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Hong Kong Capital Markets Update

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Stock Exchange Publishes Results of its Latest Review of Listed Issuers' Financial Reports

As part of its regulatory function, the Hong Kong Stock Exchange ("the Exchange") operates a Financial Statements Review Programme ("the "FSRP") under which it reviews, on a sample basis, listed issuers' published quarterly, interim and annual reports. The Exchange regularly publishes reports of its key observations and findings from the FSRP to increase listed issuers' awareness of the possible pitfalls in the preparation of their financial reports such that they may learn from others' experience and improve the quality of their own financial reports.

On 17 July 2015, the Exchange published a report which summarises the key findings and recommendations for improvement in disclosures in the listed issuers' annual reports from its review of 100 periodic financial reports released by listed issuers between October 2014 and April 2015.

Key findings and recommendations:

- Listed issuers are reminded of the additional disclosures on financial information in the annual report required under the listing rules, in particular those set out in Appendix 16 of the Main Board Listing Rules ("MB Rule") or the equivalent GEM Listing Rules. These disclosures are in addition to those required under the relevant accounting standards. Listed issuers are also reminded to pay attention to the recent amendments to the listing rules with reference to the new Companies Ordinance.
- Listed issuers should include additional disclosures on the nature and impact of significant events or transactions that occurred during the reporting period.
- Disclosures in relation to significant accounting policies, judgements and estimates should be clear, understandable and entity specific. Use of boilerplate text should be avoided.

Key areas relating to listing rules disclosures:

Information required under Appendix 16 of the MB Rule in addition to those required under accounting standards:

- management discussion and analysis
- disclosures required under the Companies Ordinance
- credit policy and ageing analysis of accounts receivable
- ageing analysis of accounts payable
- directors' emoluments
- five highest paid individuals
- distributable reserves

Annual reporting and review of continuing connected transactions as required under Chapter 14A of the MB Rule

Information required to be disclosed in the financial statements required under the Companies Ordinance include:

- directors' emoluments and retirement benefits, payments in respect of termination of directors' services and consideration for directors' services; and
- accounting disclosures relating to:
  - o aggregate amount of authorized loans;
  - o statement of financial position to be contained in notes to the annual consolidated financial statements;
  - o subsidiary's financial statements must contain particulars of ultimate parent undertaking; and
  - o remuneration of auditor.

- Listed issuers are expected to include a discussion of the financial statements impact on the initial application of the new or amended accounting standards which are not effective for the reporting period and of which have not been early adopted. If the impact is not known or cannot be reasonably estimated when the annual report is published, this fact should be disclosed.

For example, we note that the new standards on financial instruments (IFRS/HKFRS 9 *Financial Instruments*) and revenue recognition (IFRS/HKFRS 15 *Revenue from Contracts with Customers)* are generally expected to have material impacts on the amounts reported and disclosures in the financial statements for many companies. Listed issuers are reminded to comment the anticipated financial impacts on adoption of the new standards. Should the impact be unable to reasonably estimate, the company may state in their financial statements that it is not practicable to provide a reasonable estimate of the effect until they perform a detailed review.

The adoption of the new standards may require changes to systems and processes to collect the necessary data. Listed issuers are encouraged to consult with their advisors and formulate an implementation plan of the new standards at an early stage.

- Robust asset impairment review processes should be implemented by listed issuers and the quality of disclosures should be improved, particularly where the recoverable amount is based on value in use.
- Disclosure of exposure to risk arising from financial instruments should be entity-specific, rather than boilerplate text, such that investors and other users are able to evaluate the nature and extent of risks arising from the financial instruments to which the listed issuer is exposed and how those risks are managed.
- On fair value measurements, the Exchange recommended listed issuers to follow the relevant accounting disclosure requirements, which are designed to help investors and other financial statements users to assess the valuation techniques and inputs used in fair value measurements, particularly those based on significant unobservable inputs, and the effect on financial statements.

Specific findings and observations with regard to the automotive related business

For this review period, the Exchange chose automotive related businesses as its industry theme and selected annual reports of 15 issuers in this sector for review, with a focus on revenue recognition, depreciation of the manufacturing plants and equipment, capitalised product development costs, assets impairment and provisions for warranty and other obligations.

The Exchange observed that the revenue recognition policy disclosed was too generic and none of the issuers under review disclosed in their reports how the additional services, e.g. after-sales services, free maintenance period etc. are accounted for in the financial statements. While the offer of discounts, sales incentives and rebates are common in the automotive sector, the Exchange indicated there was no separate accounting policies for these sales incentives nor disclosures of the arrangements in the listed issuers' annual report under review. Listed issuers are encouraged to enhance the related disclosures in their annual reports.

Other findings identified by the Exchange include:

- insufficient disclosure on whether major parts or components of the property, plant and equipment were identified and depreciated separately.
- non-disclosure of the events and circumstances that led to the recognition of impairment losses recognized on property, plant and equipment and intangible assets.
- limited information of the warranty offered to customers and the basis for estimating the warranty provision.

The recommendations by the Exchange are based on specific information disclosed in the published reports of selected listed issuers. It should be noted that the recommendations for enhanced disclosures set forth in the Exchange's report may not represent a complete list of the minimum disclosures required under the relevant accounting standards. Listed issuers are encouraged to consult their auditors or professional advisers 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 Paul Lau or Katharine Wong of our Capital Markets Group.

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