the art of boring™

EP 209 | Accounting Shenanigans and the Pursuit of Economic Truth

[00:00] Rob Campbell: Coming up on the Art of Boring, my colleague Alex Romaines joins me to talk accounting shenanigans. Alex shares how his training as an accountant shapes the way he looks at financial statements, why the economic truth of the business often diverges from what the standards allow, and what forensic accounting means in our day-to-day investment process.

We spend most of our time on stock-based compensation and some underappreciated implications for investors. We finish with a quick tour of some other accounting flags on Alex's radar today, from stretching depreciation schedules and vendor financing to the quiet comeback of special-purpose vehicles.

[00:40] Disclaimer: This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

[00:56] Rob Campbell: Alex Romaines, welcome to the podcast.

[00:59] Alex Romaines: Thanks for having me, Rob.

[01:00] Rob Campbell: I am excited to speak to you today on the topic of accounting shenanigans.

Before we dive in, I just thought I'd step back for a second. One of the things that I think is really great about our research team is that we are not all clones of one another. Analysts and portfolio managers come from a wide variety of life experiences and backgrounds and different ways of thinking. These are all perspectives that we then bring together to make investment decisions. I'm going to suggest that you probably do not have the most exotic backgrounds of our team, but you were trained as an accountant. Can you start by sharing just how that lens shapes your day-to-day job as an investor?

[01:35] Alex Romaines: Definitely not exotic. I don't think anyone would describe accounting as exotic, but it was good training for investing. I think there are aspects of accounting where it puts people to sleep, but I think a lot of it is really good grounds for understanding financial statements.

When I trained in accounting, I did bookkeeping and then moved into audits. You get to see the other side. When you're working with a client, they have a way that they want to present their financials, and then it is your job as an auditor to determine whether that actually is going to be okay with respect to the accounting standards.

You get really good knowledge of all different kinds of businesses. The gap is that your job as an auditor is not to decide whether or not the accounting standards are fairly representing the economic reality. When you transition to being an investor and you're on the outside looking in, that's your job.

You have to ask: is what the business is presenting, and the auditors said, "Yeah, this is good. This is in line with the standards." But you have to ask: okay, where might this deviate from the actual economic truth?

[02:46] Rob Campbell: There is a huge amount of judgment that goes into some of these accounting decisions.

[02:50] Alex Romaines: Exactly.

[02:51] Rob Campbell: So, two different lenses, depending on which side you're on. Besides the training, what's been formative in shaping your view as you've gone from the auditing side to the investment side?

[03:00] Alex Romaines: When I was training to be an accountant, I did a course on valuing companies, and that was what got me interested in the investing side of it. I think my first exposure to accounting tricks, or ways companies might present their financial statements a little differently from what you might consider to be accurate, would be this book I have right here, titled *Accounting for Growth*.

It is super old and written by an English investor, Terry Smith, who is well known in the UK. Sometimes people call him the English Warren Buffett. In it he highlighted a number of public companies and assessed how they were doing their accounting. He felt that there were a number of ways in which a company might misrepresent their accounts, and if they did these accounting tricks, he would put a mark under their accounting shenanigans, as he saw it.

He showed that companies with more accounting shenanigans subsequently performed a lot worse in terms of their stock price and, in extreme cases, went bankrupt and turned out to be frauds. This is forensic accounting, always looking for fraud and crime, but it is all intertwined. That was my first exposure to it, and I found that kind of a fascinating tool for an investor.

[04:21] Rob Campbell: You mentioned Buffett, he's written on this concept quite a bit too.

[04:24] Alex Romaines: Buffett has as well, yeah. He is a very good accountant, as well as a pretty good investor! He's written extensively on the topic, and if you go back and read his letters to investors, he's not afraid to really get into the weeds of what might be the economic truth as compared to the way the company is presenting it from an accounting basis. We'll get into share-based conversations and things like that, and that's the topic that he's spoken quite a lot about.

[04:50] Rob Campbell: I know you're involved in our analyst training program, helping new people who come to the firm as they're being trained in our process and our philosophy. You are often brought in to talk specifically about the forensic accounting process. Can you just share a little bit more about what that is, why we do it, and kind of what that looks like day-to-day?

[05:10] Alex Romaines: We cover why it's important, and I think for new people coming in, it's great to give them that lesson: "Oh, hey, you're going through your financial statements." A lot of people coming in have some familiarity with that, but then you go through the ways that maybe they're going to be different.

The really important fact is that this is not some distinct checklist that you do to tick a box. This actually really helps you get to the truth of what a company is earning, which is going to be the basis for your valuation. Obviously, you have to prognosticate that growth could do this, and margins could do that, but step one is figuring out what the company is actually earning today. That is the really important piece.

There are a number of different elements to the course, and one is forensic accounting. Part of the required reading is a second book that I have here.

[05:56] Rob Campbell: He's got more than one prop!

[05:58] Alex Romaines: Yeah, I've read at least two books. *Financial Shenanigans*, by Howard Schillett. I think this is kind of the modern bible for accounting tricks, and there are so many good examples in this book.

It's not just, oh, here's what the accounting says, here is what it should be. It is littered with examples of companies that have often blown up, and it details all the warning signs that were in the lead up to that.

It is a really good book, and I like to sit in on meetings where we discuss that and share ideas with people.

[06:27] Rob Campbell: I think to your point earlier, it's not about identifying the blow-up. It is not necessarily black and white like that. It's about what the accounting tells us that might be different than the economic reality of a business.

Where can we poke a bit further, do more research, speak to management, and get a better handle on a specific aspect or change that we notice. As I understand it, that's really the motivation.

[06:47] Alex Romaines: That's exactly right, and we don't short-sell here, so you hope that most of the companies that you screen or flag as good investments are not going to blow up. You're hopefully not going to encounter too many frauds, because you are not looking for them. However, the tools are still important, even for good companies.

Obviously, there are very good companies that still want to present themselves as best as they can. So, it's your job to see where that might deviate.

[07:13] Rob Campbell: The reason we are having this conversation is because a couple of weeks ago in a team meeting, you brought up a specific shenanigan, an oldie but a goodie. I think you had some aspects that were worth reviewing for everybody and then pieces that were maybe underappreciated by the market. That is on the topic of share-based compensation.

For listeners who are unfamiliar, what is share-based compensation, why do companies employ it, and how material is it out there in the investment universe?

[07:39] Alex Romaines: It's very material. I focus on the U.S., and it is a really huge form of compensation there. Companies will pay their employees in stock (or in options, although options are less popular now), as a way of attracting talent.

In some cases, it is an important tool for companies to attract top talent. The stock compensation piece of an employee's compensation can often sway them into where they're going. It is very, very important and it has been around for a long time.

I would say the last time you had real debate about the use of equity compensation was around the tech bubble—the last one. Stock options were really popular then with Silicon Valley companies, again, as a way to attract staff.

If you're a startup, you do not have much cash. It’s hard to pay people huge sums in cash, so you pay them in stock options. Then the company IPOs and the stock price goes through the roof, the employees can make a fortune.

It was great at the time because you did not have to show an expense on your income statement. And also, if you were issuing those shares, you were potentially transferring a lot of the cost to your shareholders. It worked for a while, but there was a lot of pushback.

Buffett was someone who spoke extensively about this topic. He pointed out the fact that this is a very real expense for the other owners of the business. Eventually, the accounting standards changed, and stock options had to be recognized as an expense.

I wouldn’t say the use of stock options went away, but it was definitely greatly reduced. Stock-based compensation did not go away, and it has become more and more popular to pay employees with large amounts of stock.

There are a few potential pitfalls here, and issues where, if you just look at the financial statements, you might not get a clear picture of what the real costs are.

[09:29] Rob Campbell: I wanted to get into those, just to better understand. You mentioned that the standards changed where you did have to expense these things, but they might not always show up in the reported earnings.

[09:39] Alex Romaines: The first piece with specifically stock-based compensation, is this shenanigan where in the GAAP accounts it will be shown, but the company will try and redirect investors' attention to adjusted figures.

The first shenanigan I see quite frequently is that companies will simply add this back to their earnings and then report adjusted earnings, such as adjusted operating income, and EBITDA adjusted net income.

[10:07] Rob Campbell: This is Charlie Munger's, “when you see adjusted earnings…all shenanigans.”

[10:11] Alex Romaines: Yes, use another word. Accounting bodies spent a long time trying to clean everything up. And so, I guess companies gave up trying to deceive them and just said, “Okay, we will just add it back and report a different number.”

For some reason, this is accepted quite broadly and you'll see a lot of research that takes these adjusted figures for face value. But there aren't too many reasons why you should be adding back that expense with respect to stock-based compensation.

There are some exceptions which we can get into, but by and large, you should be considering this an expense.

If you see a company say, “Our net income is X, but we are adding back the stock-based compensation and our adjusted net income is Y,” you should probably be looking at X.

[10:55] Rob Campbell: Okay, and if you are an investor who looks at valuation through the lens of price earnings multiples, for example, and you are just assigning a multiple to these adjusted earnings, you could be really missing out on some of the true costs in the business.

[11:07] Alex Romaines: Yeah, that's a big one. If you go on your financial software, often the forward P/E is going to use the adjusted earnings as the company presents them. So, if a company just adds stock-based comp back into that figure, then that is the figure you're going to be looking at if you do not go through it yourself.

By way of example, I remember analyzing a company five years ago and I saw that they were adding back their stock-based compensation to their adjusted earnings. It was pretty significant, so I ran a forensic accounting screen, and that was one of the flags. We ended up avoiding it, which subsequently has underperformed the S&P 500, not just because of that issue, but it just highlights that this can be a useful tool.

Today, if you open up a number of different investment reports from large U.S. tech companies, you are going to see them adding back stock-based compensation to get to their adjusted net income.

[11:58] Rob Campbell: You mentioned earlier that there might be good reasons to do that and might not necessarily be a shenanigan.

[12:05] Alex Romaines: Yes, I'd always advise caution when adding things to make the net income go up, but there are situations where it might be appropriate. If you have, for example, an IPO and a company issues an extraordinary amount of stock units associated with that event, or if you have an acquisition and an extraordinary amount of units issued in that event, you could say, “Okay, this is not something that's going to happen every year. When I'm doing my valuation, I should not assume that this is like a run-rate level of stock-based compensation.” That's one example.

I think at other times, with specific types of units that are conditioned on performance, if it becomes unlikely that that performance is going to get hit, I believe that even under the accounting standards you would end up reversing the original expense. So, if you see that reversal going through, that is okay.

[12:54] Rob Campbell: One of the reasons why stock-based compensation is obviously a cost is that, as an owner, there is a dilution that goes along with it. Do companies typically try to offset that dilution by buying back shares?

[13:05] Alex Romaines: Absolutely, yes. This is the second layer of the shenanigan. I was reading a post by Michael Burry, who people will know from *The Big Short*. Burry actually used to write a lot of stock blogs, and earlier in my career these served as really helpful tools for understanding how to think about analyzing companies. He raised this exact point that companies are buying back the stock, but the cost of buying back that stock is potentially a lot higher than what we are seeing flowing through the income statement.

The reason for this is due to the accounting. If you take stock units, typically they're going to be either restricted stock units or performance stock units. Performance stock units are different because they're conditioned on performance. Usually, that's either going to be something internal, like revenue target being hit or an EBITDA target being hit, but sometimes it is an external thing. It might be conditioned on the stock price reaching a certain level.

Restricted stock units are quite straightforward. If you issue an employee 100 units and the stock price today is $1, your expense is $100. Now those are going to vest, say over four years, you just do $25 a year on the expense.

But you can see that this is very problematic if the stock price goes from $1 to $10, and then you have to buy back those 100 units, because it is going to cost you $1,000, but you are only flowing through $25 a year on expense.

[14:36] Rob Campbell: So, you have an estimate of what it might be worth today, based on the assumption that the current stock price is the basis for what that will be over the next several years. You're saying that in a rising market environment, or more specifically for a fast-growing company that is doing really well, it really understates the true cost of what it will take to buy back those shares.

[14:55] Alex Romaines: Exactly. I have had some people say, “Oh, it's only a problem if the stock price goes up.” And I say, “Well, you are probably looking at it because you want the stock prices to go up.” And you're happy if it goes up. But it does create this issue when the company has to buy back its shares to offset the dilution, it is going to cost them a lot more.

That is real money out of your pocket because that money could be used to pay a dividend, they could do an intelligent acquisition, and they could buy a productive asset. It's definitely a cost to shareholders, and I don't think it's fully appreciated.

I don't think the accounting standards have a great way to deal with it. You could potentially adjust the expense in each vesting period for what the current stock price is, which might get you closer to the truth. It is definitely a problem, even with performance stock units. Now, I mentioned you get internally based or externally based. As you go along a vesting period, you have to assess whether those targets are likely to be hit and what the likely amount of units are to be issued because often it's going to be the case that revenues at this level, you may get this many units. And If it's at this level, you get this many units.

So there's judgment there, but it still uses the grant-based share price. You still kind of have the same problem. And then for the externally conditioned units, it gets even more complicated.

I don't have the accounting standards fully memorized, but you do a Monte Carlo simulation when the awards are given to value those units based on what the potential scenarios are going to be for what the stock price might be and then the number of units given. But again, you're basing it on that Monte Carlo evaluation done at the time of the award. If the stock price is rising and rising and rising, you're going to get this problem where it's going to cost them a lot more to repurchase their stock than it's showing in the P&L.

[16:35] Rob Campbell: You mentioned different sides of the fence...I wonder if you could jump over once again. I think if I'm hearing you're right, you're saying, okay, there are aspects of stock-based compensation that are well known, so shenanigans that have been in place for a long period of time.

Maybe underappreciated is just this element of what it might cost to buy back shares. That doesn't get as much attention as hoped. Do you feel that's something that's underappreciated by just investors or, again, going over the fence is management pretty well aware of this? Do they plan for this? Presumably they're the beneficiaries in many cases.

[17:08] Alex Romaines: This is the thing. A lot of the people working at these companies have become extraordinarily wealthy from this dynamic. The cynical view is that this is a transfer of wealth from external shareholders to insiders of the company.

And I would assume that the management and the insiders of the company are generally aware of this, but it doesn't contradict any accounting standards. [They're] not doing anything wrong or illegal. It's just they're operating as they're allowed to and their share price goes up drastically. Then the recipients are going to make a lot of money. And generally speaking, their shareholders are going to foot the bill for that.

[17:42] Rob Campbell: What do you do as an investor about this? We mentioned earlier this simple valuation method of applying multiple to earnings or adjusted earnings could really get you into trouble. Is there a preferred way of treating some of this or evaluation method that you think helps to address and correct for some of these shenanigans, permissible or not?

[18:03] Alex Romaines: It's probably not a really well-developed area of business valuation, but I've seen a couple of attempts to do it, which I think at least get you in the right area. I think the most important thing is just to consider it. If you're just not considering it at all, then I think you could get burned. So just try and consider it and try and come up with an estimate.

And the way I've seen it done is you can estimate what it might cost annually to buy back those shares, which obviously is going to require you to forecast the stock price which can be a little tricky. But at the very least, you can adjust today's earnings what they're actually paying to buy back those shares.

Another approach would be to perpetually dilute the stockholders. So you assume that the shares are

not going to get repurchased, but the stock is going to perpetually dilute and then that is going to impact your evaluation as well. It's another tool which can get you probably a more accurate picture.

So there are definitely ways to do it. It is fiddly, but I think as long as investors are just looking at what the cost is and considering it, factoring into the evaluation somehow, they're going to probably get a better result.

[19:08] Rob Campbell: And it sounds like with many things, a probabilistic approach to this is often useful from a mindset perspective.

[19:14] Alex Romaines: Yeah, exactly. I mean, what's happened has happened. You're investing based on the future and there's a number of different ways that can play out.

[19:20] Rob Campbell: I know we mainly wanted to talk about stock-based compensation, but while I have you, other shenanigans that you think are particularly noteworthy and worth looking out for as investors.

[19:30] Alex Romaines: Some that I've seen recently, I won't go into the same amount of depth, but they're interesting at the moment. The first one would be depreciation schedules. I know a lot of people have talked about this.

It's another old school shenanigan. Companies have a reasonable amount of leeway as to how they depreciate their assets, as long as it's not way off base with what others in the industry are doing.

If you take an asset and you say, well, I was depreciating it over five years, but now I'm going to depreciate it over ten years, or your depreciation expense goes down, and your earnings go up. Again, it can look like you're earning more than you are. And where this debate is really centered at the moment is with the large tech companies because they have been changing their depreciation schedules, lengthening them specifically, with computing and networking equipment.

Some of that equipment is cutting edge GPUs. And the cynical argument is while these GPUs are being released at a faster and faster cadence, presumably they're becoming obsolete more and more quickly. So why are they being depreciated over a longer, longer period?

So that's something I think investors should probably be looking at and considering when they say, okay, company is earning X dollars, but if they change that depreciation schedule, you might think, okay, well, it could be lower.

[20:52] Rob Campbell: For clarity, are you suggesting that the depreciation schedules that are being used for these GPUs, for example, are just longer than what their useful lives are likely to be? Or are you saying that some of these companies are actively increasing the time of depreciation, like shifting it up, even in the face of this fast-moving technology cycle?

[21:11] Alex Romaines: You'd have to get like a semiconductor specialist to really weigh in on what the useful life of these are. I don't have that level of expertise, but there is a clue from the fact that they're

coming out more and more rapidly. The compute is so much more improved each time that maybe they are useful for less long than we think they are.

But I can tell you that the large tech companies have been increasing their depreciation schedules three, four years, two, five, six years in many cases.

[21:40] Rob Campbell: What else is on your radar?

[21:41] Alex Romaines: The other one that everyone has kind of seen recently has been vendor financing. So you've probably always seen those diagrams where all these different companies in the AI ecosystem have all the arrows going in different directions. This is another one from the tech bubble. You had so many companies that were doing this, and in many situations it ended badly.

So, it's like, we sell to you, but you don't *really* have the money to buy from us, so maybe we lend you some money, or we invest in your company, and here's a check. There's different ways you can do it, but essentially you're funding your customers. If you're looking at a company that's generating significant revenues by doing this, there is a chance that those revenues aren't going to be durable.

The last one which I kind of thought was dead is special purpose vehicles. If you remember Enron, which we all do, that was one of their key features was the use of all these crazy special purpose vehicles. Something I've seen recently is that companies are creating SPVs to house the debt to build data centers.

Those are kind of making a renaissance. If you are looking at a company and you think, *oh, well, their debt is this,* I believe it's going to be case-by-case as to whether or not it's on balance sheet and whether or not it's recourse. But just the fact that companies are doing this, is potentially something that investors are going to want to look into.

[23:07] Rob Campbell: And to your earlier point, the “step one” is to really make sure that you're considering this.

Alex Romaines: Exactly.

Rob Campbell: One question I have before we wrap up is so many of the examples that we've gone through have all been in the technology space. Is there a particular reason why that is, or are these just simply we're in a market today that's dominated by massive tech companies and so obviously that's what we'll talk about?

[23:26] Alex Romaines: It's more the latter because while I have seen some of these shenanigans outside of the tech space as well, because tech has become such a massive part of the U.S. market where I'm focused—even in the midcap space—it's a lot of tech, a lot of semiconductors that are the large, fast growing companies at the moment. The stock-based compensation issue is a bigger issue if your stock price is rising rapidly. It just sort of happens to be the best sector where that has really occurred.

So the difference between what's presented in the financials and the economic reality is just wider.

That's why it's more pertinent an issue in that space. But the issue of paying people in stock, adding back stock comp to your adjusted earnings, is not exclusive to the tech sector.

Adjusting your depreciation schedules is not exclusive to the tech sector. So no, I don't think there's anything specifically about tech that makes them more inclined to use accounting shenanigans, but it's just that that's where all the money is flowing into today so consequently we're seeing the larger issues.

[24:31] Rob Campbell: And the bigger impacts as investors.

Well, great. Alex, really appreciate your time.

Appreciate the insights. Appreciate the book recommendations. Thanks again for joining us.

Alex Romaines: Thanks for having me on.

Rob Campbell: Hi, everyone. Rob here again.

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