Are those assets . . . real?

To avoid nasty - and possibly costly - surprises in your investing, don't be afraid to look closer and ask probing questions.

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I RECENTLY returned from South Korea, where people are apparently so obsessed with their looks that plastic surgery is very common - and it's considered perfectly fine if you have gone under the knife to look better. The trend seems to be catching on in other Asian countries.

Other than seeing the occasional plastic surgery advertisements or clinics around Seoul, I couldn't tell if the people on the streets had answered the ads or visited the clinics.

What has plastic surgery got to do with investing?

Companies, like people, are not above applying a bit of artificial intervention to their financial statements to make themselves look better, or to paper over a perceived defect.

Sometimes, the intervention is relatively harmless: you go under the knife, you look in the mirror the day after, and you feel a bit more confident about yourself.

Sometimes, what began as a little tweak to the body you were born with leads to another . . . and yet another . . . until, one day, you are transfigured - or disfigured - beyond all recognition. The same may happen with financial statements of companies.

Let's examine, very briefly, how these financial statements can be manipulated - or, to put it differently, "cosmetically modified".

The topic is evergreen. Every now and then, companies are accused of presenting an inaccurate picture of their finances. Or something about the numbers that strikes sharper observers as a little awry does not get mentioned until the company reports a sharp loss.

Among the latest in this regard was British retailer Tesco, which reported its worst-ever results two weeks ago with a dramatic £6.4 billion (S$12.9 billion) pre-tax loss.

Most of it was due to the fall in property value of its British stores. This comes after an accounting scandal last year when Tesco admitted that its profit guidance was overstated by £250 million.

The issue might not be outright fraud. But investors always need to ask themselves whether they can trust the numbers they are presented.

Revenue recognition

There are typically three financial statements investors work with: the income statement, the balance sheet, and the cashflow statement. There is potential for misleading numbers to be presented in all three.

Today, we'll focus on the balance sheet. But before that, we'll take a detour through the income statement, otherwise known as the profit-and-loss statement.

The income statement shows the revenues and profits a company made, and often attracts a lot of attention.

The most obvious way that a company can mislead investors here is to report revenues that do not really belong to it.

Accountants have certain principles that companies must abide by before they can recognise revenue.

Typically, the notes to a company's financial statements will say that revenue is recognised at the point when the significant risks and rewards of the ownership of goods have been transferred to customers.

Delivery of the goods and services has to have occurred, a seller's price must be fixed, and revenue collection must be reasonably assured.

This sounds straightforward when we are talking about a carton of milk sold to a customer at a convenience store at its sticker price.

However, revenue recognition gets trickier when we factor in discounts, rebates and various other arrangements a company can have with its customers.

Things are also complicated if a company has policies that give customers the right to request a refund.

Generally speaking, an allowance for estimated returns has to be made.

An online guide by audit firm Grant Thornton gives some other pointers on recognising revenue.

"The existence of a large volume of homogenous transactions is helpful in providing an entity with the historical experience necessary to establish a reasonable estimate of returns," it says.

It adds that if the product sold can be outdated due to technological changes, or if the product has a long return period, a company might not be able to reliably estimate returns.

"If an entity is not able to make a reliable estimate of returns, it should defer revenue until either (1) a reasonable estimate of returns can be made or (2) the return period lapses," Grant Thornton says.

In other words, companies with return policies can best make the required estimates as to how much to provide for returns in their recorded revenues under certain circumstances.

This is when they sell goods that are not at risk of becoming obsolete, and they have made sufficient sales of similar goods to be able to come up with an accurate estimate of how many customers tend to return the goods.

Otherwise, a prudent company would avoid recognising these sales as revenue.

The consequences of mass returns for products sold that a company did not foresee can result in accounting quirks.

Celestial Nutrifoods, a China-based producer of soyabean food and beverages, recognised "negative revenue" of 161 million yuan (S$35 million) for the three months ended June 30, 2010, compared with sales of 223 million yuan a year previously. They were hit by substantial sales returns of 437 million yuan.

The returned goods, which were perishable, were written off as they were nearing expiry.

Accounting experts said then that these revenues should not have been recognised in the first place.

Overstating receivables

The effects of aggressive revenue recognition on the income statement pop up elsewhere.

On the balance sheet, receivables - which are what customers have yet to pay you for goods you sold them - can be overstated.

Receivables are considered assets, which are what the company's shareholders own.

Sometimes, assets are overstated. This means shareholders end up owning less than what they thought they did.

An oft-cited case is when accounts receivable keep growing faster than the rise in revenues, while the debts due from its customers never get collected. Eventually, the assets get impaired - meaning the company recognises that assets are worth less than what they were recorded at.

Sometimes, assets can get overstated and understated at the same time.

One example is Eratat Lifestyle, a mainboard stock that was a China footwear and apparel designer, manufacturer and distributor.

It was suspended at the beginning of last year after cash was found to be missing from its accounts.

We ran a couple of articles about six months ago on the firm's income statement. Looking at segmental revenues, we could see signs of deterioration in the company's core business.

There was also abnormally low interest income relative to cash balances, along with an oddly high interest payment on a bond issued by a finance company.

There were also subtle issues on Eratat's balance sheet that, in hindsight, were warning signs about business performance.

The first sign is what we mentioned earlier: receivables rising faster than revenues, leading to assets probably being overstated.

From its 2012 annual report, revenue decreased slightly to 1.03 billion yuan from 1.04 billion yuan in 2011.

Trade receivables went up to 573.6 million yuan from 530.9 million yuan.

From an initial glance, one could already tell that the company's customers (in this case the distributors of its shoes) were taking their time to pay.

How can you tell? Assume you sell S$1,000 worth of goods at the beginning of one year, all on credit. At the end of the year, customers collectively owe you S$500.

This means half of your customers still owe you money for the whole year. Or, put another way, if you have made the sales throughout the year, your customers are taking half a year on average to pay you back.

Now, usually, when you walk into a boutique to buy a shirt or jacket, you pay on the spot; you don't take six months.

Eratat, however, is not a retailer. It sells the shoes and clothes it designs and makes to middlemen, or distributors. These distributors in turn sell the shoes to customers at their retail shops, or perhaps to more middlemen.

From its 2012 annual report, we learnt that around 600 million yuan of sales were due to five large customers.

The problem with this business model is that there is no way of directly knowing how well the goods are selling to the end consumer.

You can sell goods to distributors, recognising revenue, profit and receivables. Yet if customers don't like the goods, and nobody buys them from the distributors' retail shops, the distributors that have taken on debt to finance their purchase of your goods might go bust.

Then they won't be able to pay you back what they owe you. And all that previously recognised profit will mean nothing if you have to take a huge impairment hit on your receivables.

Now your receivables are rising. You know there's a possibility that your distributors might not pay you back. You need to make more sales. And a write-off will look bad. What can you do?

Managing receivables down

We first look at Eratat's revenue recognition policy, which gives no clues.

On page 42 of its annual report, the company says: "Revenue on the sale of goods is recognised when the significant risks and rewards of ownership of the goods have been transferred to the customer. Revenue is not recognised to the extent where there are significant uncertainties regarding recovery of the consideration due, associated costs or the possible return of goods."

Revenue is also recognised for what is "received or receivable . . . net of value-added tax, rebates and discounts and after eliminating sales within the group".

So far, so good. However, since we are concerned about Eratat's receivables, we have to look at the accounting notes to it in the report.

And therein lies something odd. On page 52, the company says: "During the financial year ended 31 December 2012, the group had provided renovation subsidies to certain distributors to upgrade their retail shops to keep pace with the group's branding strategy. These renovation subsidies which amounted to RMB 41,763,000 approximately were set off against the respective distributors' outstanding trade receivables balances during the year."

Eratat adds that the renovation subsidies are a non-cash transaction - meaning no money changed hands.

Some "cosmetic surgery" has been done here to make receivables appear less than what they should be.

This is not evidence of fraud. But there is certainly some massaging of numbers going on.

This is what Eratat sounds like it was saying to its distributors: "Hey, remember those goods you bought from me, for which you owe me money? You won't owe me so much now. Use the money you otherwise planned to pay me to spruce up your shops so you can sell more of my products."

A similar adjustment was used the previous year.

Eratat said: "In the prior year, the group had granted sales incentive awards to reward its distributors for their sales performance and to encourage loyalty to the group's brand. These sales incentive awards which amounted to RMB 51,744,000 approximately were set off against the respective distributors' trade receivables balances outstanding as at 31 December 2011."

Essentially, distributors which apparently performed well were given a discount - which was called a "sales incentive".

This discount was given on goods already bought but not yet paid for.

Usually, if goods are selling so well, then there is scope for a slight discount on future goods purchased for distributors who can sell.

However, giving this incentive for past goods purchased looks suspicious in hindsight.

This suggests there were deeper issues with the company's accounts receivable that it was not revealing.

We thus see how just one item on the balance sheet - receivables - is not set in stone.

It can be overstated through aggressive revenue recognition, and understated through various commercial transactions.

More fiddling around

There are many other ways that a company's balance sheet can be fiddled around with.

A balance sheet consists of assets (which are receivables, inventories, cash, goodwill, property, plant and equipment) and liabilities (like payables, debt and provisions).

A book published last year on detecting financial statement irregularities, Asian Financial Statement Analysis by Tan Chin Hwee and Thomas Robinson, gives some examples: excluding assets and liabilities, off-balance- sheet liabilities or financing, and overstatement of assets.

Why might companies fudge the balance sheet?

The balance sheet is a common focus of creditors, and financial ratios like return on assets (ROA) and return on equity (ROE) depend on its items, the authors note.

Accounting rules provide some flexibility for companies to convey the right ratios they want.

For example, the assets and liabilities of associate companies (which the parent usually owns 20-49 per cent of) do not have to be consolidated onto the parent's balance sheet.

What is recorded, using the equity method of accounting, is the cost the parent originally paid for it, plus the investor's share of subsequent income, minus the proportionate dividends paid to it.

This means a parent company can overpay for an associate, and the associate can continue to be overvalued in the parent's books.

Assets can be understated in order to make profitability ratios like ROA and ROE look better.

Receivables can be sold to a bank at a discount in exchange for cash - a practice known as factoring. This is a common financing practice that has to be adjusted for.

There are other applications to current examples. For example, you might own shares in a property developer, which has built a number of high-end condos that it now can't sell. Are those assets overstated and the company's net asset value lower than it seems?

Some China stocks are well-known value traps because they contain a lot of cash, sometimes more than their market capitalisation. This is because nobody believes the cash is really there.

Another China-related example has to do with variable interest entities (VIEs), a legal structure used by China companies listed abroad, including e-commerce giant Alibaba. VIEs hold the permits required to do business in China, while foreigners only own an offshore company that enters into a contract with a VIE to get fees and royalty payments.

As the authors of Asian Financial Statement Analysis note: "If the VIE does not adhere to the contractual agreements it has made with a subsidiary of the listed company, cash that is generated at the VIE might remain in the VIE instead of going to the listed company."

To sum up, the balance sheet is a key financial statement that should never be taken at face value.

Assets and liabilities can be overstated or understated through a series of transactions with other companies or entities.

Whenever you see what seems like an attractive company to invest in, read the notes to its financial statements carefully for hints of accounting manipulation. You might save yourself significant trouble later on.

Balance sheet fishiness

Warning signs of an overstated financial position

Excluded assets and liabilities

- Is the company using operating leases to a greater extent than similar companies?
- Is the company using the equity method of accounting for affiliates? How would their financials look if these affiliates are consolidated?
- Has the company shifted accounts receivable off the balance sheet in a transaction that would be better classified as borrowing?
- Does the company have insufficient assets on its balance sheet to support reported operations and revenues – particularly relative to other similar companies?

Off-balance sheet liabilities/financing

- Are there financing or guarantee arrangements disclosed in footnotes or reports not reflected on the balance sheet?
- Are there discussions about contingencies or losses that are not currently reported on the income statement and for which no current liability is accrued?

Overstated assets

- Does the company have significant assets that are subject to estimates or assumptions or where objective valuations are not available?
- Does the company have unusual changes in the quantity or valuation of intangible assets, commodities or biological assets (whether reported on the balance sheet or not)?
- Were any gains or revenue based on revaluation of assets, and what percentage of operating income comes from these activities?

Source: Asian Financial Statement Analysis, Tan Chin Hwee and Thomas R. Robinson