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THE SIREN CALL OF SUBJECTIVITY

HOW LONG IS THE MARKETING PERIOD?

WHISPERED THE FINANCE DIRECTOR

HOW LONG DO YOU WANT IT TO BE?

GASPED THE FINANCIAL CONTROLLER

May 2022

The Siren Call of Subjectivity

As a young-buck equity analyst, my favourite book was Terry Smith's '*Accounting for Growth*'.

Beyond an interest in accounting shenanigans, I enjoyed the backstory of one of the best-known figures in British finance. The book is a truth-to-power narrative that got Smith fired from - and sued by - UBS Phillips & Drew. Many of the book's case studies were drawn from his employer's corporate clients.

Recognising that the tasty stuff is typically buried in the small print, Smith advocated reading accounts from the back. If you ever think to invite me to dinner, be forewarned that much of my day is spent reading accounting endnotes. Here are some recent favourites.

Revenue recognition

Purplebricks, the UK's largest online estate agent, came onto our screens because it was trading at net cash, with the shares having fallen over 95% from their peak. Purplebricks enjoys a double-feature today, kicking off with IFRS15.

The introduction of this accounting standard in January 2018 chucked a gas canister into the construction and contracting industry inferno. For Interserve & Carillion shareholders, IFRS15 was equally illuminating and destructive.

The costs associated with delivering long-term contracts are typically front-loaded. Under the old IAS percentage of completion method, profits were also front-loaded because firms simply took the known costs during the period and added an assumed margin to get to the revenue number.

But under IFRS15, firms delivering long-term contracts must report revenue according to a five-step model, focused on identifying and satisfying performance obligations, shifting the focus from inputs to outcomes.

For example, when delivering an outsourced call centre contract, the client is interested in achieving customer service KPIs. This outcome is the performance obligation. The client is not interested in the up-front costs incurred by the outsourcing firm in setting up the new call centre – the input. Therefore, under IFRS15 revenues become more stable year-on-year, whilst costs are front-loaded and profits are back-loaded, as compared to IAS 18 where more revenue and profit were recognised during initial the 'transformation phase' and less during the later 'delivery phase'.

In essence, IFRS15 led to deferred revenues and profits across sectors dependent on long-term contracts.

Back to Purplebricks. The firm applies the IFRS15 revenue model to the sale of property. From the customer's point of view, the performance obligation is selling the property. Photos, floorplans, listings and viewings, much like the costs incurred by the outsourcing firm during the transformation phase, are necessary expenses, but not the objective of the exercise.

In fact, the company recognises this explicitly by offering a money-back guarantee if a property fails to sell or achieves an acceptable offer within ten months. However, the accountants at Purplebricks argue that the performance obligation is the process of marketing the property, rather than the ultimate sale.

Therefore, revenue is recognised sooner rather than later at the final sale. This approach also introduces the siren call of subjectivity.

'How long is the marketing period?' whispered the (fictional) Finance Director.

'How long do you want it to be?' gasped the (illustrative) Financial Controller.

If the company decides to assume a shorter marketing period, revenues are recognised more quickly, with increased profits in the current period, but a reduction in profits in future periods.

In the six months to October 2021, instructions fell by 38%, but revenue came in only 7% lower thanks, in part, to an assumed reduction in the length of time it would take to sell those properties. While of benefit to the income statement, this assumption also left its mark on the balance sheet and cashflow statement with a £4.6m cash outflow to deferred income, a stark contrast to the £7.1m inflow during the previous year.

As such, it can be argued that Purplebricks' revenue recognition is at odds with IFRS15, with the substance of the agreement that it has with its customers and with the practice of other listed estate agents like Foxtons. As a result, I believe that a restatement is inevitable.

In response, a Purplebricks spokesperson said: "The policy has been applied consistently since the introduction of IFRS 15 and is part of our audited / reviewed financial statements. Following the introduction of the Money Back Guarantee, revenue is constrained to the amount which we do not expect to refund to customers under that arrangement."

Factoring receivables

In its 2021 annual report, Purplebricks outlines how the debt arising from customers who choose to pay later is sold on to a factoring firm, at a discount to the face value of the debt. This allows Purplebricks to get cash into the business sooner, whilst making any bad debt issues someone else's problem. On paper, this is a good idea, particularly if you have cashflow issues. Firms that factor their receivables usually do. But PURP was sat on £58m net cash at the half-year mark, and factoring is expensive. In the 2021 financial year factoring cost Purplebricks £4.7m. That's 5.2% of revenues.

Given that an estate agent aspires to 10% margins in a good year, and the fact that Purplebricks doesn't need the cash, the question is why factor? By factoring, the company is pretty much condemning itself to be eternally loss-making. So, there must be a good reason for doing it.

The reason, I suspect, is that a meaningful number of 'pay later' customers are bad or non-payers. Without factoring, the firm would instead have to take a bad debt provision, which would be an operating cost. However, factoring receivables is a financing cost, which pushes this £4.7m charge below the line. In other words, the only thing worse than a £4.7m factoring charge below the line, is a £4.7m bad debt provision above the line.

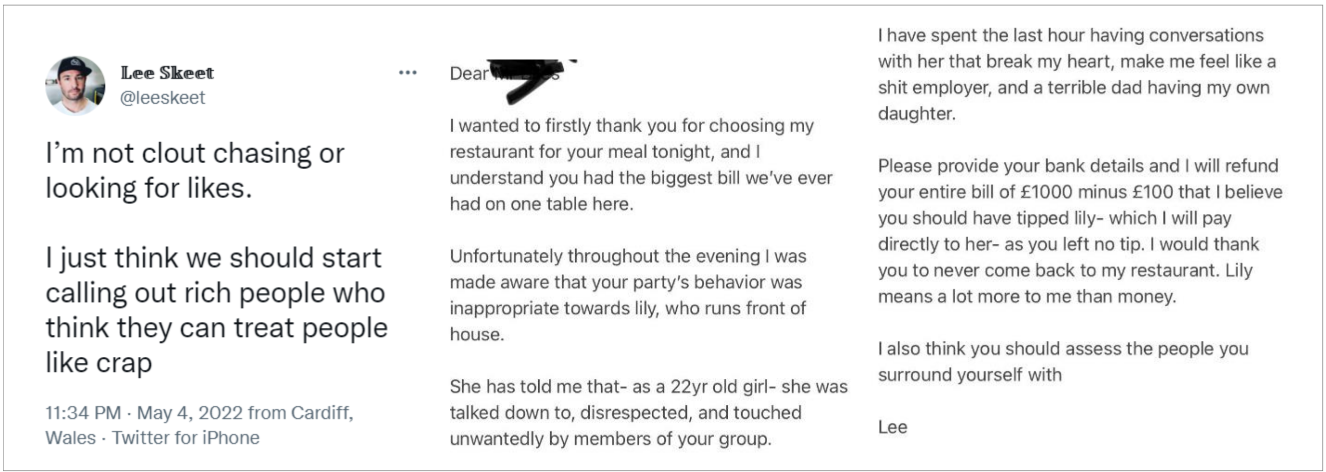
In response, a Purplebricks spokesperson said: "Collecting debt is a specialist skill and is not a core process of an estate agent. It would have required considerable investment in central overhead which was not the right one for the business at the time. It also provides a significant cashflow benefit for the business."

Related party transactions

It's rare that having started a deep dive on a stock, the stench is so bad I don't bother finishing it. But that was the case recently with Ince Group, the legal services business. I had concerns with cashflow, accrued income, and deferred consideration, but the odour became overwhelming when I got to related party transactions and executive remuneration.

In 2021, the company made payments to companies controlled by the CEO and his family members which totalled £688,000. In the same year, Ince took £2.1m in government COVID support and made 147 roles redundant, while the CEO received a 'one-off short-term incentive' of £500,000, on top of his normal salary and profit share incentive.

As Peter Drucker said, "Culture eats strategy for breakfast". If the atmosphere at the top smells like entitlement, it might be unsurprising when our due diligence throws up the instance of Ince employees, including CEO Adrian Biles, being refunded their bill and being told to "never come back" after inappropriate behaviour at a Cardiff restaurant.



Lee Skeet
@leeskeet

I'm not clout chasing or looking for likes.

I just think we should start calling out rich people who think they can treat people like crap

11:34 PM · May 4, 2022 from Cardiff, Wales · Twitter for iPhone

Dear [redacted]

I wanted to firstly thank you for choosing my restaurant for your meal tonight, and I understand you had the biggest bill we've ever had on one table here.

Unfortunately throughout the evening I was made aware that your party's behavior was inappropriate towards lily, who runs front of house.

She has told me that- as a 22yr old girl- she was talked down to, disrespected, and touched unwantedly by members of your group.

I have spent the last hour having conversations with her that break my heart, make me feel like a shit employer, and a terrible dad having my own daughter.

Please provide your bank details and I will refund your entire bill of £1000 minus £100 that I believe you should have tipped lily- which I will pay directly to her- as you left no tip. I would thank you to never come back to my restaurant. Lily means a lot more to me than money.

I also think you should assess the people you surround yourself with

Lee

While not all corporate mishaps can be sniffed out in the small print, unscrupulous practice usually comes to light in the end. For shareholders, the impact can rarely be understated.

Adam Rackley

Cape Wrath Capital

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