

# GLAUCUS RESEARCH GROUP 格勞克斯研究

*"It is easier to fool people than to convince them that they have been fooled."*

- Mark Twain

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COMPANY: Ozner Water International Holding Limited | HK: 2014  
INDUSTRY: Water Purification

In honor of April Fools' Day, Ozner Water International (HK: 2014) (the "Company" or "Ozner") recently published its second clarification ("Clarification #2") to our [detailed investment opinion](#) (the "Report") of February 16, 2015.<sup>1</sup> In our opinion, both of Ozner's clarifications make a mockery of the listing rules. Take the following statements, presented verbatim from Ozner's clarifications:

"the statement in the prospectus referring to the independent third party status of Shanghai Haoyang was **not entirely accurate**."

- Clarification #1, p. 12

"The **inconsistent disclosure** [in the statutory financial statement] were made ... before "**enhanced internal control measures were implemented** throughout the Group."

- Clarification #2, p. 2

"the probability of the Group being sanctioned or **penalized** by competent local tax authorities for the **inconsistent disclosure** of revenue recognition policy in the historical statutory financial statements is remote."

- Clarification #2, p. 2

"the disclosure on page 224 of the Prospectus was **true but was not inclusive of all changing scenarios that occurred during the Track Record Period**..."

- Clarification #2, p. 3

By the Company's own admission, it has issued statements in its prospectus or statutory filings which have been "**not entirely accurate**," "**inconsistent**," and "**not inclusive of all changing scenarios**."

According to Main Board Rule 2.13 (GEM Rule 2.18) issued by Hong Kong Stock Exchange,<sup>2</sup> "information contained in the Prospectus **must be accurate and complete** in all material respects and not be misleading or deceptive."

<sup>1</sup> Ozner published its first clarification ("Clarification #1") on March 25, 2015. The next day, we responded with our Rebuttal (the "Rebuttal"), available here: <https://glaucusresearch.com/wp-content/uploads/downloads/2015/03/GlaucusResearch-Rebuttal-to-Ozner-Water-HK-2014-Strong-Sell-Mar-26-2015.pdf>

<sup>2</sup> <http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/iporq/Documents/g141-12.pdf>

In our opinion, Ozner has admitted in its clarifications that its prospectus contained false statements, that its statutory financial statements contained false statements (which necessitated improved internal controls), and that its prospectus contained statements that did not present a complete or accurate picture of its business during the track-record period.

Why should Ozner be permitted to materially contradict its listing document? Furthermore, why should investors ever trust a company which admits to so many incomplete or false disclosures?

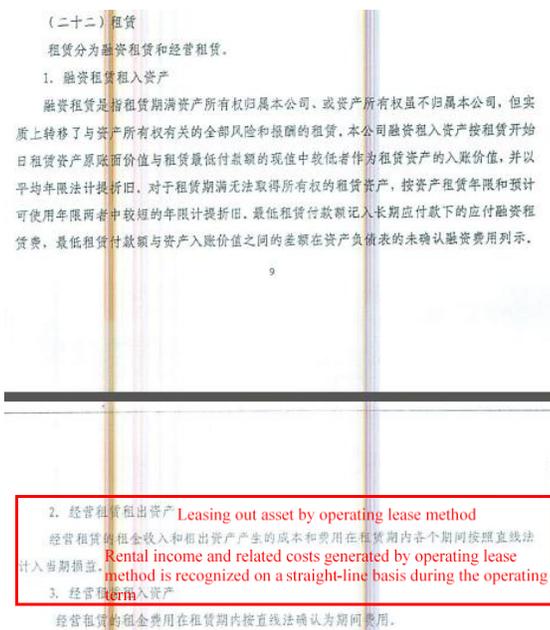
## I. SAIC Filings Indicate Material Exaggeration of Sales, Production and Profit.

### a. Profitability and Revenues from Leasing Purifiers Much Less than Reported

In our Report, we noted that according Ozner's statutory SAIC filings, annual rental fees from leasing water purifiers to end users **were 54% less than reported** in Ozner's prospectus for 2012 and 2011, respectively, and that such entities generated far less profit than the Company claimed in its prospectus.

In Clarification #1, Ozner responded that for the purposes of its statutory SAIC filings, "rental income reported to the local tax bureau in SAIC filings was recognized when relevant invoices were issued to principal distributors" and not on a straight-line basis over the one-year term of the lease, as the Group does under the IFRS for its Hong Kong prospectus.<sup>3</sup>

In our Rebuttal, **we noted that this explanation is directly and explicitly contradicted** by the very statutory SAIC filings upon which Ozner relied to exonerate itself. The statutory SAIC filings of Ozner's primary rental subsidiary, Shaanxi Haoze, state explicitly that rental income and related costs generated by operating leases (a category which include rented water purifying machines) is recognized "**on a straight line basis during the operating term**" and thus revenue was not (nor could be) recognized on an invoice basis as the Company claimed in Clarification #1.



Source: 2012 Shaanxi Haoze SAIC Filings – Note to Financial Statement 4.22

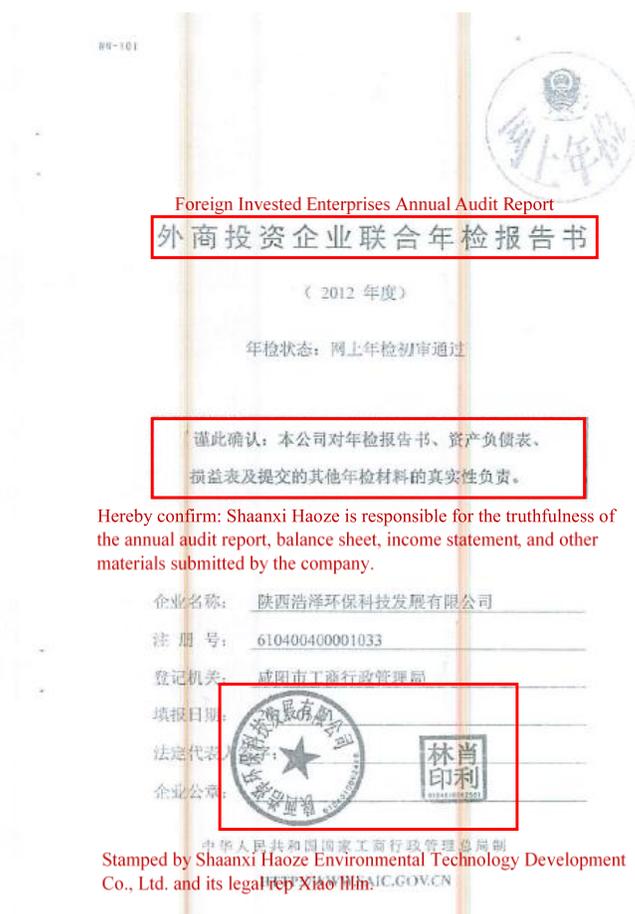
<sup>3</sup> Clarification #1, p. 5.

Ozner was caught: its explanation was directly contradicted by statutory filings which were signed and filed by the Company and reviewed and approved **by Ozner’s local auditor.**

Yet in Clarification #2, Ozner spectacularly backtracked, stating that “rental income recognition in statutory financial statements was impacted by the progress of invoice issuance during the Track Record Period and *in reality not on a straight-line basis as the statements indicated.*”<sup>4</sup> In short, Ozner is now saying that the revenue recognition statements in the statutory SAIC filings **were false.** Not to worry, Ozner promises investors that “the **probability of the Group being sanctioned or penalized ... for the inconsistent disclosure ... is remote.**”<sup>5</sup>

Is this a joke? In Clarification #1, Ozner relied on the statutory SAIC filings to supposedly exonerate itself. When we pointed out that the statutory SAIC filings clearly and directly contradicted Ozner’s excuse in Clarification #1, Ozner used Clarification #2 to backtrack and state that the statutory SAIC filings upon which it had previously relied were in reality **false statements.**

Statutory SAIC filings are reviewed and stamped by an auditor. They are required to be filed **by PRC law,** and an officer or legal representative of the Company must sign such statutory filings and attest that they are complete and accurate.



Source: 2012 Shaanxi Haoze SAIC Filings

<sup>4</sup> Clarification #2, p. 2.

<sup>5</sup> Clarification #2, p. 2.

Why should investors trust a Company that admits something as crucial as the revenue recognition policy on its statutory filings was **false**? If those statements were false, what else has the Company filed which was **false**?

Ozner's only excuse seems to be that "the inconsistent disclosure was made when the subsidiaries were private corporate entities and *before enhanced internal control measures were implemented* throughout the Group."<sup>6</sup> So the Company is admitting to a weakness in or lack of internal controls during the track-record period. **Were such weaknesses disclosed to investors in its prospectus? No.**

Does that mean that the rest of Ozner's disclosures regarding the track-record period about its business, revenues, profits, and operations could be false because of such weaknesses in internal controls?

Ultimately, Ozner's only excuse for the discrepancy between SAIC filings and its prospectus is that it issued false statements in its statutory filings. We continue to believe that the most likely explanation, and the one supported by our understanding of Chinese law, general accounting practices, and even Ozner's own description of its own accounting practices, is that the statutory filings recognized rental income on a straight line basis, meaning that in reality, Ozner's leasing of water machines was far less profitable than Ozner claimed.

**b. SAIC Filings Indicate Real Production Figures are 90% Less than Reported.**

In our Report, we presented the SAIC filings of Shangyu Haorun Environmental Technology Co., Ltd. ("Shangyu Manufacturing"), Ozner's only manufacturing subsidiary, which showed production costs which were 90% less than the costs of raw materials and components reported in Ozner's prospectus.

In Clarification #1, Ozner made the excuse that its only manufacturing subsidiary was in reality an **OEM for other subsidiaries**, and thus did not incur the procurement or production costs of manufacturing the machines because it did not **take title** to the machines.

In our Rebuttal, we pointed out that this **directly contradicted Ozner's prospectus**, which stated that Shangyu Manufacturing took title to the machines before transferring it to other subsidiaries.<sup>7</sup> In turn, this means that the manufacturing subsidiary must have taken title to the materials and components required to assemble the machines, its statutory filings should reflect both the costs and revenues of taking title to such inputs and machines before sale to other subsidiaries, and its taxes paid should reflect the VAT owed from such production and subsequent transfer.

In Clarification #2, Ozner backtracked again. This time, Ozner claimed that "the disclosure on page 224 of the Prospectus was **true but was not inclusive of all changing scenarios that occurred during the Track Record Period...**"<sup>8</sup>

In our view, Ozner was caught again. Ozner's excuse in Clarification #1 was directly contradicted by the Company's statements in its prospectus. Yet this time, Ozner's only way out was to claim that its prospectus, was true but under inclusive, and thus not a complete (nor an accurate) description of its business during the track-record period.

This should sound familiar, because confronted with damning evidence, in Clarification #1 Ozner sheepishly admitted that a statement in its Prospectus was "was **not entirely accurate**."<sup>9</sup> Clarification #2 takes the same approach.

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<sup>6</sup> Clarification #2, p. 2.

<sup>7</sup> Ozner Prospectus, p. 224.

<sup>8</sup> Clarification #2, p. 3.

Should investors believe Ozner's prospectus or its recent clarifications?

According to the Main Board Rule 2.13 (GEM Rule 2.18) by Hong Kong Stock Exchange,<sup>10</sup> "information contained in the Prospectus **must be accurate and complete** in all material respects and not be misleading or deceptive."

Is Ozner not admitting in Clarification #2 that the description of its business during the track-record period was neither accurate nor complete?

But the joke continues. Because even if Ozner's latest excuse is taken at face value, the math does not add up. Ozner claimed in Clarification #2 that "Shangyu Haorun was in charge of the procurement of raw materials and components during the ***first quarter of its operation in 2011***" and thereafter did not take title to the machines.<sup>11</sup>

Yet Ozner unequivocally stated in its prospectus that it had VAT receivables related to the "**transfer of titles to water purifying machines from Shangyu Haorun** ...which is in charge of machine manufacturing," to the rental subsidiaries in charge of leasing. If it was the case that Shangyu Haorun **ONLY** held title to the machines in first quarter of 2011, how did the transfer of title from Shangyu Manufacturing to the other subsidiaries generate input VAT receivables of RMB 20.9 million, RMB16.7 million and RMB20.0 million in 2011, 2012 and 2013 respectively?

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#### FINANCIAL INFORMATION

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VAT receivables were related to transfer of titles of water purifying machines from Shangyu Haorun Environmental Technology, which is in charge of machine manufacturing, to Shanghai Haoze Environmental Technology and Shaanxi Haoze Environmental Technology, which is in charge of machine leasing. VAT receivables were generated primarily due to the time it takes to finish the certification process with the relevant tax authorities. Such input VAT receivables can be offset against output VAT payables. VAT receivables were RMB20.9 million, RMB16.7 million and RMB20.0 million as of December 31, 2011, 2012 and 2013, respectively.

*Source: Ozner's Prospectus p. 224*

Why should we believe Ozner's Clarification #2 when the prospectus so clearly states that Shangyu Manufacturing held title to the machines in 2011, 2012 and 2013? Furthermore, if Shangyu Haorun **ONLY** held title to the machines for one quarter in 2011, how did transfer of title from the manufacturer to other subsidiaries generate output VAT payables of RMB 21.4 million, RMB 18.9 million and RMB 20.0 million as of December 31, 2011, 2012 and 2013, respectively?

Output VAT payables consisted primarily of output VAT payables related to (i) transfer of titles of water purifying machines to our operational subsidiaries and (ii) annual leasing fees paid to us by principal distributors. Output VAT payables were generated primarily due to the time it takes to finish the certification process with the relevant tax authorities. Output VAT payables related to transfer of titles of water purifying machines to our operational subsidiaries were RMB21.4 million, RMB18.9 million and RMB20.0 million as of December 31, 2011, 2012 and 2013, respectively and can be offset with input VAT receivables. Output VAT payables related to annual leasing fees were nil, RMB3.9 million and RMB18.3 million as of December 31, 2011, 2012 and 2013, respectively, which was in line with the increase in the number of water purifying machines we installed.

*Source: Ozner's Prospectus p226*

<sup>9</sup> Ozner Clarification, p. 12.

<sup>10</sup> <http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/iporq/Documents/g141-12.pdf>

<sup>11</sup> Clarification #2, p. 3.

If Shangyu Haorun did not own the title of water purification machines for *11 of the 12 quarters* during the track-record period, why did the prospectus so clearly state that it did? How else can Ozner explain the generation of VAT payables and receivables, when the prospectus clearly states that such payables and receivables were generated by the transfer of title from Shangyu Haorun to other subsidiaries in 2011, 2012 and 2013? To transfer title it must have title. In our view, Ozner is caught again.

We continue to believe that the most likely explanation is not that Ozner lied in its prospectus, but that in reality, Ozner did not incur the production costs (and thus did not have a business of the scale) reported to investors in its prospectus. Perhaps the larger question is why should investors trust a company with such material inconsistencies between its prospectus and subsequent clarifications?

## II. Why Doesn't Ozner Pay Taxes?

In our Report and our Rebuttal, we noted that Ozner paid **less than RMB 3 million** on total income taxes from FY 2011-2013, despite recording a liability for income tax payable at FYE 2013 of RMB 64 million. That means that in three years, Ozner only paid **4.5% of the taxes it supposedly accrued**.

Ozner's response in Clarification #1 was that such taxes were not paid because it did not issue invoices to its distributors.<sup>12</sup> Clarification #2 ignored the issue, presumably because the Company's answer makes no sense.

Are investors to believe that in **three years Ozner only invoiced its distributors for 4.5% of outstanding payments**? Ozner's distributors must also pay taxes on income collected from end users – why would they tolerate a multiyear delay in invoices from Ozner?

Investors should also use common sense. What business is allowed to recognize revenue, profits and RMB 68 million, RMB 150 million and RMB 306 million in **cash flow from operations** in FY 2011, 2012 and 2013, respectively, without paying taxes? If simply delaying invoices was all it took to avoid taxes, would not all businesses do it?

The Company complains that it is in compliance with regards to its tax obligations, but does that not just reinforce our original investment opinion that Ozner did not generate meaningful profits?

## III. Undisclosed Related Party Transactions

In our Report, we identified a significant undisclosed related party transaction. In the prospectus, Ozner unequivocally stated that Shanghai Haoyang Environmental Technology (“Shanghai Haoyang”) was an “**independent third party**” and went so far to say, in no uncertain terms, that “**none of Shanghai Haoyang or its directors or shareholders had any past or present relationship, including without limitation, employment or financing relationship with [Ozner] or our ... shareholders during the Track Record Period.**” This turns out to have been false. SAIC filings show that Xiao Jianping, an Ozner shareholder and director of one of its operating subsidiaries was in fact **the controlling shareholder of Shanghai Haoyang since 2010**.

In Clarification #1, Ozner admitted that “the statement in the prospectus referring to the independent third party status of Shanghai Haoyang was **not entirely accurate.**”<sup>13</sup> This was another way of saying that the statement was false. Ozner then downplayed the connections between Shanghai Haoyang and its subsidiary, calling them immaterial.

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<sup>12</sup> Clarification #1, p. 14.

<sup>13</sup> Clarification #1, p. 12.

In our Rebuttal, we pointed out that statutory SAIC filings showed a host of overlapping connections between Shanghai Haoyang and Ozner subsidiary Shanghai Haorun Environmental Works (“Shanghai Haorun”). Indeed, statutory SAIC filings showed that the supposed independent third party shared three total individuals, one auditor and one registered office building in common with Ozner subsidiary Shanghai Haorun.

In Clarification #2, Ozner made a number of excuses, including that some such persons were independent parties or service providers, and that the fact that its subsidiary’s office was situated in the same building as the supposed independent third party was *simply a coincidence*.

Perhaps the most ludicrous explanation was the statement that Ms. Chen Jie, **who was a director and legal representative of Ozner subsidiary Shanghai Haorun in November 2010**, acted on behalf of the professed independent third party, Shanghai Haoyang, at the same time, “**in her personal capacity**.”<sup>14</sup> So, to clarify, when Ozner director and legal representative signs on behalf of a supposed independent third party, she is only acting in her personal capacity?

<b>Shanghai Haorun Environmental Works</b> (Ozner Subsidiary)	<b>Shanghai Haoyang Environmental Technology</b> (Supposed Independent Third Party)
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### Chen Jie (陈洁)

Shanghai Haorun Environmental Works  
**上海浩润环保工程安装有限公司**  
**股东决定**

根据《公司法》规定，股东做出决定如下：

- 通过《上海浩润环保工程安装有限公司章程》；
- 任命肖建平担任公司执行董事；** Assigned Xiao Jianping to be Executive Director
- 任命陈洁担任公司监事；** Assigned Chen Jie to be Independent Director
- 同意设立上海浩润环保工程安装有限公司，并拟向公司登记机关申请设立登记。



2010年12月11日

Source: Shanghai Haorun Environmental Works SAIC Registration filings

**准予设立登记通知书**  
NO. 15000001201010270038  
注册号: 310115001750490

**Named Receiver: Chen Jie**  
**陈洁**

**Shanghai Haoyang Environmental Technology**  
经审查，你提交的**上海浩扬环保科技有限公司**设立登记申请材料齐全，符合法定形式，我局决定准予设立登记。请你公司自本通知书发出之日起10日内到我局领取企业法人营业执照。

**Signed Receiver: Chen Jie**  
**陈洁**

西敏 注册官：  
**签收人：陈洁**  
**签收日期：2010年11月14日**

注：本文件一式二份，一份送申请人，一份留登记机关存档。



Source: Shanghai Haoyang Environmental Technology SAIC Registration filings

Ozner expects investors to believe that Chen Jie’s signature on the right, where she asserts that she is the **named receiver** of supposed independent party Shanghai Haoyang, was personal, and not professional in nature? This fails the smell test. It appears (obviously) that she, along with Xiao Jiangping, are acting on behalf of both entities in their professional capacity. Making the entity a related, not independent party.

<sup>14</sup> Clarification #2, p.4.

Ultimately, our point was that a director of an Ozner subsidiary was the controlling shareholder of a professed independent third party, which by the way, shared an office building, an auditor, and three other individuals in common with the Ozner subsidiary in question.

Ozner's prospectus stated directly that "none of Shanghai Haoyang or its directors or shareholders had any past or present relationship, including without limitation, employment or financing relationship with [Ozner] or our ... shareholders during the Track Record Period." We believe that this statement is obviously false. We believe that this falsehood discredits Ozner, because it shows that the prospectus contained false statements to a relationship we believe was material. We further believe that this statement clearly violates the Main Board Rule 2.13 mentioned above.

Why should Ozner be allowed to issue a prospectus which contains such false statements? Why should investors trust Ozner ever again?

#### IV. Conclusion

In our previous rebuttal, we cautioned investors to think critically and seriously about our Report, our rebuttal and Ozner's clarification. Upon further reflection, we no longer believe that Ozner's statements deserve to be taken seriously. In our opinion, they are a joke. By the Company's own admission, their statements have been "not entirely accurate," "inconsistent," and "not inclusive of all changing scenarios." It is April Fools' Day and this year, the joke is apparently on investors.



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