The Stock Exchange of Hong Kong Limited (HKEx) published a report on Review of Issuers’ Annual Report Disclosure in January 2020. The review is a monitoring programme in which HKEx examines annual reports’ compliance with the Listing Rules, issuers’ corporate conduct and the disclosure of material events and developments. The consistency and materiality of disclosure compared to disclosures made in announcements and circulars are also assessed.

The Financial Statements Review Programme is also used to encourage high standards of financial disclosure.

Based on its review, HKEx recommends the following:

- Listed issuers should disclose the use of proceeds from fundraisings, information about any guarantee regarding the financial performance of an acquired business and a breakdown of investments (these were formerly recommended disclosures that are now required under the Listing Rules);
- Listed issuers should make clear disclosures of risk areas such as major regulatory or government policy changes, as well as the impact that such changes have on their operations, business plans and, where applicable, their financial performance;
- Where audit modifications are in place, listed issuers should work with their auditors towards removing those modifications. Noting a higher number of audit modifications on asset valuations of receivables and deposits, HKEx recommends recording asset impairments according to a credit loss policy supported by historical loss information and adjusted by forward-looking economic factors;
- Listed issuers should disclose the expenses grouped under “other expenses”;
- Directors and management of listed issuers should make sure that their assumptions are not too optimistic when impairment testing is performed on intangible assets, and sufficient information on the key assumptions must be disclosed; and
- Any non-GAAP\(^2\) financial measures should be unbiased, clearly defined and consistently presented. They should not be presented more prominently than GAAP measures. Where adjustments are likely to recur, they should not be described as non-recurring, infrequent or unusual without sufficient explanation.

HKEx’s review covered annual reports for the financial year of 2018, focusing on the following specific areas of disclosure:

- fund raisings through issue of equity / convertible securities and subscription rights;

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2 Generally Accepted Accounting Principles
updates on material asset impairments and results of performance guarantees after acquisitions;

continuing connected transactions;

disclosure of business review and significant investments in the management discussion and analysis (MD&A) section;

financial statements with auditors’ modified opinions;

disclosure on material other expenses / income; and

issuers listed under the new listing regime for weighted voting rights and biotech companies.

i) Fundraisings through issue of equity / convertible securities and subscription rights

The Listing Rules require annual reports to disclose details of the issuer’s equity fundraisings. In addition to the terms, size and the use of proceeds of each equity issue, issuers must also include:

a) a breakdown and description of the proceeds and how they are used during the financial year of the annual report;

b) a breakdown and description of the intended use of any unutilised proceeds with the expected timeline of their use; and

c) whether the proceeds were (or are proposed to be) used in the way that the issuer had disclosed previously (and the reasons for any material changes in their use).

The above disclosures were recommended disclosures until 3 July 2018 when they were codified as requirements under the amended Listing Rules. HKEx treated these disclosures as a matter of Listing Rule compliance when assessing annual reports published after that date, and as a matter of making recommended disclosures for annual reports published before that date.

HKEx found that most issuers complied with the above disclosure requirements. Issuers that did not comply fully had neglected to describe the intended use of the unutilised proceeds and/or the expected timeline of their use, but made those disclosures later in announcements or financial reports after HKEx’s review. Few issuers disclosed changes in the use of proceeds. HKEx did not identify any major issues resulting from the changes.

HKEx noted that the level of issuers’ compliance did not improve even after the disclosures became mandatory from 3 July 2018.

ii) Updates on material asset impairments after acquisitions

Annual reports are required to disclose information on acquired businesses, including any material impairments of assets of those businesses, in the MD&A section. HKEx recommends disclosing the basis of any independent evaluations that support such impairments, including:

a) details of the inputs used for the valuation, including the bases and assumptions for them;

b) reasons for any significant changes from previous inputs and assumptions;

c) the valuation method and the reasons for using it; and

d) an explanation of any changes to the valuation method adopted.

HKEx found that issuers generally attributed impairments on acquired assets to geopolitical factors, industry downturns, changes in government policy or regulation, or factors specific to the acquired business. Issuers that did not discuss reasons for the impairments in their annual reports did so in supplemental announcements. Most issuers had independent valuations performed on the acquired assets while others chose to conduct internal assessments instead. Most issuers disclosed the required information on the impairment of acquired assets in their annual reports, but those that did not made the disclosures in supplemental announcements in response to HKEx’s enquiries.

In respect of the impairment of assets other than acquired assets, issuers generally disclosed the justification and basis of those impairments in their annual reports. Some of these disclosures were supported by independent valuations, most of which included the four types of information mentioned above. Generally, issuers made timely asset impairment disclosures, whether the assets were from an acquired business or not.
iii) Results of performance guarantees after acquisitions

In an acquisition where the vendor provides a performance guarantee for the acquired business, the Listing Rules require issuers to disclose such guarantees in an announcement and the next annual report. The issuer must also disclose the actual performance of the acquired business and whether the performance guarantee was met. If the guarantee was not met, the issuer must disclose in an announcement how the guarantor’s obligations under the acquisition agreement (e.g., compensation for the performance shortfall, adjustment of the transaction’s consideration or buying back the business from the issuer) will be enforced. These disclosure requirements were previously recommended disclosures that have been codified into the Listing Rules with effect from 1 October 2019.4

HKEx found that performance guarantees were confirmed to have been met in more than half of the reviewed annual reports. In cases where the guarantees were not met, most of the issuers were compensated according to the terms of the acquisition agreements. In most of the other cases, the issuers took action against the vendors (including legal action) to enforce the guarantees. HKEx found that the issuers kept their shareholders informed of the rationale and status of these actions. Overall, the majority of issuers followed HKEx’s performance guarantees disclosure recommendations in their annual reports.

iv) Continuing connected transactions

The Listing Rules require issuers to disclose their connected transactions, including continuing connected transactions, in their annual reports.5 Each year, independent non-executive directors (INEDs) and auditors must review the issuer’s continuing connected transactions and confirm whether they were made:

- a) in the ordinary and usual course of business of the listed issuer’s group;
- b) on normal commercial terms or better; and
- c) according to the agreement governing them on terms that are fair and reasonable and in the interests of the listed issuer’s shareholders as a whole.6

Issuers must have adequate internal control procedures in place to ensure that their continuing connected transactions are conducted in accordance with the framework agreements’ pricing policies or mechanisms. To assist their INEDs’ annual review, the issuer’s internal audit function should review the continuing connected transactions and internal control procedures. The INEDs should ensure, inter alia, that:

- a) the issuer’s methods and procedures are sufficient to ensure that the transactions will be conducted on normal commercial terms and not prejudicial to the interests of the issuer and its minority shareholders;
- b) appropriate internal controls are in place;
- c) the internal audit function would review the transactions; and
- d) the issuer’s management provides them with sufficient information to discharge their duties.7

HKEx found that issuers generally had reasonable internal controls in place to identify connected persons, ensure that the pricing terms of transactions were in accordance with pricing policies or mechanisms, and to monitor transaction amounts to ensure that they do not exceed the annual caps.

All issuers engaged professional third parties to assess their internal controls, and most issuers required their internal audit functions to review their continuing connected transactions periodically.

In HKEx’s review, all INEDs considered their issuers’ internal controls to be properly implemented and effective, although some made recommendations for improvements. All issuers within the review that had proposed remedies for their previous non-compliance with the Listing Rules concerning continuing connected transactions had implemented those proposals.

HKEx found that issuers generally provided their INEDs with relevant information, which the INEDs confirmed to be sufficient for their annual reviews. Only a few issuers’ INEDs reported delays in obtaining relevant information.

In response, the INEDs recommended new internal guidelines to improve internal communication.

Some issuers’ INEDs performed additional work, including:

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4 Main Board Listing Rule 14.36B and paragraph 6.3(i) of Appendix 16, and GEM Listing Rule 19.36B and note 4(h) to 18.07
5 Chapter 14A of the Main Board Listing Rules and Chapter 20 of the GEM Listing Rules
6 Main Board Listing Rule 14A.55 and GEM Listing Rule 20.53
7 HKEx Guidance Letter GL73-14
a) reviewing transactions and internal controls with the audit committee, management and internal auditors;

b) reviewing quarterly reports on transactions and annual caps; and

c) reviewing lists of connected persons.

HKEx noted that most issuers complied with the Listing Rule requirements to disclose their continuing connected transactions and the findings of the INEDs’ and auditors’ review of those transactions in their annual reports.

v) Disclosure of business review and significant investments

The Listing Rules require issuers to include a business review in the MD&A section of their annual reports.

The business review must contain, inter alia:

a) a fair review of the issuer’s business;

b) the principal risks and uncertainties the issuer is facing;

c) important events affecting the issuer; and

d) likely future developments in the issuer’s business.\(^8\)

HKEx reiterated the need for annual reports to disclose regulatory or governmental policy changes and to discuss the impact of those policy changes on the issuers’ financial performance. Issuers must disclose their significant investments, including those that represent 5% or more of their total assets, in accordance with the Listing Rules.

vi) Financial statements with auditors’ modified opinions

The Listing Rules were amended so that, with effect from 1 September 2019, trading in an issuer’s securities would be suspended if the issuer published preliminary financial results where the auditor issued (or indicated it would issue) a disclaimer or adverse opinion on the issuer’s financial results.\(^10\) The suspension will be lifted if the issuer addresses the underlying issue. Otherwise, the suspension may lead to the issuer’s delisting.

HKEx recommends that issuers that have received modified opinions on financial statements make the following disclosures in their annual reports:

a) details of the modifications and their actual or potential impact on the issuer’s financial position;

b) management’s position and basis on major judgmental areas (e.g. basis for impairment and valuation of assets) and the difference between management’s view and the auditors’ view;

c) the audit committee’s view on the modified opinion and whether they reviewed and agreed with management’s position on major judgmental areas; and

d) the issuer’s plans to address the modifications.

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\(^8\) Schedule 5 of the Companies Ordinance

\(^9\) Paragraphs 32(4) and (4A) of Appendix 16 to the Main Board Listing Rules and GEM Listing Rules 18.41(4) and (4A)

\(^10\) Main Board Listing Rules 13.50A and 13.50B and GEM Listing Rules 17.49B and 17.49C
29 of the annual reports that HKEx reviewed contained modified opinions from auditors for the first time and only one third of these issuers made the above recommended disclosures in full. Further, 63 of the annual reports that HKEx reviewed had repeated modified opinions and of these issuers, 38 had resolved all the issues underlying the audit modifications (of which 6 received modified opinions for new issues) and 25 did not resolve all the underlying issues.

HKEx noted that issuers generally followed their disclosure recommendations regarding modified audit opinions. However, most issuers with repeated modified opinions did not disclose the actions that they took to resolve the underlying issues and whether they had followed their plans to resolve those issues.

Issuers with audit issues related to valuation of assets should discuss their valuation methodologies and assumptions with their auditors. Additionally, issuers with internal control issues or going concern modifications must make the necessary disclosures in their Corporate Governance Reports.

vii) Disclosure on material other expenses / income

Annual reports must include a discussion and analysis of the issuer’s performance during the financial year, highlighting the material underlying factors, trends and significant events or transactions. The issuer must describe the nature of and explain the movements of material items in the annual report.

HKEx found that half of the annual reports reviewed provided a breakdown for all or most of their “other / other operating expenses” in the notes to the financial statements. Such expenses include advertising expenses, travelling expenses, losses on asset impairments, auditors’ remuneration, legal and professional expenses and operating lease charges. All annual reports reviewed that reported material “other / other operating income” provided a breakdown of that income.

viii) Issuers listed under the new HKEx listing regime for WVR and biotech companies

In April 2018, the Listing Rules were amended to allow the listing of companies with weighted voting rights (WVR) structures and biotech companies that do not meet financial eligibility tests under Main Board Listing Rule 8.05.

Chapter 8A of the Listing Rules sets out additional restrictions and corporate governance requirements in relation to WVR shares and issuers, namely:

a) A WVR issuer cannot increase the proportion of its WVR shares after listing. New WVR shares must be issued under a pre-emptive offer to all shareholders or other pro-rata arrangements (where the number of shares in issue is reduced, the WVR beneficiaries must reduce their WVR shareholding proportionately);

b) WVR beneficiaries can only vote on a “one-share one-vote” basis on material corporate matters;

c) A beneficiary with WVR in an issuer must cease to have that WVR if he or she is no longer suitable to be a director of the issuer or transfers his or her interest in the WVR shares (or control over the WVR attached to the shares) to another person.

d) A WVR issuer must establish a Corporate Governance Committee comprising only INEDs. This committee is responsible for providing oversight and performing the following duties:

- confirm whether the above requirements have been complied with each year;
- review and monitor whether the issuer is operated for the shareholders’ benefit;
- review and monitor the management of conflicts of interests with WVR beneficiaries and all risks related to the WVR structure, and make recommendations to the board on such matters;
- recommend the appointment or removal of the compliance adviser; and
- ensure effective and ongoing communication between the WVR issuer and its shareholders.

A WVR issuer must include a summary of the Corporate Governance Committee’s work in the Corporate Governance Report, as well as a warning in the annual report that the issuer is controlled through a WVR structure. The warning must include a description of the WVR structure, the rationale for it, its associated risks for shareholders, the identities of the WVR beneficiaries, the impact of converting WVR shares into ordinary shares and all circumstances where the WVR will cease.
HKEx reviewed the annual reports of two WVR issuers. Both companies established Corporate Governance Committees and disclosed their respective committees’ work in their Corporate Governance Reports. In both cases, the Corporate Governance Committees reported that the issuer complied with the Listing Rules in relation to WVR issuers. One WVR issuer disclosed that it converted some of its WVR shares into ordinary shares to compensate for the share repurchases that it made during the year.

The annual reports of biotech companies must disclose the details of key stages for each of their core products under development to reach commercialisation, as well as the likely timeframe for successfully reaching commercialisation. The annual report must include a summary of research and development expenditure and a warning that their core product(s) may not ultimately be successfully developed and marketed. HKEx reviewed the annual reports of six biotech companies and found that they all made the required disclosures. Some biotech companies included additional information such as post-commercialisation developments of their core products and major developments of newly in-licensed or non-core products.

2. Exchange Monitoring of Issuers Listed in 2017 and 2018

HKEx reviewed the post-listing corporate activities, Listing Rules compliance and annual report disclosure of newly listed issuers (i.e. issuers listed in 2017 and 2018).

i) Post-listing corporate activities

HKEx found that 20 newly listed issuers had undertaken significant corporate actions, including 15 issuers whose original controlling shareholders of the newly listed issuers disposed of their controlling interests; five issuers that made material acquisitions of new businesses; and two issuers that reallocated their IPO proceeds to new businesses.

HKEx also found proposed transactions/arrangements that would circumvent the new listing requirements. One issuer attempted a backdoor listing by way of a very substantial acquisition of a business that would represent a large part of the enlarged issuer’s group, even though it might not be eligible for listing. Another issuer went through a significant change in control and directorship shortly after the end of the lock-up period and introduced a new service that is unrelated to the original business, had no track record and would be ineligible for listing, but would constitute a significant part of the issuer.

ii) Profit forecasts and material decrease in financial results

Most newly listed issuers did not include a profit forecast in their prospectus, but those that did were able to achieve their forecasted profits. Two thirds of the profit forecasts differed materially from the issuers’ actual financial results, mostly due to increased expenses or market downturns after listing and most of these issuers accounted for this deviation in their profit warning announcements. Half of the issuers under review did not quantify the financial impact to their profits in their profit alert announcements.

HKEx reminds issuers to observe the guidance set out in the Securities and Futures Commission’s Corporate Regulation Newsletters.11 12

iii) Changes in the use of IPO proceeds

When HKEx assesses a listing applicant’s suitability for listing, it reviews the applicant’s proposed use of proceeds.

If a newly listed issuer changes its use of proceeds shortly after listing, HKEx assesses whether it has explained all material changes in an announcement in a timely and proper manner. It was noted that generally, issuers that changed their proposed use of IPO proceeds justified them with reasons related to failures to identify acquisition targets, unexpected declines in businesses that were supposed to be expanded and changes in market or regulatory policy.

Only one issuer failed to provide an explanation for the changes in a timely manner and another issuer delayed its announcement of the changes for approximately a year until its annual report was published, and may have made inaccurate disclosure in its quarterly and interim results, announcements and reports.

iv) Non-compliance with the Listing Rules after listing

HKEx noted an increase of non-compliance with the Listing Rules among newly listed issuers, including 29 cases of non-compliance with notifiable and connected transaction requirements, 8 cases of non-compliance with financial reporting or results announcements requirements, and other cases such as failure to meet the minimum public float or directors’ non-compliance with dealing restrictions during the black-out period.

HKEx reminded issuers to consult their compliance advisers in relation to matters of Listing Rules compliance.

v) Fulfillment of conditions or undertakings imposed or provided before listing

HKEx found that all newly listed issuers that were required to provide undertakings to take certain actions had, as required, disclosed in the annual report whether or not those undertakings were fulfilled. Major shareholders are required to provide a non-competition undertaking to issuers and most of the newly listed issuers received that undertaking from their major shareholders.

However, it was noted that a few of those issuers did not disclose their major shareholders’ annual declarations to comply with their non-competition undertakings and the steps they took to do so.

3. Accounting Review of Financial Statements

HKEx reviewed the financial statements of 300 listed issuers to assess their compliance with applicable accounting standards.

i) Material intangible assets

HKAS\(^{13}\) 36, HKAS 38 and HKFRS\(^{14}\) 3 set out the recognition, measurement and disclosure requirements for intangible assets. HKEx did not find any significant non-compliance with the requirements under those standards.

Disclosures on the reasonableness of financial budgets and assumptions for determining recoverable amounts

Most issuers had goodwill and intangible assets with indefinite useful lives, which would undergo impairment tests each year. In most cases, the recoverable amounts of cash-generating units to which goodwill and intangible assets were allocated were determined using the value in use calculation.

HKEx noted cases where impairment of these assets may have occurred but were not recorded such as when the group or the cash-generating units suffered recurring operating losses or declining revenue, net profit or gross profit margin, or when the carrying amount of net assets was substantially greater than the issuer’s market capitalisation.

HKEx reminded issuers that directors and management should be responsible for ensuring that the key assumptions used in impairment testing are not overly optimistic. The audit committee should ensure that sufficient analysis (e.g. sensitivity analysis of the key assumptions) had been performed. If an independent valuer is engaged to determine the recoverable amount, independent judgment should be exercised when relying on the valuation report.\(^{15}\)

HKEx recommends issuers to disclose:

- a) the headroom available and/or the recoverable amount of the asset or cash-generating unit;
- b) an explanation of what management considers to be “reasonably possible” changes in key assumptions and the judgments and estimates involved; and
- c) information required by HKAS 36.134(f) where the reasonably possible change in key assumptions would reduce the headroom to nil, causing an impairment loss to be recognised (or a negative statement that it would not cause an impairment loss to be recognised).

Disclosure on the assessment of intangible assets with indefinite/long useful lives

HKEx noted that issuers generally did not provide specific disclosure on how they determined intangible assets to have indefinite or long useful lives. HKAS 38.90 sets out some of the factors to be considered to determine the useful life of an intangible asset:

- a) the expected usage of the asset by the entity and whether the asset could be managed efficiently by another management team;
- b) typical product life cycles for the asset and public information on estimates of useful lives of similar assets that are used in a similar way;
- c) technical, technological, commercial or other types of obsolescence.\(^{16}\)

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13 Hong Kong Accounting Standard
14 Hong Kong Financial Reporting Standard

\(^{15}\) Paragraph 11 of the Guidance Note on Directors’ Duties in the Context of Valuations in Corporate Transactions

\(^{16}\) HKAS 38.92 states that computer software and other such intangible assets are susceptible to technological obsolescence and often have short useful lives.
d) the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset;

e) expected actions by competitors or potential competitors;

f) the level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the entity’s ability and intention to reach such a level;

g) the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases;17 and

h) whether the useful life of the asset is dependent on the useful life of other assets of the entity.

HKEx reminds issuers to disclose their reasons for determining any intangible asset to have an indefinite useful life, as well as the key judgments made by management. The financial statements should highlight the fact that an annual review has been performed to support the issuer’s assessment of the useful life of its assets, particularly intangible assets with indefinite or long useful lives.

**Disclosure on accounting for business combinations**

HKEx noted significant amounts of goodwill recognised by issuers as a result of business combinations. In these cases, issuers disclosed the purchase of intangible assets, but recognised them only as goodwill. HKFRS 3R.10 requires intangible assets to be recognised separately from goodwill and at their fair value on their respective acquisition dates, even if they were not recognised separately by the acquiree. Issuers should reassess and account for all the acquired assets and assumed liabilities before recognising a gain on a bargain purchase. Clear and specific disclosure is required as to the factors that comprise the recognised goodwill and the reasons for how the gain on a bargain purchase resulted from the acquisition.

**Impairment of financial assets**

Under HKFRS 9, an allowance for loss called expected credit loss (ECL) is recognised before losses from impairment are incurred. Generally, the allowance is measured as lifetime ECLs where the asset’s credit risk has increased significantly since the initial recognition. Otherwise, it is measured as 12-month ECLs. The loss allowance for certain financial assets is always equal to lifetime ECLs.

HKEx emphasises the need to provide sufficient qualitative and quantitative information to evaluate the ECLs that the issuer chose to recognise. HKFRS 7.35G requires issuers to explain the basis of the inputs, assumptions, and estimation techniques they used to:

- a) measure 12-month and lifetime ECLs;
- b) determine whether the credit risk of their financial instruments has increased significantly since the initial recognition; and
- c) determine whether their financial assets are credit-impaired.

Issuers must explain how they used forward-looking information in determining ECLs and explain any changes to their estimation techniques or significant assumptions and the reasons for those changes. If a provision matrix was used to calculate ECLs, it should be disclosed. Additional information on any material balances on receivables should be included in the MD&A section or the financial statements.

**Fair value measurement of equity investments**

There are three categories of financial asset classification under HKFRS 9:
a) amortised cost;

b) fair value through other comprehensive income (FVOCI); and

c) fair value through profit or loss (FVPL).

Under HKFRS 9.4.1.4, financial assets are measured at FVPL unless they are held to collect contractual cash flows, in which case they are measured at amortised cost, or held to collect contractual cash flows as well as for sale, in which case they are measured at FVOCI.18 However, at initial recognition, management may make an irrevocable election to recognise subsequent changes in the fair value of an equity investment through other comprehensive income, provided that the investment is not held for trading. If the equity investment is held for trading, the changes in its fair value are recognised through profit or loss.

HKEx found that most of the issuers under review had re-measured their equity investments at fair value after adopting HKFRS 9. A few issuers reported that the costs of some of their unquoted equity investments were used as approximate estimates of their fair values as HKFRS B5.2.3 allows where “insufficient more recent information is available to measure fair value”.

HKEx reminded issuers to determine fair values of the equity investments on an ongoing basis with extensive disclosure on recurring fair value measurements. Key disclosure requirements under HKFRS 13.93 include:

a) descriptions of the valuation techniques and inputs used in the fair value measurement;

b) quantitative information on significant unobservable inputs used in the fair value measurement;

c) narrative descriptions of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement;

d) disclosures of any situation where changing one or more unobservable inputs (to reflect reasonably possible alternative assumptions) would change a fair value significantly, the effect of those changes and how those changes were calculated; and

e) descriptions of the valuation processes and policies.

Further guidance can be found in the Securities and Futures Commission’s guidance note on directors’ duties in the context of valuations in corporate transactions19 and the International Financial Reporting Standards Foundation’s illustrative examples of measuring the fair value of unquoted equity instruments.20

iii) Financial reporting in relation to revenue

HKFRS 15 sets out the disclosure requirements in relation to issuers’ revenue from contracts with customers, replacing HKAS 18 and HKAS 11 with effect from 1 January 2018.

In its review of 300 issuers, HKEx found that 230 issuers had adopted HKFRS 15 by the end of 2018, and most issuers complied with the disclosure requirements.

Disaggregation of revenue

HKFRS 15.114 requires revenue to be disaggregated to depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. HKEx found one case where the reported revenue was not disaggregated based on the timing of the revenue even though the issuer disclosed that some of its revenue was recognised at point in time while the rest was recognised over time. Inconsistencies such as this may suggest that the issuer has not complied with the disclosure requirement.

Contract balances

HKEx found that many issuers disclosed the relationship between the timing of performing their contracts and the timing of the corresponding payment. They also disclosed the effect of these factors on their contract assets and contract liabilities in the accounting policies section, but were usually brief or omitted in the financial statements or MD&A.

18 HKFRS 9.4.1.2 and 9.4.1.2A
iv) Disclosure of possible impact of applying a new or amended HKFRS in issue but not yet effective

HKAS 8.30 requires that when an entity has not applied a new or amended HKFRS in issue but is not yet effective, it should disclose this fact and known or reasonably estimable information relevant to assessing the potential impact the application of the new HKFRS will have on the entity’s financial statements in the period of initial application.

Further, HKAS 8.31 states an issuer should consider disclosing the nature of the impending changes in account policy and the dates it plans on applying the new standard.

One example of a new HKFRS noted is HKFRS 16 “Leases”, applicable to annual periods beginning on or after 1 January 2019.

HKEx reminded issuers to disclose the following in their interim and annual reports:
- a) The fact they have substantially completed their implementation analyses and stage of implementation they are at;
- b) Accounting policy choices expected to be applied by the management; and
- c) Amount and nature of expected impacts for financial statement line items affected.

HKEx also reminded issuers that when a new or amended standard is adopted initially in a financial period or years, they should make disclosures in accordance with HKAS 8.28 and HKAS 34. In previous years, HKEx has recommended:
- a) Clearly providing key judgements made by management in applying requirements of new or amended standards;
- b) Quantitative disclosures with information and explanations of changes, tailored to issuers’ circumstances and transactions;
- c) Providing an explanation on how the transition has been implemented; and
- d) Ensuring the application and implementation of the new standards are in accordance with the accounting requirements and issuers early consult auditors.

HKEx reviewed the disclosure of the expected impact of HKFRS 16 in annual reports of 300 issuers and found the majority of issuers followed the requirements of HKAS 8 and HKEx recommendations to disclose the expected impact of adopting HKFRS 16 in their annual reports.

The following information was provided by issuers:
- a) A description of the requirements of HKFRS 16 and the change of accounting policy for leases;
- b) The date they planned to adopt HKFRS 16 initially and transition provisions;
- c) Cross-reference to the note to financial statements regarding the operating lease commitments;
- d) Qualitative information of the impact of adopting HKFRS 16 on the financial statements; and
- e) Some issuers disclosed quantitative information of the impacts.

Having regard to the review, HKEx reiterate the importance of disclosing he expected impact in order to allow investors to gain an understanding of the impacts and emphasise disclosure should include entity-specific qualitative and quantitative information about the expected impacts.

v) Using Non-GAAP Financial Measures

Non-GAAP financial measures are often used in annual reports and HKEx note the increasing market focus on the use of such, with a guidance letter on the presentation of non-GAAP financial measures published in April 2019.

The key elements for presenting non-GAAP financial measures are as follows:
- a) Define each non-GAAP financial measure and explain the basis of calculation;

b) Distinguish non-GAAP financial measures from GAAP measures;

c) Do not present non-GAAP financial measures with more prominence than the most directly comparable measure calculated and presented in accordance with GAAP;

d) Set out the reasons for presenting the non-GAAP financial measures and why the information is useful to investors;

e) Provide a quantitative reconciliation from the non-GAAP financial measure to the most directly comparable GAAP measure presented in the financial statements and explain adjustments; and

f) Present comparatives and disclose non-GAAP financial measures consistently over time.

HKEx noted that in most cases non-GAAP financial measures were presented comparably to or less prominent than GAAP measures and some were presented side-by-side. HKEx also emphasised that non-GAAP financial measures should not precede comparable GAAP measures.

Explanations for using non-GAAP financial measures

HKEx noted that disclosure varied significantly and the following were the main reasons issuers used non-GAAP financial measures:

a) Internal use of the measures;

b) Belief that measures provided supplementary information to assess issuers’ performance; and

c) Measures were commonly issued in the issuers’ industries or by peers.

HKEx also noted that some issuers provided full explanations of the use, while others provided short or generic reasons. HKEx cautioned against generic disclosure and outlined that a good explanation should explain why a non-GAAP financial measure is useful, helpful or meaningful.

HKEx also noted that a caution statement to remind investors that non-GAAP financial measures were not defined under GAAP and not intended as a substitute for GAAP measures was helpful for investors as it brings the limitations to their attention.

Reconciliation and nature of adjusting items

HKEx noted that most issuers provided the reconciliation that began with GAAP figures and reconciled to non-GAAP figures, with 37 issuers using “adjusted” measures of profit, and reconciliations always being presented in table form with comparatives.

HKEx found that some issuers described the adjusting items as “non-recurring, infrequent or unusual” and the explanations did not provide adequate justification. HKEx emphasised that issuers should be cautious in describing the adjusting items as such and should provide explanations on each adjusting item specific to the issuer’s facts and circumstances.

Comparatives

HKEx found that the majority of reports provided comparatives.
Following review, HKEx reminded issuers of the following:

a) Issuers should take note of the requirement that corporate communication should be accurate, complete and not misleading (MB Rule 3.12(2) / GEM Rule 17.56(2));

b) The board is required to present a balanced, clear and understandable assessment in annual and interim reports and other financial disclosure (Code Provision C.1.5);

c) Non-GAPP financial measures are not prohibited or required and regard should be had to Guidance Letter22 HKEX-GL103-19 on the presentation of non-GAAP financial measures;

d) Issuers should establish written policies to provide a guideline to follow when preparing and presenting non-GAAP financial measures to promote consistency in presentation and the way they are calculated; and

e) The audit committee is recommended to assess management’s reasons for presenting non-GAAP financial measures, the sufficiency of the related disclosure, and determining whether measures present a fair and balanced view of the issuer’s performance.

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