



SIMPLE IS BETTER

SIMPLE IS BETTER – ISSUE -16 – NUMBERS TELLS YOU EVERYTHING

We have seen that equity investment has provided decent returns to those who have made an investment into a decent business with having decent management. I have also explained a similar concept to my articles of [Pat Dorsey](#) and [Kite Flying](#) regarding business + management combination. What if the business is decent, growing well but management is not interested to create a wealth of minority investors. Rather they are interested to create their personal wealth. We have seen in the past that many of the companies have put an effort to hide manipulation with financial statements so that minority investors can be misguided by those statements.

For understanding such kind of manipulation and save our hard earned money, we need to carefully check financial statements without getting impacted by words of management. Accounting is a language of business, we need to understand it well so that we can make communication with numbers.

We also cannot trust big name analyst because we do not know the reason behind the recommendations given by the analyst. Recommendations can be based on genuine good company, some personal interest in the company, employer of the analyst has an agreement with the company, etc.

Many of the investors prefer to meet management to identify management quality. But personally, I am not good at judging people so that rather meet management, I prefer to check financial statements. I believe that **"Action speaks louder than words"**.

One of the company which is engaged in the trading, manufacturing, and supply of paper and paper products.

Profit & Loss Account / Income Statement												
Rs Cr	Mar-09	Mar-10	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	CAGR	Cumulative
Sales	63	95	113	185	246	303	433	1,590	2,360	2,335	49%	
% Growth YOY		50%	19%	65%	33%	23%	43%	267%	48%	-1%		
Expenses	61	92	108	178	233	286	413	1,474	2,199	2,214	49%	
Operating Profit	2	3	4	7	13	17	20	116	160	121	59%	462
Operating Profit Margin	3%	3%	4%	4%	5%	5%	5%	7%	7%	5%		
Other Income	1	0	0	1	-0	0	1	1	1	3		
Depreciation	0	0	0	0	0	0	1	1	1	1		
Interest	1	2	3	5	6	10	11	10	4	5		
Interest Coverage(Times)	2	2	1	1	2	2	2	11	41	24		
Profit before tax (PBT)	1	1	1	2	6	7	9	106	157	118	71%	408
% Growth YOY		17%	26%	52%	188%	10%	37%	1050%	48%	-25%		
PBT Margin	1%	1%	1%	1%	2%	2%	2%	7%	7%	5%		
Tax	0	0	0	1	2	2	3	8	16	8		
Net profit	1	1	1	1	4	4	7	98	140	110	77%	367
% Growth YOY		16%	28%	46%	194%	10%	46%	1395%	43%	-22%		
Net Profit Margin	1%	1%	1%	1%	2%	1%	2%	6%	6%	5%		
EPS	-	-	-	-	-	0.4	0.6	8.3	5.9	4.6		

Company has posted a huge Sales, Profit growth.

If we see CAGR till FY17 then it was 57%, 75%, 90% and 96% for the sales, Operating profits, PBT and Net profits respectively. So the market likes such hyper growth -



But we should suspects such kind of hyper growth and need to check it further in details.

Cash Flow Statement											
Rs Cr	Mar-09	Mar-10	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Total
Cash from Operating Activity (CFO)	2	3	2	2	3	-3	-14	62	130	44	229
% Growth YoY		35%	-37%	4%	59%	-211%	382%	-526%	111%	-66%	
Cash from Investing Activity	-1	-3	0	-3	2	-7	-10	2	-8	-32	-59
Cash from Financing Activity	-1	2	-5	1	-5	10	25	-51	-128	-18	-170
Net Cash Flow	-0	2	-3	-0	-0	0	1	12	-6	-6	0
CFO/Sales	3%	3%	1%	1%	1%	-1%	-3%	4%	6%	2%	
CFO/Net Profit	300%	350%	173%	122%	66%	-67%	-221%	63%	93%	40%	
Capex**	0	2	0	0	1	1	13	0	8	0	
FCF	2	1	2	2	2	-4	-28	62	122	44	203
Average FCF (3 Years)										76	
FCF Growth YoY		-33%	73%	55%	7%	-284%	652%	-322%	98%	-64%	
FCF/Sales	-495%	-221%	-322%	-304%	-246%	-1%	-6%	4%	5%	2%	
FCF/Net Profit	256%	95%	166%	117%	49%	-82%	-423%	63%	87%	40%	

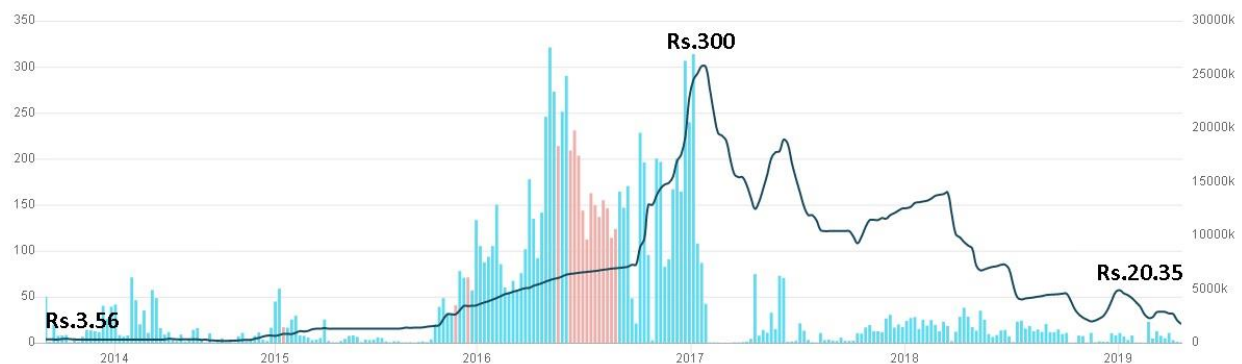
Balance Sheet											
Rs Cr	Mar-09	Mar-10	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	CAGR
Equity Share Capital	1	9	9	16	16	24	24	24	47	47	60%
Reserves	9	6	7	1	6	30	37	111	205	289	47%
Borrowings	12	23	32	42	50	89	126	108	6	19	5%
Other Liabilities	4	8	9	10	19	17	67	980	673	549	74%
Total	26	46	57	69	90	160	253	1,223	931	904	
Net Block	1	3	3	3	3	4	17	16	26	17	31%
Capital Work in Progress	-	-	-	-	-	-	-	-	-	-	
Investments	0	0	0	0	0	3	3	3	0	0	
Other Assets	24	42	53	66	87	154	234	1,204	905	888	49%
Total	26	46	57	69	90	160	253	1,223	931	904	
Working Capital	20	34	45	56	67	137	167	224	232	338	37%
Debtors	17	30	39	48	70	103	206	1,153	823	748	52%
Inventory	1	4	8	10	8	9	10	12	15	6	23%
Cash & Bank**	1	3	0	0	1	8	11	20	8	1	

Debtor Days	99	117	127	94	104	125	174	265	127	117
Inventory Turnover	69	24	14	19	32	33	43	133	154	397
Fixed Asset Turnover	43.6	29.6	36.1	61.9	72.1	79.0	26.0	98.9	90.9	140.5
Debt/Equity	1.2	1.5	2.0	2.5	2.3	1.7	2.1	0.8	0.0	0.1
Return on Equity	6%	5%	6%	8%	19%	8%	11%	73%	56%	33%
Return on Capital Employed	10%	8%	9%	12%	17%	12%	11%	48%	62%	35%

We need to ask the questions that -

- If the company has posted a huge sales, profitability growth then why the company has to dilute share capital (last 2 years was due to bonus issue)?
- Company has posted +ve CFO, +ve FCF over a period of time then also why need to dilute share capital?
- Company has a higher receivables growth compared to the sales growth, why?
- Inventory conversion days are growing and reached at the 397 days which is nearly 1 year, what is happening?
- Fixed assets turnover is growing rapidly, how it can be possible? I have not seen such kind of huge turnover into the few of the asset light and also not into the IT businesses (where huge fixed assets do not have existence)

What happens after that?



There are many examples where investors have lost their capital due to not put a huge emphasis on the numbers. If we look at the numbers carefully then they talk with us and we can protect our capital by their instructions.

One of the company provides Automatic Identification and Data Capture (AIDC) Solutions, manufactures Smart cards and Radio Frequency Identification (RFID) equipment, and financial inclusion project and services.

Profit & Loss Account / Income Statement														
Rs Cr	Mar-06	Mar-07	Mar-08	Mar-09	Mar-10	Mar-11	CAGR	Sep-12	Sep-13	Mar-15	Mar-16	Mar-17	Mar-18	CAGR
Sales	29	63	183	376	580	597	83%	556	50	39	42	72	71	8%
Operating Profit	7	17	47	118	193	156	86%	-3	-74	-4	10	10	13	6%
Profit before tax (PBT)	6	15	41	68	108	52	54%	-118	-115	-128	-35	-51	-43	
Net profit	5	13	33	48	65	66	67%	-122	-69	-112	-33	-51	-43	



So how to catch such manipulation? How to protect our capital? How to create wealth? How to know something is fishy into the company? I am going to discuss the different ways of accounting manipulation and how to recognize it in the future issues of the same series.

Now, we can say that analyzing the quality of management is more essential for creating wealth. If we found the company has used any of the manipulation technique in the past then also we should be careful with it. Because it is a higher probability of similar happens in the future. We cannot change our habits easily. Investing is not a game to make a higher return, it is a game to protect our capital, avoid errors. This will help us to create better wealth.

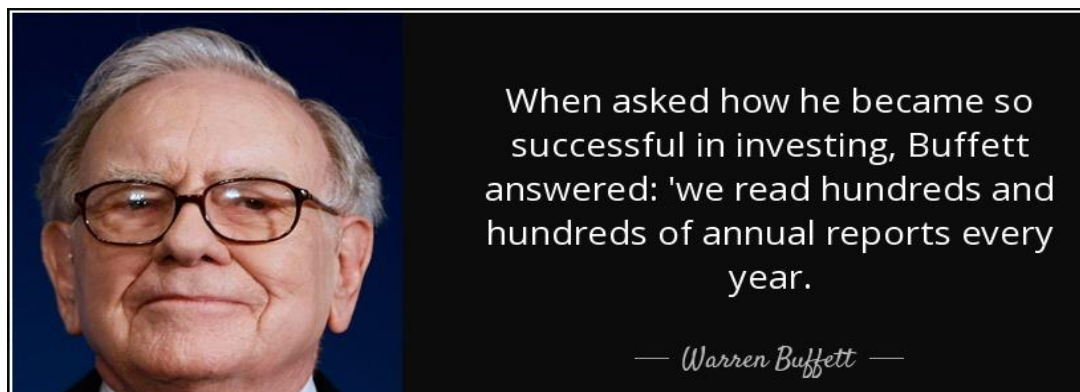
For understanding the accounting manipulation, we need to understand the financial statements so for getting the basics of financial statements. Kindly visit my posts -

- [SIMPLE IS BETTER – ISSUE -8 – OUR LIFE AND INVESTMENT – 2](#)
- [SIMPLE IS BETTER – ISSUE -9 – OUR LIFE AND INVESTMENT – 3](#)
- [SIMPLE IS BETTER – ISSUE -10 – RELATIONSHIP BETWEEN PROFIT & LOSS ACCOUNT AND BALANCE SHEET](#)
- [SIMPLE IS BETTER – ISSUE -11 – CASH FLOW STATEMENT](#)
- [SIMPLE IS BETTER – ISSUE -12 – FUND FLOW ANALYSIS](#)

There are many manipulations which are resulted through manipulating earnings. Such as Recording revenue too soon, Recording Bogus Revenue, Boosting Income Using One-Time or Unsustainable Activities, Shifting Current Expenses to a Later Period, Employing Other Techniques to Hide Expenses or Losses, Shifting Current Income to a Later Period, Shifting Future Expenses to an Earlier Period, Shifting CFO items to Investing activities, etc. We must have to understand business metrics before going for identification of Frauds. Because it may be possible that selling of land is other income for the FMCG business but core income for the real estate business.

Rewards of the Game	
Category	Rewards
Share-price effects	Higher share prices Reduced share-price volatility Increased corporate valuation Lower cost of equity capital Increased value of stock options
Borrowing cost effects	Improved credit quality Higher debt rating Lower borrowing costs Less stringent financial covenants
Bonus plan effects	Increased profit-based bonuses
Political cost effects	Decreased regulations Avoidance of higher taxes

We need to read annual reports with footnotes, corporate announcement, corporate deals, etc thoroughly.



Read annual reports but never trust it blindly. Because letters only sign by chairman and president but that is written by their PR fellows.



There is flexibility into the accounting policy which management of companies uses for their own benefits also.

Two companies from the Automobile Industry

Company A

Intangible assets, comprising of software, expenditure on Model fee, etc. incurred are amortised on a straight line method over a period of 5 years.

Company B

Technical know-how acquired is stated at acquisition cost less accumulated amortisation and impairment losses, if any. Acquired technical know-how is amortised equally over a period of estimated useful life i.e. six years.

Company A

Rs Cr	Mar-15	Mar-16	Mar-17	Mar-18
Depreciation % on average Assets	16%	11%	10%	11%

Company B

Rs Cr	Mar-15	Mar-16	Mar-17	Mar-18
Depreciation % on average Assets	10%	13%	15%	16%

We have seen that there are differences in accounting into the two companies of the same industry.

Many of the accounting practices provide a window to the companies for using it for own benefits. I will try to explain all manipulation in a simple manner into the upcoming issues of the same series.

Entire series of **"Numbers tells you everything"** is based on the books –

- [Financial Shenanigans - Howard Schilit](#)
- [Quality of Earnings - Thornton L. O'glove](#)
- [The Financial Numbers Game - Charles W. Mulford](#)
- [Creative Cash Flow Reporting - Charles W. Mulford](#)

I have tried to cover up concepts available with the above books. Companies mentioned in the series is just for an example purpose. I am not a SEBI registered research analyst.

To be continued.....

Love to read again and again

- [Confusing Absence of Evidence With Evidence of Absence, & Other Cool Mistakes We Make](#)
- [Alpha Moguls With SageOne Investment Advisors' Samit Vartak](#)

My Popular articles

- [LEARNING INVESTMENT LESSONS FROM MOVIE CHAL MAN JEETVA JAIYE](#)
- [WHY CONSIDERING ROCE \(RETURN ON CAPITAL EMPLOYED\) WITH ROE \(RETURN ON EQUITY\) IS BETTER????](#)
- [WHAT IS ROE \(RETURN ON EQUITY\)? AND WHY ALWAYS CONSIDER DEBT WHEN CALCULATING ROE?](#)

Simple is Better Series

Issue - 1	Issue - 2	Issue - 3	Issue - 4	Issue - 5	Issue - 6
Issue - 7	Issue - 8	Issue - 9	Issue - 10	Issue - 11	Issue - 12
Issue - 13	Issue - 14	Issue - 15			

2 minutes please Series – Visit YouTube channel – [Jimit Zaveri](#)**You, Me and Business Series**

Issue - 1					
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Disclaimer

Above article is just my perception, and perception can be wrong. For me, my perception can be right but for others, it might be wrong.

I am Grateful to

I am really grateful to - Mr. Neeraj Marathe Sir, Prof. Sanjay Bakshi Sir, Mr. Vishal Khandelwal Sir, Dr. Vijay Malik Sir, Mr. Rajeev Thakkar Sir, Mr. Raunak Onkar Sir, Mr. Vijay Kedia Sir, Mr. Howard Marks, Mr. Warren Buffett, Mr. Charlie Munger, Mr. Benjamin Graham, and Mr. Walter Schloss.

I am really grateful to my parents and almighty for providing me always support whenever I needed.

Please forgive me, if I forget to mention any person who has contributing value to my journey.

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*As a founder of Lucky Idiot; My mission through “**Lucky Idiot**” is to educate novice investors and to distribute learning to more and more people in a simple manner.*

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