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Are Accounting Numbers Deceptive?

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Abstract:

The financial numbers may be deceptive. This case study by taking two contrasting examples attempts to bring out the point that one has to look deeper into the accounting policies and its consistency to get the best out of the financial statements.

When Bajaj Corp came out with its financial results in the ensuing year after listing in 2011, all eyes were on the profit they would report in the books. But despite a revenue growth of 25% in 2011, the Earnings Per Share of the company had decreased by 10% compared to the previous corresponding year. The management had chosen to write off the IPO expenses in 2011, against the common practice of spreading it over few years.

Quite contrast to this practice is the case of Indosolar, a Delhi based company which went public during September 2010. The company had an accumulated loss to the tune of INR 137 crores for the year ended 31st march 2011. It chose to change its accounting policy of writing off the issue expenses hitherto practiced and transferred to share premium account. Had it not changed its policy the loss would have been more than INR 140 crores.

Keywords: Bajaj Corp limited, Indosolar limited, Accounting policies, IPO expenses, Principle and rule based standards

"The development of rule-based accounting standards has resulted in the employment of financial engineering techniques designed solely to achieve accounting objectives rather than to achieve economic objectives."

-Harvey Pitt; Former chairman – SEC

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Financial Results and Market Expectation:

When Bajaj Corp[1] came out with its financial results in the ensuing year after IBS listing in 2011, all eyes were on the profit they would report in the books. Earnings Per Share of the company was INR 30.20 against INR 33.57 in the previous corresponding year. This was in spite of the fact that the revenue grew by 25%. The main reason for the drop in profits was the fact that the Income statement contained an "exceptional item" of INR 1900 Lakhs. This exceptional item was due to the IPO expenses incurred during the year. The management chose to completely write off the expenses in 2011 as against the common practice of amortizing over few years.

Cut the scene to view the financial numbers of Indosolar[2] which went public during September 2010. The company had an accumulated loss to the tune of INR 137 crores for the year ended 31st march 2011. It chose to change its accounting policy of writing off the issue expenses hitherto practiced and transferred to share premium account. Had it not changed its policy the loss would have been more by INR 140 crores.

The connecting line of both the companies was the treatment of IPO expenses. While one company chose a policy which would hit the bottom-line the other company opted for the one which protected the profit and the implications were evident in its financial statements.

Background of Indosolar Limited

Indosolar Limited was originally incorporated as Robin Garments Private Limited in 2005 later changed its name to Robin Solar private limited in 2008. After an amalgamation later, the company became Indosolar Limited in October 2009. The company is into the manufacture of solar photo-voltaic cells from silicon wafers on a

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[1]Bajaj corp is a listed company with its corporate office in Mumbai. It is listed in NSE and BSE.

[2] Indosolar with a market capitalization of INR 71.72 crores as on 15th July 2013 is a Delhi based company listed in BSE and NSE

business to business (BTB) platform. The commercial production commenced in two batches with the second phase of the commercial production started in March 2010.

Indosolar planned to expand the manufacturing capacity with an estimated fund requirement of about INR 400 crores and filed the red herring prospects with SEBI on January 2010. The board came out with 123103448 equity shares under IPO which was priced at INR 29 per equity shares with the share premium of INR 29 per equity share. The board of the company had also issued shares through pre-IPO placement route to the tune of INR 40 per equity shares. The company had a share premium balance of INR 36 crores as per the Balance sheet as on 31st March 2010 on account of pre IPO preferential allotment. On the same date, the share issue expenses of INR 26 crores remained unamortised . The company had a policy of amortising the expenses over the period of 5 years (Annual report- 2009-10) .

The IPO proceeds totalled to INR 357 crores. The share issue expenses was INR 30.88 crores (See Exhibit 1 the extract of Cash flow statement). The shares of the company got the listing approvals effective September 2010 from both NSE and BSE. The share performance against the bench mark index from September 2010 to March 2011 is presented in Exhibit II.

During the financial year 2011, the financial year corresponding to its listing, the company reported revenue of INR 591.03 crores as against INR 131.48 crores in the previous corresponding year marking a growth of over 300%. The company, which never made profit since inception, reported a loss of INR 57.44 crores as against INR 66.38 crores in the previous year. The operating margin ratio improved from a negative 34.97% to a positive 4.69% during the year and the Net profit margin ratio improved from -50.49% to -9.22%. (See Exhibit III for the various performance ratio of Indosolar Limted).

The auditor's report of the year contained the following statement:

> *The accumulated losses at the end of the financial year are less than fifty percent of its net worth. The Company has incurred cash losses during the financial year and in the*

> *immediately preceding financial year· (Indosolar Limited, 2011)Page 27.*

An interesting disclosure in the annual report for the year 2011 was the treatment of share issue expenses.

During the financial year 2011, the company changed the erstwhile accounting policy of amortising over five year period but adjusted the earlier share issue expense against Securities premium account (See exhibit IV schedule of miscellaneous expenditure)

The notes to accounts had the following statement with respect to the new method:

> Until 31st March 2010, the company had an accounting policy to amortise share issue expenses over a period of 5 years. The share issue expenses amounting to Rs.308,863,060 incurred during the year and the balance of Rs. 26,960,927 remaining unamortised as at 31st March 2010, has now been adjusted against the Securities Premium Account as permitted under Section 78 of the Companies Act 1956, on account of a change in the accounting policy in the year ended 31st March 2011.

Had the Company continued to follow the same accounting policy, the miscellaneous expenditure written off and the net loss would have been higher by Rs. 34,778,485 for the year ended and miscellaneous expenditure would have been higher by Rs. 301,045,502 as at 31st March 2011.

Notes to accounts, Annual report 2010-11

Section 78 of the Companies Act 1956

Section 78 of the Companies Act 1956 deals with the treatment of share premium. (Exhibit V shows the provisions of Section 78). Accordingly the preliminary expenses of the company can be adjusted with share premium account. The other expense allowed under this section to be set off against share premium is the expenses relating to marketing of new shares. The accounting treatment of preliminary expense comes under the purview of AS

26 Intangible assets. According to this, preliminary expenses are the expenses incurred to bring an enterprise into existence. There are different views on whether share issue expenses form part of preliminary expenses.

Experts' opinion on preliminary expenses:

Prasad(2006) contends that share issue expenses cannot form part of preliminary expenses. According to him "preliminary expenses are those incurred in connection with incorporation of the company. Shares are issued after the company is incorporated. Share issue expenses are not a part of preliminary expense."

Adhikhari (2011) opines that if companies can tweak the accounting policies to their benefit, it becomes difficult for the users rely on the financial statements. He wrote

> *"Indosolar is a classic example of how companies play with accounting policies to their advantage. Chameleon-like policies make a company's accounts harder to understand, and confuse investors and shareholders".*

The same item of share issue expenses was dealt with by another company in a rather unaccustomed way. It raised several eyebrows as the timing of the practice was not very favourable to the company. The company in question is Bajaj Corp.

BAJAJ CORP:

As a Part of Shishir Bajaj group of companies, Bajaj Corp started with the maiden name Bhaumic Agro Products private limited in April 2006. Later the company name was changed to Bajaj Corp private limited in September 2007. The company then was converted into Public limited company in October 2007 and commenced manufacturing and sale in April 2008. The company is the exclusive licensee of brands owned by Bajaj Resources Limited. Its popular brands such as Bajaj almond oil commands 54% of the market share. Bajaj has several SBUs and products worth mentioning such as Bajaj Brahmiamla, Amla Shikai etc.

Bajaj corp came out with IPO of 45 lakhs share with the face value of INR 5 each at 660. The issue which was opened from August 2nd

to 5th 2010 was well received in the market with an oversubscription of 15.64 times. The company subsequent to the successful IPO listed its shares in BSE and NSE in August 2010.

The first earnings report of the company after the listing was the 4th quarter result of financial year 2011 which was announced on 3rd May 2011. It was reported that the turnover for the quarter was 109.8 crore with a PAT of 26.88 crores. The revenue growth translated into 27.6% compared to the corresponding quarter of the previous year whereas the PAT growth had declined by 1.94%. This was in spite of the fact that the profit before exceptional item had grown by 20%. The reason cited by the management for the drop in the profit after tax was its accounting treatment of IPO expenses.

The company had incurred expenses towards floating the pubic issue to the tune of INR 6.31 crores during the year. It completely wrote it off as exceptional items in the profit and loss account. Due to this treatment, the profit after tax had come down to INR 84.1 crores (see Exhibit VIII).

During the announcement of the result, Mr. Narayanaraman, Head of investors' relations said.

> *Profit after Tax (PAT) increased by 0.23% from Rs. 8,391.34 lakhs in FY10 to Rs. 8,410.28 lakhs in FY11.*
>
> *During the year Company incurred IPO expenses of 1,896 lacs and the same are written off in the current year which leads to reduction in PAT. The profit was hit by an extraordinary item in the form of IPO expenses. If you take that out there is a growth in profit"*
>
> *- Indian Express, Oct 22,2010*

The company also had preliminary expense and it wrote of 1/5 of the expense in the current year. During the year, the write off of preliminary expenses amounted to INR 3.16lakhs

While listing the various possible options the company had on the accounting treatment of share issue expenses, an accounting expert Anand Adhikari (2011) observed

> *"……The first was to charge the expenses to the share premium account, where almost Rs 294 crore lay idle, in the balance sheet. This would have no effect on profitability. The second was to amortise them equally over five years, which would marginally affect the bottom line. And the third - setting off the expenses against the current year's profits - would wipe out more than 20 per cent of the profits for 2010/11. Given the slowdown in the domestic economy and the sluggish stock market, the first option seemed the best"….*

Bajaj Corp chose the last option of writing off as the expense which was the main reason for it not touching the 100 crore mark. The results did not appease the share market. The share of the company fell after the announcement of the result. Exhibit VI shows the share price movement for the year 2011. Adhikari adds-on in his article that the decision of the management to write off the expenses was a bold move as companies usually try to play to gallery and want to keep the shareholders contented. The conservative approach and the restraint shown by the company in this regard is one of the rare things found in Indian companies.

Look at the information not just the data

Steven Glass, senior lawyer and expert in share holders' class actions observe that failure of companies to disclose price sensitive information to the market is one of the common reasons for share holder suits. Several analysts believe that giving conservative estimate of the profit numbers protect the managers from future litigation hassles.

Aswath Damodaran[3], one of the world renowned valuation experts quips that disclosure laws seem to have made companies to become more creative in hiding bad stuffs making it difficult for the users to detect problems. He advises investors to focus on principles rather than rules and he advises companies to target investors rather than lawyers for financial disclosures. He says,

[3] Ashwath Damodaran, "Musings on Markets", October 15, 2012. Retrieved from http://aswathdamodaran.blogspot.in/2012/10/the-disclosure-dilemma-why-more.html 1st August 2013.

"Only those who can navigate the information and able to separate information from data would have competitive advantage over others".

Exhibit 1

Cash flow statement of Indosolar

PARTICULARS	Year ended 31st March, 2011	Year ended 31st March, 2010
A. CASH FLOW FROM OPERATING ACTIVITIES		
Loss before tax	**(574,259,912)**	(663,085,150)
Adjustments for:		
Depreciation	**518,285,501**	187,362,026
Loss on sale of fixed assets	**946,923**	–
Interest expense	**635,217,017**	254,284,791
Interest income from investments	**(62,228,668)**	–
Interest income on fixed deposits	**(24,899,060)**	(1,797,236)
Excess provision no longer required written back	**-**	(787,500)
Provision for doubtful debts	**2,674,080**	–
Bad debts written off	**3,352,853**	–
Debit balances written off	**3,105,095**	–
Unrealised exchange (gain)/Loss (net)	**25,592,814**	(51,638,751)
Operating profit/ (loss) before working capital changes	**527,786,643**	(275,661,820)
Changes in operating assets and liabilities:		
(Increase)/decrease in inventories	**(229,560,110)**	(743,911,537)
(Increase)/decrease in loans and advances	**(40,594,764)**	(71,999,337)
(Increase)/decrease in debtors	**(406,500,449)**	(231,994,831)
Increase/(decrease) in current liabilities and provisions	**(205,784,816)**	837,331,639
Cash generated from operations	**(354,653,496)**	(486,235,886)
Direct taxes paid (including wealth tax paid)	**(2,674,709)**	(2,896,650)
Net cash generated from operations	**(357,328,205)**	(489,132,536)
B. CASH FLOW FROM INVESTING ACTIVITIES		
Purchase of fixed assets	**(1,314,731,960)**	(2,303,463,146)
Proceeds from sale of fixed asset	**751,000**	–
Investments made in money market mutual fund	**(660,000,000)**	–
Interest received	**82,747,196**	10,620,108
Net cash used in investing activities	**(1,891,233,764)**	(2,292,843,038)
C. CASH FLOW FROM FINANCING ACTIVITIES		
Proceeds from issue of share capital	**1,231,034,480**	191,500,000
Proceeds from premium on shares issued	**2,338,965,513**	36,400,000
Proceeds from application money received	**-**	151,650,000
Proceeds from unsecured loan	**-**	70,000,000
Repayment of unsecured loan	**(59,205,634)**	–
Proceeds from term loan	**14,970,000**	2,135,056,269
Proceeds from vehicle loan	**1,678,945**	–
Repayment of vehicle loan	**(211,989)**	–
Repayment of term loan	**(920,320,436)**	–
Repayment of short term loan	**(1,616,500,000)**	–

Exhibit II - Share price movement of Indosolar with respect to BSE sensex

	BSE Sensex		Indosolar	
Year	High	Low	High	Low
Sep 2010	20267.98	18.027.12	29.9	22.8
Oct 2010	20854.55	19768.96	25.5	21
Nov 2010	21108.64	18954.82	30.9	22.55
Dec 2010	20552.03	19074.57	27.3	22.05
Jan 2011	20664.8	18068.48	25.2	18.4
Feb 2011	18690.97	17295.62	21.2	16.15
Mar 2011	19575.16	17792.17	20	16.7

Exhibit III- Performance ratios of Indosolar

Financial Year	**2011**	**2010**	**2009**
Operating Margin	-117.53	4.69	-34.97
Gross Profit Margin	-173	-0.9	-36.19
Net Profit Margin	-208.21	-9.22	-50.49
Other Ratios			
Return On Equity	-96.78	-27.76	-50.37
Return On Capital Employed	-26.98	-17.15	-13.91
Payout Ratio	0	0	0

Exhibit IV - Schedule to the profit and loss account of Indosolar

PARTICULARS	As at 31st March, 2011	As at 31st March, 2010
SCHEDULE – 13 MISCELLANEOUS EXPENDITURE		
Share issue expenses		
Opening balance	26,960,927	–
Add : Addition during the year	–	26,960,927
Less: Utilised against share premium (refer to note 1(xiv) of Schedule 20)	(26,960,927)	–
TOTAL	–	26,960,927

Exhibit V –Section 78 of Companies Act

78. Application of premiums received on issue of shares.

1. Where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to an account, to be called" the share premium account"; and the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if the share premium account were paid-up share capital of the company.

2. The share premium account may, notwithstanding anything in sub- section (1), be applied by the company-

   a. in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares;

   b. in writing off the preliminary expenses of the company;

   c. in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; or

   d. in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

3. Where a company has, before the commencement of this Act, issued any shares at a premium, this section shall apply as if the shares had been issued after the commencement of this Act: Provided that any part of the premiums which has been so applied that it does not at the commencement of this Act form an identifiable part of the company's reserves within the meaning of Schedule Vl, shall be disregarded in determining the sum to be included in the share premium account.

Exhibit VI - Share price movement of bajaj corp

	NSE		**BSE**	
Month & Year	FV 5	FV 1	FV 5	FV 1
April2011	561.9		560.7	
May2011		105.4		107.25
June2011		117		116.05
July2011		121.2		120.35
August2011		118.85		119.25
September2011		106.4		106.1
October2011		99.8		99.65
November2011		112.9		113
December2011		98.35		98.7
January2012		102.55		102.15
February2012		115.5		115.6
March2012		115.7		115.3

Note: Pursuant to the approval accorded by the Members of the Company through Postal Ballot on April 18, 2011, the face value of ` 5/- per equity share was sub divided into face value of ` 1/- per equity share. Accordingly the quotation on BSE as well as NSE, since the first week of April 2011 till 1st week of May 2011, is available for equity share of the face value of ` 5/- each.

Exhibit VII -Snapshot of notes to accounts of Bajaj corp.

VIII. Initial Public offer (IPO) Expenses

All the IPO expenses amounting to ₹ 1,896.25 lacs are written off during the year and shown as exceptional item in the Profit & Loss Account.

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Exhibit VIII - Snapshot of the profit and loss account of bajajcorp

Profit and Loss Account for the year ended March 31, 2011

	Schedule		**For the year ended March 31, 2011 ₹ Lacs**		For the year ended March 31, 2010 ₹ Lacs
Income:					
Sales		**35,867.26**		29,457.76	
Other Income	7	**1,778.24**		513.39	
		37,645.50	**37,645.50**	29,971.15	29,971.15
Expenditure:					
Materials	8	**15,657.69**		11,678.37	
Salaries and Wages	9	**1,625.97**		1,384.28	
Selling & Administrative Expenses	10	**7,777.88**		6,668.50	
Depreciation		**179.40**		84.42	
		25,240.94	**25,240.94**	19,815.57	19,815.57
Profit Before Exceptional Items & Tax			**12,404.56**		10,155.58
Exceptional Items			**1,896.25**		–
(please refer Schedule 11(A))					
Profit Before Tax			**10,508.31**		10,155.58
- Current Tax		**2,094.00**		1,735.00	
- Wealth Tax		**4.92**		2.02	
- Deferred Tax		**(0.89)**	**2,098.03**	27.22	1,764.24
Profit After Tax			**8,410.28**		8,391.34
Balance Brought Forward			**216.21**		4,663.41
			8,626.49		13,054.75
Appropriations:					
Bonus Shares Issued			–		750.00
Interim Dividend			–		9,200.00
Proposed Dividend			**2,802.50**		–
Corporate Dividend Tax			**465.46**		1,563.54
Transferred to General Reserves			**842.00**		1,325.00
Balance Carried to Balance Sheet			**4,516.53**		216.21
			8,626.49		13,054.75
Earning per Share (EPS)					
(please refer Schedule 11(N))					
Basic (Face value of ₹ 5/- each)			**30.20**		33.57
Diluted (Face value of ₹ 5/- each)			**30.20**		33.57
Notes to the Accounts	11				

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