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Qunxing Paper Holdings Company Limited  
群星紙業控股有限公司

(Incorporated in the Cayman Islands with limited liability)  
(Stock Code: 3868)

## INTERNAL CONTROL REVIEW AND FOLLOW-UP INTERNAL CONTROL REVIEW REPORT

On 19 April 2011, the Audit Committee engaged ZHONGLEI, an independent professional advisor, for conducting the Independent Internal Control Reviews on, among other things, the financial reporting system, the internal control procedures and the corporate governance of the Group and the Report thereof was issued on 11 July 2011. ZHONGLEI concluded that other than the findings and recommendations as stated in the Report, no significant deficiency in the financial reporting system, the internal control procedures and corporate governance mechanism of the Group was found during the Internal Control Review. ZHONGLEI further stated in the Report that based on the Follow-up Internal Control Review, they observed that the Group has taken necessary actions in response to their recommendations as set out in the Report to their satisfaction. Nothing has come to their attention to indicate that the Group is unable to meet its obligations and requirements under the Listing Rules during the Independent Internal Control Reviews.

The Board and the Audit Committee have reviewed the Report and assessed the effectiveness of the Group's internal control system. In addition, the management has already taken necessary actions in response to the recommendations made by ZHONGLEI to their satisfaction. Based on the conclusion made by ZHONGLEI and in view of the concrete actions taken by the Group in response to their recommendations, the Board and the Audit Committee concluded that the Group has proper internal control system and corporate governance mechanism in place to discharge its obligations under the Listing Rules. The management will make continuous efforts to reinforce the Group's internal control system.

Reference is made to an announcement (the “**Announcement**”) of the Company dated 19 April 2011 in relation to the appointment of ZHONGLEI Risk Advisory Services Limited (“**ZHONGLEI**”) as the independent professional advisor of the Company for performing the Independent Review and Investigation and Independent Internal Control Reviews. Unless defined otherwise, capitalised terms used herein shall bear the same meanings as those defined in the Announcement.

An internal control review and follow-up review report (the “**Report**”) from ZHONGLEI was issued to the Audit Committee on 11 July 2011. The Internal Control Review covers the period from 1 January 2010 to 30 April 2011 and the Follow-up Internal Control Review covers the period from 1 June 2011 to 11 July 2011.

As stated in the Report, from conducting the Internal Control Review, ZHONGLEI concluded that other than the findings and recommendations as stated in the Report, no significant deficiency in the financial reporting system, the internal control procedures and corporate governance mechanism of the Group was found during the Internal Control Review. ZHONGLEI further stated in the Report that based on the Follow-up Internal Control Review, they observed that the Group has taken necessary actions in response to their recommendations as set out in the Report to their satisfaction. Nothing has come to their attention to indicate that the Group is unable to meet its obligations and requirements under The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the “**Listing Rules**”) during the Independent Internal Control Reviews.

The findings of ZHONGLEI following the Independent Internal Control Reviews and their relevant recommendations as well as the necessary actions taken by the Group in response to such recommendations are summarised as below:

1. from reviewing the internal controls of the Group from the perspective of the various components under the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework:
  - (a) in respect of control environment, it was found that the Group meets the requirements of the various sub-components regarding integrity and ethical values, commitment to competence, the Board, management’s philosophy and operating style, organization structure, assignment of authority and responsibility, human resources policies and practices.

The findings made by ZHONGLEI include, the fact that i) the Group has in place a staff handbook with code of conduct addressed to all staff (with proper acknowledgment provided by the staff in respect of the contents relating thereto) during pre-employment training; ii) there were clear written job descriptions explained to the staff and management has sufficient competence to perform their job duties; iii) the Company has in place four board committees consisting of an Nomination Committee, a Remuneration Committee, an Audit Committee and an Executive Committee (all of which have specific terms of reference); iv) the Group has a formal policy and procedures for monitoring the Group’s operation and investment activities and top management of the Group has implemented such policy and procedures; v) formal and informal communication methods (such as meetings and emails) are used to deliver effective responsibilities to management; vi) proper organizational structure is noted and that assignment of responsibility and delegation of authority are properly stated in the operation manual and that job descriptions are given and explained to all staff; vii) there is performance appraisal when renewing

a staff contract with proper documentation; and viii) the human resources department is responsible for staff recruitment, promotion and termination and the promotion criteria have been stated in the internal audit information;

- (b) in respect of risk assessment, it was found that the Group meets the various sub-component objectives (that is, entity wide, activity-level, risks and managing change), findings made by ZHONGLEI include the fact that (i) the Company has written entity-wide business objectives and strategic plan setting out specific business goals of the Group; (ii) the Company has, since 2007, established a business plan linking up with such entity-wide objectives and strategies with relevant disclosure in every annual report, presentation, news and media; (iii) management was involved in day to day operation to identify and consider the implications of relevant risks, at both the entity level and the activity level; (iv) Shandong Qunxing Paper Limited (山東群星紙業有限公司) (“**Shandong Qunxing**”), a main operating arm of the Company, has already established a risk control committee to execute the risk management; and (v) management had involved in day to day operation to identify the changes of economic, industry and regulatory environments;
- (c) in respect of control activities (including ongoing monitoring and separate evaluations), it was found that the Group meets various objectives on documentation of policies and performance of procedures, findings made by ZHONGLEI include the fact that the Group has established a set of policies and procedure manual to ensure management directives are carried out. Through the conducting of the Follow-up Internal Control Review, ZHONGLEI observed that the management of the Company has responded to their recommendation by updating this procedure manual in June 2011.

It was also found that the Group has established an internal audit charter so as to define and identify the mission, objectives, scope, authority and accountability of the Group’s internal audit department. Through the conducting of the Follow-up Internal Control Review, ZHONGLEI observed that the management of the Company has responded to ZHONGLEI’s recommendation by putting in place and implemented since June 2011 a formal documentation policy to record its findings, recommendations and perform follow-up work on an on-going basis, and by putting in place a formal policy to regularly record risk-based audits and distribute the relevant reports to different levels of management to ensure that those actions identified as necessary to address risks are carried out;

- (d) in respect of information and communication, it was found that the Group meets various objectives regarding information and communication. ZHONGLEI found that the Group could obtain relevant information through various external and internal channels (e.g. internet search and site visits) and that the Group has a reporting mechanism and “Corruption Reporting Procedures” to their satisfaction; and

- (e) in respect of monitoring, from the perspective of ongoing monitoring and separate evaluations, it was found that ongoing monitoring has conducted in the ordinary course of operations which includes meetings between top management and executive directors and some internal meetings within departments; from the perspective of reporting deficiencies, it was found that the Group has established formal whistle-blowing policies and procedures.

Through conducting the Follow-up Internal Control Review, ZHONGLEI observed that the management of the Company has responded to their suggestion by putting in place and implemented since June 2011 a formal documentation policy to record its findings, recommendations and perform follow-up work on an on-going basis, and by putting in place a formal policy to regularly record risk-based audits and distribute the relevant reports to different levels of management to ensure that those actions identified as necessary to address risks are carried out;

- 2. from conducting an internal control system evaluation on Shandong Qunxing regarding:

- (a) Revenue and receipt cycle

- (i) From the perspective of payment terms in the weekly sales contracts, it was observed that the weekly sales contracts that Shandong Qunxing signed with the minor customers did not specify any payment term.

Through conducting the Follow-up Internal Control Review, ZHONGLEI observed that the management of Shandong Qunxing has responded to their recommendation by amending the terms of the existing weekly sales contracts and those contracts that were signed since June 2011 with minor customers to include the specific payment terms; and

- (ii) From the perspective of contracts signed with the logistic companies. It was found that sales contracts that Shandong Qunxing signed with customers provides that the customers should bear all transportation costs but they did not specify that Shandong Qunxing is responsible for locating the logistic companies to deliver the goods to customers. Following the conducting of the Follow-up Internal Control Review, ZHONGLEI observed that Shandong Qunxing has adopted their recommendations by amending the contracts signed prior to June 2011 and those contracts that were signed since June 2011 with the logistic companies to include the specific payment arrangement;

(b) Purchase and expenditure cycle

- (i) From the perspective of written guidelines on performance evaluation on suppliers, ZHONGLEI found that the merchandiser of Shandong Qunxing, in assessing the performance of the major suppliers on a weekly basis, a vendor evaluation form (供應商評估表) would be filled in in accordance with the 《供應商評估制度》 (Vendor Assessment System). However it was found that there was no assessment criteria specified in respect of each area forming part of the overall assessment.

Following the conducting of the Follow-up Internal Control Review, ZHONGLEI observed that the management of Shandong Qunxing has, since June 2011, modified and implemented a new guideline on performance evaluation on suppliers in accordance with their recommendations by revising the standard procedure and guideline for post performance evaluation by setting the detailed assessment criteria for post performance evaluation on suppliers, such as timely delivery of goods/services, quality of goods, responses to enquires, etc and by ranking the external advisors/consultants according to their performance based on a grading system;

- (ii) From the perspective of quality clause in the weekly purchase contracts, ZHONGLEI observed that there was no quality clause in the weekly purchase contracts signed with the suppliers. Following the conducting of the Follow-up Internal Control Review, ZHONGLEI observed that the management of Shandong Qunxing has adopted their recommendations by amending the terms of the existing weekly purchase contracts and those contracts that were signed since June 2011 with the suppliers to include the quality clause;
- (iii) From the perspective of supplier master file, it was found that Shandong Qunxing has maintained a supplier master file. Information such as suppliers' full names and addresses are recorded in the file. However, information in the supplier master file was not up-to-date. Following the conducting of the Follow-up Internal Control Review, ZHONGLEI observed that the management of Shandong Qunxing has adopted their recommendation by putting in place and implementing a policy to review and update the supplier master file (as necessary) on a regular basis and maintaining the supplier master file according to the approved suppliers' list since June 2011;
- (iv) From the perspective of the policy on rotation of procurement staff, it was found that Shandong Qunxing did not have any policy on rotation of procurement staff and that the merchandisers work at the same position or deal with the same suppliers for an extensive period. Following the conducting of the Follow-up Internal Control Review, it was found that the management of Shandong Qunxing has adopted ZHONGLEI's recommendation by establishing and by having implemented, since June 2011, a rotation policy of procurement staff and by requiring the merchandisers to serve with different suppliers on a rotation basis; and

(v) From the perspective of the policy on purchase return, it was found that Shandong Qunxing has established the policy of 《退貨管理制度》 (Purchase Return System). Based on the observation of ZHONGLEI, the Purchase Return System sets out the basic criteria for the management of good returns but lacks detailed guidelines on under what circumstance should return the goods to suppliers and the administrative procedures for the goods return. Following the conducting of the Follow-up Internal Control Review, it was found that the management of Shandong Qunxing has adopted ZHONGLEI's recommendation by updating and implementing a policy on the purchase return management, such that all purchase returns shall be approved by the authorized person. In addition, the relevant documentation/correspondence with the suppliers in relation to the return shall be properly filed and passed to finance department for recording. The details of the purchase return shall be properly recorded in the supplier master file for future reference.

(c) Cash disbursement and receipts cycle

From the perspective of approval on certain payments, it was found that certain payments for utilities, electricity, sewage charges and taxes had been approved by the finance manager instead of the general manager in accordance with the company policy of Shandong Qunxing. Following the conducting of the Follow-up Internal Control Review, it was observed that the management of Shandong Qunxing has, since June 2011, adopted ZHONGLEI's recommendation by enforcing the approval procedure for payment of expenses to avoid the risk for misappropriation of assets by unauthorized staff;

(d) Inventory cycle

No material finding was found by ZHONGLEI.

(e) Human resources and payroll cycle

(i) From the perspective of segregation of duties on production, warehousing and technical support, it was found that the departments of production, storage and technical support of Shandong Qunxing were monitored by the same person (i.e. deputy general manager of Shandong Qunxing, the "**Personnel**"). The management stated that the Personnel was responsible for general management and monitoring the performance of the aforesaid departments and was also required to report to the general manager of Shandong Qunxing on a regular basis. This structure had proven to be effective for Shandong Qunxing. However, in order to strengthen the Group's internal control procedures, the duties of the Personnel have been properly segregated since June 2011 in response to the recommendation made by ZHONGLEI. Following the conducting of the Follow-up Internal Control Review, it was found that the management of Shandong Qunxing has adopted ZHONGLEI's recommendation to avoid any potential integrity issue by varying its

organisational structure through segregating the monitoring duty on production, warehouse and technical support since June 2011; and

- (ii) From the perspective of confidentiality requirement, it was found that although Shandong Qunxing has internal confidentiality requirements which required all employees (including staff in sales, purchase, production and technical departments) who can access the confidential information to sign a confidentiality agreement, only technical staff has signed the confidentiality agreement. Following the conducting of the Follow-up Internal Control Review, it was found that the management of Shandong Qunxing has, since June 2011, adopted ZHONGLEI's recommendation by requiring all existing staff to sign a confidentiality agreement and by enforcing the confidentiality requirement requiring all new staff to sign such confidential agreement upon joining the Group; and

(f) Fixed assets cycle

From the perspective of fixed asset insurance, it was found that the principal production lines of Shandong Qunxing in Zouping County, Binzhou City, Shandong have not been properly insured. Following the conducting of the Follow-up Internal Control Review, it was found that the management of Shandong Qunxing has adopted ZHONGLEI's recommendation by purchasing machinery insurance for the production line in July 2011.

(g) Cash management and treasury cycle

- (i) From the perspective of written policy on budgeting, it was found that Shandong Qunxing has prepared the budget on revenue, human resources and capital expenditure. However, no written policy has been established to regulate and govern the budgeting process and its implementation. Following the conducting of the Follow-up Internal Control Review, it was found that the management of Shandong Qunxing has adopted ZHONGLEI's recommendation by revising the policy on budgeting by establishing the written policy on the budgeting process on revenue, human resources and capital expenditures;
- (ii) From the perspective of written policy on financing, it was found that Shandong Qunxing has no written policy on financing. Following the conducting of the Follow-up Internal Control Review, it was found that the management of Shandong Qunxing has, since June 2011, adopted ZHONGLEI's recommendation by establishing and implementing a written policy on financing including the authorized level, criteria for selection of financial institution and the limited usage of the financing;

- (iii) From the perspective of the policy on reconciling the daily settlement report with bank remittance advices, it was found that Shandong Qunxing has no written policy on reconciling the settlement from customer to bank balance. Following the conducting of the Follow-up Internal Control Review, it was found that the management of Shandong Qunxing has, since June 2011, adopted ZHONGLEI's recommendation by establishing the written policy on reconciling the settlement from customers to bank balance, including the timing of performing the reconciliation and the reporting channel for any irregularities found and the following up actions to rectify the irregularities. After adopting the new policy in June 2011, it was observed that the staff of the finance department of Shandong Qunxing has reconciled the daily receipt summary to the bank remittance advices on a daily basis and performed the reconciliation with the bank statements of May 2011;
- (iv) From the perspective of reconciling bank remittance advices and bank statements, it was found that details shown in certain bank remittance advices were different with the bank statements and errors were found in certain bank statements. Following the conducting of the Follow-up Internal Control Review, it was found that the management of Shandong Qunxing has, since June 2011, adopted ZHONGLEI's recommendation, since June 2011, by reinforcing the relevant procedure to require staff from the finance department of Shandong Qunxing to check the consistency for every detail as shown in the bank statements and bank remittance advices and that the finance department should document their findings and seek for explanation from the bank for any inconsistencies noted and report to the top management to rectify the issue. It was observed that the staff from the finance department of Shandong Qunxing has performed the reconciliation of bank remittance advices and bank statements of May 2011 in June 2011; and
- (v) From the perspective of reconciling bank statements, it was found that the date shown on bank statements and the brought forward date were wrong or not in order. Following the conducting of the Follow-up Internal Control Review, it was found that the management of Shandong Qunxing has, since June 2011, adopted ZHONGLEI's recommendation by requiring staff in the finance department of Shandong Qunxing to check whether every detail shown in the bank statements was properly documented upon receipt of bank statements from banks and that the staff shall sign off on the bank statements to evidence such checking and shall contact the banker to rectify an error so discovered immediately. It was observed that the finance staff of Shandong Qunxing has performed the checking on the bank statements of May 2011 in June 2011;



(h) Financial report cycle

- (i) From the perspective of the accounting manual, it was found that Shandong Qunxing did not establish any accounting manual and that the accounting staff of Shandong Qunxing has been processing the daily accounting entries based only on their working experience. Following the conducting of the Follow-up Internal Control Review, it was found that the management of Shandong Qunxing has, since June 2011, adopted ZHONGLEI's recommendation by establishing its own accounting manual with reference to its business operation and the relevant accounting principles and financial regulations applicable to enterprises established in the Peoples' Republic of China.
- (ii) From the perspective of the segregation of keeping company seal and contract seal, it was found that the company seal and contract seal of Shandong Qunxing were kept by an administrative clerk and the seal register book (印章使用登記簿) has not been properly updated. Following the conducting of the Follow-up Internal Control Review, it was found that the management of Shandong Qunxing has, since June 2011, adopted ZHONGLEI's recommendation by establishing the 《關於印章使用專人保管的決定》 (Policy Safeguarding the Usage of Seal) to safeguard and monitor the usage of the company seal and contract seal. Under such policy, Shandong Qunxing had assigned two separate staff (both of mid to senior level in terms of seniority) to safeguard the company seal and contract seal and they are solely responsible for the usage of the seal which they kept and be responsible for filling in the seal register book for every usage.
- (i) Electronic data processing: from the perspective of information and technology department, it was observed that Shandong Qunxing has not established any information and technology policy to monitor the information processing and development, hardware and software management, information security management and that, one administrator was responsible for the information system. Following the conducting of the Follow-up Internal Control Review, it was found that the management of Shandong Qunxing has, since June 2011, adopted ZHONGLEI's recommendation by establishing the written policy of the information system to increase the operating efficiency of the information system.
- (j) Taxation: from the perspective of the policy on income tax and other tax related management, it was found that Shandong Qunxing did not have any written policy on tax calculation and approval. It was observed that there was a calculation error of individual income tax for bonus paid in December 2010. ZHONGLEI recommended that Shandong Qunxing might consider recruiting a qualified tax consultant to deal with tax matters including calculation of various taxes and filing returns. Following the conducting of the Follow-up Internal Control Review, it was found that the management of Shandong Qunxing has, since June 2011, adopted ZHONGLEI's recommendation by establishing a policy on tax management which provides for, among other things, the review and approval procedure for submission of tax return to minimize the risk for error or omission. It was also

observed that Shandong Qunxing has rectified the calculation error of individual income tax for bonus paid and settled the under-paid individual income tax in June 2011.

3. from reviewing the Company's secretarial records and board of directors' practice from the broad perspectives of the Directors, remuneration of Directors and senior management, accountability and audit, delegation by the Board, and communication with Shareholders, in assessing the Company's compliance with the code provisions (the "**Code Provision(s)**") of the Code on Corporate Governance Practices as set out in Appendix 14 to the Listing Rules), ZHONGLEI was found that the Company had complied with all the applicable Code Provisions except the deviation from the Code Provision A.2.1 regarding the segregation of roles of chairman and chief executive officer (CEO). The Company has disclosed such deviation together with its explanation in the corporate governance report as contained in its 2010 annual report.

## **VIEWS OF THE BOARD AND AUDIT COMMITTEE**

The Board and the Audit Committee have reviewed the Report and assessed the effectiveness of the Group's internal control system. In addition, the management has already taken necessary actions in response to the recommendations made by ZHONGLEI to their satisfaction. Based on the conclusion made by ZHONGLEI and in view of the concrete actions taken by the Group in response to their recommendations, the Board and the Audit Committee concluded that the Group has proper internal control system and corporate governance mechanism in place to discharge its obligations under the Listing Rules. The management will make continuous efforts to reinforce the Group's internal control system.

## **INDEPENDENT REVIEW AND INVESTIGATION**

As additional time is required by ZHONGLEI for finalising their report in respect of the Independent Review and Investigation, the Company shall continue to keep shareholders informed of the progress of the Independent Review and Investigation by making an announcement regarding the aforesaid report as soon as practicable.

By Order of the Board  
**ZHU Yu Guo**  
Chairman

Shandong, the PRC, 11 July 2011

*As at the date of this announcement, the executive Directors are Dr. ZHU Yu Guo (Chairman), Mr. ZHU Mo Qun (Vice-chairman) and Mr. SUN Zhen Shui; the non-executive Director is Ms. SUN Rui Fang; the independent non-executive Directors are Messrs. ZHAO Wei, WANG Lu and KWONG Kwan Tong.*