

Summary of “Financial Statements Review Programme Report 2015”

(published by HKEX in July 2016)

Background

HKEX has a Financial Statements Review Programme which reviews, on a risk-based basis, the periodic financial reports published by issuers. The objective is to monitor compliance with the disclosure requirements of the Listing Rules and accounting standards, and to promote higher standards of financial disclosure by issuers.

(This programme is therefore separate from HKEX’s “**Review of Disclosure in Issuers’ Annual Reports to Monitor Rule Compliance**”. See our [Jan 16 newsletter](#))

HKEX’s July report summarizes findings from its review of 100 annual, interim, and quarterly financial reports released between March 2015 and April 2016.

There are no significant breaches. However, it is also noted that HKEX has raised enquiries with relevant issuers, including referring one case to the Financial Reporting Council.

I. Key Observations

(1) Relating to Listing Rules

- **MD&A** should be “balanced” and more “entity-specific”
- Some **non-HK incorporated issuers** overlooked amended Listing Rules (Appendix 16) incorporating new “**Business Review**” requirements under the new Companies Ordinance
- **Directors’ responsibilities for financial statements and internal controls**: issuers should take proactive steps to resolve issues identified in **audit reports with modified opinions** as soon as practicable
- New “**extended auditor’s report**”: issuers alerted to start preparations, as the new reports will be effective for periods ending on or after 15 December 2016

We have prepared a more detailed summary regarding the key Listing Rule issues below.

(2) Relating to accounting standards

- Key HKFRSs that will soon become effective – e.g. Hong Kong Financial Reporting Standard (“HKFRS”) 9 “*Financial Instruments*”, HKFRS 15 “*Revenue from Contracts with Customers*”, HKFRS 16 “*Leases*”. They are expected to have material impact on some issuers, particularly on their information systems, accounting processes, internal controls and business contracting processes. (paragraphs 79- 89 of report, P.20)
- More rigorous assessment on impairment of assets (paragraphs 103 - 114, P.24);

- Non-HKFRS financial information – issuers that choose to present non-HKFRS financial information to provide additional insight into financial performance should follow guidance from reputable sources on such disclosure (paragraphs 115 - 119, P.26)
- Determination of control over investees – (paragraphs 126 - 135, P.29)

II. MD+A and “Business Review”

(1) *MD+A* (paragraphs 14-17, P. 5):

- HKEX observed that as in past reviews, “there are still instances of insufficient disclosure in relation to the nature and impact of significant events or material balances and transactions”

(2) *Business Review* (paragraphs 18-27, P. 6):

While noting that the new “Business Review” only applied to 13 issuers covered by the review, HKEX made these observations:

- Disclosures required under Schedule 5 of the Companies Ordinance (“NCO”) “appeared to be subsumed within the MD&A, but some directors’ report did not include a cross-reference to the MD&A”

Practising Governance’s comments:

For non-HK incorporated issuers, NCO “applies” following amendments in Appendix 16 of Listing Rules. HKEX accepts a “cross referencing approach” to satisfy the “Business review” requirement for these companies — “provided that the cross reference is clear and states that the cross referenced part of the annual report “forms part of the directors’ report” (paragraph 21, P. 8).

However, HK-incorporated companies must also note the Companies’ Registry’s approach re: cross referencing.

- The “Business Review section” was very general or brief, “raising doubts as to whether the content requirements of Schedule 5 had been met”
- Descriptions of principal risks and uncertainties facing the issuer were generic rather than entity-specific
 - reporting a long list of risks could make it difficult for investors to understand which risks are the most significant for issuers’ businesses. As Schedule 5 uses the term “principal”, only the risks and uncertainties that issuers are genuinely concerned about should be included
 - risks of cyber-attacks and data losses are of growing concern for businesses. Investors are likely to expect these “to be reported more often as principal risks”

Appendix 1 sets out a list of findings relating to other disclosure items under Appendix 16. Issuers should note and check if these are relevant for them.

III. Modified opinions in auditor's report (paragraphs 46-55, P. 13)

- (1) Under Paragraph 2 of Appendix 16, “Each set of financial statements presented in an annual report ... shall provide a true and fair view of the state of affairs of the listed issuer and of the results of its operations and its cash flows.”
- (2) Directors of issuers are primarily responsible for the preparation of financial statements that give a true and fair view and for establishing effective risk management and internal control systems such that the financial statements prepared are free from material misstatement, whether due to fraud or error.
- (3) Internal controls are an integral part of risk management, for which the board, relevant board committees and management are accountable.
- (4) Where auditors' reports express modified opinions, issuers must take proactive steps to resolve the issues identified with their auditors as soon as practicable.

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Appendix 1 – Other disclosures under Appendix 16 of Listing Rules

- Ageing analysis of accounts receivable (paragraph 28, P. 9)
- Directors' emoluments (paragraph 34, P. 11)
- The five highest paid individuals and senior management remuneration by band (paragraph 38, P. 11)
- Distributable reserves (paragraph 42, P. 12)