

Background of Xia Cao:

Xia Cao (pen name) is a 36 years old male, last name Zheng, born in Fujian province. He earned a PhD from Xiamen University, and currently teaches at Shanghai National Accounting Institute. He originally started writing under the name of “Shen Cao”, subsequently, he started a writing club “Shen Cao” to combat financial frauds by publishing his writings exposing them. Since 2007, he has been investigating financial reporting by companies listed in China under the identity of “Xia Cao”.

To protect his family, Xia Cao had been publishing under his pen name and does not want to publicize his real name.

According to the latest data, since 2004, the Chinese Securities Regulatory Commission had pressed charges against 125 listed companies for securities law violations. Out of these 125 companies, Xia Cao was the first to challenge 25 of them, a staggering 20% of the total number.

Article by a Chinese Blogger on CHBT

[http://txiacao.blog.hexun.com/60828015_d.html]

01/16/2011

By Xia Cao

China Biotics (CHBT) is a NASDAQ listed company. Its Chinese name is 中国生物制品股份有限公司 (China-Biotics Inc). The Company is a leading provider of biotechnology products, specializing in researching, manufacturing and selling probiotics and food additives. The Company is located in Shanghai.

The company has been controversial since it was listed publicly, with very vocal long and short investors. On August 31st, 2010, a U.S based research firm “Citron Research” published an article titled “China Biotics, where are your stores?” The principal of Citron Research Andrew Left, wrote the report alleging most of the retail stores claimed by CHBT are in fact fabricated. Some of them don’t even sell any probiotics; they are grocery stores. The day this report was published, China Biotics’ stock priced plunged 18% to \$12.47 a share.

<http://www.citronresearch.com/index.php/2010/08/30/it-doesnt-take-a-microscope-to-see-whats-wrong-with-china-biotics-nasdaqchbt/>

On October 19th, 2010, Finkelstein Thompson LLP stated that it is investigating and filing a class action lawsuit against China Biotics. The most recent disclosure from the lawsuit:

“From July 10th, 2010 to August 30th, 2010, China Biotics intentionally misled and misrepresented its real financial performance, in addition to other aspects of

fraudulent activities: 1) The Company never opened retail stores in Shanghai and some other cities as stated in its prospectus; 2) The Company's real financial performance differs dramatically from its financial statements filed with local government agencies; 3) The Company never opened retail stores with the 69 million dollar it raised in September 2009. The use of proceeds was stated in its prospectus. The lawsuit also mentioned a series of other problems about the Company and specifically challenged the Company about the existence of the Company's stores and retail locations".

China Biotics categorically denied all the allegations and hosted an investor day inviting investors to visit its facilities and investigate for themselves. According to a report sent back by Jason Nevader on September 30th, 2010:

"Based on my trip to Shanghai, I posted photos of 9 retail locations that the short sellers claimed did not exist. Of these 9 addresses, 6 had slightly incorrect addresses of the distributor locations and 3 really existed. There are two more addresses that were removed because one was a Dia supermarket and one was a Hualian supermarket that have moved. The necessary corrections have been made to the China-Biotics website".

But, the author also finds abnormal activities of the Company's reported financial and tax figures. According to the 10-K dated March 31st, 2010 and also the 10-Q for the quarter ending September 30th 2010, the Company owes over 30.57 million USD in taxes, over 200 million RMB:

See financial table here: http://txiacao.photo.hexun.com/85602491_d.html

Row headings are translated as

Revenue

Gross profit

Net profit

Value added tax

Corporate tax

Sum of two taxes

Tax payable

Cash

Total asset

Cash / Total asset

The author calculated the amount of value added tax (VAT) the Company is obligated to pay from March 31st, 2004 to September 30th, 2010 (VAT is calculated as gross profit x 17%) and the total amount of corporate income tax the Company is supposed to pay; the total number adds up to 50.42 million USD. In other words, CHBT owes taxes on 60% of the total taxes payable over an operation span of six and a half years; five and a half years ago (03/31/2005), the Company only owed

11.13 million USD taxes; the amount increased by 19.44 million (130 million RMB) over the past five and half years,.

The Company stated:

“We believe that our operations in the PRC were exempted from income taxes and value added taxes for all prior years because we had been recognized by the local government as an advanced technology enterprise. However, we have never received a written confirmation from the appropriate tax authorities for the tax exemption status of our operations in the PRC. As a result, there is no way to ascertain...”

There are three questionable aspects of this statement. First, there’s no proof of such tax exemption, let alone documents from the Chinese taxation bureau; Second, if such tax exemption were legal, why mention on an annual basis the accrued tax expenses? Third, I have never heard of any VAT exemption in the health care products industry. The author suspects the company is subject to “enterprises taxed on a deemed basis system”; its real tax payable is much much less than the taxes payable on its book; but for a Company with over 100 million USD in revenue, it is extremely unlikely to be subject to this system; therefore, the other likelihood is the Company fabricated its revenue and profit numbers.

(needs work, I don't understand this sentence)

According to a report written by Jason Nevader on September 30th, 2010 from Shanghai:

“Tax Statements

We were able to see the tax statements for Shanghai Shining, the company's retail business. There were four stacks of tax documents which corresponded with the four quarters of the fiscal year ending March 31, 2010.

The most important part of each stack was a document from the Agricultural Bank of China which showed the actual taxes paid by Shanghai Shining into the Agricultural Bank of China, where the tax authority has its bank account for receiving taxes.

This document was in each case chopped by the Agricultural Bank of China Shanghai branch and the state tax bureau.

Taxes paid for each of the quarters were as follows:

Calendar Year Quarter	USD	
	RMB	Equivalent
Q2 2009	11,971,104	1,786,732
Q3 2009	14,942,906	2,230,284
Q4 2009	22,352,378	3,336,176
Q1 2010	17,389,638	2,595,468
Total Fiscal Year 2010	66,656,026	9,948,661

The reader should note that these figures are taxes paid by Shanghai Shining only, and as such provide a representation of the retail business and its profitability. The overall amount here will differ from the cash flow statement in the 10-K for FY2010 (in which supplemental disclosure cash income taxes paid on a consolidated basis were \$5.3 million) for several reasons. First these figures include income taxes and net VAT paid by Shanghai Shining and secondly any taxes or VAT from Growing Bioengineering, the bulk business, are not reflected in these figures.

In addition, the company showed the Tax Confirmation for Shanghai Shining for 2007 – 2009. This is an official one page document that states that the company has paid its taxes, chopped by both the Shanghai tax bureau and the federal tax bureau.“

<http://seekingalpha.com/article/226882-china-biotics-what-really-happened-at-the-investor-day?source=email>

If the statements above were true, the parent Company, China Biotics, paid 9.95 million USD in taxes for the fiscal year 2010, but according to the Company's performance, VAT and corporate taxes due would have been 17.35 million USD. Even though there's a timing differential between actually paying the taxes and recognizing the tax liability, obviously CHBT does not work under the "enterprises taxed on a deemed basis system", it works under the system where the Company reports its financial performance and is taxed accordingly. If that were the case, why would the tax bureau blatantly ignore over 30 million USD taxes payable? Also the report states the taxes do not include subsidiaries, in fact, if the subsidiaries also pay taxes that are substantial, why on earth wouldn't the CFO of CHBT show it all together?

In addition to significant irregularities in tax remittances, , the Company's financials also pose substantive irregularities. As of September 30th, 2010, the Company reported a cash balance of \$159 million USD, which is 62.59% of its total assets. Part of the Company's large cash position is its \$75 million USD capital raise in October 2009 . But the author suspects whether the cash balance is real; If the Company reported fabricated financials in the past, it's extremely likely the cash balance is also significantly inflated. But according to a report sent back by Jason Nevader, he verified the cash balances are indeed real:

“Bank Accounts

1.An account with HSBC Bank in HK in the amount of HKD 286,149,623.52 (~\$36.9m).

The account was in the name of Smart Group and the statement was dated June 14, 2010.

2.An account with HSBC Bank in HK in the amount of HKD 58,853,603.14 (~\$7.6m). The account was in the name of Growing State Ltd and the statement was dated June 19, 2010.

3. An account with the Bank of Communications in the name of Shanghai Shining. This account showed not just the balance, like the first two statements, but actually all the inflows and outflows for the month of June over roughly 10 pages.

You could see many small cash inflows coming in over the month.

The balance on June 1, 2010 was RMB 618,509,085 (~\$92.3m).

On June 30, 2010 the balance was RMB 640,214,746 (~\$95.6m).

I asked Travis where the rest of the accounts were since collectively these accounts showed only \$140m and the company had \$159.7m at June 30th, 2010.

Travis confirmed they had additional smaller bank accounts in RMB, HKD and USD that make up the balance“.

This confirms that the Company's bank cash balances still mismatch its cash balances on its own balance sheet. In fact, the most common technique used by Chinese company listed overseas to inflate its assets is to inflate its cash balances. It's extremely easy to fabricate bank statements and bank letters, especially the “corporate fixed term bank deposit certificate”. I disagree. The raised funds account for less than half the company's reported cash. We think the other half, the suspect half, is due to the fabricated retained earnings of the last five years.

Overall, the author believes CHBT is involved in fabricating its five years of reported profits, causing massive tax liabilities, and also massively inflated cash balances as a result.