Staying Vigilant in 2021:

Lessons from COVID-19 Accounting Distortions & Past Blowups (Wirecard and Carillion)

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Outline

- The Veritas Forensic Analytical Framework
- Earnings manipulation:
  - Divergent treatment of COVID-related costs and their nature
  - Detecting understated provisions for bad receivables
  - IFRS 9 disclosures and risks at Canadian banks
  - Creative interest capitalization to meet guidance
  - Change in accounting assumptions to boost earnings
- Same Store Sales Growth manipulation
  - Exclusion of stores closed due to COVID and inclusion of ‘lost’ sales
- Cash flow manipulation:
  - Selective definitions of FCF
  - Supply chain financing pitfalls
- Other items: The usefulness of Going Concern note
- Case studies: Carillion Plc and Wirecard AG

The Forensic Mindset

1. Understand the Story.

- What is the market excited or not excited about and on what is that excitement based?

2. Approach each Story with a blank mind

- "If you look hard enough at something, you can trick yourself into believing its true.

3. Learn how to read a situation

- Recognize that that nothing happens without a reason. Look for cause and effect.

4. Deductions should be based on evidence.

- Look for facts; don't let your hunches blur your perceptions.

5. Focus on the people. Never give up the opportunity to listen.

- Businesses don't run themselves. Listen/read what is said and not said.

6. Never underestimate anyone.

- Fraudsters are not generally born – focus on the motivation.

7. Learn how to recognize vital facts from incidental facts.

- This requires practice and skepticism to perfect.

Analytical Framework: Key Areas of Study

- Business Operations
- Accounting & Disclosure
- Cash Flow Sustainability
- Balance Sheet Risks
- Corporate Governance

Analytical Scepticism Framework

Business Innovation = Earnings & Multiple Expansion

Accounting Innovation = Not Sustainable

The Forensic Framework: Identifying Opportunities

1) Evaluate the Business & Reporting Control Environment

2) Identify Flammable Items

3) Look For Sparks

1. Evaluate Business & Reporting Control Environment

- Understand the business
- Understand the story
- Understand accounting/disclosure and key performance metrics relied upon
- Assess control/organizational structure
- Evaluate the management incentive structure
- Adversarial management team
- More concern over stock price than business ops

2. Identify Flammable Items

- Relatively high debt and little room on covenants
- Persistent negative free cash flow
- Strategic reliance on acquisitions or asset sales
- Weak internal controls
- Decentralized reporting structure with up or out employee culture
- Changes in accounting policies/estimates
- Non-GAAP metrics that distort economic reality
- Powerful CEO/weak CFO
- Newer public companies
- Employee/Supplier/Competitor corroboration
- Change in strategic focus/ management's tone

3. Look for Sparks

- Economic, competitive shocks / business model disruption
- Missed expectations
- SEC / regulatory investigations
- Short seller report
- Harder to make acquisitions (higher multiples etc.)
- Increase in debt and associated covenants
- Persistent negative FCF

Looking Ahead

- We are already seeing signs that companies are playing with their numbers.
- If economy stalls, incentive to manage results will intensify

Where to Look: Finding Regulatory Filings

Local regulatory filings: check for red flags/inconsistencies

I. Ensure you are using the legal subsidiary name
II. Use annual filings and MD&A to see what regulatory bodies company reports to
III. Find subsidiary website and look for documents / press releases
    a. Sometimes subsidiaries file their local regulatory financials on their websites (eg. Brazil)
IV. Find the applicable organization that regulates the sub (financial or industry).
    a. UK: Companies House
    b. Australia: Australian Securities & Investments Commission
    c. US Natural Gas Pipelines : Federal Energy Regulatory Commission
    d. India: Ministry of Corporate Affairs
V. Search by board members as they will typically sit on multiple sub boards

Where to Look?

- Financial Statements & Notes
  - Internal controls certification
  - Expanded audit report – critical audit matters
  - Accounting policies note, receivables, inventory, acquisitions
  - Consider estimates used
  - Clarity of disclosures

- MD&A and Investor Presentations
  - Assess the Non-GAAP metrics used
  - Clarity of explanations of results
  - Risk section – monitor YoY changes

- SEC/OSC correspondence letters

- Interview Management/Competitors/Past Employees etc.

Where to Look?

- Management Proxy
  - Management compensation. Ownership?
  - Board composition and experience?
- Annual Information Forms
- Insider filings
- Business Acquisition Reports (8K)
  - Change in accounting policies
  - Adjustments to assets/liabilities
- "On the ground": LinkedIn, Glassdoor, competitors
- Earnings calls: changes in tone

Earnings Manipulation

COVID Costs: Inconsistent treatment

- *Divergent treatment of costs hurts comparability*
- COVID-related costs: Plant closure/ramp up, facility cleaning, protective equipment, bonuses for factory employees
- Similar companies, similar costs, different treatment

Medical Device Companies: H1-F20

In USD per share	DexCom	Cooper	Medtronic
Adjusted EPS	1.23	3.79	1.20
COVID 19 impact excluded / (included)	0.11	0.71	(0.27)
Overstate / (understate) compared to peers	9%	19%	-22%

COVID Costs: Government Subsidies

- *Some are more consistent than others*
- Iamgold: Excluded both costs and subsidies

in millions	H1-F20
COVID costs, net of est. tax	10.24
Less: government subsidy, net of tax	(4.32)
Net impact on reported Adj. earnings	5.92
Adj. earnings reported	16.50
% impact on Adj. earnings	36%

COVID Costs: Treatment of Subsidies

- *Good stuff in, bad stuff out*
- Ulta Beauty (ULTA:NSQ, $15B mkt cap, US Retail cosmetics chain):
  - Excluded costs but include benefits

in millions of USD	Qrtr ended Aug 2020
Adjusted net income - reported. *Excludes $21m of COVID-related costs*	41.5
Less: government assistance (employee retention credits) included above	(48.2)
Veritas adjusted net income	(6.7)

COVID Costs' Exclusion: Large Canadian Filers

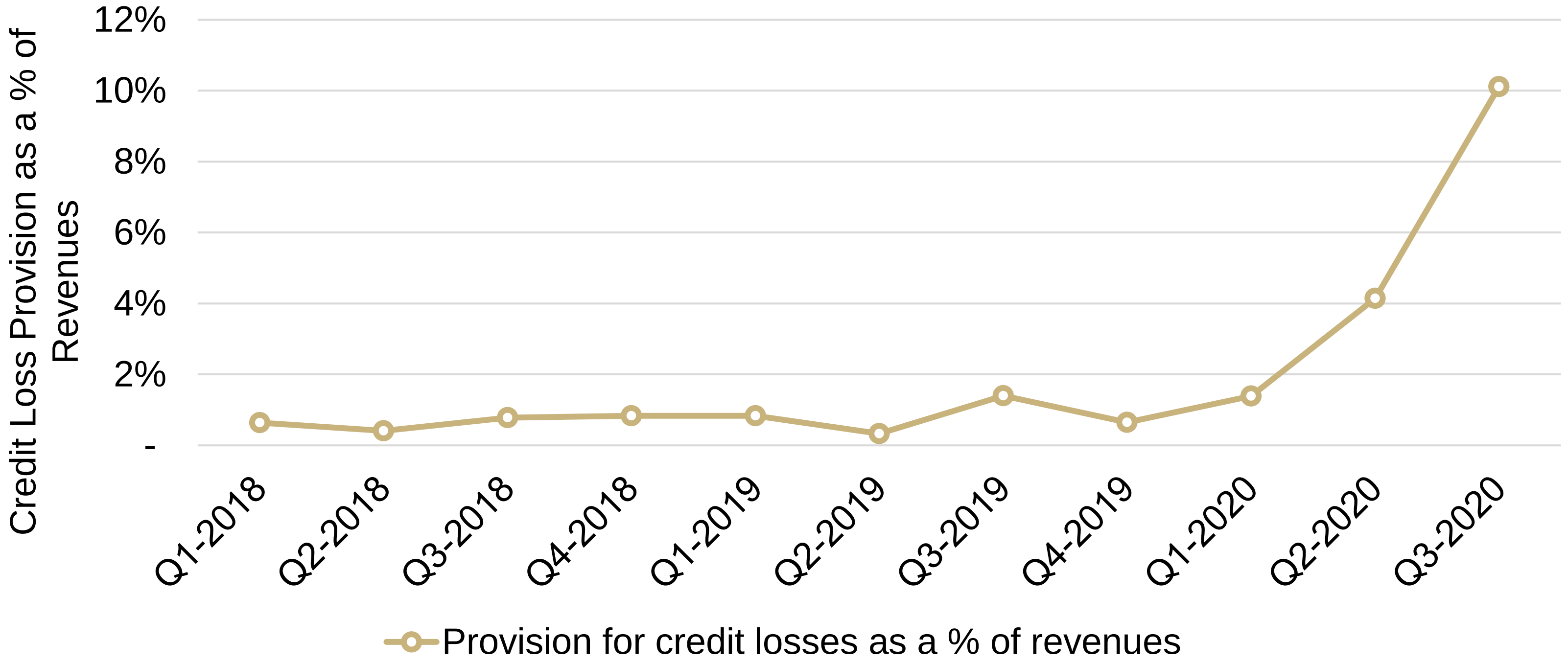
- *Watch out for inclusion of unusual costs in the COVID bucket*

Company	% Impact on Adj EPS*	Nature
Teck Resources Ltd.	**75%**	Labor, remobilization, care and maintenance costs, **financing expense that would be capitalized absent project suspension**
Teranga Gold Corp	**11%**	Incremental costs related to personnel and accommodation
First Majestic Silver Corp.	**57%**	Standby costs
Pan American Silver Corp.	**79%**	Care and maintenance costs
Alamos Gold Inc.	**11%**	Labor costs for idle employees and additional transportation and lodging costs
Torex Gold Resources Inc.	**225%**	COVID-19 screening, safety equipment purchases and cleaning
WSP Global Inc	**17%**	Severances and restructuring
Company	**% Impact on Adj EBITDA**	
Jamieson Wellness Inc.	**11%**	Protective equipment, wage premium, **reserve against A/R & inventory related to bankruptcy of a retail partner due to COVID**
Primo Water Corp	**11%**	Front-line incentives protective equipment/supplies

**YTD Q3-F20 or H1-F20*

Provision Adequacy: BPY

- *Compare provision expense to collections and tenants' health*
- Provision for credit losses have increased to 4% and 10% of revs. even though BPY has not collected 65% and 30% of its rents in Q2 and Q3, respectively



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Retail REITs: Key factors to Assess Allowance and Provisions Quality

- *Calculate provision rate and compare collection across companies*
- While RioCan and SmartCenres who ‘underprovided’ in Q2, caught up in Q3, First Capital Realty Inc appears more aggressive

	Q2-F20 rent not collected	Bad debt as % of rental revenue	Implied provision rate	Q3-F20 rent not collected	Bad debt as % of rental revenue	Implied provision rate
	A	B	B/A	C	D	D/C
CT REIT	3%	1.2%	44.5%	1.2%	0.7%	58.3%
Choice Properties	11%	4.6%	42.0%	2.0%	1.6%	81.8%
Crombie	10%	9.0%	90.4%	5.0%	1.1%	21.9%
First Capital Realty Inc.	25%	10.3%	41.3%	8.0%	2.1%	25.9%
RioCan	27%	7.2%	27.0%	6.6%	5.4%	82.1%
Smartcentres	26%	8.2%	31.7%	5.1%	5.0%	99.3%

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TC Energy: Capitalized Interest

- *Check the rationale used to capitalize interest. Is there a >50% likelihood project will be completed?*
- "…***<u>the inclusion of previously impaired capital costs in the basis for calculating capitalized interest</u>*** following our decision to proceed with construction of the ***Keystone XL pipeline***.
- TRP now meets its guidance of "flat" YoY comparable earnings
- Helps boost operating cash flow as well

in millions	Q2-F20
Capitalized interest - YoY increase	43
Comparable earnings	863
Impact on non-GAAP earnings	5%

UPS: Assumption Changes Inflate Earnings Growth

- *Watch out for changes in accounting assumptions*
- Lengthened useful life of building improvements, vehicles and equipment
- Reduced self-insurance reserves from the mid-point to the low end of the actuarial projected range of loses

in millions	2019	2018	% Change
Adjusted net income	6,543	6,301	4%
Reduction in depreciation expense	(167)	-	n/a
Reduction to self-insurance reserves	(72)	-	n/a
Veritas adjusted net income	**6,304**	**6,301**	**0.05%**
% overstated	**4%**		

Learning Moment:
Accounting for Bank Bad Debts - IFRS 39 & IFRS 9

Banks: IFRS 9 Offers A Lot of Flexibility

Stage 1

Non-Impaired Financial Assets: Financial assets which have not exhibited a significant increase in credit risk. Allowance for Credit Losses (ACL) for Stage 1 loans represent Expected Credit Losses (ECL) over the next twelve months for the underlying asset

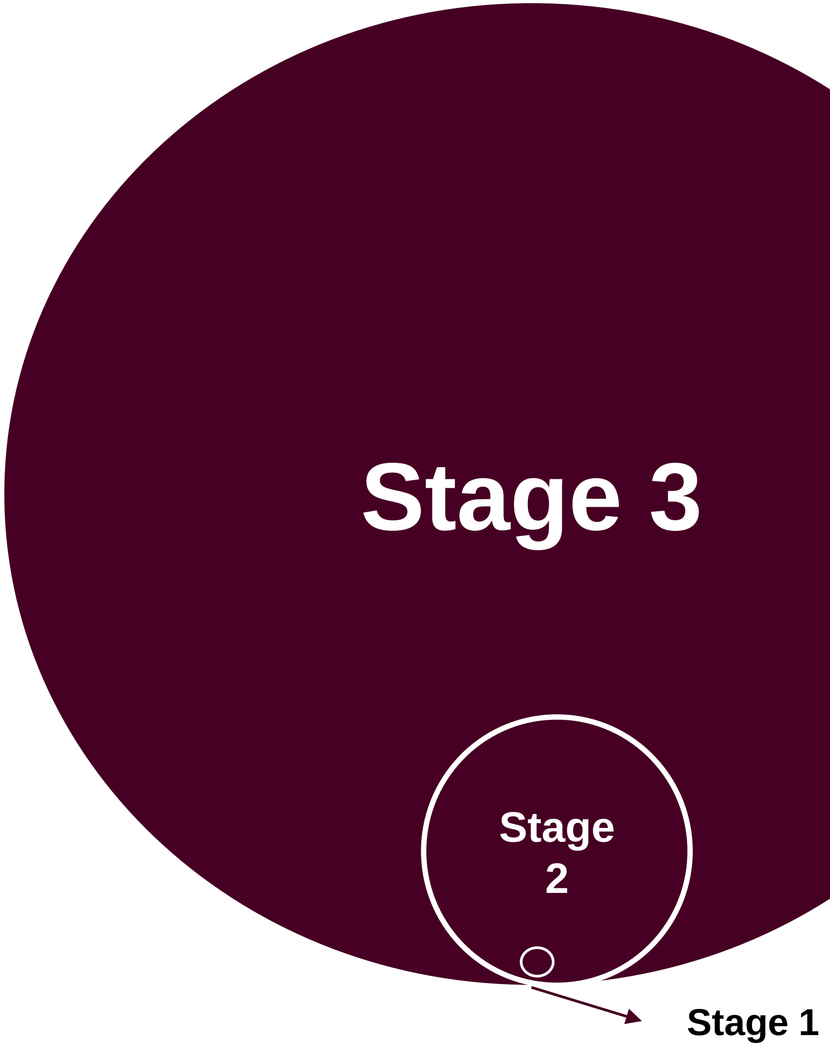
Stage 2

Financial Assets exhibiting a Significant Increase in Credit Risk ('SICR'): While each bank may have its own internal modeling for SICR events, the most relevant metric for determining a significant increase in credit risk is days in arrears with banks typically setting a threshold of 30 days in arrears. ACLs for Stage 2 loans represent **ECLs over the life of the underlying asset**

Stage 3

Impaired Financial Assets: ACLs for Stage 3 loans, which are classified as impaired, represent lifetime ECLs and are equivalent to the prior accounting standard for PCLs under IAS 39

Visualizing the Impact of Migration on PCLs



Potential Sensitivity to Performing Loan Losses

- *Key factors: higher portion of stage 2/3 loans; % of deferred loans in stage 2; pessimistic FLIs; higher weighting to adverse case; and lower threshold for SICR events*

More Conservative	Less Conservative
Bank of Montreal	Scotiabank
National Bank	CIBC
RBC	TD Bank

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COVID 19 Deferrals: Big Six Banks

- *More deferred loans = more risk. Higher percentage of deferred loans in Stage 2 highlights more conservative provisioning for performing loans*
- Deferrals largely expire by the end of Q4-F20
- Scotiabank and RBC had the highest percentage of deferred loans

As % of total loans Q2-F20	BMO	BNS	CM	NA	RY	TD	Consolidated
RESL	3.9%	7.7%	8.0%	2.3%	6.1%	4.7%	5.8%
Credit Cards	0.1%	0.6%	0.0%	0.0%	0.2%	-	0.2%
Other Personal	0.6%	1.2%	0.2%	0.0%[1]	0.6%[2]	0.3%[3]	0.5%
Non-retail	2.3%	2.5%	1.0%	2.8%	2.5%	1.5%	2.0%
Total Q2-F20	6.8%	12.0%	9.2%	5.0%	9.3%	6.5%	8.6%

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Big Six Banks – Deferred vs. Stage 2 Loans

Residential Mortgages	Deferred	Change in Stage 2	Difference (bps)	Change in Stage 2 / Deferred
Bank of Nova Scotia	17.55%	1.48%	1,606	8.4%
TD Bank	16.22%	0.63%	1,559	3.9%
CIBC	16.67%	1.19%	1,548	7.1%
Bank of Montreal	15.73%	1.25%	1,447	7.9%
National Bank	16.19%	1.85%	1,434	11.4%
RBC	15.15%	4.88%	1,027	32.2%
Credit Card	**Deferred**	**Change in Stage 2**	**Difference (bps)**	**Change in Stage 2 / Deferred**
Bank of Nova Scotia	26.24%	2.90%	2,333	11.1%
CIBC	17.01%	4.78%	1,223	28.1%
RBC	7.63%	4.12%	351	54.0%
Bank of Montreal	4.09%	4.39%	(30)	107.3%
National Bank	3.84%	4.16%	(32)	108.3%
TD Bank*	NA	7.16%	NA	NA
Other Personal	**Deferred**	**Change in Stage 2**	**Difference (bps)**	**Change in Stage 2 / Deferred**
Bank of Nova Scotia	13.07%	2.27%	1,080	17.4%
CIBC	5.53%	1.29%	425	23.3%
Bank of Montreal	4.61%	0.95%	366	20.6%
RBC	2.98%	2.65%	33	88.9%
National Bank	2.07%	4.26%	(219)	205.8%
TD Bank*	NA	2.22%	NA	NA
Business and Government	**Deferred**	**Change in Stage 2**	**Difference (bps)**	**Change in Stage 2 / Deferred**
Bank of Nova Scotia	11.32%	(0.86%)	1,219	NA
CIBC	7.75%	3.35%	440	43.2%
TD Bank	5.03%	1.93%	310	38.4%
RBC	7.44%	7.32%	12	98.4%
Bank of Montreal	6.94%	6.85%	8	98.7%
National Bank	7.05%	9.09%	(204)	128.9%

**TD has combined credit card and personal loans into the other personal loan category.*

Source: Company filings, Veritas

Big Six Banks Macroeconomic Assumptions for the NTM: Canada as of Q4-F20

- *Forward Looking Indicators drive provisions*
- BNS appears conservative due to severely pessimistic scenario

Benign Case	BMO	BNS	CM	NA	RY	TD	Average	Current
Unemployment rate	6.4%	6.7%	7.4%	8.4%	N/A	7.8%	**7.3%**	**8.5%**
Real GDP growth	9.0%	4.7%	3.6%	3.7%	N/A	3.2%	**4.8%**	**(3.9%)**
Home Price Index	9.6%	1.9%	11.2%	(1.5%)	6.1%	7.4%	**5.8%**	**8.1%**
Base Case	**BMO**	**BNS**	**CM**	**NA**	**RY**	**TD**	**Average**	**Current**
Unemployment rate	8.0%	7.3%	8.7%	8.9%	N/A	8.4%	**8.3%**	**8.5%**
Real GDP growth	6.0%	3.1%	1.6%	3.0%	N/A	2.4%	**3.2%**	**(3.9%)**
Home Price Index	4.5%	0.4%	2.4%	(5.2%)	0.6%	6.0%	**1.5%**	**8.1%**
Adverse Case	**BMO**	**BNS**	**CM**	**NA**	**RY**	**TD**	**Average**	**Current**
Unemployment rate	13.8%	14.1%	9.5%	10.4%	N/A	10.2%	**11.6%**	**8.5%**
Real GDP growth	(2.1%)	(10.8%)	0.0%	0.4%	N/A	(0.7%)	**(2.6%)**	**(3.9%)**
Home Price Index	(9.1%)	(15.2%)	(6.9%)	(9.9%)	(29.6%)	(3.5%)	**(12.4%)**	**8.1%**

Source: Company filings, Veritas

Big Six Banks Macroeconomic Assumptions for the Medium-Term: Canada as of Q4-F20

Benign Case	BMO[1]	BNS	CM	NA	RY	TD[3]	Average	Current[4]
Unemployment rate	5.9%	4.7%	5.9%	7.3%	N/A	5.7%	**5.9%**	**8.5%**
Real GDP growth	4.0%	2.7%	4.6%	2.8%	N/A	2.8%	**3.4%**	**(3.9%)**
Home Price Index	5.4%	3.3%	10.4%	2.9%	11.1%	3.1%	**6.0%**	**8.1%**
Base Case	BMO[1]	BNS	CM	NA	RY	TD[3]	Average	Current[4]
Unemployment rate	7.1%	5.5%	6.7%	8.0%	N/A	6.1%	**6.7%**	**8.5%**
Real GDP growth	3.0%	2.2%	3.8%	2.6%	N/A	2.2%	**2.8%**	**(3.9%)**
Home Price Index	2.5%	2.8%	3.0%	2.4%	4.5%	1.1%	**2.7%**	**8.1%**
Adverse Case	BMO[1]	BNS[2]	CM	NA	RY	TD[3]	Average	Current[4]
Unemployment rate	13.9%	7.1%	8.4%	9.8%	N/A	6.2%	**9.1%**	**8.5%**
Real GDP growth	0.8%	6.4%	2.0%	2.7%	N/A	2.9%	**3.0%**	**(3.9%)**
Home Price Index	(4.6%)	6.8%	(0.8%)	(0.1%)	2.9%	3.5%	**1.3%**	**8.1%**

GDP growth for Q1-2020 provided by Statistics Canada, and YoY change in Teranet – National Bank Housing Price Index as of May 2020
[1]BMO's assumptions are for calendar 2021
[2]BNS' adverse case represents severe pessimistic scenario
[3]TD uses average home price instead of a Home Price Index for its macroeconomic forecast
[4]Unemployment rate for May 2020 provided by Statistics Canada, Annualized Real

Source: Company filings, Veritas

Scenario Weighting Matters

- *Excess of reported allowance vs. base case highlights more conservative provisioning for performing loans*

	Reported Allowance	100% base case	100% adverse case
BMO	**3,075**	**2,375**	**4,875**
Difference		*(22.8%)*	*58.50%*
RY	**5,313**	**4,707**	**NA**
Difference		*(11.4%)*	-
BNS	**5,863**	**5,407**	**7,807**
Difference		*(7.8%)*	*33.20%*
CM	**2,806**	**2,602**	**3,744**
Difference		*(7.3%)*	*33.40%*
NA	**1,029**	**958**	**1,279**
Difference		*(6.9%)*	*24.30%*
TD	**8,500**	**8,157**	**NA**
Difference		*(4.0%)*	-

Source: Company filings, Veritas

BNS: Making Adjustments

- *Consider adjustments to Adjusted EPS*
- Scotiabank's adjusted EPS for Q1-F20 would have fallen well-short of consensus estimates of $1.75 absent:
  - The exclusion of negative impact to provisions from update to ECL model;
  - Positive impact from elimination of a one-month reporting lag in subs;
  - The exclusion of negative impact of a derivatives valuation adjustment

Items of Note	Diluted Adjusted EPS
Reported diluted adjusted income	$1.83
PCLs related to 'Severe Pessimistic' Scenario	($0.09)
One-month reporting lag elimination for Mexico	($0.03)
Derivatives valuation adjustment	($0.07)
Total	**$1.64**

Organic Revenue Growth Tricks

Not all SSSG Is Created Equal

- *Carefully read the SSSG definition. Assess the magnitude of 'overstatement' by considering the number of closed restaurants*

Company	Include/Exclude closed stores?	Latest SSS %	Latest SSS reporting period	% Closed Store/ System-wide
Starbucks	Included	-43%	Month of May 2020	5%
McDonalds	Included	-21%	Month of May 31, 2020	10%
A&W Revenue Royalties Income Fund	Included	-4%	3-Months to Mar. 22, 2020	12%
Boston Pizza Royalties Income Fund	Included	-55%	Month of May 2020	25%
MTY Food Group	Excluded	N/D *	Quarter ended Feb. 29, 2020	29%
Pizza Pizza Royalty Corp.	Excluded	-26%	Month of April 2020	33%
Restaurant Brands -Tim Hortons Canada	Excluded	-25%	Third week of May 2020	10%
Restaurant Brands -Burger King US	Excluded	-5%	Third week of May 2020	10%
Recipe Unlimited Corporation	Excluded	-27%	Week ended Mar. 15, 2020	42%

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PBH: Adjusting for Sales We Would Have Made

- *Watch out for made-up revenues*
- PBH reported organic revenue growth rate of 10%, including $131m of sales they ***estimate*** were lost due to COVID

In millions of Canadian dollars	Q2-F20
Q2-F20 total organic revenue	1,037
Less: mgmt's estimate of lost sales due to COVID, included above	(131)
Q2-F20 actual organic revenue	906
Q2-F19 revenue	945
Actual organic revenue growth in Q2-F20	**-4%**
Reported organic revenue growth in Q2-F20	10%

Source: Company filings, Veritas

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Note Disclosure Insights

CEMEX: Going Concern Note (year-end)

- *Understanding key risks*

2019 REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Going concern

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 26 to the consolidated financial statements, the Company´s future compliance with financial covenants under the 2017 Credit Agreement is uncertain given the impact of COVID-19. The Company plans with regard to this matter, which includes its request of lenders under the 2017 Credit Agreement to modify the related financial covenants, are described in the Note 26. This condition raises substantial doubt about the Company´s ability to continue as a going concern. The Consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Sorrento Therapeutics:
Going Concern Note (mid-year)

- *Understanding key risks and plans to resolve them. Mid-year disclosure suggests greater risk*

Liquidity and Going Concern Q3-F20

As a result of our recurring losses from operations, recurring negative cash flows from operations and substantial cumulative losses, there is uncertainty regarding our ability to maintain liquidity sufficient to operate our business effectively, which raises substantial doubt about our ability to continue as a going concern… Furthermore, the spread of COVID-19, which has caused a broad impact globally, may materially affect the Company economically… reducing the Company's ability to access capital, which could, in the future, negatively affect its liquidity…The Company has plans in place to obtain sufficient additional fundraising.

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Inflating Cash Flow

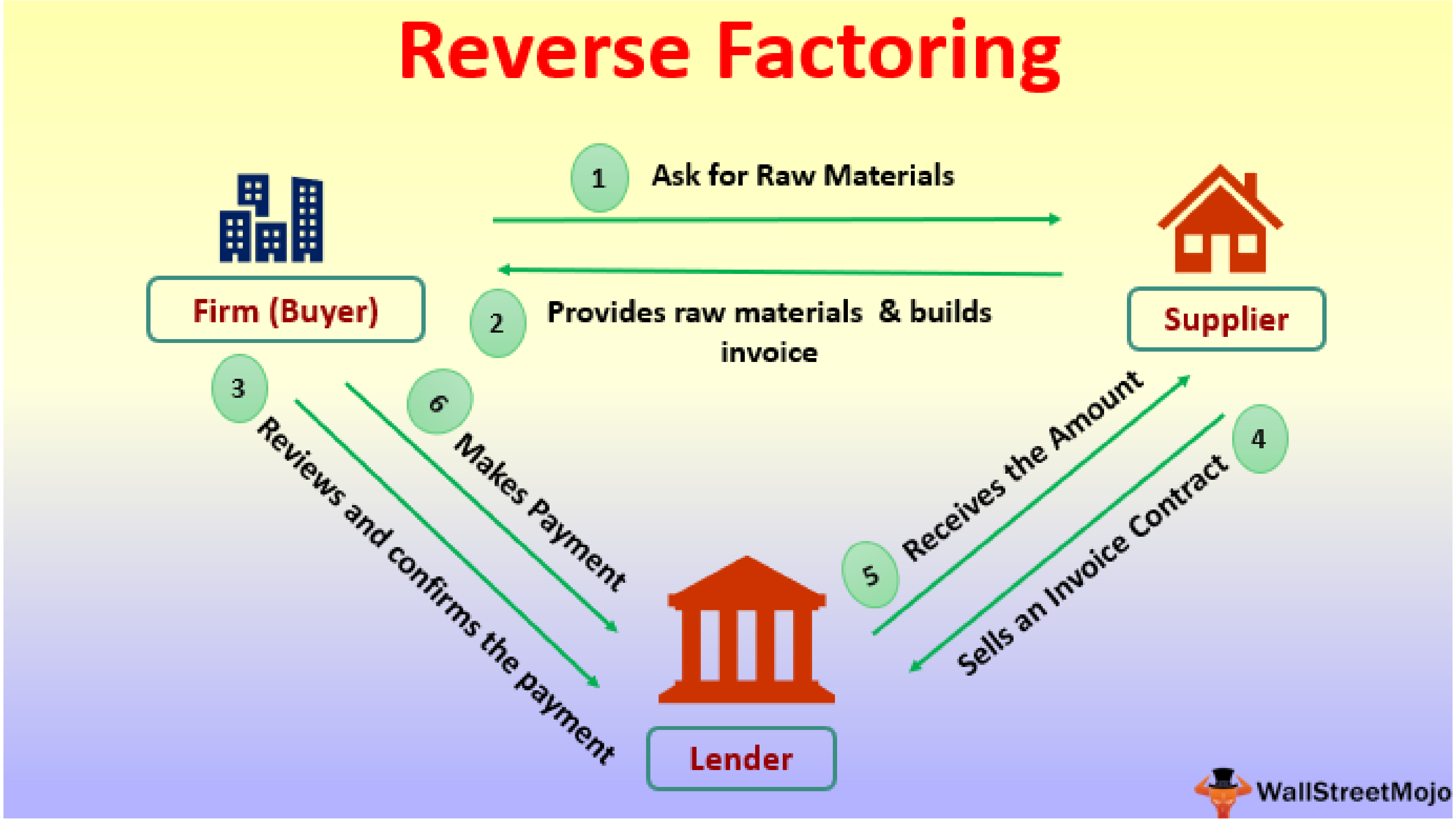
GFL: Inflating Free Cash Flow

- *Check what's not included in FCF*
- The exclusion of certain interest, leases and early prepayments/ unsustainable income from high cash balance inflate FCFE

in millions of USD	Q3-F20
Free cash flow to equity - reported	177
Tangible Equity Units - debt component *	(16)
Normalized additional interest **	(29)
Repayment of lease obligations	(13)
Adjusted Free Cash Flow to Equity	119
Boost to Free Cash Flow to Equity	48%
Paid In Kind notes - effective Q4 accrete at 7% or $56m/yr	(14)

** Quarterly interest and principal repayments. $172m debt component matures in Mar 2023.*
*** Q3 interest paid of $36M implies annualized cash interest cost of only 2.6%. Per note, the effective rate is 4.3% or ~$65m/quarter. Made interest pre-payment with proceeds from the IPO.*

Supply Chain Financing: How It Works



Supply Chain Financing

- Akin to revolving line of credit but recorded in payables - companies borrow money to pay their bills
- Extend payment terms
- Often undisclosed
- No uniform definition of when it should be classified as debt
- **Impact: Increased cash flow, reduced debt, improved leverage**
- Risks:
  - **Availability**
  - **Shortening of payment terms**
  - **Negative impact on operating cash flow in a downturn**
- The SEC is cracking down on supply chain financing
- Look for increase in "other" payables and DPO

Carillion Case Study

Business: Engineering & construction, maintaining of infrastructure assets and concession investments

Market cap: ~£2 billion

Number of employees: 46,000

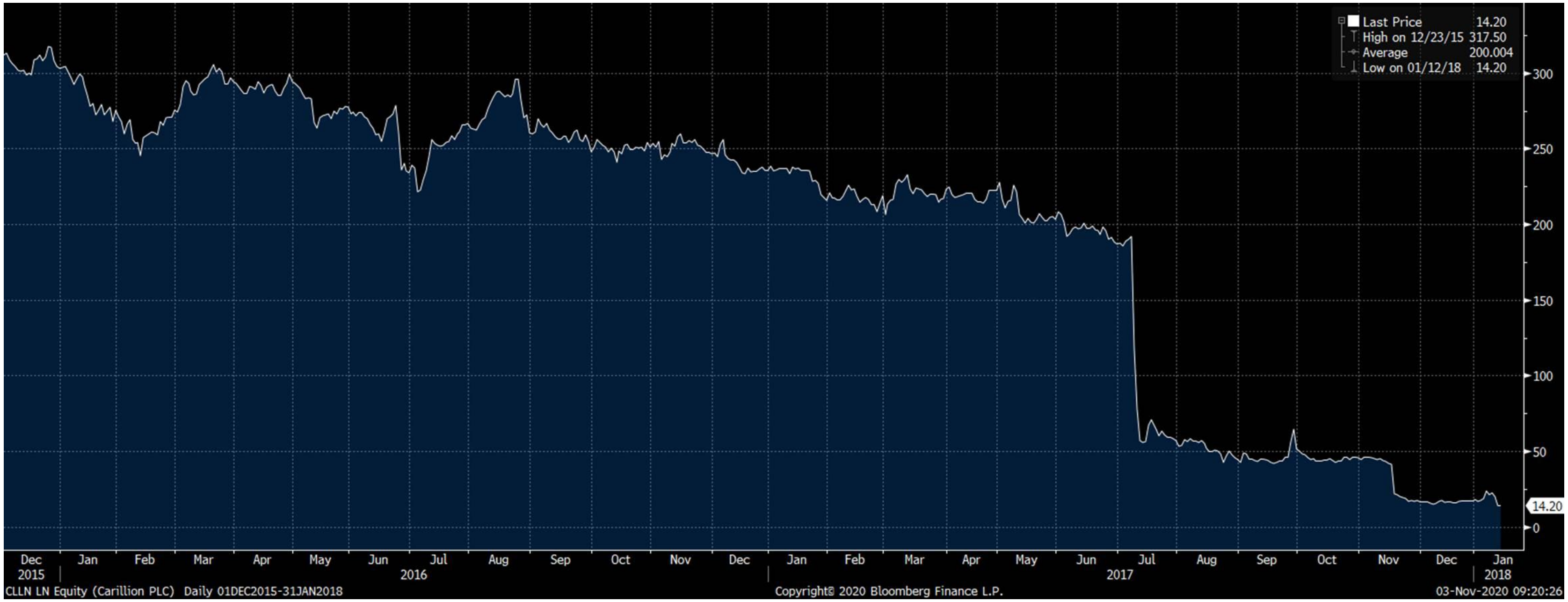
Liquidated: January 2018

Catalysts: cash losses on major construction projects and curtailment of reverse factoring facility

Carillion: When Words Diverge From Deeds

Carillion 2016 annual report:

- *We believe that good governance is an essential part of the way we undertake our business on a day-to-day basis, while maintaining* *<u>effective risk management</u>*, *<u>control</u>* *and* *<u>accountability…</u>*



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Carillion: Learning points / Key Takeaways

- Aggressive revenue recognition disguised by reverse factoring
- IFRS operating cash flow manipulated through reverse factoring
- Reported Days Payables Outstanding (DPO) excluded key account and distorted trend analysis
- Supply chain financing cut back when need it most
- Blue chip board means nothing
- Management compensation did not reward actual performance

Carillion: Why Did it Fail in H1-F17?

- ~£1 billion loss due to deterioration in the cash flows on four major construction contracts
- 2017 full-year net debt expected to be between £825m and £850m, compared to £219m in 2016.
- Banks cut down on Carillion's reverse factoring facility

		2017 £m	2016 £m
Non-recurring operating items			
Revenue	- contract receivables impairment (a)	**(251.0)**	-
Cost of sales	- contract receivables impairment (a)	**(349.4)**	-
	- onerous contract provisions (a)	**(281.2)**	-
Administrative expenses	- intangible amortisation arising from business combinations	**(7.4)**	(6.8)
	- restructuring costs (b)	**(10.7)**	-
	- closure of Caribbean operations (c)	**-**	-
	- construction workers compensation scheme (d)	**-**	(10.5)
	- goodwill impairment (e)	**(134.0)**	-
	- recovery of loan from Green Deal Finance Company	**0.7**	-
Share of results of Joint Ventures	- contract receivables impairment (a)	**(147.5)**	-
	- onerous contract provisions (a)	**(16.4)**	-
Non-operating items	- corporate transaction costs (f)	**(0.3)**	-
	- loss on reclassification of available for sale assets (g)	**(7.6)**	-
	- loss on disposal of Carillion Alawi LLC (h)	**(0.8)**	-
Net financial expense	- fair value movements in derivative financial instruments (i)	**2.0**	9.9
	- fair value movements in contingent consideration (j)	**-**	6.8
		(1,203.6)	(0.6)

Carillion: How Did We Get There?

- *No signs of a blow-up: Headline numbers don't tell the full story*
  - IFRS net operating cash flow was positive
  - DSO/DPO moved in right direction
  - An increase in net debt offset by higher EBITDA

In millions of pounds, except Days Sales and Payable Outstanding	2016	2015	2014	2013	2012	Increase through 2016	Increase through 2015
Days Sales Outstanding as per management's methodology *	70	59	71	66	58	**21%**	**2%**
Days Payable Outstanding as per management methodology**	83	75	88	80	86	**-4%**	**-12%**
Operating cash flow (IFRS)	**73**	**73**	**124**	**(78)**	**(26)**	**n/m**	**n/m**
Net debt	219	170	177	215	156	41%	9%

**Trade and construction receivables*

*** Trade payables. Material 'other' payables were excluded.*

VERITAS INVESTMENT RESEARCH

Carillion: Flawed Definitions of DSO/DPO

- *Definitions matter*
  - Days Sales Outstanding (Debtor Days) and Days Payables (Creditor Days) were crucial to detecting a brewing blow-up, but reported numbers showed no warning signs
  - Red flags - DSO: Days Sales excluded declines in customer advances. Group (total) revenue muted the problems at construction division
  - Red flags – DPO: Days Payable excluded “other” payables

	2015	2014	Trend
Total revenue (£bn)	4.6	4.1	Growing
Working capital cash movement (£m)	9.0	31.1	Neutral
Net borrowing (£m)	(169.8)	(177.3)	Reducing
Debtor days outstanding (days)[3]	51	61	Reducing
Creditor days outstanding (days)[4]	67	76	Reducing

(1) Including net proceeds from the sale of Public Private Partnership (PPP) investments.
(2) Restated for the retrospective adjustment to provisional amounts recognised on the acquisition of the Rokstad Corporation in 2014.
(3) Debtor days are based on trade receivables plus construction contract receivables divided by Group revenue, adjusted for VAT and acquisitions.
(4) Creditor days are based on trade payables, adjusted for VAT, divided by cost of sales plus administrative expenses, adjusted for non-trade creditor related expenses such as payroll costs and depreciation and the effects of acquisitions during the year.

Carillion: The Rise of Supply Chain Financing

2014 annual report:

The introduction of Carillion's Early Payment Facility (EPF) <u>at the beginning of 2013</u> has also proved to be extremely popular with suppliers…

…suppliers can choose when they take payments in respect of approved invoices and if they wish to take them even earlier, they can do so at minimal cost…

…Our Early Payment Facility (EPF), which is now used by 396 suppliers and through which we have made payments totaling £977.6 million in 2014.

2015 annual report:

Our Early Payment Facility was extended in 2015 to cover 60 per cent of our UK external spend with suppliers…

2016 annual report:

…our Early Payment Facility, allows our supply chain partners access to their payments ahead of their contractual terms, reducing their need for working capital and helping them grow and sustain local communities.

Carillion: Supply Chain Financing to the Rescue

- *Increasing reliance on reverse factoring may be dangerous and obscures the impact of rising receivables*
- Reverse factoring was rising as a % of relevant costs as cash outflows were deferred (to be paid in future periods)
  - <u>Reduced access to reverse factoring facility could create a cash crunch</u>

In millions of pounds	2016	2015	2014	2013	2012
Other creditors - reverse factoring	761	562	511	405	263
CoGS excl. wages, depreciation	3,084	2,665	2,364	2,212	2,487
Other payables as % of relevant costs	**25%**	**21%**	**22%**	**18%**	**11%**

Carillion: Disclosure Hides Reverse Factoring

- *Include all relevant payables in DPO analysis*

- Reported Days Payable excluded ‘other’ payables, obscuring the impact of reverse factoring

  - The line of credit to finance an Early Payment Facility was buried in ‘other’ payables

	2016	2015	2014	2013	2012	Increase through 2016	Increase through 2015
DPO - Trade *	83	75	88	80	86	-4%	-12%
DPO – Other **	**90**	**77**	**79**	**67**	**39**	**133%**	**99%**
DPO trade and other	173	152	167	147	125	39%	22%

**Denominator: CoGS + admin expenses*
*** Denominator: CoGS*

Carillion: The Missing Link

- *When IFRS operating cash flow does not tell the whole story: Increase in construction receivables was more than offset by increased reverse factoring activity*

- The result: stable/rising operating cash flow

	Note	2016 £m	2015 £m
Cash flows from operating activities			
Group operating profit		**145.6**	183.4
Depreciation and amortisation		**45.0**	45.4
Profit on disposal of property, plant and equipment and intangible assets		**(6.4)**	(14.4)
Profit on disposal of Public Private Partnership equity investments		**(12.7)**	(37.7)
Other non-cash movements		**1.9**	(0.3)
Non-recurring operating items		**40.2**	5.0
Operating profit before changes in working capital		**213.6**	181.4
Increase in inventories		**(6.3)**	(14.3)
(Increase)/decrease in trade and other receivables		**(290.6)**	48.0
Increase/(decrease) in trade and other payables		**301.5**	(41.1)

VERITAS
INVESTMENT
RESEARCH

Carillion: Will the Real Debt Please Stand Up

- *Make sure to include all debt-like elements in the leverage ratio*
- Reported net debt materially understated the real leverage by excluding bank financing related to reverse factoring

	2016	2015	2014	2013	2012
Net debt to EBITDA - reported	0.8	0.6	0.7	0.8	0.6
Net debt to EBITDA - adjusted	**2.5**	**1.7**	**1.7**	**1.4**	**0.6**

Carillion: Blue Chip Board Means Nothing

- **Board Chairman**: Advisor to the Prime Minister on Corporate Responsibility; former CEO and COO at very large UK and multinational companies
- **Chairman of Audit Committee:** Member of the Council of The Institute of Chartered Accountants; experience as CEO and CFO at FTSE 100 international business; chaired audit committees at two other major companies
- **Chairman of Remuneration Committee:** Chief People Officer and member of Executive Committee at an iconic multi-billion corporation
- **Other members:** UK Government Lead Non-Executive Director for the Scotland Office and Office of the Advocate General; Vice President Strategy, Royal Dutch Shell, etc…
- **Blast from the past:** Valeant, SNC…

Carillion: Management Compensation Red Flags

- *Consider key metrics used in management compensation*

Measure
EPS (30%)
Cash conversion (20%)
Net debt (6.25%)
Pre-tax profit (6.25%)
Cost reduction Targeting gross reduction against budget of £120m (6.25%)
Investor relations Aim to at least maintain the P/E ratio of the Group from the year end 2015 rating (6.25%)

- 'EPS' was based on non-IFRS 'underlying earnings'. IFRS based EPS was substantially lower
- Cash conversion did not reflect net operating cash flow
- Net debt excluded reverse factoring facility

Carillion: Management Compensation Red Flags

Cash conversion not reflective of actual net operating cash flow

- Defined as: non-IFRS cash from operations / non-IFRS profit from operations
  - Excludes taxes and interest
  - Excludes cash restructuring costs
  - Includes gross proceeds on sale of JVs and other investments (vs. gains net of costs of £12 million and £37 million in 2016 and 2015, respectively
- Net operating cash flow was £73 million in each of 2016 and 2015

		2016	2015
Cash generated from operations (cash flow statement on page 94) (£m)		115.5	120.3
Add back:	Deficit recovery payments to pension schemes (£m)	46.6	47.4
	Non-recurring operating items (£m)	21.5	6.3
	Cash flows on forward foreign currency contracts (£m)	34.6	-
Include:	Dividends received from Joint Ventures (£m)	11.8	16.8
	Disposal of Joint Ventures and other investments (£m)	47.1	54.1
Underlying cash generated from operations (£m)		277.1	244.9
Underlying profit from operations (section C above) (£m)		235.9	234.4
Underlying cash conversion (%)		117	104

Wirecard AG Case Study

Business: electronic payment processing, issuing virtual prepaid credit cards and provision of online payment risk management services

Market cap: €24 billion

Number of employees: 5,300

Bankruptcy: June 2020

Catalysts: Delayed 2019 filings with no sign-off from auditors, missing cash, fictitious assets, fraudulent revenue and regulatory capital transactions

Wirecard AG: When Analysis Fails

Negative market commentaries, including from leading business newspapers, published in each year since 2012

Wirecard: Key Takeaways

- No red flags in consolidated financials
  - Growing cash balance; positive IFRS cash flow; growing IFRS net income; sensible EBITDA adjustments
  - Fraud that faked cash balances, cash flow and carefully avoided disclosure related to acquisitions
- Local regulatory filings are key to detect irregularities
  - Great Indian Retail Group and Trans Infotech acquisitions
- Poor corporate governance: Lack of disciplinary actions at the top to punish wrongdoing in South Asian division
- Management's attitude: aggressive attacks on journalists
- The word "audited" matters: final press release before blow up omitted the word "audited"

Wirecard: Unusual Deal Making

Wirecard was a serial acquiror, making numerous individually immaterial acquisitions. Yet digging in these acquisitions revealed significant red flags

Trans Infotech Acquisition in 2012

- Price: €25 million, or ~2% of Wirecard's market cap.
- Revelations from Trans Infotech's regulatory filings:
  - A portion of purchase price paid before acquisition to finance customer relationship assets
  - Going concern problem
  - Unable to finance growth on its own

Wirecard: Unusual Deal Making

Acquisition of Great Indian (GI) Retail Group and GI Technology in October 2015 and March 2016, respectively and Star Global Currency Exchange

- E-commerce payment services and virtual prepaid credit cards
- Price: €230M cash + €110M contingent consideration, *including a capital contribution to GI Technology ahead of purchase*

Great Indian (GI) Retail Group
Hermes i Tickets GI Technology Private Limited
Star Global Currency Exchange

Wirecard: Great Indian Retail Group

- Red flags revealed from local regulatory filings:
  - Significant accounting errors in 2014 at major GI sub (Hermes I Tickets)
  - Auditor resignation in 2015
    - Per Wirecard: formality
  - Payment processing business was a small portion of acquired operations (e-ticket sales were core)

Great Indian Price Discrepancy

- *Local regulatory filings revealed price discrepancies*
- Cash spent per Wirecard FS much higher than proceeds received by GI

Hermes i Tickets + GI Technology	
Proceeds from sale of investment in subsidiary in rupees (Hermes)	2,749,940,988
€ conversion rate	0.014
Proceeds in €	**37,674,192**
Star Global	
Number of shares	504,999
Value per share	100
Investment value in rupees	50,499,900
€ conversion rate	0.013
Investment value in €	**664,074**
Total proceeds to GI in €	**38,338,265**
Total purchase price in €	340,000,000
Difference price paid vs. received by sellers in €	**301,661,735**

Wirecard: Great Indian Retail Group

- How can a business become 7x more valuable within a few months?

- A Mauritian-based intermediary bought GI and then flipped it to Wirecard within 1 month at ~7x original price.
  - No mention in Wirecard's reports.
  - In early 2018, Wirecard acknowledged the purchase from Mauritian fund
  - Per Wirecard: higher price was due to Indian GDP growth and the rapid growth of the digital payment market

Wirecard: Allegations of Fraud in Asia Division

- *Do not dismiss weak internal controls and corporate governance even if related errors appear 'immaterial'*

- FT publication from January 2019:
  - No actions were taken against Singapore executive suspected of repeatedly using fake and backdated contracts after internal investigation commissioned from outside law firm found: "serious offences of forgery and/or of falsification of accounts"
  - Not an isolated event at Wirecard's Asian operations
  - Senior management in Germany (incl. COO, treasurer and head of accounting) were aware of questionable transactions
  - Whistleblowers concerned with no action

- Wirecard's reaction:
  - Immaterial and *"…false, inaccurate, misleading and defamatory"*
  - Sued FT for "unethical reporting" and market manipulation

Wirecard: When "Audited" Matters

"Audited" matters, as Wirecard neared bankruptcy and audited statements were delayed:

- 14 February 2020: *"The **audited** consolidated financial statements for 2019 will be published on April 8, 2020."*
- 25 May 2020: *Consolidated financial statements 2019 so far without material findings; Company expects an unqualified audit opinion*
- 3 June 2020 news release (€90/share): *"Wirecard will provide detailed reports on growth plans and intended structural measures at the presentation of its annual financial statement 2019 on June 18, 2020."*

Final Takeaways

2021 Watch List

- Non-GAAP metrics:
  - Calculations or formulae, changes, presentation, prominence.
  - Exclusion of essential costs; inclusion of subsidies; material lease payments not captured; SSSG not capturing all the business; non-GAAP revenue recognition
- Revenue
  - Provisions for bad debt vs. collections vs. peers; inventory trends
- Capitalized costs
- Going concern notes
- Change in accounting assumptions
- Acquisitions games to hide negative organic growth and boost earnings
- Misaligned management compensation and change in compensation structure / metrics

2021 Watch List

- Avoiding impairments
  - Changes in asset expected lives, bad debt provisions, discount rates, growth rates, cost capitalization policies
- New Financing Structures
  - Companies using complex structures with obscure financial statement presentation
- Unusual Swings in Working Capital
  - Supply chain and receivables factoring
- Changes in Audit Report Wording or Risk Note Disclosures
- Changes in Financial Statement Presentation
- Changes in line item groupings or account classification
  - Classifying amounts as “Other”
- Changes in segment presentation

Forensic Accounting Toolbox

There are no rules only tools

Look for what is <u>not</u> included in the

financial statements

Develop critical questions not certain answers

Ask Better Questions → Make Better Decisions → Get Better Results

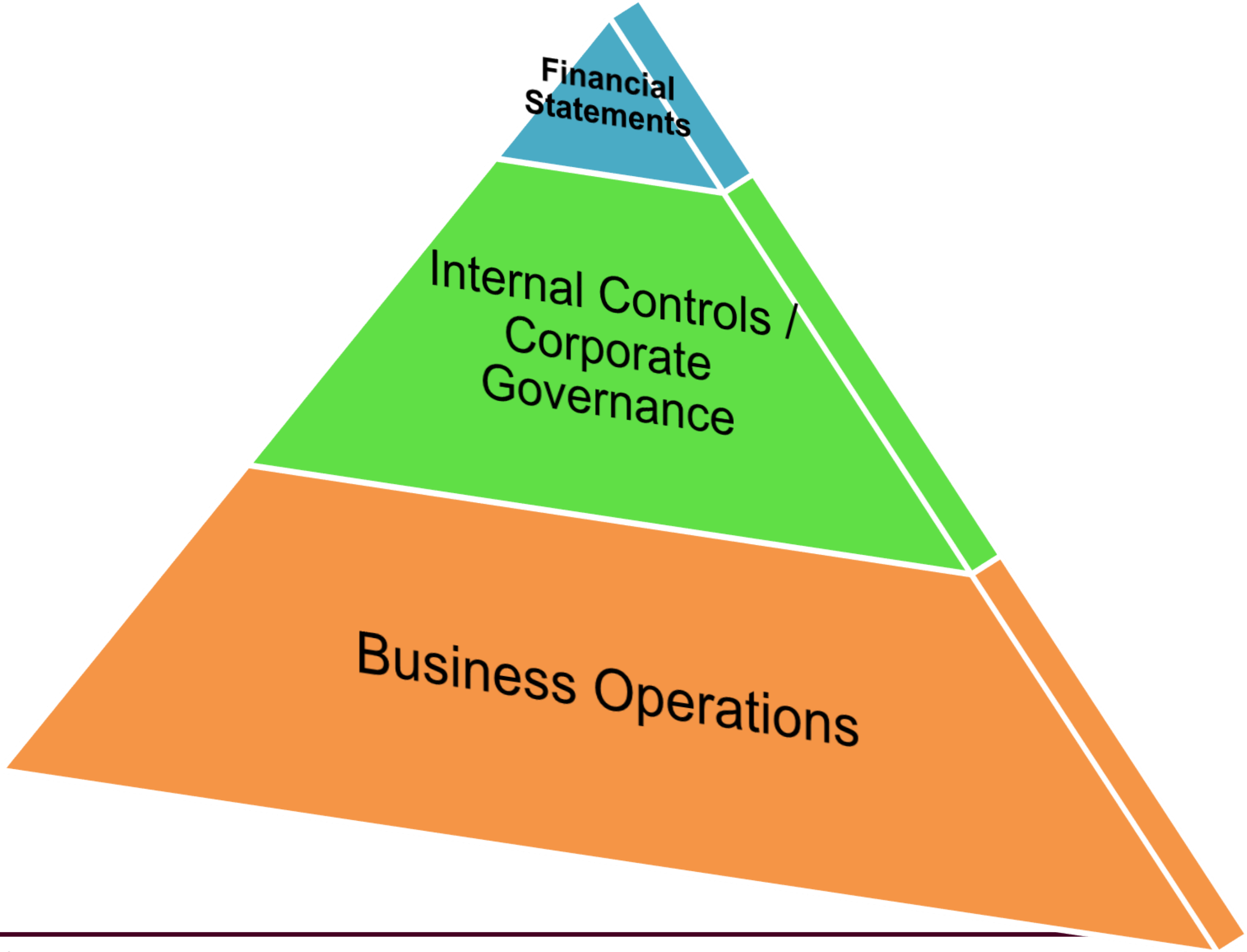
Flammable Items - What Are We Looking For? Red Flags Examples

- Aggressive accounting/estimates, incl. non-GAAP metrics
- Opaque disclosures
- High debt
- Negative free cash flow
- Material disconnect between earnings and cash flow
- Flawed executive compensation program
- Change in management's tone/strategic focus
- Departure of key executives/board members
- Change in auditor

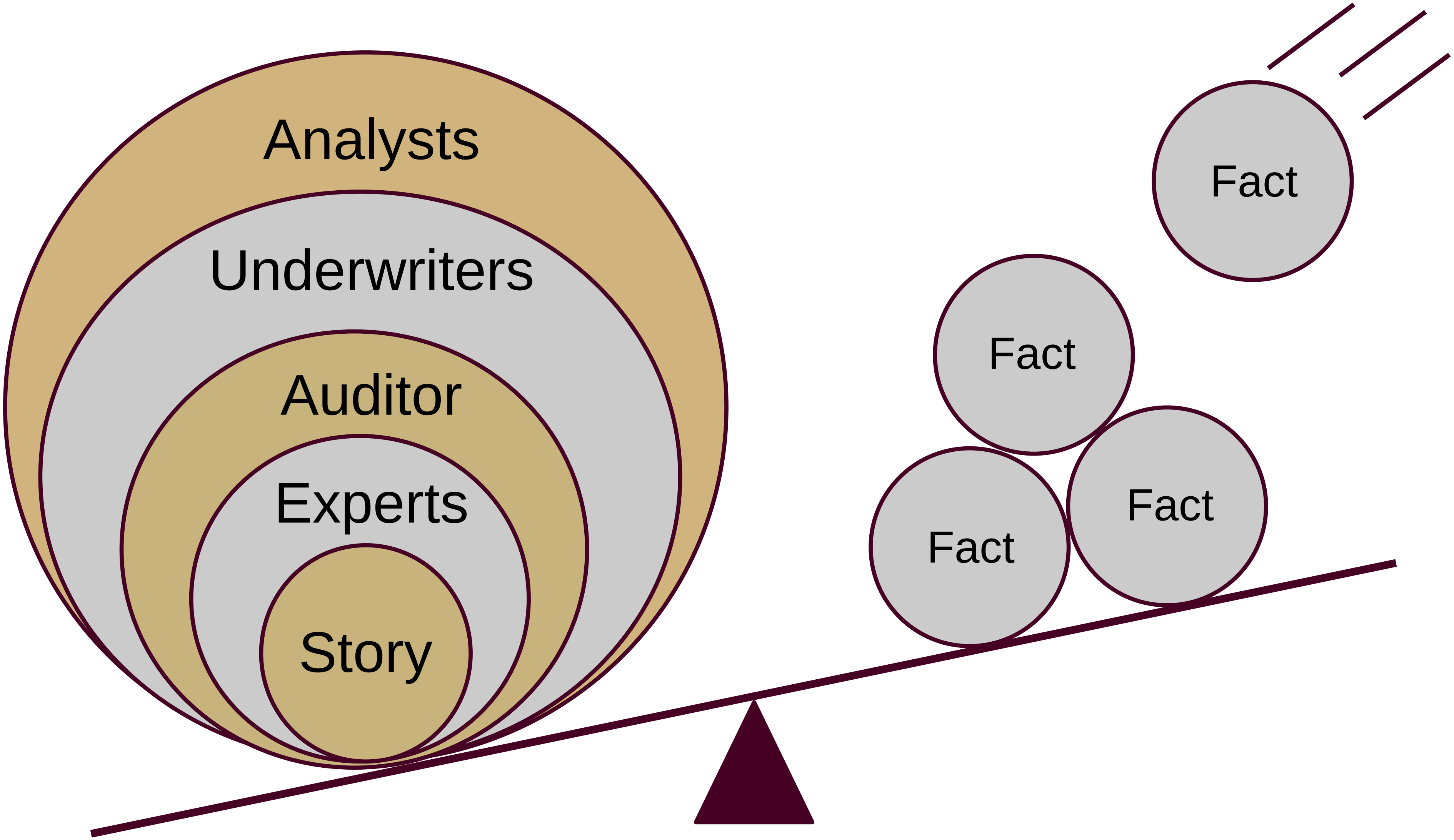
Flammable Items: Red Flags Examples (Continued)

- Strategic reliance on acquisitions or asset sales
- Weak internal controls/governance
- Decentralized reporting structure, coupled with up or out employee culture
- Insider stock sales
- Powerful CEO/weak CFO
- Adversarial management team
- Excessive concern over stock price
- High/low analyst expectations; unanimous BUY/SELL recommendations
- Negative employee/supplier/competitor feedback

Aggressive Accounting Implies Deeper Problems



Don't Blindly Trust the Story: Corroboration Is Key



Questions?