Accounts Receivable

Under Hong Kong GAAP and U.S. GAAP, provision is made against accounts receivable to the extent they are considered to be doubtful. This provision requires judgment regarding the collectibility of certain receivables both as they are incurred and as they age. Certain receivables may be initially identified as collectible, yet subsequently become uncollectible and result in a subsequent write-off of the related receivable to the statement of operations. Changes in the collectibility of accounts receivable for which provisions are not made could significantly change the calculation of such provision and the results of our operations.

Deferred Taxation

Hong Kong GAAP. Deferred taxation is accounted for at the current taxation rate with respect to timing differences between profit as computed for taxation purposes and profit as stated in the accounts to the extent that a liability or an asset is expected to be payable or recoverable in the foreseeable future. In determining whether a liability or asset is expected to be payable or recoverable in the foreseeable future, we assess the effect of our capital expenditures and other plans, such as the existing network capacity, technological changes, future market trends and projected fixed network coverage.

U.S. GAAP. We are required to recognize deferred tax assets and liabilities for the expected future tax consequences of all events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the temporary differences between the financial reporting basis and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Future tax benefits in respect of tax loss carry forwards are also required to be recognized in full. We must establish a valuation allowance for such assets if we determine it is more likely than not that we will not be able to utilize such benefits in the future.

The recording of certain deferred tax assets requires judgment regarding the results of future operations, including the assumption that there will be sufficient future operations to allow us to utilize the related deferred tax asset. Any changes in the estimate of future operations could change the recognition of such assets, which could significantly affect the results of our operations.

Carrying value of investment and goodwill

We assess the carrying value of our investments in subsidiaries, including acquired goodwill, for impairment at least bi-annually based on their recoverable amount. Our assessments generally include methodology of discounted cash flow analysis, and review of comparable entities. This methodology sometimes relies on factors such as forecasts of future performance and long-term growth rates of the investee, and selection of discount rate. If these forecasts and assumptions prove to be incorrect or circumstances change, we may be required to write down our investments.

Based on our most recent assessment of recoverable amount we believe that as at August 31, 2003 our goodwill is recoverable at the amounts at which they are stated in our financial statements.

Critical accounting estimate

Our management make their best estimates for charges of the USC payable to PCCW-HKT in order to fund the costs of network development incurred by PCCW-HKT in remote areas in Hong Kong (the “Development”). Such estimated costs are included as part of our costs of rendering services. The estimate is made based on the provisional rates announced by OFTA and is effective up to the date of the release of our financial statements. OFTA periodically reviews the actual costs incurred by PCCW-HKT in the Development and adjusts the amounts owed to PCCW-HKT, or to be refunded by it, to the respective USC contributing parties, including City Telecom (the “Rate Revisions”). Accordingly, the estimate made by our management is subject to changes based on the Rate Revisions identified during a financial year and up to the date prior to the release of our financial statements. We adjust such differences as an addition to, or reduction of, the corresponding costs of services in that particular reporting period.

Any sum received in advance from PCCW-HKT as an estimated refund of USC on a provisional basis, which is subject to the final confirmation and determination of OFTA, is recorded in other payables and accrued charges in our balance sheet.

U.S. GAAP Reconciliation

Our financial statements are prepared in accordance with Hong Kong GAAP, which differs in certain material respects from U.S. GAAP. The following tables provide a comparison of our net income and shareholders’ equity in accordance with Hong Kong GAAP and U.S. GAAP.

	Year ended August 31		
	2001	2002	2003
	HK$’000	HK$’000	HK$’000
Net income			
As stated under H.K. GAAP	53,927	91,129	257,822
U.S. GAAP adjustments:			
Compensation benefit cost associated with share options	(184)	(21,586)	2,731
Amortization of goodwill (acquired prior to June 30, 2001)	(1,019)	(1,019)	—
Reversal of amortization of goodwill (acquired after June 30, 2001)	—	1,065	1,065
Deferred tax on accelerated depreciation	1,242	(624)	(79)
Net income under U.S. GAAP	53,966	68,965	261,539
Profit from continuing operations (less taxation 2003: HK$17,778,000, 2002: HK$14,562,000, 2001: HK$18,770,000)	65,389	69,317	264,151
(Loss)/income from discontinued operations (less taxation 2003: HK$Nil, 2002: HK$4,000, 2001: HK$5,000)	(11,423)	(352)	83
Loss arising from disposal of discontinued operations	—	—	(2,695)
Net income under U.S. GAAP	53,966	68,965	261,539

	Year ended August 31		
	2001	2002	2003
Earnings/(loss) per share under U.S. GAAP			
Basic:			
Continuing operations	13.3 cents	14.0 cents	47.8 cents
Discontinued operations	(2.3) cents	(0.1) cents	(0.5) cents
Total	11.0 cents	13.9 cents	47.3 cents
Diluted:			
Continuing operations	13.2 cents	12.3 cents	42.9 cents
Discontinued operations	(2.3) cents	(0.1) cents	(0.4) cents
Total	10.9 cents	12.2 cents	42.5 cents

	Year ended August 31		
	2001	2002	2003
	HK$'000	HK$'000	HK$'000
Total shareholders' equity			
As stated under H.K. GAAP	805,306	910,183	1,184,449
U.S. GAAP adjustments:			
Goodwill	5,092	5,092	5,092
Accumulated amortization of goodwill	(2,716)	(3,735)	(3,735)
Reversal of amortization of goodwill	—	1,065	2,130
Deferred tax liabilities	(4,571)	(5,195)	(5,274)
Total shareholders' equity under U.S. GAAP	803,111	907,410	1,182,662

The principal reasons for the difference between net income as reported under Hong Kong GAAP and U.S. GAAP for the year ended August 31, 2003 is the recording of compensation cost of share options issued to employees in accordance with the requirements of U.S. GAAP, the capitalization and amortization of goodwill under U.S. GAAP, and the full provision of tax liabilities under U.S. GAAP.

Under Hong Kong GAAP, no compensation cost is required to be recognized in respect of the grant of stock options to employees and executive directors. Under U.S. GAAP, compensation expense is required to be measured either in accordance with the intrinsic value method prescribed by APB Opinion No. 25 and related interpretations or the fair value method prescribed by Statement of Financial Accounting Standards No. 123. We apply the intrinsic value method prescribed by APB Opinion No. 25 and related interpretations and disclose in our consolidated financial statements the pro forma effect that the adoption of the fair value method would have on our net income and earnings per share. Some of our options have been granted at an exercise price that is less than the market value on the date of grant. The Company also cancelled and reissued certain options granted during the year ended August 31, 2001. The reissued options are required to be accounted for in accordance with the requirements of Interpretation 44 of the Financial Accounting Standards Board (FIN 44) as variable options.

The compensation cost for stock options under U.S. GAAP represents the difference between the exercise price of the options and the Company's share price at the date on which they are exercised or at each balance sheet date if they are still outstanding. This amount is amortized over the vesting period of the options. The charge for compensation expense in the year ended August 31, 2003 primarily relates to the variable options.

Goodwill and accumulated amortization comprises goodwill arising on the acquisition in 1999 of the 963673 Ontario Limited group of companies. Under Hong Kong GAAP, such goodwill was previously charged against available reserves, whereas under U.S. GAAP, it was required to be recorded as an asset on the balance sheet and amortized over its estimated useful life of five years. In accordance with the change in accounting standards of Hong Kong GAAP, goodwill on acquisitions occurring on or after September 1, 2001 is now shown separately on the consolidated balance sheet and is amortized using the straight-line method over its estimated useful life. Goodwill arising on major strategic acquisitions of the Company to expand its product or geographical market coverage is amortized over a period of not more than 5 years. The Company has taken advantage of the transitional provisions of Hong Kong SSAP 30 and goodwill previously written off against reserves has not been restated. Where an indication of impairment exists, the carrying amount of goodwill, including goodwill previously written off against reserves, is assessed and written down immediately to its recoverable amount. Effective from fiscal 2003, goodwill under U.S. GAAP will no longer be amortized and is subject to annual impairment tests. We have performed the transitional goodwill impairment tests on the goodwill recorded prior to and after June 30, 2001, and no impairment loss was identified. We have also performed the impairment tests on the goodwill recorded prior to and after June 30, 2001 at the fiscal year end and no impairment loss was identified from the process for fiscal 2003.

Under Hong Kong GAAP, deferred taxation is accounted for at the current taxation rate with respect to timing differences between profit as computed for taxation purposes and profit as stated in the financial statements to the extent that a liability or an asset is expected to be payable or receivable in the foreseeable future. In determining whether a liability is expected to be payable in the foreseeable future, the Company assesses the effect of its capital expenditures and other plans. If these plans indicate that sufficient accelerated tax allowances will be available to offset the effect of the reversal of timing differences, a deferred tax liability is not established for such timing differences. In accordance with the requirements of Hong Kong GAAP, we have determined that on August 31, 2003, a provision was not required with respect to deferred tax liabilities amounting to HK$5.3 million. The corresponding amounts on August 31, 2002 and August 31, 2001 were HK$5.2 million and HK$4.6 million, respectively. Under U.S. GAAP, deferred taxation for such liabilities is required to be provided for in full.

New Effective Standards/Recent Accounting Pronouncements

The United States Financial Accounting Standards Board (“FASB”) has issued certain pronouncements which are effective or will be effective with respect to the fiscal years presented in the consolidated financial statements:

New effective standards

(a) In November 2002, the FASB issued FASB interpretation No. (“FIN”) 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others”. FIN 45 requires that an entity issuing a guarantee (including those embedded in a purchase or sales agreement) must recognize, at the inception of the guarantee, a liability equal to the fair value of the guarantee. The recording of this liability is not dependent on the probability that the payments will be required. The offset to the liability will depend on the circumstances under which the guarantee was issued, but could include: cash/accounts receivable if it is a standalone transaction, net proceeds in a sales transaction, or expense if no compensation is received. FIN 45 also requires detailed information to be disclosed about each guarantee or group of guarantees even if the likelihood of making a payment is remote. The recognition and measurement provisions of this interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements of this interpretation are effective for financial statements of periods ending after December 15, 2002.

We have evaluated the requirements of the above statement and believe that we have no transactions that should be disclosed or accounted for in accordance with this new standard.

(b) In December 2002, the FASB issued the Statement of Financial Accounting Standard (“SFAS”) No. 148 “Accounting for Stock-Based Compensation - Transition and Disclosure — an amendment of FAS 123”. SFAS 148 amends FASB Statement No. 123 “Accounting for Stock-based Compensation (“SFAS 123”) to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation. It also amends the disclosure provisions of SFAS 123 to require prominent disclosure about the effects on reported net income of an entity’s accounting policy decisions with respect to stock-based employee compensation. Finally, SFAS 148 amends APB Opinion No. 28 “Interim Financial Reporting” to require disclosure about those effects in interim financial information. SFAS 148 is effective for financial statements for fiscal years ending and for interim periods beginning after December 15, 2002.

As of August 31, 2003, the Company had no immediate plans to change to the fair value based method of accounting for stock-based employee compensation, and was therefore not affected by the transition provision of SFAS 148.

(c) In April 2003, the FASB issued SFAS No. 149, “Amendment of Statement 133 on Derivative Instruments and Hedging Activities”. This statement amends and clarifies the accounting for derivative instruments, including certain derivative instruments embedded in other contracts and hedging activities under SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities”. This statement clarifies when a contract with an initial net investment meets the characteristic of a derivative and when a derivative contains a financing component. This statement also amends the definition of an underlying asset to conform to the language contained in FIN 45. This statement is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003.

We have evaluated the requirements of the above statement and believe that the adoption of this new standard would not have a material impact on its financial position or on our results of operations.

(d) In May 2003, the FASB issued SFAS No. 150, “Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity”. The new statement requires that certain financial instruments that, under the previous guidance, could be accounted for as equity by issuers, be classified as liabilities in statements of financial position. SFAS No. 150 affects the issuer’s accounting for three types of freestanding financial instruments. One type is mandatorily redeemable shares, which the issuing company is obligated to buy back in exchange for cash or other assets. A second type, which includes put options and forward purchase contracts, involves instruments that do or may require the issuer to buy back some of its shares in exchange for cash or other assets. The third type of instruments that are liabilities under this statement is obligations that can be settled with shares, the monetary value of which is fixed, tied solely or predominantly to a variable such as a market index, or varies inversely with the value of the issuer’ shares. SFAS No. 150 does not apply to features embedded in a financial instrument that is not a derivative in its entirety. In addition to its requirements for the classification and measurement of financial instruments in its scope, SFAS No. 150 also requires disclosures about alternative ways of settling the instruments and the capital structure of entities, all of whose shares are mandatorily redeemable. Most of the guidance in SFAS No. 150 is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003.

We have evaluated the requirements of the above statement and believe that we have no transactions that should be disclosed or accounted for in accordance with this new standard.

Recently issued pronouncements

In November 2002, the Emerging Issue Task Force (“EITF”) reached a consensus on EITF 00-21, “Revenue Arrangements with Multiple Deliverables”, related to the timing of revenue recognition for arrangements in which goods or services or both are delivered separately in a bundled sales arrangement. The EITF requires that when the deliverables included in this type of arrangement meet certain criteria they should be accounted for separately as separate units of accounting. This may result in a difference in the timing of revenue recognition but will not result in a change in the total amount of revenue recognized in a bundled sales arrangement. The allocation of revenue to the separate deliverables is based on the relative fair value of each item. If the fair value is not available for the delivered items then the residual method must be used. The residual method requires that the amount allocated to the undelivered items in the arrangement is their full fair value. This would result in the discount, if any, being allocated to the delivered items. This consensus is effective prospectively for arrangements entered into in financial periods beginning after June 15, 2003.

We have evaluated the requirements of the above statement and believe that the adoption of this new standard would not have a material impact on our financial position or on our results of operations.