Hong Kong Capital Markets Update

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Summary of the Hong Kong Stock Exchange's review of listed issuers' financial reports

On 1 June 2018, the Hong Kong Stock Exchange (the Exchange) published its ninth report under the Financial Statements Review Programme (FSRP). The report summarises key findings from the FSRP, based on a review of 100 periodic financial reports released by listed issuers between February 2017 and April 2018.

Listed issuers were selected via a risk-based approach and were assessed according to their compliance with the disclosure requirements of the Listing Rules, accounting standards and relevant disclosure requirements of the new Companies Ordinance (Cap. 622). (the New CO).

In addition, the report contained an industry-specific review, which in this edition, was based on the annual reports of 22 selected issuers focusing on industrial engineering.

The Exchange is encouraging listed issuers to take note of the report's key discussion points in order to ensure that their finance departments have the necessary resources and training to perform their financial reporting role.

Key areas for focus and improvement

Providing investors with meaningful management commentary

Listed issuers should provide meaningful commentary for the benefit of investors in their Management Discussion and Analysis (MD&A) and Business Review to enhance shareholder value. In addition, key areas highlighted in last year's report relating to (i) adequate explanation of performance; (ii) commentary on significant balances and transactions; (iii) expalanation of principal risks facing the business; and (iv) using key performance indicators are still applicable.

The Exchange also outlined a number of areas relating to the identification of principal risks and uncertainties:

- *Cyber risk and security:* elaborate on how cyber risk has been considered and what discussions on cyber risk and security were held
- *Data fraud or theft:* elaborate on how internal controls have been evaluated to prevent critical information from being misused through data fraud or theft
- *Environmental and social risks:* consider whether environmental and social risks are relevant and elaborate on how such risks would affect their businesses across different segments and geographical locations.

Most commonly omitted or incomplete disclosures

- Some of the minimum disclosures required by paragraph 32(1) to 32(12) of Appendix 16 and Business Review under Schedule 5 of the New CO:
  - significant investments held, their performance during the financial year and their future prospects
  - gearing ratio and the basis on which it was computed
  - entity-specific principal risks and uncertainties facing the issuer
  - cross-references to the MD&A/other sections
  - detail disclosures of KPIs and non-HKFRS financial measures when they are presented
  - analysis of significant events or material balances and transactions
- Basis upon which the ageing analysis of accounts receivable and accounts payable were presented
- Directors' emoluments
- Auditors' remuneration (including non-audit services)
- Statement of reserves available for distribution to shareholders

Assessing impairment of tangible and intangible assets (including goodwill)

As investors continue to express concerns about impairment of assets in a volatile market, listed issuers are urged to ascertain whether the processes for assessing impairment are sufficient and appropriate. Directors and management are responsible for assessing the reasonableness of key assumptions such that they are not overly optimistic, in particular, where issuers are loss-making or suffering from material business deterioration. They should not rely solely on professional valuers without carrying out independent assessments.

Disclosures for Asset Impairments

Upon the recognition or reversal of an impairment loss, listed issuers should disclose the relevant information in accordance with paragraph 130 of HKAS 36. The Exchange reminds issuers to disclose:

- The description of events and circumstances that led to the recognition or reversal of impairment loss, which should be case-specific and closely related to the issuer
- The recoverable amount and whether it is determined based on fair value less cost of disposal or value in use

Paragraph 134 of HKAS 36 requires relevant disclosures for each cash-generating unit with a significant carrying amount of goodwill or intangible assets with indefinite useful lives. In particular, the Exchange reminds the issuer to disclose:

- Whether the cash-generating unit's recoverable amount is determined based on value in use or fair value less costs of disposal
- Key assumptions applied to estimate the recoverable amount and how they are determined
- The period over which management has projected cash flows based on financial budgets/forecasts approved by manager, and reason for the use of a period greater than five years (if applicable)
- Growth rate used to extrapolate cash flow projections and discount rate applied to cash flow projections
- If applicable, the magnitude of change in values of key assumptions that would cause the carrying amount of the cash-generating unit to exceed the recoverable amount

Judgements and estimates

Judgements and estimates can have significant impact on key balances in the financial statements.Consequently, listed issuers are reminded to ensure management has held thorough annual discussions with the Audit Committee and auditors in regards to the judgements of key assumptions underlying critical accounting estimates. Listed issuers should disclose the judgements that have the most significant effect, and ensure they are clear and entity-specific.

Accounting for acquisitions

Listed issuers should carefully consider whether an acquisition should be recognised as a business combination or an asset acquisition, as their accounting treatment differs significantly. In addition, listed issuers should ensure all identifiable assets are properly identified and recognised so that goodwill or gain on bargain purchase is accurately measured and disclosed.

Impact of applying key issued, but not yet effective HKFRSs

Two major standards, Hong Kong Financial Reporting Standard (HKFRS) 9 *"Financial Instruments"* and HKFRS 15 *"Revenue from Contracts with Customers"* became effective on 1 January 2018. Both standards will affect the next set of interim or annual financial statements of listed issuers with a financial year-end date of 31 December. Listed issuers should disclose more entity-specific qualitative and quantitative information, such as their current stage of implementation, accounting policy choices to be applied, and the expected financial impact for line items affected. Listed issuers who have not done so should consult their professional advisors and perform a detailed review.

Disclosures for New Accounting Standards

In respect to the possible impact of applying new or amended HKFRSs that were issued, but yet to be effective, the Exchange recommends:

- Avoiding generic boilerplate disclosures and provide more tailored and granular information on the impact of the new or amended HKFRSs
- Providing a complete list of HKFRSs and discussing their impact on the financial statements to reduce the risk of overlooking any new HKFRSs

Where the application involves a change of accounting policy, the Exchange recommends:

- Clearly providing any key judgements made by management in applying the new requirements
- Quantitative disclosure with informative and detailed explanation of the changes, tailored to the issuers' specific circumstances and transactions
- An explanation on how the transition has been implemented under the requirements of HKAS 8
- Consulting auditors early to ensure proper application and implementation of these new standards

New auditors' reporting

To ensure that auditors can complete procedures on "Other Information" as required by Hong Kong Standards on Auditing (HKSA) 720 (Revised) *"The Auditor's Responsibilities Relating to Other Information",* listed issuers should reach out to their auditors earlier. Discussions should take place about which documents comprising the annual reports will be within the scope of “Other Information” and when the relevant information will be available to the auditors for reading and consideration.

The recommendations by the Exchange are only based on specific information disclosed in the published reports of selected listed issuers. As a result, the recommendations in the report may not be a complete list of minimum disclosures required under the relevant accounting standards. Listed issuers are encouraged to consult their auditors or professional advisors to ensure proper application of the accounting and disclosure requirements.

If you have any questions about the matters discussed in this publication, please feel free to contact the following capital markets partners and directors.

Paul Lau
Partner, Head of Capital Markets
KPMG China
Tel.: +852 2826 8010
paul.k.lau@kpmg.com

Louis Lau
Partner, Capital Markets Advisory Group
KPMG China
Tel.: +852 2143 8876
louis.lau@kpmg.com

Katharine Wong
Partner, Capital Markets Advisory Group
KPMG China
Tel.: +852 2978 8195
katharine.wong@kpmg.com

Terence Man
Director, Capital Markets Advisory Group
KPMG China
Tel.: +86 1085085548
terence.man@kpmg.com

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