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Headline: China Sky special audit reveals lapses in public disclosures but no serious fraud

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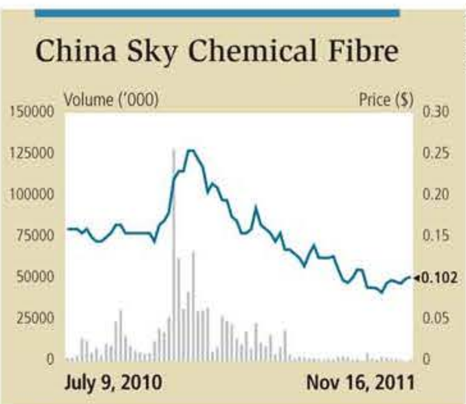
The special audit that was forced on China Sky Chemical Fibre last year has turned up a number of infractions, mostly related to its public disclosures. But no hard evidence of serious fraud has been uncovered. In fact, the findings by special auditor Stone Forest Advisory Corp, which were released on June 20, were an anti-climax after several months of contentious exchanges between officials of China Sky and Singapore Exchange (SGX) in late 2011 and early 2012.

SGX first ordered China Sky to perform a special audit on Nov 16, 2011, after months of queries about a land deal in 2006 that was later aborted, a series of interested party transactions (IPTs) and a plant upgrading project in 2009 that cost the company some RMB72 million ($14.94 million). A maker of nylon fibres, China Sky initially resisted the order for a special audit, which lawyers say is normally carried out to investigate irregularities and fraud. Noting that it would be a costly exercise and distract management from running the business, the company demanded to know why a special audit was required. It was, however, eventually forced to comply with the directive.

Now, it seems that the market's worst fears about China Sky were not warranted. Notably, Stone Forest says it did not find any "persuasive" evidence that the land transaction was "fictitious". The special auditor does, however, add that the company had issued "erroneous disclosures" on the land deal, for which it blames the board and former chief financial controller Sunny Hui. Stone Forest also says it was unable to verify if the transactions were implemented in accordance with the acquisition and termination agreements.

As for the IPTs at China Sky that had worried SGX, a lack of proper disclosure appears to have been the key problem. China Sky had used the services of Lai Seng Kwoon, who was an independent director of the company and had his own accounting firm. The company did not disclose this on the grounds that each transaction with Lai's firm never exceeded the reportable threshold of $100,000. Stone Forest says China Sky ought to have reported the aggregate fees it paid as these exceeded the reportable threshold. However, Stone Forest concedes that there is a lack of clarity on the rules. In any case, even if the aggregate fees had not breached the reportable threshold, China Sky should have reported that there were "no discloseable IPTs" during the financial years in question, rather than that there were "no IPTs", according to Stone Forest.

As for the plant upgrading project, which was not announced, Stone Forest says China Sky ought to have tabled the matter in a board meeting. The board should then have decided whether an announcement was required.



Given the absence of any evidence of fraud, was SGX justified in demanding that China Sky perform a special audit?

Audit not conclusive

Yeap Wai Kong, one of China Sky's former independent directors, tells *The Edge Singapore* that he is surprised by some of the findings revealed by the special audit. Among other things, several details of the land transaction that were subsequently rescinded had not been made known to him while he was on the board. "They were not disclosed to board members. The auditors were not aware of them," he says.

Yeap adds that more details might have been uncovered had Stone Forest been able to lay its hands on the relevant documents and files. Several documents related to the land deal, for instance, were returned to the vendor after the transaction fell through. Lai's records of the IPTs have been handed over to the Commercial Affairs Department, which is conducting its own investigation. The way he sees it, the special audit was not conclusive. "It's like the blind feeling the elephant. What is the truth?" says Yeap.

However, Yeap notes that the special audit found that there was apparently nothing fictitious about the land deal in China. And, he maintains that China Sky was basically an honestly run company. "I don't think they are crooks. The business was doing well and the CFO cooperated with the investigators. As far as I am concerned, I have done my part."

Yeap had initially supported China Sky's management in wanting to obtain clarification from SGX on the reasons for the special audit. He stepped down from the board on Jan 5, 2012, after failing to convince the company to comply with SGX's order. SGX had also reprimanded Yeap and other former directors of China Sky for not complying with its directive. Yeap subsequently tried to get a court order to quash his reprimand, arguing that he had not been given a chance to explain his position. He didn't succeed, though. "[SGX] had to do what it deemed fit, and I did what I deemed fit. And, I paid the price," Yeap says.

Among the other officials who suffered from the fallout was China Sky's former CFO Hui. The 43-year-old Hong Kong resident has not worked since resigning in February 2012. When contacted by *The Edge Singapore*, he says he is happy to be able to spend more time with his family, but declined to comment about the outcome of the special audit by Stone Forest. "I am not saying I agree or I disagree with them," he says.

Meanwhile, China Sky's former chairman and CEO Huang Zhongxuan, who also resigned in February 2012, still controls a 37.75% stake in the company, with a partner named Cheung Wing Lin. The company is now run by a professional CEO, Ling Yew Kong.

More action pending

Given the absence of any evidence of fraud, was SGX justified in demanding that China Sky perform a special audit? Will this episode give SGX a reputation for highhandedness in its regulation of listed companies? What does it mean for investors?

Jeremy Leong, an assistant law professor at Singapore Management University (SMU), calls what happened with China Sky a test case that has "imposed costs on everyone", but says it is all part of the growing pains of an emerging financial market. Coming after a string of corporate governance scandals involving S-chips, SGX's action against China Sky might boost confidence in the local market and deter low-quality companies from seeking a listing here, he adds.

"[For] people who think Singapore is a great place to list because the regulatory framework is not so good and are trying to arbitrage into a less regulated environment, this tells them: 'No, we don't want you. We only want good companies. A special audit may be required of you'," Leong says. On the other hand, local regulators have to avoid overreaching and recognise that special audits impose a significant cost on small companies, he continues. "The challenge for SGX is to make sure it is consistent, that it is very clear and very transparent, going forward."

Yeap, the former independent director of China Sky, says he was actually in favour of the special audit, even though it was a costly exercise. "Regardless of whether there is fraud or not, there are rules once you join the exchange and you have to abide by those rules," he says. Now, with the special audit done, China Sky ought to quickly see to it that its shares begin trading again so that its minority investors can realise the value of their holdings, he adds. "The minorities were penalised for no reason. Now that things are clearer, they should be given an opportunity to trade and to decide."

However, China Sky and individuals that were once linked to it might still face action from the Monetary Authority of Singapore, according to some market watchers. There is also an ongoing police investigation that could result in some parties landing in hot soup. Leong of SMU points out that the failure to make proper disclosures is a serious lapse for public listed companies. "If you look at the Securities and Futures Act, there is liability for failure to fulfil continuous disclosure obligation. The only question is whether MAS will take any action," he says.

Shares in China Sky have been suspended from trading since Nov 17, 2011. According to its last available financial statements, it reported earnings of RMB111 million for the first nine months of FY2011. The company, which was listed in 2005, had paid dividends every year until FY2009.