

HKEx GUIDANCE LETTER

HKEx-GL46-12 (December 2012) (Updated in October 2015 and January 2022)

[Updated due to adoption of Hong Kong Financial Reporting Standard 13 on Fair Value Measurement effective for annual periods beginning on or after 1 January 2013 and revisions to Hong Kong Accounting Standard 41 on Agriculture in August 2014]

[Streamlined and incorporated into the Guide for New Listing Applicants in January 2024]

Subject	Guidance on: <ol style="list-style-type: none">Unrealised fair value gains on valuation of biological assets for the purpose of trading record and profit requirements under Rule 8.05(1)(a)Disclosure requirements for applicants with biological assetsDue diligence work expected to be performed by sponsor and other professional advisers on biological assets
Listing Rules and Regulations	Main Board Rule 8.05(1)(a) Main Board Rule 2.13 Practice Note 21 of the Main Board Listing Rules
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Important note: *This letter does not override the Listing Rules and is not a substitute for advice from qualified professional advisers. If there is any conflict or inconsistency between this letter and the Listing Rules, the Listing Rules prevail. You may consult the Listing Division on a confidential basis for an interpretation of the Listing Rules, or this letter.*

1. Purpose

- 1.1 This letter provides guidance on (i) unrealised fair value gains arising from valuation of biological assets¹ for the purpose of trading record and profit requirements under Main Board Rule 8.05(1)(a); (ii) the disclosure requirements for applicants with biological assets; and (iii) due diligence work expected to be performed by sponsors and other professional advisers on biological assets.
- 1.2 Our treatment described below is unique to applicants engaging in agricultural activities² in view of the nature and inherent risks relating to the biological assets and their valuation. It is not appropriate to apply this treatment to all applicants who recognise unrealised fair value gains of their trading/ principal assets under the applicable accounting standards, e.g. investment properties and investments in securities. We consider that the risks in biological assets are higher as they are

¹ Biological asset is defined as a living animal or plant under Hong Kong Accounting Standard 41 – Agriculture.

² Agricultural activity is the management by an entity of the biological transformation and harvest of biological assets for sale or conversion into agricultural produce or into additional biological assets. Such activity covers a diverse range of activities, for example, raising livestock, forestry, annual or perennial cropping, cultivating orchards and plantations, floriculture, and aquaculture (including fish farming). (Source: paragraphs 5 and 6 of HKAS 41).

perishable and their valuation is usually subject to higher uncertainty due to the complex and not easily verifiable assumptions adopted.

2. Background

- 2.1 The Exchange considers that guidance to applicants engaging in agricultural activities is unique in view of the nature and inherent risks relating to biological assets and their valuation.
- 2.2 Hong Kong Accounting Standard 41 – Agriculture (“**HKAS 41**”) issued by the Hong Kong Institute of Certified Public Accountants (“**HKICPA**”) requires a biological asset to be measured at fair value less cost to sell, other than when its fair value cannot be measured reliably. The fair value of biological assets can be determined based on the market approach³, income approach⁴ (i.e. discounted cash flow or DCF method) or the cost approach⁵. Hong Kong Financial Reporting Standard 13 (“**HKFRS 13**”) requires an entity to use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs⁶. HKFRS 13 also establishes a fair value hierarchy that categorises into three levels the inputs to valuation techniques used to measure fair value⁷. The fair value hierarchy gives the highest priority to Level 1 inputs and the lowest priority to Level 3 inputs⁶. (*Updated in October 2015*)
- 2.3 Applicants which engage in agricultural activities have recorded in their income statements unrealised fair value gains/ losses from valuation of biological assets under the applicable accounting standards. In cases where an applicant’s profits are mainly made up of unrealised fair value gains from its biological assets, there have been concerns that allowing unrealised fair value gains to fulfill the trading record and profit requirements may not be consistent with the spirit of the Listing Rules.
- 2.4 In addition, due to the nature and inherent risks relating to the agricultural activities, biological assets and valuations of these assets, it is expected that sufficient information should be included in the applicant’s listing document and certain due diligence work should be performed by the sponsors and other professional advisers.

³ The market approach uses the prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business (Source: paragraph B5 of HKFRS 13 - Fair Value Measurement).

⁴ The income approach converts future amounts (e.g. net cash flows or income and expenses) to a single current (i.e. discounted) amount (Source: paragraph B10 of HKFRS 13).

⁵ The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (i.e. the current replacement cost) (Source: paragraph B8 of HKFRS 13).

⁶ Source: paragraph 61 of HKFRS 13.

⁷ Source: paragraph 72 of HKFRS 13. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date; Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly; and Level 3 inputs are unobservable inputs for the asset or liability (Source: paragraphs 76, 81 and 86 of HKFRS 13 respectively).

3. Relevant Listing Rules

- 3.1 Main Board Rule 8.05(1)(a) provides that 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\$35 million and, in respect of the two preceding years, be in aggregate not less than HK\$45 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.
- 3.2 Main Board Rule 2.13 requires that information contained in the listing document must be accurate and complete in all material respects and not be misleading or deceptive.
- 3.3 Practice Note 21 requires sponsors to conduct reasonable due diligence.

4. Guidance

Trading record and profit requirements

- 4.1 The trading record and profit requirement under Main Board Rule 8.05(1)(a) is one of the pre-requisite conditions to determine if an IPO applicant is eligible for listing. In view of the importance of this, the Exchange may not rely solely on the judgment of the directors and/ or accountants and may reach its own conclusion based on the information presented and disregard the accounting treatment in the financial statements to ensure that the eligibility standards of Main Board Rule 8.05(1)(a) are interpreted consistently.
- 4.2 Main Board Rule 8.05(1)(a) states that an applicant must have an adequate trading record with minimum profits, a trading record of not less than three financial years and the profits are to be generated by activities in the ordinary and usual course of the applicant's business. In determining whether any income can be counted towards the trading record and profit requirements, the Exchange must be satisfied that, based on the facts and circumstances of a particular case, the income was actively derived from commercial transactions in the applicant's ordinary business throughout the trading record period, rather than from unrealised fair value movements.
- 4.3 We consider that the sales of biological assets/ agricultural produce⁸ are the principal activities in the ordinary and usual course of business of an applicant which engages in agricultural activities. In addition, biological assets are subject to inherent risks and their valuation is usually subject to higher uncertainty due to complex and not easily verifiable assumptions adopted. Allowing an applicant engaging in agricultural activities to use unrealised fair value gains on valuation of biological assets to fulfill the trading record and profit requirements is contrary to the principles of the Listing Rules as discussed in paragraph 4.2 above. Therefore the applicant would be expected to have recorded sales of biological assets/ agricultural produce and profits (excluding unrealised fair value gains on biological assets) throughout three financial years to satisfy the three-year trading record and profit requirements under Main Board Rule 8.05(1)(a).

⁸ Agricultural produce is defined as the harvested product of the entity's biological assets under HKAS 41.

- 4.4 For agricultural companies which have recorded sales of biological assets/ agricultural produce and unrealised fair value gains/ losses in biological assets for a number of years, we recognise that unrealised fair value gains/ losses in biological assets would have already been accounted for as part of the trading profits and retrieving and separating historic costs for the purpose of profits test may be difficult if the applicants' accounting system does not capture and maintain the relevant information for that purpose. However, we consider that adjustments will need to be made to exclude the unrealised fair value gains on biological assets to demonstrate compliance with the three-year trading record and profit requirements under Main Board Rule 8.05(1)(a).
- 4.5 Different types of biological assets may have different development or fruition periods which result in different levels of uncertainty in determining their fair value. For example, it will take two years for some varieties of apple trees to bear fruits while a hog will have a gestation period of 180 days. Listing applicants engaging in agricultural activities are encouraged to consult with the Listing Division at the earliest possible opportunity to seek informal and confidential guidance as to their fulfillment of the trading record and profit requirements under Main Board Rule 8.05(1)(a).

Disclosure requirements for applicants with biological assets

- 4.6 The Exchange considers that the following disclosures, where not required by relevant accounting standards, should be made in the listing documents of applicants with biological assets:
- a. the group's results during the track record period excluding unrealised fair value gains/ losses on biological assets;
 - b. the relevant qualifications, experience and independence of the valuer, and how the directors and the sponsor are satisfied that the valuer is independent and competent to determine the fair value of biological assets;
 - c. information on the fair value measurement of biological assets and the significance of these assets to the applicant's net asset value;
 - d. the basis or reasons for using the specific technique in valuation of biological assets (i.e. quoted price in an active market, the cost approach or DCF method); *(Updated in October 2015)*
 - e. the material inputs, including bases and assumptions used in the valuation techniques (especially where discount rates are concerned), and (where appropriate) historical yield of the biological assets and commentary on the material fluctuation during the track record period;
 - f. how the sponsor is satisfied that the valuation technique chosen and the inputs used in the valuation technique are appropriate and reasonable;
 - g. that the reporting accountants are satisfied that the valuation technique chosen and the inputs used in the valuation technique are appropriate and reasonable;

- h. details of any limitations on the sponsor's due diligence in relation to biological assets (e.g. limitations in stock-take due to regulatory constraints and conditions in regulatory permits or licences which may not be fulfilled by the applicant), the alternative steps taken to address these limitations in respect of the information disclosed in the listing document and what steps can be taken going forward in respect of future disclosure of the same information. In some cases limitations on due diligence may make an applicant not suitable for listing;
- i. sensitivity analysis on changes in material inputs used in the valuation techniques, including discount rate and key assumptions and variables;
- j. details of the material cash flows used in the fair value measurement based on the DCF method, and confirmations from the directors and the sponsor that the components are consistent with market factors and assumptions used in the measurement;
- k. comprehensive details of how the applicant performs its stock-take on biological assets, and internal controls over physical existence of biological assets and the relevant record keeping;
- l. full details of the applicant's licences/ rights/ permits to carry out the agricultural activities;
- m. a robust risk factor stating that unrealised fair value gains/ losses on biological assets can fluctuate dramatically from period to period, are non-cash in nature, and are derived from many assumptions; and
- n. a risk factor, if material, that reported profits may be more volatile as any increase in the selling prices of biological assets will increase both the sales revenue and the unrealised fair value gains and vice versa.

Due diligence work to be performed by sponsor/ professional advisers on biological assets

- 4.7 Certain problems have been encountered by listed companies with biological assets including the physical existence of biological assets, inconsistencies between the licences/ rights/ permits to carry out the agricultural activities provided by the listed companies and the records of relevant authorities, and inconsistencies between the actual operations or area/ size operated by the listed companies and those stated in the relevant licences/ rights/ permits and/ or previously disclosed by the listed companies.
- 4.8 We expect more stringent due diligence work to be performed by the sponsor and other professional advisers:
 - a. an independent qualified valuer should be appointed to value the biological assets unless cogent reasons are provided;

- b. the sponsor should be satisfied that (i) the independent valuer has appropriate and adequate experience in valuation of the type of biological asset; (ii) the independent valuer's scope of work is appropriate to the opinion; and (iii) the bases and assumptions adopted by the independent valuer are fair and reasonable;
- c. the sponsor and independent valuer should be satisfied with the physical existence and the condition/ development status (e.g. age and health) of the biological assets by their independent verification (including the extent of reliance on data and information provided by the applicant and details of independent fieldwork/ physical inspections conducted) and with the disclosure in the listing document on the quantity and valuation of the biological assets;
- d. the reporting accountants should be satisfied with the physical existence of the biological assets by their independent verification (including the extent of reliance on data and information provided by the applicant and details of independent fieldwork/ physical inspections conducted) and with the measurement and disclosure of the biological assets in the accountants report;
- e. the sponsor should confirm that it has independently verified the validity and accuracy of the applicant's licences/ rights/ permits, including inspection of records maintained by the competent authorities; and
- f. the sponsor should confirm that it has independently verified that the applicant's actual operations (including area covered by the operations) are consistent with and in compliance with the relevant licences/ rights/ permits and records maintained by the competent authorities (if any).
