



DAUDS ADVISORY

Corporate Governance

“Steinhoff: How auditors, fund managers and rating agencies failed investors”

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1. It was phenomenal, wasn't it? A “darling” South African retailer with 12,000 stores in some 30 countries, employing more than 130,000 people, with a market value of more R200 billion, and ranking among the 10 biggest companies in the JSE Top 100. A retailer popular with investors, becoming the fifth most popular share for fund managers to invest in. A Steinhoff share was considered, as one fund manager put it, a quality stock.

2. Then the Steinhoff facade was exposed, and the company incurred the market's wrath. Steinhoff was repeatedly battered, and in just two days it had lost 80% of its market value. The bleeding continued, the company eventually losing R194 billion of its market value. Naturally, everybody wanted to know, how did it all go so horribly wrong?

3. It all went wrong when the Steinhoff executives, including the CEO, were overpowered by the greed gene. Make no mistake, we are all born with the gene. Some have the capacity to suppress it, others simply allow the gene to take control. As you will remember, CEO Markus Jooste believed that a man of his stature cannot have two, five or even 10 racehorses – oh no, he wanted 300!

4. Remember how the cheeky Jooste went to ABSA and said he wanted money, which the bank foolishly gave? They gave the man (through his company Mayfair Speculators) an overdraft facility of R335 million and bank guarantees of R14 million. In return, Jooste handed over his Steinhoff shares as surety. As he did so, he very well knew those shares were not worth much, certainly not anywhere close to the price they were trading for at the time (Dec. 2016), which was around R70 per share. Jooste knew this because he was well aware of the accounting shenanigans taking place at Steinhoff. He pulled the ABSA stunt on Investec, ending up owing the bank R250 million, and on Sanlam Capital Markets, ending up owing them R800 million.

5. But let's talk about the gatekeepers – the auditors, the fund managers, and the credit rating agencies. They all had a role in the Steinhoff debacle.

6. Let me start, though, by saying that none of what Steinhoff did was new, or unique. It has all been done before. Remember Worldcom and Enron? We have our own South African examples - African Bank which collapsed in August 2014 where Deloitte were the auditors. What Steinhoff and Worldcom and Enron did was creative accounting stuff – the improper booking of revenues, the improper capitalisation of losses and expenses, and the creation of off-balance sheet structures to conceal losses, out of control debt and risk.

7. Creative accounting is designed to misinform. It involves the process of manipulating accounting figures to transform financial statements from what they should be to what preparers would want to see reported. It is essentially a process of making financial statements look either somewhat or entirely different from what was intended by the accounting rules and standards. The practice consists of rule-bending and loophole-seeking.

8. Creative accounting has an inseparable cousin called creative compliance, which makes it possible for creative accounting to go undetected – at least for a while. Creative compliance is about accounting standards avoidance. It involves working around the accounting rules without necessarily breaking them. And this is where the auditors come in handy as they make a company's

financial statements look compliant, even when the spirit, if not the law, of open disclosure of accounting performance has been violated.

9. The Worldcom and Enron auditors were Arthur Andersen. All three are history now, but every now and again we visit their gravesites to brush up on what precisely led to their demise, if only to remind us not to repeat their mistakes.

10. The Steinhoff auditors were Deloitte. In December 2017, Steinhoff said a restatement of its 2017, 2016 and 2015 financial statements was needed as they cannot be relied on. The company indicated that financial statements for the years prior to 2015 might also require restatement. Until 2017 Deloitte had approved Steinhoff's annual financial statements without qualification. Which means, while Deloitte had confirmed that the statements gave a true and fair view of the company's financial performance and financial position, that was in fact not true.

11. As auditors, Deloitte were expected to ensure the robustness of Steinhoff's accounting systems and to verify the accuracy of the accounting reports. Deloitte appears to have failed miserably. The firm now faces probes in several jurisdictions, including South Africa, involving its role in the accounting irregularities at Steinhoff. Deloitte may have opened itself up to a civil claim by Steinhoff investors.

12. The following, and other, fund managers invested their clients' money in Steinhoff shares: Coronation, Allan Gray, Investec, Sanlam, Old Mutual, Discovery, Nedbank Private Wealth, Public Investment Corporation (PIC). JSE data shows that Steinhoff was the fifth most popular share for these funds to invest in. Regrettably, the fund managers all appeared to display a herd mentality, neglecting their duty to conduct proper research on Steinhoff and neglecting to apply the requisite investment skills.
13. A breath-taking admission of neglect of duty was made by Nedbank Private Wealth in a note to its clients wherein it said the fund manager drew comfort from the fact that many highly regarded individuals with strong track records served on the Steinhoff supervisory board. Which means, it must be concluded, that the fund manager saw no need to conduct any research on the company nor apply even basic investment skills, choosing instead to bet on the Steinhoff board. This has to be the clearest admission of gross negligence.
14. The fund managers were expected to ensure an objective analysis of Steinhoff's financial figures by piercing any appearance the company might have put up in its numbers. The managers were expected to clinically and independently interrogate the numbers. It's not as if the information was not there – it was there. They just needed to do their work. They had no business having blind faith in the Steinhoff board. The fund managers failed their clients miserably. And like the auditors, they may have opened themselves up to a civil claim by their clients.

15. The credit rating agency, Moody's, gave Steinhoff's debt securities a comfortable rating – Baa3 with a stable outlook. No doubt, the agency's credit metric used to determine Steinhoff's probability of default on those securities allowed it to adopt a more robust approach, but it didn't. We now know Steinhoff's debt securities contained a lot more risk than Moody's rating recognised. The rating agency failed investors.

16. Corporate governance only works when boards of directors do their work. Boards are expected to oversee management, corporate strategy, and the firm's financial reports to shareholders. A board is expected to attentively look over the shoulders of executives who handle the firm's day-to-day operations and finances. Boards are thus expected to be independent and strong. The Steinhoff board failed this standard, miserably. Investors in other jurisdictions have explored civil claims against Steinhoff. South African investors, for no rational reason, chose to adopt a wait-and-see attitude.