ENQUIRY REPORT

(Case: E02-10)
on

the Consolidated Financial Statements

of

PetroAsian Energy Holdings Limited

(formerly known as China Oil Resources Holdings Limited)

and its subsidiaries

for the years ended 31 March 2008, 2009 and 2010

Financial Reporting Review Committee (E02-10)

16 August 2011

This report was adopted by the Financial Reporting Council on 1 September 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-compliances 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

Company	PetroAsian Energy Holdings Limited (formerly known as China Oil Resources Holdings Limited) (stock code: 00850)
Council	Financial Reporting Council
Draft Enquiry Report	A draft of this report which was sent to the Company for comment on 15 June 2011
Fair Value Gains	Fair value gains on the exploitation rights arising from the 2008 and 2009 Acquisitions
FRC Ordinance	Financial Reporting Council Ordinance (Cap. 588)
FRRC	Financial Reporting Review Committee (E02-10)
Fu 718 Project	A joint development project to exploit and produce crude oil in certain parts of the Fu 718 districts in the New Joint Development Zone in the PRC. An agency of the local government, which holds the oil exploitation license for the New Joint Development Zone, is one of the parties involved in this project.
Group	The Company and its subsidiaries
HKAS	Hong Kong Accounting Standard
HKAS 1	HKAS 1 *Presentation of Financial Statements*
HKAS 12	HKAS 12 *Income Taxes*
HKFRS	Hong Kong Financial Reporting Standard
HK(SIC)-INT-21	HK(SIC) Interpretation 21 *Income Taxes – Recovery of Revalued Non-Depreciable Assets*
PRC	People's Republic of China
Relevant Financial Statements	2008 and 2009 Financial Statements, and 2010 Financial Statements
2008 Acquisition	Acquisition of a 51% equity interest in Northeast Oil (China) Development Company Limited, the controlling party of a co-operative joint venture holding oil exploitation rights, on 8 March 2008
2008 and 2009 Financial Statements	Consolidated financial statements of the Group for the years ended 31 March 2008 and 2009
2008 and 2009 Joint Auditors	The joint auditors of the 2008 and 2009 Financial Statements

2009 Acquisition	Acquisition of 100% of the vendor's rights and responsibilities in the Fu 718 Project on 15 July 2008
2010 Financial Statements	Consolidated financial statements of the Group for the year ended 31 March 2010
2010 Joint Auditors	The joint auditors of the 2010 Financial Statements

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 Relevant Financial Statements.

Background information

The Company is incorporated in the Cayman Islands and its shares are listed on the Main Board (stock code: 00850) of The Stock Exchange of Hong Kong Limited. The consolidated profit for the years ended 31 March 2008 and 2009 were HK$601.3 million and HK$10.7 million respectively, and the consolidated loss for the year ended 31 March 2010 was HK$262.5 million. The consolidated net assets at 31 March 2008, 2009 and 2010 were HK$2,079.7 million, HK$2,290.2 million and HK$2,632.1 million respectively.

The 2008 and 2009 Joint Auditors expressed unqualified opinions on both the 2008 and 2009 Financial Statements, whereas the 2010 Joint Auditors expressed a disclaimer of opinion on the 2010 Financial Statements in relation to, among others, the non-recognition of deferred tax liabilities in respect of the Fair Value Gains.

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 HKFRSs relevant to the possible relevant non-compliances are HKAS 1 and HKAS 12.

Conclusion

Based on the results of the enquiry, the FRRC concludes that there are relevant non-compliances in the Relevant Financial Statements.

The relevant non-compliances relate to the non-recognition of deferred tax liabilities in respect of the Fair Value Gains in the 2008 and 2009 Financial Statements and its subsequent financial impact on the 2010 Financial Statements. The non-recognition of deferred tax liabilities was a non-compliance with HKAS 1 and HKAS 12.

Comments on Draft Enquiry Report from the Company

The Draft Enquiry Report was sent to the Company for comment on 15 June 2011 (Annex 4A). A reply was received on 30 June 2011 (Annex 4B).

In its reply of 30 June 2011, the Company confirmed that it had no comment on the conclusion of the Draft Enquiry Report and agreed with the FRRC's findings that deferred tax liabilities should have been separately recognized in accordance with HKAS 12. However, the Company mentioned in the same letter that a prior period adjustment would be made in the consolidated financial statements of the Group for the year ended 31 March 2011 to reverse the Fair Value Gains, and consequently no deferred tax liabilities would have to be recognized.

Section 1 Introduction

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 the Cayman Islands and its shares are listed on the Main Board (stock code: 00850) of The Stock Exchange of Hong Kong Limited. Its market capitalization and the closing price of its shares on 25 August 2010 are approximately HK$2,364 million and HK$0.61 respectively.

1.1.3 The principal activities of the Group as set out in note 7 to the 2010 Financial Statements (Annex 1C) are manufacturing and sale of paints, blended solvents and plastic colorants and trading of chemical materials, provision of painting services, exploitation and sale of crude oil, and leasing of investment properties and sale of properties held for trading.

1.1.4 It was stated in note 2 to the 2008 and 2009 Financial Statements (Annexes 1A and 1B) and note 3 to the 2010 Financial Statements (Annex 1C) that they 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 2008 and 2009 Joint Auditors expressed unqualified opinions on both the 2008 and 2009 Financial Statements (Annexes 1A and 1B). The 2010 Joint Auditors expressed a disclaimer of opinion on the 2010 Financial Statements (Annex 1C). One of the issues mentioned in the auditors' report on the 2010 Financial Statements was that the Group did not recognize any deferred tax liabilities at the dates of the 2008 and 2009 Acquisitions in the 2008 and 2009 Financial Statements. An extract from this auditors' report is reproduced in Section 2.

1.2 Financial information

1.2.1 Below is an extract of the financial information of the Group from the Relevant Financial Statements (Annexes 1A, 1B and 1C):

	2010 HK$ million	2009 HK$ million	2008 HK$ million
Gain on bargain purchase/excess of fair value of net assets acquired over the cost of acquisition of the oil exploitation business	-	259.9	849.6

(Loss)/profit for the year	(262.5)	10.7	601.3
Other intangible assets – Exploitation rights	2,043.4	2,044.5	1,756.6
Deferred tax liabilities	0.5	0.5	1.0
Minority/non-controlling interests	4.1	820.5	863.2
Net assets	2,632.1	2,290.2	2,079.7

1.3 Initiation of an enquiry

1.3.1 Based on the auditors' report on the 2010 Financial Statements (Section 2), it appears that there are potential non-compliances with paragraphs 19 and 66 of HKAS 12 in the Relevant Financial Statements, i.e. no deferred tax liabilities were recognized in respect of the Fair Value Gains.

1.3.2 In relation to the above, the Council sent written requests to both the Company and the 2008 and 2009 Joint Auditors on 13 September 2010 (Annexes 2A and 2B) to obtain information and explanations about the potential non-compliances identified.

1.3.3 In its letter dated 24 September 2010 (Annex 2C), the Company claimed that *"… For the preparation of the exploitation rights valuation, we understand that the present value was calculated by the net profit after tax. As a result, we think that the income tax element was considered in the valuation process …"*. It also advised that the 2008 and 2009 Joint Auditors did not raise this issue during their audits of the 2008 and 2009 Financial Statements.

1.3.4 On 13 September 2010, the Council requested explanations from the 2008 and 2009 Joint Auditors (Annex 2B). The 2008 and 2009 Joint Auditors explained in their letter dated 15 October 2010 (Annex 2D) that no deferred tax liabilities were recognized in the 2008 and 2009 Financial Statements because:

(a) Fair value gains on the oil exploitation rights were recorded at group level for consolidation purposes. The gains on transfer of the oil exploitation rights would not be subjected to PRC enterprise income tax;

(b) The tax bases of the oil exploitation rights did not change; and

(c) The transaction would not give rise to any actual tax payment.

1.3.5 However, in the same letter, the 2008 and 2009 Joint Auditors stated that after reconsidering their views and with hindsight, it would be more appropriate to recognize deferred tax liabilities on the Fair Value Gains in accordance with HKAS

12. They also stated that the 2010 Joint Auditors would follow up on this issue with the Group and make prior year adjustments if appropriate.

1.3.6 Given the departure from HKAS 12, there are potential under/overstatements of deferred tax liabilities, minority interests and profit for the years ended 31 March 2008 and 2009. Assuming that deferred tax liabilities were not included in the valuation of the exploitation rights and a PRC enterprise income tax rate of 25% (effective 1 January 2008) is applicable, the potential under/overstatements are as follows:

	2008 Acquisition	2009 Acquisition
	HK$ million	HK$ million
Understatement:		
Deferred tax liabilities	441.0[1] (21.2% of net assets)	97.5[2] (4.3% of net assets)
Overstatement:		
Minority/non-controlling interests	216.1[3] (10.4% of net assets)	Not applicable[4]
Gain on bargain purchase/excess of fair value of net assets acquired over the cost of acquisition of the oil exploitation business (credit to profit)	224.9 (37.4% of profit for the year)	97.5 (911.2% of profit for the year)

[1] Calculated based on 25% of the fair value gain of HK$1,764 million on the exploitation rights arising from the 2008 Acquisition.

[2] Calculated based on 25% of the fair value gain of HK$390 million on the exploitation rights arising from the 2009 Acquisition.

[3] The Group holds 51% of the subsidiary acquired in the 2008 Acquisition and HK$216.1 million represents 49% interest attributable to minority/non-controlling interests.

[4] The Group acquired 100% of the vendor's rights and responsibilities in the Fu 718 Project during the 2009 Acquisition.

1.3.7 The above-mentioned potential under/overstatements would have material consequential effects on subsequent financial statements.

1.3.8 On 19 November 2010, having considered the information provided by the Company, the 2008 and 2009 Joint Auditors and the information available to the public, the Council resolved to appoint a FRRC to conduct an enquiry into the question whether or not there is a relevant non-compliance in relation to the Relevant Financial Statements.

1.3.9 The potential non-compliance is in relation to the non-recognition of deferred tax liabilities in respect of the Fair Value Gains and its subsequent financial impact on the 2010 Financial Statements.

1.4 Opportunity of being heard

1.4.1 The Draft Enquiry Report was sent to the Company on 15 June 2011 for comment. The comments of the Company were received on 30 June 2011 and were incorporated in Section 8 of this report.

Section 2 Extract from the modified auditors' report

2.1 The 2010 Joint Auditors expressed a disclaimer of opinion on the 2010 Financial Statements (Annex 1C).

An extract from the auditors' report on the 2010 Financial Statements is reproduced below:

*"**BASIS FOR DISCLAIMER OF OPINION***

Included in the consolidated statement of financial position as at 31 March 2010 are other intangible assets with a combined carrying value of HK$2,043,397,000 (2009: HK$2,044,541,000) in relation to two exploitation rights for oil exploitation in the People's Republic of China. As detailed in note 21 to the consolidated financial statements, the directors of the Company appointed an independent valuer to perform a valuation for each of the oil exploitation rights to estimate their recoverable amounts for impairment assessment purposes as at 31 March 2010 and 2009. The valuer estimated the combined value of the exploitation rights as at 31 March 2010 and 2009 to be RMB2,264,000,000 (equivalent to HK$2,575,010,000) and RMB1,874,000,000 (equivalent to HK$2,124,643,000) respectively, using discounted cash flow analysis. The valuer's reports were based on information about the proven reserves extracted from technical reports and assumptions as to the Group's ability to exploit the crude oil. These oil exploitation rights were originally recognised on acquisition at fair values of RMB1,591,000,000 (equivalent to HK$1,763,975,000) and RMB341,000,000 (equivalent to HK$389,924,000), using equivalent valuation methodology, resulting in the recognition of excess of fair value of net assets acquired over the cost of acquisition of a subsidiary/gains from a bargain purchase of HK$849,627,000 and HK$259,924,000 during the years ended 31 March 2008 and 2009 respectively.

… the Group has not recognised any deferred tax liabilities as at the dates of acquisition of the oil exploitation rights arising from the business combinations in accordance with Hong Kong Accounting Standard 12 "Income Taxes" issued by the HKICPA. It is not practicable for us to quantify the effects of the departure from this requirement in respect of (i) the carrying values of the deferred tax liabilities as at 31 March 2010 and 2009; (ii) the corresponding deferred tax credit recognised during the years then ended; and (iii) the Other Reserve as at 31 March 2010.

Any adjustments found to be necessary in respect of the above matters would affect the Group's net assets as at 31 March 2010 and 2009 and 1 April 2008, and the Group's loss/profit for the years ended 31 March 2010 and 2009."

Section 3 Appointment of the FRRC

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) Prof. LAU Hing-ling, Amy (Chairman)
(b) Ms. CHAN Mei-bo, Mabel
(c) Mrs. Ayesha M. LAU
(d) Mr. LEUNG Chi-kwan, Andrew, J.P.
(e) Ms. Josephine PRICE

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 recognition of deferred tax liabilities, in respect of fair value adjustments on intangible assets arising from business combinations during the years ended 31 March 2008 and 2009, 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

4.1 The first FRRC meeting was held on 10 January 2011 to provide background information of the case to the members of the FRRC. A requirement was issued to the Company on 11 January 2011 (Annex 3A) under section 43(1) of the FRC Ordinance. On 1 February 2011, the Company wrote to the FRRC and provided the FRRC with additional information and explanation.

4.2 The FRRC reviewed the reply from the Company and considered the findings of the enquiry and the recommendation to be made to the Council by circulation of papers. The FRRC approved the Draft Enquiry Report on 13 May 2011.

4.3 The Draft Enquiry Report was sent to the Company on 15 June 2011 for its comment. The comments received from the Company on 30 June 2011 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 16 August 2011.

4.5 The conclusion is in Section 7 of this report.

Section 5 Relevant accounting requirements

5.1 The HKFRSs relevant to the possible relevant non-compliances are HKAS 1 and HKAS 12. HK(SIC)-INT-21 elaborates on the interpretation of paragraph 51 of HKAS 12.

5.2 HKAS 1 – Presentation of Financial Statements

5.2.1 Paragraph 32 of HKAS 1 states that, *"Assets and liabilities … shall not be offset unless required … or permitted by a Standard or an Interpretation"*.

5.2.2 Paragraph 33 of HKAS 1 further states that "… *Offsetting in the income statement or the balance sheet, except when offsetting reflects the substance of the transaction or other event, detracts from the ability of users both to understand the transactions, other events and conditions that have occurred and to assess the entity's future cash flows…"*

5.3 HKAS 12 – Income Taxes

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

5.3.2 Paragraph 51 of HKAS 12 states that "*The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from <u>the manner in which the entity expects</u>, at the balance sheet date, to recover or settle the carrying amount of its assets and liabilities.*" (underline added)

5.3.3 Paragraph 66 of HKAS 12 further states that *"As explained in paragraphs 19 and 26(c), temporary differences may arise in a business combination. In accordance with HKFRS 3, an entity recognises any resulting deferred tax assets (to the extent that they meet the recognition criteria in paragraph 24) or deferred tax liabilities as identifiable assets and liabilities at the acquisition date. Consequently, those deferred tax assets and deferred tax liabilities affect goodwill or the amount of any excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination. However, in accordance with paragraph 15(a), an entity does not recognise deferred tax liabilities arising from the initial recognition of goodwill."*

5.4 HK(SIC)-INT-21 – Income Taxes – Recovery of Revalued Non-Depreciable Assets

5.4.1 Paragraph 6 of HK(SIC)-INT-21 states that *"… Recognition of depreciation implies that the carrying amount of a depreciable asset is expected to be recovered through use to the extent of its depreciable amount, and through sale at its residual value…"*

Section 6 Findings

6.1 Validity of previously provided information

6.1.1 On 11 January 2011, the Company was requested to confirm whether or not the information and explanation provided in its letter dated 24 September 2010 was valid for the purpose of the enquiry (Annex 3A).

6.1.2 In its letter of 1 February 2011 (Annex 3B), the Company confirmed that the information and explanation provided in its letter dated 24 September 2010 was valid for the purpose of the enquiry.

6.2 Intention of the 2008 and 2009 Acquisitions

6.2.1 The 2008 and 2009 Joint Auditors claimed that the gains on transfer of the oil exploitation rights had no actual PRC tax implication (Paragraph 1.3.4). However, they considered with hindsight that it would be more appropriate to recognize deferred tax liabilities on the Fair Value Gains in accordance with HKAS 12 (Paragraph 1.3.5).

6.2.2 According to the circulars dated 16 February 2007 (Annex 1D) and 22 January 2008 (Annex 1E) issued by the Company, the Company intended to operate and develop the oil exploitation business arising from the 2008 and 2009 Acquisitions.

6.2.3 The management intention of utilizing the oil exploitation rights was further demonstrated in the Company's accounting policy on exploitation rights. According to the accounting policy in the 2008 and 2009 Financial Statements, *"Exploitation rights are stated at cost less accumulated amortisation and impairment losses. Exploitation rights are amortised on a straight-line basis over the estimated useful lives of 20 years…"*

6.2.4 By stating the exploitation rights at cost less accumulated amortization and impairment, the Company implied that the exploitation rights are to be recovered through use according to HK(SIC) -INT-21 (Paragraph 5.4.1).

6.2.5 Based on the above, it appears that deferred tax liabilities relating to the Fair Value Gains should be measured at tax rates applicable to the profit generated from the oil exploitation businesses in accordance with paragraph 51 of HKAS 12.

6.3 Recognition of deferred tax liabilities

6.3.1 On 11 January 2011, the Company was requested to quantify the deferred tax liabilities in respect of the Fair Value Gains and the consequential impact on the Relevant Financial Statements, and to provide details of the calculation for each relevant year (Annex 3A).

6.3.2 In its letter of 1 February 2011 (Annex 3B), the Company replied that *"… the income tax element had been considered in the exploitation rights valuation. As in our* *interim result announcement dated on 28 November, 2011* [2010]*, the Company has engaged APEX Reservoir Service, Inc., an international independent valuer, to conduct a valuation for the exploitation right and the Joint Auditors will perform the special review on the intangible assets. In order to quantify the deferred tax liabilities, a qualified valuation is required. We will report and quantify the defer tax liabilities once the valuation is completed …"*

6.3.3 The Company appears to be of the view that if the income tax element had been considered in the valuation, i.e. reflected in the fair value of the exploitation rights, no deferred tax liabilities have to be separately recognized in accordance with HKAS 12.

Section 7 Conclusion

7.1 Based on the results of the enquiry, the FRRC concludes that there are relevant non-compliances in the Relevant Financial Statements.

7.2 The 2010 Joint Auditors disclaimed an opinion on the 2010 Financial Statements in respect of the non-recognition of deferred tax liabilities at the dates of the 2008 and 2009 Acquisitions.

7.3 The 2008 and 2009 Joint Auditors claimed that the gains on transfer of the oil exploitation rights had no actual PRC tax implication. However, according to paragraph 51 of HKAS 12, the measurement of deferred tax should be based on the manner in which the Company expects to recover or settle the carrying amount of the oil exploitation rights. According to the relevant circulars issued by the Company and the Company's accounting policy for the exploitation rights, it is apparent that the Company intends to operate and develop the oil exploitation businesses. Therefore, deferred tax liabilities on the Fair Value Gains should be determined at the income tax rates applicable to the profit generated from the oil exploitation businesses.

7.4 The Company claimed that the income tax element had been considered in the valuation of the exploitation rights arising from the 2008 and 2009 Acquisitions. However, according to paragraph 66 of HKAS 12, deferred tax liabilities should have been separately recognized. Furthermore, paragraphs 32 and 33 of HKAS 1 prohibit the offsetting of deferred tax liabilities against the carrying amount of the exploitation rights.

7.5 The FRRC concludes that there are non-compliances with HKAS 1 and HKAS 12 in relation to the non-recognition of deferred tax liabilities in respect of the Fair Value Gains in the 2008 and 2009 Financial Statements and its subsequent financial impact on the 2010 Financial Statements.

Section 8 Comments from the Company

8.1 The Draft Enquiry Report was sent to the Company for comment on 15 June 2011 (Annex 4A). A reply was received on 30 June 2011 (Annex 4B).

8.2 In its reply of 30 June 2011, the Company confirmed that it had no comment on the conclusion of the Draft Enquiry Report and agreed with the FRRC's findings that deferred tax liabilities should have been separately recognized in accordance with HKAS 12. However, the Company mentioned in the same letter that a prior period adjustment would be made in the consolidated financial statements of the Group for the year ended 31 March 2011 to reverse the Fair Value Gains, and consequently no deferred tax liabilities would have to be recognized.