LC Lawyers
林朱律師事務所
Law firm member of the EY global network

HKEX's review of issuers' annual reports for financial year ended in 2020

Li Fai
4 March 2022

The Hong Kong Exchanges and Clearing Limited ("HKEX") published on 28 January 2022 a report[1] on its annual review of listed issuers' annual reports for the financial year ended between January and December 2020 (the "Report").

The Report covers thematic reviews on selected areas and related disclosures, selected types of listed issuers, issuers' financial statement disclosures under accounting standards and compliance with annual report disclosures requirements.

This article summarizes the findings in the Report, focusing on the four identified areas considered to be of higher risks, being (i) auditors' modified opinions, (ii) material asset impairments, (iii) material lending trans-actions, and (iv) business review in the Management Discussion & Analysis ("**MD&A**") section, and also on commonly omitted items in annual reports.

Auditors' modified opinions

Each issuer is obliged to present financial statements that give a true and fair view of its state of affairs, results of operations and cash flows. The audit committee has a role in monitoring the integrity of its financial statements and annual reports, and ensuring that the management is implementing its plans to resolve the issues in the audit modifications in a timely manner.

The HKEX found that for the financial year 2020, 136 issuers received modified audit opinions on their published financial statements, as compared with 133 in the preceding year, including 51 issuers with modified opinions for the first time. The major audit modifications were, similar to last year, about the fairness of the reported value of the issuers' assets. For example, where recoverability of loans/ receivables is concerned, some issuers failed to support the expected credit losses assessment on loans and receivables with proper documentation

[1] https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Exchanges-Review-of-Issuers-Annual-Disclosure/rdiar_2021.pdf?la=en

due to a lack of internal control and management oversight over businesses that generated the relevant loans and receivables.

The HKEX recommends that issuers should develop estimates to support valuation of their major assets and consider retaining experts to perform asset valuations where necessary, and agree as early as practicable with auditors on the approach in the assessment of estimates. Further, the HKEX stresses the audit committees' responsibility in assessing and challenging the reasonableness of the management's assumptions and valuation methods adopted.

Material asset impairments

Under the Listing Rules, issuers are required to include in their annual reports a discussion and analysis of material factors underlying their financial results and position and significant events during the years. Where a material impairment on assets is recorded, the issuer should disclose the circumstances that led to the impairment. If the impairment is supported by a valuation, the HKEX recommends that 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, explanations on any change, etc.) be disclosed.

In respect of impairment on acquired assets, the HKEX found that issuers were mostly compliant. Issuers generally set out the circumstances that led to the material impairments, with a large majority attributing the impairments to the material deterioration of business or delay in projects caused by COVID-19, and most issuers supported their impairment amounts with valuations. However, information such as the basis and assumptions of inputs were omitted occasionally. Notably, the HKEX is currently investigating one case where an impairment was made of most of the reported value of a business acquired about a year ago, which raised doubts as to whether the directors had properly considered the terms of the acquisition at the time and acted in the interests of the issuer and its shareholders.

Nonetheless, the number of issuers that reported material impairments on assets other than acquired assets reduced by more than half compared to the year before.

Material lending transactions

Out of the 211 issuers that reported material loan receivables, prepayments, deposits and other receivables in their 2020 financial statements, the HKEX identified a number of cases where loans were made outside ordinary and usual course of business. There were also a few cases involving loans not properly authorised by the board of directors, or were purportedly upfront payments to suppliers and/or service providers and subsequently became unrecoverable. Other cases that are currently under the HKEX's investigation or referred to the Securities and Futures Commission included questionable instances on whether there were material deficiencies in the issuers' internal control systems and whether proper due diligence on borrowers had been performed by the directors. Although the above are isolated cases, they raise concerns about the potential dissipation of assets through lending transactions. This further highlights the importance of establishing proper internal controls to monitor these lending transactions and maintaining good corporate governance.

The HKEX noted that money lenders generally provided very limited information in annual reports about their loan portfolios, client base and risk measures and controls over their business, and the management discussions were also generic. In order to improve disclosures on how the money lending business is operated, the HKEX made recommendations to include the following information in future annual reports:

- issuers' business model and credit risk assessment policy;
- major terms of loans granted (including details of collaterals), size and diversity of clients and concentration of loans on major clients;
- management's discussion on the movements in loan impairments (and write-offs) and the underlying reasons; and
- other key internal controls in terms of, for example, credit approval, ongoing monitoring of loan recoverability and loan collection.

Business review in the MD&A section

In last year's report, the HKEX provided some recommendations to help issuers enhance disclosures on the principal risks arising from COVID-19, and was generally satisfied with the review conducted this year.

Out of the 50 issuers selected for review regarding disclosures on the impact of COVID-19, all have provided assessments of the effect of the pandemic on their operations and the relevant risks or uncertainties that might affect future performance, as well as quantitative information to illustrate the impacts of the pandemic on their financial performance and position, e.g., percentage of reduction in flight passenger capacity, hotel room occupancy rate and revenue per room. Moreover, a vast majority of them have revealed their liquidity position and working capital sufficiency, as well as measures taken to manage the impact of the pandemic, e.g., business diversification and application of technology to expand offerings.

Annual report disclosure requirements

Overall, despite some isolated cases of potentially misleading disclosures, or material non-compliance with the Listing Rules which are under investigation, the HKEX was satisfied with disclosures by issuers.

Some commonly omitted disclosures include the following aspects:

- Continuing connected transactions ("**CCTs**") – About 90% of the issuers reviewed fully complied with the requirements for CCTs. But some information in relation to terms of the CCTs, auditors' and/or independent non-executive directors' review findings were omitted. The most common being whether related party transactions are CCTs. For example, related party transactions in some cases were subject to the relevant CCT rules but the issuers failed to make announcements and/or seek approval by independent shareholders.
- Share schemes and pension schemes – A large majority of the issuers reviewed fully disclosed the information required under the Listing Rules in respect of share option and share award schemes. However, certain information in terms of share option schemes and movement of share options, such as securities available

for issue under the scheme (expressed as number of shares and percentage), were commonly omitted. Additionally, about 1/3 of the issuers reviewed granted share options to non-employee participants, a majority of which did not disclose the identities of the grantees and rationale for the grants. The HKEX reiterates that it recommends the disclosure of such information, so as to provide accountability to shareholders on the alignment of grants with the schemes' objectives. On the other hand, in respect of pension schemes, issuers should take note of commonly omitted disclosures as to defined contribution plans and defined benefit plans.

- Fundraisings through issue of equity/convertible securities and subscription rights – The most common omission was a plan for the unused proceeds including a breakdown and expected timeline, which should be disclosed in annual reports.

- Significant investments – Over 70% of the issuers fully disclosed information on their significant investments as required by the Listing Rules, and examples of commonly omitted disclosures include a discussion of issuer's investment strategy, performance of each investment during the year, size relative to issuer's total assets, and investment costs.

- Other disclosures – Over 99% of the disclosure records were compliant, but some general common omissions include certain emoluments details of the five highest paid individuals, details of subsidiaries, and percentages of revenue/ purchases attributable to the top five customers and suppliers.

Takeaways

The review conducted by the HKEX has reflected that the compliance rate for disclosure requirements under the Listing Rules is high. In furtherance of improving integrity in the financial market, the Report provides a comprehensive guide on the matters that issuers should pay attention to when preparing their disclosures, and highlights commonly omitted disclosures that issuers should take care not to miss out. Issuers should also put in place appropriate and sufficient internal control mechanisms to ensure that they are compliant with the disclosure obligations under the Listing Rules as amended from time to time, for example taking into account the new obligations introduced by the updated Corporate Governance Code that came into effect on 1 January 2022.

The author would like to thank Ms. Nicole Chan (trainee solicitor) for her contribution in this article.

KEY CONTACT

Li Fai
Partner
Fai.Li@eylaw.com.hk
+852 2629 1722

Contact us

LC Lawyers LLP
Suite 3106,
31/F One Taikoo Place,
979 King's Road,
Quarry Bay, Hong Kong
Tel: (852) 2629 3200
Fax: (852) 2956 1980
https://www.eylaw.com.hk/en_hk

Follow us on WeChat

This material has been prepared for general informational purposes only and is not intended to be relied upon as professional advice. Please contact us for specific advice.