INVESTIGATION REPORT

[Case number]

on

[Auditor]

in relation to

audit of the accounts

of

[Listco] and its subsidiaries

for the year ended 31 December 2008

Audit Investigation Board

9 September 2011

This report was adopted by the Financial Reporting Council on 6 October 2011 in accordance with section 35(3) of the Financial Reporting Council Ordinance (Cap. 588).

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LIST OF ENCLOSURES

The enclosures are not published because they may contain non-public third party information.

Notes concerning this report

This report relates to the possible occurrence of an auditing irregularity in respect of the audit of the accounts of a listed entity under the Financial Reporting Council Ordinance (Cap. 588).

Any references in this report to breaches of any law, regulation, standards of accounting, auditing and assurance, practice or principle, or Main Board Listing Rules should be understood in the context of that Ordinance only and pursuant to which this report was prepared.

This report, whenever it relates to the private rights of third parties between themselves, makes and implies no comment as to the rights and obligations, and the merits of the conduct, of these third parties as between themselves.

Abbreviations

Acquisition	Acquisition of the entire issued share capital and the shareholders' loan of [Subsidiary] at a consideration of HK$112 million which was satisfied by the issuance of the Consideration Shares
Agreement Price	The average closing price of the Company's shares in the last five trading days immediately before the date of agreement on 8 September 2008 as quoted on The Stock Exchange of Hong Kong Limited (i.e. HK$0.14 per share)
AIB	Audit Investigation Board
Announcement	Announcement of the Company issued on 9 September 2008
Audit Working Papers	Audit working papers of [Auditor] in relation to the Acquisition
[Listco]/Company	[Name of Listco]
Consideration Shares	800,000,000 new ordinary shares of the Company at a par value of HK$0.10 each
Council	Financial Reporting Council
FRC Ordinance	Financial Reporting Council Ordinance (Cap. 588)
Group	The Company and its subsidiaries
HKAS	Hong Kong Accounting Standard
HKFRS	Hong Kong Financial Reporting Standard
HKFRS 3	HKFRS 3 *Business Combinations*
HKSA	Hong Kong Standard on Auditing
HKSA 700	HKSA 700 *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*
[Subsidiary]	[Name of Subsidiary], the subject of the Acquisition
[Auditor]	[Name of Auditor]
Period	Period from the date of agreement of the Acquisition on 8 September 2008 to the completion date of the Acquisition on 28 October 2008

Relevant Financial Statements	Consolidated financial statements of the Group for the year ended 31 December 2008
2008 Audit	Audit of the Relevant Financial Statements

Executive summary

Introduction

This report is prepared pursuant to section 35 of the FRC Ordinance and contains the findings of the investigation conducted by the AIB pursuant to section 23(3)(b) of the FRC Ordinance in respect of the 2008 Audit by [Auditor]. The investigation was in relation to the measurement of the Consideration Shares at the date of the Acquisition.

Background information

The Company is incorporated in Hong Kong and its shares are listed on the Main Board (stock code: [stock code]) of The Stock Exchange of Hong Kong Limited.

The consolidated loss of the Group for the year ended 31 December 2008 was HK$797.8 million. The consolidated net assets of the Group at 31 December 2008 were HK$1,540.5 million. It was stated in note 2 to the Relevant Financial Statements (Annex 1A) that the Relevant Financial Statements were prepared in accordance with HKFRSs and it was stated in the auditor's report that the audit was conducted in accordance with HKSAs.

[Auditor] issued an unmodified report on the Relevant Financial Statements.

Initiation of investigation

The Council received a complaint on 11 October 2010. The complainant alleged, among others, that there was a possible auditing irregularity in relation to the measurement of the Consideration Shares in the Relevant Financial Statements.

Having considered all the information laid before it, the Council, on 2 November 2010, decided to initiate an investigation and directed the AIB, in accordance with section 23(3)(b) of the FRC Ordinance, to investigate the possible auditing irregularity and the question whether or not there is such an irregularity in relation to the 2008 Audit.

Scope of investigation

The investigation was to collect information and evidence relating to the question whether or not there is an auditing irregularity in relation to the 2008 Audit in respect of the measurement of the Consideration Shares at the date of the Acquisition.

Relevant financial reporting, auditing and assurance requirements

The financial reporting, auditing and assurance requirements applicable at the time of the 2008 Audit and relevant to the findings in this report are set out below:

HKFRS 3	*Business Combinations*
HKSA 700	*The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*

Views of the AIB

Based on the results of the investigation, the AIB considers that judgement is required to determine whether the published price at the date of exchange (i.e. the acquisition date) is an unreliable indicator of fair value and that it is not unreasonable for the management of the Company to use the Agreement Price instead of the published share price on the date of exchange in the fair value measurement of the Consideration Shares.

The AIB considers that the Company's accounting treatment would not lead to any non-compliance with paragraphs 24 and 27 of HKFRS 3 and there is no evidence for auditing irregularity in this respect.

In relation to the disclosure of the fair value of the Consideration Shares, it appears to the AIB that even if the shareholders were fully informed of the details of the Acquisition from an announcement or a circular, the Company still had to comply with HKFRS 3 and disclose the reason for using the Agreement Price of HK$0.14 rather than the published share price of HK$0.04 at the date of exchange in the fair value measurement of the Consideration Shares in the Relevant Financial Statements. The AIB is of the view that the inadequate disclosure, in particular, in relation to management's decision that an alternative measure is more reliable in the Relevant Financial Statements, is a non-compliance with paragraph 67(d)(ii) of HKFRS 3.

Nevertheless, the AIB considers that the inadequate disclosure would not cause any material non-compliance in the Relevant Financial Statements and therefore it would not affect the opinion in the auditor's report. The AIB considers that, according to HKSA 700, it is not unreasonable for [Auditor] to issue an unmodified report on the Relevant Financial Statements despite this non-compliance in the Relevant Financial Statements. Hence, the AIB considers that there is no evidence to support that there is an auditing irregularity in this respect.

Comments on draft investigation report from [Auditor]

The relevant sections of the draft investigation report were sent to [Auditor] for comments on 23 August 2011. In its reply dated 5 September 2011 (Annex 3D), [Auditor] confirmed that it had no comment on the draft investigation report.

Comments on draft investigation report from the Company

The relevant sections of the draft investigation report were also sent to the Company for comments on 23 August 2011. In its reply dated 29 August 2011 (Annex 3C), the Company confirmed that it had no comment on the draft investigation report.

Section 1 Introduction

1.1 Background information

1.1.1 The Company is incorporated in Hong Kong and its shares are listed on the Main Board (stock code: [stock code]) of The Stock Exchange of Hong Kong Limited.

1.1.2 The principal activities of the Group as set out in the Relevant Financial Statements were property investment, investment in securities trading, money lending, investment holding and acquiring, exploring and developing natural resources.

1.2 Financial information

1.2.1 The Relevant Financial Statements showed that the consolidated loss of the Group for the year ended 31 December 2008 was HK$797.8 million and the consolidated net assets of the Group at 31 December 2008 were HK$1,540.5 million.

1.2.2 It was stated in note 2 to the Relevant Financial Statements that the Relevant Financial Statements were prepared in accordance with HKFRSs and it was stated in the auditor's report of [Auditor] that the audit was conducted in accordance with HKSAs.

1.3 Audit of the Relevant Financial Statements

1.3.1 [Auditor] expressed an unmodified audit opinion in relation to the 2008 Audit.

1.3.2 It was stated on page 15 of a memorandum titled "Engagement Completion Memorandum 2008" <section A2 of the Audit Working Papers> (Annex 2A) that materiality in relation to the 2008 Audit at the stages of planning and completion were HK$23.35 million and HK$26 million respectively.

Section 2 Initiation of investigation

2.1 Potential auditing irregularities

2.1.1 On 11 October 2010, the Council received a complaint that there was possible relevant non-compliance with accounting requirements in relation to the measurement of the Consideration Shares issued for the Acquisition in the Relevant Financial Statements. Given the potential relevant non-compliance, the issuance of an unmodified report by [Auditor] is questionable and the complainant alleged that there was potential auditing irregularity in relation to the 2008 Audit.

2.1.2 After receiving the complaint, the secretariat of the Council reviewed the Relevant Financial Statements, the related announcements of the Company and information provided by the complainant.

2.2 Scope of the investigation

2.2.1 Having considered all the information laid before it, the Council, on 2 November 2010, decided to initiate an investigation [Case number] and directed the AIB, in accordance with section 23(3)(b) of the FRC Ordinance, to investigate the possible auditing irregularity and the question whether or not there is such an irregularity in relation to the 2008 Audit in respect of the measurement of the Consideration Shares at the date of the Acquisition.

2.3 Membership of the AIB

2.3.1 The AIB comprises the following members:

(a) Dr. P.M. Kam, Chairman;

(b) Ms. Velma Cheung;

(c) Ms. Anna Lau;

(d) Ms. Florence Wong; and

(e) Ms. Joyce Woo.

Section 3 Process of investigation

3.1 Requirements issued

3.1.1 For the purpose of the investigation, the AIB issued a requirement under section 28 of the FRC Ordinance to [Auditor] on 24 November 2010 requesting the production of Audit Working Papers and responses to written questions (Annex 3A).

3.1.2 [Auditor] provided a copy of Audit Working Papers and its responses to written questions on 22 December 2010 (Annex 3B) to the AIB.

3.2 Standards relevant to the investigation

3.2.1 The AIB referred to the following financial reporting, auditing and assurance requirements applicable at the time of the 2008 Audit during the investigation:

HKFRS 3	*Business Combinations*
HKSA 700	*The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*

3.3 The investigation report

3.3.1 This report is prepared pursuant to section 35 of the FRC Ordinance and contains the findings of the investigation conducted by the AIB pursuant to section 23(3)(b) of the FRC Ordinance in respect of the 2008 Audit by [Auditor].

3.3.2 The relevant sections of the draft investigation report were sent to [Auditor] and the Company for comments on 23 August 2011.

3.3.3 The reply from [Auditor] dated 5 September 2011 (Annex 3D) was included in the relevant section of this investigation report.

3.3.4 The reply from the Company dated 29 August 2011 (Annex 3C) was included in the relevant section of this investigation report.

3.3.5 This investigation report was adopted by the AIB on 9 September 2011.

Section 4 Measurement of Consideration Shares

4.1 Findings of fact

4.1.1 Background information

4.1.1.1 According to the Announcement (Annex 1B), the Group entered into an agreement with a third party on 8 September 2008 in relation to the Acquisition, in which the consideration was satisfied by the issuance of the Consideration Shares based on the Agreement Price of HK$0.14 per share.

4.1.1.2 The Acquisition was completed on 28 October 2008 and the published price of the Company's shares on that day was HK$0.04 per share.

4.1.1.3 The complainant alleged that the use of the Agreement Price of HK$0.14 per share rather than the published share price of HK$0.04 per share at the date of exchange in the fair value measurement of the Consideration Shares is a potential non-compliance with paragraph 27 of HKFRS 3.

4.1.1.4 The reason for not using the published price on the date of exchange to determine the fair value of the Consideration Shares was not mentioned in the Relevant Financial Statements in accordance with paragraph 67(d)(ii) of HKFRS 3.

4.1.1.5 Given the possible relevant non-compliance, there is a question of whether [Auditor] had formed an appropriate auditor's opinion on the Relevant Financial Statements in accordance with paragraphs 11 and 13 of HKSA 700 and hence whether there is a potential auditing irregularity.

4.1.1.6 The complainant stated that the non-compliance with HKFRS 3 would result in a potential understatement of the excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost, which might be material to the Relevant Financial Statements.

4.1.1.7 The potential understatement of the excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost amounted to HK$80 million ((HK$0.14 – HK$0.04) per share x 800,000,000 shares), which is approximately 10% of the loss of HK$797.8 million for the year ended 31 December 2008.

4.1.2 Review of Audit Working Papers

4.1.2.1 It was stated in a schedule titled "Acquisition – [Subsidiary]" <section F241-F245 of the Audit Working Papers> (Annex 2B) that *"… Although 'Rare' is not defined in HKFRS 3 but the International Accounting Standard Board (IASB) has stated on its website in 2008 that the deterioration of the world's markets that has occurred during the third quarter of 2008 is a possible example of rare circumstances. The acquisition of [Subsidiary] took place exactly in the period which the IASB has declared to be rare.*

During the period concerned (about 1.5 months from 9 Sep 2008 to 28 Oct 2008), the unfavourable finance market effect reduced the trading volume of the Company's shares by about 89% comparing with the corresponding trading volume of 1.5 months preceding the agreement date (decreased from average daily trading volume from 2m shares to 0.2m shares). The significant decrease of transaction volume unavoidably restricted the possible rebound of the Company's share value and evidenced the thinness of the market and thereby making the quoted price an unreliable indicator of the fair value of the equity issued.

On the contrary, as [Subsidiary]'s principal activity was properties investment, its net asset value, which comprises mainly the value of the properties held provided a more reliable measurement of the consideration and also the fair value of equity instrument issued by the Company for the acquisition at the completion date. Management noted that the market values of the properties that constituted the majority of the net asset value of [Subsidiary], between the date of agreement and completion did not change significantly according to the valuation reports issued by independent professional valuers for the properties held by [Subsidiary]. Therefore, management considered the net asset value of [Subsidiary], which has an amount close to the fair value of the equity instruments at the date of agreement, provided a more reliable and more clearly evidential measurement of the equity instruments issued by the Company at the date of exchange in this rare circumstance …

After taken into consideration the above-mentioned factors and our audit work done, including those to substantiate the above factors, we accept that the bases used by the Company to determine the fair values of shares issued were not unreasonable for the purpose of measuring the cost of acquisitions in accordance with HKFRS …

Management consider that the published price of the shares at the date of acquisition (i.e. 28 Oct 2008) was not used to measure the fair value of the shares issued. Instead, the fair value of the shares was set as HK$0.14 (i.e. the closing price of the shares as quoted on the Stock Exchange on the date of agreement of 8 Sep 2008). Such fact would be disclosed in the annual report …

… management consider that it would be unreasonable to recognies [recognize] *the significant negative goodwill of approximately HK$80 million arising from the acquisition ...*

Management consider those disclosures in the annual report would be sufficient for reasonable diligent users to determine the difference between the value attributed to the shares and the published price of the shares at 28 Oct 2008, which in total amounted to HK$80,000,000 (i.e. HK$0.14-HK$0.04) x 800,000,000).

Although we note the disclosures requirements pursuant to paragraph 67(d)(ii) of HKFRS 3, taken into accounts [account] *management's points of view that the planned disclosures would be sufficient for a reasonable diligent user to determine the effect of not adapting the published price exists at the date of exchange. In addition, taken into accounts* [account] *that the shareholders were fully informed of the details of the transaction … from the announcement on 9 Sept 2008, circular dated 30 Sep 2008 and* *they had voted in the EGM dated 16 Oct 2008 to approve the acquisition. In such case, we do not consider the disclosures management planned to make would be insufficient which would lead to the financial statements materially misstated. As such, we do not consider to mention in the audit report. In light of this, we came to the view that the 2008 Accounts* [Relevant Financial Statements] *were fairly presented in accordance with HKSA 700."*

4.1.3 Information and explanation provided by [Auditor]

4.1.3.1 On 24 November 2010, [Auditor] was requested to explain the following (Annex 3A):

(a) how did the firm satisfy itself that the published share price at the date of exchange was an unreliable indicator of fair value of the Consideration Shares and that the Agreement Price provided a more reliable measure of fair value of the Consideration Shares and the Agreement Price should be used in accordance with paragraph 27 of HKFRS 3 to reach the conclusion that the Relevant Financial Statements were fairly presented in accordance with HKSA 700 and to provide information or documents together with detailed calculations, if any, to support the explanation; and

(b) how did the firm satisfy itself that the disclosure in relation to the use of the Agreement Price rather than the published share price at the date of exchange to determine the fair value of the Consideration Shares was in accordance with paragraph 67(d)(ii) of HKFRS 3 and the Relevant Financial Statements were fairly presented in accordance with HKSA 700.

4.1.3.2 In response to Paragraph 4.1.3.1(a), [Auditor] replied on 22 December 2010 (Annex 3B) that *"… During the period from the date of agreement to the date of completion – a period of approximately seven weeks, the Company's share price decreased significantly from HK$0.14 to below par at HK$0.04 with the average daily share transaction volume falling to around 0.2 million. The substantial drop in the share price of approximately 71% was mainly attributable to the rare, but severe, financial crisis that erupted over the period. <u>Compared with the average daily share transaction volume of around 2.1 million for the seven week period immediately prior, from mid-July 2008 to the date of agreement (before the outbreak of the financial crisis), the decrease in daily volume represented a drop of 89% … demonstrating a severe contraction in the market for the Company's shares</u> and thereby raising doubts as to whether the transaction price was determinative of its fair value.*

Furthermore, <u>the average daily share transaction volume of 0.2 million from the agreement date to completion date represented only 0.025% of the 800,000,000 Consideration shares issued. The transaction price that is based on such small trading volumes added further questions as to whether it would be a reliable indicator of the fair value of the Consideration shares.</u> In particular, if the published share price at the date of completion were to be used to measure the Consideration shares, the Group would have recorded a significant negative goodwill of approximately HK$80 million, representing an approximate 71% discount on the fair value of the underlying assets of the acquiree, which would have to be credited to profit and loss as an exceptional gain.

For the Group to record such a significant exceptional gain due to the sudden and severe drop in share price based on the transaction price in a day where the trading volume was heavily affected by the rare economic downturn would seem unfounded and even irrational, particularly as the transaction was not, for all intents and purposes between the parties, supposed to be a bargain purchase.

HKFRS 3 paragraph 27 states, inter alia, that the published price at the date of exchange is an unreliable indicator only when it has been affected by the thinness of the market. While 'thinness of the market' is neither defined in HKFRS 3 nor commonly used in Standards, judgement may be used in determining whether the published price has been affected by the thinness of the market by reference to the common understanding of its meaning which is 'low trade volume of the market' or 'less numerous transactions in the market' in comparative or absolute terms. In applying that judgement, it appeared to management that the factors mentioned above, including the significant drop in the daily trade volumes and the insignificance of daily trade volumes comparable to the number of Consideration shares did support that the share price was so affected as a manner covered by HKFRS 3 paragraph 27, thereby providing justification for not using the published share price at the date of completion as a reliable measure of the fair value of the Consideration shares issued.

HKFRS 3 paragraph 27 goes on to state that if the published price at the date of exchange is an unreliable indicator, the fair value of the shares can be estimated by reference to the fair value of the acquiree obtained if such value is more clearly evident. After reaching the above conclusion, <u>management of the Company then decided that the fair value of the acquiree at completion, as represented by the published price of the Consideration shares at the date of agreement, provided a more reliable and evidential measurement of the Consideration shares issued. This was because the fair value of the acquiree consisted of mainly the fair values of the properties that were supported by the valuation reports issued by independent professional valuers … The reported valuations, which remained fairly static over the period from 31 July 2008 (RMB104 million) to 31 December 2008 (RMB102 million), showed that the fair value of the acquiree had been hardly influenced by the rare economic downturn and which thereby provided a stronger basis for supporting the fair value of Consideration shares issued</u>.

In using the fair value of the acquiree, the Group has avoided having to recognize the rather dubious and questionable in substance negative goodwill. The treatment adopted had neither an impact on the net assets nor the equity reported by the Group at the end of the period. Management considered such treatment represented more faithfully the substance of the transaction and was acceptable under HKFRS.

After taking into account these relevant factors in our audit work, we came to the view that it was not unreasonable for the management to adopt this alternative but acceptable approach under HKFRS 3 to measure the cost of business combination of [Subsidiary]. Accordingly, we concluded that the 2008 Accounts [Relevant Financial Statements]*, in this respect, were fairly presented in accordance with HKSA 700."* (underline added)

4.1.3.3 In response to Paragraph 4.1.3.1(b), [Auditor] replied that *"The annual report of the Group for the year ended 31 December 2008 contained disclosures relating to the* *transaction primarily in its Chairman's Statement and notes 25 and 29 to the 2008 Accounts* [Relevant Financial Statements]. *In addition to the annual report, the Company also communicated the captioned transaction through other means with its stakeholders, including an announcement … a circular … and at the shareholders' meeting … The details of the acquisition including the nature, basis for determining the consideration (including reference to an independent valuation report; issue price of HK$0.14 of the consideration shares) were contained in the Group's announcement dated 9 September 2008 and the circular dated 30 September 2008 and thus the stakeholders were fully aware of them. The acquisition was approved by the shareholders at an extraordinary general meeting ("EGM") on 16 October 2008, by which time the Company's share price had already dropped significantly as a result of the global economic downturn. Management considered that, with such extensive publicity, stakeholders should be able to well understand the transaction and to assess its effect at the time when the transaction took place and thus by the time when the transaction was reported as a past event in the 2008 Accounts* [Relevant Financial Statements], *the disclosures need not be so extensive …*

In the 2008 Accounts [Relevant Financial Statements], *the Group disclosed in note 29, concerning acquisitions of subsidiaries, that it had acquired the entire equity interests of [Subsidiary] on 28 October 2008 (date of acquisition). Note 29 then referred to note 25(f) of the 2008 Accounts* [Relevant Financial Statements] *which spelt out that the agreement date was 9 September 2008, the consideration of HK$112,000,000 was satisfied by the issue and allotment of 800,000,000 ordinary shares of HK$0.10 each of the Company at HK$0.14 per share and the fair value of the shares issued was based on the closing price as quoted on the Stock Exchange on the date of agreement (ie. 9 September 2008). Following that, note 29 then set out the comparison between the total consideration (with a cross reference to note 25(f)) and the aggregate fair value of the identifiable assets and liabilities of the acquired subsidiaries as at the dates of acquisition, which resulted in a small negative goodwill of HK$326K.*

From reading the above notes, it should be apparent to a financial statement user, with reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence that the published price of the shares at the date of acquisition (ie. 28 October 2008) was not used to measure the fair value of the shares issued … rather the fair value of the shares was set at the closing price of the shares as quoted on the Stock Exchange on the date of agreement … which in total amounted to HK$112,000,000 (ie. HK$0.14 x 800,000,000) … Accordingly, the acquisitions only gave rise to a negligible negative goodwill … With the information so disclosed in the 2008 Accounts [Relevant Financial Statements], *including the basis of how the value was derived and the relevant dates, a reasonable diligent user should not have had difficulty in determining the effect of the difference between the value attributed to the shares and the published price of the shares at 28 October 2008, which in total amounted to HK$80,000,000 (ie. (HK$0.14 – HK$0.04) x 800,000,000) … Accordingly, even though the disclosures might not be considered sufficiently precise, they did give effect, to a large extent if not totally, to disclosure as required under paragraph 67(d)(ii) of HKFRS 3, in particular, having regard to the fact the market value of the Consideration shares at the date of agreement is a proxy for measuring the fair value of the acquiree.*

Although we note that further explanation could have been made concerning the disclosures in respect of paragraph 67(d)(ii) of HKFRS 3, we do not consider the disclosure actually made, when considered along with all other disclosures in the financial statements, is such as to render the financial statements materially misstated and thus warranting some mention in the audit report. In light of this, we came to the view that the 2008 Accounts [Relevant Financial Statements] *were fairly presented in accordance with HKSA 700."*

4.2 Relevant financial reporting, auditing and assurance requirements

4.2.1 Paragraph 24 of HKFRS 3 states that *"The acquirer shall measure the cost of a business combination as the aggregate of: (a) the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree; plus (b) any costs directly attributable to the business combination."*

4.2.2 Paragraph 27 of HKFRS 3 states that *"The published price at the date of exchange of a quoted equity instrument provides the best evidence of the instrument's fair value and shall be used, except in rare circumstances. Other evidence and valuation methods shall be considered only in the rare circumstances when the acquirer can demonstrate that the published price at the date of exchange is an unreliable indicator of fair value, and that the other evidence and valuation methods provide a more reliable measure of the equity instrument's fair value. The published price at the date of exchange is an unreliable indicator only when it has been affected by the thinness of the market. If the published price at the date of exchange is an unreliable indicator or if a published price does not exist for equity instruments issued by the acquirer, the fair value of those instruments could, for example, be estimated by reference to their proportional interest in the fair value of the acquirer or by reference to the proportional interest in the fair value of the acquiree obtained, whichever is the more clearly evident. The fair value at the date of exchange of monetary assets given to equity holders of the acquiree as an alternative to equity instruments may also provide evidence of the total fair value given by the acquirer in exchange for control of the acquiree. In any event, all aspects of the combination, including significant factors influencing the negotiations, shall be considered. Further guidance on determining the fair value of equity instruments is set out in HKAS 39 Financial Instruments: Recognition and Measurement."*

4.2.3 Paragraph 67(d)(ii) of HKFRS 3 states that *"To give effect to the principle in paragraph 66(a), the acquirer shall disclose the following information for each business combination that was effected during the period: … (d) the cost of the combination and a description of the components of that cost, including any costs directly attributable to the combination. When equity instruments are issued or issuable as part of the cost, the following shall also be disclosed: … (ii) the fair value of those instruments and the basis for determining that fair value. If a published price does not exist for the instruments at the date of exchange, the significant assumptions used to determine fair value shall be disclosed. If a published price exists at the date of exchange but was not used as the basis for determining the cost of the combination, that fact shall be disclosed together with: the reasons the published price was not used; the method and significant assumptions used* *to attribute a value to the equity instruments; and the aggregate amount of the difference between the value attributed to, and the published price of, the equity instruments …"*

4.2.4 According to Appendix A of HKFRS 3, date of exchange is defined as *"When a business combination is achieved in a single exchange transaction, the date of exchange is the acquisition date. When a business combination involves more than one exchange transaction, for example when it is achieved in stages by successive share purchases, the date of exchange is the date that each individual investment is recognised in the financial statements of the acquirer."*

4.2.5 Paragraph 11 of HKSA 700 states that *"The auditor should evaluate the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the financial statements."*

4.2.6 Paragraph 13 of HKSA 700 further states that *"Forming an opinion as to whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework involves evaluating whether the financial statements have been prepared and presented in accordance with the specific requirements of the applicable financial reporting framework for particular classes of transactions, account balances and disclosures. This evaluation includes considering whether, in the context of the applicable financial reporting framework: (a) The accounting policies selected and applied are consistent with the financial reporting framework and are appropriate in the circumstances; (b) The accounting estimates made by management are reasonable in the circumstances; (c) The information presented in the financial statements, including accounting policies, is relevant, reliable, comparable and understandable; and (d) The financial statements provide sufficient disclosures to enable users to understand the effect of material transactions and events on the information conveyed in the financial statements, for example, in the case of financial statements prepared in accordance with Hong Kong Financial Reporting Standards (HKFRSs), the entity's financial position, financial performance and cash flows."*

4.3 Views of the AIB

4.3.1 Paragraph 24 of HKFRS 3 requires an acquirer to measure the cost of a business combination as the aggregate of the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree; plus any costs directly attributable to the business combination.

4.3.2 According to paragraph 27 of HKFRS 3 (Paragraph 4.2.2), *"The published price at the date of exchange is an unreliable indicator only when it has been affected by the thinness of the market. If the published price at the date of exchange is an unreliable indicator … the fair value of those instruments could, for example, be estimated by reference to the proportional interest in the fair value of the acquiree obtained …"*

4.3.3 The major issue is therefore whether the market was thin which rendered the published price at the date of exchange an unreliable indicator of fair value of the Consideration

Shares and that the Agreement Price was a more reliable measure of the fair value of the Consideration Shares.

4.3.4 [Auditor] explained in the letter dated 22 December 2010 that the market was considered thin given the low trading volume of the market. It stated that "*Compared with the average daily share transaction volume of around 2.1 million for the seven week period immediately prior, from mid-July 2008 to the date of agreement (before the outbreak of the financial crisis), the decrease in daily volume represented a drop of 89% … demonstrating a severe contraction in the market for the Company's shares …*"

4.3.5 HKFRS 3 does not define "thinness of the market". The AIB considers that judgement is required to determine whether the published price at the date of exchange was affected by the thinness of the market.

4.3.6 A "thin market" is referenced by the finance industry as an infrequently traded or an inactive market (Annexes 4A and 4B). The AIB obtained information in relation to the trading of the Company's shares between 1 January 2007 and 31 December 2009 (Annex 4C). Given the shares of the Company were traded in 30 out of 34 trading days during the Period, the AIB considers that the Company's shares were not infrequently traded and the market was not inactive.

4.3.7 Notwithstanding the understanding of a "thin market" referenced by the finance industry, the AIB is of the view that it would not be unreasonable for [Auditor] to interpret that the Company's shares were affected by a thin market given the significant drop in the trading volume after the financial crisis.

4.3.8 [Auditor] stated in the same letter that "*… the average daily share transaction volume of 0.2 million from the agreement date to completion date represented only 0.025% of the 800,000,000 Consideration shares issued. The transaction price that is based on such small trading volumes added further questions as to whether it would be a reliable indicator of the fair value of the Consideration shares ...*"

4.3.9 The AIB has a reservation on the view that "thinness" should be determined by comparing daily trading volume of the Company's shares to the number of Consideration Shares issued. The AIB considers that it would be more appropriate to determine whether the market was thin by comparing average daily trading volume with the number of shares in issue.

4.3.10 According to note 25 to the Relevant Financial Statements, the total number of the Company's shares in issue at the date of exchange was 3,249,609,814 shares. The AIB reviewed the daily trading volume of the shares of the Company during the Period. The trading volume at the date of exchange was 252,400 shares (Annex 4D) and the average daily trading volume during the Period was 210,859 shares (Annex 4E). The average daily trading volume during the Period represented only 0.006% of the number of shares in issue. On the basis of this low trading volume, the AIB considers that it would not be unreasonable to consider that the market was thin and hence the published price at the date of exchange was not a reliable indicator of fair value of the Consideration Shares.

4.3.11 [Auditor] further stated that *"… management of the Company then decided that the fair value of the acquiree at completion, as represented by the published price of the Consideration shares at the date of agreement, provided a more reliable and evidential measurement of the Consideration shares issued. This was because the fair value of the acquiree consisted of mainly the fair values of the properties that were supported by the valuation reports issued by independent professional valuers … The reported valuations, which remained fairly static over the period from 31 July 2008 (RMB104 million) to 31 December 2008 (RMB 102 million), showed that the fair value of the acquiree had been hardly influenced by the rare economic downturn and which thereby provided a stronger basis for supporting the fair value of Consideration shares issued …"* [Auditor] was of the view that this accounting treatment complied with paragraph 27 of HKFRS 3 which states that *"… If the published price at the date of exchange is an unreliable indicator … the fair value … could … be estimated by reference to the proportional interest in the fair value of the acquiree obtained …"*

4.3.12 On the basis that the published price at the date of exchange was not a reliable indicator of fair value, it appears to the AIB that it would not be unacceptable for the Company to use the agreed consideration (i.e. Agreement Price x 800,000,000 new ordinary shares of the Company) which approximates the net asset value of [Subsidiary] at the date of the agreement, as the fair value of the Consideration Shares, given that there was no significant change in the net asset value of [Subsidiary] during the Period. Accordingly, there is no evidence to support that there is a non-compliance with paragraphs 24 and 27 of HKFRS 3 and there is no evidence to indicate an auditing irregularity.

4.3.13 In relation to the disclosure of the fair value of the Consideration Shares, it appears to the AIB that even if the shareholders were fully informed of the details of the Acquisition from an announcement or a circular, the Company still had to comply with HKFRS 3 and disclose the reason for not using the published price, the method and significant assumptions used to attribute a value to the Consideration Shares, and the aggregate amount of the difference between the value attributed to, and the published price of, the Consideration Shares in the Relevant Financial Statements. The AIB is of the view that the inadequate disclosure, in particular, in relation to management's decision that an alternative measure of the fair value of the Consideration Shares is more reliable in the Relevant Financial Statements, is a non-compliance with paragraph 67(d)(ii) of HKFRS 3.

4.3.14 Nevertheless, the inadequate disclosure would not cause any material non-compliance in the Relevant Financial Statements and therefore it would not affect the opinion in the auditor's report. The AIB considers that, according to HKSA 700, it is not unreasonable for [Auditor] to issue an unmodified report on the Relevant Financial Statements despite this non-compliance in the Relevant Financial Statements. Hence, there is no evidence to support that there is an auditing irregularity in this respect.

4.4 Comments on draft investigation report from [Auditor]

4.4.1 [Auditor] had no comment on the report.

4.5 Comments on draft investigation report from the Company

4.5.1 The Company had no comment on the report.