THE SIGNS WERE THERE

THE CLUES FOR INVESTORS THAT A COMPANY IS HEADING FOR A FALL

TIM STEER
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Company share price disasters are like the plunges made by the famous high cliff divers of Acapulco. This is because the 135-feet dives that these brave men make from the cliffs of La Quebrada into the shallow waters below resemble what the share prices of companies do when they go spectacularly wrong. However, among the high cliff divers of Acapulco, there has never been a casualty, whereas a precipitous drop – or even a more drawn out extended swallow dive – in a company’s share price may well result in it going bust, with shareholders, employees, suppliers, bankers, auditors and now, increasingly, even regulators caught by the shock waves. Some companies do of course recover, often with new management at the helm, but even then the fall-out for shareholders and other stakeholders following the share price collapse can be severe.

For all the companies featured in this book, the dives in the share prices and the company disasters that resulted in bankruptcy could have been predicted by little more than a browse through the annual reports or prospectuses if you knew where to
look. But it seems that many of the great and the good in the world of investing do not bother to look at these important documents, and blame the auditors – and increasingly the regulators – when things go wrong. But the warning signs are regularly there, in the form of accounting shenanigans or other clear signs that a business is changing direction for the worse, or that excellent results are being reported only because of one-off and non-recurring items. Often these red flags are either not seen or are ignored by investors and other stakeholders.

The collapse in January 2018 of Carillion, which had received enormous amounts of public money as one of the UK government’s favourite construction and support services companies, is just one in a long line of corporate disasters where even a cursory look at the balance sheet by anyone with a smattering of financial training would have evoked a feeling of déjà vu and the realisation that the company was heading for a fall. Of course, not all share price disasters can be predicted by reading the annual report of a company, but it is a start and, with a little bit of knowledge, issues can be identified and a potentially loss-making decision avoided. This book is aimed at helping investors see the signs that there may be trouble ahead.

When looking at annual reports, always consider the Iceberg Principle. An annual report should be seen as an iceberg in terms of the information it contains. It cannot tell you all you need to know about a company, but if there is something in it that makes you feel uneasy, there may well be other even more uncomfortable things lying below the metaphorical water line. And that is often reason enough to sell the shares if you have a holding in the company, or to avoid it if you have not.

This book contains twenty-two stories about companies that
suffered dramatic falls in their share prices. Some survived the fall, some did not. But in the cases of twenty of these companies there were clear signs in their annual reports that all was not well, and in the initial public offering (IPO) prospectuses of the other two companies, there were items that should have raised a quizzical eyebrow or two among potential investors. Although around half of the companies featured in this book got to grips with their problems and survived, thanks to the efforts and strategy of new management, the others did not.

The share price disasters suffered by the twenty-two companies in this book are presented in groups, as there are common themes. History repeats itself, it would seem – and I should make the point that the sins that companies commit are rarely confined to just one theme.

Carillion, for example, had the stamp of another construction and support services company called Amey, which was also one of the UK government’s favourite private finance initiative (PFI) contractors in its day. As shown in their annual reports, both companies experienced a very sharp deterioration in the quality of their current assets, leading up to a precipitous decline in their share prices. Both companies had rising debt, so converting current assets into cash was important. But the cash conversion did not come through for either of them – which should have come as no surprise to those who had inspected their annual reports.

The cash did not come through at the outsourcing company Capita either. With a tendency to emphasise so called ‘underlying profits’ to investors at results presentations rather than the lower profits that were actually reported, Capita’s annual reports also showed that current asset quality was declining at a fast rate with a large increase in accrued income in particular. No surprises then...
that new management were quick to refinance the company as the accrued income was, well, not incoming at all.

Northern Rock, the UK’s biggest mortgage lender at the time of its collapse, and Cattles, a doorstep lender to the less well off, had similarities too. Whilst Northern Rock’s financing weaknesses were exposed by the financial crisis of 2007–8, both companies were far too optimistic as to the great British public’s intentions to pay off their debts. This was clear from the annual reports published by both of them before their dramatic demises. With both, lending to customers rose aggressively but their bad debt provision did not. Even the chairmen’s statements used the same language to underscore the importance they attached to ‘growth’, ‘credit quality’ and ‘efficiency’ – unfortunately, they both forgot that anyone can lend money, it is getting it back that is the difficult bit.

One of the UK’s largest software companies, Autonomy, which was acquired by Hewlett-Packard in 2011, had the whiff of iSoft about it in the way it recognised revenue from the sale of software. The lessons of iSoft, the company at the heart of one of the world’s largest failed IT projects to join up the UK’s National Health Service digitally, were seemingly ignored by Hewlett-Packard and its legion of advisers.

Large accruals of income are warning signs that there may be trouble ahead. Accruals of income are after all only estimates and therefore dependent sometimes on over optimistic and enthusiastic management. I am being kind here of course. There was certainly optimism and enthusiasm by management which resulted in trouble for iSoft, Cedar Group, Utilitywise and the renowned Australian law firm Slater and Gordon, which foolishly acquired Quindell’s personal injury business for cash in 2015.
All these companies had accruals of income in spades. Slater and Gordon paid £637 million for a business that had as its main asset an accrual of income that amounted to 40% of the year’s sales. They may wish now of course that they had not gone anywhere near Quindell as the value of Slater and Gordon shares have collapsed to virtually nothing, having been valued at over A$2 billion at one point. You see, all that accrued income never translated into cash.

The method employed by energy broker Utilitywise to recognise the revenues due from its energy suppliers depended on valuing an expected stream of commissions using a discount rate that reflected the risk that these may not be paid. To some people’s shock, Utilitywise suddenly reduced this discount rate by two-thirds with the obvious result that revenues and profits were dramatically increased. This significant change was tucked away in the annual report but just like the iceberg tip above the waterline it was a warning sign to steer clear. There was just too much flexibility in how Utilitywise made up its accounts.

Cedar Group’s shares tumbled like timber in the middle of a failed rights issue when it became obvious that the company was waiting on average nine months for its cash from the sale of software. In all probability the truth was that Cedar Group’s clients did not think that they owed the company that money. It was pretty much the same story years later at another software company where aggressive revenue recognition policies allowed sales to be significantly overstated. But a massive accrual of income of £50 million in the 2004 iSoft Annual Report was a warning sign that many missed. Surprising really because iSoft was a Cedar Group doppelgänger. Only some learn from past mistakes it seems.

Run a mile if you see related party transactions. UK investors got caught up in two small companies called Healthcare Locums...
and Erinaceous where the directors played happy families. Of course, doing business with friends and family was not the reason the share prices of these two companies collapsed but it should have been enough for investors to raise an eyebrow and put on their running shoes.

In the world of blue collar outsourcing, Mitie had parallels with failed Connaught but, thanks to the arrival of new management, the similarities were short lived – although only after they had had to significantly restate previous years’ numbers. There were quite a few accounting shenanigans at Mitie and Connaught. Both of these outsourcing companies capitalised significant start-up costs incurred in organising new contracts which allowed profits to be overstated.

NCC, a cyber security company that really ought to have been doing rather well, also capitalised significant items that allowed profits to keep moving ahead – until of course they confessed that development and software costs they had accounted for as assets rather than expenses were no longer recoverable at all. But this was not before they had raised cash for an acquisition by issuing shares at a price that reflected that all the development and software costs were going to be recovered.

Goodwill for Mitie and Carillion turned to badwill. It was not so blatantly badwill at Carillion but at Mitie it was, as the company continued to overvalue it as an asset even though the trading of a recently acquired healthcare company included in goodwill was deteriorating fast and significant losses were being reported. It said so in the 2016 Mitie Annual Report, so how could they justify a recoverable amount of £145 million for this business? The answer was they could not and they soon sold this business … for just £2!

Tribal Group is now an educational software company and is
doing well, but previously it had been a mish-mash and it suffered two share price dives. Too many acquisitions meant it lacked focus and frankly there were just too many tribes in the group to give coherence in the jungle of local government. And then it started accruing rather large amounts of income on certain contracts that well … went wrong.

Acquisitive companies often do not add shareholder value. Just ask all those investors who supported the acquisition of Matthew Clark, a doyen of the UK drinks sector, by Bargain Booze owner and new kid on the block, Conviviality. They must have been under the influence. The accounts clearly showed that Conviviality was feeling the effects of ‘acquisitionitis’ as it had to have two bites of the cherry(ade) as they reappraised and reduced the fair value of assets acquired at Matthew Clark some 22 months after buying it. That told us all we needed to know about the financial nous at Conviviality and, with that, its ability to manage large acquisitions and indeed its own business. It should have come as no surprise that Conviviality failed to account for tax and made mistakes in its forecasting.

Guardian IT, once the UK’s leading disaster recovery company, had its own disaster when it purchased leading rival Safetynet. The acquisition was no safety net for Guardian IT, though, as expectations at Safetynet were not met. Guardian IT, once a tech boom star, was gobbled up at a fraction of its former share price by SunGard Data Systems of the US. But it was clear from earlier annual reports that Guardian IT was not growing its core business but relying on acquisitions for growth.

It was obvious too that Slater and Gordon’s acquisition of Quindell’s personal injury business and Hewlett-Packard’s acquisition of Autonomy were bound to destroy shareholder value
because neither of the acquirees accounts stacked up – in both cases there was just too much subjectivity in revenue recognition. Neither Slater and Gordon nor Hewlett-Packard, it appeared, did the required level of due diligence expected of management.

Arthur Andersen moved from the limelight into the spotlight when Enron went bust. Enron had paid Arthur Andersen $27 million for non-audit services and $25 million for audit services which made this energy trading company one of its biggest clients. Arthur Andersen even felt that fees could top $100 million in total if things went their way. There were clear conflicts of interests here and when non-audit services reach a material level it is a warning sign that the numbers in the accounts may be more fiction than fact. That was the case at Findel, a UK discount retailer whose share price collapsed.

As a famous investment saying goes, a trend can be your friend. Analysing a series of numbers from one year to another would have been a useful exercise for investors in Toshiba. Normally balance sheet items like debtors and creditors move roughly in tandem with a company’s activity levels. When this trend is broken, further investigation is required. Sinking sales, a declining depreciation charge, soaring stock levels and plummeting profits between 2007 and 2013 could have been easily spotted at Toshiba. But this tawdry tale masked an even worse picture when profits were found to be overstated by some 40% following an enquiry by the Tokyo regulator. Management fell on their samurai swords.

At AO World, an internet retailer of washing machines and other white goods, a spike in spending on advertising with search engines – which was clearly shown in the company’s helpful IPO documents – indicated that there was a new cost paradigm in play and previous profits were going to be difficult to replicate. That
the trend of pedestrian growth in advertising with search engines like Google was over for this online retailer was either not seen by some investors, or just ignored. AO World has yet to report a profit since it floated – partly because of increased marketing expenditure – but curiously it did in the year before it listed its shares on the stock exchange, when spending on marketing was lower and directors off loaded shares to some established investors.

Sports Direct was another disastrous IPO. The shares dived like a swallow for 20 months after flotation, losing nearly 90% of their value. Of course that could have been because England’s finest footballers failed to qualify for the 2008 UEFA European Championship and Sports Direct had forecast good sales of white shirts bearing the three lions, but a glance at the IPO prospectus showed an unusual adjustment to inventories in the year before the flotation of the company that was worthy of a question or two.

So red flags everywhere. It is often the use of optimistic estimates, coupled with a liberal interpretation of certain accounting standards, that are the problem. The trouble with the UK’s current accounting standards is that they are too principles-based and allow leeway in the manner they are interpreted and applied. US accounting standards, by contrast, are far more rigid and prescriptive. IFRS 15 – Revenue from Contracts with Customers, a new accounting standard jointly agreed by the IASB (International Accounting Standards Board) and FASB (Financial Accounting Standards Board in the US), which came into force in January 2018, should put an end to the early recognition of revenues in a company’s accounts. It has taken sixteen years to create. Had it been around earlier, many of the recent accounting shenanigans we have seen in IT and support services companies
in particular may not have occurred. The world waits for similar regulations to do with financial instruments and leases to come into force, as they too will have a big effect on results.

In the meantime, it is worth remembering one thing: in any annual report, cash is fact (except in the case of outright fraud, as at the Italian dairy firm Parmalat, where $4.5 billion of cash was reported but did not exist) and everything else is a matter of opinion – or an estimate. Annual reports should be read from the back to the front, with scepticism and the understanding that auditors have limits on their investigative skills and are working under tight budgets. They often have to rely on management assurances for their information and they will not get it right all the time. Watchdogs, not bloodhounds, come to mind.

The concluding chapter of this book looks at what is wrong with the way the system – in terms of auditing, regulation, and so on – currently works and makes some suggestions as to how things may be changed for the better. All that apart, the overriding hope and aim of this book is to help investors to avoid the kinds of foreseeable disasters that its chapters examine.

Picking stock market winners consistently is very difficult – which is why even the very best professional investors rarely stay at the top of their game for ever. But avoiding stock market disasters – which is probably more important than picking winners – through the simple analysis of annual reports and the application of the Iceberg Principle can be done regardless of what themes and trends are playing out in financial markets. In this respect, the lessons in this book will help investors to be on top of their game all of the time.
**PART 1**

**Abracadabra**

**HOW PROFITS CAN BE MAXIMISED BY TURNING COSTS INTO ASSETS**

One way to make costs disappear is to change them into something different by calling them assets. That way the costs are removed from the income statement to the balance sheet, profits keep moving ahead, expectations are met, management keep their well-paid jobs and share prices stay up. This is allowed under International Accounting Standard (IAS) 38 – Intangible Assets, which states that development costs incurred by a company must be accounted for in this way as long as certain criteria are met. These criteria are:

- The costs are part of a project that is technically feasible and will be available for use or sale.
- There is the intention to complete the project – i.e. create the intangible asset.
The signs were there

- It can be demonstrated that the intangible asset will produce future economic benefits – i.e. that there is a market or economic use to the company for the product of the development expenditure.
- The company has adequate resources available to complete the development.
- The costs of the intangible can be reliably measured.

Once development costs have been capitalised (that is, counted as an asset rather than an expense), they are amortised (that is, the costs are gradually written off) over their useful life, starting from the point the asset is available for use. The trouble with cyber security specialists NCC, one of the two companies that feature in this section, was that the amortisation of internally generated software took place very slowly and development costs were not amortised at all. This kept profits up until, every now and then, these capitalised costs were written off through the income statement – which indicated that they probably should not have been capitalised in the first place.

Connaught, the failed public sector support services company that also features in this chapter, capitalised large amounts of staff costs it attributed to building a new software system. There is nothing wrong with this, but the amount being capitalised should have prompted suspicions. Connaught also capitalised large costs that had been incurred ahead of starting certain contracts. These costs were known as mobilisation costs and another International Accounting Standard, IAS 11 – Construction Contracts, allowed them to be capitalised and written off over the term of the contract. However, again, it was the size of these costs at Connaught that
should have raised concerns, especially as some of its competitors did not capitalise such costs but wrote them off.

The overriding lesson of intangibles included in a company’s annual report is that they cannot be precisely assessed or defined. Because of this, they offer great scope for companies to massage their profits (up or down) and so are always worth looking at with care in a company’s annual report.