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自然美
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
AUDITORS' LETTER TO THE AUDIT COMMITTEE

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; (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; (iii) the announcement of the Company dated 14 August 2020 in relation to the appointment of the auditors of the Company; (iv) the announcement of the Company dated 25 August 2020 in relation to, among others, the appointment of the internal control consultant; and (v) the announcement of the Company dated 20 November 2020 in relation to the key findings of Additional Forensic Review. Unless otherwise stated, capitalised terms used herein shall have the same meanings as those defined in the announcement of the Company dated 20 November 2020 (the "**Announcement**").

AUDITORS' LETTER TO THE AUDIT COMMITTEE

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 a forensic review on certain Group's wholly-owned subsidiaries in China ("**PRC Sales Entities**") of the Issues ("**Forensic Review**"). On 21 July 2020, the Company announced the key findings of the Forensic Review.

As disclosed in the Company's announcement dated 21 July 2020, 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 PRC Sales Entities 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**"). On 20 November 2020, the Company announced the key findings of the Additional Forensic Review.

On 27 November 2020, the Auditors wrote a letter to the Audit Committee setting out the Auditors' audit findings in relation to the Forensic Review and the Additional Forensic Review, as well as certain deficiencies in internal control identified during the audit ("**AC Letter**"). Details of the AC Letter are set out below:

ISSUE 1 – REVENUE RECOGNITION METHOD POSSIBLY DEVIATED FROM THE GROUP'S ACCOUNTING POLICIES

According to the Auditors' discussion with the finance department and IT department of the PRC Sales Entities, the PRC Sales Entities' accounting system was implemented to recognise revenue when the goods were dispatched to the logistics service provider in the past. However, the Group's accounting policies require revenue to be recognised when control of the goods has transferred to the customers, being at the point when the goods are delivered to the customers.

Financial impact and implication to the financial year of 2019 ("FY2019")

During the Forensic Review, the Forensic Accountant identified sales of goods of approximately RMB23.4 million (excluding value-added tax) recorded in late-2019 but appeared to have been received by customers in early-2020.

The Company agreed with the Forensic Accountant's findings and made accounting adjustments to recognise the RMB23.4 million sales in financial year of 2020 as revenue instead of FY2019.

Financial impact and implication to the financial year of 2018 ("FY2018")

The result of the Auditors' procedures indicated it was possible that some revenue previously recognised in late-2017 could be actually FY2018 revenue, and some revenue previously recognised in late-2018 could be actually FY2019 revenue, when applying the Group's accounting policies correctly (i.e. recognising revenue upon delivery of goods to customers).

Due to the fact that the Group did not have properly-maintained third-party goods delivery documents for the prior reporting periods that indicated the actual delivery date and the correct point of time for revenue recognition, the Auditors were unable to accurately quantify the possible financial impact, if any.

As a result, the Auditors modified their audit opinion in respect of the Group's reported revenue and cost of sales for FY2018, and the reported carrying amounts of trade receivables, inventories and contract liabilities as at 31 December 2018, which were presented as comparative figures to the Group's FY2019 consolidated financial statements.

Deficiency in internal control

The PRC Sales Entities did not have established and documented accounting procedures for handling revenue and associated costs cut-off adjustments at end of reporting period and well-kept goods delivery documents, which could lead to timely and costly procedures to prepare the required revenue and associated costs cut-off adjustments afterwards.

ISSUE 2 – GOODS EXCHANGE PROMISES

After the Auditors' interview with the Group's management, the Auditors understood that sales personnel in certain PRC Sales Entities could have verbally promised customers in prior years for goods exchange quota when confirming the sales orders ("**Goods Exchange Promises**"). It was also noted that the PRC Sales Entities had no established procedures to collect such verbal promises on a timely basis in prior years.

Financial impact and implication to FY2019

As noted in the Forensic Review, sales order listing provided by the Group had recorded approximately RMB11.1 million (inclusive of value-added tax) goods exchange transactions involving franchisees and distributors in FY2019.

Based on information and supporting documents provided by management, out of this RMB11.1 million (inclusive of value-added tax) goods exchange transactions, approximately RMB7.5 million (inclusive of value-added tax) were related to normal goods exchange that would not affect revenue recognition (e.g. return due to quality issues, unconditional return within 7 days subject to 2% total order amount). For the remaining RMB3.6 million (inclusive of value added tax) goods exchange transactions, the Auditors were unable to obtain sufficient appropriate audit evidence to satisfy themselves as to whether these exchanged goods were related to Goods Exchange Promises made before FY2019 and consequently whether they were properly recorded in FY2019. As a result, the Auditors modified their audit opinion in respect of this.

Financial impact and implication to FY2018

Due to insufficient information on the existing accounting records, the Auditors were unable to determine the amount of goods exchange related to Goods Exchange Promises made before FY2018, if any. As a result, the Auditors modified their audit opinion in respect of this.

Deficiency in internal control

1. The PRC Sales Entities did not have established and documented policy that require the sales personnel to report and the PRC Sales Entities' finance department to record those verbal Goods Exchange Promises made by sales personnel, in a complete and timely manner. The finance department may experience difficulties when applying the relevant accounting standards to revenue recognition if such information of Goods Exchange Promises were not available.

2. Making verbal promises without valid written agreement with customers could also lead to subsequent disputes.

ISSUE 3 – DISPUTED SALES ORDER IN FY2018

Financial impact and implication to FY2018

The Additional Forensic Review mentioned a purported sales order of RMB7 million in June 2018.

The Auditors inspected the purported sales order and related accounting records and also interviewed the relevant PRC Sales Entities personnel to understand the details and background. According to the management, Customer X had overdue account receivables at the time of placing the disputed sales order and he misrepresented the Group and placed the disputed sales order by using the name of another customer, Customer Y. The management further advised that both Customer X and Customer Y had denied the disputed sales order was placed by them.

Based on the information obtained, the Auditors were unable to determine the identity of customer as required by the relevant accounting standards and consequently unable to determine whether the purported sales should have been recognised as revenue in FY2018. As a result, the Auditors modified their audit opinion in respect of this.

Deficiency in internal control

The Company's internal audit department had successfully detected the incident in second half of FY2018 and a report was prepared. However, economic losses could not be avoided as the PRC Sales Entities' internal control failed to detect the incident at an earlier stage. The following deficiencies were identified:

1. the design of the goods dispatch workflow was unable to detect and report abnormal logistic flow to management and the PRC Sales Entities' finance department in a timely manner. There appeared no mandatory policy that required the logistics and warehousing department to report abnormal flow of goods (e.g. delivering goods to an address that belongs to another customer).

2. there was a lack of written or electronic confirmations from customers for finalised sales orders. The written or electronic confirmations shall be directly received by other department (e.g. the finance department) rather than the sales personnel.

ISSUE 4 – SALES PROCEEDS COLLECTION ARRANGEMENT

The Forensic Review investigated into the process of certain PRC Sales Entities' sales proceeds collection arrangement. The Auditors discussed with the management and interviewed certain sales personnel and customers to understand the sales proceeds collection arrangement in the past. The Auditors were advised that certain customers settled their trade-related payments to the Group via their relatives, friends, downstream customers, and sales personnel/employees of the PRC Sales Entities. Some of the sale personnel had kept credit cards of customers for assistance of settlement purpose.

The Auditors were also advised by the management that the PRC Sales Entities mainly relied on sales personnel to confirm terms of sales orders and inform customers about their outstanding trade balances regularly.

Deficiency in internal control

1. There were no policies to prohibit sales personnel and employees from paying on behalf of customer and keeping customers' credit cards.

2. There were no mandatory policies to require customers and their designated payers to provide details of payment (e.g. payer's name, customer name, customer code, payment on behalf relationship) when transacting the payments. In order to ascertain the source of fund from customers and for the accurate trade receivables settlement process, the PRC Sales Entities' finance department shall obtain the required details of payment before confirming the validity of such payment to other departments.

3. The PRC Sales Entities relied on sales personnel to inform customers regularly on outstanding and overdue trade receivables, while the PRC Sales Entities' finance department had no direct contact with customers. The PRC Sales Entities' finance department's ability to detect irregularity and error would be impaired if they had no direct and regular contact with all customers. The PRC Sales Entities' finance department was recommended to issue monthly statements to all customers directly. The PRC Sales Entities' finance department was also recommended to establish direct communication channel with all customers (e.g. email, intranet) in order to handle enquiries and issues directly with customers.

4. There was no comprehensive policies and procedures for trade receivable reconciliation for all relevant employees to follow.

ISSUE 5 – GOODS DELIVERY RECORD MAINTENANCE

The Forensic Review identified that certain PRC Sales Entities used to retain a warehousing and logistics service provider for arranging warehousing and delivery of goods from its warehouse to the Group's customers. Based on logistics tracking sheets maintained by that logistics service provider, in FY2019, goods with corresponding sales value of RMB68.4 million (i.e. 24% of total annual sales of the PRC Sales Entities) were purportedly delivered by special vehicles. According to the representative of that logistics service provider, goods delivered by special vehicles did not have tracking numbers as they were mostly owned by self-employed truck drivers. The management represented that goods receipt notes ("**GRNs**") related to these purported deliveries were not well-maintained by that logistics service provider and thus some were not available for inspection, not signed off by customers or with certain inconsistencies were noted.

The Auditors understood from the management that the PRC Sales Entities mainly relied on customers' complaint calls and the logistics department personnel's follow up calls with customers in order to detect non-delivery of dispatched goods.

According to an internal audit report prepared in the second half of the financial year of 2020, the internal audit department had inspected the customer complaint records of the customer service department for FY2019 and no indication of non-delivery caused by special vehicles. The internal audit department further concluded they had not found any notable irregularity in the logistics operation.

Deficiency in internal control

GRNs were not properly signed by customers and not properly kept by the PRC Sales Entities. The management may not ascertain whether the goods have been properly delivered and received by customers. It may pose potential risk of legal disputes.

ISSUE 6 – PRESSURE OF ACHIEVING SALES TARGET

The report of the Forensic Review noted certain indications that the management and the sales personnel were under the pressure of achieving sales target. The Auditors understood that the management had reviewed all sales orders placed by the top 6 customers near end of December 2019 and concluded that part of these sales orders amounted to approximately RMB13.5 million (excluding value-added tax) were overlapped with those revenue cut-off issues as described in Issue 1 above. For the remaining portion of sales transactions placed by the top 6 customers near end of December 2019 amounted to approximately RMB17 million (excluding value-added tax), the management had concluded that these sales orders were properly recorded as revenue in FY2019.

ISSUE 7 – ACCOUNTS RECEIVABLE FROM MAJOR CUSTOMERS

The report of the Forensic Review mentioned the status of the Group's accounts receivable from certain major customers as at 31 May 2020. The Auditors noted that the largest debtor had already provided one of her properties as collateral in October 2020 and settled her outstanding trade balances gradually. The Auditors also noted that for other major customers with relatively smaller outstanding balances, the management advised that they had already considered and provided the expect credit losses accordingly as at 31 December 2019.

ISSUE 8 – POSSIBLE INDICATION OF CHANNEL STUFFING PRIOR TO FY2019

The report of the Forensic Review mentioned that some documents indicated that certain PRC Sales Entities might have been engaged in channel stuffing prior to FY2019 and in some cases, goods might not have been delivered to customers in due time.

The Auditors noted that the Audit Committee had instructed the Forensic Accountant to perform the Additional Forensic Review and the Forensic Accountant had reported their findings in a report.

The Auditors had considered the findings of the Additional Forensic Review and its implication to their overall audit opinion to the Group's consolidated financial statements and resulted in the modified audit opinion.

AUDIT COMMITTEE'S RESPONSE TO THE AC LETTER

On 30 November 2020, the Audit Committee wrote to the Auditors in response to the Auditors' observations set out in the AC Letter (the "**AC Reply**") where the Audit Committee advised the Auditors that:

1. the Audit Committee acknowledged that the findings in the Forensic Review and the Additional Forensic Review revealed certain concerns in the Company's internal control system in areas such as collection of sales proceeds, Goods Exchange Promises and delivery of goods;

2. upon learning about the findings of the Forensic Review, the Board had taken various remedial actions to address the concerns identified therein. These remedial actions included restructuring the regional sales teams, redrafting the "Authorised Dealer Agreement", engaging a new logics companies, updating internal policies and the employee handbook. The details of these remedial actions can be found under the section headed "Remedial Actions – Management of Authorised Dealers" and "Remedial Actions – Enhance Logistics Management" in the Company's announcement dated 21 July 2020;

3. specific to the management of the PRC Sales Entities, the Company had revamped the composition of the board of directors in each PRC Sales Entities by appointing two external non-executive directors on 30 October 2020;

4. the Company had 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;

5. following the recommendation of Shinewing, the Company had since implemented additional internal control procedures to address the Group's internal control weakness;

6. upon learning about the key findings of the Additional Forensic Review, the Audit Committee had further 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; and

7. in response to the AC Letter, the Audit Committee had requested Shinewing to assess whether the Group's enhanced internal control is also sufficient to address the internal control deficiencies raised by the Auditors in the AC Letter and make further recommendations if necessary.

The Company will make further announcement(s) once the results of Shinewing's (1) review of the internal control systems and procedures of the Group to address the concerns identified in the Forensic Review and Additional Forensic Review and (2) assessment of whether the Group's enhanced internal control is also sufficient to address the internal control deficiencies raised by the Auditors in the AC Letter become available.

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, 30 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.