



SIMPLE IS BETTER

SIMPLE IS BETTER – ISSUE -17 – Numbers tells you everything - 2

In the previous article of the same series, I have explained needs for checking a management quality. And also explained what if we invest in the company which has troublesome management. Now, I am going to explain how we can judge the management through accounting and protect our wealth.

1. **Don't trust your Auditor**

Auditors write their opinion as "numbers are not materially in error". It does not mean that we need to believe them, they are right 100%, there is not a major error.

Company A

Satyam scam: ICAI bans four auditors for life

While Gopalakrishna was a partner at Pricewaterhouse Bangalore, Talluri Srinivas was a signing partner and engagement leader of audit team of the statutory auditors of Satyam Computers.

The chapter of Satyam scam is finally set to close as far as the accounting regulator, ICAI, is concerned. The Institute of Chartered Accountants of India (ICAI) has imposed a life-time ban on four auditors — S Gopalakrishna, Talluri Srinivas, V Srinivasa and VS Prabhakara Rao — involved in the Satyam Computers accounting fraud.

Company B

- i. We are unable to verify the correctness of the write off of USD 38,812,000 reversed in respect of software licences sold to the customer's as stated in Note no. 1 to the consolidated financial statements of the Company for the year.
- ii. We are unable to verify the correctness of the write back of ₹43,700.54 lac, reversed in respect of software licences returned to the suppliers, as stated in Note no. 1 to the consolidated financial statements of the Company for the year. Consequently the loss for the year has been understated to that extent.
- iii. During the year Company has not made the provision for Bad and Doubtful debts, as stated in Note no. 2 to the consolidated financial statements of the Company for the year, as per the accounting policy the amount shown as Trade Receivable amounting to USD38,812,000. The loss for the year has consequently been understated to that extent.
- iv. In the absence of confirmations from any of the third parties (including Company's foreign subsidiary) in respect of correctness of amount due from/to the Company, including debtors, creditors, trade advances, other liabilities etc. we are unable state correctness thereof.
- v. During the year The Company has defaulted in repayment of Loans/dues to the financial institutions to the tune of ₹8,005.29 Lac. Some of the financial Institutions have filed winding up petitions against the Company. The litigation is still pending and we are informed that in a few cases the Company has made a counter claim against the same. However, the ultimate impact is presently unascertainable as stated in note no. 4 to the consolidated financial statements of the Company for the year.

Auditor's Report



Wednesday, 16 October, 2002, 21:47 GMT 22:47 UK

Enron auditor fined \$500,000

Disgraced accountancy firm Arthur Andersen has been handed the maximum penalty allowed under US law for its role in the collapse of Enron.

Arthur Andersen was fined \$500,000 (£322,000) and sentenced to five years' probation.

Earning manipulation Shenanigans

- **Recording revenue too soon**

Many companies extend days of their quarter-end months such as 35 days of June, September, December, and March. Company shifts the initial few days of a new quarter to the old quarter so that revenue of old quarter get boost and revenue get recorded soon.

- **Recording revenue far in excess of work completed on the contract**

- **Recording revenue of licenses on an upfront basis**

For example, the Company has made a contract for the coming 5 years and the company is going to receive Rs.100 crore for 5 years of the contract period. So that company should not record Rs.100 crore on initial period rather should record revenue as received from the customer. The company recognizes revenue on the upfront though it is long term in nature so cash is not getting upfront but it only boosts up receivables.

- **Changing of revenue recognition policy with time**

Company change revenue recognition policy and record future revenue on the upfront basis which affects to the Cash Flow from Operation (CFO). As the company does not receive cash but

the company has just recorded revenue which resulted in the lower CFO compared to the Net Profit and also receivables start to boost up. By recording future revenue to the current period, the company boost up short-term revenue but sacrificing future revenue. ***We need to focus on the revenue recognition policy for better judgment for the manipulation with the recording of revenue.***

○ **Recording Revenue on Long-Term Construction Contracts Using Percentage-of-Completion Accounting**

For percentage-of-completion accounting, the company has to recognize revenue as construction complete. It depends on the estimate of management which open a door for management to make manipulation. ***Services providing companies and companies which sells products having a short production cycle are not allowed to use this method of recognizing revenue. So if any services providing companies involves into such kind of accounting then we need to be cautious.***

○ **Lease accounting tricks**

The company needs to provide appropriate discount rates for arriving at the appropriate revenue. If a company provides lower discount rates for the lease then the company record a higher current revenue and if the company provides a higher discount rates then company has to record lower upfront revenue.

	Lower Discount Rate	Normal Discount Rate	Higher Discount Rate
Lease	100	100	100
Discount Rate	8	10	12
Revenue	12.50	10.00	8.33

○ **Recording Revenue on Utility Contracts Using Mark-to-Market Accounting**

Company has made a contract to provide product on the future date but they treat it as a financial instrument and record mark-to-market changes as a revenue. This accounting treatment does not allow for contracts other than financial instruments.

● **Recording Revenue Before the Buyer's Final Acceptance of the Product**

○ **Seller Records Revenue Before Shipment**

Revenue should be recognized only when the product gets shipped to the customers but for recording revenue soon or boost up revenue, the company recognizes revenue without shipped product to the customer.

We need to check the revenue recognition policy to better understanding.

○ **Seller Records Revenue upon Shipment to Someone Other Than the Customer**

The seller has to make the shipment to the supply chain or to its franchisees but not to the final customers. But they record such shipment as a sales, and revenue gets boost up.

○ **Seller Records Revenue, but Buyer Can Still Reject the Sale**

The seller has to make the shipment to the customer but the customer has the right to reject due to any reason. As we placed an order from e-commerce site and we have an option to reject the product if we are not satisfied. If the company has recorded revenue and product reject by

the customer than the company has to record it. And such revenue recognition creates the wrong sales.

The company should not record revenue before the expiry of the time of product return by the customer. These will increase receivables as cash will not come to the company.

When we purchase goods from E-commerce sites then we get a 10 days replacement, if company record revenue before the expiry of those 10 days of replacement then it does not consider an appropriate accounting practice.

- **Recording Revenue When the Buyer's Payment Remains Uncertain or Unnecessary**

The buyer does not have the approval to make a payment to the seller, buyers can not able to make payment. Many times, sellers boost revenue by selling an existing or new product to the long credit period which increases receivable days. We need to check the trend of sales and receivable, also Receivables as a % of sales. If receivables are growing higher than sales and receivable as a % of sales growing higher then we should consider a problem in it.

Seller also provides financing to the buyers for enhancing revenue. Here, proper provisioning for the financing should be done by the seller or else default of customer affects the performance of the company.

When selling to the government companies, where payment can be delayed. Also, selling to the companies which are into trouble itself.

One of the Indian Finance Company which has a few of the clients who are into trouble itself then we have to be cautious



Client - 1

Balance Sheet								
Rs Cr	Jun-06	Jun-07	Mar-08	Mar-09	Mar-10	Mar-11	Mar-12	Mar-13
Equity Share Capital	98	135	136	266	266	498	578	809
Reserves	118	238	53	-2,496	-4,241	-4,002	-6,213	-14,282
Borrowings	452	917	934	5,666	7,923	7,026	8,719	9,407
Investments	0	0	-	0	0	0	0	0
Cash & Bank**	256	817	280	172	206	252	182	19

Profit & Loss Account / Income Statement

Rs Cr	Jun-06	Jun-07	Mar-08	Mar-09	Mar-10	Mar-11	Mar-12	Mar-13
Sales	1,234	1,618	1,439	5,163	4,919	6,281	5,469	495
Expenses	1,640	2,336	2,154	7,247	5,919	6,292	7,615	3,274
Operating Profit	-407	-718	-715	-2,083	-1,000	-11	-2,146	-2,778
Other Income	115	382	129	840	-152	44	318	152
Depreciation	13	18	18	133	163	241	342	239
Interest	32	62	78	779	1,103	1,313	1,276	1,436
Profit before tax (PBT)	-337	-416	-683	-2,155	-2,418	-1,521	-3,446	-4,301
Tax	4	3	-494	-546	-771	-493	-1,118	-
Net profit	-341	-420	-188	-1,609	-1,647	-1,027	-2,328	-4,301

Cash Flow Statement

Rs Cr	Jun-06	Jun-07	Mar-08	Mar-09	Mar-10	Mar-11	Mar-12	Mar-13	Total
Cash from Operating Activity (CFO)	-180	-553	-520	-646	-1,665	2	-886	-1,391	-5,837
Cash from Investing Activity	-346	119	14	207	235	-38	-388	-70	-266
Cash from Financing Activity	699	994	-31	290	1,465	82	1,203	1,297	5,998
Net Cash Flow	174	561	-537	-149	35	46	-70	-163	-105
Capex**	397	183	28	5	-	-	320	48	
FCF	-577	-736	-547	-651	-1,665	2	-1,206	-1,439	-6,818

Client -2

Balance Sheet

Rs Cr	Mar-09	Mar-10	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18
Equity Share Capital	339	1,666	2,035	2,035	2,187	2,187	2,409	2,409	2,409	2,409
Reserves	-	-	34	-116	-396	-687	-1,316	-1,514	-2,977	-9,117
Borrowings	1,729	2,469	4,110	6,141	7,150	8,389	10,211	10,269	10,288	9,907
Net Block	127	202	669	1,505	1,448	3,733	4,649	10,375	9,912	5,162
Capital Work in Progress	1,995	3,686	5,243	6,730	8,171	6,760	6,819	1,751	1,799	919
Investments	176	161	67	23	-	176	40	-	-	-
Other Assets	97	174	707	780	643	732	1,853	1,307	1,309	1,907
Cash & Bank**	56	94	83	79	93	69	260	53	134	688

Profit & Loss Account / Income Statement

Rs Cr	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18
Sales	7	61	163	513	1,831	2,598	2,562	3,491
Expenses	11	107	248	566	1,818	2,529	2,519	3,256
Operating Profit	-4	-46	-85	-53	13	69	43	235
Other Income	0	0	-1	7	16	292	98	-5,050
Depreciation	1	24	59	68	201	203	479	534
Interest	2	80	134	177	452	527	1,126	790
Profit before tax (PBT)	-6	-150	-280	-291	-624	-368	-1,463	-6,139
Tax	-	0	0	0	0	-	-	-
Net profit	-6	-150	-280	-291	-624	-368	-1,463	-6,139

Cash Flow Statement

Rs Cr	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Total
Cash from Operating Activity (CFO)	-71	191	65	-33	-384	721	204	1,040	1,734
Cash from Investing Activity	-1,654	-1,627	-560	-459	-590	-765	-68	-649	-9,830
Cash from Financing Activity	1,715	1,432	509	468	1,165	-122	-53	-444	8,055
Net Cash Flow	-11	-4	13	-23	191	-165	84	-54	-41
Capex**	1,748	1,803	763	336	667	906	79	52	
FCF	-1,819	-1,612	-698	-369	-1,051	-185	126	988	-4,620

- **Recording Revenue from Transactions That Lack Economic Substance**

The company sends products to own warehouses or to distributors to show selling of products has been occurred but actually real sales of products have not happened. Many a time, the company provides a bonus to the distributor on purchase value for creating demand. Also, company purchase products from the distributor at a higher price. These only use for boosting revenue by having an impact on profitability. When a company involves into the bogus revenue then it has a higher probability of not having a cash inflow so that receivables of the company will surely start increasing. We also need to suspect that if the company is recording bogus revenue then it has a higher probability of having bogus cash flow from operating activities.

- **Selling products to the companies which do not exist**

The company shows order and shipment of products to the companies which does not exist. The company boosts up revenue by dealing with fake companies. When the customer does not exist then there will be not any chances of getting payment from them.

- **Bogus Reserves Will Often Lead to Bogus Revenue or Income**

If the reserve is bogus and the company does not need to make a future payment then company release that reserve to boosts revenue.

I will explain this topic into the upcoming article where I will explain reserve into the detail. And other examples also in upcoming articles.

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

- [Berkshire Hathway AGM 2019](#)
- [Joel Greenblatt: "The Little Book that Beats the Market" | Talks at Google](#)

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

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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.

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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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