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# CGS

## CHINA GROUND SOURCE ENERGY LIMITED

### 中國地能有限公司

*(Incorporated in the Cayman Islands with limited liability)*

(Stock Code: 8128)

#### UNCERTAINTIES REGARDING SHAREHOLDING IN THE COMPANY'S SUBSIDIARY AND RELATIONSHIP BETWEEN THE GROUP AND ANOTHER COMPANY

Reference is made to the two announcements issued by the Company on 23 December 2009 and 13 January 2010.

The Independent Investigator appointed by the Company has finished its investigation with respect to (i) the equity interest of the Group in Shengxin for the period from 1 December 2005 to 30 September 2007; and (ii) the relationship between the Group and Hunan Hengxing. The Independent Investigator issued the Investigation Report on 12 February 2010.

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#### THE GROUP'S EQUITY INTEREST IN SHENGXIN

Based on two independent company searches conducted by two business information companies, two legal opinions respectively issued by two independent PRC lawyers, the relevant documents provided by the Company and enquires made by the Independent Investigator with the relevant offices and staffs of the Company, the Independent Investigator has the following findings:

1. There was an effective capital injection of RMB8,000,000 by Wujiang Xincheng in Shengxin in December 2005, pursuant to which Shengxin's registered and paid-up capital was increased from RMB14,350,000 (contributed as to RMB7,318,500 (51%) by the Group and RMB7,031,500 (49%) by Wujiang Xincheng) to RMB22,350,000 (contributed as to RMB7,318,500 (approximately 32.74%) by the Group and RMB15,031,500 (approximately 67.26%) by Wujiang Xincheng). Thus, the Group's equity interest in Shengxin was diluted from 51% to approximately 32.74% in December 2005;

2. Wujiang Xincheng and Future Frontier have issued a representation letter dated 20 December 2006 to the Department of Foreign Trade and Economic Cooperation of Wu Jiang City (the “Department”) to declare that the capital injection in December 2005 was improper and the percentage of equity interest in Shengxin held by Future Frontier should be reinstated;
3. On 20 December 2006, Shengxin applied to the Department to reinstate the percentage of equity interest held by Future Frontier on the ground that the capital injection took place in December 2005 was improper. The Department rejected such application as the capital injection took place in December 2005 did not violate any laws and regulations in the PRC;
4. In September 2007, it was agreed between Future Frontier and Wujiang Xincheng that equity interest in Shengxin held by Future Frontier should be reinstated to 51% by the transfer of 18.26% equity interest in Shengxin from Wujiang Xincheng to Future Frontier. Such transfer was successfully completed in September 2007 and the Group’s equity interest in Shengxin has been increased from approximately 32.74% to 51%;
5. Although the Group’s equity interest in Shengxin was diluted from 51% to approximately 32.74% from December 2005 to September 2007, Future Frontier still retained effective control in Shengxin by controlling over 50% of the voting rights of Shengxin’s board of directors during such period of time (which has been confirmed in writing by Wujiang Xincheng and two of the directors of Shengxin nominated by it). Therefore, Shengxin was still a subsidiary of the Company from December 2005 to September 2007 but there was a change in percentage of ownership during such period.

As a result, the Independent Investigator concluded that Shengxin was controlled by the Company from December 2005 to September 2007 and should be regarded as a subsidiary and the results of Shengxin should be consolidated into the Group’s consolidated financial statements for the two years ended 30 September 2006 and 2007 in which the Group’s equity interest in Shengxin was approximately 32.74%.

## **POSSIBLE FINANCIAL IMPACT TO THE GROUP IN RELATION TO THE DILUTION**

The Independent Investigator has assessed the possible financial impact to the Group’s consolidated income statements and consolidated balance sheets for the two years ended 30 September 2006 and 2007 with the assumption that the Group’s equity interest in Shengxin has been diluted from 51% to approximately 32.74% effective from 13 December 2005 to 20 September 2007 (the “Dilution”).

The following unaudited pro forma consolidated income statements and balance sheets are prepared by the Independent Investigator to provide information on the Group as a result of the Dilution. As it is prepared for illustration purposes only, it does not purport to represent what the financial position of the Group will be as a result of the Dilution.

**Consolidated income statement for the year ended 30 September 2006**

	<b>Audited consolidated income statement for the year ended 30 September 2006 HK\$'000</b>	<b>Adjustment for minority interest's share of profit of additional 18.26% HK\$'000 (Note a)</b>	<b>Unaudited pro forma consolidated income statement for the year ended 30 September 2006 HK\$'000</b>
Revenue	71,013		71,013
Cost of sales	<u>(61,262)</u>		<u>(61,262)</u>
Gross profit	9,751		9,751
Other income	4,795		4,795
Selling and distribution costs	(3,822)		(3,822)
Administrative expenses	(13,624)		(13,624)
Other operating expenses	<u>(7,877)</u>		<u>(7,877)</u>
Loss from operating activities	(10,777)		(10,777)
Finance costs	<u>(2,455)</u>		<u>(2,455)</u>
Loss before income tax	(13,232)		(13,232)
Income tax expense	<u>(1,056)</u>		<u>(1,056)</u>
Loss for the year	<u><u>(14,288)</u></u>		<u><u>(14,288)</u></u>
Attributable to:			
Equity holders of the Company	(16,204)	(613)	(16,817)
Minority interest	<u>1,916</u>	613	<u>2,529</u>
Loss for the year	<u><u>(14,288)</u></u>		<u><u>(14,288)</u></u>

Consolidated balance sheet as at 30 September 2006

	Audited consolidated balance sheet as at 30 September 2006 <i>HK\$'000</i>	Gain on deemed disposal of 18.26% equity interest in Shengxin <i>HK\$'000</i> <i>(Note b)</i>	Adjustment for minority interest's share of reserve movement in the current year <i>HK\$'000</i> <i>(Note c)</i>	Unaudited pro forma consolidated balance sheet as at 30 September 2006 <i>HK\$'000</i>
<b>Non-current assets</b>				
Property, plant and equipment	12,781			12,781
Prepaid lease payments	3,371			3,371
Rental deposits and golf club membership	379			379
	<u>16,531</u>			<u>16,531</u>
<b>Current assets</b>				
Inventories	5,578			5,578
Trade and retention receivables	32,103			32,103
Prepayments, trade deposits, other deposits and other receivables	2,719			2,719
Pledged deposits	59			59
Cash and cash equivalents	3,458			3,458
	<u>43,917</u>			<u>43,917</u>
<b>Current liabilities</b>				
Trade and bills payables	17,929			17,929
Accrued liabilities, deposits received and other payables	20,768			20,768
Borrowings	27,522			27,522
Due to directors	1,394			1,394
Tax payable	4,565			4,565
	<u>72,178</u>			<u>72,178</u>
<b>Net current liabilities</b>	<u>(28,261)</u>			<u>(28,261)</u>
<b>Net liabilities</b>	<u>(11,730)</u>			<u>(11,730)</u>
<b>Capital and reserves</b>				
Issued share capital	126,989			126,989
Reserves	(148,914)	830	(724)	(148,808)
Attributable to equity holders of the Company	(21,925)			(21,819)
Minority interests	10,195	(830)	724	10,089
	<u>(11,730)</u>			<u>(11,730)</u>

The Company re-gained 18.26% equity interest in Shengxin on 20 September 2007. It is assumed that the Company owned 32.74% equity interest in Shengxin for the whole year ended 30 September 2007.

**Consolidated income statement for the year ended 30 September 2007**

	<b>Audited consolidated income statement for the year ended 30 September 2007 HK\$'000</b>	<b>Adjustment for minority interest's share of profit of additional 18.26% HK\$'000 (Note a)</b>	<b>Unaudited pro forma consolidated income statement for the year ended 30 September 2007 HK\$'000</b>
Revenue	106,369		106,369
Cost of sales	<u>(94,293)</u>		<u>(94,293)</u>
Gross profit	12,076		12,076
Other income	21,815		21,815
Selling and distribution costs	(4,441)		(4,441)
Administrative expenses	(14,308)		(14,308)
Other operating expenses	<u>(8,032)</u>		<u>(8,032)</u>
Profit from operating activities	7,110		7,110
Finance costs	<u>(2,690)</u>		<u>(2,690)</u>
Loss before income tax	4,420		4,420
Income tax expense	<u>(1,153)</u>		<u>(1,153)</u>
Loss for the year	<u><u>3,267</u></u>		<u><u>3,267</u></u>
Attributable to:			
Equity holders of the Company	2,594	(251)	2,343
Minority interest	<u>673</u>	251	<u>924</u>
Loss for the year	<u><u>3,267</u></u>		<u><u>3,267</u></u>

The Company re-gained 18.26% equity interest in Shengxin on 20 September 2007. It is assumed that the Company owned 32.74% equity interest in Shengxin for the whole year ended 30 September 2007 and the acquisition of 18.26% equity interest in Shengxin has been completed on 30 September 2007.

### Consolidated balance sheet as at 30 September 2007

	Audited consolidated balance sheet as at 30 September 2007 <i>HK\$'000</i>	Cumulative effect brought forward from 30 September 2006 <i>HK\$'000</i> <i>(Note d)</i>	Adjustment for minority interest's share of reserve movement in the current year <i>HK\$'000</i> <i>(Note c)</i>	Sub-total <i>HK\$'000</i>	Adjustment for the acquisition of 18.26% equity interest in a subsidiary <i>HK\$'000</i> <i>(Note e)</i>	Unaudited pro forma consolidated balance sheet as at 30 September 2007 <i>HK\$'000</i>
<b>Non-current assets</b>						
Property, plant and equipment	17,373			17,373		17,373
Prepaid lease payments	3,498			3,498		3,498
Goodwill	1,269			1,269		1,269
	<u>22,140</u>			<u>22,140</u>		<u>22,140</u>
<b>Current assets</b>						
Inventories	4,776			4,776		4,776
Financial assets at fair value through profit or loss	38,500			38,500		38,500
Trade receivables	36,910			36,910		36,910
Prepayments, deposits and other receivables	33,940			33,940		33,940
Pledged deposits	790			790		790
Cash and cash equivalents	91,400			91,400		91,400
	<u>206,316</u>			<u>206,316</u>		<u>206,316</u>
<b>Current liabilities</b>						
Trade and bills payables	13,039			13,039		13,039
Accrued liabilities, deposits received and other payables	31,183			31,183		31,183
Borrowings	31,793			31,793		31,793
Due to directors	334			334		334
Tax payable	5,214			5,214		5,214
	<u>81,563</u>			<u>81,563</u>		<u>81,563</u>
<b>Net current assets</b>	<u>124,753</u>			<u>124,753</u>		<u>124,753</u>
<b>Net liabilities</b>	<u>146,893</u>			<u>146,893</u>		<u>146,893</u>
<b>Capital and reserves</b>						
Issued share capital	230,667			230,667		230,667
Reserves	(99,899)	106	(556)	(100,349)	450	(99,899)
Attributable to equity holders of the Company	130,768			130,318		129,754
Minority interests	16,125	(106)	556	16,575	(450)	16,125
	<u>146,893</u>			<u>146,893</u>		<u>146,893</u>

There would not be any material financial impact to the Group's consolidated financial statements for the year ended 30 September 2008 and 2009.

*Notes:*

- a. The adjustments represent the additional share of 18.26% of profits of Shengxin by Wujiang Xincheng. Profits of Shengxin for the years ended 30 September 2006 and 2007 are extracted from the Group's consolidation spreadsheet for the years ended 30 September 2006 and 2007 respectively.
- b. The adjustment represents the gain on deemed disposal from dilution of the Group's equity interest in Shengxin from 51% to 32.74%. The gain would be recognised directly in equity as per the Group's accounting policy. The amount is calculated based on the unaudited balance sheet of Shengxin as at 31 December 2005 before the capital injection of RMB8,000,000 (equivalent to HK\$7,477,000) by Wujiang Xincheng. Details calculation is stated as below:

*HK\$'000*

Net assets value as per unaudited balance sheet of Shengxin as at 31 December 2005	8,860
Amount of capital injection	7,477
Net assets value of Shengxin after capital injection	16,337
Share of net assets of Shengxin by Future Frontier before capital injection	4,519
Share of net assets of Shengxin by Future Frontier after capital injection	5,349
Gain on deemed disposal of partial interest in a subsidiary	830

- c. The adjustments represent the additional share of 18.26% of the changes in reserves of Shengxin by Wujiang Xincheng. The amounts are difference from the amount of additional share of 18.26% of profits of Shengxin by Wujiang Xincheng because buildings of Shengxin are measured at revaluated amounts and there were revaluation surpluses for both years ended 30 September 2006 and 2007. The reserves movement for the years ended 30 September 2006 and 2007 are extracted from the Group's consolidation spreadsheet for the years ended 30 September 2006 and 2007 respectively.
- d. The adjustment represents the accumulated effect of pro forma adjustments proposed for the year ended 30 September 2006.
- e. The adjustment represents the gain on acquisition of 18.26% equity interest in Shengxin by Future Froniter. Future Frontier's equity interest in Shengxin would be changed from 32.74% back to 51% after the acquisition. Future Frontier acquired 18.26% equity interest in Shengxin at HK\$4,080,000.

## RELATIONSHIP BETWEEN THE GROUP AND HUNAN HENGXING

In the process of the audit of the consolidated financial statements of the Group for the year ended 30 September 2009, a document, namely 湖南衡興環保科技開發有限公司股權轉讓合同 (Agreement for transfer of equity interest in Hunan Hengxing Environmental Technology Development Company Limited) was discovered by the Company's auditors, which shows that Shenzhen Lisai, a wholly-owned subsidiary of the Company, may have a relationship with Hunan Hengxing. Such document had never appeared in the pervious years of audit performed by the Company's auditors.

Based on two independent company searches conducted by two business information companies, the relevant documents provided by the Company and copies of the documents provided by China Standard Limited to the Company when the due diligence work was performed by the Company for its acquisition of Lisai Gardens and Lidesui as disclosed in the Circular, the Independent Investigator has the following findings:

1. Hunan Hengxing is a limited company established in the PRC on 23 February 2006 with a registered capital of RMB17,000,000, of which 70% was contributed by Shenzhen Lisai, 25% by a company called 衡陽市吉興垃圾綜合處理有限公司 and 5% by 深圳市危險廢物處理站;
2. Hunan Hengxing was established for the purpose of setting up an integrated dangerous waste centralized processing centre (the "Processing Centre") to process the medical and dangerous waste of the south Hunan province area. Construction of the Processing Centre was commenced in 2009 and is still under construction. Hunan Hengxing has not commenced its operation and no statutory audited accounts were prepared;
3. Pursuant to the 湖南衡興環保科技開發有限公司股權轉讓合同 (Agreement for transfer of equity interest in Hunan Hengxing Environmental Technology Development Company Limited) dated 18 May 2009 signed between Shenzhen Lisai, 北京北控環保工程技術有限公司 (Beijing Bei Kong Environmental Engineering Technology Company Limited) ("Beijing Bei Kong") and 山西環基環保科技開發有限公司 ("Shanxi Huan Ji Environmental Technology Development Company Limited) ("Shanxi Huan Ji"), Shenzhen Lisai had to acquire the remaining 30% equity interest in Hunan Hengxing and then disposed of the entire equity interest in Hunan Hengxing to Beijing Bei Kong and Shanxi Huan Ji as of 65% and 35% respectively;
4. On 29 June 2009, Shenzhen Lisai acquired the remaining 30% equity interest in Hunan Hengxing, and therefore 100% equity interest in Hunan Hengxing was owned by Shenzhen Lisai;
5. The disposal of Hunan Hengxing by Shenzhen Lisai was completed on 27 August 2009.



From the above findings, the Independent Investigator concluded that Hunan Hengxing was a subsidiary of Shenzhen Lisai from 23 February 2006 to 26 August 2009.

From the documents available to the Independent Investigator, there was no disclosure about the existence of Hunan Hengxing in (i) the documents provided by China Standard Limited to the Company when the due diligence work was performed by the Company for its acquisition of Lisai Gardens and Lidesui; (ii) the Circular; (iii) the local statutory accounts of Shenzhen Lisai for the two years ended 31 December 2007 and 2008; and (iv) the audited consolidated financial statements of the Group for the two years ended 30 September 2008 and 2009 contained in the 2007/2008 and 2008/2009 annual reports of the Company.

The Independent Investigator is of the view that the registered capital of RMB11,900,000 of Hunan Hengxing as at 23 February 2006 attributable to Shenzhen Lisai should have been recorded as investment cost/prepayment in the financial statements of Shenzhen Lisai according to the applicable accounting standards in both Hong Kong and the PRC. However, based on the Independent Investigator's findings, Shenzhen Lisai did not record such capital contribution to Hunan Hengxing in its financial statements that had been disclosed to the Company. While the registered capital of Shenzhen Lisai was RMB12,000,000 as at 31 December 2007 and increased to RMB30,000,000 as at 31 December 2008, the amount of equity interest of Hunan Hengxing attributable to Shenzhen Lisai was material to all the readers/users of the financial statements of Shenzhen Lisai. Therefore, the Independent Investigator concluded that such failure to properly record or non-disclosure of such material amount indicated a material weakness in the financial statements of Shenzhen Lisai provided by China Standard Limited in the Company's acquisition of Lidesui and Lisai Gardens.

#### **POSSIBLE FINANCIAL IMPACT TO THE GROUP IN RELATION TO HUNAN HENGXING**

The Independent Investigator opines that if Hunan Hengxing had been properly accounted for as a subsidiary of the Group since its acquisition, there might have been significant impact in the following accounts:

1. Property, plant and equipment;
2. Prepayments, deposits and other receivables;
3. Cash and cash equivalents;
4. Trade and bills payables;
5. Accrued liabilities, deposits received and other payables;
6. Goodwill;
7. Minority interests;
8. Administrative expenses; and
9. Financial costs.

However, since there are no management accounts of Hunan Hengxing available to the Independent Investigator, no unaudited pro forma financial information can be provided by the Independent Investigator.

## **ACTIONS TO BE TAKEN BY THE COMPANY**

In view of the findings in the Investigation Report, the Company has decided to:

1. cancel the Convertible Notes, so that the Convertible Notes shall be considered as null and void and have no further legal effect; and
2. subject to further legal advice, commence legal proceedings to claim all loss and damage suffered by the Company against China Standard Limited for its material non-disclosure of the fact that Shenzhen Lisai owned Hunan Hengxing (which should amount to misrepresentation) when the Company acquired Lidesui and Lisai Gardens.

## **DEFINITIONS**

Unless the context requires otherwise, the following expressions shall have the following meanings in this announcement:

“Board”	the board of Directors
“Circular”	the circular dated 3 October 2007 issued by the Company in relation to its acquisition of Lidesui and Lisai Gardens, which together held 100% equity interest in Shenzhen Lisai
“Company”	China Ground Source Energy Limited, a company incorporated in the Cayman Islands with limited liability, the issued Shares of which are listed on GEM
“Convertible Notes”	the zero coupon convertible notes issued by the Company to China Standard Limited in the aggregate principal amount of HK\$160,000,000, in satisfaction of part of the consideration for the Company’s acquisition of Lidesui and Lisai Gardens
“Director(s)”	director(s) of the Company
“Future Frontier”	Futures Frontier Limited, a company incorporated with limited liability in the British Virgin Islands, which was a wholly-owned subsidiary of the Company
“GEM”	the Growth Enterprise Market of the Stock Exchange
“GEM Listing Rules”	the rules governing the listing of securities on GEM
“Group”	the Company and its subsidiaries

“Hunan Hengxing”	湖南衡興環保科技開發有限公司 (Hunan Hengxing Environmental Technology Development Company Limited), a company established under the laws of the PRC
“Independent Investigator”	SHINEWING Risk Services Limited, an independent investigator appointed by the Company
“Investigation Report”	the investigation report dated 12 February 2010 issued by the Independent Investigator
“Lidesui”	深圳市利得迅環保技術有限公司 (Shenzhen Lidesui Huanbao Jishu Company Limited)
“Lisai Gardens”	深圳市利賽園林綠化有限公司 (Shenzhen Lisai Gardens Luhua Company Limited)
“PRC”	the People’s Republic of China
“Share(s)”	Share(s) of the Company
“Shareholder(s)”	holder(s) of Shares
“Shengxin”	吳江市勝信光電科技有限公司 (Wujiang Shengxin Optoelectronics Technology Co., Ltd.), a company established under the laws of the PRC
“Shenzhen Lisai”	深圳市利賽實業發展有限公司 (Shenzhen City Li Sai Industrial Development Company Limited), a company established under the laws of the PRC which is a wholly-owned subsidiary of the Company
“Stock Exchange”	The Stock Exchange of Hong Kong Limited
“Wujiang Xincheng”	吳江市信誠光電纜廠 (Wujiang City Xincheng Optoelectronics Cable Factory), a company established under the laws of the PRC and which was one of the two equity owners of Shengxin

By order of the Board  
**China Ground Source Energy Limited**  
**Chan Wai Kay, Katherine**  
*Chairman*

Hong Kong, 19 February 2010

*As at the date of this announcement, the Board comprises Ms. Chan Wai Kay, Katherine, Mr. Xu Shengheng, Mr. Wu Shu Min and Mr. Jeffrey Soo Kim Fui as executive Directors, Mr. Fu Hui Zhong as non-executive Director, Ms. Laura Chan Man Kuen, Mr. Jia Wenzeng and Mr. Paul Chow Wan Hoi as independent non-executive Directors.*

*This announcement, for which the Directors collectively and individually accept full responsibility, includes particulars given in compliance with the Rules Governing the Listing of Securities on the Growth Enterprise Market of the Stock Exchange of Hong Kong Limited for the purpose of giving information with regard to the Company. The Directors, having made all reasonable enquiries, confirm that, to the best of their knowledge and belief: (1) the information contained in this announcement is accurate and complete in all material respects and not misleading; (2) there are no other matters the omission of which would make any statement in this announcement misleading; and (3) all opinions expressed in this announcement have been arrived at after due and careful consideration and are founded on bases and assumptions that are fair and reasonable.*

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