

HKEx REJECTION LETTER
Cite as HKEx-RL13-06 (April 2006)

[Withdrawn in March 2019]

Summary	
Listing Rule	GEM Listing Rule 2.07
Reason for rejection and the subsequent disposal of the case on review	<p>At the hearing meeting considering the Company's listing application the GEM Listing Committee considered that a high standard of review should be applied in light of the facts and circumstances of the Company's case, in particular, the following:</p> <ul style="list-style-type: none"> • the Company changed its reporting accountants during its listing applications; • significant sales by the Group to companies controlled by the employees of the Group and its related parties were noted during the Active Business Pursuit Period of the Company. <p>The Listing Committee exercised its discretion under GEM Listing Rule 2.07 to request the Company to provide the Listing Division with detailed explanations regarding the issues raised by the GEM Listing Committee.</p> <p>The Company failed to address the concerns of the Listing Committee by providing the appropriate level of assurance to the Listing Division. The Listing Division therefore rejected the listing application 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 Listing, the Stock Exchange of Hong Kong Ltd</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 subsidiaries, the “Group”)

We refer to:

- (i) the listing applications of the Company (the “[**First Listing Application**]”; “[**Second Listing Application**]” and the “[**Present Listing Application**]”) dated [*day*month*year]; [*day*month*year] and [*day*month*year];
- (ii) the hearing proof of the prospectus dated [*day*month*year] (the “**Prospectus**”);
- (iii) the letter of [*day*month*year] from the Secretary to the GEM Listing Committee to the Sponsor [after hearing the *Second Listing Application* of the Company] (the “**LC Letter**”); and
- (iv) the Sponsor’s submissions dated [*day*month*year] (the “**Submissions**”) in response to the LC Letter.

Capitalised terms used in this letter shall have the same meanings as defined in the Prospectus and the Submissions, unless the context requires otherwise.

Relevant Facts

The [Present Listing Application]

The [*First Listing Application*] was filed for the first time on [*day*month*year] and lapsed on [*day*month*year] (six months after filing) as no responses were made to a set of Listing Division’s comments made on [*day*month*year]. On [*day*month*year], the Sponsor re-submitted the [*Second Listing Application*] together with an updated draft prospectus. A significant change noted in the re-filing was that the Company had changed its reporting accountants for the purposes of the [*Second Listing Application*] from [*Reporting Accountants AA*] (“[*Reporting Accountants AA*]”) to [*Reporting Accountants BB*] (“[*Reporting Accountants BB*]”). It was also noted that there were significant sales by the Group to companies controlled by employees of the Group and its related parties during the Active Business Pursuit Period (the “**Sales Transactions**”).

Views of the GEM Listing Committee

The [*Second Listing Application*] was considered by the GEM Listing Committee on [*day*month*year] [shortly before the *Second Listing application* lapsed]. The GEM Listing Committee had raised a number of concerns in relation to the circumstances of [*Reporting Accountants AA*’s] resignation and the existence and rationale for the Sales Transactions.

The GEM Listing Committee considered that the facts and circumstances of the *[Second Listing Application]* should warrant significant concern. *[Portion of Letter Purposely Omitted]*. The GEM Listing Committee considered that the resignation of *[Reporting Accountants AA]* *[shortly before the First Listing Application lapsed]* was a very serious step which had suggested that there were serious problems with *[Reporting Accountants AA's]* audit and that *[Reporting Accountants AA]* was exceedingly concerned with the audit and the Sales Transactions in particular. To check the concerns that had been raised would require a more comprehensive audit than that had been performed to date by the Company's current reporting accountants, *[Reporting Accountants BB]*, and which would include a forensic audit.

The GEM Listing Committee took note that *[Reporting Accountants BB]* had performed certain procedures including (i) site visits to and interviews with some relevant retailers, (ii) company search, (iii) inspection of original business certificates of some relevant retailers, (iv) vouching of some source documents, (v) scrutinizing the Group's sales lists to identify omissions of related party transactions and (vi) inspection of customers' profiles. The GEM Listing Committee took the view that the procedures performed by *[Reporting Accountants BB]* were not adequate in the circumstances. In light of the seriousness of the concerns identified by *[Reporting Accountants AA]*, the GEM Listing Committee had considered it necessary for *[Reporting Accountants BB]* to vet all of the Company's customers for the purposes of expressing a clear audit opinion on the Company's financial statements. The Company should also be required to explain to the satisfaction of the Exchange the detailed rationale for conducting the Sale Transactions.

The GEM Listing Committee had, therefore, in [the hearing meeting considering the Second Listing Application of Company A], requested the Sponsor and the directors of the Company to, among others:

1. explain to the satisfaction of the Exchange the reasons for *[Reporting Accountants AA's]* departure;
2. explain to the satisfaction of the Exchange how *[Reporting Accountants BB]* had been able to satisfy themselves that the related party transactions were limited to those that had been identified;
3. explain to the satisfaction of the Exchange the detailed reasons for the Sales Transactions; and
4. confirm and substantiate whether the employees who owned the businesses to which the Sale Transactions were made with (the "**Businesses**") were conducting genuine businesses.

The Sponsor's and [Reporting Accountants BB's] Submissions in response

The Sponsor and *[Reporting Accountants BB]* had made their responses to the comments of the GEM Listing Committee as follows:

1. *[Reporting Accountants AA]* had stopped carrying out its work *[shortly before the First Listing Application lapsed]* when the Sales Transactions were identified. *[Reporting Accountants AA]* had failed to propose any concrete plans for the

Company's consideration and had ceased its work. [Reporting Accountants AA] had also refused to resume work when requested by the Company to review the supporting documents which the Company had subsequently gathered. The Sponsor found the circumstances surrounding [Reporting Accountants AA's] departure unreasonable and unprofessional.

2. [Reporting Accountants BB] had performed additional audit work of a forensic nature to cover the entire sales transactions for [the active business pursuit period of the Company comprising Year 1, Year 2 and a six-month stub period thereafter] (the "ABP Period") to determine the completeness of the disclosures of the related party transactions which had included:-
 - (i) checking sales transactions of the Group during the ABP Period to sales invoices, delivery notes, and their subsequent settlements. The average coverage of the work undertaken to verify the identities and existence of the customers had represented [almost 90%] of the total sales during the ABP Period;
 - (ii) performing 100% vouching of bank-in slips and cash receipts, matching the names of the depositors on the bank-in slips with the customers for settlement through banks, checking the sequential number of cash receipts for cash settlement, comparing the dates of payments as shown in the bank-in slips and cash receipts against those shown on the invoices, etc.;
 - (iii) performing analytical procedures on the reasonableness of the terms, including gross profit margin and sales pattern in term of volume, pricing and timing/frequency of the top 50 customers, which had represented [approximately 80%] of the Group's total sales during the ABP Period. However no further analytical procedures on sales pattern were performed on the remaining [approximately 20%] of the Group's total sales during the ABP Period, which had comprised of customers with average sales amounts of [approximately HK\$20,000];
 - (iv) visiting [over 50] customers which had represented [approximately 70%] of the Group's total sales during the ABP Period;
 - (v) conducting company searches on [over 100] customers which had represented [approximately 55%] of the Group's total sales during the ABP Period;
 - (vi) conducting telephone interviews with [over 100] customers which had covered [approximately 10%] of the Group's total sales during the ABP Period; and
 - (vii) sending confirmations to customers representing [95%] of the Group's total sales during the ABP Period. Of this [95%], confirmations without negative responses were received for [over 80%] whilst the remaining [15%] were mainly walk-in customers.
3. The Sponsor submitted that the reasons for not performing ancillary audit work on 100% of the Group's sales were mainly that certain sales of the Group were related to (i) "walk-in" retail customers or customers without contact details; and (ii) customers who had declined to accede to [Reporting Accountants BB's] requests for

confirmation as they had ceased trading relationships with the Company. These sales had represented on average HK\$20,000 per customer.

4. Some employees of the Group had approached the Company's management at *[the end of Year 1]* and expressed interest in reselling the Company's products. The Company's management had endorsed these proposals after taking into account the facts that:
 - (i) the proposals could increase the Group's sales;
 - (ii) the proposals could expand the Group's sales network to the rural areas;
 - (iii) these employees were familiar with the Group's products; and
 - (iv) these employees were relatively free during the long winter in *[the PRC]*.
5. To verify whether the Businesses were genuine, *[Reporting Accountants BB]* had performed the following:-
 - (i) site visits;
 - (ii) interviews with relevant parties;
 - (iii) obtaining written confirmations from the "related parties";
 - (iv) analytical procedures on the reasonableness of the terms of the sales (e.g. gross profit margins and unit prices);
 - (v) reviewing copies of business licenses and capital verification reports;
 - (vi) vouching relevant supporting documents (e.g. sales contracts, purchase orders, invoices, receipts, or goods delivery notes); or
 - (vii) independent company searches.
6. *[Reporting Accountants BB]* submitted that they had made site visits and interviewed the beneficiaries of the related parties and had not identified any irregularities from the above procedures that warrant further work, and was not aware of any evidence that suggested that the relevant sales were not genuine.

Issue

Whether the Sponsor and *[Reporting Accountants BB]* have made responses to the comments made by the GEM Listing Committee during *[the hearing meeting considering the Second Listing Application of the Company]* to the satisfaction of the Exchange.

Applicable GEM Listing Rules

Rule 2.07 of the GEM Listing Rules provides that “... *the GEM Listing Rules are not exhaustive and that the Exchange may impose additional requirements or make listing subject to special conditions whenever it considers it appropriate.*”

Our Analysis

The Exchange applies an explicit risk based approach in determining whether the facts and circumstances of an individual case warrant a significant variation of the standard of review ordinarily accorded to IPO applications. This would mean in some, exceptional, cases that the Listing Division would not necessarily accept at face value opinions provided by qualified experts, including professional accountants. The critical point from the Exchange’s perspective is that warning signs found during the course of vetting clearly indicate that a higher standard of review should be applied to provide a high level of assurance about the eligibility, suitability and disclosure by the IPO applicant for purposes of complying with the GEM Listing Rules.

The making of the commentary and requests for detailed explanations of various issues by the GEM Listing Committee at *[the hearing meeting considering the Second Listing Application of the Company]* was one of a number of instances in which the GEM Listing Committee exercised its discretion in accordance with the GEM Listing Rules. The GEM Listing Committee took the view that their requests in the current circumstances were within their powers of discretion memorialised in Rule 2.07, proportionate to the seriousness of the issues identified and designed to address those issues squarely. The Committee had noted with concern issues which did not appear to have been resolved by obtaining appropriate assurance to a sufficiently high standard. The Committee considered that the resignation of *[Reporting Accountants AA]* was a very serious step which suggested that there were serious problems with *[Reporting Accountants AA’s]* audit and that *[Reporting Accountants AA]* was exceedingly concerned with the audit and the Sales Transactions in particular. As found by the Committee, the issues identified suggested that there might be potential problems either with the Company’s business model or the veracity of disclosure presented to the Committee, or both.

Based on the information contained in the Submissions, the Listing Division notes that certain concerns and requests previously raised by the GEM Listing Committee had not been satisfactorily addressed. In particular, the Division notes that the Sponsor and/ or *[Reporting Accountants BB]*:

- (i) has not verified the identities and existence of customers to whom *[over 10%]* of the Group’s total sales during the ABP Period were made;
- (ii) has not performed further analytical procedures on the sales pattern for *[almost 20%]* of the Group’s total sales;
- (iii) has not visited customers to whom *[over 30%]* of the Group’s total sales during the ABP Period were made;

- (iv) has not received confirmations from customers to whom *[almost 20%]* of the Group's total sales during the ABP Period were made;
- (v) has not performed any further alternative audit procedures on certain customers who are no longer contactable by the Group; and
- (vi) has on the record submitted that they would not be able or willing to extend their scope of work beyond that they have carried out to date.

Although the Sponsor and [Reporting Accountants BB] have extended their scope of work, given the gaps in complying with the requests of the GEM Listing Committee, which we view as significant, it is the view of the Listing Division that such work has fallen short of the heightened standard of review required by the GEM Listing Committee in the circumstances.

Our Conclusion

In light of the facts and circumstances of the case and our analysis set forth above, the Listing Division has concluded that the Company has not made satisfactory responses to the concerns identified by the GEM Listing Committee. The Listing Division therefore has decided to reject the *[Present Listing Application]*.

[Portion of Letter Purposely Omitted]

Pursuant to Rule 4.05(1) of the 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 Listing

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: [* date * month * year]

On [*date*month*year], the GEM Listing Committee of The Stock Exchange of Hong Kong Limited conducted a review hearing (the “**Review Hearing**”) to consider an application from the Company for a review of the decision of the Listing Division set out in [LETTER 1] dated [*date* month * year], (the “**Decision**”).

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

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

Decision

The Committee considered the submissions (both written and oral) made by the Company and the Listing Division. The Committee decided to uphold the Decision to reject the Company’s listing application.

Reasons

The Committee arrived at its decision for the following reasons:

1. The Sales Transactions were unusual, in that they were with parties who could be viewed as being related to the Company or its controlling shareholder, and constituted a material part of the ABP Period.
2. The gross profit margins of the Sales Transactions were inconsistent with the gross profit margin of the Company as a whole during [Year 1] and [Year 2].
3. The effect of the Sales Transactions was to distort the results of the ABP Period to the extent that if they were excluded from the ABP Period the Company would reflect a downward trend in sales.
4. Viewing the above factors taken as a whole, together with the other facts and circumstances of this case, the Committee concluded that the Company had failed to produce cogent evidence to convince the Committee to overturn the Decision.

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

[Signed]

Acting Secretary to the GEM Listing Committee