INVESTIGATION REPORT

(Case: I01-09)

on

[2007 Auditor]

in relation to

Audit of the Consolidated Financial Statements

of

[Listed Entity] and its subsidiaries

for the year ended 31 December 2007

Audit Investigation Board

2 August 2010

This report was adopted by the Financial Reporting Council on 5 August 2010 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 GEM 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

Acquired Subsidiaries	Subsidiaries acquired in the Acquisition
Acquisition	Acquisitions of 80% interest in [Subsidiary A] and 60% interest in [Subsidiary B] on 13 December 2007
AIB	Audit Investigation Board
Audit Working Papers	Working papers in relation to the audit of the Relevant Financial Statements
[JCE A]	[Name of JCE A], A JCE of the Group
[2007 Auditor]	[Name of 2007 Auditor]
Council	Financial Reporting Council
CGU	Cash-generating unit
[2008 Auditor]	[Name of 2008 Auditor]
February 2008 Valuation Report	Report on the valuation of the betting business of [JCE A] at 31 December 2007 prepared by [The Valuer] dated 22 February 2008
FRC Ordinance	Financial Reporting Council Ordinance (Cap. 588)
Goodwill	Goodwill recognized in respect of the Acquisition
Group	[Listed Entity] and its subsidiaries
HKAS	Hong Kong Accounting Standard
HKFRS	Hong Kong Financial Reporting Standard
HKSA	Hong Kong Standard on Auditing
JCE	Jointly controlled entity
[Legal Representative]	[Name of Legal Representative], legal representative acting on behalf of [2007 Auditor]
[Listed Entity]/the Company	[Name of Listed Entity]
MI	Minority interests

March 2008 Valuation Reports	Report on the valuations of the [Subsidiary A] Group and a subsidiary of [Subsidiary B] at 31 December 2007 prepared by [The Valuer] dated 26 March 2008
[Subsidiary B]	[Name of Subsidiary B]
[Subsidiary B] Group	[Subsidiary B] and its subsidiary
NAV	Net asset value
[Subsidiary A]	[Name of Subsidiary A]
[Subsidiary A] Group	[Subsidiary A], and its subsidiaries and JCEs
[JCE B]	A JCE of the Group
POS	Point of sale
PRC	The People's Republic of China
PYA	Prior year adjustments
Relevant Financial Statements	Consolidated financial statements of the Group for the year ended 31 December 2007
Secretariat	Secretariat of the Council
[The Valuer]	[Name of The Valuer]
2008 Accounts	Consolidated financial statements of the Group for the year ended 31 December 2008

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 audit of the Relevant Financial Statements by [2007 Auditor]. The investigation focused on the audit of the carrying amounts of certain assets, liabilities and MI arising from the Acquisition.

Background information

[Listed Entity] is a corporation listed on the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited. [Listed Entity] is incorporated in the Cayman Islands.

The loss of the Group for the year ended 31 December 2007 was HK$416.4 million and the consolidated net assets of the Group was HK$620.8 million at 31 December 2007. The Relevant Financial Statements were prepared in accordance with HKFRSs.

The Council received a complaint on 25 May 2009. The complainant, among other things, alleged that there were non-compliances with HKFRSs in the Relevant Financial Statements but its auditor, [2007 Auditor], issued an unqualified auditor's report.

Initiation of investigation

Having considered all the information available, the Council, on 3 September 2009, 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 audit of the Relevant Financial Statements.

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 audit of the Relevant Financial Statements in respect of the following areas:

(a) the disclosure of a description of the factors that contributed to a cost that results in the recognition of Goodwill;

(b) the recognition of deferred tax liabilities in respect of the Acquisition;

(c) the recognition of interests in JCEs, MI and Goodwill in respect of the Acquisition; and

(d) the recognition of impairment loss on Goodwill for the year ended 31 December 2007.

Relevant financial reporting, auditing and assurance requirements

The financial reporting, auditing and assurance requirements applicable at the time of the audit of the Relevant Financial Statements and which are relevant to the findings on the question whether or not there is an auditing irregularity in this report are set out below:

HKAS 12	*Income Taxes*
HKAS 36	*Impairment of Assets*
HKFRS 3	*Business Combinations*
HKSA 620	*Using the Work of an Expert*
HKSA 700	*The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*

Views of the AIB

Disclosure of a description of the factors that contributed to a cost that results in the recognition of Goodwill

The AIB considers that the factors that contributed to a cost that resulted in the recognition of Goodwill are not disclosed in the Relevant Financial Statements as required by paragraph 67(h) of HKFRS 3. The disclosure of the factors is crucial in enabling users of the Relevant Financial Statements to understand the components of the acquired Goodwill and the subsequent impairment loss on Goodwill in the Relevant Financial Statements.

Therefore, the AIB is of the view that the Relevant Financial Statements do not provide sufficient disclosure on the Acquisition and that [2007 Auditor] should have modified its auditor's report on the Relevant Financial Statements. This appears to be a non-compliance with the requirements of paragraphs 11 and 13 of HKAS 700.

Recognition of deferred tax liabilities

The AIB concludes that the failure to recognize deferred tax liabilities of HK$34 million in the Relevant Financial Statements is a non-compliance with paragraphs 19 and 66 of HKAS 12.

Since the AIB considers that the above non-compliance with HKAS 12 is material to the Relevant Financial Statements, the AIB is of the view that [2007 Auditor] should have expressed a qualified opinion in its auditor's report. This appears to be a non-compliance with the requirements of paragraphs 11 and 13 of HKSA 700.

Recognition of interests in JCEs, MI and Goodwill

The AIB acknowledges that paragraph 36 of HKFRS 3 does not provide specific guidelines on the application of purchase accounting for the acquiree's interests in associates (which may also apply to JCEs) in a business combination. Therefore, the AIB considers that the assessment made by [2007 Auditor] on the recognition of JCEs in the Acquisition is reasonable.

The AIB reviewed the calculation of MI and Goodwill as reflected in the Audit Working Papers and did not identify any apparent auditing irregularities in relation to the recognition of MI and Goodwill associated with the recognition of JCEs.

Recognition of impairment loss on Goodwill

Given that the recoverable amount of the CGU of lottery business management services was determined under the income approach, the AIB is of the view that monetary assets and liabilities should not be included in the carrying amount of that CGU in determining the amount of impairment loss. The AIB considers that the impairment loss on Goodwill recognized in the Relevant Financial Statements was overstated by the amount of monetary assets and liabilities of approximately HK$20.8 million. Given that the overstatement above is material, the AIB is of the view that [2007 Auditor] should have expressed a modified opinion in its auditor's report. This appears to be a non-compliance with the requirements of paragraphs 11 and 13 of HKSA 700.

Comments on investigation report from [2007 Auditor]

The relevant sections of the draft investigation report were sent to [2007 Auditor] for comments on 13 May 2010. [Legal Representative], acting on behalf of [2007 Auditor], provided comments on the draft investigation report on 12 July 2010. The comment letter is attached as Annex 5R to this investigation report.

Comments on investigation report from [Listed Entity]

The relevant sections of the draft investigation report were sent to [Listed Entity] for comments on 13 May 2010. [Listed Entity] provided its comments on 27 May 2010. The comment letter is attached as Annex 5Q to this investigation report.

Comments on investigation report from [2008 Auditor]

The relevant sections of the draft investigation report were also sent to [2008 Auditor] for comments on 13 May 2010 and a reply from [2008 Auditor] was received on 26 May 2010. [2008 Auditor] did not express any comments on the investigation report (see Annex 5P).

AIB's response to comments on investigation report from [2007 Auditor] and [Listed Entity]

The AIB reviewed the comments from [2007 Auditor] and [Listed Entity] on this investigation report and considered that the points raised by them were either without merit or irrelevant. Therefore, the AIB upholds its views.

Section 1 Introduction

1.1 General

1.1.1 This report is prepared pursuant to section 35 of the FRC Ordinance in connection with the investigation conducted by the AIB pursuant to section 23(3)(b) of the FRC Ordinance in relation to the audit of the Relevant Financial Statements (Annex 2A) by [2007 Auditor].

1.1.2 The Council received a complaint on 25 May 2009 (Annex 1A) in relation to the audit of the Relevant Financial Statements by [2007 Auditor].

1.1.3 The complainant alleged that there were a number of non-compliance with accounting requirements in the Relevant Financial Statements and questioned the issuance of an unqualified auditor's report with no modification by the auditor, [2007 Auditor].

1.2 Background information

1.2.1 [Listed Entity] is a corporation listed on the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited. [Listed Entity] is incorporated in the Cayman Islands.

1.2.2 The principal activities of the Group set out in the Relevant Financial Statements were the provision of network system integration and lottery business management services in the PRC.

1.2.3 The Relevant Financial Statements showed that the consolidated loss for the year ended 31 December 2007 was HK$416.4 million and the consolidated net assets was HK$620.8 million at 31 December 2007.

1.2.4 [2007 Auditor] was the auditor of [Listed Entity] for the year ended 31 December 2007. It expressed an unqualified audit opinion with no modification in relation to the Relevant Financial Statements.

1.2.5 [Listed Entity] appointed [2008 Auditor] as the auditor for the audit of its 2008 Accounts (Annex 2B). In the 2008 Accounts, comparative figures were restated to reflect prior year adjustments made by [Listed Entity] in respect of the Relevant

Financial Statements. The auditor's report on the 2008 Accounts is unqualified with no modification.

1.2.6 In the 2008 Accounts, the restated consolidated loss for the year ended 31 December 2007 was HK$476.4 million and the restated consolidated net assets at 31 December 2007 was HK$540.3 million. That is, there was an increase in the consolidated loss of HK$60 million (14.4%) and a decrease in the consolidated net assets of HK$80.5 million (13%) in the restated Relevant Financial Statements.

1.2.7 An extract of the financial information, before and after the PYA, of the Group for the year ended 31 December 2007 is set out below:

	Before the PYA	After the PYA	Increase/ (decrease) in NAV or profit/loss
	HK$ million	HK$ million	HK$ million
Goodwill	485.0	508.9	23.9
Intangible assets	194.7	194.7	-
Interests in jointly controlled entities	97.6	27.2	(70.4)
Net assets	620.8	540.3	(80.5)
Total assets	1,169.7	1,123.2	(46.5)
Deferred tax liabilities	-	34.0	(34.0)
Total liabilities	549.0	583.0	(34.0)
Minority interests	76.7	56.2	20.5
Turnover	361.9	361.9	-
Impairment loss on goodwill	416.0	476.0	(60.0)
Loss before taxation	(414.7)	(474.7)	(60.0)
Loss for the year	(416.4)	(476.4)	(60.0)

1.2.8 It was stated in both the Relevant Financial Statements and the 2008 Accounts that the Group's accounts were prepared in accordance with HKFRSs. While the auditors' reports of both [2007 Auditor] and [2008 Auditor] stated that their audits were conducted in accordance with HKSAs.

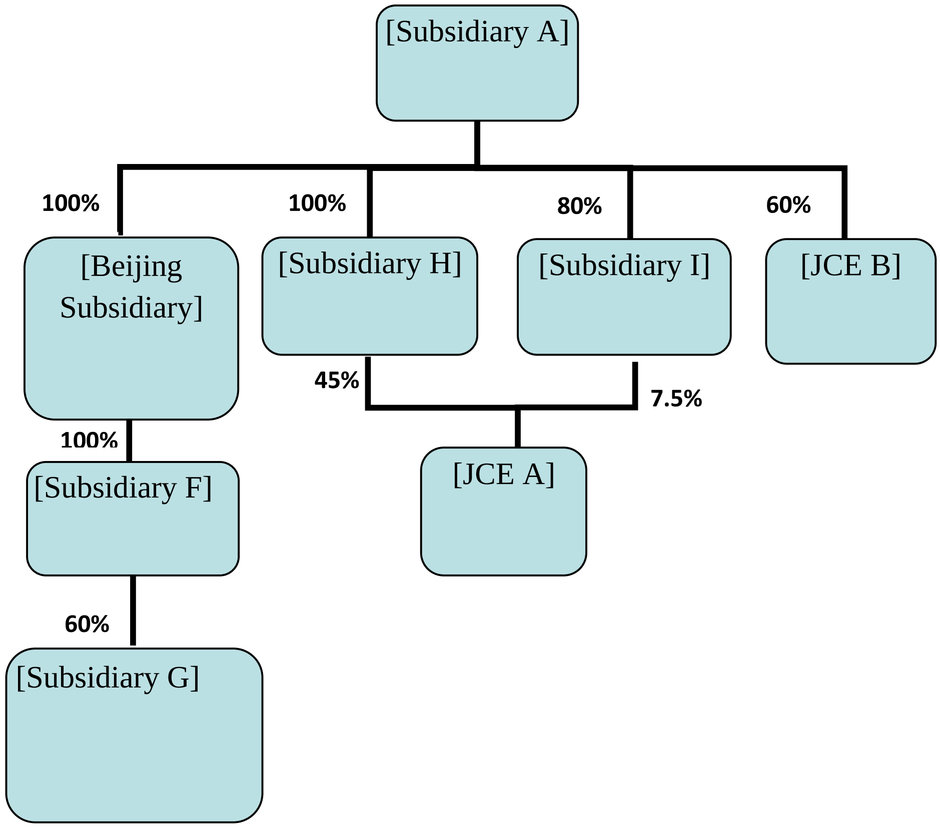
1.3 The Acquisition

1.3.1 Potential issues of non-compliance with accounting requirements being investigated are related to the acquisition of two subsidiaries by the Group on 13 December 2007. According to note 19 to the Relevant Financial Statements:

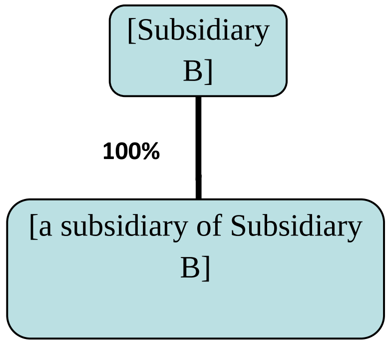
"During the year, the Group has acquired 80% equity interest in [Subsidiary A] and 60% equity interest in [Subsidiary B] for a consideration of approximately HK$1,163,314,000 and incurred a goodwill of approximately HK$901,026,000, as further detailed in note 39."

1.3.2 The group structure of the [Subsidiary A] Group and the [Subsidiary B] Group are as follows:

[Subsidiary A] Group:



[Subsidiary B] Group:



Section 2 The complaint

2.1 The complainant alleged that there was non-compliance with accounting requirements in the Relevant Financial Statements and questioned the issuance of an unqualified auditor's report with no modification by the auditor, [2007 Auditor].

2.2 After receiving the complaint (Annex 1A), the Secretariat sent a letter to [2007 Auditor] (Annex 4A) to ask for explanations on the allegations on 24 July 2009. A reply from [2007 Auditor] was received on 24 August 2009 (Annex 4B). The Secretariat reviewed the Relevant Financial Statements, other related announcements of the Company, and the information provided by the complainant, the Company and its auditor. Potential non-compliance in the Relevant Financial Statements was identified in relation to two of the allegations listed below:

(a) a description of the factors that contributed to a cost that results in the recognition of Goodwill was not disclosed in accordance with paragraph 67(h) of HKFRS 3 *Business Combinations*; and

(b) deferred tax liabilities arising from the increase in fair value of intangible assets in respect of the Acquisition were not recognized in accordance with HKAS 12 *Income Taxes*.

2.3 The review of the complaint by the Secretariat also resulted in the identification of other potential non-compliance issues which include:

(a) whether the recognition of interests in JCEs, MI and Goodwill in respect of the Acquisition was in accordance with paragraph 36 of HKFRS 3 *Business Combinations*; and

(b) whether the recognition of impairment loss on Goodwill for the year ended 31 December 2007 was in accordance with HKAS 36 *Impairment of Assets*.

Section 3 Initiation of investigation

3.1 Having considered all the information laid before it, the Council decided to initiate an investigation (reference I01-09) on 3 September 2009 and directed the AIB to investigate the possible auditing irregularity and the question whether or not there is such an irregularity in relation to the audit of the Relevant Financial Statements in respect of the following areas:

(a) the disclosure of a description of the factors that contributed to a cost that results in the recognition of Goodwill;

(b) the recognition of deferred tax liabilities resulting from the fair value adjustments on intangible assets in respect of the Acquisition;

(c) the recognition of interests in JCEs, MI and Goodwill in respect of the Acquisition; and

(d) the recognition of impairment loss on Goodwill for the year ended 31 December 2007.

3.2 The AIB consists of the following members:

(a) Mr. M.T. Shum, the Chairman (up to 31 January 2010);

(b) Dr. P.M. Kam, the Chairman (from 1 April 2010);

(c) Ms. Velma Cheung, the Acting Chairman (from 1 February 2010 to 31 March 2010);

(d) Ms. Anna Lau;

(e) Ms. Florence Wong; and

(f) Ms. Joyce Woo.

Section 4 Investigation approach

4.1 Requirements issued

4.1.1 For the purpose of the investigation, the AIB issued requirements under section 28 of the FRC Ordinance to [2007 Auditor] for the production of the Audit Working Papers, the provision of explanations/further particulars of the Audit Working Papers and response to written questions.

4.1.2 The AIB obtained the audit files from [2007 Auditor] on 29 September 2009 for a detailed review. On 21 October 2009, [2007 Auditor] confirmed that the records and documents produced were the complete set of the Audit Working Papers (Annex 5B).

4.1.3 For the purpose of the investigation, the AIB also required [Listed Entity] and [2008 Auditor] to respond to written questions under section 28 of the FRC Ordinance.

4.2 Standards relevant to the investigation

4.2.1 The AIB referred to the following financial reporting, auditing and assurance requirements applicable at the time of the audit of the Relevant Financial Statements during the investigation:

HKAS 12	*Income Taxes*
HKAS 36	*Impairment of Assets*
HKFRS 3	*Business Combinations*
HKSA 620	*Using the Work of an Expert*
HKSA 700	*The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*

4.3 The investigation report

4.3.1 The relevant sections of the draft investigation report were sent to [2007 Auditor], [Listed Entity] and [2008 Auditor] for comments on 13 May 2010 (Annex 5M), (Annex 5N) and (Annex 5O) respectively.

4.3.2 On 12 July 2010, [Legal Representative], acting on behalf of [2007 Auditor], provided comments (Annex 5R) which are included in the relevant sections of this investigation report.

4.3.3 On 27 May 2010, [Listed Entity] provided its comments in a letter which is enclosed as Annex 5Q. Details of [Listed Entity]'s comments are discussed in the relevant sections of this report.

4.3.4 [2008 Auditor] replied on 26 May 2010 (Annex 5P) and its comments are recorded in Paragraph 9.8 of this report.

4.3.5 This investigation report of the AIB was adopted by the Council on 5 August 2010 pursuant to section 35(3) of the FRC Ordinance.

Section 5 Audit approach of [2007 Auditor]

5.1 According to the "Audit Planning Memorandum" <section C3c of File no. 2> (Annex 3A) of the Audit Working Papers, the materiality in relation to the audit of the Relevant Financial Statements was HK$12 million. The final materiality as stated in the "Summary Review Memorandum" <section B5 of File no. 2> (Annex 3B) was also HK$12 million. It was calculated based on 1% of the gross assets of the Group in the Relevant Financial Statements.

5.2 In the "Audit Planning Memorandum" <section C3c of File no. 2> (Annex 3A) of the Audit Working Papers, [2007 Auditor] classified Goodwill as a high risk audit issue. [2007 Auditor] mentioned that *"We will enquire with the Company management the reason of the significant goodwill and review all the relevant agreements and documents of acquisition and issue of convertible bonds and shares, the Company's circulars and announcements, the relevant correspondences and minutes to assess the fair value of the consideration for the acquisition and the acquired subsidiaries. The Group will engage independent qualified professional valuers to perform the valuations of the fair value of [Subsidiary A] Group and [Subsidiary B] Group, we will review the valuation report to assess any impairment of goodwill required."*

5.3 The Audit Planning Memorandum did not mention about deferred tax liabilities in connection with the Acquisition and the disclosure requirements related to the Acquisition.

Section 6 Disclosure of a description of the factors that contributed to a cost that results in the recognition of Goodwill

6.1 Findings of fact

6.1.1 Background information

6.1.1.1 Note 19 to the Relevant Financial Statements stated that *"During the year, the Group has acquired 80% equity interest in [Subsidiary A] and 60% equity interest in [Subsidiary B] for a consideration of approximately HK$1,163,314,000 and incurred a goodwill of approximately HK$901,026,000, as further detailed in note 39."* However, the AIB considers that the factors that contributed to a cost that results in the recognition of Goodwill as required by paragraph 67(h) of HKFRS 3 (see Paragraph 6.2.2) were not disclosed in the Relevant Financial Statements.

6.1.1.2 The factors that contributed to a cost that results in the recognition of Goodwill were disclosed in the subsequent year's financial statements. According to note 34(b) to the 2008 Accounts (Annex 2B), *"The goodwill arising on the acquisition is attributable to the anticipated profitability of the acquired business and an unexpected increase in fair value of consideration, mainly due to the increase in share price of the Company between the agreement date and the date of acquisition."*

6.1.2 Information from the review of the Audit Working Papers

6.1.2.1 The "IPO/Listed Case Work File Completion Checklist" <section B3.5c of File no. 1> (Annex 3C) stated that *"All disclosure items have been checked and results satisfactory"*. There was no separate disclosure checklist in the Audit Working Papers in relation to the disclosure requirement of goodwill under HKFRS 3.

6.1.2.2 In the "Review and Approval Summary" <section B1.1c of File no.1> (Annex 3D), the lead director of the audit of the Relevant Financial Statements signed and declared that *"I have reviewed the audit files and I am satisfied that … disclosures in accordance with HKFRSs, Companies Ordinance and Listing Rules have been made …"*

6.1.3 Information and explanations provided by [2007 Auditor]

6.1.3.1 [2007 Auditor] stated in its reply letter dated 24 August 2009 (Annex 4B) that *"the Company illustrated that it had properly disclosed the factor contributing to goodwill to be the lottery business as disclosed in the first sentence in note 19(b) to the CFS* [Relevant Financial Statements] *on page 82, 'goodwill … has been allocated to the …CGU…of lottery business management services only'. The Company considered that it had described the factor because paragraph 67(h) of HKFRS 3 requires a description of the factors but does not mention to what extent the details are required. As the above disclosure requirement would have no financial effect on the results and the state of affairs of the Company, we considered that there was no material non-compliance with paragraph 67(h) of HKFRS 3 and modification to auditor's report was not required."*

6.2 Relevant financial reporting, auditing and assurance requirements

6.2.1 Paragraph 66(a) of HKFRS 3 states that *"An acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of business combinations that were effected during the period."*

6.2.2 Paragraph 67(h) of HKFRS 3 requires an acquirer to disclose *"a description of the factors that contributed to a cost that results in the recognition of goodwill …"* for each business combination that was effected during the financial period.

6.2.3 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."*

6.2.4 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. … (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 …"*

6.3 Views of the AIB

6.3.1 The AIB considers that the disclosure referred to by [2007 Auditor] in Paragraph 6.1.3.1 only explained the segment to which Goodwill had been allocated and was not a description of the factors that contributed to a cost that resulted in the recognition of Goodwill as required by paragraph 67(h) of HKFRS 3 (see Paragraph 6.2.2).

6.3.2 Given that the Acquisition resulted in the recognition of a significant amount of Goodwill of HK$901,026,000 in the Relevant Financial Statements and that shortly after the Acquisition, an impairment loss on Goodwill of HK$416,000,000 was recognized in the Relevant Financial Statements, the AIB is of the view that the disclosure of the factors that contributed to a cost that resulted in the recognition of Goodwill is crucial in enabling users of the Relevant Financial Statements to understand the reasons for recognizing Goodwill and its subsequent impairment.

6.3.3 In the light of the above, the AIB is of the view that the Relevant Financial Statements do not provide sufficient disclosures on the Acquisition and [2007 Auditor] should have modified its auditor's report on the Relevant Financial Statements. This appears to be a non-compliance with the requirements of paragraphs 11 and 13 of HKAS 700 (see Paragraphs 6.2.3 and 6.2.4).

6.4 Comments on investigation report from [2007 Auditor]

6.4.1 In the letter dated 12 July 2010 (Annex 5R), [Legal Representative] stated on behalf of [2007 Auditor] its comments on the views of the AIB.

6.4.2 [2007 Auditor] disagreed with the AIB's views and considered that notes 34, 35 and 39 to the Relevant Financial Statements contained information which would have sufficiently enabled users of the Relevant Financial Statements to understand the reasons for recognizing Goodwill. It was disclosed in notes 34, 35 and 39 that the consideration for the Acquisition included convertible bonds and shares of the Company, and that the increase in the value of the convertible bonds was approximately HK$383 million and the increase in the share consideration was approximately HK$112.3 million. [2007 Auditor] considered that these were the major factors that resulted in the recognition of Goodwill which have already been disclosed in the Relevant Financial Statements. (Paragraph 3.2 of Annex 5R)

6.4.3 [2007 Auditor] was of the view that since the value of Goodwill is determined based on the consideration for the Acquisition, the increase in fair value of the consideration is definitely a factor that contributed to a cost that resulted in the recognition of Goodwill. (Paragraph 3.3 of Annex 5R)

6.4.4 In addition, it was stated in the letter that *"it was not necessary to mention that there would be anticipated profitability of the acquired business because an acquirer is normally expected to purchase a business that is profitable or will be profitable in a business combination. Therefore, [2007 Auditor] considers that the "Lottery business" itself, based on its judgment, is a Generic Factor and also one of the Factors that contributed to a cost that resulted in the recognition of Goodwill. As note 19(b) of the Relevant Financial Statements had disclosed that the Goodwill was allocated to the lottery management business, this indicated the lottery business was the Generic Factor which contributed to the cost that resulted in the recognition of Goodwill. [2007 Auditor] considers that, based on its judgement, this is also the information of one of the Factors that had been mentioned in the Relevant Financial Statements."* (Paragraph 3.4 of Annex 5R)

6.4.5 [2007 Auditor] added that *"The difference between the disclosure regarding the increase in fair value of the Consideration in note 34(b) to the 2008 Accounts and notes 34, 35 and 39 to the Relevant Financial Statements, if any, just lies in the form of disclosure: disclosure in note 34(b) to the 2008 Accounts is in words while disclosure in notes 34, 35 and 39 to the Relevant Financial Statements is in narrative and table forms."* (Paragraph 3.6 of Annex 5R)

6.4.6 [2007 Auditor] reiterated the point raised in its reply dated 24 August 2009 that note 19(b) to the Relevant Financial Statements, which stated that *"goodwill with indefinite useful lives has been allocated to the cash generating unit ("CGU"') of lottery business management services only"* had complied with paragraph 67(h) of HKFRS 3. It further stated that this disclosure not only explained the segment to which Goodwill had been allocated but also explained that Goodwill arose because of the acquisition of the CGU of lottery business management services, which is a special industry. (Paragraph 3.7 of Annex 5R)

6.4.7 [2007 Auditor] stated that if notes 19(b), 34, 35 and 39 to the Relevant Financial Statements were read together, it was clear that all the factors (i.e. the acquisition of the lottery business management services and the increase in fair value of the consideration) had already been disclosed in the Relevant Financial Statements as the reasons for recognizing Goodwill. (Paragraph 3.8 of Annex 5R)

6.4.8 [2007 Auditor] further stated that as there were no guidance or rules governing the exact disclosure requirement for paragraph 67(h) of HKFRS 3, the interpretation on sufficiency of disclosure in notes 19(b), 34, 35 and 39 was a matter of judgment. [2007 Auditor] considered that it had exercised its professional judgment on the sufficiency of the disclosure of the factors by the Company in the Relevant Financial Statements. (Paragraph 3.9 of Annex 5R)

6.4.9 [2007 Auditor] concluded that *"In any event, the wording of the description of the Factors would not have financial effect on the Relevant Financial Statements of the Company"*. (Paragraph 3.5 of Annex 5R)

6.5 Response of the AIB to comments from [2007 Auditor]

6.5.1 The information disclosed in notes 34 and 35 to the Relevant Financial Statements set out the fact that the value of shares and convertible bonds had increased while note 39 provided a computation of Goodwill. The AIB is of the view that the increase in fair value of the consideration of the Acquisition, due to an increase in the value of shares and convertible bonds, may not necessarily result in the recognition of Goodwill as the recognition of Goodwill involves other factors, such as whether there is a corresponding increase in the fair value of the underlying net assets acquired at the date of Acquisition. The AIB believes that reasonable users of the Relevant Financial Statements would not have recognized the increase in fair value of the consideration as a factor solely based on the disclosures in notes 34, 35 and 39.

6.5.2 The AIB considers that other than the unexpected increase in fair value of the consideration, there are other factors that contributed to the recognition of Goodwill, such as those described in Paragraph 6.5.3, which need to be disclosed in the Relevant Financial Statements as required by paragraph 67(h) of HKFRS 3.

6.5.3 Despite the fact that HKFRS 3 is a principle-based standard, it does provide guidance on what are the factors that contribute to a cost that results in the recognition of goodwill in BC130 of HKFRS 3. In BC130, the International Accounting Standards Board considered that *"when goodwill is measured as a residual, it could comprise the following components:*

(a) the fair value of the 'going concern' element of the acquiree. The going concern element represents the ability of the acquiree to earn a higher rate of return on an assembled collection of net assets than would be expected from those net assets operating separately. That value stems from the synergies of the net assets of the acquiree, as well as from other benefits such as factors related to market imperfections, including the ability to earn monopoly profits and barriers to market entry.

(b) the fair value of the expected synergies and other benefits from combining the acquiree's net assets with those of the acquirer. Those synergies and other benefits are unique to each business combination, and different combinations produce different synergies and, hence, different values.

(c) *overpayments by the acquirer.*

…"

6.5.4 The AIB considers that the issue is the lack of relevant disclosure rather than the form (i.e. narrative or table form) or the extent of the disclosure. In view of the lack of disclosure, the AIB considers that the Relevant Financial Statements do not comply with the requirements of paragraph 67(h) of HKFRS 3.

6.5.5 In respect of the comments raised in Paragraph 6.4.9, the AIB considers that the disclosure of the factors that contributed to the recognition of Goodwill is crucial in enabling users of the Relevant Financial Statements to understand the financial impact of the Acquisition, the components of the acquired Goodwill and the subsequent impairment loss on Goodwill.

6.5.6 In the light of the above, the AIB upholds its views set out in Paragraph 6.3 and considers that [2007 Auditor] should have modified its auditor's report on the Relevant Financial Statements.

6.6 Comments on investigation report from [Listed Entity]

6.6.1 In its letter dated 27 May 2010 (Annex 5Q), [Listed Entity] stated that *"Regarding 7.3* [6.3] *of the Report, note 39(a) of the Relevant Financial Statements disclosed that "The consideration for the acquisition of [Subsidiary A] and [Subsidiary B] includes the convertible bonds of the Company with face value of … The fair value of the convertible bonds and the ordinary shares of the Company, determined using the published price available at the date of acquisition, were …" and note 39 of the Relevant Financial Statements also disclosed the increase of convertible bonds in face value to fair value and the increase of shares in fair value. Note 34 of the Relevant Financial Statements further disclosed the increase of convertible bonds in face value on 13 December 2007 to fair value on 31 December 2007. Thus, we believe that we complied with the reporting requirement of HKFRS 3 paragraph 67(h)."*

6.6.2 [Listed Entity] also added that *"we do not consider a modified or qualified opinion in the auditor's report of the Relevant Financial Statements is necessary"* as it considered that the conditions set out in paragraphs 7 or 12 of HKSA 701 *Modification to the Independent Auditor's Report* were not met.

6.7 Response of the AIB to comments from [Listed Entity]

6.7.1 The AIB considers that the comments raised by [Listed Entity] were similar to that of [2007 Auditor] which were addressed in Section 6.5 above.

Section 7 Recognition of deferred tax liabilities

7.1 Findings of fact

7.1.1 Background information

7.1.1.1 Note 39 to the Relevant Financial Statements disclosed that there were fair value adjustments of HK$135,927,000 on intangible assets in respect of the Acquisition. However, no corresponding deferred tax liabilities were recognized in accordance with paragraphs 19 and 66 of HKAS 12 (see Paragraphs 7.2.2 and 7.2.5).

7.1.1.2 Note 3 to the 2008 Accounts disclosed that *"The consolidated financial statements for the year ended December 31, 2007 did not account for the deferred tax effect that resulting from the fair value adjustments on intangible assets in respect of the acquisition of subsidiaries in 2007 in accordance with HKAS 12 "Income Taxes". … Accordingly, comparative amounts in the consolidated financial statements have been restated."* As a result of the PYA, [Listed Entity] recognized deferred tax liabilities of HK$33,982,000.

7.1.2 Information from the review of the Audit Working Papers

7.1.2.1 It was indicated in the schedule "Deferred Tax" <section E650-3 of File no. 33> (Annex 3E) that the accumulated tax losses of approximately HK$27,788,000 at 31 December 2007 included tax losses of the Acquired Subsidiaries and other subsidiaries of the Group and the total net deferred tax assets were HK$5,836,993. It was also stated that *"No deferred assets is recognized, due to unpredictable profit stream"*.

7.1.2.2 Extracts from the "Assessment of deferred tax liabilities from the acquisition of subsidiaries" in <section E950-4 of File no. 33> (Annex 3F) are set out in Paragraphs 7.1.2.3 to 7.1.2.5 below.

7.1.2.3 *"Discussed with the client, there should not be deferred tax liabilities to be provided at the moment as it is probable that the accumulated unutilized tax losses could be used to absorb the future cash inflow of the intangible assets and the subsidiaries with the intangible assets should share the Group's common expenses. The Group had accumulated unutilized tax loss of approximately HK$27,788K as at 31 December 2007, we have checked to the newly launched PRC tax regulations "2008 年中華人民共和國新企業所得稅法全文第六章第四十一條"* [(Annex 3G)] *issued on 16 March 2007 effective on 1 January 2008. It allowed that the PRC subsidiaries generating income* *from certain intangible assets would share the recurring centralized costs and common overheads of the Group. Therefore, consulted with tax advice, the unutilized tax loss could be allowed to absorb the future income generated from the intangible assets."*

7.1.2.4 *"The overall effect of the accumulated tax losses and the centralized costs and overheads of the Group on the deferred tax liabilities in respect of the fair value adjustments on the intangible assets is summarized as follows:*

Financial year	*Year of assessment*	*Tax loss b/f*	*Centralized costs*	*Income from intangible assets*	*Tax loss c/f*	*DTL at the rate of 17.4%*
		HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
		A	*B*	*C*	*D=A+B-C*	*E=D*17.4 %*
						<Note>
2008	*2008/09*	*27,788*	*14,339*	*(27,178)*	*14,949*	*-*
2009	*2009/10*	*14,949*	*14,339*	*(27,178)*	*2,110*	*-*
2010	*2010/11*	*2,110*	*14,339*	*(27,178)*	*(10,730)*	*(1,867)*
2011	*2011/12*	*-*	*14,339*	*(27,178)*	*(12,839)*	*(2,234)*
2012	*2012/13*	*-*	*14,339*	*(27,178)*	*(12,839)*	*(2,234)*
						(6,335)

Note: Discussed with the client, the Group would be exposed to both Hong Kong and the PRC tax jurisdictions of 16.5% and 25% respectively since 2008; therefore, it is more appropriate to estimate the deferred tax liabilities by using the latest effective tax rate of approximately 17.4% (i.e. HK$72,421K / HK$414,706K) for the year ended 31 December 2007. Consulted with tax advice, for some cases, it could be possible to use an even lower tax rate in case arm's length services provided by the Hong Kong or BVI subsidiaries to the PRC subsidiary with income generated from the intangibles."

7.1.2.5 [2007 Auditor] concluded that *"As the estimated deferred tax liabilities is approximately HK$6,335,000, which is immaterial and would not have material effect on the results for*

2007 and NAV as at 31 December 2007. Therefore, deferred tax liabilities was not recognized by the client in respect of the fair value adjustments on the intangible assets."

7.1.3 Information and explanations provided by [2007 Auditor]

7.1.3.1 [2007 Auditor] was requested to respond to the following on 3 November 2009 (Annex 5E):

(a) confirm that it agreed that no deferred tax asset had to be recognized in respect of the unutilized tax losses from the Acquired Subsidiaries because the recognition criteria for deferred tax assets set out in paragraph 24 of HKAS 12 (see Paragraph 7.2.3) were not met due to "the unpredictability of future profit streams";

(b) justify that the accounting treatment in the Relevant Financial Statements met the requirement of paragraph 67 of HKAS 12 (see Paragraph 7.2.6) in the determination of deferred tax as part of the accounting for business combination; and

(c) explain which provision in HKAS 12 allows the use of future expenses yet to be incurred to offset against the deferred tax liabilities resulting from the fair value adjustments.

7.1.3.2 In response to 7.1.3.1(a), [2007 Auditor] replied on 17 November 2009 (Annex 5G) that *"The unutilized tax losses of HK$27m were expected to offset future profits arising from the intangible assets. As the recognition criteria for deferred tax assets as required in Paragraph 24 of HKAS 12 were probably met, there were potential deferred tax assets to be recognized at 31 December 2007. However, as the potential tax assets of HK$4.7m (HK$27m x 17.4%) were <u>immaterial</u> which only represented 0.4% (HK$4.7m/HK$1,170m) of total assets and 0.7% (HK$4.7m/HK$621m) of net assets, we considered that non-recognition of the deferred tax assets did not have material financial effect on the financial statements of the Company."*

[2007 Auditor] also mentioned that [Listed Entity] satisfied the conditions set out in (a) and (b)(ii) of paragraph 74 of HKAS 12 to support the non-recognition of deferred tax asset.

7.1.3.3 In respect of 7.1.3.1(b), [2007 Auditor] replied that it considered paragraphs 74 and 76 of HKAS 12 and satisfied that *"the potential deferred tax assets arising from the* *unutilized tax losses of HK$27m offsetting against part of the deferred tax liabilities resulting from the fair value adjustment complied with the requirements of HKAS 12."*

7.1.3.4 In respect of 7.1.3.1(c), it is stated in [2007 Auditor]'s reply that *"After considering the above factors, the remaining potential deferred tax liabilities would only be HK$18m ((HK$135m-HK$27m) x 17.4%). The key over-riding determinant in considering the recognition of deferred tax is the materiality of the potential deferred tax liabilities needed to be recognized. As the potential deferred tax liabilities were immaterial which only represented 1.5% (HK$18m/HK$1,170m) of total assets, 2.8% (HK$18m/HK$621m) of net assets and 3.2% (HK$18m/HK$549m) of total liabilities, we considered that non-recognition of the deferred tax liabilities did not have material financial effect on the financial statements of the Company.*

There is no provision in HKAS 12 which governs the application of future expenses yet to be incurred for deferred tax assessment. The use of the future centralized costs to offset against deferred tax liabilities resulting from the fair value adjustment was just an additional factor considered for the assessment of the expected future tax position of the Company during the useful lives of the intangible assets.

On or before the date of 2007 auditor's report issued on 26 March 2008, the use of centralized costs was duly considered to be applicable in view of the newly launched tax regulations issued on 16 March 2007 with effect from 1 January 2008. However, this will no longer be easily applied for future years and other future cases after a new tax regulation "特別納稅調整實施辦法 (試行)" was further issued on 8 January 2009 (i.e. before the date of 2008 auditor's report issued on 26 March 2009) with effect from 1 January 2008 in respect of the stringent control implemented on transfer pricing and the use of centralized costs among group companies as shown in the enclosed 國稅法 (2009) 2 號."

7.1.4 Information and explanations provided by [Listed Entity]

7.1.4.1 The AIB requested [Listed Entity] to explain the following on 8 October 2009 (Annex 5A):

(a) why there was a PYA in the 2008 Accounts which recognized deferred tax liabilities of HK$33,982,000 resulting from the fair value adjustments on intangible assets in respect of the Acquisition;

(b) how the PYA in respect of the deferred tax liabilities was calculated; and

(c) why such deferred tax liabilities were not recognized in the Relevant Financial Statements.

7.1.4.2 In response to the AIB's request, [Listed Entity] replied on 22 October 2009 (Annex 5C) that *"The prior year adjustment in relation to the deferred tax liabilities related to the fair value adjustment of HK$135,927,000 on the intangible assets of the two subsidiaries acquired, as detailed in note 34 to the 2008 Accounts. It is calculated by multiplying the fair value adjustment of HK$135,927,000 by the PRC Enterprise Income Tax rate of 25%. In the preparation of the 2007 Accounts* [Relevant Financial Statements], *the Group did not recognize these deferred tax liabilities as it was noted that certain subsidiaries of the Group had unutilized tax losses which were not recognized in the consolidated accounts of the Group* [Relevant Financial Statements].*"*

7.1.4.3 [Listed Entity] was requested to respond to the following on 28 October 2009 (Annex 5D):

(a) explain why no deferred tax assets were recognized in both the Relevant Financial Statements and the 2008 Accounts in relation to the unutilized tax losses of the Group and whether or not the unutilized tax losses from the Acquired Subsidiaries met the recognition criteria for deferred tax assets in accordance with paragraph 24 of HKAS 12; and

(b) provide the unutilized tax losses for each of the Acquired Subsidiaries at the acquisition date and the calculation on the amount of unutilized tax losses.

7.1.4.4 In response to the AIB's request, [Listed Entity] replied on 16 November 2009 (Annex 5F).

7.1.4.5 In respect of 7.1.4.3(a), [Listed Entity] explained that *"A deferred tax asset shall be recognized for the carry forward of unused tax losses to the extent that it is probable that future taxable profit will be available against which the unused tax losses can be utilized. However, the term "probable" is not defined in Hong Kong Accounting Standard 12 Income Taxes ("HKAS 12"). Given the inherent uncertainty in forecasting future results, there was no deferred tax asset being recognized in both the 2007 Accounts and the 2008 Accounts."*

7.1.4.6 In relation to 7.1.4.3(b), [Listed Entity] provided a breakdown of the unutilized tax losses of the Group as follows:

	Unutilized tax losses as at the acquisition date
"Company name (incorporated in)	*HK$'000*
[Listed Entity](Cayman)	*2,647*
[Subsidiary A] (HK)	*11,213*
[Subsidiary C] (HK)	*895*
[Subsidiary D] (HK)	*649*
[Subsidiary E] (HK)	*5,914*
[Subsidiary F] (PRC)	*2,949*
[Subsidiary G] (PRC)	*3,520*
Total	*27,787"*

7.1.4.7 [Listed Entity] confirmed on 2 December 2009 (Annex 5H) that out of the total unutilized tax losses of HK$27,787,000 of the Group at the acquisition date, only the unutilized tax losses of [Subsidiary A], [Subsidiary F] and [Subsidiary G] stated in the above paragraph, i.e. HK$17,682,000, were related to the Acquired Subsidiaries.

7.2 Relevant financial reporting, auditing and assurance requirements

7.2.1 Paragraph 5 of HKAS 12 defines temporary differences as "*differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Temporary differences may be either:*

(a) taxable temporary differences, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or

(b) *deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled."*

Paragraph 5 of HKAS 12 defines tax base of an asset or liability as *"the amount attributed to that asset or liability for tax purpose."*

7.2.2 Paragraph 19 of HKAS 12 states that *"The cost of a business combination is allocated by recognizing the identifiable assets acquired and liabilities assumed at their fair values at the acquisition date. Temporary differences arise when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently. For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability. The resulting deferred tax liability affects goodwill (see paragraph 66)."*

7.2.3 Paragraph 24 of HKAS 12 states that *"A deferred tax asset shall be recognized for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilized, ..."*

7.2.4 Paragraph 34 of HKAS 12 states that *"A deferred tax asset shall be recognized for the carryforward 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 utilized."*

7.2.5 Paragraph 66 of HKAS 12 states that *"As explained in paragraphs 19 and 26(c), temporary differences may arise in a business combination. In accordance with HKFRS 3 Business Combinations, an entity recognizes any resulting deferred tax assets (to the extent that they meet the recognition criteria in paragraph 24) or deferred tax liabilities as identifiable assets and liabilities at the acquisition date. Consequently, those deferred tax assets and liabilities affect goodwill or the amount of any excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination."*

7.2.6 Paragraph 67 of HKAS 12 states that *"As a result of a business combination, an acquirer may consider it probable that it will recover its own deferred tax asset that was not recognized before the business combination. For example, the acquirer may be able to utilize the benefit of its unused tax losses against the future taxable profit of the acquiree. In such cases, the acquirer recognizes a deferred tax asset, but does not include it as part of the accounting for the business combination, and therefore does not take it into account in determining the goodwill or the amount of any excess of the* *acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination."*

7.2.7 Paragraph 74 of HKAS 12 states that *"An entity shall offset deferred tax assets and deferred tax liabilities if, and only if:*

(a) the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and

(b) the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:

(i) the same taxable entity; or

(ii) different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realize the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered."

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

7.2.9 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. …"*

7.3 Views of the AIB

7.3.1 The carrying amount of the intangible assets acquired was increased by HK$135,927,000 at the date of the Acquisition (i.e. the fair value adjustments on intangible assets acquired) but the tax base of these assets remained at cost to the previous owners. Therefore, it appears to the AIB that there were taxable temporary differences of HK$135,927,000 which would result in deferred tax liabilities in accordance with paragraph 19 of HKAS 12 (see Paragraph 7.2.2).

7.3.2 The AIB considers that the calculation of deferred tax liabilities arising from the fair value adjustments on intangible assets provided by [Listed Entity] as set out in Paragraph 7.1.4.2 is appropriate. The calculation is set out below:

	HK$'000
Fair value adjustments on the intangible assets acquired (i.e. taxable temporary differences)	135,927
Tax rate [PRC Enterprise Income Tax rate]	25%
Deferred tax liabilities	33,982

7.3.3 In assessing deferred tax liabilities arising from the Acquisition, the AIB noted from the Audit Working Papers that [2007 Auditor] had offset the accumulated tax losses of HK$27,788,000 of the Acquired Subsidiaries and other subsidiaries, and projected centralized costs of the Acquired Subsidiaries of HK$14,339,000 in each of the five years from 2008 to 2012 (i.e. future expenses to be incurred), against the income from intangible assets (i.e. recovery of the fair value adjustments on intangible assets acquired in future years) (see Paragraph 7.1.2.4).

7.3.4 The AIB was unable to locate any documentation in the Audit Working Papers which assessed whether future taxable profit would be available against which the unused tax losses could be utilized at the date of the Acquisition (see Paragraphs 7.2.3 and 7.2.4). However, the AIB considers that other available information to assess whether deferred tax assets should be recognized at 31 December 2007 could be used as a proxy in view of the proximity between the date of the Acquisition (i.e. 13 December 2007) and the year-end date (i.e. 31 December 2007).

7.3.5 In relation to whether it is probable that taxable profit will be available at 31 December 2007, the AIB obtained the following information:

(a) according to note 38 to the Relevant Financial Statements, "*No deferred tax asset has been recognized in respect of the unutilized tax losses due to the unpredictability of future profit streams.";*

(b) according to the Audit Working Papers of [2007 Auditor], *"No deferred assets is recognized, due to unpredictable profit stream."* (see Paragraph 7.1.2.1);

(c) according to the letter from [2007 Auditor] on 17 November 2009, *"… the recognition criteria for deferred tax assets as required in Paragraph 24 of HKAS 12 were probably met, there were potential deferred tax assets to be recognized at 31 December 2007…"* (see Paragraph 7.1.3.2). This is inconsistent with Paragraphs 7.3.5 (a) and (b) above; and

(d) according to the letter from [Listed Entity] on 16 November 2009, *"… the term "probable" is not defined in Hong Kong Accounting Standard 12 Income Taxes ("HKAS 12"). Given the inherent uncertainty in forecasting future results, there was no deferred tax asset being recognized in both the 2007 Accounts* [Relevant Financial Statements] *and the 2008 Accounts."* (see Paragraph 7.1.4.5)

7.3.6 Based on the summary of information obtained above, it appears that [Listed Entity] was of the view that the availability of future taxable profit was uncertain. Although [2007 Auditor] claimed that the recognition criteria for deferred tax assets as required in paragraph 24 of HKAS 12 were probably met, i.e. taxable profit would probably be available against which the unused tax losses could be utilized, the AIB is of the view that the documentation in the Audit Working Papers does not support this claim. The Relevant Financial Statements also did not recognize deferred tax assets at the date of the Acquisition. Therefore, it appears to the AIB that there were no deferred tax assets available to set off the deferred tax liabilities at the date of the Acquisition.

7.3.7 As for the offsetting of the projected centralized costs, the AIB considers that these costs should not be taken into account in determining deferred tax liabilities at the date of the Acquisition. In a letter dated 17 November 2009, [2007 Auditor] also acknowledged that *"There is no provision in HKAS 12 which governs the application of future expenses yet to be incurred for deferred tax assessment. The use of the future centralized costs to offset against deferred tax liabilities resulting from the fair value adjustment was just an additional factor considered for the assessment of the expected future tax position of the Company during the useful lives of the intangible assets."* (see Paragraph 7.1.3.4)

7.3.8 To conclude, the AIB finds that the failure to recognize deferred tax liabilities of HK$34 million is a non-compliance with paragraphs 19 and 66 of HKAS 12 and the amount is material compared to the materiality in relation to the audit of the Relevant Financial Statements of HK$12 million (see Paragraph 5.1). The under-provision represents 6.2% and 5.8% of the total liabilities at 31 December 2007 before and after PYA respectively.

7.3.9 The AIB considers that the under-provision of deferred tax liabilities in respect of the Acquisition would have a consequential effect on Goodwill recognized in the Relevant Financial Statements. Goodwill would be increased by HK$34 million (before taking into account the effect on minority interest).

7.3.10 Since the non-compliance with HKAS 12 by [Listed Entity] is material to the Relevant Financial Statements, the AIB is of the view that [2007 Auditor] should have expressed a qualified opinion in its auditor's report. This appears to be a non-compliance with the requirements of paragraphs 11 and 13 of HKSA 700 (see Paragraphs 7.2.8 and 7.2.9).

7.4 Comments on investigation report from [2007 Auditor]

7.4.1 In [Legal Representative]' letter dated 12 July 2010 (Annex 5R), it was stated that the AIB did not explain what factors had been considered to conclude the accuracy on the calculation of deferred tax liabilities set out in Paragraph 7.3.2. These factors included the appropriate applicable tax rate used for the source of income derived from each of the intangible assets. The AIB did not explain why it considered the calculation of deferred tax liabilities arising from the fair value adjustments on intangible assets provided by [Listed Entity] was appropriate. (Paragraph 2.4 of Annex 5R)

7.4.2 In addition, [2007 Auditor] considered that the amount of deferred tax liabilities should not cause an increase of Goodwill by the same amount as Goodwill would only be increased by the amount of deferred tax liabilities after accounting for minority interests. (Paragraph 2.6 of Annex 5R)

7.4.3 [2007 Auditor] expressed that the AIB's view of using the PRC tax rate of 25% for calculation on the deferred tax liabilities of all of the intangible assets is not appropriate, and provided an alternative computation of the deferred tax liabilities. (Paragraph 4.2 of Annex 5R)

7.4.4 The letter further stated that *" … (ii) the AIB's view on the amount over the materiality of HK$12 million that substantiates a qualified opinion in the auditor's report is not appropriate.*

[2007 Auditor] considers that the materiality amount in the audit planning memorandum and summary review memorandum is a benchmark guidance for the audit team to plan and perform audit work, including sampling in audit test and audit adjustments etc., and it is not a sole factor for [2007 Auditor] to consider a qualified opinion by simply comparing an amount over the materiality amount in the planning and summary review memorandum." (Paragraph 4.6 of Annex 5R)

7.4.5 [2007 Auditor] advised that it had considered both quantitative and qualitative factors in determining whether to qualify its audit opinion on the Relevant Financial Statements in relation to the possible understatement of deferred tax liabilities. [2007 Auditor] concluded that a qualified opinion was not required because it considered that the amount of possible unrecognized deferred tax liabilities was immaterial and that with or without the effect of possible deferred tax liabilities the Relevant Financial Statements were consistent with its understanding of the Company and its environment. (Paragraphs 4.7 - 4.10 of Annex 5R)

7.4.6 The letter stated that [2007 Auditor] was of the view that taking into account both quantitative and qualitative factors as well as the requirements under paragraph 11 of HKSA 701 and paragraphs 12 and 14 of HKSA 700, a qualified opinion in its auditor's report was not required and there was no non-compliance with the requirements of paragraphs 11 and 13 of HKSA 700. (Paragraph 4.11 of Annex 5R)

7.5 Response of the AIB to comments from [2007 Auditor]

7.5.1 In response to Paragraph 7.4.1, the AIB is of the view that when reading Paragraphs 7.1.4.2 and 7.3.2 together, it is clear how the AIB considers the deferred tax liabilities should have been arrived at (i.e. taxable temporary difference was the fair value increase in intangible assets acquired multiplied by the applicable tax rate which was the PRC Enterprise Income Tax rate). As set out in note 21 to the Relevant Financial Statements, most of the Acquired Subsidiaries operated in the PRC. Therefore, the source of income generated by the intangible assets would mostly be in the PRC. The AIB is of the view that management of the Group is in the best position to determine the applicable tax rate (subject to the approval of relevant tax authority). Therefore, the AIB considers that the calculation of deferred tax liabilities provided by [Listed Entity] is reasonable.

7.5.2 The AIB's position in respect of [2007 Auditor]'s comment set out in Paragraph 7.4.2 had been reflected in the extant Paragraph 7.3.9.

7.5.3 HKAS 700 requires an auditor to form an audit opinion on financial statements based on the audit evidence obtained during the course of an audit. Given that the computation on deferred tax liabilities provided in the letter dated 12 July 2010 was different from that in the Audit Working Papers as set out in Paragraph 7.1.2.4, the AIB is of the view that the former computation was not obtained during the course of the audit. As a result, the AIB considers that the computation subsequently provided in the letter is irrelevant for the purpose of this investigation.

7.5.4 The AIB reaffirms its view that the impact of the non-recognition of deferred tax liabilities arising from the Acquisition is material as the AIB considers that the line-item of deferred tax liabilities was materially misstated in the Relevant Financial Statements. The AIB is of the view that the Relevant Financial Statements, after adjusting for possible deferred tax liabilities arising from the Acquisition, would unlikely be consistent with [2007 Auditor]'s understanding of the Company and its environment as the AIB considers that the adjustment will change the line-item of deferred tax liabilities from nil to HK$34 million.

7.6 Comments on investigation report from [Listed Entity]

7.6.1 In its letter of 27 May 2010 (Annex 5Q), [Listed Entity] stated that *"Regarding 8.3.8 to 8.3.10* [7.3.8 to 7.3.10] *of the Report, which arising from different judgments on the utilization of tax losses, … since we have properly addressed the issues and adjusted the numbers as PYA in accordance with HKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors in the 2008 Accounts, in our opinion, the auditor's report of the Relevant Financial Statements should not be revised retrospectively"*.

7.6.2 [Listed Entity] also added that *"we do not consider a modified or qualified opinion in the auditor's report of the Relevant Financial Statements is necessary"* as it considered that the conditions set out in paragraphs 7 or 12 of HKSA 701 were not met.

7.7 Response of the AIB to comments from [Listed Entity]

7.7.1 The AIB considers that its conclusion stated in Paragraphs 7.3.8 to 7.3.10 were not due to different judgements in the utilization of tax losses. The reasons why the AIB considers that the tax losses of the Acquired Subsidiaries could not be utilized have been set out in Paragraphs 7.3.5 and 7.3.6.

7.7.2 The AIB is of the view that deferred tax liabilities being adjusted as PYA in the 2008 Accounts would not preclude [2007 Auditor] from having to reflect the failure to recognize deferred tax liabilities in the auditor's report on the Relevant Financial Statements.

Section 8 Recognition of interests in JCEs, MI and Goodwill

8.1 Findings of fact

8.1.1 Background information

8.1.1.1 According to note 39 to the Relevant Financial Statements, [Listed Entity] recognized interests in JCEs, MI and Goodwill at the date of the Acquisition of HK$96,942,000, HK$77,625,000 and HK$901,026,000 respectively.

8.1.1.2 In the 2008 Accounts, the amounts of interests in JCEs, MI and Goodwill arising from the Acquisition were restated to HK$26,529,000, HK$57,122,000 and HK$984,918,000 respectively.

8.1.1.3 Note 22 to the Relevant Financial Statements stated that *"The unlisted investments in jointly controlled entities were acquired as part of a business combination during the year, as further detailed in note 39. Included in the cost of investment in jointly controlled entities is a goodwill of a jointly controlled entity, [JCE A], acquired by the Group's subsidiary [Subsidiary A] in previous year."*

8.1.1.4 The issue is whether or not the recognition of HK$96,942,000 of interests in JCEs in respect of the Acquisition in the Relevant Financial Statements was in compliance with paragraph 36 of HKFRS 3 (see Paragraph 8.2.1). The amount recognized as interests in JCEs would in turn affect the amounts of MI and Goodwill recognized in respect of the Acquisition.

8.1.2 Information from the review of the Audit Working Papers

Interests in JCEs

8.1.2.1 According to the section "Interest in Jointly Controlled Entities (JCE)" <section E750 of File no. 33> (Annex 3H), the Group acquired two JCEs in the Acquisition, namely, [JCE B] and [JCE A] (see Paragraph 1.3.2).

8.1.2.2 Included in this section of the Audit Working Papers was a test on the fair value of JCEs at the acquisition date which is extracted as follows:

"1. Test on fair value of JCE at 13 Dec 2007 (date of acquisition of [Subsidiary A] by [Listed Entity])

	[JCE B]	*[JCE A]*
Carrying value at 13.12.07 recognized in JCE's individual a/cs	*15,066,754*	*11,460,696*
Goodwill at the date of acquisition of [JCE A] by [Subsidiary A] in 2006		*70,413,990*
Carrying value of JCE at 13.12.07 recognized in [Subsidiary A] a/cs	*15,066,754*	*81,874,686*
Fair value adjustment	*0*	*0*
Fair value of JCE at 13.12.2007	*15,066,754*	*81,874,686*
	Note 2	*Note 3*

2. *The client consider that the carrying value of [JCE B] approximates to its fair value at 13.12.2007. We have performed audit of [JCE B] for the year ended 31 Dec 2007 (refer [JCE B]'s audit file) and reviewed its ledger and a/cs at 13.12.2007 to assess that there were no fair value adjustment of any assets and liabilities, and no significant change of assets and liabilities between 13.12.2007 and 31.12.2007.*

3. *The client engaged professional valuers, [The Valuer], to perform business valuation of fair value of [JCE A]. As client expects the acquisition of [Subsidiary A] completed around end of Dec 07 and inform [Subsidiary A] finance team to arrange [The Valuer] to perform the business valuation at 31.12.07 for the purpose of impairment test of [JCE A]'s goodwill recognized in [Subsidiary A]'s a/cs at year ended date (see E750-1) and the fair value of JCE recognized in [Listed Entity]*'s *a/cs. We have performed audit of [JCE A] for the year ended 31 Dec 2007 (refer [JCE A]'s audit file) and reviewed its ledger and a/cs at 13.12.2007 to assess that there were no significant change of assets and liabilities between 13.12.2007 and 31.12.2007.*

	RMB	
The fair value of [JCE A] per valuation report	*149,180,000*	*Note 3(a)*
Share of fair value of [JCE A] by [Subsidiary A] group	*51%*	
RMB	*76,081,800*	
@1.07		
HK$	*81,407,526*	
Fair value per client's a/cs	*81,874,686*	
Discrepancy	*467,160*	*Note 3(b)*
	0.6%	

(a) The valuation is based on value-in-use calculations and the calculations use cash flow projections based on [JCE A]'s 10-year period cash flow and a terminal value of its infinitely cash flow after 10 years on the assumption that [JCE A] will continue on an indefinite life. As [JCE A] is a company established in the PRC for a term of 30 years from 2006, the client and we consider that the valuer's assumption of the cash flow from [JCE A]'s indefinite life is too aggressive and consider that the fair value of [JCE A] is based on the valuer's 10 year cash flow only.

(b) The valuation of fair value of [JCE A] is approximately to its carrying value recognized in [Subsidiary A]'s a/cs."

MI

8.1.2.3 According to the schedule "Acquisition of subsidiary" <section E950 of File no. 33> (Annex 3I), MI arising from the Acquisition was HK$77,625,000. It represented minority interests' share of the fair value of the net assets of the Acquired Subsidiaries.

Goodwill

8.1.2.4 According to the same schedule, Goodwill of HK$901,026,000 was derived from the following calculation:

	HK$'000	HK$'000
Total purchase consideration of the Acquisition		1,163,314
The net fair value of the identifiable assets, liabilities and contingent liabilities of [Subsidiary A] and [Subsidiary B] at the date of the Acquisition	(339,913)	
MI	77,625	
Share of identifiable net assets		(262,288)
Goodwill at the date of the Acquisition		901,026

The total purchase consideration comprised the fair value of convertible bonds and shares of [Listed Entity] issued for the Acquisition.

8.1.3 Information and explanations provided by [2007 Auditor]

8.1.3.1 [2007 Auditor] was requested to explain the following on 3 November 2009 (Annex 5E):

(a) whether or not the cost of unlisted investment in JCEs of HK$96,942,000 as stated in the Relevant Financial Statements was recognized at the fair values of [Subsidiary A]'s share of the JCEs' identifiable assets and liabilities at the date of the Acquisition of [Subsidiary A] by the Group; and

(b) what audit procedures were performed to satisfy itself that it was so.

8.1.3.2 Moreover, [2007 Auditor] was requested to justify that the continued recognition of goodwill arising from the acquisition of [JCE A] by [Subsidiary A] in previous year was in accordance with paragraph 36 of HKFRS 3 (see Paragraph 8.2.1).

8.1.3.3 In response to the AIB's request of 3 November 2009, [2007 Auditor] replied on 17 November 2009 (Annex 5G). An extract of the reply is set out below:

“Yes, the acquirer’s acquisition cost of the unlisted investment in JCE of HK$96 million (“m”) was recognized at fair value of the acquiree’s (“[Subsidiary A]’s”) share of JCE.

With reference to Issue 6 (pages 4, 18 to 21) of the enclosed Issues Paper issued after a Roundtable discussion in Brussels on 18 October 2007, the European participants had two different views in respect of the purchase accounting for the acquiree’s interests in associates in a business combination which equally applied to JCE using equity method. Views 1 and 2 mentioned in pages 18 and 19 of the enclosed Issues Paper refered exactly to the accounting treatment on the JCE adopted in 2007 and 2008 respectively.

In accordance with Paragraph 36 of HKFRS 3, the investment in JCE which itself was an identifiable asset of [Subsidiary A] should therefore be recognized at their fair value as a whole. The same interpretation was also mentioned in page 18 of the enclosed Issues Paper that the acquiree’s interest in an associate (i.e. same for JCE using equity method) represented an identifiable asset like any other asset of the acquiree, and there were no exceptions in the standard from recognizing the acquiree’s investments in associates (i.e. same for JCE using equity method) at the fair value of the investment. Therefore, there was no departure from Paragraph 36 of HKFRS 3.

We have ascertained that the fair value of the JCE at the date of acquisition approximated to the carrying amount of JCE recognized in [Subsidiary A]’s accounts of HK$96m by reviewing and making reference to the valuation report issued by [The Valuer], an independent qualified professional valuer not connected with the Group, and reviewing the key assumptions used in the valuation report. In addition, we have performed field audit on each of the JCE.

According to Paragraph 40 of HKAS 31, “Some ventures recognize their interests in jointly controlled entities using equity method, as described in HKAS 28 …”. This means that the recognition of JCE using equity method should refer to HKAS 28. Therefore, according to Paragraph 23 of HKAS 28, “… On acquisition of the investment … any difference … is accounted for in accordance with HKFRS 3 … Therefore: (a) goodwill relating to an associate (i.e. same for JCE using equity method) is included in the carrying amount of the investment …”. The same interpretation was also mentioned in page 19 of the enclosed Issues Paper that there was no justification for deviating from this requirement simply because the associate (i.e. same for JCE using equity method) was purchased as part of a business combination and not in a separate acquisition.

Therefore, the inclusion of goodwill arising from acquisition of JCE in previous year in the carrying amount of the investment in JCE was not only in accordance with HKFRS 3 but also HKAS 31 and 28. The International Financial Reporting Interpretations

Committee was asked to clarify the accounting treatment on this issue but no clarification has been received up to this moment."

8.1.4 Information and explanations provided by [Listed Entity]

8.1.4.1 In a letter from [Listed Entity] dated 22 October 2009 (Annex 5C), [Listed Entity] advised that *"The carrying amount of the interests in jointly controlled entities ("JCE") as restated in the consolidated accounts of the Company and its subsidiaries (collectively referred to as the "Group") for the year ended 31 December 2008 (the "2008 Accounts") was HK$26,529,000 as at the date of the Group's acquisition of [Subsidiary A]. The carrying amount excluded goodwill of HK$70,413,000 which arose from [Subsidiary A]'s acquisition of the JCE in the previous year prior to [Subsidiary A] itself being acquired by the Group … The acquisition of [Subsidiary A] and [Subsidiary B], including the JCE held by [Subsidiary A], by the Group (the "[Subsidiary A] Acquisition") was effected pursuant to an agreement for the [Subsidiary A] Acquisition as a whole. No separate consideration is determined for the acquisition of the JCE under the [Subsidiary A] Acquisition. Accordingly, the interests in the JCE was stated at HK$26,529,000 at the completion date of the [Subsidiary A] Acquisition, representing [Subsidiary A]'s share of the book values (which approximate the fair values) of identifiable assets and liabilities of the JCE."*

8.1.4.2 In response to the AIB's request of 28 October 2009, [Listed Entity] stated in another letter on 16 November 2009 (Annex 5F) that *"We believe that the restatement of the carrying amount of the jointly controlled entities arose from different judgments of two auditors on fair values at the date of acquisitions. We have to rely on the professional judgments and opinions of our auditors and we believe we have made the true and fair presentation of the accounts."*

8.2 Relevant financial reporting requirements

8.2.1 Paragraph 36 of HKFRS 3 states that *"The acquirer shall, at the acquisition date, allocate the cost of a business combination by recognizing the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria in paragraph 37 at their fair values at that date …"*

8.2.2 Paragraph 40 of HKFRS 3 states that *"Because the acquirer recognizes the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria in paragraph 37 at their fair values at the acquisition date, any minority interest in the acquiree is stated at the minority's proportion of the net fair value of those items."*

8.2.3 Paragraph 51 of HKFRS 3 states that *"The acquirer shall, at the acquisition date:*

(a) recognize goodwill acquired in a business combination as an asset; and

(b) initially measure that goodwill at its cost, being the excess of the cost of the business combination over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognized in accordance with paragraph 36."

8.2.4 Appendix A of HKFRS 3 defines "goodwill" as *"Future economic benefits arising from assets that are not capable of being individually identified and separately recognized."*

8.2.5 Appendix A of HKFRS 3 defines "minority interest" as *"That portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through subsidiaries, by the parent."*

8.3 Views of the AIB

8.3.1 The AIB acknowledges that the two views in relation to the purchase accounting for the acquiree's interests in associates in a business combination as stated in Paragraph 8.1.3.3 may also apply to JCEs. It appears that paragraph 36 of HKFRS 3 does not specifically provide whether: (a) the interests in JCEs should be considered as a "single identifiable asset" and recognized fully the acquiree's share of the fair value of the interests in JCEs (the accounting treatment adopted in the Relevant Financial Statements); or (b) the cost of the Acquisition should be allocated to the underlying identifiable assets, liabilities and contingent liabilities of the JCEs and so the acquirer recognizes only its share of the fair value of the underlying identifiable assets, liabilities and contingent liabilities in the JCEs (i.e. the accounting treatment adopted in the 2008 Accounts) at the date of the Acquisition. Accordingly, the AIB considers that the assessment of JCEs made by [2007 Auditor] is reasonable.

8.3.2 Since the amount recognized as interests in JCEs affects the calculation of MI and Goodwill, the amount of MI and Goodwill recognized in the Relevant Financial Statements and the 2008 Accounts are different. The AIB had reviewed the calculation of MI and Goodwill as reflected in the Audit Working Papers and had not identified any apparent auditing irregularities.

8.4 Comments on investigation report from [2007 Auditor]

8.4.1 [2007 Auditor] did not provide any comment on this section.

8.5 Comments on investigation report from [Listed Entity]

8.5.1 [Listed Entity] did not provide any comment on this section.

Section 9 Recognition of impairment loss on Goodwill

9.1 Findings of fact

9.1.1 Background information

9.1.1.1 The impairment loss on Goodwill recognized in the Relevant Financial Statements was HK$416,000,000. In the 2008 Accounts, that impairment loss was restated to HK$476,000,000.

9.1.1.2 Note 19(b) to the Relevant Financial Statements stated that *"the Group uses business segments as its primary segment for reporting segment information. For the purpose of impairment testing, goodwill with indefinite useful lives has been allocated to the cash generating unit ("CGU") of lottery business management services only.*

During the year, the Group performed an impairment review for goodwill with reference to the valuation carried out by [The Valuer], independent qualified professional valuers not connected with the Group. The valuation is based on value-in-use calculations. The calculations use cash flow projections based on financial budgets approved by the management of the Group covering a five-year period and extrapolated cash flows for the following further five-year period. …. The recoverable amount of the CGU based on value-in-use calculations is less than its carrying amount, accordingly, an impairment loss of HK$416,000,000 of CGU of lottery business management services was recognized during the year."

9.1.1.3 According to note 3 to the 2008 Accounts, *"The consolidated financial statements for the year ended December 31, 2007 did not account for the deferred tax effect that resulting from the fair value adjustments on intangible assets in respect of the acquisition of subsidiaries in 2007 in accordance with HKAS 12 "Income Taxes". Additional impairment loss on goodwill of HK$60,000,000 was recognized in accordance with HKAS 36 "Impairment of Assets". Accordingly, comparative amounts in the consolidated financial statements have been restated."*

9.1.2 Information from the review of the Audit Working Papers

9.1.2.1 The schedule "Acquisition of subsidiary" <section E950 of File no. 33> (Annex 3I) stated that an impairment test had been performed by comparing the fair values of the net assets of the Acquired Subsidiaries and Goodwill of HK$1,163,314,000 with the valuations of [Subsidiary A] Group and a subsidiary of [Subsidiary B] of

HK$748,144,000 based on the March 2008 Valuation Reports. The difference of approximately HK$416,000,000 was recognized in the Relevant Financial Statements as impairment loss on Goodwill.

9.1.2.2 The schedule included a note that was similar to note 19(b) to the Relevant Financial Statements (see Paragraph 9.1.1.2).

9.1.3 Information and explanations provided by [2007 Auditor]

9.1.3.1 On 23 December 2009, [2007 Auditor] was requested to provide the audit procedures performed on the February 2008 Valuation Report and the March 2008 Valuation Report in evaluating the appropriateness of the two reports as audit evidence (Annex 5K).

9.1.3.2 [2007 Auditor] replied on 21 January 2010 (Annex 5L) that *"For both valuation reports dated 22 February 2008* [February 2008 Valuation Report] (Annex 3J) *and 26 March 2008* [March 2008 Valuation Reports] (Annex 3K), *we have performed … audit procedures which are in accordance with HKSA 620 as shown in the working paper (Cop06) filed in Section C of [Subsidiary A] …"*

9.1.3.3 [2007 Auditor] also mentioned that in relation to the identification of the CGU to which Goodwill had been allocated for testing impairment of Goodwill, *"… there was no cash flow generated by [JCE B] because it was engaged in research and development for supporting operations of [Subsidiary A] Group. Therefore, [JCE B] was not a separate cash generating unit ("CGU") of [Subsidiary A] Group.*

Regarding [JCE A], based on the valuation report of [JCE A] dated 22 February 2008 [February 2008 Valuation Report], *two-thirds of its future cash flow and recoverable amount were related to Sport Betting Hall operation which was highly dependent on [Subsidiary A] Group. Up to both 22 February 2008 and 26 March 2008, [Beijing Subsidiary] had only signed an agreement with the licensee to obtain authorization for operating the Sport Betting Hall … but [JCE A] had not signed any agreement with the licensee. Therefore, the future operation of the Sport Betting Hall of [JCE A] was considered to be dependent on [Beijing Subsidiary] or [Subsidiary A] Group. On the other hand, [JCE A] was expected to purchase POS terminals from [a subsidiary of Subsidiary B], a newly formed subsidiary of [Subsidiary B] Group, after the business combination. Therefore, the future supply of POS terminals of [JCE A] was considered to be dependent on [Subsidiary B] Group.*

As the operations of [JCE A] and [JCE B] were highly dependent on both [Subsidiary A] and [Subsidiary B] Groups and the lottery businesses of both [Subsidiary A] Group *(together with [JCE A] and [JCE B]) and [Subsidiary B] Group were expected to integrate gradually in the long run after the business combination, they were considered as a single CGU for impairment assessment in the 2007 Accounts."*

9.1.4 Information and explanations provided by [Listed Entity]

9.1.4.1 [Listed Entity] provided information and explanations to the AIB on 16 December 2009 (Annex 5I). We set out below the information provided.

9.1.4.2 [Listed Entity] provided the following reconciliation for the change in impairment loss for the year ended 31 December 2007 from HK$416,000,000 to HK$476,000,000:

"As per	*2007*	*2008*
(HK$'000)	*Accounts*	*Accounts*
Carrying amounts of CGU excluding Goodwill	*262,288*	*163,130*
Goodwill	*901,026*	*984,918*
Carrying amounts of CGU	*1,163,314*	*1,148,048*
Recoverable amounts of CGU	*(748,144)*	*(668,878)*
Impairment	*415,170*	*479,170*
approximately	*416,000*	*476,000"*

[Listed Entity] provided the following explanations for the figures listed above:

(a) In relation to the "Carrying amounts of CGU", [Listed Entity] stated that *"Before and after the prior year adjustment the carrying amounts of cash generating unit of the lottery business management services as at 31 December 2007 (the "CGU") before impairment were HK$1,163.3 million and HK$1,148.0 million respectively. The former was based on the fair values of net assets acquired and goodwill generated from the acquisitions of [Subsidiary A] and [Subsidiary B] on 13 December 2007. The latter, which excluded the Jointly Controlled Entities (the "JCE") was analyzed as follows:*

As per accounts at 31 December 2007 of (HK$'000)	*[Subsidiary A]*	*[Subsidiary B]*	*Total*
Property, plant and equipment	*26,874*	*2,863*	
Intangible assets	*53,007*		
Intangible assets – fair value adjustment	*85,228*	*48,875*	
	165,109	*51,738*	
Less: Minority interests	*(33,022)*	*(20,695)*	
Total	*132,087*	*31,043*	*163,130*
Goodwill			*984,918*
			1,148,048

(b) In relation to the "Recoverable amounts of CGU", [Listed Entity] explained that *"The recoverable amounts of the CGU in determining the impairment losses were HK$748.1 million and HK$668.9 million in the 2007 Accounts and 2008 Accounts respectively. The former was based on two valuation reports as attached on [Subsidiary A] and [a subsidiary of Subsidiary B], the only and wholly owned subsidiary of [Subsidiary B]. The latter excluded the cash flow forecast related to the JCE of Rmb92.6 million, based on auditors' judgment on the valuation reports. The valuation of the JCE then was assessed separately and no impairment was considered to be necessary."*

9.1.5 Information and explanations provided by [2008 Auditor]

9.1.5.1 On 9 December 2009, [2008 Auditor] was requested to provide the reasons for recognizing an additional impairment loss of HK$60,000,000 for the year ended 31 December 2007 in the 2008 Accounts.

9.1.5.2 In response to the AIB's request of 9 December 2009, [2008 Auditor] replied on 16 December 2009 (Annex 5J) and included a table similar to that provided by [Listed Entity] set out in paragraph 10.1.4.2. In addition, [2008 Auditor] added that the difference of the carrying amount of the CGU of the lottery business management services excluding Goodwill in 2007 and 2008 Accounts was due to the fact that *"in preparing the 2008 Accounts, it was recognized that certain non-operating assets such as the Company's interest in the jointly controlled entities ([JCE A] and [JCE B]) and monetary assets and liabilities should be excluded from the calculation of the carrying values of the said CGU in the 2008 Accounts"*.

9.2 Relevant financial reporting, auditing and assurance requirements

9.2.1 Paragraph 6 of HKAS 36 defines a cash-generating unit as *"the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets."*

9.2.2 Paragraph 43 of HKAS 36 states that *"To avoid double-counting, estimates of future cash flows do not include:*

(a) cash inflows from assets that generate cash inflows that are largely independent of the cash inflows from the asset under review (for example, financial assets such as receivables); and

(b) cash outflows that relate to obligations that have been recognized as liabilities (for example, payables, pensions or provisions)."

9.2.3 Paragraph 68 of HKAS 36 states that *"Identification of an asset's cash-generating unit involves judgement. If recoverable amount cannot be determined for an individual asset, an entity identifies the lowest aggregation of assets that generate largely independent cash inflows."*

9.2.4 Paragraph 69 of HKAS 36 states that *"Cash inflows are inflows of cash and cash equivalents received from parties external to the entity. In identifying whether cash inflows from an asset (or group of assets) are largely independent of the cash inflows from other assets (or groups of assets), an entity considers various factors including how management monitors the entity's operations (such as by product lines, businesses, individual locations, districts or regional areas) or how management makes decisions about continuing or disposing of the entity's assets and operations."*

9.2.5 Paragraph 76 of HKAS 36 states that *"The carrying amount of a cash-generating unit:*

(a) includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the cash-generating unit and will generate the future cash inflows used in determining the cash-generating unit's value in use; and

(b) does not include the carrying amount of any recognized liability, unless the recoverable amount of the cash-generating unit cannot be determined without consideration of this liability.

This is because fair value less costs to sell and value in use of a cash-generating unit are determined excluding cash flows that relate to assets that are not part of the cash-generating unit and liabilities that have been recognized (see paragraphs 28 and 43)."

9.2.6 Paragraph 90 of HKAS 36 states that *"A cash-generating unit to which goodwill has been allocated shall be tested for impairment annually, and whenever there is an indication that the unit may be impaired, by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit. If the recoverable amount of the unit exceeds the carrying amount of the unit, the unit and the goodwill allocated to that unit shall be regarded as not impaired. If the carrying amount of the unit exceeds the recoverable amount of the unit, the entity shall recognize the impairment loss in accordance with paragraph 104."*

9.2.7 Paragraph 104 of HKAS 36 states that *"An impairment loss shall be recognized for a cash-generating unit (the smallest group of cash-generating units to which goodwill or a corporate asset has been allocated) if, and only if, the recoverable amount of the unit (group of units) is less than the carrying amount of the unit (group of units). The impairment loss shall be allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order:*

(a) first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and

(b) then, to the other assets of the unit (group of units) pro rata on the basis of the carrying amount of each asset in the unit (group of units).

These reductions in carrying amounts shall be treated as impairment losses on individual assets and recognized in accordance with paragraph 60."

9.2.8 Paragraph 12 of HKSA 620 states that *"The auditor should evaluate the appropriateness of the expert's work as audit evidence regarding the assertion being considered. This will involve evaluation of whether the substance of the expert's findings is properly reflected in the financial statements or supports the assertions, and consideration of:*

- *Source data used;*
- *Assumptions and methods used and their consistency with prior periods; and*
- *Results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of other audit procedures."*

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

9.2.10 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. …"*

9.3 Views of the AIB

9.3.1 In assessing the amount of impairment loss on Goodwill recognized in the Relevant Financial Statements, the AIB considered that two major issues need to be addressed:

(a) the identification of the CGU to which Goodwill had been allocated; and

(b) the assessment of the carrying amount and the recoverable amount of the CGU to which Goodwill had been allocated at 31 December 2007.

Identification of the CGU

9.3.2 The AIB acknowledges that identification of the CGU involves judgement (see Paragraph 9.2.3).

9.3.3 [2007 Auditor] considered that for the purpose of impairment testing, Goodwill had been allocated to the CGU of lottery business management services. [2007 Auditor] was of the view that the [Subsidiary A] Group (including [JCE B] and [JCE A]) and the [Subsidiary B] Group should be considered as a single CGU based on the following:

(a) [JCE B] had no business operations at 31 December 2007 and did not generate largely independent cash inflows;

(b) [JCE A] (i.e. Sport Betting Hall and POS operations) generated cash inflows that were largely dependent on other assets of the [Subsidiary A] Group as [Beijing Subsidiary], another company under the [Subsidiary A] Group, held the license for operating the Sport Betting Hall, and [JCE A] was expected to purchase POS terminals from a newly formed subsidiary of the [Subsidiary B] Group; and

(c) the lottery business of the [Subsidiary A] Group and the [Subsidiary B] Group were expected to integrate gradually (see Paragraph 9.1.3.3).

9.3.4 In the light of the above, the AIB is of the view that it is not unreasonable to consider the [Subsidiary A] Group and the [Subsidiary B] Group as a single CGU (i.e. CGU of the lottery business management services) for the purpose of impairment testing.

Assessment of the carrying amount and the recoverable amount of the CGU of the lottery business management services for the purpose of impairment testing

9.3.5 [Listed Entity] determined the impairment loss on Goodwill by reference to the fair values of the net assets at the date of the Acquisition (see Paragraph 9.1.4.2).

9.3.6 In arriving at the carrying amount of the CGU of the lottery business management services excluding Goodwill at 31 December 2007, the AIB is of the view that:

(a) the carrying amounts of property, plant and equipment, intangible assets and interests in JCEs at 31 December 2007, rather than their fair value at the date of the Acquisition, should be used; and

(b) monetary assets and liabilities should be excluded in accordance with paragraph 76 of HKAS 36 (see Paragraph 9.2.5).

9.3.7 In respect of Paragraph 9.3.6(a), the AIB considers that the financial impact on the impairment loss on Goodwill would not be material since the depreciation/amortization expenses on property, plant and equipment and intangible assets between the date of the Acquisition and 31 December 2007 would not be material and the share of post-acquisition profits of JCEs recognized in the Relevant Financial Statements was only HK$691,000.

9.3.8 In respect of Paragraph 9.3.6(b), according to note 39 to the Relevant Financial Statements, the aggregate amount of monetary assets and liabilities of the [Subsidiary A] and [Subsidiary B] Groups at the date of the Acquisition was approximately HK$20.8 million. The AIB was unable to obtain that amount at 31 December 2007. Assuming that there were no material changes in the amounts of the monetary assets and liabilities of the [Subsidiary A] and [Subsidiary B] Groups given the proximity between the date of the Acquisition and the year-end date, the AIB considers that HK$20.8 million should be excluded from the carrying amount of the CGU of lottery business management services.

9.3.9 As for the recoverable amount of that CGU, given that the AIB is of the view that it is not unreasonable to consider the [Subsidiary A] Group and the [Subsidiary B] Group as a single CGU (i.e. CGU of the lottery business management services) (see Paragraph 9.3.4), the amount of HK$748,144,000, which represented the valuations of the [Subsidiary A] Group and the only subsidiary of the [Subsidiary B] Group, used by [2007 Auditor] (see Paragraph 9.1.4.2) appears to be appropriate.

Impairment loss on Goodwill

9.3.10 The AIB noted that the difference between the impairment loss on Goodwill recognized in the Relevant Financial Statements and that in the 2008 Accounts of HK$60 million was mainly attributable to the difference in Goodwill recognized of HK$83.9 million (HK$984.9 million – HK$901 million) and the inclusion of monetary assets and liabilities of HK$20.8 million (see Paragraph 9.3.8).

9.3.11 Since the AIB considers that the carrying amount of the CGU of lottery business management services should not include monetary assets and liabilities for the purpose of impairment testing, the impairment loss on Goodwill was overstated by the amount of monetary assets and liabilities of approximately HK$20.8 million. The AIB is of the view that [2007 Auditor] should have expressed a modified opinion in its auditor's report. This appears to be a non-compliance with the requirements of paragraphs 11 and 13 of HKSA 700 (see Paragraphs 9.2.9 and 9.2.10).

9.4 Comments on investigation report from [2007 Auditor]

9.4.1 In [Legal Representative]' letter dated 12 July 2010 (Annex 5R), it was stated that [2007 Auditor] believed that monetary assets and liabilities of HK$20.8 million should be included in the carrying amount of the CGU of lottery business management services and the impairment loss on Goodwill was not overstated. (Paragraph 5.2 of Annex 5R)

9.4.2 [2007 Auditor] stated that *"the valuations include the entire assets and liabilities in of [Subsidiary A] Group and [Subsidiary B] Group. The first paragraph of page 1 of the valuation report in E950-1 of File No. 33 states that 'the valuers carried out a valuation of the market value of the 100% equity interest in [Subsidiary A] and its subsidiaries (the Subject)' and the first paragraph of page 1 of the valuation report in*

E950-2 of File No. 33 also states that 'the valuers carried out a valuation of the market value of the 100% business value of [a subsidiary of Subsidiary B] (the Subject)'. [2007 Auditor] had consulted the professional valuer, [The Valuer], in respect of the valuation reports and was advised that the valuation of the 100% equity interest in the [Subsidiary A] and [Subsidiary B] Groups had considered the cash flows from the CGU of lottery business and all assets and liabilities, including the monetary assets and liabilities in the terminal value in the cash flows." (Paragraph 5.2(a) of Annex 5R)

9.4.3 [2007 Auditor] was of the view that it had followed paragraph 75 of HKAS 36 as the recoverable amount included monetary assets and liabilities and the amount of such monetary assets and liabilities should have been also included in the carrying amount for the impairment assessment. (Paragraph 5.2(b) of Annex 5R)

9.4.4 [2007 Auditor] also considered that the view of the AIB in paragraph 9.3.10 which stated that *"The AIB noted that the difference between the impairment loss on Goodwill recognized in the Relevant Financial Statements and that in the 2008 Accounts of HK$60 million was mainly attributable to the difference in Goodwill recognized of HK$83.9 million (HK$984.9 million - HK$901 million) and the inclusion of monetary assets and liabilities ..."*, is misleading to readers as it was formed on the basis that the 2008 Accounts were appropriate. (Paragraphs 2.1 and 2.3 of Annex 5R)

9.5 Response of the AIB to comments from [2007 Auditor]

9.5.1 The AIB acknowledges that paragraph 75 of HKAS 36 states that *"The carrying amount of a cash-generating unit shall be determined on a basis consistent with the way the recoverable amount of the cash-generating unit is determined."*

9.5.2 The AIB is of the view that the carrying amount and the recoverable amount of the CGU of lottery business management services used to assess the impairment loss on Goodwill in the Relevant Financial Statements was not determined on a consistent basis after considering the following factors:

(a) Paragraph 43 of HKAS 36 states that in estimating future cash flows, cash flows from assets that generate cash inflows that are largely independent of the cash inflows from the asset under review (for example, financial assets such as receivables) and cash outflows that relate to obligation that have been recognized as liabilities (for example, payables, pensions or provisions) are excluded to avoid double-counting. As the March 2008 Valuation Reports were prepared using the discounted cash flow method, the AIB considers it reasonable to believe that cash flows from monetary assets and liabilities were excluded in arriving at the recoverable amount.

(b) [Listed Entity] made a PYA in relation to impairment loss on Goodwill in the 2008 Accounts. In determining the amount of the impairment loss, [Listed Entity] made reference to the calculation set out in Paragraph 9.1.4.2(a). The carrying amount of the CGU of the lottery business management services after the PYA only included property, plant and equipment and intangible assets of [Subsidiary A] and [Subsidiary B] Group. Based on the calculation provided by [Listed Entity], monetary assets and liabilities were not included in the carrying amount of the CGU in performing the impairment assessment. On the basis that the recoverable amount used in the 2008 Accounts did not include monetary assets and liabilities and the only difference between the recoverable amount used in the Relevant Financial Statements and the 2008 Accounts as set out in Paragraph 9.1.4.2(b) is the cash flow related to the JCE, it appears to the AIB that the recoverable amount of the CGU of lottery business management services used in the Relevant Financial Statements did not include monetary assets and liabilities.

(c) According to the March 2008 Valuation Reports, the value of 100% of the equity interest of [Subsidiary A] Group and a subsidiary of [Subsidiary B] at 31 December 2007 was determined by the income approach. Under the income approach, the operating values of the subject are determined by the discounted cash flow method where the estimated benefit stream attributable to the subject is used to determine the value of the subject. Monetary assets and liabilities are not expected to be included in the terminal value in a cash flow projection under this approach. Given that it was not mentioned in the March 2008 Valuation Reports that monetary assets and liabilities were included in the terminal value in arriving at the value of the [Subsidiary A] Group and a subsidiary of [Subsidiary B] (i.e. the recoverable amount of the CGU of the lottery business management services), the AIB considers it reasonable to assume that the recoverable amount used in the Relevant Financial Statements did not include monetary assets and liabilities.

9.5.3 In respect of [2007 Auditor]'s comment set out in Paragraph 9.4.4, the AIB considers that the reconciliation in Paragraph 9.3.10 assists readers of this report to understand the difference between the impairment loss on Goodwill for the year ended 31 December 2007 recognized in the Relevant Financial Statements and the 2008 Accounts. This shall not be taken as an implication that the AIB considers the relevant accounting treatments in the 2008 Accounts are appropriate.

9.5.4 In the light of the above, the AIB upholds its views set out in Paragraph 9.3.

9.6 Comments on investigation report from [Listed Entity]

9.6.1 In its letter of 27 May 2010, [Listed Entity] stated that *"Regarding … 10.3.11* [9.3.11] *of the Report, which arising from different identification of CGU, … since we have* *properly addressed the issues and adjusted the numbers as PYA in accordance with HKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors in the 2008 Accounts, in our opinion, the auditor's report of the Relevant Financial Statements should not be revised retrospectively"*.

9.6.2 [Listed Entity] also added that *"we do not consider a modified or qualified opinion in the auditor's report of the Relevant Financial Statements is necessary"* as it considered that the conditions set out in paragraphs 7 or 12 of HKSA 701 were not met.

9.7 Response of the AIB to comments from [Listed Entity]

9.7.1 The AIB considers the overstatement of impairment loss on Goodwill of approximately HK$20.8 million, which represented 5% of impairment loss on goodwill and loss before taxation before the PYA, is material.

9.7.2 Despite that impairment loss on Goodwill was adjusted as PYA in the 2008 Accounts, the AIB is of the view that the overstatement of impairment loss on Goodwill should have been reflected in the auditor's report on the Relevant Financial Statements.

9.8 Comments on investigation report from [2008 Auditor]

9.8.1 [2008 Auditor] did not provide any comment on this section.

Section 10 General comments from [2007 Auditor]

10.1 General comments from [2007 Auditor]

10.1.1 [2007 Auditor] considered that the AIB's views were formed on the basis that the 2008 Accounts were appropriate. The AIB used the 2008 Accounts as a starting point and compared the Relevant Financial Statements with the 2008 Accounts. (Paragraph 2.1 of Annex 5R)

10.1.2 [2007 Auditor] considered that the table in Paragraph 1.2.7 which compared certain key financial items in the Relevant Financial Statements with those in the 2008 Accounts was misleading as they indicated that these financial items in the Relevant Financial Statements were incorrect. (Paragraph 2.2 of Annex 5R)

10.2 Response of the AIB to [2007 Auditor]'s comments

10.2.1 The AIB disagrees with [2007 Auditor] that its views were formed on the basis that the 2008 Accounts were appropriate. The AIB did not merely assume that the 2008 Accounts were appropriate in forming its views in this report. The AIB regards that the calculation of deferred tax liabilities provided by [Listed Entity] as set out in Paragraph 7.1.4.2 with reference to the 2008 Accounts as appropriate for the reasons as more particularly set out in Paragraph 7.5.1. Save as aforesaid, the AIB did not indicate or state in the report that the 2008 Accounts were appropriate.

10.2.2 As set out in Paragraph 2, upon receipt of a complaint, the Secretariat reviewed the Relevant Financial Statements and other relevant information, including those provided by the complainant, [Listed Entity] and [2007 Auditor]. During the course of the investigation, the AIB obtained further information from [2007 Auditor], [Listed Entity] and [2008 Auditor] and reviewed all the information relevant to the investigation, including the 2008 Accounts. The AIB considered all the information and came up with its own views independently.

10.2.3 The AIB's primary objective of setting out the table in Paragraph 1.2.7 is to facilitate the understanding of this report. The table lists out certain key financial items which are subsequently discussed in the report, and it aims to provide an overview of the results and state of affairs of [Listed Entity] before and after the PYA. This shall not be taken as an indication that the 2008 Accounts, in their entirety, are appropriate.