

Keep it. Simple.



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How Management (Can) Mislead You

Lies, Damned Lies and (Bias) Disclosure

Agenda

- What this presentation is *not* about
- IFRS and Everything Else
- Adjusted Earnings Measures
- Acquisitive Growth Magic
- Shifting Revenues / costs / profits
- Window-dressed Cash Flows
- Investment Holdings Companies' Fair Values
- Other Means of Misleading
- Disclosure vs. Transparency
- Narrative vs. Reality
- But what about auditors?
- The Golden Rule: Incentive
- Summary
- Questions

"Statistics show that those who contract the habit of eating, very few survive."
—George Benard Shaw

"In ancient times they had no statistics, so they had to fall back on lies."
—Stephen Leacock



What this presentation is not about



- ✔ This presentation is about how management can *legally* use (and justify using) facts and clever disclosure to mislead investors.
 - ✔ More common than you think.
- ✔ This presentation is *not* about fraud or anything *illegal*.
 - ✔ Which can and does happen too (from time to time).

There is a big difference between something being 'legal' and something being 'moral'...

Disclaimer: These are only my opinions on disclosure and may or may not be correct. In no way am I intimating that a company or its management are dishonest or untoward. I.e. Don't sue me, this is only for education / illustrative purposes.



IFRS and Everything Else



- ✔ The **International Financial Reporting Standards (IFRS)** are rules by which companies account for business:
 - ✔ Rules make them **consistent** with each other and over time,
 - ✔ Rules make them **comparable**, and
 - ✔ Rules **limit creative interpretation** for narrow vision of truth.
 - ✔ But, even IFRS often needs management **estimates and assumptions** (very open for manipulation).
- ✔ Anything that is *not* IFRS, is *not* being regulated and audited:
 - ✔ Hence, means that it may *not* be consistent,
 - ✔ May *not* be comparable, and
 - ✔ May be open to manipulation to suit agenda.
 - ✔ (Excluding SAMREC and other niche standards.)
- ✔ Example of both IFRS-based and non-IFRS-based manipulation of the facts to follow...



Adjusted Earnings Measures

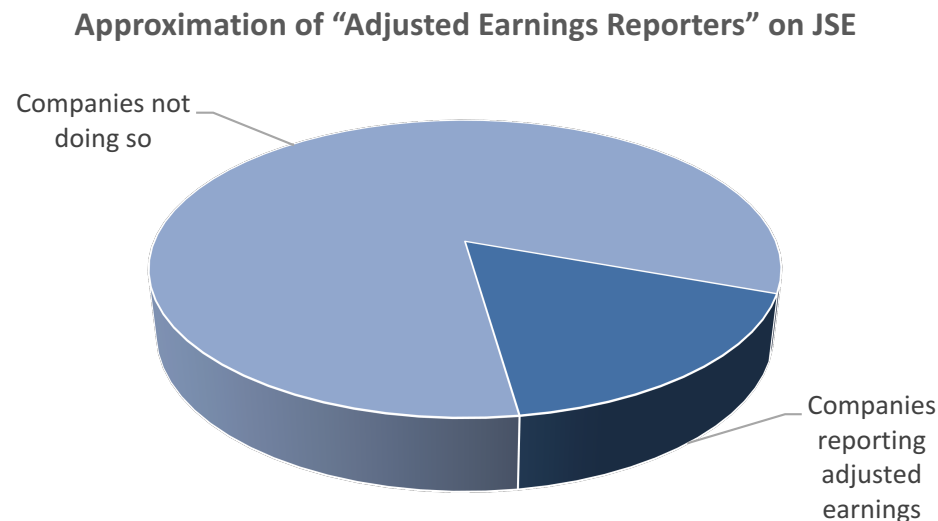


- ✔ IFRS earnings per share measures:
 - ✔ Earnings per share = EPS,
 - ✔ Headline earnings per share = HEPS,
 - ✔ Diluted EPS/HEPS, and
 - ✔ Continuing/Discontinued per share measures.
 - ✔ Nothing else. At all. Ever.
- ✔ **Any other per share measure of earnings is manufactured by management!**
 - ✔ If they don't disclose how they make it, don't trust it.
 - ✔ If they do disclose, consider if you agree with it.
 - ✔ Ask if the measure has changed from prior years?
 - ✔ Do *not* compare it with other listed companies, as it is not comparable with anything.



Adjusted Earnings Measures (cont.)

- Here is my matchbox statistic:
 - c.14 JSE-listed stocks released “adjusted / normalized / core” earnings measures from 1 June till 5 June 2017 (5 days = 1 work week!).
 - Over 70 stocks in the last month and a bit (reporting season).
 - Inaccuracies here without a detailed case-by-case search.
- That equates to around a fifth of all JSE-listed companies.
- I.e. 1/5th to 1/4th of all stocks “tweak” IFRS earnings!



Adjusted Earnings Measures (cont.)



✔ Company A:

- ✔ Every year Company A showed and emphasised its 'Normalized Earnings' number, but EPS and HEPS were flat or falling...
- ✔ Eventually, Normalized Earnings followed suite (and the share price too – see chart on next slide).
- ✔ Why? Dodgy definition hidden in notes + kept changing definition...
- ✔ FY 16 Definition: “...operating profit adjusted for depreciation, amortisation of intangibles, lease smoothing and once-off transaction costs ... **Previously**, the Group reported normalised earnings after adjusting for share-based payments and establishment costs relating ... to ... international operations.”

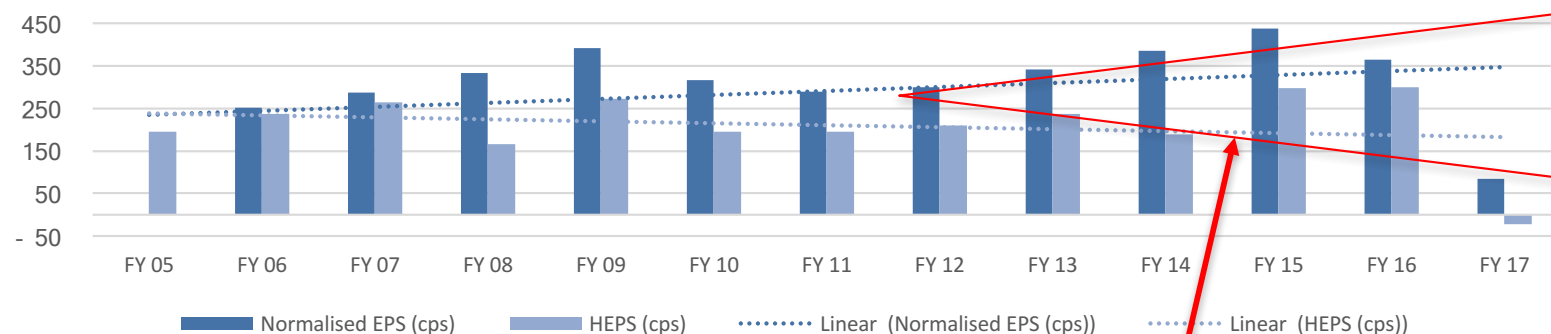


Adjusted Earnings Measures (cont.)

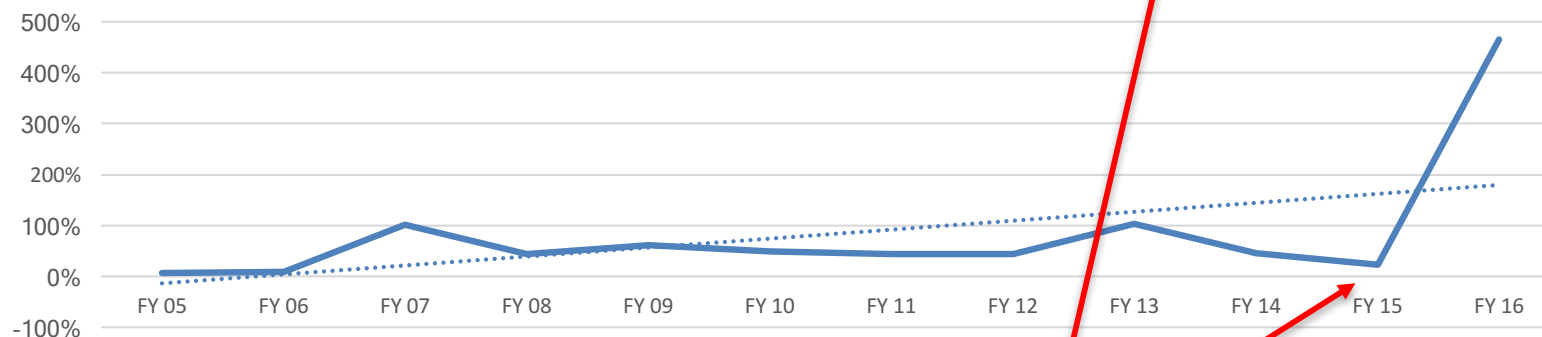


Company A:

Normalised EPS versus IFRS HEPS



Premium of Normalised over IFRS earnings (%)



Company A Share Price



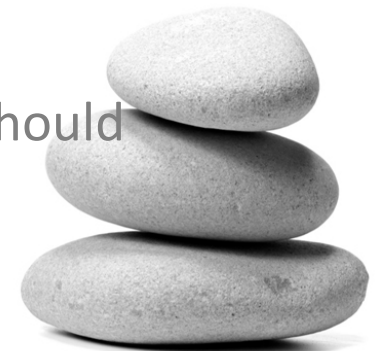
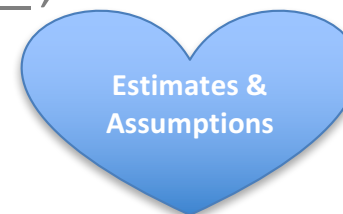
Sources: Various company reports, Profile Media, Iress, AlphaWealth workings



Adjusted Earnings Measures (cont.)



- How do we judge adjusted earnings measures?
- Always ask the following about each item being excluded in any adjusted earnings measure:
 - Is the cost **real**?
 - Is *someone* actually **paying that amount**?
 - Is *someone* **receiving that amount** in their pocket?
 - Could **management control** whether the cost was incurred or not?
 - Is the cost **repetitive** in nature?
 - Does it **regularly** occur?
 - Is it **necessary** in the execution of the company's strategy or business?
- If even a single one of these questions is 'YES', then the cost should probably not be excluded from earnings!



Acquisitive Growth Magic



- ✔ IFRS Group accounting rules:
 - ✔ IFRS dictates the (proportional) **consolidation of acquired companies** from the date of acquisition.
 - ✔ If acquisition structured correctly, **can produce the illusion of a growing business** by lifting revenues and profits.
- ✔ Nothing wrong with acquisitive growth, but consider:
 - ✔ Is it properly **disclosed**?
 - ✔ Does acquisition actually **make sense**?
 - ✔ Reversing acquisitive growth, **is the group still (organically) growing?** Don't take company's answer to this at face value...



Example: Acquisitive Growth Magic



Company B:

- New management effectively acquired Company B, turned it around and used its script and subsequent capital raises to acquire a large range of businesses.
- Ramp-up in acquisitive earnings masked the lack of operational expertise in running the acquired businesses.
- When the acquisitions stopped and the negative organic growth (i.e. decline) in core business became apparent, the highly rated script collapsed (see chart below).
- To be fair, though, many other variables at play here.
- This one tricked me too! There are more out there...



Sources: Iress, AlphaWealth workings

Shifting Revenues / Costs / Profits



- **IFRS:** Revenue recognised upon risk and reward being transferred in provision of service or delivery of product (not when cash flows).
- **IFRS:** Costs accounted for when incurred (not when cash flows).
- Some revenues and costs involve estimation of this (often services):
 - Banks and lenders provisions,
 - Construction projects,
 - Long-lead time services, and
 - Insurance contracts, amongst others.
 - But changing your “estimate”, you can change your revenue.
- Revenue and costs also recognised based on accounting policies, which can also be changed...



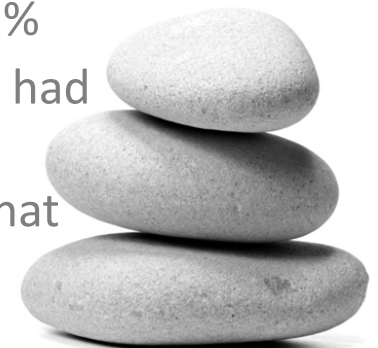
Example: Shifting Revenues / Costs / Profits



✔ Company C: Revenues

- ✔ Company C sells houses
- ✔ Changed its revenue recognition policy during FY 17.
- ✔ Old policy: “...*the Company only recognises revenue on the registration of transfer in the deeds office and not on sale.*”
- ✔ New policy: “...*recognises revenue on the earlier of the registration in the deeds office or occupation with guarantees in place.*” I.e. On sale, not on transfer.
- ✔ Did not restate prior years as managed to classify this change as “change in accounting estimate”.
- ✔ Effect on Company C’s FY 17 results:
 - ✔ FY 17 revenue got an extra R601m revenue*
 - ✔ FY 17 HEPS were reported as *growing* +7% y/y, but excluding change the HEPS would have shown a *decline* in HEPS of -11%
 - ✔ I.e. Polar opposite set of results if the “estimate” of revenue had not been changed.
- ✔ Perfectly legal, but does it really show a true reflection of what happened over this period?

*Estimates
&
Assumptions



Example: Shifting Revenues / Costs / Profits



African Bank

➤ African Bank: Costs

- African Bank lent money out,
- It's profits were basically the following:
 - Interest and other revenues earned on lending money,
 - Less: Interest on borrowings, and
 - Less: Bad debts.
- How do you incur costs for bad debts *before* they go bad?
 - You estimate them.
- African Bank underestimated its bad debts, and thus overstated its profits.
- All estimates eventually become reality, like they did in African Bank's case.
- The rest is history...
- **Note:** ABIL was far more complicated than this, but still serves as a good example for these purposes.



*Estimates &
Assumptions

Window-dressed Cash Flows



- Cash flows can be made to look better at reporting period ends by manipulating debtors, creditors and inventory balances:
- Retailers are the most common culprits here:
 - Near year end they do the following:
 - Put their stock on sale in their shops,
 - Push their creditor payments out, and
 - Demand / offer early payment terms to their debtors.
 - Hence, their working capital looks great at year end and we reward them for being cash generative businesses.
- But are they cash generative outside of reporting dates?
- Could this window-dressing of cash flows actually be destructive to their businesses?
- **Example:**
 - The entire retail sector!
 - If you want bargains, go shopping just before listed retailer's financial year ends...



Investment Holding Fair Values



- ✔ Listed investment holding companies decide how to disclose the fair value of their underlying (non-IFRS):

- ✔ Discretionary,
- ✔ Incentive to overstate them, and
- ✔ Particularly easy when it is unlisted.

✔ Example: Company D, E & F

- ✔ **Company D** had over the last decade quietly changed how it “fair valued” for the Group’s overheads:

- ✔ At first, it gave them limited value.
- ✔ Then it disclosed them at a 10.0x PE as Group was profitable (charged many subsidiaries management fees), and
- ✔ Then, more recently, made this PE “market related”, (e.g. ALSI at a PE of > 15x).
- ✔ Disclaimer: Hard to find paper trail on this, so I am relying on memory here.

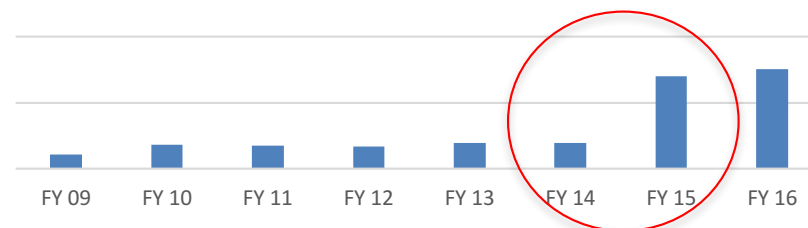
- ✔ **Company E** disclosed its major investment at cost and not market value, despite it being listed, boosting its NAV by a lot.

- ✔ **Company F** has valued its one subsidiary for millions of ZAR for years despite it never generating a cent of profit.

- ✔ None of these things added real economic value, yet all of them boost reported NAV or Sum-of-the-Parts (SOTP).

- ✔ Note: SOTP is NOT an IFRS measure, but NAV is...

Company D: Value of "Group Function"



Sources: Various company reports,
AlphaWealth workings



Other Means of Mislead



- **Segmental reclassification** shifting/hiding declines and losses around
- **Selective highlights** in results ignoring the bad news
- Quoting % change where growing, **hiding comparatives** where negative
- Sticking balance sheets before income statements = **de-emphasising negative performance**
- **Moving management targets** around to fit performance, and not the other way around
- Constructing a great narrative as a strategy, but executing something totally different (then changing strategy to fit what happened) = what I call “**retrospective strategy**” or “**post-transaction rationalising**”
- Overstating provisions in bad years to release them in good years (i.e. “**smoothing**”).
- Only disclosing **select periods in graphs** that fit management ‘narrative’ (see charts)
- **Changing graph** to create illusions of great change (see charts)

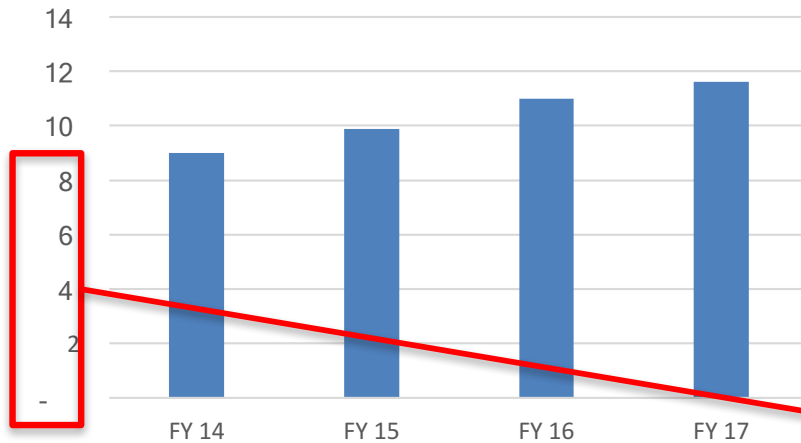


Other Means of Mislead (cont.)

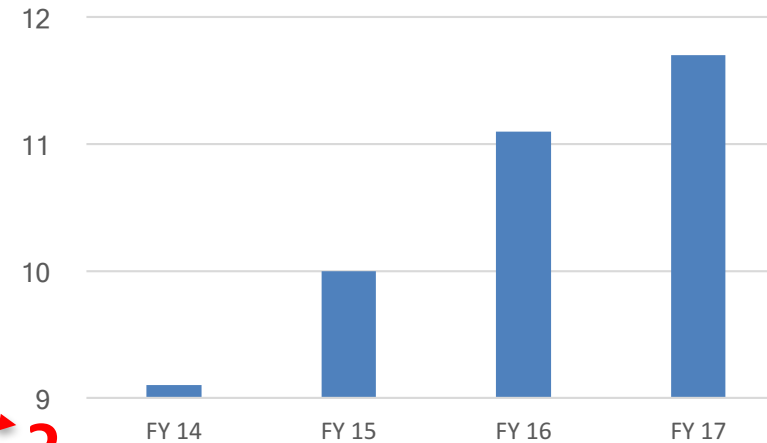


Adjusted Scales:

(A) Revenue - Unadjusted Scale

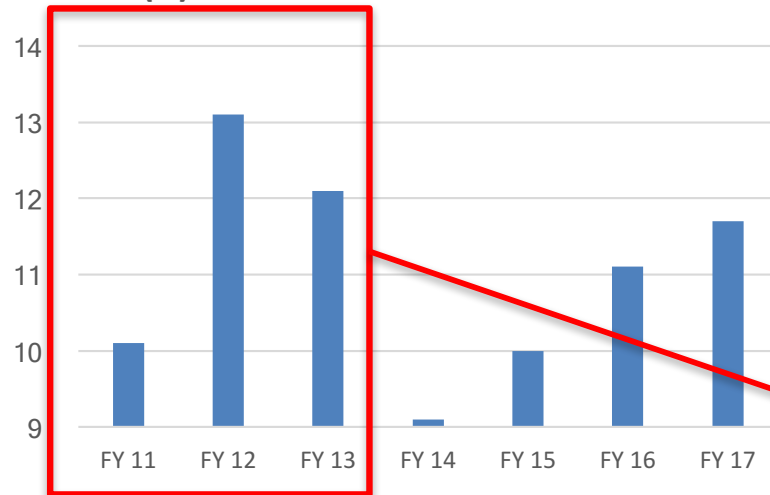


(B) Revenue - Adjusted Scale

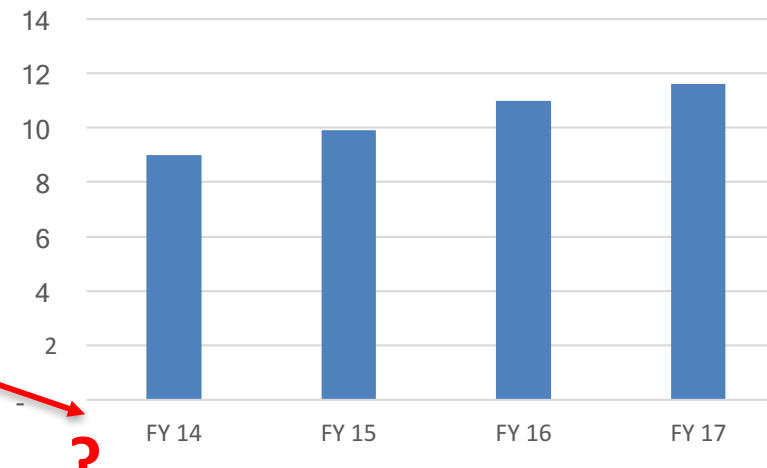


Adjusted Time Periods:

(A) Revenue - Full Time Period



(B) Revenue - Selective Time Period



Disclosure vs. Transparency



- ✔ IFRS has minimum disclosure requirements
- ✔ **Bad companies hide behind these IFRS requirements:**
 - ✔ Use them as bare minimum for disclosure,
 - ✔ Tuck important facts into notes (hide rather than highlight), and/or
 - ✔ Argue how IFRS is wrong and window-dresses their own earnings numbers (sometimes, they are right here).
- ✔ **Good companies volunteer disclosure beyond IFRS:**
 - ✔ Tell you both the good and the bad news,
 - ✔ Disclose even the things that make them look bad,
 - ✔ Talk about risks and not just returns, and
 - ✔ Offer management earnings views along side IFRS views.



Narrative vs. Reality



- Bad companies narrative does not equal reality of numbers
- Good companies narrative and numbers back each other up
- Good signs for management:
 - Set, achievable and quantifiable management targets / guidance,
 - These targets do not change, and
 - These targets are regularly achieved.
- **Rule of Thumb:** When management say that something is happening, double check that it *is* happening in the numbers too...



But what about auditors? What about the JSE? FSB? Anyone...?



External financial auditors:

- Are *external* to company, so will never know it as well as management.
- Audit on a *sample* basis.
- Are auditing IFRS only (generally).
- Rely on management for estimates, guestimates and policies.
- Not investors.*
- Do not always audit extra information provided by management.



JSE:

- If the laws/rules have been followed, it is not really their responsibility.

FSB and other regulatory bodies:

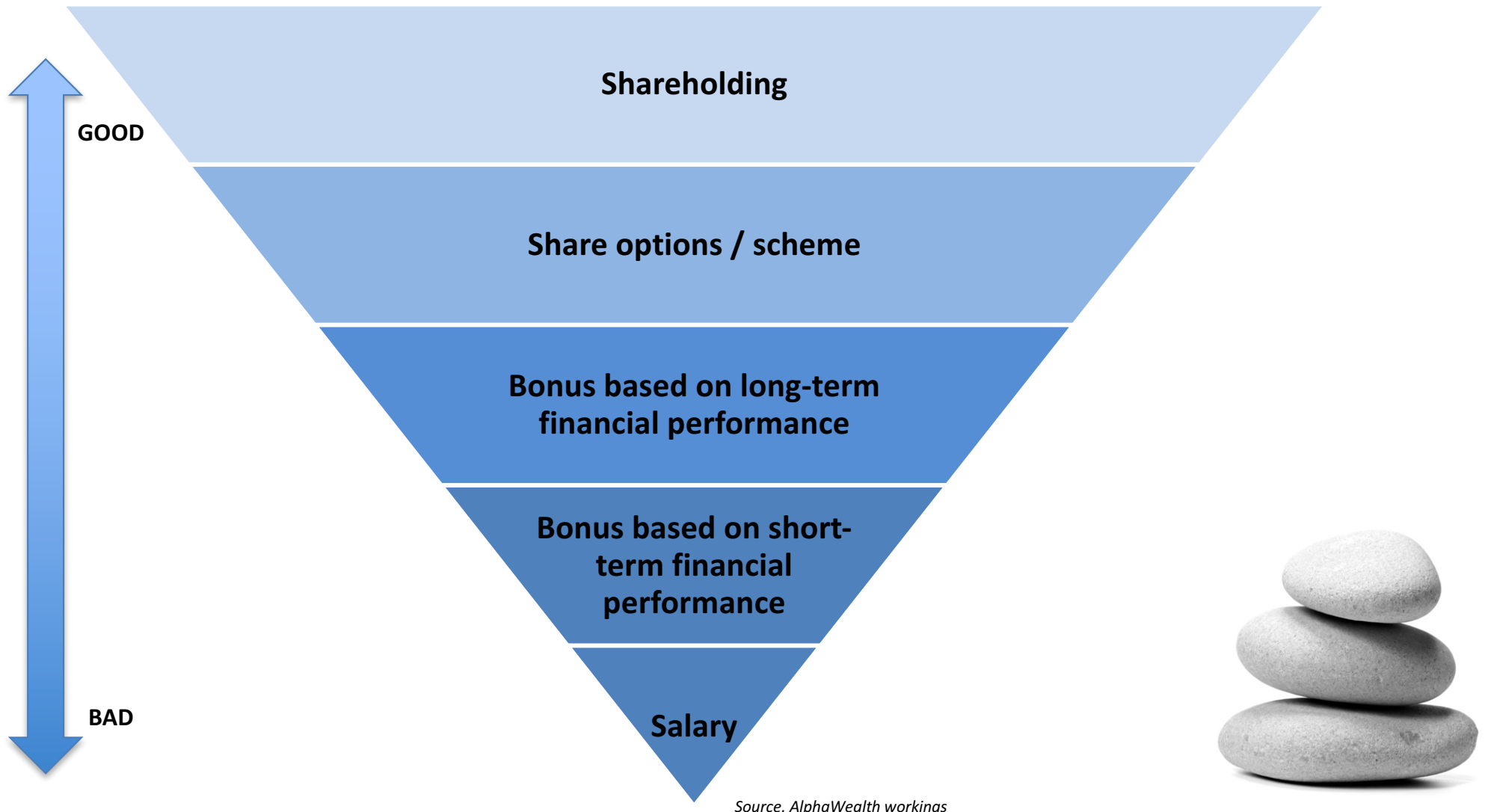
- If the laws/rules have been followed, it is not really their responsibility.

- Hence, it is ***all*** up to you to get become aware and conscious!



The Golden Rule: Incentive

- A human will act in their own self-interest.
- **Incentive = everything!**
- Hierarchy of management incentives (most to least effective):



Source, AlphaWealth workings

Summary

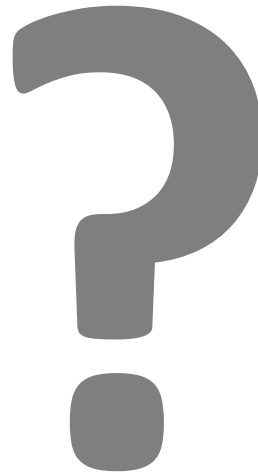


- There are many ways that management can (legally) mislead investors:
 - Non-IFRS measures,
 - IFRS manipulations, and
 - Many other ways.
- None are illegal, but many are morally questionable.
- As not illegal, you cannot rely on regulators or auditors to protect you.
- Hence, some healthy cynicism and research is probably your best defence.
- Always consider management incentives in unpacking this puzzle.



Questions

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