AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive 24th June 2016

Earnings Shenanigans …. are your profits being manipulated?

In just over a month's time investors will be bombarded with profit results announcements from listed companies for the financial year ending in June. In the financial press and from the research analysts in the investment banks there is rarely much critical analysis of the figures presented due to the vast number of companies required to report their results in a four week period. As discussed in the piece Confession Season, company management teams are always under pressure to deliver results in line or above market expectations or face the negative share price reactions. This gives management, in particular the chief financial officer (CFO), strong incentives to present the most positive picture possible of a company's financial health.

In this week's piece we are going to look at what a company can do to dress up their financial results and what tricks to look for when Australian corporates release their June profit results. Not necessarily the most exiting topic, but something fundamental to think about as the ASX200 oscillates wildly on *Brexit Day*!

The Three Statements

When a company releases its financial statements most of the attention is focused on the company's ***profit and loss statement*** (P&L) which provides a six monthly summary of its revenues, expenses, interest cost and taxes with the investment community most concerned about the net figure. The ***balance sheet*** provides a snap shot of a company's assets, liabilities and shareholders' equity and provides investors with both an understanding of how the company is financed (debt or equity) and what the it may be worth if it is liquidated. The ***cash flow statement*** shows a picture of the actual cash flowing in and out of the company over the past six months and is harder to manipulate and is similar to blood pumping through the corporate entity. A company may record sales made on their profit and loss statement as revenue and hence profit, before that cash is actually collected from their customers. Printing these three statements and reading them side by side can often reveal signs of problems a company may have that may be minimised or ignored when management present their results to the market.

The Statements don't Match?

Most attention on results day is placed upon a company's profit and loss statement and whether the company has achieved the expected profit or earnings per share guidance. Additionally management typically receive bonuses based on

profit or earnings per share growth taken from the profit and loss statement. Whilst the profit and loss statement usually provides a good guidance as to how the company has traded over the past six months, it is also the statement most open to manipulation and should be read in conjunction with the cash flow statement.

The earnings on the profit and loss statement for some businesses can diverge from the cash flow statement if, for example, a construction company such as ***Cimic*** is not physically paid for work done on a railway project in the last six months until July. Here the lumpiness of cash flows from large individual contracts will even out over time.

The red flag that we are looking for here is where a company's cash flow statement and profit and loss statements are moving in different directions over an 18 month period and where a company is showing growing profitability, but declining cash flows. In 2015 ***Dick Smith Holdings*** reported income growing from $19 million to $38 million, yet operating cash flow fell from $52 million to -$4 million. Another recent example of this can be seen in ***Slater+Gordon*** which reported that for the June 2015 financial year profits were up 6% to $82 million, but whose operating cash flow had deteriorated to $41 million. Here the company was overstating its profits through the accounting of its "legal work in progress", and was overly aggressive in anticipating the expected cash generated through won cases. Whilst the company was able to deliver the earnings growth the market was expecting, in reality the declining incoming cash flows showed signs that it was actually a business that was in trouble.

Frequent Extraordinary Items

Extraordinary items are gains or losses included on a company's income statement from unusual or infrequent events and are excluded from a company's operating earnings such as gains from a sale of an asset or more often restructuring charges. These items are excluded from earnings to give a more "normalised" view of how the company has performed over the period, but where a company has frequent extraordinary items an investor has to question the quality of the earnings that are being presented. As a long term observer of the ***Australian banks***, almost every year they put through a write-off of software below the profit line. In my mind investing in banking software is a core part of their business model and it seems curious that the institution is willing to take the productivity benefits in their normalised earnings whilst ignore a portion of the costs!

Changes in Accruals

Accruals allow a company to record expenses and revenues for which it expects to expend cash or receive cash in a future reporting period and impact both a company's earnings statement and balance sheet. As estimates they can be of varying quality. Examples include expenses such as ***Macquarie Group***'s bonuses to investment bankers that may have been earned in the financial year ending March 2016, but not actually paid out until the following financial year. The red flags here are large unexplained changes in accruals on the balance sheet which may indicate that a company is shifting expenses into future periods to dress up current earnings.

Additionally we also look for new large asset line items on the balance sheet; this may indicate that the company is capitalising expenses as an asset. We frequently see this where a company is capitalising software development costs as an asset instead of an expense. We saw this in woodchip producer ***Gunns*** which capitalised over $180 million of expenditure on developing a pulp mill as an asset on the balance sheet. This allowed the company to report relatively healthy underlying profits at a time when debt levels were climbing and the company was in distress.

Divergence from Peers

The red flag we are looking for here is where a company consistently has higher average profitability, revenue growth or better working capital management than industry peers. Invariably when management is asked they will give an answer that relates to management brilliance or superior controls, but realistically companies operating in the same industry tend to exhibit very similar characteristics and their financial statements should correspond to the statements of companies operating in the same industry. For example supermarkets such as ***Woolworths*** should have a similar cash conversion profile to Coles (operating cash flow divided by operating profits) and significant divergence would warrant further investigation.

It can also work the other way!

Paradoxically management teams can also have incentives to under-report profits in any current period, typically this could occur where a company is under heightened union scrutiny due to wage negotiations with their employees, excessive government attention from perceived excessive profits or sees some issues in an upcoming reporting period and wants to smooth their profits. For example a bank may look to aggressively boost their bad debt expense to dampen profits during a

period where politicians are calling for a Royal Commission into Australia's banking sector, and then release these reserves at a later date to boost future profits.

Our Take

Earnings misrepresentation is difficult to for investors to detect from the publically available accounts, but when revealed can have pretty extreme results for a company's share prices. In my experience this is more an art than a science, as the investor gets a sense that something is not right with the accounts, rather than definitive proof of earnings manipulation. Manipulation generally only becomes obvious *ex post facto* after management has been removed. If an investor suspects that a company is manipulating their earnings in the upcoming results season, from the above list the most common red flag is earnings not correlating with cash flows from operations.

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