



Hong Kong

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## HKEX PUBLISHES FINDINGS OF LATEST REVIEW OF ISSUERS' ANNUAL REPORT DISCLOSURES

On 29 January 2021, the Stock Exchange of Hong Kong (the **HKEx**) published its 2020 Review of Issuers' Annual Report Disclosure.<sup>1</sup> The review focuses on (i) examining issuers' annual reports in terms of compliance with the HKEx Main Board Listing Rules and GEM Listing Rules (the **HKEx Listing Rules**), issuers' corporate conduct and issuers' disclosure of material events and developments; and (ii) reviewing issuers' financial statements with a focus on fostering and encouraging high standards of financial disclosure.

Broadly, the HKEx recommends and reminds issuers to:

- disclose the impact of the COVID-19 pandemic in the business review and MD&A section in order to allow shareholders to reasonably assess how the COVID-19 pandemic has affected issuers and their business prospects;
- continuously review their current liquidity positions and expected financial resource needs to allow their businesses to operate normally and urges issuers to formulate action plans to address funding needs in a timely manner and take actions to implement those plans;
- have in place appropriate internal controls and mechanisms to monitor and assist independent non-executive directors (**INEDs**) in overseeing continuing connected transactions;
- follow the HKEx Listing Rule disclosure requirements for all their share options and award schemes;
- 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 and carefully assess the impact of the COVID-19 pandemic on impairment test and update assumptions used to reflect the latest available information and evidence;
- 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 are further reminded to get sufficient and timely information from investees for measuring fair value and preparing the disclosure and not rely solely on professional valuers without exercising any judgment in assessing the reasonableness of the valuation techniques and underlying unobservable inputs.

### 1. FINDINGS ON SPECIFIC AREAS OF DISCLOSURE

#### a. Disclosure of Business Review and Significant Investments in the MD&A Section

Issuers are required to include in their annual report a review of its business, the principal risks and uncertainties facing the issuer, important events which occurred during the financial year under review and an indication of likely future business

<sup>1</sup> [https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Exchanges-Review-of-Issuers-Annual-Disclosure/rdiar\\_2020.pdf?la=en](https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Exchanges-Review-of-Issuers-Annual-Disclosure/rdiar_2020.pdf?la=en)

developments (paragraphs 28(2)(d), 32 and 52 of Appendix 16 to the Main Board Listing Rules (18.07A(2)(d), 18.41 and 18.83 of the GEM Listing Rules)). Issuers must also disclose significant investments held, their performances during the financial year and future prospects.

### *Disclosure on Impact of Covid-19*

The HKEx reviewed the MD&A disclosure of 50 issuers with a 31 December financial year end in order to review if adequate disclosures had been made in relation to the impact of the Covid-19 pandemic. The HKEx found that a majority of the issuers reviewed made qualitative disclosures on how Covid-19 impacted their operations and the relevant risks and uncertainties that may affect their future performance. In some cases, issuers quantified the financial impact and a number of issuers provided assessments of their liquidity positions and working capital sufficiency with reference to their operations and capital commitments. Some issuers also disclosed measures taken or to be taken amid the Covid-19 pandemic to inform shareholders of how the issuer endeavoured to manage the impacts and risks. Otherwise, the HKEx found that disclosure was relatively generic, with only brief mentions of the Covid-19 pandemic but no disclosure on how the Covid-19 pandemic had or would affect their business operations specifically.

The HKEx recommends that issuers make appropriate disclosures in their next annual reports on the impact of Covid-19 on their operations, financial performance and financial positions and include an assessment of the risks and impact on their future performance. Issuers are also encouraged to continuously evaluate the situation and, where appropriate, announce material business developments to keep shareholders and investors timely informed.

### *Follow up on Last Year's Review of Issuers' Disclosure on Regulatory Changes in the Pharmaceutical and Education Industries in the PRC*

In the previous review (the **2019 Review**), the HKEx reviewed the MD&A disclosure of 46 issuers' major operations in the pharmaceutical or education industries in the PRC, finding that most issuers failed to discuss the major regulatory changes relevant to their operations and the potential impacts. In the follow-up review, the HKEx found that most issuers had improved their MD&A disclosure, disclosing details of changes in the relevant regulations and government policies and any impact on their businesses, and, where applicable, the impact on their financial performance.

### *Significant Investments*

The HKEx Listing Rules require an issuer to disclose its significant investments held (i.e., representing 5% or more of its total assets as at the financial year end date), their performances during the financial year and future prospects. To enhance transparency, a breakdown of the issuer's significant investments is also required.

The HKEx found that a majority of the 118 issuers reviewed (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), disclosed the required information in full, which was a noticeable improvement from the findings of the 2019 Review. Where issuers did not fully disclose as required, it was information on investment costs and size of particular investments relative to their total assets that was generally omitted.

### **b. Financial Statements with Auditors' Modified Opinions**

Issuers are required to provide shareholders with financial statements which fairly present their financial positions and performance and are free from material misstatements. Where this is not the case, paragraph 3 of Appendix 16 to the Main Board Listing Rules (GEM Listing Rule 18.47) requires issuers to provide more detailed or additional information. The HKEx has previously recommended that issuers with modified opinions disclose:

- details of the modifications and their actual or potential impact on the issuers' financial position;
- management's position and basis on major judgmental areas and how the management's view differs from that of the auditors;
- the audit committee's view on the modifications and whether the audit committee reviewed and agreed with the management's position regarding major judgmental areas; and
- the issuers' plans to address the modifications.

In its 2020 Review, the HKEx reviewed the annual reports of 133 issuers whose auditors expressed a modified opinion on the issuers' financial statements for the financial year ended in 2019 (68 issuers with modified opinions for the first time and 65 issuers with repeated modified opinions). The annual

report disclosure of modified audit opinions by issuers was found to have improved with around one half of issuers making the recommended disclosures in full, compared to one third in the 2019 Review.

### *Issuers with Modified Opinions for the First Time*

The number of issuers with modified opinions for the first time increased from 29 issuers in the 2019 Review to 68 issuers in the 2020 Review, mainly due to the existence of material uncertainty on those issuers' ability to continue as a going concern, with a majority attributing this to the macro environment. The HKEx however found that in a majority of cases, the liquidity and financial issues had developed over a number of years and that the existence of material uncertainty on the issuers' ability to continue as a going concern had been highlighted in the previous year auditors' report. Issuers are therefore reminded to continuously review their current liquidity positions and expected financial resource needs and are urged to formulate action plans to address their funding needs to implement those plans.

Other audit modifications included valuation of assets and recoverability of loans and receivables, with auditors generally attributing the audit modifications to insufficient evidence provided by the issuers' management to justify their estimates used to support the asset value. The HKEx therefore recommends that issuers should develop appropriate and supportable estimates for the financial reporting items. Key judgments made should also be documented and experts should be retained where necessary. Issuers should also engaged in early discussions with auditors and agree the timing, form and approach of the assessment of the estimates in advance.

A further audit modification was limited access to accounting records, which issuers generally attributed to restricted access to the books and records of entities that had been disposed of, or the departure of key personnel. Issuers are therefore encouraged to ensure adequate internal control measures are in place so as to fulfil financial reporting obligations and that duties are sufficiently segregated to avoid undue reliance on a small number of key employees.

### *Issuers with Repeated Modified Opinions*

The HKEx found that 42 of the 65 issuers with repeated modified opinions had resolved all underlying audit issues that led to the audit modifications in the previous year(s), an improvement from the 2019 Review. The remaining 23 issuers were unable

to resolve their audit modifications brought forward from the previous year, including 12 issuers with audit modifications relating solely to going concern.

The most common audit modifications related to going concern and the fairness of the reported value of material assets. Largely, this was due to the issuers' inability to provide information or evidence to satisfy auditors on the validity of their assumptions or estimates in reporting the relevant assets. The HKEx urges these issuers to put concrete plans in place to resolve these issues immediately.

### *New Listing Rules relating to Disclaimer or Adverse Opinion on Financial Statements*

Under Main Board Listing Rule 13.50A and 13.50B (GEM Listing Rules 17.49B and 17.49C), 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. If those issues remain unresolved at the end of a remedial period, the issuer may be delisted.

The HKEx's 2020 Review found that 74 issuers had 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 had unresolved audit modifications related to various matters). The HKEx urged these issuers to take prompt and appropriate action to resolve the underlying issues.

### **c. Updates on Material Asset Impairments and Results of Performance Guarantees After Acquisitions**

Paragraph 32 of Appendix 16 to the Main Board Listing Rules (GEM Listing Rule 18.41) requires issuers to announce material acquisitions, publish circulars and obtain shareholders' approval for these acquisitions. Information about the acquired businesses, including circumstances involving material asset impairments, should also be disclosed in the MD&A section of their annual reports. The HKEx has previously recommended that where an asset impairment is supported by a valuation, the issuer should disclose information on the basis of the valuation in order to enable shareholders to understand the details of and reasons for the impairments and their amounts

and the prospects of the acquired business. Where there is a performance guarantee, issuers are also required to disclose in their next annual report the performance of the acquired business and whether the performance guarantee has been met. Where the performance guarantee is not met, the issuer must publish an announcement to disclose the shortfall and whether the vendor has fulfilled its obligations under the guarantee (Main Board Listing Rule 14.36B / GEM Listing Rule 19.36B and Paragraph 6.3(i) of Appendix 16 to the Main Board Listing Rules / note 4(h) to GEM Listing Rule 18.07).

### *Update on Material Impairments on Acquired Assets*

The HKEx found that the number of issuers reporting material impairments on acquired assets was comparable to the 2019 Review, finding that the majority had disclosed the circumstances leading to the impairments and had engaged independent valuers to perform the valuations and disclosed details of the valuations. A few issuers were however found to have omitted some information, but this was subsequently disclosed in supplemental announcements following enquiries by the HKEx.

### *Results of Performance Guarantees*

The HKEx found that over half of issuers with performance guarantees ending 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 in line with the terms of the agreement. In the other cases, the issuers took legal action against the vendors or unwound the transactions. Upon review of the arrangements, the HKEx was satisfied that the issuers had taken appropriate actions to safeguard their assets and had updated shareholders on the rationale and the status of their actions in their announcements and annual reports.

A majority of issuers were found to have made the required disclosure in their annual reports, with those issuers who failed to comply making supplemental announcements following the HKEx's enquiries. Where performance guarantees were not met, a majority of issuers made announcements disclosing the shortfall and whether the vendors had fulfilled their obligations under the guarantees.

### *Update on Material Impairments on Assets (other than acquired assets)*

The number of issuers that made material impairments on assets (other than acquired assets) increased from the 2019

Review, with issuers largely attributing this to macroeconomic factors, the economic downturn in Hong Kong or industry specific factors. The HKEx found that the circumstances leading to the impairments were generally disclosed in issuers' annual reports, although a few issuers were found to omit information about the bases for adopting a particular valuation methodology and changes in particular valuation assumptions that led to the impairments. This information was however disclosed in supplemental announcements in response to enquiries by the HKEx.

The HKEx also noted an increase in the material impairments on loans and receivables, generally attributed to the economic downturn. In some cases, the HKEx found that the impairments revealed potential internal control deficiencies relating to the grant of loans and concerns were raised about directors' oversight of the lending transactions and safeguarding assets. The HKEx identified a few cases where the commercial rationale of the loan transaction was called into question and these cases are currently under investigation.

The HKEx recommends that issuers and audit committees ensure effective internal control systems are in place to manage issuers' credit risk exposure and monitor the repayment of the relevant loans and receivables to safeguard issuers' assets. Issuers are also reminded to monitor changes in economic conditions and ensure their internal control procedures are adequate and reflect any changes.

### **d. Continuing Connected Transactions**

The HKEx Listing Rules require that, in each financial year:

- i) an issuer must report its continuing connected transactions in its annual report and confirm whether its related party transactions were connected transactions under the HKEx Listing Rules and, if so, whether these transactions complied with the relevant requirements;
- ii) INEDs must review the issuer's continuing connected transactions and confirm in the annual report whether the transactions were made: (1) according to the agreement governing them, on terms that are fair and reasonable and in the interest of the issuer and its shareholders; (2) on normal commercial terms or better; and (3) in the issuer's ordinary and usual course of business; and
- iii) the auditors must review the issuer's continuing connected transactions and provide the board of directors with a confirmation on whether anything has caused them to

believe that the continuing connected transactions: (1) had not been approved by the board; (2) were not in accordance with the issuer's pricing policies; (3) were not entered into in accordance with the agreement governing them; and (4) had exceeded the annual cap.

The HKEx reviewed the annual reports of around 200 issuers that had failed to comply with the continuing connected transaction rules in the past two financial years or were listed in 2018 or 2019 and reported continuing connected transactions in their annual reports for the first time.

The HKEx found that a majority of the selected issuers fully complied with the continuing connected transaction disclosure requirements in their annual reports. A few cases of non-compliance were identified, including:

- INEDs and/or auditors finding that continuing connected transactions exceeded the approved annual caps (3 cases);
- issuers announced that their continuing connected transactions exceeded the approved annual caps despite confirmations of compliance by INEDs and auditors in the annual reports (3 cases); and
- failures to comply with the HKEx Listing Rule requirements, despite confirmations of compliance by INEDs and auditors in the annual reports (9 cases).
- The HKEx therefore reminds issuers to put in place (and review the appropriateness of) internal controls to monitor and assist INEDs in overseeing their continuing connected transactions and make reference to the best practices adopted by other issuers.

#### **e. Disclosure on Share Option and Award Schemes**

The HKEx 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 requisite disclosure requirements and reviewed the disclosure of 326 issuers with share award schemes.

##### *Share Option Schemes*

The HKEx found that a majority of issuers had fully disclosed the required information on the terms of their share options schemes and had fully complied with the disclosure requirements

regarding disclosure of the movements and details of share options granted during the financial year for each category of participant. Specific information was omitted in some cases and only a few issuers failed to separately disclose the details of share options granted to their employees and other participants.

The HKEx further found that around one third of issuers granted share options during the year to participants other than directors, chief executives, substantial shareholders or employees (mainly consultants or advisers) and while there is no HKEx Listing Rule requirement to disclose the background of the grantees, a majority of these issuers did.

##### *Share Award Schemes*

A majority of issuers with share award schemes were found to have disclosed the major terms of their share award schemes and disclosed the movements of share awards granted during the year in detail, in line with the requirements of Chapter 17 of the HKEx Listing Rules. The HKEx reminds issuers that this disclosure is useful for shareholders in evaluating the use of share award schemes and encourages issuers to follow the requirements of Chapter 17 in their future annual reports.

#### **f. Disclosure on Material Other Expenses / Income**

The HKEx reviewed disclosures relating to material other expenses / income of 374 issuers that recorded "other / other operating expenses" and 514 issuers that recorded "other / other operating income" as a line in their statements of profit or loss.

The HKEx found that 60% of issuers that reported "other / other operating expenses" provided breakdowns for all or most of those reported expenses in the notes to the financial statements and further found that these items were mainly advertising costs, travel expenses, asset impairment, auditors' remuneration, legal and professional expenses and operating lease charges. In the remaining cases, the HKEx found that the "other / other operating expenses" were not material in relation to the financial figures in the issuers' profit and loss statement.

Of the 514 issuers that recorded "other / other operating income", the HKEx found that a breakdown was generally included of all or a material portion of such income in the notes to the financial statements.

## g. Fundraisings through Issue of Equity / Convertible Securities and Subscription Rights

### *Disclosure on Use of Proceeds*

The HKEx 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 fundraising conducted in previous financial years. The HKEx found that a majority of issuers fully disclosed the required information, with a noticeable improvement from the previous Review. Of those issuers that failed to fully disclose the required information in the previous year, a majority complied with the required disclosure this year.

Of the omitted information, this was commonly found to be the expected timeline for the use of the unutilised proceeds and disclosure on unutilised proceeds from initial public offerings and their uses, which were attributed by some issuers to uncertainties in their business developments.

### *Change in Use of Proceeds*

The HKEx found that a few issuers disclosed changes in the use of proceeds in their annual reports, the extent of which was not material, relating mainly to the reallocation of funds among different stated purposes in the fundraising announcements or reassignment of funds to existing businesses.

## h. Issuers Listed under the New Listing Regime for Pre-Revenue Biotech Companies

The HKEx reviewed the annual reports of 15 pre-revenue biotech companies (out of a total of 28 pre-revenue biotech companies listed on the HKEx under Ch.18A as at 31 December 2020) that published their annual reports in the financial year ended in 2019 in order to assess their compliance with the relevant HKEx Listing Rules.

The HKEx found that all 15 biotech companies disclosed information in their annual reports as required under HKEx Listing Rule 18A.08, finding that a majority of companies disclosed additional information on their major business developments, including information on post-commercialisation of core products and the development of newly in-licensed or non-core products. The HKEx encourages biotech companies to continue this practice in future.

## 2. ISSUERS LISTED IN 2018 AND 2019

The HKEx reviewed the post-listing corporate activities, HKEx Listing Rule compliance and annual report disclosures of issuers listed in 2018 and 2019 (the **Newly Listed Issuers**).

### a. Post-listing Developments

The HKEx found that 16 Newly Listed Issuers (compared to 20 issuers in the 2019 Review) had undertaken one or more significant corporate actions after listing, including:

- i) 10 issuers where controlling shareholders disposed of their controlling interests in the issuers;
- ii) four issuers had proposed material acquisitions of new businesses; and
- iii) four issuers had reallocated part of their IPO proceeds to finance the acquisitions of new businesses.

The HKEx further found that two Newly Listed Issuers proposed acquisitions which appeared to circumvent the new listing requirements. These included one case of a controlling shareholder proposing to inject a substantial business shortly following listing, which the HKEx considered an attempt to list the substantial business without going through the due diligence required for an IPO. The proposed transaction was ruled to be an extreme transaction subject to additional due diligence and disclosure requirements. The second case involved a Newly Listed Issuer proposing to acquire a target business, which was itself previously an IPO applicant. The IPO vetting process conducted on that business had raised questions regarding its suitability for listing. The HKEx considered the proposed acquisition to be an attempt to circumvent the new listing requirements and the transaction was subsequently terminated.

### b. Profit Forecasts and Material Decrease in Financial Results

The HKEx found that a majority of Newly Listed Issuers did not publish any profit forecast in their prospectuses, however those that did were able to meet their forecasted profits.

The HKEx found that around 25 percent of the Newly Listed Issuers published profit warning announcements in respect of their first interim periods or financial years immediately after listing. One third of these issuers reported post-listing financial results that were “largely consistent” with the profit forecasts submitted to the HKEx as part of the new listing applications.

The remaining issuers were found to have reported financial results that deviated materially from the profit forecast previously submitted, with this mainly being due to matters arising after listing. The HKEx further found that a majority (around 75 percent) of profit warning announcements quantified the financial impact in terms of percentages or in dollar amounts (compared to around 50 percent in the 2019 Review), in line with the HKEx's recommendations in previous reports and the SFC's Corporate Regulation Newsletters.

### c. Changes in the Use of IPO Proceeds

The HKEx found that some Newly Listed Issuers announced changes to their proposed uses of IPO proceeds within two years after listing, which was comparable to the data from the 2019 Review. By and large, these 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 HKEx found that the changes were generally related to unexpected declines in the business that were initially planned for expansion or changes in the market or regulatory policy. Only one issuer did not explain the changes on a timely basis (a delay of one year).

### d. Non-compliance with the HKEx Listing Rules after Listing

The HKEx found that 44 Newly Listed Issuers failed to comply with the HKEx Listing Rules shortly after listing, which was comparable to the 2019 figures. Largely, non-compliance related to the notifiable or connected transaction rules where issuers failed to timely announce and/or obtain prior shareholders' approval on the relevant transactions. These instances of non-compliance were found to be mainly attributed to misunderstanding of the application of the HKEx Listing Rules or oversight.

Other instances of non-compliance with the HKEx Listing Rules included failure by directors to comply with the Model Code for Securities Transactions by Directors of Listed Issuers applicable to directors' dealings in the issuers' shares during blackout periods; share disposal by controlling shareholders during the lock-up period; delay in cancelling repurchased shares; grant of share options during prohibited periods; failure to maintain the minimum public float; and delays in publishing accounts.

The HKEx further found that around 40 percent of Newly Listed Issuers that failed to comply with the HKEx Listing Rules shortly after listing, failed to consult with their compliance advisers on the relevant transactions as required by the Listing Rules

(Chapter 3A). The HKEx reminds issuers to consult with their compliance advisers where required.

### e. Fulfilment of Conditions or Undertakings Imposed or Provided before Listing

The HKEx found that all of the Newly Listed Issuers that were required by the Listing Committee to provide undertakings to take certain actions and disclose in their annual reports whether the relevant undertakings were fulfilled, fulfilled their undertakings and made the relevant disclosures.

The HKEx also found that some major shareholders of Newly Listed Issuers provided non-competition undertakings (**NCUs**) to the issuers and in a majority of cases, the major shareholders undertook that they would take steps to comply with their obligations under the NCUs and make annual declarations in annual reports confirming their compliance. Some issuers however failed to disclose the annual declarations made by the major shareholders and the steps taken by them to comply with the NCUs. This information was however subsequently disclosed in response to the HKEx's enquiries.

## 3. COMMON DISCLOSURE OMISSIONS

Using AI technology to review issuers' annual reports, the HKEx found that issuers achieved a high compliance rate. Common disclosure omissions related to:

- i) **Pension schemes** (paragraph 26 to Appendix 16 to the Main Board Listing Rules), mainly whether forfeited contributions may be used by the employer to reduce existing contribution levels and details of the defined benefit plans;
- ii) **Top five customers and suppliers** (paragraph 31 of Appendix 16 to the Main Board Listing Rules), mainly percentages of revenue/purchases attributable to the largest customer/supplier and the five largest customers/suppliers combined and interests of any directors, close associates or any shareholder (owning more than 5 percent interests in the issuers) in the five largest customers/suppliers;
- iii) **Details of subsidiaries** (paragraph 9 of Appendix 16 to the Main Board Listing Rules), mainly the principal country of operation of the subsidiaries and the legal form of subsidiaries established in the PRC;
- iv) **Gearing ratios or the basis of calculation of the ratios**

(paragraph 32(10) of Appendix 16 to the Main Board Listing Rules), some issuers did not disclose the gearing ratios or the basis for calculation of these ratios;

- v) **Remuneration of five highest paid individuals** (paragraph 25 of Appendix 16 to the Main Board Listing Rules), mainly certain emoluments details; and
- vi) **Reserves available for distribution to shareholders** (Paragraph 29 of Appendix 16 to the Main Board Listing Rules), some issuers did not make a statement on the reserves available for distribution to shareholders as at the financial year end date.

## 4. ACCOUNTING REVIEW THEMES

### a. Material Intangible Assets

#### *Findings*

The HKEx's 2020 Review assessed issuers' compliance with the requirements under Hong Kong Accounting Standard (HKAS) 36 "Impairment of Assets", HKAS 38 "Intangible Assets" and Hong Kong Financial Reporting Standard (HKFRS) 3 (Revised) "Business Combinations" in relation to disclosures of material intangible assets. The HKEx reviewed the disclosure in relation to indication of impairment, including whether an impairment test had been performed when there was indication of impairment, and examined the level of detail of disclosure on impairment assessment. The HKEx also reviewed whether the issuers under review provided the recommended disclosures under HKAS 1 (Revised), finding that over half of the issuers provided one or more items of the recommended disclosure.

The HKEx found that 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 an annual impairment test and that most had determined the recoverable amounts of the cash-generating units to which goodwill and intangible assets were allocated based on value in use calculation.

The HKEx also reported 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 (one of the recommended disclosures under HKAS 1 (Revised)). The HKEx however found that in some cases the key assumptions were overly optimistic when compared with historical results and cash flows of the group or cash-generating units. The HKEx also

identified instances where there were indications of impairment but no impairment losses recognised. In some cases of follow-up review, the HKEx found that the group or cash-generating units continued to suffer loss, turned loss making or the actual performance did not meet the forecast but an impairment loss was not recognised. The HKEx made enquiries to request additional information and explanations in these cases.

#### *Recommendations*

##### *i. Timing of impairment assessment and indications of impairment*

HKAS 36.9 and 36.10 set out the requirements of when to perform impairment test on assets within the scope of HKAS 36. To assess whether there is any indication of impairment, issuers should consider, at a minimum, the non-exhaustive list set out in HKAS36.12 and 36.14.

When there are indications of impairment, issuers should perform an impairment test and the HKEx states that 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. The HKEx also recommends that issuers enhance disclosure i.e., whether an impairment test has been performed, the event that triggered the test and the test result (even if it does not result in impairment).

##### *ii. Disclosure on the reasonableness of the financial budgets and assumptions used in determining the recoverable amounts*

Directors and management are responsible for performing proper analysis and exercising judgment to assess the reasonableness of key assumptions applied in impairment testing (HKAS 36.33) so that assumptions applied are not overly optimistic and it is recommended that the audit committee ensures it is satisfied that sufficient analysis has been performed.

In relation to the Covid-19 pandemic, the HKEx urges issuers to carefully consider the impact on impairment test and update the assumptions used to reflect the latest available information and evidence. The HKEx reminds issuers to follow the requirements of HKAS 36.30-57 when determining the key assumptions used in the value in use calculation, noting that cash flow projections should be based on reasonable and supportable assumptions with greater weight given to external evidence. The HKEx also states that the forecast period should cover a maximum period of five years, unless a longer period can be justified.



The HKEx also reminds issuers 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 a forecast period greater than five years is used and the recommended disclosures.

Issuers are also encouraged to consider enhancing disclosure of the impact of the Covid-19 pandemic on the impairment test that provides value to investors, including any changes to cash flow projections and assumptions to reflect the impact.

### **b. Material Level 3 Financial Assets**

HKFRS 9 requires an entity to apply the requirements of HKFRS 13 “Fair Value Measurement” when measuring the fair values of financial assets.

The HKEx reviewed the financial disclosure of 71 issuers whose level 3 financial assets had accounted for over 20 percent of their total assets and found that issuers generally complied with the requirements under HKFRS 9 and HKFRS 13. Any omitted disclosures were found to be immaterial to the financial statements as a whole and the HKEx obtained confirmation from issuers that the required information would be provided in future financial reports.

#### *i. Classification of Level 3 Financial Assets*

The HKEx found that the most common investments in level 3 financial assets were unquoted equities, unlisted funds, wealth management products, derivatives and debt instruments and these were always classified at either fair value through other comprehensive income (**FVOCI**) or fair value through profit or loss (**FVTPL**). Some issuers determined the unquoted equity investments were held for trading and measured them at FVTPL. Where they were not held for trading, many issuers had elected to present subsequent change 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 or derecognition.

#### *Recommendations*

Under HKFRS 9, on initial recognition, issuers should classify financial assets as subsequently measured at amortised cost, FVOCI or FVTPL, and the classification should be based on the business model for managing the financial assets and their contractual cash flow characteristics.

The HKEx reminds issuers that they must 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. The HKEx also states that it is important for issuers to provide sufficient information on the critical judgment used to determine the classification of financial assets (HKAS 1R.122).

#### *ii. Valuation of Level 3 Financial Assets*

The HKEx found 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 and transaction price paid for an identical or a similar instrument of an investee.

The HKEx also found that some issuers used the adjusted net asset method in determining the fair values of their investments. The HKEx also noted that many issuers engaged independent valuers to perform the valuations.

The HKEx referred three cases to the Financial Reporting Council (**FRC**) for consideration as there were doubts raised regarding whether the valuations performed were in accordance with HKFRS 13. These concerns arose from inconsistent projected cash flows used in the DCF calculation; the inclusion of substantial projected revenue and cash flows in the financial forecasts when the investee did not generate any revenue and incurred recurring losses over the past years; and the net assets value appearing to be an unreasonable basis as the book value in the P/B multiple computation.

#### *Recommendations*

The HKEx urges issuers to ensure that the valuation technique and the underlying inputs reflect the current market conditions at the measurement date, taking into account the impacts of the Covid-19 pandemic. The HKEx also reminds issuers to conduct regular reviews and updates of existing valuation policies and procedures and discuss with their audit committee, auditors and valuers at an early stage. Directors are also reminded to exercise due and reasonable care, skill and diligence in assessing the valuations of financial instruments and are reminded not to rely solely on professional valuers and other experts.

#### *iii. Fair Value Disclosure of Level 3 Financial Assets*

The HKEx found that many issuers generally complied with the disclosure requirements of HKFRS 13 but considers that

the qualitative disclosure regarding the level 3 measurement (HKFRS 13.93) could be enhanced if issuers provided more entity-specific information i.e., the reasons for changes in the valuation technique and descriptions of the valuation process.

### *Recommendations*

Given the uncertainty stemming from the ongoing Covid-19 pandemic, the HKEx urges issuers to 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. The HKEx also urges 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.

The HKEx also asks issuers to take note of the HKSA 540 (Revised) "Auditing Accounting Estimates and Related Disclosures" (effective for audits of financial statements for periods beginning on or after 15 December 2019). HKSA 540 (Revised) requires auditors to evaluate whether the accounting estimates and related disclosures are "reasonable" in the context of the applicable financial reporting framework, or are misstated.

### **c. Findings regarding other Accounting Areas and Key Reminders for the Upcoming Financial Reporting Period**

The HKEx identified areas of disclosure which are in need of improvement, including:

#### *i. Accounting Policies, Judgments and Estimates*

The HKEx found that accounting policies tended to be generic and, in the case of unusual or non-recurring transactions, were sometimes omitted. Descriptions of critical accounting judgments were also sometimes repeated or referred to in the corresponding policies without elaboration of the specific facts and circumstances.

Accordingly, the HKEx recommends that in preparing the disclosure:

- information should be clear, understandable and entity-specific, not generic; and
- the accounting policies for unusual or non-recurring

transactions carried out during the reporting period should be included.

The HKEx also reminds issuers that disclosure should help investors understand the judgments made about the future and about other sources of estimation uncertainty.

#### *ii. Going Concern (GC) and Liquidity Risk Disclosure*

The HKEx found that some issuers included a discussion in the notes to the financial statements on the issue of going concern in accordance with HKAS 1R.25 and most of their auditors also concluded that there was a material uncertainty and reported this in a separate section under "Material Uncertainty Related to Going Concern". A few auditors were found to have determined and reported the going concern issue as a key audit matter when no material uncertainty existed.

The HKEx further found that for the liquidity risk disclosure, nearly all issuers 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, however the HKEx urges issuers to clearly explain how they manage the liquidity risk.

### *Recommendations*

The HKEx emphasises that the liquidity risk disclosure should be consistent with the assessment of the going concern assumption and given the increased liquidity risk in the current economic situation, issuers are encouraged to reconsider and enhance their disclosure, rather than repeating previously published information. Issuers should also clearly explain the relationship between quantitative and qualitative disclosure about liquidity risk (as required by HKFRS 7.39) in order for investors to understand the nature and extent of the risk and timing of cash flows associated with the financial liabilities.

#### *iii. Capital Disclosure*

The HKEx found that many issuers provided a general description of their objectives, policies and processes for managing their capital and most indicated that their overall capital management strategy had remained unchanged in 2019 and that they will consider adjusting dividend payments to shareholders, issuing new shares or changing the debt levels in order to balance capital structures. The HKEx also found that issuers commonly used financial ratios to analyse their capital structures.

#### *Recommendations*

The HKEx encourages issuers to provide capital disclosure reflecting their own facts and circumstances, including any changes to their capital management and explanations.

#### *iv. Expected Credit Losses (ECLs) and Credit Risk Disclosure*

The HKEx found that most issuers applied the simplified approach in calculating lifetime ECLs for trade receivables by using a provision matrix grouped by past due dates. For the long-term loan and receivable balances, other receivables and related party balances, issuers applied the general approach. In any event, the HKEx found that many issuers briefly described the basis of inputs, assumptions and the estimation techniques used to measure the ECLs (as required by HKFRS 7.35G).

#### *Recommendations*

The HKEx reminds issuers that regardless of the impairment approach adopted, issuers need to reconsider the appropriateness of the past methods and ensure that up to date inputs are used and, where necessary, engage external experts to assist their estimates.

#### *v. Revenue*

2019 was the second year that issuers adopted HKFRS 15 “Revenue from Contracts with Customers”, which establishes a single comprehensive model of accounting for revenue arising from contracts with customers. The HKEx found that most issuers disclosed one or two types of category to disaggregate revenue by using the examples of categories in HKFRS 15.B89 and 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. However, the HKEx found that accounting policies could be improved by providing more entity-specific information.

#### *Recommendations*

As Covid-19 may impact how issuers contract with customers, the HKEx urges issuers to assess the implications on revenue recognition e.g., contract enforceability and collectability of consideration, customer incentives as a contract modification or a change in the estimate of the variable consideration. Issuers are also encouraged to improve descriptions of accounting policies and ensure that these are tailored to the particular

circumstances of the issuer and disclose sufficient information about the judgment and estimates to enable investors to understand the nature, amount, timing and uncertainty of revenue and cash flow arising from contracts with customers.

#### *vi. Leases*

HKFRS 16 “Leases” came into effect for annual periods beginning on or after 1 January 2019 and contains both qualitative and quantitative disclosure requirements for lessees and lessors.

In the 2020 Review, the HKEx found that 213 issuers, with a financial year end date of 31 December 2019, adopted HKFRS 16. The HKEx found that most issuers made adequate disclosure explaining the impact of adopting HKFRS 16 and additionally the HKEx found that:

- most issuers presented the right-of-use assets and lease liabilities on the face of the statement of financial position;
- nearly all issuers disclosed the quantitative information as required under HKFRS 16.53;
- lease liabilities were separately disclosed in the maturity analysis in accordance with HKFRS 7.39; and
- a few issuers provided additional qualitative and quantitative information under HKFRS 16.59.

#### *Recommendations*

The HKEx did not identify any major issues from the review, however issuers are generally reminded to ensure that accounting policies are tailored to their circumstances and descriptions about the judgments or estimates made in the application of the lease accounting policies are sufficiently specific that investors can understand the implications. Issuers are also encouraged to reconsider their existing HKFRS disclosure when determining the extent of disclosure to be included in the next financial reports, in light of Covid-19.

#### *vii. Events after the Reporting Period*

There are two types of events after the reporting date – adjusting events and non-adjusting events. The HKEx found that most issuers with a financial year end date of 31 December 2019 provided a separate “subsequent event” note, disclosing the Covid-19 pandemic as a non-adjusting event and therefore did not have any impact on the carrying value of assets or

liabilities at 31 December 2019. Issuers also cautioned against the impact of Covid-19 on their businesses as the pandemic continued to evolve and forecast a decline in revenue and profit in 2020. A few issuers also drew attention to their liquidity risk disclosure and a few issuers assessed that Covid-19 would have a significant unfavourable impact on them in 2020.

### *Recommendations*

The HKEx recognises that the market is very challenging and continual assessment of the changing circumstances is necessary. Issuers are therefore encouraged to determine whether a subsequent event affects the recognition and measurement of assets and liabilities in the financial statements. Issuers are also recommended to refer to HKAS 10, which provides examples of adjusting and non-adjusting events and are urged to follow the recognition and measurement requirements in accordance with the relevant HKFRSs.

### *viii. Using non-GAAP Financial Measures*

The HKEx identified that there has been an increasing market focus on the use of non-GAAP financial measurements and

in April 2019, the HKEx published Guidance Letter 103-19 providing guidance on the presenting of non-GAAP financial measures in any documents pursuant to the HKEx Listing Rules.

The HKEx found that issuers generally followed the guidance in the five key elements (definitions, prominence, explanations

for using non-GAAP financial measures, reconciliation and nature of adjusting items and comparatives) when presenting the non-GAAP financial measures. The HKEx also found that some issuers used “adjusted” measures of profit where different terms were used.

### *Recommendations*

The HKEx emphasises that financial reports and all other corporate communication should be accurate, complete and not misleading and that non-GAAP financial measures are not prohibited but are not required. Issuers are reminded of the guidance in GL103-19 and are urged to take a holistic view of their current non-GAAP financial measures and consider revising their disclosure.

Issuers are also urged to determine whether, under the current economic environment, non-GAAP financial measures present a fair and balanced view of their performance and positions. HKEx refers issuers to the 29 May 2020 IOSCO Statement on Importance of Disclosure about Covid-19.

Issuers are also reminded that where items are reasonably likely to recur in the foreseeable future or are activities that affected them in the recent past, these items should not be described as non-recurring, infrequent or unusual and more accurate labels should be selected. The explanations on each adjusting item should also be specific enough to their facts and circumstances.

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