# Window Dressing

**Introduction**

One of the most basic requirements for a meaningful analysis of financial statements is the authenticity and reliability of the statements. The quality of analysis of any set of financial statements depends entirely on the reliability of such financial statements.

Financial Analysts have, therefore, to guard themselves against fudged or manipulated financial statements to save themselves from reaching wrong and misleading conclusions. In the event of fudged or manipulated financial statements, wrong conclusions will be drawn leading to catastrophic results.

Window dressing, in simple words, means the manipulation of accounts in a way so as to conceal or misrepresent vital facts and present the financial statements so as to show a better financial position than what it actually is. Any misrepresentation of the financial position of the company falls within the broad purview of "Window Dressing". Window Dressing is usually done in one or both of the following two ways:

1. Misrepresentation of Financials by manipulating accounting norms and standards
   When a company manipulates the accounting norms and conceals the actual state of affairs it is resorting to this form of Window Dressing. Some examples of this form of Window Dressing are:
   i. Non Provision for doubtful debts
      This is one of the most common methods of Window Dressing and has been extensively exposed in the Banking Sector. The present sorry state of banks particularly the Public Sector Banks is attributable to this form of Window Dressing in order to show better results than actual.

      This is prevented to a large extent by a close scrutiny of the Debtors by the Auditors and seeking balance confirmations etc. In many cases large cases of non provision of doubtful debts can be captured in a diligent audit.

   ii. Non provision for obsolete or damaged inventory
      Occasionally manufacturing companies do not write off damaged inventory or obsolete inventory in order to avoid taking the hit on their profits for the year. This is backed by suitable line of argument by the management justifying their point of view. This is a strong tool of window dressing.

   iii. Treatment of revenue expenditure as capital expenditure or a deferred revenue expense
      By treating revenue expenditure as a capital or a deferred revenue expense a company increases its profits artificially. This is also capable of being captured by a diligent audit of capital expenses.

   Window Dressing of this kind is may or may not fall in the category of a "Criminal Offense" as the management will have a cohesive line of argument to support its own accounting line. It may not be in line with the Auditor's view but it cannot be termed as deliberate act of cheating. Hence, the consequence of this form of Window Dressing is for the Auditors to "Qualify" the Report to the Shareholders and thereby forcing the management to come up

with a disclosure in the Notes to Accounts of the reasons for its accounting treatment and the impact of such treatment on the profits of the company. In this way, the analyst can make suitable adjustments to his findings and come up with cohesive and correct conclusions.

2. Outright fraudulent reporting
   As opposed to misrepresentations in the Financial Statements on the lines explained above, there is another form of Window Dressing which is far more serious and grave. This is fudging accounts by recording fictitious transactions to give a distorted picture of the financial affairs of the company. This is certainly a Criminal Offense and attracts serious penalties including imprisonment of erring employees. Under this category in order to increase profits, false credit sales may be recorded etc.

   Conclusively we can say that Window Dressing of Financial Statements arises when transactions are misrepresented while Fraudulent Reporting of Financial Statements arises when transactions are fabricated. Both are undesirable.

**Statutory Measures for Minimizing Risks of Window Dressing**

1. Accounting Standards are a major tool for eliminating the risk of window dressing of financial statements. Any deviation is reported by the Auditors of the Company.

2. The "Audit Committee" of the Board of Directors which is a mandatory compliance for companies is a very strong tool to ensure proper accounting and presentation of financial statements and dealing with deviations with norms of accounting, audit observations and qualifications.

3. Independence of Auditors stressed upon and provided for in the Companies Act is another key imperative for minimizing the risk of window dressing of financial statements.

**The concept of "Cookie Jar Reserves" or "Rainy Day Reserves" or "Piggy Bank Reserves"**

**Cookie jar accounting** or **cookie jar reserves** is an **accounting** practice in which a company takes a quantity of large **reserves** from an economically successful year and incurs them against losses from less successful years in the future. In other words, the **terms** "**Cookie Jar**," "**Rainy Day**," or "**Piggy Bank**" **reserves** are, additional reserves created against the profits of a successful year to be utilized when needed in the future.

Typically, they are funds that are often set aside in a good year by "over provisioning" of expenses for a time when regular income is disrupted or decreased in to present a stable business scenario. It is not a good accounting practice but a commonly prevalent one.

**Cookie jar accounting** is Window Dressing form as it misrepresents a company's performance by showing less profit than actually earned which has a direct impact on its tax liability for the year.

# Corporate Governance

**Introduction**

In the last couple of decade due to many cases of frauds coming to light globally and in India resulting in widespread losses to investors, employees, depositors and the government, focus in the working of companies has shifted significantly to the issue of Corporate Governance. The Companies Act 2012 is one such attempt to enhance the standard of Corporate Governance in Companies in India.

Corporate Governance are the general set of customs, regulations, habits, and policies that determine the value system within an enterprise. Good CG revolves around a value system of honesty, integrity and ethics in the conduct of business.

**The Four Pillars of Corporate Governance**

1. Statutory Compliances
   - ✔ Zero Violation
   - ✔ Timely submissions of legal documents

   Good Corporate Governance requires a zero tolerance to non compliance of applicable laws. Every business enterprise is subject to a wide range of laws that are applicable to it, such as, Companies Act, the Shops and Establishment Act, Various Industrial Laws, Tax Laws, PF and ESI Laws etc. A company with strong Corporate Governance has to be a 100% compliant one to ensure that there is no risk arising from non compliance.

   Statutory compliance is also an indication of the culture within the company which in itself is a significant indicator of its value system.

2. Good Management Practices
   - ✔ Strong Controls
     - Transparency
       - High Documentation: Creating a trail of documentation in every transaction or decision making thereby enabling the audit process and reference to the considerations behind decisions taken for the guidance of future managers.
       - Written Policies
   - ✔ Strong & effective audits
   - ✔ High accountability: Responsibilities and accountabilities are determined clearly so that there is no scope of ambiguity in performance of employees both in relation to jobs done well and negligence. This creates an output driven work culture.

   The key to Good Management Practices is to recognize the importance of “Controls” driven approach rather than “People” driven one. Large corporates cannot work effectively without strong control systems in every aspect of their working due to the following basic advantages:
   - Uniformity in the working of the company
   - Elimination of personal biases and nepotism in the running of the business enterprise.

3. Ethical Dealing

- ✔ Fair to Employees
- ✔ Honest with outsiders
- ✔ Corporate Social Responsibility

The broad elements of Ethical Dealings in a company are as follows:

- Full Legal compliance
- Fair to all – creating a "win win" situation
- Non partisan approach in dealings

There are situations when Ethical Dilemmas arise among employees which need to be addressed by the Senior Management. The principal factor contributing to Ethical dilemma may be the active frauds being committed by colleagues or seniors and the fear of repercussions

Hence to safeguards and uphold the standards of Ethical dealings companies generally have a Whistle Blowing Policy having the following salient features:

- Protection to each employee for revealing frauds, non compliance etc committed by any employee.
- Confidentiality of the Whistle Blowers.
- Discouraging the making of wild, false and unsubstantiated allegations by the imposing of severe penalties.
- Follow up with proper action on the issue involved.

4. Effective Audits – Independence of Auditors

- ✔ Systems Audit;
- ✔ Finance Audit
- ✔ Compliance Audit;
- ✔ Management Audit

The importance of Audits cannot be undermined in the management of a business enterprise. Audits form the back bone of any good Corporate Governance system. Audits in turn must be effective to serve their exalted objectives. In order for this to happen it is imperative that the "Auditors" of a company must be fully independent of the management and must be given the freedom to do their reviews and examinations as they deem fit in their professional capacity. It is for this reason that every company is required to form an "Audit Committee" of its directors which can then ensure auditors' independence and effectiveness it the performance of their duties.

**Ethics" & "Morality**

1. In simple words, "Ethics" may be defined as a set of values which are in complete recognition and compliance with the legal requirements governing an action or a business deal.
2. Morality on the other hand, is a set of values determined by the concept of "good" and "bad" in a person which drives his actions and behavior.
3. The drawback of an action or transaction driven by morality is that it may be outside the law though appearing right to the parties concerned.
4. Moral Reasoning or Morality differs from person to person depending on upbringing, education, social background, religious beliefs, prejudices and biases etc.
5. For the well being of any society, action of its citizens should be driven by law and not by "morality" for the simple reason that an action in compliance with law will always be the same

or uniform irrespective of the parties concerned whereas actions driven by morality may be highly disruptive and harmful due to complete lack of uniformity among the citizens.

*End of Chapter*

## Common Size Statements

One of the simplest steps in the study and analysis of financial statements is the conversion of the Financial Statements into Common Size Statements which then make a comparative study easy. In simple words, Common Size Statement is the representation of the Statement of Profit and Loss as a percentage of "Revenue from Sale of Goods and Services" or the Net Operating Income. In short the Revenue from Sales is taken as 100 and every other value is represented as a percentage of that. When this is done then the results of previous years for the same company become meaningfully comparative as also the results of competitors.

Let us take a simple example:

| Statement of Profit & Loss - All Values in Rs / Crores | X Ltd - Actual Data | | X Ltd - Common Size Statement | |
|---|---|---|---|---|
| | YE Mar 19 | YE Mar 18 | YE Mar 19 | YE Mar 18 |
| **Gross Income** | | | | |
| Income from Sales | 79,762.70 | 68,034.80 | 100.0% | 100.0% |
| **Expenses** | | | | |
| Cost of Materials Consumed | 54,975.00 | 48,654.00 | 68.9% | 71.5% |
| Employee benefits expense | 2,833.80 | 2,331.00 | 3.6% | 3.4% |
| Finance Cost | 345.70 | 89.40 | 0.4% | 0.1% |
| Depn & amortization exps | 2,757.90 | 2,602.10 | 3.5% | 3.8% |
| Other expenses | 9,991.50 | 8,722.80 | 12.5% | 12.8% |
| **Total Expenses** | 70,903.90 | 62,399.30 | 88.9% | 91.7% |
| **Profit before Tax (PBT)** | 8,858.80 | 7,635.50 | 11.1% | 8.3% |
| Tax Expense | 3,349.50 | 2,331.70 | 4.2% | 3.4% |
| **Net Profit for the year** | **5,509.30** | **3,303.80** | **6.9%** | **4.9%** |

If we look at the Statement of Profit & Loss of X Ltd for the two years, we find it difficult to grasp the importance thereof unless we convert the data into a common size income statement. By converting the data to a common denominator which is the sale value, we are at once able to see the relative performance in each area of cost. In this way we find that the Cost of Material Consumed has improved from 71.5% to 68.9% in 2019 vs 2018. This could help us draw conclusions like the company has negotiated better for its raw materials; its consumption ratio has improved, and so on.

Hence, we may say that common size statements give immediate meaning to the Financial Statements for a better study and analysis thereof.

Hence, we can conclusively say that:

i. A common size financial statement displays the items on a financial statement as a percentage of a common base figure.
ii. For example, if total sales revenue is used as the common base figure, then other financial statement items—such as operating expenses and cost of goods—will be compared as a percentage of total sales revenue.

iii. Investors use common size financial statements to make it easier to compare a company to its competitors and to identify significant changes in a company's financials.

**Balance Sheet**

In the case of the Balance Sheet the Common Size Statement is prepared by converting all items of assets and liabilities as a percentage of total assets which is also equal to total liabilities and is taken as 100. See the following example:

| Balance Sheet - All Values in Rs / Crs | X Ltd - Actual | | X Ltd - Common Size | |
|---|---|---|---|---|
| | YE Mar 18 | YE Mar 17 | YE Mar 18 | YE Mar 17 |
| **Equity & Liabilities** | | | | |
| Share Capital | 151.00 | 151.00 | 0.3% | 0.3% |
| Reserves & Surpluses | 41,606.30 | 36,020.10 | 70.8% | 71.3% |
| Total Equity | 41,757.30 | 36,171.10 | 71.1% | 71.6% |
| **Non Current Liabilities** | | | | |
| Long Term Borrowings | 1,585.30 | 1,105.00 | 2.7% | 2.2% |
| Deferred Tax Liabilities (Net) | 558.90 | 464.00 | 1.0% | 0.9% |
| Total Non Current Liabilities | 2,144.20 | 1,569.00 | 3.6% | 3.1% |
| **Current Liabilities** | | | | |
| Short Term Borrowings | 4,385.10 | 4,415.00 | 7.5% | 8.7% |
| Trade Payables | 10,497.00 | 8,367.30 | 17.9% | 16.6% |
| Total Current Liabilities | 14,882.10 | 12,782.30 | 25.3% | 25.3% |
| **Total Liabilities** | **58,783.60** | **50,522.40** | **100.0%** | **100.0%** |
| **Assets** | | | | |
| **Non Current Assets** | | | | |
| Tangible Assets | 15,484.90 | 14,541.50 | 26.3% | 28.8% |
| Non Current Investments | 34,072.90 | 26,214.70 | 58.0% | 51.9% |
| Total Non Current Assets | 49,557.80 | 40,756.20 | 84.3% | 80.7% |
| **Current Assets** | | | | |
| Current Investments | 2,524.70 | 3,172.50 | 4.3% | 6.3% |
| Inventories | 3,160.80 | 3,262.20 | 5.4% | 6.4% |
| Trade Receivables | 1,461.80 | 1,199.20 | 2.5% | 2.4% |
| Cash & bank balances | 71.10 | 13.10 | 0.1% | 0.0% |
| Other Current Assets | 2,007.40 | 2,119.20 | 3.4% | 4.2% |
| Total Current Assets | 9,225.80 | 9,766.20 | 15.7% | 19.3% |
| **Total Assets** | **58,783.60** | **50,522.40** | **100.0%** | **100.0%** |

We can conclude by saying that common size statements simplify the work of an analyst substantially and form the basis of ratios for a thorough analysis of Financial Statements.

*End of Chapter*

# Financial Ratios

**Introduction**

In simple words, a "ratio" is one figure presented against another related figure to give a context and meaning to the first figure. Any information in isolation will not lead to meaningful conclusions. For example if A says he has made a profit of Rs 1 crore in the month of April, no conclusion can be drawn unless the figure of profit is seen in the context of another related figure. Therefore, if he says that the turnover in the month of April was Rs 100 Crores, the conclusion drawn will be that the profit which is only 1% of sales is very low and surely an area of concern.

The analysis of financial statements is done by the use of a wide variety of ratios covering the Key Business Parameters of the enterprise's working.

Hence, we can define ratios as "indicators" of performance.

**Trend Analysis**

i. When the ratios of one year are compared with the ratios of a number of years, a trend line of performance emerges.
ii. The analysis of such trend lines graphically indicates the direction in which the performance of the enterprise in different business parameters is moving.
iii. The trend analysis is a very important tool of financial analysis as it throws up a number of action points for the management to re evaluate business strategies or take appropriate measures to reverse losing trend or maintain profitable trend.
iv. Trend Analysis is very useful in evaluating the performance trend of a single company at a time rather than intercompany comparisons.

Ratios can be categorized in the following categories:

1. Profitability Ratios

   These ratios are designed to enable an analyst to draw conclusions on the profitability of a company on a standalone basis as well as vis a vis competitors. Some key Profitability Ratios are:

   i. Operating Profit Ratio is calculated as under:

   $$\frac{\text{Operating Profits}}{\text{Income from Operations}} \times 100 \text{ where,}$$

   Operating Profits = Profit before Interest and Taxes. *HOWEVER, SOME ANALYSTS CALCULATE THIS RATIO BY TAKING PROFITS BEFORE INTEREST, TAXES AND SELLING & ADMINISTRATIVE EXPENSES.*

   Note: This ratio is represented as %.

   ii. Return on Investment or ROI is calculated as under:

   $$\frac{\text{Profit before Interest \& Tax}}{\text{Average Capital Employed}} \times 100$$

   Average Capital Employed is the simple average of opening and the closing capital employed. Capital for this purpose includes both Equity Funds and Long Term Debt

   Note: This ratio is represented as %.

iii. Return on Equity shows the return to Equity Shareholders rather than on the total capital employed.

$$\frac{\text{Profit after Tax}}{\text{Equity Funds}} \times 100$$

Note: This ratio is represented as %.

iv. EPS shows the return in terms of Rs per equity share outstanding on the Balance Sheet Date.

$$\frac{\text{Profit after Tax}}{\text{No of Outstanding Equity Shares}}$$

Analysts may compute other ratios as they deem fit in their analysis, but the above ratios will enable the analyst to draw meaningful and comprehensive conclusions on the profitability of the company.

2. Solvency or Liquidity Ratios: Indicators of ability to meet short term commitments.

i. Current Ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

A Current Ratio of around 2 is traditionally considered to be a fair indicator of short term solvency of a business though in the changed times, many blue chip companies operate with much lower Current Ratios

ii. Acid Test or Liquid Ratio

This ratio indicates the ability of the business to meet its short term commitments from assets which are available for conversion into cash in the shortest possible time.

$$\frac{\text{Current Assets - Inventories}}{\text{Current Liabilities}}$$

A Liquid Ratio of around 1 is traditionally considered to be an indicator of good liquidity of the business.

3. Long Term Solvency Ratios

This ratio is an indicator of the financial strength of the business to meet its long term commitments of funds. In short the ability of the business to service its debts and stay solvent in the long run.

i. Debt Service Coverage Ratio (DSCR)

$$\frac{\text{Profit before Interest}}{\text{Total Int \& Instalments payable in the year}}$$

The Profits should be large enough to service both the interests on debt and the repayments of principal amounts during the year. A DSCR of around 2 is considered to be a sign of good long term solvency of the business.

4. Efficiency & Structural Ratios

i. Debt Equity Ratio

$$\frac{\text{Long Term Debt}}{\text{Equity Funds}}$$

This ratio shows the extent to which the business is leveraged. The fundamental principle of leveraging of debt is that the company increases the return to its equity shareholders when it finances part of its long term cost from debt. Traditionally a Debt Equity of 2 was considered very healthy but in the present business environment companies are opting to operate with much lesser leveraging due to the risks involved in servicing of debts.

ii. Assets to Turnover Ratio

$$\frac{\text{Revenue from Sales}}{\text{Total Assets}}$$

Higher the ratio, greater is the profitability of the business. Ratios of close to 1 or below indicate structurally a non profitable business or one with a very long gestation period.

iii. Inventory Days (Raw Material + Work in Progress + Finished Goods)

$$\frac{\text{Average total Inventory}}{\text{Cost of Materials Consumed}} \times 365 \quad \text{[Ratio will be in Days]}$$

Lower inventory days indicate highly efficient working capital management with attending cost advantages apart from the Cash Conversion Cycle.

iv. Receivable Days or Days Sales Outstanding (DSO)

$$\frac{\text{Average Receivable}}{\text{Total Sales during the year}} \times 365 \quad \text{[Ratio will be in Days]}$$

Lower DSO indicates highly efficient debtors management in the company with attending cost advantages apart from the shortening of the Cash Conversion Cycle.

v. Payable Days Outstanding

$$\frac{\text{Average Payables in the year}}{\text{Total Material Consumed in the Year}} \times 365 \quad \text{[Ratio will be in Days]}$$

The higher this number greater is the brand value of the company and the willingness of its vendors to supply material to it on liberal terms. Eventually, this is a very powerful indicator of the standing, profitability and strength of the company.

5. Wealth Creating Ratios

i. Book Value Per Share

$$\frac{\text{Equity Funds}}{\text{No of Equity Shares outstanding On the Balance Sheet Date}}$$

This is also called the intrinsic value per share and is the indicator of the Net Worth of the company per share.

ii. Market Capitalization Value per share

In case of listed companies the market value per share is a strong indicator of the wealth creation by the company.

iii. P / E Ratio

This ratio is a strong indicator of the basic strength of its brand value. A consistently high P / E ratio indicates the preference of the investors to buy the company's shares at a much higher value. Nestle India Ltd is an example of such a company.

*End of Chapter*