Accounting smokescreen hides true picture

Skeletons in Ellerines' cupboard tumbled out this week when African Bank CEO Leon Kirkinis admitted that his bank paid R450m "more than we thought we did" when it bought the credit-driven retailer last year for R9,1bn.

By Rob Rose 16 May 2008

After four months in charge, African Bank last week released "adjusted" numbers for Ellerines — wiping R1,4bn off incom the retailer said it had already earned.

Officially, the restatement was to "align Ellerines with African Bank's accounting policies" and involved "derecognising income".

But at its heart, this exposed an accounting smokescreen used by retailers such as JD Group and Lewis.

It works like this: if you buy furniture for R1200 on credit over 24 months, you pay R2400 overall at R100/month. But unde "upfront" accounting, about half this amount is taken as revenue immediately, even though premiums aren't actually collec until the end of every month.

By contrast, African Bank MD Dave Woollam says "within African Bank, the revenue earned from the deal is recognised evenly over the life of the loan".

But Ellerines put in place a "reinsurance" deal that allowed it to recognise revenue from "insurance" contracts immediately rather than when payments were made. Last week, African Bank unwound this sham, saying "in substance, very little risk was transferred to the reinsurer", and insurance "should be amortised over the life of the policy".

During an uncomfortable conference call with analysts, Kirkinis was asked what the purpose of the reinsurance deal was i not simply to "earn" revenue faster. Kirkinis eventually agreed: "Yes, you've covered it."

Nick Krige, an analyst for Blue Bay Funds, says the accounting authorities — such as the Independent Regulatory Board Auditors (IRBA) — should be very interested. "You get one set of accounting policies from Ellerines that says the net asse value is R5,4bn, and now it turns out the value is really R4,7bn. This misleads ordinary investors."

Bernard Agulhas, director for standards at the IRBA, tells the FM that the accounting regulator is aware of this issue and " be looking into it".

Now that Kirkinis has opened Pandora's box, it seems Ellerines' rivals who use similar tactics are scrambling.

JD Group CEO-designate Grattan Kirk says his company couldn't comment ahead of the results on May 26, but "we've reviewed our treatment of insurance contracts and will be making an announcement at our results".

But Lewis's annual report confirms it used upfronting of revenue through a reinsurance deal with its 100%-owned insuranc company, Monarch Insurance

Monarch's returns to the Financial Services Board (FSB) show that last year it took in R454m (in insurance premiums fro Lewis customers), of which it "reinsured" R172m with a third party. It then received a R158m "commission" from that reinsurer, as well as R19m back from "reinsurance claims".

So, the reinsurer got R172m last year from Monarch, and yet it paid back R177m. This looks a curiously zero-sum deal. E what it did do was allow Monarch (and Lewis) to recognise this insurance revenue immediately.

Says Krige: "If there is no transfer of risk, then you have to assume the only purpose is to speed up the recognition of income.” Ellerines' former auditors, Grant Thornton, said it “couldn't comment on one of our ex-clients”.

Nedcor Securities analyst Syd Vianello says the rationale was pretty much that: “Everyone's doing it, so why can't we?”

He says this raises the stakes for Lewis and JD Group to “get back to reality”.

But it isn't a train smash. The “derecognised” revenue will still come into Ellerines, only later, when the customer pays the actual money. So while revenue and net asset value drop in this restatement, embedded value (the present value of expect future income) rises.

So why is this practice dangerous?

Prudent accounting should recognise revenue only when the instalment is paid. As Investec portfolio manager Chris Stew says, the danger with upfronting is that you haven't really earned the money yet. He says the effect is that in a good mark “profits grow quickly, but in a downturn, you have the compound effect of revenue collapsing”.

This is because a company has to keep writing more insurance business to keep profits up, as it has already recognised the insurance revenue — which sounds eerily similar to Leisurenet. Says Woollam: “Retailers' earnings have been fairly volatile through the credit cycles, and this practice of accounting would certainly have contributed to this volatility.”

This skewed the perception for investors. Vianello says people value a company based on earnings. “Why did the auditors allow these ‘reinsurance' deals when there was no real transfer of risk?”

Upfronting wasn't the only problem African Bank found. As many suspected, Ellerines continued selling furniture to people who couldn't afford it, after the National Credit Act came into effect. This happened after it bought Ellerines, but before it t control. Kirkinis admits: “The reality is, business was written that shouldn't have been written.”

While African Bank expected to have to reverse the “upfronted” insurance income, it hadn't expected to have to hike bad debt provisions by another R340m.

Krige commends African Bank. “They could have kept this sham going, but they looked at it, and said this isn't fair for shareholders.”

Despite this setback, analysts still believe the African Bank share price is likely to climb at least 30% in the next year. Woollam admits: “We did pay more than we thought we did for Ellerines. But even though this means we scored a soft ow goal, it doesn't mean we've lost the match.”

Source: Financial Mail

Published courtesy of

I-Net Bridge