January 2023

Review of Issuers' Annual Reports 2022

CONTENT

EXECUTIVE SUMMARY

The Listing Division undertakes an on-going programme to review issuers' annual reports as part of its monitoring activities. We adopt a thematic approach, selecting specific areas for review based on the results of previous years as well as emerging trends or matters considered to be of higher risks. In our review we consider the actions taken by the issuers and their directors to safeguard company's assets, and whether material information was disclosed to allow shareholders to properly assess the relevant matters reported on. We also assess issuers' compliance with the Rules and specific accounting standards in financial statements.

In addition, we review issuers' compliance with annual report disclosure requirements under the Rules.

Findings and Recommendation

We highlight below material findings and recommendation from our thematic review, details of which are set out in Sections II to V of this report:

(a) **Financial reporting and related controls** (Section II) – Asset valuation remained a major issue in financial reporting, as some issuers were overly optimistic and failed to apply proper assumptions in valuing their assets, or failed to substantiate the fairness of the reported values of their assets with objective evidence and documentation. These issues led to delays in the publication of financial results and/or modified opinions expressed by auditors and in more extreme cases, suspension in the trading of securities of the issuers.

Directors are primarily responsible for preparing financial statements in accordance with relevant accounting standards. They should establish and maintain proper risk management and internal controls, and deploy adequate resources to maintain them. They should critically assess management's accounting estimates and challenge the reasonableness of the assumptions adopted by the management.

(b) **Material lending transactions** (Section III) – This year, we continued to identify cases of material impairments on loan receivables that raised concerns about potential breaches of directors' duties. Further, a number of issuers reviewed did not fully follow last year's recommendation to disclose details of their material loan receivables and for money lenders, their business models, credit assessments and approval policies, and details of their loan portfolios and loan impairment assessments.

In conducting lending transactions, directors should critically assess the commercial rationale for making the loans, whether their terms are fair and reasonable, and whether the use of funds is in the interests of the issuer and its shareholders. For issuers that operate money lending businesses, the directors should also maintain effective risk management and internal control systems to assess and manage credit risk exposure and to monitor the recoverability of loans and adequacy of the collaterals. Issuers should follow our recommendation on the disclosure on their loan receivables and, for issuers operating a money lending business, such business.

(c) **Financial statement disclosure under accounting standards** (Section V) – The selected issuers' disclosure generally complied with the accounting requirements. Our review highlighted several key areas where issuers can continue to improve their financial disclosure in the upcoming financial reporting period, including judgments and estimates, material intangible assets and fair value measurements. In light of the current economic uncertainty and market volatility, it is particularly important for issuers and their audit committees to maintain a close dialogue with auditors on the audit focus areas and other emerging issues identified during the audit, and take prompt actions to address auditors' concerns.

We are generally satisfied with issuers' compliance with annual report disclosure requirements under the Rules. Issuers continued to achieve a high rate of compliance this year. Details are in Section VI and Appendix II.

Issuers should take note of our observations and recommendation 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. We adopt a thematic approach, selecting specific areas for review based on results of previous years and emerging trends or matters considered to be of higher regulatory risks. In our review we consider whether material information was disclosed to allow shareholders to properly assess the relevant matters reported on and whether the issuers maintain proper internal and financial reporting controls. We also assess issuers' compliance with the Rules[1] and specific accounting standards in financial statements. Through this thematic review we aim to identify areas for improvement and make recommendation to promote better governance and disclosure.

3. Sections II to IV of this report (**Report**) cover our thematic review on selected areas. Section V sets out findings from our review of issuers' financial statement disclosure under accounting standards. Appendix I sets out the scope and methodology of this year's review.

4. The Rules also set out specific annual report disclosure requirements. Section VI and Appendix II set out findings from our review of issuers' compliance with these disclosure Rules in their annual reports.

5. This review covered the annual reports of issuers for the financial year ended between January and December 2021.

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

II. THEMATIC REVIEW ON FINANCIAL REPORTING AND RELATED CONTROLS

6. The Corporate Governance Code (the **CG Code**) explains that directors are responsible to prepare an issuer's accounts and present a balanced, clear and comprehensive assessment of its performance. They should ensure the effectiveness of the issuer's risk management and internal controls and the adequacy of resources and experience of staff for the financial reporting functions.

7. The audit committee monitors the integrity of the issuer's financial statements, has oversight of the issuer's financial reporting system, risk management and internal controls, and reviews the effectiveness of the audit process.

8. In recent years, issuers have faced unprecedented challenges in financial reporting, including economic uncertainty, market volatility and unforeseen interruption due to COVID-19 that compromised timely preparation of financial statements and conduct of audits. Our review of issuers' published unaudited financial results, audited financial statements and announcements relating to the following areas has helped us identify matters requiring issuers' attention:

   (a) Material differences between audited and unaudited financial statements;
   (b) Auditors' modified opinions; and
   (c) Delays in publication of results.

Findings

(a) <u>Material differences between audited and unaudited financial statements</u>

9. In 2022, approximately 200 issuers published unaudited financial statements before the reporting deadlines[2] due to disruption caused by the COVID-19 pandemic. Of these, about 40 issuers subsequently published audited financial statements that reported material adjustments. A large majority of these material adjustments were related to asset impairments, and the remainder were related to errors in the application of accounting standards. The following issues were identified:

10. *Asset Valuations* – A large majority of material adjustments represented changes to the initial impairment assessments and valuations of assets due to:

    (i) Failure by issuers to make impairment assessments on their assets in their unaudited financial statements, as they relied on their auditors to ascertain the impairment loss amounts;

    (ii) Insufficient impairment loss provision made by management due to failure to collect or consider sufficient information to substantiate the assumptions for the preparation of valuations; and

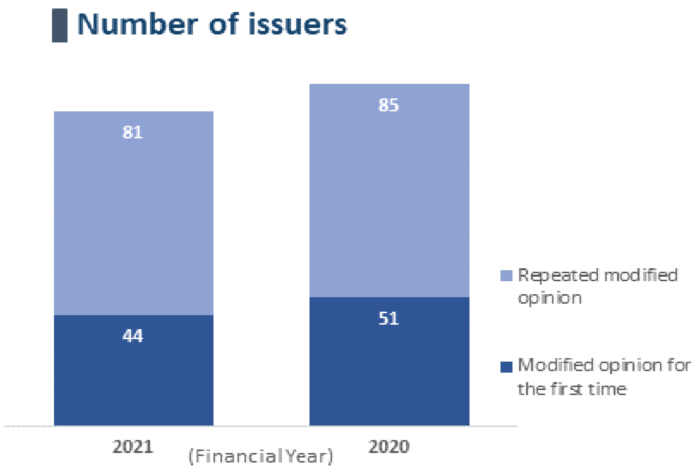
    (iii) Failure to conduct the valuation processes as the valuers were unable to perform site visits.

[2] The Exchange and the Securities and Futures Commission (**SFC**) jointly published the <u>Joint Statement</u> and provided further <u>Guidance</u> on delays in preliminary results publication amid disruption caused by COVID-19.

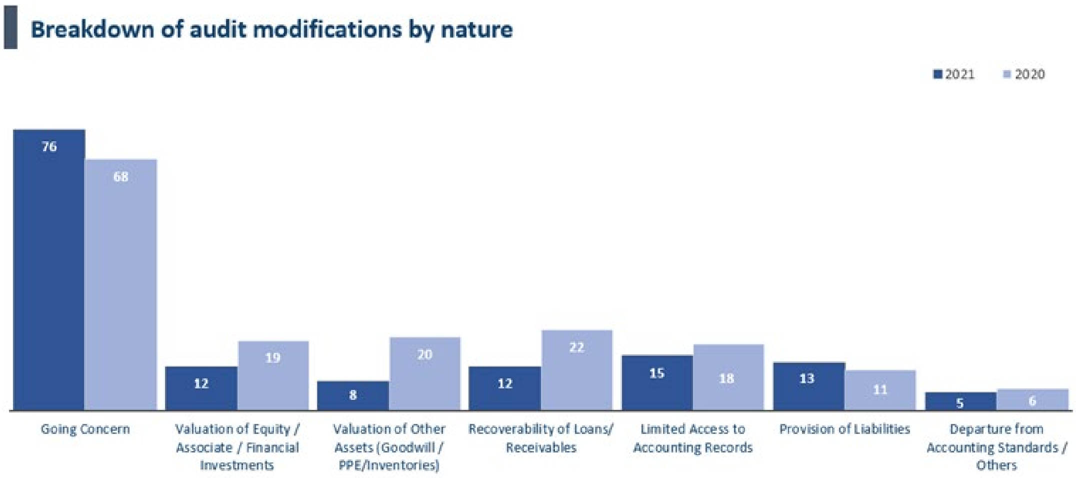
11. *Other adjustments* – In a minority of cases, material adjustments were made to reclassify items or correct misapplication of accounting standards. Some adjustments arose from human errors such as erroneous calculation of disposal gains, or under-provision for interests and other expenses.

(b) *Auditors' modified opinions*

12. For the 2021 financial year, 125 issuers received modified audit opinions on their published financial statements (2020: 136), including 44 (2020: 51) issuers with modified opinions for the first time. Compared to last year, this represented a reduction in both new and repeated modified opinions.



13. Going concern qualifications remained the most common audit modifications in both first time and repeated modified opinions reported by 30 issuers (2020: 31) and 46 issuers (2020: 37) respectively. Other common audit modifications included valuations of assets and limited access to accounting records.



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

14. *Valuations of assets* – the major area of concern raised by auditors was the fairness of the reported values of issuers' assets. These modifications were mainly due to the following:

(i) The management's inability to provide objective evidence to substantiate the values of acquired assets, recoverability of loans granted and prepayments made due to insufficient due diligence or business justifications before relevant transactions were entered into. In extreme cases, the lack of evidence caused auditors to question the commercial substance of the transactions;

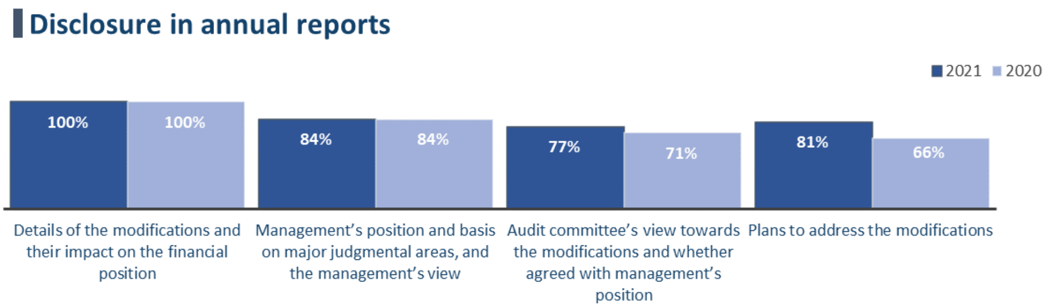
(ii) Failure by management to maintain proper controls on documentation, record keeping and segregation of duties. For example, an issuer was unable to locate the relevant documents supporting loans granted to third parties after the responsible director left the issuer; and

(iii) Failure by management to apply appropriate assumptions in assessing the valuations of assets; for example, some issuers were overly optimistic when performing valuations of the assets.

15. *Limited access to books and records* – In some cases, auditors had no access to the books and records of investees companies after the issuers disposed of these companies, or the issuers lost control or contact with them.

16. *Disclosure of modified opinion in annual reports* – We also reviewed issuers' disclosure about the modified opinions, including: details of the modifications and their impact on the financial position; management's position; audit committee's view and proposed remedial actions.

17. This year, the vast majority of issuers followed our recommendation to disclose information about modified opinions. We note improvement particularly on the disclosure of action plans to address the modifications.



(c) <u>*Delays in publication of results*</u>

18. For the 2021 financial year, a small number (85; last review: 78) of issuers failed to publish their annual results before the 3-month reporting deadline and consequently, were required to suspend their securities trading. Most of these cases were due to the following:

(i) Failure to provide sufficient audit evidence or adequately address questions raised by auditors in areas such as impairment assessments, books and records of newly acquired subsidiaries, commercial rationale of new businesses commenced during the year;

(ii) Issuers experiencing liquidity issue or under debt restructuring, resulting in management delays in the preparation of the financial statements. This included issuers operating in the PRC property sector and their affiliates. Some of these issuers were also found during the audit process to have failed to report financial guarantees; and

(iii) Identification of possible frauds or accounting irregularities, such as discrepancies in cash balance, unauthorised guarantees, unauthorised payments, unauthorised granting of loans, etc., which required independent investigations.

Recommendation

19. The above findings suggested room for improvement for some issuers in preparing financial statements, and for the audit committees to take a more active role in overseeing issuers' risk management and financial reporting processes. We would like to take this opportunities to remind issuers of the following:

(i) Preparation of financial statements

20. Directors are primarily responsible for preparing the financial statements. They should ensure that the issuer's financial statements are prepared in accordance with relevant accounting standards before they are audited by the auditors. When making accounting estimates, the management is responsible for considering all relevant factors and providing sufficient and objective information to substantiate that the underlying assumptions are appropriate.

21. To maintain the quality of financial reporting, directors should deploy adequate resources to staffing and maintaining appropriate financial reporting systems. While some factors may be outside their control, directors should incorporate appropriate alternative procedures in their financial reporting process to deal with sudden changes, including those arising from the pandemic.

(ii) Risk management and internal controls

22. In many cases, the modified opinions and delays in publication of financial results arose from issuers' failure to maintain proper risk management and internal controls, or failure to perform proper due diligence at the time they initially entered into the arrangements (such as granting of loans or asset acquisitions). As a consequence, risks arising from such arrangements may not be identified and relevant internal control measures were not put in place to manage these risks. This compromised the valuation processes and led to modified opinions and/or delays in publication of the financial statements.

23. Management should be responsible for the design, implementation and monitoring of the risk management system according to the boards' risk management policy. The board has the responsibility to shape and develop the issuer's risk culture, setting the tone at the top, and should oversee the issuer's risk management and internal control on an ongoing basis.

24. Under the CG Code, issuers should establish whistleblowing policies and systems for employees and those who deal with them to raise concerns with the audit committees about possible improprieties in any matters related to the issuers.

(iii) Audit committee

25. The audit committee has the responsibility to monitor the integrity of the issuer's financial statements, to ensure compliance with accounting standards and to review significant financial reporting judgments. It should critically assess and challenge the reasonableness of the assumptions adopted by the management in the valuations of material assets reported in the issuer's financial statements.

26. The audit committee is tasked with monitoring the effectiveness of the audit process. In this regard it should discuss with the auditors the nature and scope of the audit before the audit commences, and maintain close dialogue with the auditors to fully understand the progress of the audit and facilitate the resolution of audit issues identified during the audit.

27. The audit committee should also play an active role in overseeing the issuer's financial reporting system, risk management and internal controls. It should review the issuer's systems and ensure that management has maintained effective control mechanisms. It should also discuss with management and ensure sufficient resources are allocated for such purpose.

III. THEMATIC REVIEW ON MATERIAL ASSET IMPAIRMENTS

28. The Rules require an issuer to include in its annual report a MD&A of material factors underlying its financial results and position and significant events during the year. Where an issuer recorded a material impairment on its assets, it should discuss the circumstances that led to the impairment. Where the impairment is supported by a valuation, we recommended that the issuer should disclose details of the valuation, including the valuation method and the reason for using that method; details of the values of inputs used together with the basis and assumptions; and explanation on any changes in the valuation method used or the inputs or assumptions.

29. We reviewed issuers' financial statements and MD&A regarding disclosure about material asset impairments. We also considered the reasons for the asset impairments and compliance with the Rules, including whether the directors of issuers have properly discharged their fiduciary duties in safeguarding issuers' assets, and in providing sufficient and timely information to shareholders about these asset impairments.

30. Last year, we reviewed issuers' material lending transactions and related disclosure. We identified cases involving material breaches of the Rules, internal control deficiencies and other misconducts, and have taken disciplinary actions (including public censure on the issuers and responsible directors). We also identified deficiencies in issuers' disclosure, for which recommendation was made.

31. This year we conducted a further review in this area. We selected about 300 issuers that reported material loan receivables, including over two-third that reported money lending as one of its principal business segment.

32. Our findings are set out in the following sections:

    (a) Material asset impairments (other than loans);
    (b) Material lending transactions by money lenders; and
    (c) Material lending transactions outside the issuers' ordinary and usual course of businesses.

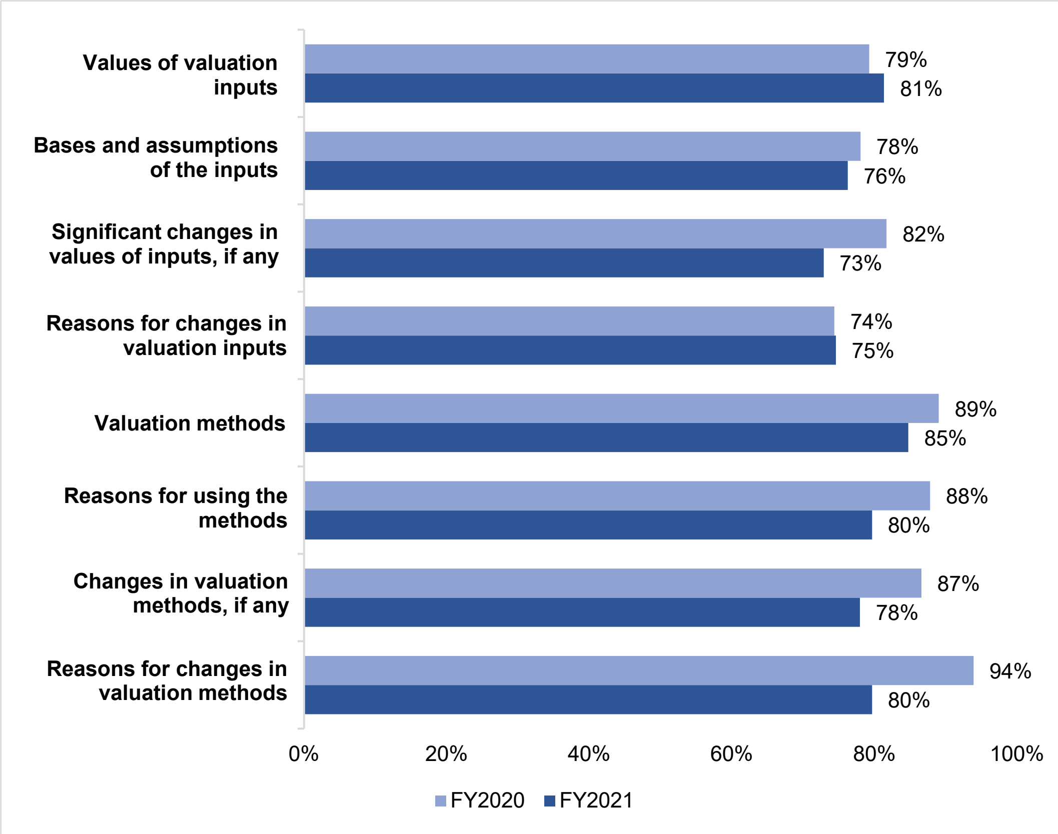
Findings

(a) *Material asset impairments (other than loans)*

33. *Rule compliance matters* – Please refer to Section II of this report for a discussion of issues related to issuers' assessments of asset impairments.

34. *Disclosure* – A large majority of the issuers reviewed have discussed the circumstances that led to the material impairments in the annual reports, and supported the reported impairment amount by valuations or other evidence. In a small number of cases, however, the issuers disclosed generic reasons for the impairments, for example, the issuers cited COVID-19 or changes in government policies as reasons for impairment, without elaboration on how those events impacted the values of their assets. We required those issuers to make further explanation in supplemental announcements.

35. A large majority of issuers that prepared valuations to support the impairment charges followed our recommendation to disclose details of the valuations to allow shareholders to understand the basis and calculation of the asset impairments. The percentages of these issuers disclosing information in the recommended areas is summarised below:



36. We also reviewed whether issuers have timely informed the market about material asset impairments by way of announcements under MB Rule 13.09 (GEM Rule 17.10). Except in two cases, issuers generally announced changes to their financial position arising from asset impairments on a timely basis.

(b) *Material lending transactions by money lenders*

37. Our review covered over 200 issuers that reported money lending as a principal activity in their 2021 annual reports[3].

38. *Rule compliance matters* – Of the money lenders, about 10% reported material impairments on loan receivables. Of these, we identified a few cases that raised concerns about whether the directors had properly discharged their fiduciary duties. These cases had the following characteristics:

(i) They involved impairments on all or a majority of the loan portfolios;

(ii) Most of the loans were long overdue and/or rolled-over over the course of a few years;

[3] Excluding banks, insurance companies and securities houses.

(iii) It appeared questionable whether the terms of the loans reflected the credit risks, for example, a majority of loans written off were unsecured and the risks were disproportionate to the interest rates charged; and

(iv) In some cases, there were no records of credit assessments performed by management.

39. The issuers generally did not perform adequate due diligence on the grants or renewals of the loans, or made proper credit risk assessments. In one case, the issuer made an impairment on most of its loan receivables after a substantial change in its board of directors.

40. The circumstances also suggested material deficiencies in the issuers' risk management and internal controls over their money lending business. These cases are currently under our investigations and referred to the SFC for their investigations.

41. *Disclosure* – In last year's report, we recommended that money lenders should enhance their disclosure in annual reports to enable investors to evaluate their money lending business and the associated risks.

42. Compared to last year, a majority of the issuers have improved disclosure of their money lending business in annual reports. However, in many cases we required the issuers to publish supplemental announcements as the disclosure did not cover all the recommended areas.

43. Common omissions in disclosure included the following:

(i) Details of business model and credit assessment policy – Some issuers simply provided a generic description of their internal control systems without details of the key procedures (e.g. credit risk assessments, ongoing monitoring of loan recoverability and loan collection);

(ii) Breakdowns of material loan receivables and major terms of the loans – Some issuers disclosed a range of interest rates for their loan portfolios without further categorisation of the types of loans and other terms that reflected different credit risks;

(iii) Breakdowns of concentration of loans with major customers (e.g. loans receivables from the top five customers); and

(iv) Management discussion on the impairment assessments of individual loan receivables, and the basis for the general loan impairment provision.

(c) <u>Material lending transactions outside the issuers' ordinary and usual course of businesses</u>

44. A number of issuers provided material loans to third parties, including loans or advances to associated companies, joint ventures or connected persons of the issuers; advances to customers or suppliers relating to the principal businesses of the issuers; and loans to third parties outside the ordinary and usual course of businesses of the issuers.

45. *Rule compliance matters* – We identified a number of cases where the issuers failed to comply with the Rule disclosure and/or shareholders' approval requirements for the provision of financial assistance.

46. We also identified a few cases where the loan impairments raised questions about the commercial rationale for the lending transactions. For example:

(i) An issuer advanced funds to several business partners in recent years allegedly to explore new business opportunities with the borrowers. Ultimately, none of those business plans materialised and the borrowers defaulted on the loans. These advances were mostly unsecured and the issuers had not performed sufficient due diligence on the borrowers;

(ii) An issuer utilised its idle cash to grant loans to earn interest income. Although the loans were relatively small in size individually, the total sum was material compared to the issuer's total assets. Most of the loans were unrecoverable shortly after they were made; and

(iii) Some lending transactions involved unauthorised transfers of funds to other parties and possible fraudulent activities.

47. These cases suggested weaknesses in internal controls and possibly fraudulent transactions. They are currently under our investigations and/or referred to the SFC for their investigations.

48. *Disclosure* – Issuers generally disclosed limited information about their lending transactions in annual reports. In some cases, loan receivables were classified under other receivables in the financial statements, and no details were provided in the notes to the financial statements or the MD&A sections of the annual reports.

Recommendation

49. Directors and audit committees should ensure that issuers have effective risk management and internal control systems to assess and manage their credit risk exposure and to monitor the recoverability of loans and adequacy of the collaterals.

50. Directors are reminded of their obligations in overseeing lending transactions to safeguard issuer's assets. In particular, they should critically assess the commercial rationale for entering into lending transactions, whether the terms are fair and reasonable, and whether the use of funds is in the interests of the issuer and its shareholders.

51. Issuers operating money lending businesses are reminded to make appropriate disclosure of their money lending businesses in annual reports. At a minimum, we recommend the following disclosure:

(i) Description of the issuers' business models, including the nature of lending services provided; customer profiles; risk management policies (including credit approval processes and credit risk assessment policies); and loan impairment policies;

(ii) Breakdowns of the loan portfolios, including the total outstanding loan receivables and number of borrowers; major terms of the loans (e.g. maturity profiles, interest rates, collaterals and/or guarantees obtained); breakdowns of loans by categories (e.g. types of borrowers, loan products or collaterals); size and diversity of borrowers (e.g. loans receivables from the five largest borrowers); and ageing analysis of the outstanding loans; and

(iii) Discussion of the movements of impairments or write-offs of loan receivables and the basis of impairment assessments, including assessments of impairments on material loans. Issuers should develop appropriate and supportable estimates to assess the recoverability of the loans to support the impairment assessments under the relevant accounting standards.

52. Generally, issuers should disclose details of the loan receivables, including major terms, reasons for granting the loans and how they meet the issuers' business strategies and discussion of any material impairments or write-offs of the loan receivables and the basis of impairment assessments.

IV. THEMATIC REVIEW ON NEWLY LISTED ISSUERS (LISTED IN 2020 AND 2021)

53. We monitored newly listed issuers' post-listing activities and compliance with the Rules, and reviewed their disclosure in announcements and annual reports.

54. This year, we reviewed 146 and 96 issuers listed in 2020 and 2021 respectively. We highlight our findings in the following areas:

(a) Post-listing developments;
(b) Changes in the use of IPO proceeds and/or business plans;
(c) Profit alerts and material changes in financial results;
(d) Non-compliances with the Rules after listing; and
(e) Fulfilment of undertakings provided before listing.

(a) Post-listing developments

55. In recent years, the SFC and the Exchange have been addressing issues related to companies seeking a listing on the Exchange for purposes that may not align with public interest, for example, "shell" creation where controllers sought listings of their businesses with the intention of disposing of their listing platforms to new investors for eventual backdoor listings of the investors' businesses, or arrangements to artificially satisfy the initial listing requirements or facilitate market manipulation of the shares at a later date[4]. While the Exchange have amended Rules to address these issues[5], we continue to closely monitor newly listed issuers for red flags suggestive of these activities.

Findings

56. As backdoor listings may involve a series of arrangements over time, we reviewed whether the newly listed issuers conducted activities including (i) disposals of controlling interests by the original controlling shareholders; (ii) material acquisitions of new businesses and/ or material disposals of original businesses; and (iii) reallocation of IPO proceeds to new businesses.

57. Nine issuers conducted one or more of the above mentioned corporate activities, representing a decrease compared to the prior year (15), including (i) six disposals of controlling interests by the original controlling shareholders (last review: 11); (ii) two material acquisitions of new businesses (last review: 1); and (iii) two issuers reported reallocation of IPO proceeds to new businesses (last review: 3).

58. We also identified an acquisition of a material new business by a newly listed issuer within the first year of its listing. We ruled the acquisition to be a reverse takeover. The transaction lapsed subsequent to our ruling.

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[4] See The SFC and HKEX joint statement on IPO-related misconduct dated 20 May 2021.
[5] See consultation conclusion on backdoor listing, continuing listing criteria and other Rule amendments dated 26 July 2019 and consultation conclusion on review of the GEM and changes to the GEM and Main Board Rules dated 15 December 2017.

59. Backdoor listings may take place through a number of corporate activities over a period of time. We will continue to closely monitor these issuers and will take a robust approach to address "shell" creation activities.

(b) *<u>Change in the use of IPO proceeds and/or business plans</u>*

60. The disclosure in a prospectus on use of IPO proceeds indicates how a new issuer intends to deploy resources and implement its business plans. This is relevant information for investors to appraise the issuer's business development. Where an issuer changes its proposed use of proceeds or business plans shortly after listing, such changes should be timely announced and the reasons for such changes clearly explained.

61. Last year, we reported 10 cases involving arrangements conducted shortly after listing and unannounced changes in use of IPO proceeds that were not disclosed in the prospectuses and were inconsistent with the issuers' business plans. For example:

(i) Issuers investing a material part of their IPO proceeds in private entities or wealth management projects associated with the IPO professional parties or their associates; and

(ii) Payments for consultancy arrangements to those parties in advance and were disproportionate to their purported purposes.

62. These arrangements lacked commercial rationale and appeared unfavourable to the issuers. Substantial losses were resulted, suggesting failure by the issuers' directors to safeguard corporate assets and shareholders' interests. Our investigations have revealed breaches of directors' duties and the Rules, resulting in public censure of some issuers and their responsible directors this year.

Findings

63. This year, we identified four cases involving changes in the use of IPO proceeds or business plans shortly after listing. These changes lacked proper disclosure and presented an array of governance issues:

(i) Three mainland property management issuers advanced funds to related parties or pledged deposits to guarantee their liabilities. These issuers failed to announce the financial assistance and/or timely comply with shareholders' approval requirements under the notifiable and connected transaction Rules; and

(ii) An issuer made substantial upfront payments to certain distributors and marketing promoters for a material new business development that were not disclosed in its prospectus nor announced. Subsequent investigations revealed a lack of board oversight and material internal control deficiencies.

We will take appropriate actions against these issuers.

64. In addition, 12 newly listed issuers reallocated funds among different intended uses disclosed in the prospectuses, or reallocated funds to their existing businesses (last review: 49). The changes were generally attributed to changes in business strategies or current business needs. We were generally satisfied that the changes were timely announced and the reasons for such changes explained.

Recommendation

65. We remind issuers that adequate and timely disclosure of material changes to the use of IPO proceeds and business plans is necessary to keep investors informed. Directors should also be mindful of the Rule requirements and the adequacy of the issuers' internal controls to safeguard assets.

(c) <u>Profit alerts and material changes in financial results</u>

66. A prospectus should contain historical and forward looking information that reflects the issuer's financial position and outlook. Where material events after listing lead to material changes in an issuer's financial performance and a profit alert announcement is published, the announcement should quantify the potential financial impact and use clear and concise language. An issuer should refrain from publishing profit alert announcement that merely repeats facts previously disclosed in the prospectus.

Findings

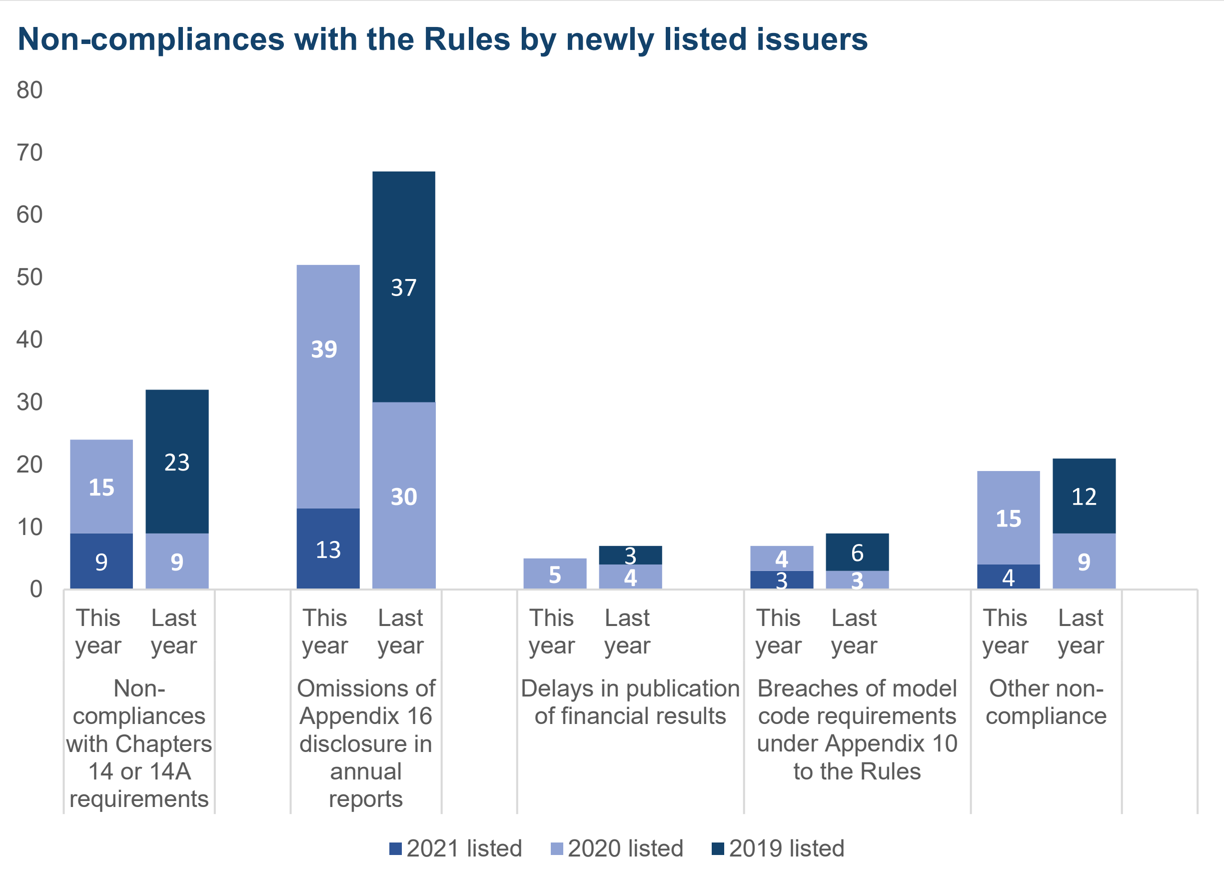
67. About 5% of newly listed issuers reported material changes to their financial results (last review: 25%). Except in one case, we were satisfied that these issuers, where required, have published profit alert announcements on a timely basis and followed our guidance on disclosure.

68. In that one case, the issuer reported a substantial decline in profits after listing due to failure to account for certain professional fees committed before listing. This raised concerns on the accuracy and completeness of the disclosure in the prospectus, and we have referred this case to the SFC for their investigations.

(d) Non-compliances with the Rules after listing

69. We recorded 107 non-compliances with the Rules, involving 87 newly listed issuers. These non-compliances are summarised below:

Findings



70. Non-compliances with the notifiable or connected transaction Rules included the following:

(i) Failure to announce subscriptions of wealth management products issued by banks or investments in investment funds. Such investments constituted acquisitions under the notifiable transaction Rules (see FAQ 057-2019); and

(ii) Failure to comply with the connected transaction Rules when making advances to connected persons (as also mentioned in paragraph 63(i) above), or exceeding the agreed annual caps on connected transactions.

Recommendation

71. We remind newly listed issuers to consult their compliance advisers on matters required under Chapter 3A of the Rules[6]. Directors of the issuers should also ensure that their financial reporting and internal controls provide adequate safeguards to ensure compliance with the Rules.

(e) <u>Fulfilment of undertakings provided before listing</u>

72. In specific cases, newly listed issuers undertook to disclose in their annual reports regulatory updates on contractual arrangements for restricted businesses in the PRC. Some Chapter 19C secondary listed issuers also undertook to seek and obtain shareholders' approvals in general meetings to amend their constitutional documents to provide shareholder protection required by the Rules[7].

Findings

73. All issuers have fulfilled their undertakings or make the relevant disclosure.

74. Some major shareholders of newly listed issuers provided non-competition undertakings to issuers to delineate their businesses with those of the issuers. These issuers have made relevant disclosure in annual reports to the effect that the major shareholders have fulfilled the undertakings. In a few cases where the issuers omitted the information, they published supplemental announcements.

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[6] Issuers should consult with their compliance advisers (i) before the publication of any regulatory announcements, circulars or financial reports; (ii) before any proposed notifiable or connected transactions or share issuances and repurchases; and (iii) before any changes in the uses of IPO proceeds.

[7] Formerly MB Rule 19C.07 and now the Core Standards under Appendix 3 of the MB Rules.

V. THEMATIC REVIEW ON ISSUERS' FINANCIAL STATEMENT DISCLOSURE UNDER ACCOUNTING STANDARDS

75. We conducted a general review on selected issuers' financial statements with a view to encouraging a high standard of financial disclosure and focused on compliance with the applicable accounting standards[8].

76. Except for three cases which were referred to the Accounting and Financial Reporting Council (the **AFRC**) for consideration, there were no significant issues identified. Where disclosure was insufficient but not material to the financial statements as a whole, issuers had confirmed that the required information would be provided in their future financial reports.

77. This section highlights several key areas[9] identified from our review, where issuers can continue to improve their financial disclosure in the upcoming financial reporting period.

A. Judgments and estimates

78. Significant judgments and estimates[10] would have implications on issuers' reported results and financial position. From our review, we note the following:

(i) Most issuers had made significant judgments in the process of applying their accounting policies and their disclosure was clearly distinguished from estimates. We observed that the better disclosure provided more tailored and detailed information based on the issuers' specific circumstances (e.g. how revenue recognition linked to the specifics of different business models), instead of repeating the corresponding accounting policies; and

Examples of accounting judgments
• Revenue recognition (e.g. determining the timing of revenue recognition at a point in time or overtime, principal versus agent consideration) • Lease classification or lease term determination with renewal options • Whether an investee was a subsidiary • Assessing the issuer's ability to continue as going concern • Whether the presumption that investment properties stated at fair value were recovered through sale or use in determining deferred tax liabilities

8 Notes 2.1 and 2.6 to paragraph 2 of Appendix 16 to the MB Rules / GEM Rules 18.04 and 18.06. Unless otherwise specified, Hong Kong Financial Reporting Standards (**HKFRSs**) and their paragraph numbers referred to in this section correspond to those in International Financial Reporting Standards (**IFRSs**).

9 The observations set out in this section are summarised based on our review and are not exhaustive. Readers should read the full HKFRSs to understand the relevant requirements and implications.

10 Hong Kong Accounting Standard (**HKAS**) 1 "Presentation of Financial Statements" paragraphs 122 and 125 set out the overarching requirement for judgments and estimates disclosure, including those that are not in the scope of another HKFRS standard.

(ii) Nearly all issuers disclosed that they had involved significant assumptions or estimations where there was a significant risk of material adjustment to the carrying amounts of assets or liabilities within the next financial year. Regarding the extent of the information provided, most of them described the nature without providing the quantitative sensitivity analysis underlying the calculation and the range of reasonably possible outcomes.

Examples of estimation uncertainty
• Assumptions used in measuring recoverable amounts of non-financial assets (e.g. property, plant and equipment, goodwill and other intangible assets) • Provision of expected credit losses on trade receivables and contract assets that were correlated with historical default rates and forecast economic conditions • Deferred tax assets based on estimated future taxable profit to utilise unused tax losses • Fair value measurement of financial investments that depended on significant unobservable inputs • Estimation of net realisable values of properties under development and inventories

79. Under the current economic conditions, issuers should ensure that their significant judgments and estimates and related disclosure are timely assessed and updated to reflect their current circumstances.

B. Material intangible assets

80. The issuers under review were across different business sectors, including consumer discretionary and healthcare. We are pleased to note that most issuers complied with the disclosure requirements[11]. Our observations are set out below:

(i) In addition to goodwill, many issuers had other intangible assets with finite or indefinite useful lives (e.g. customer relationships, licenses, patents and trademarks). They disclosed the factors that played a significant role in determining that their intangible assets had indefinite useful lives. Some issuers further mentioned that they had performed an annual review and concluded that their intangible assets continued to have indefinite useful lives;

(ii) Most cases determined the recoverable amounts of the cash-generating units (**CGUs**) containing goodwill and intangible assets based on the value in use, in which the discounted cash flow (**DCF**) method was the most common valuation technique. The issuers disclosed the key assumptions underlying the calculation. A few of them further mentioned that the impact of COVID-19 had been taken into consideration in the cash flow projections, e.g. the estimated revenue growth rate for the next five years was adjusted downward; and

(iii) Many issuers had enhanced the disclosure by incorporating one or more recommended items in our previous Reports.

[11] HKAS 36 "Impairment of Assets" paragraphs 126-137 and HKAS 38 "Intangible Assets" paragraphs 118-128.

Our recommended disclosure on material intangible assets

The following additional information in the MD&A and financial statements (where appropriate) is recommended:

- 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;
- 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;
- Providing the recoverable amount of the CGU and the headroom available;
- Highlighting whether the impairment assessment is based on a valuation by an independent professional valuer; and
- 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.

81. We recommend issuers continuously review the clarity and transparency of their disclosure. It is also important for issuers to ensure that financial budgets and key assumptions used in impairment tests are reasonable, having regard to historical cash flows, available market information and future prospects.

82. This part of the review focused on material intangible assets under HKFRSs. We have also conducted separate thematic review on issuers with auditors' modified opinions and recorded material impairments during the year, which identified some governance and disclosure issues concerning the asset valuations. Please refer to Sections II and III for details.

C. Fair value measurement

83. Our findings in relation to the fair value disclosure[12] are highlighted below:

    (i) Most selected issuers having material Level 3 financial assets provided the required qualitative and quantitative information about the valuation techniques and the underlying unobservable inputs. The most common valuation techniques were DCF method (income approach) and comparable company valuation multiples (market approach), and involved significant unobservable inputs such as discount rates, expected rates of return, long-term growth rates, book value/earnings/revenue multiples and discounts for lack of marketability, etc. Many issuers had engaged independent valuers to perform the valuations; and

[12] HKFRS 13 "Fair Value Measurement" paragraphs 91-99.

(ii) For cases other than material Level 3 financial assets, most issuers provided a table showing their assets and liabilities by fair value hierarchy level and provided the required disclosure under the respective levels. During our review, we requested a few issuers to substantiate their categorisation of fair value hierarchy, for example, how the fair values of investment properties were categorised within Level 2 instead of Level 3 and whether there were significant adjustments to the recent and relevant transaction prices[13].

Three-level fair value hierarchy – Inputs

Level 1	Level 2	Level 3
Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date	Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly	Unobservable inputs for the asset or liability

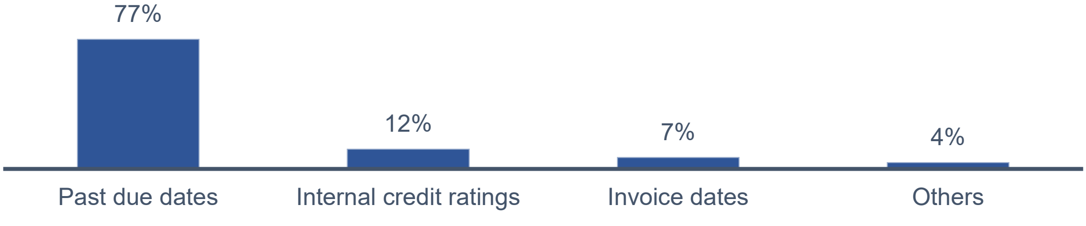
84. Given the increased volatility in market conditions, issuers are encouraged to engage in early discussion with their auditors and valuers about the valuations and the underlying inputs, and if the adjustment to a Level 2 input becomes significant to the entire measurement, this will fall within the Level 3 category and require more disclosure under HKFRS 13.

D. Expected credit losses (ECL) and credit risk disclosure

85. Most issuers had trade receivables and contract assets, which were subject to the ECL assessments at the end of the reporting period. Our observations about their credit risk disclosure[14] are summarised below:

(i) Most issuers applied the simplified approach in estimating the ECL. Many of them disclosed that they used provision matrices as the basis for calculation, which split the balance into different groupings that shared similar credit risk characteristics and applied the same expected loss rate to each grouping collectively; and

Basis of provision matrix analysis



[13] The technical article "Application of fair value hierarchy to real estate" published by the Hong Kong Institute of Certified Public Accountants mentioned that, even in highly transparent and liquid markets, it is likely that valuers will use one or more significant unobservable inputs or make at least one significant adjustment to an observable input. Accordingly, it is likely that the majority of property valuations will fall within the Level 3 category.

[14] HKFRS 7 "Financial Instruments: Disclosures" paragraphs 35A-38.

(ii) Some issuers disclosed that they were exposed to significant credit risk concentration on their major customers, where the revenue attributable to the largest customer and the five largest customers represented a significant percentage of the total revenue. To assist investors' understanding of the underlying risk, they disclosed the percentage of outstanding trade receivables due from these customers and how they had managed the risk and assessed the ECL.

86. When assessing the recoverability of trade receivables at each reporting date, issuers should reconsider the appropriateness of the past method and ensure up to date inputs are used for ECL estimation.

87. This part of the review focused on ECL estimation and disclosure for trade receivables under HKFRSs. We have also conducted separate thematic review on material lending transactions by issuers and identified some governance and disclosure issues relating to their material loan receivables and money lending businesses. Please refer to Section III for details.

E. Business combinations

88. In relation to the business combinations completed in 2021, most issuers complied with HKFRS 3 accounting and disclosure requirements. From our review, we note one case where the issuer issued new shares to settle the consideration for acquisition. Under HKFRS 3 and HKFRS 13, the fair value of consideration should be measured at the acquisition date. However, the issuer used the "agreement consideration" to account for the cost of business combination in its financial statements, rather than referencing the closing market price of the issuer's shares on the acquisition date. The accounting treatment was not in line with the relevant accounting requirements and we referred this case to the AFRC for consideration.

89. Issuers should familiarise themselves with the accounting requirements when carrying out acquisitions and, where necessary, consult with their auditors and valuers at an early stage about the accounting implications.

F. Disclosure of interests in other entities

90. Issuers generally complied with HKFRS 12 disclosure requirements. Our observations are highlighted below:

(i) Some issuers disclosed that they had involved significant judgments and assumptions in determining whether they had control, joint control or significant influence over investees. For example, where the issuers controlled the subsidiaries of which they held less than half of ownership interests, most of them provided the information specific to their circumstances, such as their representation in the investee's board of directors, additional voting rights obtained by virtue of acting in concert agreement with other shareholders; and

(ii) Where the issuers had material associates and joint ventures, the summarised financial information about these entities were provided, in particular the adjustments for any differences in the issuers' accounting policies and the reconciliation to the carrying amounts as shown in the issuers' consolidated financial statements. Examples of the reconciling items were goodwill, fair value adjustments of net assets acquired and impairment losses.

91. Issuers are reminded to provide sufficient disclosure to facilitate investors' understanding of the nature and risks and financial effects associated with their interests in subsidiaries, associates, joint arrangements and unconsolidated structured entities.

G. Going concern disclosure

92. From our review, a number of issuers disclosed that they had performed the going concern assessments[15]. All of them provided the specific events or conditions (e.g. temporary closure of operation, recurring losses, net current liabilities and net operating cash outflow), which might cast significant doubt on their ability to continue as a going concern. Some issuers further highlighted that they had made significant judgments and estimations in assessing the appropriateness of going concern assumptions. We observed that the better disclosure provided the qualitative and quantitative information about the action plans (e.g. available borrowing facilities and possible debt refinancing) to mitigate the cash flows and liquidity issue.

93. In light of the current economic uncertainty and market volatility, the circumstances affecting the going concern assessments may change rapidly. Issuers are reminded to consider the events up to the date of authorisation of their financial statements[16]. It is particularly important for issuers and their audit committees[17] to maintain a close dialogue with the auditors on the audit focus areas, going concern and other emerging issues identified during the audit, and take prompt actions to address auditors' concerns.

[15] HKAS 1 paragraphs 25-26. Moreover, the IFRS Foundation published the educational material "Going concern – a focus on disclosure" to support companies to implement the IFRS requirements related to the preparation of financial statements on a going concern basis.

[16] HKAS 10 "Events after the Reporting Period" paragraphs 14-16.

[17] When planning financial reporting and audits, issuers and their audit committees are encouraged to review the AFRC's 2022 Annual Investigation and Compliance Report and 2022 Interim Inspection Report published on 20 October 2022 and 15 November 2022 respectively. The two reports provide insights on common areas of financial reporting non-compliances in the financial statements of issuers and deficiencies and misconduct in the work of auditors.

VI. ISSUERS' COMPLIANCE WITH ANNUAL REPORT DISCLOSURE REQUIREMENTS

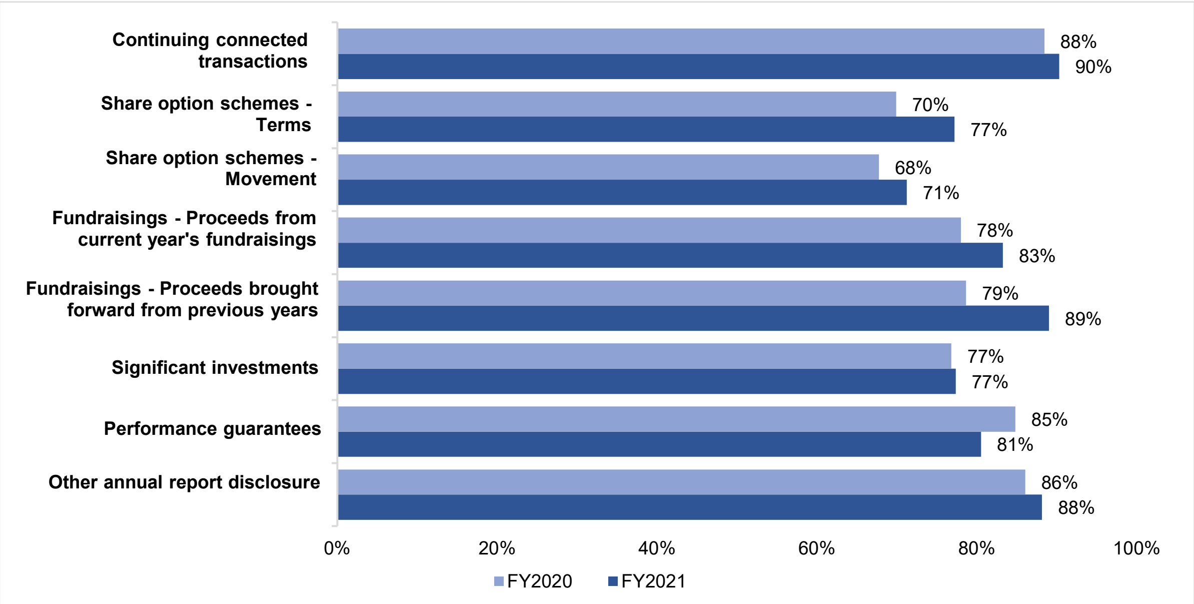
94. In this section, we report on issuers' compliance with specific Rule disclosure requirements[18] in annual reports. In addition, based on issuers' disclosure in annual reports and announcements, we reviewed issuers' compliance with the specific requirements of the Rules.

95. The following areas were reviewed:

A) Continuing connected transactions;
B) Share schemes;
C) Fundraisings through issue of equity / convertible securities and subscription rights;
D) Significant investments;
E) Results of performance guarantees after acquisitions; and
F) Other annual report disclosure.

Findings

96. *Disclosure* – Issuers continued to achieve a high rate of compliance and showed improvement compared to our last review. 99% of issuers achieved a compliance rate of 90% or above on all the disclosure items under the Rules. The chart below details issuers' compliance with the disclosure items in respective areas.



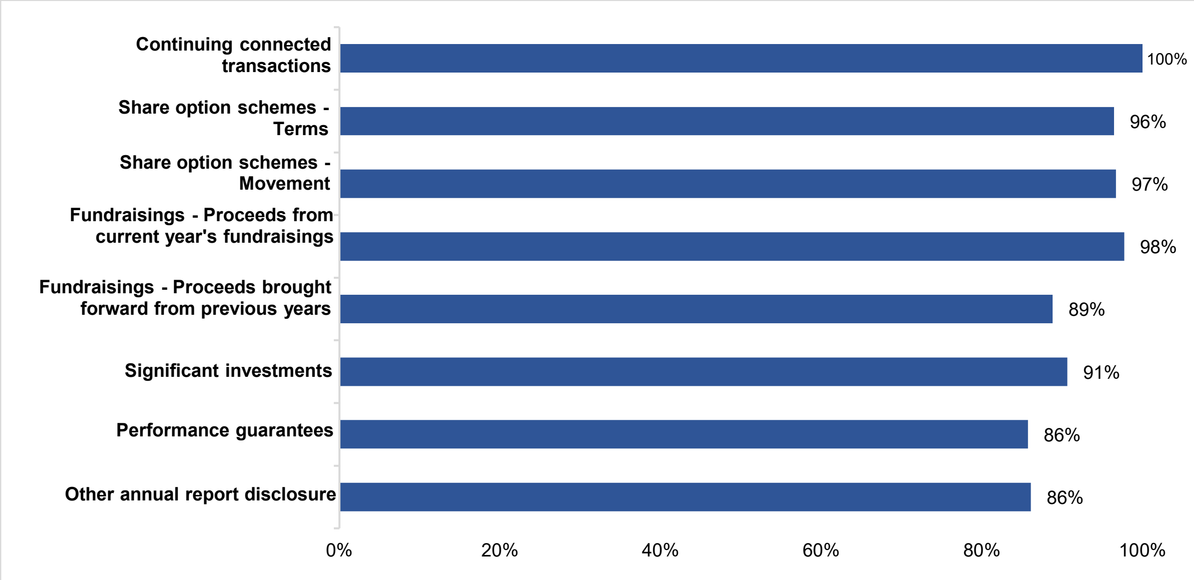
Note: The percentages refer to the number of issuers that complied with all of the Rule disclosure items in that respective area.

97. Further analysis of issuers' compliance with the disclosure Rules in each of above areas is presented in **Appendix II**.

[18] Set out in Appendix 16 of the MB Rules (Chapter 18 of the GEM Rules) and relevant chapters of the Rules governing the relevant topics.

98. We followed up on identified omissions and, where appropriate, requested issuers to make supplemental disclosure.

99. A large majority of issuers that omitted disclosure in last year's annual reports have disclosed as required this year:



100. *Other Rule non-compliances* – In reviewing issuers' disclosure, we also identified isolated cases of non-compliances with the specific requirements under the Rules and have taken appropriate actions. These cases involved:

(i) Continuing connected transactions exceeding the annual caps approved by independent shareholders, as found by independent non-executive directors or auditors during their annual reviews;

(ii) Failure to announce continuing connected transactions at the time of the agreement; and

(iii) Failure to comply with the notifiable transaction Rules when acquiring investment products. Issuers should note that acquisitions of wealth management products are transactions under the Rules subject to announcement and/or shareholders' approval requirements. They may refer to FAQ 057-2019 for guidance.

Recommendation

101. We recommend all issuers take note of these common pitfalls to ensure compliance and complete disclosure as required by the Rules.

APPENDIX I: SCOPE AND METHODOLOGY OF REVIEW

1. We review annual reports of all listed issuers (excluding collective investment schemes). This year's review covers annual reports for the financial year ended between January and December 2021.

Thematic review on selected areas and related disclosure

2. We adopt a thematic approach and select specific areas for review based on the results of previous years and areas considered to be of higher risks. The following table sets out areas covered in, and bases of selection of issuers for, the review:

Financial reporting and related controls
All issuers that: (i) published unaudited financial statements before the reporting deadlines due to disruption by the COVID-19 pandemic *(approximately 200 issuers)*; (ii) received modified audit opinions on their published financial statements *(125 issuers[19])*; and (iii) failed to publish their annual results before the 3-month reporting deadline *(85 issuers)*.
Material asset impairments
For material asset impairments (other than loans): All issuers that recorded material impairments on their assets or businesses, including assets or businesses previously acquired *(41 issuers)* and assets other than acquired assets *(42 issuers).*
For material lending transactions: All issuers that: (i) reported money lending as a principal activity in their annual reports *(210 issuers)**; and (ii) conducted lending transactions outside their ordinary and usual course of businesses and reported (a) loan receivables exceeding 8% of their total asset values*; or (b) significant loan impairments *(62 issuers)*. *Remark (*): Regardless of whether material impairments were recorded on the loan receivables.*
Newly listed issuers
All issuers that were listed in 2020 and 2021, excluding transfers of listing from GEM to Main Board *(242 issuers).*
Issuers' financial statement disclosure under accounting standards
300 issuers, based on a risk-based approach. The key selection criteria included where an issuer: (i) had material intangible assets together accounted for 25% or more of its total assets; (ii) had material level 3 financial assets together accounted for 20% or more of its total assets; (iii) experienced significant changes in net assets; (iv) was newly listed; and/or (v) was the subject of complaints concerning compliance with the Rules.

[19] Excluding 32 issuers (2020: 19) that were long suspended companies at the time they published the financial statements for 2021.

Review of issuers' compliance with annual report disclosure requirements

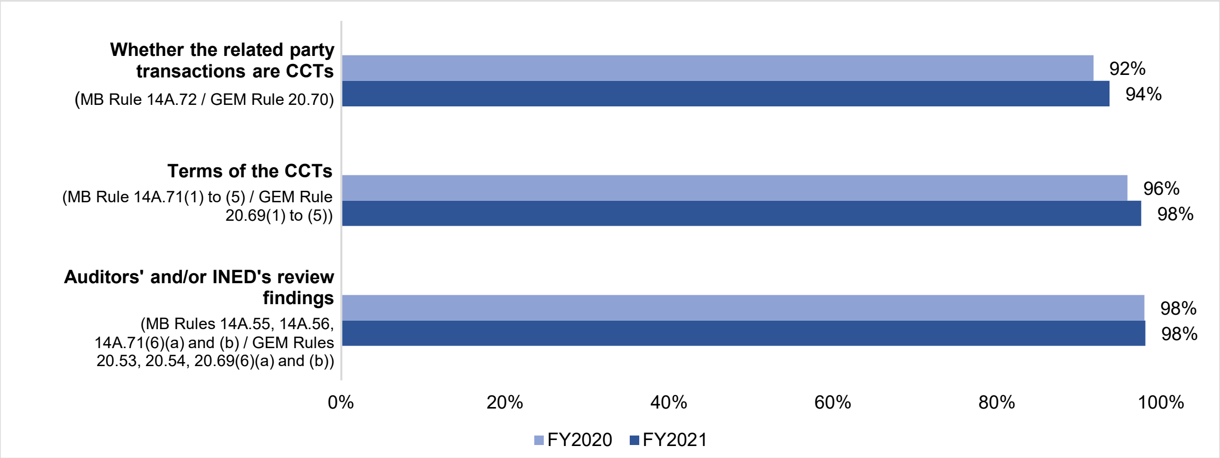
3. The following table sets out areas covered in, and basis of selection of issuers for, the review:

Continuing connected transactions (CCTs)
All issuers that (i) failed to fully comply with the CCT Rules in the last two financial years *(95 issuers)* or (ii) were listed in 2020 or 2021 and reported CCTs in their annual reports *(111 issuers)*.
Share schemes
All issuers that (i) operated share option schemes and granted options in the financial year *(285 issuers)* or (ii) operated share award schemes *(514 issuers).*
Fundraisings through issue of equity / convertible securities and subscription rights
All issuers that (i) conducted equity fundraisings during the financial year *(430 issuers)* or (ii) reported unutilised proceeds brought forward from equity fundraisings conducted in previous financial years *(710 issuers).*
Significant investments
All issuers that (i) had securities investments reported in their financial statements which in aggregate accounted for 20% of more of their total assets as at the financial year end date and (ii) had an investment in an investee company with a value of 5% or more of their total assets as at the financial year end date *(128 issuers).*
Results of performance guarantees after acquisitions
All issuers that were provided with performance guarantees by vendors in previous business acquisitions and the guarantee period ended in the financial year under review (*46 issuers*).
Other annual report disclosure under Appendix 16 of the MB Rules (Chapter 18 of the GEM Rules)
All issuers. The review was performed by an artificial intelligence model covering more than 360,000 disclosure records and involving more than 145 disclosure Rules.

APPENDIX II: ANNUAL REPORT DISCLOSURE RULE COMPLIANCE RATE ANALYSIS

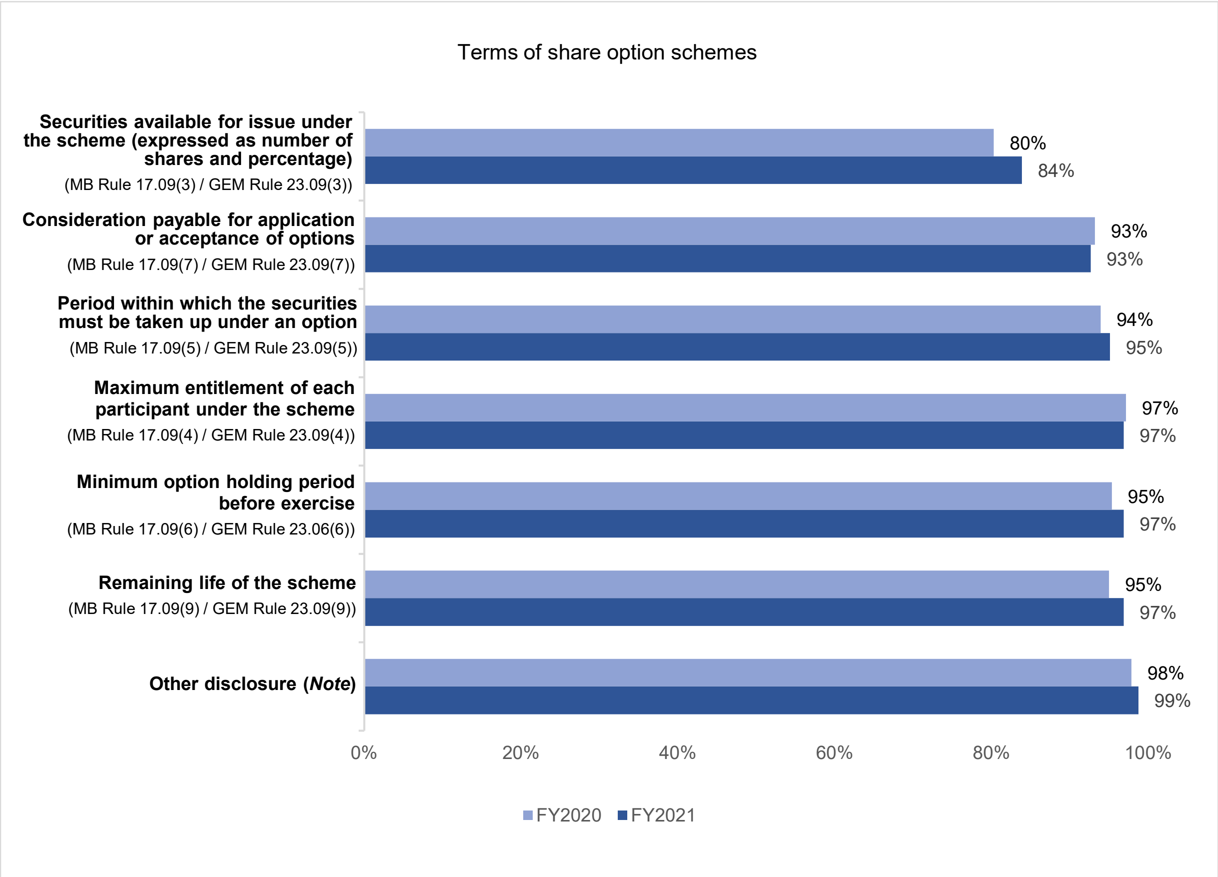
The following charts show the compliance rates with individual disclosure Rules in the respective areas. The percentages refer to issuers that complied with all of the Rule disclosure items in that respective area:

A. Continuing connected transactions

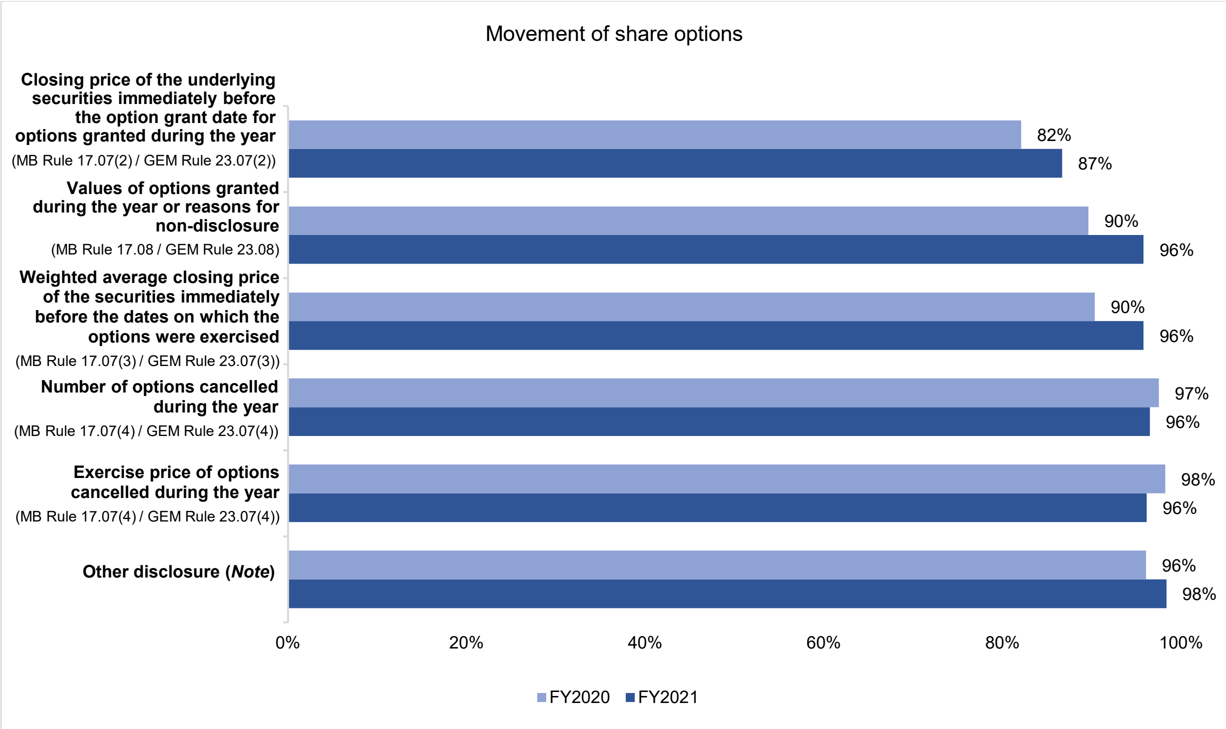


B. Share schemes

Share option schemes



Note: Other disclosure included scheme purpose, scheme participants and basis of determining the exercise price.

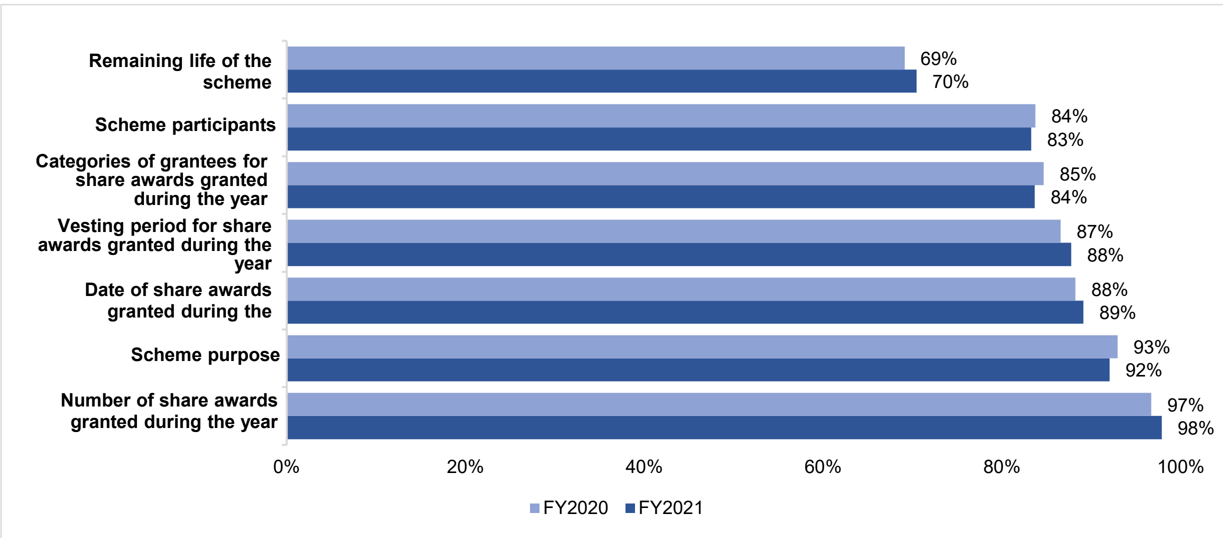


Note: Other disclosure included date of grant, vesting period, exercise price, exercise period for options granted during the year and outstanding options, number of options granted and lapsed during the year, number of options outstanding at the beginning and at the end of the year, number of options and exercise price of options exercised during the year, and accounting policy adopted for the options.

Share award schemes

In previous reports, we recommended issuers operating share award schemes make disclosure consistent with the Rule required disclosure for share option scheme[20], given these schemes are also a form of share based payment arrangements.

We selected the following disclosure items (which are required under the Rules on share option schemes and also relevant to share award schemes) for review. A majority of issuers have fully disclosed information pertinent to these selected items:

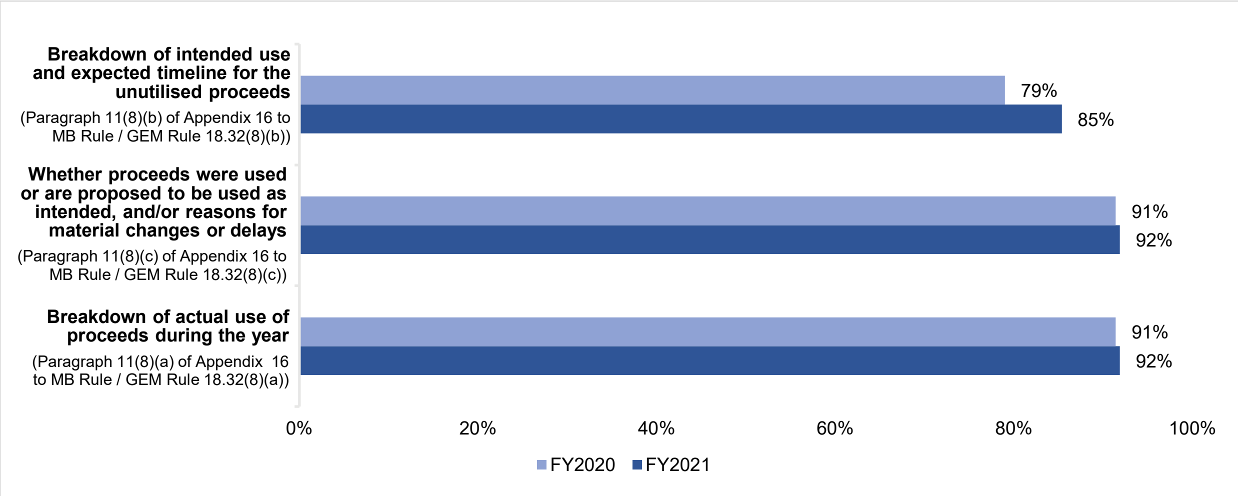


[20] Under Chapter 17 of the MB Rules (Chapter 23 of the GEM Rules).

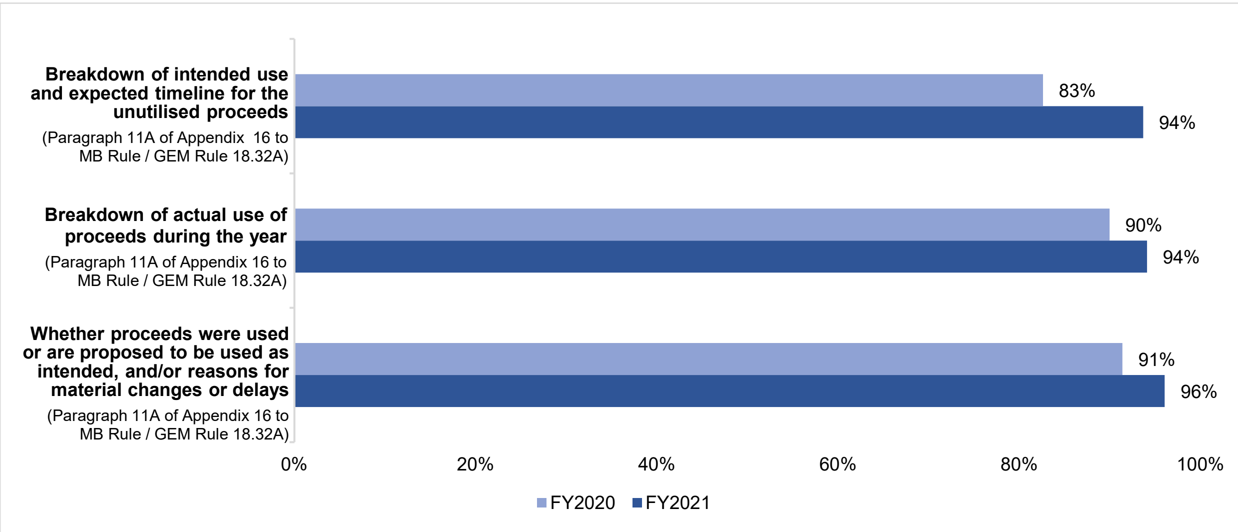
Issuers are reminded that Chapter 17 of the MB Rules (Chapter 23 of the GEM Rules) has been amended to govern all share based incentive schemes (including share award schemes). The amended disclosure requirements for all share schemes take effect for annual reports published on or after January 1, 2023. Issuers should comply with the amended disclosure Rules in their next annual reports.

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

Proceeds from current year's fundraising



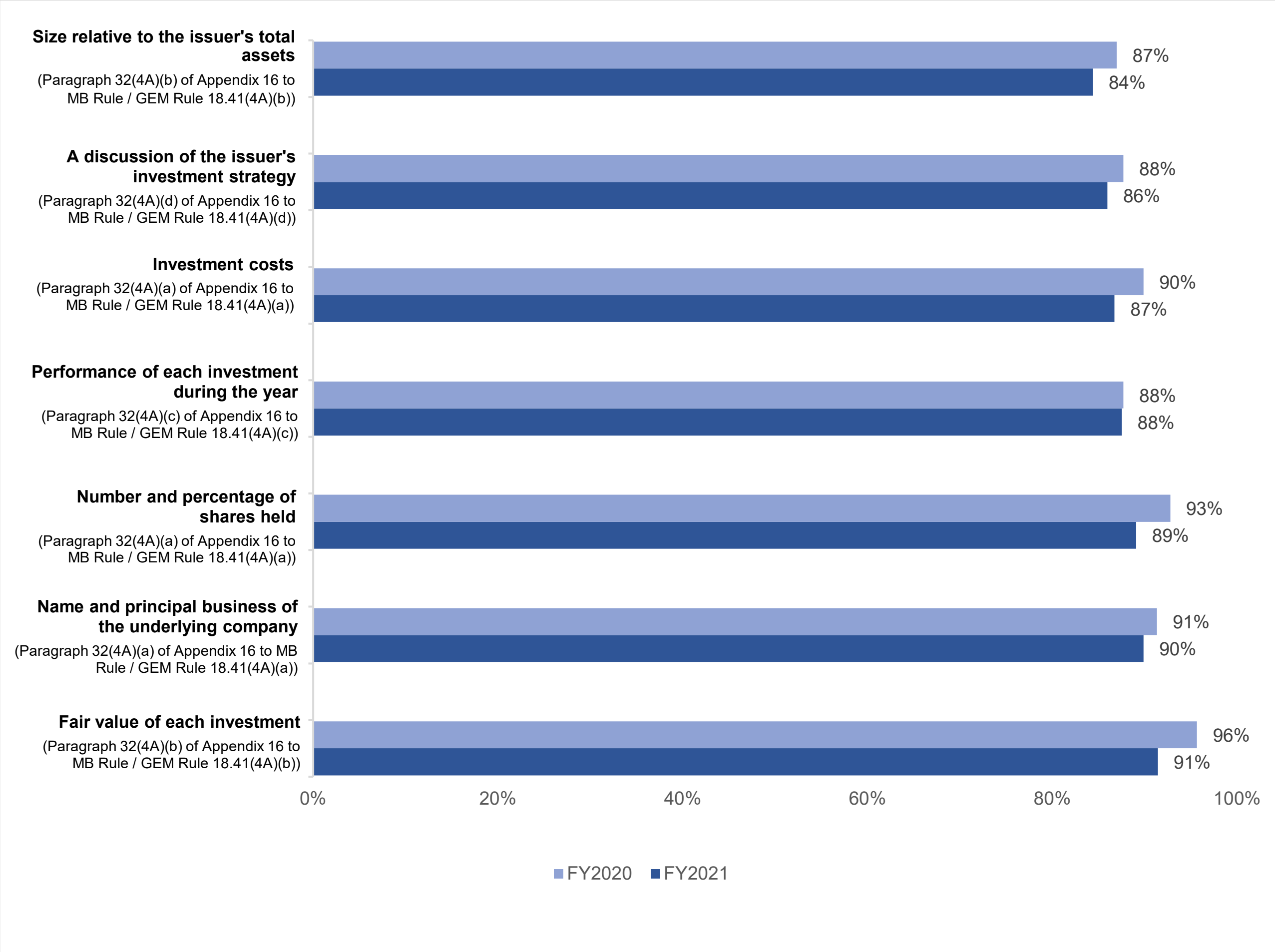
Proceeds brought forward from previous years



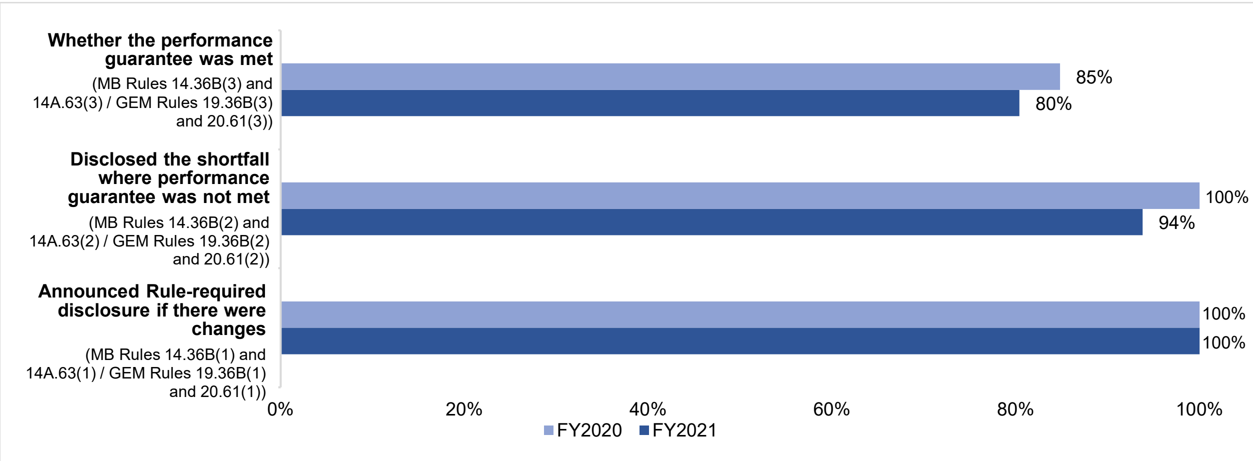
Over 10% of the issuers reviewed reported material changes in the use of proceeds in their annual reports due to unexpected changes in market conditions or regulatory policies. We were generally satisfied that adequate disclosure on the reasons for the changes have been made in issuers' annual reports and announcements, where appropriate[21].

21 See separate comments on our review of newly listed issuers in Section IV of this report.

D. *Significant investments*

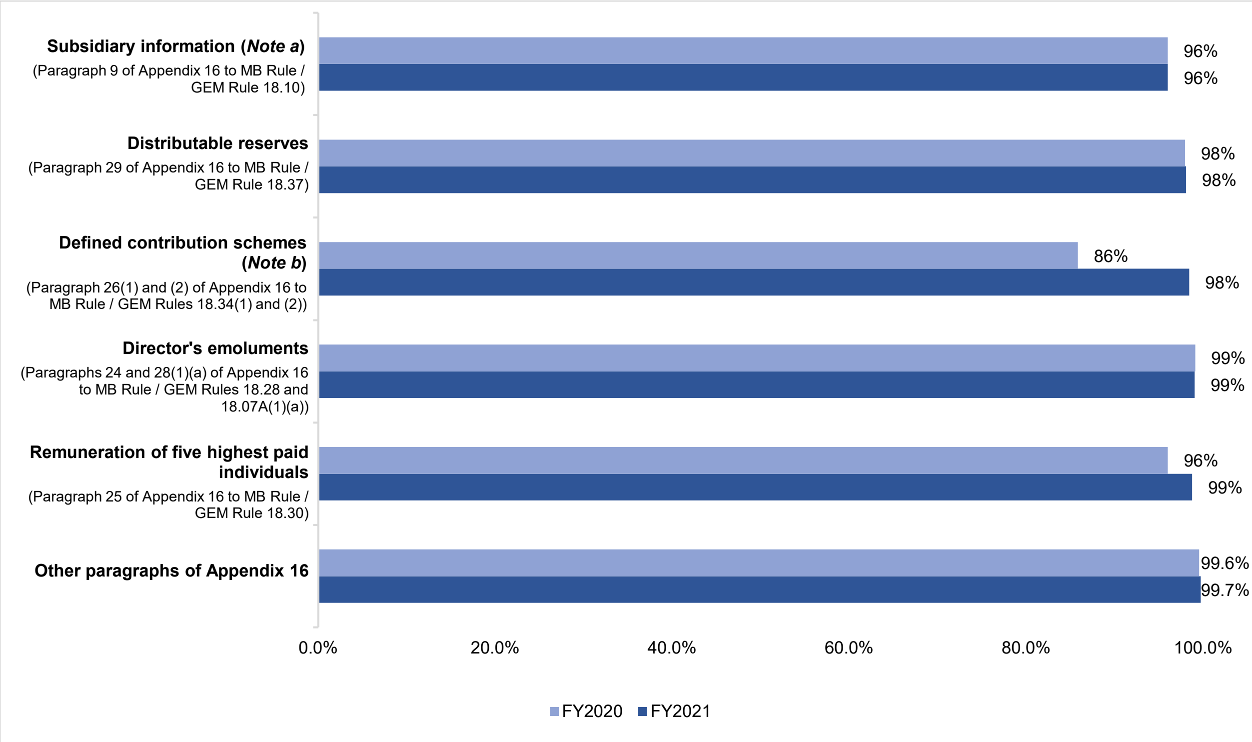


E. *Results of performance guarantees after acquisitions*



Where the performance guarantees were not met or where there were changes to the performance guarantees, we were satisfied that the issuers have made sufficient disclosure and/or taken actions to enforce the guarantees to safeguard shareholders' interests.

F. *Other annual report disclosure*



Notes:

(a) The common omissions mainly include information on the principal country of operation of subsidiaries and 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.

(b) The common omissions mainly include details of whether forfeited contributions may be used by the employer to reduce the existing level of contributions.

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