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China Fiber Optic – Breaking Fundamental Accounting Rules

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The Basics		Emerson Analytics Forecast
Ticker:	HK:3777	<i>Delisting</i>
Recent Price:	HK\$1.06	
Market Cap:	HK\$2.3bn	

A month after China Fiber Optic published its so-called "[clarification announcement](#)" on September 30, 2015, we are still awaiting the regulators' decisive actions on the company's irregular and in effect illegal practices. While we are disappointed with the regulators' inaction, we still expect the company to be delisted eventually.

Why? The reason is simple. The so-called clarifications suggest that China Fiber Optic accounts for its businesses in total disregard of basic accounting principles and logic.

Revenue Recognition: Breaking Accounting Conventions

According to p.3 of the "clarification", "the Group's consolidated financial statements prepared under IFRS required revenue to be recognized under the accrual basis.....However, Sifang Telecom's reported revenue in its financial statements filed at the SAIC were based upon both delivery of goods and issuance of VAT invoices". Many Hong Kong listed companies with the bulk of their businesses in the Mainland face the same problem of delivering their goods and services in one year and issuing invoices in the next. However, none of them treat their revenue the way Sifang Telecom does.

In p.4, the "clarification" goes on to say that "Sifang Telecom only recognized revenue on sales made in current year for which VAT invoices were issued in the current year for the purpose of reporting to SAIC". And in p.6, note 5 has this to say, as shown in Exhibit 1 below:

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Exhibit 1 – "Clarification" Announcement on Sifang Telecom's Revenue Recognition

Note 5 – "Revenue as reported by Sifang Telecom in its SAIC filing" from 2008 to 2012 were based on sales made in current year for which VAT invoices were issued in current year. The respective revenue amounts of 2008 to 2012 in Sifang Telecom's SAIC filings did not include sales made in previous years for which VAT invoices were issued in current year.

Source: "clarification" announcement, p.6

This implies that, for sales made in one year with relevant VAT invoices made in the next year, or even the year after next, they are completely ignored in Sifang Telecom's filings with the State Administration of Industry and Commerce (SAIC). The company claims that such accounting treatment is a local practice and a conservative approach. This is totally absurd. Whether it is "revenue to be recognized under the accrual basis" or "revenue based upon both delivery of goods and issuance of VAT invoices", any treatment that excludes the bulk of revenue (in 2012 this amounted to 69%, based on Rmb1.03bn of revenue that the "clarification" says Sifang Telecoms has ignored, and the Rmb1.49bn of revenue originally reported by China Fiber Optic) from accounting treatment is not a conservative approach. It is a serious accounting error.

Such arbitrary revenue recognition defies all fundamental accounting principles. This part of revenue that does not show up in the profit and loss account will certainly not generate any profit, and therefore will not contribute to any increase in equity. How is the balance sheet balanced, then?

Where are the Huge Inventories?

In p.4 of the "clarification", the company says that "The balance of 'Sales made in current year but VAT invoices were not yet issued' was listed separately in the book of Sifang Telecom's account as inventory..."

Exhibit 2 – "Clarification" Announcement on Inventory Treatment

reported as Sifang Telecom's revenue in the SAIC's filings. The balance of "Sales made in current year but VAT invoices were not yet issued" was listed separately in the book of Sifang Telecom's accounts as inventory as Sifang Telecom reported its revenue in the annual SAIC filings upon both criteria of delivery of goods and issuance of VAT invoices being satisfied. The said balance had

Source: "clarification" announcement, p.4

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The "clarification" shows in p.5 that Sifang Telecom had Rmb1.03bn of "Sales made in current year but VAT invoices were not yet issued." This implies that Sifang Telecom should have more than Rmb1.03bn of inventory at the end of 2012.

Exhibit 3 – Sales Made in Current Year but VAT Invoices Were Not Yet Issued

	Note	2008 RMB'000	2009 RMB'000	2010 RMB'000	2011 RMB'000	2012 RMB'000
Revenue as reported by Sifang Telecom in its SAIC filings	5	301,500 *	133,385 *	237,939 *	320,222 *	375,150 *
Overseas sales by Hong Kong subsidiaries	1	1,982 °	105,167 °	195,942 °	221,359 °	203,890 °
Elimination on consolidation	2	(1,196) "	(57,223) "	(115,510) "	(119,631) "	(109,840) "
Sales made in current year but VAT invoices were not yet issued	3	32,201 #	464,321 #	519,767 #	835,905 #	1,031,989 #
Miscellaneous taxes	4	-	-	-	(821)	(6,966)
Consolidated revenue as reported by the Group		334,487 ^	645,650 ^	838,138 ^	1,257,034 ^	1,494,223 ^

Source: "clarification" announcement, p.5

However, Sifang Telecom reported merely Rmb79.6m of inventory in its 2012 filings with the SAIC. This is way below the minimum Rmb1.03bn implied by the above explanation.

Exhibit 4 – Sifang Telecom 2012 Inventory

资产负债表 000015

2012年12月31日

项目	2012年12月31日	2011年12月31日
流动资产:		
货币资金	1,280,768,473.88	889,276,346.42
应收账款	2	-
预付款项	3	-
其他应收款	4	-
存货	5	92,622,889.72
流动资产合计	1,280,768,473.88	889,276,346.42
非流动资产:		
长期股权投资	6	-
固定资产	7	-
无形资产	8	-
其他非流动资产	9	-
非流动资产合计	10	79,571,523.32
资产总计	11	1,360,340,000.00
流动负债:		
应付账款	12	-
预收款项	13	-
其他应付款	14	-
流动负债合计	15	-
非流动负债:		
长期借款	16	-
应付债券	17	-
其他非流动负债	18	-
非流动负债合计	19	-
负债合计	20	-
所有者权益:		
实收资本	21	1,000,000,000.00
资本公积	22	360,340,000.00
盈余公积	23	60,000,000.00
未分配利润	24	0.00
所有者权益合计	25	1,360,340,000.00
负债和所有者权益总计	26	1,360,340,000.00

存货

10	92,622,889.72	79,571,523.32
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Source: Sifang Telecom 2012 SAIC Filings

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How can this be possible? We can offer the company an explanation (the only possible explanation), which is that "this part of the inventory is not carried on Sifang Telecom's books". But the question is: how can finished goods under delivery but not yet recognized as revenue be excluded from the inventory?

Similarly irrational treatment can also be found in such entries as "prepayments received from clients".

True Revenue in 2013 and 2014

According to the "clarification" announcement, the basis of reporting for SAIC filings was changed by Sifang Telecom beginning at 2013 to achieve consistency with revenue reported for tax purposes. Revenue as reported by Sifang Telecom in its SAIC filing commencing 2013 was changed to include both sales made in current year for which VAT invoices were issued in current year and sales made in previous years for which VAT invoices were issued in current year.

Exhibit 5 – Sifang Telecom's Revenue Recognition in Its SAIC Filings From 2013

invoices. The basis of reporting for SAIC filings was changed by Sifang Telecom beginning at 2013 to achieve consistency with revenue reported for tax purposes. Revenue as reported by Sifang Telecom in its SAIC filing commencing 2013 was changed to include both sales made in current year for which VAT invoices were issued in current year and sales made in previous years for which VAT invoices were issued in current year. Hence, the amounts

Source: "clarification" announcement, p.5

The change in accounting policy means that from 2013 onward, none of Sifang Telecom's revenue will be excluded from its SAIC filing. We can estimate its 2013 revenue as follows:

- Based on the 2013 revenue reported by China Fiber Optic, Sifang Telecom probably had revenue of Rmb1.78bn in that year;
- Based on the numbers in Exhibit 3 above, and by assuming that Sifang Telecom's "revenue on sales made in 2013 for which VAT invoices were issued in the current year" was equal to that achieved in 2012 (i.e. Rmb375m), then Sifang Telecom should have reported total revenue of about Rmb1.41bn in its 2013 filing, as it needed to include the Rmb1.03bn of sales made in 2012 but VAT invoices were not yet issued.

So, what was Sifang Telecom's true revenue?

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The Hebei Province Federation of Industrial Economics, a semi-official civic association under the leadership of the provincial government, regularly publishes a list of the "Top 100 Hebei Enterprises" in its website www.hebgy.gov.cn. The make-up of the list comprises such processes as the "voluntary reporting by the enterprises" and "inspections by statistical departments or governing departments of the enterprises". The top 100 list of 2014 is reported in the following:

Exhibit 6 – Top 100 Hebei Enterprises 2014 Revealed



The screenshot shows the website www.hebgy.gov.cn with a navigation bar containing links for 首页 (Home), 行业资讯 (Industry News), 运行分析 (Operational Analysis), 政策聚焦 (Policy Focus), 工作动态 (Work Status), 通知公告 (Notices), and 关于我们 (About Us). The main content area features the title "2014年河北百强企业名单揭晓" (2014 Hebei Top 100 Enterprises List Revealed) and a sub-header "信息来源：工经联 发布时间：2014-07-28". The text describes the selection process, mentioning that the list was compiled by the Hebei Provincial Federation of Industrial Economics (省工业经济联合会) in collaboration with the Hebei Provincial Federation of Enterprises (省企业联合会), Hebei Provincial Association of Entrepreneurs (省企业家协会), and Hebei Provincial Statistical Association (省统计学会). It notes that the process involved recommendations from local governments, voluntary reporting by enterprises, and review by statistical departments and industry associations. The list includes 2014 Hebei Top 100 Enterprises, Hebei Provincial Key Industry Headquarter Enterprises, Hebei Provincial Top 100 Manufacturing Enterprises, and Hebei Provincial Top 50 Service Enterprises, along with Hebei Provincial Top 50 Profitable Enterprises and Hebei Provincial Top 50 Tax-paying Enterprises. The announcement is dated July 25, 2014.

Source: <http://www.hebgy.gov.cn/article/20140728/zzb-2015-13783.html>

Sifang Telecom had the honor of being included in the list of Hebei's industrial leaders. From Exhibit 7 and Exhibit 8 below, we can see that Sifang Telecom reported revenue of Rmb458m and Rmb559m for 2013 and 2014, respectively. They were significantly below the numbers that Sifang Telecom should have reported had it really followed the accounting policy of revenue recognition that the "clarification" announcement claimed was effective in 2013.

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Exhibit 7 – Sifang Telecom 2013 Revenue According to the Hebei Industrial Leaders List

2014年河北重点行业排头兵企业名单			
次序	企业名称	所在地	2013年营业收入 (万元)
11	中节能港建风力发电(张北)有限公司	张家口市	22000.76
12	中节能风力发电(张北)有限公司	张家口市	10664.41
通信设备、计算机及其他电子设备制造业			
1	河北四方通信设备有限公司	石家庄市	45775
2	邢台市海纳电子科技有限责任公司	邢台市	14196
非金属矿采选业			
1	河北省矾山磷矿有限公司	张家口市	39734
铸造业			
1	金鼎重工股份有限公司	邯郸市	2430000
2	武安市广耀铸业有限公司	邯郸市	1444082
3	武安市永诚铸业有限公司	邯郸市	646011.7
4	河北龙凤山铸业有限公司	邯郸市	618535.84

Source: <http://www.hebgy.gov.cn/UserFiles/04.xls>

Exhibit 8 – Sifang Telecom 2014 Revenue According to the Hebei Industrial Leaders List

2014年河北重点行业排头兵企业名单			
次序	企业名称	所在地	2014年营业收入 (万元)
1	斯必克冷却技术(张家口)有限公司	张家口市	49543
2	廊坊市鑫佳机电有限公司	廊坊市	17000
3	廊坊中建机械有限公司	廊坊市	15306
通信设备、计算机及其他电子设备制造业			
1	富智康精密电子(廊坊)有限公司	廊坊市	918526
2	河北四方通信设备有限公司	石家庄	55936
铁路、船舶、航空航天和其他运输设备制造业			
1	中铁山桥集团有限公司	秦皇岛市	458353
2	惠阳航空螺旋桨有限责任公司	保定市	52196
3	唐山百川智能机器有限公司	唐山市	51044
4	河北南皮铁路器材有限责任公司	沧州市	21392

Source: [http://www.hebgy.gov.cn/UserFiles/02\(1\).xls](http://www.hebgy.gov.cn/UserFiles/02(1).xls)

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We have, of course, two explanations for China Fiber Optic:

- Sifang Telecom did not participate in any such rankings and have absolutely no idea where they obtained their revenue numbers, which were completely wrong; or
- While Sifang Telecom has changed the accounting policy in its SAIC filings from 2013 to include "sales made in previous years for which VAT invoices were issued in current year" in its current year revenue, it still reported revenue in the old accounting policy when participating in the above-mentioned rankings and had excluded "sales made in previous years for which VAT invoices were issued in current year."

What else can we say? China Fiber Optic manufactures an ordinary, almost commodity-like, product whose pricing is extremely transparent, but it claims a selling price many times higher than prevailing market prices. It even denies having any record of the sales contract, invoice and receipts that we have disclosed in our previous report on the company. What can we say to such shameless liars?

Similar to our experience with other liar companies that we have dealt with in the past couple of years, no matter how obvious is the gap, these liars can always come up with some impossible explanations. We asked Sound Global (0967.HK) this simple question: Did you know who was your biggest customer in 2012? And their answer was that they had a "different interpretation of customer".

We are not surprised that some publicly listed companies are liars. What we are surprised at is that China Fiber Optic's absurdly fraudulent accounting policy was endorsed by its auditors and tolerated by the securities regulators. This certainly does not bode well for Hong Kong's status as a global financial center.

Anyone who has carefully read the "clarification" announcement will have to agree that China Fiber Optic has managed to completely defy basic accounting principles. Anyone who has carefully read our reports (the previous one and the present one) will agree with our judgment that "Delisting" is the only outcome for the company.

Disclaimer

We are a group of seasoned equities analysts with many years of experience in the research of economic and political trends as well as individual stocks around the world. With background in various international investment banks, we have followed the development of the Chinese equities market right from day one.

We are determined to expose as much of the fraud in the Chinese stock market as we can. The most widespread and serious fraud is probably that undertaken by listed companies, in fabricating non-existent businesses and stealing shareholders money, among other tricks.

In exposing these crimes we challenge the listed companies to prove the integrity of their announcements and financial statements. The listed companies, of course, want everybody to believe that their announcements and financial statements are true. Their auditors, employees, independent directors, lawyers, shareholders and even the general public all hope that these announcements and financial statements are true.

We have made our best effort to ascertain that everything we say in this report is accurate. We have obtained our information from public sources that we believe to be accurate and reliable, or from sources whom we believe are not insiders or connected parties to the companies mentioned herein. However, we are certainly NOT in the business of making investment recommendations. This is not an investment report and should not be regarded as such. Read and use our reports at your own risk. Most important of all, DO YOUR OWN RESEARCH BEFORE YOU COMMIT OTHER PEOPLE'S MONEY.

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