Dear PwC - Do AutoChina's financials pass the smell test?

Investors in U.S. listed Chinese companies have suffered sizable losses over the last three months. There has been no shortage of blogs that have correctly highlighted the widespread fraud in the Chinese RTO space. Had auditors initially examined many of the publicly raised concerns, the irreparable reputational damage may have never occurred. Ironically, the impetus for the recent crescendo of losses seems to be the newfound sense of responsibility by many auditors. With regulators demanding accountability, auditors appear unwilling to put rubber stamps on Chinese financials. As a result, countless Chinese companies have no auditor, no reliable financials, and huge uncertainty about what actually exists. With the Bloomberg Chinese Reverse Mergers Index declining over 40% since November 2010, it is no longer a shock to see exchanges halt trading in Chinese stocks due to new accounting scandals, auditor resignations, or accounting restatements. However, investors appear to be extra vigilant to ensure they don't own the "next halted stock." Many of these halted securities have experienced share price declines of at least 60% once trading resumes. We continue to be mystified by the complacent shareholder base in AutoChina, which very well could be the next implosion if PwC refuses to certify the financials by June 30th.

In two past reports, The Forensic Factor (TFF) highlighted our concerns about AutoChina's (AUTC) accounting and financial profile. With the foreign filer deadline fast approaching, we want to again go on public record stating our belief that AutoChina's <u>new</u> auditor, PwC Zhong Tian, has some major questions that need to be diligenced. In this brief follow-up, TFF will NOT focus on the shady related party transactions, the complicated organizational structure, the absurd financial guidance and origination outlook, or the massive and inexplicable funding gap the company currently faces. Instead, TFF wants to revisit AutoChina's accounting issues in front of its year-end audit deadline. As PwC, and other auditors, face massive liabilities (from large investor losses and the appearance of negligence, malpractice and breach of fiduciary duty), we implore PwC to focus on our past reports and the issues below.[1,2] TFF's research serves as public record that concerns were raised to PwC regarding AutoChina's accounting and business model, and we hope PwC will take their responsibilities seriously…. and it is not unreasonable to assume that recent delays in filing audited financials are reflective of problems PwC may have found.

AutoChina announced in mid-February that they would have AUDITED financials filed in March, "We look forward to announcing our fully audited 2010 fourth quarter and year-end financial results next month."[3] This timeframe is consistent with the filing of 2009 results, which occurred on March 22, 2010. Yet, in March, not only were no audited financials filed, AutoChina seemed to retract the previous reassuring statement by issuing a new timeframe, "The company anticipates filing before June 30, 2011."[4] While no explanation was provided for the delayed audited financials, TFF would highlight an ominous research report from Chardan Capital on April 21 that may forebode problems with the financials.

<u>Red Flag: Lead Underwriter "Suspends" Coverage</u>

TFF is not the only voice that has expressed concern over AutoChina's audit. Boutique investment bank Chardan Capital was the lead underwriter for the IPO of the SPAC "Prime Acquisition Corp" on March 31, 2011. As the table below highlights, Prime Acquisition and AutoChina have almost the EXACT same management team.[5]

<u>Shared Management - AUTC and Prime Acquisition</u>

[1] http://seekingalpha.com/instablog/790526-theforensicfactor/134750-autochina-autc-the-most-preposterous-chinese-reverse-merger-yet

[2] http://seekingalpha.com/instablog/790526-theforensicfactor/136544-autochina-part-1-5-imagine-if-this-was-a-u-s-company

[3] http://www.businesswire.com/news/home/20110215007622/en/AutoChina-International-Present-Upcoming-Investment-Conferences-Comments

[4] http://online.barrons.com/article/PR-CO-20110324-904890.html

[5] http://www.sec.gov/Archives/edgar/data/1485922/000114420411017376/v215957_424b4.htm

	AUTC	Prime Acquisition
Yong Hui Li	Chairman & CEO	Chairman / Director
Diana Chia Haei Liu	Former President; Director, Member of Audit, Governance & Nominating, and Compensation Committee	CEO / Director
William Tsu-Cheng Yu	Former Director, Husband of Ms. Liu	CFO / Director
Hui Kai Yan	Corporate Secretary & Director	COO
Gary Han-Ming Chang	"Special Advisor" to AutoChina	CIO & Director
Jason Wang	CFO	Director

As one of its marquee investment banking clients, Chardan Capital faces an understandable conflict of interest in covering AutoChina. Most investment banks would never publish a negative report on a banking client unless something was very wrong. As such, TFF was **surprised** to learn that Chardan, only a few weeks after the Prime Acquisitions IPO, suspended its rating and price target on AutoChina the day before a three day weekend.[6] After reviewing the research report, it appears Chardan was not comfortable with the 2010 audit following a discussion with management. There were no details in the report explaining what management said to generate this concern, but the analyst felt compelled to suspend his rating and price target after previously defending AutoChina.

Halted Chinese Companies

Dozens of Chinese companies have been halted since early March, with a handful already getting delisted. The auditor quality of these halted and delisted stocks runs the gamut. Big 4 firms Deloitte & Touche and KPMG have the not-so-distinguished pleasure of being involved with seven of these companies. To date, AutoChina's auditor, PricewaterhouseCoopers Zhong Tian, has only been involved with one (although PwC's affiliate in Hong Kong was involved in one also). It is unclear if PwC has a higher quality audit client list or if they are more complacent than Deloitte and KPMG in identifying accounting issues.

Selective Delisted/Halted US Listed Chinese Stocks

Halt Date	Company	Ticker	Auditor
delisted	Rino International	RINO	Fraser Frost
delisted	Duoyuan Printing	DYNP	**Deloitte & Touche**
delisted	China INSOnline	CHIO	Weinberg & Co
delisted	Xinhua Sports	XSEL	**Deloitte & Touche**
delisted	Tongxin International	TXIC	Malone Bailey
3/11/11	China MediaExpress	CCME	**Deloitte & Touche**
3/14/11	China Agritech	CAGC	**Ernst & Young**
3/15/11	ShengdaTech	SDTH	**KPMG**
3/21/11	China Century Dragon Media	CDM	Malone Bailey
3/24/11	NIVS IntelliMedia Tech	NIV	Malone Bailey
3/24/11	China Intelligent Lighting	CIL	Malone Bailey
3/31/11	China Electric Motor	CELM	Malone Bailey
4/1/11	HQ Sustainable Maritime	HQS	Schwartz Levitsky Feldman
4/1/11	Keyuan Petrochemicals	KEYP	**KPMG**
4/7/11	Subaye	SBAY	**PricewaterhouseCoopers Hong Kong**
4/11/11	Puda Coal	PUDA	Moore Stephens
4/12/11	Universal Travel Group	UTA	Windes & McClaughrey
4/18/11	China Ritar Power	CRTP	Crowe Horwath

[6] http://www.fixyou.co.uk/tracker_details.php?s=AUTC

4/20/11	Duoyuan Global Water	DGW	Grant Thornton
4/20/11	China Integrated Energy	CBEH	**KPMG**
5/6/11	Wonder Auto Tech	WATG	**PricewaterhouseCoopers Zhong Tian**
5/17/11	Longtop Financial	LFT	**Deloitte & Touche**

There are numerous parties that will face difficult questions in the coming months from lawyers, regulators and authorities. Auditors of Chinese RTO frauds face MASSIVE liabilities due to large investor losses and the appearance of negligence, malpractice and breach of fiduciary duty. One of the more blatant examples of a Big 4 auditor breaching its fiduciary duty (or worse) is KPMG's audit of China Integrated Energy (ticker CBEH). CBEH hired KPMG in December 2010 to audit the company's 2010 results. On March 16th, 2011, CBEH filed its 10-k with a clean audit opinion from KPMG.[7] That same day, video surfaced that appeared to verify that CBEH was operating idle factories and was in fact a fraud.[8] CBEH's stock had declined 75% year-to-date BEFORE the shares were halted on April 20th. TFF has a tremendous amount of respect for the Big 4 accounting firms and the accounting profession in general. However, it appears that accountants have been complacent relating to the massive fraud that has occurred in Chinese RTOs.

<u>Auditor last line of defense for most investors</u>

Most U.S. investors do not have the time, money, or resources to perform the level of diligence required to flesh out these frauds (like video taping a facility for three consecutive weeks). As a result, the auditors provide one of the last lines of defense to protect investors. Auditing services are performed on behalf of shareholders and for the integrity of the markets. Given the documented concerns and red flags, TFF believes PwC should approach its audit with intense rigor and be in a position to provide extensive documentation and evidence related to its procedures. There have been many similar themes across the RTO frauds, but some of the most glaring have been odd financial statements that defy COMMON SENSE. Along these lines, TFF points out:

*It defies common sense that that AUTC has only 20 defaults out of more than 23,000 leases
*It defies common sense that a $1.7 million reserve is sufficient to cover over $850 million of leases
*It defies common sense that a grocery store has provided hundreds-of-millions of dollars of funding to AutoChina
*It defies common sense that the expense base is virtually non-existent for a national network of 300 stores and thousands of employees
*It defies common sense that AutoChina accounts for its delinquencies as "account receivables" and its related party debt as "accounts payable" and "due to affiliates"

One thing is clear: AutoChina does not look like any leasing company that we have encountered, and TFF believes the most likely reason is financial statements that PwC will not be able to support. AutoChina's reported financials are such an extreme outlier from the myriad of historical models that any prudent investor should question the numbers. TFF's work continues to support our original opinion that AutoChina has significant accounting issues and questions. Below are some of the outstanding points that PwC will need to address before any audit can be completed. This process could be the impetus for a large restatement (at best) given the company's aggressive accounting policies, or even a resignation from PwC (at worst).

I) The use of gain on sale accounting by an independent finance company does not conform to GAAP

AutoChina utilizes gain on sale accounting that dramatically overstates revenue and front-loads profits. AutoChina's accounting is so aggressive that it allows for the recognition of a profit on day one for simply providing a loan! This sales-type lease accounting generates substantial "paper"

[7] http://www.sec.gov/Archives/edgar/data/1070045/000114420411015214/v214864_10k.htm
[8] http://vimeo.com/channels/cbeh

income but significantly overstates and misrepresents economic income. Sales-type lease accounting is reserved for manufacturers that have captive finance organizations (allows a company to recognize revenue and gross profit on the sale of the equipment that they manufacture). Since AutoChina's value proposition is almost exclusively providing financing, it is unclear how the company justifies this accounting treatment. AutoChina's revenue and income would look dramatically different under GAAP lease accounting standards that should be used by non-manufactures. For example, TFF has estimated in past reports that revenue may be overstated by as much as 75%.

II) Credit and reserve makes little sense

Given the myriad of related party transactions, checkered history of management and reliance on plain old common sense, TFF is extremely skeptical towards AutoChina's claims of pristine credit quality. Based on TFF's experience with leasing companies, transportation finance, auto finance, and banks, we believe AutoChina's delinquencies and reserves are too good to be true. History has shown that when a company can recognize profits by simply providing a loan, there is very little incentive to stringently underwrite a credit.

A downside to recognizing profit upfront is future credit losses can provide a huge downside surprise (reversal of recognized gains, costs of repossession, and loss on collateral). TFF believes this concern is relevant given the recent jump in delinquent accounts relative to the minuscule provision for loan losses. In fact, TFF believes AutoChina has only reserved $1.7 million against nearly $450 million of GAAP loans (and over $850 million of loans provided over its history). According to the fourth quarter earnings press release, over 5.25% of AutoChina's loans were delinquent as of December 31, 2010, versus only 1.11% at June 30, 2010. This deteriorating loan book paints a different picture than the paltry reserve that represents less than 0.39% of the total lease portfolio. Management claims to have experienced less than 20 defaults (versus 23,000 leases) and cumulative losses of roughly 15 basis points. TFF believes this would represent one of the greatest accomplishments in modern finance, defying all conventional laws of lending.

AutoChina's credit experience seems to be even more amazing considering recent press reports coming out of China. A recent New York Times article highlighted the "brutally competitive" independent trucking market in China, "Within China, thousands of small trucking companies, many of them family-owned, compete by promising low-cost delivery. Then they overload their 18-wheelers in dangerous ways, pay bribes to ward off highway inspectors and hope to eke out tiny profits. Now, though, with global oil prices sending the cost of fuel soaring, many truckers say they are heading toward bankruptcy. Many of the factory bosses seem to recognize that there is an oversupply of small trucking companies desperate for cargo" and "are reluctant to pay higher fees to move goods."[9] A Financial Times article echoed this deteriorating trend, "One problem is that there are so many independent truckers in China that each feels they will lose business if they raise their prices even slightly."[10]

Additionally, AutoChina's accounting for reserves and delinquent loans defies financial logic and is treated differently than anything TFF has ever seen. According to management, they place delinquent loans into accounts receivable on the balance sheet and build their reserve as a bad debt expense against the A/R. The company also classifies its related party debt as "accounts payable" and "due to affiliates" on the balance sheet. TFF believes this treatment does not conform to U.S. GAAP.

III) Why is the "reported" expense base so low?

In 2010, AUTC nearly doubled its store count (157 to 300), while growing originations by 66%. Incredibly, their "sales and marketing" expense rose by less than $1 million year-over-year. AutoChina's G&A increased $8.3 million year-over-year, but stock compensation and the small

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[9] http://www.nytimes.com/2011/04/29/business/global/29truckers.html
[10] http://www.ft.com/intl/cms/s/0/47e6d13e-6e8f-11e0-a13b-00144feabdc0,s01=1.html#axzz1NNqLEGbV

increase in provisions represented a good chunk of this change. TFF estimates that AutoChina only has $23 million of total SG&A to support: over 200 members of management, 23,000 leases, 300 branches (with 6 to 7 employees per branch), and over 2,000 employees. The level of SG&A per employee suggests that AutoChina is one of the most efficient lenders in the world. After backing out some easily identifiable expenses from SG&A (including audit fees, stock comp, depreciation and provision expense), TFF estimates that AUTC only spends $9,000 to $11,000 per employee for all overhead, salaries, rent, insurance. This level of expense (again) appears to defy common sense.

SG&A per employee	
2010 SG&A	$23,850
Audit fees	481
Depreciation	1,000
Provision	1,000
Stock comp	3,000
Total	5,481
Total SG&A excluding above	18,369
Estimated average employees	1,650
Estimated end employees	2,050
SG&A per employee	$11,133
SG&A per employee	$8,960

Through the first nine months of 2010, AutoChina's transactions with related parties amounted to $865 million.[11] The related parties include a grocery store chain owned by the CEO and Director, and businesses wholly or partially owned by the CEO, his wife, his brother, and a Director. Given the sheer volume of dollars shifting back and forth between these related parties, there is ample opportunity for impropriety (such as hiding expenses and credit losses). TFF believes some of these related party transactions are simply unjustifiable and may represent a glimpse into more menacing activity. For example, why is Kaiyuan Doors, a company owned by the CEO and his wife, selling over $1 million of "trading materials" to AutoChina? Why is Wantong Longxin, a company owned by the CEO's brother, selling $4.6 million of "trading materials" to AutoChina? Why is Beiguo (the grocery story) purchasing $19 million of "trading materials" from AutoChina? Why is Hebei Kaiyuan providing office space to AutoChina rent free?[12]

IV) Interest expense / related party debt

Since AutoChina's inception, the largest provider of debt has been a grocery store chain by the name of Beiguo Commercial Building Limited, which is owned by AutoChina's CEO and another board member. But their grocery-store partner is just one of many strange bedfellows that include unusual interest free loans from the CEO and below market deals from a company owned by the CEO's brother. AutoChina's complicated web of related party debt financing has fluctuated wildly in recent periods. The fact AutoChina has been borrowing from related party entities interest free, or even at below market rates, significantly distorts the company's normalized income statement and overstates earnings. Management emphatically responded to TFF's past criticisms, stating a goal to reduce the reliance on related party funding. TFF is convinced that if the related party transactions slow, the future income statement will be dramatically different. But these assertions by management appear to have no substance, and in fact we believe the company's actions are in direct contradiction to their public promises.

[11] http://www.sec.gov/Archives/edgar/data/1417370/000114420410063155/v203555_6k.htm
[12] http://www.sec.gov/Archives/edgar/data/1417370/000114420410063155/v203555_6k.htm

On May 31, 2011, AutoChina disclosed it had entered into a $61.57 million short-term loan with a firm called Honest Best on March 29, 2011. TFF believes that Honest Best is 100% owned by AutoChina's CEO - a fact the company failed to disclose in the 6K. If TFF is correct, and Honest Best is indeed controlled by the CEO, then AutoChina has another regulatory problem. Current reports from foreign private issuers are required to be "furnished promptly after the material contained in the report is made public." In the U.S., the SEC defines "promptly" as four days. TFF does not understand why it took AutoChina over two months to provide this disclosure.

This reliance on related party transactions and debt can often be associated with unscrupulous activity and/or exchanges which are clearly not arms length in nature. TFF was not surprised to learn that "loans to related parties were the most frequent type of related party transaction" that drove SEC enforcement actions involving fraud. TFF believes PwC needs to examine how AutoChina is accounting for it interest free and sub-market debt. Under APB Opinion No. 21, debt with below market interest rates must be discounted (adjusts the principal of the debt to equivalent debt having the market rate of interest). This discount flows through the income statement. Given the large below market rate debt that is used to fund operations, AutoChina is significantly understating its interest expense.

V) Compensation expense may be dramatically understated

TFF believes that AutoChina's compensation expense is significantly understated because it does not include a realistic cash comp figure for the CEO, nor does it include the earn-out that has been offered in lieu of cash compensation. The stock compensation expense appears to be hidden from investors because it is not reflected in the company's income statement. AutoChina has used a large earnout to compensate its CEO. After examining FASB guidelines, TFF believes these earnouts should be expensed through the income statement and the existing treatment does not conform with GAAP. Although there is some ambiguity, FASB has provided a framework for expensing earnouts. Management's rationale for not expensing stock comp relies on the argument that the earnout is "based on performance that is not tied to employment," and that the "original intent" would compensate Mr. Li for EBITDA growth. TFF believes that AutoChina is incorrect. Accounting is not static, nor is it based upon intent. EITF 95-8 clearly states that earn-outs must be classified as an expense if management is not compensated at levels consistent with "other key employees." AutoChina's CEO was paid only $1.00 in salary with no bonus or other compensation in the last fiscal year. This level of compensation would clearly be defined as well below "other key employees."

As a result, the earnout should be considered "compensation" expense under U.S. GAAP. The value of stock issued to Li in 2010 was over $57 million. If this was expensed appropriately, AUTC would have had negative pretax earnings in 2010.

PwC - Is this worth the reputational risk?

The ball is in PwC's court. TFF can only hope that PwC has checked every box and in doing so has found the magical elixir that would explain a financial and operating model that seems to defy every basic element of common sense. It is our belief that PwC will not be able to reconcile and support past financials. If this is the case, AutoChina may represent just one more RTO that makes the daily halt list, destroying investor capital and auditing reputations in the process.

Disclosure:

*** The author of this article is short AutoChina stock. TFF goes to great lengths to ensure that all information is factual and referenced. All facts that we present herein are true to the best of our knowledge. All opinions presented are our own and accurately reflect our opinion on the relevant subject being discussed. We recommend that investors perform their own extensive due diligence before buying or selling any security.