HKEx LISTING DECISION
Cite as HKEx-LD66-1 (April 2009) (updated in December 2012)

Summary	
Name of Party	Company A - a Main Board applicant and its subsidiaries
Subject	Whether the gain/loss from changes in the fair value of the conversion option in relation to Company A's redeemable convertible preferred shares should be excluded from the computation of profit under Rule 8.05(1)(a)?
Listing Rules	Rules 8.05(1)(a); 4.11; HKEx-LD45-2, HKEx-LD48-2, HKEx-RL3-04, HKEx-RL23-07, and GL-46-12
Decision	The conversion option changes in relation to the preferred shares were not related to activities in the ordinary and usual course of Company A's business. Therefore, it was appropriate to exclude them from the computation of profit under Rule 8.05(1)(a). There was an increasing number of applicants issuing preferred shares. The treatment of the fair value changes in respect of them would be dealt with case by case for Rule 8.05(1)(a).

SUMMARY OF FACTS

1. Company A provided IT related services.

2. In the first year of the track record period ('Year 1'), Company A issued redeemable convertible preferred shares to two strategic investors.

3. The material terms and conditions of the preferred shares issue included:

   - Company A must redeem all preferred shares on maturity (six-year term) unless earlier redeemed or converted;

   - holders of the preferred shares were entitled to a fixed cumulative dividend per annum of the principal amount payable quarterly since Year 1;

   - holders were also entitled to convert the preferred shares into ordinary shares at the initial conversion rate of 1:1, subject to adjustment for anti-dilution protections from time to time; and

   - the preferred shares issued were denominated in Hong Kong dollars, while Company A's functional currency was RMB.

4. According to Company A's prevailing accounting policies under HKFRS, the financial instrument for the preferred shares comprised two components: the derivative component (i.e. the conversion option of the preferred shares) and the liability component. Company A designated the entire hybrid (combined) financial instrument for the preferred shares as a financial liability or financial asset at fair value through profit or loss on initial recognition and at each balance sheet date.

5. Company A opined that the fair value changes from the derivative component of the preferred shares (the 'Conversion Option Changes') did not arise in the ordinary and usual course of business for the purpose of Rule 8.05(1)(a). If the Conversion Option Changes were excluded from the computation of profit, Company A could satisfy the minimum profit requirement under Rule 8.05(1)(a).

THE ISSUE RAISED FOR CONSIDERATION

6. Whether the Conversion Option Changes should be excluded from the computation of profit for under Rule 8.05(1)(a)?

APPLICABLE LISTING RULES ACCOUNTING STANDARDS OR PRINCIPLE

Listing Rules

7. Rule 8.05(1)(a) provides that a new applicant must have:

> a trading record of not less than three financial years (see rule 4.04) during which the profit attributable to shareholders must, in respect of the most recent year, be not less than HK$20 million and, in respect of the two preceding years, be in aggregate not less than HK$30 million. The profit mentioned above should exclude any income or loss of the issuer, or its group, generated by activities outside the ordinary and usual course of its business.

8. Rule 4.11 requires that:

> the financial history of results and the balance sheet included in the accountants' report must normally be drawn up in conformity with Hong Kong Financial Reporting Standards[1] or International Financial Reporting Standards or China Accounting Standards for Business Enterprises (CASBE) in the case of a PRC issuer that adopted CASBE for the preparation of its annual financial statements. ***(Updated in December 2012)***

[1] 'Hong Kong Financial Reporting Standards' (HKFRS) includes all HKFRS, Hong Kong Accounting Standards (HKAS), Statements of Standard Accounting Practice (SSAP), and Interpretations issued by the Hong Kong Institute of Certified Public Accountants.

Accounting Standards

<u>Classification of Financial Instruments: Debt versus Equity (HKAS 32)</u>

9. HKAS 32.15 states that:

> the issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.

10. Under HKAS 32.16:

> … the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met:
>
> a. The instrument includes no contractual obligation:
>
> (i) to deliver cash or another financial asset to another entity; or
>
> (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.
>
> b. If the instrument will or may be settled in the issuer's own equity instruments, it is:
>
> (i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
>
> (ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

<u>Financial Instruments: Recognition and Measurement (HKAS 39)</u>

11. HKAS 39.2(d) states that:

> this Standard (HKAS 39) shall be applied by all entities to all types of financial instruments except financial instruments issued by the entity that meet the definition of an equity instrument in HKAS 32 (including options and warrants).

12. HKAS 39.11 provides that:

> an embedded derivative shall be separated from the host contract and accounted for as a derivative under this Standard if, and only if:
>
> (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
>
> (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
>
> (c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

13. HKAS 39.11A states that:

> Notwithstanding (HKAS 39.11), if a contract contains one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss unless:
>
> (a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or
>
> (b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

THE ANALYSIS

Standards of Review

14. The Exchange takes the view that the profit requirement under Rule 8.05(1)(a) indicates the management's past performance during the track record period. The profit requirement, and appropriate disclosure, should enable investors to make an informed assessment of the applicant as contemplated by Rule 2.03(2). When reviewing whether an applicant satisfies Rule 8.05(1)(a), the Exchange ordinarily considers the burden of proof to be on the sponsor and applicant to demonstrate compliance. In view of the importance of this standard, where the judgment of directors or their reporting accountants is expected to have a significant impact on compliance with Rule 8.05(1)(a), the Exchange does not rely solely on the judgment of the directors and/or accountants in reaching its conclusions. Instead, it may reach its own conclusion based on the information presented to ensure that the eligibility standards of Rule 8.05(1)(a) are interpreted consistently and not unduly affected by the views of individual boards and/or reporting accountants.

Precedent Cases

15. Listing Decisions HKEx-LD45-2 and HKEx-LD48-2, and Rejection Letters HKEx-RL3-04 and HKEx-RL23-07 set out the Exchange's analysis in determining whether any income can be counted towards satisfaction of the profit requirement of Rule 8.05(1)(a). Basically, the Exchange must be satisfied that, in the facts and circumstances of a particular case, the income arises in the ordinary and usual course of business, i.e. the income is actively derived from the applicant's principal business, rather than from a source incidental to it, and the timing of the income should not be arbitrary depending, to a large extent, on the discretion of the applicant's directors.

16. Whether and how the fair value gains/losses on an applicant's income statement should be reckoned under Rule 8.05(1)(a) has been considered by the Exchange in different contexts. Three examples are set out for illustration.

Case 1

17. **(Deleted in December 2012, and superseded by GL-46-12)**

18. **(Deleted in December 2012, and superseded by GL-46-12)**

Case 2

19. Applicant 2 was a property developer and investor. The Exchange decided that the unrealised fair value adjustment gains from Applicant 2's investment properties were in the ordinary and usual course of its business and could be counted as profits under Rule 8.05(1)(a). The Exchange took into consideration the nature of Applicant 2's business and the reporting accountants' confirmation that Applicant 2's accounting treatment of its investment properties had complied with the prevailing accounting standards.

20. The Exchange further required Applicant 2 to revise its prospectus to include full and prominent disclosure of the fact that unrealised profits were included in its profit and loss accounts during the track record period.

Case 3

21. Applicant 3 was a manufacturer of household products. The Exchange decided that gains and losses derived from securities investments by using unutilised cash balances were not in the ordinary and usual course of business of a household product manufacturer, and therefore profits/losses derived from these securities investments would not affect the computation of profits/losses under Rule 8.05(1)(a). The Exchange took into consideration that the fair value gains derived from Applicant 3's securities investments activities were not recurring (Applicant 3 planned to dispose of all the securities investments upon listing) and were incidental income not attributable to the Applicant 3's core business. Further, the treatment of securities investment income as 'other' gains and incomes in Applicant 3's income statement reinforced these findings.

22. Noting that Applicant 3's securities investment activities had exposed it to significant financial impact during and after the track record period, the Exchange required Applicant 3 to:

    a. disclose its plan for disposal of all securities assets upon listing and highlight the risks associated with securities investment in relevant sections of the prospectus;

    b. state the details of the fair value loss or gain realised on the disposal of the financial assets, during the track record period in the 'Summary', 'Risk Factors' and 'Financial Information' of the prospectus; and

    c. include a commentary on how Applicant 3 could arrive at a 'no material adverse change'[2] statement and state how the gain or loss would impact on Applicant 3's profit in the prospectus given that any disposal of the securities portfolio since the end of the period reported might have given rise to a fair value loss.

Factual Consideration

23. In determining whether the Conversion Option Changes should be excluded for the profit requirement of Rule 8.05(1)(a), the Exchange analysed the facts and circumstances following these general principles.

24. The Exchange took into consideration the following factors:

    Factors Favouring the *Inclusion* of the Conversion Option Changes

    a. Company A submitted that it applied the net proceeds from the issue of the preferred shares to further develop and expand its business. These proceeds were primarily applied to acquire IT related companies/businesses which were relevant and complementary to Company A's core business of providing IT related services. Consequently, it could not readily be concluded that the issue of the preferred shares, and therefore the resulting Conversion Option Changes, had no connection with Company A's ordinary course of business solely because the proceeds were not applied directly to its core business operation.

    b. It is common for companies to finance their business operations with external financing. Issuing preferred shares is one of the methods of external financing available to a company, which does not differ materially from financing via bank borrowings. Since finance costs from bank borrowings would ordinarily be included in assessing an applicant's compliance with the minimum profit requirement, it would appear inconsistent to exclude the related expenses (including the Conversion Option Changes) from the issue of the preferred shares.

    Factors Favouring the *Exclusion* of the Conversion Option Changes

[2] See paragraph 38 of Appendix 1A to the Rules which requires disclosure in the listing document 'a statement by the directors of any material adverse change in the financial or trading position of the group since the end of the period reported on in the accountants' report, or an appropriate negative statement.'

c. Company A provided IT related services. Apart from providing finance to further develop and expand its business, the issue of the preferred shares bore little relation to Company A's business operation. The issue of the preferred shares, which involved amending Company A's constitution with prior shareholders' approval, was different from normal bank borrowings. These factors tended to indicate that the issue of the preferred shares was not in the ordinary and usual course of Company A's business.

d. The Conversion Option Changes were primarily affected by the price and the volatility of Company A's shares and determined on the basis of professional valuation at the respective balance sheet dates. They did not involve any actual cash flow movement and had little correlation with how Company A's business was conducted. The more the price of Company A's shares exceeded the conversion price, the greater the loss from the Conversion Option Changes and the more difficult it would be for Company A to satisfy the minimum profit requirement under Rule 8.05(1)(a). The fact that Company A's directors would have very limited discretion/control over the Conversion Option Changes once the preferred shares were issued distinguished this case from Listing Decision HKEx-LD45-2.

e. The Conversion Option Changes were negatively correlated with the price performance of Company A's shares in that the better the shares performed, the greater the deterioration of its net profit position. Accordingly, the inclusion of the Conversion Option Changes would, distort Company A's net profit figures as an indicator of the past performance of its management during the track record period.

f. Depending on the price and volatility of Company A's shares, the financial impact of the Conversion Option Changes could be positive or negative. In determining the computation of profit under Rule 8.05(1)(a), Company A ordinarily would exclude the positive Conversion Option Changes for Year 2 of the track record period because the gain was not actively derived from its principal business (Rejection Letter HKEx-RL3-04). It followed that the same treatment should be applied to exclude negative Conversion Option Changes (i.e. losses) such as those for Year 1 of the track record period.

THE DECISION

25. Taking all of the above factors into account, in particular, those in paragraph 24(d), (e), and (f), the Exchange determined that the Conversion Option Changes were not demonstrably related to activities in the ordinary and usual course of Company A's business. Therefore, it was appropriate to exclude these from the computation of profit under Rule 8.05(1)(a).

26. The Exchange noted there was an increasing number of applicants issuing preferred shares. The treatment of the fair value changes for them would be dealt with case by case for Rule 8.05(1)(a).