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TAL Education: A Real Business With Fake Financials
Part II

Comment to Investors

TAL's reaction to our 70-page exposé is stunning and affirming. Its response, which could have been typed out while sitting on the toilet, has wholly failed to address our conclusions that a) its reported profits are fraudulently inflated, b) it engaged in two sets of non-substantive transactions, including having reported a divestment that did not actually occur, c) it likely diverted funds through a straw party, and d) is covering up a more substantial compression of its core business operating margins. The failure to respond in our view evidences utter contempt for investors and the U.S. markets.

TAL's directors claim to have carried out an investigation into the issues raised in our report within 12 days. Their statement is confined to only 51 words discussing the investigation.[1] Given there has been no attempt to convince investors there was any investigation, it's hard to even label this one a "sham". Investors should be under no illusion that this statement is anything other than a long, fat middle finger extended their way. This behavior underscores our point that managements and directors in China see no disincentive to steal money from U.S. investors – it is a "heads I win, tails you lose" bet for them.

We began our series discussing two transactions where not only is the evidence of fraud is, in our view, clear and convincing; but, the impacts can be quantified. From the outside, fraud is usually difficult to quantify – even analysts who specialize in detecting fraud usually struggle to estimate its impact. Based on feedback, we believe there was some misunderstanding by investors about the impacts of the fraud we detailed in Part I. The fraudulent inflation was not limited to below-the-line (i.e., non-operating) income inflation. Deferred revenue without matching expenses is an above-the-line profit inflation technique, which we illustrate in a reported vs. estimated real margin comparison table on page 3 of the initial report.

We continue our series of reports with a look at another transaction with a quantifiable above-the-line impact, Firstleap.[2] We focus on Firstleap second also because it is a bit of a brainteaser – we invite investors to try to reconcile to the numbers TAL reported. Taken together, Parts I and II show the variety of levers available to TAL to fraudulently inflate profits – all three transactions are obscure transactions to which investors seemed to pay scant attention at the time, and yet they have each made material contributions to profit overstatements.

Our next report in the series will detail our conclusion that TAL commits fraud in the financials for its core Peiyou business. The Peiyou fraud is more difficult to quantify, but our research suggests fraudulent overstatement of Peiyou revenue of approximately 25% to 30%. Future

[1] "The Internal Audit team as directed by and under the supervision of the Audit Committee of the Board of Directors (the "Audit Committee") uncovered no evidence that supports the allegations mentioned. The Audit Committee has reviewed the result of the investigation and concurred with the conclusion that the allegations were baseless."
[2] Estimated profit and margins in Part I already include adjustments for Firstleap.

reports will detail fundamental weakness in Peiyou, and other reasons that the real portions of TAL's profits are not sustainable.

Firstleap: Another Fraudulent Accounting Lever

Like Shunshun and Guangzhou One-on-One, Firstleap was one of TAL's major investments in FY2016 and FY2017. Management claimed deferred revenue of $45.09 million at the time it acquired Firstleap, which is a tutoring institute for pupils ages 2-15. That number strikes us as steep. Join us as we use generous assumptions to see how close to $45 million we can get.

First, Facts

On January 22, 2016, TAL reported that it completed the acquisition of 100% of Firstleap. The purported purchase price of $46.58 million, paid for partially with TAL common stock, gave TAL a network of 66 learning centers, of which 30 were self-operated and 36 were franchised, as well as $20.94 million in cash.[3]

Picking over TAL's blogs shows tuition is Rmb 15,000 for 8 months, with payment due at enrollment.[4] The schedule is rolling, so students can enroll any time.[5] On the Q2 call, CFO Rong Luo noted that total enrollment as of the end of August 2015 was "around" 20,000 students, while trailing twelve-month revenue was $30 million.[6] Let's say Firstleap had 21,000 students—again, we're just giving TAL the benefit of the doubt.

We also have Firstleap's onshore historical revenues, expenses, and gross profit. Much of the financials for Firstleap's network of learning centers flowed through the Beijing VIE, Beijing Lebai Educational Consulting Co., Ltd (BJ Lebai), and we show these in the table below.

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[3] TAL FY2016 20-F, p. F-48

[4] These are recent tuition rates, which were higher than prior rates and are thus more favorable to TAL. Per blogs on TAL's jzb.com website (http://www.jzb.com/bbs/thread-5862433-1-1.html), most comments were that ¥15,000 was required for 8 months.

[5] Per calls to Firstleap's customer service line.

[6] TAL FY2016 Q2 conference call, CFO Rong Luo: "Firstleap now operates 66, double 6, learning centers in 25 cities. Of these, 36 centers are self-operating and 30 are franchise. The numbers of students in August 2015 was around 20,000. During the period from September 1, 2014, to August 31, 2015, all the tier revenue per book was around USD 30 million, 3-0. Firstleap is a lossmaking at the moment. With cross-selling on our platform, we can help to lower down the new customer acquisition costs for Firstleap. We expect this business to become profitable within 2 to 3 years, with a profit margin of between 10% to 20%."

BJ Lebai VIE Financials			
	2014	2015	2016
Revenue	75.3	115.1	173.2
Less: sales tax, etc.		5.1	2.4
Revenue, net		110.0	170.8
Less: cost of goods sold		55.2	108.2
Gross profit		54.8	62.6

Unit: Rmb Millions

Source: BJ Lebai (北京乐柏教育咨询有限公司) Credit Report 12/2017

And it's Gone

Next, we need to make some estimates to obtain a reasonable deferred revenue number for Firstleap. As in the table above, from CY2014 to CY2015, Firstleap's gross revenue grew 52.8%, while TAL's filings show total revenue growth of 42.9% in FY2016.[7] Therefore, it seems more than fair to TAL to assume 60% run-rate enrollment growth for Firstleap in August 2015.[8] If we increment enrollment by 4% every month—a CAGR of 60.1%—we get 25,265 Firstleap students as of January 22, 2016.

Month	Students enrolled
August	21,000
September	21,840
October	22,714
November	23,622
December	24,567
January	25,265

If Firstleap collected tuition of roughly 15,000 Rmb from each of the 25,265 students enrolled, that means it received prepayments of 379 million Rmb, or about $58 million, from those students. Let's recap what we have so far:

Item	Amount
Tuition: 8-month advance prepayment	¥ 15,000
Number of students as at Aug. 31, 2015	21,000
Yearly growth rate (%)	60%
Enrollment as at Jan. 22, 2016	25,265
Est. total prepayments collected - deferred revenue (Rmb millions)	¥ 378.97

However, out of the total prepayments collected, a significant chunk had already been amortized.[9] To get at the percentage of deferred revenue remaining, let us look at eight generic

[7] TAL FY2016 20-F, p. 87

[8] This is also well above TAL's 42.9% revenue growth in FY2016. Source: TAL 2016 20-F, p. 3

[9] The tuition for the Firstleap classes is collected in advance. The term is eight months, but a rolling enrollment policy is in place. Therefore, new students can sign up at almost any time. If no new class is starting, they will

monthly cohorts that have month-on-month enrollment growth of 4% and pay a fixed tuition. We want to see what portion of the total tuition paid by these cohorts remains as deferred revenue. The tuition rate and starting student population do not matter, so we can choose round numbers.

Months left	# students	Tuition fee	Tuition received	Deferred revenue remaining
1	100	1,000	100,000	12,500
2	104	1,000	104,000	26,000
3	108	1,000	108,160	40,560
4	112	1,000	112,486	56,243
5	117	1,000	116,986	73,116
6	122	1,000	121,665	91,249
7	127	1,000	126,532	110,715
8	132	1,000	131,593	131,593
Total	921	1,000	921,423	541,977
Deferred revenue remaining (% of tuition)				59%

As we can see above, out of the prepayments collected, only about 59% remain after a full student cycle. Applying that fraction to the 379 million Rmb in prepayments from before gets us to about 223 million Rmb of deferred revenue, or $34 million. Uh-oh: that is 25% below the $45 million TAL booked. But we're not done yet.

There is a haircut we need to apply. It is a dry but important one—FASB section ASC 805. According to ASC 805, at the time of an acquisition, the acquired company's deferred revenue is no longer recorded at the amortized value of the cash received.[10] Instead, it is booked at fair value, which is equal to the acquirer's future costs to fulfill the obligations, plus a reasonable margin that a third party might charge. For TAL, this would just be the marginal cost of delivering additional lessons; sales, marketing, G&A, and other expenses already incurred would be excluded. Let us use the Firstleap Beijing VIE financials from before to see what sort of a cost structure is reasonable. Gross costs, meaning cost of goods sold and sales tax, were 52% and 64% of revenue in 2015 and 2016, respectively. Let us assume that 60% of revenue was consumed by the marginal cost of service provision as of the acquisition date.[11] After putting a reasonable margin of 10% on top, 70% of deferred revenue is matched to costs. In other words, that implies a mandatory 30% discount to pre-acquisition deferred revenue. We reproduce the figures and math below.

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normally be placed into a current class. As a result, deferred revenue as at January 22, 2016 will be a combination of prepayment balances remaining from prior and new enrollments.

[10] The deferred revenue lost due to the "haircut" is never recorded post-acquisition. http://www.globalviewadvisors.com/wp-content/uploads/2016/05/FVLE-Issue-59-Deferred-Revenue-Valuation-for-Accounting-Standards-Codification-805-Article-by-Ray-Rath-Feb-Mar16.pdf, https://www.journalofaccountancy.com/issues/2016/apr/deferred-revenue-accounting-rule-in-acquisition.html http://holtzmanpartners.com/where-did-my-revenue-go/,

[11] This is favorable to TAL, as lower gross margins mean a smaller cut to the deferred revenue balance.

FV Discount to Deferred Revenue		
	2015	2016
Sales tax, etc.	5.1	2.4
Cost of goods sold	55.2	108.2
Gross costs	60.3	110.6
Revenue	115.1	173.2
Gross costs to revenue (%)	52%	64%
2-year average ratio of cost to revenue		58%
Est. cost to revenue ratio to fulfill revenue		60%
Reasonable profit margin		10%
% revenue matched to costs		70%
Discount		30%

Unit: Rmb Millions

Source: BJ Lebai (北京乐柏教育咨询有限公司) Credit Report 12/2017

After we make this final adjustment to the 223 million Rmb deferred revenue balance from before, we get 156 million Rmb of deferred revenue at fair value—or, just $24 million. Based on the calculations we made, TAL **overstated Firstleap's deferred revenue by 90%**. Almost half of the $45 million TAL claimed was fake. We bring together our findings and assumptions below:

Bottom-Up Calculation of Likely Total Deferred Revenue at Acquisition			
Item	Amount		Formula
Tuition: 8-month advance prepayment	¥	15,000	a
Number of students as at Aug. 31, 2015		21,000	b
Yearly growth rate (%)		60%	c
Enrollment as at Jan. 22, 2016		25,265	d
Est. total prepayments collected - deferred revenue (Rmb millions)	¥	378.97	e = a * d
Balance of prepayment remaining after 8 months (%)		59%	f
Est. carrying amount of deferred revenue (Rmb millions)	¥	222.91	g = e * f
Discount per ASC 805 (%)		70%	h
Est. FV of deferred revenue as of Jan. 22, 2016 (Rmb millions)	¥	156.04	i = g * h
Foreign exchange rate, USD:Rmb at Jan. 22, 2016		6.57	j
Est. FV of deferred revenue as of Jan. 22, 2016 (US$ millions)	$	23.73	k = i / j
FV of deferred revenue from Firstleap acquisition (US$ millions)	$	45.09	m
Likely overstatement of FV of deferred revenue (US$ millions)	$	21.36	n = m - k
Likely overstatement of FV of deferred revenue (%)		90%	o = n / k

You Just Read the Charitable Interpretation

There is a twist. We assumed that the ~20,000 Firstleap students mentioned by TAL's CFO belonged only to Firstleap's self-operated network. If that number he cited was inclusive of the franchises, which constitute 55% of Firstleap's centers but generate little revenue, then the deferred revenue overstatement is even more hideous.[12] Let us dig in.

We assume that the $30 million in revenue comes only from self-operated centers. Using the same 60% annual enrollment growth as before, we need to figure out how many students were enrolled at Firstleap's owned centers of August 2015. Before August 2015, tuition had been 1,375 Rmb per month.[13] If we assume the 12 monthly cohorts through August paid 1,375 Rmb while enrollment grew 4% each month, we can figure out the size of the student body needed to bring in $30 million. At August 2015, that number was about 14,435.[14] Here is the math:

Estimated Firstleap 2014-2015 Enrollments and Revenue					
Month	Total enrollment	Additions	# Months	Tuition/month	Total revenue/month
September	9,377	0	12	¥ 1,375	¥ 154,720,500
October	9,752	375	11	¥ 1,375	¥ 5,673,085
November	10,142	390	10	¥ 1,375	¥ 5,363,644
December	10,548	406	9	¥ 1,375	¥ 5,020,371
January	10,970	422	8	¥ 1,375	¥ 4,641,054
February	11,409	439	7	¥ 1,375	¥ -
March	11,865	456	8	¥ 1,375	¥ 5,019,764
April	12,339	475	5	¥ 1,375	¥ 3,262,847
May	12,833	494	5	¥ 1,375	¥ 3,393,360
June	13,346	513	3	¥ 1,375	¥ 2,117,457
July	13,880	534	2	¥ 1,375	¥ 1,468,103
August	14,435	555	1	¥ 1,375	¥ 763,414
Growth	4.0%			Total revenue (Rmb)	¥ 191,443,599
CAGR	60.1%			Total revenue (USD)	$ 30,000,251

FX rate: 6.3814

Now that we have the number of students as of August 2015, we can apply the same 4% monthly growth rate as before to obtain Firstleap's enrollment as of the acquisition date: 17,367.

[12] Based on a 2013 article we reviewed, it seems that Firstleap's revenue from franchisees might be only 5% of their total sales; to be company-favorable, we exclude any franchisee revenue contribution here. http://learning.sohu.com/20131021/n388611760.shtml

[13] We use the lower pre-acquisition tuition because it is company-favorable. A blog post stated that the tuition charged in August of 2015 was 11,000 rmb for 8 months after the application of a 1000-Rmb discount. (Source: 8 个月，128 个课时，一周上两次，一次一个半点，算两个课时。收费 1 万 1 千多（优惠 1 千后），也就是 1 次课 1 个半点 170 块钱。)

[14] To be favorable to the company, as February of 2015 was the month of Chinese New Year, no revenue was calculated; however, we continued to apply the CAGR to increase the enrollments.

Month	Students enrolled
August	14,435
September	15,013
October	15,613
November	16,238
December	16,887
January	17,367

If we once again assume an eight-month tuition of 15,000 RMB, then carry out the same deferred revenue adjustments as we did before, the fair value of Firstleap's deferred revenue comes out to $16 million. This is an **overstatement of over 175%**. Under these conditions, actual deferred revenue would be just over a third of what TAL recorded.[15]

Bottom-Up Calculation of Likely Total Deferred Revenue at Firstleap Acquisition			
Item		Amount	Formula
Tuition: 8-month advance prepayment	¥	15,000	a
Number of students as at Aug. 31, 2015		14,435	b
Yearly growth rate (%)		60%	c
Enrollment as at Jan. 22, 2016		17,367	d
Est. total prepayments collected - deferred revenue (Rmb millions)	¥	260.51	e = a * d
Balance of prepayment remaining after 8 months (%)		59%	f
Est. Carrying amount of deferred revenue (Rmb millions)	¥	153.23	g = e * f
Discount per ASC 805 (%)		70%	h
Est. FV of deferred revenue as of Jan. 22, 2016 (Rmb millions)	¥	107.26	i = g * h
Foreign exchange rate, USD:Rmb at Jan. 22, 2016		6.57	j
Est. FV of deferred revenue as of Jan. 22, 2016 (US$ millions)	$	16.31	k = i / j
FV of deferred revenue from Firstleap acquisition (US$ millions)	$	45.09	m
Likely overstatement of FV of deferred revenue (US$ millions)	$	28.78	n = m - k
Likely overstatement of FV of deferred revenue (%)		176%	o = n / k

Conclusion

The deferred revenue in the Firstleap acquisition appears to be inflated by 2x to 3x or more. Since TAL claimed the $45.09 million in deferred revenues upon acquisition in January 2016, most, if not substantially all, of the inflation of $21 to $29 million or more would have flowed through the FY2017 income statement.

[15] If the lower tuition rate of Rmb 11,000 were applied, it would have driven the estimated fair value of deferred revenue at January 22, 2016 down by another ~25%.