Enquiry Report
Magician Industries (Holdings) Limited
Consolidated Financial Statements
for the year ended 31 March 2008

Financial Reporting Review Committee (E01-08)

25 June 2009

This report has been adopted by the Financial Reporting Council on 10 July 2009 in accordance with section 47(3) of the Financial Reporting Council Ordinance (Cap. 588).

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

Notes concerning this report

This report relates to possible relevant non-compliance by a listed entity as to whether a relevant financial report has not complied with an accounting requirement of a type specified under the Financial Reporting Council Ordinance (Cap.588).

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

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

Abbreviations

Assets	Certain non-transferable leasehold land and buildings of Magician in the PRC with a carrying amount of HK$95,607,000 million as at 31 March 2008
Council	Financial Reporting Council
Draft Enquiry Report	A draft of this report which was sent to Magician and Mazars for review and comment on 29 April 2009
FCFF	Free cash flow to the firm
FRCO	Financial Reporting Council Ordinance (Cap. 588)
FRRC	Financial Reporting Review Committee (reference, E01-08)
HKAS	Hong Kong Accounting Standards
HKAS 36	HKAS 36 *Impairment of Assets*
HKFRS	Hong Kong Financial Reporting Standards
HKICPA	Hong Kong Institute of Certified Public Accountants
Indicative Value	HK$95,607,000, being the market value of the Assets appraised by a professional valuer engaged by Magician on the assumption that the Assets are transferrable in the open market, details of which are set out in 5.1.1
Listing Rules	Rules Governing the Listing of Securities on the Main Board of The Stock Exchange of Hong Kong Limited
Magician	Magician Industries (Holdings) Limited
Mazars	Mazars CPA Limited
PPE	Property, plant and equipment
PRC	People's Republic of China
Relevant Financial Statements	Consolidated financial statements of Magician for the year ended 31 March 2008
relevant non-compliance	The non-compliance with a relevant requirement, within the meaning of Part 1 of Schedule 1 to the FRCO
Secretariat	Secretariat of the Council
The Group	Magician and its subsidiaries

Value-In-Use Calculation	Value-in-use calculation of all PPE of Magician as at 31 March 2008

Executive summary

Introduction

This report pertains to the enquiry conducted by the FRRC pursuant to section 40(1)(b) of the FRCO in relation to the Relevant Financial Statements.

Background

Magician is a corporation listed on the Main Board of The Stock Exchange of Hong Kong Limited (stock code: 00526). The auditor of the Relevant Financial Statements, Mazars, expressed a disclaimer of opinion on, among other things, the value in use of the Assets.

With reference to the above disclaimer of opinion and other information available, it appears to the Council that there may be a question whether or not there is a relevant non-compliance in relation to the measurement of the value in use of the Assets and the consequential reversal of impairment loss recognised. The value in use of the Assets was based on the Value-In-Use Calculation which might not have been performed, and the discount rate(s) used therein might not have been disclosed, in each case in accordance with HKAS 36.

Appointment of FRRC

On 6 November 2008, the Council resolved to appoint the FRRC to conduct an enquiry into the question whether or not there is a relevant non-compliance in relation to the Relevant Financial Statements.

Relevant HKFRS

The HKFRS relevant to the possible relevant non-compliance is HKAS 36.

Conclusion

Based on the results of the enquiry, the FRRC concludes that there is a relevant non-compliance in the Relevant Financial Statements.

The relevant non-compliance refers to the non-compliance in respect of (i) the measurement of the value in use of, and consequential reversal of impairment loss in relation to, the Assets in the Relevant Financial Statements, which were based on the Value-In-Use Calculation which, in turn was not performed in accordance with HKAS 36; and (ii) the failure to disclose the discount rate(s) used in the Value-In-Use Calculation as required under paragraph 130(g) of HKAS 36.

The FRRC also found the computation methodology in the Value-In-Use Calculation inappropriate.

Recommendations

The FRRC recommends the Council to request Magician to revise the Value-In-Use Calculation in accordance with HKAS 36, announce the impact of the revision on the value in use of the Assets and the consequential reversal of impairment loss, reflected as a restatement of the Relevant Financial Statements, if appropriate; and disclose the discount rate(s) used in the Value-In-Use Calculation.

Comments on Draft Enquiry Report from Magician and Mazars

The Draft Enquiry Report was sent to Magician and Mazars for review and comment on 29 April 2009.

In its reply letter of 20 May 2009, Magician disagreed with certain findings in the Draft Enquiry Report including that the basis and composition of the estimates of future cash flows used in the Value-In-Use Calculation were not in accordance with HKAS 36. Magician revised the Value-In-Use Calculation after considering the other findings in the report. In the revised Value-In-Use Calculation, it was estimated that the maximum amount of the impairment loss to be additionally reversed in respect of the Assets would be less than HK$2.0 million for the year ended 31 March 2008. Magician mentioned that the revised Value-In-Use Calculation would be reviewed by its auditor as part of the audit for the year ended 31 March 2009.

In its reply letter of 13 May 2009, Mazars stated that it would be useful to include in the report the fact that the value in use of the Assets was benchmarked to their indicative value measured by an independent professional valuer despite the potential non-compliance with HKAS 36 in relation to the Value-In-Use Calculation. Other than this, Mazars had no other comment.

Section 1 Introduction

1.1 General

1.1.1 This report pertains to the enquiry conducted by the FRRC pursuant to section 40(1)(b) of the FRCO in relation to the Relevant Financial Statements. The Relevant Financial Statements, on the face of it, is said to be prepared in accordance with HKFRS, and the applicable disclosure requirements under the Listing Rules and of the Companies Ordinance (Cap. 32).

1.2 Background information

1.2.1 Magician is a corporation listed on the Main Board of The Stock Exchange of Hong Kong Limited (stock code: 00526) with market capitalization of approximately HK$384.9 million as at 12 June 2009. Magician is incorporated in Bermuda.

1.2.2 The principal activities of the Group are manufacturing and trading of household products. The consolidated loss of the Group was HK$16.3 million for the year ended 31 March 2008 and the consolidated net assets was HK$61.6 million as at 31 March 2008.

1.2.3 The carrying amount of all PPE of Magician was HK$231.7 million in the Relevant Financial Statements. It comprised three categories of PPE, i.e.:

(i) transferable land and buildings of HK$104.8 million,

(ii) the Assets, i.e. non-transferable land and buildings, of HK$95.6 million, and

(iii) other PPE of HK$31.3 million.

1.2.4 The Assets were first impaired in the year ended 31 March 2005. Below is a summary of the recognition and reversal of impairment loss in relation to the total of the transferable and non-transferable leasehold land and buildings held by the Group in the PRC and some other key financial information of the Group for the period from 1 April 2004 to 31 March 2008 extracted from the annual reports of Magician:

	For the year ended 31 March			
	2005 HK$'m	2006 HK$'m	2007 HK$'m	2008 HK$'m
Sales	445.8	233.9	219.5	216.0
Loss for the year	(176.0)	(47.0)	(22.8)	(16.3)
Impairment loss recognized	(55.6)	(3.5)	-	-
Reversal of impairment loss	-	-	12.0	14.2

1.2.5 In relation to the reversal of impairment loss of the Assets for the year ended 31 March 2008, Magician explained in note 13 to the Relevant Financial Statements that "in light of the continuing operating loss experienced by the Group during the year, management has reviewed the carrying value of the property, plant and machinery in order to assess their recoverable amount. Management considered that the recoverable amount of the leasehold land and buildings in the PRC has been increased as a result of, among others, the completion of fire safety construction works during the year."

1.2.6 The auditor of the Relevant Financial Statements, Mazars, expressed a disclaimer of opinion in relation to, among other things, the value in use of the Assets of HK$95.6 million and the consequential reversal of impairment loss of HK$14.2 million. The Relevant Financial Statements are enclosed (Annex 1A). An extract of the auditor's opinion of the Relevant Financial Statements is reproduced below:

"BASIS FOR DISCLAIMER OF OPINION

We were not able to form a view in the previous year on the appropriateness of recognising the impairment loss of HK$4,569,000 and the reversal of impairment loss of HK$12,016,000 on property, plant and equipment and whether the property, plant and equipment of HK$211,155,000 were fairly stated at 31 March 2007. A qualified opinion has been expressed in the auditors' report on the financial statements for the year ended 31 March 2007 accordingly. Any adjustments to the opening carrying amount of the property, plant and equipment which have previously been qualified would have consequential effects on the results for the year ended 31 March 2008.

As stated in note 13 to the financial statements, in light of the continuing operating loss experienced by the Group, management has carried out an impairment review of its property, plant and equipment. However, we have not been able to obtain sufficient information from management to support its assessment on the value in use of property, plant and equipment with a carrying amount of HK$95,607,000 as of 31 March 2008 and therefore unable to satisfy ourselves whether the recognition of the reversal of impairment loss of HK$14,207,000 are appropriate. Consequently, we have been unable to satisfy ourselves whether the property, plant and equipment of HK$95,607,000 were fairly stated at 31 March 2008 and whether the loss for the year then ended was fairly stated.

There were no other satisfactory audit procedures that we could adopt to satisfy ourselves as to the matter set out in the above paragraphs. Any adjustments to the above figures may have a consequential significant effect on the Company's interests in subsidiaries as recorded in the Company's balance sheet, the Group's loss for the year and the Group's net assets as at 31 March 2008."

1.2.7 There was no disclosure of the discount rate(s) used in the measurement of the value in use of the Assets as at 31 March 2008 in the Relevant Financial Statements.

1.3 Initiation of an enquiry

1.3.1 The Secretariat identified the following issues of possible non-compliance with accounting requirements based on the auditor's disclaimer of opinion and the relevant disclosure note of the Assets in the Relevant Financial Statements:

(i) Whether or not the Assets with a carrying amount of HK$95.6 million as at 31 March 2008 were properly accounted for in accordance with HKAS 36;

(ii) Whether or not the reversal of impairment loss of HK$14.2 million for the year ended 31 March 2008 in relation to the Assets was properly accounted for in accordance with HKAS 36; and

(iii) Whether or not the discount rate(s) used in measuring the value in use of the Assets were properly disclosed in accordance with HKAS 36.

1.3.2 In order to assess whether or not it appears to the Council that the identified issues give rise to a relevant non-compliance and whether or not to initiate an enquiry, the Secretariat sent three letters to Magician on 29 July 2008 (Annex 2A), 15 August 2008 (Annex 2C) and 3 October 2008 (Annex 2G) respectively and one letter to Mazars on 11 September 2008 (Annex 2E) to collect additional information. Magician replied on 11 August 2008 (Annex 2B), 8 September 2008 (Annex 2D) and 24 October 2008 (Annex 2H) respectively. Mazars replied on 25 September 2008 (Annex 2F).

1.3.3 Magician advised the Secretariat that the value in use of the Assets and the consequential reversal of its impairment loss was based on the Value-In-Use Calculation.

1.3.4 The Secretariat was unable to obtain from Magician objective evidence to support the assumptions for the increase in the value in use of the Assets. Magician refused to provide the Value-In-Use Calculation.

1.3.5 In its letter dated 25 September 2008 (Annex 2F), Mazars mentioned that in estimating the value in use of the Assets, Magician projected a significant increase in sales in the next five years and no objective evidence was available to support this assumption. Mazars further explained that Magician experienced significant changes in management in recent years which affected the performance of Magician. It considered the time horizon of the track record under the current management was too short for it to assess whether Magician could achieve its target in the future.

1.3.6 On 6 November 2008, having considered the information supplied by Magician and Mazars, the Council resolved to appoint the FRRC to conduct an enquiry into the question whether or not there is a relevant non-compliance in relation to the Relevant Financial Statements.

1.3.7 The Council decided not to take further action on the disclaimer of opinion in relation to the appropriateness of recognising the impairment loss of HK$4.6 million and the reversal of impairment loss of HK$12 million on PPE for the year ended 31 March 2007 and whether the PPE of HK$211.2 million were fairly stated at 31 March 2007.

1.4 Opportunity of being heard

1.4.1 The Draft Enquiry Report was sent to Magician on 29 April 2009 for its review and comment. Its comments were received on 20 May 2009 and were incorporated in section 6.1 of this report.

1.4.2 The Draft Enquiry Report was sent to Mazars on 29 April 2009 for its review and comment. Its comments were received on 13 May 2009 and were incorporated in section 6.2 of this report.

Section 2 Appointment of the FRRC

2.1 On 6 November 2008, the Council appointed the FRRC in accordance with section 40(1)(b) of the FRCO for the purpose of enquiring into the question whether or not there is a relevant non-compliance in relation to the Relevant Financial Statements.

2.2 The FRRC consists of the following members:

(i) Mr. FUNG Ying-wai, Wilson (Chairman)
(ii) Mrs. CHENG TANG Ho-kuen, Lina
(iii) Mr. LAM Chi-yuen, Nelson
(iv) Mr. Roger Thomas BEST, JP
(v) Mr. TSOI Tong-hoo, Tony

2.3 The terms of reference approved by the Council are:

(i) to enquire into the question whether or not the recognition and related disclosure of a reversal of impairment loss of HK$14.2 million for the year ended 31 March 2008 and the corresponding carrying amount of the Assets are in compliance with the requirements of HKFRS issued by the HKICPA in preparing the Relevant Financial Statements and whether this gives rise to a relevant non-compliance with reference to the FRCO and to record such facts;

(ii) to exercise the powers under Division 2 of Part 4 of the FRCO and such other powers as may be delegated from time to time by the Council;

(iii) to form an opinion on whether and why there is a relevant non-compliance and how this non-compliance should be rectified; and

(iv) to report to the Council the findings of the enquiry and to make recommendations for future actions.

Section 3 The enquiry

3.1 Between July 2008 and October 2008 the Secretariat obtained various information and explanations from Magician and Mazars respectively about the Relevant Financial Statements through various correspondence between the Secretariat, Magician and Mazars. Each of Magician and Mazars also confirmed to the FRRC all information and explanations given by it to the Secretariat in its previous correspondence.

3.2 The first FRRC meeting was held on 27 November 2008 to consider the background information of the case.

3.3 The second FRRC meeting was held on 6 January 2009.

3.4 The third FRRC meeting was held on 10 March 2009. The FRRC agreed on the findings of the enquiry and the recommendations to be made to the Council and prepare the Draft Enquiry Report.

3.5 The Draft Enquiry Report was sent to Magician and Mazars separately on 29 April 2009 for their review and comment. Comments received from Magician and Mazars respectively had been incorporated in this report.

3.6 The final version of this report has been approved by the FRRC members by circulation of papers on 25 June 2009.

3.7 The conclusion and recommendation are in section 4 and a discussion of the findings is in section 5.

Section 4 Conclusion and recommendation

4.1 Conclusion

4.1.1 Based on the results of the enquiry, the FRRC concludes that there is a relevant non-compliance in relation to the Relevant Financial Statements.

4.1.2 The relevant non-compliance refers to the non-compliance in respect of (i) the measurement of the value in use of, and the consequential reversal of impairment loss in relation to, the Assets in the Relevant Financial Statements, which were based on the Value-In-Use Calculation which, in turn was not performed in accordance with HKAS 36; and (ii) the failure to disclose the discount rate(s) used in the Value-In-Use Calculation as required under paragraph 130(g) of HKAS 36.

4.1.3 The FRRC found that the basis and composition of the estimates of future cash flows used in the Value-In-Use Calculation were not in accordance with HKAS 36. In particular:

(i) The growth in sales in the cash flows projections was not based on supportable assumptions. (paragraph 33(a) of HKAS 36) (see 5.2.2 to 5.2.7)

(ii) The cash flows projections differed from the most recent financial budgets/forecast approved by management. (paragraph 33 (b) of HKAS 36) (see 5.2.8 to 5.2.16)

(iii) The estimates of future cash flows were for the period commencing 1 July 2008 and were used to measure the value in use as at 31 March 2008. (paragraphs 39(a) and (b) of HKAS 36) (see 5.3.3 to 5.3.6)

(iv) The net cash outflows from financing activities were included in the estimates of future cash flows. (paragraph 50 (a) of HKAS 36) (see 5.3.7 and 5.3.8)

The FRRC also found the computation methodology in the Value-In-Use Calculation inappropriate. In particular:

(v) The net cash flows from operating activities included in the estimates of future cash flows were determined by adjusting profit or loss for both the effects of credit terms and changes in net working capital. As the two adjustments had the same effect of converting profit or loss into receipt and payments, adjustment should have been made for either credit terms or changes in net working capital. (see 5.3.9 to 5.3.12)

(vi) Non-operating liabilities of HK$157.6 million were deducted from the "value of the firm" in the Value-In-Use Calculation. (see 5.3.13 to 5.3.16)

4.2 Recommendation

4.2.1 The FRRC recommends the Council to:

(i) inform Magician of the relevant non-compliance and the inappropriate Value-In-Use Calculation,

(ii) request Magician to :

- perform a Value-In-Use Calculation in accordance with HKAS 36 taking into accounts the non-compliance and issues identified in respect of the inappropriate Value-In-Use Calculation;

- announce the impact of the revision of the value in use of the Assets and the consequential reversal of impairment loss, reflected as a restatement of the Relevant Financial Statements, if appropriate; and

- disclose the discount rate(s) used in the Value-In-Use Calculation.

4.2.2 The FRRC does not recommend the Council to issue a notice to Magician under section 49 of the FRCO requiring the removal of the relevant non-compliance. This is because, in doing so, the Council would need to specify in such notice the manner of revising the Relevant Financial Statements. This includes specifying what assumptions should be used in the estimates of future cash flows for the projection of sales. The FRRC considers it not appropriate for the Council to specify assumptions used in the estimates of future cash flows of a listed entity.

4.2.3 The FRRC also recommends the Council to consider if there is a similar non-compliance in the financial statements of Magician for the year ended 31 March 2009 and take further actions as appropriate.

4.3 Non-compliance with HKFRS

4.3.1 The FRRC is of the opinion that Magician failed to comply with HKAS 36 in preparing the Relevant Financial Statements, in particular:

(i) Paragraph 33 of HKAS 36 states that "in measuring value in use an entity shall: (a) base cash flow projections on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. Greater weight shall be given to external evidence. (b) base cash flow projections on the most recent financial budgets/forecasts approved by management, but shall exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance…"

(ii) Paragraphs 39(a) and (b) of HKAS 36 state that "estimates of future cash flows shall include: (a) projections of cash inflows from the continuing use of the asset; (b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; …"

(iii) Paragraph 50(a) of HKAS 36 states that "estimates of future cash flows shall not include: (a) cash inflows or outflows from financing activities; or…"

(iv) Paragraph 130(g) of HKAS 36 states that "an entity shall disclose the following for each material impairment loss recognised or reversed during the period for an individual asset, including goodwill, or a cash-generating unit: ...(g) if recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use."

Section 5 Findings

5.1 General

Value in use of the Assets

5.1.1 In its letter of 11 August 2008 (Annex 2B), Magician explained the value in use of the Assets.

An extract of the letter is as follows:

"The Company and its subsidiaries' ("Group") Property, plant and equipment mainly consists of, among others, the leasehold land and buildings in the People's Republic of China ("the PRC") which was an industrial complex and a parcel of land located in Shenzhen with a carrying value of approximately HK$200 million as at 31 March 2008. As of 31 March 2008, the Real Estate Ownership Certificates of certain land and buildings were not permitted to be transferred in the open market, and the Real Estate Ownership Certificates of certain properties had not been obtained although the Group is eligible to apply for such certificates as the Real Estate Ownership Certificates of the land of these properties have already been obtained (collectively referred as "Assets without Transferable Certificates"). In order to ascertain the market value of the transferrable properties and the value in use of Assets without Transferable Certificates, the Company has engaged a professional valuer, Vigers Appraisal & Consulting Ltd. to issue a valuation report on all the leasehold land and buildings of the Group. No commercial value has been assigned by the valuer on the Assets without Transferable Certificates. However, for indicative purpose, the valuer advised that the market values of the Assets without Transferable Certificates assuming they were entitled to be transferred in the open market ("Indicative Value") were HK$95,607,000. This amount has been used as the value in use in the Relevant Financial Statements by the management."

Auditor's disclaimer of opinion

5.1.2 The auditor of the Relevant Financial Statements, Mazars, included in its report a disclaimer of opinion in relation to the carrying amount of the Assets, the opening balances of certain PPE and the Assets, and the corresponding recognition and reversal of impairment loss. (see 1.2.6)

5.1.3 In its letter of 11 August 2008 (Annex 2B), Magician stated the events and circumstances leading to the issue of the auditor's disclaimer of opinion on the Relevant Financial Statements. Magician also confirmed that the value in use of the Assets and the consequential reversal of its impairment loss of HK$14.2 million was arrived at based on the Value-In-Use Calculation.

An extract of the letter is as follows:

"According to our understanding, the auditors did not consider such Indicative Value as a proper basis for determining the recoverable amount of the properties as it neither reflects the value in use nor the fair value less costs to sell of the properties. To determine the value in use, the auditors required management to prepare cash flow projections. As the auditors considered that sufficient explanation & justifications on the assumptions used in the preparation of the cash flow projections were not provided by management, a qualified opinion on the property, plant and equipment with carrying value of HK$95,607,000 was issued by the auditors.

The reversal of impairment amounting to HK$14,207,000 is related to the Assets without Transferrable Certificates with Indicative Value of HK$95,607,000 and such amount was based on the value in use estimated by the management with reference to professional valuation."

5.1.4 In its letter of 25 September 2008 (Annex 2F), Mazars explained the events and circumstances leading to the disclaimer of opinion in the auditor's report on the Relevant Financial Statements.

An extract of the letter is as follows:

"The Group experienced significant changes in management in recent years which affected the performance of the Group. Since the new management has taken over the daily operation of the Group in March 2006, they have adopted strategies to improve the Group's productivity, efficiency and profitability. We acknowledge the continuous improvements in the results of the Group but the time horizon of the Group's track record, under the current management, is too short for us to rely on and to assess whether the Group could achieve the target in the future.

During our review of the cash flow projections prepared by management, we noted that the projected sales of the Group for the coming 5 year would increase in [magnitude of increase] every year. As explained by management, they had been devoting resources to develop new products to serve the needs of customers, exploring opportunity to expanding the business to new markets such as Middle East, Japan and Australia and were in the process of negotiation with several customers in [continent]. Management was satisfied that the plan would be successful and would contribute to a continuous increase in sales in the future. However, no objective evidence (such as confirmed sales contracts/sales orders) was available for us to review as the plan was still in preliminary/negotiation stage. We considered that if the outcome turns out to be adverse, it may have significant potential impact on the validity of the assumptions used in the preparation of the cash flow projections and may in turn affect the estimated value in use of the property, plant & equipment. There were no other satisfactory audit procedures that we could adopt to satisfy ourselves in this regard. Consequently, we expressed a disclaimer opinion on the Company's consolidated financial statements."

Magician's view on the transferability of the Assets

5.1.5 In its letter of 8 September 2008 (Annex 2D), Magician stated that despite certain land use rights to some of the Assets were not transferable and some of the Assets did not have real estate ownership certificates as at 31 March 2008, it believed that it could ultimately convert the non-transferrable land use rights to transferrable and obtain the real estate ownership certificates in respect of the relevant Assets.

An extract of the letter is as follows:

"It was a common phenomenon that Shenzhen Land Bureau issued non-transferable REOC [real estate ownership certificates] to many foreign investors for setting up manufacturing buildings and structures in Shenzhen in the past. Therefore, properties with non-transferable REOC or properties without REOC are not rare cases in Shenzhen.

It has always been the Group's intention to obtain the transferable REOC where appropriate. By the date of the approval of the Relevant Financial Statements [8 July 2008], the Group has successfully converted non-transferable REOC in respect of leasehold land and buildings with carrying value of HKD23.3M as at 31 March 2008 to transferable REOC. It is only a matter of time and eventually, all of the non-transferable REOC will be converted into transferable REOC and REOC will be obtained for properties without REOC in the near future."

Indication(s) of impairment for the Assets

5.1.6 In the letter of 8 September 2008 (Annex 2D), Magician mentioned the indication(s) that the impairment loss in prior periods for the Assets may no longer exist or may have decreased.

An extract of the letter is as follows:

"In current year, in light of the continuing operating loss experienced by the Group, management engaged the Valuers to review the carrying value of the leasehold land and building and assess the recoverable amounts of the Assets by reference to the Assets' value in use. In assessing whether there is any indication that an impairment loss recognised in prior periods for the Assets no longer exist or have decreased, management have considered the indicators from both the external and internal sources of information according to paragraph 111 of HKAS 36 as below:

External sources of information

- By reference to the valuation report, the Indicative Value of the Assets has increased during the year.
- In view of the environment in which the Group operates or the market to which the Assets is dedicated, the Group is now expanding the business in some other markets and it is expected that there is an increasing trend in the properties market in the People's Republic of China ("the PRC") in the future.

Internal sources of information

- Because of the change of the Group's market strategy to focus on higher margin products and devote in developing new products as well as the adoption of effective measures for internal productivity and cost management, management expected that the value in use of the Assets would increase.

- The continuous improvements in the results of the Group as indicated in the Group's annual report in recent years prove that the economic performance of the Assets is better.

- The completion of fire safety construction work in current year has enhanced the condition of the properties which increases the potential commercial usage of the properties. Consequently, the recoverable amounts of the Assets increased by reference to both the value in use estimated by management and the Indicative Value of the Assets provided by the Valuers.

As the event of completion of fire safety construction work was unique to the Group when compared with other indicators as mentioned above, management considers that the disclosure of this event in the 2008 annual report is useful to the readers."

One cash generating unit

5.1.7 Magician stated in its letter of 17 February 2009 (Annex 3J) that it identified only one cash generating unit in its business.

An extract of the letter is set out below:

"The Group had only one cash-generating unit as at 31 March 2008….. Our Group had a single line of business in manufacturing and trading of household products. All the assets of the Group was utilized for this business. The Shenzhen subsidiary of the Company was the sole manufacturing and processing unit for all the Group's products that attracted the Group's turnovers. Therefore, the assets of all Group companies, i.e. the whole Property, Plant and Equipment of the Group was the smallest identifiable group of assets that generated cash inflows of all the Group's turnover. The Assets was an integral part of the PPE as a cash generating unit in generating cash inflows of the Group."

Allocating impairment loss to individual assets within the cash-generating unit

5.1.8 In its letter dated 19 December 2008 (Annex 3B), Magician stated that the value in use of the Assets was derived from the Value-In-Use Calculation.

An extract of the letter is as follows:

"The calculations of the value in use for all property, plant and equipment as at 31 March 2008 is attached as Appendix 2 and the value in use for all property, plant and equipment as at 31 March 2008 is HKD231,836,000. Excluding the carrying amount of the transferable leasehold land and building and other property, plant and equipment approximately HKD136 million as at 31 March 2008 from this HKD232 million is the estimated value in use of land and buildings in the People's Republic of China (the Assets) of HKD96 million as at 31 March 2008; …"

5.1.9 Magician further clarified on 17 February 2009 (Annex 3J) the basis of deriving the value in use of the Assets from the Value-In-Use Calculation.

An extract of the letter is set out below:

"The carrying values of the other Property, Plant & Equipment ("PPE") categories namely "Leasehold improvement", "Plant & machineries", "Furniture, fixtures, office and computer equipment", "Motor vehicles", "Moulds", "Construction in progress" were at their Net Book Value after impairment. The VIU [value in use] of the Assets at HKD96 million was arrived by deducting the carrying value of the respective other PPE categories at HKD25.4 million, and the market value of the transferable leasehold land and building at HKD104 million from HKD232 million."

5.1.10 By deducting the market value of transferable leasehold and buildings of HK$104 million and the carrying amount of other PPE of HK$25.4 million from the value in use of all PPE of HK$232 million, the value in use of the Assets should have been HK$102.6 million instead of HK$96 million as stated in the letter of Magician. Magician subsequently clarified in another letter dated 20 May 2009 that the carrying amount of other PPE should be HK$32 million instead of HK$25.4 million i.e. the amount of the value in use of the Assets of HK$96.0 million is correct.

5.1.11 Note 13 to the Relevant Financial Statements stated that an impairment loss of HK$5.2 million was recognised for the moulds based on the Value-In-Use Calculation.

5.1.12 Paragraph 104 of HKAS 36 provides for the methodology for allocating the impairment loss for a cash-generating unit to individual assets within the unit. It states that

"An impairment loss shall be recognised 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 recognised in accordance with paragraph 60."

Paragraph 106 of HKAS 36 allows an arbitrary allocation of the impairment loss if it is not practicable to estimate the recoverable amount of each individual asset of the cash-generating unit. It states that "If it is not practicable to estimate the recoverable amount of each individual asset of a cash-generating unit, this Standard requires an arbitrary allocation of an impairment loss between the assets of that unit, other than goodwill, because all assets of a cash-generating unit work together."

5.1.13 Paragraph 122 of HKAS 36 provides for the methodology for allocating reversal of impairment loss for a cash-generating unit to individual assets within the unit. It states that “A reversal of an impairment loss for a cash-generating unit shall be allocated to the assets of the unit, except for goodwill, pro rata with the carrying amounts of those assets. These increases in carrying amounts shall be treated as reversals of impairment losses for individual assets and recognised in accordance with paragraph 119.”

The standard is silent on the allocation of reversal of impairment loss over individual assets if it is not practicable to estimate the recoverable amount of each individual asset of the cash-generating unit. The FRRC considers that the methodology of allocation of reversal of impairment loss should be the same as that for allocation of impairment loss.

5.1.14 However, the FRRC considers that Magician did not derive the value in use of the Assets by deducting the market value of the transferrable leasehold land and buildings and the carrying amount of other PPE from the value in use of all PPE as claimed by it. If the carrying amount of other PPE was subtracted from the value in use of all PPE, there should be no recognition of impairment loss for the mould. The FRRC has no intention to pursue this further since the amount was not material to the Relevant Financial Statements.

5.1.15 In a letter from Mazars dated 13 May 2009 (Annex 4B), Mazars commented that “the impairment loss of the moulds of HK$5.2 million was specifically related to the idle moulds and there was no impairment loss provided for those moulds that were in use at the balance sheet date”. Magician also made similar comments on this point in its letter dated 20 May 2009 (Annex 4A).

5.2 Basis for the estimates of future cash flows in the Value-In-Use Calculation

5.2.1 In its letter of 19 December 2008 (Annex 3B), Magician enclosed copies of the Value-In-Use Calculation (Annex 3C) and the projected consolidated profit and loss account (Annex 3D). The Value-In-Use Calculation and the projected consolidated profit and loss account were the same as those provided by Mazars in its letter of 19 December 2008 (Annex 3H).

Sales projections

5.2.2 In the projected consolidated profit and loss account (Annex 3D), the management projected the following increase in sales from 2009 to 2013:

	Projected				
	For the year ended 31 March				
	2009	2010	2011	2012	2013
Increase in sales (in %)	[%]	[%]	[%]	[%]	[%]

5.2.3 On 13 January 2009, the FRRC required (Annex 3I) Magician to explain the projected increase in sales and gross profit from 2009 to 2013 with supporting evidence.

5.2.4 In its letter of 17 February 2009 (Annex 3J), Magician mentioned that the current management had implemented various measures to cope with the challenges that existed and the management believed that Magician could be able to achieve the target of increasing sales as projected for the next five years with the continuous effort in these measures. An extract of the letter is set out below:

"Due to historical reason, the production facilities of the Group was designed to process substantial higher capacity than the current operating level. Therefore, the productivity and cost effectiveness would be substantially improved with the significant increase of sales volume. Therefore, the current management had implemented various measures to cope with the challenges that existed in internally as well as in the industry, and resulted in satisfactory outcomes. With the continuous effort in these measures, the management believed that the Group could be able to achieve the target of increasing sales and gross profits as projected for the next 5 years. Some of the abovementioned measures that our Group has adopted for the past year are explained below:-

1. The Group had strengthened the sales and marketing team by reorganizing the establishment and the duties in order to deliver better customer services, explore business opportunities beyond the status quo as well as matching product development capability. As a result, our Group had attracted substantial increase in sales from one of our major customers which sought to raise their orders to us substantially from the year of 2009. To substantiate the above, the Memorandum of Understanding dated 18 December 2008 entered into between [that customer] and one of our Group company, Magician Industrial Company Limited (Appendix C) and a list of new customers signed up in 2008 (Appendix D) are provided for your reference.

2. The Group focused on developing new products so as to attract better margin. Due to the historical reason, the proportion of new products on offer was low that contributed to the overall lower gross profit margin in the past. With continuous effort of developing more new products with customers, the general trend of gross profits margin would be upward. For your information, our Group developed about [number] new products in the year ended 31 March 2007 and [number] new products in the year ended 31 March 2008.

3. Through emerging of various departments and streamlining the operations within the Group, a more flexible allocation of workforce and production schedule for various workflows were attained for catering the seasonal order pattern. Meanwhile, such arrangements also serve to optimize the human resources deployment, to achieve cost saving in slack labour and to reduce overtime wages. In addition, the streamlining the operations by enhancing the utilization rate of facilities and by re-engineering work processes would reduce the wastage as well as increase productivity.

4. It was generally acknowledged that the direct materials costs had already risen to a very high level in the first half of 2008. Although a temporary rise could not be ruled out in the second half of 2008, the management believed that the prices would be more likely to be stabilised than rise further for a prolonged period.

Meanwhile, alternative supply sources were sought for better prices and of the approximate quality; for example, [example]. Therefore, the forecast did not take the continuing rising model for the direct costs.

The management opined that with the outcomes of these continuous measures would contribute to achieve the targeted increase in sales and gross profit margin as projected in the next 5 years.

With hindsight, when comparing the turnovers and the gross profits figures from the periods for the six months ended 30 September 2007 and 2008, increases of HK$25 million and of HK$5 million were noted respectively that reflected the results of improvement effort."

5.2.5 In its letter of 17 February 2009 (Annex 3J), Magician also provided a copy of the memorandum of understanding dated 18 December 2008 (see 5.2.4(1)), which indicated that one of the major customers of Magician, sought to place [percent] more of its 2008 orders in year 2009.

5.2.6 A comparison of the actual sales performance for each of the four years ended 31 March 2008 based on information contained in previous annual reports of Magician and projected sales performance provided by Magician in its letter of 19 December 2008 is set out below:

	Actual				Projected				
	2005	2006	2007	2008	2009	2010	2011	2012	2013
(Decrease)/increase in sales (in %)		(48%)	(6%)	(2%)	[%]	[%]	[%]	[%]	[%]

5.2.7 It was noted that the sales generated by the Company were declining from 2005 to 2008. The projections did not appear to be consistent with past actual outcomes and there was no objective evidence to support the projected increase in sales. It appears to the FRRC that the assumption for the growth in projected sales from 2009 to 2013 was not supportable at the time of preparation of the Value-In-Use Calculation. The FRRC considers that there is a relevant non-compliance with paragraph 33(a) of HKAS 36 in respect of the basis for the estimates of projected sales in future cash flows (see 4.3.1(i) and 4.1.3(i)).

Comparing cash flow projections with the most recent financial budgets/forecasts approved by management

5.2.8 According to the Value-In-Use Calculation (Annex 3C) provided by Magician in the letter of 19 December 2008, the credit terms for "cost of sales – raw materials" and "cost of sales – direct labour & others" were three months and one month respectively.

5.2.9 It was noted that the cost of sales as shown in the Value-In-Use Calculation (Annex 3C) could not be reconciled with that in the projected consolidated profit and loss account (Annex 3D), allowing for the effects of relevant credit terms. For instance, estimated cost of sales of HK$26.8 million of July 2008 in the projected consolidated profit and loss account was more than the sum of estimated future cash outflows from "cost of sales, direct labor and others" of HK$7.1 million of August 2008 and "cost of sales, raw materials" of HK$17.3 million of October 2008 in the cash flow projections.

5.2.10 On 13 January 2009, the FRRC required (Annex 3I) Magician to

(i) confirm whether or not the cash flow projections were based on the most recent financial budgets/forecast prepared by management (see 5.2.11); and

(ii) provide the relevant reconciliation of the cost of sales (see 5.2.12).

5.2.11 Magician replied in writing on 17 February 2009 (Annex 3J). An extract of the letter in relation to 5.2.10(i) is as follows:

"Appendix 2d "Projected Consolidated Profit & Loss Account for the period from 1 April 2008 to 31 March 2013" [to Magician's letter of 19 December 2008] was the most recent financial forecasts under the assumptions made in Appendix 5b and were both approved by the management of the Company.

The information of "Projected Consolidated Cashflow Statement for the period from July 2008 to March 2041" [Value-In-Use Calculation] in Appendix 2 [to Magician's letter of 19 December 2008] was then extracted from "Projected Consolidated Profit & Loss Account for the period from 1 April 2008 to 31 March 2013" in Appendix 2d [to Magician's letter of 19 December 2008]."

5.2.12 Magician mentioned in its letter of 17 February 2009 (Annex 3J) in relation to 5.2.10(ii) that the discrepancy is attributable to projected depreciation included in cost of sales, for instance, projected depreciation included in cost of sales was HK$2.3 million for July 2008.

5.2.13 On 24 February 2009 (Annex 3M), a follow-up letter was sent to Magician requesting it to further clarify the discrepancy in relation to the cost of sales.

5.2.14 In its letter of 3 March 2009 (Annex 3N), Magician explained that projected depreciation included in cost of sales was primarily estimated based on the ratio of depreciation in cost of sales to total cost of sales for the year ended 31 March 2008. An extract of the letter is as follows:

"When we prepared the calculation of value in use, we used the ratio of depreciation in Cost of Sales (HKD15,862,291.10) to total Cost of Sales (HKD182,104,000) as at 31 March 2008, i.e. 8.71%, to project the depreciation included in Cost of Sales in the Projected Consolidated Profit and Loss Account for the year ended 31 March 2009. Depreciation for July 2008 HKD2,332,858 was derived from using 8.71% times Cost of Sales in July 2008. We did not include the late adjustments and audit adjustments on the depreciation charges in preparing the value in use of the Property, plant and equipment.

The depreciation rates of the Property, plant & equipment adopted by the PRC subsidiary were different from the depreciation rates adopted by the Group. The late adjustments and audit adjustments of HKD3.5 million were mainly to adjust for such depreciation difference so that the depreciation rates adopted by the PRC subsidiary in company level were in line with the depreciation rate adopted by the Group in consolidation level based on Hong Kong Accounting Standards."

5.2.15 According to the Relevant Financial Statements (Annex 1A) and the 2008/2009 interim report of Magician (Annex 1B), depreciation for the year ended 31 March 2008 and for the six months ended 30 September 2008 was HK$16.0 million and HK$6.5 million respectively and estimated average monthly depreciation was HK$1.2 million. According to projected consolidated profit and loss account (Annex 3D), projected depreciation for July 2008 included in general & administration expense was HK$0.2 million. Excluding that, estimated projected depreciation included in cost of sales for July 2008 should be approximately HK$1.0 million. Based on the Value-In-Use Calculation (Annex 3C), projected capital expenditure for July 2008 was HK$1.4 million. The FRRC considers the level of projected capital expenditure did not justify the significant increase in projected depreciation as compared to the actual depreciation for the period from 1 April 2007 to 30 September 2008.

5.2.16 The projected cash outflows included in the Value-In-Use Calculation was less than the expenses from the projected consolidated profit and loss account, which was claimed by Magician to be the same as the most recent financial budgets/forecast approved by management, after adjusting for the effects of relevant credit term. It appears to the FRRC that Magician was unable to fully explain the discrepancy between the cash flow projections and the most recent financial budgets/forecast and the FRRC considers that there is a relevant non-compliance with paragraph 33(b) of HKAS 36. The effect of which might otherwise decrease the value in use of all PPE as at 31 March 2008 (see 4.3.1(i) and 4.1.3(ii)).

5.3 Composition of the estimates of future cash flows in the Value-In-Use Calculation

5.3.1 In the Value-In-Use Calculation (Annex 3C), it was noted that:

(i) the projections of cash flows for the purpose of measuring the value in use of all PPE as at 31 March 2008 did not include the actual cash flows from their continuing use for the period from April 2008 to June 2008;

(ii) the projections of cash flows for the purpose of measuring the value in use of all PPE as at 31 March 2008 included net cash outflows from financing activities and the total nominal value of such net cash outflows as at 31 March 2008 was HK$118.1 million (the present value of such net cash outflows was estimated to be HK$31.6 million);

(iii) in determining the net cash flows from operating activities for the purpose of measuring the value in use of all PPE as at 31 March 2008, adjustments were made to the profit or loss for both the effects of relevant credit terms and changes in net working capital; and

(iv) in the measurement of the value in use of all PPE as at 31 March 2008, certain non-operating liabilities of HK$157.6 million was deducted from the FCFF of HK$389.4 million.

5.3.2 On 13 January 2009, the FRRC required (Annex 3I) Magician to clarify further the composition of the estimates of future cash flows set out in 5.3.1. Magician replied on 17 February 2009 (Annex 3J).

Commencement date of the estimates of future cash flows

5.3.3 An extract of the letter dated 17 February 2009 (Annex 3J) in relation to 5.3.1(i) is as follows:

"We finished the revised forecasts, projected Consolidated Profit & Loss, at the end of June 2008 and then revised the calculation of VIU of the Group at the beginning of July 2008 accordingly. Thus we used July 2008 as the starting month for the projected cashflow statement."

5.3.4 In accordance with paragraph 39 of HKAS 36, projections of cash flows for the purpose of measuring the value in use of all PPE as at 31 March 2008 should be for the period starting 1 April 2008 (see 4.3.1(ii)).

5.3.5 The FRRC considers that not including the net cash flows for the period from April 2008 to June 2008 in the Value-In-Use Calculation is a relevant non-compliance with paragraph 39 of HKAS 36 (see 4.1.3(iii)).

5.3.6 According to the 2008/2009 interim report of Magician (Annex 1B), net cash outflows from operating activities for the six months ended 30 September 2008 was HK$23.9 million.

Inclusion of net cash flows from financing activities in the estimates of cash flows

5.3.7 An extract of the letter dated 17 February 2009 (Annex 3J) in relation to 5.3.1(ii) is as follows:

"The cashflow template we used had an interest expenses item being deducted from the cash inflows. Interest expenses is an deduction item from the cash inflows in most cases. Then our first inception was to include it as a deduction item in the cashflow statement."

5.3.8 The FRRC considers that the inclusion of net cash outflows from financing activities in the Value-In-Use Calculation is a relevant non-compliance with paragraph 50(a) of HKAS 36. By doing so, the value in use of all PPE as at 31 March 2008 would have been understated by approximately HK$31.6 million (see 4.3.1(iii)) and 4.1.3(iv)).

Adjusting the profit or loss for the effects of both credit terms and changes in net working capital

5.3.9 An extract of the letter dated 17 February 2009 (Annex 3J) in relation to 5.3.1(iii) is as follows:

"We found the formula of the Free Cash flow Model from the Financial Management Module reference materials for the Qualifying Programme printed by HKICPA in Appendix B. The formula included a deduction of changes in working capital item and thus this item was deducted from the Group's cashflow statements submitted."

5.3.10 On 24 February 2009, a follow-up letter (Annex 3M) was sent to Magician requesting it to clarify why the profit or loss was adjusted for both the effects of relevant credit term and the changes in net working capital.

5.3.11 In its letter of 3 March 2009 (Annex 3N), Magician stated that "it is usual to put the estimated revenue inflow in the month when the revenue will be received and put the estimated cash outflow in the month when the payment will be made in preparing a cashflow statement. The cash inflow and outflow in the month was estimated by reference to the credit terms of income and expenses in preparing the value in use calculation of the Property, plant and equipment."

5.3.12 The FRRC considers that it was inappropriate to determine the net cash flows from operating activities included in the Value-In-Use Calculation by adjusting the profit or loss for the effects of both relevant credit terms and changes in net working capital since they have the same effect of converting the profit or loss into cash receipts and payments (see 4.1.3(v)).

Free cash flow to the firm

5.3.13 The following is an extract of the letter from Magician dated 17 February 2009 (Annex 3J) in relation to 5.3.1(iv):

"The non-operating liabilities as at 31 March 2008 included the followings and the nature and details of them can be found from the notes to annual report for the year concerned ("Annual Report"):

	HKD	Notes to Annual Report
Long-term bank borrowing	116,667,000	21(b)
Current portion of long-term bank borrowing	11,111,000	21(b)
Zero-coupon convertible bonds	17,389,000	23
Loan from a related company	6,396,000	19
Loan from a shareholder	6,000,000	20
	157,563,000	

The above non-operating liabilities had been used to generate past cashflows for creating existing net worth of the Group. The purpose of borrowing the above loan was to settle the past long outstanding operating liabilities like trade payable and bank loan borrowed in the past. This HKD158 million was classified as non-operating liabilities as the amount was of capital nature and were deducted from the VIU of the whole Group to get the VIU [value in use] of the PPE. The VIU of the PPE would be used to generate future increase in net worth of the Group."

5.3.14 According to the financial management module reference materials from the HKICPA (Annex 3K) provided by Magician in the letter of 17 February 2009, "the free cash flow to the firm (FCFF) model values the firm ("the enterprise value") rather than the equity stake. The value of the firm is the present value of the expected future cash flows to all claimants of the firm. This cash flow is referred to as free cash flow to the firm. Once the value of the firm is established, the value of equity is obtained as follows:

Value of equity = value of firm – net debt

where net debt is defined as interest-bearing debt less cash.

FCFF represents cash flow that is available to pay interest and principal to lenders and dividends to shareholders. FCFF is measured as follows:

FCFF = EBIT (1-t) + depreciation – capital expenditure – increase in net working capital

where t is the corporate tax rate and net working capital is defined as non-cash current assets less non-interest bearing current liabilities.

5.3.15 By including the non-operating liabilities of HK$157.6 million as a deduction in the Value-In-Use Calculation, the present value in the calculation becomes the "value of equity". The value in use of the PPE, being the only cash generating unit of the business of Magician, should be measured by the "value of the firm" approach in the Value-In-Use Calculation.

5.3.16 The FRRC considers that it was inappropriate to deduct the non-operating liabilities from the FCFF in the Value-In-Use Calculation (see 4.1.3(vi)).

5.4 Non-disclosure of the discount rate(s) used in the Value-In-Use Calculation

5.4.1 Magician explained in its letter dated 19 December 2008 (Annex 3B) that "…the auditor had given a qualified opinion in the auditors' reports for the 31 March 2008 financial statement that the auditor was not able to obtain sufficient information from management to support its assessment on the value in use of property, plant and equipment with a carrying amount of HKD95,607,000 as of 31 March 2008 and therefore unable to satisfy themselves whether the property, plant and equipment of HKD95,607,000 were fairly stated. This qualified opinion was meant to draw the attention of the readers of the financial statements on this matter thus we viewed that disclosing the discount rate will not provide supplemental information for the disclosed values which were based on valuation report."

5.4.2 Mazars explained in its letter of 19 December 2008 (Annex 3H) why no reference was made in the auditor's report for the non-disclosure of the discount rate used in the Value-In-Use Calculation in the Relevant Financial Statements. An extract of the letter is set out below:

"The Relevant Financial Statements do not contain the disclosure required by paragraph 130(g) of Hong Kong Accounting Standard 36 "Impairment of Assets" ("HKAS 36") in relation to the discount rate used in the estimation of the value in use. As the Relevant Financial Statements have included relevant disclosures as required by paragraph 130(a) - (e) of HKAS 36, we consider that failure to disclose the discount rate as required by paragraph 130(g) of HKAS 36 is not material enough for a qualified opinion to be issued in this respect."

5.4.3 The FRRC considers that failure to disclose the discount rate(s) used in the measurement of the value in use of the Assets was a relevant non-compliance with paragraph 130(g) of HKAS 36 (see 4.3.1(iv) and 4.1.2).

Section 6 Comments from Magician and Mazars

6.1 Comments on Draft Enquiry Report from Magician

6.1.1 The Draft Enquiry Report was sent to Magician for review and comment on 29 April 2009. A reply was received on 20 May 2009 (Annex 4A).

6.1.2 Magician disagreed with the following findings of the FRRC -:

(i) The growth in sales in the cash flow projections was not based on supportable assumptions. (see 6.1.3)

(ii) The cash flow projections differed from the most recent financial budget/forecast approved by management. (see 6.1.4 and 6.1.5)

(iii) The estimates of future cash flows used in the Value-In-Use Calculation should start from the period commencing 1 April 2008. (see 6.1.6)

Magician's comments on each of the above points are set out below.

Unsupportable assumptions on growth in sales in the cash flow projections

6.1.3 An extract from the letter dated 20 May 2009 (Annex 4A) is as follows:

"It should be appreciated that:-

1. The current management took over the Group in March 2006 which was the month for the end of the financial year 2006.
2. The improvement effort of the current management had been evidenced by the financial performance of the Group since the first year of management in terms of improvement of gross profitability and reduction in costs.
3. Unlike service sectors, turnaround programmes in industrial sectors would be likely to take more time to materialize the effort committed.
4. The improvement effort committed by the management were planned and executed progressively, and that, again, had been evidenced by the financial performance of the Group in 2007 and 2008.
5. As revealed in the annual report 2008, sales and marketing effort had been stepped up. Amongst various measures, a general manager was recruited in 2007 to ensure the improvement effort be consistently and continuously implemented. The results of these efforts had been gradually materialized in various forms, such as new customers signed, improved gross margins and recently the sale turnover.
6. Sales target was set based on all these continuous effort and the achievement, and the sale order pattern in the second quarter of the year would be a good and reliable indicator of the sale trend for the year as the seasonal peak would be from July to September for the Group.
7. The designed production capacity for the Group could support a sales turnover of [currency and amount] without any substantial additional capital investment, and more sales could be accommodated with the Group's outsourcing unit.

Therefore, Magician considered our projected growth in sales was solidly backed by the on-going effort committed by the current management."

Difference between the cash flow projections and the most recent financial budget/forecast approved by management

6.1.4 An extract from the letter dated 20 May 2009 (Annex 4A) is as follows:

"As stated in 5.2.14, we had fully explained that we did not include the late adjustments and audit adjustments on the depreciation charges in the projected profit and loss account for the year ended 31 March 2009 (i.e. the budget/forecast profit and loss account) at the time preparing the value in use of the Property, plant and equipment. The discrepancy between the cashflow projections and the most recent financial budgets/forecast was due to the depreciation adjustments that we had not finalized by the time of completing the value-in-use calculation. We use the ratio of depreciation in Cost of Sales (HK$15.9 million) to total Cost of Sales (HK$ 182 million) as at 31 March 2008 i.e. 8.71%, to project the depreciation included in Cost of Sales in the Projected Consolidated Profit and Loss Account for the year ended 31 March 2009. We finished this projected Consolidated Profit & Loss at the end of June 2008. At the time of preparing the Projected Consolidated Cashflow Statement, there were late adjustments in respect of depreciation, which had not yet been put through in time for this VIU exercise purposes. as time became rush under tight reporting timeframe. The late adjustments HK$3.5 million were mainly in relation to adjust the depreciation rates of the Property, plant and equipment used by the PRC subsidiary in its management account to be in line with the depreciation rate adopted by the Group. If the adjustments are taken, the adjusted depreciation included in Cost of Sales is HKD12.3 million, the revised ratio is 6.75% and the revised yearly projected depreciation in Cost of Sales for the year 2009 is HKD14.3 million and the average monthly depreciation in Cost of Sales is HKD1.19 million. This monthly average depreciation is comparable to your calculated average HK$1 million. Moreover, all other figures used for the cashflow projection were directly extracted from the projected profit and loss account approved by the management. Therefore, we considered the discrepancy between the cash flow projections and the most recent financial budget/forecast was fully explained."

6.1.5 The FRRC considers that it was inappropriate to project depreciation based on the cost of sales.

Commencement date of the cash flow projections

6.1.6 An extract from the letter dated 20 May 2009 (Annex 4A) is as follows:

"Besides, the reason mentioned in 5.3.3, we like to point out that the sales order trend in the second quarter of a year was always a good indicator of the sales order for the remaining year; therefore incorporating that would give a better view of the sales forecast for the Group. However, by incorporating that in a forecast would lead to advancing the time horizon one quarter forward that excluded the actual figures in the second quarter as forecast was meant to deal with the periods ahead instead of the actual happenings. Nevertheless, the projections of cash inflows and outflows were derived from the continuing use of the asset, and we considered 3-month figures would not be material to the overall results for such a long time horizon of projection.

Moreover, as stated in 5.3.6, the net cash outflows from operating activities for the six months ended 30 September 2008 was HK$23.9 million. It was the mixed results of:-

(i) the seasonal phenomenon that the first half year the group would experience a greater extent of net cash outflow from operating activities comparing to the net cash outflow of the second half of year. The peak production months were from July to September which built up trade and bills receivables, inventories and trade payables.

(ii) the decision to increase in certain raw material due to the commodity market trend at that time; and

(iii) the increase in sales.

Thus it was evidenced by the increase in trade and bills receivables HK$37.8 million, increase in inventories HK$16.9 million and the increase in trade payables HK$33.8 million at 30 September 2008 comparing to the corresponding figures at 30 September 2007. In general, net cash inflow would be expected for the year."

6.1.7 In its reply letter of 20 May 2009 (Annex 4A), Magician mentioned that it revised the Value-In-Use Calculation after considering certain findings of the FRRC in 4.1.3. An extract from the reply letter is as follows:

"Finally, taking into account of your comments in 4.1.3.(ii) to (iv), we estimated the maximum amount of the impairment losses to be additionally reversed in respect of the Assets would be less than HK$2 million for the year ended 31 March 2008, representing less than 1% of the total Property, plant and equipment as at 31 March 2008. Meanwhile, the revised value-in-use calculation for the year ended 31 March 2008 would be reviewed by the auditors as part of their audit for the year ended 31 March 2009."

6.2 Comments on Draft Enquiry Report from Mazars

6.2.1 The Draft Enquiry Report was sent to Mazars for review and comment on 29 April 2009. A reply letter was received on 13 May 2009 (Annex 4B).

6.2.2 In its reply letter of 13 May 2009 (Annex 4B), Mazars stated that "we understand that the value of the Assets calculated by the Company of HK$95.6 million, despite of its potential non-compliance with HKAS 36, was benchmarked to the Indicative Value measured by an independent professional valuer, Vigers Appraisal & Consulting Limited. We believe it would be useful information to the Committee if this fact is stated in the Conclusion and Recommendation Section of the Report." Other than that, Mazars did not have any other comment on the findings of the enquiry report.