

Forensic Analysis – How to Avoid Negative Surprises

Zohair Haiderally

Seeking sustainable methods of alpha generation, most fund managers are adopting investment styles that involve concentrated portfolios made up of high-conviction calls and long investment horizons. Such choices are often preceded by proprietary research on sector themes and detailed valuation scenarios. However, this process is complicated by the need to safeguard these convictions against unique risks inherent in global investing, such as potential accounting irregularities and corporate governance shortfalls, which could blindside even the hardest working fund manager.

For investors, knowing the right ratios can also help to avoid companies that have poor earnings quality or are aggressive in revenue and earnings recognition. A good company analysis requires looking at the following five fundamental aspects:

- Revenue – Top line is the starting point of any investment decision
 - Earnings – Understanding how much of the top line is retained for investors
 - Working capital – Assessing how efficient the business operations are
 - Cash flow – Recognizing the cash generated and available for investors after capex and working capital investments
 - Leverage – Understanding the business's ability to repay borrowings
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Growth: It is important to understand whether the company's rate of growth is sustainable, particularly in comparison to the industry's. Even though top-line revenue growth is an important metric, a forensic analyst is more focused on organic growth, since many companies simply grow via acquisitions. Given that some companies report organic growth and others do not, there is no universal methodology for computing it; nor is it an audited number. It is important to look at organic growth because companies may present good growth indices, whereas in reality, the reported growth number does not reflect the company's actual ability to grow. Revenue could also be inflated by the use of aggressive estimates and judgments where there is long-term revenue at play by booking future revenue early, and all this needs to be stripped out when computing growth. Key areas to watch for are how unbilled receivables, receivables and deferred revenue have moved. Simply put, organic growth is a company's top-line growth achieved by using existing capacity via either pricing power or increased volume.

Earnings: Investors are mainly focused on earnings (and thereafter, cash flow). Before investing in a company, the key questions they ask are how much profit does it generate and what kind of margins does it make? Growth potential in future earnings (translated into free cash flow) determines company valuation and stock price.

Sales, costs, assets and liabilities all help to determine a company's earnings. Earnings per share (EPS) is basically how much earnings a shareholder is entitled to compared to the price per share paid. However, earnings may be inflated using aggressive assumptions and estimates and accounting gimmicks. A forensic analyst focuses on recurrent income after stripping out income and gains of a one-off nature, since a company's long-term value depends on its sustainable earnings. To this end, in addition to the audited earnings figure, some companies report adjusted earnings to provide better insight.

However, these adjusted numbers may include items that one would consider part of normal expenses, even though they are categorized as 'one-off' to boost recurring earnings. Other earnings management techniques used are dipping into cookie jars or delaying provisions and charges to show better results, which are not sustainable in the long run. The key earnings ratio is return on capital employed using recurring operating profit after adjusting for one-offs and earnings aggressiveness.

Cash flow: Even though in theory cash is difficult to manipulate and companies know that most investors focus more on cash, companies today tend to use techniques such as off-balance-sheet non-recourse [securitization](#) of receivables, stretching of payables, and sale and purchase of inventory to show better cash flow. Classifying working capital as investing cash flow is a technique used by the media industry. A key cash flow ratio is free cash flow to the firm, to identify how much cash the company is generating after adjusting for unsustainable effects. Cash conversion is used to assess how much of the earnings is converted to cash and whether cash was managed in any way.

Working capital: Investors use asset-efficiency ratios to gauge how efficiently management is operating the business – management of inventory, customer receipts and supplier payments. Efficiency ratios show how fast products are selling, how long customers are taking to make payment, and how much supplier credit is stretched.

The most common efficiency ratios are the inventory turnover, receivables turnover, inventory days, receivable days outstanding, payable days outstanding, net working capital, and fixed asset turnover ratios. Increasing receivable days could indicate aggressive revenue recognition in the absence of any other valid reason for the increase.

Leverage: This measure indicates whether the company is drowning in debt. However, it needs to be analyzed based on the industry the company operated in. Generally, banks use net debt to EBITDA as a leverage ratio to determine whether they can lend more and at what interest rate. Companies tend to use off-balance-sheet lending, such as leased assets, put options, sales and lease-backs, commitments, and raising debt via entities that are not consolidated, to avoid debt on the balance sheet.

Forensic analysts who have a good understanding of accounting and accounting standards are able to look at all these factors and identify potential red flags in a company. An asset manager should obtain clarifications from company management and determine whether their responses are reasonable before making an investment decision. Forensic analysts may not catch fraud, but they will certainly be able to identify red flags to avoid making an investment decision based purely on valuation or future potential, without a thorough understanding of the financials. Analysts, through detailed [forensic analysis](#), are therefore able to reassure an asset manager of the quality of a company's earnings.

Emerging-market investors are increasingly [leveraging forensic analysis](#) in their investment decisions. For example, a large US-based asset manager uses a team of analysts based in MA Knowledge Services' Beijing delivery center to carry out corporate governance reviews covering related-party transactions, conflicts of interest, remuneration policy and board expertise and experience to mitigate deficiencies in the control structure.

Similarly, a Europe-headquartered long-term-equity-focused asset manager leverages a team of three analysts with strong accounting and IFRS skills based in MA Knowledge Services' Colombo delivery center to cover Asian markets. These analysts look for unsustainable accounting manipulations, estimates and practices adopted by companies under coverage in this market.

Asset managers use output produced by an MA Knowledge Services team as part of their fundamental research to further engage with these companies.

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