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NATURAL BEAUTY

Natural Beauty Bio-Technology Limited

自然美生物科技有限公司

(Incorporated in the Cayman Islands with limited liability)

(Stock code: 00157)

INSIDE INFORMATION KEY FINDINGS OF ADDITIONAL FORENSIC REVIEW

This announcement is made by Natural Beauty Bio-Technology Limited (the “**Company**”, and together with its subsidiaries, the “**Group**”) pursuant to Rule 13.09 of the Rules Governing the Listing of Securities (the “**Listing Rules**”) on The Stock Exchange of Hong Kong Limited (the “**Stock Exchange**”) and the Inside Information Provisions (as defined under the Listing Rules) under Part XIVA of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong).

Reference is made to (i) the announcements of the Company dated 24 March 2020, 29 April 2020, 24 June 2020, 21 July 2020, 27 July 2020 and 23 September 2020 in relation to, amongst others, an investigation on certain audit findings raised by the Company’s previous auditors (the “**Forensic Review**”); (ii) the announcements of the Company dated 21 May 2020 and 14 August 2020 in relation to the conditions for the resumption of trading in the shares of the Company (the “**Resumption Conditions**”); (iii) the announcement of the Company dated 14 August 2020 in relation to the appointment of the auditors of the Company; (iv) and the announcement of the Company dated 25 August 2020 in relation to, amongst others, the appointment of the internal control consultant. Unless otherwise stated, capitalised terms used herein shall have the same meanings as those defined in the announcement of the Company dated 21 July 2020 (the “**Announcement**”).

KEY FINDINGS OF ADDITIONAL FORENSIC REVIEW

As disclosed in the announcement of the Company dated 21 May 2020, one of the Resumption Conditions is for the Company to conduct an appropriate investigation into certain issues raised by the previous Auditors (the “**Previous Auditors**”), announce the findings and take appropriate remedial actions.

As disclosed in the Company’s announcement dated 24 March 2020, in response to the Previous Auditors’ enquires on the sales made by the Group to certain distributors and how certain individual distributors and customers settled their payments to the Group (the “**Issues**”), the Audit Committee has engaged PricewaterhouseCoopers Management Consulting (Shanghai) Limited as Forensic Accountant to conduct Forensic Review on certain Group’s wholly-owned subsidiaries in China (“**Subject Group Companies**”) of the Issues.

On 21 July 2020, the Company announced the key findings of the Forensic Review based on a draft report on the Forensic Review dated 6 July 2020 (the “**Draft Forensic Review Report**”) together with the response of the Company on such key findings. The report on the Forensic Review was finalised and issued on 19 November 2020 with no material change against the Draft Forensic Review Report.

As disclosed in the Announcement, the Forensic Accountant noted several documents which seemed to suggest that after Eastern Media International Corporation (“**EMIC**”, one of the Company’s substantial shareholders) acquired the Company’s shares in November 2018, the CEO and personnel of EMIC were made aware that during the period from 2016 to 2018, there were certain instances where the Subject Group Companies might have engaged in channel stuffing and hence goods might not have been delivered to certain customers after the sales were made (together, the “**Allegation**”). The Board and the Audit Committee took the Allegation seriously, and thus the Audit Committee instructed the Forensic Accountant to conduct additional procedures to investigate into the Allegation (the “**Additional Forensic Review**”).

The Additional Forensic Review mainly focused on (i) the top six distributors or franchisees of the Subject Group Companies in 2019; (ii) two franchisees who were identified from the electronic document review that certain goods might not have delivered to them in due time; and (iii) a franchisee whose name was allegedly used by another franchisee to place a sales order in June 2018 (together, the “**Subject Customers**”) for the period from 1 January 2016 to 31 December 2018 (the “**Review Period**”) with a view to ascertaining facts that are relevant to the Allegation.

A report on the Additional Forensic Review was issued on 19 November 2020 (“**Additional Forensic Review Report**”), and was sent to the Audit Committee.

The Company would like to announce the key findings of the Additional Forensic Review together with the response of the Audit Committee as set out below:

1. **Review of record of returns of sales and/or exchanges of goods**

Background

The Forensic Accountant analysed the sales orders of RMB130,756,415 placed by the Subject Customers during the Review Period and noted that there were certain sales transactions with subsequent possible returns of sales and/or exchanges of goods.

The Forensic Accountant also noted that any exchange of goods is recorded in the Company's inventory management system by way of (1) marking the existing sales order entry as a return of goods; (2) entering a new entry of sales order; and (3) linking the two entries as one transaction.

The Forensic Accountant noted five sales orders with a total amount of approximately RMB18 million involving possible returns of goods and/or exchanges of goods. Out of the RMB18 million sales, approximately RMB12.4 million has been identified to possibly involve subsequent returns of goods (see "Transaction Group A" below) and exchanges of goods of approximately RMB11 million (see "Transaction Group X" below). It is noted that there was an overlap in Transaction Group A and Transaction Group X as regards to sales of approximately RMB5 million as some of the relevant sales order entries were not linked in the inventory management system as exchanges of goods.

Findings

Transaction Group A

The Forensic Accountant noted that there appeared to be a returns of goods of approximately RMB12.4 million (i.e. about 9% of the total sales orders during the Review Period) relating to five sales orders between April and May 2017, where the relevant sales had been recognised in December 2016 ("**Transaction Group A**").

The Forensic Accountant was advised by the Company that Transaction Group A was in fact exchanges of goods associated with five subsequent sales orders but was not linked in the Company's inventory management system as an exchanges of goods. The Company explained that for three of the five sales orders, new orders were placed by the customers the second day after the returns of sales; for the remaining two sales orders, the goods were returned in April 2017 and the customers placed new orders between April and June 2017 with similar sales amount. The Forensic Accountant was provided with three internal approval documents dated April 2017 to support that the relevant customers were entitled to exchange goods in the second quarter of 2017 for the same value of the orders they placed earlier.

To understand whether the goods of Transaction Group A were in fact delivered to the customers, the Forensic Accountant also reviewed the logistics records and electronic documents in relation to Transaction Group A. It appeared to the Forensic Accountant that: (1) goods totalling RMB 4,957,262 were first delivered to the Subject Group Companies' Shanghai office at Changping Road, but according to the Company were subsequently returned, with new orders of similar amount placed between April and June 2017, and the goods were delivered to the customers in the same period; (2) goods totalling approximately RMB1.1 million (including tax) were yet to be delivered as of February 2017. Forensic Accountant further looked into this RMB1.1 million sales order and noted from a subsequent email chain dated 24 March 2017 that the Company and the customer reached an agreement that goods of RMB0.3 million would be delivered in March 2017, with the remaining sales of RMB0.8 million being executed by a new sales order by April or June 2017. The Forensic Accountant noted that the above two sales orders were supported by the Company's internal logistics records, whilst no third-party evidence could be provided to substantiate that goods for these sales orders were delivered to the customers when the sales were recognised in December 2016. On the other hand, the Forensic Accountant noted from logistics documents that the new sales orders placed between April and June 2017 were delivered to the customer.

Transaction Group X

The Forensic Accountant noted that goods relating to the sales of RMB10,965,558 were first exchanged after the sales were made ("**Transaction Group X**"), and out of which sales of RMB5,334,374, which overlaps with Transaction Group A, were returned with new orders of similar amount placed between April and June 2017, and goods of the new sales order were delivered to the customers in the same period.

The Forensic Accountant did not note any evidence that suggests that the Subject Customers had other cross-year sales return exceeding RMB100,000.

Transaction Group B

The Forensic Accountant noted that there were additional goods exchange totalling RMB16,552,572 from January 2016 to June 2019 and RMB452 in June 2020 (which was accidentally accepted according to the Company). Some of the sales orders had incurred multiple rounds of goods exchange and/or were made across different financial years. Due to the potential workload involved, the Forensic Accountant did not identify all rounds of goods exchange and therefore could not identify their corresponding original sales amount and the total amount involved in the multiple rounds of goods exchange occurred.

Notes from the Company:

Based on the above, the Company noted the following:

- A. Goods in Transaction Group A appeared to be returned in the Company's inventory management system but were actually exchanged;
- B. Exchanged goods in Transaction Group A were all delivered to the customers by June 2017 and were supported by third party logistics records;
- C. Goods in Transaction Group X were exchanged and out of which sales of RMB5,334,374 were covered in Transaction Group A, which as mentioned above, appeared to be returned in the Company's inventory management system but were actually exchanged; and
- D. Sales in Transaction Group B were identified as exchanges of goods but no details were given as to their corresponding original sales amount and the total amount involved.

2. Review of logistics documents

Background

The Forensic Accountant reviewed the logistics documents of sales orders totalling RMB81,405,468, representing 62% of the Subject Customers' total sales during the Review Period to ascertain whether goods were in fact delivered to the customers for these transactions. For logistics related findings in respect of Transaction Group A, please refer to the above.

Findings

The Forensic Accountant noted that as the third-party logistics records were not required to be kept for a long period of time, these records were not well-maintained. As such, some of the transactions were not properly supported by third-party logistics records but were nonetheless supported by the Subject Group Companies' internal records.

Furthermore, certain logistic records appeared to suggest that apart from those findings noted in paragraph 1 above, there was an additional amount of goods valued at RMB3,012,944 which might not have been delivered to customers within the agreed delivery period. Among these transactions, the Forensic Accountant noted an internal approval document indicating that in December 2017, the then CEO of the Company agreed that the goods sold to one customer valued at RMB854,701 would not be delivered at the time of the order and that the customer would be granted a right to exchange goods. The Forensic Accountant examined various supporting documents to substantiate that the exchanged goods were delivered to the customer by way of the following: (i) the logistics records revealed that goods in the original sales order were delivered to the customer by various shipments between March 2018 and June 2019; (ii) a sales order list and goods exchange records showed that a goods exchange for this sales order of RMB771,935 was processed between July 2018 and July 2019; (iii) goods exchange of RMB19,528 was supported by warehouse receipt records and (iv) goods exchange of RMB720,645 was supported by delivery records.

Notes from the Company:

Based on the above, the Company noted the following:

- A. Third-party logistics records were not well-maintained, but goods delivery was nonetheless supported by internal records;
- B. Goods valued at RMB3,012,944 might not have been delivered to customers within the agreed delivery period; and
- C. The then CEO of the Company agreed that the goods valued at RMB854,701 would not be delivered at the time of the order and that the customer would be granted a right to exchange goods.

3. Reconciliation between the total sales amount and the total sales receipt

Background

In order to assess if all sales transactions had been settled, the Forensic Accountant performed the reconciliation between the total sales amount (i.e. the total sales amount of original sales orders taking into account any exchange and return of goods) and the total sales receipt (i.e. the total sales amount actually received taking into account any exchange and return of goods) of the Subject Customers during the Review Period.

Findings

The Forensic Accountant did not notice any major discrepancy between the total sales amount and the total sales receipts of the Subject Customers during the Review Period.

Further, among the sales receipts of RMB133,549,667, the Forensic Accountant reviewed transactions of RMB58,118,956 on a sample basis. For transactions of RMB50,518,339 (representing 86.9% of the sampled transactions), the Subject Group Companies provided the relevant POS slips or bank statements to substantiate that the payments had been received.

For the remaining transactions of RMB7,600,617 (representing 13.1% of the sampled transactions), the Forensic Accountant noted the following observations:

- For transactions of RMB6,082,383 (representing 10.5% of the sampled transactions), certain information such as customer codes or payer accounts was not documented on the POS slips/bank statements. However, other supporting documents revealed that the Subject Group Companies had received the proceeds with amount matched to the sampled amount.
- For transactions of RMB717,970 (representing 1.2% of the sampled transactions) which all involved Customer W, the customer codes stated on the POS slips were one of Customer W's customer codes but it's not the same code of Customer W as reflected in the Accounts Receivable sub-ledger. The Forensic Accountant was informed that Customer W has multiple customer codes and the customer codes stated on POS slips were inaccurate. However, due to potential workload, the Forensic Accountant did not review all receipts involving Customer W.
- For transactions of RMB800,264 (representing 1.4% of the sampled transactions) which all involved Customer W, the Forensic Accountant was informed that Customer W previously paid one of the Subject Group Companies sales entities, Entity A, by multiple instalments and then some of the remaining proceeds were transferred to the Company's another sales entity, Entity B, by a lump sum transaction of RMB800,264, as Customer W's customer codes were managed by Entity B thereafter. However, as the Forensic Accountant could not trace the original sales amount, the Forensic Accountant were not able to substantiate the payment made by Customer W.

Notes from the Company

Based on the above, the Company noted the following:

- A. The Forensic Accountant did not notice any major discrepancy between the total sales amount and the total sales receipts of the Subject Customers during the Review Period;
- B. There were some deficiencies to verify the actual payers for the sales order; and
- C. The Company has taken various remedial actions to address the concerns in relation to payer identity verification such as installing a new POS terminal from UnionPay to allow backend payer identity verification. For details, please refer to the section headed “Remedial Actions – Concerns over how certain individual distributors and customers settled their payments to the Company” in the Announcement.

4. Other findings

Based on the Forensic Accountant’s electronic document review, multiple members of the then management appears to be involved in the logistics arrangement stated above, including the former CEO, the former CFO, the former COO, the former sales general manager and the supply chain general manager. The Forensic Accountant was advised that except for the supply chain general manager, the other management members had already left the Company. Therefore, the Forensic Accountant were unable to interview these individuals to seek their explanations on the issues noted above.

Key Limitations

The Additional Forensic Report is subject to limitations. Key limitations are set out below:

- the Forensic Accountant analysed the sales return and/or goods exchange of the Subject Customers. The results of the analysis can only indicate the sales return and/or goods exchange involving the Subject Customers, but cannot be extrapolated to the general population of transactions.

- For the selected sales transactions of RMB13,078,155 (representing 16% of total selected transactions of RMB81,405,468) and subsequent goods exchange of RMB279,788 (representing 3% of total subsequent goods exchange of RMB8,188,267), the Forensic Accountant was only provided with the Subject Group Companies' internal logistics records without any third-party evidence. Moreover, the Forensic Accountant identified 32 out of 237 records with discrepancies in the parcel weight and/or number of boxes between the Subject Group Companies' internal logistics records and the logistics fee settlement records, goods volume (in terms of boxes) would first be converted into parcel weight and then be further added to the total weight of parcels, while on the internal logistics records, the goods volume would not be taken into consideration in determining the parcel weight. Moreover, in certain circumstances, a sales order might be shipped together with other sales orders. Therefore, the weight and/or number of boxes on two records might be different.
- The Forensic Accountant performed keyword searches in the logistics fee settlement records during the Review Period using terms relating to the Subject Group Companies' office, branch offices and warehouses, with an attempt to identify any goods shipped to the above locations. However, the Forensic Accountant was unable to ascertain the completeness of their search results due to insufficient information stated on the logistics records (e.g. street information not included in logistics fee settlement records etc.).

Audit Committee's remarks on key findings of Additional Forensic Review

As disclosed above, during the Forensic Review of 2019 sales transactions, the Forensic Accountant noted from several documents that seemed to suggest that the Subject Group Companies might have been engaged in channel stuffing during the Review Period. The Audit Committee understands that the term "channel stuffing" does not have a universal definition, but is generally referred to a business practice whereby a company sells its products to its distributors in a quantity which is more than the distributors would willingly order, with a view to artificially inflating short-term sales figures. The Audit Committee further understands that mandatory sales targets and/or unusually long return policies are common red flags for channel stuffing. However, the Audit Committee does appreciate that the mere existence of a certain red-flag (e.g. minimum sales targets) does not necessarily mean that a company has in fact engaged in channel stuffing as such company may have legitimate commercial reasons to enter into such arrangements with its customers (e.g. the minimum sales target has been reached after arm's length negotiations between the parties based on reasonable forecast of end-customer demand).

Based on the information available to Company at the time of making the Announcement, the Company was not aware of any material evidence which would substantiate the Allegation. Nonetheless, the Board and the Audit Committee took the Allegation seriously, and in order to investigate into these matters, the Audit Committee has instructed the Forensic Accountant to conduct the Additional Forensic Review.

The Audit Committee noted certain findings of the Additional Forensic Review, in particular the extended period of time allowed for goods exchange for certain sales and the delayed delivery of goods, raise a serious concern of the existence of channel stuffing during the Review Period. The Audit Committee would like to know whether there were legitimate commercial reasons for such sales practice but noted that the Forensic Accountant was unable to interview the previous management for an explanation. Regardless, the Audit Committee considers the sales practices during the Review Period is generally unsatisfactory and recommend the Company to take active steps to ensure that the Company will not engage in channel stuffing.

The Additional Forensic Review has reported that there was no major discrepancy between the total sales amount and the total sales receipts of the Subject Customers during the Review Period. The Audit Committee is of the view that this demonstrates the Company has not suffered material financial loss during the Review Period.

The Auditors advised that they would consider the findings in the Additional Forensic Review Report and determine the implications, if any, for their audit opinion of the Group's consolidated financial statements for the year ended 31 December 2019.

The Board of Directors concurs with the Audit Committee's view above.

The Audit Committee notes that the Board has taken various remedial actions to address the concerns identified in the Forensic Review, which shall also be applicable to address the issues identified in the Additional Forensic Review. These remedial actions include restructuring the regional sales teams, redrafting the "Authorised Dealer Agreement", engaging a new logics companies, updating internal policies and the employee handbook. For details, please refer to the section headed "Remedial Actions – Management of Authorised Dealers" and "Remedial Actions – Enhance Logistics Management" in the Announcement.

Specific to the management of the Subject Group Companies, the Audit Committee notes that the Company has revamped the composition of the board of directors in each Subject Group Companies in mainland China by appointing two external non-executive directors on 30 October 2020.

In addition, as disclosed in the Company’s announcement dated 25 August 2020, the Audit Committee notes that the Company has also instructed an independent internal control consultant (“**Shinewing**”) to conduct an independent review of the internal control systems and procedures of the Group to address the concerns identified in the Forensic Review. The Audit Committee understands that upon the recommendation of Shinewing, the Company has since implemented additional internal control procedures to address the Group’s internal control weakness. Shinewing is also in the process of reviewing the Group’s implementation of all the enhanced internal control measures. Upon learning about the key findings of the Additional Forensic Review, the Audit Committee has also instructed Shinewing to (1) make further recommendations to enhance the internal control in respect of concerns raised by the Additional Forensic Review; and (2) review the implementation progress of the enhanced internal control measures.

CONTINUED SUSPENSION OF TRADING

Trading in the Shares on the Stock Exchange has been suspended at the request of the Company since 9:00 a.m. on 25 March 2020 and will remain suspended until further notice. Shareholders and potential investors of the Company are advised to exercise caution when dealing in the securities of the Company.

By order of the Board
Natural Beauty Bio-Technology Limited
LEI Chien
Chairperson

Hong Kong, 20 November 2020

As at the date of this announcement, the Board comprises Dr. Lei Chien and Mr. Pan Yi-Fan as executive directors; Ms. Lu Yu-Min, Ms. Lin Shu-Hua and Mr. Chen Shou-Huang as non-executive directors; and Mr. Chen Ruey-Long, Mr. Lu Chi-Chant and Mr. Yang Shih-Chien as independent non-executive directors.