

# HKFRSs / IFRSs UPDATE

**2010/13**

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## WHAT MAKES GOOD CORPORATE REPORTING? WHAT DEFICIENCIES ARE IDENTIFIED IN HKFRSs REPORTING?

### BACKGROUND

This BDO Update provides a summary of the recommendations and review findings in the reports recently published by three Hong Kong regulators and a UK regulator. This BDO Update is intended to serve as a helpful source of reference for auditors or preparers of financial statements in their audit or preparation of 2010 year-end financial statements under HKFRSs.

You may refer to the [BDO Update of 28 October 2009](#) for details of the 2009 findings which may serve as a good comparison of what have been improved since the last reports, and what are the new areas of concern of these regulators.

These local and overseas regulators and their 2010 published reports are:

Regulator	Published Report	Date
Hong Kong Exchanges and Clearing Limited (HKEx)	<a href="#">Financial Statements Review Programme Report 2010</a>	August 2010
Hong Kong Institute of CPAs (HKICPA)	<a href="#">Quality Assurance Annual Report 2009</a>	March 2010
Financial Reporting Council (Hong Kong) (FRC)	<a href="#">Investigation Report 2</a>	2 August 2010
Financial Reporting Review Panel (Panel) of the FRC of the UK	<a href="#">Annual Report</a>	August 2010

### WHAT MAKES GOOD CORPORATE REPORTING?

The Panel was established in 1990 as part of the Financial Reporting Council of the UK. The aim of the Panel is to improve the quality of corporate reporting in the UK. In discharging this responsibility, the Panel has published its annual report based on findings from the Panel's review of accounts in the year to 31 March 2010.

The 2010 Panel report contains a very useful section summarising what the Panel considers to be the characteristics of good corporate reporting. These characteristics are reproduced below, which should be seen as useful benchmarks for preparers of financial statements.

<b>A single story</b>	The narrative in the front end is consistent with the back end accounting information; significant points in the financial statements being explained in the narrative reports so that there are no surprises hidden in the accounts.
<b>How the money is made</b>	The business review gives a clear and balanced account which includes an explanation of the company's business model and the salient features of the company's performance and position, good and bad.
<b>What worries the Board</b>	The risks and uncertainties described in the business review are genuinely the principal risks and uncertainties that the Board is concerned about. The descriptions are sufficiently specific that the reader can understand why they are important to the company. The links to accounting estimates and judgments are clear.
<b>Consistency</b>	Highlighted or adjusted figures, key performance indicators (KPIs) s and non-GAAP measures referred to in the business review are clearly reconciled to main heading figures in the accounts and any adjustments are clearly explained, together with the reasons why they are being made.
<b>Cut the Clutter</b>	Important messages, policies and transactions are highlighted and supported with relevant context and are not obscured by immaterial detail. Cross-referencing is used effectively; repetition is avoided.
<b>Clarity</b>	The language used is precise and explains complex accounting and reporting issues clearly; jargon and boiler-plate are avoided.
<b>Summarise</b>	Items are reported at an appropriate level of aggregation and tables of reconciliations are supported by, and consistent with, the accompanying narrative.
<b>Explain change</b>	Significant changes from the prior period, whether matters of policy or presentation, are properly explained.
<b>True and fair</b>	The spirit as well as the letter of accounting standards is followed.

## WHAT DEFICIENCIES ARE IDENTIFIED IN HKFRSs REPORTING?

Three of the 2010 published reports contain findings arising from the annual reviews of HKFRSs or IFRSs financial statements, while the fourth is an investigation report of a set of HKFRSs financial statements of a listed group. The findings of these reports will serve to direct the attention of preparers of financial statements to areas where a more rigorous application of HKFRSs, both in terms of disclosure and accounting, is warranted.

### Hong Kong experience - HKEx

The Listing Division completed its 2008/09 annual review of listed issuers' published financial reports for compliance with the disclosure requirements of the Listing Rules and accounting standards, and published its review report in August 2010. This is the second published report which summarises the Listing Division's observations and findings.

During the review process, the Listing Division:

- Selected and reviewed 100 published periodic financial reports of issuers covering annual, interim and quarterly reports released between October 2008 and September 2009
- Issued 98 letters to issuers that contained more than 400 enquiries and observations requesting explanations and information about the accounting treatment adopted or clarifications on possible non-compliance or omitted disclosures

- Based on the responses to its enquiries, except for four cases which have been referred to the FRC to consider further enquiry and investigation of possible accounting and auditing irregularities and one caution letter to an issuer, there were no significant breaches of the Listing Rules or accounting standards that would render the financial statements false or misleading or would require a restatement or reissue of financial statements or warrant disciplinary action by the Listing Committee
- Where the omitted disclosures were regarded as less significant or material, issuers were requested to confirm in writing that the required information will be provided in their future financial reports

As a comparison, the previous review covering the 2007/08 review programme involved:

- 100 reports of listed entities reviewed covering annual, interim and quarterly reports released between July 2007 and September 2008
- 96 enquiry letters issued containing 500+ enquiries and observations
- 2 serious cases warranting follow-up action referred to the FRC

The major findings and recommendations in the August 2010 HKEx report are:

Disclosure of significant "other" account balances were simply described as "other gains/expenses" or "other receivables/payables" without further details
Performance indicators (e.g. "EBITDA" or "adjusted EBITDA") were used without adequate explanation of their meaning, how they are computed and what they were supposed to indicate
Where going concern is an issue, adequate information on going concern assessment should be included in the corporate governance report and other relevant sections of the annual report
Clearer explanations of the assessment of the effectiveness of internal controls should be made in corporate governance reports where there is a matter which indicates a weakness in internal controls
Robust asset impairment review processes should be in place so that shareholders and investors have confidence on the reported asset values
Disclosures of the amortisation/depreciation method adopted for mining assets, in particular, the measurement basis and key assumptions used in the estimation of proven and probable reserves, should be improved
Disclosure of assumptions and methods to arrive at fair values of financial instruments, including the assumptions and valuation techniques used, should be more detailed

## Hong Kong experience - HKICPA

Approximately 140 reviews (i.e. initial reviews and follow up reviews on auditors' responses) were carried out in 2009. More than 105 letters were issued to CPA Practices and 79 cases were closed. Three cases involving more significant departure from relevant accounting standards were referred to the compliance department of the HKICPA in 2009 and concluded by the Professional Conduct Committee in the same year.

As a comparison, the 2008 review involved:

- 160 reviews of financial statements of listed entities, mostly with financial year-end of 31 December 2007 or 31 March 2008
- 110+ enquiry letters issued
- 2 serious cases warranting follow-up compliance action

In the 2010 HKICPA report, there are common accounting issues that seem to be related to or exacerbated by the Global Financial Crisis which include:

- Impairment of assets including goodwill
- Investments in available-for-sale financial assets
- Going concern considerations
- Financial risk management disclosures

Other specific topics include application issues in:

- Accounting for business combinations
- Revenue recognition on multiple deliverables
- Agriculture accounting and disclosures

## UK experience - Panel

The 2010 Panel report contains the results of the following:

- 308 sets of accounts (2008/09: 326) were reviewed
- 146 companies (2008/09: 112) were approached by the Panel for further information or explanation
- 3 companies (2008/09: 2) were the subject of a Panel press release having agreed to restate amounts reported in prior periods

The review has covered both "Targeted Reviews" and "Reviews of Annual Financial Statements". The "Targeted Reviews" included:

- Directors' reports, in particular business reviews and other disclosures
- Financial institutions because of public interest
- Impairment disclosures
- Half-yearly financial reports
- Accounts with qualified audit reports

## Common theme of identified deficiencies

Three of the more significant ones are further explained below:

- i. Business combination accounting HKFRS 3 and HKAS 38
- ii. Impairment assessment and disclosures HKAS 36
- iii. Financial risk management disclosures HKFRS 7 and HKAS 1

### Business combination accounting HKFRS 3 and HKAS 38

The findings concern insufficient rigour in the application of HKFRS 3 "Business Combination" and HKAS 38 "Intangible Assets" and the need for improvements in reporting the effects of acquisitions, and in particular:

- (a) Identifiable assets, liabilities and contingent liabilities that existed at the acquisition date have not been all identified (i.e. identification issue)
- (b) The identifiable assets, liabilities and contingent liabilities have not been properly measured at fair value on acquisition (i.e. fair value measurement issue)

Relevant extracts of the Panel report demonstrating these deficiencies:

The Panel approached a number of companies that had reported a significant business combination where there was a question whether all identifiable intangible assets meeting the IFRS recognition and measurement criteria on acquisition had been appropriately distinguished and recorded. Decisions taken by management after the acquisition do not affect the need to account for these in accordance with the standards.

The Panel was also obliged to challenge some companies on their aggregation of intangible assets when it appeared that what was presented as a single class might, in fact, consist of more than one class of intangible assets, in respect of each of which detailed disclosures are required.

### *Hong Kong experience - FRC investigation report*

Business combination accounting is the subject of the FRC investigation report dated 2 August 2010 in relation to the 2007 audit of a listed group. The FRC investigation report was prepared by its Audit Investigation Board (AIB) and has been referred to the HKICPA to determine if any disciplinary actions are warranted.

Based on its findings, the AIB is of the view that the auditor should have modified the audit opinion in its report in accordance with the relevant auditing and assurance requirements given the non-compliances with accounting requirements in the financial statements of the listed entity. The non-compliances identified include:

- The non-disclosure of a description of the factors that contributed to a cost that results in the recognition of goodwill
- The non-recognition of deferred tax liabilities on taxable temporary difference arising from fair value adjustments on the intangible assets of the subsidiaries acquired
- The overstatement of impairment loss on goodwill in the financial statements of the listed entity

The FRC has reminded the preparers of financial statements that in preparing financial statements:

- All necessary disclosures should be made in accordance with the relevant accounting requirements
- Deferred tax assets and liabilities arising from business combinations should be properly recognised
- The carrying amount and the recoverable amount of a cash-generating unit should be determined on a consistent basis for the purpose of assessing the amount of impairment loss

### **Impairment assessment and disclosures HKAS 36**

The Global Financial Crisis has brought a lot of issues to financial reporting, including impairment of assets. As a result, the regulators have paid special attention to this area in their reviews of financial statements. The findings concern failures to provide all the relevant and often extensive disclosures required about impairment testing under HKAS 36.

Relevant extracts of the HKEx report demonstrating these deficiencies:

We noted 20 cases where there were no detailed explanations on why no impairment of a significant asset was made when there were indications of possible impairment (paragraph 9 of HKAS 36); for example, where subsidiaries, associates and joint venture suffer recurring operating losses this raises the issue of whether the carrying value of those investments need to be impaired.

We also noted that 10 issuers recognised material impairment losses on goodwill or other assets. However, explanations on the events and circumstances that led to the recognition of impairment losses (paragraph 130(a) of HKAS 36) tended to be short and generic. In some cases material impairment losses on goodwill or assets were recognised shortly after the related assets were acquired but there was no disclosure or explanation of what specific event or changes in circumstances subsequent to the acquisition led to the impairment.

Seven issuers had performed discounted cash flow calculations in determining their recoverable amounts of the assets based on "value-in-use" or "fair value less costs to sell". However, the key assumptions, particularly the discount rate and growth rate, and explanations of the methodology used by the management, were not disclosed in the financial statements as required under paragraphs 134(d) and 134(e) of HKAS 36.

### **Financial risk management disclosures HKFRS 7 and HKAS 1**

In the light of the Global Financial Crisis, the regulators have also reviewed the sufficiency of financial risk management disclosures in the financial statements because such information is considered an important information set for users of financial statements.

The findings concern the poor quality of disclosures given by many companies other than financial institutions about risk arising from financial instruments, capital risk management and critical accounting estimates, assumptions and judgments made by management in preparing financial statements. In particular, the disclosures sometimes tend towards the boiler-plate.

Relevant extracts of the Panel report demonstrating these deficiencies:

The three specific issues referred to in last year's report continued to give rise to enquiries by the Panel. These were:

- ▶ An analysis, by class of financial asset, of the age of the financial assets that are past due but not impaired at the balance sheet date.
- ▶ A maturity analysis for financial liabilities showing the remaining contractual liabilities with a description of how the company manages the inherent liquidity risk. A number of companies continued to provide the analysis on a discounted basis – whereas the standard requires an undiscounted approach, including future interest payments.
- ▶ A sensitivity analysis in respect of each type of market risk to which the company is exposed at the end of the reporting period.

Relevant extracts of the HKICPA report demonstrating these deficiencies:

#### e) Fair value

A number of enquiry and recommendation letters were issued by the QAD in respect of fair value disclosures required by HKFRS 7. The QAD would like to highlight a few frequently omitted disclosures for members' attention in preparing future financial statements:

- ▶ When a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities shall be disclosed;
- ▶ If changing one or more of those assumptions to reasonably possible alternative assumptions would change fair value significantly, the entity shall state this fact and disclose the effect of those changes; and
- ▶ For an investment in equity instruments that do not have a quoted market price in an active market, a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably is needed.

## CONCLUDING REMARKS

Publilius Syrus, a Latin writer of maxims, flourished in the 1st century BC:

*"From the errors of others a wise man corrects his own."*

These four reports are useful source of reference for both preparers and auditors of financial statements. Not only have they identified deficiencies requiring improvements but also highlighted some good practice. You are advised to read through the reports which hopefully will serve to improve the corporate and financial reporting of your employer or practice, so that useful information is presented to readers of financial statements.

**WARNING:** It should be emphasised that this Update only represents a general discussion of the review reports based on our understanding and is not a substitute of reading the full review reports which are the authority.

## BDO's support and assistance on HKFRSs

For any support and assistance on HKFRSs, please talk to your usual BDO contact or Stephen Chan, Partner and Head of Technical & Training at +852 2853 5820 or email [StephenChan@bdo.com.hk](mailto:StephenChan@bdo.com.hk)

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