Issue N° 22
November 2016

Equity Solutions

EQUITY IN A NUTSHELL

Window-Dressing of Financial Statements & Detecting Financial Fraud

Listed companies like to give investors the appearance of a well-run organisation so that it helps their share price go higher. Though most act ethically when reporting financial performance, sometimes, companies use accounting chicanery to exaggerate their results or present them in a misleadingly positive light. For instance, Enron's share price plunged from USD 80 in year 2000 to USD 0.25 in 2001 as investors lost more than USD 60 bn. The signs of financial fraud in Enron were visible years before it filed for bankruptcy in 2001. These signs included the facts that: (1) sales jumped from USD 10 bn in 1995 to USD 100 bn in 2000 while net profit did not even double, (2) financial cash inflows were shifted to operating cash flow to give an impression of strong cash flow generation and (3) genuine operating cash outflows were shifted to the Investing section. This issue of the Nutshell encapsulates the major kinds of accounting gimmickry that unethical managements use to 'cook the books' and also the various ways in which investors can arm themselves with the knowledge needed to detect the warning signs. We have divided such window-dressing techniques into two types, namely the manipulation of earnings and of cash flows.

A. MANIPULATION OF EARNINGS

In accrual accounting, revenues are reported when they are earned (rather than when cash is received), while expenses are reported when they are incurred (rather than when payment is made). In order to inflate current period earnings, managements either push revenues into the current period or shift expenses to the later period. Conversely, to inflate earnings for the later period, one can simply hold back today's revenues to push them to later period or accelerate later period expenses into the current period's operations.

1. Recording revenue too early

In September 2004, the multinational software giant Computer Associates (CA) was charged for a USD 3.3 bn securities fraud by the SEC for using practices like the '35-day month' and the '3-day window' to record revenues before completing any obligations under the contract.[(1)] Executives at CA extended the last month of every quarter to 35 days and used both backdated and forged sales contracts to report fictitious sales growth. CA sold long-term licenses (going back seven years) allowing customers to use mainframe computer software; however, it recorded the present value of all licensing revenue for the entire contract immediately. An alert investor could have recognised this fraud by noticing a sharp jump in long-term account receivables on the company's balance sheet. Also, its cash flow from operations significantly lagged its net income.

2. Recording fraud revenue

From 1998 to 2003, the barcode specialist Symbol Technologies created revenues that lacked economic substance[(2)] by paying cash to resellers so that it could purchase its own products from distributors. It would mark-up the price so that distributors could earn profits, and it would pay the reseller a bonus of 1% of purchase price. The net result was that Symbol would purchase its own products back at a much higher price than at which they were sold. In this process, it reported a net loss but actually increased its revenues.

3. Hiding expenses or shifting them to a later period

Companies account for their costs by expensing or capitalising them. Routine operating costs are expensed, while costs incurred on assets are capitalised. Sometimes companies improperly capitalise routine operating expenses to boost earnings.

The best example for this is WorldCom, which entered into many long-term network-access arrangements to lease line costs from other telecommunication carriers. The company initially expensed these costs as routine operating expenses on its income statement. However, as its revenue growth slowed after the technology meltdown in 2000, the company changed its accounting and started capitalising these costs on the balance sheet.

From mid-2000 to early 2002, WorldCom capitalised billions of dollars of operating costs that should have been expensed, thus overstating profits. However, its free cash flow fell from USD 2.3 bn in 1999 to negative USD 3.8 bn in 2002.[(3)]

Source: Securities and Exchange Commission and company's filings
(1), (2), (3): Full reports available on https://www.sec.gov/

A prudent investor would have recognised this as a fraud given the firm's spiking tech spend in a period of tech slowdown. A large decline in FCF when margins are increasing is another red flag.

4. Using one-time activities to increase revenue

Visteon, an auto-parts supplier and former Ford subsidiary, filed for bankruptcy[4] in 2009 due to high legacy costs and unsustainable debt on the balance sheet. The company's sales were on a downward trend since 2008 as the auto industry faced large production cuts in the face of plunging sales.

Despite the decline in top-line, its operating profit dipped only marginally as Visteon was reporting adjusted operating profit that excluded its restructuring expenses over many quarters. This large discrepancy between revenue and operating profit should have tipped off a diligent investor, as continuous restructuring expenses should ideally be a part of operating expenses and should have lowered the operating profit.

B. MANIPULATION OF CASH FLOW

In addition to the income statement, companies also provide a separate cash-flow statement where cash flows are divided into three sources, namely from **operations**, **investing** and **financing**. Savvy investors compare cash flow from operations with net income, as high net income with low cash flow from operations signals accounting manipulations. (Also see Nutshell #20: Financial statements unravelled)

1. Classifying Financing cash flows as Operating cash flows

Managements know that investors benchmark earnings to cash flow from operations to test a company's earnings quality, and therefore sometimes use deceptive methods to boost operating cash flows. In a well-known example, the auto-parts supplier Delphi, spun off from General Motors in year 2000, was in the doldrums due to declining auto sales and a deteriorating economy.

To boost its cash flow from operations, Delphi offered to sell USD 200 mn of precious metal inventory to a bank. The transaction worked liked this: Delphi would take a USD 200 mn short-term loan from the bank with the inventory as collateral.

But instead of recording this as a short-term loan (which would have increased Delphi's liability (as well as cash flow from financing), Delphi misled investors by recording the transaction as sale of USD 200 mn inventory.

This increased Delphi's revenues and overstated cash flow from operations by USD 200 mn. In fact, to distract investors from its Cash flow from Operations statement, Delphi created a new statement called 'Operating Cash flow' and defined it very differently.[5]

2. Shifting operating cash flow to the investing section

Here, companies improperly shift operating cash outflow to the investing section so as to boost cash flow from operations. In 2000, WorldCom capitalised billions of dollars that it had paid other operators for using their networks.

As these costs were normal operating expenses, their capitalisation resulted in a jump in WorldCom's operating cash flow, even though its FCF fell from USD 2.3 bn in 1999 (the year before it started capitalising costs) to negative USD 3.8 bn in 2002.

Prudent investors would recognise this fraud by noticing the significant jump in technology spending in the period of tech slowdown.[6]

3. Boosting operating cash flow using acquisitions or disposals

Tyco bought over 700 small companies for a cumulative ~USD 29 bn from 1999 to 2002. As it did not disclose these acquisitions (considering them "immaterial"), it was able to generate strong cash flow from operations, at USD 5.6 bn in 1999, USD 6.9 bn in 2000 and USD 5.2 bn in 2001.

In contrast, its FCF after acquisitions was negative each year, which was a warning sign that operating cash flow was not what it appeared to be.

However, this was only an irregular and not an illegal accounting practice; and investors need to be careful to judge whether high cash flow from operations is sustainable.[7]

C. CONCLUSION

In addition to analysing the company's financial statements (income statement, cash flow statement and balance sheet), an investor should also give importance to its accounting policies, related-party transactions and quality of management.

Tips for Investors

Here are some key warnings signs investors should watch out for. Major red flags indicating the presence of accounting manipulation are:

- Absence of checks and balances among senior management
- Inappropriate compensation structure that encourages aggressive financial reporting
- Inappropriate business relation between companies and board members
- An auditor lacking objectivity and appearance of independence
- Recording revenues without economic substance or not following accounting standards
- Routinely recording restructuring charges or shifting losses to discontinued operations
- Receivables (primarily long-term and unbilled) growing much faster than sales
- Cash flow from operations lagging behind net income
- Inappropriately capitalising normal operating expenses

Source: Securities and Exchange Commission and company's filings
(4), (5), (6), (7): Full reports available on https://www.sec.gov/

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Investment Rating Definitions:

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Neutral	Stock that is expected to perform in line with its MSCI sector index over a 12-month investment horizon.
Sell	Stock that is expected to underperform its MSCI sector index over a 12-month investment horizon.
Restricted	Covered stock that is not rated or assigned a target price as the Societe Generale group has a capital market transaction with that company.

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The product category of single equity, stock, share is rated at '4'.

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Risk Levels	Losses
0 - Lowest Risk	There is a 95% probability that the product will not depreciate in value in one year.
1 - Low Risk	There is a 95% probability that the product will not lose more than 5% of its value in one year.
2 - Medium Risk	There is a 95% probability that the product will not lose more than 15% of its value in one year.
3 - High Risk	There is a 95% probability that the product will not lose more than 30% of its value in one year.
4 - Highest Risk	There is a minimum of 5% probability that the product will lose more than 30% of its value in one year.

MSCI Disclaimer

Glossary (1/2)

Societe Generale Private Banking Investment Universe

Societe Generale Private Banking defines and maintains an investment universe, aiming at ensuring the liquidity and the meaningful coverage of companies subject to potential investments. This investment universe complies with rules defined as follows:

- **Issuers are constituents of MSCI indices**: The constituents of the indices retained cover developed and emerging countries with increased precision (average market capitalisation) for Germany, Belgium, France, the UK and Switzerland.
- **Market Capitalisation**: To avoid the inclusion of securities whose market capitalisation could be too low in light of the potential investments by clients and/or managers, only securities whose market capitalisation is greater than €500 mn have been chosen.
- **Liquidity**: To ensure minimum liquidity for investments, only securities with a six-month average daily trading volume greater than EUR 300,000 are selected.
- **Reliable Financial Information**: Only securities tracked by at least three sell side financial analysts are included in the universe.
- **Social and Environmental Responsibility Policy of SG Group**: Societe Generale has defined a framework for Social and Environmental Responsibility. This framework sets out restrictions on listed securities identified by SG Group and deleted from the universe.

Societe Generale Private Banking Recommended Universe

The Recommended Universe is made of companies from the Investment Universe as defined by Societe Generale Private Banking guidelines. Members are chosen by Equity Solutions. There are no lower nor upper limits on the number of stocks in the Recommended Universe. There is no specific constraint in term of geographical or industry representation. A company from the recommended universe can be subject to a rating change, as decided by the Equity Solutions expert covering the company. When a stock is downgraded to a Sell rating, it is still followed for at least 3-month, after which Equity Solutions issues a coverage termination alert.

Financial Terms and Acronyms

ADR (American Depositary Receipt): is a negotiable certificate issued by a US bank representing a specified number of shares in a foreign stock that is traded on a US exchange. ADRs are denominated in US dollars, with the underlying security held by a US financial institution overseas.

BACKLOG: often refers to a company's sales orders waiting to be fulfilled. Even if it provides the revenue visibility, the companies usually try to avoid to have an extensive backlog because that creates the risk of unmet demand and thus can have negative impact on future earnings

BENCHMARK: is, generally, a broad market, market-segment stock or bond index that is used as a reference to evaluate the performance of a security, mutual fund or investment manager.

BV (Book Value): is the total value of net assets of a company. It consists of the firm's fixed assets plus its current assets, minus short-term liabilities, long-term creditors and any provisions.

BV/S (Book Value Per Share): is the total value of the net assets of a company divided by the total number of outstanding shares.

C/I (Cost Income Ratio): is used for valuing banks. It shows a company's costs in relation to its income. Formula: (Operating Costs/Operating Income)*100.

CAGR (Compound Annual Growth Rate): is a term used for the geometric progression ratio that provides a constant rate of return over a specific time period.

CAPEX (Capital Expenditure): is the fund used by the company to acquire or upgrade the physical assets such as property, industrial buildings or equipment. The most capital intensive industries include oil, telecom and utilities.

CAR (Capital Adequacy Ratio): is a measure of a bank's capital. It is expressed as a percentage of a bank's risk-weighted credit exposures. Formula: (Tier One Capital + Tier Two Capital)/Risk Weighted Assets.

CET I (Common Equity Tier I Ratio) : is a measure of the bank's common equity capital as a percentage of risk-weighted assets. It is generally compared to a defined benchmark stipulated by the regulatory authority to determine whether a bank is sufficiently capitalised.

DIVIDEND YIELD: Dividend per share or DPS (total dividend paid out divided by the total number of shares) expressed as a percentage of current stock price.

EBIT (Earnings Before Interest and Taxes): profit before taking into account interest payments and income taxes. Also referred to as operating income, it is calculated as a company's gross income minus all its operating expenses.

Financial Terms and Acronyms (contd.)

EBIT Margin: Ratio that expresses EBIT as a percentage of total sales (EBIT/Sales*100); also referred to as operating margin.

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortisation): profit before taking into account interest payments, income taxes and non-cash operating expenses (depreciation and amortisation). It is calculated as a company's gross income minus its cash operating expenses only.

EM (Emerging Market) :is a country that has some characteristics of a developed market, but does not meet standards to be a developed market. This includes countries that may become developed markets in the future or were in the past.

EPS (Earnings Per Share): is the division of total net profit by the number of shares.

EV (Enterprise Value) is a measure of a company's value, often used as an alternative to straightforward market capitalisation. It is calculated as (market cap + debt + minority interest + preferred shares) − total cash − cash equivalents.

EV/EBITDA: compares the total value of the company to its EBITDA.

EV/SALES: compares the total value of the company to its sales.

FCF (Free Cash Flow): represents the difference between operating cash flow and capital expenditures and shows the company's ability to generate shareholder's value after laying out the money required to maintain or expand its asset base. Without enough cash, it would be difficult for a company to develop new products, make acquisitions, pay dividends and reduce debt.

FFO (Funds from Operations): measures a REIT's operating performance. It is net income plus gains (minus losses) from property sale and purchase. Non-cash expenses like depreciation and amortisation are added back because value of real estate tends to rise over time rather than depreciating like other fixed assets and investments. FFO per share is often used in place of earnings per share when analysing REITs.

FY1 (Fiscal Year One): refers to the current fiscal year.

FY2 (Fiscal Year Two): refers to the next fiscal year.

FY16E: Fiscal year 2016 estimation, **FY17E:** Fiscal year 2017 estimation

GDP (Gross Domestic Product): is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

GDR (Global Depositary Receipt): is very similar to an ADR. It is a bank certificate issued in more than one country for shares in a foreign company. The shares are held by a foreign branch of an international bank. The shares trade as domestic shares, but are offered for sale globally through the various bank branches.

GOODWILL: is an intangible asset that arises as a result of the acquisition of one company by another company for a premium value and can have as origin the value of a company's brand name, solid customer base, good customer relations, good employee relations and any patents or proprietary technology.

GROSS INCOME: gross profit calculated as a company's total sales minus its cost of goods sold (COGS) that corresponds to labour and production costs.

GROSS MARGIN: expresses gross income as a percentage of total sales (Gross Income/Sales*100).

IPO (Initial Public Offering): is the first sale of stock by a private company to the public to expand its growth or, sometimes, repay its debt.

LIKE FOR LIKE (LFL) GROWTH: is a measure of growth in sales, adjusted for new or divested businesses. This is a widely used indicator of retailers' performance. This adjustment is important in businesses that show a significant change through expansion, disposals or closures.

LTV (Loan-To-Value Ratio): is a financial term used to express the ratio of a loan to the value of an asset purchased. The term is commonly used by financial institutions and real estate companies to represent the ratio of the loan as a percentage of the total appraised value of real property.

NAV (Net Asset Value): is similar to book value and is also called per investment unit. NAV is the marked-to-market value of the company's property investments less liabilities.

ND (Net Debt): is calculated as a company's total debt minus cash and other similar liquid assets.

NET MARGIN: is a financial ratio which measures the profitability of the net income of a company. Formula: Net Profit/Sales.

NI (Net Income or Bottom Line): represents a company's total earnings (or profit) which is calculated by adjusting revenues for the costs, depreciation, interest, taxes and other expenses.

OPERATING MARGIN: See definition of EBIT Margin.

Glossary (2/2)

ORGANIC GROWTH: is the growth rate that a company can achieve by increasing its output and enhancing sales, excluding any profits or growth from takeovers or M&A activities.

P/E or PER (Price Earnings Ratio): reflects the trading price of a share in relation to the expected earnings. Formula: Share Price/Earnings Per Share.

P/TBVS (Price To Tangible Book Value): expresses the share price with regard to the accounting value of the company. Formula: Share Price/Tangible Book Value Per Share.

PAYOUT RATIO: is the proportion of earnings paid out as dividends to shareholders and typically expressed as a percentage. A lower payout ratio is generally preferable to a higher payout ratio. A ratio greater than 100% indicates the company is paying out more in dividends than it makes in net income.

PMI (Purchasing Managers Index): is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment

PROFIT WARNING: is the announcement made by the company before its earnings release indicating the investors that its earnings would not meet the analysts' expectations.

RWA (Risk Weighted Assets): is a measure of the bank's assets, weighted according to their risk. It involves the risk weighting of both on and off-balance-sheet exposures. It is generally used to calculate risk-based capital ratio which is the ratio of a bank's capital to its risk weighted assets.

REVENUE GROWTH: Illustrates the growth of sales over a given period.

ROA (Return on assets): a financial ratio that is calculated as net income divided by total assets and shows how profitable a company is relative to its total assets

ROC (Return on invested capital): a profitability ratio which is calculated as net income minus dividends divided by total invested capital.

ROE (Return On Equity): The amount of net income returned as a percentage of shareholders' equity. Return on equity measures a corporation's profitability by disclosing how much profit a company generates with the money shareholders have invested.

SHARE BUYBACK (Share Repurchase): A program by which a company buys back its own shares from the marketplace, reducing the number of outstanding shares. It usually indicates that the company's shares are undervalued and pushes the share prices up. SHAREHOLDER'S EQUITY: is the amount of the funds contributed by the owners (the stockholders) plus the retained earnings (or losses).

STOCK SPLIT: is a corporate action in which the company divides its existing shares into multiple shares to make shares seem more affordable for small investors without changing the underlying value of the company.

TBV (Tangible Book Value): is the book value excluding intangible assets.

TBV/S (Tangible Book Value Per Share): allows to estimate the accounting value of a company by measuring its stockholders' equity per share. Formula: Re-valued Net Assets/Total Shares of Company.

WACC (Weighted Average Cost of Capital): also referred to as the firm's cost of capital, it is the rate that a company is expected to pay on an average to all its security holders to finance its assets.

WORKING CAPITAL: is the difference between a company's current assets and current liabilities and shows whether the company has sufficient short-term assets to cover its short-term debts.

Indices

MSCI AC WORLD: is a free float-adjusted market capitalisation weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index consists of the following 23 developed market country indexes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the UK, and the US (as of 2 June 2014).

MSCI AC ASIA PACIFIC: is a free float-adjusted market capitalisation weighted index that is designed to measure the equity market performance of the developed and emerging markets in the Pacific region. The MSCI AC Pacific Free Index consists of the following 12 developed and emerging market countries: Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Taiwan, and Thailand (as of 2 June 2014).

MSCI EUROPE: is a free float-adjusted market capitalisation weighted index that is designed to measure the equity market performance of the developed markets in Europe. The MSCI Europe Index consists of the following 15 developed market country indexes: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the UK (as of 2 June 2014).

MSCI EMERGING MARKETS: is a free float-adjusted market capitalisation index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, the Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey* and the UAE (as of 2 June 2014).

MSCI WORLD HIGH DIVIDEND YIELD: is based on the MSCI World Index, its parent index, and includes large- and mid-cap stocks across 23 Developed Markets (DM) countries (as of 31 March 2014). The index is designed to reflect the performance of equities in the parent index (excluding REITs) with higher dividend income and quality characteristics than average dividend yields that are both sustainable and persistent.

MSCI WORLD VALUE: captures large- and mid-cap securities exhibiting overall value style characteristics across 23 Developed Markets countries (as of 31 March 2014). The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield. With 853 constituents, the index targets 50% coverage of the free float-adjusted market capitalisation of the MSCI World Index.

MSCI WORLD GROWTH: captures large- and mid-cap securities exhibiting overall growth style characteristics across 23 Developed Markets countries (as of 31 March 2014). The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

MSCI WORLD SMALL CAP: captures small cap representation across 23 Developed Markets (DM) countries (as of 31 March 2014). With 4,302 constituents, the index covers approximately 14% of the free float-adjusted market capitalisation in each country.

MSCI WORLD LARGE CAP: captures large-cap representation across 23 Developed Markets (DM) countries (as of 31 March 2014). With 737 constituents, the index covers approximately 70% of the free float-adjusted market capitalisation in each country.

MSCI EMEA: is a free float-adjusted market capitalisation weighted index that is designed to measure the equity market performance of the emerging market countries of Europe, the Middle East and Africa. The MSCI EM EMEA Index consists of the following 10 emerging market country indexes: the Czech Republic, Greece, Hungary, Poland, Russia, Turkey, Egypt, South Africa, Qatar and the UAE.

MSCI LATAM: captures large- and mid-cap representation across five emerging market (EM) countries (as of 31 March 2014) in Latin America. With 137 constituents, the index covers approximately 85% of the free float-adjusted market capitalisation in each country.

MSCI EMERGING ASIA: captures large and mid-cap representation across eight EM countries (as of 31 March 2014). With 537 constituents, the index covers approximately 85% of the free float-adjusted market capitalisation in each country.

MSCI RUSSIA: is designed to measure the performance of the large- and mid-cap segments of the Russian market. With 22 constituents, the index covers approximately 85% of the free float-adjusted market capitalisation in Russia.

MSCI BRAZIL: is designed to measure the performance of the large- and mid-cap segments of the Brazilian market. With 70 constituents, the index covers about 85% of the Brazilian equity universe.

MSCI INDIA: is designed to measure the performance of the large- and mid-cap segments of the Indian market. With 64 constituents, the index covers approximately 85% of the Indian equity universe.

Euro Stoxx 50: is the leading blue-chip index for the eurozone and provides a blue-chip representation of supersector leaders in the Eurozone. The index covers 50 stocks from 12 Eurozone countries. The Index is licensed to financial institutions to serve as underlying for a wide range of investment products such as Exchange Traded Funds (ETF), Futures and Options and structured products.

FTSE 100: comprises the 100 most highly capitalised blue chip companies, representing approximately 81% of the UK market. It is used extensively as a basis for investment products, such as derivatives and exchange-traded funds.

S&P 500: includes 500 leading companies in the leading industries of the US economy. It is a core component of the US indices that could be used as building blocks for portfolio construction. It is also the US component of S&P Global 1200.

Nikkei 225: is the leading index of Japanese stocks. It is a price-weighted index comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. The Nikkei is equivalent to the Dow Jones Industrial Average Index in the US.

Sources: FactSet, MSCI global equity indexes, SGPB

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