

HKEx REJECTION LETTER
Cite as HKEx-RL24-08 (October 2008)

[Withdrawn in April 2019; Superseded by HKEX-GL45-12]

Summary	
Listing Rule	GEM Listing Rule 11.12A(1)
Reason for rejection and the subsequent disposal of the case on review	<p>The GEM Listing Approval Group of the Listing Division rejected the listing application of the Company for the reason that the Company was not able to comply with the minimum operating cash flow requirement under GEM Listing Rule 11.12A(1) after excluding an adjustment for a non-cash item in relation to the settlement of certain employment-related expenses directly by the immediate holding company of the Company.</p> <p>The Listing Division's rejection decision was upheld by the GEM Listing Committee.</p>
Contents	<p><u>LETTER 1:</u> Extracts of the decision letter of the Head of IPO Transactions Department of the Listing Division, The Stock Exchange of Hong Kong Limited</p> <p><u>LETTER 2:</u> Extracts of the decision letter of the Acting Secretary to the GEM Listing Committee on hearing of the Company's application to review the decision of the Listing Division</p>

LETTER 1

[Date]

[Name and Address of Sponsor]

Dear Sirs

Re: Application for new listing of a GEM listing applicant
(the "Company" together with its subsidiary, the "Group")

We refer to your application Form 5A dated [**day*month*year*] made on behalf of the Company (the "Application"), the [*draft*] Proof of the Company's prospectus dated [**day*month*year*] (the "Prospectus") and your submissions dated [**day*] and [**day*month*year*] (the "Submissions"). Capitalised terms used in this letter have the same meanings as those defined in the Prospectus and the Submissions, unless otherwise stated.

The GEM Listing Approval Group of the Listing Division (the "Approval Group") held a meeting on [**day*month*year*] to consider the Application. Having considered the relevant facts and circumstances, the Approval Group resolved that the Group is not able to comply with the minimum operating cash flow requirement under Rule 11.12A(1) of the GEM Listing Rules.

Accordingly, the Application is rejected. The analysis and conclusion of the decision are set out below.

A. Relevant Facts

1. The Group is *[a service company]*. During *[the first year of the Track Record Period (comprising Year 1 and Year 2)]*, the Group incurred certain employment-related expenses (the “Employment Expenses”) of HK\$*[●]* million which were settled directly by *[Entity X]*, the immediate holding company of the Company, and treated as a capital contribution to the Group (the “Settlement”).
2. *[Portion of Letter Purposely Omitted]*
3. The Settlement was presented in the cash flow statement of the audited financial statements of *[Entity Y]* (the principal subsidiary of the Company) for *[Year 1]* as “Increase in capital reserve” under “Cash flows from financing activities”. *[Entity Y]*’s audited financial statements for *[Year 1]* were approved by its Directors and signed off by *[the Reporting Accountants of the Company]* on *[*day*month*year]*. In *[Entity Y]*’s audited financial statements, the operating cash flow before changes in working capital and tax paid (“Operating Cash Flow”) presented an outflow of HK\$*[●]* million for *[Year 1]*.
4. The Settlement was presented in the Group’s consolidated cash flow statement in the Accountants’ Report as an adjustment of HK\$*[●]* million for a non-cash item under “Cash flows from operating activities” (the “Adjustment”). As such, the Group’s Operating Cash Flow presented an inflow of HK\$*[●]* million for *[Year 1]*.
5. If the Adjustment was not made, the Group’s Operating Cash Flow for *[Year 1]* would be an outflow of HK\$*[●]* million, and the Group’s aggregate Operating Cash Flow for *[Year 1 and Year 2]* would be an inflow of *[less than HK\$20 million]*.
6. The cash flow statements of the Group for *[Year 1 and Year 2]* were prepared in accordance with Hong Kong Accounting Standard 7 (“HKAS 7”) and the Adjustment was made in order to reflect the Group’s actual cash flows from its operating activities. The Employment Expenses, as submitted by the Sponsor, are common in the *[industry]* as attractive remuneration packages and often required for recruiting talented *[employees]* to join from larger and more established firms, and the Company considered that these expenses constituted normal operating activities of the Group and were in the ordinary and usual course of the Group’s *[business]*. As such, the Sponsor considered that the Group’s aggregate Operating Cash Flow of HK\$*[●]* million *[as disclosed in the Accountants’ Report]* for *[Year 1 and Year 2]* is the Group’s positive cash flow in accordance with Rule 11.12A(1).
7. The Group generated total Operating Cash Flow of HK\$*[●]* million for *[Year 1 and Year 2]*, recorded a net profit of HK\$*[●]* million in *[Year 2]* after a net loss in *[Year 1]*. The Company is expected to maintain a similar level of profits in *[the year immediately after Year 2]*, and meet the profit test under Main Board Listing Rule 8.05 within two years in *[two years immediately after Year 2]*. The Sponsor considered that the cash flow and profit levels strongly indicated that the Group has a viable business with both substance and prospects. If the Exchange was to consider the 24-month period ended *[three months after the end of Year 2]*, the Group’s Operating Cash Flow would be HK\$*[●]* million, which meets the minimum requirement of HK\$20 million under Rule 11.12A(1).

B. Applicable Listing Rules and Interpretations, and Relevant Accounting Standards

8. Rule 11.12A(1) of GEM Listing Rules requires a new applicant or its group must have an adequate trading record of at least two financial years comprising a positive cash flow generated from operating activities in the ordinary and usual course of business before changes in working capital and tax paid of at least HK\$20,000,000 in aggregate for the two financial years immediately preceding the issue of the listing document.
9. The note to Rule 11.12A(1) further states that “*A statement of cash flow prepared using the indirect method for submission to the Exchange for the purpose of satisfying rule 11.12A must also be included in the prospectus for disclosure purpose... Details regarding cash flow statement prepared under the indirect method are further described under Hong Kong Accounting Standard 7*”.
10. Operating activities are defined in HKAS 7 as the principal revenue-producing activities of the entity and other activities that are not investing or financing activities. According to paragraph 14(d) of HKAS 7, cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity, and generally result from the transactions and other events that enter into the determination of profit or loss. Examples of cash flows from operating activities include, among others, cash payments to and on behalf of employees.
11. As stated in the Consultation Conclusions on the Growth Enterprise Market issued by the Exchange on 2 May 2008 (the “Consultation Conclusions”), the Operating Cash Flow requirement of Rule 11.12A(1) is a good indicator of the business viability of an applicant.
12. When reviewing whether a new listing applicant satisfies the requirement of Rule 11.12A(1), the Listing Division ordinarily considers the burden of proof to be on the sponsor and the listing applicant to demonstrate compliance. In view of the importance of this listing eligibility standard, in areas where significant judgment is required by directors or the reporting accountants that affects the Listing Division’s analysis of Rule 11.12A(1), the Listing Division does not rely solely on the judgment of the directors and/ or reporting accountants in reaching its conclusions. Instead the Listing Division may reach its own conclusion based on the information presented in order to ensure that the eligibility standards of Rule 11.12A(1) are interpreted in a consistent manner and not unduly affected by the views of individual boards of directors and/ or reporting accountants.

C. The Issue

13. Whether the Settlement constitutes operating activities in the ordinary and usual course of the Group’s business, and if not, whether the Company would be able to fulfil the Operating Cash Flow requirement under Rule 11.12A(1).

D. Analysis

14. The Approval Group considers the Operating Cash Flow requirement under Rule 11.12A(1) to be a question of fact. In particular, the Approval Group will consider whether the Group is able to fulfil the Operating Cash Flow requirement without relying on activities conducted outside the Group’s ordinary and usual course of business.

Ordinary and usual course of business

15. Rule 11.12A(1) requires the Operating Cash Flow to be generated from operating activities “in the ordinary and usual course of business”. Therefore, by simply asserting

that Operating Cash Flow prima facie meets Rule 11.12A(1) because it is prepared under an accepted accounting standard is not sufficient. The operating inflows and outflows making up the Operating Cash Flow must also have to be made in an applicant's ordinary and usual course of business.

16. The Approval Group does not dispute that the Employment Expenses were incurred for the ordinary and usual course of the Group's business. The Employment Expenses had to be incurred by the Group during its business operations in generating its income for [Year 1]. Without incurring such expenses, the Group would most likely not be able to generate the level of revenue it did in [Year 1].
17. The Approval Group, however, considered that the Adjustment will distort in substance what ought to be the Group's cash outflow from operating activities in its ordinary and usual course of business during the relevant period. Normally, it would not be expected to be part of the Group's ordinary and usual operating activities to have a third party incurring expenses on the Group's behalf. Had the Employment Expenses not been settled by [Entity X] on the Group's behalf, they would be expected to be incurred by the Group in its ordinary and usual course of business and reflected as part of the Group's operating cash outflow. The effect of which would be a negative Operating Cash Flow of HK\$[●] million for [Year 1].
18. The Operating Cash Flow requirement is intended to be an indicator of the Group's business viability. If the Settlement was to be accepted as the Group's usual and ordinary course of business, the purpose of Rule 11.12A(1) would be rendered useless as an eligibility requirement. The Approval Group did not consider it appropriate to accept the Settlement as in the usual and ordinary course of the Group's business, and thus the Adjustment should not be taken into account when ascertaining whether the Company is able to meet Rule 11.12A(1).

Compliance with HKAS 7

19. The note to Rule 11.12A(1) aims to inform users that the statement of cash flow using the indirect method, prepared in accordance with HKAS 7 must be submitted to the Exchange and included in the prospectus. This note serves to facilitate a consistent form of disclosure by applicants. The Approval Group has not sought to disagree with the Operating Cash Flow as presented in the Group's financial statements. It is asserted by the Sponsor and the applicant that prima facie the Company's cash flow statement on its face complied with the minimum cash flow requirement under Rule 11.12A(1) of the GEM Listing Rules, and was prepared by a "big four" international accounting firm in accordance with applicable accounting standards stated under that Rule. However, the assessment of an applicant's ability to comply with the financial eligibility requirements under GEM Listing Rules may not necessarily be treated identically to its accounting presentation. The same principle is set out in the Listing Division's rejection letter HKEx-RL10-06. The Listing Division may exclude certain income/ expense which may not be generated/ incurred from an applicant's usual and ordinary course of business even if it, prima facie, is able to meet the profit requirement under Main Board Listing Rule 8.05(1)(a) based on the financial data presented in its audited financial statements.
20. Therefore, based on the facts and circumstances of this case as discussed above, the Approval Group considered it is not appropriate to accept the Group's cash flow position under its current accounting presentation for the purpose of determining the Group's ability to meet the eligibility requirement under Rule 11.12A(1).

Quantitative requirement under Rule 11.12A(1)

21. The Approval Group disagreed with the Sponsor's argument that a two financial-year period as the basis for the cash flow eligibility requirement was arbitrary when the Rule was considered. The intention of the revised GEM regime, as stated in paragraph 2 of the Consultation Conclusions is to reposition GEM as a second board and as a stepping stone towards the Main Board of the Exchange. The two financial-year period would enable a level of track record where the Operating Cash Flow requirement can be ascertained. This two financial-year period fits in with the requirement for an issuer to be listed on GEM for at least one year, rendering the total period of financial scrutiny and regulatory assessment three years in total, before it can apply to transfer its listing to the Main Board, mirroring the three-year track record period requirement for Main Board applicants.
22. Rule 11.12A(1) clearly sets out that the timeframe for the Operating Cash Flow requirement is the "two financial years immediately preceding the issue of the listing document". This will reduce applicants from "shopping" for the ideal period which enables them to meet the requirement, which may cause confusion in the disclosure in the prospectus, among others. Therefore, the Sponsor's suggestion to use the 24-month period preceding *[three months after the end of Year 2]* in ascertaining compliance with Rule 11.12A(1) cannot be accepted because the proposed period does not fall within the financial years of the Company as required under the GEM Listing Rules.
23. The Approval Group also pointed out that the proposal to implement the Operating Cash Flow requirement of Rule 11.12A(1) was made known to potential applicants as early as July 2007.

Capital expenses

24. The Approval Group noted it was also submitted that the Employment Expenses, on a non-accounting standpoint, should be treated as capital expenses, and thus should not be treated as an operating cash outflow. However, the Approval Group looked at the Operating Cash Flow using the indirect method prepared under HKAS 7 as a starting point for the assessment of an applicant's ability to comply with the financial eligibility requirements. The Employment Expenses have been included as part of the net profit of the Group for a reason, that is, they were common in the *[industry]* as attractive remuneration packages and often required for recruiting talented *[employees]* to join from larger and more established firms, and were incurred in the usual and ordinary course of the Group's business. The assertion of the Employment Expenses now being capital in nature on a non-accounting standpoint and not being considered as an operating cash outflow of the Group is without basis.

E. The Conclusion

25. The Approval Group has taken note of the details set out in the Submissions, among others, that the Group has started to be profitable in *[Year 2]* and the Company would be able to meet the Main Board eligibility requirements in time. The Approval Group has no comment on this. However, the Company is applying to list on GEM Board which has certain eligibility requirements. These requirements, such as the Operating Cash Flow requirement, are clear. To be able to list on GEM, these requirements are to be complied with.
26. Having considered all relevant facts and circumstances, which include, among others, that the Settlement does not constitute "operating activities in the ordinary and usual course of

the Group's business", the Approval Group considered that the Adjustment should be disregarded. As a result, the Group's aggregate Operating Cash Flow in the ordinary and usual course of business for [Year 1 and Year 2] for the purpose of Rule 11.12A(1) would be a cash inflow of [less than HK\$20 million].

27. On the basis of the Approval Group's analysis set forth above, it is concluded that the Company is not able to comply with the Operating Cash Flow requirement of HK\$20 million under Rule 11.12A(1). Accordingly, the Application is rejected on such basis.

[Portion of Letter Purposely Omitted]

Pursuant to Rule 4.05(1) of GEM Listing Rules, the Company has the right to have this decision reviewed by the GEM Listing Committee.

[Portion of Letter Purposely Omitted]

Yours faithfully
For and on behalf of
The Stock Exchange of Hong Kong Limited

[Signed]

Head of IPO Transactions Department

LETTER 2

[Date]

[Name and Address of Sponsor]

Dear Sirs,

Re: Review Hearing of the GEM Listing Committee
(the “Review Hearing”) regarding the Company
Date of the Review Hearing: [*time* day* month* year]

On [*day*month*year], the GEM Listing Committee of The Stock Exchange of Hong Kong Limited considered an application from the Company for a review of the decision of the Approval Group of the Listing Division and set out in [LETTER 1] dated [*day*month*year] (the “Division’s Decision”).

The Review Hearing was held before the GEM Listing Committee comprising [names of members purposely omitted] (the “Committee”).

Note: Terms and expressions used and defined in the written submissions of the Listing Division shall have the same meanings when used herein unless otherwise defined.

Decision

The Committee considered all the submissions (both written and oral) made by the Company and the Listing Division. The Committee determined to uphold the Division’s Decision that the Company was not able to comply with the Operating Cash Flow requirement of HK\$20 million under Rule 11.12A(1) of the GEM Listing Rules and, accordingly, the Application was rejected on such basis.

Reasons

The Committee arrived at its decision for the following reasons:

1. Rule 11.12A(1) of the GEM Listing Rules required a new applicant or its group must have an adequate trading record of at least two financial years comprising a positive cash flow generated from operating activities in the ordinary and usual course of business before changes in working capital and taxes paid of at least HK\$20,000,000 in aggregate for the two financial years immediately preceding the issue of the listing document.
2. Whether Rule 11.12A(1) was complied with was a question of fact. In examining the facts of each case, one must look beyond the description given to a transaction and should instead focus on the substance of the transaction.
3. There was no dispute that the Employment Expenses were incurred for [Entity Y]’s ordinary and usual course of business. Without these expenses, the Company could not have hired or retained the staff to generate the level of business activities it did in [Year 1]. At the Review Hearing, the Company further confirmed that the Employment Expenses were incurred for recruiting staff providing services exclusively for [Entity Y] and that these employees did not provide service to [Entity X]. In fact, [Entity X] was an investment holding company holding shares in the Company. Accordingly, the Settlement

did not constitute operating activities in the ordinary and usual course of the Group's business.

4. It might be the practice of *[Entity X]* to pay for the start-up costs of its subsidiaries but the Settlement did not constitute operating activities in the ordinary and usual course of the Group's business.
5. For the purposes of ascertaining whether the Company was able to comply with Rule 11.12A(1), the Adjustment should not be taken into account. The Adjustment would distort in substance what ought to be the Group's cash outflow from operating activities in its ordinary and usual course of business during the relevant period. The economic reality was that, had the Employment Expenses not been settled by *[Entity X]* on the Group's behalf, they would have to be incurred by the Group in its ordinary and usual course of business and reflected as part of the Group's operating cash outflow.
6. By simply asserting that the Operating Cash Flow prima facie met Rule 11.12A(1) because it was prepared under the accepted accounting standards was not sufficient. The operating inflows and outflows must also have to be in substance made in the Company's ordinary and usual course of business.
7. The above ruling was made strictly on the interpretation of Rule 11.12A(1) that the Company failed to comply with the eligibility requirement under the GEM Listing Rules. The Committee considered that the non-compliance with the Operating Cash Flow requirement under the Rule could not be remedied by way of disclosure.

Yours faithfully
For and on behalf of
The Stock Exchange of Hong Kong Limited

[Signed]

Acting Secretary to the GEM Listing Committee