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HKEx's review of issuers' annual reports for financial year ended in 2021

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The Hong Kong Exchanges and Clearing Limited (HKEx) published on 20 January 2023 a report[1] on its annual review of listed issuers' annual reports for the financial year ended between January and December 2021 (the Report).

The Report covers thematic reviews on specific areas based on the results of previous years as well as emerging trends or matter to be of higher risks. This article summarizes HKEx's findings, focusing on (i) financial reporting and related controls, (ii) material asset impairments, and (iii) issuers' compliance with annual report disclosure requirements.

Financial reporting and related controls

Directors of a Hong Kong listed issuer are responsible to prepare the issuer's accounts and present a balanced, clear and comprehensive assessment of its performance. They should ensure the effectiveness of the issuer's risk management and internal controls and the adequacy of resources and experience of staff for the financial reporting functions. The audit committee monitors the integrity of the issuer's financial statements, has oversight of the issuer's financial reporting system, risk management and internal controls, and reviews the effectiveness of the audit process.

Material differences between audited and unaudited financial statements

HKEx found that in 2022, approximately 200 issuers published unaudited financial statements before the disclosure deadlines due to disruption caused by the COVID-19 pandemic. Of these, about 40 issuers subsequently published audited financial statements that reported material adjustments. A large majority of these material adjustments were related to asset impairments due to:

(i) failure by issuers to make impairment assessments on their assets in their unaudited financial statements, as they relied on their auditors to ascertain the impairment loss amounts;

[1] https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Exchanges-Review-of-Issuers-Annual-Disclosure/rdiar_2022.pdf?la=en

(ii) insufficient impairment loss provision made by management due to failure to collect or consider sufficient information to substantiate the assumptions for the preparation of valuations; and

(iii) failure to conduct the valuation processes as the valuers were unable to perform site visits.

In a minority of cases, material adjustments were made to reclassify items or correct misapplication of accounting standards. Some adjustments arose from human errors such as erroneous calculation of disposal gains, or under-provision for interests and other expenses.

Auditors' modified opinions

HKEx found that for the 2021 financial year, 125 issuers received modified audit opinions on their published financial statements, including 44 issuers with modified opinions for the first time. Going concern qualifications remained the most common audit modifications. Other common audit modifications included valuations of assets and limited access to accounting records.

HKEx also reviewed issuers' disclosure about the modified opinions, including: details of the modifications and their impact on the financial position; management's position; audit committee's view and proposed remedial actions. HKEx found that the vast majority of issuers followed its recommendation to disclose information about modified opinions, and noted improvement particularly on the disclosure of action plans to address the modifications.

Delays in publication of results

HKEx found that for the 2021 financial year, a small number of issuers failed to publish their annual results before the three-month reporting deadline and consequently, were required to suspend their securities trading. Most of these cases were due to the following:

HKEx has the following recommendations:

(i) Preparation of financial statements: Directors should deploy adequate resources to staffing and maintaining appropriate financial reporting systems. While some factors may be outside their control, directors should incorporate appropriate alternative procedures in their financial reporting process to deal with sudden changes, including those arising from the pandemic.

(ii) Risk management and internal controls: Issuers should establish whistleblowing policies and systems for employees and those who deal with them to raise concerns with the audit committees about possible improprieties in any matters related to the issuers.

(iii) Audit committee: The audit committee should discuss with the auditors the nature and scope of the audit before the audit commences, and maintain close dialogue with the auditors to fully understand the progress of the audit and facilitate the resolution of audit issues identified during the audit. The audit committee should review the issuer's systems and ensure that management has maintained effective control mechanisms. It should also discuss with management and ensure sufficient resources are allocated for such purpose.

(i) failure to provide sufficient audit evidence or adequately address questions raised by auditors in areas such as impairment assessments, books and records of newly acquired subsidiaries, commercial rationale of new businesses commenced during the year;

(ii) issuers experiencing liquidity issue or under debt restructuring, resulting in management delays in the preparation of the financial statements; and

(iii) identification of possible frauds or accounting irregularities, such as discrepancies in cash balance, unauthorized guarantees, unauthorized payments, unauthorized granting of loans, which required independent investigations.

Material asset impairments

The Listing Rules require an issuer to include in its annual report a management discussion and analysis (MD&A) of material factors underlying their financial results and position and significant events during the year. Where an issuer recorded a material impairment on its assets, it should discuss the circumstances that led to the impairment. Where the impairment is supported by a valuation, HKEx recommends that the issuer should disclose details of the valuation (including the valuation method and the reason for using such method, details of the value of inputs used with basis and assumptions, and explanations on any changes in the valuation method used or the inputs or assumptions).

Material asset impairments (other than loans)

HKEx found that a large majority of the issuers reviewed have discussed the circumstances that led to the material impairments in the annual reports, and supported the impairment amounts by valuations or other evidence. In a small number of cases, however, the issuers disclosed generic reasons for the impairments, for example, the issuers cited COVID-19 or changes in government policies as reasons for impairment, without elaboration on how those events impacted the values of their assets. A large majority of issuers that prepared valuations to support the impairment charges followed HKEx's recommendation to disclose details of the valuations to allow shareholders to understand the basis and calculation of the asset impairments. Except in two cases, issuers generally announced changes to their financial position arising from asset impairments on a timely basis.

Material lending transactions outside the issuers' ordinary and usual course of businesses

A number of issuers provided material loans to third parties, including loans or advances to associated companies, joint ventures or connected persons of the issuers; advances to customers or suppliers relating to the principal businesses of the issuers; and loans to third parties outside the ordinary and usual course of businesses of the issuers.

HKEx identified a number of cases where the issuers failed to comply with the Listing Rule disclosure and/or shareholders' approval requirements for the provision of financial assistance. HKEx also identified a few cases where the loan impairments raised questions about the commercial rationale for the lending transactions. These cases suggested weaknesses in internal controls and possibly fraudulent transactions.

Issuers generally disclosed limited information about their lending transactions in annual reports. In some cases, loan receivables were classified under other receivables in the financial statements, and no details were provided in the notes to the financial statements or the MD&A sections of the annual reports.

HKEx recommends that directors and audit committees should ensure that issuers have effective risk management and internal control systems to assess and manage their credit risk exposure and to monitor the recoverability of loans and adequacy of the collaterals. Directors should critically assess the commercial rationale for entering into lending transactions, whether the terms are fair and reasonable, and whether the use of funds is in the interests of the issuer and its shareholders. Generally, issuers should disclose details of the loan receivables, including major terms, reasons for granting the loans and how they meet the issuers' business strategies and discussion of any material impairments or write-offs of the loan receivables and the basis of impairment assessments.

Compliance with annual report disclosure requirements

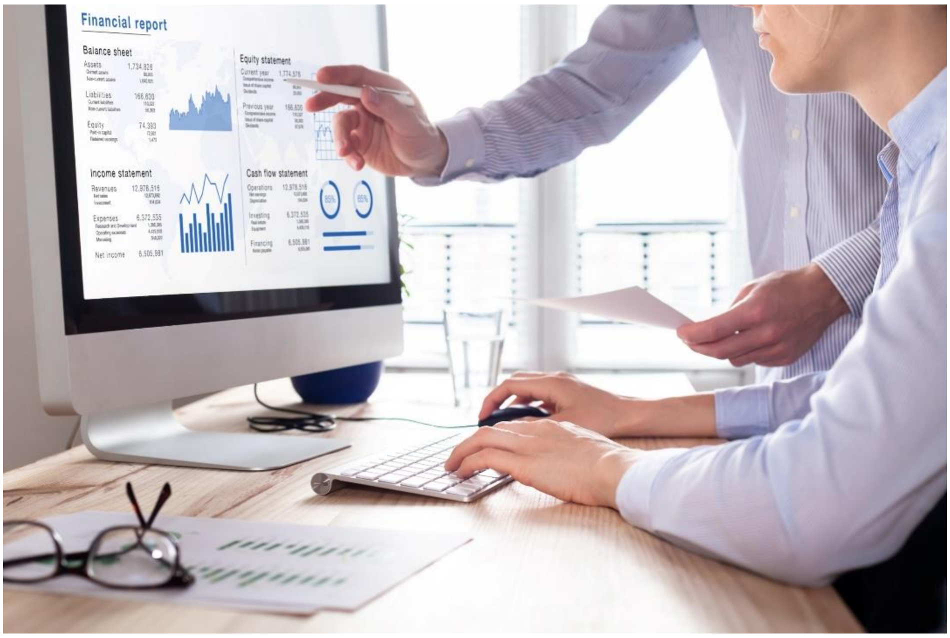
HKEx found that issuers continued to achieve a high rate of compliance and showed improvement compared to the HKEx's last review. 99% of issuers achieved a compliance rate of 90% or above on all the disclosure items under the Listing Rules. A large majority of issuers that omitted disclosure in last year's annual report have disclosed as required this year.

HKEx recommends all issuers take note of these common pitfalls to ensure compliance and complete disclosure as required by the Listing Rules. Commonly omitted disclosures include:

(i) continuing connected transactions;
(ii) share option schemes – terms;
(iii) share option schemes – movement;
(iv) fundraisings – proceeds from current year's fundraising;
(v) fundraisings – proceeds brought forward from previous years;
(vi) significant investments; and
(vii) performance guarantees.

Takeaways

HKEx has reminded in the Report that the directors are primarily responsible for preparing financial statements in accordance with the relevant accounting standards. They should critically assess management's accounting estimates and challenge the reasonableness of the assumptions adopted by the management. In conducting lending transactions, directors should critically assess the commercial rationale for making the loans, whether their terms are fair and reasonable, and whether the use of funds is in the interests of the issuer and its shareholders. Furthermore, in light of the current economic uncertainty and market volatility, it is particularly important for issuers and their audit committees to maintain a close dialogue with auditors on the audit focus areas and other emerging issues identified during the audit, and take prompt actions to address auditors' concerns.



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