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Anatomy of a Short Attack

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When a lengthy "short" report is published, a company's stock price will almost often experience a near-term drop as momentum traders react to the allegations. Billions of dollars can hang in the balance as investors sift through a densely written report posted on a website. In some cases, the publication will set off an extended battle in the media between corporate executives, short-sellers, and large investors that can last for weeks or even months.

Equally important to the company's ultimate fate is the drama playing out "behind the curtains." Actors including internal auditors, the independent accounting firm, the audit committee, regulators, and large shareholders seek to assess the veracity of the charges and see if they missed something of significant magnitude. The results of this frenzy of activity will often determine if the attack ends up as a minor footnote or a company- and career-ending debacle.

The current conditions of the COVID-19 pandemic have created a perfect storm for companies that are subject to an attack by short-sellers. Market volatility is exceptionally high. Visibility on many companies' financial outlook is poor. Communication between management and board members regarding sensitive issues is challenging. And auditors face difficulties in performing work on the ground when many offices and facilities are shuttered.

For these reasons, it is more important than ever that both companies and investors understand the dynamics when a short-seller drops an apparent "bombshell" report on the market, often at the most inconvenient time.

Assessing the Credibility

The first issue to consider is: what's the story? Short-sellers may claim that a stock is doomed to fail because of some emerging competitive threat, changing consumer preferences, or dwindling reserves of cash. The accuracy of these predictions will become manifest in time but do not speak to the integrity of the financials.

Other reports assert that the reported financials are fundamentally inaccurate. Revenues have been fabricated, profits are inflated, and assets do not exist. The authors may even accuse senior management of outright fraud and posit that the equity has no value.

When short-sellers level these types of inflammatory charges against a company, a range of parties involved must assess their credibility. Who are the authors of the report, and what is their track record? What evidence do they present to support their claims? Was there a corporate insider who provided or validated vital information?

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The parties best positioned to know if allegations are accurate are usually members of senior management. If a report contains a fundamental misunderstanding of a company's business model or accounting policies, management should be able to quickly defang the argument and substantiate the scale of the business. A swift public statement will be followed by calls to the largest shareholders to defuse their concerns and answer their questions.

Assuming management can convince these large investors, they may take the opportunity to add to their positions at a lower cost, which can stabilize the share price and even pressure short-sellers to cover their positions as the stock price starts to rise.

At the other extreme, there are times when the evidence supplied in a short report is so unassailable that large holders abandon the stock, the price plummets, and the stock market intervenes to halt trading. In these cases, the company will rarely be able to preserve its listing when the dust settles. Years of bitter litigation often follow over the assets that remain.

Most cases fall somewhere in between. The arguments in a lengthy short report are enough to raise substantial doubt, but not entirely conclusive. The company may issue a terse dismissal of the claims. But in the background, a sequence of events begins that will determine the outcome of the drama.

Moving Up the Chain

If the scope of allegations is limited to a particular business segment, senior management will task the company's internal audit team to investigate if transactions were improperly recorded. Even if this investigation ultimately leads to a restatement of prior financial results, the consequences will not be fatal. But if the alleged conduct is systemic or if it appears that senior management was potentially involved, a quiet internal resolution is usually off the table.

Next to management, a company's public accounting firm should be best positioned to assess the information contained in a densely researched short report.

Well-funded short-sellers sometimes claim to employ techniques well beyond the toolbox available to an auditor, including recording months of video, collecting footage from drones or satellites, and sending hundreds of observers into the field. Most audit firms are unlikely to engage directly with the report's author for liability reasons. But if the report offers substantial evidence of overstated revenues or misappropriated assets, the outside auditor may examine the prior scope of its audit work.

A senior audit partner at one of the Big Four firms in China, explained: "Hindsight is 20/20. Sometimes you may go back and review all of the confirmations to see if there was any potential flaw. Could they have been falsified in any way?"

If the annual audit is in progress, the auditor may choose to expand the scope of the testing or employ enhanced audit procedures. "This type of report can definitely lead us to do more work, to do more vigorous testing of revenues, see if there is any round-trip booking. There is a heightened level of caution about management representations," the senior partner said.

If the auditor discovers evidence of concerns that rise to the level of materiality, the need to “assess very quickly, what is management’s attitude towards this information? What are they going to do about it? Who’s involved?” said Francine McKenna, a former director at a Big Four firm who writes extensively about the industry. “The auditor has to make sure that any significant or material allegations are raised to the level of the board, to the audit committee. … They’re looking at whether or not they need to hire a law firm and a forensic accounting firm to do an investigation.”

The Independent Investigation

At this point, management, the audit committee, and the external auditors are coming under intensifying pressure. The company may be receiving inquiries from both the Securities and Exchange Commission and the stock market where it is listed. Management is aware that it is unlikely to get the auditors to sign off on its financial statements without a thorough independent investigation. Audit committee members might begin to consider their exposure and reputational damage if a fraud occurred under their watch, even if they were unaware of it.

The independent investigation will typically be conducted by a law firm that, in turn, retains a forensic accounting firm, working under the direction of the audit committee. These investigations are incredibly uncomfortable for all parties; they depend upon management’s cooperation for their success, but they are simultaneously seeking to determine to what extent top leaders were aware of or orchestrated deceptive transactions. The parameters and timeframes of these investigations are carefully negotiated in advance. Even so, they will typically cause the company to incur millions of dollars in fees to lawyers and consultants.

While this process is going on, the company will be constrained in making any comments on allegations of wrongdoing, even as short-sellers may continue to drip additional adverse reports on the market as they seek to erode support for the stock.

Upon the launch of an independent investigation, the audit firm’s office of the general counsel, risk management, and audit quality assurance will carefully scrutinize the prior work that was done by the local team and try to assess the fallout. Audit partners need to demonstrate that they adhered to audit standards in their work and were not negligent. Every prior decision gets placed under a microscope. The Big Four auditors typically set up their local member firms to "ring-fence" legal liability, but they are loath to see their brands tarnished. In extreme cases, a Big Four firm may even eject the local firm from the global network for embarrassing lapses in audit quality.

The effectiveness of an independent investigation depends on the ability of the audit committee to guide the process to a decisive conclusion. In some cases, an investigation will thoroughly refute the principal claims of a short report. Other times, the investigation discovers that prior financial statements are unreliable and assigns responsibility to the executives involved. But often, the results are murky, leaving auditors in an awkward position.

The senior audit partner, who has reviewed the fruits of several such investigations, said: "Often these reports are not conclusive. The company may be able to get back on its feet and move on to some extent. But you would never be super-comfortable that these guys did not lie or didn't do anything wrong. That is the hard part."

The company will often issue a press release summarizing the findings of the investigation, but the report itself is not made public. And the consequences are far from over.

The Fallout

If the investigation concludes that a significant restatement of prior financial results is required, this can have a far more dramatic impact on the share price and corporate reputation than the initial short report. Significant shareholders will exit the stock. The company will be locked out of the capital markets. Law firms will announce a parade of class-action suits. Customers and partners may doubt the sustainability of the business.

To preserve the company's listing, stock market officials will want to see a good-faith plan to complete the required restatements, regain compliance with all listing requirements, and create a more robust governance and internal control environment going forward. In some cases, regulators will also expect changes to the existing management and board composition as a condition of remaining listed.

The company is unlikely to retain its existing audit firm, whose confidence in management has been severely eroded and now views the once-valued client as a reputational liability. While the auditor may not resign outright, it will set a series of increasingly unachievable requirements to sign-off on financial statements. The company will need to retain a new auditor to re-audit multiple years of financials adjusted to reflect all the issues unearthed during the independent investigation.

The road to recovery from such an episode is long and perilous. The board needs to balance demonstrating accountability with preserving the critical talent and relationships that allowed the company to thrive in the first place. Management must keep the underlying business on the rails while navigating restatements, investigations, lawsuits, and media scrutiny. Once burned, investors have deep reserves of skepticism. But if they see that the business is resilient and that management is providing reliable disclosure, then there is an opportunity to rebuild a following over time.

If the reconfigured leadership team is not willing or able to implement dramatically better reporting and governance practices, the prognosis for recovery is poor. It may be that exiting the public markets through a going-private transaction is the best available option. If the fundamentals of business were already deteriorating or the liquidity position is weak, then the company's very survival may be in question. Thousands of jobs may disappear. The entire direction of an industry may change. All of these consequences flow from the publication of a dense, single-spaced report on an obscure financial website.

As long as there are profits to be made, short-sellers will continue to seek out opportunities to publish the next incendiary report. To avoid this fate, management and boards of public companies need to continuously ask themselves: Are there any weaknesses in how we report our financial results? Are there any management decisions that could be construed as contrary to shareholder interests? Is how we describe our business sufficiently clear to avoid misunderstandings?

The best strategy for dealing with short sellers is to take pains to avoid placing your company under the microscope in the first place.