HKEx LISTING DECISION
Cite as HKEx-LD45-2 (First Quarter of 2005)

[Withdrawn in April 2019; Superseded by HKEX-GL45-12]

Summary	
Name of Party	Company A - a Main Board listing applicant and its subsidiaries (the "Group")
Subject	Whether (a) deferred tax credits arising out of netting off the tax effect from bad debt provisions; and (b) tax refunds arising out of capitalization of retained profits and statutory surplus reserves, in the financial statements of Company A could be counted towards satisfaction of the profit requirement of Listing Rule 8.05(1)(a)?
Listing Rule	Listing Rule 8.05(1)(a)
Decision	The Exchange determined that: a. the deferred tax credits arising out of netting off the tax effect from bad debt provisions were related to activities within the ordinary and usual course of Company A's business and, therefore, could be counted towards satisfaction of the profit requirement of Listing Rule 8.05(1)(a); and b. the tax refunds arising out of capitalization of retained profits and statutory surplus reserves were capital restructuring activities rather than relating to the operation of the business of Company A, and the circumstances under which the tax refunds were recognised were discretionary. Consequently, the Exchange determined that such tax refunds were not demonstrably related to activities within the ordinary and usual course of Company A's business for the purpose of Listing Rule 8.05(1)(a).

SUMMARY OF FACTS

1. In connection with Company A's listing application, the Exchange was required to review whether a significant amount of tax credits and tax refunds in the financial statements of Company A in its three financial year track record period could be counted towards satisfaction of the profit requirement of Listing Rule 8.05(1)(a).

2. In the circumstances of Company A's case, if the tax credits were not counted as profits for the purpose of Listing Rule 8.05(1)(a), Company A would not satisfy the track profit requirement whether or not the tax refunds were counted.

Tax credits

3. The deferred tax credits arose as a result of the bad debts provisions made during the track record period. According to the relevant tax regulations, such bad debt expenses would be deductible in calculating the corporation income tax upon application subject to approval by the relevant tax authority.

4. The relevant accounting practice (Paragraph 34 of SSAP 12, see below) requires that there must be adequate profits to utilise the tax benefits before such tax benefits can be recognised in the income statement of a company. Directors of the Company A were of the view that the Group would have sufficient profits to fully utilise the deferred tax assets within the period allowed under the relevant tax regulations. The Reporting Accountants concurred with the views of the directors of Company A. Consequently, the Reporting Accountants considered it appropriate to recognise the deferred tax credits in the period in which the bad debt provisions arose, and such recognition was in accordance with the relevant accounting standards.

Tax refunds

5. The tax refunds were attributable to the capitalization of the retained profits and statutory surplus reserves of Company A into paid up capital during the track record period. According to the relevant tax regulations, corporate income tax previously paid on the retained profits and statutory surplus reserves that were subsequently capitalized could be refunded. During the track record period, the Group had a consistent history of receiving a significant amount of tax refunds and recognised these on an accrual basis.

6. The Reporting Accountants confirmed that the relevant condition precedent for recognition of tax refunds on an accrual basis was completion of all legal procedures for the increase in paid-up registered capital. This was in accordance with the relevant accounting practice (Paragraph 22 of the Accounting Framework, see below). Furthermore, the Reporting Accountants considered that the tax refund recognition was consistent with the accounting policies of Company A. Consequently, it was considered appropriate for Company A to recognise the tax refunds on accrual basis upon completion of all legal procedures for the increase in paid-up registered capital and the application for tax refund had been lodged with the relevant tax authority.

THE ISSUE RAISED FOR CONSIDERATION

7. Whether (a) deferred tax credits arising out of netting off the tax effect from bad debt provisions; and (b) tax refunds arising out of capitalization of retained profits and

statutory surplus reserves, in the financial statements of Company A could be counted towards satisfaction of the profit requirement of Listing Rule 8.05(1)(a)?

APPLICABLE LISTING RULES OR PRINCIPLE

8. Listing 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$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'.

9. Listing Rule 4.11 states that *'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 International Financial Reporting Standards'.*

10. Paragraph 34 of Hong Kong Statement of Standard Accounting Practice 12 – Income Taxes ('SSAP 12') states that:

    'a deferred tax asset shall be recognised for the carry forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised'.

11. Paragraph 22 of the Framework for the Preparation and Presenting of Financial Statements (the 'Accounting Framework') issued by the Hong Kong Institute of Certified Public Accountants states that:

    'in order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions'.

THE ANALYSIS

12. In determining whether any income can be counted towards satisfaction of the profit requirement of Listing Rule 8.05(1)(a), the Exchange must be satisfied that, based on

the facts and circumstances of a particular case, the income arises from the ordinary and usual course of business.

13. Given that the deferred tax credits were related to bad debt provisions that arose from the sales previously booked as income of the Group and this form of accounting treatment being acceptable to the Reporting Accountants, the Exchange determined that Company A’s deferred tax credits were generated by activities within the ordinary and usual course of the Company’s business and, therefore, could be counted towards satisfaction of the profit requirement of Listing Rule 8.05(1)(a).

14. Regarding the tax refunds, the Exchange was of the view that the capitalization of retained profits and statutory surplus reserves into paid up capital were capital restructuring activities rather than activities relating to the operation of the business of Company A. In addition, the timing of such activities was arbitrary, depending, to a large extent, on the discretion of the directors of Company A. Therefore, the Exchange determined that the materials submitted for consideration were not sufficient to establish that such refunds were referable to activities within the ordinary and usual course of Company A’s business for the purpose of Listing Rule 8.05(1)(a).

THE DECISION

15. Based on the facts and circumstances of the case and the Exchange’s analysis of the Listing Rules, the Exchange determined that:

    a. the deferred tax credits arising out of netting off the tax effect from bad debt provisions were related to activities within the ordinary and usual course of Company A’s business and therefore, could be counted towards satisfaction of the profit requirement of Listing Rule 8.05(1)(a); and

    b. the tax refunds arising out of capitalization of retained profits and statutory surplus reserves were capital restructuring activities rather than activities relating to the operation of the business of Company A, and the circumstances under which the tax refunds were recognised were discretionary. Consequently, the Exchange determined that such tax refunds were not demonstrably related to activities within the ordinary and usual course of Company A’s business for the purpose of Listing Rule 8.05(1)(a).