Enquiry Report
Paradise Entertainment Limited
Consolidated Financial Statements
for the years ended 31 December 2007 and 2008

Financial Reporting Review Committee (E02-09)

24 February 2010

This report has been adopted by the Financial Reporting Council on 18 March 2010 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 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

CGU	Cash-generating unit (being the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets)
Company/Paradise	Paradise Entertainment Limited (stock code: 01180)
Council	The Financial Reporting Council
DeXinglong	DeXinglong Medicine Management Consulting Company Limited
Draft Enquiry Report	A draft of this report which was sent to Paradise for comment on 8 January 2010
Drug Assets	Assets including Intangible Assets, Payments for Investments, and PPE
FRC Ordinance	Financial Reporting Council Ordinance (Cap. 588)
FRRC	Financial Reporting Review Committee (E02-09)
Group	The Company and its subsidiaries
HKAS	Hong Kong Accounting Standard
HKAS 36	HKAS 36 *Impairment of Assets*
HKAS 38	HKAS 38 *Intangible Assets*
HKFRS	Hong Kong Financial Reporting Standard
Intangible Assets	Intangible assets relating to the beneficial rights to four drugs (ALR, Pazu, ZG and CDH) under development not yet available for use with carrying amounts of approximately HK$90.5 million and HK$90.6 million as at 31 December 2007 and 2008 respectively
Listing Rules	Rules governing the Listing of Securities on the Main Board of The Stock Exchange of Hong Kong Limited
Payments for Investments	Payments for investments representing deposits paid for the acquisition of beneficial rights to five drugs (Pamai, Clinda, OND, Bromhexine and Phentolamine) under development not yet available for use with carrying amounts of approximately HK$59.7 million and HK$63.4 million as at 31 December 2007 and 2008 respectively and the corresponding consultancy fees with carrying amounts of approximately HK$1.3 million and HK$1.4 million as at 31 December 2007 and 2008 respectively

PPE	Leasehold improvements and plant and machinery acquired for the research and development of the drugs under development by the Group and included in property, plant and equipment with carrying amounts of approximately HK$28 million and HK$22.9 million as at 31 December 2007 and 2008 respectively
relevant non-compliance	The non-compliance with a relevant requirement, within the meaning of Part 1 of Schedule 1 to the FRC Ordinance
Secretariat	Secretariat of the Council
SFDA	State Food and Drug Administration
VIU	Value in use
2007 Auditor	The auditor of the 2007 Financial Statements
2008 Auditor	The auditor of the 2008 Financial Statements
2007 VIU Calculation	Value-in-use calculation of nine drug projects for the year ended 31 December 2007
2008 VIU Calculation	Value-in-use calculation of nine drug projects for the year ended 31 December 2008
2007 Financial Statements	Consolidated financial statements of the Group for the year ended 31 December 2007
2008 Financial Statements	Consolidated financial statements of the Group for the year ended 31 December 2008

Executive summary

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 2007 and 2008 Financial Statements.

Background

Paradise is a corporation listed on the Main Board of The Stock Exchange of Hong Kong Limited (stock code: 01180). The 2007 Auditor expressed an 'except for' qualified opinion and the 2008 Auditor expressed a disclaimer of opinion on the impairment in value of the Drug Assets in relation to nine drugs for the years ended 31 December 2007 and 2008 respectively.

Appointment of the FRRC

On 23 September 2009, 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 2007 and 2008 Financial Statements.

Relevant HKFRS

The HKFRSs relevant to the possible relevant non-compliances are HKAS 36 and HKAS 38.

Conclusion

Based on the results of the enquiry, the FRRC concludes that there is a relevant non-compliance in the 2007 and 2008 Financial Statements.

The relevant non-compliance relates to the measurement of the VIU of, and impairment loss in relation to, the Drug Assets in the 2007 and 2008 Financial Statements, which were based on the 2007 and 2008 VIU Calculations which, in turn, were not performed in accordance with HKAS 36.

Recommendation

The FRRC recommends the Council to request Paradise to revise the 2007 and 2008 VIU Calculations in accordance with HKAS 36, announce the impact of the revision on the VIU of the Drug Assets and the consequential impairment loss and deferred tax liability, reflected as a restatement of the 2007 and 2008 Financial Statements.

Comments on Draft Enquiry Report from Paradise

The Draft Enquiry Report was sent to Paradise for comment on 8 January 2010.

In its reply letter of 22 January 2010, Paradise confirmed that it had no further information to be provided on the Draft Enquiry Report.

Section 1 Introduction

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 2007 and 2008 Financial Statements. It was stated in notes 3 and 4 of the 2007 and 2008 Financial Statements respectively that the financial statements were prepared in accordance with the HKFRSs, accounting principles generally accepted in Hong Kong and the applicable disclosure requirements under the Listing Rules and the Hong Kong Companies Ordinance.

1.2 Company information

1.2.1 Paradise is a corporation listed on the Main Board of The Stock Exchange of Hong Kong Limited (stock code: 01180) with market capitalization of approximately HK$115 million as at 22 February 2010. Average daily trading turnover for the three months ended 22 February 2010 was approximately 1.5 million shares. The closing price of Paradise as at 22 February 2010 was HK$0.235. Paradise is incorporated in Bermuda.

1.2.2 The principal activities of the Group include the research, development, sale of biopharmaceutical products and sale of live baccarat betting units, development and operation of electronic gaming systems.

1.2.3 The consolidated loss of the Group was HK$172.5 million and HK$92.7 million for the years ended 31 December 2007 and 2008 respectively. The consolidated net assets of the Group were HK$279.3 million and HK$199.2 million as at 31 December 2007 and 2008 respectively. The 2007 Auditor and the 2008 Auditor expressed an 'except for' qualified opinion and a disclaimer of opinion on the respective financial statements due to scope limitation on the assessment of the impairment in value of the Drug Assets in relation to nine drugs. The extract of the above modified auditors' reports are in Section 2. The 2007 and 2008 Financial Statements are enclosed for reference (Annexes 1A and 1B).

1.3 Initiation of an enquiry

1.3.1 Based on the auditor's report of the 2008 Financial Statements, the Secretariat identified the following questions on possible non-compliance with accounting requirements:

(a) Whether or not the recognition of the Intangible Assets satisfied each of the requirements stipulated in paragraph 57 of HKAS 38 (see Paragraph 6.2.1 for details of paragraph 57 of HKAS 38)*;*

(b) Whether or not the Group had tested impairment of the Intangible Assets and the related PPE in accordance with HKAS 36 (see Section 6.3 for extract of relevant paragraphs of HKAS 36); and

(c) Whether or not there was any indication that the carrying values of the Payments for Investments and the related PPE might be impaired, and if there was such indication, whether or not Paradise had tested impairment of these assets in accordance with HKAS 36.

1.3.2 In relation to the above, the Secretariat had sent five written requests for information to Paradise and one written request to the 2008 Auditor to obtain information and explanations about the carrying values of the Drug Assets between May and August 2009.

1.3.3 In its letter received on 29 May 2009 (Annex 2A), Paradise said that it "had considered the recognition criteria and requirements stipulated in paragraph 57 of HKAS 38 *Intangible Assets*…the directors of the Company (the "Directors") concluded that the recognition criteria of intangible assets stipulated in paragraph 57 of HKAS 38 *Intangible Assets* have been met…". In its letter dated 7 August 2009 (Annex 2D), Paradise provided a "Review of 4 Research and Development Projects and 5 Generic Drugs" and a "2007 Update of 4 Research and Development Projects and 5 Generic Drugs" on the nine drugs dated 10 April 2006 and 10 April 2007 respectively prepared by a third party expert engaged by Paradise, to review the status of the drug projects.

1.3.4 In its letter received on 29 May 2009 (Annex 2A), Paradise also explained that impairment test had been performed in relation to the Drug Assets. Paradise determined the VIU of the Drug Assets and concluded that no impairment was considered necessary.

1.3.5 In its letter of 28 August 2009 (Annex 2G), the 2008 Auditor explained that "no satisfactory information was obtained by us prior to the completion of audit. Accordingly, we are not able to assess the amount of any impairment provision. As the financial impact of any potential impairment of intangible assets (and its deferred tax liabilities recorded), payments for investments, property, plant and equipment in connection with the Group's biopharmaceutical business would have pervasive effects both to the results and net assets of the Group as of 31 December 2008, we considered the issue of disclaimer opinion was necessary…"

1.3.6 With reference to the information obtained from Paradise and the 2008 Auditor, the Secretariat identified the following issues:

(a) Paradise did not determine the fair value less costs to sell of the Drug Assets. (see Section 5.1)

(b) Paradise was unable to provide information and explanation to substantiate that the assumptions used in the 2007 and 2008 VIU Calculations, based on which the recoverable amounts were determined, were reasonable and supportable as required by paragraph 33(a) of HKAS 36. (see Section 5.2)

(c) The impairment to the Drug Assets were determined as a group of assets, i.e. treating them as a single CGU, which did not comply with paragraphs 6 and 22 of HKAS 36. (see Section 5.3)

(d) The carrying amounts of the PPE should have been allocated to the relevant CGUs as required by paragraphs 102 and 104 of HKAS 36. (see Section 5.4)

1.3.7 On 23 September 2009, having considered the information provided by Paradise, the 2008 Auditor and 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 2007 and 2008 Financial Statements.

1.3.8 The potential non-compliance is in relation to the carrying amounts of the Drug Assets, including Intangible Assets, Payments for Investments, and PPE, in relation to nine drugs brought forward from previous years. There was a potential consequential impact on deferred tax liability if impairment loss was required to be recognised.

1.4 Opportunity of being heard

1.4.1 The Draft Enquiry Report was sent to Paradise on 8 January 2010 for comment. The comments of Paradise were received on 22 January 2010 and were incorporated in Section 8 of this report.

Section 2 Extract of the modified auditors' reports

2.1 The 2007 Auditor expressed an 'except for' qualified opinion on the 2007 Financial Statements.

An extract of the auditor's report of the 2007 Financial Statements is reproduced below:

"**BASIS FOR QUALIFIED OPINION**

1. Scope limitation – Impairment of intangible assets, payments for investments, property, plant and equipment in connection with the Group's biopharmaceutical business

In connection with the Group's biopharmaceutical business, the Group had intangible assets of HK$90,520,000 stated in the consolidated balance sheet as at 31 December 2007 relating to beneficial rights to drugs under development not yet available for use and detailed in note 19 to the financial statements; payments for investments representing deposits paid for the acquisition of beneficial rights to drugs under development not yet available for use and the corresponding consultancy fees stated in the consolidated balance sheet as at 31 December 2007 at a total carrying amount of HK$61,002,000 and detailed in note 21 to the financial statements; and leasehold improvements and plant and machinery with carrying amounts totaling HK$28,030,000 as at 31 December 2007 acquired for the research and development of the drugs under development by the Group and included in property, plant and equipment.

We have not been provided with sufficient information and explanations to assess whether any impairment in value should be recognised in respect of the abovementioned intangible assets, payments for investments and property, plant and equipment. There are no other satisfactory audit procedures that we could adopt to determine whether any impairment in value should be made in the financial statements in respect of them. Any adjustments found to be necessary might have consequential effects on the net assets of the Group as at 31 December 2007, the results of the Group for the year then ended and the related disclosures thereof in the financial statements.

2. Scope limitation – Prior year's audit scope limitation affecting opening balances of intangible assets, payments for investments and property, plant and equipment in connection with the Group's biopharmaceutical business

As detailed in our report dated 27 April 2007 on the financial statements of the Group for the year ended 31 December 2006, we were unable to obtain sufficient information and explanations to assess whether any impairment in value should be recognised in respect of the intangible assets of approximately HK$90,471,000 and payments for investments of HK$56,994,000 stated in the consolidated balance sheet as at 31 December 2006; and leasehold improvements and plant and equipment with carrying amounts totaling HK$32,206,000 included in property, plant and equipment stated in the consolidated balance sheet as at 31 December 2006. Any adjustments found to be necessary in respect thereof had we obtained sufficient evidence would have had consequential effects on the net assets of the Group as at 31 December 2006,

the results of the Group for the years ended 31 December 2007 and 2006 and the related disclosures thereof in the financial statements."

2.2 The 2008 Auditor expressed a disclaimer of opinion on the 2008 Financial Statements.

An extract of the auditor's report of the 2008 Financial Statements is reproduced below:

"BASIS OF OPINION

1. Scope limitation – Impairment of intangible assets, payments for investments, property, plant and equipment and deferred tax liabilities in connection with the Group's biopharmaceutical business

In connection with the Group's biopharmaceutical business, the Group had intangible assets of approximately HK$90,566,000 stated, and in the consolidated balance sheet as at 31 December 2008 relating to beneficial rights to drugs under development not yet available for use and detailed in note 19 to the consolidated financial statements; deferred tax liabilities of approximately HK$16,763,000 on the intangible assets relating to beneficial rights to drugs under development not yet available for use and detailed in note 33 to the consolidated financial statements; payments for investments representing deposits paid for the acquisition of beneficial rights to drugs under development not yet available for use and the corresponding consultancy fees stated in the consolidated balance sheet as at 31 December 2008 at a total carrying amount of approximately HK$64,741,000 and detailed in note 21 to the consolidated financial statements; and leasehold improvements and plant and machinery with carrying amounts of approximately HK$22,913,000 as at 31 December 2008 acquired for the research and development of the drugs under development by the Group and included in property, plant and equipment.

We have not been provided with sufficient information and explanations to assess whether any impairment in value should be recognised in respect of the abovementioned intangible assets, payments for investments and property, plant and equipment, and the related deferred tax liabilities on the intangible assets relating to beneficial rights to drugs under development not yet available for use. There are no other satisfactory audit procedures that we could adopt to determine whether any impairment in value should be made in the consolidated financial statements in respect of them. Any adjustments found to be necessary might have consequential effects on the net assets of the Group as at 31 December 2008, the results of the Group for the year then ended and the related disclosures thereof in the consolidated financial statements.

2. Scope limitation – Prior year's audit scope limitation affecting opening balances of intangible assets, payments for investments and property, plant and equipment in connection with the Group's biopharmaceutical business

We were unable to obtain sufficient information and explanations to assess whether any impairment in value should be recognised in respect of the intangible assets of approximately HK$90,520,000 and payments for investments of approximately HK$61,002,000 stated in the consolidated balance sheet as at 31 December 2007; and leasehold improvements and plant and equipment with carrying amounts of

approximately HK$28,030,000 included in property, plant and equipment stated in the consolidated balance sheet as at 31 December 2007. Any adjustments found to be necessary in respect thereof had we obtained sufficient evidence would have had consequential effects on the net assets of the Group as at 31 December 2007, the results of the Group for the years ended 31 December 2008 and 2007 and the related disclosures thereof in the consolidated financial statements."

Section 3 Appointment of the FRRC

3.1 On 23 September 2009, 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 2007 and 2008 Financial Statements. The FRRC consists of the following members:

1. Mr. LIE Tai-chong, David, O.M., J.P. (Chairman)
2. Mrs. CHAN NGAN Man-ling, Edith
3. Ms. LEE Sau-wai, Cecilia
4. Mr. LI Man-bun, Brian David
5. Mr. WONG Tak-wai, Alvin

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 carrying amounts of the intangible assets of approximately HK$90.5 million and HK$90.6 million as at 31 December 2007 and 2008 respectively relating to beneficial rights to four drugs under development not yet available for use and the related deferred tax liabilities, deposits paid for the acquisition of beneficial rights to five drugs under development not yet available for use and the corresponding consultancy fees of approximately HK$61 million and HK$64.7 million as at 31 December 2007 and 2008 respectively, and the Company and its subsidiaries' property, plant and equipment with carrying amount of HK$22.9 million as at 31 December 2008 relating to beneficial rights to drugs under development not yet available for use in the consolidated financial statements of the Company for the years ended 31 December 2007 and 2008;

(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 and why 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 future actions.

Section 4 Process of the enquiry

4.1 The first FRRC meeting was held on 9 October 2009 to provide the background information of the case to the members of the FRRC. On 13 November 2009, Paradise wrote to the FRRC and confirmed that the information and explanation provided in its previous letter received on 29 May 2009 (Annex 2A), letter dated 18 June 2009 (Annex 2B) and additional information provided on 24 June 2009 (Annex 2C) and letters dated 7 August 2009 (Annex 2D), 18 August 2009 (Annex 2E) and 28 August 2009 (Annex 2F) were valid for the purpose of the enquiry. Two requirements were sent to Paradise on 16 October 2009 (Annex 3A) and 4 December 2009 (Annex 3D) respectively to obtain additional information and explanation.

4.2 The second FRRC meeting was held on 8 January 2010. The FRRC agreed on the findings of the enquiry and the recommendation to be made to the Council and approved the Draft Enquiry Report.

4.3 The Draft Enquiry Report was sent to Paradise on 8 January 2010 for its comment. The comments received from Paradise on 22 January 2010 were 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 24 February 2010.

4.5 The conclusion and recommendation are in Section 7.

Section 5 Findings

5.1 Recoverable amount being the higher of fair value less costs to sell and VIU

5.1.1 In its letter received on 29 May 2009 (Annex 2A), Paradise confirmed that the VIU approach was used in determining the recoverable amounts of the Drug Assets.

5.1.2 In relation to the recoverable amounts of the Intangible Assets, Paradise explained in its letter received on 29 May 2009 (Annex 2A) that "Since the Company has no intention to dispose of the relevant intangible assets, in considering the impairment on the relevant intangible assets which are not yet available for use, the Company has adopted the "value in use" approach rather than comparing their carrying value with their "realisation approach" by preparing a business plan forecast which was reviewed and approved by the Management on the respective balance sheet dates."

5.1.3 In relation to the recoverable amounts of the Payments for Investments, Paradise explained that "Since the Management intends to continue with the research and development of those undertaking projects and has no intention to cease or to dispose of such projects, the Company has adopted the "value in use" approach in assessing their impairment implication. After reviewing and approving the business plan of those projects held under payments for investments, the Directors have concluded that no impairment implication of payments for investments existed at the respective balance sheet dates."

5.1.4 In relation to the recoverable amounts of the PPE, Paradise explained that "Since the Company has no intention to dispose of the property, plant and equipment with carrying amount of HK$22,913,000 and there is no second-hand market for the benchmarking, in conducting the impairment review on such property, plant and equipment, the Management considered that the "realisation approach" is not applicable and instead adopted the "value in use" amount of the intangible assets under development, with the payments for investments in the biopharmaceutical business being taken into consideration in making the impairment decision on the relevant property, plant and equipment. After taking into account of the business plan of the biopharmaceutical business, the Directors have concluded that no impairment implication of the relevant property, plant and equipment existed on the respective balance sheet dates."

5.1.5 In its letter of 13 November 2009 (Annex 3B), Paradise replied that "The recoverable amounts of items 3(a) [the Intangible Assets], (b) [the Payments for Investments] and (c) [the PPE] were their value in use for the purpose of testing their impairment. Since the Group has no intention to dispose of the assets in items 3(a) [the Intangible Assets], (b) [the Payments for Investments] and (c) [the PPE], we have not considered determining their fair values less costs to sell."

5.1.6 Paragraph 18 of HKAS 36 (see Paragraph 6.3.2 for details of paragraph 18 of HKAS 36) states that HKAS 36 defines recoverable amount as the higher of an asset's or CGU's fair value less costs to sell and its VIU and paragraph 20 of HKAS 36 specifies when an entity may use the asset's VIU as its recoverable amount (see Paragraph 6.3.3 for details of paragraph 20 of HKAS 36). Since 'no intention to dispose of the assets' is not a technically justifiable reason for not determining fair

values less costs to sell of the Drug Assets for impairment assessment purpose and Paradise did not provide a valid reason for such, it appears that Paradise did not determine the recoverable amounts of the Drug Assets according to paragraph 18 of HKAS 36.

5.2 Reasonable and supportable assumptions

5.2.1 Paradise adopted the following key assumptions in determining the VIU of the Drug Assets.

(a) Estimated numbers of patients in China (of the diseases addressed by the drugs)
(b) Estimated numbers of clients who may use the drugs (out of those in (a))
(c) Estimated numbers of units of drugs used per client per annum
(d) Estimated selling prices of a unit of the drugs
(e) Estimated gross profit margins of the drugs

5.2.2 Paradise provided the 2007 and 2008 VIU Calculations in its letters of 13 November 2009 (Annex 3B) and 24 June 2009 (Annex 2C).

5.2.3 In its letter of 18 August 2009 (Annex 2E), Paradise only provided three articles which claimed to support the assumptions relating to one of the drugs which had the highest recoverable amount in the 2008 VIU Calculation. Of the three articles provided, one of them was considered out of date since it was published in year 1996 and the information in the other two articles could not be reconciled to the 2008 VIU Calculation. In its letter of 28 August 2009 (Annex 2F), Paradise has provided another two medical research analysis for three drugs recognised under the Intangible Assets, however, the figures in the research analysis could not be reconciled to the assumptions adopted in the 2008 VIU Calculation.

5.2.4 In its letter of 13 November 2009 (Annex 3B), Paradise provided the following information to substantiate the key assumptions adopted as mentioned in Paragraph 5.2.1 above.

Estimated numbers of patients in China

5.2.5 Paradise provided research results of Nan Fang Pharmaceutical Economic Research Centre of SFDA and DeXinglong for each of the nine drugs (the "Research Results"). The estimated numbers of patients in China in the Research Results approximate those being used in the 2007 and 2008 VIU Calculations. It appears that the estimated numbers of patients in China used in the 2007 and 2008 VIU Calculations are not unreasonable.

Estimated numbers of clients who may use the drugs

5.2.6 In its letter of 13 November 2009 (Annex 3B), Paradise mentioned that the estimated numbers of clients using the drugs was based on the judgment of people with expertise in this area.

An extract of the letter is as follows:

"Research results of DeXinglong annexed to this letter setting out the market share of the pharmaceutical companies of the same types of drugs for the year of 2007 and

2008 to substantiate the assumptions of the estimated number of patients in China as at 31 December 2007 and 2008. The Group adopted the assumption of the estimated number of clients as at 31 December 2007 and 2008 based on the judgment of the expertise experience of Mr. Xie Ji ("Mr. Xie") and Mr. Zhu Weixiong ("Mr. Zhu") with reference to the research results of DeXinglong.

As mentioned in our letters dated 7 August 2009 and 29 August 2009, both Mr. Xie and Mr. Zhu have vast and solid experience in pharmaceutical business and DeXinglong is a pharmaceutical consulting company specialized in pharmaceutical research and analysis as well as organizing different pharmaceutical conference and provision of relevant training…"

5.2.7 The estimated peak market share of each of the nine drugs is derived by comparing the highest estimated numbers of clients during their product life cycles to the estimated numbers of patients in China for the same period (see Paragraph 5.2.5 above). It is found that the estimated peak market shares of eight of the nine drugs, with the exception of ALR, are not unreasonable, as compared to the market shares of the most popular similar drugs stated in the Research Results.

5.2.8 The 2007 and 2008 VIU Calculations assumed that ALR will secure a market share of [certain]% in China in years 2012 and 2013 respectively. However, the Research Results of ALR show that the most popular similar medicine (核糖核酸) in Beijing managed to secure a market share of 51.92%, the most popular similar medicine (肝得健) in Guangzhou 25.41% and the most popular similar medicine (甘草酸二銨) in Shanghai 15.33% as at 16 January 2009. Thus, it appears that the assumption that ALR will secure [certain]% of the market share in China as a whole were not reasonable and supportable. This is a non-compliance with paragraph 33(a) of HKAS 36 (see Paragraph 6.3.5 for details of paragraph 33(a) of HKAS 36).

Estimated numbers of units of drugs used per client per annum

5.2.9 In its letter of 13 November 2009 (Annex 3B), Paradise provided instruction booklets for each of the nine drugs, but the dosage as stated in the instruction booklets cannot be reconciled to those being used in the 2007 and 2008 VIU Calculations.

5.2.10 In its letter of 26 November 2009 (Annex 3C), Paradise provided a table which reconciles the estimated numbers of units of drugs used per client as stated in the instruction booklets to those being used in the 2007 and 2008 VIU Calculations.

5.2.11 The reconciliation table involves estimation made by in-house expertise on the number of dosage used per day and the number of days required for a full treatment. In the absence of contradictory information, it appears that the estimated numbers of units of drugs used per client per annum in the 2007 and 2008 VIU Calculations are not unreasonable.

Estimated selling prices of a unit of the drugs

5.2.12 In its letter of 13 November 2009 (Annex 3B), Paradise provided the market prices of similar drugs from "Yaopinnet.com (藥源網) and yy338.com (藥狐)", claimed by Paradise as "being two of the most popular pharmaceutical websites" to support the estimated selling prices of a unit of eight of the nine drugs (i.e. except CDH).

However, the volume and packaging of each of the eight drugs as stated in these two websites are not comparable with those of Paradise.

5.2.13 In its letter of 26 November 2009 (Annex 3C), Paradise provided a table which reconciles the estimated unit selling prices and price ranges from www.yaopinnet.com and www.yy338.com of seven out of the nine drugs (i.e. except ALR and CDH) to the 2007 and 2008 VIU Calculations of the same unit and same packaging, i.e. the unit selling prices of drugs packaged in different forms are excluded for comparison purpose. The reconciliation table provided by Paradise shows that the estimated unit selling prices of those seven drugs are not unreasonable. However, it was noted that the unit selling prices of the major competitors as stated in the Research Results were not provided by Paradise for comparison purpose.

5.2.14 By referencing to medical websites, www.yp900.com, www.yaopinnet.com and www.wh-price.gov.cn, the estimated unit selling prices of one of the seven drugs, namely Clinda of Paradise, are found to be [certain] times higher than the unit selling prices of some of the major competitors in www.yp900.com and www.yaopinnet.com. However, considering that the peak market share (see Paragraph 5.2.7 for the calculation of peak market shares) of Clinda is [certain]% and its estimated unit selling price is within the selling price range of those provided by Paradise for similar drugs of small market shares (see Paragraph 5.2.13 above), it appears that the unit selling price of Clinda used in the 2007 and 2008 VIU Calculations is not unreasonable.

5.2.15 For ALR, it is packaged in a vial for injection purpose according to its instruction booklet; whereas 博路定, a similar drug, is packaged in tablet form. However, in its letter of 26 November 2009 (Annex 3C), Paradise confirmed that the unit selling price of 博路定 "is comparable to the unit selling price of ALR in the Value-in-use Calculations as ALR and 博路定 are both drugs used for the treatment of serious hepatitis". Assuming that ALR and 博路定 are comparable, the estimated selling price of ALR (HK$[certain amount] per 0.1mg) is approximately [certain]% higher than the selling price of the same unit of 博路定 from www.yaopinnet.com.

5.2.16 In its letter of 18 December 2009 (Annex 3E), Paradise provided the unit selling prices of two similar drugs selling in the market with the same form (one of which are developed by Paradise) which are comparable to the estimated unit selling price of ALR, it appears that the estimated unit selling price of ALR is not unreasonable.

5.2.17 For the remaining drug, CDH, in its letter of 13 November 2009 (Annex 3B), Paradise mentioned that "We calculate the estimated selling price of CDH, being one of the drug projects based on the expertise experience of Mr. Xie and Mr. Zhu because CDH is the antitussive troche which is not yet available in the market."

5.2.18 The instruction booklet of CDH states that each tablet of CDH contains 5mg of dextromethorphan hydrobromide (氫溴酸右美沙芬) and 2mg of buccal (苯佐卡因), and it is used for the relief of cough and pharynx/larynx pain. The Research Results on CDH indicates that most antitussive drugs (鎮咳藥) in China contain dextromethorphan hydrobromide and there are 12 similar drugs, of which five of them are packaged in the same form as CDH, which have already obtained product approval in China. The Research Results on CDH also indicates the market shares of those drugs' manufacturers in year 2008. There may not be a similar drug in the

market which has the exact composition of CDH, however, given CDH is also a generic drug used for antitussive and the other assumptions in the 2007 and 2008 VIU calculations of CDH are based on the Research Results on CDH, there is a question of why Paradise did not estimate the selling price of CDH based on that of similar drugs in the market.

Estimated gross profit margins of the drugs

5.2.19 In its letter of 13 November 2009 (Annex 3B), Paradise mentioned that "The Group adopted the assumption of the estimated gross profit margin based on the characteristics of the drugs and profit margin of new drugs currently in the market for each of nine drug projects as at 31 December 2007 and 2008." According to the 2007 and 2008 VIU Calculations provided by Paradise, the estimated gross profit margin of each of the nine drugs is [certain]%.

5.2.20 In its letter of 18 December 2009 (Annex 3E), Paradise mentioned that according to the 2008 annual report of Chongqing Huapont Pharm. Co. Ltd. (stock code: SHE002004), "地奈德膏 is a new drug with gross profit margin of 91% and the average gross profit margin of the drugs of 15g 迪皿、方希、地奈德乳膏、復方氨肽素片及 20 粒維胺脂膠囊 is 74%. Given that all nine drugs of the Group are marketed and sold through the same distribution channel and new drugs can generate gross profit margin of 90%, the management of the Company adopted the same gross profit margin of [certain]% for each of the nine drugs for 2007 and 2008." Paradise also provided the gross profit margin of Weijia, the only product that Paradise successfully obtained the production approval from the SFDA in year 2001, which ranges from [certain]% from year 2001 to year 2008.

5.2.21 According to Paradise's website (http://www.hk1180.com/drugsabout.html), Paradise has "8 generic (non-patented) drugs in total [i.e. excluding ALR]…These generic drugs are non-patented products that are being produced by other drug manufacturers in China also. The manufacturer is required to submit quantitative analysis data on each drug to SFDA and if the required information fulfils the required physical and biochemical standards, production permit will be granted for each product."

5.2.22 Taking into account the gross profit margin achieved by Weijia, it appears that the estimated gross profit margin of [certain]% for ALR is not unreasonable based on the track record of Weijia. However, it is questionable that the other eight generic drugs could also have the same gross profit margin of [certain]% by the reason of "marketing and selling through the same distribution channel".

5.2.23 Based on the research on some of the pharmaceutical companies listed in Hong Kong as listed below, their gross profit margin ranges from 29% to 79% (extracted from the consolidated financial statements of respective listed entities) which depends on the types of drugs.

Name of listed entity	Stock code	Gross profit margin for the year ended 31 December 2008
Sino Biopharmaceutical Limited	01177	79%
China Shineway Pharmaceutical Group Limited	02877	72%
Shandong Luoxin Pharmacy Stock Co., Ltd.	08058	47%
Tong Ren Tang Technologies Co., Ltd.	08069	45%
The United Laboratories International Holdings Limited	03933	38%
China Pharmaceutical Group Limited	01093	33%
Guangzhou Pharmaceutical Company Limited	00874	29%

5.2.24 Since Paradise's estimated gross profit margin of [certain]% for the remaining eight generic drugs fall within the range of the above listed pharmaceutical companies, it appears that the estimated gross profit margins used in the 2007 and 2008 VIU Calculations are not unreasonable.

5.3 Determination of impairment to the Drug Assets in relation to each drug independently

5.3.1 The 2007 and 2008 VIU Calculations provided by Paradise show that the recoverable amounts of the Drug Assets in relation to all of the nine drugs were determined by treating them as one single CGU. The recoverable amount of all the Drug Assets in total was higher than their total carrying amount, and, therefore, no impairment loss was recognised.

5.3.2 Since the cash flows which could be generated by the Drug Assets in relation to each of the nine drugs should be independent of each other, it should be taken that there were nine CGUs. Accordingly, the recoverable amounts of the Drug Assets in relation to each of the nine drugs should be determined independently and compared with the carrying amounts individually to assess the requirement for impairment.

5.3.3 In its letter of 13 November 2009 (Annex 3B), Paradise mentioned that the "cash flows which could be generated by the above intangible assets, payments for

investments and PPE in relation to each of the nine drugs is not independent of each other. Since the Company adopts the same gross profit margin for new drugs and the new drugs are to be marketed and sold through the same distribution channel, the Company disagrees that impairment to the above assets in relation to each of the nine drugs should be tested separately."

5.3.4 It is considered that adopting the same gross profit margin, marketing and distributing through the same channel do not make the nine drug projects interdependent of each other for the purpose of determining a CGU. It appears that grouping the Drug Assets in relation to each of the nine drugs as one CGU does not comply with paragraphs 6 and 22 of HKAS 36 (see Paragraphs 6.3.1 and 6.3.4 respectively for details of paragraphs 6 and 22 of HKAS 36).

5.3.5 The 2007 and 2008 VIU Calculations show that the individual recoverable amounts of the Drug Assets in relation to seven drugs were lower than their respective carrying amounts as at 31 December 2007 and 2008.

5.3.6 If impairment of the Drug Assets of the nine drugs were determined independently in accordance with paragraph 59 of HKAS 36 (see Paragraph 6.3.6 for details of paragraph 59 of HKAS 36) for the year ended 31 December 2007 and based on the 2007 VIU Calculation, impairment loss of HK$29.1 million should have been recognised, representing 16.9% of the consolidated loss before tax of the Group and 10.4% of the consolidated net assets as at 31 December 2007. A list of the recoverable and carrying amounts of the Intangible Assets and the Payments for Investments (excluding the corresponding consultancy fees capitalized) is set out below:

	Carrying amount	Recoverable amount	(Shortfall)
Drug projects	HK$ million	HK$ million	HK$ million
ALR	24.6	91.4	-
Pazu	22.2	18.6	(3.6)
ZG	18.3	27.2	-
CDH	25.4	18.4	(7.0)
Sub-total	90.5	155.6	(10.6)
Pamai	15.0	9.8	(5.2)
Clinda	11.8	6.6	(5.2)
OND	12.6	8.8	(3.8)
Bromhexine	9.6	7.3	(2.3)
Phentolamine	10.7	8.7	(2.0)
Sub-total	59.7	41.2	(18.5)
Total	150.2	196.8	(29.1)

5.3.7 Similarly, for the year ended 31 December 2008 and based on the 2008 VIU Calculation, an accumulated impairment loss of HK$37.4 million should have been recognised, representing 18.8% of the consolidated net assets as at 31 December 2008. The additional impairment loss of HK$8.3 million represents 9.3% of the consolidated loss before tax of the Group for the year ended 31 December 2008. A list of the recoverable and carrying amounts of the Intangible Assets and the Payments for Investments (excluding the corresponding consultancy fees capitalized) is set out below:

	Carrying amount	Recoverable amount	(Impairment)
Drug projects	HK$ million	HK$ million	HK$ million
ALR	24.6	93.0	-
Pazu	22.3	17.7	(4.6)
ZG	18.3	27.4	-
CDH	25.4	18.1	(7.3)
Sub-total	90.6	156.2	(11.9)
Pamai	15.9	9.9	(6.0)
Clinda	12.5	5.4	(7.1)
OND	13.4	7.5	(5.9)
Bromhexine	10.2	6.5	(3.7)
Phentolamine	11.4	8.6	(2.8)
Sub-total	63.4	37.9	(25.5)
Total	154.0	194.1	(37.4)

5.4 Impairment to PPE

5.4.1 In its letter of 13 November 2009 (Annex 3B), Paradise "agrees that the PPE should be allocated on a reasonable and consistent basis and allocated to the cash-generating units for the purpose of testing impairment. However, since the nine drugs are of similar nature with the same profit margin and the PPE used to produce the drugs are of generally the same types, the PPE are not allocated individually among the nine different drugs for impairment testing purpose."

5.4.2 As mentioned in paragraph 5.3.2, the cash flows which could be generated by the Drug Assets in relation to each of the nine drugs should be independent of each other.

Accordingly, the recoverable amounts of the PPE should have been allocated to the CGU in relation to each drug for the purpose of determining their recoverable amounts, it appears that there is a non-compliance with paragraphs 102 and 104 of HKAS 36 (see Paragraphs 6.3.8 and 6.3.9 respectively for details of paragraphs 102 and 104 of HKAS 36).

Section 6 Relevant accounting requirements

6.1 The HKFRSs relevant to the possible relevant non-compliances are HKAS 38 and HKAS 36.

6.2 HKAS 38 – Recognition of Intangible Assets

6.2.1 Paragraph 57 of HKAS 38 states that "An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following: (a) the technical feasibility of completing the intangible asset so that it will be available for use or sale. (b) its intention to complete the intangible asset and use or sell it. (c) its ability to use or sell the intangible asset. (d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset. (e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset. (f) its ability to measure reliably the expenditure attributable to the intangible asset during its development."

6.3 HKAS 36 – Impairment of Assets

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

6.3.2 Paragraph 18 of HKAS 36 states that "this standard defines recoverable amount as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use".

6.3.3 Paragraph 20 of HKAS 36 states that, "… sometimes it will not be possible to determine fair value less costs to sell because there is no basis for making a reliable estimate of the amount obtainable from the sale of the asset in an arm's length transaction between knowledgeable and willing parties. In this case, the entity may use the asset's value in use as its recoverable amount."

6.3.4 Paragraph 22 of HKAS 36 states that "Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs…"

6.3.5 Paragraph 33(a) of HKAS 36 states that "In measuring value in use an entity shall 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." [emphasis added]

6.3.6 Paragraph 59 of HKAS 36 states that "If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss."

6.3.7 Paragraph 64 of HKAS 36 states that "If an impairment loss is recognised, any related deferred tax assets or liabilities are determined in accordance with HKAS 12 *Income Taxes* by comparing the revised carrying amount of the asset with its tax base".

6.3.8 Paragraph 102 of HKAS 36 states that "In testing a cash-generating unit for impairment, an entity shall identify all the corporate assets that relate to the cash-generating unit under review. If a portion of the carrying amount of a corporate asset:

(a) can be allocated on a reasonable and consistent basis to that unit, the entity shall compare the carrying amount of the unit, including the portion of the carrying amount of the corporate asset allocated to the unit, with its recoverable amount. Any impairment loss shall be recognised in accordance with paragraph 104.

(b) cannot be allocated on a reasonable and consistent basis to that unit, the entity shall:

(i) compare the carrying amount of the unit, excluding the corporate asset, with its recoverable amount and recognise any impairment loss in accordance with paragraph 104;

(ii) identify the smallest group of cash-generating units that includes the cash-generating unit under review and to which a portion of the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis; and

(iii) compare the carrying amount of that group of cash-generating units, including the portion of the carrying amount of the corporate asset allocated to that group of units, with the recoverable amount of the group of units. Any impairment loss shall be recognised in accordance with paragraph 104."

6.3.9 Paragraph 104 of HKAS 36 requires 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."

Section 7 Conclusion and recommendation

7.1 Conclusion

7.1.1 Based on the results of the enquiry, the FRRC concludes that there is a relevant non-compliance with HKAS 36 in the following areas in relation to the 2007 and 2008 Financial Statements.

Recoverable amount being the higher of fair value less costs to sell and VIU

7.1.2 Paradise did not provide a justifiable reason for not determining fair values less costs to sell of the Drug Assets. It appears that Paradise did not determine the recoverable amounts of the Drug Assets according to paragraph 18 of HKAS 36 (see Paragraph 6.3.2 for details of paragraph 18 of HKAS 36). However, considering the nature of the Drug Assets, the fair values less costs to sell of the Drug Assets would approximate their VIU as fair value would likely be derived from an estimate of the future cash flows the entity expects to generate from the Drug Assets, it might not have a significant impact on the financial statements. Therefore, no further action is recommended to be taken in this respect.

Reasonable and supportable assumptions

7.1.3 Paradise adopted several key assumptions in its 2007 and 2008 VIU Calculations. Among those key assumptions, it appears that the estimated number of clients who may use the ALR drug is not reasonable and supportable, which is a non-compliance with paragraph 33(a) of HKAS 36 (see Paragraph 6.3.5 for details of paragraph 33(a) of HKAS 36). There is also a question on the basis for the estimated selling price of the CDH drug.

Determination of impairment to the Drug Assets in relation to each drug independently

7.1.4 Paradise did not provide valid reasons to substantiate the interdependency of the nine drug projects for the purpose of determining a CGU. It appears that grouping the Drug Assets in relation to the nine drugs as one CGU for the purpose of assessing impairment does not comply with paragraphs 6 and 22 of HKAS 36 (see Paragraphs 6.3.1 and 6.3.4 respectively for details of paragraphs 6 and 22 of HKAS 36).

7.1.5 As a result of the above non-compliance, the determination of the impairment loss of each of the Drug Assets did not comply with paragraph 59 of HKAS 36 (see Paragraph 6.3.6 for details of paragraph 59 of HKAS 36).

7.1.6 If the Intangible Assets and the Payments for Investments (excluding the corresponding consultancy fees capitalized) in relation to each of the nine drugs were determined independently (based on the recoverable amounts in the 2007 and 2008 VIU Calculations shown in Paragraphs 5.3.6 and 5.3.7 above), an accumulated impairment losses of HK$29.1 million and HK$37.4 million should have been recognised as at 31 December 2007 and 2008 respectively. Note that these amounts are derived from information provided by Paradise and have not been verified by the FRRC, and no account has been taken of any adjustments to the VIU Calculations of the ALR and CDH drugs as referred to in Paragraph 7.1.3 above.

Impairment to PPE

7.1.7 Since the related PPE should have been allocated to the CGU in relation to each drug for the purpose of determining their recoverable amounts, it appears that there is a non-compliance with paragraphs 102 and 104 of HKAS 36 (see Paragraphs 6.3.8 and 6.3.9 respectively for details of paragraphs 102 and 104 of HKAS 36).

Consequential deferred taxation

7.1.8 If it is necessary to recognise impairment to the Drug Assets as a result of this enquiry, it is likely that there is a need for deferred taxation adjustment in accordance with paragraph 64 of HKAS 36 (see to Paragraph 6.3.7 for details of paragraph 64 of HKAS 36).

7.2 Recommendation

7.2.1 The FRRC recommends the Council to request Paradise to revise the 2007 and 2008 VIU Calculations in accordance with HKAS 36, announce the impact of the revision on the VIU of the Drug Assets and the consequential impairment loss and deferred taxation, reflected as a restatement of the 2007 and 2008 Financial Statements.

7.2.2 The FRRC does not recommend the Council to issue a notice under section 49 of the FRCO to Paradise requiring the removal of the relevant non-compliance. This is because, in doing so, the Council needs to specify in such notice the manner of revising the 2007 and 2008 Financial Statements. This includes specifying what assumptions should be used in the 2007 and 2008 VIU Calculations. The FRRC considers it is not appropriate for the Council to dictate assumptions used in the estimates of future cash flows of a listed entity.

Section 8 Comments from Paradise

8.1 Comments on Draft Enquiry Report from Paradise

8.1.1 The Draft Enquiry Report was sent to Paradise for comment on 8 January 2010. A reply was received on 22 January 2010 (Annex 4A).

8.1.2 In its reply letter of 22 January 2010, Paradise confirmed that it had no further information to be provided on the Draft Enquiry Report.