Charltons - Hong Kong Law - 11 June 2018

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Hong Kong Stock Exchange Reports on Financial Statements Review 2017

The Hong Kong Stock Exchange released its [**Financial Statements Review Programme Report  2017**](http://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Exchanges-Review-of-Issuers-Annual-Disclosure/frm_17.pdf?la=en) on 1 June 2018.  The report sets out the Stock Exchange’s key findings on compliance with accounting standards and disclosure requirements under the Listing Rules and Companies Ordinance based on a review of 100 financial reports issued between February 2017 and April 2018. The Stock Exchange highlighted the importance of the following:

**1.    Providing investors with a meaningful management commentary**

Management Discussion and Analysis (**MD&A**) and Business Review sections should contain information necessary for investors to evaluate the issuer’s performance, financial position and future prospects so that shareholders’ value can be enhanced.

The Stock Exchange reminded issuers of the need to consider all key aspects of performance, identify major components of growth or profit or reasons for incurring losses, and provide an adequate explanation of performance (for example rather than merely stating figures, issuers should  discuss the underlying causes of changes).  Information disclosed in the MD&A should be relevant, material, prioritised appropriately, clearly and simply presented, and be consistent with information disclosed in other sections of the report.  Material facts and disclosures should not be omitted, glossed over or obscured with unnecessary immaterial information.

Disclosure of principal risks and uncertainties in the Business Review should include a clear, comprehensive and entity-specific description of the principal risks, likelihood of the risks, potential impact on the issuer, how the risks are being managed and mitigated, and where applicable, why the assessment of principal risks changed.  A wide range of circumstances should be considered when identifying the principal risks and uncertainties, for example:

* *Cyber risk and security*: issuers should explain how they have considered cyber risk and what discussions concerning cyber risk and security have been held;
* *Data fraud or theft*: issuers should explain how they have evaluated their internal controls to avoid the misuse of critical information through data fraud or theft; and
* *Environmental and social risks*: issuers should carefully consider whether any environmental and social risks (including climate change and natural disasters, environmental regulations, outbreak of contagious diseases, staff attraction and retention) are relevant, and where they are, explain how these risks affect their businesses across different segments and geographical locations.

Issuers that include key performance indicators (**KPIs**) and non-Hong Kong Financial Reporting Standard (**HKFRS**) financial measures, should ensure that these financial measures are not misleading, do not obscure their financial results and financial position, and do not provide an incomplete description of their financial results based on accounting standards.  Issuers should define KPIs and non-HKFRS financial measures clearly with accurate and meaningful labels, explain the reason for using such measures, not use such measures to avoid disclosing adverse information to the market, not present such measures more prominently than the HKFRS measures, reconcile such measures to comparable HKFRS measures with clear explanation of any adjustments, and present comparative measures consistently over time.

Where financial statements include balances or transactions that are unusual or material due to their nature, size or incidence, the issuer should include adequate information in the MD&A to enable investors to understand these balances and transactions.

In the context of disclosure, issuers should assess materiality.  Where an omission or misstatement of information would likely influence or change a reasonable investor’s investment decision, the information is likely to be considered to be material.  Materiality applies to both quantitative and qualitative information disclosed in the MD&A.

**2.    Judgements and estimates**

Each year, an issuer should ensure that its management holds a thorough discussion with the Audit Committee and auditors, during which the management explains the judgements of key assumptions underlying critical accounting estimates.  This is important given the significant impact a judgement or estimate may have on the financial statements’ key balances.

**3.    Assessing impairment of tangible and intangible assets**

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

Further, directors should critically assess and make sure that management and staff responsible for financial reporting have the necessary qualifications, experience, expertise and time to conduct impairment testing.  Directors should also consider whether external experts, such as professional valuers, should be engaged.

Where professional valuers are involved in impairment testing, directors and management are responsible for performing proper analysis and exercising independent judgement to assess the reasonableness of key assumptions applied so that assumptions (including growth rates and discount rates) are not overly optimistic, especially if the issuer is loss-making or experiencing material deterioration in revenue, net profits or gross profit margin.  Directors and management should not rely solely on professional valuers or other experts.

**4.    Accounting for acquisitions**

Where an issuer completes an acquisition, it must exercise care in determining whether the transaction constitutes a business combination or an asset acquisition. To qualify as a business combination, the activities and assets acquired must constitute a business.  The accounting treatments for a business combination and for an asset acquisition are very different.  An issuer that is an acquirer in a business combination should ensure that all identifiable assets are properly identified and recognized in order for goodwill or a gain on bargain purchase to be accurately measured.

**5.    Impact of applying key HKFRSs in issue but not yet effective**

Information concerning the estimated impact of new and amended standards should become more accurate closer to the effective date.  Issuers should not include generic boilerplate disclosures, and information on the impact of new or amended HKFRSs should be more tailored and granular.

Two major standards, HKFRS 9 “Financial Instruments” and HKFRS 15 “Revenue from Contracts with Customers”, are effective for annual periods commencing on or after 1 January 2018.  However, issuers significantly impacted by these standards should have disclosed more entity-specific qualitative and quantitative information in relation to these standards in their annual reports for the year ended 31 December 2017, including the stage of implementation they are at, accounting policy choices expected to be applied by management, and the amount and nature of expected impacts for financial statement line items affected.  Issuers with a financial year end of 31 December must apply HKFRS 9 and HKFRS 15 in their 30 June 2018 interim financial statements.

HKFRS 16 “Leases” will be effective for annual periods commencing on or after 1 January 2019.  Issuers should progressively provide more entity-specific qualitative and quantitative information in relation to such standard for the 2018 reporting period.

**6.    New auditors’ reporting**

Hong Kong Standard on Auditing (**HKSA**) 720 “The Auditor's Responsibilities Relating to Other Information” was revised for audits of financial statements for periods ending on or after 15 December 2016.  Under this revised standard, auditors are required to consider whether there is any material inconsistency between (i) the Other Information (financial or non-financial information, other than financial statements and the auditor’s report thereon, included in an annual report) and (ii) the financial statements or the auditors’ knowledge obtained in the audit; and report on whether there is any uncorrected material misstatement in the Other Information.

Issuers should communicate with their auditors about: (i) which documents comprise the annual report and will be within the scope of Other Information, and thus within the scope of the auditors’ responsibilities; and (ii) a comprehensive timetable of when Other Information will become available to the auditors for their consideration so that they can complete the necessary procedures pursuant to HKSA 720 (Revised) before the date of the audit report.

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