DYNASTY
Since 1980

Dynasty Fine Wines Group Limited
王朝酒業集團有限公司
(Incorporated in the Cayman Islands with limited liability)
(Stock code: 828)

UPDATE ON RECENT DEVELOPMENT OF SUSPENSION – REPORT OF INTERNAL INVESTIGATION

This announcement is made by Dynasty Fine Wines Group Limited (the "**Company**") pursuant to Rule 13.09 of the Listing Rules 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).

References are made to the Announcements.

A. BACKGROUND

As set out in the announcement of the Company dated 14 August 2015, the Company was informed by its auditors, PwC, that they had received anonymous allegations against certain transactions of the Group.

Upon being notified of the allegations, the Board authorised the AC to undergo an independent investigation of such allegations. The AC then engaged legal advisers, who in the legal representation of the AC engaged EY, an independent accounting firm, to conduct the Internal Investigation. The independent review period as agreed with the AC is from 1 January 2010 to 31 December 2011. The scope of work undertaken by EY was limited to the Allegations, being the allegations raised in three letters received by PwC between the end of December 2012 and February 2013.

During the course of the Internal Investigation, two additional anonymous allegation letters were received by EY (the "**Fourth Allegation Letter**") and PwC (the "**Fifth Allegation Letter**") respectively. Overall speaking, subject to completion of the audit, the Company will then consider whether to extend the scope of Internal Investigation in relation to the allegations set out in the Fourth Allegation Letter. As there were no substantive allegations set out in the Fifth Allegation Letter, the Company considered that it was not necessary to extend the scope of the Internal Investigation.

As set out in the announcement of the Company dated 25 September 2013, the Company on 18 September 2013 received the Interim Investigation Report dated 17 September 2013 issued by EY.

As at the date of this announcement, the Company received the updated draft Investigation Report dated 29 July 2016 issued by EY. This announcement sets out, among other things, the principal observations from EY and the responses provided by the Management to EY as contained in the updated draft Investigation Report.

B. SUMMARY OF THE ALLEGATIONS

Based on the first three allegation letters received by PwC, the Allegations mainly covered the following major areas:

I. First Allegation – Sales arrangement with Customer A

1. It was alleged that the sale of goods to Customer A (a main distributor in Eastern China) in the amount of RMB430 million recorded in 2010 was fictitious.

2. It was alleged that in order to achieve its sales targets and obtain the related bonus, Shanghai Dynasty Sales Co (a member of the Group) and Customer A entered into a main distributor agreement in 2010. It was alleged within several weeks of signing this agreement, Customer A had paid Shanghai Dynasty Sales Co RMB430 million in bank notes (including term bills) and the Group issued VAT invoices to Customer A in the amount of RMB430 million. It was alleged, however, Customer A did not take delivery of the goods, nor did it sell the goods. It was further alleged the obligation to sell the RMB430 million worth of goods was to be discharged entirely by Shanghai Dynasty Sales Co. Furthermore, it was alleged under the aforesaid agreement, Shanghai Dynasty Sales Co undertook to complete the sale of goods to external parties as soon as possible in 2011 and would repay Customer A with the sales proceeds plus interest.

II. Second Allegation – Sales arrangement with Customer B

It was alleged that in 2011, following the model of the agreement signed with Customer A in 2010, the Group entered into a similar agreement with Customer B.

III. Third Allegation – Sales arrangement with other customers

It was alleged that by reviewing the VAT invoices of the Group's sales companies (including Shanghai Dynasty Sales Co) issued in 2010 and 2011, the few customers whose purchases in the fourth quarter of 2010 or 2011 having exceeded RMB50 million were counter-parties cooperating with the Group to create fictitious sales.

IV. Fourth Allegation – Unsellable inventory

1. It was alleged that the RMB500 million worth of wine stored at both Jiangsu Taicang and Fujian Zhangzhou warehouses in 2010 remained in the warehouses because they were not fit for sale. It was alleged as time had passed, the inventory stored in the warehouses was no longer sellable for the following reasons:

   (a) the weather was hot and humid. After being subjected to high temperature and humidity of two rainy seasons, the packaging and labels became mouldy;

   (b) the labelling and packaging of the wine products no longer met the latest government requirements. Some products had pesticide residues exceeding the standards;

   (c) some wine products were produced more than two years ago. Supermarkets in mainland China did not allow display of wines with production dates that were more than two years old for sale;

   (d) there were packaging and label materials worth tens of millions of RMB which had been disposed of but had not yet been properly reflected in the financial records; and

   (e) approximately 2.3 million cases of goods were returned by customers due to product quality issues. Around 800,000 cases of goods stored in Jiangsu Taicang warehouse could not be sold to supermarkets as they were produced more than two years ago. Approximately 100,000 cases of goods would require reworking or else be written off, as the product labels did not comply with the latest regulatory requirements and could not be sold on the market.

2. It was alleged that most of the abovementioned deteriorated wine inventory stored in Jiangsu Taicang and Fujian Zhangzhou warehouses had been relocated. It was alleged that it would be very difficult to find out the real situation of the wine inventory.

C. SUMMARY OF INVESTIGATION REPORT

Set out below is a summary of the principal observations made by EY in the updated draft Investigation Report, and the responses provided by the Management, being all executive Directors from time to time, to EY during the Internal Investigation:

I. Sales Arrangement

(A) Customer A

Background relationship with Customer A

The Group has been conducting sales with Customer A prior to the signing of the Distributor Agreement in November 2010. These sales were made via Shanghai Dynasty Sales Co (a member of the Group), instead of Tianjin Dynasty Sales Co (another member of the Group, being party to the Distributor Agreement). For the years 2010, 2011 and 2012, sales continued to take place between Customer A and Shanghai Dynasty Sales Co albeit with a year-on-year decrease. Customer A made purchases with Tianjin Dynasty Sales Co under the Distributor Agreement in 2010.

1. Relevant terms of the Distributor Agreement

Observations

(a) On 11 November 2010, Customer A and Tianjin Dynasty Sales Co (not Shanghai Dynasty Sales Co as alleged) entered into the Main Distributor Agreement under which:

(i) Customer A was appointed as the main distributor of the Group's dry red and semi-dry white wines in Eastern China till 31 December 2013;

(ii) Tianjin Dynasty Sales Co guaranteed Customer A's gross profit be at least 1%, otherwise Tianjin Dynasty Sales Co would compensate Customer A to make up the difference; and

(iii) Tianjin Dynasty Sales Co should stipulate that the Designated Distributors in Eastern China order from Customer A through two ways: (AA) Customer A should order goods from Tianjin Dynasty Sales Co upon receiving payments from the Designated Distributors. Tianjin Dynasty Sales Co would then directly despatch the goods ordered to the Designated Distributors; or (BB) Customer A should store a certain level of inventory and despatch to the Designated Distributors, in the event that Tianjin Dynasty Sales Co could not despatch the corresponding goods directly.

(b) On the same day, Customer A and Tianjin Dynasty Sales Co signed a Supplemental Agreement under which it was agreed that:

   (i) Customer A would purchase RMB450 million of products by the end of 2010 and would pay the Group RMB100 million in November 2010, RMB100 million in December 2010, and RMB250 million by end of December 2010;

   (ii) Tianjin Dynasty Sales Co promised to proactively work together with Customer A to reduce the inventory;

   (iii) In the event of failure by Tianjin Dynasty Sales Co to reduce more than 50% of the first RMB100 million of inventory before the second instalment payment, Customer A reserved the rights to suspend or terminate the Supplemental Agreement; and

   (iv) In the event of failure by Tianjin Dynasty Sales Co to reduce RMB300 million worth of inventory by the Spring Festival of 2011, Customer A reserved the right to determine whether to continue with the Supplemental Agreement or terminate the Supplemental Agreement and demand refund of the payment.

(c) After Chinese New Year 2011, Tianjin Dynasty Sales Co and Customer A agreed to vary the Distributor Agreement and reduced the contract amount from RMB450 million to RMB350 million due to poor market conditions.

2. Background of Strategic Cooperation with Customer A

Observations

(a) According to interviews conducted by EY with the executive Directors (including one former executive Director), the appointment of Customer A as the main distributor of the Group's dry red wine in Eastern China at the end of 2010 sought to achieve the following three objectives: (i) to stabilise the prices of the Group's products in the retail market and mitigate parallel trade situation in Zhejiang and Jiangsu Provinces; (ii) to prepare for the upcoming peak season during Chinese New Year; and (iii) to fulfil management's expectation on achieving financial targets.

(b) Further, a draft document observed on the computer of another former executive Director who resigned on 28 November 2014 by EY during the Internal Investigation contains the description that "Customer A, as a strategic business partner of the Group, assumes the reservoir (蓄水池) function for fulfilling the short term financial reporting requirements. According to the Group's needs, Customer A can stock up the Group's products in order to remove concerns over quarterly and annual financial reporting requirements with respect to the short-term sales targets of the Group. In addition, Customer A is responsible for working with the Group to manage the product price and sales channels."

EY could not verify whether the former executive Director mentioned above was in fact the creator of the document. According to the Group's response, a former member of the sales team of Shanghai Dynasty Sales Co prepared this document. Due to the lapse of time and the fact that the said employee left in 2012, at this stage the Group was not able to verify how this document was submitted to the Management.

Response from the Management in February 2014 as set out in the Investigation Report

In relation to the above observations made by EY, the Management provided the following responses:

(a) All transactions under the Distributor Agreement were real and already carried out. The purpose to establish the main distributor model in Eastern China was not "to fulfil the Group's short-term financial reporting and sales performance requirements".

(b) As background, in 2009 and 2010, consumer markets were constantly forcing down the prices of the Group's products. This led to large fluctuations of price in dry red wine and other products. The Group thus considered transformation of its distribution model in 2010 in order to stabilise the market price. Due to the nature of the wine and spirits industry, the main distributor model was very common in the industry – some famous brands all handed over their products to performing distributors to act as their national or regional main distributors with satisfactory results.

(c) The main distributor model was entered into in order to stabilise product prices in Eastern China via control on sales sources, and unifying supply chains and other control measures.

(d) In fact it was Customer A which proactively proposed the main distributor arrangement – it happened that Customer A was making strategic adjustments to its market position at around the same time. Both parties had considered their respective market positions, and based on their long-term development goals, focused on recovery and long-term development of the market for the Group's wines.

(e) As the main distributor for Eastern China, Customer A needed to maintain an appropriate level of strategic inventory. Therefore, Customer A, to a certain extent, needed to act as a "reservoir" for the Group's wines, i.e., to accumulate a certain amount of strategic inventory based on past sales. This is also common practice in the FMCG sector.

(f) The draft document discovered on the computer of a former executive Director referred to above was not the decision of the Management. The draft document was drafted by a sales person from Shanghai Dynasty Sales Co and sent to the company. The contents of such document were not decided by the Management, nor could the salesman's personal proposals be considered to represent the Management's understanding of the Group and Customer A's partnership.

3. The Goods

Observations

(a) According to the Main Distributor Agreement, the Group was committed to proactively work together with Customer A to reduce the inventory by RMB150 million by the end of 2010 and by RMB200 million before the Chinese New Year in 2011. Customer A reserved the right to terminate the agreement and demand refund if the aforementioned targets could not be met. It was observed that the inventory reduction target sets out in the Distributor Agreement was not met by the target date stated thereunder.

(b) Customer A used the two inventory vouchers issued by Tianjin Dynasty Sales Co at Customer A's request on 29 November 2010 and 29 December 2010 respectively as supporting evidence for Customer A's purchases. According to the inventory vouchers, Customer A confirmed that the RMB350 million worth of goods belonged to Customer A but that the goods were to be stored at the Group's offsite warehouses (exact warehouses not specified). Based on EY's understanding of the Distributor Agreement and interviews with Customer A, in actual practice, the Group was entrusted by Customer A to manage the above-mentioned goods and despatch goods to the downstream distributors as and when it received Goods Delivery Entrust Orders from Customer A. According to the Management's representation, the above-mentioned goods were stored at the Jiangsu Taicang warehouse among others (because it was located near Customer A's downstream distributors).

(c) According to documents provided by the Management to EY, goods were delivered to downstream distributors of Customer A between December 2010 and the middle of May 2013. The value of the related goods sold (including tax) was approximately RMB1 million in 2010, RMB136 million in 2011, RMB158 million in 2012 and RMB27 million from January 2013 to the middle of May 2013, totalling approximately RMB322 million. This included goods for self-pick up by Customer A totalling approximately RMB17 million in 2011, RMB30 million in 2012 and RMB9 million in 2013 respectively. The remaining portion of approximately RMB28 million comprised of undelivered goods and goods to be retained by Customer A.

(d) According to the records provided by the Group, in respect of the sales of RMB350 million recognised in 2010, approximately RMB1 million of the corresponding goods were in fact delivered to the Designated Distributors in 2010.

(e) EY reported that the Management should evaluate this issue and consider whether to recognise the full amount agreed upon in the Supplemental Agreement as revenue in 2010.

(f) Tianjin Dynasty Sales Co issued VAT invoices to Customer A totalling RMB350 million in 2010, and recognised the associated revenue. According to the Group, it despatched goods to the downstream distributors in line with Customer A's "Entrusted Delivery Orders" (the "**Entrusted Delivery Orders**"). The Group provided EY with copies of the Entrusted Delivery Orders from Customer A, as well as sales support documents related to Customer A's RMB350 million purchase. The following are observations from EY:

(i) the volume of goods per the sales support documents provided by the Group was lower than volume of goods despatched by the Group in relation to the RMB350 million purchases by Customer A;

(ii) the Group was unable to provide sufficient supporting documentation, so EY was unable to fully match the Entrusted Delivery Orders to the Group's sales support documents.

Accordingly EY was unable to reconcile Customer A's goods despatch records provided by the Group to the Group's sales support documents and Entrusted Delivery Orders. EY was unable to verify the accuracy of Customer A's goods despatch records relating to the RMB350 million worth of goods.

(g) During EY's review of goods despatch documents relating to the RMB350 million sale to Customer A provided by the Group (value of documents provided by the Group totaled approximately RMB252 million (the "**Documented Value**")), EY noted a portion of the sales support documents indicated the date of production. Of these orders with production dates on, EY identified 47 orders where the date of wine production was later than 31 December 2010. Dates of production were spread between 2011 and 2013 and totaled approximately RMB49 million.

Response from the Management in February 2014 as set out in the Investigation Report

In relation to the above observations made by EY, the Management provided the following responses:

(a) At the end of 2010, the Group obtained the following supporting documents: (i) invoices issued to Customer A totalling RMB350 million; (ii) corresponding receipt vouchers; (iii) outbound movement information from the accounting system; and (iv) inventory vouchers issued by the Group at Customer A's request (confirming the ownership of the goods belonged to Customer A).

From the information obtained, it was possible to determine that at the end of 2010, all conditions required to recognise the whole amount of revenue were met.

(b) The Group's accounting treatments were based on accounting evidence. Although at the end of 2010, most of the goods were stored in the Group's warehouses, and had not been delivered to Customer A's downstream distributors, the goods in the Group's warehouses belonged to Customer A. The Group had provided inventory vouchers to Customer A at Customer A's request confirming the ownership of the goods. The Group simply provided storage services to the owner of the goods (Customer A) in accordance with the arrangement titled "Temporary storage at the Group's offsite warehouses" set out in the inventory voucher. Accordingly, the Group could recognise RMB350 million revenue in 2010. The RMB350 million revenue recognised by the Group in 2010 did not breach any laws or regulations in place at the time, nor did the Group manipulate or attempt to manipulate sales revenue.

(c) Looking at historical data, the fourth quarter is a peak season for the Group in terms of accumulating inventory due to New Year and Spring Festival – the sales volume and value of dry red and semi-dry white wines make up a large proportion of total annual sales. Sales of dry red and semi-dry white wine in the fourth quarter in Eastern China in 2008 and 2009 were RMB167 million and RMB238 million (excluding VAT). The year-on-year increase was 55% and 43% respectively. From the standpoint of total sales value and year-on-year increase, the RMB330 million sales in the fourth quarter of 2010 (representing a year-on-year increase of 39%) represented a reasonable stock-up.

(d) In respect of production dates stated on the sales support documents, portion of goods had later production dates because the customer requested products with later production dates (ie, close to date of delivery). China Administration for Quality Supervision, Inspection and Quarantine (AQSIQ) regulations specified that the sellable period for products with the QS label was before 31 December 2011. Therefore, after the latter half of 2011, certain retailers would require suppliers to provide products with production dates close to the date of delivery. In order to guarantee supplies for these retailers, Customer A and its downstream distributors raised the same requirement with the Group. The Group's sales division agreed to swap some of the wine originally purchased by Customer A in 2010 for 'new' wine produced in 2011 or later, which did not carry the QS label. This was entirely made to satisfy the customer and ensure supplies.

Response from the Management in May 2016 as set out in the Investigation Report

Owing to change in market conditions and the impact of change in national policies, the actual progress of distribution was far less than expected. The expectation was over-optimistic from today's perspective. According to available information, it would be more appropriate for progressive recognition with reference to actual delivery dates rather than full recognition at the time of one-off invoicing in 2010.

EY response to the Group's response on paragraph (d) above as set out in the Investigation Report

The Group had not provided any further supporting documentation relating to the wine produced in 2010 but not sent to customers, such as the volume, subsequent movements, inventory levels or storage locations. As the goods despatch documents relating to the RMB350 million purchase by Customer A provided by the Group were incomplete (in the aggregate amount of the Documented Value), EY was unable to verify apart from approximately RMB48 million, how much of the goods in the RMB350 million goods despatch records represented new (2011 to 2013) wine sent directly to customers, nor was EY able to trace the status of the goods produced during or before 2010 which were not accepted by Customer A.

Further response from the Management as set out in the Investigation Report

Following internal checking, the Group had not discovered any instances where 2010 goods were sent to customers but customers later returned the 2010 wine and exchanged it for 2011 wine. Wine produced during 2010 which was unable to be despatched to customers was classified as the Group's own goods and had been stored in the Group's transit depot. During the 2013 year end stock-take, products in transit warehouses were re-organised according to their production date. The results of the 2013, 2014 and 2015 stock-take were still being verified as at the date of the Investigation Report – the Group would make the appropriate valuations and accounting entries for these goods in its accounts in accordance with the relevant accounting standards.

4. Settlement of amounts due from Customer A and invoicing to Customer A

Observations

It was observed from the accounts receivable ledger of Tianjin Dynasty Sales Co that Customer A's payment history to the Group was as follows:

(i) By 31 December 2010, the Group received RMB200 million by bank transfer and RMB200 million in bank notes from Customer A. The Group pledged the RMB200 million bank notes received from Customer A to obtain a bank loan of RMB180 million, whereupon the RMB200 million bank notes were not accounted for as notes receivable but instead the accounts receivable was reduced by RMB180 million. This might lead to potential understatement of assets (notes receivable) and liabilities (short-term loans).

(ii) Tianjin Dynasty Sales Co received the difference between the pledged bank notes of RMB200 million and the bank loan of RMB180 million upon the loan due date and used this amount to reduce the remaining balance due from Customer A. At the same time, Tianjin Dynasty Sales Co recorded RMB350 million revenue and RMB380 million collections in the accounting records, leading to the credit balance of RMB30 million in accounts receivable from Customer A at the end of 2010. The Group received RMB400 million in total from Customer A in 2010 while the Group only issued VAT invoices in RMB350 million. Of the RMB50 million difference, RMB30 million was reduced from the account receivables and RMB20 million was not recorded in the accounting records.

(iii) Ultimately, Customer A had paid RMB450 million in total to Tianjin Dynasty Sales Co (including the RMB400 million mentioned above) under the Distributor Agreement, which was RMB100 million in excess of the invoiced value. After the Group and Customer A had reached an agreement in 2011 not to execute the remaining RMB100 million of the Supplemental Agreement, the Group refunded such amount to Customer A.

Response from the Management in February 2014 as set out in the Investigation Report

In relation to the above observations made by EY, the Management provided the following response:

Normally, the Group passed bank notes to the bank for discounting. However, at the end of 2010, the Group's bank's line of notes discounting was used up. Even if there had been notes discounting facility available, the discount rate at that point was close to an annual rate of 14%, whereupon the pledging rate was only 6%. On the principle of cost-saving, the Group dealt with the bank notes by pledging the bank notes. The Group's accounting staff treated the pledging of bank notes the same as discounting bank notes. As such, this accounting treatment increased cash at bank, whereas the credit side reduced the receivables from Customer A.

5. Performance guarantees

Observations

(a) EY observed in a document entitled "Supplemental Explanation" (**補充說明**) dated 26 November 2010 that Customer A and Tianjin Dynasty Sales Co agreed that in relation to the Supplemental Agreement, every time before Customer A made an instalment payment, a performance guarantee should be issued to guarantee the performance of all Tianjin Dynasty Sales Co's obligations under the Supplemental Agreement.

(b) It was observed that four performance guarantees (of RMB100 million each, and one of which was not available for inspection during the Internal Investigation) were issued by a bank to guarantee that Tianjin Dynasty Sales Co would fulfil its obligations to Customer A under the Supplemental Agreement. The expiry dates of the performance guarantees (except for the one performance guarantee the copy of which was not available) all fell in June 2011. Customer A confirmed that the four performance guarantees were not extended or renewed after the expiry dates. According to the PBOC loan list of Tianjin Dynasty Sales Co, RMB400 million guarantees existed, but they were not disclosed in the financial statements. EY further observed the reference number of the guarantees provided did not match those stated in the PBOC loan listing.

Response from the Management in February 2014 as set out in the Investigation Report

In relation to the above observations made by EY, the Management provided the following response:

The performance guarantees were issued at Customer A's request to ensure (i) in the event it exercised its right to a refund under the Supplemental Agreement, the Group would be able to refund in time; and (ii) the Group would coordinate to distribute its products. During the period of the Supplemental Agreement, Customer A did not raise any requests to terminate the Supplemental Agreement, return of inventory or refunds, so the performance guarantees were not exercised. Neither Tianjin Dynasty Sales Co nor the bank could reconcile the reference numbers to those in the PBOC loan listing.

6. Compensation to Customer A

Observations

In respect of Customer A's gross profit

(a) According to the Main Distributor Agreement, Tianjin Dynasty Sales Co was to ensure to offer Customer A the lowest purchase prices with a gross margin of no less than 1%. However, Customer A's view was that the Group would compensate Customer A the 1% guaranteed gross margin regardless of Customer A's actual gross margin. An amount of RMB3.5 million (representing 1% of RMB350 million) was paid to Customer A in May 2013 and accounted for by the Group as sales expense.

(b) It was observed that Customer A earned minimum or even zero gross margin on the downstream sales of products under the Supplemental Agreement, which significantly differed from the gross profit ratio observed in sales transactions between Shanghai Dynasty Sales Co and Customer A during the Review Period that were outside the scope of the Distributor Agreement (which was approximately 20%).

In respect of compensation to Customer A for locked-up working capital

EY discovered two confirmations whereupon Tianjin Dynasty Sales Co undertook in June 2011 that (i) for purchase of the Group's products made by the Designated Distributors from Customer A and settled in the form of bank notes, Tianjin Dynasty Sales Co was to compensate Customer A on a monthly basis on an annual interest rate of 6.3% and the face value of the bank notes (in the form of the Group's products); and (ii) in respect of working capital locked up in distributing inventory of dry red wine and semi-dry white wine, Tianjin Dynasty Sales Co was to compensate Customer A starting from 1 July 2011 on a monthly basis on an annual interest rate of 6.3% and the value of the inventory at each month end (in the form of the Group's products). According to subsequent document in 2013, the locked up working capital compensation for the period was from July 2011 to June 2012, and amounted to approximately RMB6 million. As of June 2013, Customer A had not received the goods in kind as compensation. No provision was made for the above arrangement in Tianjin Dynasty Sales Co's financial accounts for the years 2011 and 2012.

Response from the Management in February 2014 as set out in the Investigation Report

In relation to the above observations made by EY, the Management provided the following responses:

(a) Apart from dry red and semi-dry white wine, Customer A also sold other products of the Group. If calculated upon the average price margin between Customer A's purchase and sales between 2010 and 2012, the gross profit rate might appear high in average for Customer A. However, if consideration is given to additional expenditure on sales channels and daily operations, the profit rate could be low. Also, while the gross profit rate set out in the Main Distributor Agreement of 1% was relatively low, due to the gigantic sales volume, the profit Customer A made thereunder was definitely in excess of that generated from other products.

(b) At the same time, Customer A's profit needed to be looked at in conjunction with changes in the Group's product price historically. Between 2009 and 2010, the Group's product prices were under constant pressure from the consumer markets. Generally, Customer A made profit from the price gap between purchase and sales, but as dominating malls and supermarkets reduced the price by using subsidies, this caused the price of dry red and other wines to plummet. After close cooperation between Customer A and the Group in price control, in 2011, price of dry red wine was restored from RMB25.8 per bottle to over RMB30, and remained in the range between RMB33 to RMB40 between 2012 and 2013. Such steady rise in price also benefited both parties by securing a stable margin source.

(c) The Distributor Agreement did not include a compensation clause for locked-up working capital. Customer A's request for such compensation was due to slower than expected sales of products, which affected their working capital efficiency. The return of funds was slow and Customer A thus requested the Group to make such compensation in June 2011. This locked-up capital compensation was just one of the ways to seek compensation from the Group in an unfavourable market. From the industry practice point of view, the compensation would turn into sales promotion support of Customer A and would have a positive impact on the sales of the Group's products.

(d) According to common practice in marketing expenses allocation between winery and distributors, the compensation did not become effective until the goods were fully distributed. In addition, expenses must be agreed and approved by the Group before they could be paid and recorded as company expenses. "Locked-up capital compensation" and "gross profit compensation" etc. were two of the forms used by distributors to justify requests of market development support from winery, as a common practice in the industry.

(e) The 6.3% compensation from the Group to Customer A was calculated based on:

    (i) From 1 July 2011, monthly compensation was calculated according to actual stock levels of dry red and semi-dry white wine at month end, using an annualised interest rate of 6.3%;

    (ii) The actual inventory value was based on payments from Customer A to Tianjin Dynasty Sales Co less (1) payment from distributors to Customers A; (2) amounts owing from Customer A to Shanghai Dynasty Sales Co; and (3) the RMB30 million of dry red and semi-dry white which Customer A had agreed to maintain as a base stock level;

(iii) If distributors paid Customer A in commercial bills, Tianjin Dynasty Sales Co must compensate Customer A. The exact amount of compensation depended on the face value of the bill, the 6.3% interest rate and the time to maturity of the commercial bill at the time of receipt. Therefore the final amount of compensation would depend on payments from Customer A and its distributors. In addition, Customer A had made clear that compensation in kind was to be carried out before June 2013. As a result, the Group considered the 6.3% compensation should be recorded only when the amount of compensation (in the form of wine and monetary payment) between the Group and Customer A had been confirmed. During 2013, the amount had been accrued for and at the date of the Investigation Report, had already been paid in the form of inventories.

7. Inventory management

Observations

In respect of ownership of RMB350 million inventory

EY noted that Customer A confirmed that the purchase of goods was recognised in Customer A's books and records based on two inventory vouchers dated 29 November 2010 and 29 December 2010 respectively which were issued by Tianjin Dynasty Sales Co at Customer A's request. The inventory vouchers stated that the goods were temporarily stored at the Group's warehouses without specifying the exact location. According to the Management, the goods were stored at the Jiangsu Taicang warehouse. According to the two inventory vouchers, Customer A acknowledged its ownership of the goods.

In respect of inventory management

(a) EY noted in practice, the Group was responsible for inventory management and would despatch goods to downstream distributors as and when it received "Goods Delivery Entrust Orders" from Customer A. Customer A informed EY that the Group was responsible for management and delivery of the goods prior to despatch to Customer A or distributors, that liability for loss or damage to the goods during storage or transport lay with the Group, and that Customer A's representatives had never visited the Group's warehouses or conducted stock takes at the Group's warehouses.

(b) EY observed the Group had issued RMB350 million of VAT invoices in 2010 and the corresponding goods were stored in the Group's warehouses and were recorded as having been delivered and were no longer reflected in the Group's inventory. EY understood that for these goods for which sales invoices had been issued and which were stored in the Group's warehouses, the Group did not maintain a full set of record of physical inventory movements. Both the Group and Customer A represented that they carried out stock reconciliation at irregular intervals where the two parties would check how much stock remained undespatched, but the reconciliation was performed verbally. In this connection, no written documentation was maintained. The goods sold to Customer A, which were stored in the Group's warehouses, was not kept separate from the Group's goods. Goods belonging to Customer A and the Group were stored together in the Jiangsu Taicang warehouse and it was not possible to identify which goods belonged to Customer A or which belonged to the Group.

The Group provided inventory balances for the RMB350 million of goods purchased by Customer A based on despatch records as at 31 December 2010, 2011 and 2012. The Group also provided EY with warehouse records from the Jiangsu Taicang and Tianjin area warehouses. Of the three points in time above, the inventory balance as at 31 December 2010 was greater than the manual warehouse records for the Taicang warehouses.

According to the breakdown provided by the Group, some of the goods were stored in the Zhong Chu Mian warehouse in Tianjin as at 31 December 2010 and 2011. The Group separately provided EY with electronic warehouse records of Zhong Chu Mian. The records did not indicate ownership of the goods. EY had compared the Zhong Chu Mian electronic records to the balance calculated by the Group. The balance per the electronic records as at 31 December 2010, 2011 and 2012 in time were all higher than the Group's calculated balances.

Due to the variances between the inventory balances of goods belonging to the Group per the warehouse records and those provided by the Group, EY was unable to verify the accuracy of the inventory balance breakdowns belonging to Customer A provided by the Group.

8. Sales arrangement with downstream distributors of Customer A

Observations

In respect of guarantees in favour of three of Customer A's downstream distributors

EY observed that Shanghai Dynasty Sales Co acted as a guarantor for three of the Designated Distributors in an effort to alleviate the funding pressure of these distributors during the process of distributing dry red wine. The guarantee was provided in the form of an amount due from Customer A to Shanghai Dynasty Sales Co in the amount of RMB50 million.

Response from the Management in February 2014 as set out in the Investigation Report

In relation to the above observations made by EY, the Management provided the following response:

In order to secure the supply of dry red wine to regular customers in Zhejiang and Jiangsu province, the Group issued a written guarantee at the request of Customer A in June 2011. The three Designated Distributors had all cleared the payment guaranteed by the Group to Customer A by the end of December 2012. The Group was relieved from any related obligations.

EY's response as set out in the Investigation Report

The Group provided the copies of payment supporting documents from the three Designated Distributors to Customer A. However, Customer A did not issue written confirmation in terms of release of the related liabilities.

Observations

In respect of assistance provided to a distributor for purchase of goods from Customer A

EY noted a Designated Distributor was required by Tianjin Dynasty Sales Co to help distribute 160,000 cases of dry red wine belonging to Customer A. The Designated Distributor applied for a loan from a state owned enterprise(*) in Tianjin in the amount of RMB30 million to fund the purchase from Customer A, claiming that the loan and the respective interests were to be borne by Tianjin Dynasty Sales Co. The Designated Distributor requested Tianjin Dynasty Sales Co to compensate the associated tax charges incurred during the purchase and re-sale transaction. It was noted Tianjin Dynasty Sales Co paid RMB300,000 to the Designated Distributor on 31 December 2012, with such payment being recorded as "other receivables – taxation". During the Internal Investigation, the Management provided documents dated 2013 in which (i) the Designated Distributor confirmed it had borrowed such sum in the amount of RMB300,000 from Tianjin Dynasty Sales Co for tax payment in advance, and the Designated Distributor would repay Tianjin Dynasty Sales Co by the end of 2013; and (ii) the Designated Distributor confirmed the loan in the sum of RMB30 million from the state owned enterprise in Tianjin and the interests were to be borne by itself (not by Tianjin Dynasty Sales Co.), and (iii) the Designated Distributor confirmed that by April 2013, the Designated Distributor had received from the Group an aggregate of 958,836 bottles dry red wine, with an aggregate value of approximately RMB30 million, which the Designated Distributors had purchased from Customer A in July 2012.

(*) Mr. Bai Zhisheng, a former executive Director and chairman of the Company, has been the general manager of the enterprise since 2005 and his last position was the chairman (董事長) till December 2013, Mr. Hao Feifei, an executive Director, has been the general manager of the enterprise since mid of August 2012 to July 2015.

Response from the Management in February 2014 as set out in the Investigation Report

In relation to the above observations made by EY, the Management provided the following responses:

(a) According to the Main Distributor Agreement, the Group was obliged to assist Customer A in further distribution. Assistance to distributors to digest inventory was also a common practice in the FMCG or winery industry as it helped control the distributors and maintain market stability.

(b) The Designated Distributor involved was a then existing customer of the Group which was introduced to Customer A for wine purchase. The RMB300,000 loan was a one-off transaction with an aim to relieving the Designated Distributor's short term pressure to pay taxes, without any ulterior motive. The Designated Distributor declared that it would repay the loan of RMB300,000 to the Group by the end of 2013.

(c) As regards the loan made by the Designated Distributor, the Group had never made any commitment to guarantee such loan or interest payment. The Designated Distributor had declared that repayment obligation of the loan capital and interest lied with itself.

(B) Customer B

1. Relevant terms of contract

Observations

(a) Pursuant to Customer B Distributor Agreements, Customer B was appointed as the exclusive distributor of the Group in Jiangsu Province to develop and maintain the Jiangsu market. According to the sales plan in the strategic cooperation framework agreement, Customer B was required to achieve specified sales targets, namely RMB80 million in 2011, RMB175 million in 2012, RMB219 million in 2013 and RMB748 million in 2014.

(b) According to the terms of the main distributor agreement in 2011, Shanghai Dynasty Sales Co should pay (i) sales support for 2011 calculated at 4% of overall actual purchases by Customer B based on a procurement target of RMB80 million for 2011; and (ii) an agency fee for 2012 calculated at 6% of overall actual purchases by Customer B based on a procurement target of RMB120 million for 2012. Customer B and the Group subsequently agreed that the agency fee was 6% of overall purchases for both 2011 and 2012.

2. Sales

Observations

(a) EY observed that the sales targets for 2011 and 2012 were not met. Shanghai Dynasty Sales Co issued VAT invoices in the aggregate amounts of approximately RMB42 million and approximately RMB36 million in the years 2011 and 2012 respectively.

(b) EY observed that revenue was recognised in the accounting records in line with the issue of VAT invoices to Customer B. The dates and quantities on the invoices bore no direct relation to the actual goods delivery to downstream customers.

3. The Goods

Observations

(a) EY observed that Shanghai Dynasty Sales Co was responsible for the storage and delivery of goods to the Yangzhou warehouse rented by Shanghai Dynasty Sales Co. while Customer B was responsible for delivery from the Yangzhou warehouse to downstream customers. Both Customer B and Shanghai Dynasty Sales Co kept their own inventory movement records.

(b) As stated above, VAT invoices in the amount of approximately RMB42 million and RMB36 million were issued to Customer B in 2011 and 2012 respectively. Customer B paid the Group RMB50 million and RMB30 million at the end of 2011 and in June 2012 respectively. Some of the invoiced goods were temporarily stored in the Group's warehouses. According to an ownership confirmation issued by Customer B on 28 March 2013, approximately RMB15 million worth (sales value, including tax) of goods were temporarily stored in the Group's warehouse by the end of 31 December 2012 and the ownership of these goods belonged to Customer B. The Group had stated that responsibility for managing the goods bought by Customer B lied with the Jiansu province branch office of Shanghai Dynasty Sales Co, the Group's logistics division did not have the relevant records. At the same time, the Jiangsu province branch office did not maintain a complete record of movement of inventory between itself and Customer B. Accordingly, the Group was unable to obtain physical warehouse records relating to Customer B (including for the Yangzhou warehouses) and therefore the Management was unable to provide breakdown of inventory balances as at 31 December 2011, sales figures (including tax) or goods despatch records relating to the sale to Customer B.

(c) All of the inventories were recorded as sold and delivered upon the issuance of VAT invoices. On this basis, these goods were no longer reflected in the Group's inventory balance.

Response from the Management in February 2014 as set out in the Investigation Report

In relation to the above observations made by EY, the Management provided the following responses:

(a) The purpose of a sole distributor agreement with Customer B was to leverage Customer B's network of retailers in Jiangsu and to strengthen the Group's relationship with end retailers in the Jiangsu region. However, due to Customer B's internal restructuring and the unfavourable winery market externally, little progress was made towards distribution of the products under the Customer B Distributor Agreements. Therefore, Customer B requested the Group to postpone delivery of goods.

(b) Some Jiangsu distributors focused on current profit to the detriment of long term development. They used the rebate intended for building end customer network to reduce the product price and sold products beyond the agreed area into Zhejiang and Shanghai which disrupted other markets, which caused confusion about the market price. As such, the Group decided to replicate the exclusive distributor model in the Eastern China area and tried to establish an exclusive distributor of other products in Jiangsu Province to assist the development strategy of the Group in that province.

(c) Besides, the Jiangsu branch office of Customer B was one of the most influential companies in Jiangsu supermarket system in 2011. Both Customer B and the Group shared a common vision for the direction of change for the retail network in Jiangsu Province. Thus, the Group hope the market coverage in Jiangsu could be expanded through cooperation with Customer B.

(d) Due to (i) internal restructuring of Customer B, its logistics network failed to have as large an impact as expected, leading to almost no increase in retailer coverage of the Group's products in Jiangsu; and (ii) imported wines and related national restriction policies caused a significant unfavourable market change, the progress of distributing the products in Jiangsu Province was slow and failed to meet sales targets for all products as set out in the Customer B Distributor Agreements. As such, Customer B requested a slowdown in deliveries as it had limited warehouse space and the Group agreed to delay deliveries. Both parties have signed a confirmation letter relating to the types and number of goods owned in the warehouses of the Group.

Response from the Management in May 2016 as set out in the Investigation Report

Due to changes in the domestic wine market and impart of changes in national policy, the progress of product sales was far below expectation. The expectation in the original agreement was over-optimistic. According to available information, it would be more appropriate for progressive revenue recognition with reference to actual delivery dates rather than full recognition at the time of one-off invoicing.

4. Sales support and refund paid to Customer B

Observations

(a) According to Customer B, the purchase prices of the goods purchased from the Group were the same as the selling prices to downstream customers. Accordingly, the gross margin was nil. Customer B profited from the transactions by way of the agreed sales support.

(b) Customer B paid RMB80 million in aggregate between end of 2011 and June 2012, and according to Customer B, the Group should pay RMB4.8 million to Customer B as agency fee, which were calculated based on 6% of overall purchases of RMB80 million in 2011 and 2012. The Group provided documents showing aggregate payments of approximately RMB4.39 million in 2013. The Group explained that the unpaid portion was set off against leasing charges owing to the Group from Customer B. Accordingly the Group had settled all amounts owing to Customer B.

(c) According to Customer B, the Management and Customer B held a meeting in April 2013. The two parties reconciled the related data in the meeting. It was confirmed that Shanghai Dynasty Sales Co had transferred goods with the total sales value of approximately RMB78 million to Customer B. These goods which belonged to Customer B had been temporarily stored in the Group's warehouses. The difference between the prepayment made by Customer B to Shanghai Dynasty Sales Co and the value of the goods transferred to Customer B was refunded to Customer B in June 2013.

Response from the Management in February 2014 as set out in the Investigation Report

In relation to the above observations made by EY, the Management provided the following response:

Under the Customer B Distributor Agreements, Customer B was the exclusive distributor in Jiangsu Province. The Group paid rebate to Customer B in line with performance against sales targets.

(C) Other customers

1. Sales arrangement between the Group and Customer C

Observations

(a) EY observed that in the fourth quarters of 2010, the Group issued invoices in the aggregate value of approximately RMB67 million to Customer C, which exceeded RMB50 million.

(b) EY noted that the invoices in the aggregate value of approximately RMB35 million to Customer C between 2010 and 2012 were ordinary VAT invoices. According to China tax law, Customer C could not deduct for input VAT based on these ordinary VAT invoices.

(c) EY observed that the Group offset its receivables from Customer C by various charges in the aggregate amount of approximately RMB39 million.

(d) EY observed the value of goods invoiced but not yet delivered to Customer C was approximately RMB11 million. The Group was unable to provide goods movement records, sales breakdown or inventory balance for goods belonging to Customer C at the Group warehouses as at 31 December 2010, 2011 and 2012.

(e) EY understood that goods for Customer C were normally sent from the Group to the warehouse of Customer C, and that delivery from the warehouse of Customer C to its downstream distributors was the responsibility of Customer C. Customer C confirmed the above and indicated that the Group occasionally would deliver the goods to the downstream distributors of Customer C.

Response from the Management in February 2014 as set out in the Investigation Report

The Group issued VAT invoices or ordinary VAT invoices according to the customers' request. Customer C had already confirmed and cleared those ordinary invoices. The Group considered offsetting receivables against certain charges could avoid red tape around fund transfers in and out and increase utilisation of funds.

Response from the Management in May 2016 as set out in the Investigation Report

The Management had re-visited the original information and reviewed certain supplementary supporting documents. The Management issued confirmations to Customer C regarding information of invoicing and goods delivery as well as goods owed to the respective parties as at year end, which had been confirmed by Customer C. At that time, over-optimistic market expectation had resulted in huge gap between progress of actual and estimated sales. According to available information, it would be more appropriate for progressive revenue recognition with reference to actual delivery dates rather than full recognition at the time of one-off invoicing.

2. Sales arrangement between the Group and Customer D

Observations

(a) EY observed that the sales invoice issued to Customer D in second quarter of 2010 and 2011 amounted to approximately RMB110 million and RMB61 million respectively, which exceeded RMB50 million.

(b) EY observed a summary of tripartite agreements between the Group, Customer D and its downstream distributors. There was no clear wording indicating that the Group would first transfer ownership of the goods to Customer D and that Customer D would then transfer ownership to its downstream distributors. Customer D confirmed that sales contracts with the Group were all signed jointly with its second-tier distributors and there were tripartite agreements during 2012 and 2013 with the Group, each valid for one year and was subject to renewal every year.

(c) The Group provided EY with the year-end receivables balances owing from Customer D at 31 December 2010 and 2012, stamped by Customer D. There were variances between these figures and the balances shown in the Group's accounts.

(d) The Group was unable to provide goods movement records, sales (including tax) breakdown or inventory balance for goods belonging to Customer D at the Group's warehouses as at 31 December 2010, 2011 and 2012.

(e) EY observed that Shanghai Dynasty Sales Co owed Customer D RMB900,000 in interest in relation to a loan extended to Customer D from Customer D's holding company. The loan was used to pay Shanghai Dynasty Sales Co for goods, which were invoiced in 2010 but not yet delivered to downstream customers.

(f) EY observed that RMB50 million worth of goods were channel stuffed to Customer D at the end of 2009 and these goods were distributed in 2010 and the first half of 2011; RMB100 million worth of goods were channel stuffed to Customer D in June 2010, and RMB32 million worth of these goods were distributed by the end of October 2012; RMB28 million worth of the goods were channel stuffed to Customer D in December 2011, and RMB9 million worth of these goods were distributed by October 2012.

Response from the Management in February 2014 as set out in the Investigation Report

In relation to the above observations made by EY, the Management provided the following responses:

(a) The Management took the view that "channel stuffing" referred to the fact that delivery of Dynasty's wine products was not as fast as expected due to the market condition, causing the distributors not being able to receive the sales proceeds on time and cash flow slowed down. The Management considered that this was a common practice in the industry and it was common that inventory needs to be digested over time.

(b) The Group's explanation for the variance between the year-end receivables balances owing from Customer D and the Group's accounts was attributable to (i) notes receivable subsequently received were not recorded in a timely manner; and (ii) a portion of the Group's sales to second-tier distributors had been recorded into Customer D's receivables. Regarding item (ii), the Management provided the following explanations: 1) Shanghai Dynasty Sales Co was required to pay marketing support expenses when selling the goods to Customer D; 2) once Customer D sold the goods to its second-tier distributors, part of the marketing support expenses should be paid directly by Shanghai Dynasty Sales Co (instead of Customer D) to the second-tier distributors of Customer D; 3) the marketing support expenses were billed by second-tier distributors to Shanghai Dynasty Sales Co based on calculation from the sales amount of Customer D to the second-tier distributors; 4) after communication with second-tier distributors based on such expenses due to them, Shanghai Dynasty Sales Co would treat the marketing support expenses as receipt in advance, and then sold the goods and invoiced directly to second-tier distributors. As there were many second-tier distributors and thus not feasible to set up individual accounts of second-tier distributors, therefore the aggregate amounts were recorded into receivables from Customer D. This increased portion of receivables would be offset upon submission of expenses reimbursement invoices from the second-tier distributors to Shanghai Dynasty Sales Co; 5) since submission of expense reimbursement invoices by the second-tier distributors to Shanghai Dynasty Sales Co and the processing of expense reimbursement by Shanghai Dynasty Sales Co took considerable time, there were timing differences resulting in inconsistencies between account receivables of Shanghai Dynasty Sales Co and account payables of Customer D.

(c) In order to encourage the distributors to sell the Group's products, and based on long-term interests of both parties, RMB900,000 was an incentivising compensation paid to distributors and constituted ordinary cost of operation for the Group. The amount paid was not agreed at the beginning nor was it mandatorily enforced, but rather was determined by specific market conditions.

(d) In relation to the tripartite agreements, there was no written framework agreement in place between the Group and Customer D. However, both sides have reached a verbal agreement for Customer D to act as a first-tier distributor. Under this agreement, the Group delivered goods to Customer D and collected from Customer D payment for said goods. At this point the ownership and risks for the goods had been transferred to Customer D. Customer D maintained a certain level of stock and delivered goods to its second-tier distributors in line with their orders. Customer D then collected payment for said goods from its downstream distributors. The fact that it was Customer D which was responsible for delivering goods to downstream distributors and collecting monies from them reflects Customer D's role as the Group's first-tier distributor. The Group could control the sales price and region of the second-tier distributors effectively, to prevent parallel trading and price undercutting. However, ownership of the goods sold to second-tier distributors rests with Customer D, not with the Group, and payment for goods was collected by Customer D.

Response from the Management in May 2016 as set out in the Investigation Report

(e) The Management has re-visited the original information and reviewed certain supplementary supporting documents. The Management issued confirmations to Customer D regarding information of invoicing and goods delivery as well as goods owed to the respective parties as at year end, which have been confirmed by Customer D. At that time, over-optimistic market expectation has resulted in huge gap between progress of actual and estimated sales. According to available information, it would be more appropriate for progressive revenue recognition with reference to actual delivery dates rather than full recognition at the time of one-off invoicing.

II. Unsellable inventory

Observations

(a) In relation to the allegation that unsellable inventory were stored in Jiangsu Taicang and Fujian Zhangzhou warehouses, EY reviewed warehouse lease agreements for Jiangsu Taicang and Fujian Zhangzhou warehouses. EY discovered that rental expenses incurred in relation to the Jiangsu Taicang and Fujiann Zhangzhou warehouses in 2010, 2011 and 2012 respectively were approximately RMB0.99 million, RMB4.84 million and RMB4.62 million respectively.

(b) EY identified certain documents referring to various quality issues of the products in various regions, including Jiangsu Taicang and Fujian Zhangzhou warehouses: (i) mouldy packaging and labels; (ii) packaging and labels not compliant with the latest national regulations; (iii) products with a production date more than two years, which are unfit for sale; (iv) raw materials, like packaging materials and labels etc., which have been disposed but had not been accounted for in the financial records; and (v) requests for returns made by customers due to product quality issues.

(c) EY noted various reports on quality issues (such as sedimentation and leakage) frequently received by sales companies in various regions; and at the same time, a lot of complaints about product quality have been received from consumers.

(d) EY noted:

1) The distributors and supermarkets refused to sell wine products with "QS Labels";

2) The overall inventory volume stored in warehouses in various regions (excluding those at the Group's headquarter) was approximately 2.24 million non-standard cases, 1.78 million of which had been purchased by distributors; and

3) Among the 1.78 million cases, 1.48 million had "QS Labels" attached which did not comply with the relevant regulations. In order to be eligible for sales, these products had to be re-labelled prior to sale.

(e) EY noted that as at the end of 2012, inventory of approximately 2.14 million mixed cases was held by the sales companies of the Group. Out of which, approximately 1.10 million mixed cases (which accounted for approximately 51% of the overall volume) were not fit for sale due to outdated labels or other issues. The wine products with outdated labels were stored in 3 warehouses in Tianjin (Zhongchumian, Zhongchuliang and Zhongyou warehouses), the Jiangsu Taicang warehouse, the Guangzhou Huangpu warehouse, the Fujian Zhangzhou Zhaoshang warehouse, the Ningbo warehouse and other province-level warehouses in various regions. Amongst these stocks, 100% of stock stored in Tianjin Zhongchuliang and Ningbo warehouses was "problematic stock", specifically: 1) stock with quality issues; 2) QS label; 3) SO2 content unlabelled; and 4) returned by distributors.

(f) EY found that a staff member of the Group sent the head of sale support department of Tianjin Dynasty Sales Co a stocktake count sheet of Fujian Zhangzhou and Jiangsu Taicang warehouses as of January 2013. In the stock count sheet, there were approximately 506,000 cases (out of which 505,000 cases were applied with the labels of "Permissible Production" or "Safe Quality") at the Jiangsu Taicang warehouse and approximately 134,000 cases (all applied with the labels of either "Permissible Production" or "Safe Quality") at the Fujian Zhangzhou warehouse, totalling approximately 640,000 cases.

(g) According to the Group, as of end of March 2013, the overall inventory volume with label issue was approximately 1.19 million cases, totalling approximately RMB119 million and that with quality issues was approximately 265,000 cases, adding up to approximately RMB36 million.

Response from the Management in February 2014 as set out in the Investigation Report

In relation to the above observations made by EY, the Management provided the following response:

According to an announcement issued by General Administration of Quality Supervision, Inspection and Quarantine of the People's Republic of China (AQSIQ), "Quality Safe (QS) label was applicable till the end of 2011". The Group still had some QS-labelled products, which had exceeded the expiry date mentioned in the above announcement and needed to be reprocessed. According to the announcement by AQSIQ, companies were entitled to relabel, so the Group would relabel these 1.48 million cases of products before delivery. The announcement explicitly acknowledged companies the right to print and attach QS labels in accordance with AQSIQ regulations, and the printing and attaching do not require any pre-approval from AQSIQ. Quality issues and "expired product" derived from misunderstanding on the part of the staff of logistics department of the Group, quality issue actually refers to the QS label, which should be changed to the "Permissible Production Label" in accordance with the regulations and the expired products refer to products that exceeded the expiry date mentioned in the above announcement, rather than products that expired in quality. As of 31 March 2013, the products that required relabelled were approximately 1.2 million non-standard cases.

EY's response as set out in the Investigation Report

Due to (i) the overwhelming number of locations and regions involved; and (ii) the fact that both quality and label issues were beyond the expertise of EY, EY had not been able to carry out further verification of the response from the Management.

Response from the Management in May 2016 as set out in the Investigation Report

The unsellable inventories were due to three sources: (i) the unsellable wines in warehouse that have not yet been delivered; (ii) the wines in the market which should be returned or exchanged due to changes in national policies; (iii) raw materials stocked up for products which will no longer be produced due to changes in product mix, including packing materials, labels etc. In respect of the unsellable inventories, the Group would put through accounting adjustments pursuant to relevant Accounting Standards based on stocktake results.

III. Other Issues

EY mentioned the following issues in the Investigation Report:

1. Potential understatement of selling expenses

   EY observed a document relating to approximately RMB42.56 million of unrecorded selling expenses. During the Internal Investigation, inconsistencies were discovered between expense data provided by the Management and information discovered by EY, and no information regarding expense reconciliation was available. Therefore EY was unable to ascertain whether certain expenses had been properly recorded. EY also noted that this issue was not included in its preliminary scope of work and therefore recommended the AC to consider whether to expand the scope in order to enable further investigation.

   Response from the Management in February 2014 as set out in the Investigation Report

   In relation to the above observations made by EY, the Management provided the following responses:

   (a) As a common practice in the domestic FMCG industry, factories did not usually have direct contact with the end customers in the distributors' sales channels. As a result, the distributors must pay the product distribution costs themselves. It often happened in the winery industry that contributions towards marketing expenses of distributors might be discussed verbally by sales staff but were temporarily not reported to the Group.

   (b) The expenses paid by factories to customers were usually regarded as sales support from the factory. The factory would then consider whether to pay and also the payment amount based on the overall budget and market planning for the year.

(c) There was no contractual liability to pay pass-through expenses or "related product expenses" and support. As the goods had not been fully sold yet, the pass-through expenses were neither due nor settled. The pass through expense would be settled only when the contract was due and mutual agreement by the Group and the distributor(s). The Group did not regard the pass-through expense as Group's expense until settlement (disbursement) and approval by the Group.

Response from the Management in May 2016 as set out in the Investigation Report

The Group would re-visit all the selling expenses from 2010 to 2014, which would be re-allocated to respective years in accordance with accrual basis of accounting principles.

2. Reconciliation of discrepancies of inventory records

EY observed there were discrepancies between the quantities of goods which were shipped from Sino-French Dynasty Co to Tianjin Dynasty Sales Co and the quantities of goods which were received by Tianjin Dynasty Sales Co from Sino-French Dynasty Co. It was also observed that manual records maintained by warehouse staff could not be reconciled to the inventory records in the Group's ERP (Yongyou) system.

Response from the Management in May 2016 as set out in the Investigation Report

In relation to the above observations made by EY, the Management provided the following response:

In the past, the warehouses of Sino-French Dynasty Co and Tianjin Dynasty Sales Co were separately managed by different departments, hence the related records could no longer be sorted out. The Group re-constructed the warehouse records based on stocktake results as of the end of 2013 in order to ensure that the books and records matched with the balances of physical goods.

3. Inventory items with negative balances in quantities and values

Based on the combined inventory movement summaries of Sino-French Dynasty Co, Tianjin Dynasty Sales Co and Shanghai Dynasty Sales Co, EY noted that there were negative amounts and balances for certain stock items from 2009 to the end of 2012.

Response from the Management in May 2016 as set out in the Investigation Report

In relation to the above observations made by EY, the Management provided the following response:

Due to frequent changes in personnel, ineffective administration and record keeping of information/documents, previous accounting and warehouse records could no longer be clearly verified. The Management prepared to put through adjustments to the warehouse records based on stocktake results as at the end of 2013, and then used the warehouse records to further adjust the book value of inventories in the accounting records. For the discrepancies identified, appropriate accounting treatments would be made in accordance with accounting standards.

IV. Limitations of the Internal Investigation

The Internal Investigation was subject to limitations in terms of documents and information:

(a) in relation to Customer A:

(i) EY has requested but not been able to directly reconcile the detailed purchases/stock in records of Customer A to match with goods despatch records from the Group to downstream distributors of Customer A;

(ii) EY has requested but not been able to reconcile the inventory remaining in the Group's warehouses belonging to Customer A in relation to the purchase of RMB350 million by Customer A as at 31 December 2010, 2011 and 2012;

(iii) the Group was unable to locate the originals of the Entrusted Delivery Orders from Customer A between 2010 and 2012;

(iv) the inventory belonging to Customer A reportedly held at Tianjin area – Zhong Chu Mian warehouse were not identifiable from the warehouse records provided by the Group;

(v) the Group was unable to provide supporting documents for the goods belonging to Customer A which were in transit from Tianjin to Taicang warehouses as at 31 December 2010;

(vi) the Group was unable to provide the goods despatch notes and warehouse records for Ningbo and Hangzhou warehouses where some of the RMB350 million of goods purchased by Customer A from the Group was reportedly stored;

(vii) the Hangzhou branch office of the Group had not retained the sales orders from one of Customer A's downstream distributors. Only goods receipt confirmations reportedly from such Customer A's downstream distributor were provided by the Group; and

(viii) the Group has not provided the volume, subsequent movements, remaining inventory levels or storage locations of the old wine produced before year end 2010 which was considered as the Group's own inventory and was stored in the Group's transit warehouse(s), to be managed and dealt with by the Group;

(b) in relation to Customer B:

(i) EY has requested but not been able to reconcile the purchases/stock in records by Customer B from the Group to match with inventory remaining at the Group's warehouses and goods despatch records of the Group; and

(ii) EY has requested but not been able to obtain the Group's warehouse records, goods despatch records or inventory balances relating to goods purchased by Customer B;

(c) in relation to Customer C and Customer D:

(i) EY has requested but not been able to directly reconcile the purchases/stock in records by Customer C/Customer D from the Group to match with inventory remaining at the Group's warehouses;

(ii) EY has requested but not been able to obtain any warehouse records or inventory balances related to goods purchased by Customer D to perform any follow-up procedures (including but not limited to verifying the goods despatch records); and has only been able to obtain a portion of the warehouse records, goods despatch records and inventory balances related to goods purchased by Customer C. The Group was unable to provide warehouse records, goods despatch notes or breakdowns (by volume and value, including tax) of the inventory belonging to Customer C/Customer D as at 31 December 2010, 2011 and 2012; and

(iii) due to document retention issues, the Group was unable to provide all the purchase orders and good despatch records for Customer C;

(d) only sample testing was performed by EY as regards rental expenses and EY has not yet been provided with a complete record of warehouse information (as 9 out of 128 samples of rental contracts were unable to be located due to personnel changes). In addition, during EY's review of a portion of inventory movement records, one address shown in the movement records did not appear in the list of warehouses provided by the Group;

(e) based on the behavioural analysis of imaged hard drives of certain custodians EY noticed certain observations. EY was unable to verify the completeness of the computer data provided by the Group; and

(f) as a result of the above limitations, EY's findings should not be relied upon to discover all the findings that might exist. EY stressed that having full access to the information may reveal issues that were not covered by the Investigation Report.

Response from the Management in May 2016 as set out in the Investigation Report

(a) in relation to Customer A:

The Management had re-visited the original information and reviewed certain supplementary supporting documents in respect of RMB350 million sales to Customer A and complied a summary. The Management also issued confirmations to certain downstream distributors to verify the information in the aforesaid summary, which was confirmed by the downstream distributors. The amounts of goods owed by the Group to Customer A as of end of the respective years 2010 to 2014 were clearly reflected in the above-mentioned information. However, the detailed amounts will be finalised by the Management and adjustments will be put through in the financial statements if necessary.

The Management has performed certain procedures to confirm goods delivery details from 2010 to 2014 with Customer A and its downstream distributors. EY did not participate in the procedures or confirm the information with Customer A directly.

(b) in relation to Customer B:

The Management had re-visited the original information and reviewed certain supplementary supporting documents in respect of sales to Customer B and complied a summary which captured the details of goods delivery information from the Group to downstream customers of Customer B. However, the detailed amounts will be finalised by the Management and adjustments will be put through in the financial statements if necessary.

The Management had performed certain procedures for the purposes of re-visiting information and supplementing supporting documents. EY did not participate in the procedures or confirm information with Customer B directly.

(c) in relation to Customer C and Customer D:

The Management had re-visited the original information and reviewed certain supplementary supporting documents and complied the summaries which captured the details of goods delivery between the Group and Customer C and Customer D respectively, from 2010 to 2014. However, the detailed amounts will be finalised by the Management and adjustments will be put through in the financial statements if necessary.

The Management had performed certain procedures for the purposes of re-visiting information and supplementing supporting documents. EY did not participate in the procedures or confirm the information with Customer C or Customer D directly.

D. AC'S AND THE BOARD'S VIEWS ON THE INVESTIGATION REPORT

The AC accepted the factual findings made by EY as documented in the Investigation Report. The AC also noted the limitations of the Internal Investigation relating to unavailability of certain records, including the limitations summarised above; and that the Investigation Report currently remains a draft pending further input from the Management and formal adoption by the Board. The AC has requested the Management to seek advice from PwC and/or other professional advisers regarding the observations made by EY, and take steps to address the issues as soon as possible.

The Board also expressed its acceptance of the factual findings made by EY as documented in the Investigation Report.

E. AUDIT IN LIGHT OF OBSERVATIONS AS SET OUT IN THE INVESTIGATION REPORT

As at the date of this announcement, the Management has provided the Investigation Report to PwC. The Management is collating certain information and document supporting the findings of the Internal Investigation and the responses from the Management as requested by PwC. Upon receipt of the information and documents, PwC may request interviews with the Management and EY, and further information and documents from the Management when necessary to update its audit plan and continue to complete the audit of the consolidated financial statements for the four years ended 31 December 2015.

F. TIMETABLE

In view of works in respect of the completion of the audit by PwC, the Board would like to advise that the Company is striving to complete the Internal Investigation and publish the outstanding financial results of the Group under the expected timeline as below:

Expected timeline:

Completion of Internal Investigation	At or before the end of September 2016
Release of annual results for the years ended 31 December 2012, 2013, 2014 and 2015, and address any audit qualifications (if any)	At or before the end of December 2016
Release of the interim results for the six months ended 30 June 2013 and 2014	At or before the end of January 2017
Release of the interim results for the six months ended 30 June 2015	At or before the end of February 2017
Release of annual reports for the years ended 31 December 2012, 2013, 2014 and 2015 and the interim reports for the six months ended 30 June 2013, 2014 and 2015	To be updated by future monthly announcement

Note: The dates specified for the events set out in the expected timeline above are indicative only and may be revised depending on the circumstances.

PwC has agreed to work closely with the Company to plan to complete its work according to the abovementioned timeline.

G. SUSPENSION OF TRADING

Trading in the shares of the Company on the Stock Exchange has been suspended with effect from 9:00 a.m. on 22 March 2013 and will remain suspended until further notice.

H. DEFINITIONS

In this announcement, unless the context otherwise requires, the following expressions shall have the following meanings:

"AC"	audit committee of the Board, comprising all independent non-executive Directors
"Allegations"	the allegations raised in three letters received by PwC between the end of December 2012 and February 2013
"Announcements"	announcements of the Company dated 14 March 2013, 22 March 2013, 26 March 2013, 30 April 2013, 31 May 2013, 28 June 2013, 31 July 2013, 21 August 2013, 30 August 2013, 25 September 2013, 8 October 2013, 31 October 2013, 29 November 2013, 31 December 2013, 28 January 2014, 28 February 2014, 27 March 2014, 28 April 2014, 30 May 2014, 30 June 2014, 31 July 2014, 29 August 2014, 30 September 2014, 31 October 2014, 26 November 2014, 31 December 2014, 30 January 2015, 27 February 2015, 31 March 2015, 16 April 2015, 30 April 2015, 29 May 2015, 30 June 2015, 14 August 2015, 31 August 2015, 30 September 2015, 23 October 2015, 26 November 2015, 15 December 2015, 29 January 2016, 1 March 2016, 31 March 2016, 3 May 2016 and 30 June 2016
"Board"	the board of Directors
"Customer A"	a customer of the Group in Shanghai, appointed by the Group to act as the main distributor of the Group's dry red and semi-dry white wine in Eastern China at the end of 2010, which is a state-owned enterprise in the PRC
"Customer B"	a customer of the Group in Shenzhen, appointed by the Group as the exclusive distributor of the Group's products in Jiangsu at the end of 2011, which is a listed company in the PRC
"Customer B Distributor Agreements"	the following agreements entered into between Shanghai Dynasty Sales Co and Customer B collectively: (i) the strategic cooperation framework agreement in 2011; (ii) the main distributor agreement, sales commitment and supplemental agreement in 2011; and (iii) the logistics service agreement in 2012
"Customer C"	a customer of the Group in Quanzhou and one of distributors of Tianjin Dynasty Sales Co

"Customer D"	a customer of the Group in Shanghai and one of distributors of Shanghai Dynasty Sales Co
"Designated Distributors"	the distributors designated by the Group for the distribution/ sales of the Group's products
"Directors"	directors of the Company
"Distributor Agreement"	the Main Distributor Agreement and the Supplemental Agreement
"ERP (Yongyou) system"	enterprise resource planning system, an integrated software application that integrates internal and external management information across the entire organization to facilitate the flow of information between all business functions inside the organisation
"EY"	Ernst & Young Advisory Services Limited
"FMCG"	fast moving consumer goods
"Goods Delivery Entrust Orders"	the delivery order issued by Customer A to the Group for the delivery of Customer A's goods to its distributors by the Group
"Group"	the Company and its subsidiaries
"Hong Kong"	the Hong Kong Special Administrative Region of the PRC
"Investigation Report"	the updated draft investigation report dated 29 July 2016 issued by EY in respect of the Internal Investigation
"Internal Investigation"	an internal investigation conducted by EY
"Listing Rules"	the Rules Governing the Listing of Securities on the Stock Exchange
"Main Distributor Agreement"	the distributor agreement in the amount of RMB450 million entered into between Tianjin Dynasty Sales Co and Customer A dated 11 November 2010
"Management"	the executive Directors from time to time (**)
"PBOC"	People's Bank of China

“PRC” or “China”	the People’s Republic of China, which for the purpose of this announcement, shall exclude Hong Kong, the Macau Special Administrative Region of the PRC and Taiwan
“PwC”	PricewaterhouseCoopers, auditors of the Company
“Review Period”	the period from 1 January 2010 to 31 December 2011
“Shanghai Dynasty Sales Co”	Shanghai Dynasty Grape Winery Sales Co., Ltd., a subsidiary of the Company
“Sino-French Dynasty Co”	Sino-French Joint-Venture Dynasty Winery Ltd., a subsidiary of the Company
“Stock Exchange”	The Stock Exchange of Hong Kong Limited
“Supplemental Agreement”	the supplemental agreement dated 11 November 2010 in relation to the Main Distributor Agreement entered into between Tianjin Dynasty Sales Co and Customer A
“Tianjin Dynasty Sales Co”	Tianjin Dynasty Winery Sales Co., Ltd., a subsidiary of the Company
“VAT”	value-added tax
“RMB”	Renminbi, the lawful currency of the PRC
“%”	per cent.

(**) Mr. Hao Feifei was appointed as an executive Director of the Company on 7 December 2012. Mr. Yin Jitai was appointed as an executive Director on 6 June 2014. Mr. Sun Yongjian was appointed as an executive Director on 13 June 2014. Mr. Bai Zhisheng resigned as an executive Director on 29 January 2014 and Mr. Huang Yaqiang resigned as an executive Director on 28 November 2014.

By order of the Board
DYNASTY FINE WINES GROUP LIMITED
Hao Feifei
Chairman

Hong Kong, 2 August 2016

As at the date of this announcement, the Board comprises three executive Directors, namely, Mr. Hao Feifei, Mr. Yin Jitai and Mr. Sun Yongjian, five non-executive Directors, namely, Mr. Heriard-Dubreuil Francois, Ms. Shi Jing, Mr. Jean-Marie Laborde, Mr. Wong Ching Chung and Mr. Robert Luc, and three independent non- executive Directors, namely, Dr. Zhang Guowang, Mr. Yeung Ting Lap Derek Emory and Mr. Sun David Lee.