RBC Global Asset Management

Managing accounting risk in Asia as stock pickers

The RBC Asia Equity team

Executive summary

- Rising incidences of corporate fraud mean it is important for investors to continue to develop an appropriate toolkit to analyse financial statements to reduce investment risk.
- It remains very difficult for auditors to uncover fraud, especially when dealing with management teams or other individuals who are being deliberately misleading.
- While particular attention is - and should be - paid to Asia given weaker governance historically, fraud is a global phenomenon. Chinese standards have risen significantly in recent years.
- The RBC Asia Equity team highlights some key 'red flags' that we look for and discuss other methods to mitigate the risks from aggressive accounting practices.

Our toolkit to identify aggressive accounting practices

In recent years there have continued to be incidents of accounting and corporate fraud, often uncovered by investment firms that specialise in short selling. In 2020 we witnessed two of the largest accounting scandals in recent memory: one involving one of the largest wireless payment services providers based in Europe, and the other the largest domestic coffee chain in China. According to PwC's 2020 Global Economic Crime and Fraud Survey, fraud is at the second highest level it has been in the past two decades.[1]

Fraud can take many forms and may be perpetrated by any individual(s) within an organisation. Many instances of fraud were made possible by aggressive accounting practices deployed by management teams, many of which had agendas that conflicted with acting in the best interests of minority shareholders. These accounting issues and scandals highlight the critical need for us, as fiduciary of our clients' assets, to focus on the anchors of sound investment practices and accounting scrutiny, both in developed and developing markets.

This article looks at how deliberate acts of fraud by a management team or a corporate board are very difficult to uncover, even by auditors. While there is no perfect screen or set of rules that allow us to be able to detect fraud, we rely on an internally developed forensic accounting toolkit as a valuable first line of defence. With a stringent framework of identifying accounting red flags, both qualitatively and quantitatively, we seek to identify companies within our investment universe that are most at risk of aggressive accounting practices.

Accounting standards are broadly aligned globally and the risk of accounting fraud is not necessarily higher in emerging markets

As Asian markets have grown in recent years to become a larger part of global equity markets, one prevailing perception is that developed markets in Europe and North America tend to exhibit fewer traits of profit manipulation or fraud. The reputation of Chinese companies has been hurt by high profile examples of reverse takeovers on the NASDAQ, where Chinese companies exploited regulatory arbitrage to their advantage. In truth, the risk of financial data manipulation is likely greater for Chinese-listed firms in the U.S. where American regulators are currently barred from inspecting Chinese audits. We believe such risks are not symptomatic of widespread governance problems in Chinese companies, however, but that a subset of mainland companies managed to use regulatory loopholes and more easily escape investors' scrutiny due to both Chinese and U.S. regulators' historical lack of attention to the regulatory matters.

From an accounting assurance perspective, Asian-listed companies are bound by similar audit requirements, such as quarterly reviews and annual audits, in a similar manner to their counterparts in developed markets such as the U.S. and Canada. For example, the Chinese Accounting Standards (CAS) have been overhauled in the past 15 years in an effort to bridge the gap with the International Financial Reporting Standards (IFRS). Contrary to common belief, the current CAS are substantially converged with IFRS.[2]

We believe that the opportunity for financial data manipulation, aggressive accounting or even outright fraud exists just as much in developed markets as emerging markets such as China.

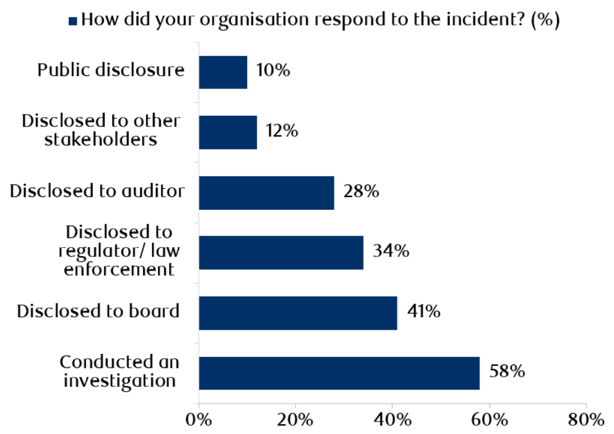
[1] PwC's Global Economic Crime and Fraud Survey 2020, https://www.pwc.com/gx/en/forensics/gecs-2020/pdf/global-economic-crime-and-fraud-survey-2020.pdf. [2] Deloitte IAS Plus, https://www.iasplus.com/en/jurisdictions/asia/china.

Most fraud goes undetected

Many of the largest frauds over the last 10 years happened under the watch of the 'big four' accounting firms (KPMG, PwC, Deloitte, and Ernst & Young). Large audit firms, by nature, are no guarantee that a company's financial statements are not fraudulent. While auditors are critical in ensuring financial statements are presented fairly according to relevant accounting principles, their ability to detect a management team's intentional fraudulent behaviour is very limited.

According to the above-mentioned PwC survey, most fraud goes undetected as only roughly 28% of the incidents were reported to the auditor and 12% to other stakeholders (Exhibit 1).[3]

Exhibit 1: Most fraud goes undetected



Source: PwC Global Economic Crime and Fraud Survey, Macquarie Research. Data as at October, 2020.

The primary role of the auditor is to state that the financial statements are management's responsibility; finding or rooting out fraud is not the auditing firm's duty. In instances where the auditors find evidence of a potential fraud, then they are obliged to report their findings. To circumvent the scope of its auditors, management teams committing fraud may forge documents and misrepresent data input assumptions.

On the other hand, some accounting standards are meant to be interpreted based on the management team's judgement. Although financial statements are perceived to reflect a company's true financial position, some of the numbers can actually be highly subjective.

Accounting toolbox is an integral part of our investment process

As equity investors, one of our primary objectives is to minimise the risk of investing in companies that are associated with fraudulent accounting. To achieve this, our investment process is designed to try to weed out not just outright fraud, but also to try to identify aggressive (but entirely legal) accounting activity where companies may be bringing forward revenue or manipulating profit in an unsustainable manner. In other words, borrowing earnings from the future will at some point trigger a corresponding hit to future earnings.

Aggressive accounting practices are usually prerequisites for CFOs to manipulate profits. While this can be done in various forms, some accounting tricks are more prevalent owing to the scope of human interpretation as well as the specific industry in which they operate. One of the first steps of our financial statement scrutiny is to conduct a meeting, usually in person, with the 'C-suite'. More importantly, we strive to maintain continuous engagement with the management team. We take meetings with management teams very seriously and perform due diligence on most of the key members regularly. Building on our collective experience of engaging with companies across the Asia Pacific region we have put together an accounting toolbox that combines qualitative and quantitative assessments and this is an integral part of our investment process.

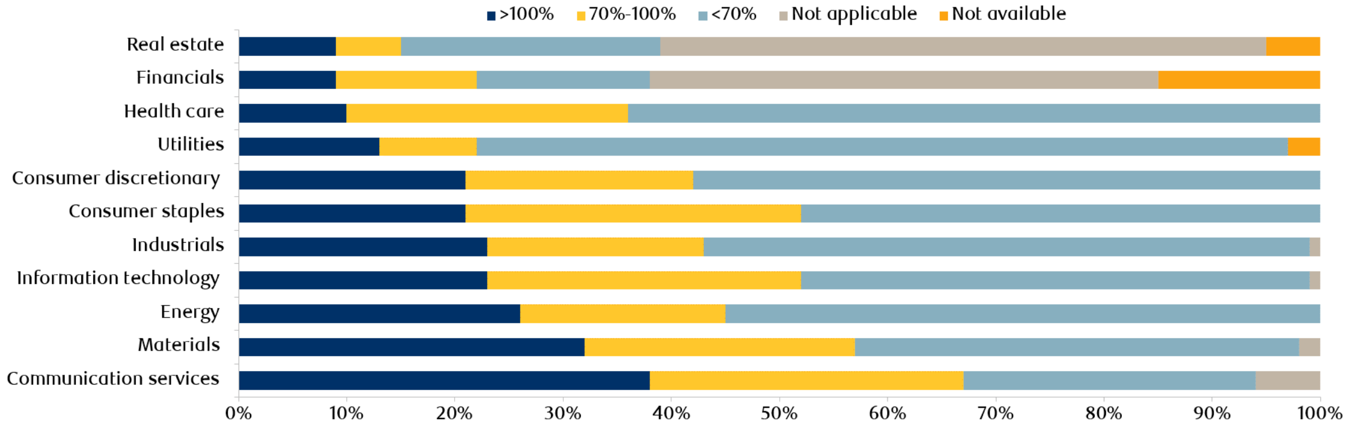
Accounting red flags

Collectively, the RBC Asia Equity team identified a list of accounting red flags which, in our opinion, are most pertinent to our investment philosophy. These red flags often guide our engagement with management and compel each of our analysts to ask questions to provoke the necessary research and analysis. Examples of red flags include:

- High debt or high cash levels: unless the company is in acquisition mode we are generally more sceptical of companies with either high cash or high debt ratios.
- Unusual capital expenditure /depreciation ratios compared to industry peers: significant capital expenditure programmes can be one of the easiest ways to siphon cash out of a business and this is why we investigate capex spending in detail and compare capex to depreciation ratios against industry. In 2016, the shares of China's largest dairy farm operator at the time plunged by as much as 90% within one hour after accusations by a short seller that the company had inflated its profitability and cash balance. The dairy company engineered a highly unusual capex manoeuvre in which it sold around fifty thousand cows to a finance company for approximately US$146 million, after which the buyer leased back the cattle to the company. This cow-leaseback transaction helped

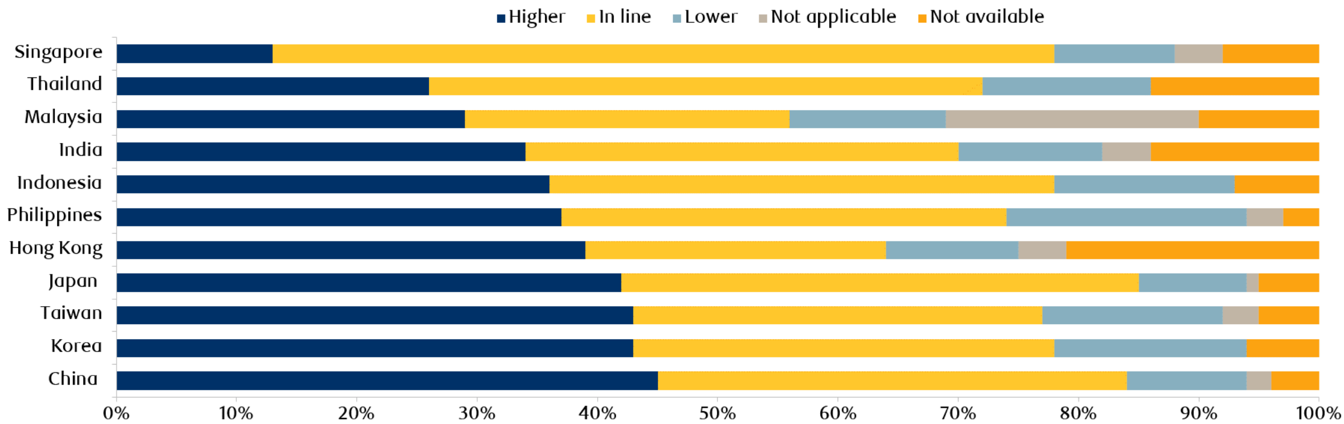
[3] PwC's Global Economic Crime and Fraud Survey 2020, https://www.pwc.com/gx/en/forensics/gecs-2020/pdf/global-economic-crime-and-fraud-survey-2020.pdf.

Exhibit 2: Depreciation/capex levels by sector



Source: Macquarie Research. Data as at October, 2020.

Exhibit 3: Margins vs. peers domestically



Source: Macquarie Research. Data as at October, 2020.

overstate spending on cattle farms, the likely purpose of which was to support the company's income statement fraud. While this was a real business, more than $4 billion of market value was wiped out due to the capex fraud. (Exhibit 2)

- Large build-up of goodwill on the balance sheet: we perform reasonability tests to assess whether or not goodwill has been impaired and whether assumptions such as growth rates and discount rates are in line with peers; this is particularly relevant for acquisitive firms.
- Frequent and large related party transactions including to/from unconsolidated joint ventures or affiliated entities.

Case study 1: Drawn by its high return on capital, strong cash-generative profile and high dividend payout ratio, the RBC Asia Equity team invested in a Singaporean software solutions provider which catered to the underpenetrated financial sector in SE Asia. While this software firm met many of our criteria, its founder and Chairman started to engage in extensive related-party transactions with private entities but provided little detail of the nature of these transactions. Many of these opaque private entities were in fact held by the founder of the company. This software provider was accused of shifting a large number of its payroll and off-balance sheet debt to these related parties, thereby inflating its reported results. While we divested from this software company upon learning of such poor governance practices, it became a critical case study in developing our accounting toolkit and ultimately the investment decision-making process. While a 'big four' audit firm subsequently released a report that stated no irregularities had taken place, the share price of the software firm has remained depressed since.

- Outsized margins and profitability that are unusual for the industry and cannot be explained. Usually, operating expenses as a percentage of revenue can be predicted with some degree of accuracy. (Exhibit 3)

Case study 2: China's largest retail coffee chain reported a material improvement in cost structures months before the financial misconduct was uncovered in mid-2020, even in the midst of the company's aggressive store expansion phase. Specifically, the company's gross margin expanded mysteriously from -17% to +48% percent in the span of three quarters. This was attributed to a 420% drop in sales and marketing expenses during 2018 and 2019, a period during which store count sky-rocketed throughout China. While this was a big tell-tale sign to us, the company's shares of continued to rise as more investors bought in to the story of growth and a magical reduction of expenses in what was a highly competitive retail coffee market. Ultimately, the Chinese rival to Starbucks confirmed that it had fabricated US$300mn in revenue and $190 million in expenses, sending the shares plummeting and eventually having to de-list from NASDAQ.

The core of our investment criteria is assessing a company's cash stewardship. The quality of a company's capital management programme, such as a clear return on equity (ROE) or return on invested capital target, is generally a good indicator of the interest alignment between the management team and minority shareholders. Next, we examine the company's cash flow statements in detail and scrutinise how these funds are channelled into different areas of the business. Good quality companies tend to have efficient and stable working capital and reinvest free cash flows in the core business or pay dividends to shareholders.

A consistently high cash dividend pay-out ratio does not mean profits and cash cannot be misappropriated, as shown in our Singaporean case study where the majority 60% shareholder allegedly recycled his dividends into related parties in a complex series of transactions to supplement revenue growth for the listed entity. However it usually indicates that the business is generating decent cash flows organically and that the flow of profits is traceable. (Exhibit 4)

Within Asia, in general Taiwanese corporates distribute their profits to their shareholders more than their regional peers; Japan, meanwhile, has a clear lead in disclosing transparent ROE targets. Some other capital management practices we consider include frequency of equity raises, change in asset turnover, and debt-to-free-cash flow.

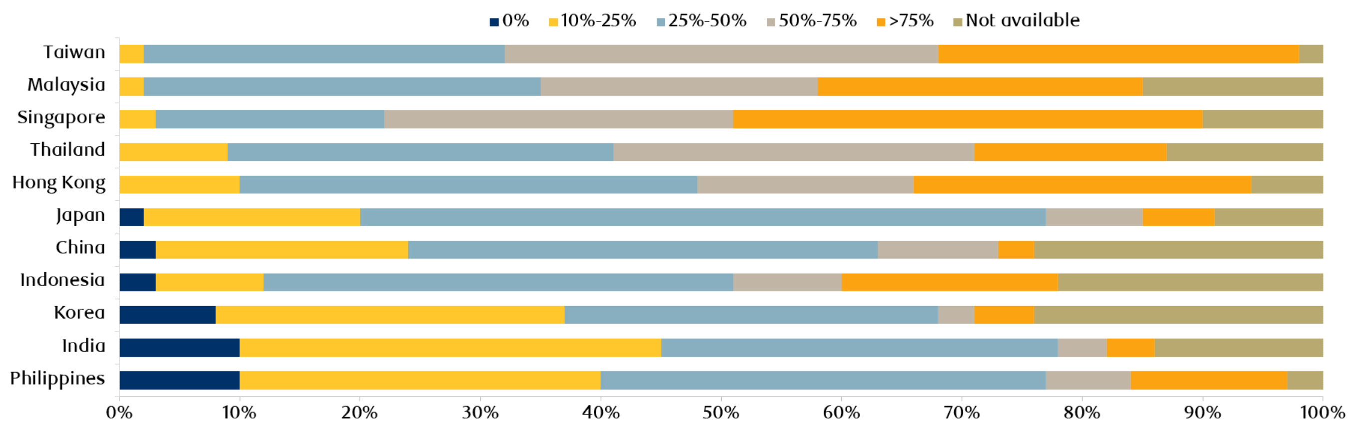
Finally, we also take into consideration the length, depth and transparency of the relationship between the company and the auditor as well as the composition and independence of the Board. Interestingly, the co-founder of the de-listed Chinese coffee giant was once sentenced to 18 months in prison for illegal business activity.

Quantitative screening

To complement our in-house process, we also utilise an external third party forensic accountant, GMT Research, to go through historical financial statements.[4] GMT Research's fake cash flow model measures the risk of profit manipulation through reconciliation of a firm's operating cash flows versus adjusted cash earnings over a specific timeframe. In doing so, GMT flags businesses that are at higher risk of fabricating their cash flows via manoeuvring working capital practices. In essence, GMT takes the focus on cash stewardship to a higher level and identifies firms that may be deploying manipulative accounting practices to portray a more favourable cash flow situation to the outside world.

As part of our process to evaluate all existing and potential investments, we utilise GMT Accounting Screens which summarise a firm's Beneish's M-Score and Altman Z-Score, as well as the nature of any accounting red flags.[5] We will then investigate and will require satisfactory explanations for any items that was flagged before we move on to the

Exhibit 4: Average Cash payout ratio by country in 2017-2019



Source: FactSet, Macquarie Research. Data as at October, 2020.

[4] GMT Research is an accounting research firm focused on Asia and regulated by Hong Kong's Securities and Futures Commission. They develop proprietary methodologies to detect financial anomalies, or traits similar to past accounting shenanigans. [5] The M-Score is a mathematical model that uses eight financial ratios to identify whether a company has manipulated its earnings. The Altman Z Score is used to predict the likelihood that a business will go bankrupt within the next two years.

next step of investment analysis. In particular, we examine closely the following GMT considerations:

- Operating cash flows discrepancy versus dividends paid and capex spend over the past five years.
- Changes in working capital which would be indicative of channel stuffing, or similar unsustainable practices
- Debt management that looks odd but may be trying to provide a false representation of the balance sheet
- Strangely low or high auditor fees, or frequent changes to auditor.

Inevitably, GMT's methodology is less relevant for businesses in high-growth and loss-making stages as is often the case in the IT software and healthcare industries. If we identify companies in these sectors that we consider attractive investments for our portfolio we examine in detail their research and development spending and capitalisation policies. It is imperative to note that many companies we look at do raise red flags. What is important is how many flags there are, and whether we can find logical explanations that allay our concerns.

Conclusion

Despite years of effort on the part of regulators to adopt internationally recognised accounting standards, individual companies may continue to adopt unsound or aggressive accounting practices. Financial data can be presented in many different ways depending on a company's goals, and companies will often choose the option that casts their performance in the best light. Furthermore, opportunities for fraud and aggressive accounting are numerous in both developed and developing markets. As a result, critical examination of these financial statements is becoming increasingly important for equity investors who wish to uncover the true financial picture of a business.

We believe that the accounting risk assessment system we have in place allows us to work through our investment process diligently and significantly reduces the chances of us becoming the victim of any fraudulent activities. Despite this there will always be an element of risk attached to investment and the possibility of fraud cannot be completely eradicated. The core of our philosophy is to look for high quality businesses and this means we place a lot of emphasis on a company's management, the quality of its cash flows and the sustainability of its business practices.

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Derek is an associate portfolio manager on the Asian Equity Team at RBC GAM. He is the team's consumer, technology and internet specialist. Derek joined the firm in 2013 as part of a graduate program that allowed him to work in a variety of roles within in Toronto and Hong Kong, across fixed income, Canadian equities and Asian equities. Prior to this, Derek was at a global accounting firm, where he was responsible for the financial advisory and audit of publicly-listed corporations in Toronto.

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