

HKEX REJECTION LETTER
Cite as HKEx-RL9-05 (March 2005)

[Withdrawn in April 2019; Superseded by HKEX-GL45-12]

Summary	
Listing Rule	Listing Rule 8.05
Reason for rejection	Failure to satisfy the profit requirement of Listing Rule 8.05
Contents	Extracts of the response of the Executive Director-Listing, the Stock Exchange of Hong Kong Ltd

[Date]

[Name and Address of Sponsor and Co-sponsor]

Dear Sirs,

Re: Application for new listing of a Main Board listing applicant
(the “C ompany” together with i ts s ubsi diaries, the “Group”)

We refer to your application form dated [**day*month* year*] applying, on behalf of the Company, for the listing of the shares of the Company on the Main Board of the Exchange. We also refer to your submissions dated [**day*month*year*] (the “**Submissions**”) in response to our comments [**day*month*year*]. Capitalized terms used in this letter have the same meanings as those defined in the [***] Proof of the Company’s prospectus dated [**day*month*year*] (the “**Prospectus**”), unless otherwise stated.

Based on the facts and submissions provided to us, the Listing Division is of the view that the Group is not able to demonstrate to our satisfaction that it has complied with the minimum profit requirement of HK\$30 million in respect of the first two years [*i.e. Year 1 and Year 2*] of the Track Record Period [*i.e. Year 1, Year 2 and Year 3*] under Rule 8.05(1)(a) of the Listing Rules. We would like to take this opportunity to explain in detail our reasoning in reaching this conclusion.

1 Background

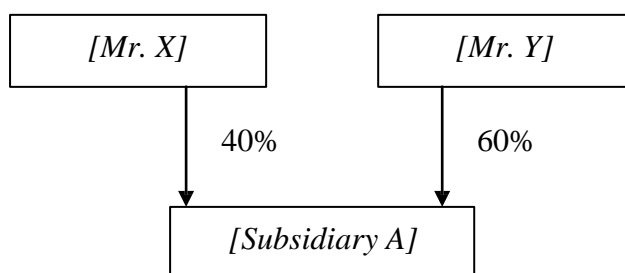
1.1 The Group’s principal activities involve the provision of [***].

1.2 [*Subsidiary A*] was the only operating subsidiary of the Group during the Track Record Period. The company was established in the PRC with limited liability on [** day* month* year*] and was converted into a Sino-foreign co-operative joint venture [*in the 9th month of Year 3*]. [*Mr. X*] is the chairman of the Board and an executive Director of the Company. [*Mr. X*] and his elder brother, [*Mr. Y*], are the founders of [*Subsidiary A*].

1.3 Based on the information provided in the Prospectus and the Submissions, we note that *[Subsidiary A]* has undergone the following shareholding changes during the Track Record Period:

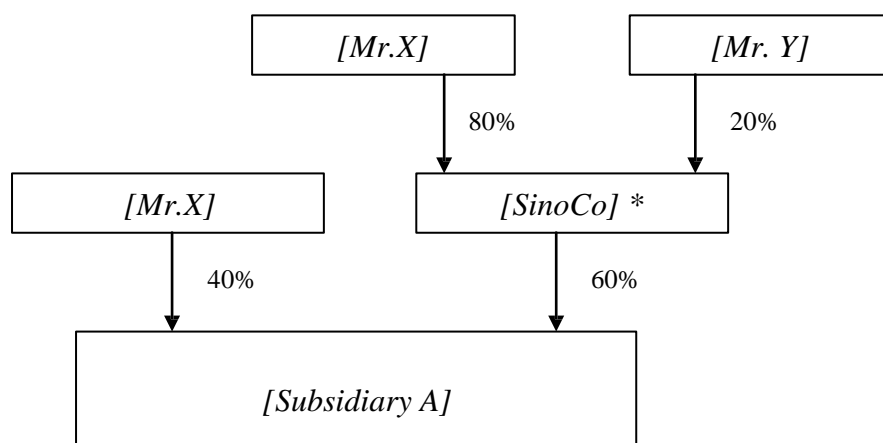
1.3.1 *[From the beginning of Year 1 to immediately before the 1st Round of Equity Transfer (mentioned in para. 1.3.2) in the 6th month of Year 2]*

During the period from *[the beginning of Year 1 to immediately before the 1st Round of Equity Transfer in the 6th month of Year 2]*, *[Subsidiary A]* was then owned as to 40% and 60% by *[Mr. X]* and *[Mr. Y]* respectively.



1.3.2 *[1st Round of Equity Transfer –in the 6th month of Year 2]*

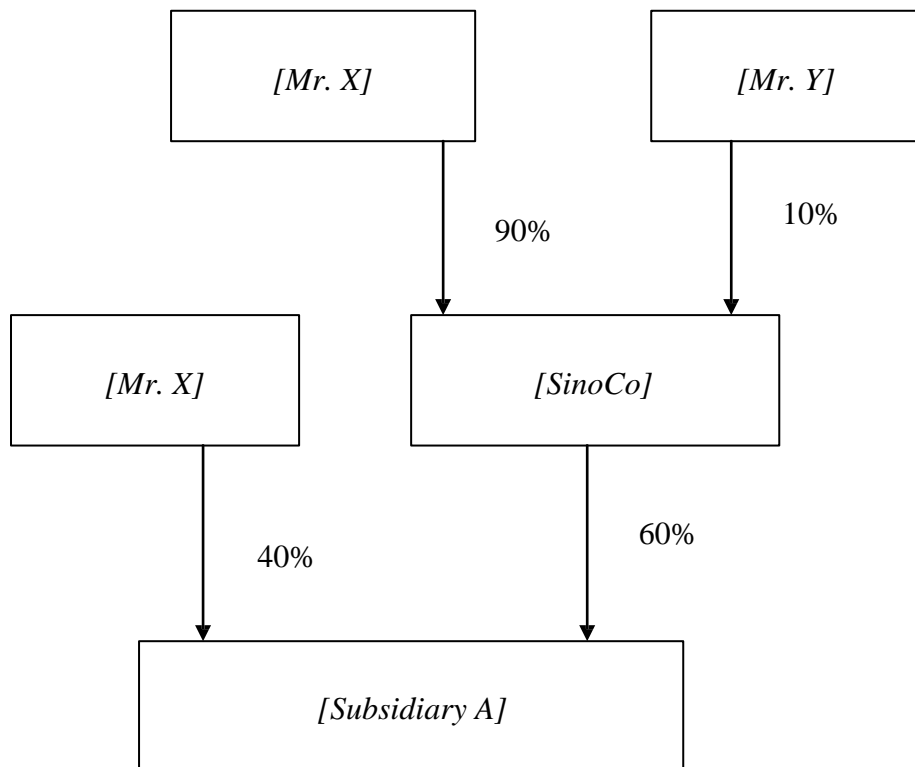
[During the sixth month of Year 2], *[Mr. Y]* entered into an equity transfer agreement pursuant to which he agreed to transfer his 60% equity interest in *[Subsidiary A]* to *[SinoCo]*. *[SinoCo]* was then owned as to 80% and 20% by *[Mr. X]* and *[Mr. Y]* respectively. *[With effect from the completion of the 1st Round Equity Transfer]*, the effective interests of *[Mr. X]* and *[Mr. Y]* in *[Subsidiary A]* were 88% and 12% respectively.



* *[SinoCo]* does not form part of the Group during the Track Record Period and upon proposed listing

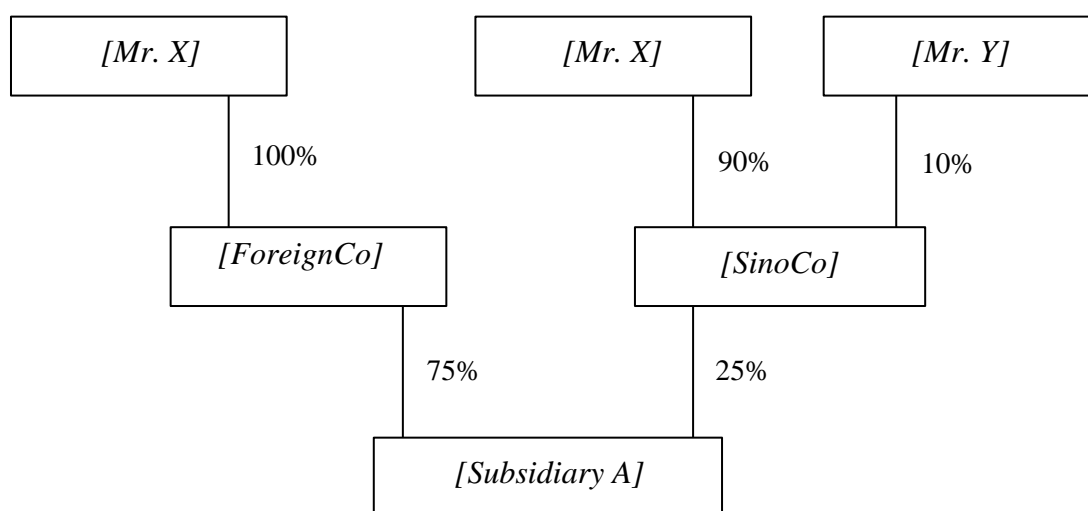
1.3.3 [Immediately after the Capital Increase in [SinoCo] in the 7th month of Year 2 to immediately before the 2nd Round of Equity Transfer (mentioned in para.1.3.4) in the 8th month of Year 3]

[In the 7th month of Year 2], [SinoCo's] registered capital was increased resulting in its shareholding interest owned as to [approximately 90%] and [approximately 10%] by [Mr. X] and [Mr. Y] ("Capital Increase in [SinoCo]"). respectively. As a result, [Mr. X] and [Mr. Y] held approximately 94%] and [6%] effective interests respectively in [Subsidiary A].



1.3.4 [Immediately after the 2nd Round of Equity Transfer in the 8th month of Year 3 to the present]

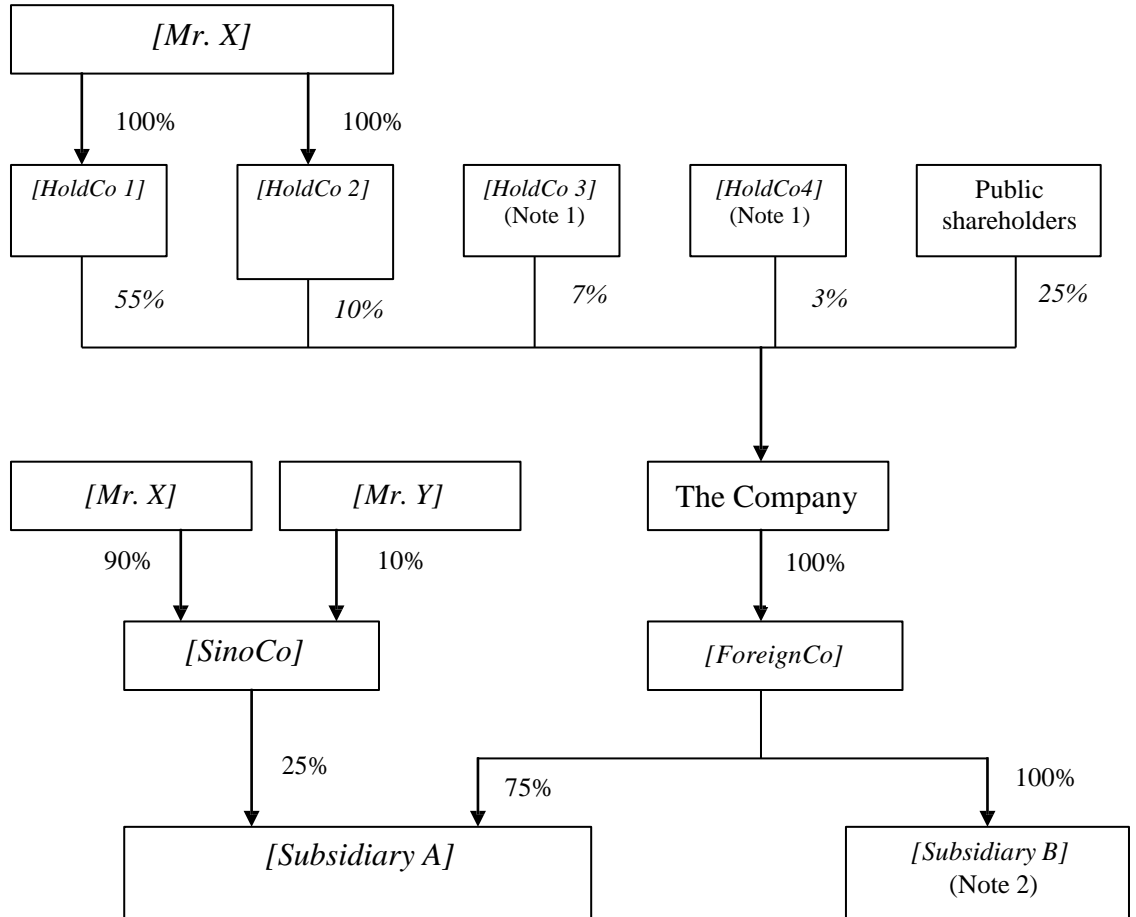
[During Year 3], [Mr. X] and [SinoCo] entered into an equity transfer agreement with [ForeignCo] to acquire 40% equity interest in [Subsidiary A] from [Mr. X] and a 35% equity interest in [Subsidiary A] from [SinoCo]. [In the 8th month of Year 3], [Subsidiary A] obtained a foreign investment enterprise approval certificate from the People's Government of the PRC and [in the 9th month of Year 3], [Subsidiary A] was converted from a PRC limited liability company into a Sino-foreign co-operative joint venture. As of [day of completion of the 2nd Round of Equity Transfer in the 8th month of Year 3], [Subsidiary A] became owned as to 75% and 25% by [ForeignCo] and [SinoCo] respectively. As a result of this equity transfer, the effective interests of [Mr. X] and [Mr. Y] in [Subsidiary A] became approximately [97.5] and [2.5%] respectively.



Pursuant to [Subsidiary A's] articles of association and a joint venture contract taking effect from [the completion of the 2nd Round of Equity Transfer in the 8th month of Year 3], all after-tax profits of [Subsidiary A] are distributed as to 90% to [ForeignCo] and as to 10% to [SinoCo]. The Sponsor and Co-sponsor (collectively the “**Sponsors**”) submitted that while it was intended that the entire interests of [Subsidiary A] be injected into the Group, the [relevant PRC regulations on the management of foreign funded enterprises in the industry of Subsidiary A] limited the type of projects that could be undertaken by wholly-owned foreign enterprises. The regulations also required at least a 25% equity interest to be held by the Chinese party (i.e. [SinoCo] in this case) for Sino-foreign joint venture [enterprise in the relevant industry]. As such, the Group's stake in [Subsidiary A] is limited to 75% and a co-operative joint venture was set up to satisfy the PRC regulatory requirements. The profit sharing ratio was determined so as to reflect more closely the control of [Mr. X] in [Subsidiary A]. The Group may acquire the remaining equity interest of [Subsidiary A] currently held by [SinoCo] when such restriction is lifted.

1.3.5 Upon completion of the Offering

The diagram below illustrates the corporate structure of the Group immediately following the completion of the Offering.



Note 1: *[HoldCo 3] and [HoldCo] 4 are pre-IPO investors*

Note 2: *[Subsidiary B] is a wholly-owned foreign investment enterprise and was established by [ForeignCo] [after the Track Record Period].*

[Portion of Letter Purposely Omitted]

Control over [Subsidiary A]

- 1.4 The Sponsors submitted that *[Mr. X]* has effective control over *[Subsidiary A]* (or the Group) both at the shareholder’s level, as well as its day-to-day management, operations, organization, accounting, financial policies, personnel, marketing and related matters throughout the Track Record Period, notwithstanding that *[Mr. X]* only held a 40% equity interest in *[Subsidiary A]* *[before the 1st Round of Equity Transfer in the 6th month of Year 2]*.
- 1.5 Based on the Submissions and the Prospectus, *[Mr. X]* was the legal representative, sole director and general manager of *[Subsidiary A]* from *[the beginning of Year 1 to immediately before the 2nd Round of Equity Transfer in the 8th month of Year 3]*. He was in charge of both the operational and financial aspects of *[Subsidiary A]* including, among others, the formulation of its operational plans, investment plans and proposed annual financial budgets. On this basis, he had absolute control of *[Subsidiary A]* during this period. *[Immediately after the 2nd Round of Equity Transfer to a few months after the Track Record Period]*, two additional directors were appointed, namely *[Mr. Y]* and *[Mr. Z]*. However, *[Mr. Y]* had not been involved in the day-to-day management of *[Subsidiary A]*. *[Mr. X]*, with the assistance of *[Mr. Z]*, managed and operated the business of *[Subsidiary A]* during this period.
- 1.6 The Sponsors’ submitted that on important matters regarding *[Subsidiary A]*, *[Mr. Y]* acted in concert with *[Mr. X]* by voting in the same manner as his brother at the two shareholders’ meetings held since *[the beginning of Year 1 to immediately before the 1st Round of Equity Transfer in the 6th month of Year 2]*. *[Mr. X]* and *[Mr. Y]* made a statement (the “**Statement**”) *[shortly prior to the submission of the listing application]* to confirm that, during the period from the establishment of *[Subsidiary A]* to *[immediately before the 1st Round of Equity Transfer in the 6th month of Year 2]*, *[Mr. Y]* was acting in concert with *[Mr. X]* in the shareholders’ meetings of *[Subsidiary A]*. *[Mr. Y]* further confirmed that *[Mr. X]* had absolute control over *[Subsidiary A]* subsequent to its shareholding change *[pursuant to the 1st Round of Equity Transfer in the 6th month of Year 2]*.

Track record profit and accounting treatment

- 1.7 The Group’s accounts have been prepared in accordance with International Financial Reporting Standards (“**IFRS**”). Based on the Sponsors’ Submissions, the Group’s financial statements are prepared using the pooling of interests method as if the Group’s structure (i.e. holding 75% equity interest in *[Subsidiary A]*) had been in existence throughout the Track Record Period. On the basis of the degree of control exercised by *[Mr. X]* during the Track Record Period, the Reporting Accountants, are of the view that the restructuring of *[Subsidiary A’s]* shareholdings during the Track Record Period falls within the definition of “business combinations involving entities or businesses under common control” which is excluded from the scope of

IFRS 3 (the “**Common Control Exclusion**”). As such, the Group’s reorganization and the restructuring of *[Subsidiary A’s]* shareholding was accounted for using the pooling of interests method, and *[Subsidiary A]* was accounted for as if it had been a subsidiary of the Group throughout the Track Record Period (see paragraph 1.9).

1.8 The Reporting Accountants further submitted that in view of the fact that the 75% equity interest in *[Subsidiary A]* held by the Group has a 90% profit entitlement, this share of profit should be included in the accounts of the Group for the entire Track Record Period.

1.9 The operating results of the Group during the Track Record Period as per the Accountants’ Reports and your submission *[*day*month*year]* as follows:

	<i>[Year 1]</i>	<i>[Year 2]</i>		<i>[Year 3]</i>
(HK\$’000 equivalent)		<i>[Before the 1st Round of Equity Transfer]</i>	<i>[After the 1st Round of Equity Transfer]</i>	
		<i>[First six months]</i>	<i>[Second six months]</i>	
Profit before minority interests	<i>[Approx. 10,000]</i>	<i>[Approx. 13,000]</i>	<i>[Approx. 16,000]</i>	<i>[Approx. 57,000]</i>
Minority interests	<i>[Approx. (1,000)]</i>	<i>[Approx. (1,300)]</i>	<i>[Approx. (1,500)]</i>	<i>[Approx. (5,700)]</i>
Net profits attributable to shareholders	<i>[Approx. 9,000]</i>	<i>[Approx. 11,000]</i>	<i>[Approx. 14,000]</i>	<i>[Approx. 51,000]</i>

Note: The figures in the above table are based on figures denominated in RMB in the Prospectus translated at the rate of HK\$1.00 to RMB1.06. 10% minority interests were assumed throughout the Track Record Period.

2 Division’s view in relation to Rule 8.05(1) of the Listing Rules

Requirements under Rule 8.05(1) of the Listing Rules

2.1 Rule 8.05(1) requires the new applicant to have an adequate trading record under substantially the same management and ownership. “*This means that the issuer, or its group (excluding any associated companies and other entities whose results are recorded in the issuer’s financial statements using the equity method of accounting) as the case may be, must satisfy each of the following:*

(a) *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\$20,000,000 and, in respect of the two preceding years, be in aggregate not less than HK\$30,000,000. 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;

- (b) *management continuity for at least the three preceding financial years; and*
- (c) *ownership continuity and control for at least the most recent audited financial year.”*

2.2 The Division is of the view that the Company does not meet the minimum profit requirement under Rule 8.05(1)(a) of the Listing Rules, taking into account the profit attributable to the Group during the Track Record Period. It is the Division’s view that in applying the minimum profits test, the Group’s historical ownership interest in *[Subsidiary A]* at the relevant points in time would be taken into account. In particular, the profit attributable to shareholders of the Group for each of the three years under Rule 8.05(1)(a) would be limited by the Group’s interest in *[Subsidiary A]* held by *[Mr. X]*. As *[Mr. X]* held 40% interest until *[middle of Year 2]*, the profit attributable to the Group for this period is limited to 40% (on the basis that the Group may consolidate the results of *[Subsidiary A]* for this period, please refer to paragraph 3.7 below for further details). Together with *[Mr. X’s]* indirect effective interests of approximately *[31.5%]* which are included in the potential listed group, the Group’s aggregate profit for the *[the first two years of the Track Record Period]* would be approximately *[HK\$20.64 million]* (see paragraph 3.8 below) which is below the minimum threshold of HK\$30 million. On this basis, the Group fails the minimum profits test.

2.3 In arriving at our view, the Division has the following consideration:

- (i) Rule 8.05(1)(a) applies to the group, being the issuer and its subsidiaries that is the subject of listing. In the present case it comprises *[ForeignCo]* and its 75% interest in *[Subsidiary A]*. The Group is ultimately held by *[Mr. X]*. The interest in *[Subsidiary A]* held by *[SinoCo]* remains outside the Group and thus does not form part of the *issuer* that is the subject of listing.
- (ii) The minimum profit test under Rule 8.05(1)(a) therefore refers to the *historical profit attributable to the group* based on the equity interests held by these entities during the three year period. In addition to the exclusion of profit attributable from the interest held by *[SinoCo]*, it is also not appropriate to include the profit attributable to *[Mr. Y]* historically in the three year track record of the Group. This is because *[SinoCo]* does not form part of the Group and *[Mr. Y’s]* interest has not been and will not be included in the Group before and after listing.
- (iii) In other words, the profit attributable to the Group would be calculated based on the rationale explained in paragraph 2.2 above. This treatment is consistent with the Division’s interpretation of Rule

8.05(1)(a), for example, if the issuer held 51% interest in a subsidiary during the first two years and acquired the remaining 49% interest (from parties outside the Group) in the third year, the profit applicable under Rule 8.05(1)(a) would be the profit attributable to shareholders of 51% and 100% interest in the subsidiary for the first two years, and the third year respectively.

- (iv) The Group's accounts are currently presented on an *as if* basis taking into account its current 75% equity interest in [*Subsidiary A*] which is entitled to a 90% share of profit, applied retrospectively to the three years track record. The fact that the co-operative joint venture arrangement (with the 90% profit entitlement) only took effect from [*the completion of the 2nd Round of Equity Transfer in the 8th month of Year 3*] was disregarded. We are of the view that accounts prepared on this basis would be pro forma accounts. Rule 8.05(1)(a) makes reference to Rule 4.04 which requires the preparation of a set of historical accounts of the Group's financial performance and not pro-forma accounts.
- (v) While it is the Division's view that the accounts presented under Rule 4.04 do not necessarily represent the track record profit for the purposes of assessing Rule 8.05(1)(a), it would nevertheless present the historical picture of the Group during the three years, and is the starting point for our analysis. In the present case we can see no basis to adjust the track record profit in assessing Rule 8.05(1)(a) and to include 75% of the Group's interest in [*Subsidiary A*] (with 90% share of profit) throughout the three years [*of the Track Record Period*].

- 2.4 Based on the above, it is our view that the minimum profits test should take into account the Group's historical ownership interest in [*Subsidiary A*] at the relevant points in time. Accordingly, the Group does not comply with the minimum profit requirement of HK\$30 million in respect of the first two years of the Track Record Period under Rule 8.05(1)(a) of the Listing Rules.

3 Current accounting treatment for the results of [*Subsidiary A*] during the Track Record Period

- 3.1 In addition to the items discussed above, we would also like to set out our views on the accounting treatment adopted by the Group. The Exchange ordinarily interprets Rule 8.05 as an eligibility standard, while requirements of Chapter 4 of the Listing Rules relate to the contents of Accountants' Report. The requirements of Chapter 4 are therefore considered separately.
- 3.2 Rule 4.08(3) requires accountants' report to be prepared in accordance with the Auditing Guideline – Prospectuses and the reporting accountant (AG 3.340) issued by the Hong Kong Institute of Certified Public Accountants. Rule 4.11 requires 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 or IFRS.

- 3.3 As the group reorganization of the Company for listing takes place after the Track Record Period prior to listing, the Division is of the view that accounting treatment should in the present case be accounted for in accordance with point 1(f) of Appendix 3 of AG 3.340, i.e. we agree that the combined basis could be used in accounting for the group reorganization to be taken place prior to listing. However, since the shareholding interests of the issuer changed or in substance changed throughout the Track Record Period, we are of the view that these changes should be accounted for historically in accordance with the relevant accounting standards at the relevant points in time, i.e. for the present case, IFRS. The interests that the Group could combine should be [Mr. X's] respective interest at the different points in time during the Track Record Period and should not include [Mr. X's] remaining indirect interests held through [SinoCo] as these interests remain outside the Group and do not form part of the issuer's interests. Therefore, the Division disagrees with the percentage of interests used by the Company for the combination accounts. Such treatment does not reflect [Mr. X's] interests during the relevant periods.
- 3.4 Paragraph 11 of IFRS 3 "Business Combination" states that "*A group of individuals shall be regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities. Therefore, a business combination is outside the scope of this IFRS when the same group of individuals has, as a result of contractual arrangements, ultimate collective power to govern the financial and operating policies of each of the combining entities so as to obtain benefits from their activities, and that ultimate collective power is not transitory*".
- 3.5 The Reporting Accountants consider that in view of the Statement and the control over [Subsidiary A] demonstrated by [Mr. X], the restructuring of [Subsidiary A's] shareholding is a business combination described under paragraph 11 of IFRS 3 and accordingly, is outside the scope of IFRS 3 which requires the adoption of acquisition accounting. The Division disagrees with the proposition that if a business combination falls within a business combination under common control in IFRS 3, the pooling of interests method could then be applied as a default. Further justification on why the pooling of interests method is appropriate having regard to the generally accepted principles supporting the pooling of interests method is required before applying such a basis of accounting.
- 3.6 The Division also questions whether, given that [Mr. X] held a minority interest (i.e. 40%) in [Subsidiary A] up to [the middle of Year 2], the Group is in a position to consolidate the results of [Subsidiary A] or alternatively, whether its results should be accounted for under the equity accounting method.

- 3.7 The Sponsors submitted that *[Mr. X]* has effective control over *[Subsidiary A]* (see paragraphs 1.4 and 1.5 above). IAS 27 defines control to be *the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities*. While the Sponsors submitted that *[Mr. X]* has effective control, the question of whether he has the *power* to control *[Subsidiary A]* has not been established to our satisfaction. In particular, we are concerned that the Statement, which was only signed by *[Mr. X]* and *[Mr. Y]* *[shortly prior to the submission of the listing application]*, represents an artificial means to provide evidence on the application of a retrospective basis to support a more favourable accounting treatment for the applicant in an attempt to meet the track record requirement. In the event that the Group could not meet the condition for consolidation under IAS 27, the Group would be unable to consolidate the results of *[Subsidiary A]* for the period until *[the middle of Year 2]*. Please also see our views quoted in paragraph 3.3 above regarding the application of the retrospective basis.
- 3.8 Subject to the Sponsors and Reporting Accountants establishing the basis for consolidation of *[Subsidiary A]* throughout the Track Record Period, it is our view that the profit attributable to the Group would be calculated having regard to the Group's interest in *[Subsidiary A]* as follow:
- (i) 40% interest in *[Subsidiary A]* from *[the beginning of Year 1 to immediately before the completion of the 1st Round of Equity Transfer in the 6th month of Year 2]*;
 - (ii) upon acquisition of a 60% interest in *[Subsidiary A]* by *[SinoCo]* *[pursuant to the 1st Round of Equity Transfer in the 6th month of Year 2]*, it is arguable that an additional indirect interest in *[Subsidiary A]* of 28% held through *[SinoCo]* is included (i.e. 80% of (60% -25%)). Given that 25% interest in *[Subsidiary A]* held by *[SinoCo]* remained outside the Group after the proposed listing, only *[Mr. X's]* indirect interest in the 35% interest acquired would be included;
 - (iii) *[Approximately 71.5%]* *[upon completion of the 1st Round of Equity Transfer in the 6th month of Year 2]*, taking into account the additional capital injection by *[Mr. X]* which increased his interest in *[SinoCo]* to *[approximately 90%]* (i.e. an additional 10 % of 35%); and
 - (iv) based on profit attributable to 75% equity interest (i.e. 90%) from *[the 8th month of Year 3]*, after acquisition of the interest by *[ForeignCo]* and its conversion into a co-operative joint venture.

Profit attributable to shareholders for *[the first two years of the Track Record Period]* would then be shown as follows and would equal approximately *[HK\$20.64 million]* in aggregate:

(HK\$'000 equivalent)	<i>[Year 1]</i>	<i>[Year 2]</i>	
		<i>[Before the 1st Round of Equity Transfer]</i> <i>[First six months]</i>	<i>[After the 1st round of Equity Transfer]</i> <i>[Second six months]</i>
Profit before minority interests	<i>[Approx. 10,000]</i>	<i>[Approx. 13,000]</i>	<i>[Approx. 16,000]</i>
Minority interests	<i>[Approx. (6,000)]</i> <i>[60% of 10,000]</i>	<i>[Approx. (7,800)]</i> <i>[60% of 13,000]</i>	<i>[Approx. (4,560)]</i> <i>[28.5% of 16,000]</i>
Net profit attributable to shareholders	<i>[Approx. 4,000]</i>	<i>[Approx. 5,200]</i>	<i>[Approx. 11,440]</i>

*Note: The figures in the above table are based on figures denominated in RMB in the Prospectus and your submission dated [*day*month*year] translated at the rate of HK\$1.00 to RMB1.06.*

4 Conclusion

- 4.1 The Division has decided to reject the listing application of the Company as it fails to meet the minimum profit requirement under Rule 8.05(1)(a) of the Listing Rules *[for the first two years of the Track Record Period]*.
- 4.2 In relation to the accounting treatment adopted by the Group, the Division is of the following views:
- (i) the Group's accounts should be presented on a combined basis showing *[Mr. X's]* respective interest at the different points in time during the Track Record Period; and
 - (ii) the Group has yet to demonstrate that it has the power to control *[Subsidiary A]*, and on that basis it is not clear whether the consolidation of the Group's 40% interest in *[Subsidiary A]* for the period up to *[the middle of Year 2]* is appropriate.

Please note that the above does not represent the only material issue identified by the Listing Division which may affect the proposed listing of the Company.

Please also note that, pursuant to Rule 2B.05 of the Listing Rules, the Company has the right to have the Listing Division's decision reviewed by the 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