

Report Date: April 7, 2020
Company: iQIYI, Inc.
Ticker: IQ US
Industry: Internet Media
Stock Price (USD): \$16.76
Market Cap (USD, Millions): \$12,295.9



iQIYI: The Netflix of China? *Good Luckin*

Introduction

Our research shows us that iQIYI, Inc. (“IQ”) was committing fraud well before its IPO in 2018 and has continued to do so ever since. Like so many other China-based companies who IPO with inflated numbers, IQ is unable to legitimately grow their business enough to true up their financial statements. We estimate IQ inflated its 2019 revenue by approximately RMB 8-13 billion, or 27%-44%.

IQ does this by overstating its user numbers by approximately 42%-60%. Then, IQ inflates its expenses, the prices it pays for content, other assets and acquisitions in order to burn off fake cash to hide the fraud from its auditor and investors.

We conducted in person surveys of 1,563 people within IQ’s target demographic in China during October and November 2019 and found that approximately 31.9% of IQ users have access to its VIP-only content through their memberships with IQ’s partners such as JD.com or Xiaomi TV. IQ accounts for dual memberships on a gross basis, meaning it records the full amount of revenue and records its partners’ share as expenses. This allows IQ to inflate its revenues and burn off fake cash at the same time.

We also obtained Chinese credit reports for all of IQ’s VIEs and WFOEs since 2015. When compared to IQ’s prospectus, we found that the deferred revenues reported to the SEC were inflated by 261.7%, 165.5% and 86.2% in 2015, 2016 and 2017, respectively. Deferred revenue is a balance sheet account that arises when customers prepay for a service to be delivered in the future. Because IQ’s subscription customers prepay, most of its revenues are a function of deferred revenue. These pre-IPO overstatements inherently cause IQ’s post-IPO revenues to continue to be overstated.

Arguably one of the most egregious examples of accounting fraud IQ commits is the inflation of its barter transaction revenue. Barter sublicensing revenues are determined by IQ’s internal estimates of the value of the content it traded. In other words, IQ’s management can effectively assign *any value they want* to these transactions, providing an easy opportunity to inflate its revenues. Based on the highest-end estimated value per non-exclusive episode provided by a former IQ employee involved in content acquisition, IQ would have needed to barter the licenses for ~3.9x and ~3.2x the total number of TV series episodes produced by all Chinese production companies to legitimately reach its reported barter revenues in 2018 and 2019, respectively.^{1,2,3}

¹ IQ only barter non-exclusive licenses: 2018 20-F, p. F-24

² According to China’s SARFT, there were 10,646 total TV episodes produced in China [in 2019](#) and 13,726 episodes produced [in 2018](#).

³ The former IQ employee told us a non-exclusive license could be worth up to RMB 10,000 per episode maximum

IQ is a mature company. It will be 10 years old this month and has lost money for 10 consecutive years. IQ's losses are rapidly accelerating, unlike its growth. IQ lost RMB 10.3 billion in 2019, RMB 1.2 billion more than 2018. Meanwhile, paying subscriber growth in 4Q19 was its lowest ever at only 0.7%. IQ's advertising revenue was down -15% in 2019 and it still has a negative gross margin. To us, even these horrific losses are meaningless, considering the abundance of fraud we have already discussed. However, if what we've said thus far doesn't concern you, all we can say is "*good Luckin*"

1. IQ Overstates its User Numbers:

Our research uncovered data from three independent sources showing that IQ overstates its DAU numbers by 42% to 60%.

Data from IQ's Back-End System Contradict its DAU Claims

Two Chinese advertising companies provided us data from IQ's back-end system which show that IQ's actual mobile DAUs from September 2019 were **60.3% lower** than the 175 million average mobile DAUs claimed by IQ in October 2019.

The advertising agencies had access to IQ's back end DAU data for China's 19 "tier 1" cities. In January 2019 and January 2020, IQ published reports on the state of the online movie industry, wherein it provided a breakdown of the geographic distribution of its users.^{4,5} IQ's reports indicate that in 2018, 36% of IQ's users were in China's 19 Tier 1 cities. The 2019 report only disclosed growth rates for each of China's five tiers of cities from 2018 to 2019. Applying these growth rates to the 2018 distribution, we were able to calculate that the 19 tier 1 cities represented 35.6% of IQ's total users in 2019.

We collected 4 days of DAU data from the same week in China's 19 Tier 1 cities from IQ's back end data provided by the two ad companies (3 weekdays and 1 weekend day) in September 2019. The average mobile DAUs from the data we collected from IQ's back-end platform was 24.7 million. The lowest day was 23.36 million and the highest day was 25.88 million. A more detailed summary is provided below:

Average of DAUs for 4 Days by O/S and City				
Original Tier 1 Cities		iOS	Adroid	Total
1	Beijing	1,023	1,480	2,503
2	Guangzhou	743	1,203	1,945
3	Shenzhen	710	1,193	1,903
4	Shanghai	873	1,060	1,933
Sub-total: DAUs		3,348	4,935	8,283
New Tier 1 Cities				
1	Chongqing	445	1,290	1,735
2	Changsha	303	875	1,178
3	Chengdu	570	1,260	1,830
4	Dongguang	230	728	958
5	Hangzhou	203	358	560
6	Kunming	133	488	620
7	Nanjing	483	778	1,260
8	Ningbo	408	768	1,175
9	Qingdao	295	758	1,053
10	Shenyang	203	405	608
11	Suzhou	343	625	968
12	Tianjing	323	603	925
13	Wuhan	398	810	1,208
14	Xi'an	335	903	1,238
15	Zhengzhou	275	830	1,105
Sub-total: DAUs		4,943	11,475	16,418
Total: DAUs in 19 cities		8,290	16,410	24,700

Source: ad companies with access to iQIYI backend platform

Units: thousands

⁴ www.100ec.cn/detail--6491609.html

⁵ www.199it.com/archives/998277.html

Based on the 175 million average mobile DAUs number disclosed by IQ in October 2019 and the 35.6% of DAUs in tier 1 cities as disclosed in IQ’s 2019 report mentioned above, we expected 62.29 million (175m x 35.6%) DAUs in China’s tier 1 cities.⁶ However, we found only 24.7 million DAUs in the tier 1 cities from the back-end data provided by the ad companies. This is **60.3% lower than what IQ’s disclosures implied.**

Est. Difference in Mobile DAUs for the combined 19 Tier 1 Cities Ad Agency Backend Data vs. iQIYI Reported DAUs	
	<i>unit: '000</i>
Nationwide avg. mobile DAU (Oct 2019) reported by iQIYI	175,000
Adjusted % of users in combined 19 Tier 1 Cities	35.6%
Predicted share of DAUs from combined 19 Tier 1 Cities	62,290
Avg. DAU for combined 19 Tier 1 Cities from Ad Companies (fall 2019)	24,700
Difference	-60.30%

IQ’s “Heat Index” Maps Show Evidence of Click Farm Activity

IQ created its own content monitoring and ranking metric to provide a sense of the popularity of its programming. It is called the Content Heat Index and is publicly available on IQ’s website.^{7,8}

According to a note on the Heat Index, these lists are compiled from data from the most recent three months. The typical trend for newly released popular programs starts with a spike and then trails off. A few months after the peak, we found that a consistent pattern of provinces/ zones ranked in the top 10 for most viewers included areas with low populations, such as Macau, Hainan, Tibet or Inner Mongolia.

Mainland China has 23 provinces, 5 autonomous regions, 4 municipalities (Beijing, Shanghai, Guangzhou, and Shenzhen) whose populations are individually reported by the National Bureau of Statistics. Among these total 32 different regions, Tibet always ranks last for population. In 2018, China’s National Bureau of Statistics reported it had just 1.478 million residents and only a small percent of which are Han Chinese immigrants.⁹ Tibet also has its own distinct local languages and culture. Logic suggests Tibet should not show up in the top 10 for any of IQ’s shows.

⁶ <https://www.tmtpost.com/4172679.html>

⁷ <https://index.iqiyi.com/>

⁸ <https://www.theverge.com/2018/9/4/17819326/china-baidu-iqiyi-ai-view-counts-click-farm-heat-value>

⁹ <http://data.stats.gov.cn/english/easyquery.htm?cn=E0103>

However, recent checks on IQ’s popular programs including “*Old Boy*,” “*Idol Producer*” and “*Hot Blood Dance Crew*” included regions with very small populations such as Tibet, Hainan, Ningxia or Inner Mongolia in the top 10:¹⁰

iQIYI Heat Index - Top Locations			
Top Locations	Idol Producer	Hot Blood Dance Crew	Old Boy
1	Beijing	Jiangxi Prov.	Beijing
2	Tibet Prov.	Fujian Prov.	Tianjin
3	Zhejiang Prov.	Guangdong Prov.	Inner Mongolia
4	Jiangsu Prov.	Guangxi Prov.	Shanghai
5	Chongqing	Tibet Prov.	Liaoning Prov.
6	Hainan Prov.	Zhejiang Prov.	Jiangsu Prov.
7	Fujian Prov.	Hunan Prov.	Ningxia Prov.
8	Tianjin	Beijing	Tibet Prov.
9	Guangdong Prov.	Hebei Prov.	Heilongjiang Prov.
10	Hebei Prov.	Yunnan Prov.	Shaanxi Prov.

source: iQIYI company data, April 2020 - based on most recent 3 mos data

It is nearly impossible for regions with such small populations to generate enough organic traffic to top IQ’s heat index charts. Instead, we believe these highly abnormal patterns are indications that IQ employs methods to inflate the viewership levels of its content.¹¹

¹⁰ 注：数据来自于近 3 个月内爱奇艺全站, data comes from the most recent three months for IQ’s site

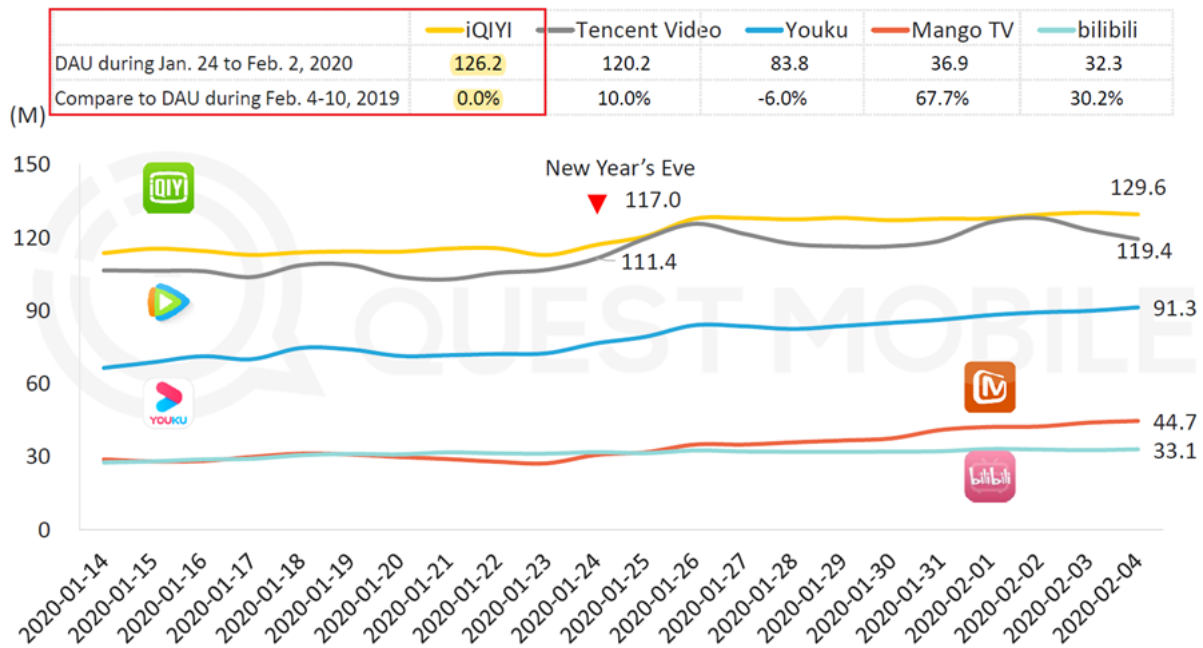
¹¹ Heat Index data is shown is for the most recent three months. We believe these bots/click farms are active at all times, but their impact is most impactful a few months after new content is released as organic viewership levels fall.

QuestMobile

In February 2020, QuestMobile published a special report titled “China Mobile Internet Amid COVID-19 Plague” which shows that IQ overstates its DAU numbers by at least 42%.

The report shows that IQ’s average mobile DAUs were only 126.2 million during the first 10 days of the 2020 Chinese Lunar New Year, versus 180 million average mobile DAUs claimed by IQ. Furthermore, the QuestMobile report shows IQ’s DAUs did not grow between the 2019 and 2020 Chinese Lunar New Year.¹²

DAU of Typical Online Video Platforms



¹² QuestMobile: China Mobile Internet Amid COVID-19 Plague, slide 26

2. IQ Inflates its Revenues:

Our analysis found that IQ inflated its 2019 revenue by approximately RMB 8-13 billion, or 27%-44%.

Barter Transactions: A Black Box

IQ's barter sublicensing revenues are so inflated that they wouldn't come close to being believable even if IQ bartered every single TV episode produced in China in each of the last three years.

IQ's reported barter sublicensing revenues imply it traded every single TV episode produced in China in 2018 and 2019 for ~RMB 79,000 and ~RMB 64,000 each, respectively.^{13,14} A former IQ employee who worked in content acquisition (hereinafter referred to as "the former") told us that non-exclusive licenses are typically worth RMB 1,000 to 5,000 per episode, or a maximum of up to RMB 20,000 for an extremely popular show.

To give IQ every benefit of the doubt, we used the maximum of RMB 20,000 per episode, according to the former, as the average value of the episodes that IQ bartered. Even doing so, IQ would have needed to barter the licenses for ~3.9x and ~3.2x the total number of TV series episodes produced by all Chinese production companies in order to legitimately reach its reported barter revenues in 2018 and 2019, respectively.

Barter sublicensing revenues are determined by IQ's internal estimates of the value of the content it traded. In other words, IQ's management can effectively assign *any value they want* to these transactions, providing management an easy opportunity to inflate its revenues which it obviously takes advantage of. Large-scale non-monetary barter transactions are a serious red flag. In September 2019, the SEC charged Comscore (NASDAQ: SCOR) and its CEO with fraud involving non-monetary revenues from bartered exchanges of data, and at scale much smaller than IQ's.¹⁵

The former also emphasized the massive difference between the value of exclusive and non-exclusive content. An exclusive license for a popular show would be worth between RMB 3 and RMB 5 million – approximately 1,000x more than a non-exclusive license for the same show. According to IQ's own disclosures, IQ only barter these *non-exclusive* licenses:

*"The Group also enters into nonmonetary transactions to exchange online broadcasting rights of licensed copyrights with other online video broadcasting companies from time to time. The exchanged licensed copyrights provide rights for each party to broadcast the licensed copyrights received on its own website only. Each transferring party retains the right to continue broadcasting the exclusive content on its own website and/or sublicense the rights to the content it surrendered in the exchange."*¹⁶

¹³ According to China's SARFT, there were 10,646 total TV episodes produced in China in [2019](#):

¹⁴ According to China's SARFT, there were 13,726 total TV episodes produced in China in [2018](#):

¹⁵ <https://www.sec.gov/news/press-release/2019-186>

¹⁶ IQ 2018 20-F, p. F-24

In an exclusive deal, the seller forfeits the streaming and sublicensing rights of the content to the purchasing party. In a non-exclusive deal, the seller retains the right to stream the content on its own site as well as sublicense the content to others, as explained in IQ's disclosure above. The table below shows the absurdity of IQ's purported barter sublicensing revenues:

Barter Transaction Revenue Reality Check: 2017 - 2019

Year	2017	2018	2019
IQ reported barter sublicensing revenue	762,741,000	1,082,964,000	682,941,000
Total episodes produced in China (1)	13,470	13,726	10,646
Implied RMB per episode	56,625	78,899	64,150

(1) Total TV episodes produced in China, as reported by the State Administration of Radio, Film and Television (SARFT)

Deferred Revenue Discrepancies

IQ's reported deferred revenue is significantly overstated which further shows that it inflates its revenue. Deferred revenue is a balance sheet account that is supposed to arise when a customer has prepaid for a service delivered in the future. Because most of IQ's customers prepay, revenues are a function of deferred revenue.

We obtained Chinese credit reports for all of IQ's VIEs and WFOEs since 2015. These are the onshore operating entities listed below:

- Beijing iQIYI Science & Technology Co., Ltd., (aka "Beijing iQIYI")
- Shanghai iQIYI Culture Media Co., Ltd. (aka "Shanghai iQIYI")
- Shanghai Zhong Yuan Network Co., Ltd. (aka "Shanghai Zhong Yuan")
- iQIYI Pictures (Beijing) Co., Ltd. (aka "iQIYI Pictures")
- Beijing iQIYI Cinema Management Co., Ltd. (aka "Beijing iQIYI Cinema")

When aggregated and compared to IQ's F-1 prospectus, we found that the deferred revenues reported to the SEC were overstated by 261.7%, 165.5% and 86.2% in 2015, 2016 and 2017, respectively.

Comparison of Deferred Revenue in SEC Filings & Chinese Credit Reports			
Year	Total VIE & WFOE	SEC Form F-1	Difference
2015	93.963	339.880	261.7%
2016	300.037	796.703	165.5%
2017	877.206	1,633.650	86.2%

Units: RMB, Millions

Sources: IQ F-1, p. F-4; IQ DRS (12/6/17), p. F-4; Chinese credit reports

Overstating its numbers to this extent in the years prior to its IPO creates a serious problem for IQ: it must post increasingly inflated results in order to make up for pre-existing fraud and still show growth, which we believe to be the only basis for IQ's current valuation. IQ's financials are littered with evidence of its various methods of inflating revenues, many of which lead back to its deferred revenue accounts.

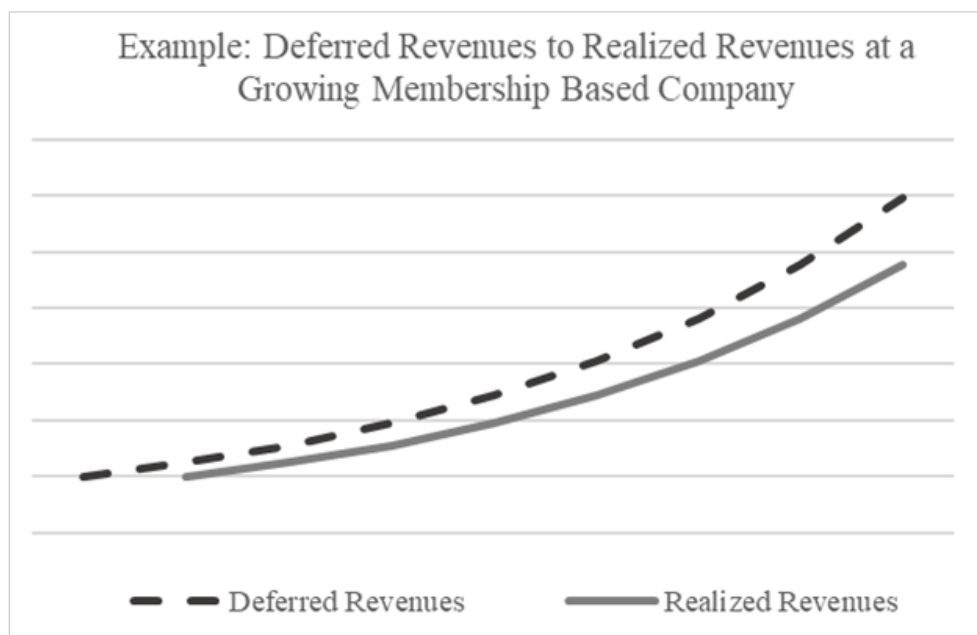
IQ's Claims of Membership Growth are Contradicted by Declining Real Deferred Revenue

We contend that IQ's management must be misrepresenting its number of paying subscribers, the average membership period, or both.

Between 3Q18 and 1Q19, IQ reported an increase of 16.1 million paying subscribers and an increase in the average subscription period from 6 months to 8 months.^{17,18} However, IQ's deferred revenue declined by 17% during the same period – this mathematical contradiction shows that at least one of these numbers is made up.

With stable net membership growth and steady average revenue per user (“ARPU”), the deferred revenue curve should lead the realized revenue curve. Further, increasing average subscription periods should result in greater front-end accumulation of deferred revenues. When charted, it should produce a steeper slope for the deferred revenue trend line.

The chart below is an example of what we would expect to see if management's claims were true. The deferred revenue curve consistently leads the realized revenue curve as subscribers pay more upfront for services to be delivered in the future.

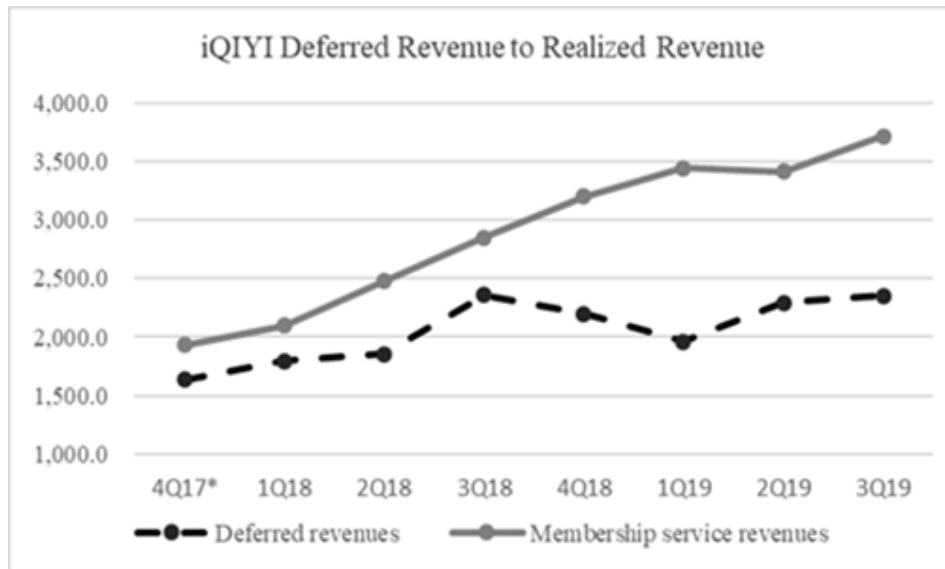


This following chart shows IQ's actual deferred and realized revenue curves. The relationship between IQ's deferred revenues and realized revenues is the opposite of what we would expect based on their claims – the realized revenue curve consistently leads the deferred revenue curve and the gap between the two is widening.

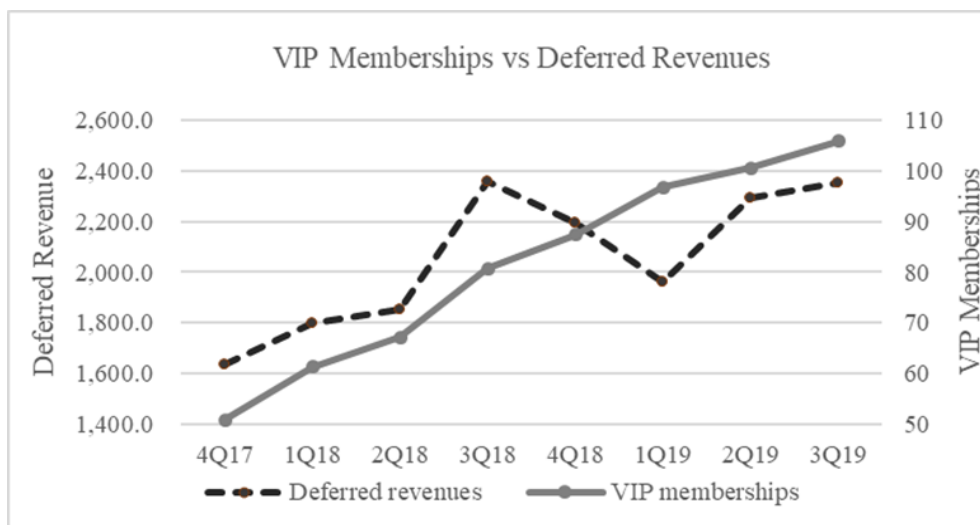
¹⁷ IQ 3Q18 Earnings Call, October 31, 2018

¹⁸ IQ 1Q19 Earnings Call, May 17, 2019

This chart strongly suggests that management is lying about its purported growing average subscription period, steady ARPU, growing number of paying subscribers, or all three:



Because IQ’s management claimed it added 16.1 million net paying subscribers and that the average subscription period had increased from about 6 months to 8 months between 3Q18 and 1Q19, we expected to find significant growth in deferred revenue as the prepayments accumulated. However, we found the opposite. The chart below shows IQ’s reported paying subscribers compared to its reported deferred revenue balance:



IQ’s deferred revenues declined from RMB 2,356.3 million at the end of 3Q18 to RMB 1,960.7 million at the end of 1Q19, a 17% decline during that 6-month period. This directly contradicts management’s claims of growth in the number of paying subscribers and the average subscription period – it is mathematically impossible for both of those statements to be true given the corresponding decline in deferred revenues.

Dual Membership Programs Allow IQ to Inflate its Revenues and Burn Off Fake Cash

Our on the ground due diligence in China found that approximately 31.9% of IQ users have access to its VIP-only content through partnerships with IQ’s partners such as JD.com, Xiaomi TV and Ctrip, among others. IQ accounts for dual memberships on a gross basis, meaning it records the full amount of revenue and records its partners’ share as an expense.¹⁹ We believe this is an improper method of accounting for these dual memberships which allows IQ to inflate its revenues and burn off fake cash at the same time.²⁰

IQ’s management has not been forthcoming with data on the number of dual members, percent of total members brought in through these partnerships, or IQ’s actual revenue share in these partnerships. IQ’s IR representative has told investors that the revenue split with JD was 50/50, but did not disclose the economics of the deals with other partners. IQ’s IR has also dismissed the revenue/ARPU impact of the JD dual memberships and each of the other partnerships as “ignorable” and “immaterial.”

We conducted in person surveys in three of China’s most affluent cities: Beijing, Shanghai and Guangzhou. Our survey correspondents matched IQ’s target user demographic of 18-40 year-old residents of these cities with at least some college education.²¹ We identified 1,563 who fit IQ’s target demographic. Of these, 613 people had access to an IQ VIP membership.²² We inquired how they obtained their VIP access. The results are shown below:²³

iQIYI Subscribing VIP Member Survey Beijing, Shanghai, Guangzhou: Conducted in Oct & Nov 2019		
Item	Respondents	
Total survey respondents	1,563	
Total respondents with iQIYI VIP membership meeting demographic criteria	613	
Free riders (obtained access through a friend or relative)	65	
Total effective iQIYI paying subscribers	548	
Item	Respondents	% Effective Paying Subscribers
Obtained iQIYI VIP membership through an iQIYI-JD Plus dual membership	120	21.9%
Obtained iQIYI VIP membership through a non-JD partnership	55	10.0%
Obtained iQIYI VIP membership through any partnership program	175	31.9%
Paying iQIYI for VIP Membership - not in a partnership program	373	68.1%

According to analysis by a statistician, our survey results on dual memberships with JD were consistent and statistically significant. The data from 548 effective IQ paying subscribers produced an average of 21.9% of respondents who indicated their VIP membership was a dual

¹⁹ IQ 2018 20-F, p. F-23

²⁰ Gross basis accounting should only be used when the company is the principal in the transaction. When dual members pay one of IQ’s partners for a membership which includes access to IQ’s content, IQ is not the principal and, therefore, should account for these on a net basis.

²¹ Based on demographic information on IQ viewers provided by Chinese advertising companies.

²² Dual members are members who either are or became IQ annual VIP membership and activated a free JD Plus membership or who are or became a JD plus member and activated a free IQ VIP membership.

²³ Between 18.4% and 25.4% with a 95% confidence interval.

membership with JD.²⁴ Additionally, our survey results found another approximately 10% of respondents with VIP status indicated they obtained their membership through another dual membership program.²⁵ Combined, the dual membership programs for IQ VIPs in Beijing, Shanghai and Guangzhou totaled approximately 31.9%.

In IQ's earnings calls, management has disclosed a few specific partnerships, such as JD.com, Ctrip and Xiaomi, as well as certain other categories of partners (such as financial institutions and mobile network companies), but no information on the total number of these partnerships or their economics. However, details on the "2 for 1" offers can easily be found online.²⁶ In the Spring of 2019, JD put out a special "3 for 1" deal: JD Plus, IQ and Zhihu for RMB 149/year.²⁷

Our surveys indicate that after JD, the most common partnerships were with financial institutions offering credit cards and mobile phone network providers:²⁸

iQIYI VIP Membership Partnerships - Survey Results	
Credit Card	20
China Telecom, China Mobile	19
Ctrip	4
Xiaomi TV	4
Meituan	1
China Telecom / China Mobile prepaid card	1
Unspecified TV (possibly Xiaomi, Qiyiguo, etc.)	2
Qiyiguo: 奇异果 (JV)	1
QCS: 屈臣氏, WATSON'S	1
Ping An Insurance	1
WIFI	1
Total	55

Through swaps of advertising purchases, other services and commissions for membership revenues with related parties and other partners, IQ can easily inflate membership revenues while simultaneously providing a channel to burn off fake cash. IQ's partnership with Xiaomi is an example of how convoluted the economics of these partnerships can be.

Xiaomi was reported as a related party up to the end of 2017 and details of the IQ-Xiaomi transactions were presented in IQ's prospectus. Although Xiaomi has continued to disclose IQ as

²⁴ Mean = 21.9%, Median = 22.0%

²⁵ Mean=10.0%, Median=11.1%

²⁶ <https://www.jd.com/news.aspx?id=37090>, https://www.hotbak.net/key/京东_plus%20爱奇艺.html

²⁷ <http://www.leikeji.com/article/26462>

²⁸ Our survey results do not represent all partnerships. Other partnerships are evident from ads in Chinese media.

a related party, IQ has not done the same.^{29,30} The table below is an excerpt from IQ’s 2018 20-F showing these historical transactions:³¹

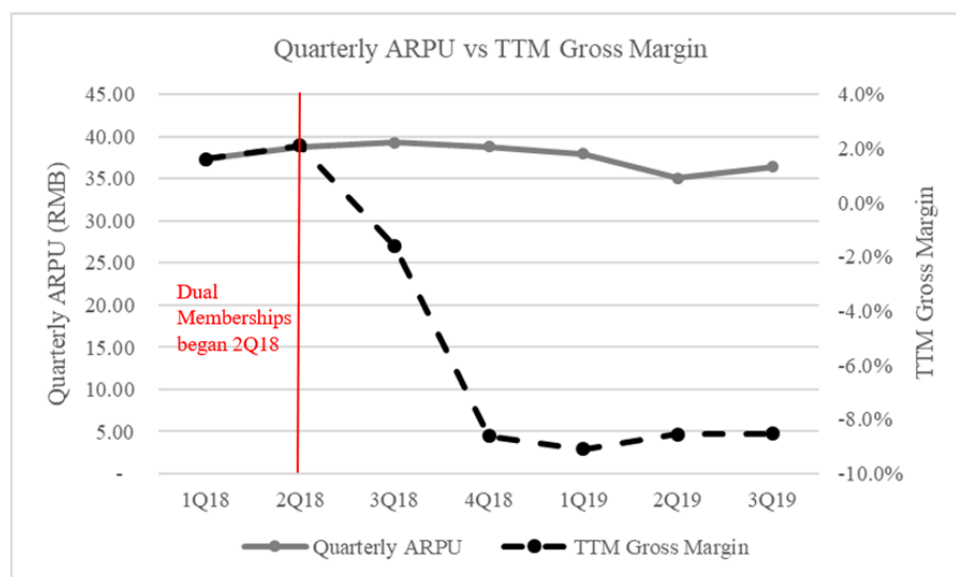
Xiaomi - iQIYI Reported Related Party Transactions				
Membership services	2015	2016	2017	2018
Membership services revenue earned from memberships sold by Xiaomi Group	2,089	26,794	81,450	DND
Advertising services provided to Xiaomi Group	-	60,751	9,249	"
Other services provided to Xiaomi Group	10,616	7,132	4,625	"
Sub-total	12,705	94,677	95,324	N/A
Cost of revenues	2015	2016	2017	2018
Commissions to Xiaomi Group	8,650	18,108	42,565	DND
Advertising services provided by Xiaomi Group	10,474	44,010	82,773	"
Sub-total	19,124	62,118	125,338	N/A
Net Annual Transactions with Xiaomi	(6,419)	32,559	(30,014)	N/A

Units '000 RMB

Source: iQIYI 2018 20-F, p. F-50; F-1A p. F-60

The exact details of IQ’s agreement with Xiaomi have not been disclosed by either party. However, the financials show that IQ paid large “commissions” to Xiaomi for the memberships provided and also purchased advertising and other services from Xiaomi. The net impact of their disclosed transactions from 2015 to 2017 resulted in a loss for IQ but RMB 110.3 million of membership revenue. Details from the Xiaomi partnership show how such opaque collaborations can be abused by management.

The extent of IQ’s use of these dual membership programs is abundantly clear when we compare IQ’s ARPU to its gross margin since its IPO. Because IQ accounts for these dual memberships on a gross basis, its ARPU has remained relatively steady while its gross margin has plummeted:



²⁹ Xiaomi 2018 annual report, Note 39(a) Related party transactions, p.301.

³⁰ We find the decision to cease disclosing such details problematic because Xiaomi’s co-founder is on IQ’s board, and the growth trend over the prior three years suggest that their collaboration was growing by several magnitudes each year.

³¹ IQ 2018 20-F, pp. 92, F-50

Xin'ai Sports (iQIYI Sports): \$110 Million of Revenue Inflation

IQ created ~\$110 million of deferred revenue by overstating its purported contribution to its Xin'ai Sports (iQIYI Sports) JV.

IQ states that it acquired a 32% stake in Beijing Xin'ai Sports Media Technology,³² a JV which is majority owned by Wuhan DDMC,³³ a publicly traded company in China.³⁴ IQ claims their 32% stake came from an RMB 796 million (US\$115.773 million) investment. However, when we compared the shareholding and investments disclosed by Wuhan DDMC, we found IQ's equity was recorded as a cash investment of just RMB 38.25 million (\$5.6 million)³⁵ and found no record of any additional contribution due.

IQ simply overstated its investment by claiming an additional non-cash contribution in the form of "content to be delivered" which IQ valued at approximately RMB 757.75 million (US\$110.21 million). As of December 31, 2018, this non-cash contribution was recorded on IQ's books as RMB 726.2 million of "deferred revenues in relation to services to be provided to a related party."

By comparing the public filings of IQ and Wuhan DDMC (Xin'ai's parent company) we conclude that the deferred revenue recorded by IQ is fraudulent and no non-cash contribution actually exists.³⁶ In IQ's 2018 20-F, it claimed the remaining deferred revenue of RMB 726.155 million "mainly represents deferred revenue in relation to content distribution, licenses of intellectual property and traffic support services to be provided to one of the Group's equity investees."³⁷

	As of December 31,		
	2017	2018	2018
	RMB	RMB	US\$
Amounts due to related parties:			
Loans due to Baidu Group (iv)	50,000	700,000	101,811
Due to Baidu Group (v)	77,628	421,942	61,369
→ Deferred revenue in relation to services to be provided to equity investee (vi)	—	726,155	105,615
Due to Others	2,471	125,663	18,277
	130,099	1,973,760	287,072

(i) The balance mainly represents amounts due from Baidu Group for advertising and other services.

(ii) The balance mainly represents loans provided to the Group's equity investees with an interest rate of 5% that will mature in 2019.

(iii) The balance mainly represents amounts due from or paid in advance to its equity investees for content distribution service

(iv) As of December 31, 2017 and 2018, the total outstanding balance represents an interest-free loan of RMB50,000, which is due on demand and the remaining outstanding balance as of December 31, 2018 is an interest-free loan of RMB650,000 (US\$94,539) provided by Baidu in January 2018 that will mature in January 2023. In April 2017, the Group borrowed a RMB denominated loan of RMB2,220,000 with an interest rate of 3.92% from Baidu Group, which was fully repaid in December 2017.

(v) The balance as of December 31, 2017 and 2018, represents accrued expenses for bandwidth and cloud services provided by Baidu Group.

(vi) The balance as of December 31, 2018 mainly represents deferred revenue in relation to content distribution, licenses of intellectual property and traffic support services to be provided to one of the Group's equity investees.

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³² 北京新爱体育传媒科技有限公司

³³ 武汉当代明诚文化股份有限公司:SHA 600136

³⁴ IQ 2018 20-F, p. F-33

³⁵ FX Rate: US\$1.00 = RMB 6.8755

³⁶ Wuhan DDMC owns Xingying (北京新英体育传媒有限公司) which holds Xin'ai (北京新爱体育传媒科技有限公司)

³⁷ IQ 2018 20-F, p. F-51

The cash flow statements in IQ’s 2018 20-F indicate that RMB 763.75 million of its investments were made through non-cash contributions.³⁸ When deducted from the total claimed investment amount of RMB 796 million, the remaining cash contribution is RMB 32.25 million. This is extremely close to the RMB 38.25 million **total** investment Xin’ai received from IQ, as disclosed in Wuhan DDMC’s filings. We believe the RMB 6 million difference is the result of other non-cash investments that IQ’s management refers to as “insignificant” in size.³⁹

IQ 2018 20-F:	Note	Year ended December 31,			
		2016 RMB	2017 RMB	2018 RMB	2018 US\$
Acquisition of long-term investments with non-cash consideration		—	—	763,750	111,083

The year-end 2018 balance of RMB 726.155 million in “deferred revenue to be provided” is RMB 37.6 million (US\$5.5 million) less than the non-cash consideration of RMB 757.75 million that IQ claimed to have made.

Since the investment was made in 3Q18, the difference of RMB 37.6 million was likely recognized as revenues by IQ in the second half of 2018, leaving the remaining RMB 726.155 million available to be used by management to artificially boost its top line, as needed.⁴⁰

Wuhan DDMC released several announcements with details about the ownership of Xin’ai Sports, broken down by each shareholder and their total contributions. In an auditor’s letter to the Shanghai Stock Exchange, Mazers, DDMC’s auditor, explained the position of each shareholder before and after each capital increase, including what additional capital contributions were made to the JV in each of the announcements.⁴¹

Importantly, the auditor noted no additional capital contributions from IQ after its initial RMB 38.25 million investment in August 2018. In fact, IQ was diluted in the two subsequent rounds.

The excerpt and table below show the shareholders and their respective stakes at the time of the company’s formation. The box in red is Beijing iQIYI Technology Company, Ltd. and shows its stake initially began as 38.25% based on an RMB 38.25 million investment.^{42,43}

³⁸ IQ 2018 20F, p. F-10

³⁹ Management also explained that while the Group holds additional equity investments, the other companies were not significant. See IQ 2018 20-F, p. F-33.

⁴⁰ IQ 2018 20-F, p. F-4.

⁴¹ "Proposal on the Signing of Capital Increase Agreements and Related Party Transactions" 关于《关于对武汉当代明诚文化股份有限公司有关受让控股子公司股权并增资暨资产出售的问询函》的回复 http://static.sse.com.cn/disclosure/listedinfo/announcement/c/2019-04-15/600136_20190415_2.pdf

⁴² 武汉当代明诚文化股份有限公司重大资产购买的进展公告, 2018-111, 2018-08-07

⁴³ 新英体育 - 盈利预测审核报告 2018-11-23, p.4

“1) Establishment of Xin’ai Sports JV:

On August 6, 2018, Beijing Xinying Sports Media Co., Ltd. (hereinafter referred to as "Xinying Media"), Beijing iQIYI Technology Co., Ltd. (hereinafter referred to as "IQ"), Yu Lingxiao, Beijing Xinying Huizhi Media Technology Enterprises (Limited Partnership) (hereinafter referred to as "Xinying Huizhi") signed the "Joint Venture Agreement" to jointly establish Beijing Xinai Sports Media Technology Co., Ltd. (hereinafter referred to as "Xin’ai Sports") (see the company announcement for details, announcement number: Lin No. 2018-111), the proportion of equity of each party and the amount of capital contributed are as follows.”⁴⁴

①新爱体育设立时，公司及一致行动人持股情况及董事会席位 **Beijing Xin'ai Sports**

2018年8月6日，北京新英体育传媒有限公司（以下简称“新英传媒”）、北京爱奇艺科技有限公司（以下简称“爱奇艺”）、喻凌霄、北京新英汇智传媒科技企业（有限合伙）（以下简称“新英汇智”）签署《合资协议》，共同设立北京新爱体育传媒科技有限公司（以下简称“新爱体育”）（详见公司公告，公告编号：临 2018-111 号），各方股权比例及出资金额如下：

Investor Name	Invested Capital (Rmb,10k)	% Interest
股东姓名/名称	出资额（人民币/万元）	持股比例
北京新英体育传媒有限公司	4,250	42.50%
北京爱奇艺科技有限公司	3,825	38.25%
喻凌霄	425	4.25%
北京新英汇智传媒科技企业（有限合伙）	1,500	15.00%
合计	10,000	100%

Xin’ai’s filings *never* mention an additional non-cash investment nor record a receivable for IQ’s purported RMB 757.75 million additional non-cash contribution. In 2018, Xin’ai Sports received two additional rounds of financing and twice increased its registered capital. The additional investments were sold at a premium to the contributions made by the founding shareholders; therefore the total contribution exceeded the registered capital, the excess is reported as capital reserve (“additional paid in capital” or “APIC”) and detailed in the auditor’s letter.

⁴⁴ "Proposal on the Signing of Capital Increase Agreements and Related Party Transactions"关于《关于对武汉当代明诚文化股份有限公司有关受让控股子公司股权并增资暨资产出售的问询函》的回复 http://static.sse.com.cn/disclosure/listedinfo/announcement/c/2019-04-15/600136_20190415_2.pdf

Below are translations of the relevant excerpts from the auditor's letter, followed by screenshots of the excerpts from the original Chinese letters:

1) Capital Increase Initial A Round

*"...According to the "Capital Increase Agreement", **Hexie Anlang** (和谐安朗) will subscribe for 10.00% of Xin'ai Sports' equity at 300 million yuan, corresponding to the new registered capital of Xin'ai Sports of 12 million yuan, and the excess of 288 million yuan will be included in Xin'ai Sports Capital Reserve; **Zhixing Bingjing** (知行并进) will subscribe for 3.33% equity of Xin'ai Sports for 100 million yuan, corresponding to Xin'ai Sports' newly added registered capital of 4 million yuan, and the excess of 96 million yuan will be included in Xin'ai Sports Capital Reserve; **Huiying Borun** (汇盈博润) will be 100 million yuan The subscription of 3.33% equity of Xin'ai Sports corresponds to the newly added registered capital of Xin'ai Sports of RMB 4 million, and the excess of RMB 96 million is included in the Xin'ai Sports Capital reserve."⁴⁵*

②A 轮融资完成时，公司及一致行动人持股情况及董事会席位

1) A 轮首次增资 **Capital Increase Initial A Round**

2018年8月7日，公司召开了第八届董事会第四十八次会议，会议审议通过了《关于公司签署增资协议暨关联交易的议案》，同意公司与新爱体育、新英传媒、爱奇艺、喻凌霄、新英汇智、和谐安朗、知行并进、汇盈博润签署《增资协议》。根据《增资协议》，和谐安朗将以3亿元认购新爱体育10.00%的股权，对应新爱体育新增注册资本1,200万元，超出部分28,800万元计入新爱体育资本公积；知行并进将以1亿元认购新爱体育3.33%的股权，对应新爱体育新增注册资本400万元，超出部分9,600万元计入新爱体育资本公积；汇盈博润将以1亿元认购新爱体育3.33%的股权，对应新爱体育新增注册资本400万元，超出部分9,600万元计入新爱体育资本公积。

⁴⁵ "Proposal on the Signing of Capital Increase Agreements and Related Party Transactions"关于《关于对武汉当代明诚文化股份有限公司有关受让控股子公司股权并增资暨资产出售的问询函》的回复 http://static.sse.com.cn/disclosure/listedinfo/announcement/c/2019-04-15/600136_20190415_2.pdf

2) Capital Increase Round A2

“... According to the Capital Increase Agreement, **Jianteng Peisheng (健腾沛盛)** will subscribe for 8.96% equity of Xin'ai Sports for 300 million yuan, corresponding to the new registered capital of Xin'ai Sports of 12 million yuan, and the excess of 288 million yuan will be included in Xin'ai Sports Capital Reserve; **Qiwei Investment (曜伟投资)** will subscribe for 1.49% equity of Xin'ai Sports for 50 million yuan, corresponding to Xin'ai Sports' newly added registered capital of 2 million yuan, and the excess of 48 million yuan will be included in Xin'ai Sports Capital Reserve.”⁴⁶

2) A 轮二次增资 Capital Increase Round A2

2018年9月4日，公司召开了第八届董事会第五十次会议，会议审议通过了《关于引入外部投资者对新爱体育增资的议案》，同意公司、新英传媒、新爱体育、爱奇艺、喻凌霄、新英汇智、和谐安朗、知行并进、汇盈博润、健腾沛盛、曜伟投资签署《增资协议》。根据《增资协议》，健腾沛盛将以3亿元认购新爱体育8.96%的股权，对应新爱体育新增注册资本1,200万元，超出部分28,800万元计入新爱体育资本公积；曜伟投资将以0.5亿元认购新爱体育1.49%的股权，对应新爱体育新增注册资本200万元，超出部分4,800万元计入新爱体育资本公积。

该次增资完成后，新爱体育注册资本变更为1.34亿元，各股东持股明细如下：

股东姓名/名称	出资额（人民币/万元）	持股比例
北京新英体育传媒有限公司	4,250	31.72%
北京爱奇艺科技有限公司	3,825	28.54%
喻凌霄	425	3.17%
北京新英汇智传媒科技企业（有限合伙）	1,500	11.19%
珠海和谐安朗投资企业（有限合伙）	1,200	8.96%
珠海知行并进文化产业投资基金（有限合伙）	400	2.99%
汇盈博润（武汉）投资中心（有限合伙）	400	2.99%
嘉兴健腾沛盛股权投资基金合伙企业（有限合伙）	1,200	8.96%
宁波梅山保税港区曜伟股权投资合伙企业（有限合伙）	200	1.49%
合计	13,400	100.00%

⁴⁶ "Proposal on the Signing of Capital Increase Agreements and Related Party Transactions"关于《关于对武汉当代明诚文化股份有限公司有关受让控股子公司股权并增资暨资产出售的问询函》的回复 http://static.sse.com.cn/disclosure/listedinfo/announcement/c/2019-04-15/600136_20190415_2.pdf

Xin'ai's schedule of shareholders shows that IQ's total contribution to the JV is only RMB 38.25 million. IQ's total contribution doesn't change in either of the two subsequent rounds of financing and no additional paid in capital ("APIC") was ever recorded for IQ. IQ's investment is listed under the name of one of its subsidiaries, Beijing iQIYI, in the table below:

Investor, Chinese Name	Investor, English Name	7/24/2018		08/07/2018			9/4/2018		
		Registered Capital	Total Contribution	Registered Capital	APIC	Total Contribution	Registered Capital	APIC	Total Contribution
北京新英体育传媒有限公司	Xinying Sport	42,500	42,500	42,500		42,500	42,500		42,500
北京爱奇艺科技有限公司	Beijing iQIYI	38,250	38,250	38,250		38,250	38,250		38,250
北京新英汇智传媒科技企业(有限合伙)	Xinying HuiZhi	15,000	15,000	15,000		15,000	15,000		15,000
喻凌霄	Yu Lingxiao	4,250	4,250	4,250		4,250	4,250		4,250
珠海和谐安郎投资企业(有限合伙)	Hexie Anlang			12,000	288,000	300,000	12,000	288,000	300,000
汇盈博润(武汉)投资中心(有限合伙)	Huiying Borun			4,000	96,000	100,000	4,000	96,000	100,000
珠海知行并进文化产业投资基金(有限合伙)	Zhixing Bingjing			4,000	96,000	100,000	4,000	96,000	100,000
嘉兴建腾沛盛股权投资合伙企业(有限合伙)	Jianteng Peisheng						12,000	288,000	300,000
宁波梅山保税港区曜伟股权投资合伙企业(有限合伙)	Yaowei Investment						2,000	48,000	50,000
Total		100,000	100,000	120,000	480,000	600,000	134,000	816,000	950,000

When Xin'ai's end of year financial data was reconciled with the APIC reported in the auditor's letter, the total assets equal the total equity and liabilities match up. The tables below are composed of information from Wuhan DDMC's 2018 annual report showing the balance sheet for Beijing Xin'ai.⁴⁷

Had IQ actually committed to contribute RMB 796 million, then Xin'ai's current assets should be increased by approximately RMB 757.75 million⁴⁸ and recorded as APIC – **which it does not** (notice the RMB 816 million APIC balance in the table above, with no APIC from IQ, matches the APIC on the balance sheet below); or this should appear as "other receivables," **which it also does not** (the table on the following page shows Wuhan DDMC's total "other receivables" balance is only RMB 211 million).⁴⁹

Key financial information of significant non-wholly owned subsidiaries

重要非全资子公司的主要财务信息

Units: Rmb

单位:元币种:人民币

子公司名称 Company Name	期末余额					
	流动资产	非流动资产	资产合计	流动负债	非流动负债	负债合计
Beijing Xin'ai Sports Media Technology Co., Ltd.	Current Assets	Non-current Assets	Total Assets	Current Liabilities	Non-current Liabilities	Total Liabilities
北京新爱体育传媒科技有限公司	667,564,234.10	185,468,356.44	853,032,590.54	38,501,417.26		38,501,417.26

	12/31/2018		12/31/2018
Current assets	667.564	Current liabilities	38.501
Non-current assets	185.468		
		Registered capital	134.000
		APIC	816.000
		Loss in the year	(135.469)
		Equity	814.531
Total assets	853.032	Total equity and liabilities	853.032

Units: RMB, Millions

⁴⁷ 武汉当代明诚文化股份有限公司, 2018 年度报告, p.177, 重要非全资子公司的主要财务信息

⁴⁸ 796m-38.25m=757.75m

⁴⁹ Chinese GAAP does not report "contra-equity" items such as a subscription receivable but will only record it as "other receivables" (其他应收款).

A disclosure on page 128 of Wuhan DDMC's 2018 annual report further belies IQ's non-cash contribution claim. Wuhan DDMC's "other receivables" balance is only RMB 210.886 million. Further, the largest counterparty accounts for only RMB 70 million, far too small to include the RMB 757.75 million non-cash commitment that IQ claims to have made.⁵⁰

(10). 按欠款方归集的期末余额前五名的其他应收款情况
Top 5 Counterparties of Other Receivables as of the End of the Period

Rank	Amount	单位: 元币种: 人民币			
单位名称	款项的性质	期末余额	账龄	占其他应收款期末余额合计数的比例(%)	坏账准备期末余额
第一名	对关联公司的应收款项	70,000,000.00	1年以内	21.11	3,500,000.00
第二名	对非关联公司的应收款项	66,000,000.00	1-2年、2-3年	19.91	9,000,000.00
第三名	对非关联公司的应收款项	45,830,528.79	1年以内	13.82	2,291,526.44
第四名	对非关联公司的应收款项	15,585,466.99	1年以内	4.70	779,273.35
第五名	保证金	13,470,000.00	1年以内	4.06	673,500.00
合计	/	210,885,995.78	/	63.60	16,244,299.79

The total equity contributions made to Xin'ai Sports, as reported by Wuhan DDMC, do not show *any non-cash contributions*. Even if IQ had made a non-cash contribution of RMB 757.75 million as it claims, then the corresponding liability should have been recorded as a contribution payable, not deferred revenue; and Xin'ai should show a receivable in the same amount.

Neither of these entries appear in the financial statements of IQ or Wuhan DDMC/Xin'ai. Therefore, we conclude that IQ simply made up this non-cash contribution to add RMB 757.75 million of fraudulent deferred revenue which management uses to inflate its revenues.

IQ's 2019 20-F reveals that it recognized RMB 146.3 million in revenue from the Xin'ai cookie jar reserve. The 2019 disclosure is split into current and non-current portions, but by simply adding the two together we see that the Xin'ai deferred revenue account decreased from RMB 726.2 million in 2018 to RMB 579.9 million in 2019:⁵¹

	As of December 31,		
	2018 RMB	2019 RMB	2019 US\$
Amounts due to related parties, current:			
Loans due to Baidu Group (iv)	50,000	50,000	7,182
Due to Baidu Group (v)	421,942	1,014,283	145,693
Deferred revenue in relation to services to be provided to an equity investee (vi)	94,785	169,677	24,373
Due to Others	125,663	370,298	53,189
	692,390	1,604,258	230,437
Amounts due to related parties, non-current:			
Loans due to Baidu Group (iv)	650,000	650,000	93,367
Due to Baidu Group (v)	—	1,570	226
Deferred revenue in relation to services to be provided to an equity investee (vi)	631,370	410,187	58,920
Due to Others	—	126	17
	1,281,370	1,061,883	152,530

- (i) The balance mainly represents amounts due from Baidu Group for advertising and other services.
- (ii) The balance mainly represents loans provided to the Group's equity investees with an interest rate of 5% that will mature in 2020.
- (iii) The balance mainly represents amounts due from or paid in advance to its equity investees for content distribution service.
- (iv) As of December 31, 2018 and 2019, the total outstanding balance represents an interest-free loan of RMB 50,000, which is due on demand and an interest-free loan of RMB 650,000 provided by Baidu in January 2018 that will mature in January 2023.
- (v) The balance as of December 31, 2018 and 2019, represents accrued expenses for bandwidth and cloud services provided by Baidu Group.
- (vi) The balance as of December 31, 2018 and 2019 mainly represents deferred revenue in relation to content distribution, licenses of intellectual property and traffic support services to be provided to an equity investee.

⁵⁰ 武汉当代明诚文化股份有限公司, 2018 年度报告, p.128, 重要非全资子公司的主要财务信息

⁵¹ IQ 2019 20-F, p. F-62

Advertising Revenue Inflation

The Shanghai government publishes reports showing the biggest advertising companies. The rankings are based on advertising revenues reported to the Shanghai SAIC office. Based on these 2015 - 2018 reports, we conclude that IQ's SEC filings contain cumulative estimated advertising revenue overstatements of RMB 5.155 billion between 2015 and 2018.⁵² Because we used the most favorable possible estimates for IQ where data was not available, we believe the actual overstatements are significantly larger than our estimates.

IQ's primary advertising company is Shanghai iQIYI Culture Media Co., Ltd., or "Shanghai iQIYI."⁵³ IQ's secondary advertising company, Shanghai Zhong Yuan Network Media Co. ("Zhong Yuan") conducts its separate live broadcasting advertising business. Its revenues were reported in the Shanghai SAIC's report on the top 10 online media companies in 2015.⁵⁴

The calculations below show the extent of IQ's advertising revenue overstatements. While it appeared IQ was winding down its advertising revenue inflation in 2017 in preparation for its IPO, IQ's ad revenue inflation nearly tripled to RMB 1.537 billion in 2018.⁵⁵

Comparison of SAIC vs. SEC Reported Advertising Revenues

Company	2015	2016	2017	2018
Shanghai iQIYI Culture Media Co., Ltd.	1,653.1	3,357.5	7,050.4	7,336.5
Shanghai Zhong Yuan Network Media Co.	240.3	488.1 ⁽¹⁾	86.9 ⁽³⁾	454.7 ⁽⁴⁾
Subtotal	1,893.4	3,845.6	7,137.3	7,791.2
VAT Adjustment	56.8	230.7 ⁽²⁾	428.2	N/A ⁽⁵⁾
Total SAIC Revenue	1,950.2	4,076.3	7,565.5	7,791.2
SEC Reported Advertising Revenue	3,399.9	5,650.4	8,159.9	9,328.1
Overstatement	1,449.7	1,574.1	594.4	1,536.9
<i>% Overstatement</i>	<i>74.3%</i>	<i>38.6%</i>	<i>7.9%</i>	<i>19.7%</i>

Units: RMB, Millions

Notes on estimates and calculations:

(1) The 2016 SAIC ad industry report did not include a list of top 10 internet advertisers. To generate an estimate, we applied the y/y growth rate of Shanghai iQIYI to Zhong Yuan

(2) In 2016, the VAT rate for advertising services was raised from 3% to 6%

(3) The 2017 SAIC ad industry report top 10 internet advertisers all had at least RMB 87mm in revenue. Since Zhong Yuan did not make the list, we assumed RMB 86.9mm in revenue for 2017.

(4) The 2018 SAIC ad industry report top 10 internet advertisers all had at least RMB 454.8mm in revenue. Since Zhong Yuan did not make the list, we assumed RMB 454.7mm in revenue for 2018.

(5) IQ began reporting its revenue net of VAT in 2018.

⁵² IQ F-1 Prospectus, filed December 6, 2017

⁵³ IQ F-1 Prospectus, p. 5

⁵⁴ There was no 2016 SH SAIC report for online media companies and Zhong Yuan did not make the top 10 list in 2017.

⁵⁵ The revenue numbers in the Shanghai SAIC reports are shown net of VAT. Prior to 2018, SEC reported revenues were not net of VAT. Our table adjusted for this difference so the numbers could be compared on an apples-to-apples basis.

In its prospectus filed with the SEC, IQ claimed 2015 advertising revenues of RMB 3.4 billion. The tables below show that IQ only reported RMB 1.95 billion of advertising revenues to the SAIC in 2015, an overstatement of 74%. (revenues in RMB 10,000):⁵⁶

2015 年上海广告经营单位前十排名 2015 Shanghai Top 10 Advertising Companies			4. 本市互联网媒介单位广告营业收入前十位 Top 10 Online Media Co.		
序号	单位名称	广告营业收入 (万元)	序号	单位名称	广告营业收入 (万元)
1	群邑(上海)广告有限公司	1331814	1	上海全土豆文化传播有限公司	483666
2	上海李奥贝纳广告有限公司	836911	2	上海因特菲思网络科技有限公司	40182
3	凯帝珂广告(上海)有限公司	826109	3	上海二三四五网络科技有限公司	40049
4	电通安吉斯(上海)投资有限公司	299354	4	上海聚力传媒技术有限公司	33814
5	上海分众德峰广告传播有限公司	292406	5	上海众源网络有限公司	24033
6	上海新网迈广告传媒有限公司	230784		Shanghai Zhongyuan Network Co., Ltd.	
7	谷歌广告(上海)有限公司	166929	7	上海携程商务有限公司	11790
8	上海爱奇艺文化传媒有限公司	165314	8	上海巨流信息科技有限公司	9251
	Shanghai iQIYI Culture Media Co. Ltd.		9	上海汉涛信息咨询有限公司	7600
10	上海韵洪广告有限公司	155931	10	上海平安汽车电子商务有限公司	6084

There was no online media company top 10 in the 2016 report, so we generously applied Shanghai iQIYI's year-over-year growth rate to Zhong Yuan in order to estimate its 2016 revenue of RMB 488 million. The table below is an excerpt from the 2016 SAIC advertising industry report shows that iQIYI Culture had advertising revenues of RMB 3.358 billion. IQ reported advertising revenues of RMB 5.65 billion to the SEC in 2016, a 38.6% overstatement (revenues in RMB 10,000):⁵⁷

2016 年上海广告经营单位前十排名 2016 Shanghai Top 10 Advertising Companies		
1. 本市广告企业营业收入前十位		
序号	单位名称	广告营业收入 (万元)
1	群邑(上海)广告有限公司	1279234
2	上海李奥贝纳广告有限公司	928352
3	凯帝珂广告(上海)有限公司	746459
4	上海全土豆文化传播有限公司	611822
5	电通安吉斯(上海)投资有限公司	547837
6	上海爱奇艺文化传媒有限公司	335752
	Shanghai iQIYI Culture Media Co. Ltd.	
8	上海环胜广告有限公司	218941
9	谷歌广告(上海)有限公司	163359
10	上海腾迈广告有限公司	152387

The 2017 and 2018 SAIC advertising industry reports did include lists of the top 10 online media companies list. However, Zhong Yuan did not make it into the top 10 in either year. In 2017 and 2018, the 10th place company had RMB 87 and 455 million in advertising revenues, so in order

⁵⁶ Shanghai 2015 Advertising Industry Market Conditions Report: Introduction, 上海广告市场状况报告 2015 年度: 前言, available at www.scjgj.sh.gov.cn

⁵⁷ The 2016, 2017 and 2018 reports are available at www.scjgj.sh.gov.cn

to use the most generous possible estimate for IQ, we assumed Zhong Yuan had RMB 86.9 million in advertising revenue in 2017 and 454.7 million in 2018.

In total, IQ’s SAIC reported advertising revenue was 7.566 billion and 7.791 billion in 2017 and 2018, respectively. IQ reported advertising revenues of RMB 8.16 billion and 9.328 billion to the SEC in those years, representing overstatements of 7.9% and 19.7% in 2017 and 2018, respectively. The tables below are the relevant excerpts from the 2017 and 2018 SAIC advertising industry reports (revenues in RMB 10,000):

2017 年上海广告经营单位前十排名

2017 Top 10 Advertising Companies

1. 本市广告企业营业收入前十位

序号	单位名称	广告营业收入 (万元)
1	群邑 (上海) 广告有限公司	935532
2	上海李奥贝纳广告有限公司	779869
3	上海爱奇艺文化传媒有限公司	705035
Shanghai iQIYI Culture Media Co., Ltd.		
5	上海全土豆文化传播有限公司	601524
6	凯帝珂广告 (上海) 有限公司	409002
7	上海德峰广告传播有限公司	207606
8	上海剧星传媒股份有限公司	198992
9	上海车智广告有限公司	196506
10	上海韵洪广告有限公司	177636

3. 本市互联网媒介单位广告营业收入前十位 2017 Top 10 Online Media Co.

序号	单位名称	广告营业收入 (万元)
1	上海爱奇艺文化传媒有限公司	705035
2	上海全土豆文化传播有限公司	601524
3	上海连尚网络科技有限公司	69335
4	上海二三四五网络科技有限公司	33651
5	上海携程商务有限公司	28945
6	上海聚力传媒技术有限公司	28019
7	上海新数网络科技股份有限公司	26500
8	上海天擎信息技术有限公司	25299
9	上海花事电子商务有限公司	13525
10	上海丫丫信息科技有限公司	8700

2018 年上海广告经营单位前十排名

2018 Top 10 Advertising Companies

1. 本市广告企业营业收入前十位

序号	单位名称	广告营业收入 (万元)
1	群邑 (上海) 广告有限公司	1396405
2	电通安吉斯 (上海) 投资有限公司	775972
3	上海爱奇艺文化传媒有限公司	733651
Shanghai iQIYI Culture Media Co., Ltd.		
5	上海李奥贝纳广告有限公司	690863
6	上海全土豆文化传播有限公司	504548
7	上海文化广播影视集团有限公司	466865
8	上海创彩广告有限公司	268420
9	上海德峰广告传播有限公司	259358
10	上海菲索广告有限公司	258141

2. 本市互联网媒介单位广告营业收入前十位 2018 Top 10 Online Media Co.

序号	单位名称	广告营业收入 (万元)
1	上海爱奇艺文化传媒有限公司	733651
2	上海全土豆文化传播有限公司	504548
3	上海剧星传媒股份有限公司	251607
4	上海开城信息科技有限公司	210000
5	上海宾谷网络科技有限公司	109484
6	珍岛信息技术 (上海) 股份有限公司	85000
7	上海邑尚网络科技有限公司	75048
8	上海花事电子商务有限公司	61782
9	上海二三四五网络科技有限公司	53183
10	上海证大喜马拉雅网络科技有限公司	45479

We strongly believe IQ’s advertising revenues remained inflated throughout 2019 because its 2018 advertising revenues were overstated by almost 3x more than they were in 2017. However, as of the date of this report, the Shanghai SAIC office had not published a “*State of the Advertising Industry*” report for 2019.

3. Inflated Expenses and Prices of Assets Conceal Revenue Inflation

Our research shows IQ inflates expenses and the purchase prices of assets to burn off fake cash and conceal its revenue inflation.

The Skymoos Acquisition

In July 2018, IQ paid ~\$300 million to acquire Chengdu Skymoos Digital Entertainment (“Skymoos”).^{58,59} We believe this transaction was a sham intended to burn off fake revenues and siphon off cash from IQ’s recent Nasdaq listing. It’s simply not credible to us to believe anybody would pay ~\$300 million for this company. Skymoos hasn’t shown the ability to develop a game on its own. Months before the acquisition, a Chinese court ruled that Skymoos stole the IP and game design underlying its only successful game. IQ only acquired part of Skymoos’s business. IQ didn’t even get the Skymoos.com domain name in the acquisition.

Skymoos is a video game business with whom IQ partnered to create a video game to accompany the 2015 release of a TV series based on a very popular novel, the “*Journey of the Flower*” (花千骨). Skymoos’ single “success” was only possible because of IQ’s marketing investments, the original author’s creative vision, and top tier production talent. Skymoos’ contribution to the partnership should have been its game design. However, three months before it was acquired by IQ, a Chinese court found Skymoos guilty of illegally stealing the game design and rules for this very game, “*Journey of the Flower.*” Before its acquisition by IQ, Skymoos had twice tried and twice failed to be acquired by two different Chinese listed companies (Jinya Tech, 300028.SZ and Ningbo Fubang, 600768.SHA); both of whom were subsequently charged with illegal or fraudulent market practices.

Even before the launch of the “*Journey of the Flower*” game itself, Skymoos immediately sought to capitalize on its good fortune, but failed. In February 2015, Skymoos announced it was going to be 100% acquired by Jinya Technology (金亚科技 300028.sz) for RMB 2.2 billion in cash and shares, which gave Jinya’s share price an immediate boost:⁶⁰



⁵⁸ IQ 6-K, July 18, 2018

⁵⁹ <https://variety.com/2018/biz/asia/china-iqiyi-skymoos-1202878010/>

⁶⁰ guba.eastmoney.com

On June 4 and 5, 2015, Jinya Technology received two “Investigation Notices” from the China Securities Regulatory Commission (“CSRC”).⁶¹ Jinya was forbidden from engaging in the asset restructuring necessary to consecrate the deal, and in July 2015 the deal was unwound.⁶² The CSRC investigation later found that after a large loss in 2013, Jinya Technology engaged in fraud. Jinya hid years of continued losses which would have triggered its delisting.⁶³

In June 25, 2015, not long after the “*Journey of the Flower*” game’s release, a company called Snail Digital (苏州蜗牛数字科技股份有限公司) filed a lawsuit against both Skymoons and IQ accusing them of appropriating the game design and operating rules and violating its copyrights for its game “*Taiji Panda*.” The plaintiff’s complaint noted that:

*“...in June 2015, after Skymoons Interactive and IQ’s mobile game ‘Journey of the Flower’ was launched, Snail Digital received reports from players about the game. After conducting a comparison, its staff found numerous instances where the game ‘Journey of the Flower’ plagiarized content from ‘Taiji Panda.’ In addition, in the “Computer Software Copyright Registration Certificate” on file for “Journey of the Flower” at the National Copyright Administration of China, the functional module structure diagram, functional flowchart, and detailed functional design were all related to the ‘Wushen system’ in ‘Taiji Panda’ structural analysis; and moreover, all used game screenshots from ‘Taiji Panda’.”*⁶⁴

After the Jinya merger fell through, Skymoons needed to find a buyer. At the time, analysts observed that since *Journey of the Flower*, the business appeared dormant, was unlikely to produce any explosive news, and remained under the shadow of ongoing IP theft litigation.

Nonetheless, in July 2016, Ningbo Fubang (宁波富邦, SHA: 600768) announced it would pay a combined total of RMB 3.9 billion to acquire 100% of Skymoons through a combination of cash and stock. Regulators did not look favorably on the backdoor listing and the transaction was blocked.⁶⁵ The two companies attempted to restructure the deal and obtain an approval by decreasing the stake to 70%.^{66,67} Despite their efforts, the deal was abandoned. The CSRC also initiated an investigation into Ningbo Fubang, and in late 2017 announced that Ningbo Fubang’s Chairman Ying and another executive responsible for the attempted Skymoons acquisition conspired to profit personally through an insider trading scheme; the two had their gains confiscated, and were fined.⁶⁸

⁶¹ <http://guba.eastmoney.com/news,300028,725443621.html>

⁶² <https://www.ifanr.com/1068925>

⁶³ <http://stock.jrj.com.cn/2018/06/27145224734601.shtml> , In both 2014 and the pre-IPO period the CSRC found Jinya inflated profits through fictitious customers, forging contracts, fictional remittances, forging bank documents, forging and receiving materials, and concealing expenses. In 2014, this fraud increased total profit by RMB 80.5 million and inflated bank deposits of approximately 218 million yuan. Moreover, the 2014 annual report included a fraudulent advance payment of RMB 310 million.

⁶⁴ <http://www.nbd.com.cn/articles/2018-04-11/1207375.html>

⁶⁵ <http://v.youxiputao.com/articles/10445>

⁶⁶ <https://www.ifanr.com/1068925>

⁶⁷ <http://finance.sina.com.cn/stock/s/2018-01-09/doc-ifyqinz0773572.shtml>

⁶⁸ http://finance.ifeng.com/a/20171209/15855397_0.shtml

We don't believe it's a coincidence that both of the other companies who were willing to acquire Skymoos at such a rich valuation were found to have engaged in fraud. We believe Skymoos could not possibly command such a high valuation from a reputable company based on its own merits because, according to our research, it has none.

On March 30, 2018, only three and a half months prior to IQ's July 2018 acquisition, the Suzhou People's Intermediate Court ruled that Skymoos had stolen the IP that formed the foundation and structure of the "Journey of the Flower" game. Skymoos and IQ were ordered to cease the infringements, and pay Snail Digital an RMB 30 million fine (a very large sum for an IP case between Chinese domestic firms).^{69,70,71} The fact that Skymoos was not the true originator of the design of its only successful game and depended upon both creativity and talent of others as well as IQ's investments and marketing power to promote and commercialize the game completely undermines the ridiculous valuation that IQ ascribed to it.

Our reviews of Chinese copyright records found that **Skymoos has registered no new publication copyrights since the July 2018 acquisition.**⁷² Instead, we found only the distribution rights for 4 games under its name, **all of which were licensed from other game companies:**

中华人民共和国国家新闻出版广电总局
State Administration of Press, Publication, Radio, Film and Television of The People's Republic of China

站内搜索输入 [] 工作邮箱用户名 [] 登录

首页 | 新闻资讯 | 政务信息 | 办事服务 | 互动交流 | 总局党建 | 视听阅读

办事服务 | 结果公示 | 许可事项 | 业务查询 | 办事平台 | 场景服务 | "互联网+政务服务" 政策文件

行政许可 | 许可结果 | 游戏审批结果 | 拍摄公示

Detailed Query List
查询详细列表

游戏名称: [] 出版单位: [] 运营单位: 天象互动 | 文号: [] 原游戏名称或文号: [] [] 搜索

Game Name	Publisher	Distributor	Document	Publication #	Date
游戏名称	出版单位	运营单位	文号	出版物号	时间
神翼永恒	天津电子出版社有限公司	天津天象互动科技有限公司	国新出审[2020]179号	ISBN 978-7-498-07267-2	2020年01月22日
海战行动	天津电子出版社有限公司	天津天象互动科技有限公司	国新出审[2019]2095号	ISBN 978-7-498-06603-9	2019年07月26日
龙族血统	天津电子出版社有限公司	天津天象互动科技有限公司	国新出审[2019]1107号	ISBN 978-7-498-06296-3	2019年03月20日
卓越大天使	成都益众九州网络科技有限公司	天津天象互动科技有限公司	国新出审[2019]622号	ISBN 978-7-498-06036-5	2019年02月26日
疯狂原始人-正版3D回合手游	天津电子出版社有限公司	天津天象互动科技有限公司	新广出审[2018]292号		2018年01月11日
要塞突袭	天津电子出版社有限公司	天津天象互动科技有限公司	新广出审[2017]10532号		2017年12月27日

⁶⁹ <http://www.nbd.com.cn/articles/2018-04-11/1207375.html>

⁷⁰ <http://ip.people.com.cn/n1/2018/0410/c179663-29915711.html>

⁷¹ <https://news.66law.cn/a/20190628/103231.html>

⁷² <http://www.sapprft.gov.cn/sapprft/channels/7026.shtml>

Game Name		Publisher	Distributor	Date	Timeline
神翼永恒	Eternal Divine Wing*	Tianjin Electronic Publishing Co., Ltd.	Skymoons	22-Jan-20	Post-Acquisition
海战行动	Naval Operations*	Tianjin Electronic Publishing Co., Ltd.	Skymoons	7-Jul-19	
龙族血统	Dragon Lineage*	Tianjin Electronic Publishing Co., Ltd.	Skymoons	20-Mar-19	
卓越大天使	Angel of Excellence*	Chengdu Yingzhong Kyushu Network	Skymoons	26-Feb-19	
疯狂原始人- 正版3D回合手游	The Croods 3D Mobile Version	Tianjin Electronic Publishing Co., Ltd.	Skymoons	11-Jan-18	Pre-Acquisition

*English name is a direct translation only

Of these licensed games, management has only publicly commented on “The Croods.” In the prepared remarks of IQ’s 1Q19 earnings call, CEO Gong Yu highlighted the game as an example of Skymoons capabilities. The statement is carefully worded to suggest a major role in its development, but in fact only credits Skymoons for “*launching*” and “*adapting*” the game, not designing it:

*“Another more recent example is our game business. Our subsidiary Skymoons launched a 3D turn-based mobile game The Croods, which is based on a famous IP licensed from DreamWorks Animation’s 2013 popular animated feature film The Croods. The game has performed exceptionally well since it was launched in February, exceeding our expectation. This is another good showcase of our ability to adapt IP into online games.”*⁷³

A further check of the IP for the of The Croods, 疯狂原始人, revealed that in November 2016, a mobile version of The Croods had already been produced and distributed by Shanghai Oriental Peral Cultural Development company.⁷⁴ As such, it appears that Skymoons did nothing more than publish an updated version of a two-year-old mobile game. This appears to be the extent of Skymoons’ technical capabilities – if this company is actually worth more than RMB 2 billion, then the world is much richer than we thought.

Skymoons’ founder, He Yunpeng, is a tech entrepreneur who was an executive at a prior, failed Baidu acquisition. He was formerly a VP of 91 Wireless, an app distribution company that was acquired by Baidu for \$1.9 billion in 2013.⁷⁵

91 Wireless proved to be a disastrous acquisition. After Baidu merged it with Douku games to form Baidu games, the company struggled with scandals and investigations, was unable to compete, and ultimately was sold off in March 2017, resulting in a massive loss of over \$1.7 billion for Baidu.^{76,77} Although He Yunpeng left shortly after the 91 Wireless acquisition to go

⁷³ IQ Q1 2019 earnings call

⁷⁴ 上海东方明珠文化发展有限公司, 疯狂原始人(移动), 新广出审[2016]3331号, 2016年11月15日

⁷⁵ <https://techcrunch.com/2013/07/15/baidu-agrees-to-buy-chinese-android-app-distributor-91-wireless-for-1-9b/>

⁷⁶ <https://www.chinamoneynetwork.com/2017/11/29/baidus-growing-graveyard-discarded-business-units>

⁷⁷ Baidu 2017 20-F, p. F-34: In May 2017, the Company completed the disposal of its mobile game business to third-party companies, a total gain of RMB923 million (US\$142 million) was recognized in “Other income, net”.

form Skymoos, we consider Baidu’s willingness to work with him again on another acquisition highly suspicious.

During our due diligence on Skymoos, we found that IQ didn’t even acquire all of Skymoos’ businesses. Previously, both Jinya and Ningbo Fubang attempted to buy both Chengdu Tianxiang Interactive Digital Entertainment Co. and its sister Chengdu Tianxiang Interactive Technology Co. However, IQ only acquired the first, Chengdu Skymoos Interactive Digital Entertainment Co.⁷⁸ Its sister company, Chengdu Skymoos Interactive Technology Co., remained 99% held by He Yunpeng and retained the www.skymoos.com website and multiple permutations thereof.

序号	网址名称	域名	网址	网站备案许可证号	审核时间
1	成都天象互动科技有限公司	skymoos.com	www.skymoos.com www.skymoos.net www.skymoos.cn www.skymoos.com.cn	蜀ICP备14010235号-1	2016-12-20
2	成都天象互动科技有限公司	skymoos.net	www.skymoos.com www.skymoos.net www.skymoos.cn www.skymoos.com.cn	蜀ICP备14010235号-1	2016-12-20
3	成都天象互动科技有限公司	skymoos.cn	www.skymoos.com www.skymoos.net www.skymoos.cn www.skymoos.com.cn	蜀ICP备14010235号-1	2016-12-20
4	成都天象互动科技有限公司	skymoos.com.cn	www.skymoos.com www.skymoos.net www.skymoos.cn www.skymoos.com.cn	蜀ICP备14010235号-1	2016-12-20
5	成都天象互动	skymoos-cd.com	www.skymoos-cd.com	蜀ICP备14010235号-2	2016-12-20

On the other hand, the Skymoos that IQ acquired had to come up with something else. It appears the best its creative team could come up with was www.crimoon.net.

序号	网址名称	域名	网址	网站备案许可证号	审核时间
1	天象互动数字娱乐	crimoon.net	www.crimoon.net	蜀ICP备13004494号-2	2018-08-14

While neither site is impressive, the www.crimoon.net site comes across as unsophisticated if not amateurish and generally lacking in content. Considering the fact that IQ paid **RMB 2.4 billion** for this supposed “game development company,” we find this to be ridiculous at face value and believe it is indicative of utter incompetence by IQ’s management at best, or a completely fraudulent transaction designed to siphon cash out of the publicly-traded company and into management’s pockets, at worst. We invite readers to visit both sites:

- [Skymoos.com](http://www.skymoos.com) (not acquired by IQ)
- [Crimoons.net](http://www.crimoons.net) (created by IQ)

⁷⁸ China SAIC registration files for Chengdu Tianxiang Interactive Digital Entertainment Co. (成都天象互动数字娱乐有限公司) and its sister Chengdu Tianxiang Interactive Technology Co. (成都天象互动科技有限公司)

Look around and ask yourself, “which looks like it might be owned by a NASDAQ listed tech company with a market cap of over \$12 billion?”

Since both companies use the same logo and Skymoos / 天象互动 name, we wonder if IQ’s management might find He Yunpeng’s Skymoos.com website a convenience. Since IQ apparently has no intent to build out Skymoos, they are likely happy to have its former sister company keep up a more presentable site that displays the Skymoos name and logo, and posts content for curious visitors, who would likely just assume it was IQ’s Skymoos website.

Skymoos’ myriad of issues calls into question how IQ’s management reached the RMB 2.4 billion valuation and how the acquisition was accounted for. In fact, IQ didn’t provide a reconciliation of Skymoos’ financials to US GAAP financials for the years prior to the acquisition, claiming doing so would require “undue cost” due to a prior reorganization:

“The unaudited pro forma revenue and net loss for the years ended December 31, 2017 and 2018 is not presented as the historical financial information of the acquired business of Skymoos prepared under US GAAP is not available without undue cost, given the acquiree underwent a reorganization prior to the Company’s acquisition.”⁷⁹

We believe the above statement is a bald-faced lie by IQ’s management. The purchase agreement (included as Exhibit 4.66 of the same 20-F) includes the following as a closing condition:

***“The Target Companies have delivered to the Purchasers:** (i) all capital verification reports of the Group Members and all relevant notes and schedules thereto issued by the accountants engaged by them from the date of incorporation of the Target Companies, the details of which are set forth under Schedule VIII: List of Financial Reports; (ii) **the audited balance sheets of the company for 2016 and 2017 prepared on a consolidated basis under the US GAAP, and the relevant audited income statements and cash flow statements, together with all relevant notes and schedules, and in the absence of audited statements, the management statements shall be provided (hereinafter collectively referred to as the “Financial Statements”)**”⁸⁰*

Not only would converting Skymoos’ historical financials into U.S. GAAP not require “undue cost,” it wouldn’t have cost IQ anything at all – Skymoos had delivered GAAP financial statements to IQ prior to the deal’s closing date. This directly contradicts the already weak excuse provided by IQ’s management, exposing their brazen lie.

⁷⁹ IQ 2018 20-F, p. F-32

⁸⁰ IQ 2018 20-F, Exhibit 4.66, Section 4.1.1(j)(ii) (p. 19)

Content Price Inflation

IQ inflated the purchase price for at least one program it licensed from Wuhan DDMC (“DDMC”) in 2018. As we discussed earlier in this report, DDMC is the parent company of IQ’s partner in the iQIYI Sports JV (aka the Xin’ai Sports JV), which IQ used to claim an additional RMB 757.75 million in fake deferred revenue.

IQ’s subsidiary, Beijing Qiyi Century, was DDMC’s top customer in the film and television media segment in 2018. DDMC’s public disclosures reveal what appears to be an exorbitant premium paid by IQ for the drama “*If Time Flows Back*.”

DDMC disclosed that RMB 458.0 million of its 2018 film and TV revenue came from IQ. All of this came from the sale of the online broadcasting rights for two titles: “*If Time Flows Back*”⁸¹ and “*The Drug Hunter*.”⁸² Below is an excerpt from DDMC’s 2018 annual report showing its top 5 customers by revenue:

	Company Name	Product of Service Provided	Period	Sales Amount in the Period	Units: 10k Rmb 单位: 万元
序号	客户名称	提供产品或服务	持续合作期限	本期销售金额	上期销售金额
Beijing Qiyi Century	1 北京奇艺世纪科技有限公司	《猎毒人》、《如果岁月可回头》影视作品网络播映权 (1)	1 年	45,801.89	-
Shanghai Cultural Media Group	2 上海文化广播影视集团有限公司	《猎毒人》、《如果岁月可回头》影视剧电视台播映权 (2)	1 年	18,030.66	-
	3 湖南广播电视台卫视频道	《你迟到的许多年》影视剧电视台播映权	1 年	16,509.43	-
	4 北京鼎泰弘力影视文化传播有限公司	《失忆之城》著作权及项目投资收益权转让	1 年	7,547.17	-
Jiangsu Prov. Broadcasting Group	5 江苏省广播电视集团有限公司	《猎毒人》影视剧电视台播映权 (3)	1 年	6,238.21	-
	合计			94,127.36	-

Notes:

- (1) Beijing Qiyi Century: “The Drug Hunter”, “If Time Flows Back”, Online broadcasting rights, Rmb 458.0 million
- (2) Shanghai Cultural Media Group, “The Drug Hunter”, “If Time Flows Back”, TV broadcasting rights. Rmb 180.3 million
- (3) Jiangsu Province Broadcasting Group, “The Drug Hunter”, TV broadcasting rights, Rmb 62.5 million

⁸¹ 《如果岁月可以回头》

⁸² 《毒猎人》

DDMC sold IQ exclusive one-year online broadcast rights for “*If Time Flows Back*.” DDMC sold Shanghai Cultural Media Group one-year TV broadcast rights for the same program. DDMC also sold online broadcast rights for “*The Drug Hunter*” to IQ and sold the TV broadcasting rights to both Shanghai Cultural Media Group and Jiangsu Provincial Broadcasting Group.⁸³

DDMC reported total revenue of RMB 471.69 million from “*If Time Flows Back*” and RMB 231.96 million from “*The Drug Hunter*.”⁸⁴ These two programs were crucial to DDMC’s film and television media segment profitability in 2018. “*If Time Flows Back*” was the leading revenue generator and achieved a 36.00% gross margin. “*The Drug Hunter*” was the sixth largest revenue generator and delivered a 73.25% gross margin:

2018年度公司主要影视作品销售情况如下：
2018 information on the sales of major TV programs:

Units: 10k Rmb
单位：万元

Program Name 影视剧名称	Revenue 营业收入	Expense 营业成本	Margin 毛利率
如果岁月可回头	<i>If Time Flows Back</i> 47,169.81	30,189.34	36.00%
失忆之城	7,547.17	4,200.00	44.35%
给 19 岁的我自己	147.64	3,051.58	-1966.84%
你迟到的许多年	16,509.43	16,179.25	2.00%
许你浮生若梦	4,867.92	3,349.22	31.20%
猎毒人	<i>The Drug Hunter</i> 23,196.57	6,204.32	73.25%
我们的四十年	1,970.64	1,509.43	23.40%
合计	101,409.19	64,683.13	36.22%

At a 3.0x premium, “*If Time Flows Back*” stands out as being well above market price.

The price IQ paid for “*The Drug Hunter*” also appears to be above the market price. When two or more TV stations air a program together, they typically pay the same rate.⁸⁵ Applying this cost sharing formula to the DDMC’s total revenues for these two programs and the revenues reported for each customer, we find that IQ paid a significant premium for both programs. If Shanghai Cultural Media and Jiangsu Province Broadcasting both paid RMB 624 million for “*The Drug Hunter*,” we estimate that IQ paid a 1.7x premium compared to the TV rate.

⁸³ Wuhan DDMC, Announcement on the response to the post-review inquiry letter of the 2018 annual report. 武汉当代明诚文化股份有限公司,关于 2018 年年度报告的事后审核问询函回复的公告, pp.4, 27

⁸⁴ Wuhan DDMC, Announcement on the response to the post-review inquiry letter of the 2018 annual report. 武汉当代明诚文化股份有限公司,关于 2018 年年度报告的事后审核问询函回复的公告, p.8

⁸⁵ <https://36kr.com/p/5172076>: table: 2015-2018 年古装仙侠魔幻题材电视剧版权价格一览, 2015-2018 List of copyright prices for costume, fairy, magical dramas

Wuhan DDMC Program	Wuhan DDMC Revenue	Shanghai Cultural Media	Jiangsu Province Broadcasting	Other*	Beijing Qiyi Century	iQiyi Premium
“The Drug Hunter”	231.97	62.38	62.38	0	107.20	1.7x
“If Time Flows Back”	471.69	117.92	0	2.95	350.82	3.0x
Total	703.65	180.31	62.38	2.95	458.02	

The super-premium IQ paid was very helpful to their partner’s financial performance. In 2018, 92.5% of DDMC’s gross margin from its sales of major TV programs came from the two shows sold to IQ. If the program “*If Time Flows Back*” were priced at just 2x that paid by the TV stations, DDMC’s gross margin from its TV programs in 2018 would have dropped by 34.7%:

Wuhan DDMC: Gross Margin - Based on Reported Revenues				
Program	Revenue	Cost	Gross Margin	Gross Margin
Totals for major TV programs reported	1014.09	646.83	367.26	36.22%
“If Time Flows Back”	471.69	301.89	169.79	36.00%
“The Drug Hunter”	231.97	62.04	169.92	73.25%
Sub-total	703.65	363.94	339.72	48.28%
As % of major TV programs reported	69.39%	56.26%	92.50%	

Wuhan DDMC: Gross Margin - If "If Times Flows Back" Sold to iQiyi at a 2x Premium to TV				
Program	Revenue	Cost	Gross Margin	Gross Margin
Totals for major TV programs reported	1014.09	646.83	367.26	36.22%
“If Time Flows Back”	353.77	301.89	51.88	14.66%
“The Drug Hunter”	231.97	62.04	169.92	73.25%
Sub-total	585.74	363.94	221.80	37.87%
As % of major TV programs reported	57.76%	56.26%	60.39%	
Impact on Gross Margin (%)				-34.7%

Units: Rmb millions

The Chinese media has reported that competition among online platforms for top content intensified between 2016 and 2018. This resulted in some online broadcasting licenses selling for up to 2x the price paid by TV stations, especially for the popular “costume and magic/fantasy dramas” segment. However, the premiums paid by IQ still appear inflated.⁸⁶

A CITIC report provided a table of the highest cost copyrights from the years 2012–2018.⁸⁷ The top programs’ license fees for both online and TV broadcasters increased each year until the premium ratio between online and TV peaked at 1.88x in 2017. However, there was a reversal in 2018 and the premium declined by 20% to 1.5x.

⁸⁶ <https://36kr.com/p/5172076>: 由于视频平台之间对优质内容的争夺，剧集的台端和网端版权价格也有明显的差距。部分剧集网端价格是台端价格的 2 倍以上。Due to the competition for high-quality content between video platforms, there is also a clear gap for the pricing of the episodes’ copyrights between the TV station and online network-end. The price of some episodes on the online networks is more than twice that on the TV side.

⁸⁷ Citic Securities, 2019-07-01, “差异化竞争下的在线视频龙头, p.24

2012-2018 Copyright License Costs for Top TV Programs

图表59: 2012 - 2018 年中国头部电视剧版权费

Program	剧目	Year	上线时间	Individual Program Price (Online Platforms)	Individual Program Price (TV Stations)
				单集售价 (互联网, 单位: 万元)	单集售价 (电视台, 单位: 万元)
	甄嬛传	2012		30	190
	龙门镖局	2013		80 - 90	-
	武媚娘传奇	2014		100	250
	花千骨	2015		130	160
	幻城	2016		400	230
	择天记	2017		750	400
	如懿传	2018		900	600

资料来源: 艾瑞咨询, 中信建投证券研究发展部

Sources: iResearch, CITIC Securities Research & Development Dept.

Units: Rmb '0000

While the 1.7x premium IQ paid for the “*The Drug Hunter*” was only slightly above the 2018 average, IQ paid **double** the average premium for “*If Time Flows Back*” at 3.0x.

Due to the developing partnership between IQ and DDMC as well as IQ’s ability to be a long-term customer for DDMC, we would expect IQ to have considerable leverage in price negotiations with DDMC. However, instead of IQ using its leverage over DDMC to get discounts, the opposite occurred.

We believe that IQ and DDMC conspired to over-report the price IQ paid for “*If Time Flows Back*.” This was a mutually beneficial agreement between the two partners; the premium made up a significant portion of DDMC’s profit in 2018, and IQ was able to burn off some of the fake cash it had on its balance sheet from inflating its revenues.

4. Misleading Financial Reporting Creates the Appearance of a Cash Generative Company

We adjusted IQ's 2019 operating cash flow ("OCF") down from \$561 million to -\$1.157 billion by applying accounting methods consistent with others in its industry. IQ's management, analysts and bulls have described the company as "*the Netflix of China*." However, we believe this comparison is nothing more than a fallacy perpetuated by management and other promoters.

Content licensing and production costs are by far the largest expense for both companies. However, the OCF calculations used by IQ and NFLX are completely different. While Netflix accounts for "all additions to steaming content assets" as cash outflows from operating activities, IQ categorizes acquisitions of licensed copyrighted material as cash outflows from investing activities. Not only do the initial purchases have no negative impact on IQ's OCF, but the subsequent amortization has a positive impact on OCF. IQ's accounting methods are clearly intended to disguise the fact that its business is hemorrhaging cash. In contrast, the consistently profitable Netflix is OCF negative. Netflix's statement of cash flows is displayed below. It classifies all of its cash used for content as "net cash used in operating activities." This drives its negative OCF:⁸⁸

NETFLIX, INC.			
CONSOLIDATED STATEMENTS OF CASH FLOWS			
(in thousands)			
	Year Ended December 31,		
	2018	2017	2016
Cash flows from operating activities:			
Net income	\$ 1,211,242	\$ 558,929	\$ 186,678
Adjustments to reconcile net income to net cash used in operating activities:			
Additions to streaming content assets	(13,043,437)	(9,805,763)	(8,653,286)
Change in streaming content liabilities	999,880	900,006	1,772,650
Amortization of streaming content assets	7,532,088	6,197,817	4,788,498
Amortization of DVD content assets	41,212	60,657	78,952
Depreciation and amortization of property, equipment and intangibles	83,157	71,911	57,528
Stock- based compensation expense	320,657	182,209	173,675
Excess tax benefits from stock- based compensation	—	—	(65,121)
Other non- cash items	40,428	57,207	40,909
Foreign currency remeasurement loss (gain) on long- term debt	(73,953)	140,790	—
Deferred taxes	(85,520)	(208,688)	(46,847)
Changes in operating assets and liabilities:			
Other current assets	(200,192)	(234,090)	46,970
Accounts payable	199,198	74,559	32,247
Accrued expenses	150,422	114,337	68,706
Deferred revenue	142,277	177,974	96,751
Other non- current assets and liabilities	2,062	(73,803)	(52,294)
Net cash used in operating activities	(2,680,479)	(1,785,948)	(1,473,984)

IQ reports three items related to content in its statement of cash flows: amortization of licensed copyrights, amortization and impairment of (self) produced content, and impairment of licensed copyrights. Being amortization charges, each provides a positive contribution to OCF. Under "changes in operating assets and liabilities," the cash outflows for (self) produced content are listed. These are combined with other items to create the total OCF. IQ's largest cash expense, "acquisition of licensed copyrights" is recorded further below under "cash flows from investing

⁸⁸ Netflix, 2018 10-K, pp. 42, 46.

activities.” By removing the cash outflows from acquiring licensed copyrights from OCF and recording it under cash flows from investing, IQ’s OCF *appears* positive:⁸⁹

IQIYI, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2017, 2018 AND 2019
(Amounts in thousands of Renminbi (“RMB”) and U.S. dollars (“US\$”))

Note	Year ended December 31,			
	2017 RMB	2018 RMB	2019 RMB	2019 US\$
Cash flows from operating activities:				
Net loss	(3,736,932)	(9,061,231)	(10,276,739)	(1,476,162)
Adjustments to reconcile net loss to net cash provided by operating activities				
Depreciation of fixed assets	348,921	312,138	476,068	68,383
Amortization and impairment of intangible assets	112,860	346,672	972,760	139,728
Amortization and impairment of licensed copyrights	7,882,190	12,236,239	12,743,323	1,830,464
Amortization and impairment of produced content	811,448	2,265,543	2,977,181	427,645
Provision for doubtful accounts	56,048	107,223	58,006	8,332
Unrealized foreign exchange (gain)/loss	(333,601)	940,479	155,079	22,276
Loss on disposal of fixed assets	4,594	4,184	13,257	1,904
Accretion on convertible notes payable or convertible senior notes	112,457	23,912	346,279	49,740
Barter transaction revenue	(762,741)	(1,082,964)	(682,941)	(98,098)
Share-based compensation	233,424	556,211	1,084,520	155,782
Share of losses on equity method investments	263	16,965	155,073	22,275
Fair value change and impairment of long-term investments	32,938	(189,639)	162,350	23,320
Fair value change of assets and liabilities remeasured at fair value on a recurring basis	—	13,005	5,711	820
Other investment income	—	—	(25,272)	(3,630)
Deferred income tax benefit	(12,214)	(45,086)	(77,312)	(11,105)
Amortization of deferred income	—	(5,346)	(12,446)	(1,788)
Other non-cash (income)/expenses	(2,532)	20,128	37,820	5,433
Changes in operating assets and liabilities				
Accounts receivable	(512,060)	(543,988)	(810,774)	(116,460)
Amounts due from related parties	56,720	(155,361)	45,717	6,567
Produced content	(1,962,221)	(4,544,977)	(3,596,339)	(516,582)
Prepayments and other assets	(549,301)	(735,191)	(854,906)	(122,800)
Accounts payable	1,050,178	583,099	(654,987)	(94,083)
Amounts due to related parties	(184,882)	435,911	460,964	66,213
Customer advances and deferred revenue	836,946	466,961	880,844	126,525
Accrued expenses and other current liabilities	646,814	808,277	73,907	10,616
Interest payables	(123,618)	9,253	58,644	8,424
Other non-current liabilities	6,085	101,769	190,440	27,355
Net cash provided by operating activities	4,011,784	2,884,186	3,906,227	561,094
Cash flows from investing activities:				
Acquisition of fixed assets	(1,022,315)	(611,910)	(740,163)	(106,318)
Acquisition of intangible assets	(110,290)	(387,539)	(127,505)	(18,315)
Acquisition of licensed copyrights from related parties	—	(58,660)	(324,040)	(46,545)
Acquisition of licensed copyrights from third parties	(9,087,438)	(12,983,396)	(11,633,509)	(1,671,049)
Purchase of long-term investments	(553,003)	(883,375)	(706,149)	(101,432)

Although we expect that professional investors will have scrutinized the statements of cash flows and picked up on this simple accounting gimmick, we would be remiss not to point out this difference and its massive impact on IQ’s headline numbers.

⁸⁹ IQ 2019 20-F, p. F-12

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