JULY 2018

Making Sense of Emerging Markets Accounting Data

Some investors pass on allocating equity funds to one of the highest-growth regions, emerging markets. They are fearful of accounting manipulation or intimidated by the daunting task of interpreting financial statements that are difficult to reconcile with their more familiar developed market equivalents. In part, these concerns are a throwback to the questionable accuracy of financial statements in years past—although even today, it may not be wise to take all reported numbers at face value. We find that even when using the best "off-the-shelf" emerging markets financial data, much work is necessary if one intends to use those data to build robust emerging markets portfolios.

Earnings on a cliff

In any given year, some companies report gains and others report losses. In a perfect world, if we arranged firms on a spectrum from the most negative earnings to the most positive, we might expect to see a fairly normal distribution of winners and losers.

In examining real-world distributions of earnings, on the other hand, we see something different. When looking at U.S. companies, for example (see Exhibit 1, top panel), we might spot a "kink" in the distribution; there seems to be a slight buildup of firms reporting just to the positive side of zero, as managers use a range of accounting tricks—some legal, some perhaps not—to eke out a positive number.

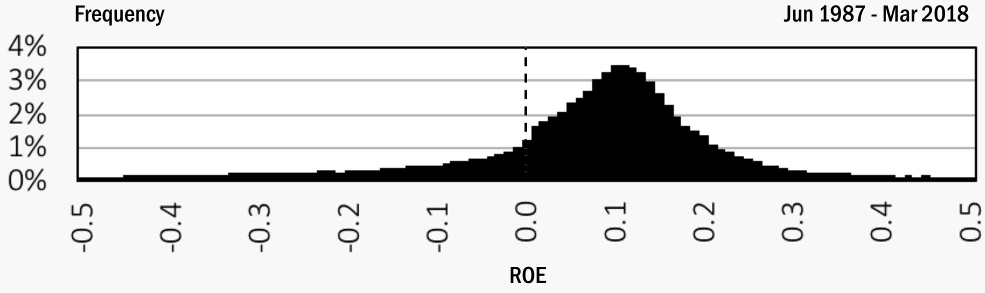
What about emerging markets? Not surprisingly, EM companies manage earnings, too—they just take it to a whole new level! In almost all emerging markets, we observe an unnatural "cliff" of earnings clustered to the right of zero (see Exhibit 1, bottom panel). Different reporting standards, weaker auditing, and lax enforcement create a perfect storm that results in reported numbers that are disconnected from actual results.

Seeing through the financial numbers game

While the public might take these earnings numbers at face value, investors who are able to see through the accounting games managers play and distinguish between good and bad results are presented with a compelling opportunity. For example, when we scrutinize companies' financials with the use of quantitative tools like accruals-based measures of *earnings quality* or data-driven models for *predicting financial fraud* we find it's possible to identify bargain stocks, oversold for honestly reporting an earnings miss. This process also exposes overvalued companies, poised for a fall when inflated results inevitably reverse. Through a deeper understanding of the rules of the game and a bit of work with the data, the challenge of uncovering earnings manipulation in emerging markets becomes a distinct advantage.

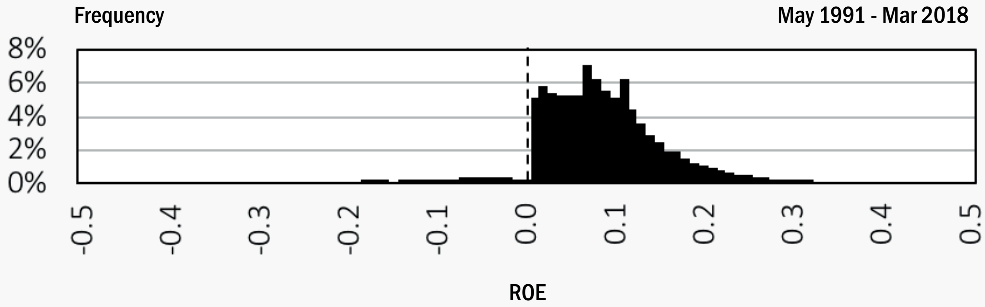
Exhibit 1. Distribution of Return on Equity (ROE) in the U.S. and Emerging Markets

United States

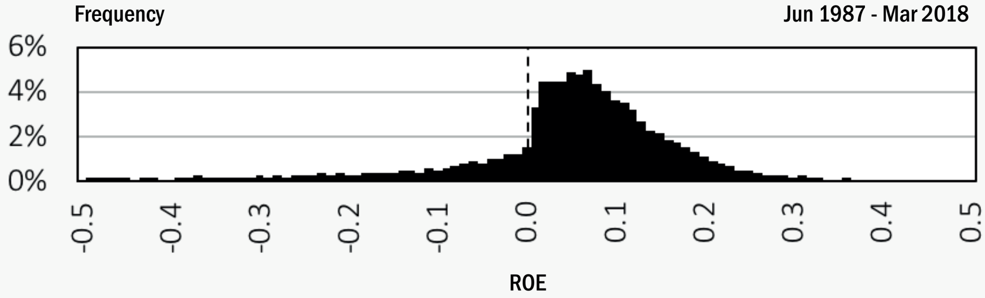


Emerging Markets

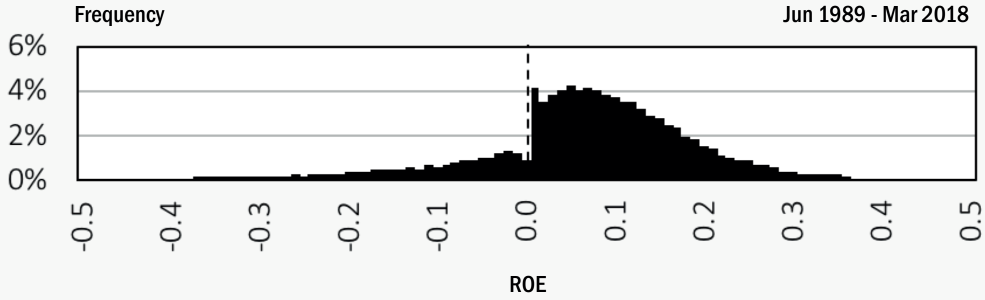
China



South Korea



Taiwan



Source: Rayliant Investment Research

Line item differences

One would expect that a balance sheet line item as fundamental as *Property Plant* and *Equipment* (PPE) would be fairly consistent across countries. If only things were that simple. In China, for example, among other exclusions, it turns out that PPE is reported net of *Construction in Progress*—quite a meaningful entry for firms in an economy experiencing such rapid expansion. Instead, the value of ongoing construction projects shows up as a separate item in the financial statements of Chinese companies and, consequently, as a separate variable in the data provided by popular Chinese financial data vendors.

For investors using fundamental information to rate stocks, the upshot is that both knowledge and effort are required to adjust Chinese companies' data before they are comparable with firms reporting according to US GAAP (or any other set of accounting standards, for that matter). Failing to recognize the nuances in cross-country accounting practices could lead to serious disparities in valuation models—where "Garbage In, Garbage Out" is a fact of life—and, in turn, less favorable outcomes for investors.

"Virtually certain" confusion in translating reporting standards

Accountants deal in numbers, and when they use language, precision is critical. But precise language is challenged when we cross borders. Most of us would agree that "virtually certain" and "reasonably certain" mean two different things—some might say two very different things. That distinction becomes quite important when we're talking about, say, our level of "certainty" that a company goes bankrupt. But when the Korean Accounting Standards Board (KASB) translated International Financial Reporting Standards (IFRS) from English to Korean, they used the same Korean expression (가능성이 거의 확실한) to represent both "virtually" and "reasonably" certain outcomes, creating serious ambiguity in the way that Korean firms report, for instance, the existence of a liability. This is another example of how specific knowledge of a market is critical if one is to make use of its data to invest.

Accounting differences: Not a problem, rather an opportunity

With major differences in accounting standards and interpretations across regions, not to mention questions about the quality of financial reporting in developing economies, it's not surprising that some investors shy away from analyzing the large number of stocks listed in emerging markets. At Rayliant, however, we feel that avoiding emerging markets is the greater risk. The same features that make unraveling the puzzle of foreign financial statements challenging create an amazing opportunity for those with the knowledge and diligence to crack that code. By investing to build a high-quality global financial database and in the development of tools to uncover suspect accounting, Rayliant is unlocking hidden value in the oft-overlooked emerging markets.

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