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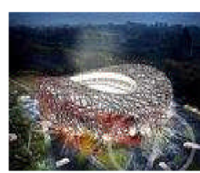

June 2011 Due Diligence Newsletter

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The CFO — the glue between the investor and the company:

Arguably one of the most important positions in a company is that of the Chief Financial Officer. One only has to look at the recent financial upheavals in Chinese companies to recognize the importance of a solid, experienced CFO. In my experience, the root cause of the downfall of many Chinese companies comes from the lack of a strong Chief Financial Officer. During many of our due diligence and reconstruction assignments, as we piece together what's occurred in an effort to bring the company back from the abyss and into GAAP compliance, we almost always find that a lack of leadership, knowledge, and internal controls, on the part of the CFO, has been the primary cause.

Functioning as the CFO of a Chinese company isn't for wimps. It takes an iron man. The job requires the resoluteness of a special forces operative, the calm of a riverboat gambler, the skill set of a CPA, and the liver of a Chinese government official.

When something goes wrong with a Chinese company, you can usually trace the problem back to something that's occurred early in the game, usually long before the contract is signed between the company and the institution. Prior to the contract, there's a great deal of good will between both parties – the CEO trying

to convince you he wants a 20 multiple while you're trying to get from him, between gambei's of baijo, the actual and projected numbers. The path to success or destruction usually starts prior to signing the contract. This isn't because the institution doesn't do a good job in laying out the process and giving the company a list of changes to be made in order to successfully function as a publicly listed company. On the contrary, most institutions do a good job in this area. In addition, many institutions have offices in China and Chinese speaking staff the company can call with questions. So how could everything go so wrong? Why would the deal blow up after the initial goodwill, after the company has successfully gone public and received its money, the CEO is worth a fortune, at least on paper, and you've kept every promise you've made?

In my opinion everything went wrong because both parties were never in sync, they had different expectations from the start, and most importantly, there was no personal bond between the parties. The bridge between you and the company had a few missing planks. It needed a strong CFO from start to finish and beyond to align expectations, complete the transaction, and maintain compliance.

If you look back and analyze the transactions that have gone from gold to dust, much of this demise could have been avoided by having a strong CFO in place to act as that bridge – not only between the investor and the company, but also between the investor and the CEO. When we're asked to bring a company back into compliance and act as the CFO, we almost always find that the company and investor were on two different pages of the same book. Let's go back before the signing of the contract, and I'll reconstruct what's happened. The institution will explain to the CEO and Controller (I'll call the head of the company's accounting and finance department the Controller even though they may carry the title of CFO) of the company the process, timelines and set expectations. Both the CEO and Controller will listen, both nod in agreement, and both pledge their undying cooperation. But what they're thinking is very different, and Chinese financial goals are not usually long term. The CEO is thinking – give me the money. He's pretty simple to figure out. In order to get it, he knows he has to go through a process he doesn't fully understand. Given the choice, he really doesn't care if he's public or private as long as he gets funding. I know he's been told it's easier to raise

capital once you're public and that the valuations are generally better, but he's not thinking past getting the money. Once I get the money, he's thinking, I can grow the business, make more money, and the investors will be happy.

The Controller is thinking that he hasn't got a clue about GAAP, but he has to do it because his boss is telling him to. Generally, he needs pre-audit help and guidance to conform the company's books and records to GAAP. The Controller's primary job, to this point, has been more a bookkeeping function than acting as a CFO or Controller. He keeps track of the books and records and follows the directions of the CEO. If the CEO asks for a check, or to make a loan to a related party, or to print bank statements that vary from their actual statements, he'll do it**. It may be a public company on the face, but it's a private Chinese company under the covers**. Only the CFO is capable of educating his staff, changing their routines, and establishing a clear set of job functions and internal controls that create the financial integrity required from a public company. If he has the trust of the CEO, he'll be the one to overcome a great deal of the problems we've seen.

When a CFO is in place at the beginning of the process, the direction is set from the first day. Everyone's on the same highway. He and the CEO are in lock-step and he'll help establish and maintain GAAP. However, in order for that to happen, he has to have the support and confidence of the CEO. That's no easy task in China where anyone who is not 100% Chinese will always be considered an outsider. Therefore, the CFO has to be strong enough to create the confidence that he has the knowledge to work with the auditor and the institution to take the company public; strong enough to control the CEO from making related and unrelated party loans, making unreported cash sales, and performing other daring feats in breach of GAAP; strong enough to have the accounting and finance staff follow his direction over more senior Chinese staff who resist change; strong enough to establish and maintain internal controls and accounting integrity; and, equally as important, strong enough to demonstrate to the CEO that by following his advice and direction, that he, the company and shareholders will achieve significant monetary benefits. Can it be done? Sure, I've seen it quite a few times. But it's seldom successful unless you have a strong CFO.

In addition, in a number of companies where we've performed due diligence, the lack of a strong, experienced auditor has exacerbated the problem.

Let me give you, as an example, a situation that occurred during one of our recent due diligence assignments. The company on which we were performing due diligence had, we were told by the investor, a competent Chinese CFO. The CFO had worked with the CEO for many years and the books and records seemed to be in good order as they had just gone through a US GAAP audit by a small, but experienced PCAOB audit firm. This firm had completed the audit fieldwork for the last two years, but had not yet signed the audit reports. We were brought in by the investor to provide a new, more experienced bi-lingual CFO and to perform due diligence to see if we felt there was a possibility of future restatements.

What we discovered was that almost 50% of one of the subsidiaries business was comprised of off-the-books (cash) transactions from rental revenue which was not reflected in the company's books, nor was it provided to the auditors. The audit report, which at the time was unpublished, substantially understated revenue and income. The auditor missed it. Also, since the cash-based rental revenue was not included in the US GAAP financials, it was also not reported for tax purposes. This meant that the Company should have accrued a material tax liability for both sales tax and income tax. If discovered by the taxing authorities, it would have resulted in the tax liability being owed, plus possible material penalties and/or interest.

In this example the auditor created a situation that could have ultimately been devastating for the stock and for investor confidence in the company and the CFO (not to mention for their firm). Thankfully, we're seeing fewer and fewer issues with auditors of this caliber when we look at a company. That situation seems to be resolving itself as the names of less competent firms become known. The majority of auditors that we've worked with have been competent and provided reliable audit services for their Chinese clients. Those auditors don't make the news, just the minority such as the one mentioned above. Also, the former CFO, through ineffective maintenance of the company's books and records, started the ball rolling by not recording the cash rental revenue. A weak CFO, coupled with a lower end auditor, is a toxic situation for the company.

In short, the CFO is the glue that creates the bond of trust between the company and the investor. If you have a strong CFO, he can usually work with the CEO to mitigate problems; make sure filings are done on time; ensure the accuracy of the books and records; and run a transparent accounting function. Put a wimp or someone with little experience in this position and you get a bookkeeper who follows the direction of the CEO, and the situation will almost always end badly.

The CFO's role is not limited to overseeing the accounting function and supervising the audit process. The CFO is also critical in organizing the efforts of the various service providers involved in both the pre- and post-public process, including investment bankers, U.S. counsel, PRC counsel, public/investor relations firm, Sarbanes Oxley specialists, and others. Without this point person, the process can be disorganized and take substantially longer than planned.

The CFO also acts as a "face to the street," communicating directly with shareholders, potential investors, analysts, securities regulators, U.S. advisors and service providers. This is a critical component to delivering the company's story after they are public. It is an understatement to say that investors are concerned about the integrity of the reported financial results of Chinese companies. If investors can hear the financial story from a seasoned CFO who is comfortable explaining numbers and answering the investors' questions and concerns, it can only add to the confidence that the marketplace has in the company.

A strong an effective CFO creates shareholder value and can eliminate many of the current issues that we've seen.

Loans and inter-enterprise lending：

Unsecured loans which have no specific repayment terms are common practice for private Chinese companies and generally go unnoticed by the government. Companies that are owned and controlled by one individual (the CEO) will often loan funds, at the direction of the CEO, to companies owned by his friends. The loans are done in place of bank loans, which are more difficult to obtain and require security and high interest rates. The loans are usually short term in nature and used for working capital by the borrowing party. Often, the borrowing party will reciprocate with a loan back to the

company when needed. These transactions are generally small-scale financing between companies on a handshake basis.

However, there are several factors that should be considered with respect to such loans:

- These types of loans constitute “inter-enterprise lending” and violate the PRC General Lending Rules, which are federal laws that govern the borrowing and lending of funds. Essentially, only authorized banks are allowed to make loans, and any such activity between private enterprises is expressly prohibited.

- A fine in the amount of one to three times the income generated by the lending party from such inter-enterprise loans may be imposed by the People’s Bank of China, at their discretion.

- This fact should be disclosed in the company’s financial statements. They should either accrue a penalty, or disclose the existence of a contingent liability arising from the violation. Because the penalty is discretionary, it may not be appropriate to accrue a penalty, but a disclosure should be made.

- The company eliminates all outstanding loans receivable prior to becoming public.

We have also seen situations where the companies actually charge interest on the loans, but the interest is collected in cash by the CEO (who is also the principal shareholder) and not reported as income. By doing this, the CEO can take unreported personal income, the company avoids additional taxable income, and the company can claim that they did not make any income from the loan so they should not be penalized for inter-enterprise lending since there was no tangible benefit to them.

Taxes:

Recently, a pre-public company we were examining was issued a "Notice of Offering Preferential Policy by the city-level office of the State Administration of Taxation (SAT). The notice stated that:

- The company shall be exempt from all undeclared taxes which were incurred before the end of their last fiscal year, including VAT and all other enterprise income taxes;

- The company shall be exempt from the relevant taxes related to its integration of assets, change of property rights, and financial adjustments during its process of offshore financing; and

- The term of these preferential policies extended an additional two fiscal years into the future.

The company obtained a legal opinion from a law firm addressing the Company's tax matters. The opinion was rather vague about the local SAT notice, verifying only that the Company received the notice, and reiterating the provisions outlined in the notice. The opinion did not expressly state that the notice was validly issued, or that the local SAT office has authority to issue such an exemption. We noted a number of material issues with respect to this fact pattern. The SAT is a local tax bureau and the PRC tax code explicitly states that the State Council (the central government authority on taxation) is the only body that has the right to grant exemptions or forgiveness with respect to income tax and VAT. The local SAT is not authorized to issue the exemptions described in their letter. If taxes were due under the PRC tax code but were not declared by the company prior to the end of their last fiscal year, the local SAT cannot waive them.

The company was exempt from income tax based on the nature of their business (agricultural preliminary processing) pursuant to the federal tax statutes, and the amount of income tax expense (being zero) was properly reflected in their audited financial statements. However, the disclosures were misleading. Their Income Taxes footnote stated that, "the PRC local government has provided various incentives to companies in order to encourage economic development. Such incentives include reduced tax rates and other measures. The Company has been granted an income tax exemption which expires on December 31, 2010 and accordingly, was exempted from substantially all of its income tax in the 2010 and 2009 period." The reason that the company did not pay tax was due to its status as an agricultural preliminary processor pursuant to the PRC tax code, not because of the local tax bureau waiver, which was in fact invalid.

Additionally, the audited results did not include a material VAT accrual, which we discovered when reconciling their VAT returns to their US GAAP financials. This was presumably the reason they obtained the waiver letter. It was not clear whether the auditors

relied on the local SAT tax exemption letter to justify booking no VAT accrual, or whether the auditors simply did not reconcile the VAT return to the audited financial statements. Either way, based on our experience, there is substantial risk involved by not recording this accrual, and taking any tax exemption based on the local SAT notice. We recommended that, if this was an audit error, the company should bring it to the attention of their auditors and have the report re-issued. There was little harm in doing so since they are still a private company. If the company and its auditors were relying on the local SAT notice for this, or any future tax exemption, they should consider getting a second opinion from a large international law firm with PRC tax specialty. The second opinion should explicitly address the issue of whether the GSAT has authority under PRC tax regulations to issues this type of exemption.

Variable Interest Entity (VIE):

A number of Chinese companies that we've inspected have had a Variable Interest Entity (VIE) issue that was not apparent when the investor first visited the company. A VIE issue usually occurs when a company is private and has an owner who is entrepreneurial and involved in a number of businesses. In this situation he's likely to use the cash flow from the company to fund another one of his companies. For example, a manufacturing company that uses a portion of its cash to fund the owner's real estate or assurance company. This can create a serious problem for the company that wants to go public and complete a GAAP audit. Let's explain.

A **Variable Interest Entity** (VIE) is a term used by the United States Financial Accounting Standards Board (FASB) in FIN 46 and refers to refer to an entity in which an investor holds a has a controlling interest which is not based on the majority of voting rights. This is an important issue because the company will need to consolidate such entities if it is the primary beneficiary of the VIE.

The analysis of whether an entity is a VIE is fairly complex, but the basic idea is that an entity is considered a VIE if it cannot exist without additional financial support from the indirect control party (the company), and if the equity holders of the entity do not have decision making authority or don't receive either profits or losses in relation to their investment.

Generally, a reporting entity that has a variable interest in a variable

interest entity (VIE) is required to consolidate the VIE into its financial statements if the reporting entity is the primary beneficiary of the VIE and to include certain disclosures in the consolidated financial statements. If the reporting entity is not the primary beneficiary, but has a significant variable interest in the VIE, the reporting entity is required to include certain disclosures in its financial statements. The accountant should be familiar with ACG 15 and / or FIN 46.

What this can mean is that in order to complete a GAAP audit on the company we're focused on financing, we also have to complete an audit on the companies that the company is funding and that the financials, as a result, have to be consolidated. The financials of the VIE entities are usually in disarray and contain as many, if not more, issues as the main company. The increases the cost, time, and risk involved in taking the company public.

A Resounding Call for Greater Due Diligence

"…China has proven to be a graveyard of good intentions for high-profile investors who swore up and down that good research, big law firms and bigger accounting firms will protect their investments. Time after time, their best practices and high-priced talent have failed to detect even the most elementary red flags."

source: "ChinaCast Education: Curious Dealings Raise Red Flags," by Roddy Boyd, editor, The Financial Investigator.com, article dated March 30, 2011

From a Monday morning perspective, it is impossible to argue with the above statement.

An urgent groundswell has surfaced among U.S. investors clamoring for greater due diligence to be applied to the China-based U.S. listed sector. Corporate governance and transparency issues are at the top of investor concerns. With today's pervasive lack of investor confidence, the need for independent, extensive, and credible due diligence has never been more apparent.

Last year was certainly challenging for those investors who purchased China-based U.S. listed stocks. Allegations of fraud or confirmed fraud cases in 2010 impacted the following companies:

- Northeast Petroleum (NEP)
- Fuqi International FUQI)
- Rino International (RINO)
- China Biotics (CHBT)
- China Sky One Medical (CSKI)
- China Marine Food Group (CMFO)
- Orient Paper (0NP)
- China Education Alliance (CEU)

As a result, investor confidence was undermined and valuations fell across the board within the sector. The ROTH Capital China Research Coverage Universe (including 68 Chinese small cap companies) ended 2010 down -12.3%, while Nasdaq and Russell 2000 recorded gains of +16.9% and +25.3% respectively.

The performance of this sector in Q1 2011 has again been negatively impacted by a steady stream of either actual or alleged corporate malfeasance. More than a handful of company stocks have been halted for trade on the NYSE, AMEX, and Nasdaq stock exchanges. The reasons vary from delays in their required filings with the SEC, actual firings or resignations of auditors during the preparation of the company filings, in addition to the publishing of various and numerous research reports identifying and alleging fraudulent business practices. Just within the past two months, the following stocks have been halted:

- China Media Express(CCME)
- Puda Coal (PUDA)
- China Intelligent Lighting (CIL)
- Universal Travel (UTA)
- China Electric Motor (CELM)
- Subaye (SBAY)
- China Century Dragon Media (CDM)
- China Agritech (CAGC)
- Keyuan Petrochemical (KEYP)
- NIVS Intellimedia Technology (NIV)
- Duoyuan Global Water (DGW)

In fact, as of April 11, twelve of the fifteen stocks halted on the NYSE, the AMEX, or the Nasdaq were China-based companies.

One of the main problems with this sector is that many of these companies should never have come public in the first place. There are 400+ China-based companies listed in the U.S. today—most of them came public since 2005. To encourage entrepreneurship during the past decade, the PRC permitted Chinese businesses to list their shares in Western Capital Markets. Nearly 75% of the public Chinese companies today entered the U.S. equity markets "through the backdoor" via a reverse merger or RTO. Reverse mergers involve a closely held private company which buys a sufficient number of shares in a publicly traded shell company to transform itself essentially into a publicly traded entity. The goal of achieving a listing status is thereby achieved. By selecting the RTO process, the company also saves both time and money versus the more conventional route of a registered initial public offering (IPO). The resulting downside to investors is that these China-based companies received less due diligence and management scrutiny when they first came public. Even SEC Commissioner, Luis Aguilar, admitted in a speech he gave in April this year that reverse mergers do not involve the same vetting from underwriters and investors that occurs with an IPO. This article contends that if a more rigorous screening process had been imposed on those seeking a U.S. listing initially, the current fallout out would likely be less pervasive.

But investors face other issues with this sector as well. Cultural, linguistic, and geographical differences are only part of the challenge. Many of these companies have limited track records. Operating a young public company today in the U.S. is no doubt a difficult task. Operating a U.S. listed company located in China with limited experience and where the cultural and business practices are vastly different from here only exacerbates the challenge. This difference in fundamental business perspective is far from trivial—particularly when a Chinese management team does not understand nor appreciate the expectations of a U.S.-based sophisticated investor. Recently, sell-side bankers, attorneys, and accounting firms have made a more concerted effort to educate Chinese management teams as to the obligations associated with being a public company. This action on the part of the financial community has been largely taken to mitigate their own potential liabilities. Just within the past year, several financial firms have published checklists for investors who wish to differentiate between China-based companies. Other entities have recommended a set of critical criteria to be met in order

to minimize the potential for negative surprises. While these suggestions offer some assurance to investors seeking less risk, they provide no guarantees.

As with most successful investment approaches, hard work as a component of extensive due diligence, cannot be avoided. Greater effort is required when doing your "homework" on China-based companies. While it is possible to jump on a plane within the U.S. with the objective of visiting directly with a company management team in their offices—this approach is much more problematic with China-based companies located half a world away, with a management team that speaks a different language (both literally and figuratively), and with a business carrying multiple sets of books designed for different audiences. This is the current reality—nothing can be substituted for extensive due diligence performed in China by knowledgeable in-country professionals whose objectives are based upon uncovering the facts. For the institutional investor, this translates into the harsh reality that greater effort or deeper resources are required when investing in China-based companies. Large investment firms with substantial resources here and in Asia are doing just that. For the bulk of the U.S. professional investors who focus on China-based companies, this is not an option.

A number of U.S.-based investor relation firms offer much needed company exposure to the local investment community. To varying degrees, several sell-side research firms also provide valuable perspective to investors. The research effort, however, is often driven by past or future underwriting fees. While the overall company input provided to "the street" is credible and represents a value-added service, this input is also undeniably influenced by the realities underpinning their respective business models. Each business has an agenda, which may potentially bias their perspective.

At Agile Asset Management, we are convinced that many attractive investment opportunities do exist in China. Yet one has to be extremely selective. One must approach this sector company by company. Our objective is to mitigate some of the challenges associated with investing in the China-based U.S. listed sector. The commitment we make to our clients is to provide company information in an unbiased, strictly objective context. We focus upon a broad array of relevant criteria often requested by investors today regarding these companies. The primary objective of our due diligence is not only to be factual and critically informative, but also instructional and insightful. Our due diligence is conducted both in the U.S. and in China. We engage

various professionals to assist us in this due diligence process. These resources are paid directly by Agile Asset Management for the services they provide to us. As a result, the input we provide to our clients is strictly independent and free from any conflicts of interest. In the spirit of “rigorous objectivity”, we refuse to provide any specific recommendations—“buy” or “sell”—rather we allow our clients to reach their own conclusions based upon the facts and insights we provide. If you would like more information regarding the various services Agile Asset Management provides to investors, please visit our website: www.agileasset.com

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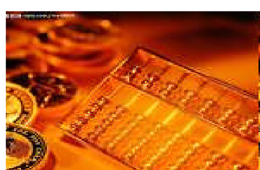

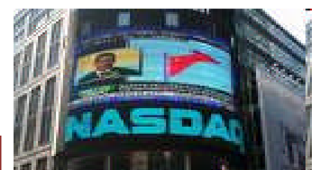

Thornhill Capital provides onsite due diligence; US GAAP-compliant financial reconstruction; audit preparation and process management; design, testing and implementation of effective internal controls over financial reporting required by Sarbanes Oxley; reconciliation of Chinese tax reports to US financial statements; bi-lingual CFOs; translation services; and a variety of other accounting, compliance, and administrative services for companies listed in the US.

A full list of services can be found at www.thornhillcapital.net

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