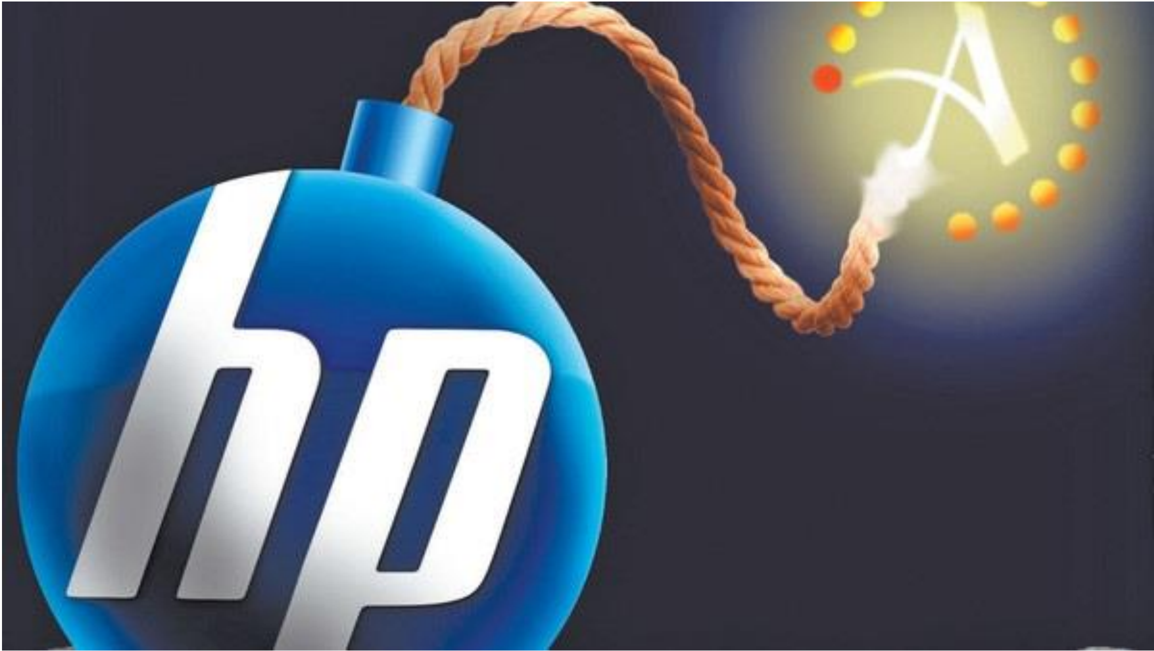

Eyes Wide Shut

BEHIND THE MASKS OF ACCOUNTING FRAUD

By Lev Janashvili and James A. Kaplan

Published in BusinessInsider | November 26, 2012

A Teachable Moment

Just a day after we published GMI Ratings' first "Black Swan Risk List", the biggest accounting scandal in recent memory burst into national news, conforming to our prognosis with uncanny timing. Hewlett-Packard, a prominent member of our risk list with an ESG score of 'F' and a forensic accounting risk rating (AGR®) in the second percentile, announced a massive write-down related to its acquisition of Autonomy.

The news caused a firestorm that continues to spread, fed by expressions of outrage and by equally heated postmortem commentary by analysts who anticipated – or should have anticipated – this debacle.

This is certainly a "teachable moment" (pardon the cliché), but we should not let the perfectly understandable outrage blind us to one of the central lessons that this latest scandal teaches us with unmistakable clarity. As we wrote last week, because bogus accounting remains rampant among public companies, investors and D&O insurers cannot continue to relegate forensic accounting to the margins of their analysis of issuer risk.

Today, we know that reported financials can materially distort economic reality — not only through fraudulent methods, but also through clever exploitation of accounting conventions. After accounting scandals erupt, the relevance of forensic accounting seems obvious. But progressive students of issuer risk understand -- before such events -- that their analysis is never complete without a thorough scrutiny of the integrity of reported financials.

HP: An Opportunity to Learn from Loss

No case study is conclusive, but the HP write-down is richly instructive. Our AGR® model has consistently rated HP's accounting and governance practices as "Very Aggressive". In fact, since December of 2009, HP's AGR percentile ranking has ranged between the 1st and 4th percentile, indicating a higher accounting and governance risk than 96-99% of AGR-rated North American companies. HP also has poor ratings based on GMI Ratings' Litigation Risk, Financial Distress and Equity Performance models. We wrote about HP's accounting practices in May 2012, and it is important to note that HP's pattern of aggressive accounting predates the acquisition of Autonomy in 2011.

Pre-acquisition AGR ratings for Autonomy also revealed significant accounting-related risks. Autonomy's ratings had fluctuated more widely, and they actually improved to the low-average range during the year before the deal with HP. But the ratings had dropped to the 3rd percentile as recently as June 2009. Autonomy's AGR risk taxonomy included red flags for Operating Revenue/Operating Expense, Asset-Liability Valuation, including Asset Turnover and Intangible Assets/Assets.

The historical AGR ratings and risk metrics for HP and Autonomy paint a stark picture of the evolution of a man-made Black Swan anomaly fueled by greed, enabled by flawed accounting conventions and the financial community's complacency about the integrity of reported financials. Agnes Grunfeld, GMI Ratings' Managing Director, explains:

> *"After the acquisition of Autonomy for $11 billion, HP allocated almost the entire purchase price to Goodwill and Intangibles. US GAAP does not allow for the amortization of Goodwill. So unlike Property, Plant & Equipment which is depreciated, or Intangibles which are amortized into expenses, there are no ongoing expenses associated with Goodwill. However, when the firm determines that the assets are impaired they have to be written down all at once, causing shock-waves. HP recorded $6.6 billion in Goodwill for this purchase, $4.6 billion in amortizable Intangibles and practically nothing in tangible assets. At the time, the offer represented a 79% premium above Autonomy's market value. Goodwill does a pretty good job of reflecting such rich valuations which is precisely why we track it in the AGR model.*

Second Black Swan Risk List of 40 Companies: Risk Characteristics

To continue our analysis of near-term Black Swan risks, we developed a more focused list of 40 high-risk North American companies with market caps between $5 billion and $100 billion. Just as last week's list of 200 companies, the new list identifies issuers with the most aggressive accounting practices based on our AGR model. Inclusion in this list signifies an elevated risk of adverse events that can materially affect share prices.

Not All Risk Ratings Are Created Equal

Importantly, while we selected the companies on this list based on their extremely poor AGR scores, some of these companies have average or even favorable ESG ratings. This is an important observation; it suggests that investors focusing exclusively on ESG research may be overlooking material sources of risk only captured in other non-traditional metrics such as forensic accounting. Still, companies with 'D' and 'F' ESG ratings are 10% above the distribution of the universe from which these companies were drawn.

Economic Sectors

Technology, Industrial and Healthcare companies not only feature prominently on this list, but they are also over-represented relative to the sector distribution of the universe from which these companies were drawn.

Clearest Red Flags

In last week's report, we also identified 16 specific risk metrics that most commonly characterize these stocks before the precipitous loss of shareholder wealth. In the new list of 40 companies, the same risk metrics predominate. In particular, risks stemming from compensation practices and high-risk events have a pronounced impact on issuer risk.

###

A version of this report first appeared on Business Insider, co-authored with James A. Kaplan.