Indian Annual Reports: Facts or fiction?

With nearly 50% of Indian stocks failing to deliver positive returns over the last 20 years, there is more to Indian stocks than meets the eye. Whilst some of these firms may indeed have failed to deliver on genuine business grounds, several of these companies never intended to benefit minority shareholders in the first place. Before the annual report deluge for FY13 begins, we dig into our forensic accounting knowledge bank to give you case studies of how to navigate through camouflaged annual reports.

We have repeatedly pointed out over the last three years the vital importance of accounting quality in shaping investment returns. Our annual accounting thematic, our proprietary forensic accounting model and our hundreds of bespoke accounting projects give us a wealth of knowledge when it comes to understanding how certain corporates in India flatter their books.

In this note, before the FY13 Annual Reports start pouring in, we help investors identify the most popular accounting tricks that corporates use to mask the true health of their businesses. We provide 'real life' examples of how various firms have used these aggressive policies in India. The caveat is that the use of such accounting policies is a red flag but not necessarily indicative of financial misdemeanour or fraud.

Aggressive accounting policies highlighted in this note

Revenue recognition policies: Some ways to spot aggressive revenue recognition policies include '% change in receivables/ % change in revenues' and 'operating cash flow growth/operating profit growth'. We look at the specific cases of **ICSA**, **Godrej Properties** and **Unitech** in this note.

Provisioning: Provision for doubtful debts and provisioning coverage ratio (in the case of banks) are often manipulated to help boost PBT. We look at the practices of **Bajaj Electricals** & **some Indian banks** for insights on this front.

Auditor & the Auditor's Report: Frequent changes in auditors and qualifications made/issues raised by the auditors should be carefully analysed as reflected in our case studies on **Arshiya International** and **Lanco Infra**. We also look into auditor's remuneration using **Crompton Greaves**, **CESC** and **JSW Energy** as case studies

Related Party Transactions: Related party transactions not executed at arm's length need careful scrutiny as we discuss in the case of **Crompton Greaves**.

Cash Yield: A sub-par cash yield may imply either non-operating income being booked as revenues or the cash & marketable investments figure on the balance sheet being misstated. **Arshiya International** as well as **Geodesic and Tanla Solutions** are interesting case studies.

ESOPs accounting & fee income accounting for banks: The cost associated with ESOPs is typically not properly reflected in a bank's P&L, thus inflating reported profits. Likewise, fee income, both fund-based and non-fund-based, can be accounted for in aggressive ways to flatter PBT. We see both of these aggressive practices at play in the **top private sector banks**.

Capitalising R&D costs: By capitalising R&D costs, companies can defer its recognition as expense on the P&L; we turn to the case of **Tata Motors (JLR)**.

Pension accounting: By adjusting the various assumptions used in estimating pension expense for a period, a company can flatter its reported earnings as highlighted in our case study on **Indian Overseas Bank**.

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Some case studies featured in this note:

Low cash yield earned by Arshiya International - With competitors like Gateway Distriparks earning cash yields of 5-8%, Arshiya International's abysmal yields (0.5-2%) raise a red flag.

Provisioning coverage ratio (PCR) misuse in banks - PCR can be used to make bottom-lines look better than they are. Bank of Maharashtra, Andhra Bank and Dena Bank fare poorly on our metric to measure this.

Issues raised by Lanco Infra's statutory auditors - Lanco Infra's reported profits for FY07 were higher by ₹412mn and these were not properly corrected in FY08. Also, it appears that AS-21 was not followed properly in the FY07 annual accounts. The auditors had clearly raised these concerns in their reports.

Related Party Transactions of Crompton Greaves - An aircraft purchase and that too with a related party in the business of providing aircrafts on a lease basis in FY08 raises concerns on the appropriateness of such a transaction in Crompton Greaves' case, given that it could have simply hired the aircraft.

Cash yields of Geodesic & Tanla Solutions - Given that non-operating assets such as idle cash and marketable investments would be expected to generate a yield of at least 3-4%, and given that peers such as Info Edge have been earning yields of 6-8%, the low yields earned by both Geodesic & Tanla Solutions raise a red flag.

Indian Overseas Bank's aggressive pension assumptions - Assumptions of a higher expected rate of return on plan assets along with lower salary escalation rate seem aggressive in IOB's case.

CONTENTS

Section 1: The importance of accounting quality

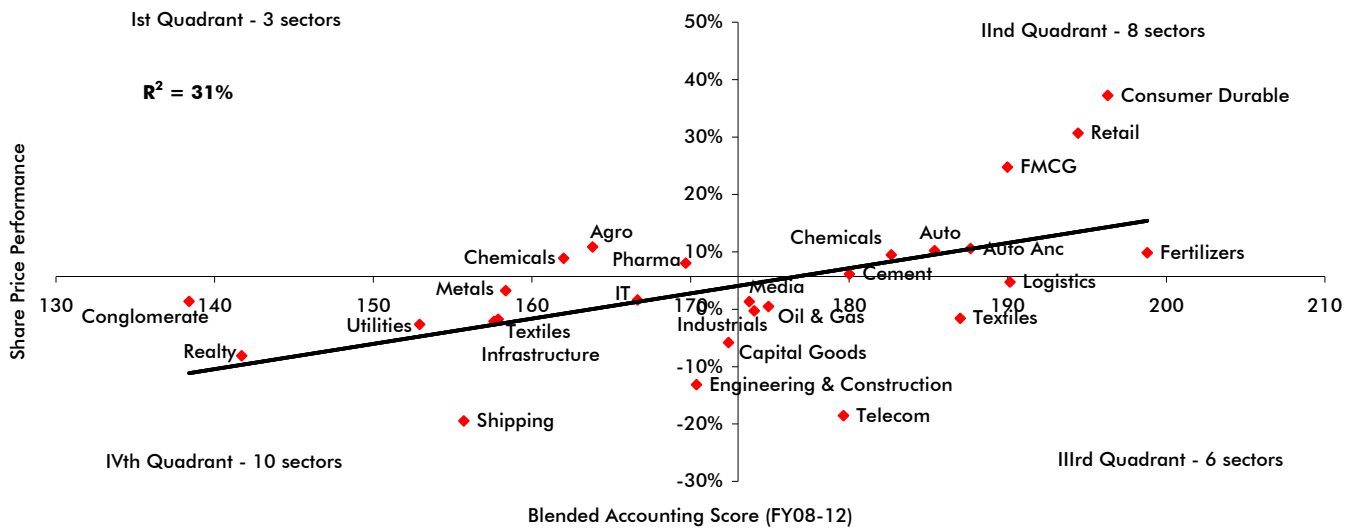
Whilst the more sensational accounting frauds like Global Trust Bank, Satyam or Reebok India have rocked the Indian market from time to time, most accounting shenanigans that certain Indian companies indulge in are lower profile (than the headline-grabbing cases) but no less damaging for shareholder returns. Consider, for example, the fact that nearly 80% of all firms listed in India have failed to beat inflation in terms of stock returns over the past 20 years. Even more worryingly, more than 50% of listed Indian companies have failed to deliver positive nominal returns over this period.

Whilst some of these firms may indeed have failed to deliver on genuine business grounds, we believe several of these businesses were never intended to benefit minority shareholders in the first place. Consider, for example, Reebok India's case of falsification of accounts (Source: http://www.livemint.com/Companies/vkpTgJ1M39TbRHvG1nZGsK/Reebok-India-fake-sales-and-secret-depots.html). Not only were the sales allegedly exaggerated through 'parallel accounting' and were never passed on to the company, incidents of goods invoiced merely to inflate sales (but not dispatched), suspicious third party transactions, circular trading, and retrospective increases in the price of good already sold, are all believed to have been present in some form or the other.

Similarly, Global Trust Bank, a leading private sector bank at the turn of the century, has been associated with several irregularities since 2001. At the core appears to be the issue of 'inappropriate' exposure to capital market activities, which resulted in huge NPAs, which in turn were significantly under-provisioned for by the bank. As a result, the bank's reported net worth of ₹4,004mn (as on 31 March 2002) eventually turned out to be negative when inspected by the RBI.

Anecdotes apart, the point that accounting quality has a significant bearing on investment returns has been the central message of our annual accounting analysis of the BSE500 firms (conducted by our colleague, Bhargav Buddhadev). A few charts (shown below) from his January 2013 note highlight this issue more clearly.

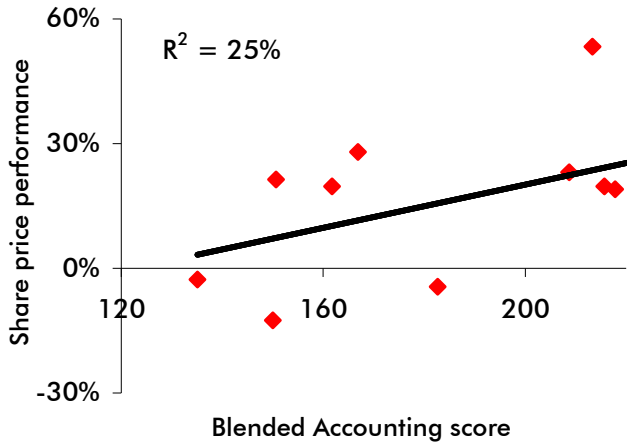
Exhibit 1: 65% of sectors show positive correlation with their blended accounting score



Source: Company, Ambit Capital research; Note: The axes cross each other at the average accounting score and the average share price performance; share price performance is from 1 April 2007 to 26 November 2012.

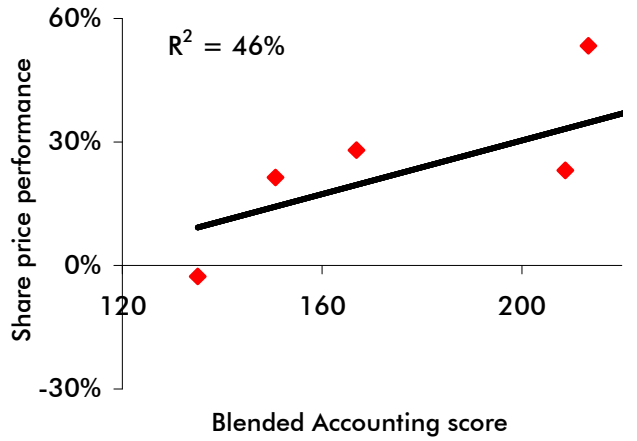
Whilst the exhibit on the preceding page highlights how accounting scores have an important bearing on stockmarket performance at a sectoral level, the exhibits below show that even within a sector, accounting quality affects share price performance. In fact, within a sector, the more one tends to focus on similar-sized firms, the more pronounced the impact of accounting quality becomes.

Exhibit 2: Share prices vs blended accounting scores (FY08-12) for the Auto Ancillary sector



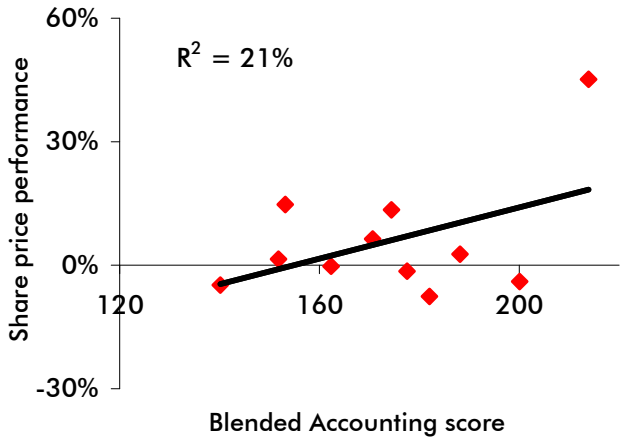
Source: Company, Ambit Capital research; Note: Share price performance is from 1 April 2007 to 26 November 2012.

Exhibit 3: Share prices vs blended accounting scores (FY08-12) for the Auto Ancillary sector (Bucket 2 #)



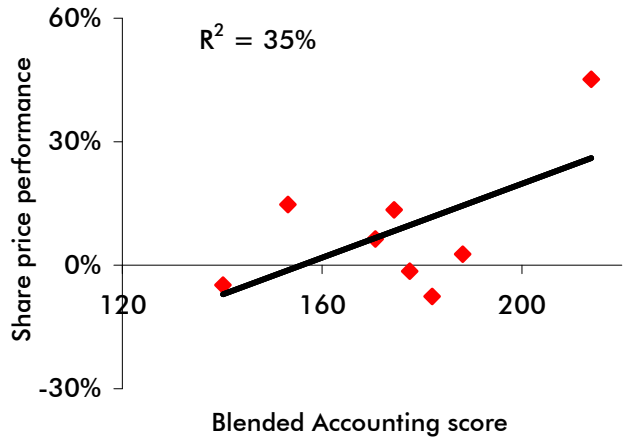
Source: Company, Ambit Capital research; Note: Share price performance is from 1 April 2007 to 26 November 2012; #Bucket 2 denotes the universe of the next 100 largest firms in India on market cap basis after the first 50.

Exhibit 4: Share prices vs blended accounting scores (FY08-12) for the Industrials sector



Source: Company, Ambit Capital research; Note: Share price performance is from 1 April 2007 to 26 November 2012.

Exhibit 5: Share prices vs blended accounting scores (FY08-12) for the Industrials sector (Bucket 2 #)



Source: Company, Ambit Capital research; Note: Share price performance is from 1 April 2007 to 26 November 2012; #Bucket 2 denotes the universe of the next 100 largest firms in India on market cap basis after the first 50

Whilst the charts shown above are from our accounting thematic published on 4 January 2013 (*The importance of accounting quality* Click here for detailed note), most of our forensic accounting analysis is conducted for clients on a bespoke basis. In this note, we dig into our treasure trove of bespoke projects and provide examples of the most common accounting shenanigans used by corporate India. In doing so, we hope to help clients to more critically assess the deluge of annual reports that are about to come their way as the FY13 annual report season begins.

Section 2: Specific policies to watch out for

Whilst there are multiple ways in which corporates can use aggressive accounting policies to conceal their actual business realities in the published financial statements, in this note, we focus on some of the most-commonly exploited policies and related measures.

A. Revenue recognition policies (page 7)

One of the simplest ways of flattering the bottom-line is to flatter the top-line. Aggressive revenue recognition policies in one period, however, will mean lower top-line in some subsequent period and hence this needs to be monitored. Some metrics that should help detect aggression include debtor days, 'percentage change in receivables/percentage change in revenues', and 'operating cash flow growth/operating profit growth'.

B. Provisioning (page 11)

Given that provisioning for doubtful debts requires making estimates, it can easily be adjusted downwards to inflate profits. Likewise, in the case of banks, a related measure, the Provisioning Coverage Ratio (PCR), should be analysed, as a bank can simply make lower provisions during periods of distress.

C. The auditor and the auditor's report (page 14)

The auditor's report is probably amongst the most important sections of the annual report that minority shareholders need to watch out for. Any qualifications made or issues raised by the auditor imply that something is amiss and that the books of accounts as presented by the management **do not** reflect the actual state of the firm's business. Likewise, investors should watch out for frequent changes in the statutory auditor, as this would imply frequent disagreements between the auditor and the management, which eventually resulted in the auditor parting ways. On the other hand, a disproportionate increase in audit fees versus the increase in top-line calls for caution as well.

D. Related party transactions (page 18)

A related party transaction should take place at arm's length. This does not always happen in corporate India. Overpaying for an asset purchased from a related party, sale of goods or other assets to related parties at a significant discount to their fair market values, and loans given to related parties at concessional rates or loans taken from related parties at exorbitant interest rates are just a few examples of how these transactions might not be in the best interests of the minority shareholders. Similarly a high extent of related party transactions and a sudden increase in the same should also raise red flags.

E. Unsubstantiated capex (page 19)

A company incurring capital expenditure that does not eventually get reflected in a rise in its installed capacity should raise a red flag with regards to the actual use the money is being put to.

F. Cash yield (page 20)

Cash yield reflects the amount that is being earned on cash and marketable investments. A low investment income as a percentage of cash and marketable investments relative to its peers would be a cause for concern, as it could possibly mean that either the balance sheet has been misstated or that revenues are being overstated by diverting non-operating income into the top-line. Yet another possibility relates to the cash not being used in the best interests of the firm.

G. ESOPs accounting and fee income accounting for banks (page 21)

As a sector, private banks in India are now the biggest users of ESOPs. Whilst ESOPs are a powerful financial incentive, the cost associated with the incentive is typically not properly reflected in many Indian banks' P&L, thus inflating the reported profits. Likewise, fee income, both fund-based and non-fund-based, can be accounted for in aggressive ways to better manage the bottom-line. Put together, accounting aggression around ESOPs and fee income, if corrected, can erode away a significant portion of the top Indian private banks' RoA premium over the system.

H. Capitalising R&D expenses (page 24)

By capitalising its R&D costs, a company can inflate its current year profits by depreciating it over a period of time (as against expensing it in the current year). Aggressively capitalising R&D costs would, however, mean lower profits in subsequent years.

I. Pension accounting (page 25)

By adjusting the assumptions involved in pension accounting, a company can manipulate stated earnings. The three key assumptions that investors need to look at to spot aggressive practices by the company are: the discount rate assumption, the expected return on plan assets assumption and the assumption for rate of increase in salary. These assumptions are usually buried away in the footnotes.

A. Revenue recognition policies

One of the simplest ways for a company to flatter its profits is by flattering its revenues. Revenues can be overstated by using aggressive revenue recognition policies such as increasing the proportion of business done on credit, holding the books open beyond the end of the quarter/year (given that quarter to quarter, companies are judged based on their sales numbers), booking sales towards the year-end followed by a reversal of the same in the next financial year, etc. For example, if the amount of cheques being held by the company and not yet deposited in the banks increases suddenly and significantly, it is a cause for concern. Some relatively easily measurable numbers through which such exaggerated revenues can be detected are:

- **Rate of change in receivables vs rate of change in revenues**: The rate of change in receivable exceeding the rate of change in revenues could be an indication of an aggressive revenue recognition policy adopted by the company (see our analysis of Unitech's revenue recognition practices – see page 8).
- **Lower growth in operating cash flows than in operating profits**: A decline in the CFO/EBITDA ratio or a negative CFO/EBITDA ratio would indicate that the reported earnings (which would be based on the accrual system of accounting) are significantly higher than the actual cash earnings (as measured by the cash from operations). This is an indication that accounting aggression is at work to boost the top-line (see our analysis of Godrej Properties' revenue recognition practices – see page 9).
- **Debtor days ratio**: This is another way of looking at the first measure highlighted above. A high ratio should raise concerns about the quality of revenues recognised, because a high number likely means that the revenue increase might have been achieved by relaxing credit terms (see our analysis of ICSA's revenue recognition practices – see page 10).

The case of Indian real estate developers

According to Indian accounting practices, real estate developers are required to recognise revenues from ongoing projects based on the 'percentage of completion' method. This method is generally followed when the date of commencement of the project and the date of completion of the project fall under different accounting periods. Revenues would be recognised when the actual costs incurred to date exceed some percentage (say 20%) of the estimated total project costs. Given that this practice involves a lot of estimates, the percentage of completion method allows accelerated revenue recognition on the P&L.

Aggressive accounting

Given that revenues from ongoing projects form a significant part of the total revenues reported by real estate developers (for example, ~64 % of the reported consolidated revenues by Unitech in FY12 were revenues recognised on ongoing projects under the percentage of completion method), this methodology can be used to inflate the reported revenues and the resulting bottom-line.

Whilst some companies only include construction-linked expenses (i.e. land conversion costs, depreciation of plant & equipment, etc) in determining the stage of completion, others include the land cost as well. Given that land costs could form a significant part of the overall project costs (especially in tier-1 cities), companies that include land cost in determining the stage of completion can easily overstate their top-line by recognising revenues from projects even before they start realising revenues from their customers which is usually linked to construction. In addition to including the land cost, the cost threshold itself (under the percentage of completion method) can be aggressively chosen.

However, according to the revised guidance note (dated 11 February 2012) issued by the Institute of Chartered Accountants of India (ICAI), revenue should be recognised under the percentage of completion method only when: (1) the stage of completion reaches a reasonable level of development **(25% of the construction and development cost)**, (2) at least 25 % of the saleable area is secured by contracts of agreements with buyers, and (3) at least 10% of the total revenues according to the sale agreements has been realised by the developer. This guidance note applies to projects that have commenced/recognised revenue for the first time on or after 1 April 2012. Consequently, the new accounting rules should hit the top-line of those real estate developers that have historically had an aggressive approach towards revenue recognition (see the table below). The table shows that whilst DLF recognises revenues on ongoing projects when the actual costs incurred to date exceed 30% of the estimated total project cost, it does include the land costs in determining the stage of completion. On the other hand, whilst Oberoi Realty has set this threshold at 20%, it does not include land cost.

Our real estate team analysed the revenue recognition policies followed by various real estate developers. The ratings assigned by our team for these firms are based on cash conversion, debtor days and the methodology followed to recognise revenues on ongoing projects.

Exhibit 6: Ratings based on cash conversion and revenue recognition (FY09-12)

Name	Geo Class	% completed or Project completed	Threshold	Land cost included	(%) CFO/ EBITDA (FY09-12)	(%) CFO/ EBITDA (1HFY13)	Debtor days (FY12)	Rating
Sobha	South	%	25% cost	No	107	80	98	+++
Oberoi Realty	West	%	20% cost	No	74	1	21	+++
Phoenix Mills	West	%	30% cost subject to registrations of properties	No	121	NA	70	+++
DLF	North	%	30% cost	Yes	81	145	62	+++
Brigade	South	%	25% cost	NA	44	187	15	+++
Puravankara	South	%	0% cost	No	21	NA	70	++
HDIL	West	Proj	-	-	-62	NA	109	++
Peninsula Land	West	%	30% cost	No	-1	NA	145	++
Prestige	South	%	25% cost	No	-26	NA	300	++
Indiabulls	West	%	25% cost	NA	-561	NA	186	+
Mahindra	West	%	25% cost and 10% sales subject to plinth completion	Yes	-35	NA	115	+
Godrej Properties	West	%	20% cost	Yes	-503	NA	192	+
Anant Raj	North	%	30% cost	Yes	-53	NA	264	+
Unitech	North	%	20% cost	Yes	63	NA	277	+
Parsvnath	Diversified	%	30% cost	Yes	44	NA	533	+
Sector median					10		130	

Source: Company, Ambit Capital research, Legend: +++ implies the firm does well on all the metrics, namely revenue recognition policies, cash conversion and debtor days. ++ implies the firm does well on any two of the metrics. + indicates that the firm does well only on one of the metrics.

Case study: Unitech

Unitech

Ticker	UT IN
Mcap (US$ mn)	1,417
6mth ADV (US$ mn)	27.5
Stance	Not Rated

Source: Bloomberg

Unitech uses the percentage of completion method to recognise its revenues from ongoing projects and the company recognises revenues when the actual costs incurred to date exceed 20% of the total estimated cost of the project. Not only does it include the land cost (on a proportionate basis) whilst determining the stage of completion, but the threshold of 20% is also much lower when compared to its peers (for example, DLF and Parsvnath have set this threshold at 30%). The aggressive practice adopted by Unitech is also reflected in its change in debtor days. Its debtor days have substantially increased from 40 (in 2008) to 281 (in 2012) on a consolidated basis. Also, the income recognised from ongoing projects (under the percentage of completion method) as a percentage of total revenues

has been consistently increasing since 2009—from only ~26% of the reported top-line in 2009 to ~64% of the reported top-line in 2012.

This aggressive revenue recognition policy is also visible in a mismatch between the percentage change in receivables and the percentage change in turnover (as shown below). In each of the past four years, the rate of change in Unitech's receivables has surpassed the rate of change in turnover.

Exhibit 7: Unitech - change in turnover vs change in receivables

	FY09	FY10	FY11	FY12
% change in turnover (YoY)	-30	1	16	-29
% change in receivables (YoY)	25	36	49	-2

Source: Company, Ambit Capital research

Oberoi Realty

Ticker	OBER IN
Mcap (US$ mn)	1,439
6mth ADV (US$ mn)	0.5
Stance	BUY

Source: Bloomberg

Oberoi Realty, on the other hand, uses a relatively conservative approach towards recognition. Whilst the threshold for 'percentage of completion' methodology is the same as Unitech (20%), Oberoi Realty does not include cost of land in determining the stage of completion. Consequently, not only has this conservative approach towards revenue recognition resulted in its debtor days being significantly better than its peers (25 days in FY12), its pre-tax CFO/EBITDA (ex-other income) ratio is quite high too (~95% in FY12), indicating better cash conversion relative to its peers. Also, advance from customers on the current liabilities side of the balance sheet of Oberoi Realty currently stands at ₹7.2bn or 17% of the net worth.

Case study: Godrej Properties

Godrej Properties

Ticker	GPL IN
Mcap (US$ mn)	903
6mth ADV (US$ mn)	0.5
Stance	Not Rated

Source: Bloomberg

Like Unitech, Godrej Properties too appears to follow an aggressive revenue recognition policy, wherein it recognises revenues when the actual costs incurred to date exceed 20% of the total estimated costs of projects. Also, the land cost is included in determining the stage of completion. The aggressive practice adopted by Godrej Properties is also reflected in its debtor days. Although this measure has declined relative to its history, it is still quite high relative to both the industry average of 130 days (refer to Exhibit 8) as well as to other real estate developers such as Oberoi Realty.

Exhibit 8: Comparison of debtor days - Godrej Properties vs Oberoi Realty

	FY08	FY09	FY10	FY11	FY12
Godrej Properties	502	484	239	190	204
Oberoi Realty	25	33	16	16	25

Source: Company, Ambit Capital research

The lower growth in operating cash flows than in operating profits is reflected in Godrej Properties' negative CFO/EBITDA ratio. Cash profits (as reflected by its CFO) have been consistently lower than its reported earnings (EBITDA, excluding other income). This has resulted in a negative CFO/EBITDA ratio.

Exhibit 9: Comparison of pretax CFO/EBITDA excluding other income - Godrej Properties vs Oberoi Realty

	FY08	FY09	FY10	FY11	FY12
Godrej Properties	-151	-467	-1715	-372	-731
Oberoi Realty	109	65	128	73	95

Source: Company, Capitaline, Ambit Capital research

ICSA

Ticker	AURFI IN
Mcap (US$ mn)	6
6mth ADV (US$ mn)	0.1
Stance	Not Rated

Source: Bloomberg

Case study: ICSA

ICSA appears to have followed an aggressive revenue recognition policy as reflected in its debtor days. The change in debtor days (from 121 in FY07 to 257 in FY12) raises questions about the quality of revenues recognised in its books. We note that some companies tend to relax their credit terms, resulting in the high debtor days and accelerated revenue recognition.

Exhibit 10: ICSA – debtor days analysis

(in ₹ mn)	FY07	FY08	FY09	FY10	FY11	FY12
Net Sales	3,325	6,721	11,222	12,375	13,939	9,071
Average Debtors	1,098	2,470	4,150	5,225	5,797	6,385
Debtor days	121	134	135	154	152	257

Source: Company, Ambit Capital research

ICSA's cash profits (as reflected by its CFO) have been consistently lower than its reported earnings (EBITDA excluding other income). This seems to have resulted in a negative pre-tax CFO/EBITDA ratio.

Exhibit 11: Analysis of pre-tax CFO/EBITDA excluding other income

(in ₹ mn)	FY07	FY08	FY09	FY10	FY11	FY12
CFO	(215)	(1,140)	(702)	(783)	(863)	(991)
EBITDA (ex Other income)	822	1,787	2,692	2,454	2,942	(580)
CFO/EBITDA	-26%	-64%	-26%	-32%	-29%	NA

Source: Company, Capitaline, Ambit Capital research

B. Provisioning

1. Debtor Provisioning

Provision for doubtful debts (PFD) as a percentage of gross debtors can be a good indicator of the aggression or conservatism in approach followed by a company whilst recognising its profits for the year.

Given that provisioning for doubtful debts requires making estimates, it can be adjusted downwards to inflate profits. A low PFD as a percentage of gross debtors, relative to either its own history or its peers, is an indication of the aggressive accounting approach followed by the company. A low percentage relative to its own history could imply that profits, which would have otherwise been lower had the company followed its previous policy, have been inflated in the current fiscal year by manipulating the provision for doubtful debts.

Case study: Bajaj Electricals

Bajaj Electricals

Ticker	BJE IN
Mcap (US$ mn)	332
6mth ADV (US$ mn)	0.3
Stance	BUY

Source: Bloomberg

Historically, Bajaj Electricals seems to have followed an aggressive approach towards provisioning for doubtful debts. Whilst its peers such as Havells have made provisions for doubtful debts of 2-2.5% of gross debtors, debtor provisioning by Bajaj Electricals has been of only 0.5-1%. This is in spite of the fact that the share of debtors outstanding for more than six months was more than 24% in FY12 as against 4% for Havells.

Exhibit 12: Debtor provisioning - Bajaj Electricals vs Havells India

Metric	Bajaj Electrical				Havells India*			
	FY09	FY10	FY11	FY12	FY09	FY10	FY11	FY12
Provision for Doubtful Debtors (₹ mn)	54	49	55	117	21	16	29	43
Gross Debtors (₹ mn)	5,597	7,512	10,661	11,094	889	811	1,147	1,640
PFD as a % of Gross Debtors (%)	**1.0**	**0.7**	**0.5**	**1.1**	**2.4**	**2.0**	**2.5**	**2.6**

*Source: Company, Ambit Capital research; * Standalone entity.*

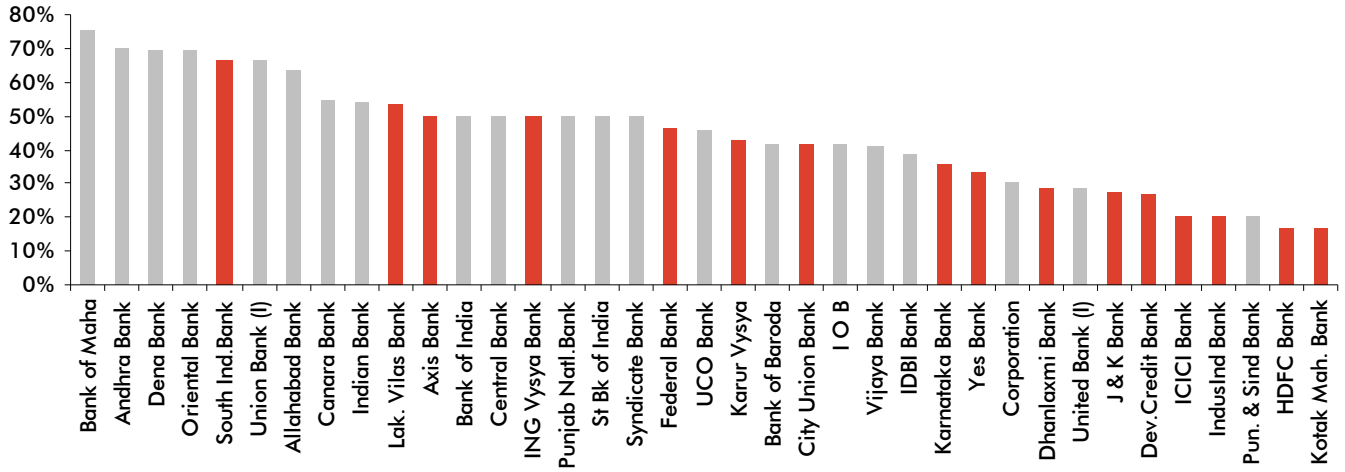
2. Provisioning Coverage Ratio (PCR)

Just as a normal firm can play around with its PFD, a bank can manage its bottom-line by tinkering around with its provisioning coverage ratio. As mentioned earlier, a low PCR either with respect to its own history or relative to peers may suggest aggression on the part of the bank towards accounting.

Based on our banking team's work (refer to our note dated 7 December 2012, *Forensic accounting redux*, Click here for detailed note), there is another interesting way to understand the misuse of PCR for inflating the bottom-line. The number of quarters (over the past eight years) that a bank has seen a sequential decline in pre-provisioning profit with a simultaneous dip in the provisioning coverage ratio can be telling. State-owned banks fare poorly on this metric, occupying 9 of the 10 ranks at the bottom of the heap (as seen in the exhibit on the next page which ranks 37 listed banks in the market). With 5 of the 7 banks featuring in the top quartile, new private sector banks are clear winners on this metric.

As can be seen in the following exhibit, the five banks that fare poorly on this metric are Bank of Maharashtra, Andhra Bank, Dena Bank, Oriental Bank and South Indian Bank.

Exhibit 13: Proportion of quarters of lower provisioning coverage ratio when pre-provisioning profit declined QoQ



Source: Company, Ambit Capital research, RED indicate private sector banks

A straightforward way is to look at trends in PCR over time, with a consistently falling PCR being an obvious reason for caution. Banks that have consistently shown a YoY decline in their PCR over the past three years include Corporation Bank, Union Bank, Karnataka Bank, Indian Bank and Punjab National Bank (see table on the next page).

Exhibit 14: YoY trends in provisioning coverage ratio

Bank	Decline in PCR?		
	FY10 over FY09	FY11 over FY10	FY12 over FY11
St Bk of India	No	No	No
Kotak Mah. Bank	No	No	Yes
Lak. Vilas Bank	Yes	No	Yes
ING Vysya Bank	No	No	No
Karur Vysya Bank	Yes	No	Yes
Federal Bank	Yes	Yes	No
Oriental Bank	Yes	No	Yes
HDFC Bank	No	No	Yes
ICICI Bank	No	No	No
IDBI Bank	No	No	Yes
Corporation Bank	**Yes**	**Yes**	**Yes**
Bank of Baroda	Yes	No	Yes
Canara Bank	No	Yes	Yes
UCO Bank	Yes	No	No
United Bank (I)	Yes	No	No
Union Bank (I)	**Yes**	**Yes**	**Yes**
Dhanlaxmi Bank	Yes	No	Yes
IndusInd Bank	No	No	No
Dena Bank	Yes	No	No
Central Bank	No	Yes	Yes
Axis Bank	No	No	Yes
Bank of Maha	Yes	No	No
Syndicate Bank	Yes	No	No
Bank of India	Yes	No	Yes
Allahabad Bank	No	Yes	Yes
Pun. & Sind Bank	Yes	No	Yes
Andhra Bank	No	Yes	Yes
Karnataka Bank	**Yes**	**Yes**	**Yes**
I O B	Yes	No	Yes
Vijaya Bank	Yes	Yes	No
Indian Bank	**Yes**	**Yes**	**Yes**
South Ind.Bank	No	No	Yes
City Union Bank	No	Yes	Yes
J & K Bank	No	No	No
Punjab Natl.Bank	**Yes**	**Yes**	**Yes**
Dev.Credit Bank	No	No	No
Yes Bank	No	No	Yes

Source: Capitaline, Ambit Capital research

C. The auditor & the auditor's report

The auditor's report is amongst the most important sections of the annual report that minority shareholders need to watch out for. Any qualifications made by the auditor requires the utmost attention as these may imply that something's amiss and that the books of accounts as presented by the management **do not** reflect the actual state of the company's business realities. Things that investors should be wary of include:

- **Auditor:** An auditor change (for example, PwC's reluctance to audit the books of accounts of Arshiya International in FY10 and the books being subsequently audited by MGB & Co).
- **Auditor's Report:** Qualifications made or issues raised by the auditor (for example, issues raised by Lanco Infra's auditors on the consolidated financial statements in FY07 and FY08).
- **Auditor's Remuneration:** Change in auditor's remuneration vis-à-vis change in revenue (for example, change in the auditor's remuneration for Crompton Greaves and CESC).

Watch out for an auditor change!

An auditor change should raise a red flag because it could imply that the auditor is not in agreement with the financial statements presented by the management.

Case study: Arshiya International

Arshiya International

Ticker	ARST IN
Mcap (US$ mn)	31
6mth ADV (US$ mn)	0.4
Stance	Not Rated

Source: Bloomberg

In August 2009 (FY10), based on the company filings, PriceWaterhouseCoopers (PwC) refused to audit the books of accounts of Arshiya International. Consequently, Arshiya International changed its auditor in FY10 (August 2009) from PwC to MGB &Co.

MGB & Co. in India is a member firm of MGI International, which is headquartered in London, UK, since 1947. MGB & Co. also audits the accounts of Zee Group and Welspun Corp (a flagship company of the Welspun Group).

Clearly, such instances where a high profile auditor such as PwC refuses to audit the books of accounts of a company should raise a red flag, because it may indicate a disagreement by the auditor of the financial statements presented by the management.

Auditor's Report - Watch out for issues raised!

Amongst the first things to look for whilst analysing an auditor's report is to keep an eye out for any qualifications made by the statutory auditor. Whilst there are several reasons why an auditor may qualify his reports, one common reason is when the accounts have not been drawn up according to the generally accepted accounting principles.

This can be better understood by looking at the issues raised by Lanco Infratech's auditors, PwC, in the auditor's report in FY07 and FY08.

Case study: Lanco Infra

Lanco Infra

Ticker	LANCI IN
Mcap (US$ mn)	495
6mth ADV (US$ mn)	3.7
Stance	Not Rated

Source: Bloomberg

In FY07, the auditors of Lanco Infra had raised the following issues in respect of the consolidated financial statements:

- Profits were higher by ₹169.29mn (or 9% of consolidated profits for FY07) due to non-elimination of intra-group transactions and unrealised profits pending clarification from ICAI.

- The consolidated financial statements were presented considering M/s Lanco Kondapalli Power Private Limited (LKPPL) as a subsidiary with effect from 1 April 2006 when in fact, LKPPL became a subsidiary of the company with effect from 15 November 2006. As a result, profits were higher by ₹242.94mn (or 13% of consolidated profits in FY07).

Not only did the company not meet the requirements of AS-21 on the consolidated financial statements (given that according to AS-21 issued by the ICAI, consolidation should have been carried out from 15 November 2006, the date on which holding subsidiary relationship came into existence), the above treatment resulted in the profits for FY07 being higher by ₹412.23mn (or 22% of consolidated profits for that year).

The excess profit of ₹412.23mn, which had been recognised in the P&L account of Lanco Infra in FY07, had to be reversed in FY08. According to the generally accepted accounting principles, such a reversal should have been made against current-year profits (i.e. FY08 profits in this case) as a prior-period adjustment. Lanco Infra instead chose to adjust these excess profits against the balance of profit brought forward from the previous year. Consequently, the correction to FY08 profits was not made as required. The auditors too had raised their issues on such a treatment in their report on the consolidated financial statements for FY08.

Issues raised by Lanco's auditors in FY07 Annual Report (on Page 63)

"Attention is drawn to the following:

- *As detailed in note 4(xvi) of Schedule 19, pending clarification from the ICAI on non elimination of intra group transactions and unrealized profits arising out of construction of projects under Build Operate Own and Transfer basis, the Company has not eliminated revenues and unrealized profits in the consolidated financial statements. As a result the consolidated revenue and net profit after minority interest are higher by ₹1692.97 millions and ₹169.29 millions respectively.*
- *M/s Lanco Kondapalli Power Private Limited (LKPPL) has become a subsidiary of the Company with effect from November 15, 2006. However the consolidated financial statements have been presented considering LKPPL as a subsidiary with effect from April 01, 2006. As a result the consolidated revenues and net profit after minority interest are higher by ₹3270.90 and ₹242.94 millions respectively."*

Issues raised by Lanco's auditors in FY08 Annual Report (on Page 71)

"Attention is drawn to Note 4.viii on Schedule 19 to the consolidated financial statements regarding the adjustment of excess profits recognised in the previous year aggregating to ₹412.23 million against the balance of profit brought forward from the previous year, which in our opinion and according to the generally accepted accounting principles in India should have been adjusted against the current year's profit as a prior period adjustment. Consequently the net profit after tax and minority interest for the current year has been overstated by the above amount."

Auditor's remuneration: Watch out for growth in remuneration vis-à-vis growth in revenues!

The growth in audit fees should not in the normal course of affairs exceed the growth in revenues. However, in specific instances, auditors' remuneration CAGR might exceed the revenue CAGR. Ideally, this can be justified only when there has been a change in auditor and the books of accounts are now being audited by a more reputed firm. In most other circumstances, a disproportionate increase in auditor's remuneration relative to the increase in top-line calls for caution. Furthermore, ideally audit fees should be 50% or more of the auditor's total remuneration from the listed entity. Likewise, auditor's remuneration that is quite high as compared to that paid by the listed entity's peers to their auditors also raises a red flag. These points have been covered in the following case studies on Crompton Greaves, CESC and JSW Energy.

Case Study: Crompton Greaves' auditor's remuneration

Crompton Greaves

Ticker	CRG IN
Mcap (US$ mn)	1,162
6mth ADV (US$ mn)	5.1
Stance	SELL

Source: Bloomberg

Exhibit 15: Crompton Greaves - auditor's remuneration vis-à-vis peers

	FY10	FY11	FY12
Crompton			
Net Sales (₹ mn)	91,409	100,051	112,486
Auditor's remuneration (₹ mn)	68.2	63.2	93.4
Audit Fees (₹ mn)	ND	55.7	86.1
Audit Fees as a % of Total revenues	NA	0.06	0.08
Thermax*			
Net Sales (₹ mn)	31,855	48,524	53,041
Auditor's remuneration (₹ mn)	6.4	9.2	11.6
Audit Fees (₹ mn)	4.4	5.2	5.6
Audit Fees as a % of Total revenues	0.01	0.01	0.01
Siemens*			
Net Sales	93,152	120,289	129,199
Auditor's remuneration (₹ mn)	20.0	23.0	33.0
Audit Fees (₹ mn)	12.5	15.0	23.0
Audit Fees as a % of Total revenues	0.01	0.01	0.02
Alstom T&D*			
Net Sales (₹ mn)	35,659	40,200	41,292
Auditor's remuneration (₹ mn)	12.6	10.0	14.8
Audit Fees (₹ mn)	5.0	6.3	3.6
Audit Fees as a % of Total revenues	0.01	0.02	0.01

*Source: Company, Ambit Capital research; * Standalone numbers, as the company either does not have a subsidiary or does not disclose auditor's remuneration on a consolidated basis.*

It is worth highlighting the auditor's remuneration for Crompton Greaves. As can be seen in the table above, auditor's remuneration for Crompton Greaves as a percentage of the firm's consolidated revenues is high as compared to its peers such as Thermax, Siemens and Alstom T&D. More specifically, whilst Crompton's consolidated revenues are similar to Siemens' revenues, Crompton's auditor's fees as well as the auditor's remuneration is nearly thrice as high as that for Siemens.

Case Study: CESC and JSW Energy

CESC

Ticker	CESC IN
Mcap (US$ mn)	682
6mth ADV (US$ mn)	2.6
Stance	Not Rated

Source: Bloomberg

JSW Energy

Ticker	JSW IN
Mcap (US$ mn)	1941
6mth ADV (US$ mn)	2.1
Stance	BUY

Source: Bloomberg

Exhibit 16: Auditor's compensation comparison (standalone entity)

Company	Metric	Auditor's compensation (₹ mn)				3-yr CAGR (%)
		FY09	FY10	FY11	FY12	
JSW Energy	Auditor's compensation	1.8	8.0	4.3	5.2	42
	Audit fees	1.4	1.5	1.8	2.5	21
	Audit Fees/Total remn	78%	19%	42%	48%	
CESC	Auditor's compensation	7.0	6.5	11.6	10.4	14
	Audit fees	2.6	2.6	2.6	3.5	10
	Audit Fees/Total remn	37%	40%	22%	34%	
Adani Power	Auditor's compensation	2.1	5.7	4.6	ND	48*
	Audit fees	0.7	1.8	3.0	3.0	62
	Audit Fees/Total remn	34%	32%	65%	ND	
Thermax	Auditor's compensation	5.8	6.4	9.2	11.6	26
	Audit fees	3.7	4.4	5.2	5.6	15
	Audit Fees/Total remn	64%	69%	57%	48%	
Siemens	Auditor's compensation	29.1	20.0	23.0	33.0	4
	Audit fees	12.5	12.5	15.0	23.0	23
	Audit Fees/Total remn	43%	62%	65%	70%	

Source: Company, Ambit Capital research; Note: ND indicates proper disclosures are not available. For Adani Power, we have calculated the 2-year CAGR (FY09-11), as the FY12 data is not disclosed properly.*

The above table brings out several interesting points:

- The growth in JSW Energy's and Adani Power's total auditor's remuneration is relatively high at 42% and 48% respectively;
- For CESC, audit fees are only a third of the auditor's total remuneration;
- Adani Power's audit fees CAGR is relatively high at 62%; and
- With the exception of Siemens, for all of these firms, total remuneration for their auditors is increasing at a significantly faster rate than the general rate of white-collar wage inflation in India (which has been around 10-15% over the last three years).

D. Related party transactions

Investors should lookout for suspicious related party transactions undertaken by listed entities. At its simplest, the extent of related party transactions and the trend in these transactions are important; a sudden increase can be bad news. However, it is often trickier than this, as the instances illustrated here show.

Parties would be considered 'related' if at any time during the financial year, one party is able to either control the other party or can exercise significant influence over the other. Thus, related parties would include subsidiaries, associates, joint ventures, key management personnel & their relatives, etc. Ideally, transactions between related parties should be at arm's length. An arm's length transaction would mean that both the parties seek to execute the transaction in their best interests. However, in several cases, related party transactions are conducted in a manner that is not in the best interests of one party. Overpaying for an asset purchased from a related party, sale of goods or other assets to related parties at significant discount to their fair market values, loans given to related parties at exceptionally concessional rates or loans taken from related parties at exorbitant interest rates are just a few examples of how these transactions might not be in the best interests of the minority shareholders. Likewise, unwarranted transactions with related parties should raise a red flag.

This point can be better understood by analysing certain related party transactions that Crompton Greaves has undertaken over the last 5-6 years.

Crompton Greaves

Ticker	CRG IN
Mcap (US$ mn)	1,162
6mth ADV (US$ mn)	5.1
Stance	SELL

Source: Bloomberg

Case study: Crompton Greaves

During FY08, Crompton Greaves purchased co-ownership rights in an aircraft from a related party, M/s Asia Aviation Ltd., for an amount of ₹562.5mn. Mr. Gautam Thapar, MD & CEO of Crompton Greaves, was also a director of M/s Asia Aviation Ltd, a company in the business of providing air charter services.

Whilst it is arguable that the aircraft purchase was unwarranted, the fact that it had been executed with a related party in the business of providing aircrafts on a lease basis also raises concerns regarding the appropriateness of such a transaction, given that Crompton Greaves could have simply hired the aircraft.

This transaction was followed by the purchase of another aircraft during FY11 for ₹2700mn. However, no disclosures were made by the company in its annual report for FY11 as to whether or not this was a related party transaction. When these issues were raised by investors with the management in 2QFY12, the management transferred the entire block of aircrafts at book value to its unlisted related parties, M/s Asia Aviation Ltd (₹411.7mn) and M/s Avantha Holdings Ltd (₹2,405mn). This last point can be detected from the FY12 annual report.

E. Unsubstantiated capex

A company incurring capital expenditure that does not eventually get reflected in a rise in its installed capacity should raise a red flag with regards to the actual use the money is being put to. This can be detected by analysing the change in gross-block (more specifically change in Plant & Machinery) vis-à-vis change in capacity.

Case study: S. Kumars Nationwide

S. Kumars

Ticker	SKNL IN
Mcap (US$ mn)	38
6mth ADV (US$ mn)	0.8
Stance	Not Rated

Source: Bloomberg

Exhibit 17: S. Kumars - change in capacity vs change in gross block

	FY07	FY08	FY09	FY10	FY11
Installed Capacity					
Spinning (spindles)	51,524	38,564	38,564	38,564	38,564
Spinning (YoY growth)		**-25%**	**0%**	**0%**	**0%**
Weaving (in mn)	27	22	34	34	34
Weaving (YoY growth)		**-19%**	**59%**	**0%**	**0%**
Apparels (in mn)	1.1	1.1	1.1	1.1	1.1
Apparels (YoY growth)		**0%**	**0%**	**0%**	**0%**
P&L and Balance Sheet					
Sales (₹ mn)	12,295	16,057	15,502	21,548	27,574
Sales YoY (growth)		**31%**	**-3%**	**39%**	**28%**
Gross Block (₹ mn)	6,388	4,831	6,817	8,813	10,679
Gross Block YoY (growth)		**-24%**	**41%**	**29%**	**21%**
Capital WIP (₹ mn)	2,959	5,274	6,071	5,641	5,176
CWIP YoY (growth)		**78%**	**15%**	**-7%**	**-8%**
Plant & Machinery (₹ mn)	5,517	4,281	5,440	7,075	8,536
P&M YoY (growth)		**-22%**	**27%**	**30%**	**21%**

Source: Company, Ambit Capital research. Note: Standalone numbers as reported by the company in its annual report.

In FY08, a decline in the plant & machinery was accompanied by a similar decline in the installed capacity of spinning and weaving. However, after FY08, every year the company has been incurring capex towards plant & machinery (as reflected in its Fixed Assets Schedule). Barring FY09, when there was an increase in installed capacity for weaving, there has been no further change in the capacity in either FY10 or FY11. On a related note, gross block turnover for the firm has been on a decline over these years. Such instances where a change in plant & machinery is not accompanied by a change in the installed capacity would call for caution too.

F. Cash yield

Cash yield indicates the amount that is being earned on cash and marketable investments. A low cash yield for a specific company as a percentage of cash and marketable investments relative to its peers could mean that either the balance sheet has been misstated and/or that the revenues are being overstated by diverting non-operating income into the top-line. Yet another possibility relates to the cash not being used in the best interests of the firm.

Ideally, cash and marketable investments should at least earn a return of 3-4%. A lower cash yield than this in absolute terms or relative to peers should raise concerns.

Case study: Arshiya International

Arshiya International

Ticker	ARST IN
Mcap (US$ mn)	31
6mth ADV (US$ mn)	0.4
Stance	Not Rated

Source: Bloomberg

Historically, Arshiya International has been earning a significantly lower yield on cash and marketable investments as compared to its peers. Whilst its competitors such as Gateway Distriparks have been earning cash yields of 5-8%, Arshiya International has been earning much lower returns. In fact, in FY12, the cash yield was as low as 0.5%.

Exhibit 18: A tale of two 'cash yields'

Company name	Investment income as a percentage of cash and marketable investments				
	FY08	FY09	FY10	FY11	FY12
Arshiya International	4.2	4.8	1.4	2.2	0.5
Gateway Distriparks	7.8	8.1	4.0	5.7	7.7

Source: Company, Ambit Capital research

Case study: Geodesic & Tanla Solutions

Geodesic

Ticker	GEOD IN
Mcap (US$ mn)	17
6mth ADV (US$ mn)	0.5
Stance	Not Rated

Source: Bloomberg

Historically, both Geodesic and Tanla Solutions have been earning relatively low income on cash and marketable investments. Whilst Tanla Solutions' cash yield for FY09 appears to be decent, it has been declining ever since and was as low as 0.5% in FY11. Geodesic's cash yield has in fact been always lower than that of Tanla Solutions (for all the three years analysed).

Given that non-operating assets, such as idle cash and marketable investments, would generate a yield of at least 3-4%, and given that peers such as Info Edge have been earning investment income of 6-8%, such a dismal yield raises red flags.

Tanla Solutions

Ticker	TANS IN
Mcap (US$ mn)	7
6mth ADV (US$ mn)	0.0
Stance	Not Rated

Source: Bloomberg

Exhibit 19: Investment income comparison - Geodesic, Tanla Solutions and Info Edge

Company	Investment income as a percentage of cash and marketable investments			
	FY09	FY10	FY11	FY12
Geodesic	1.4	0.4	0.3	1.8
Tanla Solutions	2.1	0.7	0.5	1.9
Info Edge	8.4	7.9	6.2	7.3

Source: Company, Ambit Capital research. Note: Geodesic's FY12 figures are slightly overstated given that company has not provided the breakup of interest income.

G. ESOPs accounting and fee income for banks

1. ESOPs accounting

As highlighted in our banking team's note dated 8 April 2013 (*'High-powered incentives for private sector bankers are bad news'* Click here for detailed note), the behaviour of management teams around the world usually responds to financial incentives.

Given the business model of the Financial Services sector (pursuit of near-term profits by a lender boosts the share price today but could wreck the business three years from now), given its complex accounting practices which places enormous power in the hands of the senior management to postpone bad news and given the less-than-ideal regulation of the sector (see our note dated 29 October 2012: *'The debasing of the RBI'* Click here for detailed note), the use of such high-powered incentives should be scrutinised very carefully by investors.

Our banking team's analysis of stock options in force in the top-six private sector banks (see our note dated 18 April 2013: *The growing regulatory risk around financial incentives in private banks* Click here for detailed note) suggests that not only are banks heavy issuers of employee stock options (relative to other sectors), the fact that the cost of such ESOPs is not expensed in the banks' P&L statements using a proper valuation method serves to flatter banks' profitability.

Exhibit 20: Impact of ESOP 'expense' on bank's reported profitability

Bank	Outstanding ESOPs (% of outstanding shares)	Reported net profit - FY12 (₹ mn)	Adjusted net profit - FY12 (₹ mn)	% reduction in net profit
HDFC Bank	4.3%	51,671	47,893	7.3%
IndusInd Bank	4.1%	8,026	7,472	6.9%
Kotak Mahindra Bank	1.6%	10,851	10,430	3.9%
Axis Bank	2.8%	42,422	40,951	3.5%
Yes Bank	6.5%	9,770	9,475	3.0%
ICICI Bank	2.4%	64,653	62,836	2.8%

Source: Company, Ambit Capital research

As is clear from the exhibit above, proper expensing of ESOPs would have meant a P&L hit of between 3% (for ICICI Bank and Yes Bank) and 7% (for HDFC Bank and IndusInd Bank) for these banks. In RoA terms, properly expensing the ESOPs would have shoved 10 bps from RoAs of these banks (which are around 140 bps).

2. Fee income accounting

Our banking team, in their thematic on fee income accounting dated 2 May 2013 (*Fee Income: the Achilles' heel* Click here for detailed note), highlights that the six-largest private sector banks account for nearly 50% of the core fee income generated by the entire banking system. The nature of this fee income and its accounting treatment has a significant impact on the elevated RoAs that these banks report (140 bps vs 80 bps for the rest of the system).

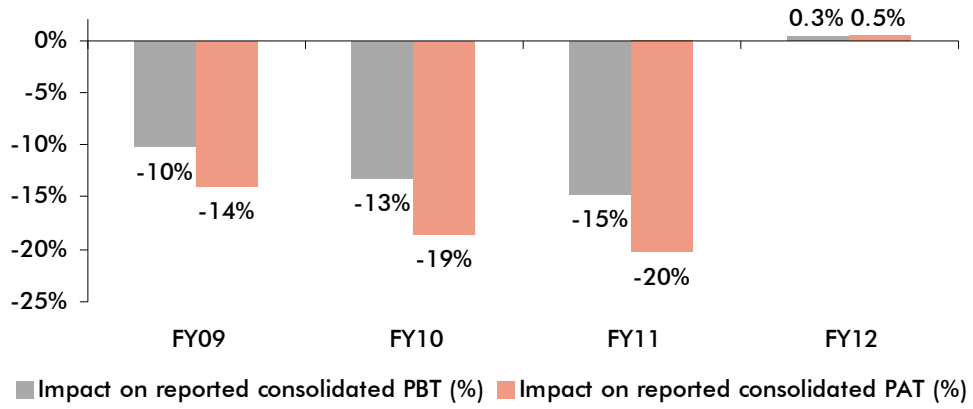
Fund-based fee income

Banks, the world over, typically charge their borrowers on an all-in-cost basis. In India, however, against the backdrop of the recent sluggishness in the underlying growth opportunities and in the face of intense competition, banks have gradually

become more focused on charging borrowers a combination of yields and fees. Whilst the yield (linked to the banks' base rates) accrues over the duration of the asset, the fee income is often booked upfront, thus bloating the earnings.

We illustrate using the case of ICICI Bank (where we have the luxury of ICICI Bank's corresponding disclosures under US GAAP) to show how the earnings reported under Indian GAAP would be impacted if fee income on the fund-based business was amortised instead of being recognised upfront (neither US GAAP nor IFRS allows upfront booking of fee income related to lending).

Exhibit 21: ICICI Bank - impact of amortisation of loan processing fee income (i.e. spreading the fee income over the life of the loan) on consolidated PAT



Source: Company, Ambit Capital research

Based on the ICICI Bank example, if the fee income was amortised over the life of the loan, PAT of the private sector banks would fall by around 15-20%. That translates into an RoA drop of 20-30bps.

Non-fund-based fee income

Whilst most banks amortise fee income from bank guarantees over the duration of the underlying asset, two banks choose to recognise revenue upfront based on certain conditions.

Exhibit 22: Revenue recognition policy for guarantee fee income

Bank	Revenue recognition policy
Axis Bank	Amortised over the period of the guarantee
HDFC Bank	Amortised over the period of the guarantee
ICICI Bank	Amortised over the period of the guarantee
Kotak Mahindra Bank	Amortised over the period of the guarantee
IndusInd Bank	Only deferred payment guarantees are recognised on an accrual basis, **rest are recognised on the transaction date**
Yes Bank	Guarantee commission up to ₹0.1mn is recognised **at the time of issue of the guarantee**; beyond ₹0.1mn, the commission is amortised over the period of the guarantee.

Source: Company, Ambit Capital research

On the other hand, most banks choose to charge the fee derived from the issue of letter of credit (LC) upfront; this is not a big issue when LCs typically mature within a year. However, a significant proportion (around 20% we reckon) of these instruments also extend beyond a year, especially when covering the purchase of capital goods. Such LCs typically are for 1-3 years.

Exhibit 23: Revenue recognition policy for LC (letters of credit) fee income

Bank	Revenue recognition policy
Axis Bank	Recognised when due
HDFC Bank	Amortised over the period of LC
ICICI Bank	Recognised when due
Kotak Mahindra Bank	Amortised over the period of LC
IndusInd Bank	Recognised when due
Yes Bank	Recognised when due

Source: Company, Ambit Capital research

With the limited disclosures that are available, it is difficult to quantify the extent of downside risk to these banks' earnings and return ratios. But clearly based on the aggression in terms of ESOPs and fee income accounting that these private sector banks exhibit, it may not be too far fetched to expect a significant part of their 60 bps RoA premium to the system to be wiped out if more prudent accounting was followed.

H. Capitalising R&D expenses

According to generally accepted accounting principles, expenditure incurred on research should be expensed when incurred, i.e. no part of such an expense should be recognised as an intangible asset. Expenditure incurred on development can be recognised as an intangible asset only on fulfilment of certain conditions.

Aggressive accounting

By capitalising the R&D costs, companies can defer the recognition of expense on the P&L. This would inflate the firm's bottom-line for the current year at the cost of profits in subsequent years.

Case study: Tata Motors and Jaguar Land Rover

Tata Motors

Ticker	TTMT IN
Mcap (US$ mn)	15,975
6mth ADV (US$ mn)	58.1
Stance	BUY

Source: Bloomberg

Jaguar Land Rover (JLR) seems to have consistently followed an aggressive approach towards accounting for R&D costs. Whilst the proportion of total R&D expenses capitalised by its peer group (Volkswagen, BMW and Mercedes Benz) over the past three years was at 25-35%, JLR has been capitalising R&D expenses of 80-90%. This has boosted JLR's earnings. Had JLR followed a similar policy of capitalising ~33% of the R&D cost (in line with its peers) and recognising the remaining 67% of R&D cost as an expense on the P&L, its restated profits for the past two years is likely to have been lower by 22% (as shown in the tables below).

Exhibit 24: Capitalisation of R&D expenses - JLR vs its peers

Company name	R&D expenditure capitalised as a percentage of total R&D		
	FY10	FY11	FY12
Volkswagen (automotive division)	27%	36%	23%
BMW	44%	34%	29%
Mercedes Benz	34%	30%	28%
Average	**35%**	**34%**	**27%**
Jaguar Land Rover	91%	82%	83%

Source: Company, Ambit Capital research

Exhibit 25: Jaguar Land Rover - restated earnings based on the revised rate for R&D expensing

(in GBP mn)	FY10	FY11	FY12
Reported net earnings	24	1,036	1,481
Reported PBT	51	1,115	1,507
Add: R&D expense as per reported accounts	48	119	149
Add: Amortisation charge on capitalised development costs	52	100	183
Less: R&D charge @ 67%	(339)	(436)	(603)
Less: Amortisation charge on capitalised development costs	(17)	(33)	(60)
Restated PBT	(204)	865	1,176
Income tax expense	(111)	61	20
Tax rate	54%	7%	2%
Restated net earnings	(93)	804	1,156
Impact	**NA**	**-22%**	**-22%**

Source: Company, Ambit Capital research

I. Pension accounting

Various actuarial assumptions are involved in determining the pension expense for a period. These include both demographic assumptions (about future characteristics of the current and former employees) as well as financial assumptions (as regards the discount rate, the expected return on assets and the rate of salary increase). Given that a number of assumptions are involved in determining the pension expense and liability for a period, these assumptions can be easily adjusted to inflate the reported earnings.

Aggressive accounting

By adjusting the assumptions used in estimating the pension expense for a period, a company can boost its reported earnings. Three key assumptions that investors need to look at to spot aggressive practices by a company are: the discount rate assumption, the expected return on plan assets assumption and the assumption for rate of increase in salary.

- **Discount rate assumption**: Ideally, the discount rate should be chosen with reference to the market yield on 10-year Government bonds. A higher discount rate would result in a lower pension obligation.
- **Expected return on plan assets assumption**: The expected return on plan assets assumption should ideally be made based on the basis of yield on Government bonds. A higher expected return assumption would lead to a higher expected return on assets, resulting in a lower pension expense recognised for the year. Also, a higher assumption would result in a higher present value of plan assets, thus lowering the funded status of an underfunded plan.
- **Rate of salary increase**: Given that the pension benefits would generally be based on the level of the employee's salary at the time of retirement, a higher salary would result in a higher pension obligation. Hence, a company might use an aggressive approach (by using a significantly lower rate of salary increase, resulting in a lower pension obligation).

Thus, an aggressive accounting policy used would be one where either the discount rate used is high, the expected return on plan assets assumption is overly optimistic and/or the rate of escalation in salary is low relative to peers.

Case study of aggressive assumptions: Indian Overseas Bank

Indian Overseas Bank

Ticker	IOB IN
Mcap (US$ mn)	1,077
6mth ADV (US$ mn)	2.1
Stance	Not Rated

Source: Bloomberg

Based on our banking team's forensic accounting work ('*Forensic accounting scores for Indian banks*', *16 August 2011*, *Click here for detailed note*), Indian Overseas Bank appears to have made the most aggressive changes to its pension assumptions in FY11. In fact, amongst PSU banks, Andhra Bank, Corporation Bank, Syndicate Bank, Indian Overseas Bank (IOB) and United Bank have historically had an aggressive approach towards pension assumptions. On the other hand, PSU banks with a more conservative approach are Allahabad Bank, Bank of Baroda, Bank of India and Union Bank.

Delving into this further, if we compare the pension assumptions of Indian Overseas Bank (IOB) to Bank of Baroda (BOB), historically, we find that whilst the discount rate assumption used by Indian Overseas Bank is in line with Bank of Baroda's assumption, over the past two years, Indian Overseas Bank's expected rate of return on plan assets assumption used by IOB has been significantly higher and the salary escalation rate assumption has been significantly lower than the assumptions used by BOB.

Exhibit 26: Pension assumptions comparison - Indian Overseas Bank vs Bank of Baroda

Pension assumption used:	Bank of Baroda				Indian Overseas Bank			
	FY09	FY10	FY11	FY12	FY09	FY10	FY11	FY12
Discount rate (%)	7.5	8.0	8.5	8.8	7.5	8.0	8.5	8.5
Salary escalation rate (%)	4.0	4.0	4.0	4.0	4.0	4.0	3.0	3.0
Expected rate of return on plan assets (%)	8.0	8.0	8.0	8.0	9.2	8.0	9.1	8.5

Source: Company, Ambit Capital research; ND: Not Disclosed

Clearly, these assumptions would have resulted in a

- lower pension obligation (due to a lower salary escalation rate assumption),
- higher present value of plan assets (due to a higher expected return on plan assets assumption), and
- lower pension expense (resulting from a higher expected return on plan assets assumption)

for IOB (relative to BoB).

Case study of change in accounting policies: Tata Steel

Tata Steel

Ticker	TATA IN
Mcap (US$ mn)	5,774
6mth ADV (US$ mn)	31.6
Stance	BUY

Source: Bloomberg

Tata Steel acquired Corus (now Tata Steel Europe) in 2007. In FY08, the first year after consolidation, the defined benefit pension plan operated by Corus (British Steel Pension Scheme) had actuarial gains. These gains were recognised in the P&L (consistent with the Indian accounting standards) in the consolidated accounts of Tata Steel.

From FY09, the company has changed its policy. Since then the pension liability of Tata Steel Europe Ltd. has been computed and accounted for in accordance with IFRS and there have been actuarial losses from this defined benefit pension plan which does not hit the consolidated P&L. Instead, IFRS allows Tata Steel to take the actuarial losses through the 'Reserves & Surplus'.

The justification provided by the company is that given the large share of Tata Steel Europe Ltd. in the consolidated P&L, periodic changes in the assumptions underlying the computation of the pension liability would cause undue volatility in the stated consolidated profits.

That being said, we would like to highlight that the company has always made appropriate disclosures in its notes to accounts. This disclosure is also made by the company in its quarterly filings with the stock exchanges. This example is primarily to show how a few changes in accounting policies may cause a significant change to the reported bottom-line.

In fact, the auditors of Tata Steel too have, since 2009, highlighted this point in their audit report. For example, in the FY09 annual report, the auditors have made the following comments:

"Attention is invited to the Note 11 (d) of Schedule N to the financial statements regarding change in accounting policy for recognition of actuarial valuation change of ₹. 5496.58 crores (net of taxes) [Gross: ₹. 6098.20 crores] in the pension funds of Tata Steel Europe Limited, a subsidiary, for reasons specified therein. Had the company followed the previous practice of recognizing actuarial valuation changes in the profit and loss account, the deferred tax expense would have been lower by ₹. 601.62 crores and the profit after taxes, minority interest and share of profits of associates would have resulted in a loss of ₹. 545.68 crores."

Had Tata Steel followed the previous policy of recording actuarial valuation changes in the consol P&L, its restated earnings would have been as under:

Exhibit 27: Tata Steel - Restated earnings if the previous policy had been followed

(in ₹ mn)	FY08	FY09	FY10	FY11	FY12
Consol Profit after taxes (as stated by the company)	123,500	49,509	(20,092)	89,827	53,898
Actuarial gain/ (loss)	59070*	(54,966)	(35,412)	(4,028)	(23,723)
Net profit (had the actuarial gains/(losses) been charged to the P&L)	123,500	(5,457)	(55,505)	85,799	30,175

*Source: Company, Ambit Capital research, Note: * has already been reflected in the P&L.*

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