Investing in Asia: Lessons from Recent Case Studies
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Presenters

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“...there were fake revenue in the past so there were fake cash recorded on the books.”

-Longtop’s Chairman in conversation with Deloitte
How do companies use accounting and financial reporting tricks to create a more favorable picture of financial health than the underlying economics of the business support?
Part I: Accounting landscape in Asia

Part II: Specific areas of concern and current shenanigans

Part III: Case studies
Part I: Accounting Landscape in Asia
Risks, Obstacles and Nuances to Analyzing Asian Companies

- Lack of access to certain data (e.g., insider sales, related parties)
- Language barrier
  - Local language news
  - Discrepancies between the local language filing and the English filing
  - Access to local filings (e.g., SAIC)
- Short interest
- Less frequent filings than in the U.S. (e.g., Hong Kong)
  - Even quarterly filings for ADRs are much less robust versus domestic filers
- Limited operating history
  - A lot of recent IPOs
- Different accounting and auditing standards
- Liquidity issues on certain exchanges
- Recent changes – Allowing Mainland companies listed in HK to have Chinese auditors and follow Chinese accounting standards
### Transition to IFRS

Transition approaches range from word for word adoption to adding local provisions to IFRS to working with the IASB to eliminate differences between local GAAP and IFRS over time (convergence).

<table>
<thead>
<tr>
<th>Country</th>
<th>Current Accounting</th>
<th>Transition to IFRS</th>
<th>Intended Transition Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Korea</td>
<td>K-IFRS</td>
<td>Adoption</td>
<td>2011</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>HKFRS</td>
<td>Adoption</td>
<td>2005</td>
</tr>
<tr>
<td>Singapore</td>
<td>SFRS</td>
<td>IFRS (Local Flavor)</td>
<td>2012 (?)</td>
</tr>
<tr>
<td>Australia</td>
<td>AAS</td>
<td>IFRS (Local Flavor)</td>
<td>?</td>
</tr>
<tr>
<td>India</td>
<td>Indian GAAP</td>
<td>IFRS (Local Flavor)</td>
<td>?</td>
</tr>
<tr>
<td>Taiwan</td>
<td>ROC GAAP</td>
<td>Proposed Adoption</td>
<td>2013 (?)</td>
</tr>
<tr>
<td>PRC</td>
<td>CAS</td>
<td>Convergence</td>
<td>2012 (?)</td>
</tr>
<tr>
<td>Japan</td>
<td>J-GAAP</td>
<td>Convergence</td>
<td>After 2015</td>
</tr>
</tbody>
</table>
PCAOB Presently Cannot Inspect Audit Firms in China; Meeting with Chinese Regulators Yielded Little

Foreign auditors may not adhere to PCAOB standards (Satyam’s auditor, PWC India was penalized).

Statement on Delegation to China
Washington, D.C., July 6, 2011  The Public Company Accounting Oversight Board announced today that a joint PCAOB and Securities and Exchange Commission delegation will meet next week in Beijing with representatives of China's Ministry of Finance and the China Securities Regulatory Commission...

The Sarbanes-Oxley Act of 2002 requires that all public companies whose securities trade on U.S. exchanges must use an audit firm that is registered with the PCAOB, regardless of where the public company and the audit firm are located. To date, the PCAOB has been blocked from conducting inspections of auditing firms in China due to sovereignty concerns raised by Chinese regulators.

Chinese and U.S. Regulators Held Meeting in Beijing On Audit Oversight Cooperation
Washington, D.C., Aug. 8, 2011  The Sino-U.S. Symposium on Audit Oversight was held in Beijing on July 11-12, 2011. In attendance were officials of the China Securities Regulatory Commission (CSRC), the Chinese Ministry of Finance (MOF), the U.S. Public Company Accounting Oversight Board (PCAOB), and the U.S. Securities and Exchange Commission (SEC). The symposium, which was contemplated by the outcomes of the third US-China Strategic and Economic Dialogue (S&ED), represented an important step toward Sino-U.S. cooperation on audit oversight of public companies. At the symposium, the officials briefed each other on their respective audit oversight system and inspection procedures. They also exchanged views on how to deepen cooperation on cross-border audit oversight....
Through candid discussions, the two sides enhanced mutual understanding, and discussed initial arrangements for follow-up collaboration.
SEC Tries to Force the Issue in Deloitte/Longtop Case

SEC Files Subpoena Enforcement Action Against Deloitte & Touche in Shanghai

Washington, D.C., Sept. 8, 2011 – The Securities and Exchange Commission today filed a subpoena enforcement action against Deloitte Touche Tohmatsu CPA Ltd. for failing to produce documents related to the SEC’s investigation into possible fraud by the Shanghai-based public accounting firm’s longtime client Longtop Financial Technologies Limited.

What is going on here? Opinion of a former SEC lawyer*:

“[The court action is essentially] a battle between the S.E.C. and Chinese regulators forcing D.& T. Shanghai to assert Chinese law as an explanation for why it cannot produce records... Auditing firms know that the S.E.C. has the right to subpoena and review and consider audit work papers. This is about bringing to a head the dispute over access to information relating to audits of Chinese companies.”

Unilateral Changes from Auditors?

Even without changes in the regulatory and oversight landscape, auditors may be changing their practices.

VanceInfo’s Q2 2011 conference call:

“By the way on our cash balance, **we were informed by our auditors that in response to investors general concerns on Chinese companies’ cash balances after the Longtop scandal, as part of the second-quarter review the auditors have performed audit procedures on cash balances** of all SEC-registered Chinese companies. Again this is for all SEC-registered Chinese companies. **In Q2 Deloitte has performed audit procedures rather than the regular review procedures on their cash balances.** As for Vanceinfo our eight largest bank accounts were selected for direct cash confirmation procedures with the banks. You are welcome to verify this enhanced procedure with the auditors.”

AsiaInfo-Linkage’s Q2 2011 conference call:

“In the second quarter of 2011 **we initiated our independent auditor to implement additional procedures on our cash and bank accounts, which are typical procedures conducted only for annual audits.** We provided the complete record of cash and bank accounts balance as of June 30 2011 for those procedures. Those procedures, on a sample basis, consist of obtaining bank account confirmation, accessing e-banking systems for short-term investments, and checking loan record status and other financial instrument records of the Company. These procedures were conducted independently by our independent auditor without the presence of AsiaInfo-Linkage personnel. We are confident and satisfied with the results of those additional procedures conducted by our independent auditor. Going forward, we will continue to cooperate with our independent auditor to perform procedures on items where it is deemed necessary on a quarterly basis and we are confident that the Company will maintain our stringent financial reporting, internal control and corporate governance standards.”
SEC Filings vs. SAIC Filings

Do differences between reported numbers in SEC filings and SAIC filings mean anything?

**Our take: not necessarily.**

Filings with the Securities and Exchange Commission (SEC) are generally meant for investor use and analysis. Results are reported on a consolidated basis. Results are audited.

Filings with China’s State Administration of Industry and Commerce (SAIC) are meant for business registration and license purposes. Results may not be consolidated or audited.
Part II: Specific Areas of Concern and Current Shenanigans
Current Shenanigans We’re Seeing in Asia

• Selling to related parties (both disclosed and undisclosed)
  • Syntax-Brillian
  • Suntech Power

• Decline in deferred revenue
  • AsiaInfo-Linkage
  • Perfect World

• Inflated Asset values / Aggressive capitalization of expenses
  • Sino-Forest
  • Syntax-Brillian

• Fabricating cash
  • Longtop Financial Technologies
  • China MediaExpress
  • Satyam

• Rising DSO / Extended Payment terms / Hiding receivables
  • Apollo Solar Energy Technology
  • VanceInfo
Current Shenanigans We’re Seeing in Asia

• Poor working capital management / rising working capital excused by growth story
  • Suntech Power
  • Syntax-Brillian
• VAT rebates, government grants & low tax rates
  • Skyworth Digital
• Unusual transactions
  • Longtop Financial Technologies
• Shift in business model away from core
  • Syntax-Brillian
  • Skyworth Digital
  • Apollo Solar Energy Technology
• Change in revenue recognition policy
  • Syntax-Brillian
  • China Security & Surveillance Technology
Restatement Examples: Chinese Companies Listed in the US

• Failure to include convertible preferred stock in share count used for EPS calculations, resulting in overstated EPS (ZST Digital Network, Rodobo International).

• Failure to account for options to purchase shares in a related party as compensation expense to CEO/Chairman, which overstated EPS (China XD Plastics).

• Share purchases by CEO/Chairman and controlling shareholder accounted for as buybacks, which understated shares outstanding, and overstated EPS (SOKO Fitness & Spa).

• Recognition of gain related to government induced change in land use rights when the right had not been obtained, which overstated pretax income (China Shuangji Cement).

• Government funding recognized as reduction of operation expenses (should have been treated as partly long term loan and partly an offset to capex), which understated operating expense (China HGS Real Estate).

• Payment for operating expenses misclassified as capex, overstating CFFO (Tianli Agritech).

• Payment for exploration misclassified as investing cash outflow, overstating CFFO (CNOOC).
Part III: Case Studies
Longtop Financial Technologies (LFT)
Over the years, Longtop’s chairman gifted 11.25 million shares of stock to current and former employees and consultants as a way of thanking those who helped build the business.

- Longtop claimed no formal agreement existed, no vesting schedule
- $80 million charge recorded in 9/2010 qtr for stock gift to current employees
- $25 million charge recorded in 12/2007 qtr for stock gift
- Charges were considered one-offs.

The CFO extolled the Chairman’s “generosity” in a 4/2011 conf call, adding that:

“Our chairman is 60 years old. He is a very rare person, and having a lot of money is not important to him. He is not motivated by money. He is also frugal. Even though he is over 60 years old and has wealth well in excess of $100 million, he and his wife still travel economy class when they go to the United States.”

Narrative was offered to explain these gifts. Nevertheless, they were unusual.
The Recent Stock Gift was Incredibly Large

Recipients received large amounts of stock. Longtop only said there were over 100 recipients of the Sept 2010 gift. If all 303 employees categorized as G&A had received stock, that would have amounted to US$136,532/employee.

Given average wages in China, these amounts seemed unusually high.

<table>
<thead>
<tr>
<th>($ millions, except employee count and estimated gift/current employee)</th>
<th>Cost of Revenues-Software Dev.</th>
<th>Cost of Revenues-Other Services</th>
<th>R&amp;D</th>
<th>Sales and Marketing (S&amp;M)</th>
<th>General and Administrative (G&amp;A)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated Allocation of Gift to Current Employees</td>
<td>10.1</td>
<td>8.5</td>
<td>4.7</td>
<td>14.9</td>
<td>41.4</td>
<td>79.5</td>
</tr>
<tr>
<td>Employees at March 2010</td>
<td>2,492</td>
<td>747</td>
<td>279</td>
<td>437</td>
<td>303</td>
<td>4,258</td>
</tr>
<tr>
<td>Estimated Gift/Current Employee</td>
<td>$4,054</td>
<td>$11,350</td>
<td>$16,787</td>
<td>$34,017</td>
<td>$136,532</td>
<td>$18,671</td>
</tr>
</tbody>
</table>
## Dealings with Entity Partially-Owned by Longtop Execs

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 2007</td>
<td>Longtop acquired remained half of LTI, which it had formed in 2006 with certain other investors. LTI provided outsourcing.</td>
</tr>
<tr>
<td>March 2007</td>
<td>Acquired Minecode, which provided outsourcing services to MSFT.</td>
</tr>
<tr>
<td>July 1, 2007</td>
<td>In order to focus on core software development/IT services business, Longtop discontinued its outsourcing operations. LTI (and new sub Minecode) were disposed of through a pro-rata dividend to Longtop’s pre-IPO shareholders, including execs.</td>
</tr>
<tr>
<td>September 2007</td>
<td>Longtop and LTI enter into arrangement wherein Longtop provided outsourcing services to LTI at market rates. Wasn’t Longtop out of the outsourcing business?</td>
</tr>
<tr>
<td>October 2007</td>
<td>IPO on NYSE</td>
</tr>
<tr>
<td>March 2009</td>
<td>Longtop and LTI amended the arrangement from market to cost plus 5% (appeared favorable to LTI). Fee structure was effective retroactively back to April 1, 2008.</td>
</tr>
</tbody>
</table>
Dealings with Entity Partially-Owned by Longtop Execs

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 2010</td>
<td>Longtop acquired an IT outsourcing business (Zhongbo)</td>
</tr>
<tr>
<td>July 2010</td>
<td>Longtop sold part of its ‘non-financial services IT outsourcing services division’, which including recently-acquired Zhongbo. Division was deconsolidated. Déjà vu: Longtop says its “strategy is to focus on our core competency, which is the FinTech vertical”.</td>
</tr>
<tr>
<td>July 2010</td>
<td>20-F confirmed that Longtop’s Chairman, CEO, and CFO each remained on the board of LTI.</td>
</tr>
</tbody>
</table>

Why did Longtop still have an outsourcing services division in 2010?

Didn’t Longtop originally divest LTI to get out of this business?
Another Curiosity: Same Contact Info

Longtop’s and LTI’s websites had the same contact info for Xiamen and Shanghai:

<table>
<thead>
<tr>
<th>LFT’s Contact Info</th>
<th>LTI’s Contact Info</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contact Us</strong></td>
<td><strong>Contact Us</strong></td>
</tr>
<tr>
<td>Beijing Headquarters: Block 1, No. 11 Hepingli Dongjie, Beijing, P.R.China</td>
<td>Toronto 120 Eglington Ave East, 10th floor Toronto, ON, Canada. Zip: M4P 1E2</td>
</tr>
<tr>
<td>TEL:86-10-94217758 FAX:86-10-66418118</td>
<td>Tel: 1-416-232-2077</td>
</tr>
<tr>
<td>Xiamen Operations Center: No. 61 Wanghai Road, Xiamen Software Park</td>
<td>Beijing Address: 3/F Building 5, No.11, Hepingli East Street, Dongcheng District, Beijing, China. Zip: 100013</td>
</tr>
<tr>
<td>TEL:86-592-2396888 FAX:86-592-2398222</td>
<td>Tel: 86-10-50048990/04217758/04217759 Fax: 86-10-60418118/04023101</td>
</tr>
<tr>
<td>Shanghai R &amp; D Center: 3/F, Building A5, Area A, No.700 Yeshan Road, Xuhui District, Shanghai</td>
<td>Shanghai Address: 3/F, Tower A5, Block A, No.700 Yi Shan Road, Xuhui District, Shanghai, China. Zip: 200233</td>
</tr>
<tr>
<td>TEL:86-21-64835658 FAX:86-21-64834307</td>
<td>Tel: 86-21-64835658 FAX: 86-21-64834307</td>
</tr>
</tbody>
</table>

Dealings with LTI were not significant relative to Longtop’s results but spoke to the character of management.

Was LTI formed to enrich Longtop executives after the IPO?
Unusual HR Structure

Approximately 80% of Longtop’s employees were contracted through an entity that Longtop claimed was an unrelated party even though it had ‘Longtop’ in its name:

In addition, as of March 31, 2010, 3,413 of our total 4,258 employees were contracted through third-party human resources companies of which 3,235 were contracted through Xiamen Longtop Human Resources Service Co., Ltd., or XLHRS, which is unrelated to us. The third-party human resources companies, including XLHRS, are responsible for managing, among other things, payrolls, social insurance contributions and local residency permits of these contracted employees....from a management point of view, we consider these 3,413 persons to be our employees.

Inconsistent disclosures: In a March 2010 conference call, Longtop said there were two benefits from this model as:

• Longtop would have to pay more if it performed the HR administration internally
• Longtop would have to accrue provisions for certain liabilities if it did not use the HR company

However, when Longtop abandoned this structure in March 2011, it said the change would be margin neutral. **Which story was true?**
The Whole Thing Unravels

Longtop’s CFO in an April 2011 conference call:

“[w]e are on schedule to report our Q4 2011 financial results on May 23, 2011 and plan to file our 20-F in July 2011...We want to emphasize that we will not have to restate our financial results...Our cash is real...certain investors actually come in and do due diligence on our cash balances.”

Three weeks later, Deloitte resigned and sent its resignation letter:

As part of the process for auditing the Company’s financial statements for the year ended 31 March 2011, we determined that, in regard to bank confirmations, it was appropriate to perform follow up visits to certain banks. These audit steps were recently performed and identified a number of very serious defects including: statements by bank staff that their bank had no record of certain transactions; confirmation replies previously received were said to be false; significant differences in deposit balances reported by the bank staff compared with the amounts identified in previously received confirmations (and in the books and records of the Group); and significant bank borrowings reported by bank staff not identified in previously received confirmations (and not recorded in the books and records of the Group).

In the light of this, a formal second round of bank confirmation was initiated on 17 May. Within hours however, as a result of intervention by the Company’s officials including the Chief Operating Officer, the confirmation process was stopped amid serious and troubling new developments including: calls to banks by the Company asserting that Deloitte was not their auditor; seizure by the Company’s staff of second round bank confirmation documentation on bank premises; threats to stop our staff leaving the Company premises unless they allowed the Company to retain our audit files then on the premises; and then seizure by the Company of certain of our working papers.

Stock is halted. CFO resigns. Deloitte resigns alleging fraud.
Apollo Solar Energy (566.HK)
Initial Red Flag – Change in Auditor – Where there is Smoke there is Fire

• Apollo changed auditors in July 2010. Once we looked at the initial 2009 and H1/10 filings, it was interesting due to several other red flags:
  • Change in business model: Transformed itself from a toy company to a solar company in November 2009
  • Customer concentration: 86% of acquired backlog in November 2009 was related to one customer (CKY). Subsequently, 98% of estimated backlog at 12/10 related to one (Hanergy) customer.
  • Related party transactions: As part of large contract with Hanergy, Hanergy would purchase subscription shares, ultimately becoming a 23% stakeholder by 2012.
    • The second largest customer order in FY10, China Gogreen, also became a related party via purchasing CBs from GS-Solar (ultimate holding company of Apollo Group and 80% owned by Mr. Lin, remaining 20% by his family) for HK$500m, post delivery of its order.
    • CKY was also not independent, as it is described as an associate of both Mr. Lin (founder of Apollo Group) and GS-Solar in the acquisition circular filed in October 2009.
Initial Red Flag – Change in Auditor – Where there is Smoke there is Fire

- **Extended payment terms / rising DSO:** Payment terms versus closest competitor were generous

<table>
<thead>
<tr>
<th></th>
<th>Apollo</th>
<th>GT Solar</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Varies by contract, but 50% cash deposit for Hanergy needed prior to</td>
<td>Cash deposit or LC at placement of order. 90% of value of equipment</td>
</tr>
<tr>
<td></td>
<td>shipment. 15% upon receipt of equipment and 10% within 1 week from the</td>
<td>prior to shipment via LC or cash. 10% balance paid upon customer</td>
</tr>
<tr>
<td></td>
<td>SOP. However, Hanergy does not have to pay for 25% of each line (HK$4.96b)</td>
<td>acceptance, which is generally 2-12 months after shipping. Often milestone</td>
</tr>
<tr>
<td></td>
<td>until 12 – 21 months after SOP (generally 2-4 months after shipping).</td>
<td>payments necessary with CVD reactors.</td>
</tr>
<tr>
<td>DSO (incl unbilled):</td>
<td>45 days at 12/09 to 95 days at 06/10</td>
<td>DSO (incl unbilled): 124 days at 12/09 to 97 days at 06/10</td>
</tr>
</tbody>
</table>

- **Unusual transactions:** In June 2010, Fujian Apollo (an indirectly wholly-owned subsidiary of the Company), agreed to sell (with an independent third party) an intangible asset and transfer technology know-how. We find the transaction odd as in February and September 2009, just months prior to the acquisition, Apollo Group (in its previous form) contracted with GS-Solar Fujian (subsidiary of former holding company of Apollo Group and then sister company), to purchase various technologies. **Why sell know-how so close after the acquisition?**

- **Quality of earnings concerns:** The intangible asset sale boosted H1/10 EBIT by 54% in H1/10
Situation deteriorated post H1/10

- FY10 results:
  - *Rising DSO trend continued*

<table>
<thead>
<tr>
<th>FY09</th>
<th>06/10</th>
<th>12/10</th>
</tr>
</thead>
<tbody>
<tr>
<td>45</td>
<td>95</td>
<td>165</td>
</tr>
</tbody>
</table>

- *Extended payment terms* – Hanergy not paying according to contract. Contract is a publicly available document.
- *New signal* – declining deferred revenues

- H1/11 results:
  - 8 days before H1/11 results, Apollo issues a profit warning citing a “provision in respect of trade receivables due from a customer.” The share price declined 25% on the news.
  - DSO continues to rise to **305 days**
  - FCF turns negative
  - Write-down of intangible assets. *Red flag of aggressive capitalization of intangibles.* We had adjusted for lower amortization expense in our quality of earnings analysis.
  - CEO and board member turnover. *Corporate governance red flags.*
  - Acknowledgement by Company of tough business environment
Apollo Solar Energy

Addition to Biggest Concerns List

Profit warning from large write-off of accounts receivable.
China Security & Surveillance Technology (CSR)
Retention Money: What does this Represent?

Retention money is a “Marketing Tool” or Contractual Payment Term:

Upon acceptance by customers, the Company recognizes revenue from the sale of the equipment. As a marketing tool, generally, a small portion of the contract amount (usually 10%) will not be paid upon acceptance, but will be paid when the equipment has been in operation for a period of time. Such amount of the deferred payment is considered deferred revenue until the final payment is made.

These contracts call for acceptance by the customer when installation is complete and require payment of 90% of the total contract price by that time. After the acceptance, the customers are allowed to retain 10% of the contract price for negotiated terms up to a few months which will be paid when the customers are satisfied that the equipment works properly for a sustained period of time. In such instances, 90% of such revenue is recognized upon the acceptance by the customers and the remaining 10% of the revenue is deferred until the customer is satisfied with the long term viability of the equipment. (9/2006 letter to SEC)

Warranty Obligation is Immaterial:

The Company issues a one to three year warranty with the sales of its surveillance and security systems. The warranty covers labor costs only. Management believes that the amount of future costs to service items covered by warranty is not material, so no liability has been recognized for such future costs at December 31, 2005 and 2004.
Change in Revenue Recognition for Retention Money

Change in description of the retention money concurrent with a change in accounting for retention money, which now relates to the warranty:

In early 2006, the Company began performing much larger security installation contracts than it had been doing previously. As a marketing approach, the Company prepared standard contracts with its new larger customers, whereby 90% of the contract amount was due when installation was complete and payment of the remaining 10% was deferred for one year. Because of the newness of the larger contracts and the inability to immediately determine the amount of warranty work that would be required, the Company initially deferred recognizing the 10% of the contract amount as revenue and amortized this amount to income over the one year period. During the second and third quarters of 2006, the Company carefully monitored the warranty work requested by its customers, and determined that very little warranty work had been required to be performed. Consequently, effective October 1, 2006, the Company reduced its estimate of future warranty requirements to approximately 1% of contract installation revenue. The fourth quarter reflects this change in the estimated warranty expenses and this fourth quarter adjustment increased revenue, tax expense and net income, by $3,557, $534 and $3,023, respectively.
### Change in Revenue Recognition of Retention Money

This change in revenue recognition policy provided a large boost to CSR’s earnings:

<table>
<thead>
<tr>
<th>(in $mils. exc. per share data and %)</th>
<th>6/07</th>
<th>3/07</th>
<th>12/06</th>
<th>9/06</th>
<th>6/06</th>
<th>3/06</th>
<th>12/05</th>
<th>9/05</th>
</tr>
</thead>
<tbody>
<tr>
<td>Installation Revenue</td>
<td>39.2</td>
<td>34.0</td>
<td>33.4</td>
<td>41.3</td>
<td>6.5</td>
<td>13.0</td>
<td>7.4</td>
<td>11.9</td>
</tr>
<tr>
<td>Impact of Change in Revenue Recognition on quarterly Revenue (9% of installation revenue)</td>
<td>2.6</td>
<td>2.3</td>
<td>3.5</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Impact of Change in Revenue Recognition on quarterly Net Income</td>
<td>1.9³</td>
<td>1.8</td>
<td>3.0</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Impact of Change in Revenue Recognition on quarterly EPS</td>
<td>0.05</td>
<td>0.05</td>
<td>0.09</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Impact of Change in Revenue Recognition as a percentage of quarterly EPS</td>
<td>45%</td>
<td>38%</td>
<td>44%</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
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CSR: Deferred Revenue Should be Higher

CSR’s payment terms suggested that 30-70% of signed but not started contracts should be deferred. Typical payment terms:

- 30% of the contract amount is due upon contract signature
- 40% of the contract amount is due upon delivery of the equipment
- 20% of the contract amount is due upon completion of the installation and acceptance by the customer.

However, customer advances and deferred revenue was only 11% of signed contract backlog at 6/2007:

<table>
<thead>
<tr>
<th></th>
<th>6/07</th>
<th>3/07</th>
<th>12/06</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer Advances and Deferred Revenue</td>
<td>3.0</td>
<td>8.3</td>
<td>6.2</td>
</tr>
<tr>
<td>Sales</td>
<td>52.1</td>
<td>38.4</td>
<td>40.9</td>
</tr>
<tr>
<td>Signed Contract Backlog</td>
<td>28.2</td>
<td>21.9</td>
<td>22.4</td>
</tr>
</tbody>
</table>

Was CSR sticking to its revenue recognition policy? Or getting more aggressive? Was backlog inflated?
Disconnect: Why is there an Installation-in-Progress Balance?

No projects in backlog had been started at 6/2007:

During the second quarter of 2007, we signed 59 new contracts with a total contract value of approximately $45.5 million, of which we recognized $17.3 million in revenues. Of the 59 projects, 27 were finished as of June 30, 2007, and, accordingly, approximately $0.8 million of revenue related to warranty requirements was deferred to the third quarter of 2007. The remaining 32 projects had not been started as of June 30, 2007, and the value of these backlog projects was approximately $28.2 million. During the second quarter of 2007, the Company also completed implementation of 23 contracts signed in first quarter of 2007 (representing all of the contracts that had been signed, but not yet implemented, during first quarter of 2007), and recognized the revenue of $21.9 million related to those contracts.

So why was there a balance for ‘installation-in-progress’ inventory?

<table>
<thead>
<tr>
<th>(in $ mils.)</th>
<th>6/07</th>
<th>3/07</th>
<th>12/06</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred Cost of Goods Sold</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Installation in progress</td>
<td>18.3</td>
<td>18.7</td>
<td>17.1</td>
</tr>
<tr>
<td>Inventory (net)</td>
<td>39.0</td>
<td>22.1</td>
<td>19.7</td>
</tr>
<tr>
<td>Deferred Income</td>
<td>0.8</td>
<td>0.8</td>
<td>0.8</td>
</tr>
</tbody>
</table>

Does it make sense that no projects had been started? Or was CSR just saying that to make the low deferred revenue balance not seem so strange?
CSR Chart

China Security & Surveillance Technology Inc. (CSR)  1-Jun-2007 to 1-Jun-2010 (Daily)
GICS Industry: @NA
GICS Sector: @NA
GICS Sub-Industry: @NA

Data Source: Prices / Exshare
Perfect World (PWRD)
Perfect World: Deterioration in Leading Indicator

Deferred revenue and advances from customers declined to a recent low at 12/2009. Almost all of PWRD’s revenue flows through deferred revenue as prepaid cards, which allow video game players to purchase in-game items.

<table>
<thead>
<tr>
<th>(RMB millions, exc. days)</th>
<th>Q4, Dec-09</th>
<th>Q4, Dec-08</th>
<th>Q4, Dec-07</th>
<th>Q3, Sep-09</th>
<th>Q3, Sep-08</th>
<th>Q2, Jun-09</th>
<th>Q2, Jun-08</th>
<th>Q1, Mar-09</th>
<th>Q1, Mar-08</th>
</tr>
</thead>
<tbody>
<tr>
<td>DS Advances from Customers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>20</td>
<td>20</td>
<td></td>
<td>22</td>
<td>21</td>
<td>15</td>
<td>17</td>
<td>18</td>
<td>40</td>
</tr>
<tr>
<td>DSDR</td>
<td>52</td>
<td>64</td>
<td>57</td>
<td>57</td>
<td>65</td>
<td>56</td>
<td>63</td>
<td>68</td>
<td>65</td>
</tr>
<tr>
<td>Total DSDR</td>
<td>67</td>
<td>84</td>
<td>76</td>
<td>79</td>
<td>87</td>
<td>71</td>
<td>80</td>
<td>87</td>
<td>105</td>
</tr>
</tbody>
</table>

Deferred revenue growth trailed competitors, except for SNDA which was also on our Biggest Concerns List:

<table>
<thead>
<tr>
<th>(%)</th>
<th>Q4, Dec-09</th>
<th>Q4, Dec-08</th>
<th>Q4, Dec-07</th>
</tr>
</thead>
<tbody>
<tr>
<td>PWRD</td>
<td>-5.4%</td>
<td>8.4%</td>
<td>15.0%</td>
</tr>
<tr>
<td>NTES</td>
<td>3.0%</td>
<td>0.9%</td>
<td>-3.8%</td>
</tr>
<tr>
<td>CYOU</td>
<td>3.6%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SNDA</td>
<td>-19.8%</td>
<td>5.0%</td>
<td>-2.1%</td>
</tr>
</tbody>
</table>
Perfect World

Perfect World Co. Ltd. (PWRD)
GICS Industry: Software
GICS Sector: Information Technology
GICS Sub-Industry: Home Entertainment Software

19-Feb-2010 to 1-Jun-2010 (Daily)
High: 42.090
Low: 24.710
Last: 25.480

Data Source: Prices / Exshare

Addition to Biggest Concerns List

Stock falls as guidance misses expectations.

Removal from Biggest Concerns List
Deterioration in Receivables and Deferred Revenue

DSO was up, which ASIA had previously said was due to the acquisition of Linkage. Due to this acquisition and divestment of an IT Security business, comparability was hindered. However, adjustments were possible.

Accounts receivable had increased:

| ($ millions, exc. days) | Q4, Dec-10 | Q4, Dec-09 Adjusted | IT Security Business Adjustment | Linkage Adjustment | Q4, Dec-09 Reported
|-------------------------|------------|---------------------|-------------------------------|--------------------|---------------------
| Accounts Receivable     | 185.3²     | 138.8⁴              | (14.0)⁶                      | 80.8               | 72.0⁷               |
| Revenue                 | 110.7³     | 99.6⁵               | (14.9)⁶                      | 41.1               | 73.4⁸               |
| DSO                     | 153        | 127                 |                               |                    | 89                  |
| YoY Change              | 26         |                     |                               |                    |                     |

Deferred revenue had fallen:

| ($ millions, exc. days) | Q4, Dec-10 | Q4, Dec-09 Adjusted | IT Security Business Adjustment | Linkage Adjustment | Q4, Dec-09 Reported
|-------------------------|------------|---------------------|-------------------------------|--------------------|---------------------
| Deferred Revenue        | 28.0       | 45.3³               | (16.3)⁵                      | 16.0               | 45.5                |
| Revenue                 | 110.7²     | 99.6⁴               | (14.9)⁶                      | 40.1               | 73.4⁸               |
| DSDR                    | 23         | 41                  |                               |                    | 57                  |
| YoY Change              | (18)       |                     |                               |                    |                     |
Less Contract Signings Disclosed

Although ASIA does not disclose backlog or dollar amounts of its contract signings, the frequency of contract signings disclosed by ASIA had declined:

Since it takes around 9 months from contract signing to the recognition of 90% of the contract revenue, the lack of contract signings in recent quarters hinted at upcoming top line pressure.
ASIA

Atlantico-Linkage Inc. (ASIA-US)
GICS Industry: Software
GICS Sector: Information Technology
GICS Sub-Industry: Application Software

1-Sep-2009 to 1-Sep-2011 (Daily)
High: 32.160
Low: 8.310
Last: 11.140

Addition to Biggest Concerns List

Removal from Biggest Concerns List

Data Source: Prices / Exshare
Suntech Power Holdings (STP)
Suntech Power (STP): Sales to Related Parties

In H1'09 STP Records 18% of Equipment Sales ($116 mils) to GSF Portfolio Companies

June-Sept 08 STP Invests $258 mils. in GSF (86% Stock Ownership but only 50% of Voting Interest)

In Following Periods - STP Receives virtually no Cash (6%) for H1’09 Sales to GSF
Suntech Power (STP): Related Party Sales

Despite owning 86% of the investment fund, STP did NOT consolidate the fund as its voting interest was 50% and it was not a general partner of the fund.

Thus, STP could recognize significant revenue from this unconsolidated related party:

<table>
<thead>
<tr>
<th>in $ mils. exc %</th>
<th>Q1'09</th>
<th>FY08</th>
</tr>
</thead>
<tbody>
<tr>
<td>Related Party</td>
<td>104.9</td>
<td>0</td>
</tr>
<tr>
<td>Receivables</td>
<td>100.6</td>
<td>7.7</td>
</tr>
<tr>
<td>Related Party Sales</td>
<td>31.9%</td>
<td>0.4%</td>
</tr>
<tr>
<td>Related Party Sales / Sales</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
STP: Unusually High Purchase Commitments

Relative to other players in the industry, STP had unusually high inventory and inventory purchase commitments:

<table>
<thead>
<tr>
<th></th>
<th>SPWR</th>
<th>FSLR³</th>
<th>YGE</th>
<th>TSL⁴</th>
<th>STP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inventory</strong></td>
<td>252.0</td>
<td>122.0</td>
<td>299.1</td>
<td>85.7</td>
<td>231.9</td>
</tr>
<tr>
<td><strong>NTM Purchase Obligations</strong></td>
<td>456.5</td>
<td>353.2</td>
<td>272.5</td>
<td>467.6</td>
<td>1,474.1</td>
</tr>
<tr>
<td><strong>NTM Sales</strong></td>
<td>1,371.8</td>
<td>1,942.0</td>
<td>1,143.0</td>
<td>778.1</td>
<td>1,614.7</td>
</tr>
<tr>
<td><strong>NTM Purchase Obligations / NTM Sales</strong></td>
<td>33.3%</td>
<td>18.2%</td>
<td>23.8%</td>
<td>60.1%</td>
<td>91.3%</td>
</tr>
<tr>
<td><strong>NTM Purchase Oblig. + Inventory / NTM Sales</strong></td>
<td>51.6%</td>
<td>24.5%</td>
<td>50.0%</td>
<td>71.1%</td>
<td>105.7%</td>
</tr>
<tr>
<td><strong>Industry average</strong></td>
<td>33.8%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

High levels of ‘take or pay’ inventory commitments put STP at higher risk of having excess inventory, which could lead to inventory charges, discounts, etc.
Suntech Power

Suntech Power Holdings Co. Ltd. ADS (STP) 1-Jun-2009 to 21-Sep-2011 (Daily)
GICS Industry: Semiconductors & Semiconductor Equipment
GICS Sector: Information Technology
GICS Sub-Industry: Semiconductors

Addition to Biggest Concerns List
China MediaExpress (CCME)
The Bull Case

- CCME reported an operating margin of 72% in Q3 2010 and profit margin of 55%
- Great cash flow
- Auditor was a ‘Big 4’ Firm: Deloitte
- Starr International had recently invested in CCME, presumably having done due diligence.
- Payment terms were not increasing: Q3 2010 10-Q said that credit period was 30-60 days, identical to the 2009 10-K. DSO were at a low.
- 12/9/2010: CFO bought 100,000 shares at $15/share. (per a Form 4)
- 12/16/2010: CCME announced it would pay a semi-annual dividend.
- “…CCME has no comparable competitors…” (per its web site)
The Bull Case: Stated Hyperbolically*

“It’s a dividend stock. It’s a growth stock. It’s a value stock. It’s a short squeeze. It’s marginable. It is optionable. Insiders are buying. It’s everything you want and more. They’re growing at over 100%. Their forward P/E is around 5. They’re going to be paying out 5-10% of their net profits semi-annually beginning with the six-month period ending Dec. 31...Anyway, I’m saying it. This is the best stock in the world, bar none, at the current price, at the current point in time.”

*in the words of a seekingalpha contributor.
FX Gain in Operating Earnings

Administrative expense declined substantially in Q3 2010, due to an unquantified (if minor) FX gain. A Company representative acknowledged this gain in the conference call.

<table>
<thead>
<tr>
<th>($ millions, except %)</th>
<th>Q3, 9/10</th>
<th>Q2, 6/10</th>
<th>Q1, 3/10</th>
<th>Q4, 12/09</th>
<th>Q3, 9/09</th>
<th>Q2, 6/09</th>
<th>Q1, 3/09</th>
<th>Q4, 12/08</th>
</tr>
</thead>
<tbody>
<tr>
<td>Administrative Expenses</td>
<td>0.2</td>
<td>1.7</td>
<td>0.6</td>
<td>0.9</td>
<td>0.6</td>
<td>0.5</td>
<td>0.8</td>
<td>0.3</td>
</tr>
<tr>
<td>Revenue</td>
<td>57.0</td>
<td>53.5</td>
<td>44.5</td>
<td>32.0</td>
<td>26.1</td>
<td>19.1</td>
<td>18.8</td>
<td>16.8</td>
</tr>
<tr>
<td>Administrative Expenses/Revenue</td>
<td>0.4%</td>
<td>3.1%</td>
<td>1.3%</td>
<td>2.8%</td>
<td>2.3%</td>
<td>2.7%</td>
<td>4.5%</td>
<td>1.6%</td>
</tr>
</tbody>
</table>

Aggressive classification? Such gains are often included in other income.
Cash Flow Growth

Usually, rapidly-growing companies do NOT generate large cash flows, as cash is consumed in working capital, expenses, or capital expenditures.

But not at CCME, which reported rapid growth in cash flows.

<table>
<thead>
<tr>
<th>($ millions)</th>
<th>Q3, 9/10</th>
<th>Q2, 6/10</th>
<th>Q1, 3/10</th>
<th>Q4, 12/09</th>
<th>Q3, 9/09</th>
<th>Q2, 6/09</th>
<th>Q1, 3/09</th>
</tr>
</thead>
<tbody>
<tr>
<td>CFFO</td>
<td>30.8</td>
<td>25.3</td>
<td>12.9</td>
<td>16.4</td>
<td>12.2</td>
<td>9.2</td>
<td>8.5</td>
</tr>
<tr>
<td>Capital Expenditures</td>
<td>(1.1)</td>
<td>(0.6)</td>
<td>(1.9)</td>
<td>(0.5)</td>
<td>(0.8)</td>
<td>(0.2)</td>
<td>(0.5)</td>
</tr>
<tr>
<td>FCF</td>
<td>29.7</td>
<td>24.6</td>
<td>11.1</td>
<td>15.9</td>
<td>11.4</td>
<td>9.0</td>
<td>8.0</td>
</tr>
</tbody>
</table>

Seemed too good to be true. It was.
Disclosure Seems Erroneous: Does Capex Make Sense?

Disconnect: CCME said its costs $1,000 to equip a new bus with a TVs and control system.

If this were the case, capex in 2009 would have been at least $4.9m. Actual capex was much lower.

When we find errors in SEC filings, the possibility of more errors increases.
Disclosure Seems Erroneous: 2 to 3 Screens/Bus? Or 1.6?

In the 2009 10-K, CCME stated that “[o]n average, two to three digital television displays are installed on each inter-city express bus within CME’s network.”

We estimated that new buses only averaged 1.61 screens per bus added in 2009.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Televisions Installed at Year End</td>
<td></td>
<td>41,216</td>
<td>33,306</td>
<td>22,361</td>
<td>2,252</td>
</tr>
<tr>
<td>Number of Express Buses at Year End</td>
<td></td>
<td>20,161</td>
<td>15,260</td>
<td>10,053</td>
<td></td>
</tr>
<tr>
<td>TVs/Buses</td>
<td></td>
<td>2.04</td>
<td>2.18</td>
<td>2.22</td>
<td></td>
</tr>
<tr>
<td>Estimated TVs Installed During Year</td>
<td></td>
<td>7,910</td>
<td>10,945</td>
<td>20,109</td>
<td></td>
</tr>
<tr>
<td>Estimated Buses Equipped During the Year</td>
<td></td>
<td>4,901</td>
<td>5,207</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TVs/Buses Equipped During the Year</td>
<td></td>
<td>1.61</td>
<td>2.10</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Low Pay to Executives

Although more common in Asia, CCME’s top executives received little in cash compensation. If CCME had to pay more normal, market rates for executive compensation, earnings could have been impacted.

FISCAL 2009 COMPENSATION TABLE

<table>
<thead>
<tr>
<th>Name and Principal Position</th>
<th>Year</th>
<th>Salary</th>
<th>Bonus</th>
<th>Stock Awards</th>
<th>Option Awards</th>
<th>Non-Equity Incentive Plan Compensation</th>
<th>Nonqualified Deferred Compensation Earnings</th>
<th>All Other Compensation</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zheng Cheng (Principal Executive Officer)</td>
<td>2009</td>
<td>$38,067</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$38,067</td>
</tr>
<tr>
<td></td>
<td>2008</td>
<td>$37,410</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$37,410</td>
</tr>
<tr>
<td></td>
<td>2007</td>
<td>$30,789</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$30,789</td>
</tr>
<tr>
<td>Jacky Lam (Principal Financial Officer)</td>
<td>2009</td>
<td>$79,778</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$79,778</td>
</tr>
<tr>
<td></td>
<td>2008</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>2007</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>
Two Founding Shareholders Sell at 27% Below Market Price

On 10/13/2010, CCME announced that two founding shareholders were selling:

Starr International Company, Inc. ("Starr International"), through its wholly-owned subsidiary, Starr Investments Cayman II, Inc. ("Starr Cayman"), has agreed to purchase an aggregate of 1.5 million shares of the Company’s common stock in two private transactions. Mr. Ou Wen Lin and Mr. Qing Ping Lin, two of CME’s founding shareholders, through their holding companies, Thousand Space Holdings Limited and Bright Elite Management Limited have agreed to sell 1,000,000 and 500,000 shares of the Company’s common stock, respectively, to Starr International at $9 per share. Although the agreement was signed after the Chinese Golden Week holiday, it has been under discussion between the parties since the middle of September, and the selling price was based on CME’s average closing trading prices for that month. It is CME’s understanding that Mr. Ou Wen Lin and Mr. Qing Ping Lin intend to use proceeds from the stock sale to finance their other personal business projects that are unrelated to CME.

Why accept such a discount? Were selling shareholders eager to get out?
Two Founding Shareholders Sell at 27% Below Market Price

China MediaExpress Holdings Inc. (CCME)
GICS Industry: Media
GICS Sector: Consumer Discretionary
GICS Sub-Industry: Advertising

10/13/2010: Press release announcing that two founding shareholdings have agreed to sell 1.5 million shares at $9.

10/12/2010: Stock closed at $12.27
The Damage

Deloitte resigns, noting issues with reported bank accounts encountered during the bank confirmation process. Stock is halted.
Deloitte’s Concerns, per an 8-K

DTT has informed the Company in its resignation letter that it was no longer able to rely on the representations of management and that it had lost confidence in the commitment of the Board and the Audit Committee to good governance and reliable financial reporting. Prior to its resignation, DTT raised the following issues (some of which may be considered to be disagreements) encountered during the audit, including: **issues related to the authenticity of bank statements; a loss of confidence in bank confirmation procedures carried out under circumstances which DTT believed to be suspicious; issues concerning the validity of certain advertising agents/customers and bus operators (including with respect to certain of the Company's top ten customers); concerns over possible undisclosed bank accounts and bank loans; information on file with the State Administration of Industry and Commerce as to certain subsidiaries appearing to be inconsistent with comparable financial information provided to DTT; the verification of the validity of a sampling of tax invoices issued in connection with certain large transactions; the verification of certain subsidiary tax payments with the local office of the State Administration of Taxation; the verification of salary payments made in cash directly to employee bank accounts; the verification of the production process for advertising programs; and the potential double counting of a certain number of buses.** As a result, **DTT had requested that the bank confirmation process be re-done at the banks' head office** and that the issues described above be addressed by an independent forensic investigation. DTT stated in its resignation letter that, in its view, the Company was not in good faith willing to proceed with the course of action requested by DTT;
Lessons Learned

- Errors or disconnects in financial reporting could be a sign of something more sinister.
- Selling shareholders wanted out, even at a discount. They wanted to invest in other business projects unrelated to CCME. I would too.
- Cash balance frauds can look pretty clean as everything can be fabricated. DSOs were falling.
- Unusually low compensation expense.
- Does this make sense? How does a rapidly-growing company generate so much cash? How are margins so high?
- Caveat emptor: Fraudsters know how to provide comfort to the longs (cash flow, an insider buy from the CFO, dividends, big name investor).
Presentations available on the frauds at Syntax-Brillian and Satyam
Questions

questions@cfraresearch.com