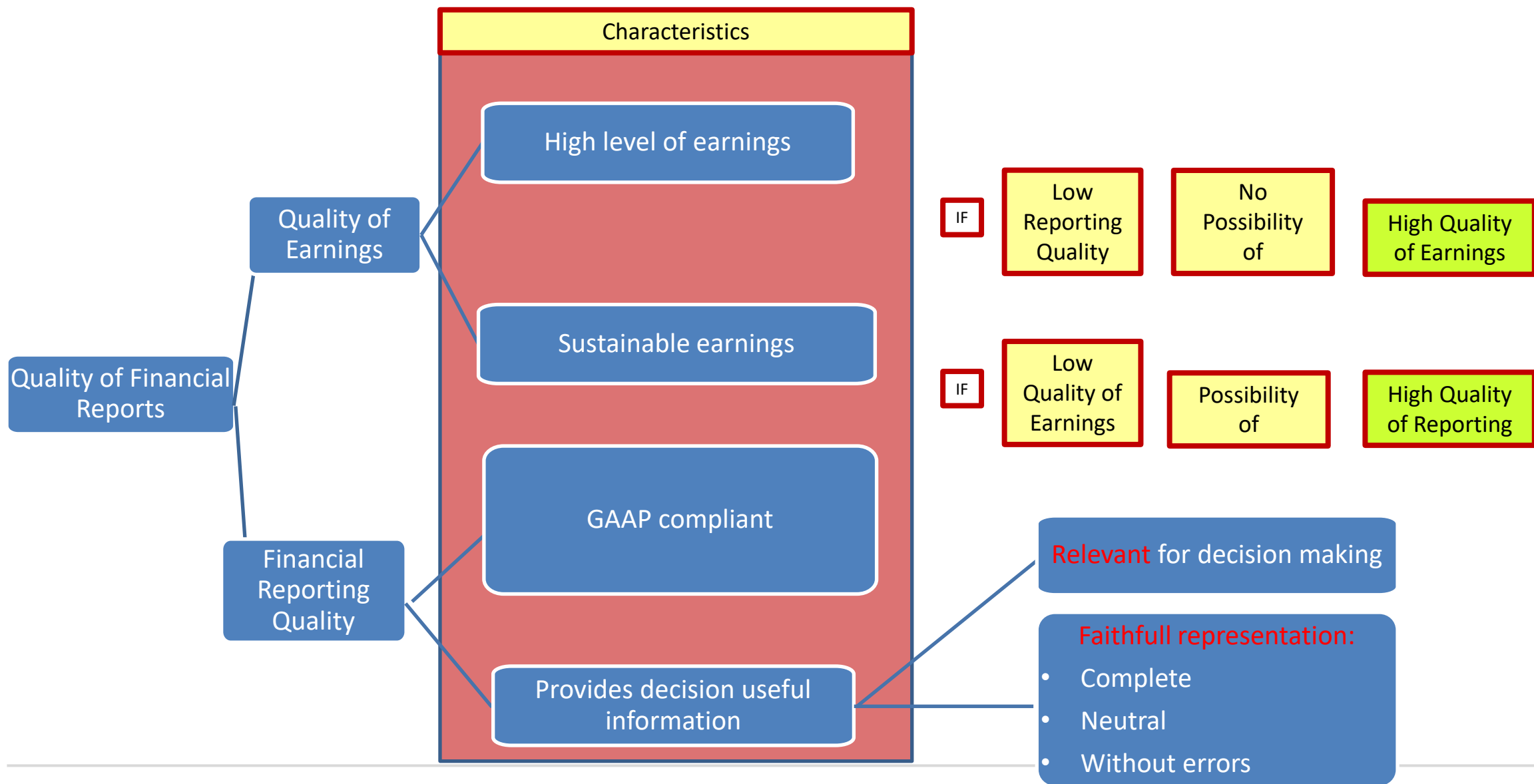
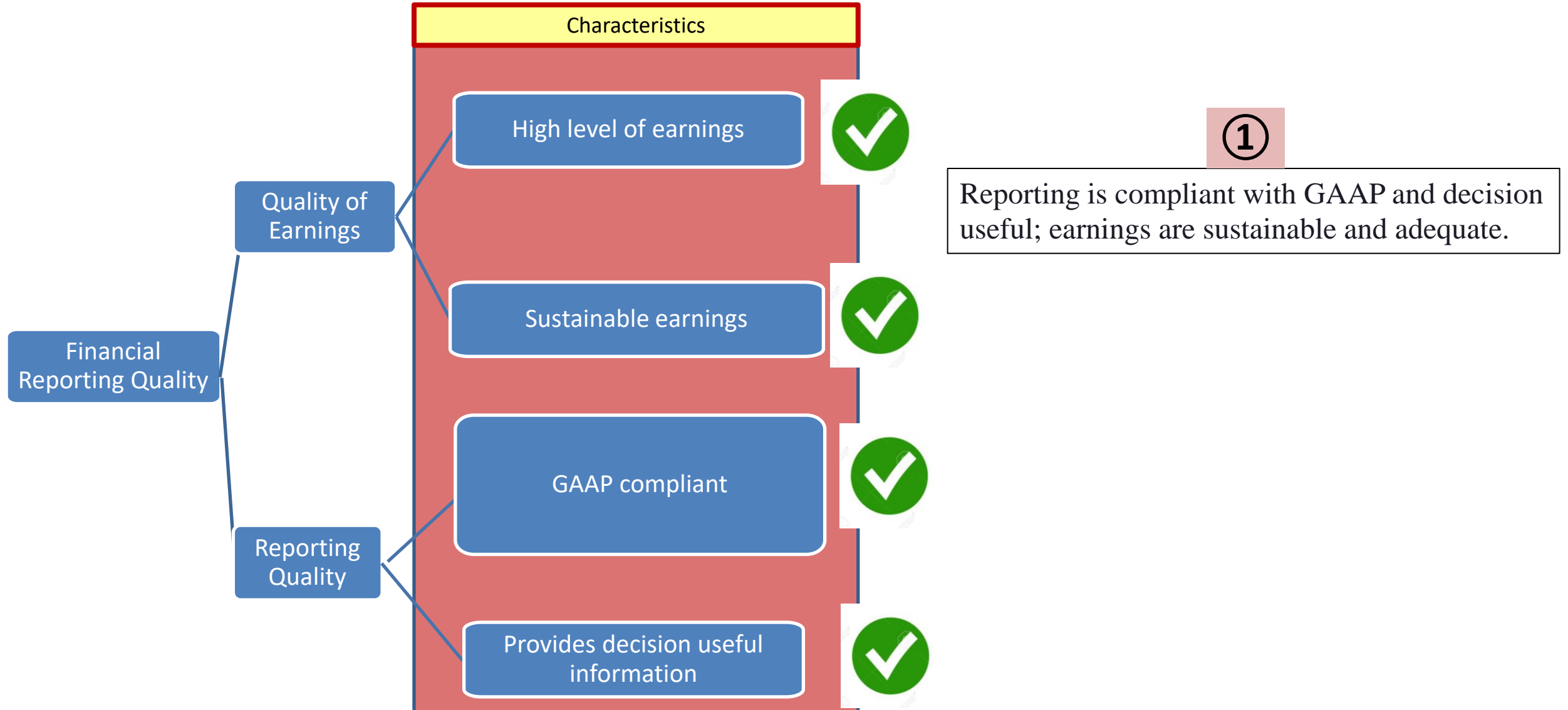
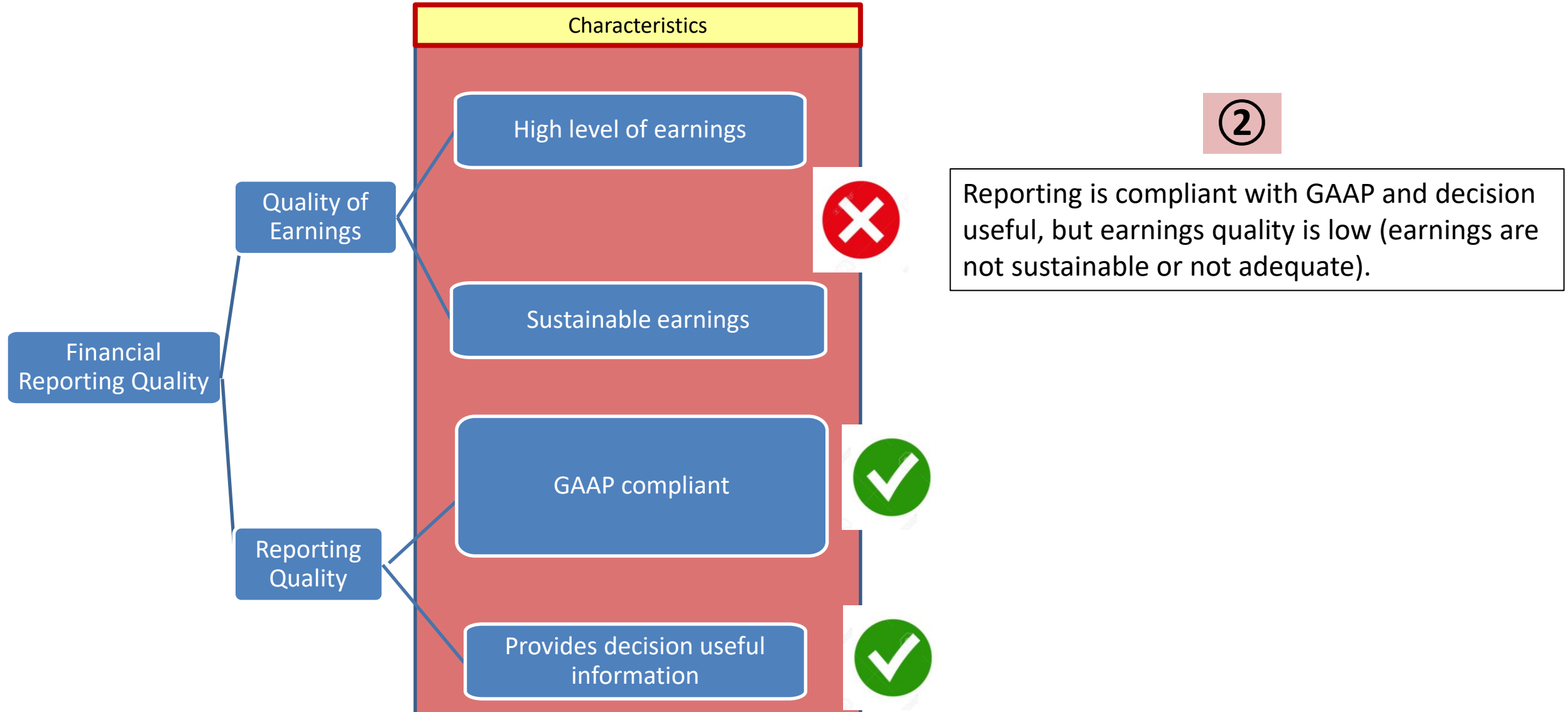
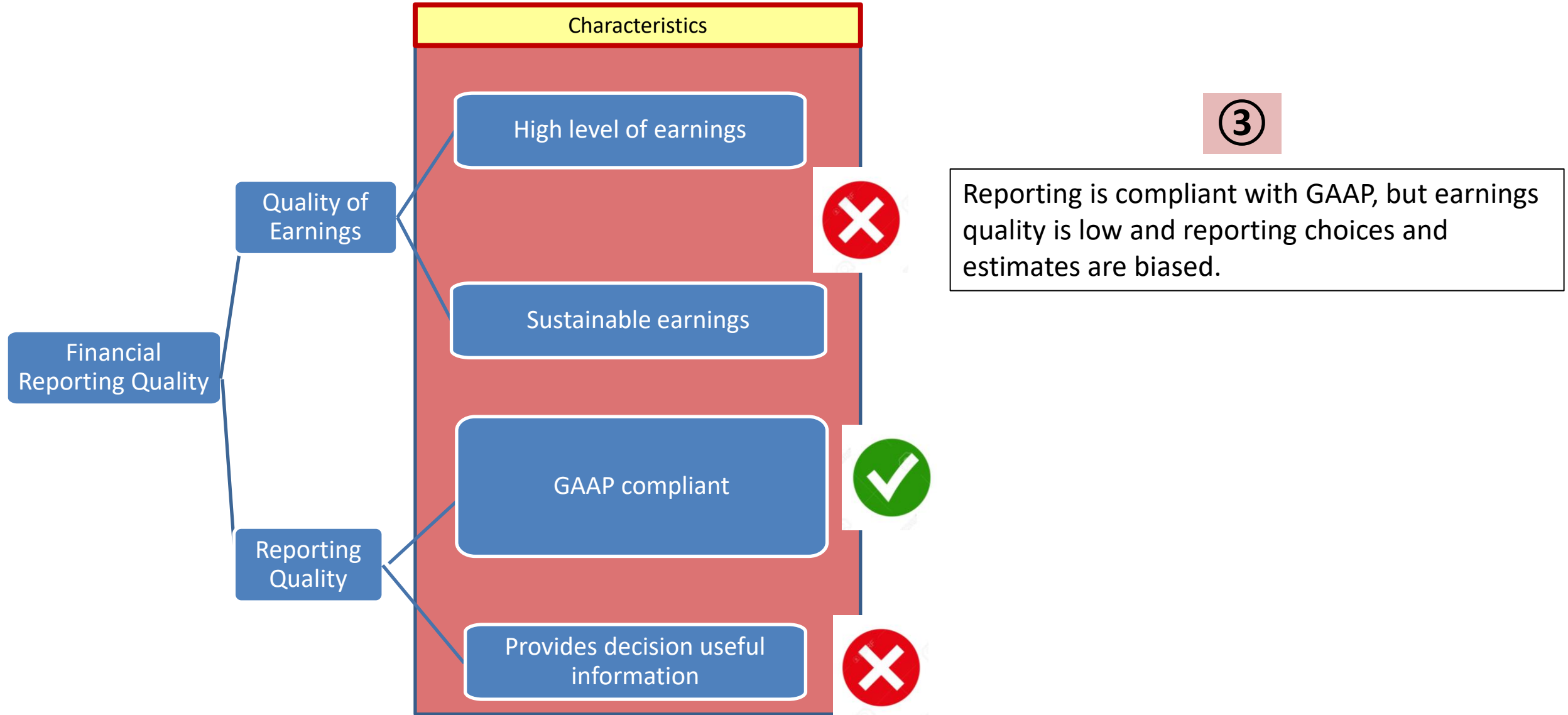


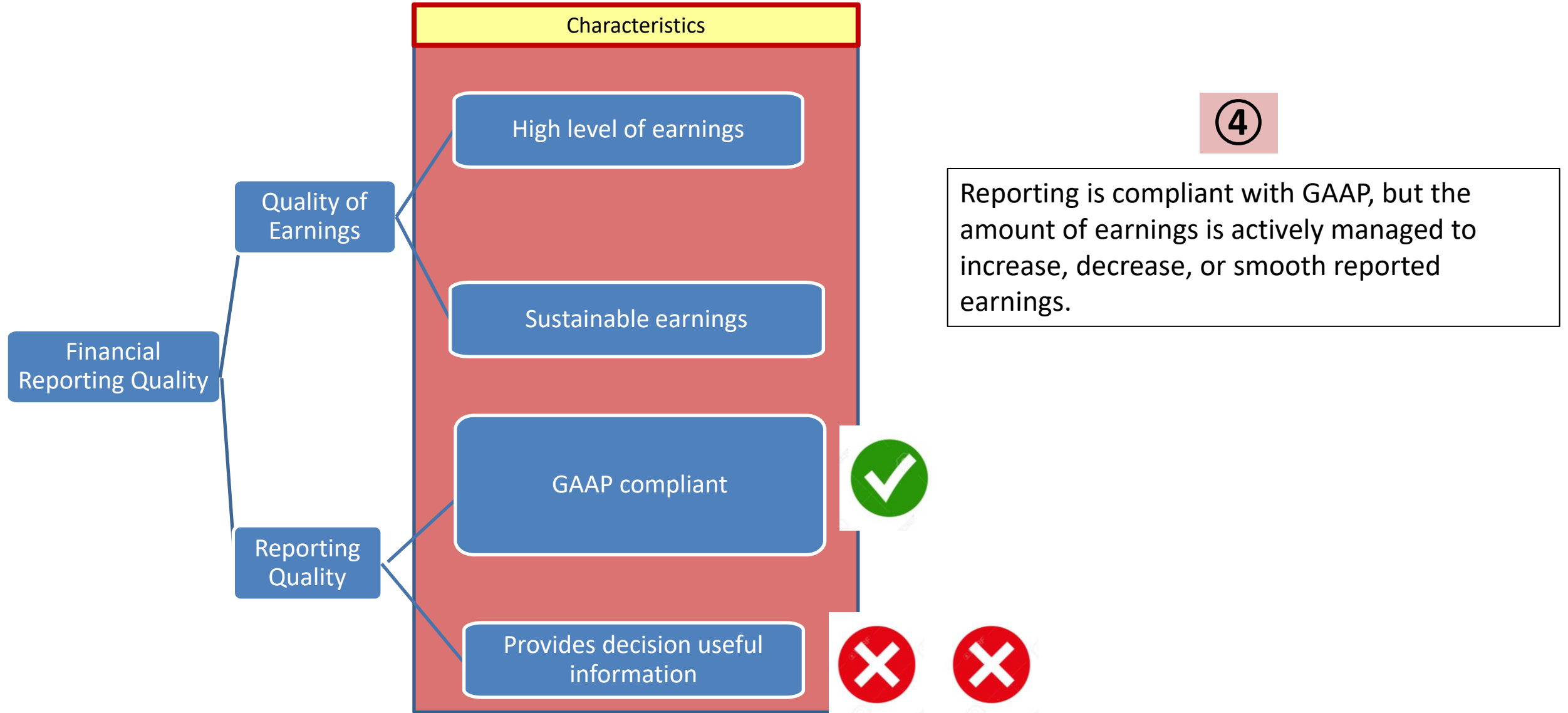
FINANCIAL REPORTING QUALITY

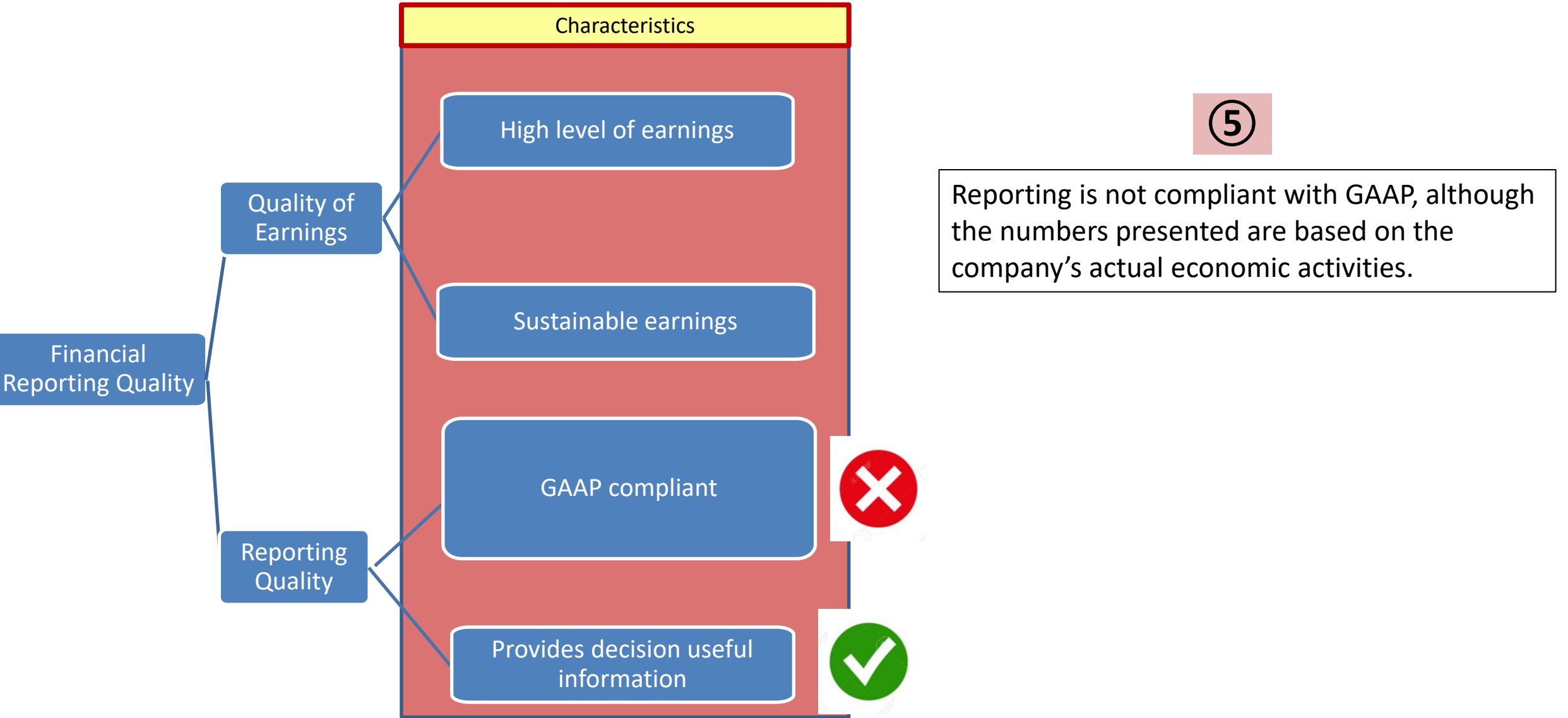


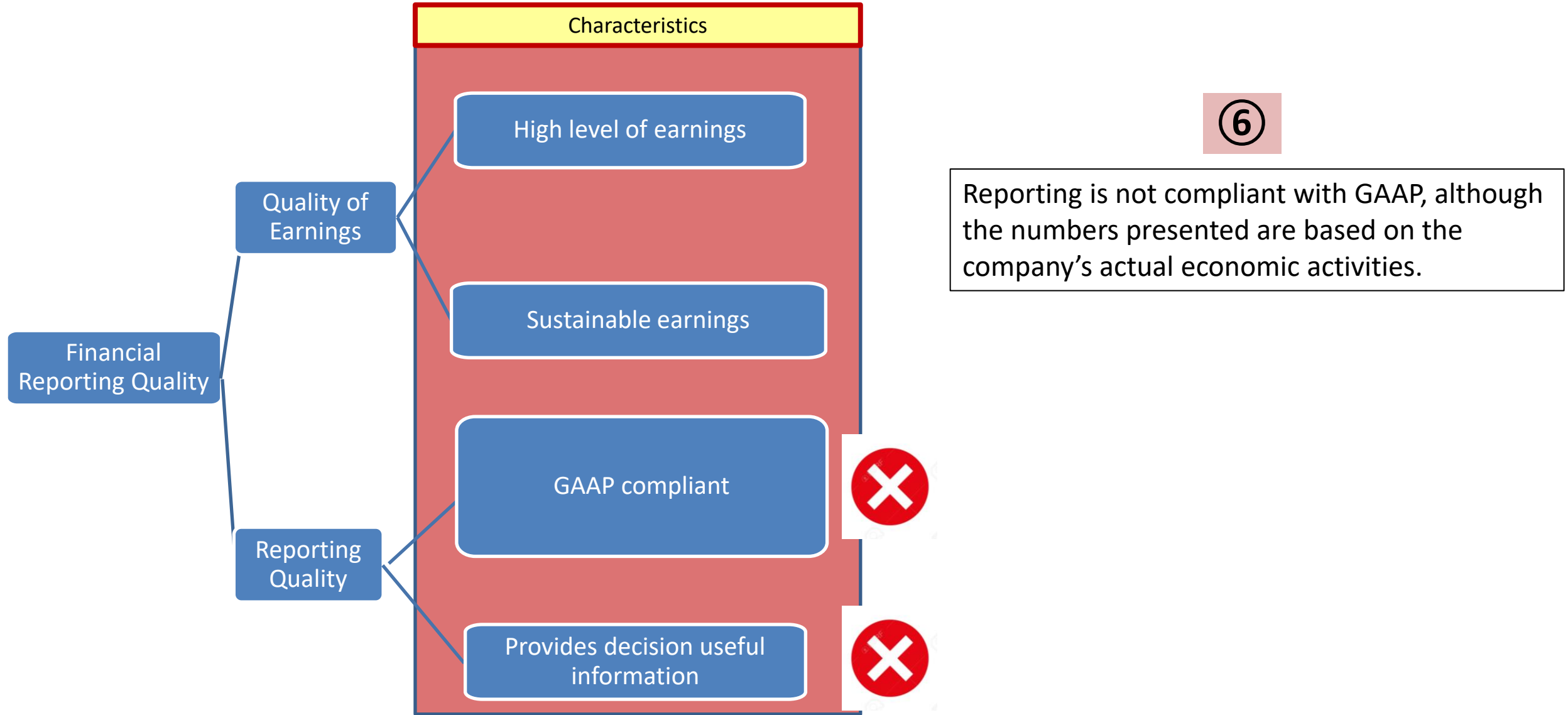












AGGRESSIVE ACCOUNTING



Choices that result in an improvement of current reported earnings or of the financial position

CONSERVATIVE ACCOUNTING



Choices that result in a decrease of reported current earnings or of the current financial position

FINANCIAL STATEMENTS ARE MORE USEFUL WHEN THEY ARE NEUTRAL (neither aggressive nor conservative) AND UNBIASED

AGGRESSIVE ACCOUNTING TENDS TO LEAD TO LOWER FUTURE RESULTS.
CONSERVATIVE ACCOUNTING TENDS TO LEAD TO HIGHER FUTURE RESULTS.

EARNINGS SMOOTHING

EARNINGS SMOOTHING THROUGH ACCRUED LIABILITIES BASED ON MANAGEMENT ESTIMATES

EXAMPLES OF CONSERVATIVE / AGGRESSIVE ACCOUNTING

CONSERVATIVE	AGGRESSIVE
EXPENSE CURRENT COSTS	CAPITALIZE CURRENT COSTS
SHORTER LIVE ESTIMATES FOR PP&E	LONGER LIVE ESTIMATES FOR PP&E
LOWER ESTIMATES OF RESIDUAL VALUE	HIGHER ESTIMATES OF RESIDUAL VALUE
ACCELERATED DEPRECIATION	STRAIGH-LINE DEPRECIATION
EARLY RECOGNITION OF IMPAIRMENTS	DELAYED RECOGNITION OF IMPAIRMENTS
VERY HIGH ACCRUALS FOR BAD DEBT	VERY LOW ACCRUALS FOR BAD DEBT
LARGE VALUATION ALLOWANCES FOR DTAs	TINY VALUATION ALLOWANCES FOR DTAs

BIASES CAN ALSO BE FOUND IN THE WAY FINANCIAL STATEMENTS ARE PRESENTED

Transparent financial statements are **helpful** to evaluate and understand the performance of the firm

Obscure financial statements providing minimum disclosure and emphasizing the positives while obscuring negative developments

AVOID THE COMMON THOUGHT OF THINKING ABOUT CONSERVATIVE ACCOUNTING AS GOOD AND HONEST



SMOOTH ACCOUNTING

SOMETIMES GAAP ITSELF ISSUES MANDATORY STANDARDS OF CONSERVATIVE NATURE:

Research Dollars mandatory expensed

Legal liabilities when a cash out is probable. However in order to capitalize a legal asset more strict conditions to be met

Write downs of inventory mandatory, but subsequent right ups not allowed (US GAAP)

Conservative accounting is bad for financial statement users. However, in some instances can there are benefits that explain its use:

- 1) Reduction of the likelihood of future litigation from investors claiming they were misled
- 2) Reduction of current taxes
- 3) Protection those with less information than the management team

BEAT OR MEET A BENCHMARK

- Career motivations
- Incentive compensation (Bonus related to operating performance or stock performance)
- Improve their credibility with investors (equity and fixed income)

TYPICAL BENCHMARKS

- Earnings guidance provided by Management during prior analyst presentations
- Consensus expectations
- The results of the prior year

For companies with poor performance or highly leveraged (or both) another motivation for aggressive accounting is avoiding the violation of covenants

When results are well above expectations, management may be motivated to use conservative accounting that allow this excess earnings to appear in subsequent periods

Three circumstances that make more probable the existence of low-quality financial reporting:

- ① The company has weak internal controls.
- ② The board of directors provides inadequate oversight.
- ③ A large range of accounting treatments is accepted and/or penalties for accounting fraud are inconsequential

Rationalization of poor behaviour:

- ① I will fix it over the next period
- ② I have to do it to pay for the college of my son

①

Securities Regulator

(SEC in USA, FCA in UK, etc.)

They typically require

- A standard registration process when companies issue new publicly traded securities (prospectus)
- Specific requirements for financial reporting and disclosures (periodicity of reporting, audited FS, relevant facts disclosure, etc...)
- Mandatory independent audit of financial statements
- A mandatory management comment on the financial condition of the company
- A statement signed by the person / people responsible for the financial statements
- A standard process for reviewing securities registered for the first time, and periodic reviews afterwards

②

Enforcement actions by regulators

- Fines
- Suspension of participation in public markets (issuance and trading of securities)
- Public disclosure of the results of disciplinary procedures
- Criminal prosecution

OTHER COMMENTS

On top of the audit opinion, in the US it is required that all firms listed in the country must include an assessment of the effectiveness of the internal controls of the Company.

A clean opinion doesn't mean that a fraud cannot be occurring. Bear in mind that the auditor is selected and paid by the company being audited

Another potential source of influence for the improvement of the Quality of Reporting are private contracts (ie bond indentures and financial lenders). Almost always these contracts include covenants and directions about how to calculate de covenants.

Describe presentation choices, including non-GAAP measures, that could be used to influence an analyst's opinion.

Summary non-GAAP financial performance

The table below reclassifies items relating to seed capital and the translation of non-Sterling balance sheet positions to aid clarity and comprehension of the Group's operating performance, by excluding the mark-to-market volatility of these items, and to provide a more meaningful comparison with the prior year. For the purposes of presenting 'Adjusted' profits, personnel expenses have been adjusted for the variable compensation on foreign exchange translation gains and losses.

Non-GAAP alternative performance measures (APMs) are defined and explained on page 31.

£m	FY2018/19 Reported	Reclassification of		FY2018/19 Adjusted	FY2017/18 Adjusted
		Seed capital- related items	Foreign exchange translation		
Management fees net of distribution costs	294.3	–	–	294.3	250.5
Performance fees	2.8	–	–	2.8	21.9
Other revenue	5.9	–	–	5.9	4.1
Foreign exchange	11.3	–	(6.2)	5.1	1.8
Net revenue	314.3	–	(6.2)	308.1	278.3
Investment securities	0.5	(0.5)	–	–	–
Third-party interests	3.8	(3.8)	–	–	–
Personnel expenses	(84.2)	–	1.4	(82.8)	(73.2)
Other expenses excluding depreciation & amortisation	(26.8)	3.3	–	(23.5)	(21.5)
EBITDA	207.6	(1.0)	(4.8)	201.8	183.6
<i>EBITDA margin</i>	66%	–	–	66%	66%
Depreciation & amortisation	(4.8)	–	–	(4.8)	(5.0)
Operating profit	202.8	(1.0)	(4.8)	197.0	178.6
Net finance income/expense	17.4	(9.7)	–	7.7	4.6
Associates & joint ventures	(0.3)	–	–	(0.3)	(0.4)
Seed capital-related items	–	10.7	–	10.7	10.1
Profit before tax excluding FX translation	219.9	–	(4.8)	215.1	192.9
Foreign exchange translation	–	–	4.8	4.8	(1.6)
Profit before tax	219.9	–	–	219.9	191.3

Non-GAAP measures typically **exclude items of non-recurrent nature** to “improve” comparability and make easier the assessment of the performance of the underlying business.

In US GAAP, companies include non-GAAP measures in their financial statements must:

- Display the most comparable GAAP metrics
- Explain why this Non-GAAP metrics are useful
- Reconcile non-GAAP vs GAAP.
- Disclose any additional purpose for which the firm includes non-GAAP metrics.
- Include, in any non-GAAP measure, any items that are likely to recur in the future, even those treated as nonrecurring, unusual, or infrequent in the financial statements.

IFRS companies include non-GAAP measures in their financial statements must:

- Define and explain the relevance of such non-IFRS measures.
- Reconcile non-GAAP vs GAAP

BEWARE OF NON-GAAP MEASURES → Companies can use them to mislead analysts and reduce their focus on GAAP metrics



Describe accounting methods (choices and estimates) that could be used to manage earnings, cash flow, and balance sheet items.

REVENUE RECOGNITION

① FREE ON BOARD ISSUES

If a company chooses **FOB** terms at the shipping point it means that the company will recognize revenue sooner than if FOB at the destination terms were chosen

② SHIPMENT TIMING ISSUES

- Accelerating the shipment of finished goods in periods with lower than expected earnings, and
- Delaying the shipment of finished goods in periods with higher than expected earnings

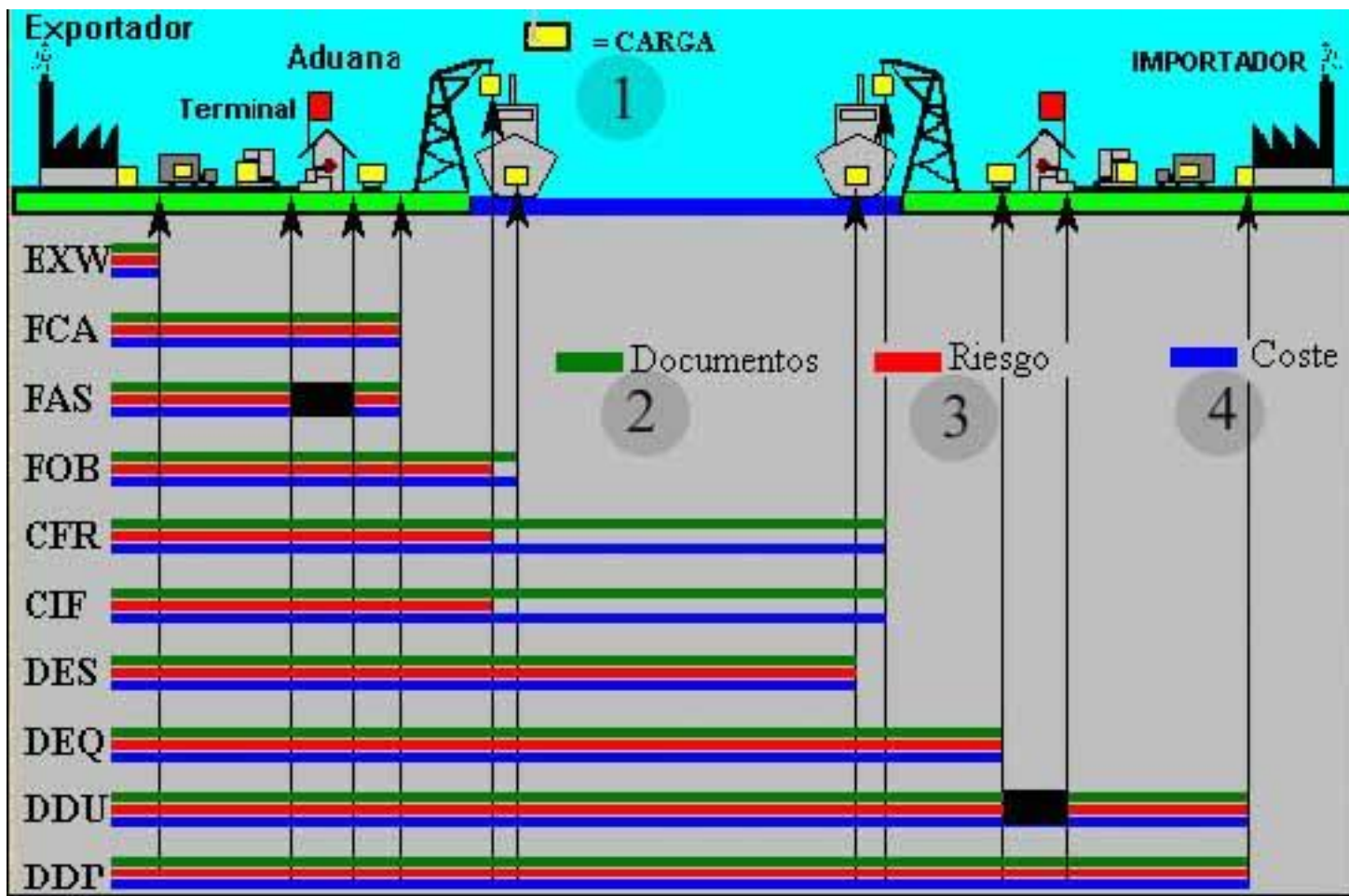
channel stuffing

③ BILL-AND-HOLD

Bill-and-hold

It increases current earnings but reduces future earnings

①
② *Com*



¿CUANDO SE TRANSFIEREN LOS RIESGOS Y LA PROPIEDAD?

- **Channel Stuffing:** (Investopedia) “A deceptive business practice used by a company to inflate its sales and earnings figures by deliberately sending retailers along its [distribution channel](#) more products than they are able to sell to the public”
- **Bill and Hold:** (Investopedia) “A form of sales arrangement in which a [seller](#) of a good bills a customer for products but does not ship the product until a later date. In order for a transfer of ownership to occur, certain conditions must be met. These conditions include: payment for the goods, that the goods be segregated from all other similar goods by the seller, and that the goods be finished and ready for use”
 - Take or pay:** (Investopedia) “A provision, written into a contract, whereby one party has the obligation of either taking delivery of goods or paying a specified amount”
- **Probit regression model:** (Wikipedia) “In statistics, a probit model is a type of regression where the dependent variable can only take two values, for example married or not married”
- **Sham sales:** (Business Dictionary) “That [serves](#) no [business](#) purpose or [provides](#) no [economic benefit](#) but is entered into for deception, such as to escape a [tax liability](#).”



Describe accounting methods (choices and estimates) that could be used to manage earnings, cash flow, and balance sheet items.

ESTIMATES OF CREDIT LOSSES

① BAD DEBT PROVISION. (aka uncollectable customer credit accounts)

- Conservative Accounting: Overestimate the % of uncollectible receivables → ↓ Receivables in BS → ↓ Net Income
- Aggressive Accounting: Underestimate the % of uncollectible receivables → ↑ Receivables in BS → ↑ Net Income

Result smoothing overestimating bad debt provision during Good years, and reducing this bad debt provision in the following years.

Other reserve of similar functioning is the reserve for warranty expense

VALUATION ALLOWANCE

It reduces the carrying value of a DTA as a contra-account.

- Conservative Accounting: Overestimate the Valuation Allowance → ↓ DTA in BS → ↑ Income Tax → ↓ Net Income
- Aggressive Accounting: Underestimate the Valuation Allowance → ↑ DTA in BS → ↓ Income Tax → ↑ Net Income

DEPRECIATION METHODS AND ESTIMATES

CONSERVATIVE	AGGRESSIVE
SHORTER LIVE ESTIMATES FOR PP&E	LONGER LIVE ESTIMATES FOR PP&E
HIGHER ESTIMATES OF RESIDUAL VALUE	LOWER ESTIMATES OF RESIDUAL VALUE
ACCELERATED DEPRECIATION	STRAIGH-LINE DEPRECIATION

AMORTIZATION AND IMPAIRMENTS

Amortization of intangibles. Same as depreciation in tangible assets

Goodwill not amortised. Delay of impairment increase current earnings at the expense of future earnings.

INVENTORY METHOD

FIFO vs WEIGHTED AVERAGE COST

If rising prices → FIFO lower costs, higher Net Income, higher AR

Relevance → FIFO more accurate balance sheet, WAC more accurate Net Income

RELATED PARTY TRANSACTIONS

Close monitoring (i.e. services received by a company controlled by someone of the management team)

Adjustment of these costs to a normal (market Price)

CAPITALIZATION OF COSTS

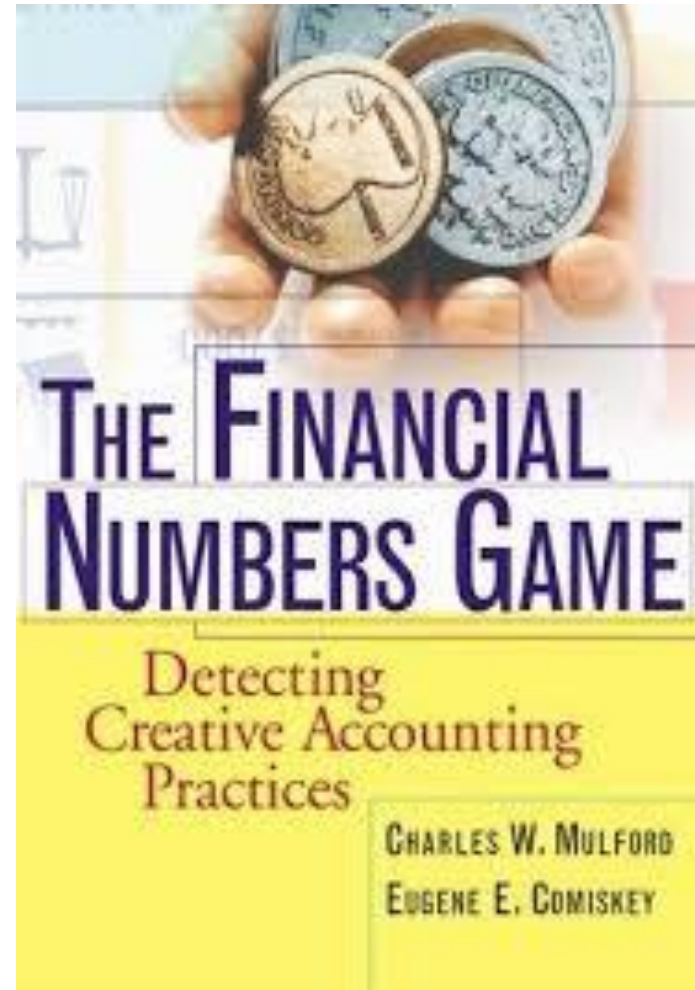
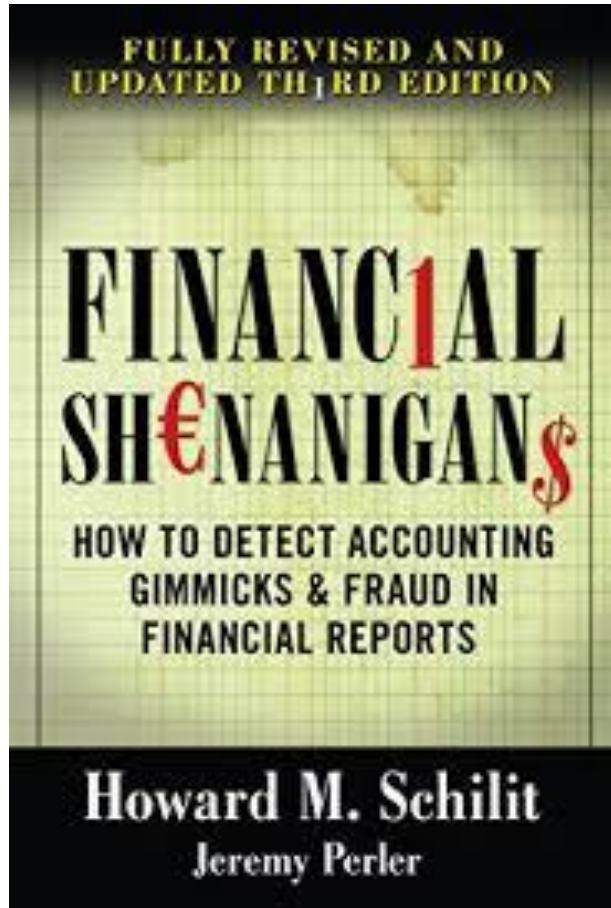
Capitalise vs Expense (Higher Net Income current period and lower future periods)

Capitalise vs Expense (Higher CFO, lower CFI, same total Cash Flow)

OTHER CASH FLOW EFFECTS

Delaying payments to suppliers artificially improves financial position

Capitalizing interest expense increases CFO and decreases CFI





Artículo Ignacio de la Torre. Arcano

GOTHAM CITY RESEARCH LLC www.gothamcityresearch.com info@gothamcityresearch.com

GOTHAM CITY RESEARCH LLC

Let's Gowex:
a Pescanovan Charade
en español: La Charada Pescanova
Price Target: €0.00 per share

"The company [Iber-x/Gowex] made a large profit on a **€42.0 million turnover** in 2002"

Gowex,
2003

"In 2003, the Company had **€2.7M turnover** from three sales staff."

Gowex,
2010

	2009	2010	2011	2012	2013
Boringo			1.80%	1.86%	1.57%
iPacs			0.67%	0.84%	0.97%
Ruckus			0.50%	0.84%	0.48%
Gapo			0.00%	0.46%	0.44%
Townstream			0.89%	0.70%	n.a.
Average			0.77%	0.94%	0.87%
GOWEX	0.07%	0.07%	0.06%	0.05%	0.06%

Does this make any sense?

REVENUE RECOGNITION RED FLAGS

Changes in the criteria / method for recognizing revenues

Existence of Bill-and-hold transactions

Existence of barter transactions

Existence of rebate programs

Obscurity regarding how revenue is recognized when a product/ service has various components

Revenue growth well above peers

Receivables turnover trending downwards

Reductions in Total Asset turnovers (specially coupled with M&A)

Significant nonoperating items.

INVENTORIES

Inventory turnover trending downwards

LIFO liquidation under US GAAP . Inventory levels going down and selling old inventory of very low Price, hence depressing margins

CAPITALIZATION

Changes in the criterion for capitalization of costs towards more aggressive accounting

RELATIONSHIP OF REVENUE AND CASH FLOW

$\frac{CFO}{Net\ Income}$ trending downwards or below 1

OTHER WARNING SIGNS

Use of estimated lives for PPE, salvage values, not in line with peer companies

Fourth quarter earnings well above/ below the patterns shown by peers

A significant volume of transactions with related parties

A significant volume of non-recurrent expenses that appear to recur

Low levels of disclosure

Profitability (Operating margins or Gross Margins) well above peer average

A lot of emphasis placed in Non-GAAP metrics.

A lot of M&A activity (danger of using opportunities to manipulate asset values)

OTHER WARNING SIGNS. DEPARTING THOUGHTS

- When a company restructures a division and a large restructuring charge is recognized, analysts and investors may consider adjusting prior year results.
- Sometimes this kind of news are interpreted as good news since low performing assets are disposed and hence results may improve going forward.

END