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山東墨龍石油機械股份有限公司

Shandong Molong Petroleum Machinery Company Limited*

(A Sino-foreign joint stock limited company incorporated in the People's Republic of China with limited liability)

(Stock Code: 568)

ANNOUNCEMENT INTERNAL CONTROL REVIEW REPORT

Reference are made to the announcements of Shandong Molong Petroleum Machinery Company Limited (the “**Company**” or “**Shandong Molong**”) dated 27 September 2019, 11 February 2018, 16 January 2018, 25 September 2017, 25 August 2017, 26 July 2017, 26 June 2017, 26 May 2017, 15 May 2017, 27 April 2017, 21 March 2017 and 8 February 2017, and the new release published by The Stock Exchange of Hong Kong Limited (the “**Stock Exchange**”) on 6 September 2019 in relation to the material misstatement of the financial information disclosed by the Company for 2015 and 2016.

As disclosed in the announcements of the Company dated 21 November 2019 and 16 January 2020, The Company has, in accordance with the directions of the Stock Exchange, appointed Crowe (HK) Risk Advisory Limited to conduct a review of the effectiveness of the Group’s internal control system, so as to improve the internal control system designed and implemented by the Company’s management according to the Group’s Practical Regulations on Corporate Governance and as required under the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the “**Listing Rules**”), and to assess the adequacy of the systems, structures and monitoring measures formulated by the Group and whether they are sufficient for the directors of the Company (the “**Directors**”) to make an appropriate assessment of the financial position and prospects of the Company (the “**Relevant Listing Rules Compliance Review**”); and has disclosed the results of the Relevant Listing Rules Compliance Review and of its follow-up review.

Internal Control Review Report

In compliance with the judgment (the “**Judgment**”) of and Court order made by the High Court of the Hong Kong Special Administrative Region of the People’s Republic of China in respect of the petition (the “**Petition**”) filed by the Securities and Futures Commission (the “**SFC**”) under section 214 of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong), the Company has appointed Crowe (HK) Risk Advisory Limited, an independent external auditor acceptable to the SFC (“**Crowe**” or the “**Independent External Auditor**”) to review and prepare a report on the internal control and financial reporting procedures of the Company (the “**Internal Control Review Report**”) so as to ensure that the Company complies with all relevant rules and regulations in Hong Kong and minimise the risk of recurrence of the misconduct complained of in the Petition. The Company has also been ordered to publish and implement the suggested measures as many be advised in the Internal Control Review Report by the Independent External

Auditor.

Findings #1

Adjustment on the management responsibilities of certain existing management and administrative personnel are needed to enhance the integrity of the management and to comply with the relevant provisions in the Securities and Futures Ordinance

Entity

Shandong Molong

Process Involved

Corporate Integrity Governance

Findings in the Review

During the course of the review, the management of the Company confirmed that, among the seven former senior management and administrative personnel of Shandong Molong who were involved in the misconduct as set out in the Petition of the SFC and the order of the Court of First Instance (the “**Involved Persons**”), some are still in management positions within the Group.

It is understood from the management of the Company that the Involved Persons, who are still in employment, are only employees of the Group.

As stated in the Petition of the SFC, given that the Involved Persons who are still under employment were then serving as key management and executive personnel, it is inevitable for the SFC to believe those personnel, in the unlikely event that they were not aware of the fact that they are performing the Group’s functions. It is a suspicion of misconduct involved in the financial exaggeration plan.

For the purposes of complying with the requirements of the Court order, Shandong Molong may consider that, due to the current employment of the Involved Persons, certain existing management and executive personnel (i.e. the Involved Persons) do not have the appropriate integrity to adequately and effectively implement proper internal control and financial reporting procedures to ensure the Company’s financial information is properly prepared and disclosed. The management of the Company has indicated that, the current management duties of those personnel will be handed over to suitable personnel to be sourced and identified in the future. They have also undertaken that, those personnel will not be involved in management duties relating to internal control activities and/or financial information reporting, etc., if they are still under employment in the future.

Impact

With reference to the provision in section 214(2) of the Securities and Future Ordinance, the prohibition on any direct or indirect involvement or participation in the management of the Group’s affairs by the relevant personnel in any way may further ensure the credibility of the preparation and disclosure of financial information.

Risk rating

High

Recommendations

The Group is recommended to make reference to the provision in section 214(2) of the Securities and Future Ordinance and comply with the disqualification order of the Court of First Instance, and complete the identification of suitable personnel to replace the management duties of the Involved Persons as soon as possible.

Findings #2

Control over the management of inside information is required to be strengthened to comply with the inside information provisions of the Securities and Futures Ordinance

Entity

Shandong Molong

Processes Involved

Corporate Integrity Governance

Findings in the Review

Shandong Molong has established certain written management systems to regulate the mechanism of inside information confidentiality and its disclosure to the public. Among others, according to the “Management System for Changes in Shareholdings of Directors, Supervisors and Senior Management”, directors, supervisors, senior management and shareholders holding more than 5% of the Company’s shares shall inform the secretary to the board of directors in writing of relevant trading plans before trading in the Company’s shares and its derivatives, so as to allow the secretary to the board of directors to make timely disclosure in accordance with the relevant regulations, including the requirements relating to the disclosure of inside information in Chapter 13 of the Listing Rules and Part XIVA of the Securities and Futures Ordinance. However, with reference to the announcement of Shandong Molong on 7 December 2020 and the discussion with the management of the Company, the following incidents concerning undisclosed inside information were confirmed:

- A shareholder of the Company intended to sell the Company’s shares in January 2020 and signed an agreement of intent in equity transfer, but did not inform the board of directors in time so as to make a timely disclosure;
- The then chairman of the board of directors knowingly failed to perform his/her duty as a director by reporting such inside information to Shandong Molong in order to allow Shandong Molong’s disclosure to the public the relevant intended transfer of shares in the Company; and
- The then secretary to the board of directors (currently an executive director) failed to perform his/her duty as the secretary to the board of directors by identifying and disclosing such inside information in a timely manner.

Management explained that, the reason for the improper disclosure of the incident was the shareholders of the Company and the then chairman of the board of directors were not fully aware of the duty of confidentiality and disclosure of inside information; therefore the board of directors did not have timely information of the potential share sale and failed to make disclosure to the public.

Impact

By signing a written undertaking and conducting targeted training, it can be ensured that the shareholders of the Company and the member of the board of directors have a proper

understanding of the confidentiality and disclosure of inside information, which may mitigate the risk of disciplinary action being taken against the Company and relevant personnel by regulatory authorities for breaches of relevant laws or regulations, including requirements on disclosure of inside information in Chapter 13 of the Listing Rules and Part XIVA of the Securities and Futures Ordinance.

Risk Ratings

High

Recommendations

It is recommended that the Group take the following measures to enhance or maintain awareness of the relevant personnel on the duty of confidentiality and disclosure of inside information of the Company:

- To require shareholders holding more than 5% of the Company's shares to sign an undertaking to ensure compliance with relevant regulations and to report their potential or actual share transactions to the board of directors of the Company in a timely manner; and
- To arrange training for directors and secretary to the board of directors on the handling of inside information to ensure that they are fully aware of their responsibilities to identify and disclose inside information and to disclose any inside information required to be disclosed in a timely manner.

In addition, the secretary to the board of directors should monitor the price movements of the Company's shares on an on-going basis and report any abnormalities to the board of directors in a timely manner for further follow-up and confirmation.

Findings #3

Improvement on monitoring of the employment, promotion and termination investigation of management personnel is required to strengthen the integrity and conduct of management personnel

Entity

Shandong Molong

Processes Involved

Corporate Integrity Governance

Findings in the Review

During the review, the following areas were identified for improvement in the Group's current investigation procedures for the employment, promotion and termination of management personnel:

- (a) Investigation and control of employment and promotion of management personnel

Shandong Molong has established its Anti-Corruption Regulations, which require background investigation (on areas including educational background, working experience and criminal records) for the personnel to be employed and promoted (including board members and senior management), and during the review, room for improvement was found in the execution of the following processes:

- In the background investigation of the employment of the Company's board members, Shandong Molong only keeps written records of the minutes and resolutions of the board of directors and its nomination committee to set out the results of the background investigation of the appointees. However, there were no sufficient written records of the manner and procedures of the investigation, the investigators and the information used for the investigation; and
- The Company confirms that the above background investigation procedures also cover management personnel other than members of the board of directors (e.g. deputy general managers and financial officers), but in addition to the above deficiencies, there is no documentation to support that criminal record investigation on such personnel have been properly conducted.

(b) Control of termination investigation

In accordance with the "Measures for Management of Accountability ", Shandong Molong is required to conduct outgoing audit and keep written records of the resignation of its management personnel and employees in key positions, but the Company confirms that:

- At present, there is no specific definition of personnel in key positions, such as whether they include non-board members, financial officers, personnel of subsidiaries, etc.; and
- No relevant written records in respect of the outgoing audit process have been kept to support the results of the outgoing audit (including the impact to the Group of departing personnel and remaining responsibilities, etc.).

Impact

Complete written records of the employment, promotion and termination investigations provide sufficient traces of review to support the results of investigation. Clearly defining the target can ensure that investigations are conducted in a comprehensive manner and that risks related to talents, ethics and integrity are properly controlled.

Risk Rating

Moderate

Recommendations

Shandong Molong should improve its investigation procedures for the employment, promotion and termination of management personnel with respect to the above findings in the review, and keep complete documentation, including criminal investigation records. Shandong Molong should also improve the contents of its "Measures for Management of Accountability " to clearly define the ranks or positions that must be subject to an outgoing audit.

Findings #4

Arrangement for effective directors' and officers' liability insurance in accordance with Listing Rules is required

Entity

Shandong Molong

Processes Involved

Corporate Integrity Governance

Findings in the Review

The Company has arranged directors' and officers' liability insurance (the "**Liability Insurance**") for its directors, supervisors and senior management in accordance with Code Provision A.1.8 of the Corporate Governance Code set out in Appendix 14 to the Listing Rules. However, the latest Liability Insurance expired in October 2020 and had not been renewed at the time of review. The Company explained that as the specific terms of the Liability Insurance are currently being re-examined and have recently been submitted to the board of directors for consideration and approval. Liability Insurance will be arranged for the directors, supervisors and senior management upon approval at general meeting.

Impact

Effective Liability Insurance arranged for directors and senior management will be able to comply with the code provision of Appendix 14 A.1.8 of the Listing Rules and will mitigate the financial losses of directors and officers arising from legal action.

Risk Rating

Moderate

Recommendations

Shandong Molong is recommended to assess the risks of legal action against the directors and senior management and to complete the arrangement of Liability Insurance in accordance with the relevant code provisions as soon as possible.

Findings #5

Improvement on existing written management system is required

Entity

Shandong Molong

Processes Involved

Corporate Integrity Governance

Findings in the Review

As a company listed in both Hong Kong and Shenzhen, Shandong Molong is required to comply with the laws and regulations applicable to both Mainland China and Hong Kong, in particular the Listing Rules and the Securities and Futures Ordinance under the laws of Hong Kong. Shandong Molong has established a written management system at the company level to regulate the Group's corporate governance. However, the existing management system was mainly prepared with reference to the Rules Governing the Listing of Shares on Shenzhen Stock Exchange to comply with the statutory requirements in both Mainland China and Hong Kong, without explicitly and specifically stating the requirements to comply with the same or relevant Hong Kong laws and regulations.

In view of the circumstances described in findings in the review #1 and #2 above, it could be seen that the current management system can be further improved, including but not limited to covering the following provisions of the Securities and Futures Ordinance:

- Interpretation of misconduct (Sections 193 and 245 of the Securities and Futures Ordinance);

- The duty of officers of a corporation to prevent misconduct (Section 279 of the Securities and Futures Ordinance);
- Disclosure requirements for inside information (Section 307B of the Securities and Futures Ordinance);
- The duty of officers of a corporation to disclose inside information (section 307G of the Securities and Futures Ordinance); and
- Requirements relating to false or misleading data (Section 384 of the Securities and Futures Ordinance).

Impact

To clearly and specifically state the laws and regulations and related internal control measures to be complied with in the written management system (especially including the aforementioned "Securities and Futures Ordinance") would effectively regulate corporate compliance controls and reduce the risk of the Company and its senior management being penalised under the regulatory regime for non-compliance with the relevant laws and regulations.

Risk Rating

Moderate

Recommendations

Shandong Molong should identify the key PRC and Hong Kong laws and regulations that the Group is required to comply with, clearly set out the relevant legal requirements (including the abovementioned Securities and Futures Ordinance) and internal control mechanisms in its existing written management system in respect of the areas listed above, ensuring that its employees (in particular directors and senior management) have full understanding on the relevant legal obligations (including legal obligations arising from non-compliance with such requirements) and implementing appropriate internal control measures to comply with such requirements.

Findings #6

Improvement on compliance management mechanism is required

Entity

Shandong Molong

Processes Involved

Compliance Supervision Mechanism

Findings in the Review

We understand from the management of the Company that the Company Secretary is responsible for the Group's compliance with Hong Kong laws and regulations, including the Securities and Futures Ordinance and the Listing Rules, and that the Company has appointed Ample Capital Limited as its compliance adviser for a term of two years with effect from 8 October 2019 in accordance with the requirements in the direction from the Listing Committee of The Stock Exchange of Hong Kong Limited issued on 6 September 2019 to provide ongoing advice on compliance matters in relation to the Listing Rules.

According to the existing compliance management mechanism, if the Company and its subsidiaries have any doubts in relation to compliance with Hong Kong laws and regulations, they will seek advice from the Company Secretary and compliance adviser. As the mechanism is unilateral i.e. the Group obtains compliance advice from the responsible compliance unit as and

when required, the Company is unable to keep valid supporting documentation to monitor and confirm its continued compliance with applicable Hong Kong laws and regulations in its operations.

Impact

The Group's internal and external compliance units' regular issue of written confirmation documents could ensure that the Group's compliance is continuously and effectively monitored and assist the Group in confirming its continued compliance.

Risk Rating

High

Recommendations

Shandong Molong to require compliance consultants to issue compliance certification documentations (such as compliance checklists, monitoring reports or compliance statements) on a regular basis in relation to the Group's compliance according to the existing compliance management mechanism so that the Group can continuously ensure that its operations continue to comply with the applicable Hong Kong laws and regulations.

Findings #7

Improvement on estimated sales confirmation mechanism is required

Entity

Shandong Molong

Shouguang Baolong Petroleum Equipment Co., Ltd.* (壽光寶隆石油器材有限公司)

Weihai Baolong Special Petroleum Materials Co., Ltd.* (威海市寶隆石油專材有限公司)

Shouguang Maolong New Materials Technology Development Co., Ltd.* (壽光懋隆新材料技術開發有限公司)

Processes Involved

Compliance with Financial Reporting Procedures

Findings in the Review

The Group settles and recognises sales revenue in accordance with sales contracts. There are two types of contracts, namely customer receipt and customer collection (i.e. storage and sales). The Group recognises sales revenue based on the customer's receipt or collection records.

According to the current accounting system (the "**ERP system**"), the ERP system automatically generates sales record and recognises revenue and related costs based on sales invoices and the cost information of the products sold in the system. For transactions that are not invoiced but which receipt or collection has been recognised, the amount of uninvoiced sales and related costs for the month can only be aggregated in reliance on the "Provisional Estimated Revenue and Costs Schedule" compiled by the Finance Department. Manual accounting is used to record and recognize the sales revenue and related costs (the "**Provisional Revenue and Costs**") after the amounts are confirmed with the sales department that the sales transaction meets the conditions for revenue recognition and the sales unit price is confirmed.

According to the Company's management, it is unable to ensure the conversion of manual accounting to automatic accounting because the ERP system was purchased from a supplier and not self-developed. However, considering that the potential risk of financial inaccuracy due to human error in the manual accounting of Provisional Revenue and Costs (including incorrect

contract prices or transactions that do not meet the agreed terms of receipt or collection), it is recommended that the Group explore with the ERP system software supplier the possibility of replacing manual accounting with automatic accounting and discontinuing manual accounting.

Impact

The conversion from manual accounting to automatic accounting of Provisional Revenue and Costs reduces the risk of inaccurate financial information caused by manual operations (e.g. incorrect entry of contract unit prices or total transaction amounts).

Risk Rating

High

Recommendations

It is recommended that the Group discuss with the ERP system software supplier the possibility of replacing manual accounting with automatic accounting and discontinue manual accounting.

Advice of the Audit Committee and the board of directors

Having considered the Internal Control Review Report and the actions taken/to be taken by the Group, the Audit Committee and the board of directors are of the view that the Company's proposed measures are adequate and sufficient to address the findings of the Internal Control Review Report and that the Group will develop an adequate internal control system to meet its obligations under the Listing Rules and all relevant Hong Kong laws and regulations.

Shareholders and potential investors of the Company are advised to exercise caution when dealing in the shares of the Company.

By order of the Board
Shandong Molong Petroleum Machinery Company Limited*
Yang Yun Long
Chairman

Shandong, PRC
12 May 2021

As at the date of this announcement, the Board comprises the executive Directors, namely Mr. Yang Yun Long, Mr. Yuan Rui, Mr. Liu Min and Mr. Li Zhi Xin; the non-executive Directors, namely Mr. Yao You Ling and Mr. Wang Quan Hong; and the independent non-executive Directors, namely Mr. Tang Qing Bin, Mr. Song Zhi Wang and Mr. Cai Zhong Jie.

* For identification purposes only