

Spotting the Liar in the Boardroom

Alongside our forensic accounting model, we also use questioning techniques popularised by the CIA to figure out whether the CEOs we are meeting are making things up.

“He that has eyes to see and ears to hear may convince himself that no mortal can keep a secret. If his lips are silent, he chatters with his fingertips; betrayal oozes out of him at every pore.” – Sigmund Freud

Forensic accounting is our primary line of defence

Marcellus' forensic accounting model stratifies the Indian stockmarket into ten deciles wherein decile 1 contains the cleanest companies and decile 10 contains companies who are almost completely fabricating their financial statements. If we overlay on these deciles the amount of debt companies have taken, we can see that the companies in the three worst deciles have the highest debt:equity ratios. Keeping in mind that there are several large cap companies in the three worst deciles, it is certain that as interest rates continue to rise, we will see more prominent companies blowing up. The question is that, forensic accounting apart, can we spot them before they blow-up? The answer is an emphatic “yes” – a mixture of adequate diligence on companies combined with the use of questioning techniques popularised by the CIA can be very effective in spotting liars.

The L-squared technique is our secondary line of defence

The specific skill that intelligence officers are taught is to go into L-squared mode (“look & listen”) as soon as they ask a question because research shows that most of the “tells” come within five seconds of the question being asked. So what are the tells that we look out for? [We have ranked these by order of effectiveness i.e. as you go down the list, the tells have a higher reliability rate.]

1. **The story behind the numbers:** Every set of financial statements has a story embedded in it. In a genuine set of financial statements, not only does the story make sense (eg. revenue growth is a few percentage points higher than nominal GDP growth, profitability growth is a few percentage points faster than that thanks to efficiency improvements and growth in free cashflows is a little bit faster than profit growth thanks to improvement in working capital) but the CEO also knows the story pretty well (without having to referring to a Powerpoint deck). When the CEO can't clearly tell us the story embedded in his own financial statements and/or when the CEO and the CFO tell us different stories about the same set of accounts, our antennae go up.
2. **Buying time:** Abraham Lincoln said that *“No man has a good enough memory to be a successful liar.”* We find that even when faced with straightforward questions, a liar will need to buy time. Why? Because making things up takes time and effort even though the human mind works 10x faster than we talk. Therefore, buying two seconds – by giving long winded answers or by using “no answer” statements (like “that is a great question” or “that’s a legitimate

concern”) or by repeating the question – is actually the equivalent of twenty seconds of thinking time. So if we see a CEO who repeatedly buys time in a meeting, we start worrying.

3. **The “Halo Effect”** – Often in response to our question, the CEO will begin by making a statement which is intended to enhance his status (in our eyes). So for example, when we asked the CEO of an auto ancillary company why his capex was equivalent to 10% of his revenues in the last three years. He began his answer by saying “You have to realise my relationships with Japanese OEMs goes back 30 years...” By making status enhancing statements, the CEO is asserting his dominance over us and using a time tested trick – as shown by Stanley Milgram in a legendary experiment (see <https://explorable.com/stanley-milgram-experiment>) we are wired to believe people in positions of power! If the CEO punctuates the meeting with multiple status enhancing statements, it is time to think about an early flight home and dinner with the family.
4. **Belittling**: If a CEO feels cornered and/or if his brain is getting scrambled, he will take to belittling our questions. Eg. when we asked a promoter why he had purchased six luxury cars using the company’s money, his response began “I have been running this company for 20 years and have met hundreds of major foreign investors over the years but none of them have raised this issue.” [That masterly statement from the CEO contains status enhancers, evasion and belittling of Marcellus.]
5. **Anger**: This is the most compelling tell. When the CEO loses it and starts threatening us or abusing us, we are almost 100% sure that his wicket is about to fall. Between us, we have 30 years of experience of probing companies and we have not found a single instance where an abusive/threatening CEO or promoter has lasted for more than five years after threatening us.

In isolation each of these tells merely arouses suspicion rather than confirming that the CEO is a liar. However, if we encounter three or more of these tells in the same meeting then our house rule is to move on to other, cleaner companies.

If you want to read more about how to spot liars, a good book to read is “Spy the Lie” by three ex-CIA operatives – Philip Houston, Michael Floyd and Susan Carnicero. Our thanks to Nitin Bhasin at Ambit Capital for bringing this book to our notice.

Note: the above material is neither investment research, nor investment financial advice. Marcellus is not authorized to provide either. Marcellus does not seek payment for or business from this email in any shape or form.

Saurabh Mukherjea is the author of “The Unusual Billionaires and “Coffee Can Investing: the Low Risk Route to Stupendous Wealth”. He’s also the Founder of Marcellus Investment Managers.