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Citron reports on Longtop Financial (NYSE:LFT)

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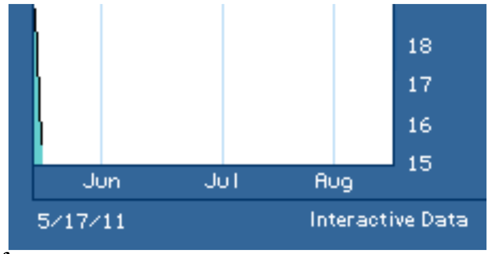
"Money made through dishonest practices will not last long"...Chinese Proverb

stock ticker: **LFT**

1d 3m 6m 1y 2y 5y

Introduction

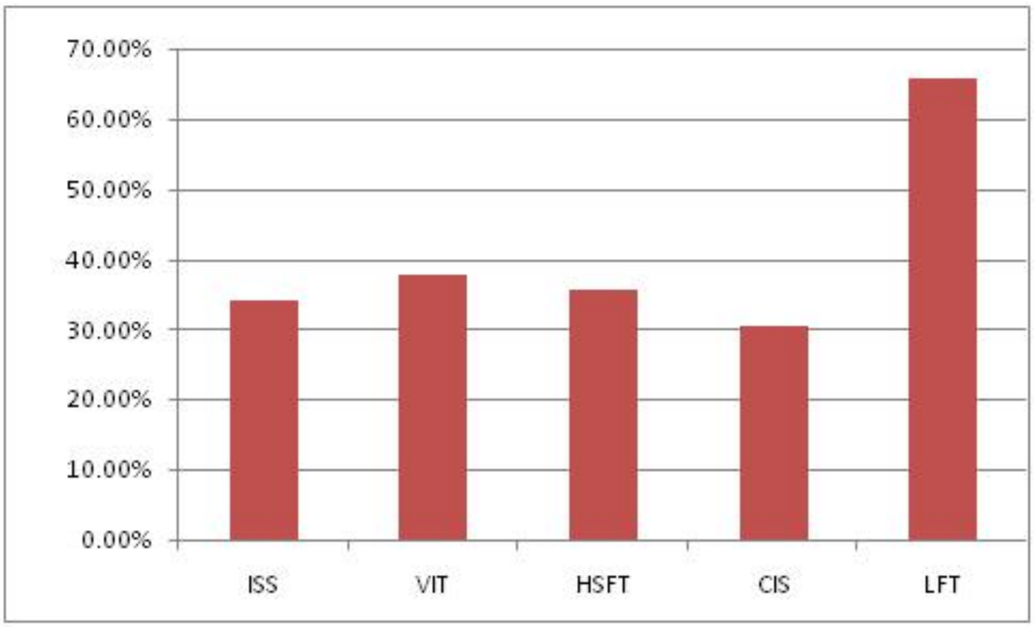
To think the fraud in the US listed Chinese stocks is limited to the RTO market is naïve.



Citron introduces a story that has all the markings of a complete stock fraud — with off balance sheet transactions that create outsized margins and management with backgrounds unsuitable to run a public company.

The most obvious risk factor in the China space, and the factor that has linked so many of these collapsed stocks, is obviously "the story too good to be true". Which brings us to the curious case of Longtop Financial (NYSE:LFT), a company that produces software for the banking sector. In this report, Citron outlines several concerns which should be considered by the auditors as they prepare the company's annual audit. It is the opinion of Citron that every financial statement from its IPO to this date is fraudulent … read on to understand.

Margins far in excess of competitors



Ticker	Company	Market Cap
ISS	Isoftstone	388 m
VIT	VanceInfo	1,450 m
HSFT	HiSoft	619 m
CIS	Camelot Information Syst.	916 m
LFT	Longtop Financial	1,460 m

LFT reports spectacularly high margins — much greater than any peer company. In the fiscal year March 2010 LFT reported gross margins of 69% and non-GAAP operating margins of 49%. Peers report gross margins between 15-50% and operating margins of 10-25% or even lower.

Management's explanation for the high margins is that they have more standardized software sales then peers and standardized software has very high gross margins of around 90%. The company claims that these solutions and modules can be deployed to new customers with fewer man-hours and expenses.

Furthermore, even if you believe the standardized software gross margin is 90%, then this implies that LFT is generating 60-65% gross margins on customized software development which is still much higher than peers. If the China space has taught us anything, it is that when something seems too good to be true, it probably is. So what is the real reason for these supersized margins?

1. Unconventional Staffing Model

Until recently, the vast majority of LFT's employees were not directly employed by the company. As of March 31, 2010 LFT had 4,258 employees of which 3,413 (80%) were employed by third-party HR staffing companies.

Of the employees at staffing companies, 95% (3,235) were from a single firm called Xiamen Longtop Human Resources Services Co (XLHRS), but this entity has no verifiable business presence except for LFT. (The remaining 5% were being serviced by Beijing FESCO and Randstad Shanghai Temp Staffing, both of which do have a verifiable business presence beyond LFT).

LFT has consistently claimed that (XLHRS) is an unrelated party. The existence of Longtop Staffing has allowed LFT to transfer the majority of its cost structure off-balance sheet which creates opportunities for massive accounting fraud. Does any of this sound unrelated to you?

- Xiamen Longtop Human Resources (XLHRS) shares a name with its only customer: Longtop Financial.
- XLHRS was formed in May of 2007, just months before LFT's IPO
- Even though it is its largest line item expenditure by far, XLHRS is never mentioned in filings until the annual report filed July 2008.
- XLHRS has no website and does not seem to be soliciting any customers, even though they just lost their only customer
- LFT did not have any long term contract and did not have to pay any penalties or minimums in their relationship with XLHRS
- XLHRS used the same email server as their only client — as evidenced by these help wanted ads placed by them that ask perspective employees to contact them at "longtop.com. For example, this is a 2009 job listing listing for XLHRS using a Longtop.com email address: **http://www.xmjob.com.cn/web/temp/sh.aspx?ID=101114**
- As of writing of this report, Citron has reason to believe that XLHRS has for months been located in the same building as Longtop Financial.
- When the outsourcing agency relationship was challenged, the company's response was to terminate it, and take all the employees in-house.

Same building, same email, same name, no other customers … but a totally unrelated party?

If in fact XLHRS is discovered to be anything other than a completely independent company, then every financial statement from inception to the present will have to be restated, and Longtop will go down in history as "another China fraud stock".

Previously, the company claimed this outsourcing arrangement was part of the justification of its outsized margins. Yet now that they are dumping XLHRS, the company says there will be no financial penalty, no cost and no margin loss associated with "taking a Mulligan" on the whole relationship! Great trick!

"Extreme outsourcing" is a common characteristic of other stocks in the China space that have collapsed under findings of fraud. Why? Because it obliterates transparency. For example: the large advertising sales teams responsible for CCME's huge reported income couldn't be located – the company claimed they were outsourced. Similarly, DGW and DYP claimed outsourced distributor networks; reality was another matter.

We understand that Citron is making a bold claim in saying that Longtop is committing fraud by setting up their own HR Company to lay off certain liabilities. What the outsource maneuver does is make invisible a lot of metrics that would afford meaningful insight into how the company operates, such as ratios of revenues per employee, costs per employee, etc.

Even though all the indicators and evidence would suggest XLHRS is a subsidiary of LFT, and **not** an unrelated party, **would management be that brave to set up a company with the same name in order to deceive?**

YES!! THEY HAVE DONE IT BEFORE — AND HAVE BEEN FOUND LIABLE, TOO.

2. Key Management Background Misdeeds

- "Study the past if you would define the future." Confucius

Before they founded Longtop, Chairman and CEO Jia and Lian worked for a company named Xiamen Dongnan Computer Co. They conveniently left this out of their bios in the prospectus.
http://www.sec.gov/Archives/edgar/data/1412494/000119312507211136/df1.htm

> **Mr. Xiaogong Jia** *is one of our founders and has served as the chairman of our board of directors since our inception in June 1996. Mr. Jia has over 29 years of experience in China's IT industry. He is currently a standing director of the China Business Council, director of Fujian Computer Society, vice-president of Xiamen Computer Society and standing vice chairman of Xiamen Software Industry Society. Prior to founding our company in 1996, Mr. Jia has served various positions including deputy head engineer, vice general manager and general manager of Xiamen Longtop Electronic Computer Company.*
>
> **Mr. Weizhou Lian** *is one of our founders and has served as our director and chief executive officer since our inception in June 1996. He has over 20 years of experience in China's IT industry. Prior to founding our company, Mr. Lian held various positions, including technology department manager, sales department manager, vice general manager and general manager, of Xiamen Longtop Electronic Computer Company from 1985 to 1996.*

A reason for this omission could be that they were sued by their former employer for unfair business practices.

[Translated Case: Xiamen Dongnan vs Jia Xiaogong and Lian Weizhou]

In the lawsuit, they were found liable for drawing salaries from their old employer while working for their own company.

Leading up to mid-1996, Jia Xiaogong (LFT Chairman, aka Ka Hiu Kung) and Lian Weizhou (LFT CEO, aka Lin Wai Chau) were working as managers **at Xiamen Dongnan Computer Co** (XDCC) and its parent company.

On July 15, 1996, unbeknownst to their employer, Jia Xiaogong, Lian Weizhou, and two others set up a company called **Xiamen Dongnan Rongtong Electronic** Co (XDREC), and allegedly recruited 43 of their co-employees.

The suit also alleged that on October 15, Lian signed a contract with one of XDCC's major clients, but inscribed on the contract that he was working for XDREC instead of XDCC. The two company names sound very similar in both Chinese and English so it would be likely that the client thought he was signing a contract with XDCC. (The good ole' same name confusion trick!)

And this is what we found most amazing:

Then, on November 26 Xiaogong and Weizhou allegedly sent a letter to the Xiamen Postal Office stating, "due to our business needs, our address has changed from 5th floor, Huli Information Building to 11th floor, Huanjian Building, Xinzhong Road, Xiamen; please forward all relevant mails to the new address". The new address was a PO Box they set up to illegally intercepting the mail of their namesake company. http://www.xmjob.com.cn/web/temp/sh.aspx?ID=101114

It should be noted that this was no ordinary case. It went to the high court in Fujian. Talk about a **"textbook case"** – this case has literally become one! Here it is referenced as one of the cases in the book entitled:

"Anti Unfair Competition Law: Principal Cases"

So we are supposed to believe the management would never pull the same name trick.....even though they have done it in the past. Do You Really Believe This??

At the very least, had this track record of management been properly disclosed in the prospectus, investors would have had the option of considering it before deciding to plunge hundreds of millions of US investment dollars into this company. This was, after all, the foundation of the current Longtop. Would the IPO have actually closed?

3. Non-transparent Management Transactions

In a day in age where Warren Buffet and Bill Gates are pleading with billionaires to give half of their fortune away to charity, Longtop Founder and Chairman Hiu Kung Ka has gifted 70% of his stock holdings to his own employees and friends in the first 4 years of the company being public. This transaction is not just fishy…..it stinks.

We challenge anyone, including the analysts, to find any CEO or Chairman of a publicly traded company on any exchange in the world, who has "gifted" this amount of stock to his own employees.

Does the guy — who set up a dummy P.O. Box to divert his employer's mail and steal its customers –seem like the kind of guy who would just give away his net worth with no encumbrances? We know that Hiu Kung Ka is a shrewd businessman who doesn't mind playing loose with the rules. And we are supposed to believe that he has just "gifted" 9 million shares, valued at over a quarter billion dollars?

It is the opinion of Citron that this transaction has an undisclosed "tail". Was money used to either pay off hidden liabilities of the company? Or does it generate an undisclosed benefit to Mr. Ka? Either way, this type of transaction undermines the credibility of management, which, in the absence of full transparency, must extend to revenue recognition, acquisitions, and staffing cost issues, LFT's largest expense.

4. Audit is coming – will it be a day of reckoning?

LFT is audited by Deloitte Touche Tohmatsu, the mainland China arm of Deloitte & Touche. Prior to this year, investors would have regarded Deloitte as "the gold standard" for accounting in China.

However, in the wake of the CCME debacle, in which Deloitte's recent resignation letter identified no less than ten separate instances of the most egregious corporate malfeasance, Citron has to wonder how it was that Deloitte was all too happy to sign off on CCME's books in 2009.

Obviously the halo over Deloitte's head has been broken. There are a lot of bridges to be crossed before Longtop's current-year audit can be put to bed.

A Note to Analysts

Last week the analysts were quick to defend the company –against accusations that were never made. Instead of just dismissing any bear case … Citron says do what you are paid to do … start ANALYZING. The last thing Wall St. needs is more discounted cash flow analysis based on asking for management's forecasts.

Citron challenges you to answer these concerns **without starting with the phrase "after discussions with management".** Do LFT's margins truly pass the smell test in cost-competitive China? Does the staffing story make perfect sense to you? How about management's stock gifts?

If not, what are the risks of "massaged" revenue recognition, and/or the ugly implications of related party impacts on acquisitions, cost accounting, and stock transactions?

Other Issues

As telegraphed by the analysts and management, there are concerns about the revenue recognition from some of LFT's larger customers. We will save all information on the revenues for Part 2 of our reporting on Longtop**.** The other issues that will be addressed in future reports are beneficial ownership of its acquisitions and the nonsensical answers the company has given for its unusual staffing model, which leaves critical investors thinking they are just **"making it up as they go along"**.

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