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AUSNUTRIA DAIRY CORPORATION LTD

澳優乳業股份有限公司

(Incorporated in the Cayman Islands with limited liability)

(Stock code: 1717)

STATUS UPDATE ON INTERNAL CONTROL REVIEW

Following the Unresolved Issues raised by EY in the EY Letter dated 29 March 2012, the Special Review Committee, which was established in March 2012, was concerned with the Unresolved Issues and any weaknesses in the internal control systems of the Company and the China Subsidiary which might have given rise to the Unresolved Issues. In view of this, the Special Review Committee appointed PKF on 7 May 2012 as the internal control advisor to assist the Special Review Committee in reviewing the internal control systems of the Company and the China Subsidiary which are relevant to and might have given rise to the Unresolved Issues, particularly the sales cycle of the China Subsidiary.

PKF has completed the Internal Control Review and submitted the report of the Internal Control Review to the Special Review Committee and the Board on 1 November 2013.

The objectives of the Internal Control Review are to (a) assist the Special Review Committee and the Board in identifying the weaknesses in the internal control systems of the Company and the China Subsidiary which might have given rise to the Unresolved Issues; and (b) make recommendations to rectify the above weaknesses and/or enhance the existing procedures, systems and controls (including accounting and management policies) of the Company and the China Subsidiary which might have given rise to the Unresolved Issues, with a view to prevent the Unresolved Issues from occurring again in the future.

The Special Review Committee has also instructed PKF to address the internal control deficiencies raised by EY and which were covered in the PwC Report.

PKF has made specific recommendations and rectification measures at certain components of internal control systems at both entity-level and process-level of the Company and the China Subsidiary during the Internal Control Review. PKF has reviewed the rectifications (including the quarterly reconciliation of balances with distributors with a granted credit limit) carried out by the Company and the China Subsidiary. The China Subsidiary plans to perform annual reconciliation of balances with all distributors in January 2014 after the end of financial year 2013.

Based on the final results of their Internal Control Review during the Testing Period, PKF did not note any material deficiencies in the entity-level and process-level components of internal control systems of the Company and the China Subsidiary identified in the first phase of the Internal Control Review, which have not been rectified, and considers that the material internal control weaknesses that might have given rise to the Unresolved Issues raised by EY and covered in the PwC Report have been rectified.

In view of the results of the Internal Control Review, the Special Review Committee and the Board consider that the material internal control weaknesses that might have given rise to the Unresolved Issues raised by EY and covered in the PwC Report have been rectified. The Special Review Committee and the Board are committed to (i) supervising the management of the Company and the China Subsidiary to complete the implementation of PKF's recommendations to rectify the outstanding medium risk internal control weaknesses, and (ii) maintaining sound and effective internal controls to safeguard shareholders' investment and the Group's assets.

References are made to the various announcements of the Company since 29 March 2012 in relation to, among other things, the Unresolved Issues raised by EY in the EY Letter, a summary of the key findings of the Review carried out by PwC in respect of the Unresolved Issues (the "**PwC Report**"), the preliminary responses from the Management in relation to the Review, the remedial actions taken or to be taken by the Company, the appointment of PKF as the internal control advisor to the Special Review Committee and their review and follow-up review on the internal control systems of the Company and the China Subsidiary (collectively, the "**Internal Control Review**").

Terms used herein shall have the same meanings as those defined in the announcement of the Company dated 18 August 2013, unless otherwise defined herein.

Following the Unresolved Issues raised by EY in the EY Letter dated 29 March 2012, the Special Review Committee, which was established in March 2012, was concerned with the Unresolved Issues and any weaknesses in the internal control systems of the Company and the China Subsidiary which might have given rise to the Unresolved Issues. In view of this, the Special Review Committee appointed PKF on 7 May 2012 as the internal control advisor to assist the Special Review Committee in reviewing the internal control systems of the Company and the China Subsidiary which are relevant to and might have given rise to the Unresolved Issues, particularly the sales cycle of the China Subsidiary.

The Internal Control Review and the implementation of recommendations by PKF was conducted in two phases, the details of which are set out below:

1. PKF carried out the first phase of the Internal Control Review in May 2012 pursuant to which PKF has identified a number of weaknesses in the internal control systems of the Company and the China Subsidiary which might have given rise to the Unresolved Issues and made a number of recommendations to strengthen the related areas of internal control systems.

The Special Review Committee was concerned with the weaknesses identified by PKF and, accordingly, has requested the Company and the China Subsidiary to implement PKF's recommendations to ensure that similar incidents that might have given rise to the Unresolved Issues will not occur again in the future.

The Company and the China Subsidiary have taken rectification actions in strengthening internal control systems of the Company and the China Subsidiary as detailed in the section headed “Summary of rectifications on the internal control deficiencies in the Company and the China Subsidiary relating to the Unresolved Issues” below.

2. PKF carried out the second phase of the Internal Control Review between 27 May 2013 and 9 June 2013 (the “**Testing Period**”) to review the rectification actions as well as other information and documents submitted by the Company and the China Subsidiary up to 31 October 2013. PKF submitted the report of its findings of the Internal Control Review to the Special Review Committee and the Board on 1 November 2013.

The scope and key findings of the Internal Control Review are set out below.

OBJECTIVES AND SCOPE OF THE INTERNAL CONTROL REVIEW

The objectives of the Internal Control Review are to (a) assist the Special Review Committee and the Board in identifying the weaknesses in the internal control systems of the Company and the China Subsidiary which might have given rise to the Unresolved Issues; and (b) make recommendations to rectify the above weaknesses and/or enhance the existing procedures, systems and controls (including accounting and management policies) of the Company and the China Subsidiary which might have given rise to the Unresolved Issues, with a view to prevent the Unresolved Issues from occurring again in the future.

The Special Review Committee has also instructed PKF to address the internal control deficiencies raised by EY and which were covered in the PwC Report.

The Internal Control Review covered certain components of internal control systems at both entity-level and process-level of the Company and the China Subsidiary, details of which are set out as follows:

Entity level control

- Control environment
- Risk assessment
- Information and communication
- Monitoring

Process level control

- Sales and delivery
- Inventory management for physical quantity of finished goods
- Financial reporting and budgeting
- Information system management
- Related party transactions

SUMMARY OF RECTIFICATIONS ON THE INTERNAL CONTROL DEFICIENCIES IN THE COMPANY AND THE CHINA SUBSIDIARY RELATING TO THE UNRESOLVED ISSUES

(A) Authenticity of delivery notes

During its audit process for 2011, EY raised doubts over the authenticity of delivery notes relating to certain sale transactions of the China Subsidiary in December 2011. The Special Review Committee, upon its establishment, was concerned with the above issue and accordingly, took the initiative to request the Management to carry out reviews to, among other things, quantify the financial impact in relation to the Unresolved Issues.

Based on its review, the Management informed the Special Review Committee that goods covered by the Questionable December Transactions had not yet been delivered to the distributors before the end of 2011 and accordingly, the Questionable December Transactions should not be recognised as sales in December 2011. Further, according to the findings of the Review by PwC, apart from confirming the extent of the Questionable December Transactions, PwC has also found that there were Questionable November Transactions and other questionable transactions for the period from January to November in 2011 with similar patterns to those of the Questionable December Transactions, particularly the authenticity of the relevant underlying delivery notes and other transportation documents.

In order to prevent the recognition of sales of goods before the distributors' acknowledgement of receipt of goods, the China Subsidiary has improved the New Sales Order System to require the distributors to: (i) acknowledge the receipt of goods online; and (ii) have free access to review and check its order status and account balances with the China Subsidiary online.

The China Subsidiary has also established accounts receivable management policies, including the following:

- (i) those distributors, which have transactions with the China Subsidiary in the month, are required to confirm the balances online. An accountant of the China Subsidiary follows up the outstanding confirmations at the beginning of the following month; and
- (ii) the China Subsidiary collects confirmations from the distributors and performs the reconciliation with the distributors with a granted credit limit on a quarterly basis and with all distributors on an annual basis.

The internal audit department of the China Subsidiary has selected samples of delivery of goods to cross-check information from the Logistic Company and distributors of the China Subsidiary.

(B) Integrity of the Old Sales Order System and the warehouse barcode system

EY and PwC noted that data in the Old Sales Order System and the warehouse barcode system had been manually altered. The historical data before alteration could not be retrieved because the hard disk which had been used to store the historical data was damaged and there was no backup of the data kept.

In order to detect for any unauthorised alteration to the data in the IT System, the China Subsidiary has purchased and installed a bastion host (an equipment that keeps track the access and changes made to the servers which store all the critical business information of the Company and the China Subsidiary) to monitor operation on the IT System. In addition, an administrator from the information technology (“IT”) department of the China Subsidiary is assigned to examine, on daily basis, the access and change log, which contains detailed information of log-in user names, operations and operation times. The manager of the IT department of the China Subsidiary will double check the access and change log weekly. The head of the IT department will review the access and change log on an unscheduled basis each month. Any unusual access to or operation on the IT System will be reported to the Chief Financial Officer of the Company with copy to the Audit Committee of the Company.

In addition, the China Subsidiary has improved its various daily IT operation and management processes, in particular setting out rigorous controls over the access to database and system backdoor and the data alteration.

In order to keep proper storage of critical business information of the Company and the China Subsidiary and allow retrieval of historical information when necessary, the China Subsidiary has implemented daily and monthly data backup of the information in the IT System and engaged an independent IT consultant to test data restoration on a monthly basis.

Besides the backup of critical business information, the China Subsidiary has implemented a new policy in relation to the backup of emails whereby all the China Subsidiary’s emails are diverted to a designated email account. The emails received and sent in this designated account are automatically downloaded into a computer on a daily basis, which will then be backed up to a separate hard disk on a monthly basis.

(C) Discrepancy in the quantity of goods sold and delivered as recorded by the China Subsidiary and by the Logistic Company

PwC noted that there were discrepancies between the Accounting Records and the Warehouse Records, and between the internal records of delivery and the external records from the Logistic Company. Therefore, the quantity of goods delivered to the distributors recorded in the Accounting Records and/or the Warehouse Records may not be accurate, which, in turn, affect the accuracy of the amount of sales recorded in the Accounting Records.

In order to verify the quantity of goods delivered to the distributors recorded in the Accounting Records, the China Subsidiary performs monthly reconciliation among records in the New Sales Order System, the Accounting Records, the Warehouse Records and the external records from the Logistic Company.

Monthly physical stock-takes are carried out by the warehouse staff with the participation of the personnel from the finance department of the China Subsidiary. The stock-take results are reconciled with the Accounting Records and the Warehouse Records and reviewed by accounting deputy manager who is not responsible for keeping records of inventory in the finance department.

In order to facilitate the reconciliation of the internal records of delivery and the external records from the Logistic Company, (a) the Logistic Company, at the request of the China Subsidiary, enhanced its system to generate numberings of the delivery notes automatically in sequence solely for the Group and revised the format of its delivery notes to include necessary details of goods delivered for the China Subsidiary to enable easy checking against its internal records of delivery, and (b) the China Subsidiary has requested its finance department to settle logistic expenses only after reconciliations of the Warehouse Records and the records of the Logistic Company have been completed.

(D) Sub-standard control environment and communication

During the Review by PwC, it was revealed that (a) staff from different departments of the China Subsidiary were instructed to prepare certain underlying documents relating to the Questionable December Transactions; and (b) the developer of the warehouse barcode system was instructed to alter the data in the warehouse barcode system (as stated in (B) above) for December 2011 with a view to matching the data previously provided to EY. None of the staff who were involved in these matters had questioned such instructions nor attempted to report the matters to the senior management of the Company.

In view of such control weaknesses, the Company and the China Subsidiary have amended the code of conduct, established and announced the anti-fraud and whistleblowing policies and procedures and sought the undertakings for compliance with code of conduct from all staff of the Company and the China Subsidiary. Training on the anti-fraud and whistleblowing policies and procedures had been provided to all staff of the Company and the China Subsidiary.

PKF reviewed these rectifications (including the quarterly reconciliation of balances with distributors with a granted credit limit) carried out by the Company and the China Subsidiary during their follow-up review. The China Subsidiary plans to perform annual reconciliation of balances with all distributors in January 2014 after the end of financial year 2013.

SUMMARY OF OVERALL RESULTS OF THE INTERNAL CONTROL REVIEW AND OUTSTANDING ISSUES AND ACTION PLANS

During the follow-up review, all material internal control deficiencies (which may lead to potential material adverse financial impact and/or require urgent rectifications) of the aforementioned entity-level and process-level components of internal control systems of the Company and the China Subsidiary identified by PKF in the first phase have been rectified by the Company and the China Subsidiary. However, there are certain outstanding medium risk internal control weaknesses, which may not lead to potential material adverse financial impact or require urgent rectifications. Nevertheless, the management of the Company and the China Subsidiary have developed the following plans to implement the recommendations of PKF to rectify such outstanding medium risk internal control weaknesses:

1. PKF noted that the management of the Company and the China Subsidiary discuss the threats and risks to the businesses arising from changes of internal or external environment (such as change in government policies), assess the impact and develop means of protecting the business in regular management meetings. However, the Company and the China Subsidiary have not performed a systematic risk assessment. In response to this, the China Subsidiary has commenced the systematic risk assessment for 2014 and targets to submit the same to the Board for consideration and approval in December 2013.
2. PKF noted that the China Subsidiary did not request any written declaration from external business partners other than its distributors to confirm whether these parties are related parties and/or connected persons (as defined in the Listing Rules) of the Company or the China Subsidiary. In response to this, the China Subsidiary has revised its policy on related party transactions to extend the request for written declarations of relationship with the Company or the China Subsidiary from its suppliers and other business partners with material transactions on an annual basis or before the commencement of business relationship with the Company or the China Subsidiary. The Company or the China Subsidiary plans to collect the declaration from these existing business partners with material transactions with the Company or the China Subsidiary by December 2013.

Based on the final results of their Internal Control Review during the Testing Period, PKF (i) did not note any material deficiencies of the aforementioned entity-level and process-level components of internal control systems of the Company and the China Subsidiary identified in the first phase of the Internal Control Review, which have not been rectified, and (ii) considers that the material internal control weaknesses that might have given rise to the Unresolved Issues raised by EY and covered in the PwC Report have been rectified.

In addition to the rectification measures recommended by PKF, the Company and the China Subsidiary have taken other actions in strengthening internal controls and information technology system of the Company and the China Subsidiary, and restructuring the Board and the senior management of the China Subsidiary (including the resignation of the chief executive officer of the Company and the China Subsidiary, Mr. Chen), the details of which were disclosed in the announcement of the Company dated 18 August 2013.

In view of the results of the Internal Control Review and all the rectification actions taken by the Company and the China Subsidiary, the Special Review Committee and the Board consider that the material internal control weaknesses that might have given rise to the Unresolved Issues raised by EY and covered in the PwC Report have been rectified. The Special Review Committee and the Board are committed to (i) supervising the management of the Company and the China Subsidiary to complete the implementation of PKF's recommendations to rectify the outstanding medium risk internal control weaknesses, and (ii) maintaining sound and effective internal controls to safeguard shareholders' investment and the Group's assets.

By order of the Board
Ausnutria Dairy Corporation Ltd
Yan Weibin
Chairman

Changsha City, the People's Republic of China, 11 November 2013

As at the date of this announcement, the Board comprises three executive directors, namely, Mr. Yan Weibin (Chairman), Mr. Bartle van der Meer (Chief Executive Officer) and Ms. Ng Siu Hung, one non-executive director, namely, Mr. Dai Li, and three independent non-executive directors, namely, Mr. Qiu Weifa, Mr. Jason Wan and Mr. Chan Yuk Tong.