

Company announcement

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September 2021 Quarterly Update

Transcript of a recording shared with attendees at PET's September 2021 Quarterly Update Webinar held on 16 November 2021 at 11.00am AEDT.

Speaker: David Krasnostein AM, Chairman

Thank you, Greg – and good morning, everyone.

The purpose of today's webinar is to achieve 3 things:

- update you on our efforts to have the company's shares resume trading on the ASX;
- provide you with further detailed disclosure relating to the fraud and mismanagement issues that have impacted the company; and
- to give you an update on how the business is currently tracking.

As you will be aware, relisting has been an important priority for the Board and management.

This has required us working through some very complex matters and getting to the bottom of what occurred in the company.

That has been hard, it has been time consuming, it was stressful for all involved, and it was costly.

Recently, the company met with representatives of the ASX to discuss this matter and to seek some additional clarity on the steps necessary to achieve relisting.

Following those conversations, it is now clear that the pathway to relisting involves satisfying ASX in relation to two key requirements.

The first involves submitting statutory accounts without audit qualifications on opening balances.

In anticipation of this requirement, the Board took the decision to have this year's first half financials audited - rather than just reviewed, as is typically the case for half year numbers - providing us with a base from which to submit a set of unqualified audited accounts dealing with results of the second half of the year.

So, we hope to meet this requirement at our next reporting period, in February of next year, subject of course to ASX's satisfaction.

The second ASX requirement to relisting involves the ASX being satisfied that the company has taken all reasonable measures to ensure shareholders are fully informed in relation to all relevant matters concerning the Company.

In particular those matters which led to the suspension of our listing; the potential financial and other impacts of those matters; and the steps being taken by the company to address those matters.

We are now in a position to brief shareholders more fully having now completed a number of important phases of the investigations, placing us in a position to provide shareholders with a more detailed update as to where those matters now sit.



We have also done much of the work in terms of restructuring the business and putting in place processes and other governance standards that ensure these matters cannot reoccur.

I will shortly hand over to our CEO, Lachie McKinnon and CFO, Matthew Parker, to talk to these matters in some detail.

But first I want to make a couple of important points in terms of the timing of these issues and the important role that both Lachie and Matt have played in helping to identify the issues, formulate an appropriate response to those issues, and manage the company through an extremely challenging period.

It is important that shareholders understand that the matters we are now dealing with are largely legacy issues inherited by the current senior management.

Lachie joined the company in January 2020 and took over as Managing Director in May when the previous managing director stood down after the 2020 AGM on May 25.

Matt joined as CFO in early May 2020.

When I accepted the invitation to join the Board in March this year and assume the Chairmanship after the May AGM, I did so knowing in advance that the company had a difficult period to work through.

That was not the case for Lachie and Matt who joined with very different expectations of what their roles would be in the company. Both thought they were joining a fast growing global company and would be engaged in positive and exciting expansion activities. Instead, they have spent their first year dealing with a mountain of stressful issues, cleaning up fraud and mismanagement, and replacing the senior management team globally.

The Board is extremely grateful to both of them for their integrity, diligence and their willingness to stay the course and work through these challenges for the benefit of the shareholders. Their hard work in what has been a long and stressful period, is now paying off as we start to close the door on a number of the issues and look forward to the future of the company and restoring value for shareholders.

I am pleased to say that I can see and feel the progress that has been made because a greater percentage of our time today is spent talking about growing sales, expanding production capability, hiring new staff, broadening our product range and completing high profile international projects, and less time is taken up with discovering and fixing past problems and irregularities.

I'll now ask Lachie to run through some detail of what occurred, the company's response, and our view on outstanding potential liabilities and costs.

Speaker: Lachlan McKinnon, Managing Director & Chief Executive Officer

Thank you David.

And I would like to add my welcome to the shareholders who have joined us on this webinar and continue to show a close interest in the company.

I joined the company and was appointed Managing Director in May 2020 along with Matt as newly appointed CFO. We both joined what we saw as a fast-growing global company with a fantastic Australian product and we were looking forward to contributing to part of its success story. Despite the legacy issues we still remain excited by that opportunity

An early priority was to familiarise ourselves with the quality and rigour of the systems and procedures in place at the company, and in particular with respect to our China operations.

That orientation became difficult and frustrating for both of us. Initially we attributed it to some difficult personalities, cultural differences, and sloppiness in record keeping and processes and procedures. However, a growing number of potential irregularities were identified, and Matt led the internal investigations to clarify and validate those matters.



These investigations involved asking questions of employees – some of whom were unco-operative - and reviewing company documentation and records, many of which were difficult to retrieve or could not be found.

This reached a head in August, when Arnold Bloch Leibler (ABL) our company legal counsel, were instructed to retain KPMG forensic, to assist with our investigations. KPMG was engaged in two capacities. KPMG's forensic department was engaged to conduct an independent internal investigation into PET's internal operations to assist the company in determining any corporate law issues that may arise out of any conduct uncovered.

Separately, we had notified the irregularities to KPMG's audit department in July. As our incumbent auditor, KPMG's audit department focused on potential accounting irregularities, particularly those associated with related parties.

As a result of our inquiries, various irregularities were identified and further investigations were required to establish the extent of any mismanagement or potential fraud.

Our concerns were reported to the Board, and it was subsequently decided that the company should seek a trading halt on the ASX and then request a suspension of trading, which came into effect on 21 September last year. The suspension ensured the company's shares were not being traded while we continued with the investigations and attempted to quantify the impact of any irregularities that were confirmed.

We also took a decision at that time to engage FTI to provide additional independent consulting support for our China business. FTI is a global corporate finance consultancy specialising in financial due diligence.

Like KPMG, FTI was engaged in two distinct capacities - firstly, to assist with the ongoing management of the China business on an interim basis and secondly, via ABL's engagement, to undertake a forensic review focusing on the Chinese manufacturing operations.

Again, the purpose of the investigation into the Chinese manufacturing operations was to assist the company in determining whether there were any corporate law consequences arising from any conduct uncovered. These investigations were undertaken based on a materiality level of zero.

As a result of its extensive investigations, PET identified false accounting across both our China sales organisation and in relation to our China factory operations. It was established that invoices had been falsified and fictitious transactions had been documented with vendors who did not exist or who had provided no service or product to the company.

During this period of investigation, we also retained expert IT consultants to assist with the gathering of evidence and the retrieval of company records and documents that had been deleted or destroyed. This process was complicated by the necessity to comply with local Chinese regulations relating to moving some of these records and material outside of China.

Focusing on a four-year period, the task of attempting to create a true record of what transactions occurred and the true beneficiaries of various payments that were made has been difficult and has taken some 10 months to conclude. It has involved direct costs of some \$2.5 million. These costs relate to forensic analysis support, audit assurance, legal advice, various independent consultants and translation services – among other investigation-related expenses.

Our subsequent reporting of these matters, including an unavoidably complex set of accounts, has attempted to include a holistic representation of what transpired. Additional senior audit and technical support was engaged to assist with that process.

I would like to point out that the investigations into mismanagement and apparent fraud in China extended to efforts to establish the level of knowledge and/or involvement of former PET employees and executives, including head office, and at least one China based director who has since left the Board. The level of co-operation offered by some of those people has been very limited, but we are



continuing those investigations in the absence of that co-operation. I'll have more to say about this a little later.

Before handing over to Matt to outline some of the related tax matters that have now become apparent and issues relating to the awarding of share options, I want to advise you of issues that have been revealed in respect of our manufacturing operations at our Changxing factory.

In 2019 the company included in ASX announcements that certain products – other than Phoslock - were produced in this factory and that investments were being made to reduce wastewater discharge from the site. As a result of our investigations, we believe that the products concerned were not produced at the factory and, in the main, were sourced from suppliers associated with a former non-executive director of the company.

We have also identified instances of payments being made to Chinese government officials that did not appear to be legitimately required. In particular, we have identified a payment to a local government official apparently to allow wastewater to continue to be discharged into the drainage system. Our investigations are still ongoing, but we believe that such payments may have been made with the knowledge or approval of Australian-based managers.

A further potential incident of fraudulent activity that we have identified involved a fatal traffic accident in which the driver of one of the vehicles was a person hired from an outsourced labour company. Investigations have revealed this person was unlicensed and the vehicle he was driving was unregistered. Company management at the time deemed that PET had liability for the accident and authorised the payment of approximately 287,000-Australian-dollars as compensation through various third parties. However, the ultimate beneficiaries of these payments remain unclear.

So, Matt will now address the tax and share option issues....

Speaker: Matthew Parker, Chief Financial Officer and Company Secretary

Thanks Lachie.

The matters about which I am now going to brief you are complex, but it is important shareholders are advised about potential outstanding liabilities which are yet to be determined.

The company initiated a full tax review to ensure we complied with our tax obligations. As a result of the review, we adjusted income tax payable associated with the treatment of certain deductions and research and development activities.

Our investigations determined that our application in 2019 to receive 'High-Tech Enterprise Status' was falsified and involved incorrect assertions that we had certain engineering expertise and employed a certain number of engineers who were – we now know – in fact salespeople with no engineering expertise.

This had the effect of adjusting the corporate tax rate in relation to historic and future profits earned by our China subsidiaries from 15% to 25%. We also incurred late fees associated with this adjustment. These adjustments may also result in additional penalties or incur additional costs associated with rectification activities in future periods.

Currently, no amount has been provided for such costs as it is not possible to measure the contingent liability with sufficient reliability as it remains subject to the outcome of future events not wholly within the control of the Group. The cost to the Group was \$374,000 for rectifying the mis-reporting of tax and \$150,000 in forensic tax analysis over 5 years.

The investigation also identified an issue arising from the analysis by our Australian tax advisors on payroll tax associated with the vesting of options issued to employees, consultants and directors during the year ended 31 December 2019 and prior. These payroll taxes amounted to \$213,000 paid to the state revenue office for what we now believe were shares issued to people who were not eligible to receive those shares and/or under vesting conditions that were insufficiently certain. The



business also incurred costs of approximately \$165,000 in recovering the records and tracking down beneficiaries of the vested options to enable this calculation.

The approval process relating to the vesting of these shares lacked accounting rigour and any reasonable level of governance. The 65 million options involved equated to some 10% of the company's shares on issue at that time.

The process of unravelling the detail of what options were awarded to whom, the beneficiaries who ultimately exercised the options, what performance conditions were applied, and the various tax implications – both at an employee and company level – has been difficult, prolonged, and costly. While we have a clearer picture of what took place, we remain exposed to potential further costs and liabilities which are very difficult to quantify.

As Lachie has described the process to understand all these matters, to document them, and have them forensically audited to enable an assessment of any subsequent impact has required significant resources. The cost of this is \$2.5m, which Lachie detailed, and an additional \$1.7m for other related matters bringing the total to over \$4m. This total overall cost can be summarised in the following broad categories.

- being audited three times by two different audit firms in 10 months with very low materiality thresholds,
- legal advice across multiple jurisdictions,
- forensic investigations,
- document retrieval and recovery,
- the recreation of accounts over four years,
- interim management,
- specialist legal and tax consultancy including a focus on share capital matters,
- legal and investigative services in relation to various suspect payments,
- insurance related matters,
- IT security and jurisdiction matters, and
- the ongoing BHZQ litigations and arbitration and potential litigation advice in Australia.

I'll now hand back to Lachie, thanks Lachie

Speaker: Lachlan McKinnon, Managing Director & Chief Executive Officer

Thanks Matt.

In summary, the incidences of apparent fraud and mismanagement that have centred on our China operations have been found to be far-reaching and to have been perpetrated over a long period of time. These matters have involved both China based employees and, we believe, previous senior management of the company based here in Australia. A large number of individuals outside of the company have also been implicated. The fraudulent activity relates to a broad cross section of matters including false accounting and falsification of invoices and service contracts; improper tax reporting; misappropriation of funds including improper payment of bonuses; the improper awarding and vesting of options and a range undisclosed related party transactions.

As we have previously reported to shareholders, our response to these matters has included the restructuring of our organisation in China; a comprehensive and systematic review of all current China contracts and contractual arrangements with third parties; and the implementation of changes which will strengthen PET China's financial reporting procedures, delegated authority policies and general risk management framework.

In terms of more recent developments.....As shareholders are aware, we have had to go through a process of appointing a new auditor after KPMG resigned. As the Chairman has noted, the Board took the decision to have this year's first half financials audited – rather than just reviewed, as is typically



the case for half year numbers. This provides a basis for the preparation of unqualified accounts for the second half.

Due to our investigations into certain payments that have been made, we are concerned that criminal activity may have occurred and have therefore decided to enter into a cooperative working relationship with the Australian Federal Police. [ABL Note: AFP have confirmed that they are executing today and will confirm no difficulty with the above statement] To date, we have expended some \$1.2 million on our investigations into these payments, which Matt detailed in his summary

We also continue to deal with the BHZQ and Xingyun lake receivables. This is a very complex matter which involves contractual transactions, payments, related party involvements and other details which are not yet fully understood. The BHZQ receivable is now the subject of arbitration and court review in China. The revenue and profit recorded for projects such as these were used as a material driver in support of the prior management's decision to award options to a range of beneficiaries, despite the vesting condition lacking accounting rigour and any reasonable level of governance.

I would also like to confirm that we are continuing to investigate potential claims against certain individuals and, to the extent that PET receives advice that these claims are viable, PET intends to pursue them as soon as possible with the aim of having the relevant parties held accountable for their actions and in the hope that some of the misappropriated company funds can be recovered.

Although investigations are still ongoing, we are now at a point where we believe we have taken all reasonable steps to establish what occurred and to place the business on a sound footing. We have confronted these difficult issues head-on and with a determination to have them fully addressed. Let me just recap on what steps we have taken:

1. Accessing company records and attempting to restore deleted and missing items to the best of our ability.
2. Understanding the systems and processes used by previous management.
3. Reconstructing a set of company accounts going back 5 calendar years and covering 4 years of accounts.
4. Investigating fraudulent or suspicious transactions.
5. Seeking to identify all corporate law issues arising out of irregular conduct
6. Conducting a forensic review of manufacturing operations.
7. Reviewing our compliance with environmental waste disposal and bring the company into compliance.
8. Recalculating our known tax obligations and make good our compliance, including the payment of late fees.
9. In so far as we can, tracing all payments to third parties, related parties and staff and determining their legitimacy.
10. Reviewing all customer contracts.
11. Reviewing all employment contracts and develop replacement contracts reflecting best practice.
12. Restructuring our China business, including the recruitment of a trusted and skilled management team.
13. Recruiting skilled management and sales people to support our global operations.
14. Tightening all financial controls.
15. Renewing the Board of Directors and strengthen corporate governance.
16. Rolling out a complete set of company policies in line with best practice, and
17. Bringing remuneration and incentive schemes up to date and in accordance with best practice.

The cost to the company has been significant. But we believe we are through the difficult and complex tasks of reconstructing our accounts and attending to the known tax issues. While there is more work



to do, including in relation to tracking down people who were responsible for these matters - or who have improperly benefited - these costs are not expected to be at the levels we have already expended.

I might hand back to the chairman to make some concluding remarks on these matters before I provide a brief update on our current business activities.

Speaker: David Krasnostein AM, Chairman

Thank you Lachie.

After listening to Lachie and Matt describe their first 18 months at the company, I hope you now have an insight into the mountain of issue they have been dealing with, the stressful environment they have been working in, and the progress they have made in getting us to a point where we can now look forward to growing shareholder value and capitalise in the enormous opportunities out there.

I have already seen more of their time and energy focussed outward rather than inward as they devote more time to doing the jobs they were excited about and why they joined us in the first place.

I would like to reiterate that we intend to take legal action against those responsible for the fraud, mismanagement and gross negligence that we have found and that have resulted in loss and damage to the company.

We are in the final stages of examining the viability of those claims. We will update you with further information as soon as we confirm that we have viable claims, and proceedings are commenced. We would like to emphasise that any action we do take will be taken with strong regard to costs – we will not spend money unless it is justified.

As Matt and Lachie have made clear, we have gone to considerable lengths to ensure our accounts are now fair and accurate.

Given the changes we have implemented, our financial controls and management processes are now tight and fit for purpose and we have a management team in place that is capable, motivated and has demonstrated an incredible commitment to set this company back on a course whereby shareholders can have full confidence in our operations.

And you have a largely new Board that is committed to high governance standards and to rebuilding value for all shareholders.

On that note – and before we open up to questions - I would like to ask Lachie to provide a brief overview of how the business is currently tracking.

Speaker: Lachlan McKinnon, Managing Director & Chief Executive Officer

Business update: unscripted

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About PET

Phoslock Environmental Technologies Limited (ASX: PET) specialises in engineering solutions and water treatment products to remediate polluted lakes, rivers, canals and drinking water reservoirs.

Headquartered in Melbourne, PET has offices in Brisbane, Beijing, Bremen (Europe) and Manchester (UK). PET also has registered entities in Canada and the USA, and manufacturing operations based in Changxing, China. PET is represented by licensees, distributors and agents in ten other countries including SePRO Corporation in the United States and HydroScience in Brazil.

Phoslock® is a proprietary and unique water treatment product that permanently binds excess phosphorus in the water column and sediments.

Phoslock is certified for use in drinking water in North America, Europe, Brazil, Australia, and China. Along with Phoslock, PET also supplies zeolites and specialised strains of bacteria that address water pollution issues.

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