings

200. In this year's review, 213 issuers, with a financial year-end date of 31 December 2019, adopted HKFRS 16. Our findings and recommendation set out below focused on lessees as the accounting requirements for lessors are largely brought forward from HKAS 17.

201. For the leases previously classified as the operating leases under HKAS 17, most issuers under review provided adequate information to explain the impact of initial adoption of HKFRS 16 in accordance with the requirements under HKAS 8.28[52] and HKFRS 16.C12-C13.

202. In addition to the transitional disclosure, we noted the following:

- Many issuers presented the right-of-use assets and lease liabilities on the face of the statement of financial position, while some issuers included the lease liabilities in the line item "borrowings" (HKFRS 16.47).

- Nearly all issuers under review disclosed the quantitative information as required by HKFRS 16.53 (e.g. depreciation charges, additions and carrying amounts of right-of-use assets and interest expenses on lease liabilities). Some of them provided the required disclosure in a tabular format (HKFRS 16.54). In some cases, disclosure was scattered across a number of notes without the required cross-references (HKFRS 16.52).

- Lease liabilities were separately disclosed in the maturity analysis in accordance with HKFRS 7.39.

- A few issuers provided additional qualitative and quantitative information under HKFRS 16.59 (e.g. variable lease payments, extension options or termination options, restrictions or covenants imposed by leases).

Recommendation

203. Although we have not identified any major issues from the cases reviewed, we remind issuers that accounting policies should be tailored to their circumstances, and descriptions about the judgements or estimates made in the application of the lease accounting policies should be sufficiently specific that investors can understand the implications, e.g. the judgements made about the lease terms with lease extension or termination option.

[52] HKAS 8 "Accounting Policies, Changes in Accounting Estimates and Errors".

204. In light of Covid-19 pandemic, we encourage issuers to reconsider their existing HKFRS 16 disclosure when determining the extent of disclosure to be included in the next financial reports. In determining whether additional qualitative and quantitative information under HKFRS 16.59 is necessary, issuers should refer to HKFRS 16.B48-B52 for the application guidance on the lessee disclosure.

205. In May 2020, the IASB issued the amendment to IFRS 16 "Covid-19-Related Rent Concessions", which applies to Covid-19 related rent concessions that reduce lease payments due on or before 30 June 2021. The amendment does not affect lessors[53]. The amendment is effective for annual reporting periods beginning on or after 1 June 2020. Earlier application is permitted. In June 2020, the HKICPA issued the corresponding amendments to HKFRS 16 and provided examples to illustrate the application of this amendment to common rent concession fact patterns observed in Hong Kong.

(7) Events after the reporting period

206. HKAS 10 defines events after the reporting period as those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue. There are two types of events:

Events after the reporting date	Definition	Financial statement effect
Adjusting events	Those that provide evidence of conditions that existed at the end of the reporting period	Adjust the amounts recognised in its financial statements (HKAS 10.8)
Non-adjusting events	Those that are indicative of conditions that arose after the reporting period	Should not adjust the amounts recognised in its financial statements (HKAS 10.10) If the event is material, disclose (a) the nature of the event; and (b) an estimate of its financial effect, or a statement that such an estimate cannot be made (HKAS 10.21)

53 Lessors are still required to assess whether rent concessions are lease modifications under HKFRS 16.79-80 and 16.87 and, if so, account them accordingly and disclose the impact of Covid-19 on their leasing activities (HKFRS 16.92).

Findings

207. Most of the issuers with a financial year-end date of 31 December 2019 provided a separate "subsequent event" note, which disclosed that the Covid-19 pandemic was a non-adjusting event, therefore, they considered that this did not have any impact on the carrying value of assets or liabilities at 31 December 2019. They also cautioned that the impact of Covid-19 on their businesses continued to evolve and expected a decline in revenue and profit in 2020 as compared to 2019. A few issuers also drew investors' attention to their liquidity risk disclosure.

208. On the other hand, a few issuers determined that the Covid-19 would have a significant unfavourable impact on them in 2020. Up to the date on which the financial statements were authorised for issue, they assessed that the going concern assumption was still appropriate but disclosed the conditions indicated the existence of material uncertainties that may cast significant doubt on their ability to continue as a going concern in accordance with HKAS 10.14-16 and HKAS 1R.25-26.

Recommendation

209. As the market is currently extremely challenging, it is likely to require continual assessment of the changing circumstances after the reporting date that the issuers face. It is important for issuers to determine whether a subsequent event affects the recognition and measurement of assets and liabilities in the financial statements (i.e. an adjusting event).

210. Issuers are recommended to refer to HKAS 10, which provides examples of adjusting events (HKAS 10.9) and non-adjusting events (HKAS 10.22). They should follow the recognition and measurement requirements in accordance with the relevant HKFRSs. For example, HKAS 37 "Provisions, Contingent Liabilities and Contingent Assets" contains specific application rules on particular situations, i.e. onerous contracts[54] and restructuring, which explain the circumstances that must be met in order to recognise a provision as at the reporting date (HKAS 37.63-83).

[54] An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. In May 2020, the IASB issued "Onerous Contracts – Cost of Fulfilling a Contract (Amendments to IAS 37)" to specify that the "cost of fulfilling" a contract comprises the "costs that relate directly to the contract". The amendments are effective for annual periods beginning on or after 1 January 2022. Early application is permitted. The HKICPA issued the corresponding amendments to HKAS 37 in June 2020.

(8) Using non-GAAP financial measures

211. In recent years, there is an increasing market focus on the use of non-GAAP financial measures[55] because there is generally no standardised definition and method for calculating the 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:

Key elements for presenting non-GAAP financial measures
(a) **Definitions** – 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) **Prominence** – 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) **Explanations for using non-GAAP financial measures** – 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) **Reconciliation and nature of adjusting items** – 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) **Comparatives** – Issuers should present comparatives and disclose non-GAAP financial measures consistently over time.

Findings

212. This year, we were pleased to note that issuers under review generally followed the guidance in the five key elements as mentioned above when presenting the non-GAAP financial measures.

213. In addition to the traditional non-GAAP financial measures (e.g. EBIT and EBITDA), some issuers used "adjusted" measures of profit where different terms were used (e.g. adjusted EBITDA, adjusted net profit and underlying profit). Issuers should continue to pay particular attention to the following:

- The label "adjusted" was sometimes omitted in the narrative disclosure;

55 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. GAAP as referred in this report includes HKFRS, IFRS or other accounting standards that are accepted by the Exchange.

- A few issuers labelled the non-GAAP financial measures as "non-GAAP" underlying profit to avoid investors' confusion with the GAAP measures; and

- The reconciliations were always presented in table form with comparatives. The items being excluded[56] appeared justifiable but had not been clearly explained in the annual reports. Some issuers generally described the adjusting items, taken as a whole, as "non-cash, non-recurring, infrequent or unusual" in nature, without providing an explanation on each adjusting item.

Recommendation

214. Issuers should take note that financial reports and all other corporate communication should be accurate, complete and not misleading[57]. Non-GAAP financial measures are neither prohibited nor required. Issuers should consider the guidance in GL103-19 and take a holistic view of their current non-GAAP financial measures and consider revising their disclosure.

215. Under the current economic environment, issuers should determine whether the non-GAAP financial measures present a fair and balanced view of their performance and position. Issuers should read the IOSCO's statement[58] on reporting in the time of Covid-19, which highlights that non-GAAP financial measures should not be presented inconsistently from period-to-period, defined inadequately, or are used to obscure rather than supplement GAAP information.

216. 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 them 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 their facts and circumstances (such as the item is commonly adjusted for by the issuers' peers) and avoid giving the appearance of "cherry picking" to achieve a positive measure.

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[56] Examples of adjusting items were: (i) fair value gains or losses (e.g. investment properties and financial assets); (ii) impairment charges (e.g. property, plant and equipment and trade receivables); (iii) share-based payment expenses (equity-settled); (iv) restructuring charges; (v) gains or losses on disposals (e.g. subsidiaries and associates); and (vi) listing expenses.

[57] MB Rule 2.13(2) / GEM Rule 17.56(2).

[58] See the "IOSCO Statement on Importance of Disclosure about COVID-19" published by the International Organization of Securities Commissions (the **IOSCO**) on 29 May 2020.

Other points to note

217. In view of Covid-19 pandemic and its economic effects, investors need high-quality financial disclosure more than ever. Issuers should include "information that is relevant, material and entity-specific" and present them in an effective way; and should avoid making irrelevant and immaterial disclosure.

218. The amendments to the definition of "material" [59] in HKAS 1R.7 has been effective for annual periods beginning on or after 1 January 2020. Issuers should assess whether information, either individually or in combination with other information, is material in the context of their financial statements taken as a whole. In particular, issuers should take note of the following:

HKAS 1R.7 – Examples of circumstances that may result in material information being obscured
(a) information regarding a material item, transaction or other event is disclosed in the financial statements but the language used is vague or unclear;
(b) information regarding a material item, transaction or other event is scattered throughout the financial statements;
(c) dissimilar items, transactions or other events are inappropriately aggregated;
(d) similar items, transactions or other events are inappropriately disaggregated; and
(e) the understandability of the financial statements is reduced as a result of material information being hidden by immaterial information to the extent that a primary user is unable to determine what information is material.

219. It is important for issuers, in particular their audit committees, to have in-depth conversations with their auditors, either at an early stage or throughout the audit (e.g. about key audit matters, going concern and liquidity issues, fair value and impairment measurements and other significant events or transactions that occurred during the reporting period and after the reporting date). Doing so may help to minimise the risk of last minute surprises.

220. We also encourage issuers to stay alert to the changes to the financial reporting and auditing standards. In light of Covid-19 pandemic, local and international standard-setters (the HKICPA, IFRS Foundation and International Federation of Accountants) provide recent standard developments and guidance materials on their designated websites.

- End -

[59] The new definition of "material" is *"Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity".*

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