

# **ENQUIRY REPORT**

**(E01-10)**

**on**

**the Consolidated Financial Statements**

**of**

**[Listco] and its subsidiaries**

**for the year ended 31 December 2008**

**Financial Reporting Review Committee**

**16 September 2011**

**This report was adopted by the Financial Reporting Council on 6 October 2011 in accordance with section 47(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 possible relevant non-compliance by a listed entity. Relevant non-compliance exists when a relevant financial report does not comply 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

Acquisition	Acquisition of the entire issued share capital and the shareholders' loan of [Subsidiary] at a consideration of HK\$112 million which was satisfied by the issuance of the Consideration Shares
Agreement Price	The average closing price of the Company's shares in the last five trading days immediately before the date of agreement in relation to the Acquisition on 8 September 2008 as quoted on The Stock Exchange of Hong Kong Limited (i.e. HK\$0.14 per share)
Announcement	Announcement of the Company issued on 9 September 2008
Auditor	Auditor of the Relevant Financial Statements
[Listco]/Company	[Name of Listco]
Consideration Shares	800,000,000 new ordinary shares of the Company at a par value of HK\$0.10 each
Council	Financial Reporting Council
Draft Enquiry Report	A draft of this report which was sent to the Company for comment on 10 August 2011
FRC Ordinance	Financial Reporting Council Ordinance (Cap. 588)
FRRC	Financial Reporting Review Committee [Case number]
Group	The Company and its subsidiaries
HKAS	Hong Kong Accounting Standard
HKFRS	Hong Kong Financial Reporting Standard
HKFRS 3	HKFRS 3 <i>Business Combinations</i>
[Subsidiary]	[Name of Subsidiary], the subject of the Acquisition
Period	Period from the date of agreement of the Acquisition on 8 September 2008 to the completion date of the Acquisition on 28 October 2008
Relevant Financial Statements	Consolidated financial statements of the Group for the year ended 31 December 2008

## **Executive summary**

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### **Introduction**

This report pertains to an enquiry conducted by the FRRC pursuant to section 40(1)(b) of the FRC Ordinance in relation to the Relevant Financial Statements (Annex 1A).

### **Background information**

The Company is incorporated in Hong Kong and its shares are listed on the Main Board (stock code: [stock code]) of The Stock Exchange of Hong Kong Limited. The consolidated loss of the Group for the year ended 31 December 2008 was HK\$797.8 million and the consolidated net assets of the Group at 31 December 2008 were HK\$1,540.5 million.

The Auditor issued an unmodified report on the Relevant Financial Statements.

The Council received a complaint on 11 October 2010 in relation to the measurement of the Consideration Shares in the Relevant Financial Statements.

### **Appointment of the FRRC**

On 19 November 2010, 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 HKFRS 3.

### **Conclusion**

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

The FRRC is of the view that the Company's accounting treatment could not be considered as a non-compliance with paragraphs 24 and 27 of HKFRS 3.

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

## **Comments on Draft Enquiry Report from the Company**

The Draft Enquiry Report was sent to the Company for comment on 10 August 2011. In its reply dated 19 August 2011 (Annex 3), the Company confirmed that it had no comment on the Draft Enquiry Report.

## **Section 1 Introduction**

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### **1.1 Background information**

- 1.1.1 This report pertains to an enquiry conducted by the FRRC pursuant to section 40(1)(b) of the FRC Ordinance in relation to the Relevant Financial Statements.
- 1.1.2 The Company is incorporated in Hong Kong and its shares are listed on the Main Board (stock code: [stock code]) of The Stock Exchange of Hong Kong Limited. Its market capitalization and the closing price of its shares on 11 October 2010 are approximately HK\$280 million and HK\$0.227 respectively.
- 1.1.3 The principal activities of the Group as set out in the Relevant Financial Statements were property investment, investment in securities trading, money lending, investment holding and acquiring, exploring and developing natural resources.
- 1.1.4 It was stated in note 2 to the Relevant Financial Statements (Annex 1A) that the Relevant Financial Statements were prepared in accordance with HKFRSs, accounting principles generally accepted in Hong Kong and applicable disclosure requirements under the Listing Rules and the Hong Kong Companies Ordinance.
- 1.1.5 The Auditor issued an unmodified report on the Relevant Financial Statements (Annex 1A).

### **1.2 Financial information**

- 1.2.1 The consolidated loss of the Group for the year ended 31 December 2008 was HK\$797.8 million and the consolidated net assets of the Group at 31 December 2008 were HK\$1,540.5 million.

### **1.3 Initiation of enquiry**

- 1.3.1 The Council received a complaint on 11 October 2010 in relation to the measurement of the Consideration Shares in the Relevant Financial Statements.
- 1.3.2 On 19 November 2010, having considered the information provided by the complainant and the information available to the public, 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.
- 1.3.3 The potential non-compliance is in relation to the measurement of the Consideration Shares issued for the Acquisition in the Relevant Financial Statements.

## **Section 2 Details of the complaint**

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- 2.1 According to the Announcement (Annex 1B), the Group entered into an agreement with a third party on 8 September 2008 in relation to the Acquisition, in which the consideration was satisfied by the issuance of the Consideration Shares based on the Agreement Price of HK\$0.14 per share.
- 2.2 The Acquisition was completed on 28 October 2008 and the published price of the Company's shares on that day was HK\$0.04.
- 2.3 The complainant alleged that the use of the Agreement Price rather than the published share price at the date of exchange in the fair value measurement of the Consideration Shares in the Relevant Financial Statements is a potential non-compliance with paragraph 27 of HKFRS 3.
- 2.4 The reason for not using the published price on the date of exchange to determine the fair value of the Consideration Shares was not mentioned in the Relevant Financial Statements in accordance with paragraph 67(d)(ii) of HKFRS 3.
- 2.5 The complainant alleged that there was no substantiation that the published share price at the date of exchange was an unreliable indicator of fair value and that other valuation methods provided a more reliable measure of the equity instrument's fair value.
- 2.6 The complainant stated that the non-compliance with HKFRS 3 would result in a potential understatement of the excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost which might be material to the Relevant Financial Statements.
- 2.7 The potential understatement of the excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost amounted to HK\$80 million ((HK\$0.14 – HK\$0.04) per share x 800,000,000 shares), which is approximately 10% of the loss of HK\$797.8 million for the year ended 31 December 2008.

### **Section 3 Appointment of the FRRC**

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- 3.1 On 19 November 2010, the Council appointed the FRRC in accordance with section 40(1)(b) of the FRC Ordinance for the purpose of enquiring into the question whether or not there is a relevant non-compliance in relation to the Relevant Financial Statements. The FRRC consists of the following members:
- (a) Dr. LI Ka-cheung, Eric, G.B.S., J.P. (Chairman)
  - (b) Prof. CHEN Chien-wen, Kevin
  - (c) Mr. LAU Siu-ki, Kevin
  - (d) Ms. LEE Sau-wai, Cecilia
  - (e) Ms. Melissa Kaye PANG, M.H., J.P.
- 3.2 The terms of reference approved by the Council are:
- (a) to enquire into the question whether or not there is a relevant non-compliance within the meaning of the FRC Ordinance in relation to the measurement of the Consideration Shares at the date of the Acquisition as reflected in the Relevant Financial Statements;
  - (b) to exercise the powers under Division 2 of Part 4 of the FRC Ordinance and such other powers as may be delegated from time to time by the Council for the purpose of the enquiry;
  - (c) to form an opinion on whether there is a relevant non-compliance and how this non-compliance should be rectified; and
  - (d) to report to the Council the findings of the enquiry and to make recommendations for further actions.

## **Section 4 Process of the enquiry**

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- 4.1 The first FRRC meeting was held on 10 December 2010 to provide background information of the case to the members of the FRRC. Two requirements were issued to the Company on 13 December 2010 (Annex 2A) and 24 January 2011 (Annex 2C) respectively under section 43(1) of the FRC Ordinance. The Company provided a written reply together with information and explanation to the FRRC on 21 December 2010 (Annex 2B) and 31 January 2011 (Annex 2D) respectively.
- 4.2 The FRRC reviewed the replies from the Company, and considered the findings of the enquiry and the recommendations to be made to the Council by circulation of papers. The FRRC approved the Draft Enquiry Report on 20 July 2011.
- 4.3 The Draft Enquiry Report was sent to the Company on 10 August 2011 for its comment. The reply received from the Company in its letter dated 19 August 2011 (Annex 3) was incorporated in Section 8 of this report.
- 4.4 The final version of this report was approved by the FRRC members by circulation of papers on 16 September 2011.
- 4.5 The conclusion is in Section 7.

## **Section 5 Relevant financial reporting requirements**

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- 5.1 The HKFRS relevant to the possible relevant non-compliance is HKFRS 3.
- 5.2 Paragraph 4 of HKFRS 3 states that “A business combination is the bringing together of separate entities or businesses into one reporting entity. The result of nearly all business combinations is that one entity, the acquirer, obtains control of one or more other businesses, the acquiree. If an entity obtains control of one or more other entities that are not businesses, the bringing together of those entities is not a business combination. When an entity acquires a group of assets or net assets that does not constitute a business, it shall allocate the cost of the group between the individual identifiable assets and liabilities in the group based on their relative fair values at the acquisition date.”
- 5.3 Paragraph 24 of HKFRS 3 states that “The acquirer shall measure the cost of a business combination as the aggregate of: (a) the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree; plus (b) any costs directly attributable to the business combination.”
- 5.4 Paragraph 27 of HKFRS 3 states that “The published price at the date of exchange of a quoted equity instrument provides the best evidence of the instrument’s fair value and shall be used, except in rare circumstances. Other evidence and valuation methods shall be considered only in the rare circumstances when the acquirer can demonstrate that the published price at the date of exchange is an unreliable indicator of fair value, and that the other evidence and valuation methods provide a more reliable measure of the equity instrument’s fair value. The published price at the date of exchange is an unreliable indicator only when it has been affected by the thinness of the market. If the published price at the date of exchange is an unreliable indicator or if a published price does not exist for equity instruments issued by the acquirer, the fair value of those instruments could, for example, be estimated by reference to their proportional interest in the fair value of the acquirer or by reference to the proportional interest in the fair value of the acquiree obtained, whichever is the more clearly evident. The fair value at the date of exchange of monetary assets given to equity holders of the acquiree as an alternative to equity instruments may also provide evidence of the total fair value given by the acquirer in exchange for control of the acquiree. In any event, all aspects of the combination, including significant factors influencing the negotiations, shall be considered. Further guidance on determining the fair value of equity instruments is set out in HKAS 39 *Financial Instruments: Recognition and Measurement.*” (underline added)
- 5.5 Paragraph 67(d)(ii) of HKFRS 3 states that “To give effect to the principle in paragraph 66(a), the acquirer shall disclose the following information for each business combination that was effected during the period: ... (d) the cost of the combination and a description of the components of that cost, including any costs directly attributable to the combination. When equity instruments are issued or issuable as part of the cost, the following shall also be disclosed: ... (ii) the fair value of those instruments and the basis for determining that fair value. If a published price does not exist for the instruments at the date of exchange, the significant assumptions used to determine fair value shall be disclosed. If a published price exists at the date of exchange but was not used as the basis for determining the cost of the combination,

*that fact shall be disclosed together with: the reasons the published price was not used; the method and significant assumptions used to attribute a value to the equity instruments; and the aggregate amount of the difference between the value attributed to, and the published price of, the equity instruments ...”*

- 5.6 According to Appendix A of HKFRS 3, a business is defined as “*An integrated set of activities and assets conducted and managed for the purpose of providing: (a) a return to investors; or (b) lower costs or other economic benefits directly and proportionately to policyholders or participants. A business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be, used to generate revenues. If goodwill is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business.*”
- 5.7 According to Appendix A of HKFRS 3, a business combination is defined as “*The bringing together of separate entities or businesses into one reporting entity.*”
- 5.8 According to Appendix A of HKFRS 3, date of exchange is defined as “*When a business combination is achieved in a single exchange transaction, the date of exchange is the acquisition date. When a business combination involves more than one exchange transaction, for example when it is achieved in stages by successive share purchases, the date of exchange is the date that each individual investment is recognised in the financial statements of the acquirer.*”

## Section 6 Findings

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- 6.1 On 13 December 2010, the Company was requested to justify the following (Annex 2A):
- (a) the published share price at the date of exchange was an unreliable indicator of fair value of the Consideration Shares and that the Agreement Price provided a more reliable measure of fair value of the Consideration Shares and should be used in accordance with paragraph 27 of HKFRS 3 in the Relevant Financial Statements; and
  - (b) the Relevant Financial Statements had been prepared and presented in accordance with the disclosure requirements of paragraph 67(d)(ii) of HKFRS 3 since there was no disclosure regarding (i) the reasons the published price was not used; (ii) the method and significant assumptions used to attribute a value to the Consideration Shares; and (iii) the aggregate amount of the difference between the value attributed to, and the published price of, the Consideration Shares, in the Relevant Financial Statements.
- 6.2 In response to Paragraph 6.1(a), the Company replied on 21 December 2010 (Annex 2B) that “... According to the valuation report, the fair value of the property as at 31 July 2008 was RMB104 million (equivalent to approximately HK\$118 million) which is close to the consideration of HK\$112 million. Other than holding the property for rental proposes [purposes], [Subsidiary] does not have any other business. Given the nature of the transaction, the acquisition of [Subsidiary] as investment vehicle was effectively a transaction of acquiring its principal asset (i.e. the property) ... We were aware that the quoted price of the Company’s shares decreased significantly following the collapse of Lehman Brothers on 15 September 2008 ... During the period from the date of agreement to the date of completion, the Company’s share price decreased significantly from HK\$0.14 to HK\$0.04. The substantial drop in the share price was believed to be mainly attributable to the rare, but severe, financial crisis that took place during the period. [Subsidiary]’s principal activity was property letting. Its net asset value, which comprises mainly the value of the property held, provided a more reliable measurement of the consideration and also the fair value of equity instrument issued by the Company for the acquisition at the date of exchange. We noted that the market values of the property, that constituted the majority of the net asset value of [Subsidiary], between the date of agreement and completion did not change significantly according to the valuation reports issued by independent professional valuer for the property held by [Subsidiary]. Therefore, we considered the net asset value of [Subsidiary], which has an amount more close to the fair value of the equity instruments at the date of agreement, provided a more reliable and more clearly evidential measurement of the equity instruments issued by the Company at the date of exchange ...” (underline added)
- 6.3 In response to Paragraph 6.1(b), the Company replied that “... since the transaction was considered, in substance, as an acquisition of asset, rather than a business combination, the disclosure requirements under HKFRS 3 paragraph 67(d)(ii) could be kept to a minimum. The annual report of the Group for the year ended 31 December 2008 contained disclosures relating to the transaction primarily in its Chairman’s Statement, notes 25 and 29. It was stated in note 29 of the annual report

*that: ‘The Group acquired the entire equity interests of [Subsidiary] on 28 October 2008 (date of acquisition).’ Note 29 then referred to note 25(f) of the annual report which mentioned that: ‘On 8 September 2008, the Group entered into an agreement with a third party to acquire 100% interest in [Subsidiary] at a consideration of HK\$112,000,000 which was satisfied by the issue and allotment of 800,000,000 ordinary shares of HK\$0.10 each of the Company at HK\$0.14 per share. The fair value of the shares issued was based on the closing price as quoted on the Stock Exchange on the date of agreement (i.e. 9 September 2008).’ Note 29 further set out the comparison between the total consideration (with a cross reference to note 25(f)) and the aggregate fair value of the identifiable assets and liabilities of the acquired subsidiaries as at the dates of acquisition which resulted in a small negative goodwill of HK\$326K. We considered that, with the highly transparent disclosures contained in the Group’s announcement and circular regarding the acquisition, following by the results of the EGM, shareholders certainly had adequate information and knowledge to understand the substance of the transaction, and to assess its effect at the time when the transaction took place. As a result, by the time when the transaction was reported as a past event in the annual report, where we put emphasis that the transaction was naturally a “property acquisition” deal, we considered that any disclosures under HKFRS 3 could be kept to a minimum.” (underline added)*

- 6.4 Since the Company mentioned in Paragraphs 6.2 and 6.3 that the Acquisition was in substance an acquisition of asset rather than a business combination, it appears to the FRRC that it may not be appropriate for the Company to account for the Acquisition as a business combination.
- 6.5 On 24 January 2011, the Company was further requested to explain why the Acquisition was accounted for as a business combination rather than an acquisition of investment property in accordance with HKAS 40 *Investment Property* in the Relevant Financial Statements and whether the Acquisition met the definition of a business combination as set out in paragraph 4 and Appendix A of HKFRS 3 (Annex 2C).
- 6.6 On 31 January 2011, the Company replied (Annex 2D) that “... (ii) [Subsidiary]’s main asset was [a property]; (iii) [Subsidiary], through its holding of [a property], had been carrying out a business of property letting operation that consisted of inputs (individual rental units and the property agent), processes (services provided by the property agent including housekeeping, repair and maintenance, building security, rental collection and others) and outputs (rental contracts) that are used to generate revenues; and (iv) Such operation was an integrated set of activities and assets conducted and managed for the purpose of providing a return to the Group.”

## Section 7 Conclusion

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- 7.1 Based on the reply from the Company as stated in Paragraph 6.6, it is reasonable for the Company to account for the Acquisition as a business combination rather than an acquisition of investment property as what the Company acquired met the definition of a business in Appendix A of HKFRS 3 (Paragraph 5.6) and hence the Acquisition met the definition of a business combination in paragraph 4 and Appendix A of HKFRS 3 (Paragraphs 5.2 and 5.7).
- 7.2 Paragraph 24 of HKFRS 3 requires an acquirer to measure the cost of a business combination at the fair values, at the date of exchange, of the equity instruments issued by the acquirer, in exchange for control of the acquiree; plus any costs directly attributable to the business combination.
- 7.3 The major issue is therefore whether the published price at the date of exchange is an unreliable indicator of fair value and that the Agreement Price is a more reliable measure of the fair value of the Consideration Shares.
- 7.4 The Company claimed that *“The substantial drop in the share price was believed to be mainly attributable to the rare, but severe, financial crisis that took place during the period ... we considered the net asset value of [Subsidiary], which has an amount more close to the fair value of the equity instruments at the date of agreement, provided a more reliable and more clearly evidential measurement of the equity instruments issued by the Company at the date of exchange ...”*
- 7.5 According to paragraph 27 of HKFRS 3 (Paragraph 5.4), *“The published price at the date of exchange is an unreliable indicator only when it has been affected by the thinness of the market.”* Therefore, a substantial drop in the price of the Company’s shares would not in itself render the published price at the date of exchange an unreliable indicator of fair value. However, the FRRC is of the view that the financial crisis, which caused the substantial drop in the price of the Company’s shares, might lead to a thin market at the date of exchange.
- 7.6 HKFRS 3 does not define “thinness of the market”. The FRRC considers that judgement is required to determine whether the published price at the date of exchange was affected by the thinness of the market. A “thin market” is referenced by the finance industry as an infrequently traded or an inactive market (Annexes 4A and 4B). In addition to this understanding, the FRRC considers that it would not be unreasonable to also interpret a market with low trading volume as a thin market.
- 7.7 The FRRC obtained information in relation to the trading of the Company’s shares between 1 January 2007 and 31 December 2009 (Annex 4C). Given the shares of the Company were traded in 30 out of 34 trading days during the Period, the FRRC considers that the shares of the Company were not infrequently traded and the market was not inactive.
- 7.8 According to note 25 to the Relevant Financial Statements, the total number of the Company’s shares in issue at the date of exchange was 3,249,609,814 shares. The FRRC reviewed the daily trading volume of the shares of the Company during the Period. The trading volume at the date of exchange was 252,400 shares (Annex 4D)

and the average daily trading volume during the Period was 210,859 shares (Annex 4E). The average daily trading volume during the Period represented only 0.006% of the number of shares in issue. On the basis of this low trading volume, the FRRC considers that it would not be unreasonable to consider that the market was thin and hence the published price at the date of exchange was not a reliable indicator of fair value of the Consideration Shares.

- 7.9 Paragraph 27 of HKFRS 3 further states that *“If the published price at the date of exchange is an unreliable indicator or if a published price does not exist for equity instruments issued by the acquirer, the fair value of those instruments could ... be estimated ... by reference to the proportional interest in the fair value of the acquiree obtained ...”* In relation to this, the Company stated that *“... We noted that the market values of the property, that constituted the majority of the net asset value of [Subsidiary], between the date of agreement and completion did not change significantly according to the valuation reports issued by independent professional valuer for the property held by [Subsidiary]. Therefore, we considered the net asset value of [Subsidiary], which has an amount more close to the fair value of the equity instruments at the date of agreement, provided a more reliable and more clearly evidential measurement of the equity instruments issued by the Company at the date of exchange ...”* On the basis that the published price at the date of exchange was not a reliable indicator of fair value, it appears to the FRRC that it would not be unacceptable for the Company to use the agreed consideration (i.e. Agreement Price x 800,000,000 new ordinary shares of the Company) which approximates the net asset value of [Subsidiary] at the date of the agreement, as the fair value of the Consideration Shares, given that there was no significant change in the net asset value of [Subsidiary] during the Period. Accordingly, there is no evidence to support that there is a non-compliance with paragraphs 24 and 27 of HKFRS 3.
- 7.10 In relation to the disclosure of the fair value of the Consideration Shares, it appears to the FRRC that even if the shareholders were fully informed of the details of the Acquisition from an announcement or a circular, the Company still had to comply with HKFRS 3 and disclose the fact that the published price of HK\$0.04 at the date of exchange was not used in the fair value measurement of the Consideration Shares, the reason for not using the published price, the method and significant assumptions used to attribute a value to the Consideration Shares, and the aggregate amount of the difference between the value attributed to, and the published price of, the Consideration Shares in the Relevant Financial Statements. The FRRC considers that the inadequate disclosure, in particular, in relation to management’s decision that an alternative measure of the fair value of the Consideration Shares is more reliable in the Relevant Financial Statements, is a non-compliance with paragraph 67(d)(ii) of HKFRS 3.

## **Section 8 Comments from the Company**

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- 8.1 The Draft Enquiry Report was sent to the Company for comment on 10 August 2011. In its reply dated 19 August 2011 (Annex 3), the Company confirmed that it had no comment on the Draft Enquiry Report.