An explosion of accounting fraud

By Steve Clapham, Hardman & Co Analyst

Source: Shutterstock

An explosion of accounting fraud

Background

A wave of new accounting frauds is likely in this cycle

A huge amount has been written about Carillion and its ineffectual audit but, unfortunately, I believe Carillion could be the tip of the iceberg and that the next few years are likely to see an explosion in the discovery of frauds. After the last long bull market in the 1990s, a series of massive frauds was uncovered – Enron in 2000, WorldCom, Qwest and Global Crossing the following year, Tyco in 2002 and HealthSouth in 2003. In the space of just four years, nearly $0.5tr of market cap evaporated (probably equivalent to $1.5tr today).

Major accounting collapses in last cycle

Year	Company	Size of losses ($bn)
2000	Enron	78
2001	WorldCom/Qwest/Global Crossing	295
2002	Tyco	60
2003	HealthSouth	50

Source: Behind the Balance Sheet, from various sources

Accountants and regulators would probably claim that this could not happen now, thanks to the introduction of new accounting rules and Sarbanes Oxley in the US. Certainly, many of the new accounting practices would prevent a repeat of Enron's accounting shenanigans, but fraudsters will find a way around any rule.

Just look at Valeant, the pharmaceutical giant that was revealed to be manipulating its earnings, where $80bn of value evaporated in nine months in 2015/16, after short-seller Citron Research published a damning report. Valeant was using a technique known as "channel stuffing", while also using a related party to disguise that it was overstating its revenue.

Fortunately, we have more short-sellers today – they publish their findings to smash the target's share price and allow them to bank a profit. These forensic analysts have uncovered many frauds – one recent example was a report that raised major questions about luggage maker Samsonite, forcing its CEO to resign. That this is the main difference in investor protection today is hardly a pat on the back for regulators, nor does it mean that all or even the majority of frauds have been discovered.

Accounting scams probably even more prevalent today than formerly

Accounting scams are as prevalent today, and probably even more so than formerly, for three main reasons:

- First, an unusually long economic cycle has increased the pressure on company executives to maintain a track record of successive quarterly growth in earnings. This extended bull market, which, in 2017, exhibited a stunning lack of volatility, also breeds complacency and a lack of scepticism among investors. With valuations ever higher, company executives are fearful of any earnings disappointment that could cause their share price to collapse.
- Second, the incentives for fraud are much greater than formerly. CEOs, particularly in the US, but also over here, are enjoying unprecedented compensation packages. Faced with the prospect of a multi-million performance

award, executives are hugely incentivised to bump their earnings using accounting tricks.

Meanwhile, brokerage analysts are today far less experienced than they were 20 years ago – they follow many more companies, are lower-paid, and simply don't have the time to investigate dubious accounting; predominantly, their primary focus is to predict the next quarterly earnings number. There is today, therefore, a greater incentive to manipulate EPS, and less chance of being discovered.

One commentator suggested that sell-side analysts don't uncover frauds – we disagree. Paul Morland, a former Hardman & Co analyst, published a sell note on Autonomy when he was working at the company's broker. He cited deferred revenue trends as an indication that revenue recognition was not all it should have been, and he has been cited in the CFO's recent trial. Derek Terrington, Hardman & Co's media analyst, when at Phillips and Drew, exposed Robert Maxwell with his famous note on the company with the recommendation, "Can't Recommend A Purchase". Many years ago, as a conglomerate analyst, I exposed accounting chicanery at Williams Holdings (whose audit fee represented 15% of its auditor's annual revenues) and at BTR, causing the latter's share price to collapse. So we think the sell-side can play an important role, but perhaps less so than formerly.

- Third, the universe of quoted stocks has shrunk by half in the last 20-odd years. Many stocks have been taken over by industry competitors or by private equity, which has been buying up credible companies at the smaller end of the market; incumbent managements are incentivised to sell, as they are rewarded with equity kickers by the new owners.

Bronte Capital's John Hempton, one of the world's top short practitioners, recently said, "there is quite an absurd amount of small-cap fraud". He also sees a lot of large-cap fraud – these companies have premium ratings because they have above-market growth rates; he points out that it's easy enough to produce above-market growth if you are making up the numbers. By definition, this means that a lot of value will be destroyed as such stocks are brought down to earth.

Fraud is a late cycle phenomenon

Source: Twitter

A bear market will eventually follow the current uptrend, leading to frauds being more naturally exposed…

Inevitably, the bull market will end at some point, and we shall have a bear market. There are signs that the US market is already starting to wane, although we may need a recession to induce a major correction. In bear markets, frauds are more naturally exposed – as Warren Buffett pointed out, “it’s only when the tide goes out that you learn who has been swimming naked” – and this time, we shall see major casualties.

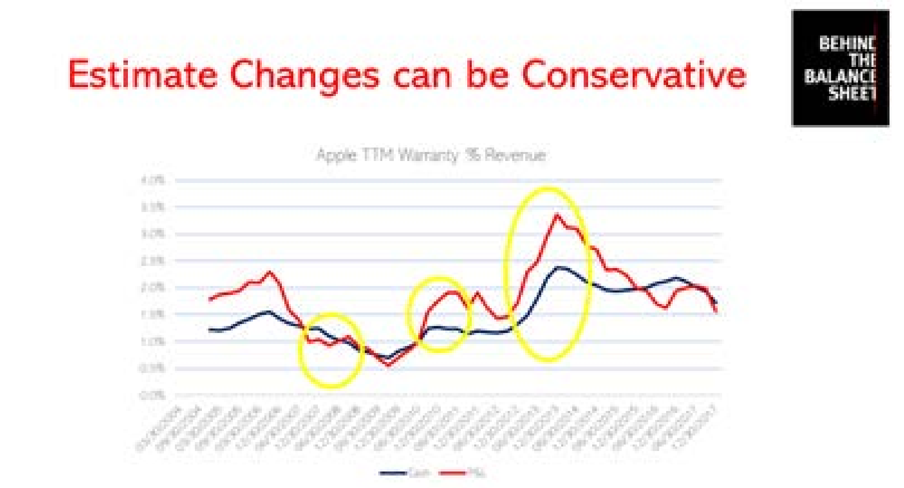
…and some investors are preparing ahead

Some smart investors are already making preparations. One of London’s largest hedge funds has hired two forensic accountants. A major long-only institution recently asked me to develop a forensic accounting training course for its global analyst team, which I am now rolling out to my institutional client base. The course has over 100 examples of real-life accounting chicanery and features some household-name companies like Netflix, Vodafone, Tesco and Folli Follie. We are probably early, but it’s better to be prepared.

We are considering modifying this course slightly to make it more useful to the private investor and offering it to the Hardman & Co readership base. If you are a private investor, interested in improving your analytical skills and looking to avoid stocks with earnings holes, please get in touch with us by emailing Grace Merrall (gm@hardmanandco.com) to register your interest. The course will be either a one-day course on a Saturday or spread over three evening sessions. There will be a charge for the course, although well below that for equivalent professional training courses.

We show below a sample slide from the course, which illustrates that, sometimes, Finance Directors can be overly conservative. Here we are looking at changes in accounting estimates, and we illustrate how variations in warranty provisions can be used to boost margins and earnings or, in this case, to depress them.

Sample slide from the course



Source: Behind the Balance Sheet

The illustration here is of a comparison of (1) the trailing 12-month ratio of P&L warranty charges to revenue vs. (2) the trailing 12-month ratio of cash spend on warranty costs to revenue. Twice in the last few years, Apple has built up its warranty provisions way in excess of actual spend, possibly because of the introduction of a new product. This depressed margins at the time by up to 1%. More recently, the P&L charge has been below cash spend, flattering earnings.

About the author

Steve Clapham is responsible for analytical coverage of a number of support services clients at Hardman & Co.

He is a founding partner of the Balance Sheet Surgery LLP, which specialises in in-depth investment research and analyst training. Steve has been an investment analyst for the last 25 years, working on the sell side for a number of investment banks covering the transport, utilities and conglomerates sectors. In 2005, he moved to the buy side, where he was a partner at Toscafund Asset Management LLP, and then Head of Research at Altima Partners LLP.

Steve was part of the group of investors that acquired Hardman & Co in late 2012. He holds a degree in Technology and Business Studies, and is a member of the Institute of Chartered Accountants of Scotland.

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The fact that Hardman & Co is commissioned to write the research is disclosed in the disclaimer, and the research is widely available.

The full detail is on page 26 of the full directive, which can be accessed here: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf

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