AVOIDING POTHOLES IN LISTED COMPANIES

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FOREWORD

This report started as a research project undertaken by four NUS BBA (Accountancy) Honours students working with CPA Australia, under the supervision of my colleague and co-author of this report, Associate Professor Richard Tan, and me. Their research provided much of the basis for the section on "Corporate Governance and Disclosure" in the report. Following the completion of that research project, we decided that while those warning signs and red flags in corporate governance and disclosure are valuable for helping public investors avoid potholes in listed companies, our own experience tells us that investors must also focus on two other areas: business model and certain events/transactions.

With that in mind, we expanded the report to cover the four areas of Business Model, Corporate Governance, Disclosure and Reporting, and Events and Transactions – what we call the B-C-D-E Model. In the report, we use actual examples of SGX-listed companies to illustrate many of the issues we discuss. Not all the companies we have named in the report are companies with accounting or corporate governance lapses. Some have seen their business disrupted, particularly by technological changes, leading to a significant deterioration in their performance.

I would like to thank CPA Australia for being a partner for this report. Thanks are also due to the students - Lim Ze Hao, Neo Zhao Zhi Bryan, Sitoh Zi En Pamela and Yap Ying Ning - for their research assistance; Cindy Pan of Morgan, Lewis & Bockius in Shanghai for her expert advice on issues relating to legal representative and company chops for Chinese companies; and other market players who have shared their expertise with us.

I hope that public investors, especially retail investors, will find the report useful.

Associate Professor Mak Yuen Teen, PhD, FCPA (Aust.)

EXECUTIVE SUMMARY

Companies do not implode from accounting and corporate governance scandals overnight. Often, there are early warning signs, followed by more serious red flags. The business model may be questionable to start with. Fissures in the corporate governance of the company may be evident. Certain reporting deficiencies may start appearing. More serious red flags such as sudden resignation of independent directors, qualified accounts, and delays in reporting and holding annual general meetings may follow. Regulatory actions may then be directed at the company. Finally, the full scale of the problem unravels.

Companies may perform poorly or fail because of changes in the business environment, industry disruption or other business challenges. Companies with good corporate governance, such as a highly experienced and independent board, competent senior management and good risk management practices, are better placed to navigate such challenges. Nevertheless, doing business involves taking on risk, and risks of poor performance or business failure are unavoidable. Capital market investors should be prepared to accept such risks when they invest in companies.

However, investors have the right to expect that those who control, govern and manage companies have in place proper corporate governance practices and act with integrity.

> “In the world of business, bad news often surfaces serially: you see a cockroach in the kitchen; as the days go by, you meet his relatives.”
>
> *–Warren Buffett,*
> *Letter to Shareholders, Berkshire Hathaway Inc., 2014*

How can public investors, especially retail investors, with little technical knowledge and no access to non-public information monitor the risks of companies running into trouble from poor corporate governance, before they invest and as long as they remain invested in the company? Or to paraphrase Mr Buffett, how can they spot the “cockroaches” that may tell them that there is infestation in the “kitchen”?

B-C-D-E MODEL

In this report, which is aimed primarily at retail investors, we discuss **warning signs and red flags** that can be gleaned from public information, such as annual reports and announcements on SGXNet. These warning signs and red flags fall into four areas: business model, corporate governance, disclosure and reporting, and events and transactions. We call it the **"B-C-D-E"** model. Poorly governed companies do not get an "A"!

Business model is about how the company is making money or expects to do so. History is replete with examples of companies that go public with business models based on hope or even deception, often capitalising on what is in vogue. In the 1980s, there was the "dotcom" bubble, when some truly innovative companies were accompanied by "copycats", many of whom had little substance in their business models, or fraudulent companies riding on the wave. More recently, we have companies jumping onto the bandwagons of e-commerce, financial technology and cryptocurrency. History often repeats.

Corporate governance is primarily about the ownership, board and key management, remuneration policies, and risk management and internal controls.

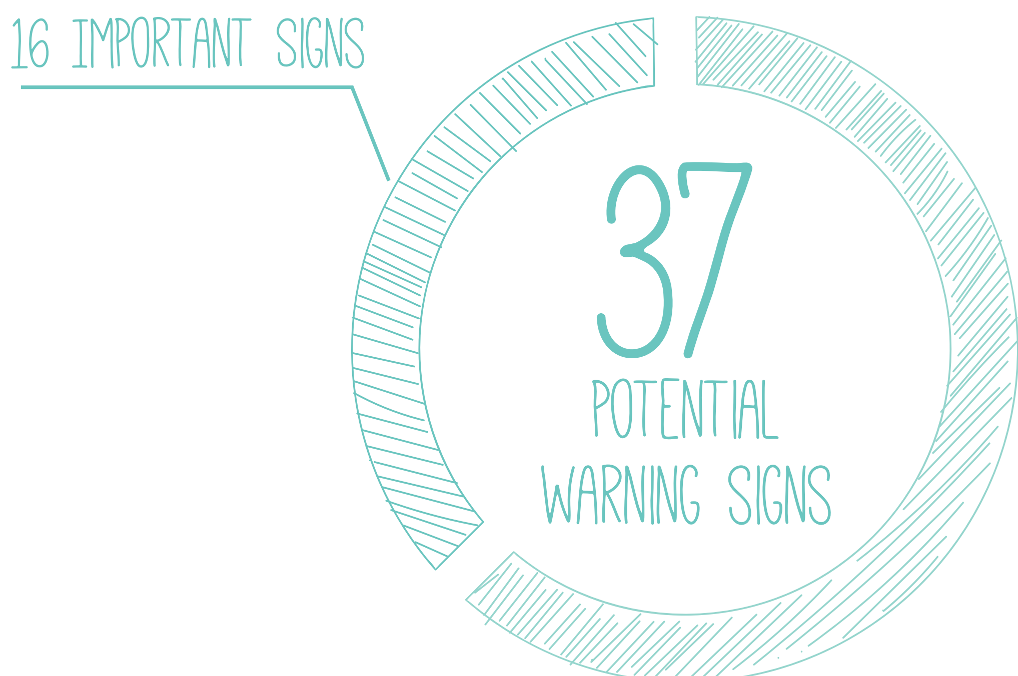
Disclosure and reporting is about timely disclosures and reporting of financial results, external audit and conduct of shareholder meetings.

Events and transactions concern specific events and business transactions that impact the company or that it engages in.

STUDY OF TROUBLED COMPANIES

We also discuss the findings from a study on the corporate governance and reporting warning signs and red flags that tend to differentiate companies that had major corporate governance or accounting lapses over the past five years causing significant losses to public investors – what we call "troubled companies".

After analysing 37 potential warning signs and red flags identified from various sources, we found 16 of them to be the most important. We classified the 16 into warning signs or red flags based on how strongly they differentiated the troubled companies from peers that that did not have similar lapses – what we call "control companies" – and how early they appeared. Not surprisingly, those that most strongly differentiated the two groups tend to appear relatively late and are therefore somewhat less useful for investors in avoiding significant losses.



INVESTORS THEREFORE NEED TO LOOK OUT FOR EARLY WARNING SIGNS EVEN IF THEY MAY NOT NECESSARILY MEAN THAT THE COMPANY WOULD FALL INTO A CORPORATE GOVERNANCE ABYSS:

THE STRONGEST EARLY WARNING SIGNS WERE:

Unexplained changes in results attracting an SGX query; foreign incorporation; change of sponsor (for Catalist companies); and independent directors participating in performance incentive plans (generally share option plans).

OTHER EARLY WARNING SIGNS WERE:

Having a founder who is also the executive chairman/CEO; non-payment of dividends; disclosure/trading queries from SGX; profit warning; foreign auditor(s) for the listed entity or key subsidiaries; key operations in countries with weak rule of law; and low management ownership.

IN TERMS OF RED FLAGS, THE KEY ONES WERE:

The engagement of an independent third party to undertake a special audit or independent review; AGM delays; modified auditor's opinion; sudden resignation of the audit committee chairman; and sudden resignation of other independent directors. Discrepancies between unaudited and audited results and significant or frequent restatements were other key red flags.

Some disclaimers are in order.

- First, investors should not assume that a company is heading for trouble just because they see one or more of the warning signs. However, if they see a number of these warning signs, they should certainly exercise caution and monitor what is going on. If they see any of the red flags, they should be particularly concerned.
- Second, the warning signs and red flags discussed in this report are not necessarily exhaustive.

INTRODUCTION

Asia has become a 'thriving hotbed of investment activity' and with it, has seen its fair share of corporate scandals — with some rivaling those in the United States and Europe.[i] Singapore has not been spared. Such scandals often led to tumbling share prices and irreversible damage to a company's reputation – and in the worst case, to shareholders and other stakeholders losing all their claims.

Research has shown that poor corporate governance can lead to an almost immediate and significant drop in the valuation of public securities,[ii] whereas good corporate governance delivers superior stock returns for firms across emerging and developed markets.[iii]

One of the first major corporate scandals involving a company listed on the Singapore Exchange (SGX) (or its predecessor stock exchange) arguably occurred in 1985 with the collapse of Pan-Electric Industries. This led to regulatory reform, such as the mandatory requirement in the Singapore Companies Act for listed companies to have an audit committee.

In line with many other markets, Singapore moved from a merit-based to a disclosure-based regime at the end of the last millennium. The stock exchange was demutualised in 1999 and listed in 2000. With more companies listed since the early 2000s, there has been an escalation in the number of those embroiled in accounting or corporate governance scandals.

The first half of the 2000s saw a small wave of scandals involving several Singapore-incorporated companies, such as Accord Customer Care Solutions, Auston International Group, Citiraya Industries and Informatics Holdings. In 2004 came the major scandal involving China Aviation Oil – arguably the first involving a People's Republic of China (PRC) company listed on SGX, or "S-chip". This preceded what became the first wave of S-chip scandals in the late 2000s, involving companies such as Beauty China, China Printing & Dyeing, China Sun Bio-chem Technology, FerroChina, Fibrechem Techologies and Oriental Century.

A second wave of S-chip scandals followed soon after, engulfing companies such as Celestial Nutrifoods, China Gaoxian, China Hongxing Sports, China Milk Products Group, China Sky Chemical Fibre, Falmac, Hongwei Technologies, New Lakeside, Sino-Environment and Sinotech Fibre.

Unfortunately, there seems to have been a third wave of S-chip scandals over the last few years, as companies such as China Fibretech, China Sports International, Eratat Lifestyle, Midas Holdings, Oriental Group and Yamada Green Resources reveal serious lapses.

However, it is not just S-chips that have been affected. Other foreign listings, such as Noble Group and YuuZoo Corporation, and homegrown companies, such as Datapulse Technology, Epicentre, Singapore Post and Swiber Holdings, have also been plagued by serious accounting and/or corporate governance lapses.

These scandals and serious lapses resulted in outcomes including investigations by regulatory authorities, reprimands, long-term trading suspensions, significant financial losses, significant share price declines, judicial management, and mandatory delisting. Consequently, public investors have faced considerable losses and this has arguably contributed to a loss of confidence, which has in turn adversely affected valuations and liquidity.

This report aims to provide a guide on warning signs and red flags especially for retail investors who only have access to public information, such as annual reports and corporate announcements, and who have limited expertise in analysing corporate governance and financial statements. These warning signs and red flags are classified into the following categories: business model, corporate governance, disclosure and reporting, as well as events and transactions. By closely monitoring key warning signs and red flags, investors will be better positioned to take early action to minimise or prevent losses.

THE B-C-D-E MODEL

In looking for warning signs and red flags, investors should focus on four areas: **B**usiness model, **C**orporate governance, **D**isclosure and reporting, and **E**vents and transactions. We call it the **"B-C-D-E" model**.

BUSINESS MODEL

is about how the company is making money or expects to do so.

CORPORATE GOVERNANCE

is primarily about the ownership, board and key management, remuneration policies, risk management and internal controls.

DISCLOSURE & REPORTING

is about timely disclosures and reporting of financial results, external audit and conduct of shareholder meetings.

EVENTS & TRANSACTIONS

concern specific events and business decisions that impact the company or that it engages in.

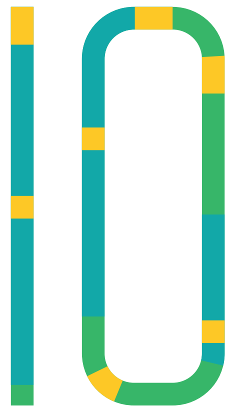
BUSINESS MODEL

An investor buying into a stock, whether through an IPO or from an exchange, should first seek to understand the company's business model.

Unless the purchase is intended to be speculative in nature and held only for a very short period of time, an investor should study the business model to understand, for example, the growth potential and future sustainability of the business. Investors should satisfy themselves knowing that the model makes sense.

Investors should critically analyse the information in the prospectus, annual report and other sources to understand the business model and risks before sinking their money into the shares. Some companies have run into financial or governance difficulties shortly after listing.

Some of the companies in this section on "Business Model" started with sound business models which have been disrupted. With good governance and the right management, they may be able to get back on track. Others have questionable business models to start with, and such companies are particularly vulnerable to accounting and corporate governance lapses.



KEY QUESTIONS INVESTORS SHOULD ASK ABOUT A BUSINESS MODEL

1 IS THE COMPANY LISTING WHEN THE BUSINESS IS AT THE PEAK OF ITS CYCLE?

Before subscribing to shares in an IPO, investors should understand the industry and market sector the company operates in. An owner of a company deciding to list the company's shares will often look into listing at a time when the company's performance is at its peak, so as to fetch an attractive offer price for himself and other existing shareholders. Barring other factors, the best time to list from the owner's standpoint is when the industry/market is reaching or at its peak. If a slowdown in the industry should happen, this will adversely impact the share price.

2 IS THERE AN EXPANSION PLAN WHICH IS OVERLY AMBITIOUS RELATIVE TO THE COMPANY'S CURRENT OPERATIONS AND CAPABILITIES?

The plan may include:

- New products or services which promise new technology that will make the company an industry disruptor (fintech, e-commerce, etc). Often such products or services seem very "high-tech" but investors should critically assess whether the new technology is simply a "good idea".
- New markets in remote geographical locations or countries with weak regulatory regimes and unique business challenges (money laundering risk, difficulties in repatriation of earnings, difficulties in enforcing court orders, etc.).
- Multiple new markets which may be challenging to manage.

YuuZoo Corporation

In its 2016 annual report, YuuZoo revealed its "Project 500" business strategy based on the "strong foundation it has built in the form of franchisees and partners". Its business plan included expanding into multiple locations through new partnerships, acquisitions and other initiatives. However, its share price fell from S$0.48 after its RTO in September 2014 to S$0.038 in March 2018.

YuuZoo recorded a revenue drop of 67% to S$9.7 million in the fourth quarter of 2017 (ended 31 December). In April 2018, the Commercial Affairs Department (CAD) raided its offices and took away key documents and records including franchisee agreements and business plans of franchisees. The company is being investigated for possible breaches of the Securities and Futures Act and trading in its shares has been suspended.

Trek 2000

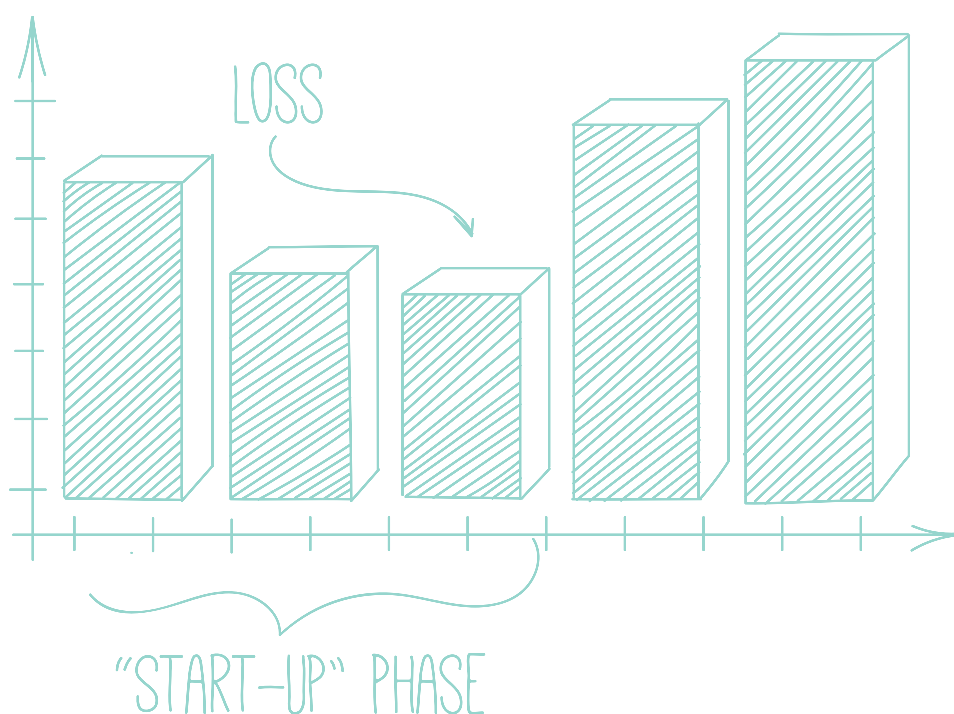
Another example is Trek 2000. Based on its 2017 annual report, the company has big plans to target growth in the medical technology space where it believes it can be a game-changer. It all came crashing down in April 2018 when a forensic review disclosed sham documents and suspicious transactions involving related entities.

3 IS THE COMPANY LOSS-MAKING?

It is not unusual for a company to make losses at the early stages of its life cycle. If a company lists early in its life cycle, then it may be loss-making at the time of its listing. There is no guarantee that a company will ultimately be profitable, so investing in such companies is relatively riskier although the payoffs may be greater. The presence of credible "cornerstone" investors may provide some indicator of likely success but is no guarantee. In recent times, e-commerce and fintech companies have been able to seek a listing despite a history of losses.

If a company is already well past its start-up phase and continues to make losses, then significant changes to the company's existing business model and strategies may be required. Investors need to understand the changes that have occurred within the business model and strategies that will make the new company successful. If the company management remains the same, what are they doing differently to make the company profitable after it has been listed? If a new business is being infused into the company, does current management possess the appropriate experience, business acumen and skill sets to formulate the right strategies? Investors should be particularly careful about companies raising funds to allow existing owners to exit from an unprofitable business or to pay off loans.

Investors should study the business model and strategies carefully, and ask themselves whether it is too good to be true. In addition, they should ask themselves whether they are prepared to forego dividends for several years; accept a fall in share price which may take several years to recover, or provide additional capital.



Ayondo Limited

In April 2016, Starland Holdings announced that it had signed a non-binding memorandum of understanding to acquire the entire equity interest of Ayondo Holding AG for S$157.5 million through a reverse takeover. Starland is a Catalist-listed investment holding company in real estate. Ayondo described itself as a global financial technology group that offers a sophisticated online trading platform. It specialises in social trading and was the first company to offer social trading services under a portfolio management licence issued by the German regulator, Bafin. Ayondo's prospectus shows that it has not been profitable since financial year 2014. On 25 September 2017, Starland announced that the conditions precedent had not been met and the proposed transaction had therefore lapsed. Ayondo owed Starland S$0.992 million for expenses which it had incurred for the transaction and which Starland had paid on its behalf. This amount, plus interest, was subsequently converted into a redeemable convertible loan in anticipation of a planned listing of Ayondo through an IPO. The agreed conversion price was at a discount of 33% off the IPO price. Starland subsequently elected to receive the amount owing in cash, payable within 14 days of the listing of Ayondo. Ayondo listed at S$0.26 per share and commenced trading on 26 March 2018.

On 14 August 2018, Ayondo made the following announcement:

"**During the second quarter ended 30 June 2018, the Group's financial performance was below its expectations at the time of the IPO. After a review of the Group's cash flow position and the immediate plans for business expansion, the Company has re-allocated S$1.511 million of the IPO Net Proceeds from platform enhancement spend and S$3.938 million from marketing spend and utilised them for general working capital purposes**".

The latter refers to normal operational expenses such as staff expenses, legal and professional costs and other operating expenses.

In January 2019, the CEO of the company suddenly resigned. It was later revealed that there was discontent and disagreement between the controlling shareholders and the CEO over issues such as the progress of the business, funding requirements, performance and future direction. In February 2019, accounting-related issues were also reported in its 99.91%-owned UK subsidiary.

Ayondo's share price has been in freefall since its IPO. Its share price had fallen to S$0.048, well down from its IPO price of S$0.26, before it was suspended from trading on 1 February 2019.

An investor considering investing in Ayondo could have asked the following questions:

- is the business model that involves social trading a viable one?
- why did the reverse takeover fail?
- why did Starland not accept the shares which were offered at a 33% discount? (granted, Starland said it was based on consideration of its core operating business, but was Starland, which was a potential RTO partner so pessimistic about the share price of Ayondo post-IPO?)

4 IS THE BUSINESS MODEL IN VOGUE, FASHIONABLE OR A "FLAVOUR-OF-THE-MOMENT"?

This is particularly relevant to companies in e-commerce, fintech, and other emerging technologies. These companies are often asset-light with substantial funding needed to develop solution platforms and expand into new markets. Their business model is that of a disruptor, and the business culture tends to focus on more risk taking and experimenting, working at a fast pace, with a greater risk appetite and tolerance.

Investors will want to look closely into the track record of these companies and their founders' backgrounds. They should not simply be impressed by business plans and strategies described in the IPO prospectus. Investors should understand how funds raised in the IPO will be spent. If the company has not been profitable in the last few years, how confident would investors feel about the prospects of a company becoming profitable after listing or shortly thereafter?

Spackman Entertainment

Spackman Entertainment listed on SGX in July 2014, promoting itself as one of Korea's leading theatrical film production groups with the prospect that Korean films will continue to dominate the domestic box office in Korea. Its success depends heavily on the commercial success of its films, which is unpredictable. Since FY2014, Spackman has only reported a net profit in FY2017. After reporting a profit in the first quarter of FY2018, it reported losses in the following two quarters, and issued a profit warning indicating that it expected a net loss for FY2018.

While Korean films and music are increasingly popular, potential investors need to evaluate the company and its business from an investment perspective. To draw another analogy: Just because an investor supports Manchester United, it does not mean that its shares are a good investment.

TT International

TT International went from a consumer electronics retailer to a developer (through a 51%-owned subsidiary) of Big Box - a warehouse, retail and concert mall. As of December 2017, TT has total debt in excess of S$400 million. The company has been undergoing a period of restructuring under a scheme of arrangement since April 2010. Big Box has been placed under receivership, and TT International's shares have been voluntarily suspended from trading since 4 August 2017.

5 IS THE COMPANY CONTINUING TO INCREASE ITS BORROWINGS OR OTHER CAPITAL-RAISING WITH A CHALLENGING PATH TO PROFITABILITY?

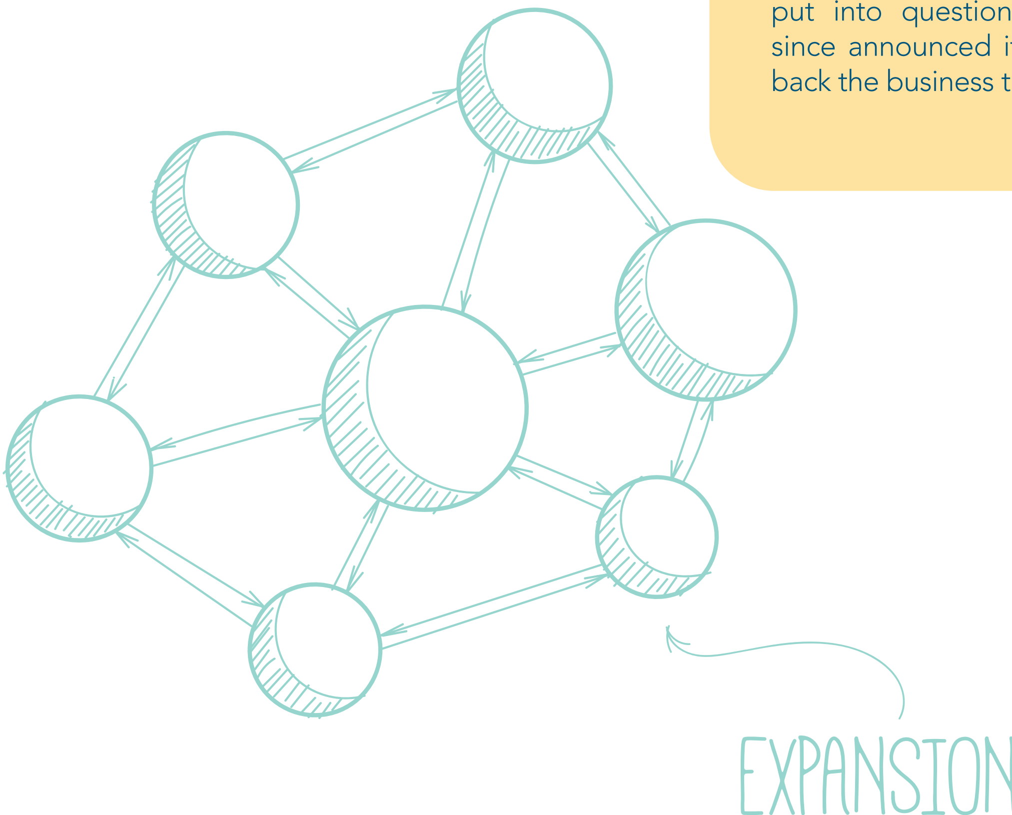
A question for the investor is, when will it need to raise further cash again and from whom. Banks may tighten credit, increase credit spreads for the additional risks, or impose additional conditions. All these will negatively impact share value as well as the company's profitability.

6 IS THE COMPANY MAKING A MAJOR ACQUISITION IN A NEW BUSINESS AREA UNRELATED TO ITS EXISTING CORE BUSINESS?

While this may appear an usual business expansion, investors will want to know the parties behind the acquisition. For example, are related parties or close business associates involved? What business synergies do the board and management see from the acquisition? What is the basis of valuation? What additional costs or capital will need to be infused into the newly acquired company? Does management possess the right expertise to manage such a non-core business?

Datapulse Technology

Datapulse Technology, a company in the digital storage business, suddenly decided to diversify into the hair care business by making an acquisition without proper due diligence one day after a new board was formed. While the initial acquisition amount estimated at S$3.5 million was not large, the new business required a significant injection of working capital and new capital investment to replace ageing plant and equipment. As it turned out, the vendor of the new business had close business relationships with the new controlling shareholder. Within seven months of the acquisition, when it reported its financial year 2018 results, Datapulse had impaired S$1.1 million in goodwill from the acquisition, a clear indication that it had overpaid. The profitability and sustainability of the new business was put into question. The company has since announced it is proposing to sell back the business to the vendor at a loss.



EXPANSION

7 IS THE BUSINESS MODEL BASED ON OUTDATED TECHNOLOGY OR CONSUMER PREFERENCES?

The business may be profitable only because the company has not been investing in new technology to renew itself. Such a model is not likely to be sustainable, and is highly exposed to technological and digital disruption. The company may either be forced to incur significant costs in later years to upgrade itself or be forced out of business. Many investors tend to focus on cost control in a company. However, in this age of fast technological advancement, investors should also question the company on their investment in new technology to mitigate risks of disruption. One industry which has been disrupted by technology is the retail industry, but it is by no means the only one.

FJ Benjamin

After four consecutive years of losses and fall in turnover, FJ Benjamin reported a modest S$939,000 profit before tax for FY2018, against a loss of S$16 million in FY2017. This turnaround was achieved by reduction in operating cost, improved consumer sentiment, store growth, and full year contribution from new stores opened in FY2017. There is a limit to how much a company can keep reducing its operating costs, and in FJ Benjamin's case, opening new stores will add to operating costs, and cost management will increasingly be more challenging. Some important questions are: Can FJ Benjamin stay profitable though the traditional way of managing cost and opening new stores? Are its brands and store concepts in tune with current and emerging consumer preferences?

The retail industry is one which has been significantly disrupted by technological changes, especially online shopping, and changes in consumer preferences. Online shopping is an area the Company has yet to embark on. Depending largely on its current brick-and-mortar stores may not be sustainable given increasing costs and limited market reach compared to online stores, and changing consumer preferences.

Recognising the need to embrace technology, the company announced the setting up of an Omnichannel Advisory Board in March 2018 to guide them in giving their customers a truly immersive and seamless experience that integrates their physical stores and online channels. While FJ Benjamin has not been tainted by accounting or corporate governance lapses, the route to profitability is likely to remain challenging.

8 IS THE COMPANY'S BUSINESS HEAVILY RELIANT ON ONE OR A FEW MAJOR CUSTOMERS?

Such a business model presents a critical concentration risk as the loss of one major customer may have a significant adverse impact on the company's profitability and survival.

Serial Systems

On 2 October 2018, Serial Systems announced that Texas Instruments (TI) has terminated its distribution agreement with the company. TI distribution business accounted for 47% and 54% respectively of total group revenues for FY2017 and the first six months of FY2018. Its share price fell by 25% the following day. The company did not disclose the reason for the loss of the distribution agreement.

YuuZoo Corporation

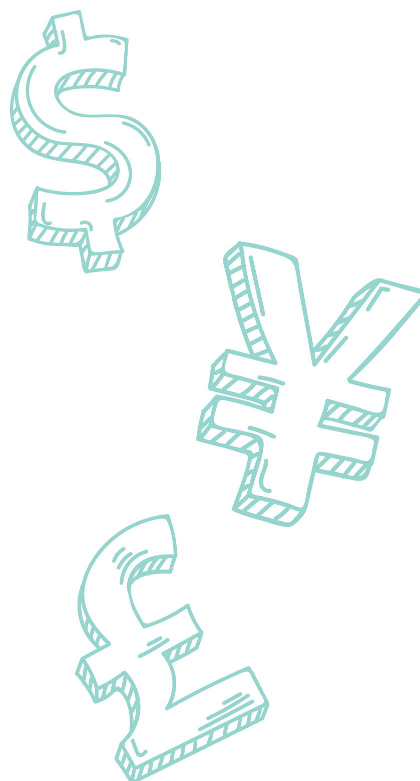
At YuuZoo, a significant portion of the company assets (and revenues) were from unlisted shares issued by its franchisees and other non-cash sources. The commercial substance of the franchisees and the value of the shares issued or other revenues were questionable. The company claimed to use independent valuers without disclosing who they were; or disclosed what it claimed to be a reputable valuer whose credibility or even existence is doubtful; or disclosed reputable valuers but the assumptions used are unknown.

9 IS A SIGNIFICANT PROPORTION OF THE COMPANY'S TOTAL ASSETS IN THE FORM OF INTANGIBLE OR OTHER DIFFICULT-TO-VALUE ASSETS?

The value of intangibles may not be easily determined even with the use of professional valuers. Companies could say that they use independent valuers but the identity or credibility of these valuers may be in doubt. Investors should be cautious where no independent valuers are used, or where the valuer's name or how the valuation is done, is not disclosed.

10 IS THE COMPANY'S BUSINESS AND OPERATIONS PRIMARILY IN FOREIGN COUNTRIES WELL KNOWN FOR FRAUD, MONEY LAUNDERING AND OTHER ABUSES?

In such operating environments, the risk is high and board members, especially the Audit/Risk Committee, may need to ensure a greater level of risk and control assurance. However, this will translate into higher governance costs and may receive push-back from management. Is the board receiving assurance mainly from management or an independent party such as internal audit? If it is primarily from the former, this is an additional red flag. Hence, it is important for investors to ask the board about the form of assurance that they are getting in order to satisfy themselves that the risk governance and control activities are adequate as well as effective. In recent times, there have been a number of irregularities discovered (too late) by the board of S-chip companies, with one the most recent cases including Midas Holdings.



CORPORATE GOVERNANCE AND DISCLOSURE

There has been extensive research that has looked at indicators of poor corporate governance. Various corporate governance ratings also identify certain indicators.

RESEARCH ON PREDICTORS OF CORPORATE FRAUD AND MISCONDUCT

Academic studies have examined corporate governance indicators that are predictors of fraud, misconduct or non-compliance. A study of Chinese companies found that those subjected to enforcement actions by the securities regulator were more likely to have lower proportions of outside directors and chairmen with shorter tenure[iv]. According to another study, US companies with lower proportions of independent directors on the board, audit and compensation committees have been found to be more likely to be involved in corporate fraud.[v] Another US study found that less frequent board and Audit Committee (AC) meetings are associated with increased probability of earnings management.[vi]

Several other board-related indicators have been found to be correlated with regulatory actions, including management-dominated boards, a founder serving as the Chief Executive Officer (CEO) and a CEO who is also the Chairman.

Firms facing regulatory action were also less likely to have an AC and were more likely to have shares that were widely held.[vii]

Fraud incidence was also found to be associated with non-board-related indicators, including unexplained changes in financial statements,[vii] high proportion of short-term incentives in executive remuneration[ix] and lack of dividends.[x]

Studies also found a correlation between company failure and indicators of poor corporate governance. Discrepancies between a company's unaudited and audited financial figures were also found to forewarn growing concern uncertainties.[xi] Companies were also more likely to fail when they combine the roles of CEO and Chairman, or have a lower Independent Director (INED) ratio.[xii]

Compliance with mandatory disclosure requirements also improves with a higher INED ratio, with Chinese companies having at least 30 percent of INEDs linked to reduced instances of disclosure lapses.[xiii] The external governance environment, such as the legal framework and quality of law enforcement, was also found to be negatively correlated with disclosure lapses. Firms that make fewer voluntary disclosures may also be inclined to engage in earnings management.[xiv]

Finally, Chinese companies listing in the United States through reverse takeover (RTO) were found to have a lower quality of financial reporting and higher incidence of fraud. However, lower financial reporting quality was observed to only correlate with such companies from China, where there are weaker legal enforcement and investor protection. The rule of jurisdiction law in which a company is based is also a key determinant.[xv]

INDICATORS OF POOR CORPORATE GOVERNANCE IN SCORECARDS AND INDICES

A number of corporate governance scorecards and indices that have been developed include penalty items to capture indicators of poor corporate governance. These include the Singapore Governance Transparency Index (SGTI), Governance Evaluation for Mid and Small Caps (GEMS), ASEAN Corporate Governance Scorecard (ACGS) and ISS Governance QualityScore.

Examples of penalty items include very small or very large boards, lack of independent directors, high number of directorships held by independent directors, long tenure of independent directors, external auditor issuing a modified opinion, and restatements of financial statements.

OTHER INDICATORS

From other sources such as case studies, other indicators such as change of continuing sponsor for Catalist companies and management attending all committee meetings, have been identified as additional possible warning signs.

The following two pages show 52 corporate governance and reporting warning signs and red flags identified from prior research, corporate governance scorecards and case studies.

We next identify a sample of troubled companies and control companies, and compare corporate governance warning signs and red flags for these two groups.

INDICATORS OF POOR CORPORATE GOVERNANCE FROM PRIOR RESEARCH, SCORECARDS AND OTHER SOURCES

BOARD AND MANAGEMENT

- Board size is smaller than 6 or larger than 11
- Chairman is currently the CEO, or was a recent CEO
- CEO is also the founder of the company
- 50% or more executive directors (EDs) on the board
- Board is less than one-third independent
- Long tenure of independent directors (more than 9 years)
- Lack of board gender diversity
- Independent directors concurrently holding multiple directorships
- Executive directors concurrently holding more multiple external directorships
- Board committees do not consist of all non-executive and/or independent directors
- Low frequency of board meetings
- Chairperson of any board committee is not an independent director
- Same independent directors sitting on the nominating, remuneration and audit committees
- Lead Independent Director (LID), if any, is not on the nominating committee or the LID failed to meet other independent directors separately
- Number of meetings of the board and board committees held is not disclosed
- Low frequency of audit committee meetings
- Attendance of every board member at board meetings is not disclosed
- Poor director attendance at board and committee meetings
- Management attends all committee meetings
- CEO/Managing Director/Executive Director not subject to re-election
- Frequent turnover of senior management (Executive Directors & CFO)
- Directors or senior management resigning and raising corporate governance-related concerns
- Other directors resigning without adequate disclosure of reasons
- Appointments or resignations of independent directors who are closely linked to controlling shareholders
- Disqualified director joins board within 5 years of the end of disqualification
- Director(s) and/or key officers of the company have been sanctioned (e.g. reprimanded or convicted) during the past 5 years
- Non-disclosure of director information (academic and professional qualifications, date of first appointment as a director or date of last re-election as a director, etc)

OWNERSHIP

- Largest shareholder has control exceeding beneficial ownership, e.g. through the use of a pyramid structure or cross-shareholdings
- Low insider ownership (holdings by officers and directors)
- Low board ownership

REGULATORY ACTIONS

- The company faced regulatory actions by SGX and/or other authorities or breached listing rules in the 3 years (including special audits, independent reviews and notices of compliance)
- Legal violations pertaining to labour/ employment/ consumer/ insolvency/ commercial/ competition or environmental issues
- Company has been asked by SGX to suspend trading activity, or only suspended trading after repeated queries by SGX

AUDIT

- External auditor is not a registered public accountant based in Singapore
- External auditor issues a modified opinion
- Non-audit fees exceed the audit fees
- Directors or senior managers have an employment relationship with the current external auditor in the past two years
- The company has changed its auditor and has not given appropriate reasons for the change

REMUNERATION

- High percentage of short-term incentives in remuneration of EDs
- Company discloses remuneration of any of its key management personnel with an unlimited top band
- Share options were issued to independent directors

DISCLOSURE AND REPORTING

- Unexplained changes in financial statements
- Discrepancies between unaudited and audited results
- Restatements of financial statements
- Annual results are not released within 60 days after the fiscal year-end or interim results are not released within 45 days of end of interim period, or the company has a late AGM
- Issuance of a profit warning within 30 days after the IPO or after a results announcement
- Poor disclosure quality evidenced by few voluntary disclosures

OTHERS

- Company has main operations in a country with weak rule of law
- The company does not pay dividends
- Significant interested party transactions involving major shareholders, directors or senior management or evidence of serious conflicts of interest
- Company listed via a Reverse Takeover
- Change of sponsor (Catalist)

IDENTIFYING TROUBLED COMPANIES

First identified was a sample of 33 companies listed on the SGX which had serious accounting or corporate governance lapses causing significant financial and reputational damage to the company and losses to shareholders over the past five years. We excluded companies that were involved in bribery scandals as their red flags and warning signs are likely different. We also excluded companies that have been in the news for questionable corporate governance issues, but were not accompanied by outcomes that resulted in a significant fall in shareholder value.

We call the sample of 33 companies with serious accounting or corporate governance lapses, "troubled companies". Companies in this group would have suffered one or more of the following outcomes following the lapses: investigation by authorities, reprimand, entry or potential entry into SGX watchlist based on financial criteria, judicial management, long-term suspension of shares, mandatory delisting, or significant loss of shareholder value. Appendix 1 shows the list of 33 troubled companies included in our study.

For each company in the "troubled companies" group, another company without significant lapses and which is as closely matched as possible to the company in the "troubled companies" group based on industry sector and market capitalisation, was selected. These latter companies form the "control companies". Companies with clear doubts about their compliance or corporate governance were dropped from the "control companies" and another company was selected. Through this process, 27 companies were selected for the "control companies".

We limited our study to the past five years since SGXNet only provides information for five years.

COMPARING CORPORATE GOVERNANCE AND DISCLOSURE WARNING SIGNS AND RED FLAGS

We analysed 37 corporate governance and reporting warning signs and red flags for SGX-listed companies that had major accounting and corporate governance lapses between 2013 and 2018. The warning signs and red flags are based on the 52 discussed in the previous section. We used those that were most common across the different sources and for which data were available.

We then identified those indicators that most clearly differentiate the troubled companies and the control companies. We also analysed the timing of these warning signs and red flags.

The indicators that most clearly differentiated the two groups were classified as red flags, while those that were more prevalent for the troubled companies but did not exhibit the same difference from the control companies are classified as warning signs.

Red flags tended to appear much later when, unfortunately, considerable shareholder value has already been destroyed.

Therefore, while red flags more clearly differentiated the two groups, they tend to be less useful for shareholders in avoiding losses.

We also analysed the China listings, or S-chips, further to determine if the warning signs and red flags are different.

THE TOP WARNING SIGNS AND RED FLAGS

Based on our analysis, the warning signs that were most prevalent for the troubled companies are:

- unexplained changes in results attracting an SGX query;
- foreign incorporation;
- change of sponsor (for Catalist companies); and
- independent directors participating in performance incentive plans (such as share option plans).

The above warning signs were at least twice as likely to appear for the troubled companies as compared to the "control companies".

Other warning signs that were more prevalent for the troubled companies, but less so than the above four warning signs, are:

- having a founder who is also the executive chairman/CEO;
- non-payment of dividends;
- disclosure/trading query from SGX;
- profit warning;
- foreign auditor(s) for the listed entity or key subsidiaries;
- operations in countries with weak rule of law;
- low management ownership

Several warning signs identified from the literature were not markedly different for the troubled companies compared to the "control companies". These include having a combined chairman and CEO, lack of diversity and busy independent directors. This may be because these practices are so common among companies listed here that they are equally likely to be present in both groups of companies. We caution that this does not mean that they do not adversely affect the corporate governance of companies, however, they are not as useful as warning signs.

Finally, we found that some commonly cited warning signs were actually less common for the troubled companies, for example, independent directors. However, in the case of long-tenure independent directors, this may be because troubled companies are often recent listings (and therefore independent directors have been more recently appointed). For the troubled companies, the median period between listing and the serious lapses emerging was 9 years, with a mean of just over 10 years.

These companies have been listed from between 1 and 23 years before the serious lapses occurred. For "control companies", the median period of listing until the time of the study was just over 14 years, with a mean of nearly 17 years. They have been listed from between 5 and 38 years.

Another explanation is that independent directors of troubled companies tend to resign after serving for relatively short periods, making their tenure shorter (see later discussion of unexpected resignation of directors under red flags).

In terms of red flags, **the engagement of an independent third party to undertake a special audit or independent review**, usually at the direction of the SGX, has the highest discriminatory power. None of the "control companies" had a special audit or independent review, while nearly half of the troubled companies did. Other key red flags that clearly differentiated the troubled companies include **AGM delays, modified auditor's opinion, sudden resignation of the audit committee chairman, and sudden resignation of other independent directors**. These were at least five times more likely to happen for a troubled company than a control company. **Discrepancies between unaudited and audited results** was also a common red flag.

Significant or frequent restatements were uncommon for companies generally, but where they do occur, they are an important red flag as they occurred in nearly 10% of the troubled companies but did not occur for any control companies.

Perhaps surprisingly, changes in external auditor, which were generally rare, occurred with about the same frequency for the two groups, so was not necessarily a red flag.

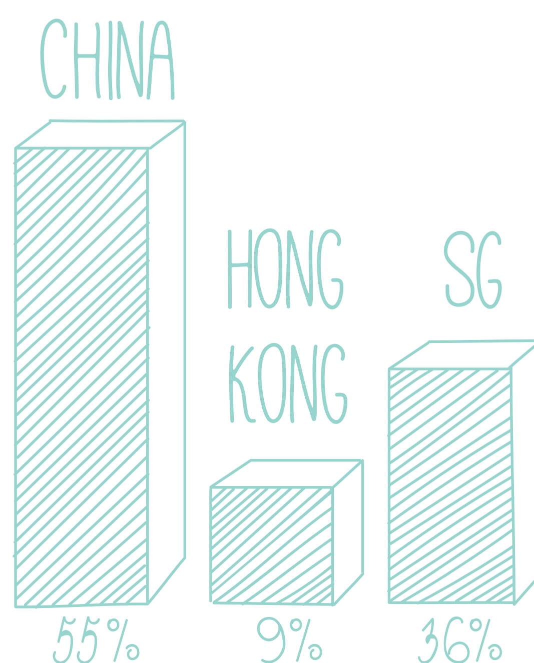
> **"For the troubled companies, the median period between listing and the serious lapses emerging was 9 years, with a mean of just over 10 years."**

S-CHIPS VERSUS OTHER COMPANIES

For our troubled companies, 55% have their principal place of business in China, 9% in Hong Kong and 36% in Singapore. The dominance of S-chips in our sample is reflected in "foreign incorporation", "foreign auditors" and "key subsidiaries operating in countries with weak rule of law" appearing as important warning signs in our earlier analysis.

We next compared the warning signs and red flags for troubled S-chips and troubled non-S-chips (excluding foreign operations, foreign auditors and subsidiaries operating in risky jurisdictions which would apply to all, or mostly to, S-chips). The top four warning signs that were more prevalent for S-chips were significant unexplained changes in financial results attracting an SGX query, management attending all board committee meetings; profit warnings and non-payment of dividends. Significant unexplained changes in financial results attracting an SGX query was six times more likely to occur for a troubled S-chip than for troubled non-S-chips. Perhaps this indicates that SGX is more vigilant in scrutinising S-chips.

Interestingly, many warning signs were less likely to be found for troubled S-chips compared to troubled non-S-chips. In particular, long-tenure independent directors, management-dominated boards, independent directors participating in performance incentive plans, change of Catalist sponsor and poor remuneration disclosures were less common warning signs in troubled S-chips compared to troubled non-S-chips.



The fact that long-tenure independent directors are less of a warning sign for troubled S-chips may be a function of such companies getting into trouble more quickly after their listing or independent directors in such companies choosing to retire or resign after serving relatively short periods. S-chips generally do not extensively use share-based incentive plans and this may account for the less prevalent participation in such schemes by independent directors. S-chips also tend to be relatively conservative in remuneration payments to management (at least in terms of amounts that are publicly disclosed) and may therefore have little reason not to disclose actual remuneration amounts paid to management.

In terms of red flags, the main difference between troubled S-chips and troubled non-S-chips are AGM delays, modified auditor's opinion and sudden resignation of independent directors.

Appendix 2 discusses the issues of the legal representative and company chop, two features of Chinese companies that create additional and unique corporate governance risks for these companies that investors should be aware of.

“ The top four warning signs that were more prevalent for S-chips were significant unexplained changes in financial results attracting an SGX query, management attending all board committee meetings; profit warnings and non-payment of dividends. ”

EVENTS AND TRANSACTIONS

The fourth area that investors should focus on are certain events and transactions that appear unusual or out of the ordinary. Here, we discuss some of the more common ones.

AD HOC DIVERSIFICATION

There is considerable research which shows that diversification, especially into unrelated businesses, hurt shareholder value. In general, highly-diversified conglomerates tend to trade at a discount. The reason is that investors do not need companies to diversify for them because they can invest in a diversified portfolio of stocks themselves. **Diversification is often undertaken to reduce volatility of earnings and business risk of the company, but is more beneficial to management of the company rather than to investors who are more concerned about overall risk and performance of their portfolio.** Diversification within the same industry into different geographical markets or diversification into related businesses is generally better accepted by investors than diversification into unrelated businesses.

Directors and management who want to keep their jobs may want to diversify into unrelated businesses when their existing businesses have been heavily disrupted or are in sunset industries. However, they may not have the expertise to succeed in the new businesses, which may already have many existing players with significant expertise. The learning curve may be a steep one. This is not to say that companies should not be open to new business opportunities but investors should consider whether the company has the management capabilities and the resources to succeed – or are able to acquire such capabilities and resources.

There are some safeguards under the SGX rules as diversification through acquisitions require shareholder approval if they exceed certain thresholds, especially if they change the risk profile and are not considered to be in the ordinary course of business. However, there are ways that companies can work around the rules.

For example, they may diversify "organically", that is, build new business internally without buying other companies. Or they can make acquisitions that involve relatively small upfront consideration, which are then followed by significant investments for additional capital expenditure and working capital. We have also seen companies announce large investments in apparently new businesses without seeking shareholder approval – by arguing that the new business includes some activities that are already undertaken by the company. For example, there is a food and beverage company which made a significant investment into property overseas without shareholder approval by arguing that the property includes an F&B outlet operated by the company.

Some companies either cannot decide what business they want to diversify into or venture into areas that defy belief. One such company started as a construction company in China, and tried diversifying into mining in South Africa, then micro power plants in South Korea, followed by ski resorts in Japan, and most recently an operating gas field in Russia, among others. Another company in the electronics industry decided to buy a durian farm. Other examples include diversifying from the structural steel business to waste management; construction and property investment to education; precision engineering to ticketing, e-commerce and digital payment; precision moulding to water treatment; F&B to investment, fund management and advisory; restaurants and property to financial leasing services; F&B to fintech, fund management and travel; contract clothing manufacturing to strategic planning, corporate advisory, financial restructuring advisory and management consulting services; medical to nickel mining to oil trading to investment to dental clinics.

MMP Resources

On 11 June 2008, Sino Construction Limited, announced its IPO and listing on the SGX Mainboard, and its share price closed the following day at S$0.382. It later changed its name to MMP Resources Limited (MMP). Although it is a small cap company, it has big and constantly changing diversification plans that should raise doubts in investors' minds as to whether it has the financial resources and know-how to execute.

MMP started out as a construction firm in Daqing, China in 1998, engaging primarily in the construction, civil engineering, project consultancy and management services businesses. In 2014, it acquired various companies to enter into the Malaysian construction market, the oil and gas industry and the titanium and heavy mineral resources industry. In early 2015, it embarked on a restructuring strategic plan to focus on micro power plants, with the aim of becoming a significant player in the global energy market, and in April that year, announced that its subsidiary had completed the construction of its first micro power plant in South Korea. This was reportedly part of the company's multi-year programme to roll out a number of micro power plants.

In December 2015, MMP released further restructuring initiatives for FY2016, which indicated a shift to renewable fuels, fuel technology, renewable energy generation, commercial and retail construction, as well as building materials. In April 2016, MMP stated that the current tariff rates and high capital investment required to continue pursuing renewable power generation opportunities in South Korea would place excessive financial strain on MMP.

The company then announced its intentions to acquire a Japanese ski tour operator and a ski lodge in Hokkaido, Japan. This was said to be part of the company's strategic direction to focus on construction opportunities, asset acquisitions and brand growth in Tier-1 markets, particularly in the tourism, hospitality and leisure (THL) industry. In July 2016, MMP signed a memorandum of understanding to acquire the entire issued share capital of a Hokkaido ski operator and ski lodge owner, for 80 million yen. Further, in September 2016, it announced the formation of a wholly-owned subsidiary incorporated in Japan to carry out its strategy of focusing on construction opportunities, asset acquisition and the THL industry. It later said that the company decided to rent some of the Hokkaido ski operator's premises instead of acquiring the entire issued share capital. The lease agreement was said to allow for the redevelopment of buildings to "house high value global brand tenants which operate within the lifestyle and aspirational retail space".

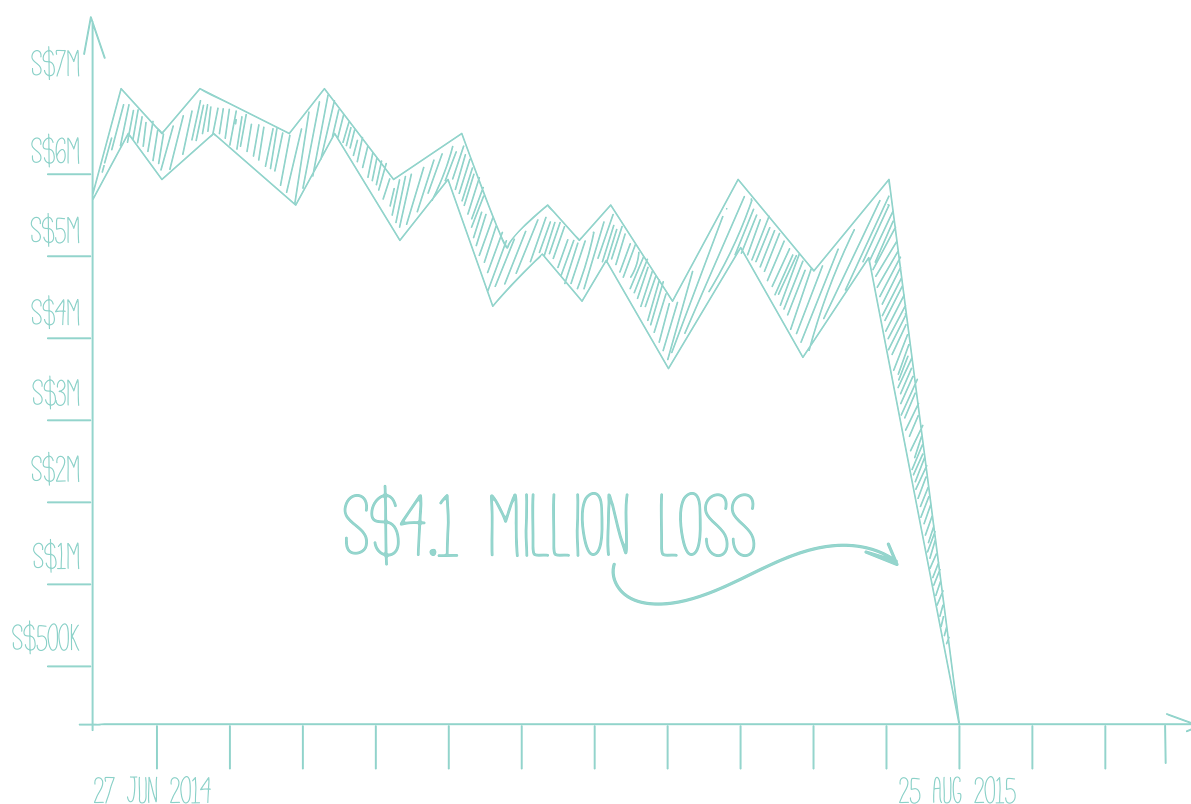
In November 2016, MMP announced that its Japanese subsidiary had entered into a binding term sheet to purchase a three storey property for redevelopment. The property was located in an area near a number of ski resorts. Later that same month, it announced that its Japanese subsidiary had entered into another agreement with the ski operator on the operations and management of one of the ski field areas. In December 2018, it signed a binding term sheet to acquire a 50% interest in an operating gas field in the Russian Federation.

MMP changed its auditors from Ernst & Young LLP in FY2013 to Moore Stephens LLP and then to Nexia TS PAC for FY2017. However, it received disclaimers of opinion from all three auditors for every financial year between FY2012 and FY2017. In November 2015, MMP applied to transfer its listing from the Mainboard to Catalist. This was rejected by SGX in January 2016. By 25 February 2019, MMP's share price had fallen to just S$0.005.

ICP Ltd

On 27 June 2014, ICP Ltd, a Catalist-listed company in the hotel management and franchising, hotel funds management, and shipping investment and chartering business, announced that it was purchasing a 19.9% stake in Tiaro Coal, an Australian coal exploration company listed on the Australian Securities Exchange. The shares were priced at A$0.135 each, with the total consideration amounting to A$3.051 million. On 1 April 2015, ICP announced that Tiaro had been placed in voluntary liquidation, purportedly following disputes with Tiaro's former controlling shareholder which resulted in major shareholders of Tiaro refusing to provide additional funding and financial support to Tiaro. On 25 August 2015, ICP announced an impairment loss of S$4.1 million on its investment in Tiaro.

Investors should ask what due diligence was done and why the company would invest in a coal exploration company, only for it to be fully impaired just over a year later.



RAPID-FIRE ACQUISITIONS AND DISPOSALS/WRITEOFFS

Investors should be alert to companies that make rapid-fire acquisitions and then dispose of the acquired businesses or take large impairment losses soon after – and keep repeating the same trick.

This raises questions about due diligence when making acquisitions. There is also the possibility that the businesses acquired are from undisclosed related parties and these transactions are means of transferring resources from the company to related parties.

YuuZoo Corporation

Over the years, YuuZoo embarked on a series of acquisitions purportedly aimed at cementing its position in e-commerce and social networking and also diversifying into related industries. It first eyed Infocomm Asia Holdings (IAH). With its rights to distribute popular games across South East Asia – such as Grand Theft Auto V and NBA 2K14 – along with its reportedly large base of over 35 million users in the region, IAH looked to be a promising member of YuuZoo's extended family. Its adoption into YuuZoo's family would also allow YuuZoo to expand the use of its YuuCollect payment platform. YuuZoo announced that it fully acquired IAH on 16 February 2015, with an effective consideration of S$18 million. IAH chalked up significant debts. It also owed its new parent almost S$6.5 million, which led to legal action in July 2015. While the lawsuit was settled in December 2015, YuuZoo decided that it no longer wanted to fully acquire IAH, announcing that it was only acquiring 30% of IAH, with an effective consideration of S$2.895 million. YuuZoo then recognised impairment losses of nearly S$7.5 million on IAH just a year later, both on its investment in IAH, as well as the amount IAH owed it.

Following that, YuuZoo decided to turn its attention to movie studios, apparently eyeing synergies between e-commerce and entertainment products. On 19 October 2015, it paid more than S$4.5 million for a five percent stake in RS Media & Entertainment Group (RS Media) – which produced movies with both Chinese and Western themes. This, however, had a sudden and mysterious ending, with YuuZoo impairing the full amount of its investment.

It then signed an agreement to acquire a 33.3% stake in Relativity Media in October 2016, for an amount between US$50 million and US$150 million. However, the investment amount was later reduced to S$15 million in November 2016. In February 2017, YuuZoo aborted its planned investment in Relativity Media after earlier disclosing that it had closed the deal, blaming the failed acquisition on unmet conditions. It had already paid US$2.5 million to Relativity Media's receiving party. Nothing further was heard about this amount.

SPLITTING TRANSACTIONS

A large transaction may be structured or carried out through a series of smaller transactions. In some cases, this may be an attempt to circumvent the rules requiring transactions beyond prescribed thresholds to be disclosed or approved by shareholders.

For example, as the chapter 9 rules on IPTs set a de minimis amount of S$100,000 per transaction – whereby transactions of less than S$100,000 do not have to be disclosed – companies may split a transaction into a number of smaller transactions. They may also split an acquisition into multiple transactions to avoid shareholder approval under chapter 10. Alternatively, splitting a transaction may be done to reduce shareholder scrutiny or avoid a drastic impact on the share price from a single large transaction.

While SGX may require transactions to be aggregated under the rules, certain transactions may be undertaken before an attempt to split a transaction becomes evident. "Aggregation" may not be able to reverse earlier transactions if they have already been concluded or binding agreements signed.

YuuZoo Corporation

In YuuZoo's FY2016 annual report, it was disclosed that there were no transactions with interested persons during 2016. The company's quarterly and full year results announcements also said that there were no interested person transactions entered into during the relevant reporting period. However, the notes to the FY2016 annual report indicated that the company had entered into significant related party transactions during 2016 with related parties who are connected to a director of the company. SGX queried the company.

YuuZoo responded that it had a service agreement with Sandbox Global Co Ltd, a company in which Mobile FutureWorks Inc, a company which is the controlling shareholder of YuuZoo and in which its then executive chairman, Thomas Zilliacus, has a controlling interest. The agreement between Sandbox and YuuZoo had been in place since before YuuZoo was listed. Under the service agreement, YuuZoo outsourced to Sandbox services and development work related to mobile games. YuuZoo paid Sandbox a fixed fee of US$15,000 per month. Further, YuuZoo placed its own Bangkok-based employees in the office of Sandbox, and pays for an agreed portion of the general office expenses.

YuuZoo said that it did not make separate quarterly announcements on each payment, as the payments for each quarter fell under the S$100,000 threshold.

In this case, each payment is a recurring payment for the same services with the same related party and the annual amount exceeded the de minimis amount of S$100,000. It should have been disclosed as a single annual amount.

AGGRESSIVE VALUATIONS

Aggressive valuations can take various forms. For example, companies may try to give the impression that their shares are worth more than their current market price by inflating the issue price of their shares when they are used in a share exchange transaction or an acquisition.

For example, they may say that the shares are issued at S$1 when the market price is just S$0.25 – the reality is that the other party will base the transaction on the market price rather than the notional issue price. Investors may be misled into thinking that a higher issue price means that the company has to issue fewer shares in a share exchange transaction or acquisition – and therefore the company got a "bargain". Companies like YuuZoo and Spackman Entertainment have been involved in transactions where the issue price of the company shares is above the current market price, sometimes by a considerable margin. Placing a higher notional value on the shares may also be designed to give investors the impression that an external party believes that the shares are worth more than the current market price.

Noble Group was accused by Iceberg Research of using aggressive mark-to-market valuations for long-term commodity derivative contracts and for a huge gap between the market value and carrying value of Yancoal, in which Noble held a 13 per cent stake. Noble treated Yancoal as an associate despite the relatively small stake, by claiming that it exercised "significant influence" over Yancoal. Noble then used the accounting policy for associates and carried Yancoal on its balance sheet at a value that was US$603 million higher than Yancoal's market value.

Companies may also cite reports by analysts or valuers to suggest that their shares are undervalued, when the analysts' or valuers' reports themselves may be questionable.

Spackman Entertainment

On 22 May 2018, Spackman Entertainment Group Limited (SEGL) announced that it had entered into a share sale and purchase agreement (SPA) with certain existing shareholders of the company's associated company, Spackman Media Group Limited (SMGL). SMGL is incorporated in Hong Kong. Under the SPA, SEGL will purchase 2.3 million ordinary shares of SMGL representing 7.52% equity interest of SMGL at US$3 per SMGL share for a purchase consideration of US$6.9 million. The purchase consideration was to be satisfied through the issue of 101,607,865 newly issued ordinary shares of SEGL at an issue price of S$0.09 per share, which is a premium of 26.8% over the volume weighted average price of S$0.071 for SEGL shares.

After the transaction, SEGL's shareholding in SMGL increased from 33.76% to 41.28%. SEGL said that the vendors are all unrelated third parties of SEGL, the directors and the substantial shareholders of SEGL.

This followed three earlier SPAs announced on 2 March , 11 October and 22 December 2017 for similar exchanges of shares. These SPAs were said to be with "unrelated third parties" who were generally not disclosed.

SEGL acquired its initial stake in SMGL through a share swap with SMGL announced on 30 December 2015 and completed in 2016. Under the share swap agreement, SEGL transferred its 45.8% stake in Singapore-incorporated Spackman Media Group Private Limited to SMGL, in exchange for 7.5 million shares in SMGL amounting to 24.53%. Based on the initial paid-up capital and the number of shares, the average price per share was about S$0.48.

The acquisition of the additional stakes in SMGL in March, October, December 2017 and May 2018 valued SMGL's shares at US$3 each – or more than 8 times the amount paid for the initial stake. Based on the FY2017 audited financial statements for SMGL, it has a profit before tax of US$269,560, net tangible assets of US$7.9m and net asset value of US$12.7m.

On 6 August 2018, SEGL announced yet another SPA with "certain existing shareholders" of SMGL to increase its stake in SMGL from 41.28% to 43.88%, again at an average price of US$3 per SMGL share, to be satisfied through the issue of new SEGL shares valued at a total of US$4 million. It said that if regulatory approval was not received for the listing and quotation of the new shares, SEGL would be required to satisfy the purchase of the SMGL shares through the payment of US$1.75 million in cash instead. After some queries, SGX duly approved the listing and quotation of the new shares on 3 September 2018.

On several occasions, SEGL cited a report by an unnamed analyst who it claimed had estimated SMGL's value per share to be between US$4.70 to US$8.00. An online search found an analyst putting a bullish valuation on SMGL in 2017. This same analyst had set a target price for SEGL of S$0.32 in 2017, then lowered it to S$0.27, then S$0.23, then S$0.20 and finally S$0.10 last month, but consistently maintained a "buy" recommendation for SEGL. Investors should treat such analysts and their valuation estimates with a great deal of scepticism as they are not accountable for their estimates and recommendations.

Just before the announcement of the first SPA in March 2017, SEGL shares closed at S$0.174. By 25 February 2019, it had closed at S$0.024.

Shareholders should ask themselves this question: given the profitability, NTA and NAV of SMGL and the implied price to historical earnings and price to book ratios, does the average price per share of SMGL of US$3 make sense?

Addvalue Technologies

On 17 October 2018, Addvalue Technologies announced that it had received queries from two shareholders through its website asking about the value of its intellectual property (IP) and urging the company to make the value public so that the market will have a better idea of what the company is worth. Addvalue has a market capitalisation of S$48 million. The company said that it engaged Everedge Global (NZ) Limited, "an intangible asset specialist recognised by the Intellectual Property Office of Singapore (IPOS)". It said that after taking into account the IPs of the group, and excluding the company's human capital, Everedge valued the business of the group at S$123 million as at 31 May 2017 – or nearly three times the company's current market capitalisation. Addvalue's share price had been steadily declining and closed at S$0.027 as at 17 October 2018. Following the announcement, the company's share price increased as much as 7.8% the following day. Some questions that investors should consider include: Were the shareholders who urged the company to disclose the value of its IPs related to management or major shareholders? Why did the company engage a NZ valuation firm? They should also note that the company did not disclose the valuation report.

A few years earlier on 25 March 2014, Addvalue had announced that it had entered into a conditional sale and purchase agreement with an unrelated third party buyer from PRC for the entire ordinary share capital of its subsidiary, Addvalue Communications Pte Ltd, for a cash consideration of S$330 million. This would increase the NTA of the group from US$0.004 to US$0.203, an increase of 5,108%. Following the announcement, the company's share price increased from S$0.062 to S$0.155. More than four years later, the deal has not been consummated.

Over the years, the company has announced various deals with few specifics and no financial details, often followed by rights issues. On 20 February 2019, it announced "a watershed breakthrough into the exciting and fast growing aviation market" involving "a significant design contract" between its wholly-owned subsidiary and another "world leader" which has a joint venture with another well-known global company. As at 25 February 2019, its share price had fallen to just S$0.022.

The track record of an issuer is relevant when assessing the credibility of its announcements.

INTERESTED PERSON TRANSACTIONS

Interested person transactions (IPTs), also called related party transactions or connected transactions in other markets, are considered one of the key risks to minority investors especially in companies with dominant shareholders. While there may be commercial reasons for such transactions – and hence they are not prohibited – controlling shareholders, directors, management and their associates may use such transactions to divert company resources to themselves.

SGX has fairly extensive rules governing disclosure and approval of IPTs in chapter 9 of the rulebook. Nevertheless, investors should scrutinise and question these transactions, and where their approval is required and they are not convinced, they should vote against the transactions.

There are certain limitations in the listing rules, such as the benchmarks used to determine the materiality of transactions, transactions that are not covered (such as remuneration), and related parties that are not captured by the rules. A company may also pass off related parties as unrelated third parties and use confidentiality agreements to hide the identity of the related parties.

Investors should also be wary of companies that undertake unusual transactions (e.g. in terms of nature or valuations) with undisclosed third parties. There is no assurance that undisclosed third parties are necessarily unrelated parties. Companies may cite confidentiality agreements for not disclosing the identity of these third parties.

Datapulse Technology

At Datapulse Technology, a new board was constituted through the appointment of three new independent directors and a new CEO/executive director, following a change of controlling shareholder.

The day after the new board was formed, it entered into an agreement to buy a Malaysian company, Wayco Manufacturing, which is in a new business of haircare products. This was done without any due diligence and using "independent valuations" of properties provided by the vendor. The acquisition was completed just four days later.

Publicly available information shows close relationships involving the new controlling shareholder, Ng Siew Hong; the new CEO, Kee Swee Ann; and the vendor, Ang Kong Meng. Mr Kee used to be the general manager of Wayco and therefore worked for Mr Ang. He is also director and/or shareholder of two private companies audited by Ang & Co, which was founded by Mr Ang. Mr Ang is a controlling shareholder and non-executive chairman of a Cayman Islands-incorporated company called HKE Holdings which listed in Hong Kong in 2018. Mr Kee had initially been proposed as an independent director of HKE although he was subsequently replaced, possibly because of health reasons which he cited for his resignation as Datapulse's CEO not long after his appointment. Ms Ng and Mr Ang are joint shareholders of at least two private companies. It also emerged later that Ms Ng and Mr Ang had been together in discussions with the former controlling shareholder to buy his controlling stake.

Despite the relationships involving Mr Ang, Mr Kee and Ms Ng, the Wayco acquisition was not considered an IPT under chapter 9 of the SGX Rulebook. Therefore, the approval of independent shareholders was not sought.

CHAIN LISTING

Rule 210(6) of the SGX Mainboard Rulebook states: "A subsidiary or parent company of an existing listed issuer will not normally be considered suitable for listing if the assets and operations of the applicant are substantially the same as those of the existing issuer. In arriving at a decision, the Exchange will consider the applicant's business or commercial reasons for listing." Rule 406(7) of the Catalist Rulebook contains similar requirements.

A number of SGX-listed companies have recently spun off part of their businesses as separate listings or have proposed to do so. Examples include Lian Beng Group, Declout, Spackman Entertainment, Addvalue and MM2. There may be good business or commercial reasons for companies to spin off and separately list a part of its business. Spinning off businesses that have little synergies with the company's other businesses allows investors to only invest in the businesses they like. However, there are risks to minority shareholders if the assets and operations of the newly listed entity will be "substantially the same as those of the existing issuer" or if key assets are transferred to the newly listed entity, reducing the value and earnings potential of the existing listed company.

Investors should be particularly wary about companies that have already destroyed considerable shareholder value spinning off another entity to entice investors to put in even more money. If management has destroyed considerable value the first time, should investors believe that it would be different this time?

Ideally, a company which spins off an existing business should make an in specie distribution to existing shareholders so that their interests are not diluted. These shareholders can then decide which listed entities they want to remain invested in. However, this is rarely done by listed companies here.

CHANGE OF CONTROL WITHOUT A MANDATORY GENERAL OFFER

In the earlier part of the report, we discussed the risks when someone is able to control the company with a relatively small stake. Companies where there is a controlling shareholder who owns a "minority controlling stake", for example 20%, but controls the board and key management positions often pose greater risks to minority shareholders than where the controlling shareholder holds a majority stake. This is because for the former companies, the controlling shareholder exercises great control with relatively little alignment of interest. There is considerable research evidence which shows that the greater the "wedge" or difference between control and ownership, the greater the risk for minority shareholders.

Investors should be watchful when there is a change of control without a mandatory general offer, that is, a new shareholder buys less than 30% of the ordinary shares, gains control but manages to avoid making a general offer. In a number of cases, a new controlling shareholder bought 29.9%, just below the 30% that would have triggered a mandatory general offer. There may be other concert parties who did not sell their shares but who are working with the new controlling shareholder. Even though the takeover code states that a mandatory general offer can be triggered if the new controlling shareholder and concert parties together own at least 30% of the shares, there are often situations where no mandatory general offer is triggered.

The new controlling shareholder may be looking to use the control to take out cash or other resources, through IPTs, remuneration, acquisitions or other transactions. Where the controlling shareholder has paid a significant premium to gain control, it may not be because of optimism about the future prospects of the company, but the opportunity to extract cash and other resources from the company, at the expense of minority shareholders.

> " Investors should be watchful when there is a change of control without a mandatory general offer – that is, a new shareholder buys less than 30% of the ordinary shares, gains control but manages to avoid making a general offer. "

DEATH SPIRAL CONVERTIBLES

In his Regulator's Column on 25 August 2016, Mr Tan Boon Gin, the then chief regulatory officer of SGX and current CEO of SGX Regco, warned about the impact and risks of "death spiral convertibles". As he explains, "death spiral convertibles" are "convertible bonds where the conversion price is not fixed. A subscriber exercises such a convertible based on a formula where the conversion price "floats" or is pegged to the market price of the shares at the time of conversion. The conversion price is also always at a discount to, or lower than, the market price prevailing at the time of conversion. If the market price of the shares falls, the conversion price declines and the number of shares the subscriber gets at exercise will increase. Conversely, a rising market price for the shares will mean a higher conversion price and fewer shares for the subscriber at exercise."

He warns about the following risks of "death spiral convertibles": acute dilutive and share price impact, adverse impact on the company's ability to obtain other financing, possible restrictions and complex pre-emptive rights, high up-front fees and break fees, and other adverse effects on shareholders (such as priority claims on winding up or liquidation for securities that have not been converted).

A Business Times article on 10 June 2016 ("Singapore-based firm starts fund to buy 'death spiral' convertibles") mentioned a number of companies that have used such convertibles, including Annica Holdings, Attilan Group (the former Asiasons Capital), Cacola Furniture International, Elektromotive Group, ISR Capital, LionGold Corp, Magnus Energy Group, OLS Enterprise and YuuZoo Corp.

Where companies have issued such "death spiral convertibles", there is a very high risk that the share price will go into a free fall.

“Where companies have issued such "death spiral convertibles", there is a very high risk that the share price will go into a free fall.”

CONTINUED VIGILANCE NEEDED

Based on the warning signs and red flags that we found to be most useful in differentiating between troubled companies and other companies, we identified at least another 14 companies that appear to be clearly heading for trouble in the months ahead because they already have many of the warning signs and red flags discussed in the report. Investors need to continue to stay vigilant.

To summarise, for companies they invest in, investors should closely study the business model; watch out for warning signs and red flags in corporate governance, disclosure and reporting; and pay attention to unusual events and transactions.

APPENDIX I

List of Troubled Companies

1. Advance SCT Limited
2. Anwell Technologies Limited
3. Asia Fashion Holdings Limited
4. China Essence Group Limited
5. China Fibretech Limited
6. China Paper Holdings Limited
7. China Sports International Limited
8. China Taisan Technology Group Limited
9. Dapai International Holdings Co Limited
10. Datapulse Technology Limited
11. DMX Technologies Limited
12. Epicentre Holdings Limited
13. Emerging Towns & Cities Singapore Limited
14. Eratat Lifestyle Limited
15. Foreland Fibretech Holdings Limited
16. Fujian Zhenyun Plastics Industry Co Limited
17. Healthway Medical Corporation Limited
18. Jason Holdings Limited
19. KLW Holdings Limited
20. Midas Holdings Limited
21. MMP Resources Limited
    (formerly Sino Construction Limited)
22. New Silkroutes Group Limited
23. Noble Group Limited
24. Oriental Group Limited
25. Pacific Andes Resources Development Limited
26. SBI Offshore Limited
27. Singapore Post Limited
28. Sunvic Chemical Holdings Limited
29. Swiber Holdings Limited
30. Trek 2000 International Limited
31. Universal Resource & Services Limited
    (previously Sky China Petroleum Services)
32. Yamada Green Resources Limited
33. YuuZoo Corporation Limited

APPENDIX 2

Legal representative and company chops for Chinese companies [1]

S-Chips are subject to the People's Republic of China (PRC) Company Law, which requires the appointment of a Legal Representative (LR) by every business registered in China, whether domestic or foreign. The LR is appointed by the board of directors or the shareholders in accordance with the Articles of Association of a company. The appointment or change of the LR shall be subject to registration with a competent government authority.

The LR need not be an employee of a company and he or she may not actually be participating in a company's daily management and operation. This person is the designated principal of the company and is conferred with the legal right to represent – and enter into binding obligations on behalf of – the company. A company can only have one LR.[xvi]

All actions by the LR are binding on the company even if they were beyond the LR's authorised scope, so long as laws and the company's Articles of Association were not violated. Consequences that arise must be borne by the company.[xvii] A LR thus possesses broad powers and potentially unlimited personal liability.

In China, chops are used to legally authorise corporate documents, often substituting a signature. The LR chop is a carved stamp bearing the LR's own name[xviii] that is held by the LR.[xix] The LR may also use his chop to appoint or dismiss employees of the firm as well as issue documents to the authorities – powers typically reserved for the board.[xx]

Shareholders or the board of directors can resolve to discharge a LR from his or her responsibilities. However, the company chop is required to officiate the appointment of the new LR so that he or she can perform a full takeover of responsibilities. Should the company chop be in possession of the displaced LR and he or she refuses to return the chop, the company remains bound to all agreements entered by the former LR and corporate control is not truly regained in practice.[xxi]

[1] The material in this Appendix benefited significantly from comments provided by Ms Cindy Pan of Morgan, Lewis & Bockius in Shanghai.

Selection and appointment of the Legal Representative

Investors should be aware of the person designated as the company's LR. The removal process can be a very onerous undertaking if the LR is, for example, a Chairman who is a substantial/controlling shareholder of the company.

While PRC Company Law mandates the LR to be the Chairman, an executive director or a manager of the company,[xxii] the risk can be mitigated by greater power distribution. As the LR need not be a shareholder, nor are there residence or citizenship requirements, a nominal LR who holds the title of manager or director but is not really involved in management[xxiii] or a substantial shareholder is prudent. Although a Singaporean director as the LR would be the ideal, this is impractical in reality.

Termination agreement and veto power

The LR's signature is not always required for his/her removal if the LR is not concurrently serving as a member of decision-making body that can remove him/her.

However, if the LR is also a director or shareholder of the company and his/her signature is necessary for his/her removal as LR, the LR can be asked to sign an undated removal letter upon appointment.

Limiting Legal Representative's power via the Articles of Association

Acts of the LR are binding on the company only if they are not in violation of the company's Articles of Association. Hence, stipulating the scope of the LR's responsibilities and authority reduces the potential abuse of power. However, investors should note that such limitations in authority may be ineffective if the third party had reasonably and genuinely relied on the representations made by the LR.[xxiv]

According to the PRC contract law, a contract executed by and between the LR and a third party will generally be deemed valid, even if such LR does not have the authority to do so. If the company claims that such a contract should be invalid due to the defect of the LR's authority, the company shall bear the burden to prove that (i) the LR does not have the authority or has exceeded his or her authority, and (ii) the third party knew or should have known the defect of the LR's authority before or when signing the contract. For example, if the company has notified the scope of authority of its LR to the third party in written form, then the company will not be bound by the act that in excess of the authority conducted by its LR. In practice, it could be very difficult to prove whether the third party "knew or should have known" the defects of a LR's authority. Therefore, in most cases, the company will be held liable for acts of its LR. After assuming the responsibilities to the third party, the company has the right to claim compensation against the LR on the basis of tort liability.

Controls over the company chops

Various other chops exist besides the LR's chop, each serving a different purpose. The most powerful of all is the company chop as it can cover the functions of all the other chops except the customs chop and the invoice chop.[xxv] Segregation of duties should be in place to curtail the already broad powers of the LR. No other chops, particularly the company chop, should be assigned to the LR, notwithstanding his or her role as the Chairman, ED or manager.

As previously mentioned, the removal of a rogue LR alone is ineffective if possession of the company chop is not simultaneously regained. Repossessing the chop is a lengthy and arduous process as even if the company were to seek a court order, either the signature of the current (rogue) LR or the company chop must be presented to obtain approval. It is thus important to regain custody of the company chop prior to replacing the LR.[xxvi]

A strong system of internal controls must also be in place to prevent misuse. This includes keeping records of when the chop is used, who it is used by, and the purpose it is used for. Robust physical controls such as keeping the company chop in a locked safe on the company's premises at all times are imperative. The possibility of having supervisory or dual access controls may be explored as well. Under the latter, the company chop can be removed from its safe only with the approval of two authorised individuals. The authorisation to access and use the company chop cannot be delegated to other employees. If properly enforced, no employee will be able to single-handedly abscond with the company chop.

The best practice is to separate the "approval right" and "access and use right". The "approval right" is usually held by the LR or heads in relevant departments, and the "access and use right" is usually held by the custody department (such as legal department or finance department). When the company chop is going to be used, the chop requester first goes through the approval process, and then asks for the custody department to stamp with the approval email. The custody department checks the approval and keeps the record of the use of the chop. This way, the whole process of using the chop can be monitored and controlled.

If the former LR refuses to release the company chop, the company should timely apply for carving a new chop, notify main partners and report to police. Such a series of actions show a cautious and responsive attitude and can minimise potential liabilities of the company.

The company may also sue the former LR to return the company chop with the evidence supporting his removal.

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