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Regulatory Action

16 July 2018

SGX RegCo reprimands Dapai International Holdings Co. Ltd., Executive Chairman Chen Xizhong, former CEO Chen Yong and former CFO Lawrence Lam Pong Sui

Public reprimand: Breach of Listing Rules

1. Singapore Exchange Regulation (“**SGX RegCo**”) reprimands Dapai International Holdings Co. Ltd. (“**Dapai**” or the “**Company**”) [达派国际控股有限公司], Mr Chen Xizhong [陈锡忠] (Executive Chairman), Mr Chen Yong [陈勇] (former Chief Executive Officer) and Mr Lawrence Lam Pong Sui [林傍水] (former Chief Financial Officer) for breaches of the Listing Rules.
2. Based on the findings in the independent reviews by BDO LLP (“**BDO**”) and Kordamentha Pte Ltd (“**Kordamentha**”) into allegations that various transactions by the Dapai Group and certain sales distributors and renovation contractors relating to the Company’s initiative to open 500 retail outlets in the People’s Republic of China were fictitious and/or misrepresented, the instances of non-compliance with the Listing Rules are as follows:
 - (a) Listing Rule 703(1)(a) requires an issuer to announce any information known to the issuer concerning it or any of its subsidiaries or associated companies which is necessary to avoid the establishment of a false market in the issuer’s securities. Appendix 7.1 paragraph 3 clarifies that a false market may exist if information is not available that would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to subscribe for, or buy or sell the securities.

The Company had made non-factual, false and misleading statements on various transactions by the Dapai Group, the veracity of the proposed opening of the 500 outlets as well as on the payments to its distributors and contractors involved in the opening of the 500 outlets.

- (b) Listing Rule 703(4)(a) requires an issuer to observe the Corporate Disclosure Policy set out in Appendix 7.1 of the Listing Manual to provide timely disclosure of material information in accordance with this policy. The Exchange regards disclosure as fundamentally important to the operation of a fair and efficient market for the trading of securities. Appendix 7.1 paragraph 25 states, *inter alia*, that the content of a press release or other

public announcement is as important as its timing. Each announcement should be factual, clear and succinct.

The Company had made non-factual, false and misleading statements in its 2009 and 2010 annual reports that the system of internal controls maintained by the Company's management throughout the financial years ended 31 December 2009 and 31 December 2010 up to the dates of the respective annual reports, was adequate to meet the needs of the Group in its current business environment. The Board's confirmations given in the annual reports on the system of internal controls were false and misleading.

- (c) Listing Rule 719(1) requires an issuer to have a robust and effective system of internal controls, addressing financial, operational and compliance risks.

The Company had no procedure in place to keep track on how and when the 500 retail outlets were started. There was also no proper centralised documentation in place, the journal entries on payment to distributors and contractors were brief and poor controls were prevalent for the opening of the 500 retail outlets. Although these were highlighted at the Audit Committee meetings on 17 February 2012 and 28 July 2012 by the internal auditor and Mr Terence Ng Kiat Peen (who replaced Mr Lawrence Lam Pong Sui as the Chief Financial Officer since 1 July 2011), no further actions were taken.

3. Listing Rule 720(1) read with Listing Rule 210(5)(b) requires directors and management to demonstrate character and integrity expected of directors and management of listed issuers.

SGX RegCo is of the view that Mr Chen Xizhong (Executive Chairman), Mr Chen Yong (former Chief Executive Officer) and Mr Lawrence Lam Pong Sui (former Chief Financial Officer), who were responsible for the payment and reporting of the transactions relating to the opening of the 500 retail outlets, failed to demonstrate the character and integrity expected of directors and management of listed issuers, in breach of Listing Rule 720(1) read with Listing Rule 210(5)(b).

4. SGX-listed companies are advised to consult SGX RegCo before they appoint Mr Chen Xizhong, Mr Chen Yong and Mr Lawrence Lam Pong Sui as a director and/or management (including appointments to the position of legal representative).
5. SGX RegCo has referred the case to the relevant authorities.

Background of events leading to the public reprimand

6. On 11 November 2009, the Company (formerly known as China Zaino International Ltd) announced that it intended “to strengthen its distribution network through the set-up of 500 new retail outlets at prime locations of 1st, 2nd (mostly) and 3rd tier cities in Beijing, Fujian, Jiangsu, Shandong and Zhejiang in collaboration with its distributors”.
7. The “initial renovation, furniture and fitting costs of the 500 new retail outlets totaling RMB250 million” was to be incurred in the fourth quarter of 2009, “capitalized to the Group’s balance sheets as deferred expenditures”, and subsequently “amortized for five years”.
8. The Company further elaborated that “in order to mitigate execution risks, the Group will be working with selected existing distributors and let them manage the retail outlets for the first 2 years, FY2010 and FY2011. The Group will pay the first 2 years’ rentals of the 500 new retail outlets, totaling RMB160 million.” The Company appointed a total of six distributors and each was to be subjected to a sales target and “in the event that the distributor fails to meet 70% of sales target, the Group reserves the right to change distributor or to operate the retail outlets itself or in collaboration with the distributor”.
9. On 24 February 2010, the Company announced its unaudited fourth quarter and full year financial statements for FY2009. The Company explained that there “were net cash outflows from investing activities of RMB397.1 million in Q4 09 and RMB527.4 million in FY 09”, which were mainly due to, *inter alia*, “the payments for the cost of initial renovation, furniture and fitting costs, plus the first 2 years prepaid rentals of the 500 new DAPAI retail outlets” (emphasis added). “Acquisition of deferred expenditures” amounted to RMB334.6 million. This was despite the Company separately announcing on the same day that the Company only targeted “to open all the outlets in the second half of 2010”.
10. On 23 February 2011, in its unaudited fourth quarter and full year results for FY2010, the Company stated that “up to 31 December 2010, 145 outlets had been opened, located mostly in first-tier and second-tier cities of Beijing, Fujian, Jiangsu, Shandong and Zhejiang”.
11. On 9 May 2011, in its unaudited first quarter results for the period ended 31 March 2011, the Company stated that “up to 31 March 2011, all the 500 outlets had been opened, covering major cities in Beijing, Fujian, Jiangsu, Shandong and Zhejiang”.
12. On 11 November 2011, in its unaudited third quarter results for the financial period ended 30 September 2011, the Company recognised impairments of “approximately RMB26.1 million on the prepaid rental and RMB50.6 million on the leasehold improvements for these outlets” due to the “non-performance since commissioning” of the 500 outlets.
13. The Company further stated that “payments were made progressively to the (four) contractors upon the completion of the outlets. These payments are supported by invoices submitted by the respective contractors and payments were remitted via bank transfers/ cheque payments to the respective contractors” (emphasis added).
14. On 28 February 2012, in its unaudited fourth quarter and full year financial statements for FY2011, the Company stated that in addition to the impairments earlier recognised, there were further

write-offs of “prepayments and other receivables (prepaid rental for the 500 outlets) of RMB52.3 million” and “property, plant and equipment relating to the leasehold improvements of the 500 outlets of RMB135.1 million”.

BDO Agreed-Upon Audit Procedures

15. BDO was appointed by the Company on 7 April 2016 to conduct Agreed-Upon Audit Procedures to address allegations in a complaint document that two distributors 厦门宜众贸易有限公司 and 福州伊派贸易有限公司 (the “**Highlighted Distributors**”) and four contractors (the “**Highlighted Contractors**”) did not seem to have any sales or supply transactions with the Company. BDO’s findings and report (the “**BDO Report**”) were announced by the Company on 14 December 2016.
16. The BDO Report noted that an internal audit of 30 outlets in Beijing and Shandong was performed in December 2011 (the “**Internal Audit**”), and the Internal Audit report “indicated that the auditors had initially only managed to see two outlets out of 30 selected outlets while another four were not opened at the addresses provided”. BDO was “not able to verify further actions taken to find out the reasons why the addresses of new outlets were not reflected to Dapai or why (Dapai) were not informed of the closure of the outlets”. In addition, the then “CFO had mentioned that there was no procedure to keep track on how and when the outlets were started”. BDO stated that as “there was a significant number of outlets that were not correctly reflected in the listing maintained by the company, further actions should have been taken to verify that the listing was accurate and what were the actual number of outlets in operation.”
17. BDO was “not able to obtain most of the original documents from the Highlighted Distributors or Contractors such as purchase orders or invoices”. The Company was unable to provide documents to BDO for their “assessment of two Highlighted Distributors”, nor for the “approval for appointment of four Highlighted Contractors”. BDO stated that “as the document retention period in China is 15 years, Dapai should further assess if there are any legal implications of not keeping their documents.”
18. BDO was not “able to review who had approved the selection of the distributors or what were the reasons provided for their appointment”. One of the Highlighted Distributors which the Company claimed to have managed 50 sales outlets had responded to BDO’s confirmation request and had confirmed that they did not have any transactions recorded in FY2009 with Dapai although Dapai had represented that “the appointment of Distributors was based on good track records.”
19. BDO found that “(a)lthough the agreements for the Highlighted Contractors indicated that the last milestone for payment should be upon full completion of the work, the Highlighted Contractors, as well as all the other contractors, had already been paid in full by March 2010.” BDO was “not able to further verify when construction of each of the outlets was completed”, as “supplier delivery reports were mostly not available for review”. BDO found that payments were not “made progressively to the contractors upon the completion of the outlets”. “[P]ayment was made without reference to completion of outlets but based on lump sum payments” as the amount of RMB250 million was fully paid by March 2010 even though the Company had reported subsequently that only 145 outlets had been opened by 31 December 2010.

20. In relation to prepaid rental of RMB 320,000 per outlet provided to the Distributors, totaling RMB 160 million for the 500 outlets, BDO expressed concern on “the lack of documents available on how the prepaid rental should be or were administered or the lack of restrictions on the type/size of shops that they should be used for.” The “nature and intent of this advance was however not clearly specified in the agreements with the Distributors”.
21. The BDO Report noted, *inter alia*, the following weaknesses in internal controls:
- (a) Lack of internal controls over payments to the Contractors, payment of prepaid rental and monitoring of outlets, with no procedure to keep track on how and when the outlets were started, and no centralized documents and proper control;
 - (b) Selected sample documents not being available for review, which additionally could be a breach of local regulations on document retention;
 - (c) Apparent lack of management oversight over the payments of RMB250 million to the Contractors as they were made in lump sums rather than based on services rendered or goods provided;
 - (d) No documents on the conditions or parameters for using prepaid rental of RMB160 million given to the Distributors were available, and BDO could not obtain any analysis such as obtaining lease agreements to review the actual terms; and
 - (e) No records that lease agreements were obtained during that time to check that the Distributors had correctly and completely applied the prepaid rental amount to outlets managed for Dapai.

Kordamentha Special Audit

22. Kordamentha was subsequently engaged to follow up on the outstanding matters pertaining to the alleged transactions that BDO was not able to fully verify. Kordamentha’s findings and report (the “**Kordamentha Report**”) were announced by the Company on 7 July 2017.
23. Kordamentha was informed by both Highlighted Distributors that “they do not have any transactions with Dapai for the period 2007 to 2012” and “Dapai appears to have fabricated the transactions with them”.
24. Based on visits to the Highlighted Contractors, Kordamentha found that none of the Highlighted Contractors had transacted to the amounts claimed by the Company. Further, two of the Highlighted Contractors represented that they do not deal in prepayments.
25. The Kordamentha Report stated that “the deferred asset listing for FY2009 indicate that rental were fully paid to (the Highlighted Distributors) by 13 November 2009, i.e. two days after the signing of the agreements”. However, “scanned copies of the receipts” were notably “dated 13 December 2010 for the payment of the two years’ rental for the outlets” to one of the Highlighted Distributors, representing a one-year gap. In addition, there “were no details of who issued the receipt and the receipts did not bear any official company stamp” and “no information on which outlets the payments were for”.
26. Kordamentha concluded that “the purported transactions between the Group and the respective third party Distributors and Contractors cannot be corroborated and the veracity of the transactions could not be verified.”

Veracity of the 500 outlets and payments to distributors and contractors

27. The Company disclosed that it had set up the 500 outlets but is unable to produce supporting documents to prove the existence of all the 500 outlets. Noting the matters above and the observations of the Internal Audit, BDO Report and Kordamentha Report, the Exchange is drawn to the irresistible conclusion that the majority of outlets had never been opened.
28. The Company disclosed that the amount of RMB410 million had been remitted to the Distributors and the Contractors for the purported opening the 500 outlets. However, the Highlighted Distributors and Highlighted Contractors had denied receiving payments with some even denying business relationships with the Company. The Company was unable to provide supporting documents that it had indeed made the relevant payments to the Distributors and the Contractors for the purposes of opening the 500 outlets. In the circumstance, the Exchange is drawn to the irresistible conclusion that the money paid out was not used for the alleged Distributors or Contractors, but for other undisclosed purposes.
29. In light of the above, SGX RegCo is of the view that the Company had made non-factual, false and misleading statements on the veracity of the purported opening of the 500 outlets as well as on the payments to its distributors and contractors, **in breach of Listing Rule 703(1)(a) read with Paragraph 3 of Appendix 7.1 of the Listing Manual.**

False confirmations of adequacy of internal controls

30. The BDO Report highlighted a lack of internal controls over payments to Distributors and Contractors, payment of prepaid rental and monitoring of outlets. The BDO Report stated, *inter alia*, that BDO was “not able to obtain most of the original documents from the Highlighted Distributors or Contractors such as purchase orders or invoices”. Also, the Company was unable to provide BDO with most of the requested documents to support the transactions. BDO noted that under Chinese law, the Company is required to retain its accounting records for 15 years.
31. In light of the above, SGX RegCo is of the view that the Company had made false and misleading statements in its annual reports that the system of internal controls maintained by the Company’s management throughout the financial years ended 31 December 2009 and 31 December 2010 up to the dates of the respective annual reports, was adequate to meet the needs of the Group in its current business environment, **in breach of Listing Rule 703(4)(a) read with Paragraph 27 of Appendix 7.1 of the Listing Manual.**

Failure to put in place robust internal controls

32. BDO noted that the then CFO, Mr Terence Ng Kiat Peen (who replaced Mr Lawrence Lam Pong Sui as the Chief Financial Officer from 1 July 2011) had reported in the Audit Committee meeting on 28 July 2012 that “there was no procedure in place to keep track on how and when the outlets were started”, and the “(Company) depended on the confirmation of the distributors and contractors as the Management was not experienced. There were also no centralized documents and no proper control, and the journal entries were brief.” BDO noted that “no further action was taken to improve the reporting process for the 500 outlets” after the Audit Committee meeting on 28 July 2012.

33. BDO had noted, based on the report of the Internal Audit performed in December 2011, the internal auditor had selected 15 outlets located in Beijing and 15 outlets in Shandong to conduct physical visits, and was informed by the Company that nine out of the 15 outlets selected in Beijing and all the 15 outlets selected in Shandong were closed. A new list provided for Shandong outlets comprised six outlets located in Xi'an in Shaanxi, which had not been part of the five provinces (namely¹ Beijing, Fujian, Jiangsu, Shandong and Zhejiang) the Company selected for its expansion programme in 2009. This was tabled to the Audit Committee on 17 February 2012. BDO did not note any follow-up action on the Internal Audit findings.
34. BDO also noted that the Company had failed to retain accounting records that were required to be kept for 15 years under Chinese law.
35. In light of the above, SGX RegCo is of the view that the Company has failed to put in place a robust and effective system of internal controls, **in breach of Listing Rule 719(1)**.

Failure to demonstrate character and integrity

36. Mr Chen Xizhong, Mr Chen Yong and Mr Lawrence Lam Pong Sui did not respond to the show cause letters issued in relation to their breaches of Listing Rules.
37. Mr Chen Xizhong as the Executive Chairman of the Company and Mr Chen Yong as the former Chief Executive Officer of the Company have caused the Company to breach Listing Rules 703 and 719(1). As directors, they have a duty to act in the interests of the Company and shareholders as a whole. They are required to ensure announcements are true and accurate and inter alia, to ensure that a robust and effective system of internal controls to address the financial, operational and compliance risks of the Company is put in place but they have failed to do so.
38. In light of the above, SGX RegCo is of the view that Mr Chen Xizhong and Mr Chen Yong have failed to act in the interest of shareholders as a whole by failing to safeguard the interest of the Company and shareholders. They have failed to demonstrate the character and integrity expected of the directors and management of listed issuers, **in breach of Listing Rule 720(1) read with Listing Rule 210(5)(b)**.
39. Mr Lawrence Lam Pong Sui, as the former Chief Financial Officer of the Company, was responsible for “oversee[ing] and coordinat[ing] the operations of the Group's finance department as well as managing all the financial, accounting and taxation functions of the Group”. By failing to ensure that the Company had a robust and effective system of internal controls addressing financial, operational and compliance risks and by making the significant payments for the 500 outlets without supporting documents and without verifying the existence of the 500 outlets, Mr Lawrence Lam Pong Sui has failed to demonstrate the character and integrity expected of a key management of listed issuers, **in breach of Listing Rule 720(1) read with Listing Rule 210(5)(b)**.
40. SGX-listed companies are advised to consult SGX RegCo before they appoint Mr Chen Xizhong, Mr Chen Yong and Mr Lawrence Lam Pong Sui as a director and/or management (including to positions as legal representatives).

¹ Announced on 11 November 2009.

Referral to the relevant authorities

41. SGX RegCo has referred the case to the relevant authorities.

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