

HKEx GUIDANCE LETTER

HKEx-GL26-12 (January 2012) (Updated in January 2022)

Subject	Guidance on business models with significant forfeited income from prepayments _
Listing Rules	Main Board Rules 8.04 and 8.05(1) GEM Rule 11.06
Related Publications	N/A
Author	IPO Transactions<u>Vetting</u> Department

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1. Purpose

- 1.1 Some business relies significantly on forfeited income from prepaid services and products (i.e. customers' unexercised rights or breakage as referred to in Hong Kong Financial Reporting Standard 15 "Revenue from Contracts with Customers"). This document discusses the Exchange's observations on the risks involved in asuch business model that relies significantly on forfeited income from prepaid services and products. It also gives guidance on how to make disclosure to the Exchange and in the listing document. _

2. Relevant Listing Rules and Accounting Standards

- 2.1 Main Board Rule 8.04 (GEM Rule 11.~~0406~~) provides that both the issuer and its business must, in the opinion of the Exchange, be suitable for listing.
- 2.2 Main Board Rule 8.05(1)(a) states that to meet the profit test, a new applicant must have an adequate trading record of not less than three financial years during which the profit attributable to shareholders must, in respect of the most recent year, be not less than HK\$~~2035~~2035,000,000 and, in respect of the two preceding years, be in aggregate not less than HK\$~~3045~~3045,000,000. The profit should exclude any income or loss of the

issuer, or its group, generated by activities outside the ordinary and usual course of its business.

- 2.3 Under Hong Kong Accounting Financial Reporting Standard 1815 “Revenue” (HKAS 18—Revenue) states that from Contracts with Customers, if a reporting entity is able to estimate reasonably the level of income that it is entitled to from customers’ unexercised rights (also known as “breakage” which is an arrangement in which customers do not exercise all of their contractual rights), it should recognise the estimated breakage amount as a basis for recognising revenue in proportion to the pattern of rights exercised by customers. Otherwise, breakage amount is recognised as revenue only when the likelihood of customers exercising their rights becomes remote.

3. **Business Model that Relies on Forfeited Income Breakage**

- 3.1 The Exchange notes ~~in recent applications~~ that applicants who ~~are providers of~~ provide personal care services to individual customers (e.g. slimming and beauty services) tend to have this business model:
- (a) a significant part of the applicant’s revenue during the track record was ~~from prepaid packages of services or products.~~ This trend would continue after listing;
 - (b) these prepaid packages had a validity period ranging from 3 months to a year or more from the date of purchase, which could be extended at the applicant’s discretion;
 - ~~(c) prepayments received were initially recorded as deferred revenue in the balance sheet, and subsequently recognised as revenue when the services were provided to customers. Upon expiry of a prepaid package, any remaining deferred revenue would be recognised as income (forfeited income); and~~
 - (c) the forfeited income upon receipt of a prepayment from a customer, an entity shall recognise a contract liability. An entity shall derecognise that contract liability (and recognise revenue) when it transfers those goods or services and, therefore, satisfies its performance obligation. Meanwhile, the estimated breakage shall be recognised as revenue either in proportion to the pattern of rights exercised by the customers, or when the likelihood of the customers exercising their rights becomes remote (see paragraph 2.3); and
 - (d) the breakage constituted a material portion of the applicant’s revenue for each year of the track record period, in some cases over 30% of the yearly revenue. If the ~~forfeited income were~~ breakage amount was excluded, the applicant would be unable to meet the minimum profit requirement under Rule 8.05(1)(a).

4. Guidance

- 4.1 Income for services and/or products not rendered and/or utilised may be regarded as revenue generated in the usual and ordinary course of business for the purpose of Rule 8.05 if it is an industry norm to include ~~forfeited income~~breakage in business operations.
- 4.2 However, if an applicant has a short history of operating a business with ~~forfeited income~~breakage, its reliance on ~~forfeited income~~the breakage amount is significantly above the industry norm, and/or if the operation is associated with a high level of complaints or legal claims, these factors taken together may warrant significant concern. Accordingly, a heightened standard of review will be adopted.
- 4.3 This is because an exceptionally high level of ~~forfeited income~~breakage amount in the applicant's income portfolio compared to its industry peers could indicate that it should not be considered as generated in the usual and ordinary course of business for the purpose of Rule 8.05(1)(a).
- 4.4 Further, the Exchange might not consider the applicant suitable for listing, if, after considering the totality of the facts, continued reliance on ~~forfeited income~~breakage would potentially render the business not sustainable, its business model relies on unethical selling methods, or there is concern about the applicant's capacity to provide contracted services/products.
- 4.5 Where the facts and circumstances of an individual case warrant, the Exchange will request specific disclosure in the listing document and a detailed submission on the basis upon which the sponsor and the directors consider that the applicant's business satisfies Rules ~~8.05(1)(a)~~ and ~~Rule~~ 8.04.

Disclosure in Listing Document

- 4.6 The listing document should include the following disclosure, **where material**:

Details of prepaid packages giving rise to ~~forfeited income~~breakage

- (a) the number of years the applicant has derived revenue from ~~forfeited income~~breakage;
- (b) the level of ~~forfeited income~~breakage compared to the total revenue of the business;
- (c) the validity period of the prepaid packages and whether and how the validity period may be extended;

- (d) the number of complaints and claims received and the reasons behind these complaints and claims;
- (e) the level of repeat customers, i.e. those who continue to buy further packages upon expiry of the prepaid packages, and the product/service mix of the repeat purchases;

Quality control and complaints handling

- (f) the products and services offered and the respective profit margins during the track record period and their correlation with ~~forfeited income~~breakage;
- (g) the utilisation rate of the facilities to show that the applicant had and continues to have sufficient facilities to meet customers' needs even during peak periods and at popular locations;
- (h) the associated risks to enable investors understand the extent of the applicant's reliance on ~~forfeited income~~ from breakage and its financial impact on the applicant's business; and
- (i) other internal control measures or policies (or the lack thereof):
 - (i) any policy on refund of prepaid packages;
 - (ii) any policy on extending the validity period for prepaid packages;
 - (iii) any policy on payment of commission to staff for selling prepaid packages;
 - (iv) procedures for registering and handling complaints;
 - (v) adoption of best practice guidance issued by consumer protection bodies;
 - (vi) procedures to ensure compliance with advertisement guidelines issued by competent authorities; and
 - (vii) guidelines on referring customers to certified professionals (e.g. medical practitioners) and sharing of fees in those cases.

Submission Required

4.7 The Exchange normally requires the following submission:

- (a) an analysis on the outlook for revenue and profit if ~~forfeited income~~breakage and related expenses were deducted from the track record period profits;

- (b) a comparative analysis with industry peers on items in paragraph 4.6 (a) to (e) and on other material aspects of operation; and
- (c) sponsor's confirmation that:
 - (i) the applicant has adequate capacity to provide the contracted services/products; and
 - (ii) the internal control measures are adequate.