Telestone Technologies - A "RINO" in sheep's clothing

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There has been no better arena for recent fraud allegations and admissions than Chinese reverse mergers. From the host of boutique research shops, to online blogs, to even Barron's and The Wall Street Journal (online.barrons.com/article/SB50001424052... and online.barrons.com/article/SB50001424052...), the underbelly of Chinese reverse mergers has been exposed.

One name that has sidestepped the microscope until now is Telestone Technologies (NASDAQ: TSTC). However, after a deep dive into Telestone, The Forensic Factor ("TFF") has concluded that Telestone is possibly the most egregious target of the entire vilified Chinese reverse merger universe. TFF believes indisputable, as well as circumstantial, evidence exists that supports our request to the NASDAQ to halt trading in TSTC immediately to ensure investors are not acting with incomplete and/or inaccurate information. Our request to the NASDAQ is based on the following reasons that will be highlighted in this report:

- A failure to generate a penny of cumulative cash flow, despite claims of spectacular revenue and earnings growth.
- A revenue recognition and accounts receivable policy that does not appear to conform to GAAP accounting.
- A blatant admission in their public filings that they recognize revenue and services before goods and services are rendered - while failing to disclose any unbilled receivables.

- An apparent change in the ratio of allowance for doubtful accounts that overstated earnings last quarter by roughly $0.22 per share. The overstatement occurred directly in front of an $18.9 million capital raise.
- Two separate auditor resignations, a mere seven months apart from each other.
- A claim to have developed a meaningful "new industry standard" in wireless despite spending less than $1 million per year in research and development.
- A much smaller public competitor that has a notably different balance sheet, A/R policy, and cash flow profile.
- ***Their glorified and seminal entry into the U.S. market is with a distributor that was incorporated fifteen months AFTER Telestone claims to have started the relationship.***
- Three different CFO's in the last three years, as well as a history of IR and corporate contacts that appear and vanish with a convoluted trail that would leave the great Sherlock Holmes stumped.
- A reputable IR firm that "specializes in doing investor relations for small Chinese companies" (http://www.ebix.com/articles/Motley%2009-22-09.pdf) stopped working with Telestone just ten days after TFF began emailing them with company-specific questions.

While TFF is not calling Telestone a fraud (that is for regulators and class action lawyers to determine), we do believe that Telestone's recent capital raise was completed under the auspices of misleading information, as well as a blatant lack of disclosure replete with forensic discrepancies. As investors undoubtedly learned from RINO, which was halted for three weeks and declined nearly 85%, in the land of Chinese reverse mergers, appearances are not always what they seem.

REVENUES, ACCOUNTS RECEIVABLE, AND CASH FLOWS - OH MY!

Telestone Technologies came public through several unusual reverse mergers in 2004 and 2007, with one such merger actually including a company called Success Million International Limited that "had no business operations since incorporation" (http://google.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHtmlSection1?SectionID=6199067-126789-184701&SessionID=KhklHe9tsQLslA7). Like many reverse mergers, TSTC was able to grow revenues and net income at a steady and predictable pace.

Telestone did a meager $3.5 million of revenue in Q1'05 that ballooned to $43.1 million in the most recent quarter - which incidentally was reported nine days before raising $18.9 million from institutional investors. Further, TSTC has reported net income that increased from $860,000 in Q1'05 to a whopping $12.05 million in Q3'10. What is extremely concerning to TFF is that this spectacular revenue and net income growth over 23 quarters has produced just *eight* quarters of positive cash flow (Table 1):

	Q3'10	Q2'10	Q1'10	Q4'09	Q3'09	Q2'09
Net Inc	12.05	1.72	(1.13)	5.18	4.24	1.97
CFO	(0.71)	(2.18)	(1.14)	3.92	1.24	(2.37)
	Q1'09	Q4'08	Q3'08	Q2'08	Q1'08	Q4'07
Net Inc	1.15	3.31	1.12	1.78	0.84	2.32
CFO	(1.92)	1.36	1.44	(0.91)	(0.42)	0.83
	Q3'07	Q2'07	Q1'07	Q4'06	Q3'06	Q2'06
Net Inc	1.87	1.85	0.45	1.64	0.74	1.52
CFO	(2.08)	(1.50)	(1.12)	(0.75)	(0.96)	0.24
	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05	TOTAL
Net Inc	0.72	1.46	0.63	0.78	0.86	47.05
CFO	(1.54)	1.87	0.18	(0.22)	(0.68)	(7.42)

Table 1, source - Telestone SEC filings and FactSet

Many growth "stories" have negative cash flow cycles for short periods of time, but generally operating cash flow will trend towards net income. However, TSTC's cumulative cash flow since Q1'05 is actually NEGATIVE. Since the first quarter of 2005, TSTC has reported with the U.S. SEC (its SAIC filings in Chine show poorer results) net income of $47.05 million. During that same period of time, operating cash flow was negative $7.42 million. TFF can not recall an example of such an alarming and inexplicable delta between operating cash flow and net income over such a long time period.

After examining Telestone's revenue recognition policies, the payables policies of its largest customers, as well as public comments from management, TFF has concluded that Telestone is either reporting falsified financial results or has failed to conform to GAAP. Let us discuss our confusion, concern, and disbelief around certain financial issues that we can only hope the PIPE buyers were aware of at the time of purchase.

First, big revenue and net income numbers are irrelevant if there is never any cash that accrues to the company. Unfortunately for TSTC investors, TFF has yet to find an acceptable explanation (other than the nefarious) that would adequately explain the cash flow leakage. It appears that Telestone is recognizing revenue from customers (real or otherwise) that is never collected. Further, the miniscule and declining allowance for doubtful accounts seems to directly contradict the trends in accounts receivable.

According to Telestone's own revenue recognition policies from its 10K, revenues are only recognized when they are invoiced/billed (bold and underlined is emphasis of TFF) (http://yahoo.brand.edgar-online.com/DisplayFiling.aspx?TabIndex=2&FilingID=7159133&companyid=64423&ppu=%252fDefault.aspx%253fcompanyid%253d64423):

It is the common practice in the PRC that invoices are not issued to customers until payments are received. The Company follows the practice of reporting its revenue for PRC tax purposes when invoices are issued. For PRC tax reporting purpose, the PRC subsidiaries of the Company recognizes revenue on an "invoice basis" instead of when goods are delivered and services are rendered. ***<u>This is not in strict compliance with the relevant laws and regulations.</u>*** *Accordingly, despite the fact that the PRC subsidiaries of the Company had made full tax provision in the financial statements, these PRC subsidiaries may be subject to penalties for the deferred reporting of tax obligations. The exact* *amount of penalties cannot be estimated with any reasonable degree of certainty. The board of directors considers it is more-likely-than-not that the tax penalties will not be imposed.*

Try to ignore the fact that Telestone admits that they are not complying with PRC tax policy and as such could be subject to future penalties. Also try to ignore that Telestone blatantly states that they are not recognizing revenues when goods and services are rendered. Instead focus on TSTC's policy of recognizing revenue when customers are invoiced (even if services are never performed - but this isn't the point, yet). Based on their policies, logic would suggest that there are zero unbilled revenues (which seems appropriate given zero unbilled receivable disclosures in the filings). This is supported by a disclosure from the 10K that states "Accounts receivables are stated at the amount billed to customers" (http://yahoo.brand.edgar-online.com/DisplayFiling.aspx?TabIndex=2&FilingID=7159133&companyid=64423&ppu=%252fDefault.aspx%253fcompanyid%253d64423). If there were any doubt, this policy towards revenue recognition was affirmed on TSTC's Q3'09 call when CEO Han Daqing responded to a question on revenue recognition by stating "We book revenue when we issue invoices" (http://yahoo.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHtmlSection1?SectionID=6893261-38775-54427&SessionID=PfNbHjMCVRMFY77). Telestone has led investors to believe revenue is only recognized when invoices are created.

TFF believes Telestone's revenue recognition does not reconcile with accounts receivable (A/R) balances in the context of trailing twelve month revenues. <u>The fact the company claims to only recognize revenues when an invoice is created, combined with no long-term accounts receivable and a nominal bad debt reserve, would imply the company would collect the majority of its revenues within a year.</u> That has not been the case. On the contrary, TFF found that Telestone's A/R to TTM revenue has been over 100% for the last *twenty* quarters, or five years. But that is not the only major flag in Telestone's A/R structure. Equally as alarming are the: staggering DSO's, declining bad debt reserve, and a mysterious long-term receivable that only appeared in Q3'09.

	Q3'10	Q2'10	Q1'10	Q4'09	Q3'09	Q2'09
Revs	43.10	16.60	11.10	33.00	18.89	12.13
A/R	139.90	107.20	96.60	95.20	59.20	70.80
LT A/R	-	-	-	-	18.80	-
ADA	(5.80)	(6.20)	(6.20)	(6.20)	N/A	N/A
DSO's	292.13	581.20	783.24	259.64	371.63	525.31
ADA/AR	4.15%	5.78%	6.42%	6.51%	N/A	N/A
AR/TTM rev	134.78%	134.69%	128.59%	132.37%	111.05%	165.30%
	Q1'09	Q4'08	Q3'08	Q2'08	Q1'08	Q4'07
Revs	7.90	14.39	8.41	6.05	6.49	12.63
A/R	74.10	67.90	59.90	56.80	53.20	49.40
LT A/R	-	-	-	-	-	-
ADA	(6.10)	(5.80)	(5.00)	(4.80)	(4.40)	(4.40)
DSO's	844.18	424.67	641.02	844.96	737.75	352.02
ADA/AR	8.23%	8.54%	8.35%	8.45%	8.27%	8.91%
AR/TTM rev	201.63%	192.13%	178.38%	164.78%	132.77%	128.71%
	Q3'07	Q2'07	Q1'07	Q4'06	Q3'06	Q2'06
Revs	9.30	11.65	4.80	7.48	5.23	5.22
A/R	44.70	35.20	33.90	32.70	27.40	25.30
LT A/R	-	-	-	-	-	-
ADA	(3.60)	(3.30)	(3.30)	(2.90)	(2.50)	(2.50)
DSO's	432.58	271.93	635.63	393.45	471.51	436.21
ADA/AR	8.05%	9.38%	9.73%	8.87%	9.12%	9.88%
AR/TTM rev	134.52%	120.71%	149.14%	150.62%	138.73%	136.98%

	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05	
Revs	3.78	5.52	3.95	4.40	3.53	
A/R	27.90	25.10	27.80	25.30	22.90	
LT A/R	-	-	-	-	-	
ADA	(2.60)	(2.50)	(2.30)	(2.10)	(1.90)	
DSO's	664.29	409.24	633.42	517.50	583.85	
ADA/AR	9.32%	9.96%	8.27%	8.30%	8.30%	
AR/TTM rev	158.07%	144.25%				

Table 2 - source - Telestone's SEC filings

As seen from the Table 2 above, Telestone has had greater than 100% of its trailing twelve months revenues in A/R for every quarter dating back to its reverse merger. One possible explanation is that Telestone has massive collection problems as well as bad debt issues. Given the purported customer base (more on this below), bad debt is probably not the explanation. However, TFF does note that the allowance for doubtful accounts (ADA) as a percentage of accounts receivable (A/R) has dropped by over half in the last two years. We would also note that the ADA as a percentage of A/R fell to just 4.15% in Q3'10, while actually falling sequentially in absolute dollars, despite accounts receivable increasing 30% QoQ, or $22.7 million. Had ADA remained constant as a percentage of A/R sequentially, the reserve would have been $8.08 million (5.78% of $139.9M). This consistent reserve would have resulted in earnings that were $2.28 million, or $0.22 per share, lower than what was reported. Again, we are hopeful that institutional investors that purchased the recent PIPE were clearly informed that Telestone had actually reduced their absolute level of ADA's to overstate earnings. Ironically, the problems at Telestone are far greater than a $0.22 accounting benefit in front of a deal.

A second explanation for Telestone's inability to collect receivables in a timely manner (or at all), could be that they recognize revenues on percentage of completion. But based on the company's disclosures and public statements, as well as the lack of disclosures around unbilled receivables, this explanation seems impossible.

A third explanation could be that Telestone's biggest customers take longer than one year to pay them. If this were the case, Telestone would be required under GAAP accounting to book a long-term receivable (more on this to come). An online blog called Sharesleuth also explored the accounts receivables issue (sharesleuth.com/shorttakes/2010/08/small.../). They found that Telestone's largest customers had no accounts payable extending beyond 12 months. In China Mobile's 10K, the company discloses "All of the accounts payable are expected to be settled within one year or are repayable on demand" (http://quicktake.morningstar.com/stocknet/secdocuments.aspx?symbol=chl). This effectively rules out extended payables as the answer because Telestone claims that China Mobile, China Unicom, and China Telecom represented 99% of revenues and receivables year-to-date (http://www.faqs.org/sec-filings/101115/TELESTONE-TECHNOLOGIES-CORP_10-Q/).

THE GAME OF AUDITOR MUSICAL CHAIRS

A fourth explanation for the unnerving accounts receivable is far more ominous. As mentioned above, an unusually large long-term receivable popped up in Q3'09 ($18.8 million) and then was eliminated the following quarter just as quickly as it appeared. TFF believes that Telestone's juggling auditors may hold the key to the mysterious long-term A/R. During fiscal years 2007 and 2008, a French outfit called Mazars CPA Limited was Telestone's auditor. During the middle of 2009, Telestone announced that Mazars had resigned. The press release was dated July 13, 2009 (www.istockanalyst.com/article/viewiStock...), which would have been around the time the financials should have been filed for Q2'09. In that release, Telestone announced it had engaged QC CPA Group, LLC, with CEO Daqing stating, "We are glad to cooperate with QC CPA Group, LLC. We believe that QC CPA Group, LLC can provide us with high-level and professional service. We had a nice cooperation with Mazars CPA Limited and we look forward to having a pleasant cooperation with QC CPA Group, LLC in the future." Well this "pleasant cooperation" lasted exactly two reporting periods before QC CPA Group also promptly resigned. Surprisingly, there was no press release that TFF could find disclosing this resignation. Instead, Telestone surreptitiously rehired Mazars with no disclosure of the change until item 9 of the following year's annual report (http://yahoo.brand.edgar-online.com/DisplayFiling.aspx?TabIndex=2&FilingID=7159133&companyid=64423&ppu=%252fDefault.aspx%253fcompanyid%253d64423):

During the Company's fiscal years ended December 31, 2008 and 2007 and through July 8, 2009, the Company engaged Mazars CPA Limited previously as the independent registered public accounting firm prior the engagement of QC CPA Group, LLC on July 9, 2009 through January 14, 2010. QC CPA Group, LLC performed the interim reviews of the Company's financial statements for the period ended June 30, 2009 and September 30, 2009. QC CPA Group, LLC resigned on January 14, 2010 and the Company engaged Mazars CPA Limited as the Company's new independent registered public accounting firm on January 18, 2010 to audit the Company's financial statements for the year ended December 31, 2009.

TFF has found minimal information on QC CPA, other than from their website, which is under construction (http://qccpagroup.com/Company/company.html). What is known is that QC CPA Group, out of Beavercreek, Ohio, had very little time to review Telestone's Q2'09 financials if they began on July 9th. So the first full quarter, and the last one that QC CPA would review, was Q3'09. Ironically, this was the quarter in which TFF found the only long-term receivable entry in the company's history. While TFF finds it quite concerning that Telestone had two auditors resign within a calendar year, we are equally troubled by the sudden appearance and disappearance of a massive $18.8 million long-term receivable. Putting aside the fact that QCP resigned only six months after Mazars resigned (the smoke is thick); the question is why did they require a long-term receivable line item of such materiality?

Based upon Telestone's public filings, TFF believes that the company will need to restate its financial results. In Telestone's investor presentation filed with the SEC in February 2010 (http://www.sec.gov/Archives/edgar/data/817129/000114420410006824/v174012_ex99-1.htm), their purported cash conversion cycle is highlighted on slide thirteen. On this slide (with a picture of the Anhui Wangcheng Building -

which TFF points out is found primarily in a Google search with TSTC marketing materials), Telestone clearly states that they receive 10% of the cash from a typical project after 24 months - a term they define as the "warranty period." Based on Telestone's own admissions of extended, 24-month payment terms, then 10% of all contract values should be booked as long-term receivables. According to Wiley GAAP Policies and Procedures (http://books.google.com/books?id=-kWDqTb-troC&dq=if+an+account+receivable+is+not+due+to+be+collected+for+more+than+one+year&q=long-term+account+receivable#v=snippet&q=long-term%20account%20receivable&f=false), any receivable should be classified as long-term if it "is not due to be collected within one year." Further, GAAP stipulates that the receivable "should be discounted at an interest rate that fairly reflects the rate that would have been charged to the debtor under a normal lending situation." As we will examine later, Telestone's primary competitor adheres to this accounting methodology. TFF is convinced that QC CPA discovered this material misrepresentation and required Telestone to classify the warranty segment as long-term. TFF is confused why QC CPA did not require Telestone to restate past periods, but perhaps the answer to that question lies in the fact QC CPA resigned after one full quarter on the job as Telestone's auditor. Amazingly, when Mazars re-emerged as Telestone's auditor, just six months after resigning, the long-term receivable entry disappeared.

In addition to the long-term receivable misrepresentation, TFF was very troubled to find that the PCAOB highlighted Telestone in a report titled "ISSUER AUDIT CLIENTS OF NON-U.S. REGISTERED FIRMS IN JURISDICTIONS WHERE THE PCAOB IS DENIED ACCESS TO CONDUCT INSPECTIONS" (http://pcaobus.org/International/Inspections/Documents/issuer_audit_clients_of_certain_non-US_firms_by_client.pdf). In this report the PCAOB listed Telestone as a company that filed financial statements with the SEC where the PCAOB is "currently prevented from conducting inspections." While this in no way confirms Telestone is a fraud, Telestone does confess in Note 9a buried at the end of its 10K that there is **"more than a remote likelihood that a material misstatement in our annual or interim financial statements would not be prevented or detected on a timely basis by our internal controls"** (http://investing.businessweek.com/research/stocks/financials/drawFiling.asp?docKey=136-000114420410017465-5E4UI5128FLD4VEKE6LADUAO80&docFormat=TXT&formType=10-K).

THE NON-EXISTANT R&D BUDGET

Before TFF details why Telestone is more than a simple restatement waiting to happen (based upon fabricating a relationship with a domestic distributor), it is worth exploring other areas of concern relating to their business and financial models. Telestone claims to have developed a proprietary technology called WFDS. From their website, they state "After intensive research on the demands of carriers in the 3G age, Telestone developed and commercialized its third generation technology for the local access network, WFDS™ (Wireless Fiber-Optic Distribution System), which provides a scalable, multi-access local access network solution for China's three cellular protocols" (underlined by TFF for emphasis) (www.telestone.com/english/about.asp). In fact a Google search of "WFDS" only turns up information about the technology that is directly linked to press releases issued by Telestone. The question TFF would like management to answer is how Telestone has developed world class technology with virtually zero research and development.

In a September investor presentation, just several months before their capital raise, Telestone proclaimed their "new WFDS technology leads competition in becoming industry standard" (http://google.brand.edgar-online.com/displayfilinginfo.aspx?FilingID=7459501-5723-8756&type=sect&TabIndex=2&companyid=64423&ppu=%252fdefault.aspx%253fsym%253dtstc). Pages 11 - 17 are devoted to extolling the technological breakthroughs of WFDS (although the pictures of projects appear to be in slums). In that same presentation (presumably used as the pitch book for Telestone's capital raise), page 8 and 9 display gorgeous facilities and engineers wearing with high-tech lab coats. Further, Telestone boasts that they have "Over 100 R&D specialists and telecom industry experts" (page 8) and lists its "focus on R&D to maintain industry leadership position and high margins" in the Investment Summary (page 28). Telestone has tried to convince the investing world that they indeed have infrastructure to perform "intensive research." TFF BELIEVES TELESTONE'S SEC FILED FINANCIAL RESULTS ARE INCONSISTENT WITH ALL OF THESE STATEMENTS.

First, year-to-date Telestone has reported a meager $632,000 of R&D expense (http://finance.yahoo.com/news/Telestone-Technologies-prnews-163541163.html?x=0&.v=1). Annualizing the first nine months, Telestone will spend roughly $845,000 in R&D in 2010. Telestone has commented in public filings that they employ 100 specialists in R&D. As such, their projected R&D expense would imply an average salary of roughly $8,450 per specialist, per year assuming 100% of R&D costs went towards compensation (no overhead absorption or non-comp R&D costs). A recent J.M. Gemini guide for Information Technology salaries (http://www.gemini.com.hk/assets/doc/survey_china.pdf) would suggest Telestone's reported numbers have been falsified - either R&D is understated, which means income is overstated, or Telestone has misrepresented their R&D capabilities. The "Guide to China Market Salaries 4th Quarter 2010" displays annual salary levels for various technology jobs ranging from 36,000 RMB for low-end jobs to 540,00 RMB for IT Managers. Based on the descriptions from Telestone, TFF believes that the company has represented their R&D staff to be quite senior. Assuming their entire R&D team were entry level (which their pictures and descriptions do not suggest), then that would still imply an average salary at the lowest end of the J.M Gemini range.

A DIFFERENT TALE WHEN COMPARING CHINA GRENTECH

Comparing Telestone's balance sheet to its public competitor China GrenTech supports TFF's belief that Telestone's story and results don't reconcile. In Telestone's most recent 10K (http://www.faqs.org/sec-filings/100331/TELESTONE-TECHNOLOGIES-CORP_10-K/), they cite China GrenTech (NASDAQ: GRRF) as their close competitor. GRRF recently traded at $3.14, which donned it a meager $75 million market capitalization. Amazingly, nanocap GRRF looks like the behemoth when comparing its financials to Telestone's. In its most recent 20F (http://scottsdale.brand.edgar-online.com/DisplayFiling.aspx?TabIndex=2&FilingID=7337228&companyid=702122&ppu=%252fdefault.aspx%253fcompanyid%253d702122%2526amp%253bformtypeId%253d53), GRRF reported PP&E of $65 million, a level that seems appropriate for a company working with "the big 3" in China. Telestone on the other hand has PP&E of just $1.3 million, or 95% less than GRRF. TFF wonders how a company that claims to have world-class engineering and strong relationships with the Big 3 has just $1.3M of property. As of their most recent fiscal year, GRRF had total assets net of accounts receivable of $293 million. By this same measurement, Telestone had total assets of just $21 million, or 93% less than their much smaller market cap rival.

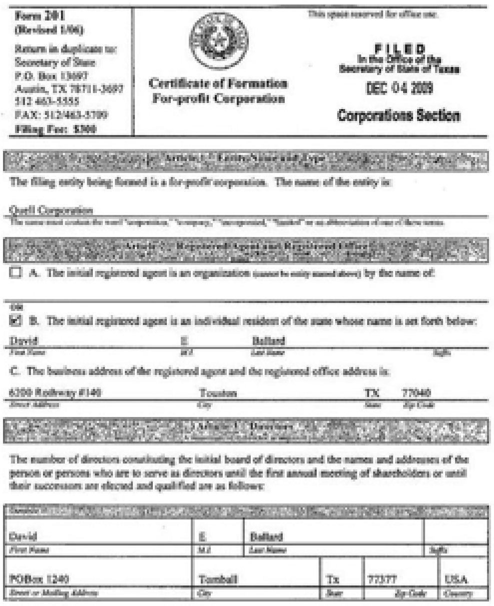
Continuing our comparison, GRRF, which is listed as a competitor in the same business by Telestone, carries long-term receivables of $66 million on its balance sheet. The concern TFF has about Telestone's treatment of receivables seems validated by GRRF's long-term receivables. GRRF defines their its long-term receivables appropriately, "Accounts receivable due beyond one-year are classified as long-term accounts receivable in the accompanying consolidated balance sheets and discounted at the applicable discount rate at the time of the receivable is recorded." Given the fact Telestone discloses a nearly identical revenue recognition model, TFF would expect regulators to force a restatement based upon these issues finally coming to light. In case you were wondering, GRRF's auditor is KPMG.

The glaring discrepancy between Telestone and China GrenTech is only eclipsed by the disparity in valuations. If Telestone traded with GRRF's market cap, TSTC would have a $6.06 stock price. If Telestone traded with the same price/sales multiple (assuming Telestone's sales are not fictitious), TSTC would have a $2.95 stock price. Last year, GRRF generated $13 million of operating cash flow, while Telestone's was negative. If we took the last four quarters that Telestone generated positive cash flow, ignoring all of the negative quarters in-between, applying GRRF's same price-to-cash flow multiple would yield TSTC with a $3.65 stock price. Any of these prices would be significantly below Telestone's current price of $10.40 per share. But TFF believes the appropriate stock price for Telestone may ultimately be well below any of these prices. TFF believes that the issues at Telestone extend well beyond their accounting and misrepresentation of financial results.

THE FLAGSHIP PARTNER THAT DIDN'T EXIST

On August 9th, 2010, Telestone announced their first U.S. based partner - a company called Quell Corporation out of Houston, Texas (http://www.telestone.com/english/is1.asp?id=207). In this press release, Telestone declared Quell Corp would be its exclusive distributor and also promoted their win with a local Houston hospital. Despite repeated attempts by TFF to contact Quell Corp and Telestone, we have been unable to identify the hospital and confirm the $2 million contract was completed in 2010 as stated. Telestone proclaimed in that August 9th press release that they had been working with Quell for nearly twelve months, "In September of 2008, Telestone Technologies selected Quell Corporation as an exclusive distributor for WFDS(NYSE:TM) technologies to the customer base in the Houston area." Further, the earnings call, held just three days later, referenced either Quell or the Houston win 7 different times. And only three months later, Telestone raised $18.9 million from PIPE investors, with Quell Corp and the U.S. opportunity presumably being a focal point of the raise.

However, based upon public information, it is the opinion of TFF that Quell Corp did not exist until over a full year AFTER Telestone claims that they selected Quell as their exclusive Houston distributor. Searches on corporationwiki and businessprofiles revealed that Quell Corp was not incorporated until December 4, 2009 (http://businessprofiles.com/details/QUELL_CORPORATION/TX-0801201353) and (http://www.corporationwiki.com/Texas/Houston/quell-corporation/38215578.aspx#addresses-company). An incorporation search on the Texas Secretary of State online access site (www.sos.state.tx.us/corp/sosda/index.shtml) also confirmed Quell Corp did not exist when Telestone claimed to have begun their partnership (see Certificate of Incorporation below). While TFF is always reluctant to cry "fraud," Telestone appears to have started working with a partner on a contract one full year before the partner filed its certificate of formation. The incorporation date of Quell also makes TFF wonder how a newly-formed company was able to win a Houston-based opportunity for $2 million, selling a Chinese equipment vendor's products. Wasn't there an RFP, a trial period, negotiations? TFF finds is hard to fathom all of this could have happened within 8 months of Quell's formation.



Form 201
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Certificate of Formation
For-profit Corporation

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Secretary of State of Texas
DEC 04 2009
Corporations Section

Article 1 – Entity Name and Type

The filing entity being formed is a for-profit corporation. The name of the entity is:

Quell Corporation

Article 2 – Registered Agent and Registered Office

☐ A. The initial registered agent is an organization (cannot be entity named above) by the name of:

OR

☒ B. The initial registered agent is an individual resident of the state whose name is set forth below:

David E Ballard
First Name M.I. Last Name Suffix

C. The business address of the registered agent and the registered office address is:

6200 Rodfway #140 Touston TX 77040
Street Address City State Zip Code

Article 3 – Directors

The number of directors constituting the initial board of directors and the names and addresses of the person or persons who are to serve as directors until the first annual meeting of shareholders or until their successors are elected and qualified are as follows:

David	E	Ballard			
First Name	M.I.	Last Name			Suffix
POBox 1240	Tomball	Tx	77377	USA	
Street or Mailing Address	City	State	Zip Code	Country	

TFF has searched for more information on Quell Corp, but has had limited success finding any other business wins for Quell. TFF emailed founder and general partner, David Ballard, but Mr. Ballard has yet to respond to TFF's questions. Additionally, the website of Telestone's large domestic partner, Quell, appears to be under construction with no contacts listed (http://quellcorp.com/about.html). Additionally, TFF found it odd that the website domain was updated on August 4th, 2010, just five days prior to Telestone announcement that they were partnering with Quell for the first U.S. project win (http://www.networksolutions.com/whois-search/quellcorp.com). Other oddities that TFF found relating to Quell:

- A Google search of "Quell Corp and David Ballard" only returned results that are associated with Telestone
- However, David Ballard also appears to be the Principal of a company called Axis Engineering (http://www.axisengineering.net/contacts.html).
- A gentleman named George Bain is credited with the website design for Quell in the bottom right of the homepage (http://quellcorp.com/index.html). This same gentleman is listed as a site inspector, Lab Technician for David Ballard's other company, Axis Engineering (http://www.axisengineering.net/contacts.html).
- Axis Engineering, has the same mailing address as Quell Corp -

Axis Engineering, Inc.

6200 Rothway, Suite 140

Houston, TX 77040-5059

NOW YOU SEE THEM, NOW YOU DON'T

At this point, it should be abundantly clear why TFF believes the NASDAQ has a reasonable basis to halt trading in TSTC until the questions raised by TFF are addressed. However, a careful examination of the front men for Telestone and the revolving door at CFO should be sufficient for investors and analysts to reach their own conclusions.

Since 2008, Telestone is averaging exactly one CFO per year. In 2008, a gentleman named Liu Dongping was CFO. In the first quarter of 2009, he decided to quit and was replaced by Hong Li (google.brand.edgar-online.com/EFX_dll/ED...). As an example of the company's flippant attitude towards the SEC, Hong Li's name changed to Li Hong in the second quarter 10Q (TFF acknowledges that switching the placement of first and last name is not uncommon, yet it is uncommon for SEC certified financials). Ms. Li lasted just one year and decided to step down for personal reasons, a fact disclosed in a press release dated May 12, 2010 (www.prnewswire.com/news-releases/telesto...). Hong Li was replaced by Yu Xiaoli (idc.api.edgar-online.com/efx_dll/edgarpr...). According to the 2010 proxy, Ms. Yu is only 34 years of age and has been with Telestone in various roles for nearly 12 years.

According to the 8K filed with the SEC that announced her hiring (http://idc.api.edgar-online.com/efx_dll/edgarpro.dll?FetchFilingConvPDF1?SessionID=Gu40HEphleiJpIS&ID=7249709), Ms. Yu became CFO effective May 11th, 2010. Yet, after less than one day on the job, Telestone filed an amended 10K that was somehow reviewed, certified, and signed by Ms. Yu (http://google.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHTML1?ID=7249893&SessionID=kXRfHqxOZWy6c27). TFF believes these types of actions, which grow progressively worse as we illustrate below, are indicative of a company that warrants significant scrutiny. Despite the red flags around the seemingly interchangeable CFO's, TFF is more alarmed by the involvement of the new VP of Finance, Richard Wu.

TFF has confirmed with Roth Capital, the banker for Telestone's most recent deal, that Richard Wu was present for the roadshow representing the company (along with CEO Han Daqing). Yet, despite being the face for the company on its largest capital raise since its reverse merger, TFF can not find one press release or 8K filing announcing his hiring. TFF can only assume that Mr. Wu showed up at the company after the 8K filed on 9/14/10 (it does not list him in the management team slides), but before the first press release on October 4th that lists him as a contact (google.brand.edgar-online.com/EFX_dll/ED...). TFF asks how the VP of Finance that led the most recent capital raise could appear at Telestone with no press release, no 8K, or no inclusion in management's slides. In fact, despite being the spokesperson on the most recent earnings call and investor call (http://www.prnewswire.com/news-releases/telestone-technologies-corporation-schedules-conference-call-to-provide-an-investor-update-111373689.html), there is nary a mention of Mr. Wu on the company's website under the management page (http://www.telestone.com/english/management.asp).

So what do we know about Mr. Wu? A company called China Natural Gas (NASDAQ: CHNG) introduced Mr. Wu as CFO on October 23, 2008 (http://google.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHTML1?ID=6207655&SessionID=ICNbHekbu8AGp77). Yet, just six months later, China Natural Gas announced Mr. Wu was resigning for health reasons (http://www.naturalgaschina.com/InvestorRelations/PressRelease/3839.html). While TFF respects health concerns and understands their unforeseen effects, TFF finds it disturbing that Mr. Wu surfaced a few months later at another nanocap called China Medicine Corp. China Medicines (NASDAQ: CHME) announced Mr. Wu as their new CFO on August 31, 2009 (http://www.cmc621.com/news/newinfo.php?id=407&typeid=2). In the same troubling manner, Mr. Wu resigned from China Medicine on December 15, 2009 (www.biospectrumasia.com/content/241209CH...), after just four months of employment. While TFF sees potential warning flags with Mr. Wu's brief stints and subsequent resignations, TFF is far more troubled by actual inconsistencies in Mr. Wu's resume information from both press releases:

- In the first press release from China Natural Gas, Mr. Wu claims "over 12 years of experience" with a laundry list of positions.
- Yet in the second press release from China Medicine, just ten months later, Mr. Wu boasts 14 years of experience. Regardless of how one cuts the calendar, it is impossible to add two years of experience in a ten month span.
- Further, in the second press release, Mr. Wu fails to include any mention of his role as CFO and COO of China Operations for the failed Tejari World venture.

Additionally, TFF has been unable to confirm Mr. Wu's matriculation at Wharton School of Business, which he references in both press releases. To be clear, TFF has yet to confirm that he did not receive an MBA degree in finance and accounting in 1995. However, Wharton School would not confirm his enrollment to TFF. While this is understandable, unanswered emails from TFF to Mr. Wu and Telestone's former IR firm are unacceptable.

On November 24th, TFF emailed Richard Wu and John Mattio at Hayden Communications - Telestone's outsourced IR firm - seeking confirmation of his enrollment at Wharton. TFF also called Mr. Wu directly. TFF also asked for specific info or IR kits from the company's website. The IR kit segment of Telestone's website has since been removed and is under construction (http://www.telestone.com/english/online.asp).

TFF did not receive a single response initially from Hayden Communications or Mr. Wu. However, just ten days after TFF's email, Hayden Communications appeared to have resigned from their role as IR for Telestone (seekingalpha.com/news-article/178513-tel...). After another round of TFF emails to Hayden Communications, HCI President Scott Hayden responded with a respectful email stating, "We don’t comment publicly on decisions that we or our clients make. Feel free to reach out to TSTC and I am sorry we could not be more help." TFF has yet to hear back from Mr. Wu or Telestone.

The same day that Hayden Communications stopped working with Telestone, CCG (Crocker Coulson Group) was announced as the new IR firm. It is worth noting that while TFF does not know CCG, and has no reason to question the integrity of the firm, Barron's has been very critical of the stock performance of companies represented by Telestone's new IR firm (http://online.barrons.com/article/SB50001424052970204304404575449812943183940.html#articleTabs_panel_article%3D3).

The oddities, carelessness, or blatant deception (TFF is simply throwing out a range of possibilities) extends to Telestone's IR contacts as well. Looking at press releases dating back to early 2007, TFF was shocked at the blatant inconsistencies of contact information, names, titles, and emails - mistakes that justify questions about the legitimacy of the individuals listed:

- July 20, 2007 - FD is referenced as Telestone's IR firm (www.telestone.com/english/is1.asp?id=93)
- October 15, 2007 - Sissi Wang is no longer listed as a contact (www.telestone.com/english/is1.asp?id=133)
- December 12, 2007 - Phoebe Cui replaces Todd Lu as a contact, but has the same number as Sissy (www.telestone.com/english/is1.asp?id=142)
- January 29, 2008 - Fang Cui appears, yet has the same number as Phoebe (name change? Or did they forget the fictitious name) (http://www.telestone.com/english/is1.asp?id=144)
- March 24, 2008 - Nick Li added as Secretary of the Board (http://www.telestone.com/english/is1.asp?id=149)
- May 14, 2008 - Preston Zhu added as new IR contact (http://www.telestone.com/english/is1.asp?id=158)
- July 19, 2008 - Nick Li changes his name to Nick Lee (http://www.telestone.com/english/is1.asp?id=159)
- August 13, 2008 - Nick Li is back, but this time he uses Fang Cui's email address as his contact info (http://www.telestone.com/english/is1.asp?id=177)
- September 12, 2008 - Nick Li email changes again (http://www.telestone.com/english/is1.asp?id=180)
- February 23, 2009 - Jean Wen appears with Fang Cui's same phone number (http://www.telestone.com/english/is1.asp?id=185)

- March 16, 2009 - Ya Ding appears for first time (http://www.telestone.com/english/is1.asp?id=186)
- October 19, 2009 - Ren Hu is referenced in a press release as Secretary of the Board. The press release says he is conducting meetings with investors, which is odd for an individual that has never appeared before. Nick Li was Secretary before, did he get fired? Resign? (http://www.telestone.com/english/is1.asp?id=202).
- October 20, 2009 - John Mattio of HCI is added as IR contact. Also, Ren Hu appears as a contact with a gmail account instead of a Telestone email AND a phone number with a New Jersey area code. Odd for the Secretary of the Board to have a New Jersey phone number. (http://www.telestone.com/english/is1.asp?id=196)
- November 12, 2009 - Ren's phone number changes to a Chinese number, but he keeps his gmail address (http://www.telestone.com/english/is1.asp?id=201)
- April 27, 2010 - Dan Feng appears as Secretary of Board, Ren Hu vanishes (http://www.telestone.com/english/is1.asp?id=204)
- May 4, 2010 - Vicente Liu appears as VP of Finance. He has a Hong Kong telephone number (http://www.prnewswire.com/news-releases/telestone-technologies-corporation-reports-results-for-the-first-quarter-2010-93720614.html)
- June 1, 2010 - Vicente changes his name to Vincente (http://www.prnewswire.com/news-releases/telestone-technologies-corporation-appoints-mr-guobin-pan-as-new-president-95305274.html)
- July 16, 2010 - Dan Feng becomes Feng Dan and title changes to Assistant CFO (http://www.dailyfinance.com/rtn/pr/telestone-technologies-corporation-provides-net-income-guidance-of-22-9-million-for-year-2010/rfid348752244/)
- August 16, 2010 - Liping Zhang appears as Board Secretary (http://www.telestone.com/english/investor.asp?id=205)
- October 4, 2010 - Richard Wu added as VP of Finance. (http://www.prnewswire.com/news-releases/telestone-secures-44-million-line-of-credit-from-bank-of-beijing-104267113.html)
- November 9, 2010 - Feng Dan title changes again to IR associate (http://online.barrons.com/article/PR-CO-20101109-906263.html)
- November 15, 2010 - Richard Wu and Feng Dan have the same phone number - yet the numbers are different that the October 4 press release (http://online.wsj.com/article/PR-CO-20101115-902774.html)

AN UNSURPRISING BED FELLOW

TFF would respectfully point out that certain shareholders and/or related parties of Telestone have found themselves in hot water with regulators in the past. While TFF has no reason to suggest there is anything improper that has occurred between Telestone and certain individuals, it is worth noting one of the Telestone parties in this report.

Andrew Worden filed a 13D on September 22, 2009 disclosing ownership of approximately 7% of Telestone stock. Mr. Worden was discussed by Barron's in its critical article on Chinese reverse mergers (online.barrons.com/article/SB50001424052...), with Barron's stating "Investors would be well advised to steer clear of stocks like those in the PIPE deals involving Andrew B. Worden's Barron Capital" (http://online.barrons.com/article/SB500014240529702043044045754498129 43183940.html#articleTabs_panel_article%3D3). Barron's also discussed Mr. Worden's prosecution for wire fraud and settled SEC civil suit. While TFF does not know Mr. Worden, the profile that Barron's discusses seems worrisome given the plethora of issues TFF has discovered.

In Mr. Worden's 13D, filed with the SEC on September 22, 2009 (http://google.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHTML1?ID=6808087&SessionID=UPPIHFsgRbCxKG7), he disclosed:

On September 10, 2009, the Reporting Person Barron Partners LP purchased an aggregate of 240,000 Common Stock shares of the Issuer at a price of $4.58 per share in an open market transaction. Also, on September 10, 2009, the Reporting Person Barron Partners LP sold an aggregate of 174,000 Common Stock shares of the Issuer in a cross trade at a price of $4.58 per share to Reporting Persons Andrew Worden, Rossplan LP, Golden1177 LP, and JBWA2 LP. The aggregate number of Issuer's securities owned by the Reporting Persons as of September 10, 2009, represented approximately 7.3% of the issued and outstanding shares of the Issuer's common stock. The aggregate number of Issuer's securities owned by the Reporting Persons as of the date of filing, represents approximately 7.8% of the issued and outstanding shares of the Issuer's common stock.

TFF is deeply troubled by this filing for two reasons. First, it would appear that this transaction was a cross between related parties at $4.58 constituting 414,000 shares. Yet on September 10, 2009, Telestone's total volume was only 576,000, so Mr. Worden's cross represented 72% of the volume and had the affect of overstating the natural volume on Telestone. Second, and perhaps even more troubling, is that the price quoted by Mr. Worden on this "open market" transaction was $4.58 - yet the low price for Telestone's stock on that day was $4.92!!! How could Mr. Worden constitute 72% of the volume, and do so at a price that was not recorded by the exchanges? The fact he sold 1/3 of his position just two months after his first filing is concerning given the stock went parabolic the day of his massive cross transaction at a price that TFF can't find in historical information. After Mr. Worden's cross transaction that created the appearance of heavy volume, Telestone's stock spiked 400% over the following 3 months. While Mr. Worden appears to own closer to 4% of Telestone today, TFF would still like to understand the mechanics of the disclosed price relative to the existing market prices on that day.

One final observation is that a search of "Golden1177 LP," which is a holder included in Mr. Worden's 13D filing, also is a holder and filer in Orient Paper (AMEX: ONP) (chinesecompanyanalyst.com/2010/08/09/onp.../). While TFF has no opinion on ONP, we would note that thoughtful research has been presented that credibly asserts that ONP is a fraud (http://www.muddywatersresearch.com/research/orient-paper-inc/initiating-coverage-onp/).

NASDAQ - PROTECT INVESTORS AND END THE MADNESS

TFF is nearly convinced that Telestone has misrepresented its prospects, size, and business to the investment community. They have raised capital under the auspices of a business that appears to be incongruous with its financial assets. These assertions are only magnified when comparing Telestone to its tiny rival China GrenTech. Further, the involvement of a U.S. based distributor that has a corporate life that fails to sync with Telestone's assertions appears dubious at best, and fraudulent at worst. Throw in a merry-go-round of frontmen and questionable individuals for the final ingredients in a cocktail of deceipt that the NASDAQ should address.

Sadly, retail investors (as well as institutions) have been deceived by Telestone, and the result has been Internet chatrooms filled with misplaced theses that could lead to additional losses, "TSTC is not simply a "manufacturer" or "distributor" of stuff, they are the creator and sole owner of an intellectual property that has the potential to become the gold standard in the *global* wireless industry" ((http://investorshub.advfn.com/boards/read_msg.aspx?message_id=46646495).

As the long-standing saying goes, "If it looks like a duck, walks like a duck and quacks like a duck, it probably is a duck."

Disclosure: I am short TSTC.

Comments (5)

JoeNatural, Contributor

Hey, nice "hit piece" on TSTC. I knew one was coming, as shorts were doing their best to put a lid on the stock for about the last 4 trading sessions, knowing the "hit piece" was coming and thus they'd cash in. Very clever and profitable. Nice work.

I see you're short of course, so congrats on your stack of cash.

What's next ? Well, we have guidance due out any day now from the company that is going to blow every short out of the water, at least those that haven't covered by then. Funny isn't it how nothing was mentioned about TSTC's recent statement that DSO's are expected to improve dramatically ? Maybe the "hit piece" author didn't want to disclose this ? Wouldn't make as much money if he did or have quite the same effect.

Well even with the recent capital raise due to a hard time collecting from the three major telcos in China, EPS will still be huge, but heck, it was the first capital raise in 7 years from the public markets. Not bad, eh ?

Personally, I'm thankful for the "hit piece," as I was able to finally buy in to the stock.

11 Jan 2011, 01:18 PM

Brendan Rose, Contributor

Mazars CPA is a 10,000+ headcount Hong Kong based auditor. Not a small French company.

Also, the fact that current receivables exceeds trailing 12 month revenue does not necessarily imply any problems. If AR's exceeded FORWARD 12 month revenue, that would be a problem.

Any response? Are you just sloppy? Or is this just a hatchet-job piece of BS.

11 Jan 2011, 03:12 PM

Brendan Rose, Contributor

Is the author unaware that financial statements for tax purposes differ from financial statements prepared in accordance with GAAP? For tax purposes, they delay revenue recognition until cash/invoices exchange hands. For GAAP purposes, they book revenue when goods/services are rendered.

This is not inconsistent. This is normal. Just as companies record depreciation differently for tax/GAAP purposes.

This is a hatchet job. Every claim that I've been able to check/verify has been misleading, or completely wrong.

On R&D personnel, did it occur to you that this is a company that books the majority of its revenue from network integration services? And that the company might be referring to network design engineers as development personnel, even though those development expenses are booked in COGS? I'm not sure that's right. I hope the company will clarify. But I don't see a single damning/true claim in this entire report.

What is your strongest claim that is verifiably true?

11 Jan 2011, 04:12 PM

OKMONEY

It's a well written, well thought out and researched article; now the ball is in Telestone's court. Can TSTC refute the allegations?

11 Jan 2011, 10:31 PM

Rics Pics

Just don't understand why the company didn't come out with some kind of response. Not that they need to respond to this SHORT guy, but the stock did tank 26% in one day. Hope I was right in picking up more share at 7 and change.

12 Jan 2011, 05:50 PM