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**Company:**

Duoyuan Global Water Inc. (DGW)

**Industry:**

Water Treatment

**Recommendation:**

Strong Sell

**Estimated Value:**

< \$1.00

**Report Date:**

April 4, 2011

**Price:**

\$5.49

**Market Cap:**

135.11 million

**Float:**

10.3 million

**Avg Volume:**

416,379

- We estimate DGW's actual revenue is no greater than US\$800,000 annually, versus the US\$154.4 million it claims. Our estimate is based on DGW's PRC audit report, which is highly reliable.
- Muddy Waters caught DGW red handed forging its PRC audit report. DGW's actions validate the audit report's significance.
- Our extensive surveillance of DGW's factory confirms our revenue estimates.
- We identified four errors in DGW's US audit, which indicates the auditor was sloppy.
- DGW has much in common with its troubled sister company, DYP. We believe these commonalities further DGW's fraud.
- DGW engages in improper undisclosed related party transactions that transfer money to its chairman.

## **DGW: Clean Water, Dirty Money**

### **DGW: 多元差得多远?**

Muddy Waters, LLC estimates that Duoyuan Global Water's ("DGW") value is less than \$1.00 per share. DGW is a massive fraud, overstating revenue by over one hundred times. We estimate DGW's actual revenue is no greater than US\$800,000 annually. Our estimate is based on DGW's PRC audit report, which is highly reliable (the audit report is different than the controversial SAIC financial statements). Subsequent to our obtaining DGW's PRC audit report from its SAIC file, DGW replaced it with a forged audit report. DGW's actions validate the audit report's significance. Our extensive surveillance of DGW's factory confirms our revenue estimates. We identified four errors in DGW's US audit that indicate the auditor was sloppy. DGW has much in common with its troubled sister company, DYP. We believe these commonalities further DGW's fraud. DGW shows little evidence of using investor funds for capital expenditures. Its claimed distribution network is a sham. DGW engages in improper undisclosed related party transactions that transfer money to its chairman.

### **DGW is a Massive Fraud, Overstating Revenue by Over One Hundred Times.**

DGW is overstating its revenue by over one hundred times. It recently reported 2010 revenue of RMB 1.0 billion (US\$154.4 million), up from reported revenue of RMB 783.4 million (US\$114.8 million) in 2009.<sup>1</sup> In reality, DGW's 2009 revenue was RMB 3.3 million (US\$0.3 million) to RMB 5.6 million (US\$0.8 million). Our research indicates that 2010 revenue did not meaningfully grow.

The above actual figures are largely based on the 2009 audit report performed on the DGW subsidiary that manufactures all of DGW's products, Duoyuan Water Treatment Equipment Manufacturing (Langfang) Co. Ltd. ("DGW Langfang"). The audit report is included in DGW Langfang's SAIC file per local practice. The audit report should not be confused with the standard SAIC financial statements – it carries the attestation of a licensed PRC auditor and anti-forgery seals. Lest there be any doubt about the audit report's significance, subsequent to our first viewing of the SAIC file, DGW replaced the audit report with a forged one that shows financials matching those it reports to investors. We herein compare the genuine and forged audit reports, both of which are available for download in full on the Muddy Waters website at:

Genuine: [www.muddywatersresearch.com/wp-content/uploads/2011/04/LangfangWater2009Original.pdf](http://www.muddywatersresearch.com/wp-content/uploads/2011/04/LangfangWater2009Original.pdf)

Forgery: [www.muddywatersresearch.com/wp-content/uploads/2011/04/LangfangWater2009Fake.pdf](http://www.muddywatersresearch.com/wp-content/uploads/2011/04/LangfangWater2009Fake.pdf)

Given the effort to which DGW went to cover up its 2009 audit report – specifically, forging documents for its government file – investors should place significance on it.

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<sup>1</sup> <http://www.sec.gov/Archives/edgar/data/1465317/000095012311027953/0000950123-11-027953-index.htm>

Our extensive surveillance of DGW's factory supports the RMB 2.3 million (US\$0.3 million) revenue figure. As detailed in the next section, we saw no product shipments and very little manufacturing activity during our tours and surveillance of the factory.

Duoyuan Clean Water Technology Industries (China) Co. Ltd. ("DGW Beijing") 2009 SAIC financial statements showed revenue of RMB 3.3 million (US\$0.5 million), and a loss of 30.5 million (US\$4.5 million). These numbers likely consolidate some – if not all – of DGW Langfang's results. Thus DGW's consolidated 2009 revenue ranges from RMB 3.3 million (US\$0.5 million) to RMB 5.6 million (US\$0.8 million).

Until October 2009, DGW's corporate structure was simple – DGW Langfang produced all of DGW's products at its facility at 6 Xiangyundao Road. It then sold the products to DGW Beijing, which in turn sold them to DGW's distributors. (In *Different Flowers from the Same Garden: DGW and DYP*, we discuss how DGW's corporate structure became significantly more complicated post-IPO in order to make it easier to drain investor funds.) Historically DGW booked approximately 75% of its consolidated revenue in Langfang and the balance in Beijing. Because Langfang is the heart of DGW's operation, we focused our research on it.

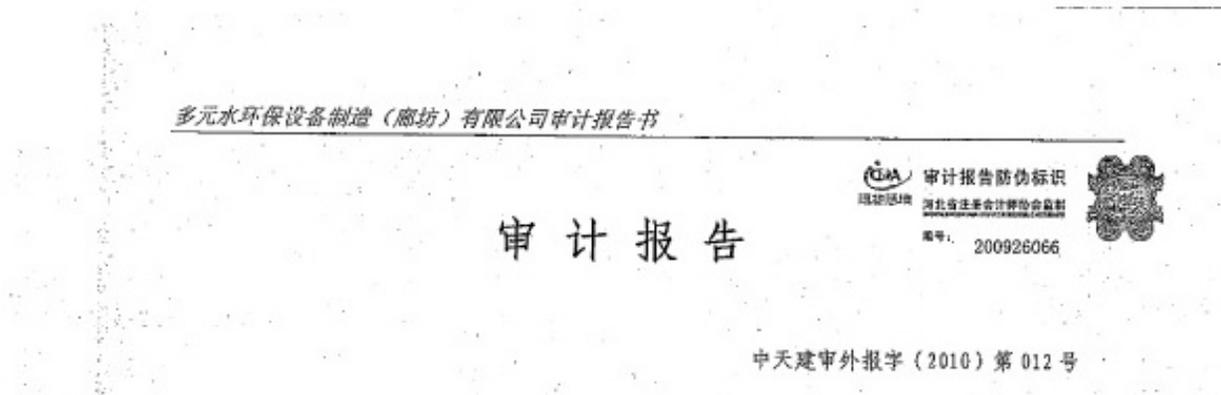
### **Creating Value DGW Style: Forging PRC Audit Reports.**

Muddy Waters caught DGW red handed (and hopefully red faced, but we doubt that Chairman Guo really cares). It replaced the genuine 2009 audit report in its SAIC file with a forged 2009 audit report. Again, audit reports are available for download on the Muddy Waters website (see *supra* for links).

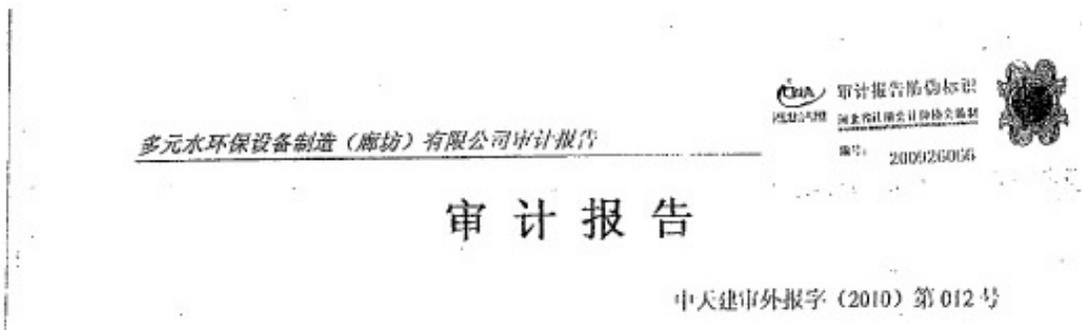
We viewed and copied DGW Langfang's SAIC file in February and March 2011. Subsequent to our obtaining the genuine DGW Langfang 2009 audit report in February, which shows that it only generated 2009 revenue of US\$0.3 million, DGW replaced the report with a forgery. The forged report shows DGW Langfang generated 2009 revenue of US\$85.7 million. DGW also inserted a forged 2008 audit report that shows revenue of US\$61.7 million. DGW had clearly become worried about being exposed as a fraud, and was taking countermeasures.

We authenticated the original 2009 audit report, which was prepared and certified by Langfang Zhongtianjian Certified Public Accountants Co. Ltd., as accurate and genuine by two means: 1) we compared the documents with audit reports issued by the same auditor for other Langfang-based entities controlled by Chairman Guo, and 2) we had an experienced PRC auditor review all of the reports. The following describes some of the major telltale signs of forgery by comparing the two 2009 audit reports:

1(a) The genuine 2009 report, page three: Letter from the Auditor – the upper right corner contains an anti-forgery seal.



1(b) The forged 2009 report, page two: Letter from the Auditor. Note the differences, the seal appears to have been photocopied, cut and glued. The seal number is the same as the one on the genuine report; however, the insignia lacks the clarity of that on the genuine report. Note also how the seal is out of alignment with the masthead. Further, part of the masthead is obscured.



2(a) The genuine 2009 audit report, page four: letter from auditor signature page. The date of the letter is March 3, 2010.



2(b) The forged 2009 audit report, page three: letter from the auditor signature page. The date is clear to non-Chinese speakers because the forger did not use Chinese characters for the numbers. The signatures below differ from those above, as do the accountants' personal seals. The audit firm's seal below may or may not be forged – if it is not forged, it would imply that DGW had some cooperation from the audit firm in forging the report.



3(a) The genuine 2009 audit report, page five: the 2009 income statement showing RMB 2.3 million revenue (US\$0.3 million) and a loss of RMB 6.5 million (US\$1.0 million). Note the auditor's seal in the bottom right corner. This seal is on every page of the genuine report.

附件1-1

### 应纳税所得额调整表

2009年度

编制单位：多元水环设备制造（廊坊）有限公司

金额单位：元

项 目	本年数	调整数	审定数
一、营业收入	2,327,492.13		2,327,492.13
减：营业成本	1,897,232.21		1,897,232.21
营业税金及附加			0.00
销售费用	480,302.19		480,302.19
管理费用	6,455,756.26		6,455,756.26
财务费用	9,226.87		9,226.87
资产减值损失			0.00
加：公允价值变动收益			0.00
投资收益			0.00
其中：对联营企业和合营企业的投资收益			
二、营业利润	-6,515,025.40	0.00	-6,515,025.40
加：营业外收入	50,500.00		50,500.00
减：营业外支出	84,820.55		84,820.55
其中：非流动资产处置损失			
三、利润总额(亏损总额以“-”号填列)	-6,549,345.95	0.00	-6,549,345.95
加：纳税调整增加额		93,989.40	93,989.40
减：纳税调整减少额			0.00
五、本年度应纳税所得额	-6,549,345.95	93,989.40	-6,455,356.55

单位负责人：郭文华

财务负责人：杨志新



3(b) **Now THAT's creating value!** The forged 2009 audit report, page five: the 2009 income statement showing RMB 585.1 million revenue (US\$85.7 million) in 2009, and RMB 421.2 million (US\$61.7 million) revenue in 2008. The income statement shows profit of RMB 136.8 million (US\$20.0 million) and RMB 85.7 million (US\$12.6 million) in 2009 and 2008, respectively. Note that there is no auditor's seal in the bottom right corner. In stark contrast to the genuine report, none of the pages in the forged report have an auditor's seal in the bottom right corner.

### 利润表

多元水环保设备制造(廊坊)有限公司		2009年度
项目	上年数	本年数
产品销售收入	421,202,564.00	585,105,324.09
其中：出口产品销售收入		
减：销售折扣与折让		
产品销售净额	421,202,564.00	585,105,324.09
减：产品销售税金		
产品销售成本	306019358.2	383333502.9
其中：出口产品销售成本		
产品销售毛利	115,183,205.79	201,771,821.23
减：销售费用	5,061,504.90	5,395,569.20
管理费用	12,316,796.11	14,156,313.45
财务费用	-102,809.24	-235,600.33
其中：利息支出（减利息收入）		
汇兑损失（减汇兑收益）		
产品销售利润	97,907,714.02	182,455,538.91
加：其他业务利润		
营业利润	97,907,714.02	182,455,538.91
加：投资收益		
加：营业外收入		
减：营业外支出		
加：以前年度损益调整		
利润总额	97,907,714.02	182,455,538.91
减：所得税	12,238,464.25	45,613,884.73
净利润	85,669,249.77	136,841,654.18

In addition to the foregoing, the forged reports are approximately half the length of the genuine report. The main difference is that the notes to the financial statements in the forged reports are abbreviated. Forging the notes so that they correspond to the forged financial statements would take more time. We believe that DGW felt a sense of urgency about engaging in a cover up, which caused it to hastily forge the reports.

### **DGW Langfang: Less a Factory and More an Adult Daycare Center<sup>2</sup>**

We conducted extensive surveillance on DGW, during which we saw minimal production, no shipments (in or out), and got the impression that the workforce was largely being paid to be physically present.

We conducted surveillance on DGW's factory in Langfang, Hebei on five occasions between January and April 2011, including constant surveillance for approximately 80 consecutive hours in March 2011. During this time, we witnessed no trucks entering or exiting the factory. The only delivery we noticed was a tuk tuk (a motorized rickshaw) that dropped off a small package. This means that DGW neither shipped nor received product during this time. At a minimum, we would expect to see several trucks everyday delivering raw material, parts, and components. We would also expect to see several trucks everyday picking up finished product for delivery to distributors and customers. Nearby factories (none of which belong to companies that are public in the US) showed such activity.

Despite having two factory buildings each about 200,000 square feet (i.e., each close in size to four football fields), there were few signs of human activity. The only significant movements we witnessed took place between 8:20 am and 8:40 am when approximately 240 workers arrived to start their workdays, 5:30 pm when the same number of workers went home, and 10:00 am when some workers headed to a breakfast cart in front of the factory. The sole manufacturing facility of a rapidly growing company selling one billion RMB of product annually should be a hive of activity with production workers scurrying about, and a bustling shipping and receiving department.

There is a significant discrepancy between the number of workers DGW claims to have at Langfang and the number it actually does have. We spoke with several employees who stated that DGW Langfang has approximately 200 employees. We counted approximately 240 employees during our surveillance.<sup>3</sup> In contrast, Chairman Guo claimed that there are 580 employees at the Langfang factory as of March 2011.<sup>4</sup> (Note the 580 production employees is a decrease from the 813 workers stated in DGW's F-1.)<sup>5</sup> Moreover, Chairman Guo claimed that 170 employees (of the 580) work the night shift. We saw no workers come or go for a night

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<sup>2</sup> Thanks to Roddy Boyd for coining this term in his description of China MediaExpress Holdings' (NASDAQ: CCME) corporate office, which also served a primary function of furthering stock fraud. See [www.thefinancialinvestigator.com](http://www.thefinancialinvestigator.com) - CCME: Fiction's End.

<sup>3</sup> We are confident that most of DGW's workers live outside of the factory. Were they living at the factory, there would be food deliveries made two to three times per day. Our surveillance shows that this is not the case.

<sup>4</sup> DGW March 23, 2011 conference call to discuss Q4 and fiscal 2010 results (Q&A portion).

<sup>5</sup> DGW F-1, p. 102.

shift, and the factory and its grounds were completely dark from 6 pm onward. Unless the 170 workers wear night vision goggles, it would be very difficult for them to work.

In conversations with DGW employees, we learned that most of the office workers are recent college graduates. They are apparently paid average wages for the area, but accepted the offer from DGW because they had no alternatives. It seems that many of the employees are searching for jobs elsewhere.

During our three tours of the factory, we witnessed minimal production activity. There was much work in progress laid out on display, but few workers and tools around it, and little noise or material movement. The production equipment we saw was not particularly sophisticated; rather, it was typical of Chinese manufacturers, involving lower-end Chinese made equipment and relying on labor-intensive (versus machine intensive) production practices. More importantly, results of the multi-million dollar capital investment projects and upgrades DGW claims to have undertaken were conspicuously absent (see DGW Shows Little Evidence of Using Investor Funds for Capital Expenditures).

### *Beijing – Little to Nothing Doing*

We obtained the 2009 Annual Inspection report for Beijing, which shows that it generated revenue of RMB 3.3 million in 2009. The Annual Inspection report is derived from the SAIC financials. This number likely consolidates some – if not all – of DGW Langfang’s revenue. We think it likely consolidates all of DGW Langfang’s revenue because if we assumed that Beijing generates 25% of actual revenue (the same as its proportion of reported revenue), then its 2009 revenue would have been RMB 0.8 million (US\$0.1 million), giving the Company a total 2009 revenue base of RMB 3.1 million (US\$0.4 million).

We visited DGW’s Beijing headquarters on two occasions – once to call on DGW as a potential client, and once to inquire about renting office space. DGW occupies a small portion of the building, and had only four employees (and many empty desks) in the office when we visited. Contrary to disclosures in DGW’s SEC filings, companies with no affiliation to the Duoyuan Group rent the majority of the space in the building. Despite DGW’s claim that its founder / chairman / CEO, Wenhua Guo, devotes most of his time to running DGW,<sup>6</sup> two Beijing office employees stated that Chairman Guo is rarely in the office.

### **There are Major Errors in DGW’s Audit, Showing Inattentiveness and Providing Management the Opportunity to Perpetuate the Fraud.**

There are four clear indications that DGW’s auditor, Grant Thornton Hong Kong,<sup>7</sup> was inattentive during its audits of DGW.

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<sup>6</sup> DGW 2009 20-F, p. 15.

<sup>7</sup> Grant Thornton’s Hong Kong office merged with the Hong Kong office of BDO International in November 2010. This follows the October 2009 disappearance of GT Hong Kong’s managing partner amid allegations that he stole over \$12 million from friends and clients. (<http://www.cfoinnovation.com/content/commentary-when-accountant-disappears>) These events raise serious questions about the culture of GT’s Hong Kong office, and may partly

- The auditor failed to detect that DGW is claiming to make rent payments to a landlord when DGW actually owns the building in which it claims to lease space. We question where the purported rent payments really go.
- The auditor failed to see that DGW's financial statements accounted for the purported land transfer in a way that improperly boosted 2008 operating cash flow.
- The auditor also failed to see that the loan Chairman Guo repaid to DGW in 2008 also improperly boosted 2008 operating cash flow. These combined misclassifications boosted operating cash flow by RMB 88.3 million (US\$12.9million), or 57.6%.
- Our manufacturing experts believe that it is impossible for DGW to have zero work in process inventory as of December 31, 2008 and 2009 while generating anything close to the sales volumes and growth it claims. We believe that an attentive auditor would have found the lack of work in process to be a significant issue – in fact, the SEC's Corporate Finance division flagged it as a potential problem in September 2010.<sup>8</sup>

### *The Property Swap that Wasn't*

DGW claims that in 2008 it swapped its Beijing office building at 3 Jinyuan Road for a factory at 6 Xiangyundao Road in Langfang owned by a non-public entity controlled by Chairman Guo, Duoyuan Information Terminal Manufacturing (Langfang) Co. Ltd. ("Terminal").<sup>9,10</sup> In reality, Terminal was wound up by March 2008 – prior to DGW's IPO – and merged into DGW Langfang. By virtue of the merger, the property that Terminal owned was also merged into DGW Langfang. However, DGW Beijing, which owned the office building that was purportedly swapped for Terminal's property, never transferred ownership of the building to Terminal (in which case it would have reverted to DGW Langfang because of the merger). Our attorney viewed the current building ownership record, which show that DGW Beijing has remained the owner.

DGW's SEC filings claim that the value of each property was approximately RMB 75 million at the time of the swap (approximately \$11 million).<sup>11</sup> We believe that the values of both properties were nowhere near that level – particularly Terminal's factory. Terminal's factory requires local government approval to be transferred because it was likely purchased with a government subsidy. Therefore, this land is inherently less valuable than freely alienable land. Further our inquiries in Langfang indicate that Terminal was a troubled business by 2007, thus Chairman Guo had nothing to lose by merging Terminal into DGW.

It is difficult to say with certainty why DGW used the purported swap as a mechanism to transfer in ownership of Terminal's factory, and why it never completed the outbound transfer. The best explanation we have developed is that Chairman Guo wanted to inflate the size of DGW's balance sheet as much as possible in preparation for its 2009 IPO, and that he was able to do so

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explain the deficiencies in DGW's audits. Following the merger, DGW has engaged BDO's Hong Kong office as its auditor.

<sup>8</sup> <http://www.sec.gov/Archives/edgar/data/1465317/000000000010057876/filename1.pdf>

<sup>9</sup> 20-F, p. 42.

<sup>10</sup> Note that DGW's filings sometimes refer to this entity as Duoyuan Facsimile, which is incorrect.

<sup>11</sup> DGW F-1 (filed January 11, 2010), p. 123.

by “paying” in kind. We think that the reason Chairman Guo never transferred out the DGW Beijing property is that the transfer taxes DGW would have to pay would show that the office building (and therefore Terminal’s factory) were worth nowhere near their purported values.

#### *Auditor Sloppiness Regarding DGW’s Purported Rent Payments*

The auditor evidently has not detected any irregularities in the rent that DGW purports to pay to Terminal, despite 1) Terminal having been wound up and merged into DGW in 2008, prior to DGW’s IPO, and 2) DGW’s never having transferred to Terminal the office building that DGW purports to lease. This rent totaled RMB 1.1 million (US\$160,000) in 2009.<sup>12</sup> Had the auditor realized that DGW is not actually paying rent to Terminal, it is likely that investors would have asked a number of pointed questions of DGW sooner.

DGW’s sister company, Duoyuan Printing, Inc. (“DYP”) also purports to have paid US\$0.2 million in rent to Terminal in fiscal 2009<sup>13</sup> for space in the same building. We question where this money really goes (along with the rent that DGW pays). Further, our fieldwork indicates that the vast majority of the Beijing office building is rented out to parties unaffiliated with the Duoyuan companies, which undermines DGW and DYP’s contentions that that they each rent substantial portions of the building. We estimate the rent that is collected on the building annually to be approximately RMB seven million (US\$1.0 million).

#### *Auditor Failing to Detect Incorrect Classification of the Purported Property Transfer on the Cash Flow Statement*

DGW’s auditor was clearly inattentive in not seeing that DGW had misclassified property deposits in the cash flow statement in a way that artificially boosted its pre-IPO year operating cash flow. DGW purports to have agreed to acquire Terminal’s property for RMB 75.6 million cash, and having paid a deposit of RMB 44.5 million (US\$6.5 million) in 2007 prior to engaging in the swap. DGW further purports that after agreeing to the swap with Terminal, Terminal returned the deposit in 2008.<sup>14</sup> Because these payments relate to the purchase of capital assets, they should be classified on the cash flow statement as investing activities. However, DGW recorded them as operating cash flow items.<sup>15</sup> The effect was to bump up 2008 operating cash flow (the fiscal year prior to the IPO) by RMB 44.5 million.

#### *Auditor Failing to Detect Incorrect Classification on the Cash Flow Statement of the Loan Chairman Guo Repaid in 2008*

DGW shows a related party loan repayment as a cash flow from operations, improperly boosting 2008 operating cash flow by RMB 43.8 million (US\$6.4 million) in preparation for DGW’s IPO. Chairman Guo repaid in 2008 RMB 43.8 million in loans DGW made to two entities Guo controls entirely: Beijing Huiyuan Duoyuan Digital Printing Technology Institute (“Huiyuan”)

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<sup>12</sup> DGW 2009 20-F, p. F-25.

<sup>13</sup> DYP Fiscal 2009 10-K, p. 28.

<sup>14</sup> Supra FN 10.

<sup>15</sup> See DGW 2009 20-F, p. 25 and F-1, p. F-15.

and Huanan Duoyuan Water Supply Co. Ltd.<sup>16</sup> DGW shows the repayment of the loan as an operating cash flow in its 2008 (again, the year before its IPO) financial statements.

The proper classification of the loan repayment is a cash flow from financing activities, rather than cash flow from operations. Neither company is a supplier or customer of DGW, although as we discuss *infra* in DGW Engages in Improper Undisclosed Related Party Transactions that Transfer Money to Chairman Guo, the relationship between Huiyuan and DGW is improper and most likely detrimental to DGW shareholders' interests. Because neither company is a customer or supplier of DGW, then the repayment should not be classified as a cash flow from operations.

*Auditor Credulous of No Work in Process at Year End – We Are Not*

Grant Thornton has made an obvious error in its audit by not taking issue with DGW's claims of having no work in process as of December 31, 2008 and 2009. Interestingly, the genuine 2009 PRC audit report for DGW Langfang facility shows work in process of RMB 3.3 million (US\$0.5 million) as of December 31, 2009.<sup>17</sup> The forged audit report even shows work in process of RMB 1.7 million (US\$0.2 million) as of December 31, 2008 (it shows no work in process as of December 31, 2009). Muddy Waters' manufacturing experts believe that it would be impossible for DGW to have no work in process as of year-end 2008 and 2009 were it generating anywhere close to the level of revenue and year-over-year growth it claims. In a manufacturing operation engaged in regular production of a variety of standard and custom manufactured parts, work in process would typically range between 20% to 40% of current orders.<sup>18</sup> Further, DGW proudly states it utilizes an enterprise resource planning ("ERP") system. One of the basic benefits of an ERP system for a manufacturer is that it allows for real-time monitoring of raw material, work in process, and inventory levels so that management can monitor the business's performance on an ongoing basis without a disruption or stopping production. We emailed DGW's CFO to ask a) why the PRC audit report for Langfang disagrees with the US GAAP audit with respect to work in process, and b) why the work stoppage to facilitate the inventory count is necessary when DGW has an enterprise resource planning system. He responded that he would speak with the Company to clarify.

The SEC flagged the lack of work in process as an issue in September 2010.<sup>19</sup> DGW responded to the SEC query by stating that starting in 2008, the Company "elected to complete production of then existing work in process and suspend manufacturing of all further work in process prior to the inventory count cutoff dates" in order to perform a complete physical inventory;<sup>20</sup> however, this explanation does not hold water. The negative impact from a major, long-term, company-wide disruption in production and business would far outweigh the benefit of facilitating an inventory count and valuation. Again, the ERP system would make this entirely unnecessary.

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<sup>16</sup> DGW F-1, p. F-15.

<sup>17</sup> Genuine 2009 DGW Langfang PRC Audit Report, Notes to Financial Statements p. 6.

<sup>18</sup> Interviews with US and Chinese manufacturers, Feb and March 2011.

<sup>19</sup> *Supra* FN 8.

<sup>20</sup> <http://www.sec.gov/Archives/edgar/data/1465317/000095012310097028/filename1.htm>, p. 3.

Because DGW claims that it is experiencing consistently expanding sales revenues, it would be impossible to stop all production on 90 products and take a count of completed products without having any significant impact on company performance. To do as DGW claims would mean to halt all incoming orders, and slowly push out all current orders until 100% of all production is in a completed state. (Stopping new production in a factory generating revenue comparable to that DGW claims may be possible in a situation where the company is only engaged in plastic injection molding or making another short production cycle product.) However, the production cycle of most of DGW's equipment and products should be approximately 30 days or more.<sup>21</sup> If DGW's claims were true, it would be halting production on new orders sometime in late November or early December in order to clear the schedule of existing production and prepare for the year end count of all inventory. With the timing of Chinese New year, at which time most Chinese factories halt production, DGW would be planning for major, back to back disruptive events, thus requiring it to either refuse new orders in November or force customers to wait until sometime in late February (at the earliest) to receive their shipments. In other words, DGW would be delaying or refusing new orders for a period of approximately three months. Based on our discussions with competitors, this would be atypical for the industry.

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<sup>21</sup> Our interviews with DGW's competitors indicate that the typical production cycle for DGW's products is 30 to 60 days.

Nevertheless, to illustrate the improbability of having no work in progress at any time, Muddy Waters photographed two competitors' operations. The below photographs show that the accumulated work in process throughout the factories is extensive:



DGW claims to have an ERP system to manage its manufacturing processes. The ERP system supposedly tracks all materials and orders, and “integrate(s) all ... data and processes into a unified system and use a centralized database to store information.”<sup>22</sup> Such a system should be able to rapidly calculate work in process without a significant disruption or even a temporary stoppage of production.

### **Different Flowers from the Same Garden: DGW and DYP.**

We express no opinion on DGW’s troubled sister company, DYP, other than to note we uncovered that the land DYP claims to own actually belongs to a similarly-named entity 100% owned by DGW / DYP Chairman Guo (by way of an intermediary entity).<sup>23</sup> DGW has five characteristics in common with DYP that we believe are important to DGW’s fraud.

Both companies claim to sell through networks of independent distributors, which can make it easier to control the customer verification process during the audit. DYP claims to have over 85 distributors in 28 provinces of China.<sup>24</sup> DGW claims to have over 80 distributors in 28 provinces of China.<sup>25</sup> Book cooks tend to like purporting to sell to distributors more than to end users because 1) it is easier to get confirmation of receivables and revenue (the response rate tends to be high when selling through a largely invented distribution network), and 2) there is no need to come up with new customers to support increasing sales.

Both companies have (or had in the case of DYP) CFOs who had no China experience and who do not speak Chinese. DGW’s CFO, Stephen Park, is an American-born Korean. DYP’s former CFO, William Suh, is also an American-born Korean. Both were hired from the United States, and neither speaks Chinese. Muddy Waters is inherently suspicious of companies that hire CFOs without China experience or Chinese language skills. In such situations, it is easy for the chairman to wall off the CFO, then commit fraud and steal money without the CFO’s knowledge.

Both companies formed numerous subsidiaries after going public and raising money. DGW and DYP formed their subsidiaries in Beijing and Langfang, Hebei, which have been their bases of operation; therefore, these subsidiaries have not served to expand the companies’ geographic reaches. While the ostensible purpose of forming the subsidiaries is to enter new lines of business and increase existing production capacity, we are skeptical.

On the other hand, forming numerous subsidiaries can make it easier to drain shareholders’ money from the companies. More subsidiaries creates greater complexity, particularly when combined with the undisclosed related-party transactions in which DGW engages (see DGW Engages in Improper Undisclosed Related Party Transactions that Transfer Money to Chairman

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<sup>22</sup> 20-F, p. 35

<sup>23</sup> The entity that owns the land is Langfang Duoyuan Digital Technology Co., Ltd. (廊坊多元数码技术有限公司), which Chairman Guo likely intended to be confused with Duoyuan Digital Printing Technology Industry (China) Co. Ltd. (多元数码印刷技术产业(中国)有限公司)

<sup>24</sup> DYP 2009 10-K, p. 2.

<sup>25</sup> 20-F, p. 36.

Guo). In other words, the complex structure enables the chairman to play a shell game with money. Further, companies with less capitalization receive less scrutiny in the PRC, which makes it easier to fool the local regulators.

Both companies announced aggressive capital expenditure programs after going public. As we state *infra*, we believe that much of DGW's reported and planned capital expenditures are illusory. We cannot opine on those of DYP, but we invite readers to form their own inferences.

Both companies misrepresent property transactions in their public filings. Because property is a high priced asset, it is at the center of much corporate malfeasance in China. DGW mischaracterizes how its Langfang subsidiary obtained a portion of its property. As discussed *supra*, DGW claims that it obtained the land via a swap with another company that Chairman Guo owns; however, this is untrue. DYP claims to own land underlying its factory that it does not. One of Chairman Guo's own companies, Langfang Duoyuan Digital Technology Co., Ltd., owns the land. Note that the Chinese and English names for this company are quite similar to those of a subsidiary of DYP. We doubt that the similarity of the names is coincidental; we believe that the names are intended to confuse.

### **DGW Shows Little Evidence of Using Investor Funds for Capital Expenditures**

We are skeptical that funds raised have been used for their intended purposes – particularly with respect to capital expenditures. DGW has raised a net total of US\$170.2 million from investors since going public in June 2009. As of December 31, 2009, DGW purported to be in the process of capital investments (excluding land purchases and development) of US\$18.0 million. On our three visits to the factory, we have seen little evidence of capital investment in machinery. Many of the processes we observed were performed manually, whereas in a well-managed and well-capitalized factory, we would have found automation instead.

DGW has acquired land in Daxing as it has announced, and DGW is building on it. However, we are skeptical regarding how funds will actually be used for this project. It is clear that DGW has no need for additional capacity. Therefore any such investment is likely to be a financial black hole.

### **DGW's Claimed Distribution Network is a Sham.**

DGW claims to sell its product to over 80 distributors in 28 provinces<sup>26</sup>. In reality, its distribution network is barely existent at best. As we discuss *supra*, many book cooks consider claiming to use a distributor business model advantageous to committing fraud. We posed as a potential customer and met with DGW's marketing manager. He was unable or unwilling to identify any distributors. DGW's SAIC files indicate that DGW created sales offices around the country several years ago; however, we were unable to locate any at their previously advertised addresses. We believe that the sales offices no longer exist. We received contact information for one distributor from an investor who performed due diligence on DGW in 2009. When we

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<sup>26</sup> *Supra* FN 25.

contacted this distributor, he expressed that DGW's primary business is in the stock market, and thus he does not sell DGW much product any more.

We met with DGW marketing manager Liu Huanzhen attempting to buy water treatment equipment. He informed us that we would have to place orders through one of DGW's distributors. He did state that DGW has 80 distributors. We asked him for a referral to a distributor, and he refused to provide any names or contact information. In other words, it appears to be impossible to become a DGW client. In a separate inquiry we made to a DGW sales employee, we specifically inquired as to whether there was a sales office or distributor in the greater Shanghai with which we could work. The employee told us that DGW had neither in the Shanghai area. This would be highly unusual for a company of appreciable scale in China, and directly contradicts the map of DGW's purported distribution contained in its 20-F<sup>27</sup> and F-1 in which Shanghai and its neighboring provinces have 23 distributors.



Referring to the SAIC files, we searched online for DGW sales offices in various cities. We found websites and listings on B2B sites, including Alibaba, for purported DGW sales offices. We then called ten of the offices we found through these sources. The numbers either were disconnected or the people answering the telephones had never heard of DGW. We provide screen shots of the 10 webpages with the contact information for the sales offices as a download from our website at:

[www.muddywatersresearch.com/wp-content/uploads/2011/04/DGWSalesOffices.pdf](http://www.muddywatersresearch.com/wp-content/uploads/2011/04/DGWSalesOffices.pdf)

<sup>27</sup> Courtesy of DGW's 2009 20-F, p. 36.

We have posted a video of our attempts to call DGW's sales offices on You Tube at the following URL:

[http://www.youtube.com/watch?v=uDSlymgaH\\_g](http://www.youtube.com/watch?v=uDSlymgaH_g)

We contacted one real distributor of DGW product. The information came from an investor who performed due diligence on DGW in 2009. The distributor is based in northeast China. His comments were:

- DGW's prices are too high.
- Few customers request DGW's product.
- DGW is not competitive, and does a poor job of marketing and promotion.
- DWG products make up a tiny portion of his sales.
- DGW's main focus is on making money on stocks.

To create and then dismantle a sales network, replacing it with a loosely controlled distribution network upon which the Company becomes completely dependent defies conventional business wisdom. It only makes sense if the objective is to create opacity and obfuscate actual business performance.

### **DGW Engages in Improper Undisclosed Related Party Transactions that Transfer Money to Chairman Guo.**

DGW Langfang's audit report shows that it is transferring money in undisclosed transactions to a company owned by Chairman Guo, Beijing Huiyuan Duoyuan Digital Printing Technology Institute ("Huiyuan").

Huiyuan, a sole proprietorship, is a special type of legal entity that is particularly opaque, and therefore well-suited for draining money from DGW. Guo established Huiyuan in 2000 as a sole proprietorship with registered capital of RMB 30,000 (approximately US\$3,600 in 2000). Sole proprietorships do not pay enterprise income tax, are not audited, and thus receive less scrutiny from the tax bureau and SAIC. Shareholders of sole proprietorships are deemed to be the legal owners of the proprietorships' assets.<sup>28</sup>

According to the genuine 2009 audit report for DGW Langfang, DGW Langfang had improper payables owed to Huiyuan as of December 31, 2009. (We show the page from the audit report listing these payables in Appendix A.) In the audit report, we see Chairman Guo attempting to obscure this information. The audit report lists different payables to Huiyuan using different Chinese characters (but having the same pronunciation) for Huiyuan's name.<sup>29</sup> We have searched for the alternate entity, but there is none. Thus, both names refer to the same entity, which Chairman Guo solely owns.

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<sup>28</sup> There is no limitation on liability for sole proprietorship shareholders.

<sup>29</sup> Huiyuan was alternately written in the genuine 2009 audit report as 慧元研究所 and 惠元研究所.

The 2009 Annual Audit Report of DGW Langfang showed an account payable balance of RMB 26.2 million (US\$3.8 million) to Huiyuan at year-end. The payable grew 434% during 2009. This payable is unusual because (among other reasons) the payable is far more than the revenue DGW Langfang generates. Further, Huiyuan is in the printing business (if it has a business other than tunneling cash out of DGW) – we cannot conceive of a justification for DGW to be doing business with Huiyuan. Most importantly, DGW does not disclose these related party transactions in its SEC filings.

Despite Huiyuan's equity capital being de minimus, and recording no revenue in 2009 according to its SAIC file, it has managed to make investments totaling at least RMB 30.5 million (US\$4.5 million) in other entities over the years.

### **DGW's Internal Review**

On September 28, 2010, DGW announced that its board of directors had engaged Skadden, Arps, Slate, Meagher & Flom LLP to conduct a review of DGW's internal controls.<sup>50</sup> We understand that the review has taken longer than originally expected. Given our findings, Muddy Waters expects the review to identify material deficiencies.

### **Estimated Value**

We estimate DGW's value at less than \$1.00 per share. Muddy Waters, LLC believes that DGW is the biggest fraud we have encountered so far in terms of revenue overstatement. We are unable to determine how much cash is left in the Company, and we believe that the book values of assets are overstated. Unfortunately we believe that shareholders will ultimately be able to recover very little of value from the Company.

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<sup>30</sup> <http://www.sec.gov/Archives/edgar/data/1465317/000095012310089367/h04504e6vk.htm>

## **Appendix A**

Genuine 2009 DGW Langfang PRC Audit Report, Notes to  
Financial Statements page 8 (showing Accounts Payable to  
Huiyuan)

(十二) 应付工资

项 目	期初余额	期末余额
工资	479,111.45	550,643.00
住房公积金	70,029.20	62,064.12
养老保险	76,252.96	47,512.92
医疗保险	26,195.76	13,879.65
失业保险	4,938.12	4,561.29
大病统筹	190.00	944.12
工伤保险	1,158.38	1183.30
其他	101,306.70	0.00
<u>合 计</u>	<u>759,182.57</u>	<u>680,788.40</u>

(十三) 其他应付款

项 目	期初余额	期末余额	账 龄	比例%
水环保（中国）	699,914.66	1,703,733.97	3年以上	5.91
北京多元电气	52,637.95	13,619.00	3年以上	0.05
慧元多元研究所	4,867,284.65	26,237,801.09	3年以上	91.03
肯缪斯	300,000.00	300,000.00	3年以上	1.04
集团	822,898.38	0.00	3年以上	0.00
廊坊水环保	7,028,895.54	0.00	3年以上	0.00
信息中国	3,304,731.79	0.00	3年以上	0.00
廊坊数码	2,053,557.70	0.00	3年以上	0.00
其他	431,127.87	568,145.65	滚动	1.97
<u>合 计</u>	<u>19,561,048.54</u>	<u>28,823,299.71</u>		<u>100.00</u>

