AUDITING FRAUD II

Property Problems

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It has been a long time since an Asian property company collapsed but investors would be wise to consider the possibility. Our analysis of subjective accounting standards and auditing costs shows that many property companies have weak balance sheets and even these numbers may be unreliable given limited audits, especially in China and India. China Vanke, Carnival, Hopson and Shenzhen Investment stand out as the worst offenders. Several others attract attention due to their extreme exposure to at least one of the ratios reviewed, including Lippo Karawaci, NTT Urban, CapitaMalls and Tokyu Fudosan. Still, property companies in Malaysia and Indonesia look very healthy. Moreover, share prices of quality companies with normal audit fees and less subjective accounting actually rose 47% over the last three years underlining the importance of financial statements in stock selection.

What Should an Audit Cost?

Based on 700 property companies from around the world, normal audit fees are 0.8 to 4.0 basis points for developers and 0.5 to 3.0 for asset managers. But, as with industrials, there are notable variances. For example, Australian REITs Dexus (DXS AU) and CFS (CFX AU) have the same asset value and market cap but Dexus pays 4x the fees of CFS. In China, Guangzhou R&F (2777 HK) and Poly Real Estate (600048 CH) both pay very low fees in absolute terms but once calculated relative to assets, Guangzhou's are 12x Poly's. Some Indian companies also attract attention for their low absolute level of fees. For example, Rander Corp (RFL IN) is small, with a market capitalisation of US$150m, but how good is a US$360 audit?

Email Rob for his auditing spreadsheet to scan companies in your portfolio for accounting issues.

Auditing Red Flags

We compiled a list of auditing red flags based on eleven ratios using the most subjective accounting standards for the Asian property sector and compared results with their audit fees. China Vanke (200002 CH), Carnival (996 HK), Hopson (754 HK) and Shenzhen Investment (604 HK) stand out from the 230 companies for the most red flags (7) and very cheap audits. Red flags matter as the 62 companies with four or more red flags underperformed our quality stocks by 45% over the last three years; so there are relative investing opportunities within the sector. Auditors seem less worried than investors given that 33 of the 62 companies had low audit fees.

Mining the Data

Chinese companies dominate each red flag list but in aggregate the Indian market looks worse. For example, Indian inventories have risen from 660 days in 2009, to 959 in 2013. By comparison, China's have grown relatively slowly, from 807 days in 2009, to 863 today. However, pre-sales days in China confirm demand is slowing relative to supply. Since the peak of 344 days in 2010, they have fallen to 294 in 2013. On a happier note, the Indonesian and Malaysian property markets look much healthier as revenues are rising and inventory days are at their lows.

Figure 1: Property Problems? Asian Companies with 6 or More Red Flags and Low Auditing Costs

Name (Ticker) - Flags		Name (Ticker) - Flags		Name (Ticker) - Flags	
China Vanke (200002 CH)	- 7	Shenzhen Invest. (604 HK)	- 7	Carnival Group (996 HK)	- 7
Hopson Dev. (754 HK)	- 7	China Fortune (600340 CH)	- 6	Risesun Real (002146 CH)	- 6
Franshion (817 HK)	- 6	Evergrande Real (3333 HK)	- 6	Shanghai Shimao (600823 CH)	- 6
Thaihot Group (000732 CH)	- 6				

Source: GMT Research

What Should an Audit Cost?

Fundamental investors need high quality published accounts. Moreover a high quality audit should be of benefit to the company. A good auditor will suggest how accounting processes can be improved, advise management on corporate best practice and check that the directors, never mind shareholders, are not being deceived. A cheap audit might signify thriftiness but it also suggests that either management does not want anyone looking too closely at the business or the controlling shareholder sees the business as their personal fiefdom.

Fundamental investors need quality audits

Pragmatic managements hire quality auditors

Accountants typically charge by the hour, so, although the final fee may be discounted and altered, the audit cost remains, at its core, a time-driven calculation. The fee therefore provides an indication of either the amount of time spent verifying the accounts or the seniority of staff looking at the audit. For example, all audits in China must be signed off by a qualified accountant, but unfortunately there are not enough to go around. As a result, there is not much difference in salary for qualified staff between the local and the major firms. However, at a local firm far more of the basic auditing will be done by cheaper underlings who have less experience and are unlikely to ask awkward questions.

Audit fees are a guide to quality of the audit and the seniority of audit staff

In the past, this lack of local staff even resulted in companies being audited by accounting staff that were unable to speak or read the local language. The overseas offices of major audit firms, typically in North America, often flew into Asia for a whistle-stop audit prior to and after an IPO. With the benefit of hindsight, it is not hard to see why so many US listed Asia plays have blown up.

Beware fly-by audits; make sure the auditor is based in Asia

In this report, by looking into the audit costs for over 700 listed property companies, we attempt to set out some benchmarks for audit fees. Although cost cannot be the only measure of auditing quality, it provides a start.

We have compared fees globally

We think that assets provide a better basis for comparison when reviewing property companies so fees were divided by asset values. To create some benchmarks, we have taken the range from the 21st percentile to the 79th percentile to represent a fair and reasonable cost. For many types of property company that means the highest "normal" fee is 4x the lowest "normal" fee. Outside this range and one starts to wonder just what happened. Why should an audit cost many multiples of that of a similar company in the same industry or how can a proper audit be done for a fraction of the price of competitors? Sadly, audit fees are not disclosed by listed companies in Korea and Taiwan, so while we have checked these companies for problem accounts there is no comparison with fees.

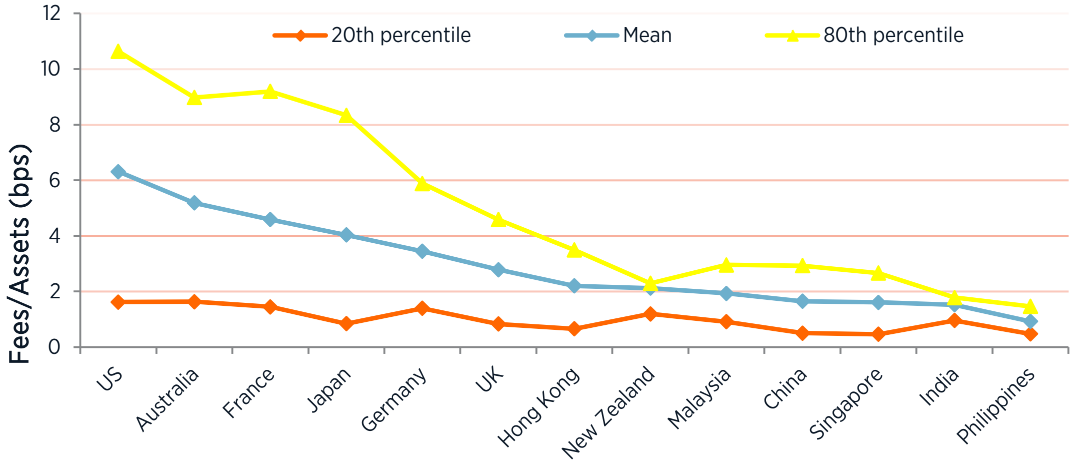
Creating some fee benchmarks

20th percentile is Low
80th percentile is High

Fee levels vary between countries, as shown in Figure 2, and are highest in the US (0.8-11 basis point range) and lowest in India and the Philippines (0.5-1.5 basis point range). Some of this difference will be due to salary levels but, as mentioned earlier, is more likely to be due to staff seniority and, perhaps, different company types. Nonetheless the major difference in cost will be due to differences in the amount of effort and time put in. The US benchmarks may also be distorted due to the small sample size of just 9 companies. For a complete comparison of fees by country please see Appendix I.

Costs vary from country to country and across the type of company

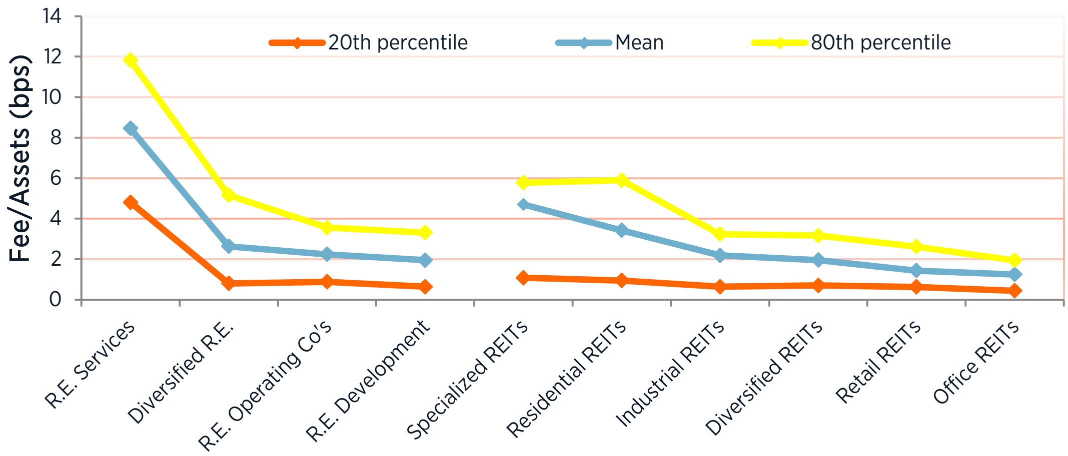
Figure 2: Auditing Fees/Turnover Around The World



Source: GMT Research

On a sub-sector basis, it is surprising that is not substantially easier to audit asset managers (REITs) where there are few moving parts rather than developers. But again that may be due to the fact that a high proportion of the developers are based in cheap audit countries whereas the REITS are based in expensive audit countries.

Figure 3: Auditing Fees/Turnover Across Different Property Types



Source: GMT Research

There is surprisingly little difference in fees across the property types

The spread between the 20th to 80th percentiles averages between 0.8-3.0 Bps of turnover so even in the normal range audit fees can vary by up to 4-5x. Most companies cluster within our 'normal' ranges for audit fees. However, in almost every sector there are 'extreme' fees, as shown in Figure 4, both exceptionally high and low. For example, in the diversified real estate sector, the minimum audit fee is 0.13bp whilst the highest is 18bp. One can but wonder what is so different at the companies whose fees are so far outside the normal range.

But there are norms and exceptions

Figure 4: Auditing Fees/Assets for Different Types of Property Company*

Sector	Min. (Bps)	20th percentile (Bps)	Mean (Bps)	80th percentile (Bps)	Max. (Bps)	No of co.'s
Real Estate Services	3.50	4.80	8.5	11.8	15	11
Diversified Real Estate	0.13	0.79	2.6	5.1	18	156
Real Estate Op. Company	0.20	0.89	2.2	3.6	70	107
Real Estate Development	0.01	0.64	1.9	3.2	17	255
Specialized REITs	0.51	1.09	4.7	5.8	18	10
Residential REITs	0.51	0.95	3.4	5.9	7	9
Industrial REITs	0.12	0.64	2.2	3.2	23	15
Diversified REITs	0.19	0.70	2.0	3.2	18	48
Retail REITs	0.37	0.63	1.4	2.6	11	27
Office REITs	0.27	0.44	1.2	1.9	10	27

* For companies around the world with at least US$100m of assets. Source: GMT Research

Extreme fees may be due to a lack of disclosure

These differences could have arisen for several reasons: limited disclosure; perhaps tax or corporate advice was bundled together as part of the audit fee; a corporate reorganization; or perhaps the company structure is just more complex than its competitors; or possibly only the parent company's fees were disclosed in the accounts? But the differences can be dramatic. For example, Dexus Property and CFS Retail are both REITs listed in Australia with similar market capitalisation and similar asset value. Yet Dexus' audit costs 4x that of CFS, as shown in Figure 5. Guangzhou R&F and Poly Real Estate, two Chinese developers, both have very low fees but even so, Poly's are 12x Gungzhou's.

Figure 5: Contrasting Audit Costs for Auto Parts Companies

Name	Ticker	Mkt Cap (US$bn)	Assets (US$bn)	Audit Cost ($)	Audit Fee (Bps)
Dexus Property	DXS AU	5.7	7.1	2,720,000	3.412
CFS Retail Prop.	CFX AU	5.7	7.9	760,000	0.854
Guangzhou R&F	2777 HK	4.2	23.2	280,000	0.670
Poly Real Estate	600048 CH	8.3	51.9	1,530,000	0.054

Source: GMT Research

In theory, Asia is complex and should be expensive

But not in reality- a US$52bn of assets audited for 0.05 basis points

Given that businesses in Asia often have multiple interconnecting relationships, complicated holding structures, trade across different jurisdictions where the legal situation can be unclear and use offshore companies to optimise their tax, one would think fees could be quite high. Presumably, auditing such companies is fraught with difficulty. Yet for some companies the audit fees would suggest that this is just not the case. For example, as Rander Corp shows that in India it is possible to get the auditor to certify the accounts for less than a Hong Kong audit partner's lunch. In the table below, China Poly's fees were just 0.05 basis points of assets which were less are less than half the fees of the next cheapest, China Resources Land. How much time could possibly have been spent checking China Poly's US$52bn of assets?

Figure 6: Asia's Lowest Property Audit Fees

Name	Ticker	Sector	Mkt Cap (US$bn)	Assets (US$bn)	Audit Cost ($)	Audit Fee (Bps)
Poly Real Estate	600048 CH	Real Estate Develop.	8.3	51.9	276,525	0.05
China Res. Land	1109 HK	Real Estate Develop.	11.1	36.3	433,050	0.12
Ascendas Real Est.	AREIT SP	Industrial REITs	4.6	5.8	69,915	0.12
China Fortune-A	600340 CH	Diversified Real Estate	5.5	12.2	162,662	0.13
China Vanke Co	200002 CH	Real Estate Develop.	14.3	79.2	1,382,626	0.18
Nanjing Gaoke	600064 CH	Diversified Real Estate	0.9	2.6	48,799	0.18
Belle Corp	BEL PM	Real Estate Develop.	1.4	0.7	23,579	0.32
Special mention for fewest dollars paid						
Rander Corp Ltd	RFL IN	Real Estate Develop.	149	0.0	359	0.80
Swan Energy Ltd	SWAN IN	Real Estate Develop.	248	0.2	4,137	0.20
Amfirst Reit	ARET MK	Office Reits	212	0.4	10,937	0.27

Source: GMT Research

Accounting Red Flags

Some accounting standards are ripe for manipulation

Eleven ratios that should worry auditors

Ideally, accounts should show an honest and faithful representation of a company's affairs. They would avoid legalese and provide clear explanations where necessary. Given that many accounting standards are reasonably simple, clear and well understood, this should be possible. However property companies are somewhat different and so some standards can be flexed to suit management. We are particularly concerned with investments in related companies, customer advances, pre-sales, inventory, receivables, pre-paid expenses, intangibles, capitalised interest and deferred tax liabilities. All of them give management room for interpretation rather than necessarily encouraging honesty.

Red Flags represent a "Sanity Test"

A high quality audit not only tests the business processes, i.e. do invoices go through the system and get properly accounted for, but also conducts a "sanity" test, i.e. does a ratio, process, relationship, etc., look right. In this report, our Red Flags represent the "sanity test" that should have given auditors pause for thought. To this end, we awarded companies red flags wherever the numbers on our ratios either seemed excessive or made a material impact on the accounts.

Report covers 230 companies…

…Spreadsheet over 1,500

We looked through the accounts of over 1500 property companies globally, 800 of which are based in Asia and 230 with a market capitalisation in excess of US$1bn. This report only covers those 230 companies but our spreadsheet contains the data on all 1500 companies (available from robert@gmtresearch.com on request).

The ratios are important because those companies with a higher amount of red flags underperformed those with less. The 62 companies which had four or more red flags under-performed those with fewer red flags by 37% over the last three years, as shown in Figure 7. The "quality" list, companies which had 2 flags or less and normal auditing fees, not only rose on average by 47% in absolute terms but added another 8% of out-performance compared to those with 4+ flags.

Figure 7: Red Flags and stock performance

Red Flags	0	1	2	3	4	5	6	7
Performance over 3 years								
Equal weight	24%	29%	20%	(11%)	(21%)	(25%)	(27%)	(7%)
Cap. Weighted	29%	41%	39%	(14%)	(14%)	(7%)	(8%)	10%
No of companies	43	39	29	24	25	21	10	6
Performance over 1 year								
Equal weight	(7%)	(5%)	(6%)	(9%)	(14%)	(22%)	(21%)	(16%)
Cap. Weighted	(4%)	(4%)	(5%)	(15%)	(20%)	(17%)	(10%)	(28%)
No of companies	51	49	34	27	24	24	11	6

NB The number of companies change because not all companies were listed three years ago. Source: Bloomberg and GMT Research

Common sense would suggest that the more stressed the balance sheet, the more time auditors need to go through the books. Still over half of the companies with 4 or more red flags had low auditing fees. By comparison, just 23% of companies in Asia have low fees. We list the 33 high flag, low fee companies in ascending alphabetical order in Figure 8.

Problematic accounts should result in expensive audits But not for these companies

Interestingly, all of the companies in this short-list are developers rather than asset managers (REITs) and all of them apart from DLF (which is Indian) are either China-based or have significant Chinese operations. One might expect that size would confer some economies of scale and indeed China Vanke, China Resources Land, Country Garden and Poly Real Estate have some of the lowest fees. However, China Vanke and Country Garden had more than enough red flags, 7 and 5 respectively, to offset some of the size benefits and drive costs back up.

Bad boys are all developers and mostly Chinese

Figure 8: 4+ Red Flags and Low Audit Fees

Name	Ticker	Industry	Mkt Cap (US$bn)	Red Flags	Audit Fee (Bps)
Beijing Capital	600376 CH	Real Estate Development	1.6	5	0.30
Beijing Urban	600266 CH	Real Estate Development	1.3	4	0.26
Carnival Group	996 HK	Real Estate Operating Co.	1.0	7	0.88
China Fortune-A	600340 CH	Diversified Real Estate	5.5	6	0.13
China Merchant	200024 CH	Real Estate Development	4.5	5	0.26
China Res Land	1109 HK	Real Estate Development	11.1	4	0.12
China Vanke	200002 CH	Real Estate Development	14.3	7	0.18
Country Garden	2007 HK	Real Estate Development	7.8	5	0.33
DLF Ltd	DLFU IN	Diversified Real Estate	6.4	4	0.13
Evergrande Real	3333 HK	Real Estate Development	6.4	6	0.43
Financial St	000402 CH	Real Estate Development	2.9	5	0.30
Franshion Ppt	817 HK	Diversified Real Estate	2.7	6	0.36
Greattown Hldg	900940 CH	Real Estate Development	1.3	5	0.50
Guocoland Ltd	GUOL SP	Real Estate Development	2.1	5	0.45
Hang Lung Group	10 HK	Diversified Real Estate	7.4	4	0.55
Hangzhou Binj.	002244 CH	Real Estate Development	1.3	4	0.28
Hopson Dev.	754 HK	Real Estate Development	2.0	7	0.44
Jinke Properties	000656 CH	Real Estate Development	1.3	5	0.27
Kaisa Group Hldg	1638 HK	Real Estate Development	1.5	5	0.55
Kerry Properties	683 HK	Diversified Real Estate	4.5	4	0.71
Longfor Properties	960 HK	Real Estate Development	6.8	4	0.28
Macrolink Real	000620 CH	Real Estate Development	1.6	4	0.49
Poly Property	119 HK	Diversified Real Estate	1.6	5	0.66
Poly Real Estate	600048 CH	Real Estate Development	8.3	4	0.05
Risesun Real -A	002146 CH	Real Estate Development	3.3	6	0.21
Shang Lujiazui-A	600663 CH	Diversified Real Estate	4.4	4	0.50
Shang Shimao	600823 CH	Real Estate Development	1.6	6	0.23
Shenzhen Invest	604 HK	Diversified Real Estate	1.7	7	0.68
Shui On Land	272 HK	Real Estate Development	2.1	5	0.51
Sunac China Hldg	1918 HK	Real Estate Development	1.5	5	0.49
Suning Universal	000718 CH	Diversified Real Estate	1.3	4	0.43
Thaihot Group	000732 CH	Diversified Real Estate	1.4	6	0.20
Yinyi Real Estate	000981 CH	Real Estate Development	1.1	4	0.65

Source: GMT Research

The “quality” list includes a lot of REITs, but it also contains a few Chinese developers such as China Sports, Wanda Commercial and China World, amongst others. The rest is made up of regional developers including Vista Land & Life from the Philippines, Oberoi Realty in India, UEM Sunrise in Malaysia and others in Japan and Australia, as show in Figure 9.

Figure 9: "Quality Stocks": Low Flags and Normal Fees

Name	Ticker	Type	Market Cap (US$bn)	Flags	Audit fee (Bps)	3 year stock Performance
Ascott Residence	ART SP	Residential REITs	1.5	0	5.75	5%
Australand Prop.	ALZ AU	Diversified REITs	2.3	1	2.79	44%
Bukit Sembawang	BS SP	Real Estate Develop.	1.2	2	1.12	39%
BWP Trust	BWP AU	Industrial REITs	1.5	0	0.70	45%
CFS Retail Prop.	CFX AU	Retail REITs	5.7	0	0.85	11%
China Sports	600158 CH	Real Estate Develop.	1.4	2	2.98	50%
China World	600007 CH	R. E. Operating Co.	1.6	0	1.08	4%
City Development	CIT SP	Diversified Real Estate	7.5	0	5.38	(8%)
Cromwell Prop.	CMW AU	Office REITs	1.6	0	1.67	42%
Daibiru Corp	8806 JP	R. E. Operating Co.	1.1	0	0.93	56%
Daito Trust Cons	1878 JP	Diversified Real Estate	8.4	0	1.68	58%
Dexus Property	DXS AU	Diversified REITs	5.7	0	3.41	27%
E-House China	EJ US	Real Estate Services	1.4	2	10.06	(6%)
Fortune Reit	778 HK	Retail REITs	1.6	0	0.96	72%
Fragrance Group	FRAG SP	Real Estate Develop.	1.2	1	0.78	47%
GLP J-Reit	3281 JP	Industrial REITs	2.2	0	1.13	N/A
Goodman Group	GMG AU	Industrial REITs	8.1	2	2.18	36%
Goodman Property	GMT NZ	Diversified REITs	1.1	1	2.21	11%
GPT Group	GPT AU	Diversified REITs	6.0	1	1.45	23%
Great Eagle	41 HK	Diversified Real Estate	2.3	0	1.08	(2%)
Growthpoint Prop.	GOZ AU	Diversified REITs	1.1	0	1.19	35%
Ho Bee Land Ltd	HOBEE SP	Real Estate Develop.	1.2	2	0.92	55%
Hydoo Internat.	1396 HK	Real Estate Develop.	1.3	0	2.04	N/A
IGB Corp Bhd	IGB MK	Diversified Real Estate	1.1	1	1.09	28%
Investa Office F	IOF AU	Office REITs	1.9	1	0.91	31%
Kenedix Inc	4321 JP	Diversified Real Estate	1.1	1	3.57	197%
Kiwi Income Prop	KIP NZ	Diversified REITs	1.0	0	1.19	11%
Leopalace21 Corp	8848 JP	Diversified Real Estate	1.1	1	3.86	330%
Logan Property	3380 HK	Real Estate Develop.	1.5	1	3.02	N/A
Mirvac Group	MGR AU	Diversified REITs	6.0	1	2.43	38%
Mitsui Fudosan	8801 JP	Diversified Real Estate	28.0	2	0.93	131%
Nomura Real Est.	3231 JP	Diversified Real Estate	3.5	2	1.32	41%
Oberoi Realty	OBER IN	Real Estate Develop.	1.4	1	1.73	7%
Orix Jreit Inc	8954 JP	Office REITs	2.6	1	0.66	56%
Parkwaylife Reit	PREIT SP	Health Care REITs	1.1	0	1.85	31%
Shang Jinq Exp.	900911 CH	Diversified Real Estate	1.4	0	0.95	18%
Singapore Land	SL SP	R. E. Operating Co.	3.1	0	1.02	31%
SP Setia Bhd	SPSB MK	Real Estate Develop.	2.3	1	0.82	(28%)
Stockland	SGP AU	Diversified REITs	8.2	1	2.08	8%
Sunway Bhd	SWB MK	Diversified Real Estate	1.7	2	2.82	N/A
Swire Pacific	19 HK	Diversified Real Estate	17.2	0	1.09	(11%)
Tokyo Tatemono	8804 JP	Diversified Real Estate	3.8	2	1.28	207%
UEM Sunrise Bhd	UEMS MK	Real Estate Develop.	3.2	1	0.69	(18%)
United Indl Corp	UIC SP	Diversified Real Estate	3.7	0	0.84	19%
UOL Group Ltd	UOL SP	Diversified Real Estate	4.1	2	1.45	35%
Vista Land & Life	VLL PM	Real Estate Develop.	1.2	1	1.66	91%
Wanda Commercial	169 HK	Real Estate Develop.	1.3	2	1.87	300%
Westfield Retail	WRT AU	Retail REITs	8.8	1	0.84	19%
Wheelock Property	WP SP	Real Estate Develop.	1.7	2	1.14	(2%)
Wing Tai Hldgs	WINGT SP	Real Estate Develop.	1.2	1	1.15	27%
Yuexiu Real Estate	405 HK	Retail REITs	1.3	0	1.02	(10%)

Source: GMT Research

In the rest of this report, we talk through each of the eleven test ratios and highlight those companies that are materially exposed to each one.

Red Flag 1: Related Companies

Scored if investments in related companies exceed 20% of equity.

Flagged if >20% of equity

To control risks, limit liability and to enhance management control, each property project is usually a separate company. Furthermore, particularly with larger projects, developers often get involved in partnerships, joint ventures and multiple shareholders. As a result, it is not unusual for a property company to have multiple subsidiaries, associates and joint ventures. However such holdings also provide a convenient way to hide leverage, contingent liabilities and possibly profits. In the less professional/regulated parts of the world, it is not impossible to think that the controlling shareholder might use the listed vehicle to provide financial support for a privately owned contractor or developer.

Property companies often have lots of subsidiaries and associates

In Hong Kong, developers must disclose the gearing and asset values of these companies. Unfortunately the same rules are not always in place elsewhere so unconsolidated related companies become an accounting black hole. As with all the ratios in this report, we understand that, in principle, some investments may need to be made and so it is not an automatic red flag, but once they become material, it is time the auditor took a closer look. This can prove very difficult if the related company is audited by someone else or does not have coterminous accounting periods.

Hong Kong companies have to disclose assets and leverage but it is not the same elsewhere

Equity investments in related unconsolidated companies

Equity investments look innocuous but may conceal contingent liabilities and parent company guarantees. It is of course possible that if the stakes are carried at book value they might be a source of hidden value. However, it is rare that property companies, which are usually always looking to borrow money, leave assets seriously undervalued on the balance sheet without some supporting note.

Unconsolidated equity investments can hide both value and liability

The list in Figure 10 contains four Australian REITs (Westfield Group, Charter Hall, Westfield Retail and Goodman Group) for whom the investments in related companies might be used to control asset holding companies so explaining the size of the investment. However, to have such a large percentage of the company's net asset value in related parties suggests that remaining assets are debt funded thereby creating liquidity risk. It also begs the question as to whether minority investors are being sufficiently rewarded for funding other companies.

Why do the REITs need to invest in other companies?

Figure 10: Investments in Related Companies as % Equity

Short Name	Ticker	Industry	Mkt cap (US$bn)	Investments in related companies	Audit Fee (Bps)	Audit Fee Range
Westfield Group	WDC AU	Retail REITs	21.0	102%	3.2	High
CapitaMalls Asia	CMA SP	R.E. Operating Company	7.3	93%	0.5	Low
Ruentex Development	9945 TT	Real Estate Development	2.1	92%	N/A	N/A
Capitaland Ltd	CAPL SP	Diversified Real Estate	10.8	89%	0.6	Low
Charter Hall Group	CHC AU	Diversified REITs	1.4	77%	5.3	High
KWG Property	1813 HK	Real Estate Development	1.7	74%	0.7	Normal
Westfield Retail	WRT AU	Retail REITs	8.8	67%	0.8	Normal
Central China	832 HK	Real Estate Development	0.6	63%	1.5	Normal
Goodman Group	GMG AU	Industrial REITs	8.1	59%	2.2	Normal
Sunac China Holding	1918 HK	Real Estate Development	1.5	58%	0.5	Low

Source: Bloomberg and company accounts

At least these Australian companies seem to be spending money on getting properly audited. The same cannot be said for CapitaMalls which has reinvested 93% of its equity in related companies and yet the audit fee is just 0.5bp of assets. The same is also true for Capitaland and Sunac China.

Loans to Related companies

Most large companies do not make material loans to related unconsolidated companies. Presumably, this is because if the projects are good enough, such investments should be made with equity so that shareholders get most of the upside.

Most companies do not make material loans

One Chinese company, Sunshine 100, and two Indian ones, Unitech and Prestige, nonetheless have material debt relationships with related companies. To have greater than 20% of book value lent out without material disclosure seems to take on an unnecessarily large risk. At least the auditors have spent some time on the accounts at the Indian companies. However, an audit fee of just 0.5bps for Sunshine seems rather low for a company taking on so much credit risk, as shown in Figure 11.

Lending >25% of book value with limited disclosure should raise questions

Figure 11: Money lent to related companies

Name	Ticker	Industry	Mkt cap US$m	Money owed by related company as % of equity	Auditing Fees (Bps)	Audit Fee Range
Sunshine 100	2608 HK	Real Estate Development	1.0	43%	0.5	Low
Unitech Ltd	UT IN	Real Estate Development	1.3	31%	1.6	Normal
Prestige Est.	PEPL IN	Diversified Real Estate	1.3	29%	1.0	Normal
Greentown	3900 HK	Real Estate Development	2.1	17%	1.4	Normal
Oberoi Realty	OBER IN	Real Estate Development	1.4	13%	1.7	Normal
Sunac China	1918 HK	Real Estate Development	1.5	12%	0.5	Low
Growthpoint	GOZ AU	Diversified REITs	1.1	10%	1.2	Normal

Source: Bloomberg and company accounts

In most of this report, we have not looked at companies with a market cap below US$1bn. However the amounts that Sunteck Realty, Sobha Development and Godrej Properties are lending to related companies seemed so out of line that we thought it worth a mention, see Figure 12.

But it is worse at the small Indian companies

Figure 12: Money lent to related companies- Small companies

Name	Ticker	Industry	Mkt cap (US$m)	Money owed by related company as % of equity	Auditing Fees (Bps)	Audit Fee Range
Sunteck Realty	SRIN IN	Div. Real Estate	0.4	80%	0.2	Low
Sobha Dev.	SOBHA IN	Real Estate Develop.	0.7	66%	1.6	Normal
Godrej Prop.	GPL IN	Real Estate Develop.	0.9	47%	1.5	Normal
Housing Dev.	HDIL IN	Real Estate Develop.	0.7	33%	0.9	Normal
Omaxe Ltd	OAXE IN	Real Estate Develop.	0.5	30%	1.1	Normal
Beijing Prop.	925 HK	R.E. Operating Cos.	0.6	28%	3.2	Normal
Mbk Pcl	MBK TB	R.E. Operating Cos.	0.9	27%	N/A	N/A

Source: Bloomberg and company accounts

Red Flag 2: Customer Deposits

Scored if customer deposits reduce net debt by more than 30%.

Flagged if Net Debt fell by 30%

Deducting customer deposits/prepayments from a company's reported net debt position reveals its true financial position.

Customer deposits help guarantee revenues, boost liquidity, reduce credit risk and lower funding costs. In short, customer advances are normally good for both management and investors. However, too much of a good thing can be a problem. Excessive customer deposits can obscure a company's true financial position by making it appear that there is surplus cash. In the absence of strict escrow regulations that ring-fence these deposits so that they are only used to finance the project they were intended for, unscrupulous management can use them for other purposes.

Customer Advances should be a good thing...

...but only if used wisely

Auditors are do not seem to share our concerns on this because the companies with the highest exposure to customers deposits (relative to net debt) all had low audit fees, as shown in Figure 13. This might be because, with the exception of China Fortune, all the companies have net debt/equity ratios below 50%. However, adjust for advances and the numbers look very different. Hangzhou Binj., China Fortune, China Vanke, Kaisa Group, Sunning Universal, Country Gardens and Franshion's adjusted net debt/equity levels all rise above 70%.

Take away Customer Advances and debt levels rise above 70%

Figure 13: Customer Advances/Deposits impact on Net Debt

Name	Ticker	Industry	Mkt cap US$bn	Net debt/equity with advances	Net debt/equity without advances	Audit Fee (Bps)	Audit Fee Range
Longfor Prop.	960 HK	Real Estate Develop.	6.8	39%	64%	0.3	Low
Hangzhou Binj.	002244 CH	Real Estate Develop.	1.3	49%	77%	0.3	Low
China Fortune	600340 CH	Diversified Real Estate	5.5	55%	87%	0.1	Low
China Vanke Co.	200002 CH	Real Estate Develop.	14.3	38%	72%	0.2	Low
Kaisa Group	1638 HK	Real Estate Develop.	1.5	47%	72%	0.5	Low
Suning Universal	000718 CH	Diversified Real Estate	1.3	45%	71%	0.4	Low
Aeon Mall Co.	8905 JP	R.E. Operating Co.	5.6	30%	45%	0.7	Low
China Overseas	81 HK	Real Estate Develop.	1.3	40%	55%	0.4	Low
Country Garden	2007 HK	Real Estate Develop.	7.8	46%	70%	0.3	Low
Franshion Prop	817 HK	Diversified Real Estate	2.7	42%	79%	57%	0.4

Source: GMT Research

Far less dramatic but still worth noting are those companies that look conservative i.e. have net cash balances but then move into a debt position once advances are accounted for. Only Shanghai Industrial and China Sports are in this position and both move from net cash to 20% net debt once advances are adjusted for, as shown in Figure 14.

Only two companies go from net cash to net debt

Figure 14: Customer Advances/Deposits impact on Net Debt: Conservative Companies

Name	Ticker	Industry	Mkt cap (US$bn)	Net debt without advances	Audit Fee (Bps)	Audit Fee Range
Shanghai Ind.	600748 CH	Real Estate Develop.	1.2	21%	0.5	Low
China Sports	600158 CH	Real Estate Develop.	1.4	20%	3.0	Normal

Source: GMT Research

Red Flag 3: Pre-Sales

Scored if pre-sales exceed 50% of turnover.

Flagged if > 50% of Turnover

Pre-sales not only affect debt numbers but can also provide a level of certainty about future revenues. However, as noted in our customer advances red flag section, money is fungible and can be used for other projects thereby allowing companies to over-reach. This could cost customers their deposits if projects fail. In order to protect customers where pre-sales are allowed, most countries only permit developers to take in a small percentage of the sales value upon signing and then take further partial payments as the project progresses. Today only China and Indonesia (that we are aware of) allow companies to take 100% of sales value on signing.

Advances are fungible which is why many countries are wary of large Pre-Sales deposits

Unsurprisingly, Chinese companies have the largest pre-sales in the region, as shown in Figure 15. However, this has been falling since 2010 and is now below 300 days suggesting that growth is slowing. Only Taiwan has seen pre-sales grow since 2010 and even there it peaked in 2012. Limited pre-sales funding elsewhere in the region means companies have to rely on internal funding which results in slower growth. However, it is probably healthier and results in a more sustainable property market.

The amount of Pre-Sales is falling in China which suggests demand is slowing

Figure 15: Customer Advances/Deposits impact on Net Debt

Country	2009	2010	2011	2012	2013	No of companies
China	304	344	339	325	294	196
Philippines	295	284	281	220	206	12
Japan	154	162	138	130	142	44
Taiwan	125	102	104	160	122	31
Hong Kong	67	109	67	78	82	48
Thailand	47	56	67	65	57	45
Australia			34	44	39	2
Singapore	41	38	34	28	35	13
Malaysia	78	75	62	66	33	9
Indonesia					173	7

Source: GMT Research

Whilst there are reports that China's property sector is in a bubble, at least pre-sales mean there is a degree of certainty over 2014 revenues. Companies with the biggest exposure to presales are all Chinese, as shown in Figure 16. The problem is that most seem to have used pre-sales cash to buy inventory. All these companies are in a net debt position, even with pre-sales cash, so the auditors should be checking that they can fund the completion of the buildings already promised, never mind new developments. For example, Beijing Capital has pre-sold 18 months of turnover but bought 5½ years of inventory leaving it with a net of 2.9 years to fund. Even with pre-sales cash, net debt/equity is 67%, so raising further funding may become a problem.

Pre-Sales cash has been used to fund larger land purchases.....

...so how will they fund final construction?

Figure 16: Top Pre-Sales by Company

Name	Ticker	Industry	Mkt cap (US$bn)	Pre-Sales (years)	Inventory years	Audit Fee (Bps)	Audit Fee Range
Zhongtian Urban	000540 CH	Real Estate Develop.	1.1	2.0	3.8	0.7	Normal
Hangzhou Binj.	002244 CH	Real Estate Develop.	1.3	1.8	3.2	0.3	Low
China Fortune	600340 CH	Diversified Real Estate	5.5	1.8	2.8	0.1	Low
Beijing Capital	600376 CH	Real Estate Develop.	1.6	1.7	5.5	0.3	Low
Sunshine City	000671 CH	Real Estate Develop.	1.4	1.7	3.3	0.9	Normal
Commodities City	600415 CH	Diversified Real Estate	2.3	1.6	2.5	0.6	Low
Kaisa Group Hldg	1638 HK	Real Estate Develop.	1.5	1.5	2.6	0.5	Low
Beijing Urban	600266 CH	Real Estate Develop.	1.3	1.4	3.5	0.3	Low
Jinke Properties	000656 CH	Real Estate Develop.	1.3	1.3	3.2	0.3	Low

Source: GMT Research

Red Flag 4: Inventory

Scored if Inventory exceeds 730 days of turnover.

Flagged if > 2 years Turnover

In most Asian markets, it takes around three years to go from land purchase to completion. Assuming a steady production of projects, valued at cost plus construction on the balance sheet, inventories would be in the range of 1-2 years of turnover. Inventory in excess of that suggests that either the company is struggling to sell or there is about to be a massive ramp-up in operations. Either way, auditors should be taking a close look at what is happening.

Excessive inventory should attract auditor attention

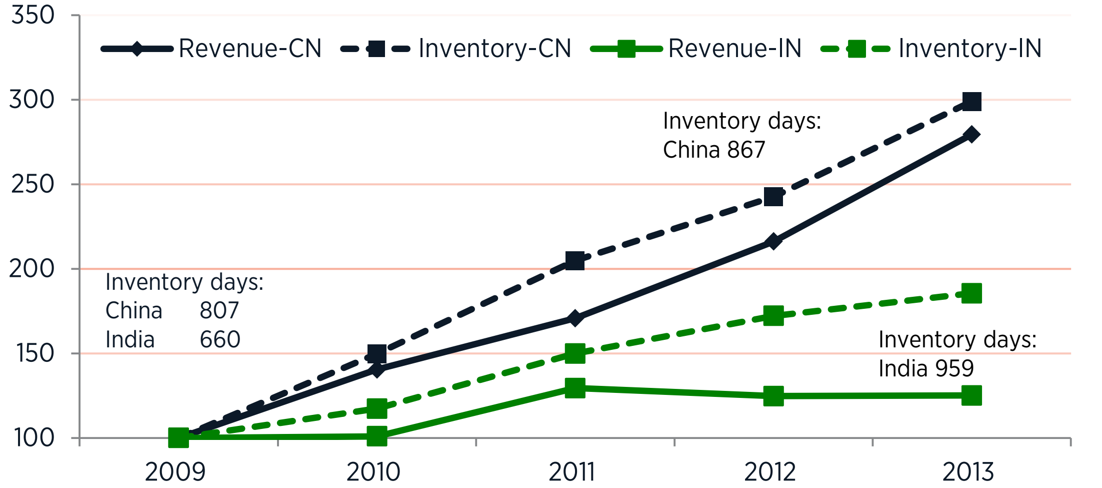
Inventory years were calculated using sales, rather than the traditional cost-of-goods-sold method. It is a less accurate and somewhat more generous way of measuring inventory, but limited levels of disclosure mean it is hard to get good quality cost-of-construction data for enough companies.

Turnover based Inventory days are generous

Before getting into the detail, a quick look at the national data shows that while revenues have grown 2.8x in China over the last four years, as shown in Figure 17, inventories have grown even faster, expanding Inventory days from 807 to 863 days. The real disaster, however, is in India where inventories have continued to grow while revenues have flat-lined over the past two years. On the back of this, inventory days have exploded from 660 in 2009 (which is ok) to a worryingly high 960.

Inventory growth exceeds Revenue growth in both China and India

Figure 17: Revenue and Inventory in China and India (re-based in 2009)

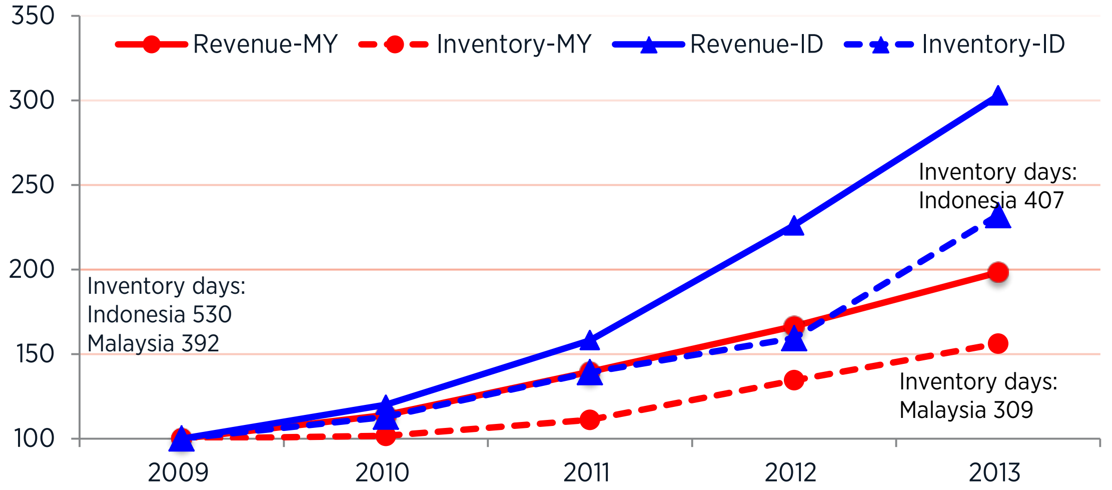


Revenue and Inventory were both indexed and based on 100 in 2009. Source: GMT Research

The data looks far more encouraging in Malaysia and Indonesia, as shown in Figure 18, where revenues have been growing faster than inventories over the last four years and as such inventory days are now at their lows.

It all looks better in Malaysia and Indonesia

Figure 18: Revenue and Inventory in Malaysia and Indonesia (re-based in '09)



Revenue and Inventory were both indexed and based on 100 in 2009. Source: GMT Research

It comes as no surprise to find Chinese companies dominating the highest inventory list. Moreover, apart from Beijing Capital, Hopson, Shanghai Chengtou and Thaihot, they all have pre-sales of less than a year's turnover so have to fund their inventory themselves, as shown in Figure 19. One can but hope that it consists of high quality land bank and not unsold developments in third tier cities.

No surprise then that Chinese companies have a problem

The audit fees are low for everyone but we should note that part of the reason that Cheung Kong's fees look low is because of the consolidation of Hutchison Whampoa. Strip those assets out, it is a separately audited company, and the fee doubles. The cost would still be low but it does show just how cheap some of the other audits are.

But fees stay low, Cheung Kong's fees provide a guide to just how low

Figure 19: Highest Inventory Days in Asia

Name	Ticker	Industry	Mkt Cap (US$bn)	Inventory (Years)	Pre-Sales (Years)	Audit Fee (Bps)	Audit Fee Range
Guocoland Ltd	GUOL SP	Real Estate Develop.	2.1	7.7	0.7	0.4	Low
Oceanwide Hldg.	000046 CH	Div. Real Estate	3.3	6.3	0.2	N/A	N/A
Beijing Capital	600376 CH	Real Estate Develop.	1.6	5.5	1.7	0.3	Low
Shang Lujiazui	600663 CH	Div. Real Estate	4.4	5.4	0.5	0.5	Low
Hopson Dev.	754 HK	Real Estate Develop.	2.0	4.9	1.0	0.4	Low
Cheung Kong	1 HK	Real Estate Develop.	40.2	4.7	0.4	0.2	Low
Shanghai Cheng.	600649 CH	Real Estate Develop.	3.2	4.7	1.1	N/A	N/A
China Enterprise	600675 CH	Real Estate Develop.	1.4	4.6	0.4	0.6	Low
Keppel Land	KPLD SP	Real Estate Develop.	4.3	4.4	0.0	0.7	Low
Thaihot Group	000732 CH	Div. Real Estate	1.4	4.3	1.2	0.2	Low

Source: GMT Research

Re-running the screen excluding Chinese companies generates a list of names more evenly spread across ASEAN, as shown in Figure 20. It should be noted that unlike Chinese companies, Singapore listed property companies like Oxley, Frasers and Bukit Sembawang value their inventory net of customer advances or "progress billing", so inventory looks smaller than it would under Hong Kong Chinese accounting. In addition, in this auditing report in general they avoided getting red-flagged for pre-sales. But even taking that into account, it still looks as if only the top five companies have overly large inventories. These include Bangkok Land, Bukit Sembawang, Highwealth Construction, Oxley holdings and possibly Belle Corp.

Beware some inventories in Singapore and India may be distorted by "Progress billing"

Figure 20: Highest Inventory Days in Asia excluding China

Name	Ticker	Industry	Mkt Cap (US$bn)	Inventory (Years)	Audit Fee (Bps)	Audit Fee Range
Bangkok Land	BLAND TB	Real Estate Operating Co.	1.0	3.8	N/A	N/A
Bukit Sembawang	BS SP	Real Estate Develop.	1.2	3.1	1.1	Normal
Highwealth Cons.	2542 TT	Real Estate Development	1.4	2.8	N/A	N/A
Oxley Holdings	OHL SP	Real Estate Development	1.8	2.8	1.0	Normal
Belle Corp	BEL PM	Real Estate Development	1.4	2.6	0.3	Low
Frasers Centre.	FCL SP	Real Estate Development	4.6	2.3	N/A	N/A
DLF Ltd	DLFU IN	Diversified Real Estate	6.4	2.3	0.1	Low
Oberoi Realty	OBER IN	Real Estate Development	1.4	2.1	1.7	Normal
Supalai Pub Co	SPALI TB	Real Estate Development	1.0	2.1	N/A	N/A
Lippo Karawaci	LPKR IJ	Real Estate Development	2.2	2.1	N/A	N/A

Source: GMT Research

Red Flag 5: Work in Progress

Scored if work-in-progress exceeds 30% of assets.

Flagged if> 30% of assets

Given that un-developed land bank can distort developers' inventory and that asset managers typically don't have much inventory, work-in-progress was also tested as a percentage of assets to get a sense of how much activity was actually going on. This should have a bearing on how many transactions the auditors would need to test in the audit as well as how mature a company's assets are. There is overlap with inventory and again some of the same Chinese names appear, like China Vanke, Thaihot, Suning Universal and Jinke Properties. However, Pruksa Real Estate heads the list with 87% of its assets currently under construction, as shown in the table.

Landbank can distort inventory and give a false idea of activity

Work in Progress is better

Figure 21: Work in progress as % of assets

Name	Ticker	Industry	Mkt Cap (US$bn)	Work in progress as % of assets	Audit Fee (Bps)	Audit Fee Range
Pruksa Real Est.	PS TB	R.E. Development	1.6	87%	N/A	N/A
Oceanwide Hldg.	000046 CH	Diversified Real Estate	3.3	75%	N/A	N/A
Suning Universal	000718 CH	Diversified Real Estate	1.3	71%	0.4	Low
China Vanke Co	200002 CH	R.E. Development	14.3	65%	0.2	Low
Sunshine City	000671 CH	R.E. Development	1.4	64%	0.9	Normal
Yanlord Land	YLLG SP	R.E. Development	1.7	63%	0.9	Normal
Thaihot Group	000732 CH	Diversified Real Estate	1.4	61%	0.2	Low
Beijing Urban	600266 CH	R.E. Development	1.3	60%	0.3	Low
Yinyi Real Est.	000981 CH	R.E. Development	1.1	59%	0.6	Low
Jinke Properties	000656 CH	R.E. Development	1.3	59%	0.3	Low

Source: GMT Research

Remove both Chinese companies and the pure property developers from our screen and a few Taiwanese and Thai companies come up. However, these companies are relatively small and only Hemeraj Land has a market capitalisation over US$1bn, as shown below.

Outside China, only small companies get flagged

Figure 22: Work in progress as % of assets

Name	Ticker	Industry	Mkt Cap (US$bn)	Work in progress as % of assets	Audit Fee (Bps)	Audit Fee Range
Chong Hong Con.	5534 TT	Div. Real Estate	0.7	51%	N/A	N/A
Open House	3288 JP	Real Estate Services	0.6	46%	5.0	Normal
Huaku Develop.	2548 TT	Div. Real Estate	0.7	42%	N/A	N/A
Lippo Cikarang	LPCK IJ	Div. Real Estate	0.5	39%	N/A	N/A
Radium Life Tech	2547 TT	Div. Real Estate	0.7	37%	N/A	N/A
Indiabulls Real	IBREL IN	Div. Real Estate	0.7	34%	1.8	Normal
Hemaraj Land	HEMRAJ TB	R. E. Operating Co.	1.0	33%	N/A	N/A
Grand Canal Land	GLAND TB	R. E. Operating Co.	0.5	31%	N/A	N/A

Source: GMT Research

Red Flag 6: Receivables

Scored when receivables exceed 60 days turnover or 20% of equity.

Flagged if > 20% of equity

Excessive receivables are a problem in any industry and suggest that either a company is selling to people that are struggling to pay, a sales force has been channel-stuffing to boost year-end revenues, or perhaps the product is not competitive enough to get normal credit terms.

Why do developers have receivables problems?

Given that developers in Asia are largely selling homes to retail buyers who are presumably either paying cash or mortgages, we were surprised to find any companies that had a receivables problem. To see that the top four names, Oxley Holdings, Renhe Commercial, Vista Land and Life and Shanghai Zhangli, had close to a year or more's receivables is staggering, as shown in Figure 23.

Four had more than 300 days

At least this is one list not full of Chinese names but in a country where everyone relies on pre-sales this should come as no surprise. Still, it does make one wonder how Renhe Commercial, Shanghai Zhanglia and Shanghai Industrial manage to have over six months of receivables.

How do you have long Receivables and Pre-Sales at the same time?

Figure 23: Receivable days

Name	Ticker	Industry	Mkt Cap (US$bn)	Receivable days	Receivable as % of equity	Audit cost (bps)	Audit Fee range
Oxley Holdings	OHL SP	R.E. Development	1.8	567	298%	1.0	Normal
Renhe Comm.	1387 HK	R.E. Operating Co.	1.1	519	4%	3.1	Normal
Vista Land & Life	VLL PM	R.E. Development	1.2	336	38%	1.7	Normal
Shang Zhangjia	600895 CH	Diversified Real Estate	1.6	331	23%	0.9	Normal
Unitech Ltd	UT IN	R.E. Development	1.3	232	14%	1.6	Normal
Megaworld	MEG PM	R.E. Development	3.4	231	19%	0.5	Low
Fragrance Gp	FRAG SP	R.E. Development	1.2	210	25%	0.8	Normal
Shanghai Indus	600748 CH	R.E. Development	1.2	187	36%	0.5	Low
China Merchant	200024 CH	R.E. Development	4.5	180	52%	0.3	Low
E-House China	EJ US	Real Estate Services	1.4	178	43%	10.1	Normal

Source: GMT Research

None of the companies with extensive receivables had high audit costs. But it is good to see that most do at least have normal audit costs.

Normally, one would assume that property titles do not pass to the customer until full payment has been made and so defaults should not be a problem. At worst, companies might have to take repossession prior to re-selling the property. But in order to be prudent, receivables are also compared against equity to see how badly a default could affect shareholders. The companies listed in Figure 24 show those with the highest receivables as a percentage of equity. Most would be highlighted by our screen based on receivable days; however, China Fortune stands out as a company with normal receivable days but they are still material as a percentage of equity. Worryingly, the audit cost is very not only low but the lowest on this list.

Receivables are also checked as a % of equity to measure credit risk

Figure 24: Receivables as a % of equity (excludes companies in Figure 23)

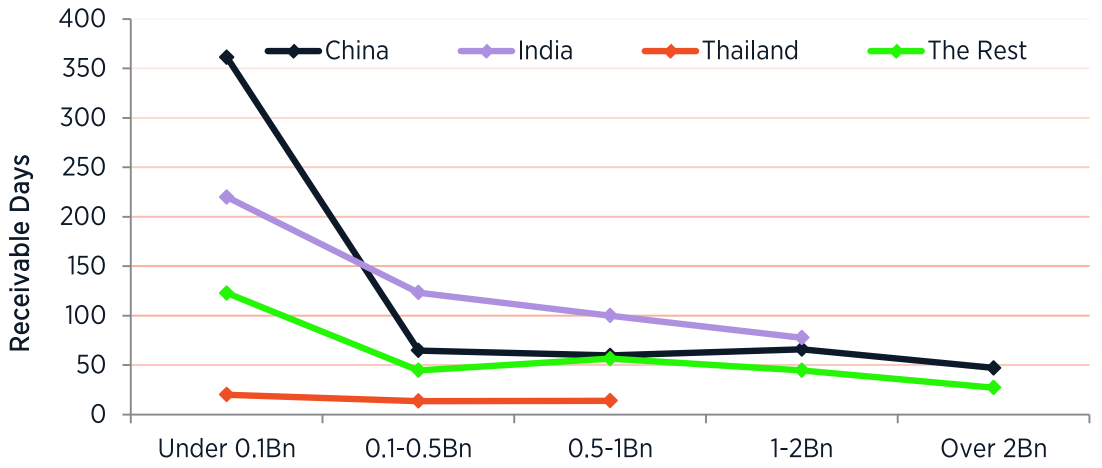
Name	Ticker	Industry	Mkt Cap US$bn	Receivable days	Receivable as % of equity	Audit cost (bps)	Audit Fee range
Tianjin Jin-A	000897 CH	R.E. Development	1.3	158	79%	0.9	Normal
Lend Lease Gp	LLC AU	Diversified Real Estate	7.1	66	51%	5.9	High
China Vanke Co	200002 CH	R.E. Development	14.3	112	49%	0.2	Low
Risesun Real	002146 CH	R.E. Development	3.3	106	47%	0.2	Low
China Fortune	600340 CH	Diversified Real Estate	5.5	51	41%	0.1	Low
Sunshine City	000671 CH	R.E. Development	1.4	71	40%	0.9	Normal
Zhongtian Urban	000540 CH	R.E. Development	1.1	66	36%	0.7	Normal
Gemdale Corp	600383 CH	R.E. Development	5.9	116	35%	N/A	N/A
CIFI Holdings	884 HK	R.E. Development	1.1	88	33%	1.2	Normal
Beijing Capital	600376 CH	R.E. Development	1.6	135	31%	0.3	Low

Source: GMT Research

Thai companies now have the best credit control

Finally, it is good to see that Thai companies appeared to have learned from the Asian financial Crisis and are still keeping receivable days much lower than the rest of Asia, as shown in Figure 25. Meanwhile, small companies in the property sector in China suffer from long receivables days in the same way that small industrial companies do as demonstrated in our earlier report, Auditing Fraud: Tomorrow's Scandals.

Figure 25: Receivables as a % of equity, grouped by market capitalisation



Source: GMT Research

Red Flag 7: Prepaid Expenses

Scored when prepaid expenses exceed 40% of turnover or 20% of equity.

Flagged if >40% of Turnover

It is understandable that developers need to prepay some costs. Locking in raw material suppliers on availability and price allows the developer greater certainty to plan. But, as with most of the ratios we are looking at it, is a question of scale and materiality. Particularly as prepaid expenses can be a fertile ground for manipulating accounts. Companies can make payments to connected parties for services that will never happen (fraud), can pretend to make payments to connected parties (more fraud) making the balance sheet appear stronger, etc. Prepayments can also expose shareholders to credit risk, or just the risk that the goods paid for will never materialise.

Prepaying may solve some problems but it introduces credit risks or worse.

Unitech and DLF both feature highly on this list because of the way they account for pre-sales. Rather than break the numbers out in a simple transparent method, India seems to follow the Singapore model where customer advances are netted against work done so reducing inventory values and disguising customer deposits. We would much rather see accounts that explicitly separate out client money until the transactions are complete as that is a better reflection of the economic reality. Nonetheless, having avoided the pre-sales red flag, they get caught here, as shown in Figure 26.

Some Indian companies avoided the Pre-Sales flags but are caught here

It is the size of the prepayments that continue to amaze. Why is it necessary to pay so far in advance (and of course using turnover is generous, using cost of goods would make the number look far worse) for raw materials. Even Shenzhen Investment and Evergrande which are at the bottom of our list have prepaid over 5 months of turnover.

The scale of the prepayments is amazing

Figure 26: Ten highest Prepaid Expenses as a % of Turnover

Name	Ticker	Industry	Mkt Cap (US$bn)	Pre-payment as a % Turnover	Audit fee (Bps)	Audit Fee Range
Unitech Ltd	UT IN	Real Estate Development	1.3	292%	1.6	Normal
Carnival Group	996 HK	Real Estate Operating Co.	1.0	234%	0.9	Low
DLF Ltd	DLFU IN	Diversified Real Estate	6.4	108%	0.1	Low
Sunshine City	000671 CH	Real Estate Development	1.4	102%	0.9	Normal
Hopson Dev.	754 HK	Real Estate Development	2.0	82%	0.4	Low
Thaihot Group	000732 CH	Diversified Real Estate	1.4	74%	0.2	Low
Oceanwide Hldg	000046 CH	Diversified Real Estate	3.3	47%	N/A	N/A
Wuhan Langold	002305 CH	Real Estate Development	1.1	44%	1.1	Normal
Evergrande Real	3333 HK	Real Estate Development	6.4	42%	0.4	Low
Shenzhen Invest	604 HK	Diversified Real Estate	1.7	42%	0.7	Low

Source: Bloomberg and company accounts

Prepayments are also tested against equity to get a sense of how important they are. Six out of the ten companies in Figure 26 re-appear in Figure 27. So shareholders at China Vanke, Risesun, Zhugang Holdings and Hangzhou are vulnerable if anything goes wrong. It is slightly encouraging that auditors seem to be paying at least some attention to the problems because at least three of the companies had slightly higher normal audit fees.

Prepayments vs Equity used to double check for materiality

Figure 27: Ten highest Prepaid Expenses as a % of Equity

Name	Ticker	Industry	Mkt Cap (US$bn)	Pre-payment as a % equity	Audit fee (Bps)	Audit Fee Range
Sunshine City	000671 CH	Real Estate Development	1.4	208%	0.9	Normal
Thaihot Group	000732 CH	Diversified Real Estate	1.4	124%	0.2	Low
Zhuguang Hldg	1176 HK	R. E. Operating Co.	1.3	82%	1.6	Normal
Evergrande Real	3333 HK	Real Estate Development	6.4	82%	0.4	Low
Unitech Ltd	UT IN	Real Estate Development	1.3	63%	1.6	Normal
Risesun Real	002146 CH	Real Estate Development	3.3	58%	0.2	Low
Hangzhou Binj	002244 CH	Real Estate Development	1.3	45%	0.3	Low
Greattown Hldg	900940 CH	Real Estate Development	1.3	40%	0.5	Low
China Vanke	200002 CH	Real Estate Development	14.3	37%	0.2	Low
Carnival Group	996 HK	R. E. Operating Co.	1.0	37%	0.9	Low

Source: Bloomberg and company accounts

Red Flag 8: Intangibles

Scored if intangibles are greater than 20% of equity.

Flagged if> 20% of equity

It is very hard to understand why a property company would have intangibles on its balance sheet. Presumably, it is rare to generate goodwill by paying more than market value for property assets. As for intangibles such as brand value, software and intellectual property, just how much can these add to a building's value? We believe auditors need to take even more care when auditing a property company with meaningful intangibles. Valuation leaves a lot of room for discretion and should require a detailed justification.

Hard to justify intangibles in a property company

Thankfully the list of companies with material intangibles is short with just eight names on our list. Intriguingly, three of them are REITs, and include Industrial and Infrastructure, Mori Hills Investment and Japan Hotels. It is surprising that yield plays need to boost their equity values with intangibles

Odd that REITs would have material intangibles

Given the problems that American auditors have had doing "fly-by" audits on Chinese companies i.e. where a Mandarin-illiterate auditor flies in, checks the documents and then leaves, only to find that they missed a fraud, one can but hope that someone verified the intangibles on E-House China's balance sheet.

Beware the "Fly by" auditor

Figure 28: Asia's Top Intangibles/Equity

Name	Ticker	Industry	Mkt Cap (US$bn)	Intangibles/ Equity	Audit Fee (Bps)	Audit Fee Range
Tokyu Fudosan	3289 JP	Diversified Real Estate	4.9	32%	N/A	N/A
Lend Lease	LLC AU	Diversified Real Estate	7.1	29%	5.9	High
Belle Corp	BEL PM	Real Estate Development	1.4	29%	0.3	Low
Industrial & Infr.	3249 JP	Industrial REITs	1.4	27%	N/A	N/A
Mori Hills Invest.	3234 JP	Office REITs	1.9	24%	N/A	N/A
E-House China	EJ US	Real Estate Services	1.4	23%	10.1	Normal
Japan Hotel Reit	8985 JP	Hotel & Resort REITs	1.2	22%	N/A	N/A
Daikyo Inc	8840 JP	Real Estate Development	1.7	21%	5.2	High

Source: Bloomberg and company accounts

Red Flag 9: Capitalised Interest

Scored when capitalised interest is greater than 10% of EBITDA and 20% of earnings.

Flagged if> 10% of EBITDA & 20% of Earnings

Capitalised interest is designed to help match revenues and costs. Adding the financing costs to the value of the property during construction makes sense as it helps match the costs to the revenues i.e. when the property actually gets sold.

Gives management flexibility but increases risks

But capitalising costs this way creates flexibility. Money is fungible, so if a company has several developments under way, the allocation of interest costs is at management's discretion. Moreover, anything that puts off cost recognition heightens the risk of forecasting error and a possible write-down in the future. Last but not least, while the published accounts may capitalise interest costs, the tax accounts do not have to do the same, possibly creating a deferred tax liability.

We ran 3 screens

There is nothing intrinsically wrong with capitalising interest - it is the materiality that matters. To get a sense of which companies are affected, the screens were run three times.

1) Largest impact

In Figure 29, we list companies ranked by the impact on profits if interest costs were not capitalised. Earnings fall by over half for all of the companies shown. Furthermore, EBITDA coverage of the capitalised interest cost at under 2x looks pretty thin at Hopson, Lippo Karawaci and KWG property. Hopson is also notable for its low audit fee.

Figure 29: Largest Earnings Impact from Capitalising Interest

Name	Ticker	Industry	Mkt Cap (US$bn)	Capitalised interest/ EBITDA	Earnings effect w/o capitalising	Audit Fee (Bps)	Audit Fee Range
Hopson Dev	754 HK	Real Estate Develop.	2.0	75%	(83%)	0.4	Low
Lippo Karawaci	LPKR IJ	Real Estate Develop.	2.2	55%	(81%)	N/A	N/A
Kaisa Group	1638 HK	Real Estate Develop.	1.5	39%	(69%)	0.5	Low
Beijing North-H	588 HK	Real Estate Develop.	1.3	29%	(64%)	1.9	Normal
Financial St-A	000402 CH	Real Estate Develop.	2.9	38%	(62%)	0.3	Low
KWG Property	1813 HK	Real Estate Develop.	1.7	67%	(61%)	0.7	Normal
Evergrande Real	3333 HK	Real Estate Develop.	6.4	41%	(61%)	0.4	Low
Sunac China	1918 HK	Real Estate Develop.	1.5	32%	(61%)	0.5	Low
Goodman Group	GMG AU	Industrial REITs	8.1	30%	(59%)	2.2	Normal
Sino Ocean Land	3377 HK	Real Estate Develop.	3.9	36%	(55%)	1	Normal

Source: Bloomberg and company accounts

2) Loss makers turned profitable

But possibly at greater risk of misleading investors are those companies for whom capitalisation of interest turns a loss into a profit, as shown in Figure 30. For four of our six companies, only Poly Property and Stockland can actually afford to pay their interest bill. For all the rest, capitalised interest is greater than 100% of EBITDA. Yet again the auditors do not seem too worried.

Figure 30: Loss-Makers before Capitalising Interest

Name	Ticker	Industry	Mkt Cap (US$m)	Capitalised interest/ EBITDA	Earnings effect w/o capitalising	Audit Fee (Bps)	Audit Fee Range
Shui On Land	272 HK	R.E. Development	2.1	100%	Turns to loss	0.5	Low
Guocoland Ltd	GUOL SP	R.E. Development	2.1	100%	Turns to loss	0.4	Low
Beijing Capital	600376 CH	R.E. Development	1.6	100%	Turns to loss	0.3	Low
Glorious Prop.	845 HK	R.E. Development	1.1	100%	Turns to loss	1.9	Normal
Poly Property	119 HK	Div. Real Estate	1.6	62%	Turns to loss	0.7	Low
Stockland	SGP AU	Diversified REITs	8.2	31%	Turns to loss	2.1	Normal

Source: Bloomberg and company accounts

3) Large losses made smaller

Less misleading, but probably worse from an investors' perspective, are those companies that are loss-making even after capitalising interest. Losses would look even worse if they were unable to capitalise their financing costs, as shown in Figure 31. We hope that both Renhe Commercial and Carnival group have pre-funded their projects because they clearly cannot pay interest out of cash flows. However it does at least look as if the auditor at Renhe Commercial has noticed there might be an issue.

Figure 31: Loss Makers, Before and After Capitalising Interest

Name	Ticker	Industry	Mkt Cap (US$bn)	Capitalised interest/ EBITDA	Earnings effect w/o capitalising	Audit fee (Bps)	Audit Fee Range
Renhe Commercial	1387 HK	R. E. Operating Co.	1.1	100%	Loss making	3.1	Normal
Carnival Group	996 HK	R. E. Operating Co.	1.0	100%	Loss making	0.9	Low

Source: Bloomberg and company accounts

Red Flag 10: Deferred Tax Liabilities

Scored when deferred tax liabilities are greater than 15% of equity.

Flagged if> 15% of equity

It is easy to understand why a company might have short-term deferred tax liabilities: subsidiaries with mismatched corporate year-ends, different international tax payment dates and deals creating tax liabilities that do not fit with the accounting year. But all of these should net out the following year. Long-term tax liabilities are a different matter and should attract auditor attention. For a detailed discussion on the issues involved please refer to Appendix II.

Long term deferred tax liabilities are the problem

The scale of the deferred tax for the top four companies makes up a large part of their balance sheets, as shown in Figure 32. How have Wanda, Sunac, Mitsubishi Estate and NTT Urban Development created such liabilities meanwhile getting their audits done so cheaply?

Unpaid taxes are greater than equity!

Figure 32: Deferred Tax Liabilities as a % of Equity in Asia

Name	Ticker	Industry	Mkt Cap (US$bn)	Deferred Tax/ Equity	Audit fee (Bps)	Audit Fee Range
Wanda Commercial	169 HK	Real Estate Development	1.3	102%	1.9	Normal
Sunac China Hold	1918 HK	Real Estate Development	1.5	48%	0.5	Low
Mitsubishi Estat	8802 JP	Diversified Real Estate Activities	32.8	39%	0.6	Low
NTT Urban Dev	8933 JP	Real Estate Operating Companies	2.9	34%	0.8	Low
Tokyo Tatemono	8804 JP	Diversified Real Estate Activities	3.8	24%	1.3	Normal
Zall Development	2098 HK	Real Estate Development	1.2	23%	1.3	Normal
Yuexiu Property	123 HK	Diversified Real Estate Activities	1.8	22%	0.8	Normal
China South	1668 HK	Diversified Real Estate Activities	3.1	22%	1.0	Normal
Tian An China	28 HK	Real Estate Development	1.2	20%	2.0	Normal
Nomura Real Est.	3231 JP	Diversified Real Estate Activities	3.5	20%	1.3	Normal

Source: Bloomberg and company accounts

Red Flag 11: Unrealised Profit

Scored when unrealised profits are greater than 30% of equity.

Flagged if>30% of equity

The flip-side of notional taxes are the notional profits that create them

If concerned about accounts being embellished, perhaps investors should be more focused on the amount of profit that deferred tax liabilities relate to, as opposed to simply comparing deferred tax liabilities to equity (as we have done earlier). For example, whilst two companies might have a similar level of deferred tax liabilities relative to their equity, if one has a tax rate of just 15% (Hong Kong), and another of 40% (Japan), the magnitude of the implied profit differs dramatically, i.e. 5.5x the deferred tax liability in Hong Kong, versus 1.5x in Japan.

3 Chinese developers rely on unrealised profit to provide their equity base

The companies with the largest unrealised profits are presented in Figure 33. Given the similarity of tax rates, the table is essentially a re-ordered list of the earlier deferred tax list but it does remind investors that for Wanda Commercial, Carnival and Sunac, unrealised profits are greater than their equity base. Any change in this estimation of value would have a serious effect on their book value.

Figure 33: Largest Unrealised Profit as a % of Equity

Name	Ticker	Industry	Mkt Cap (US$bn)	Deferred Tax/ Equity	Unrealised Profit/ Equity	Audit fee (Bps)	Audit Fee Range
Wanda Comm.	169 HK	R.E. Development	1.3	102%	307%	1.9	Normal
Carnival Group	996 HK	R.E. Operating Co.	1.0	48%	143%	0.9	Low
Sunac China	1918 HK	R.E. Development	1.5	48%	143%	0.5	Low
Hang Lung Gp	10 HK	Div. Real Estate	7.4	15%	85%	0.6	Low
Zall Dev.	2098 HK	R.E. Development	1.2	23%	68%	1.3	Normal
Yuexiu Property	123 HK	Div. Real Estate	1.8	22%	67%	0.8	Normal
China South	1668 HK	Div. Real Estate	3.1	22%	66%	1.0	Normal
Renhe Comm.	1387 HK	R.E. Operating Co.	1.1	22%	65%	3.1	Normal
Mitsubishi Estat	8802 JP	Div. Real Estate	32.8	39%	63%	0.6	Low
Tian An China In	28 HK	R.E. Development	1.2	20%	61%	2.0	Normal

Source: Bloomberg and company accounts

For these companies unrealised profits are at least 1/3 of book value

Due to the tax multiplier effect mentioned earlier, there are several companies for whom deferred tax is not meaningful but the implied unrealised profit is a substantial percentage of book value, as shown in Figure 34. Wheelock, New World, Kerry and Hang Lung have been around for a long time so perhaps it is understandable that they have substantial unrealised profits. It is harder to rationalise this for the newer Chinese developers.

Figure 34: Largest Unrealised Profit as a % of Equity but With Deferred Tax under 15%

Name	Ticker	Industry	Mkt Cap (US$bn)	Deferred Tax/ Equity	Unrealised Profit/ Equity	Audit fee (Bps)	Audit Fee Range
Wheelock & Co	20 HK	Div. Real Estate	8.6	6%	33%	0.6	Low
New World Dev	17 HK	Div. Real Estate	9.6	6%	34%	1.8	Normal
Kerry Properties	683 HK	Div. Real Estate	4.5	7%	42%	0.7	Low
Hang Lung Prop.	101 HK	Div. Real Estate	13.5	8%	43%	0.4	Low
Global Logistic	GLP SP	R.E. Operating Co.	10.5	8%	38%	0.4	Low
Beijing North	588 HK	R.E. Development	1.3	10%	31%	1.9	Normal
Hopson Dev.	754 HK	R.E. Development	2.0	11%	33%	0.4	Low
CIFI Holdings	884 HK	R.E. Development	1.1	11%	33%	1.2	Normal
Guangzhou R&F	2777 HK	R.E. Development	4.2	11%	34%	0.7	Normal
China Overseas	81 HK	R.E. Development	1.3	12%	35%	0.4	Low

Source: Bloomberg and company accounts

Conclusion

Extreme fees should raise concern

Firstly, assuming that managements at most companies are honest and most auditors do an acceptable job, the normal range of audit fees within an industry should represent a fair cost of auditing. Sadly, auditing costs are not a simple panacea but they offer investors a glimpse as to how management treats the construction and disclosure of a company's public accounts. Therefore fees outside the range should worry investors.

So should multiple flags and 'normal' fees

Secondly, although auditors cannot be expected to find and prevent all fraud, it is not unreasonable to expect a comprehensive audit, particularly when the accounts have obvious problems. The poor performance of companies with multiple red flags shows that investors recognise warning signs, so it is surprising that many of these companies' auditors did not raise their levels of due diligence. So, while investors should be concerned when they see companies with lots of problems and low auditing costs, even companies with multiple red flags whose costs are in the normal range should attract investor scrutiny. For a detailed breakdown of all the 4+ flag stocks please refer to Appendix III.

Investing on the back of extreme audits is a leap of faith

Anyone investing in companies which pay less than the normal range is taking a leap of faith that either the internal systems are superb and/or that management is transparent and honest. Conversely, investing in companies that pay a lot more than normal ignores the possibility that the auditor has seen something but been persuaded to overlook it.

Malaysia and Indonesia look attractive.

But watch out in China and India

At a macro level it is clear that the property markets in both China and India need a period of digestion to allow their property companies to sell down their inventories before they are forced to. Given the size of the inventory overhang, the sooner this happens, the better. In contrast, developers in Malaysia and Indonesia look set to experience a period of good returns as they benefit from increasing revenues and low inventories.

APPENDIX I: AUDIT FEES BY COUNTRY (BASIS POINTS OF TURNOVER)

Market	Region	Country	Min.	20th percentile	Mean	80th percentile	Max.	No. of companies
Developed	Asia	**Australia**	0.45	1.63	5.2	8.98	47.05	47
Developed	Asia	**Hong Kong**	0.19	0.66	2.2	3.50	11.82	75
Developed	Asia	**Japan**	0.20	0.85	4.0	8.34	17.74	60
Developed	Asia	**New Zealand**	1.07	1.19	2.1	2.30	5.36	8
Developed	Asia	**Singapore**	0.12	0.46	1.6	2.53	9.01	43
Emerging	Asia	**Bangladesh**	0.35	0.35	0.3	0.35	0.35	1
Emerging	Asia	**China**	0.05	0.52	1.7	2.92	16.25	204
Emerging	Asia	**India**	0.13	0.77	1.3	1.71	6.25	28
Emerging	Asia	**Malaysia**	0.27	0.91	1.9	2.96	5.76	61
Emerging	Asia	**Philippines**	0.21	0.47	0.9	1.46	2.06	13
Emerging	EMEA	**South Africa**	0.62	0.94	1.8	2.41	3.58	11
Developed	Europe	**Austria**	0.40	0.71	1.0	1.33	1.90	4
Developed	Europe	**Belgium**	1.09	1.40	24.2	42.49	69.56	3
Developed	Europe	**France**	0.51	1.45	4.6	9.20	18.32	21
Developed	Europe	**Germany**	0.78	1.40	3.4	5.88	17.21	26
Developed	Europe	**Holland**	0.19	0.57	0.9	1.25	1.62	4
Developed	Europe	**Spain**	1.67	1.67	1.7	1.67	1.67	1
Developed	Europe	**Sweden**	0.80	3.79	8.3	12.75	15.74	2
Developed	Europe	**Switzerland**	0.79	0.88	1.8	2.21	5.18	8
Developed	Europe	**UK**	0.19	0.83	2.8	4.59	14.72	40
Emerging	Europe	**Russia**	3.27	4.53	6.4	8.31	9.57	2
Developed	Tax	**Guernsey**	5.24	5.24	5.2	5.24	5.24	1
Developed	Tax	**Jersey**	3.71	4.14	4.8	5.43	5.86	2

Source: Bloomberg and company accounts

Appendix II: Deferred Tax Liabilities

Long term deferred tax is the difficult one

It is easy to understand why a company might have short-term deferred tax liabilities: subsidiaries with mismatched corporate year-ends, different international tax payment dates and deals creating tax liabilities that do not fit with the accounting year. But all of these should net out the following year. Long-term tax liabilities are a different matter and typically arise from three main areas:

Created when Tax depreciation is faster than published rates so tax liabilities are accrued

A. Governments allowing aggressive tax depreciation rates

In some jurisdictions, notably Japan, the government allows companies to accelerate the depreciation of their assets. This has the benefit of reducing corporate tax bills whilst encouraging investment. However, these companies report a slower depreciation rate to their shareholders, which translates into higher reported profits but also a higher reported tax bill. When reported tax is higher than actual tax paid, a deferred tax liability is created.

In the example Taxable profit is lower than reported profit

For example, in the table below a company buys an asset and uses a five year deprecation rate in the report to shareholders. This creates a depreciation charge of $100 per annum so, all other things being equal, yearly profits are reported as $630. However, when reporting to the tax authorities the company depreciates the asset over two years. This results in a yearly depreciation charge of $250. As a result, the actual taxable net profit is $150 lower than that reported to shareholders and a deferred tax liability of $45 is accrued in the first two years of the asset life

Figure 35: Accelerated Depreciation: Published Accounts: What Investors See

		Year 1	Year 2	Year 3	Year 4	Year 5
Profit and loss						
	Core profit	1,000	1,000	1,000	1,000	1,000
	Depreciation	(100)	(100)	(100)	(100)	(100)
	Profit	**900**	**900**	**900**	**900**	**900**
	Tax @ 30%	(270)	(270)	(270)	(270)	(270)
	Earnings	630	630	630	630	630
Balance sheet						
Asset	Fixed Asset	500	500	500	500	500
	Depreciation	(100)	(200)	(300)	(400)	(500)
	Net Fixed Asset	400	300	200	100	0
Liability	Deferred Tax Liability	45	90	60	30	0
Asset	Effective Loan from Govt.	45	90	60	30	0

Source: GMT Research

Reported profits catch up later

The liability then unwinds in years 3, 4 and 5 when the tax is actually paid, as shown in Figure 35. The underlying life and profitability of the asset are unchanged but the company gets to delay some of its tax payments. Typically, Japanese companies double-depreciate for the taxman, but then under-depreciate in their public accounts.

Figure 36: Accelerated Depreciation: Tax Accounts: What the Government Sees

		Year 1	Year 2	Year 3	Year 4	Year 5
Profit and loss						
	Core profit	1,000	1,000	1,000	1,000	1,000
	Depreciation	(250)	(250)	0	0	0
	Profit	**750**	**750**	**1,000**	**1,000**	**1,000**
	Tax @ 30%	(225)	(225)	(300)	(300)	(300)
	Earnings	525	525	630	700	700
Annual Deferred Tax		+45	+45	(30)	(30)	(30)
Cumulative Deferred Tax		45	90	60	30	0

Source: GMT Research

B. Asset revaluation

This is regularly used by property companies to mark to market property assets. Revaluations improve the balance sheet and reduce gearing ratios. In Figure 36, a company revalues its assets every year and a $200 profit is booked and taxed in Years 1, 2 and 3. When the asset is sold in year 4, at the valuation used in year 3 there is no profit left to be booked. However, the tax is paid in year 4, extinguishing the accrued tax liability.

Revaluation profits also create a profit liability

Figure 37: Asset Revaluation: Published Accounts: What Investors See

		Year 1	Year 2	Year 3	Year 4
Profit and loss					
	Core profit	1,000	1,000	1,000	1,000
	Revaluation	200	200	200	0
	Profit from sale of assets				0
	Profit	**1,200**	**1,200**	**1,200**	**1,000**
	Tax@ 30%	(360)	(360)	(360)	(300)
	Earnings	840	840	840	700
Balance sheet					
Liability	Deferred tax liability	60	120	180	0
Liability	Retained earnings	140	280	420	420
Asset	Fixed assets – incr. in value by	200	400	600	0
Asset	Increase in cash	0	0	0	420

NB No profit is booked on the sale in year 4 as it has already been accrued forover the previous years.
Source: GMT Research

The tax accounts in Figure 37 show a different picture, with no tax accrued or paid until the sale happens and the profit is crystallised.

Figure 38: Asset Revaluation: Tax Accounts: What the Government Sees

	Year 1	Year 2	Year 3	Year 4
Profit and loss				
Core profit	1,000	1,000	1,000	1,000
Profit from sale of assets				600
Profit	**1,000**	**1,000**	**1,000**	**1,600**
Tax @ 30%	(300)	(300)	(300)	(480)
Earnings	700	700	700	1,120

N.B. Taxes are paid when profits are crystallised via a transaction. Source: GMT Research

Most revaluations have some level of subjectivity over both size and timing. When such profits become a material part of a company's earnings, investors need to exercise caution, particularly given the cyclical nature of asset markets in Asia.

Subjectivity is the problem

C. Intra-group transactions

By moving assets between connected companies, businesses are able to 'create' a profit in their published accounts without any real transactions taking place. This 'profit' then requires a tax liability to be accrued. In contrast, group tax accounting means that these transactions are ignored by the tax authorities.

Yet more profits from booking rather than transactions

One way to create profits from an intra-company transaction is to transfer assets under IFRIC 12 from a group construction company to a group operating company. Aggressive managements are then able to book profits during the construction period thanks to the building contract and capitalising any losses in the concession company.

IFRIC 12 allows intragroup deals to create profits

The published accounts, Figure 38, show investors a growing profitable company in the early years at the cost of slightly lowered profits in the later years. In year 1 and 2 the group books a $300 dollar profit as the group construction company charges the group concession company for building the asset. Although the concession company has financing and running costs, these are all capitalised because the concession is

So now groups can sell to themselves and book profits

under construction. This way only the intragroup profits, and not its losses, are recognised. Once the asset is built, the $350 costs capitalised in the first two years increase the depreciation charge by $70. A relatively small cost, and spread out over several years, to pay to produce profits of $300 in the early years.

Investors get an indication of what is happening because the group has to start accruing deferred taxes of $90 on this "notional' profit. Only when the concession actually starts making money in year 4 does this start to unwind as taxes are paid.

Figure 39: Building Concession Assets: Published Accounts: What Investors See

		Year 1	Year 2	Year 3	Year 4	Year 5
Profit and loss						
	Construction profit	300	300	-	-	-
	Start-up losses	Capitalised	Capitalised			
	Concession profit			100	100	100
	Incr. depreciation			(70)	(70)	(70)
	Profit	**300**	**300**	**30**	**30**	**30**
	Accumulated losses	-	-	-	-	-
	Tax @ 30%	(90)	(90)	(9)	(9)	(9)
	Earnings	210	210	21	21	21
Cash flow						
	Cash Profit/Loss	(50)	(50)	100	100	100
	Cash Tax paid	-	-	-	(30)	(30)
	Cash flow	(50)	(50)	100	70	70
Balance sheet						
Liability	Deferred tax liability	90	180	189	168	147
Liability	Retained earnings: - construction	210	420	420	420	420
	- operation	-	-	21	42	63
Liability	Start-up costs (debt)	50	100	-	-	-
Assets	Fixed asset increase	350	700	630	560	490
Assets	Cash	-	-	-	70	140

NB Assumes concession assets are written off over 10 years. Source: GMT Research

Book profits now over 2 years…

The problem is that because there is no third party transaction, the profit is at management's discretion. What is the correct construction margin - 2/5/10/20%? Moreover, management has every incentive to front-load profits from the concession because the more projects they have, the faster profits grow. Even better, profit growth is exaggerated as the brought-forward profits will be booked over the relatively short construction period of one to three years, whereas the reduction is then be divided over the life of the asset, possibly 20-30 years. Last but not least, this early profit booking boosts both earnings and asset values, thus obscuring the company's true financial health.

…Payback later over 20 years

Follow the taxman…

Both the asset revaluation and building concession assets approach beg a simple question. If the taxman does not recognise the profit and so the tax liability and, importantly, want the tax, why should investors?

…or ask for more disclosure

If management believes a genuine 'arm's length' profit has been made, and that this is not mere front-loading, the accounts should explain in a single clear note how the profits arose, what tax rate was used and when the tax is expected to be paid. For further clarity, profits, in both the P&L and balance sheet, could be split into realised and unrealised. Investors would also be prudent to adjust debt ratios to account for 'loans from the taxman', split profits into actual and 'hoped for', and press management as to exactly why it is necessary to produce accounts with yet-to-be-recognised profits.

APPENDIX III: PROPERTY CO'S IN ASIA WITH A MARKET CAPITALISATION>US$1BN WITH 4+ ACCOUNTING RED FLAGS, IN DESCENDING ORDER OF RED FLAGS

Name	Ticker	Equity in Related Cos.	Loans to /from Related cos.	Impact of Deposits on Net Debt	Pre- Sales as % of Sales	Inventory days	WIP as % of asset	Receivable days	Rec'vables as % of equity	Prepay. as % of Sales	Prepay. as % of Equity	Intangible as % of Equity	Earnings without capitalised interest	Deferred tax as % of Equity	Un- realised profit as % of Equity	Red Flag	Audit Fee range
Carnival Gp	996 HK			20%	231%	4,013	3%	7	0%	234%	37%		Loss making	48%	143%	7	Low
China Vanke	200002 CH	4%		121%	126%	976	65%	112	49%	23%	37%	1%	(34%)	1%	3%	7	Low
Shenzhen Inv.	604 HK	27%				1,378	37%	16	2%	42%	16%	1%	(34%)	20%	60%	7	Low
Hopson Dev	754 HK	11%	0%	46%	99%	1,785	41%	9	1%	82%	24%	0%	(83%)	11%	33%	7	Normal
Sunshine City	000671 CH	2%		72%	171%	1,195	64%	71	40%	102%	208%	0%				7	Normal
Yuexiu Prop.	123 HK	26%		26%	80%	1,128	48%	0	0%	12%	7%		(35%)	22%	67%	7	Normal
China Fortune	600340 CH	0%		139%	178%	1,004	51%	51	41%	12%	36%	0%				6	Low
Evergrande R	3333 HK			57%	42%	720	46%	37	20%	42%	82%	1%	(61%)	14%	41%	6	Low
Franshion Ppt	817 HK	0%	0%	79%	81%	384	41%	74	15%	26%	18%	0%		15%	45%	6	Low
Guocoland	GUOL SP	20%		10%	65%	2,824	53%	114	9%				Turns to loss	2%	12%	6	Low
Risesun Real	002146 CH	0%		74%	108%	817	58%	106	47%	36%	58%	0%				6	Low
Sh. Shimao	600823 CH	21%		78%	48%	836	37%	64	11%	39%	25%	0%				6	Low
Thaihot Group	000732 CH			44%	120%	1,569	61%	32	15%	74%	124%	1%				6	Low
Xinhu Zhongbao	600208 CH	41%		45%	80%	1,351	50%	159	29%	5%	3%	2%				6	N/A
Greentown	3900 HK	40%	17%	42%	81%	735	37%	43	14%	1%	1%		(39%)	3%	8%	6	Normal
Tian An China	28 HK	11%	3%		29%	1,208	34%	75	3%	17%	2%	0%	(19%)	20%	61%	6	Normal
Beijing Capital	600376 CH	25%		17%	171%	1,993		135	31%	4%	3%	0%	Turns to loss			5	Low
China Merch.	200024 CH	6%		43%	134%	1,023	52%	180	52%	10%	11%	0%				5	Low
Country Garden	2007 HK	0%		79%	101%	512	52%	58	23%	4%	5%	0%	(48%)	3%	9%	5	Low
Financial St.	000402 CH	0%		7%	68%	885	43%	16	3%	30%	24%	0%	(62%)			5	Low
Greattown Hldg	900940 CH	0%		35%	48%	1,635	53%	5	1%	41%	40%					5	Low
Jinke Prop.	000656 CH	10%		56%	129%	1,162	59%	51	26%	8%	15%	0%				5	Low
Kaisa Group	1638 HK			103%	152%	959	51%	40	12%	2%	3%		(69%)	8%	23%	5	Low
Poly Prop.	119 HK	2%	6%	63%	67%	944	48%	50	13%	4%	4%	2%	Turns to loss	4%	11%	5	Low
Shui On Ld	272 HK	3%	2%	18%	59%	901	23%	31	2%	8%	2%		Turns to loss	16%	47%	5	Low
Sunac China	1918 HK	58%	12%	1%	44%	688	42%	12	7%	8%	18%	2%	(61%)	48%	143%	5	Low
Oceanwide	000046 CH			4%	16%	2,283	75%	96	14%	47%	25%	0%				5	N/A
Cifi Holdings	884 HK			8%	68%	521	33%	88	33%	2%	3%		(48%)	11%	33%	5	Normal
Glorious Prop.	845 HK	0%		15%	53%	1,219	40%	77	9%	9%	4%	0%	Turns to loss	9%	28%	5	Normal
Guangzhou R&F	2777 HK	13%		32%	38%	678	40%	65	20%	1%	2%	3%	(24%)	11%	34%	5	Normal
New World Ch.	917 HK	23%	0%	51%	56%	622	32%	44	4%	20%	6%	4%	(31%)	5%	16%	5	Normal
Renhe Com.	1387 HK			3%	34%	2,789		519	4%	20%	1%	2%	Loss making	22%	65%	5	Normal
Sino Ocean	3377 HK	4%		66%	111%	995	52%	35	7%	13%	10%	1%	(55%)	5%	14%	5	Normal
Wuhan Langold	002305 CH	3%		10%	20%	1,377	43%	156	24%	44%	24%					5	Normal
Yanlord Land	YLLG SP	4%	0%	59%	54%	1,068	63%	15	3%	4%	2%	0%	(67%)	8%	23%	5	Normal
Zall Dev.	2098 HK	12%		7%	21%	1,681	31%	53	4%	13%	3%	0%	(20%)	23%	68%	5	Normal
Zhongtian U.	000540 CH	0%		64%	202%	1,374		66	36%	13%	26%	3%				5	Normal
Zhuguang	1176 HK					7,924	0%	15	0%	975%	82%	1%	Loss making	13%	40%	5	Normal
Beijing Urban	600266 CH	16%		43%	142%	1,281	60%	43	10%	19%	16%					4	Low
China Res Ld	1109 HK	3%	4%	65%	99%	770	0%	18	4%	4%	3%		(12%)	9%	27%	4	Low

Name	Ticker	Equity in Related Cos.	Loans to /from Related cos.	Impact of Deposits on Net Debt	Pre- Sales as % of Sales	Inventory days	WIP as % of asset	Receivable days	Rec'vables as % of equity	Prepay. as % of Sales	Prepay. as % of Equity	Intangible as % of Equity	Earnings without capitalised interest	Deferred tax as % of Equity	Un- realised profit as % of Equity	Red Flag	Audit Fee range
DLF Ltd	DLFU IN	1%	8%			829	0%	78	6%	108%	33%	7%		1%	2%	4	Low
Hang Lung	10 HK	4%				214		70	3%				(16%)	15%	85%	4	Low
Hangzhou Binj.	002244 CH			163%	180%	1,174	12%	43	15%	35%	45%	0%				4	Low
Kerry Properties	683 HK	24%		2%	3%	275	5%	70	4%	9%	2%	0%	(6%)	7%	42%	4	Low
Longfor Pro.	960 HK	8%	0%	185%	104%	678	45%	11	3%	14%	15%		(32%)	8%	24%	4	Low
Macrolink	000620 CH	16%		31%	73%	1,878		78	15%	26%	18%	0%				4	Low
Poly Real Es.	600048 CH	5%		74%	129%	1,057		44	19%			0%	(51%)			4	Low
Shang Lujiazui	600663 CH	44%		41%	53%	1,963	5%	7	1%	0%	0%	0%				4	Low
Suning Univ.	000718 CH			98%	115%	1,016	71%	15	6%	6%	9%	0%				4	Low
Yinyi Real E.	000981 CH	5%		21%	119%	1,375	59%	45	12%	10%	10%	0%	(15%)			4	Low
Gemdale Cp.	600383 CH	8%		33%	95%	874		116	35%	3%	3%					4	N/A
Highwealth Con	2542 TT			22%	61%	1,036	59%	9	3%	16%	20%	0%		0%	1%	4	N/A
Shanghai Chent	600649 CH	48%		1%	105%	1,709		80	5%	3%	1%	16%				4	N/A
Beijing North	588 HK	0%		8%	15%	1,364	47%	44	4%	1%	1%		(64%)	10%	31%	4	Normal
Goldin Prop.	283 HK		0%		34%	20,917	31%	98	0%	24%	0%	0%	Turns to loss	8%	23%	4	Normal
IJM Land	IJMLD MK	33%				617	38%	64	8%	6%	3%		(20%)			4	Normal
Kwg Prop.	1813 HK	74%	0%			885	31%	6	1%	24%	13%		(61%)	5%	15%	4	Normal
Oxley Hldg	OHL SP	2%				1,032	48%	567	298%				(34%)	2%	12%	4	Normal
Shanghai New	600638 CH	26%		32%	84%	2,586		19	1%	4%	1%	0%				4	Normal
Unitech Ltd	UT IN	0%	31%			658	0%	232	14%	292%	63%	0%				4	Normal

Source: GMT Research

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What we do
GMT Research provides independent insight into markets, sectors and companies throughout Asia. Our unique method of mining a comprehensive collection of corporate financial statements for key data allows us to evaluate the financial health of a company, sectors and the market at large. We also investigate the application of accounting standards by companies and sectors, shedding light on the quality of reported profits. Armed with this information, we help investment professionals navigate the financial landscape.

Gillem Tulloch has been a financial analyst since 1994 and has been based in Asia since 1995, with spells in Singapore, Thailand, Korea and most recently Hong Kong. Over his career, Gillem has covered sectors ranging from telecoms to printing to electronics. He has achieved top industry rankings in regional polls like Asiamoney and Institutional Investor, and has appeared on Bloomberg and Business Week. Gillem has worked in research and strategy for several large sell-side institutions, including Cazenove, Nomura and CLSA, and founded the independent research company Forensic Asia before moving on to establish GMT Research.

Robert Medd trained as a Cost and Management Accountant in the UK. He moved to Hong Kong in 1996 to work in Research at Deutsche Bank, where he was rated by Institutional Investor, Asiamoney etc. for his Microstrategy and Quant research. He then moved to Goldman Sachs to help generate ideas for hedge funds. Robert has since been on the buy side at Deephaven and Fortress and a couple of smaller funds. Ever since he arrived in Asia, Robert has met and analysed companies across the whole region from India to Japan and Mongolia to New Zealand.

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