

## 6.0 EXECUTIVE SUMMARY

### Compensation Claim - RMB282,992,774

- 6.1 Fulian Knitting Co., Ltd (“Fulian” or “Subsidiary”), a wholly-owned subsidiary of Foreland Fabrictech Holdings Limited (“the Company” or “Foreland”), and Jiangxi Longdu Clothing & Accessories Weaving Limited Co. Ltd (“Jiangxi Longdu”) entered into an agreement M1309038 on 27 September 2013 and a supplemental agreement on 29 September 2013 under which Fulian was to supply 324,990 yards of dyed textile to Jiangxi Longdu for a consideration of RMB4,062,375.
- 6.2 The dyed textile was delivered to Jiangxi Longdu in October 2013. Jiangxi Longdu purchased the dyed textile from Fulian to manufacture winter jackets for Mega Chinese Limited (“Mega Chinese”).
- 6.3 On 17 November 2013, Jiangxi Longdu purportedly complained to Fulian about the quality of the dyed textile supplied by Fulian. Fulian purportedly conducted its own internal investigations between 19 November 2013 and 6 December 2013 and reported to the Company’s Board of Directors (“BOD”) on 11 December 2013 via the Chinese Circular dated 10 December 2013.
- 6.4 On 25 November 2013, Fulian purportedly sent a Mr. Cai Zhi Meng (“Mr. Cai”), the deputy general manager of Fulian’s marketing department, and a Mr. Yang Ying Qun (“Mr. Yang”), an employee of Fulian, to Jiangxi Longdu to investigate into Jiangxi Longdu’s complaint.
- 6.5 Fulian engaged Fujian Minhua Law Firm to advise them on whether Fulian had breached the above agreements and jointly appointed Fujian Hua Tie Certified Public Accounting Firm (“Fujian Hua Tie”) with Jiangxi Longdu to assess the losses suffered by Jiangxi Longdu.
- 6.6 The compensation claim of RMB282,992,774 was made up of:
- a. Fujian Hua Tie’s assessment of Jiangxi Longdu’s loss at RMB275,284,800; and
  - b. Jiangxi Longdu’s loss of interest for the period 1 January 2014 to 30 April 2014 at RMB7,707,974.40.

- 6.7 Arising from the settlement agreement dated 3 May 2014 between Fulian and Jiangxi Longdu, Fulian paid the sum of RMB282,992,774.40 to Jiangxi Longdu on 6 May 2014.
- 6.8 In September 2014, Jiangxi Longdu paid the sum of RMB3,079,380 to Fulian, being the outstanding amount due from Jiangxi Longdu to Fulian, after receiving the settlement sum of RMB282,992,774.40 from Fulian on 6 May 2014.

Minutes Of Directors' Meetings And Announcements

- 6.9 Based on our review of the Company's minutes of Directors' Meetings and announcements, we note as follows:
- a. The Company's BOD had agreed to appoint solicitors to advise on whether Fulian had breached the agreements with Jiangxi Longdu and to jointly appoint an independent accountant with Jiangxi Longdu to assess the losses suffered by Jiangxi Longdu.
  - b. Mr. Cheung Hanford Ho Fat ("Mr. Cheung"), Mr. Tan Chee Kian ("Mr. Tan") and Mr. Lim Siang Kai ("Mr. Lim"), the Company's former independent directors, had requested to meet Fujian Minhua Law Firm and Jiangxi Longdu to understand the matter. However, we note that the Company's former independent directors did not meet with Fujian Minhua Law Firm and Jiangxi Longdu notwithstanding that they visited Fulian's office in early January 2014 (NB: The Company Directors' Meeting on 8 January 2014 was duly convened and held in the meeting room of Fulian).
  - c. The Company's former independent directors had a difference of opinion with the Management (i.e. the legal representative of Fulian, Mr. Tsoi Kin Chit ("Mr. Tsoi")), and the general manager of Fulian, Mr. Zhang Hong Lai ("Mr. Zhang")) in relation to the handling of Jiangxi Longdu's purported claim against Fulian.
  - d. The difference of opinion includes, amongst others, the following:
    - i. Whether the items listed in the List of Economic Losses (i.e. an undated document from Jiangxi Longdu detailing the breakdown of the items and the amount for each item that Jiangxi Longdu was claiming for) provided by Jiangxi Longdu were reasonable;

- ii. The quantum of loss assessed by Fujian Hua Tie and the work performed by Fujian Hua Tie;
  - iii. To re-appoint a reputable law firm and a reputable audit firm to re-assess Jiangxi Longdu's purported claim against Fulian; and
  - iv. To convene an Extraordinary General Meeting of the Company to seek shareholders' view in relation to the settlement with Jiangxi Longdu.
- e. Due to the aforesaid difference of opinion, Mr. Cheung and Mr. Tan resigned as the Company's independent directors with effect from 26 February 2014 and 1 April 2014 respectively.
- f. At the Directors' Meeting held on 3 May 2014, the settlement with Jiangxi Longdu was put to a vote. The directors present at this meeting were Mr. Tsoi, Mr. Zhang, Mr. Chen Chao Ying and Mr. Lim. Mr. Tsoi, Mr. Zhang and Mr. Chen Chao Ying voted in favour of the settlement while Mr. Lim voted against it (NB: As at 3 May 2014, Mr. Lim was the sole independent director of the Company).
- g. Mr. Lim resigned as the Company's independent director with effect from 2 June 2014.

#### Whether The Dyed Textile Supplied To Jiangxi Longdu Was Defective

- 6.10 The Management did not provide conclusive evidence to show that the dyed textile supplied to Jiangxi Longdu was indeed defective:
- a. No evidence that the samples sent by Jiangxi Longdu to SGS-CSTC Standards Technical Services Co., Ltd. ("SGS"), an organisation providing inspection, verification, testing and certification services, were samples extracted from Fulian's dyed textile delivered in October 2013 save for the internal memo dated 3 December 2013 which mentioned that Mr. Cai and Mr. Yang had travelled to Jiangxi Longdu to jointly extract the samples and went to a logistics company to courier the samples to SGS (Shanghai Branch) thereafter; and
  - b. Fulian did not engage a third party to perform an independent quality assurance test to verify Jiangxi Longdu's claim of the defective dyed textile.

Whether The Complaint Made By Jiangxi Longdu Was Within The Contractual Time Frame To Make The Complaint

- 6.11 Based on the agreement M1309038 between Fulian and Jiangxi Longdu, Jiangxi Longdu had 30 days from 15 October 2013, 18 October 2015 and 20 October 2013 (dates of delivery) to complain to Fulian, of any defects on the dyed textile supplied.
- 6.12 The internal memo dated 28 November 2013 indicates that the date of complaint by Jiangxi Longdu was 24 November 2013, the Chinese Circular indicates that it was in early December 2013 and the Company's announcement dated 13 December 2013 indicates it was 17 November 2013. According to Mr. Tsoi, there was a typo error in the Chinese Circular. The complaint made by Jiangxi Longdu should be in early November 2013 and not in early December 2013.
- 6.13 If the purported complaint made by Jiangxi Longdu to Mr. Tsoi was on 17 November 2013 and there was a typo error in the month of the complaint made by Jiangxi Longdu in the Chinese Circular, the Chinese Circular should have indicated that it was mid December 2013 and not early December 2013.
- 6.14 In this regard, it is not clear if Fulian had considered whether the complaint made by Jiangxi Longdu was within the contractual time frame. If the purported complaint was on 24 November 2013 or in early December 2013, Jiangxi Longdu's complaint would have been "out of time" based on the agreement(s).

Fujian Minhua Law Firm's Scope Of Work

- 6.15 From our meeting with Mr. Ye Hua Qiang (叶华强) of Fujian Minhua Law Firm and our review of Fujian Minhua Law Firm's Legal Advice dated 23 December 2013 ("the Legal Advice") as well as Fulian's letter dated 12 December 2013 to Fujian Minhua Law Firm, it appears that limited information and instructions were given to Fujian Minhua Law Firm and their scope of work was also limited. It is not clear whether Fulian has sought advice from Fujian Minhua Law Firm as to how they could defend the purported claim by Jiangxi Longdu and / or minimise any loss Fulian might suffer arising from such purported claim.
- 6.16 Fulian did not seek Fujian Minhua Law Firm's assistance on, amongst others, their negotiation with Jiangxi Longdu's representative(s) / legal advisor(s), to dispute the items listed in the List of Economic Losses.

- 6.17 Fulian had also not sought legal advice on the extent of responsibility that Jiangxi Longdu would have to share for not carrying out any quality assurance tests on the dyed textile before mass production of the winter jackets.
- 6.18 In this regard, it appears that Fujian Minhua Law Firm might not have rendered an extensive legal advice to Fulian to mitigate Fulian’s “exposure” in respect of the purported claim by Jiangxi Longdu.
- 6.19 We have requested but have not been provided with Fujian Minhua Law Firm’s letter of engagement and working files in relation to the Legal Advice. In this regard, we are not able to establish the extent of work performed by Fujian Minhua Law Firm.

Factors Not Considered By Fujian Hua Tie In Assessing The Quantum Of Losses Suffered By Jiangxi Longdu As Well As Steps Taken By Jiangxi Longdu To Mitigate Its Losses

- 6.20 Based on our review of Fujian Hua Tie’s Appraisal Report dated 31 December 2013 (“the Appraisal Report”), it appears that Jiangxi Longdu purchased dyed textile to manufacture winter jackets for Mega Chinese. According to Jiangxi Longdu, because of the defective dyed textile supplied by Fulian, Jiangxi Longdu was unable to fulfill the order from Mega Chinese and the contract with Mega Chinese was cancelled. Fujian Hua Tie has assessed the losses of Jiangxi Longdu at RMB275,284,800 as follows:

*The contract sum between Jiangxi Longdu and Mega Chinese less the total scrap value of the winter jackets*

*RMB294,401,800 - (RMB100 x 191,170 units)*

- 6.21 We note that Fujian Hua Tie did not comment on the accuracy, veracity and / or reasonableness of the items listed in the List of Economic Losses in the Appraisal Report. The items listed in the List of Economic Losses are as follows:

a. Material costs	-	RMB196 per winter jacket
b. Business expenses loss	-	RMB120 per winter jacket
c. Wages costs	-	RMB198 per winter jacket
d. Loss of profit	-	RMB453 per winter jacket

- e. Packing and transportation costs - RMB35 per winter jacket
- f. Delivery loss - RMB278 per winter jacket
- g. Branding loss - RMB230 per winter jacket

6.22 We also note that Fujian Hua Tie was informally / formally appointed by Fulian and Jiangxi Longdu on 20 December 2013 / 29 December 2013 which were a Friday and a Sunday respectively. If so, Fujian Hua Tie took only two to eight business days after their informal / formal appointment to complete their “field work” (the Appraisal Report was dated 31 December 2013), which would have included, amongst others, to visit Jiangxi Longdu’s factory to inspect the purported defective winter jackets, to review the items listed in the List of Economic Losses provided by Jiangxi Longdu and to issue the Appraisal Report. Fujian Hua Tie’s scope of work might have also included engaging an independent valuer to assess the scrap value of the defective winter jackets.

6.23 Based on our review of the Appraisal Report, it appears that Fujian Hua Tie had not taken into account the following factors when assessing Jiangxi Longdu’s losses:

- a. Whether Jiangxi Longdu had compensated Mega Chinese for the cancellation of its contract with Mega Chinese;
- b. Whether Jiangxi Longdu had purchased insurance for its contract with Mega Chinese (as per the contract between Jiangxi Longdu and Mega Chinese, we note that Jiangxi Longdu was supposed to have an insurance coverage amounting to 110% of the total contract sum);
- c. Whether the insurance policy(ies) that Jiangxi Longdu was supposed to purchase covered their purported claim against Fulian; and
- d. Whether Jiangxi Longdu had taken any steps to mitigate its losses.

6.24 We have requested but have not been provided with Fujian Hua Tie’s working files in relation to their assessment of Jiangxi Longdu’s losses. As such, we are not able to establish the extent of work performed by Fujian Hua Tie.

#### Veracity Of The Contract Between Jiangxi Longdu And Mega Chinese

- 6.25 We note that Mega Chinese is a company with a paid up share capital of HKD1. In this regard, it is not clear why Jiangxi Longdu would have entered into such a huge contract with Mega Chinese and whether Mega Chinese had the financial capability to pay Jiangxi Longdu for the winter jackets purchased amounting to RMB294,401,800.
- 6.26 It is also questionable whether Jiangxi Longdu was able to fulfill its obligation by manufacturing the 191,170 pieces of winter jackets for Mega Chinese.
- 6.27 As per the contract between Jiangxi Longdu and Mega Chinese, the winter jackets were to be shipped to Hong Kong. We note that the registered office of Mega Chinese is the same as its corporate secretarial agent (Room 2203, 22/F, CFC Tower, 28 Mody Road, Tsim Sha Tsui, Kowloon, Hong Kong). We are not aware whether Mega Chinese has a business address separate from its registered address. In this regard, we are not able to establish whether Mega Chinese has the required storage space to store the 191,170 pieces of winter jackets that they had ordered from Jiangxi Longdu.
- 6.28 We have visited the registered office of Mega Chinese but note that it is currently occupied by CCOR & Co., CPA / Patrick P.K. Chiang, CPA. / Or Fei Yuek & Co., which appears to be an audit firm / a corporate secretariat firm.

#### Joint Appointment Of Fujian Hua Tie

- 6.29 Fulian and Jiangxi Longdu had jointly agreed to appoint Fujian Hua Tie on 20 December 2013 (i.e. date of the agreement between Fulian and Jiangxi Longdu).
- 6.30 It appears that the Management did not seek the approval of the BOD before agreeing with Jiangxi Longdu on the joint appointment of Fujian Hua Tie as the aforesaid agreement was signed before the Directors' Meeting held on 24 December 2013.
- 6.31 We also note that the Company's announcement dated 26 December 2013 stated that *"Having assessed the Legal Opinion, the Board is of the view that the Company should continue its negotiation with Jiangxi Longdu to reach an amicable settlement and to approach Jiangxi Longdu to consider the joint appointment of an independent auditor firm for the purpose of assessing the Claim and determination of a reasonable compensation amount"*.

- 6.32 Mr. Tsoi claimed that he had obtained approval from the BOD before agreeing with Jiangxi Longdu on the joint appointment of Fujian Hua Tie. This is however, not supported by the former independent directors' recollections of events that took place.

#### Internal Controls / Corporate Governance

- 6.33 We note the following weaknesses in the internal controls / corporate governance in Fulian:
- a. Quality assurance process;
  - b. Adequacy of insurance coverage;
  - c. Maintenance of proper books and records; and
  - d. Sole director at Fulian.

#### Cash And Cash Equivalents Of Fulian - RMB292,298,353

- 6.34 Based on our review of Fulian's bank statements, fixed deposit slips and fixed deposit certificates, we note that the sum of RMB292,298,353 as at 31 December 2013 was made up of the following:
- a. Bank balance of RMB72,298,352.45; and
  - b. Fixed deposits of RMB220,000,000.
- 6.35 We also note that Fulian's bank account and fixed deposit account(s) were maintained with Industrial and Commercial Bank of China ("ICBC").
- 6.36 The bank balance of RMB72,298,352.45 and the fixed deposit balance RMB220,000,000 were the same as the bank balance and fixed deposit balance recorded in the general ledger of Fulian as at 31 December 2013.
- 6.37 We have visited ICBC to obtain the bank confirmations on Fulian's bank balance and fixed deposit balance as at 31 December 2013.

- 6.38 We are not able to obtain the bank confirmations on Fulian's bank account and fixed deposit account(s) from ICBC as ICBC's officers told us that they were not able to extract any information of past customers from their system owing to a recent upgrade in their computer systems. All historical data of past customers is not kept with their branches.
- 6.39 We have also sent bank confirmations to ICBC (Head Office at Beijing and Fujian Provincial Branch) directly. However, both ICBC (Head Office at Beijing and Fujian Provincial Branch) had refused to accept our letters as we are not able to provide them with the recipient's name and contact details. As such, the bank confirmation letters were returned to us.
- 6.40 In this regard, we are not able to confirm the bank balance and fixed deposit balance of Fulian as at 31 December 2013.

#### Internal Controls / Corporate Governance

- 6.41 We note the following weaknesses in the internal controls / corporate governance of Fulian over its cash management:
- a. Holding significant amount of cash in hand;
  - b. Holding cash in excess of the set limit of RMB200,000 at month end; and
  - c. Sole signatory to bank accounts.

#### Investment In Subsidiary And Amount Due From Subsidiary

##### Interview With Management On The Assumptions For The Impairment Tests Carried Out

- 6.42 We have conducted an interview with the Management on the assumptions and basis for the impairment tests carried out with regard to the carrying amount relating to the investment in a subsidiary and amount due from a subsidiary as at 31 December 2013.
- 6.43 We have adopted and followed FRS 36 Impairment of Assets as the guideline for the assessment.

- 6.44 We have asked the Management about the indications of impairment and it appears that there are clear indications that the carrying amount of Investment in a Subsidiary and the Amount due from a Subsidiary may be impaired.

Verification Of The Assumptions For The Calculation Of Impairment Loss

- 6.45 We have discussed with the Management and reviewed the documentary evidence on the methodology and assumptions adopted in the assessment of impairment loss.
- 6.46 Our assessment and comments of the assumptions and methodology adopted are set out below:

<u>Items</u>	<u>Management's Assumptions</u>	<u>BDO's Assessment</u>	<u>Comments</u>
<b>Methodology</b>	The Management has adopted a Value In Use ("VIU") approach to evaluate the recoverable amount in relation to the operating subsidiary, considered as the only identifiable cash generating unit ("CGU").	Accepted.	N.A.
<b>Revenue FY2014</b>	- Revenue for FY2014 was projected based on Management's internal assessment of potential purchase orders compiled by sales team.	Accepted.	A comparison with the actual FY2014 revenue has shown that the Management's assumption is reasonable.

<u>Items</u>	<u>Management's Assumptions</u>	<u>BDO's Assessment</u>	<u>Comments</u>
Revenue - subsequent years	Subsequent to FY2014, the sales volume is projected to increase by 10% per annum and the average cost of fabric will increase by 3% based on the price inflation of China.	Accepted.	Although Management has no basis for the 10% increase in sales volume, however, based on the FY2014 actual revenue growth, the 10% growth rate for the subsequent years seems reasonable.
Gross profit margin ("GPM")	Management has assumed that the gross profit margin will reach a moderate 2% in FY2014, subsequently increasing to a more sustainable 10% from FY2015 onwards, and finally attaining 13% by FY2018.	Not accepted, the assumptions may have to be re-adjusted to reflect the slow recovery.	Given the historical financial performance, it was reasonable, at the time of preparation, for the Management to assume that the gross profit margin will become positive. However, the Management currently has no business plan in place to turn around the business, other than trying to achieve more purchase orders and introduce new textile, which has yet to yield higher gross profit margin. The Company is currently in a gross

<u>Items</u>	<u>Management's Assumptions</u>	<u>BDO's Assessment</u>	<u>Comments</u>
			loss position for FY2014 due to the low sales and high depreciation of plant and machinery.
<b>Selling and distribution expenses ("S&amp;D")</b>	Management has assumed that the selling and distribution expenses will grow in tandem with the revenue growth. The FY2014 S&D expenses are projected based on the 6M2014 results.	Accepted.	N.A.
<b>Administrative expenses</b>	Management has assumed that the administrative expenses will grow at China's inflation rate of 3% per annum. However there was no basis for the assumed administrative expenses for FY2014.	Not accepted.	Based on the historical average, the administrative expense usually account for approximately 5% of revenue. The assumed FY2014 administrative expenses accounted for 8.6% of revenue, which is considered high based on our assessment.

<u>Items</u>	<u>Management's Assumptions</u>	<u>BDO's Assessment</u>	<u>Comments</u>
<b>Depreciation</b>	Management has assumed a depreciation of RMB7.2 million per year in respect of plant and machinery.	Not accepted.	The depreciation of plant and machinery considered in the computation sheet does not reflect the actual depreciation amount.
<b>Amortisation of land use rights</b>	Management has assumed an amortisation of RMB567,000 per year in respect of land use rights.	Not accepted.	The amortisation of land use rights considered in the computation sheet does not reflect the actual amortisation amount.
<b>Capital expenditure</b>	Management has assumed that the capital expenditures for FY2014 to be approximately RMB14 million and reduced to RMB1 million for the subsequent years.	Not accepted.	The capital expenditure amounts assumed is significantly higher than actual amounts incurred for FY2014. The RMB1million for subsequent years seems reasonable, as the Company had spent approximately RMB1million in capital expenditure annually prior to the completion of the new factory.

<u>Items</u>	<u>Management's Assumptions</u>	<u>BDO's Assessment</u>	<u>Comments</u>
<b>Change in net working capital</b>	Management has not considered the change in net working capital in the free cash flow computation.	Not accepted.	Change in net working capital should be considered in the computation of FCF, especially for a manufacturing company such as Fulian, whereby a significant amount of working capital is necessary for operation.
<b>Terminal year FCF</b>	Management has adopted the FY2018 FCF as the basis to compute the terminal year FCF without adjusting the future depreciation and capital expenditure.	Not accepted.	For a manufacturing company such as Fulian, the terminal value should include the replacement costs of plant and equipment.
<b>Discount rate</b>	Management has used Foreland Fabrictech Holdings Ltd's WACC obtained from Bloomberg as of Q3 2013.	Accepted.	N.A.
<b>Terminal growth rate</b>	Management has assumed a terminal growth rate of 1% based on its assessment of future operations.	Accepted.	N.A.

<u>Items</u>	<u>Management's Assumptions</u>	<u>BDO's Assessment</u>	<u>Comments</u>
<b>Discount period</b>	Management has adopted an end-point discounting.	Not accepted.	A mid-point discounting will be more appropriate as it assumes that the cash will be received throughout the period. End-point discounting assumes that the cash will only be received at the end of each period.
<b>Enterprise value versus equity value</b>	Management has not considered the value of the excess cash and borrowings in deriving the equity value as compared to the enterprise value.	Accepted.	Fulian has minimum cash balance subsequent to the compensation and no borrowings. It is therefore reasonable to assume that the enterprise value corresponds to the equity value.

Proposed Impairment Loss

6.47 We have recomputed the impairment amount based on the assumptions detailed below:

- a. Since the FY2014 management accounts are readily available, we have considered them as the basis for the projection from FY2015 to FY2018;
- b. Sales volume will increase by 10% and average cost will increase by 3% annually subsequent to FY2014;

- c. GPM will return to positivity in FY2015 instead of FY2014 as originally assumed by the Management and increase to a sustainable 10% from FY2016 to FY2018;
- d. Selling and distribution expenses will grow in tandem with revenue;
- e. Administrative expenses are assumed to be 5% of revenue from FY2016 to FY2018;
- f. Annual depreciation of plant and machinery is assumed to be RMB20 million from FY2015 to FY2018 based on the historical average;
- g. Annual amortisation of land use rights is assumed to be unchanged at RMB617,000 from FY2015 to FY2018 based on the actual amortisation;
- h. Capital expenditure is assumed to be RMB1 million from FY2015 to FY2018;
- i. Inventory, trade receivables and trade payables are assumed to have the same turnover days as of FY2014. The turnover days will be used to compute the change in net working capital;
- j. For the terminal year beyond FY2018, it is assumed that the future capex will be the same as depreciation as the Company has to purchase new equipment to replace the current ones in the future;
- k. Discount rate is assumed to be unchanged at 15%;
- l. Terminal growth rate is assumed to be unchanged at 1%; and
- m. Mid-point discounting is adopted.

6.48 We have incorporated certain Management's original assumptions which we deem as appropriate and further assumptions which were not included in the original computation but in accordance with commonly adopted valuation methodology and the requirements of FRS 36.

6.49 The VIU of the CGU computed based on our assumptions is approximately RMB69 million, which resulted in an impairment loss of RMB215,234,788 as compared with the Management's assessment of an impairment loss of RMB223,138,731.

## Conclusions And Views

6.50 During the course of our work, we also note that:

- a. The Management was aware that the internal quality assurance test carried out before mass production of the purported defective dyed textile supplied to Jiangxi Longdu was not adequate to meet the quality requirement(s) under the agreements with Jiangxi Longdu.
- b. According to Mr. Tsoi, the complaint by Jiangxi Longdu to Fulian on the purported defective dyed textile was via telephone call(s) to him only.
- c. However, the internal memo dated 28 November 2013 indicated that Mr. Cai had also received telephone call(s) from Jiangxi Longdu on the purported defective dyed textile. Mr. Cai and Mr. Yang had travelled to Jiangxi Longdu to investigate into the matter.
- d. Jiangxi Longdu made payments of RMB675,000 and RMB675,000 to Fulian on 14 November 2013 and 29 November 2013 respectively to settle the invoices rendered by Fulian under agreement M1309038 notwithstanding that Jiangxi Longdu had purportedly made the complaint to Fulian about the defective dyed textile supplied under the said agreement in early November 2013 or on 17 November 2013 or on 24 November 2013.
- e. There is no conclusive evidence that the Management had travelled to Jiang Xi Province to investigate and inspect the purported defective winter jackets as well as to meet with Jiangxi Longdu's representative(s).
- f. It appears that Fulian's staff had travelled to Jiang Xi Province on two occasions in November 2013 to investigate and inspect the purported defective winter jackets as well as to jointly extract the samples and went to a logistics company to courier the samples to SGS (Shanghai Branch) for testing.
- g. There is no conclusive evidence that the charges to courier the extracted samples to SGS were paid by Jiangxi Longdu.
- h. There is a discrepancy in the date of the purported telephone call from a Mr. Zhang, the marketing manager of Jiangxi Longdu, to Mr. Cai. The internal memo dated 3 December 2013 indicated that the aforesaid telephone call was made on

30 November 2013 while Mr. Cai informed that the said telephone call was made on the night of 29 November 2013. According to Mr. Cai, there was a typo error in the date of the purported call from Mr. Zhang in the internal memo dated 3 December 2013.

- i. We note that 30 November 2013 was a Saturday. As Mr. Cai could not recall the name of the logistics company which they had visited to courier the fabric sample to SGS (Shanghai Branch), we are not able to establish whether the said logistics company opened on Saturdays.
- j. There is no conclusive evidence that the Management had carried out an internal investigation to establish the actual cause of the defective dyed textile save for the internal memos dated 28 November 2013 and 10 December 2013.
- k. There is no conclusive evidence to establish that the dyeing machine's temperature sensor was "unstable" and this was the cause of the defective dyed textile save for the internal memo dated 10 December 2013.
- l. The five copies of the production orders pertaining to the dyed textile supplied to Jiangxi Longdu in October 2013 indicated that the dyed textile supplied to Jiangxi Longdu was of six colours: blue, yellow, green, orange, grey and black.
- m. As per the English and Chinese quality assurance reports by SGS, the colours of the fabric sample selected for SGS' testing were red and black (NB: Mr. Tsoi clarified that orange stated in the production orders refers to orange and red (桔紅)). As Jiangxi Longdu had already used the dyed textile supplied by Fulian to manufacture the purported defective winter jackets and the winter jackets had already been disposed off, we are not able to establish whether the orange stated in the production orders refers to orange and red (桔紅).
- n. There is no discrepancy between the contents of the photocopies of the "original" English and Chinese quality assurance reports and the contents of the "email" Chinese quality assurance report extracted from the Legal Advice save for the difference in the footnotes.
- o. According to SGS' representative(s), there is a difference in the footnote between their email copy report and their original copy report. Their original

copy report would contain reference codes whilst their email copy report would not.

- p. It appears that the quality assurance report was available and was provided to Fujian Minhua Law Firm before or at the time it was appointed by Fulian. As such, it is not clear why Mr. Tsoi claimed that Fujian Minhua Law Firm had requested for the quality assurance report as soon as possible so that Fujian Minhua Law Firm could advise Fulian on the merits of Jiangxi Longdu's purported claim against Fulian.
- q. There is a discrepancy between the Company's announcement dated 18 December 2013 and the business profile of Jiangxi Longdu dated 20 May 2015 with regard to the information on the shareholder(s) of Jiangxi Longdu. The Company's announcement dated 18 December 2013 indicated that the shareholder of Jiangxi Longdu is Mr. Chen Enzhan whereas the business profile of Jiangxi Longdu indicated that its shareholder(s) is Hong Kong Yong Sheng.
- r. The Company had made an error in Note 19 of its audited financial statements for the financial year ended 31 December 2013 as the interest rate should be 0.7% per month and not 7% per annum.
- s. Jiangxi Longdu was required to pay a fee of RMB1,485,133.50 to the Fujian High People's Court within seven days to confirm its representation in the suit against Fulian (i.e. within seven days from 25 December 2013). The Management informed that as Fulian was negotiating with Jiangxi Longdu to resolve the dispute amicably, Jiangxi Longdu did not pay the aforesaid fee to the Fujian High People's Court. There was however, no evidence that Jiangxi Longdu would have proceeded with the aforesaid suit.
- t. There is no evidence that Fulian and Jiangxi Longdu had negotiated more than 10 times on a settlement proposal as Jiangxi Longdu claimed in its letter to Fulian dated 31 December 2013.
- u. There is no evidence that Fulian had performed market research on the value of the defective winter jackets before entering into an agreement with Jiangxi Longdu to value each defective winter jacket at RMB100. According to Mr. Tsoi, it was Fujian Hua Tie which had engaged an independent valuer to value the defective winter jackets.

- v. There is no evidence that Fulian had compensated its other customers for defective dyed textile supplied to these customers prior to Jiangxi Longdu's purported claims against Fulian.
- w. There is no evidence that the Management had assessed the competency of Fujian Hua Tie before deciding to jointly appoint Fujian Hua Tie with Jiangxi Longdu to assess the purported losses suffered by Jiangxi Longdu.
- x. There are discrepancies between the agreement M1305009 provided to us in May 2015 and the agreement M1305009 provided to us on 24 November 2015. The discrepancies are as follows:

**May 2015 Copy**

A tick against the type of textile was "marked" on the left side of the agreement.

As per clause six of the agreement M1305009 dated 12 May 2013, it was stated "验收方法、标准及提出异议的期限：需方按原订标准验收货物，如对质量有异议，应在货物到达三十天内通知供货方" (which we understand to be that any defect in the textile shall be made known to Fulian within 30 days upon delivery).

The words "合同专用章" (contract seal) was stated in Jiangxi Longdu's corporate seal.

**November 2015 Copy**

A tick against the type of textile was "marked" on the right side of the agreement.

As per clause six of the agreement M1305009 dated 12 May 2013, it was stated "验收方法、标准及提出异议的期限：需方按原订标准验收货物，如对质量有异议，应在货物到达三个工作日之内通知供货方" (which we understand to be that any defect in the textile shall be made known to Fulian within three working days upon delivery).

The words "合同专用章" (contract seal) was not stated in Jiangxi Longdu's corporate seal.

6.51 We set out below, questions in respect of Jiangxi Longdu's purported claims against Fulian:

- a. Whether the dyed textile supplied to Jiangxi Longdu was indeed defective;

- b. The veracity of the complaint and if it was made, whether the complaint was made within the contractual time frame;
- c. Why did Jiangxi Longdu pay Fulian on 14 November 2013 and 29 November 2013 if Jiangxi Longdu had made a complaint in early November 2013 or on 17 November 2013 or on 24 November 2013 about the defective dyed textile supplied under the agreement M1309038;
- d. Why did the Management not consider Jiangxi Longdu's "culpability" or responsibility for the purported losses suffered since Jiangxi Longdu did not perform any quality assurance test before mass production of the winter jackets;
- e. The veracity of the contract between Jiangxi Longdu and Mega Chinese;
- f. Limited information and instructions were given to Fujian Minhua Law Firm and their limited scope of work does not appear sufficient for Fujian Minhua Law Firm to assess Jiangxi Longdu's claim in details;
- g. The accuracy, veracity and / or reasonableness of the items listed in the List of Economic Losses (NB: Without the benefit of reviewing the documentary evidence, there is insufficient basis to conclude that the delivery loss and branding loss, amongst others, listed in the List of Economic Losses are reasonable claims);
- h. Why Fujian Hua Tie did not comment on the accuracy and veracity of the items listed in the List of Economic Losses when these form the basis of Jiangxi Longdu's claim against Fulian;
- i. Why Fujian Hua Tie did not take into account, inter alia, the following factors when assessing Jiangxi Longdu's losses:
  - i. Whether Jiangxi Longdu had compensated Mega Chinese for the cancellation of its contract with Mega Chinese;
  - ii. Whether the insurance policy(ies) that Jiangxi Longdu was supposed to purchase covered its purported claim against Fulian; and
  - iii. Whether Jiangxi Longdu had taken any steps to mitigate its losses, etc.

- j. Fujian Hua Tie was informally / formally appointed on 20 December 2013 / 29 December 2013 which were a Friday and a Sunday respectively and had only taken two to eight business days to issue the Appraisal Report;
- k. Why Jiangxi Longdu paid RMB3,079,380 to Fulian in September 2014 to settle the outstanding sum due to Fulian after having received the settlement sum of RMB282,992,774.40 on 6 May 2014; and
- l. Comparing Fulian's revenue for financial years 2013 and 2014, it appears that Fulian's sales had not been affected by the purported defective dyed textile supplied to Jiangxi Longdu (i.e. there is no indication that Fulian's reputation was affected as a result).

6.52 In view of our aforesaid findings and the questions in respect of Jiangxi Longdu's purported claim against Fulian, we have doubts on:

- a. The veracity of the purported defective dyed textile;
- b. The veracity of the complaint made by Jiangxi Longdu, including the date on which it was purportedly made;
- c. The veracity of the claim made by Jiangxi Longdu against Fulian;
- d. The purported sample sent to SGS by Jiangxi Longdu for testing;
- e. The veracity of the contract between Jiangxi Longdu and Mega Chinese; and
- f. The existence of Hong Kong Yong Sheng, the shareholder of Jiangxi Longdu.

6.53 Without the benefit of reviewing further documentary evidence which we have not been provided with, we also have doubts on the accuracy, veracity and / or reasonableness of the items listed in the List of Economic Losses as follows:

- a. Material costs - RMB196 per winter jacket
- b. Business expenses loss - RMB120 per winter jacket
- c. Wages costs - RMB198 per winter jacket

- d. Loss of profit - RMB453 per winter jacket
- e. Packing and transportation costs - RMB35 per winter jacket
- f. Delivery loss - RMB278 per winter jacket
- g. Branding loss - RMB230 per winter jacket

6.54 From our findings, we note that the Management had carried out the following before entering into a settlement with Jiangxi Longdu:

- a. Appointed Fujian Minhua Law Firm to advise Fulian on the merits of Jiangxi Longdu’s purported claim against Fulian. However, limited information and instructions were given to Fujian Minhua Law Firm and their limited scope of work does not appear sufficient for Fujian Minhua Law Firm to assess Jiangxi Longdu’s claims in details; and
- b. Jointly appointed Fujian Hua Tie to assess Jiangxi Longdu’s purported claim against Fulian as well as the quantum of losses suffered by Jiangxi Longdu. However, Fujian Hua Tie did not take into account certain factors which we have set out in paragraph 6.23 of this report when assessing the quantum of losses suffered by Jiangxi Longdu as well as steps taken by Jiangxi Longdu to mitigate its losses.

6.55 From our findings, we are of the view that the Management should have carried out the following before entering into a settlement with Jiangxi Longdu:

- a. Appoint a third party to carry out an independent quality assurance test to verify Jiangxi Longdu’s claim relating to the defective dyed textile;
- b. Provide full information on Jiangxi Longdu’s purported claim against Fulian to Fujian Minhua Law Firm and seek their advice on how to defend Fulian and mitigate Fulian’s “exposure” to the purported claim;
- c. Request Fujian Hua Tie to comment on the accuracy, veracity and / or reasonableness of the items listed in the List of Economic Losses in the Appraisal Report since these form the basis of Jiangxi Longdu’s claim against Fulian;

- d. Request Jiangxi Longdu to provide Fulian with documentary evidence to substantiate the accuracy, veracity and / or reasonableness of the items listed in the List of Economic Losses;
- e. Request Jiangxi Longdu to provide Fulian with documentary evidence to demonstrate that Jiangxi Longdu had taken steps to mitigate its losses as well as documentary evidence to demonstrate that Jiangxi Longdu had compensated Mega Chinese for the cancellation of the contract;
- f. To engage a more renowned law firm / audit firm to re-assess Jiangxi Longdu's purported claim against Fulian in view that the purported claim was substantial; and
- g. To convene an Extraordinary General Meeting to seek shareholders' view in relation to the settlement with Jiangxi Longdu (as appropriate).

6.56 As a director of Fulian, Mr. Tsoi has a duty to protect and act in the interests of Fulian. In our view, without taking reasonable steps to defend Fulian and mitigate Fulian's "exposure" in respect of the purported claim by Jiangxi Longdu prior to entering into the settlement agreement with Jiangxi Longdu, Mr. Tsoi may not have acted in the interest of and / or fully discharged his duty owed to Foreland and / or Fulian:

- a. By not providing Fujian Minhua Law Firm with the full facts / information, Fujian Minhua Law Firm would not be in a position to render Fulian comprehensive legal advice to defend Fulian and mitigate Fulian's "exposure" in respect of the purported claim by Jiangxi Longdu;
- b. By not taking the Company's former independent directors' requests to seek a second legal opinion;
- c. By not taking the Company's former independent directors' requests to engage a reputable audit firm to re-assess Jiangxi Longdu's purported claim against Fulian;
- d. By not engaging a third party to verify Jiangxi Longdu's claim on the defective dyed textile;

- e. By not verifying the accuracy, veracity, and / or reasonableness of the items listed in the Economic Losses which form the basis of Jiangxi Longdu's claims against Fulian; and
  - f. By not clarifying with Fujian Hua Tie and understanding the basis of their assessment of the losses purportedly suffered by Jiangxi Longdu.
- 6.57 Owing to the substantial amount claimed by Jiangxi Longdu against Fulian, Mr. Tsoi, as a director of Fulian, should have taken all reasonable steps to defend Fulian and mitigate Fulian's "exposure" in respect of the purported claim by Jiangxi Longdu. By relying on the Legal Advice (which in our view, was limited) and the Appraisal Report that is neither comprehensive nor detailed to enter into the settlement agreement with Jiangxi Longdu, Mr. Tsoi may not have acted in the interest of Foreland / Fulian and may have breached his fiduciary duties towards Foreland / Fulian.
- 6.58 As the directors of Foreland, Mr. Tsoi, Mr. Zhang and Mr. Chen Chao Ying have to act in the interest of Foreland and / or Fulian (a wholly-owned subsidiary of Foreland). Based on our findings, it appears that inadequate due diligence was carried out in respect of the purported claim by Jiangxi Longdu. In this regard, by voting in favour to enter into the settlement agreement with Jiangxi Longdu, Mr. Tsoi, Mr. Zhang and Mr. Chen Chao Ying may not have acted in the interest of Foreland and / or Fulian and may have breached their fiduciary duties owed to Foreland and / or Fulian.
- 6.59 We are of the view that Mr. Tsoi, Mr. Zhang and Mr. Chen Chao Ying should have taken all reasonable steps to defend Fulian and mitigate Fulian's "exposure" before agreeing to enter into the settlement agreement with Jiangxi Longdu considering that the settlement sum of RMB283 million (NB: As per the Statement of Claim dated 9 December 2013 filed by Jiangxi Longdu in the Fujian High People's Court, Jiangxi Longdu was claiming for a sum of RMB289 million against Fulian) would have almost "wiped out" Fulian's entire cash balance of RMB288 million (balance as at 30 April 2014 as per Fulian's general ledgers) (NB: As per the audited financial statements for the financial year ended 31 December 2013, the cash balance was RMB292 million).
- 6.60 As a shareholder of Foreland as well as a director of Foreland and Fulian, Mr. Tsoi has an interest in Fulian's business dealings and owed a duty to act in the interest of Foreland's shareholders, regardless of whether he has a material interest in the transaction or otherwise. In this regard, it is also our view that Mr. Tsoi may have breached Rule 103 (5) of the Exchange's listing rules.

- 6.61 We note that there are discrepancies in the date of Jiangxi Longdu's complaint between the internal memo dated 28 November 2013 (i.e. on 24 November 2013), the Chinese Circular (i.e. in early December 2013) and the Company's announcement dated 13 December 2013 (i.e. on 17 November 2013).
- 6.62 We also note that Fulian and Jiangxi Longdu had agreed to jointly appoint Fujian Hua Tie to assess Jiangxi Longdu's purported claim against Fulian as well as the quantum of losses suffered by Jiangxi Longdu on 20 December 2013. However, the Company's announcement dated 26 December 2013 stated that *"Having assessed the Legal Opinion, the Board is of the view that the Company should continue its negotiation with Jiangxi Longdu to reach an amicable settlement and to approach Jiangxi Longdu to consider the joint appointment of an independent auditor firm for the purpose of assessing the Claim and determination of a reasonable compensation amount"*.
- 6.63 In view of the aforesaid two incorrect announcements, the Company may have breached Rule 703(4) (25) (a) of the Exchange's listing rules which stated *"each announcement should be factual, clear and succinct"*.
- 6.64 With regard to the weaknesses in the internal controls / corporate governance in Fulian, we recommend the following:
- a. Fulian should carry out third parties' assurance testing(s) for higher grade textile before mass production.
  - b. Fulian should maintain production reports as this will keep the Management informed of the overall efficiency of Fulian's machines and whether the textile is manufactured in accordance with the standard(s) required instead of maintaining production orders which merely set out the requirements.
  - c. The Management should consider to purchase insurance (if available) to cover the event of defective textile supplied to customers.
  - d. The Management should maintain written records for external / internal meetings as these are useful for future reference.
  - e. The holding company should appoint another director(s) in Fulian. This will enable Fulian's board to delegate the execution functions to other directors (as necessary) and maintain a good corporate governance structure.

- f. The Management should consider not holding a large amount of cash in hand as this may lead to theft and the loss of interest to be earned.
- g. Cash received from the customers should be deposited daily.
- h. The Management should continue to monitor and strengthen its controls on the amount of cash kept at each month end.
- i. Fulian should have at least two signatories to its bank account(s).

6.65 Rule 719 (1) of the Exchange's listing rules states that *"An issuer should have a robust and effective system of internal controls, addressing financial, operational and compliance risks. The audit committee (or such other committee responsible) may commission an independent audit on internal controls for its assurance, or where it is not satisfied with the systems of internal control"*.

6.66 In view of our aforesaid findings, the Company may have breached Rule 719 (1) of the Exchange's listing rules as the Company may not have put in place robust internal controls to address financial, operational and compliance risks.

6.67 On the possible breaches of the directors' duties as well as the Exchange's listing rules mentioned above, we recommend that the Company should also seek legal advice on the same.

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