

Marcellus: Accounting fraud and liquidity crunches are bedfellows



Major accounting frauds typically come to light when liquidity tightens. Given the over 2% point jump in money market rates in India in the last 12 months, the probability of major accounting fraud coming to light in the Indian stockmarket is growing.

“In many ways, capital markets are designed to circulate good news. Financial services firms...typically make more money when share prices rise. Corporate issuers are incentivized to announce good news...and investors to believe it. This dynamic is part of what occasionally creates asset bubbles and boom/bust cycles. Investors who remain objective and sceptical, while the herds echo and amplify each other’s excitement, have a better chance of profiting from the more blatant disconnects from reality.” – Howard Schilit, Financial Shenanigans (2018)

When liquidity tightens....

In recent months Marcellus has highlighted how a combination of a strong dollar, rising oil prices, strong government spending (fuelling booming consumption) alongside sclerotic tax collection almost certainly condemns India to rising interest rates and higher borrowing costs in the wholesale money market. The money market is now the lifeblood of the Indian economy since the CASA (current & savings account) funded public sector banks have been washed away by NPAs. In

this note, we dwell on a different dimension of the liquidity crunch – accounting fraud and why such frauds come to light in the midst of a rising interest rate environment.

....Enron, WorldCom, Satyam and Madoff emerge from the woodwork

The most spectacular accounting frauds usually come to light when the stockmarket is tanking and the cost of money is rising. So, for example, Satyam imploded in January 2009, four months after the Lehman bust triggered a liquidity freeze in India; the scandal in Enron came to light in October 2001, 15 months after the dotcom bust and a month after 9/11 had pushed the US stockmarket further into the mire; WorldCom filed for bankruptcy in July 2002 after having cooked its books frenetically in the wake of the dotcom bust; and Bernie Madoff confessed to his sons in December 2008 – three months after Lehman went under – that his wealth management scheme was in reality a massive Ponzi scheme. As night follows day, when liquidity tightens, big accounting scams come to light.

Why does this happen? We think there are three reasons. Firstly, the central driver of accounting fraud is the promoter's need/desire to siphon cash out of the company. When liquidity is easily available, he can either cover his tracks by borrowing money in his own name and infusing it in the company (say, through short term loans) or the company itself can avail of short term loans. The surfeit of liquidity sloshing around the company creates an impression that everything is alright. However, when liquidity tightens, these short term loans dry up and staff/suppliers/creditors raise the alarm that the company is out of cash. By this juncture, typically the Indian promoter has taken flight.

Secondly, the money that the promoter borrows is usually collateralised by either his properties or his shares. A liquidity crunch typically hits the value of both of these asset classes. That in turn leads lenders to issue margin calls to promoters.

Thus, the promoter – who has already pilfered money from his listed entity – now finds himself being chased by his lenders. It wasn't a coincidence we think that two prominent Indian jewellers took flight six months after wholesale money market rates started rising in India (from August 2017 onwards). Unless a miracle shores up the value of real estate and shares in India, we should expect more promoters to take flight rather than taking the trouble to meet margin calls.

Thirdly, in a growing economy corporates can show genuine growth in revenues and hence growing working capital needs. Hence in a booming economy everyone – shareholders, auditors, lenders – buys the logic of rising short term borrowing to finance working capital needs (even though the actual driver of higher borrowing might be the promoter's pilferage of cash). When the economy then slows – in the wake of rising interest rates – that fig leaf is removed. The auditors, with their professional reputation on the line, now become less willing to sign off on growing pile of receivables. Given that from 2018 onwards, the Ministry of Corporate Affairs has oversight of the audit profession in India, we expect an increasing number of auditors to pull the plug on promoters who are cooking the books.

Investment implications

The fledgling team in Marcellus, staffed with Chartered Accountants and CFA charterholders, spends most its time reading annual reports and building forensic accounting screens. Our models are telling us that a disproportionate number of Indian companies who have enjoyed generous lending terms from Indian lenders (private and public, banks and NBFCs) in recent years have smelly accounting. Therefore, unless there is a sharp pullback in the next six months in borrowing costs (say, on the back of a big drop in oil prices) the bells will toll for promoters who are fudging the figures and their lenders.

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