

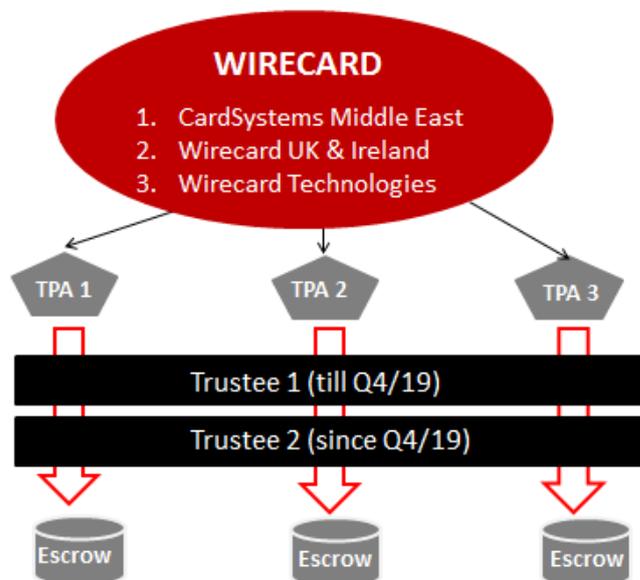
## From the Fund Manager's desk...

### Wirecard irregularities: 99% wealth gone in 9 days

**Who is wirecard?** Wirecard AG is an insolvent German payment processor and financial services provider at the centre of a recent financial scandal in Germany. The company offers its customers electronic payment transaction services and risk management, as well as the issuing and processing of physical cards.

**Why does it matter?** To give you a better sense of the sheer size and scale of the company, its shares in 2018 had hit a peak of Euro191, valuing it at more than Euro24bn after which it went on to replace Commerzbank in the prestigious Dax 30 German index. Moreover, when some financial irregularities came to light and Singapore police raided Wirecard's offices, back in Germany BaFin (German Financial regulator) announced a two-month ban on short selling, citing Wirecard's "importance for the economy" and the "serious threat to market confidence" (**Ref to Exhibit 1**)

**Exhibit 1: Mechanism: Money said to be in third party (TPA) foreign escrow accounts didn't actually exist and the probable lie was not detected even by a well-known big 4 auditor of the company**



Source: Ambit Asset Management, [Source](#)

**What is the scam?** A renowned Big 4 auditing firm (been with the company since 2008) failed to report Wirecard's "unorthodox financial arrangements" possibly due to irregularities in accounting and auditing processes.

Later another Big 4 auditing firm was called in to do a special audit which stated it could not verify that arrangements responsible for most of Wirecard profits reported during 2016 to 2018 to be genuine.

The controversy is centred on the missing \$2 billion from Wirecard, which was said to be stored in banks across foreign geographies, but an investigation turned up nothing. The money represented around a quarter of the total revenue the company had between 2016 and 2019.

**Wirecard acknowledges that the Euro1.9bn of cash probably does "not exist" and says it will file for insolvency.**

Source: [Media article 1](#), [Media article 2](#), Refer to Appendix

## We keep getting reminders that Accounting matters...

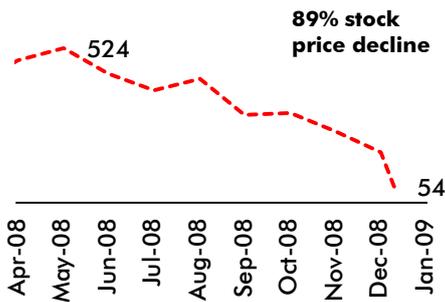
Quality (Good financials/company + Clean Accounting) is of prime importance and we keep getting reminders of this from time to time with frequency and magnitude of frauds like Wirecard now common place. In India too, reverberations of IL&FS' accounting shenanigans were felt by the Indian economy throughout CY19. In recent times we also saw troubles at DHFL, Yes Bank rooted to some extent in questionable accounting/reporting practices which were exposed, leading to massive decline in investor wealth. Apart from this, there were a few others (HDIL, CCD, Jain Irrigation, PC Jewelers) whose stock prices declined massively on concerns over accounting practices. Over the last decade there have been quite a few such frauds. Let us look at some famous reminders of accounting fraud in the past decade. **(Ref to Exhibit 2).**

**Exhibit 2: Well-known reminders of accounting frauds/discrepancy which lead to wealth destruction**

|  | Description   | What Happened?   | Auditors  | Wealth Destruction  |
|--|---|--|---|---|
| <b>Indian IT services &amp; back-office accounting firm</b>                      | <ul style="list-style-type: none"> <li>Accounting scandal of Rs7800cr (\$1.47bn) in which brought to limelight the importance of 'Ethics &amp; Corporate governance'</li> </ul> | <ul style="list-style-type: none"> <li>Overstatement of Income, Margins, Cash Balances &amp; underreported liabilities. Fraud took place to divert company funds into real-estate investment</li> </ul>                        | <ul style="list-style-type: none"> <li>Global Big 4 Auditing firm</li> </ul>        | <ul style="list-style-type: none"> <li>87% stock price decline</li> </ul> |
| <b>Company known for products related to Power generation &amp; transmission</b> | <ul style="list-style-type: none"> <li>Accounting scam of Rs3000cr gave importance towards check on irregular party transaction</li> </ul>                                      | <ul style="list-style-type: none"> <li>Company's net worth was understated due to unauthorized &amp; inappropriate write-offs &amp; charges debited to the financial statement of 2017 &amp; 2018</li> </ul>                   | <ul style="list-style-type: none"> <li>Originally a Mumbai based auditor</li> </ul> | <ul style="list-style-type: none"> <li>83% stock price decline</li> </ul> |
| <b>Beverage company that manufactures fruit juice</b>                            | <ul style="list-style-type: none"> <li>GST fraud of Rs40cr gave importance towards quality of accounting reporting</li> </ul>   | <ul style="list-style-type: none"> <li>Company allegedly created sales &amp; purchases of its products over 30 fake units for availing fraudulent credit &amp; tax evasion, involving sales of Rs300cr had surfaced</li> </ul> | <ul style="list-style-type: none"> <li>Global Big 4 Auditing firm</li> </ul>        | <ul style="list-style-type: none"> <li>87% stock price decline</li> </ul> |

Source: Ambit Asset Management, Company

**Indian IT services & back-office accounting firm (Price in Rs)**



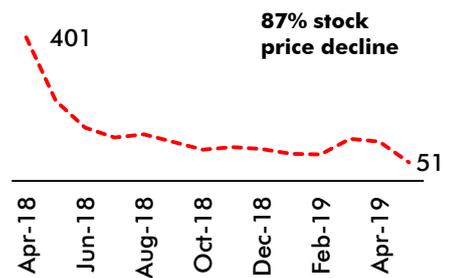
Source: Company, Ambit Asset Management

**Company known for products related to Power generation & transmission (Price in Rs)**



Source: Company, Ambit Asset Management

**Beverage company that manufactures fruit juice (Price in Rs)**

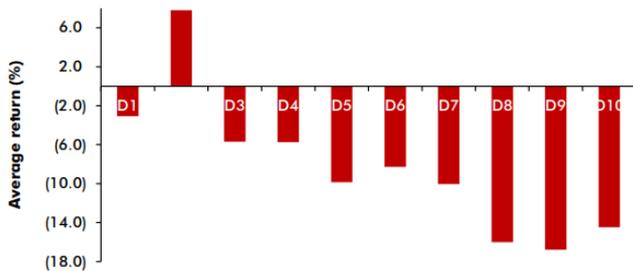


Source: Company, Ambit Asset Management

**Accounting Quality is Important to avoid losses**

Further our observation that high accounting quality means higher investment returns over long term, while poor accounting quality means lower investment returns over same time frame has always stood the test of time.

**Exhibit 3: Zone of Darkness (D8-D10) companies continued to underperform at several notches below Zone of Safety (D1-D5) companies**



Source: Bloomberg, Ambit Capital research, Company. Universe for this company is BSE-500 companies (ex-BFSI) with market cap of above `1bn at Nov'18. Share price performance is calculated over 21 Dec'18 to 02 Dec-19. These are average returns of the deciles.

**Exhibit 4: Performance of accounting deciles over long periods of time**

| Since            | Decile | Median share price performance |            |            |            |          |
|------------------|--------|--------------------------------|------------|------------|------------|----------|
|                  |        | 2014                           | 2015       | 2016       | 2017       | 2018     |
|                  |        | 5 yr. CAGR                     | 4 yr. CAGR | 3 yr. CAGR | 2 yr. CAGR | 1 yr Abs |
| Zone of Safety   | D1     | 6%                             | 7%         | 5%         | -5%        | -5%      |
|                  | D2     | 10%                            | 2%         | 11%        | -5%        | 11%      |
|                  | D3     | 5%                             | 11%        | 5%         | -3%        | -9%      |
|                  | D4     | 8%                             | 1%         | -1%        | -15%       | -11%     |
|                  | D5     | 7%                             | 6%         | 7%         | -14%       | -9%      |
| Zone of Pain     | D6     | 8%                             | 3%         | 4%         | -14%       | -7%      |
|                  | D7     | 6%                             | 5%         | 3%         | -17%       | -8%      |
| Zone of Darkness | D8     | 1%                             | 5%         | 3%         | -16%       | -9%      |
|                  | D9     | 6%                             | 0%         | 9%         | -20%       | -13%     |
|                  | D10    | 1%                             | 3%         | -7%        | -28%       | -19%     |

Source: Ambit Capital research, Company, Bloomberg, Ambit Capital research; Note: Accounting score is based on annual financials over FY09-FY18. For deciles constructed using FY14 scores we have plotted the stock price performance for five years i.e. 27 November 2014 to 27 November 2019, for deciles constructed using FY15 scores we have plotted the stock price for four years i.e. from 27 November 2015 to 27 November 2019 and so on.

**...as guardians of your wealth we take this seriously**

"It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you'll do things differently."

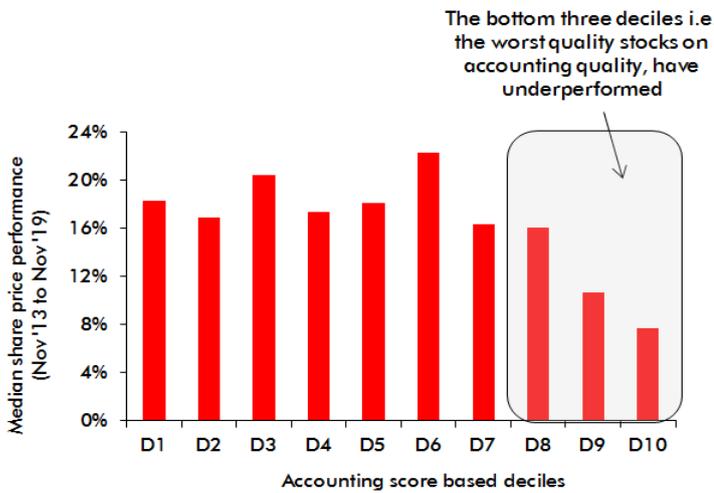
- Warren Buffet

**Forensic Accounting Framework for evaluation 'Clean' stocks**

At Ambit, focus on accounting quality & corporate governance has been the cornerstone of our investment philosophy. Ambit's proprietary 'forensic accounting' framework, which helps us weed out firms with poor quality accounts, ranks the investible universe based 11 quantifiable ratios under four key categories: balance sheet misstatement, profit & loss misstatement, cash pilferage and audit quality (Refer Exhibit 6).

Whilst markets can remain irrational over the short/medium term and test even the most stable investment philosophies, at Ambit, we have always believed that for long-term wealth creation accounting quality plays a very instrumental role and is a critical hygiene factor, lack of which is severely detrimental to portfolio returns. Even an analysis over the preceding years suggests that accounting quality does play an active role in shaping investment returns over the long run. Superior accounting quality firms continue to outperform poor accounting quality firms in the long run as is evident in performance differential for companies in bottom quality decile of D8-D10 over companies in D1-D7 which have superior accounting practices (Refer Exhibit 5).

**Exhibit 5: Decile based ranking of portfolio stocks so that we can further monitor, accounting quality is of paramount importance**



Source: Ambit Asset Management

**Exhibit 6: We make use of these checks as an additional safeguard as we know that lack of accounting quality is severely detrimental to portfolio returns**

**Accounting checks**

**P&L Mis-statement**

- Abysmally low CFO/EBITDA ratio over a long run
- High volatility in Depreciation Rates
- Boasting earning through lower debtor provisioning

**B/S Mis-statement**

- Low Cash yield implying balance sheet misstatement
- Writing-off losses directly through balance sheet
- High contingent liability

**Pilferage Checks**

- High Miscellaneous expenses
- Unsubstantiated capex or delay in plant commissioning
- Historically generating negative free cash flows
- Increasing advances to related party

**Auditor Quality**

- High auditor remuneration

Source: Ambit Asset Management

**The framework is not just theoretical and has seen results in practice:** Out of key 16 companies which gained significant attention over the past decade owing to alleged financial irregularities, 14 featured in bottom quality deciles (D8-D10). Most of these cases fared very poorly on capital intensity, related-party transactions and working capital adjustments whilst raising pledges. We believe featuring even once in Zone of Darkness in any of these eight years should have warranted attention. Needless to say the stock returns of these companies were either negative or significantly lower than even risk free rates in India.

**Exhibit 7: 14 out of 16 companies with alleged accounting irregularities featured in Zone of Darkness at least once; share price performance of these companies was negative or below the risk free rate of return in India**

| S.no | Company name             | Accounting Deciles over years* |      |      |      |      |      |      |      | FY12-FY19    |                    |                          |
|------|--------------------------|--------------------------------|------|------|------|------|------|------|------|--------------|--------------------|--------------------------|
|      |                          | FY12                           | FY13 | FY14 | FY15 | FY16 | FY17 | FY18 | FY19 | Revenue CAGR | EBITDA growth CAGR | Share price performance# |
| 1    | Conglomerate#1           | D10                            | D10  | D10  | D10  | D10  | D8   | D8   | D6   | -4%          | -20%               | -43%                     |
| 2    | Realty#1                 | D10                            | D10  | D10  | D10  | D10  | D10  | D10  | D10  | -7%          | -37%               | -32%                     |
| 3    | Healthcare Services#1    | D10                            | D9   | D6   | D8   | D6   | D3   | D4   | D9   | 6%           | -8%                | 2%                       |
| 4    | Heavy Engineering#1      | D9                             | D9   | D9   | D4   | D9   | D9   | D10  | D8   | -19%         | -42%               | -28%                     |
| 5    | E&C and Infra#1          | D10                            | D10  | D10  | D10  | D9   | D9   | D10  | N/A  | -8%          | -189%              | -39%                     |
| 6    | Media#1                  | D2                             | D2   | D1   | D4   | D3   | D8   | D6   | D9   | 15%          | 18%                | 4%                       |
| 7    | Heavy Engineering#2      | N/A                            | N/A  | D8   | D9   | D10  | D10  | D7   | D6   | -5%          | -13%               | -17%                     |
| 8    | Heavy Engineering#3      | N/A                            | N/A  | D8   | D7   | D9   | D9   | D10  | D9   | 13%          | 3%                 | -37%                     |
| 9    | Logistics#1              | D10                            | D10  | D9   | D10  | D10  | D10  | D10  | D8   | -17%         | -22%               | -25%                     |
| 10   | Auto ANC#1               | D9                             | D9   | D7   | D7   | D7   | D9   | D8   | N/A  | -6%          | -24%               | -41%                     |
| 11   | Consumer Discretionary#1 | N/A                            | D8   | D7   | D8   | D9   | D8   | D6   | N/A  | 23%          | 48%                | -39%                     |
| 12   | Retail#1                 | N/A                            | D2   | D4   | D5   | D4   | D5   | D5   | D3   | 16%          | 1%                 | -15%                     |
| 13   | Aviation#1               | D6                             | D6   | D5   | D4   | D4   | D4   | D6   | D6   | 6%           | 14%                | -34%                     |
| 14   | FMCG#1                   | N/A                            | N/A  | N/A  | D7   | D8   | D9   | D9   | N/A  | 33%          | -230%              | -44%                     |
| 15   | IT#1                     | N/A                            | N/A  | D10  | D10  | D10  | D10  | D10  | D10  | 69%          | 66%                | 7%                       |
| 16   | Consumer Discretionary#2 | D9                             | D9   | D10  | D10  | D9   | D8   | D8   | N/A  | -11%         | -6%                | -43%                     |

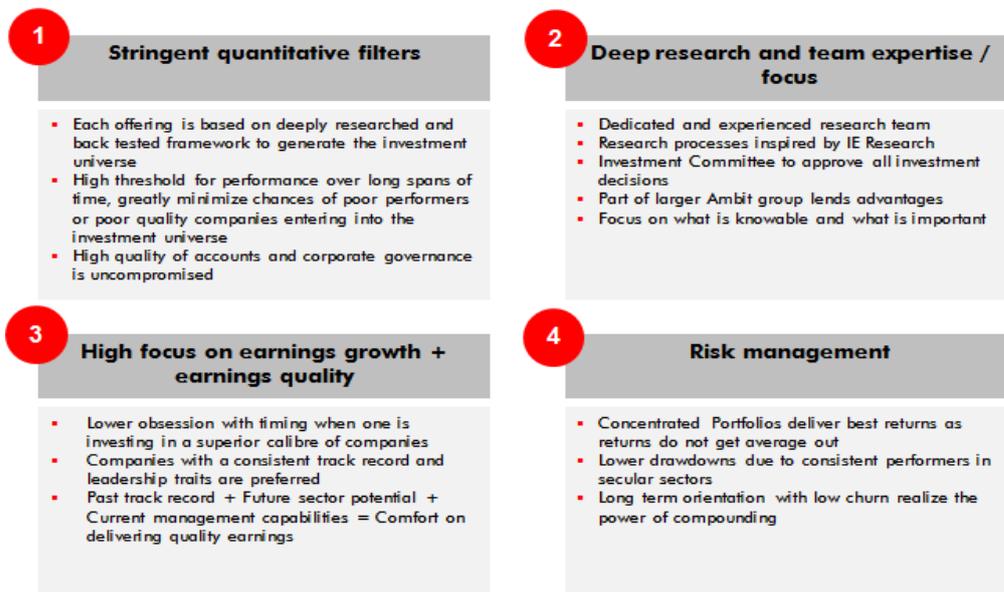
Source: Ambit Capital research, Company. \*Deciles are shown from the financial year they are available or FY12 whichever is earlier. This largely depends on availability of financial information for previous six years. Revenue and EBITDA CAGR are calculated from FY12 to FY19 except for consumer discretionary#1, Aviation#1 and consumer discretionary#2 where it is calculated till FY18. Share price performance is calculated from 31 Dec-12 to 31 Dec-19, except for Heavy Engineering#3, Consumer discretionary#1 and FMCG#1 where it calculated from 08 Apr-15, 12 Apr-13 and 08 July-15 respectively to 31 Dec-19. Share price performance of Auto anc#1 is calculated from 31 Dec'12 to 13 Aug-19

## Accounting Quality necessary but not sufficient alone...

Accounting Quality is an essential condition for return but not sufficient by itself which is why we go the extra mile. In matters of accounting Quality we take no chances and leave no stone unturned to get to the bottom of any suspicions we may have on accounting and auditor checks.

- Invest in firms which are: **(a) Good-** On the basis of capital allocation track record and quality of improvement in financial metrics over the past six years, and **(b) Clean-** Based on the quality of their accounts & corporate governance.
- **The focus on ‘good’ helps generate upside while not compromising on ‘clean’ reduces downside risk.** Essentially, while the objective is to generate returns, the even bigger goal is to better manage drawdowns because we believe doing the latter successfully is critically vital in achieving the former.

### Exhibit 8: ...and so all Ambit strategies go the extra mile to marry safety with returns



Source: Ambit Asset Management, Financial Times

# Appendix

## Exhibit 9: The Wirecard Fraud timeline as per Media articles

| Year        | Event  |
|-------------|--|
| 1999        | <ul style="list-style-type: none"> <li>Wirecard launched as a payment processor helping websites to collect credit card payment from their customers.</li> </ul>   |
| 2002        | <ul style="list-style-type: none"> <li>Markus Brown, ex-consultant at KPMG, took over as new Chief Executive.</li> <li>Went public by taking over the listing of a defunct call centre group avoiding scrutiny applied to an Initial Public Offering.</li> </ul>   |
| 2006        | <ul style="list-style-type: none"> <li>Moved into Banking i.e. they could both issue credit cards and handle money on behalf of merchants.</li> <li>The unusual hybrid model of banking and non-banking business made it difficult to compare with peers.</li> <li>Convinced investors to reply on the company's adjusted versions of the financial statements.</li> </ul>   |
| 2010 - 2014 | <ul style="list-style-type: none"> <li>Capital raise of Euro500m from shareholders, buying up small payment companies across Asia in a series of oddly structured deals. Singapore became the headquarters in the region.</li> </ul>   |
| 2015        | <ul style="list-style-type: none"> <li>FT newspaper began writing a series of articles suggesting inconsistencies in their accounts.</li> <li>J Capital Research reports that Wirecard's operations across Asia are far smaller than it claims. In response, Wirecard says short sellers are paying for this kind of news and report.</li> </ul>   |
| 2016        | <ul style="list-style-type: none"> <li>Bought a prepaid payment card business from Citigroup, entering the North American market.</li> </ul>   |
| 2017        | <ul style="list-style-type: none"> <li>Clean audit from EY in 2017 and a marked improvement in reported cash generation prompted renewed investor enthusiasm for Wirecard shares, whose price doubled.</li> </ul>  |
| 2018        | <ul style="list-style-type: none"> <li>Group's own legal staff began an investigation into Wirecard's Singapore headquarters finance team after an internal whistleblower raised allegations about a plan to fraudulently send money to India via third parties in a type of scheme known as "round tripping".</li> <li>Shares hit a peak of Euro191, valuing it at more than Euro24bn.</li> <li>Replaces Commerzbank in the prestigious Dax 30 index.</li> </ul>  |
| 2019        | <ul style="list-style-type: none"> <li>FT published its first story on the Singapore investigation, claiming that the internal investigation in Singapore had been squashed. They also claimed that half of Wirecard's business is actually outsourced, with the payments processing handled by partners who pay Wirecard a commission. It said that arrangements with three partner companies in the Philippines, Singapore and Dubai were responsible for most of the group's worldwide profits</li> <li>Singapore police raid Wirecard's offices. BaFin announces a two-month ban on short selling, citing Wirecard's "importance for the economy" and the "serious threat to market confidence"</li> <li>Wirecard issues Euro500m of bonds classified as investment grade by Moody's, the credit rating agency.</li> </ul> |
| 2020        | <ul style="list-style-type: none"> <li>KPMG's special audit report says it could not verify that arrangements responsible for most of Wirecard profits reported during 2016 to 2018 to be genuine.</li> <li>Wirecard acknowledges that the Euro1.9bn of cash probably does "not exist" and says it will file for insolvency.</li> </ul>  |

Source: Ambit Asset Management, Financial Times

**For any queries, please contact:**

Ashu Tomar - Phone: +91 22 6623 3244, Email - aiapms@ambit.co

Ambit Investment Advisors Private Limited -  
Ambit House, 449, Senapati Bapat Marg,  
Lower Parel, Mumbai - 400 013

**Risk Disclosure & Disclaimer**

Ambit Investment Advisors Private Limited ("Ambit"), is a registered Portfolio Manager with Securities and Exchange Board of India vide registration number INP000005059.

This presentation / newsletter / report is strictly for information and illustrative purposes only and should not be considered to be an offer, or solicitation of an offer, to buy or sell any securities or to enter into any Portfolio Management agreements. This presentation / newsletter / report is prepared by Ambit strictly for the specified audience and is not intended for distribution to public and is not to be disseminated or circulated to any other party outside of the intended purpose. This presentation / newsletter / report may contain confidential or proprietary information and no part of this presentation / newsletter / report may be reproduced in any form without its prior written consent to Ambit. All opinions, figures, charts/graphs, estimates and data included in this presentation / newsletter / report is subject to change without notice. This document is not for public distribution and if you receive a copy of this presentation / newsletter / report and you are not the intended recipient, you should destroy this immediately. Any dissemination, copying or circulation of this communication in any form is strictly prohibited. This material should not be circulated in countries where restrictions exist on soliciting business from potential clients residing in such countries. Recipients of this material should inform themselves about and observe any such restrictions. Recipients shall be solely liable for any liability incurred by them in this regard and will indemnify Ambit for any liability it may incur in this respect.

Neither Ambit nor any of their respective affiliates or representatives make any express or implied representation or warranty as to the adequacy or accuracy of the statistical data or factual statement concerning India or its economy or make any representation as to the accuracy, completeness, reasonableness or sufficiency of any of the information contained in the presentation / newsletter / report herein, or in the case of projections, as to their attainability or the accuracy or completeness of the assumptions from which they are derived, and it is expected each prospective investor will pursue its own independent due diligence. In preparing this presentation / newsletter / report, Ambit has relied upon and assumed, without independent verification, the accuracy and completeness of information available from public sources. Accordingly, neither Ambit nor any of its affiliates, shareholders, directors, employees, agents or advisors shall be liable for any loss or damage (direct or indirect) suffered as a result of reliance upon any statements contained in, or any omission from this presentation / newsletter / report and any such liability is expressly disclaimed. Further, the information contained in this presentation / newsletter / report has not been verified by SEBI.

You are expected to take into consideration all the risk factors including financial conditions, risk-return profile, tax consequences, etc. You understand that the past performance or name of the portfolio or any similar product do not in any manner indicate surety of performance of such product or portfolio in future. You further understand that all such products are subject to various market risks, settlement risks, economical risks, political risks, business risks, and financial risks etc. and there is no assurance or guarantee that the objectives of any of the strategies of such product or portfolio will be achieved. You are expected to thoroughly go through the terms of the arrangements / agreements and understand in detail the risk-return profile of any security or product of Ambit or any other service provider before making any investment. You should also take professional / legal /tax advice before making any decision of investing or disinvesting. The investment relating to any products of Ambit may not be suited to all categories of investors. Ambit or Ambit associates may have financial or other business interests that may adversely affect the objectivity of the views contained in this presentation / newsletter / report.

Ambit does not guarantee the future performance or any level of performance relating to any products of Ambit or any other third party service provider. Investment in any product including mutual fund or in the product of third party service provider does not provide any assurance or guarantee that the objectives of the product are specifically achieved. Ambit shall not be liable for any losses that you may suffer on account of any investment or disinvestment decision based on the communication or information or recommendation received from Ambit on any product. Further Ambit shall not be liable for any loss which may have arisen by wrong or misleading instructions given by you whether orally or in writing. The name of the product does not in any manner indicate their prospects or return.

The product 'Ambit Good & Clean Portfolio' has been migrated from Ambit Capital Private Limited to Ambit Investments Advisors Private Limited. Hence some of the information in this presentation may belong to the period when this product was managed by Ambit Capital Private Limited.

You may contact your Relationship Manager for any queries.