Some pointers to read an annual report

About me

- Individual investor in the Indian equity markets since 2009
- Chartered Accountant by education, MBA by vocation and investor by choice
- Fundamental investor since 2011
- Styles-Value/Deep Value
- Broker: Discount brokerage(Zerodha)
- Sectors I follow-Infrastructure(Telecom/Realty), Media, FMCG, Textiles, Energy, Renewables.
- Do not understand: Pharma, IT, Commodity markets, Index trades
- Role Model: Sanjay Bakshi, Shivanand Mankekar

Why read annual reports if you have screener.in?

- PDF vs Excel/HTML
- Numbers already populated in screener.in
- Lower information overload
- Data often obsolete(eg Aug-16 release of annual report for Mar-16)
- Boilerplate/standard information(eg Audit report, accounts)
- Since audited accounts for Mar16 released by May-16, only ‘new information’ is AGM notice & resolutions to approve

Annual Report vs Audited financials

- Common
  - Audit Report(& exception reports in Form A/Form B)
  - P&L, Balance Sheet and Segment reporting
  - Key notes to accounts (usually important events)

- Only in annual report usually
  - Cash Flow Statement
  - Detailed footnotes
  - Director’s reports
  - Detailed audit report including test of internal control
  - Change in shareholding pattern of promoters and key shareholders
  - Subsequent developments(if key to ‘going concern’)
  - Related party transactions, managerial remuneration, BRR report and other sensitive information.

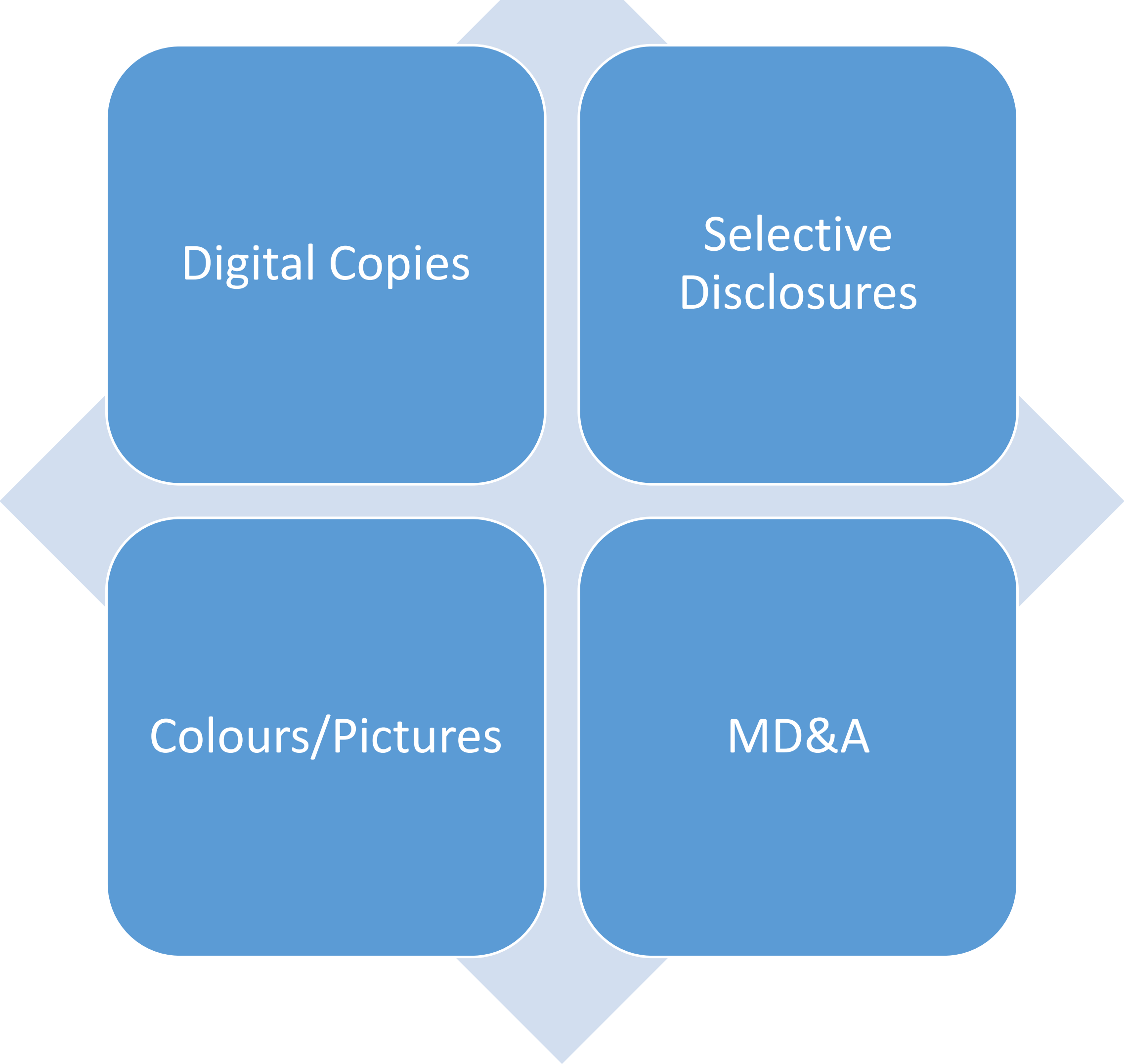
Some questions answered in annual report

Question	Refer	Comment
What are the key products/regions of the company's revenue stream? Revenue, EBIT, Capex etc	Segment Reporting footnotes(also in quarterly financials)	Usually companies do not disclose much info here.
What % of the consolidated revenue/PAT is under main auditor	Audit report	Auditor states extent of reliance on other auditors or MIS financials
Are the key management staff well paid?	KMP remuneration in Board report	Low salaries to CFO & CS vs CEO is a red flag for accounts/compliance
Is there a working internal audit?	Search if internal audit is named	Companies may boast of internal audit w/o naming the auditor.
What are the key tax/litigation matters?	Footnotes on provisions/CL and CARO 2013	The potential litigation exposure is quantified. Compare with industry
How complex is the entity structure	#of subsidiaries, %standalone profit as compared to total profit	Identify number of subsidiaries and extent to which standalone=consol
How transparent is the company?	MD&A Risks/Mng remuneration	Usually lacking
CSR Spending?	CSR report	Is full amount spent? Project focus?

Tricks companies play in annual reports

Where certain footnotes can be incriminating, companies change the alignment of the text from horizonal to vertical or vice versa. This is the case for segment reporting, related party transactions etc. Example-A leading integrated petrochem manufacturer

Using ‘PR agencies’ to hype up the annual report(colourful, graphs, charts) after the promoter has accumulated enough and wants to offload stocks. Example-Temptation Foods



'one reportable segment'. This helps them avoid divulging data on revenue, EBIT and capex at the segment level

MD&A is elevator analysis/ merely commentary on up/down without insight

GMR Industries

- Background
- With a family trust resolving succession issues, reputed board members and iconic projects some even being the subject of case studies such as Delhi Airport/Kishangadh highway etc, GMR Infrastructure does command valuation premiums even basis reported numbers, while it trades at a P/BV of 1.6(negative PE multiple).
- However, it has been mired in regulatory issues(delays in gas linkages to power plants, court ordered delays in hydel plants, Maldives airport nationalization, Kishangadh highway bid cancellation due to 'force majure', CAG audit report claiming undue benefit to DIAL operator and power tariff regulators delayed acceptance of force majure to permit fuel price hike pass through), Some of these have reflected in the audit report with the management refusing to write down asset balances which are clearly doubtful
- The below table indicates that if the audit adjustments were given effect to, the company's reported loss would increase by 74%-172%, while the reported networth will erode by 53%-96%. **This shows the importance of perusing the audit report and not just going by reported numbers**

- Key Points

GMR Annual Report 2015-16-Audit Adjustment impact				
		Impact for FY-16		
Note	Point	Loss increase by	Networth reduce by	Comment
42(ii)(b)	Indirect construction costs and borrowing costs in period Jul-12 to Jun15 where construction was on hold pending supply of natural gas	103.38	1163	Auditors estimate
42(viii)(b)	Capitalisation beyond date of declation of commercial operations	369.09	369.09	Auditors estimate
41(iii)	GMR Kishangarh Udaipur Highway-capital advance to EPC contractor and bank guarantee to NHAI	859.36	859.36	My estimate from EOM para
30(d)/43€	Maldives Airport natioanlized assets	1594	1594	Auditors estimate
30(d)	Not certain' payments to Maldives airport subcontractors	536	536	ceased work which may not be reimbursed
42(xi)	Alaknanda Hydro Plant asset value not written off despite stay on construction work	258.62	258.62	My estimate from EOM para
		3720.45	4780.07	
	Group level numbers(excl minority interest)	2161	4960	
	% impact	172%	96%	Nearly entire NW will be written off
	%impact excluding Maldives	74%	53%	Assuming Maldives is eventually recovered from SAARC Aid etc

KRBL

- Typical 'lala' company with sole propritary auditor albeit quite well paid at 18lakhs, underpaid professional KMP(CFO at 35lakhs and CS at 7 lakhs; cost auditor at 0.5lakh).
- Spent just 10% of CSR budget(!)-prudent financial management :D
- Brand focus with commensurate R&D investments
- Exports are largely to middle east
- However, the company substantiates its leadership posiiton claim with data from AC Nielen on overall, traditional and modern trade market shares.
- Some accounting red flags via unexplained expenses growth in key items not commensurate with sales/explained factors
- **In totality, since the CAGR in revenues, EBIT, PBT are in line, and there has been debt reduction, the company does not seem a risk. However, above is an example of analysis which one could do to identify accounting risk.**

Note	Pg	Item	FY 2016	FY 2015	Variance	Comment
29	149	Internal Auditor's Fees	32.5	20.22	61%	E&Y appointed from 1 Oct 2015, at probably double the remuneration of earlier auditor(Pg41)
29	149	Land, Warehouse & Godown Rent	948.75	278.72	240%	Topline growth only 7%, so this is unusual
29	149	Insurance Charges	144.92	77.95	86%	Topline growth only 7%, so this is unusual
29	149	Testing & Inspection Charges	107.4	28.02	283%	Export Sales growth only 40%(overall 7%) so this is unusual
30.02	150	Auditor Remuneration(Taxation matters)	10.77	1.69	537%	Unexplained auditors payments-red flag

India Cements

- **Unexplained Increase in auditor remuneration by 25%**-Statutory auditors are M/s.Brahmayya & Co. (Registration No.000511S) and M/s.P.S.Subramania Iyer & Co. The Board of Directors at its meeting held on 26th May, 2016, based on the recommendation of the Audit Committee approved the payment of remuneration to the Statutory Auditors of Rs.50,00,000/- (Rupees Fifty Lakhs only) EACH *(enhanced from Rs.40 Lakhs each) for the year 2016-17, besides reimbursement of service tax and all travelling and out of pocket expenses.*

- **Unresolved CSK(Chennai Super Kings) dispute:** The Company was informed that CSKCL had sought the permission of BCCI, for the distribution of its shares by India Cements Shareholders Trust to the non-promoter shareholders of India Cements and India Cements Ex-cricketers Trust, on September 30, 2015. The Company has also been informed that the approval of BCCI is awaited.

- **Price increase despite overall capacity bulge-possible cartels? As the company puts it "**The Indian cement industry which has a capacity of over 370 million tons could achieve a capacity utilisation of around 70% only for the year under review. The South in particular was affected with a much lower capacity utilisation. While the industry had to cope with inflationary pressures, including additional pay-outs on account of wage board settlements for the employees, the impact of the same was considerably reduced due to the sharp fall in oil prices and thereby reduction in the price of fuel. With fairly consistent selling price of cement coupled with improved operating parameters, the Industry could make reasonable bottom line despite lower capacity utilisation; the silver lining being the recovery in cement demand towards the end of the fiscal. ..The overall net plant realisation for the year was Rs.3793 per ton against Rs.3587 per ton in the previous year reflecting an increase of 6%“

- **Competition Act penalty still pending finality:** The order passed by the Competition Commission of India (CCI) on 20th June 2012 against certain cement manufacturers including the Company alleging contravention of the provisions of The Competition Act, 2002 and imposing a penalty of Rs.187.48 Crores on the Company among others, was appealed against and the Competition Appellate Tribunal (COMPAT) allowed the same by its order dated 11.02.2015 setting aside the Order CCI and has remitted the matter back again to the CCI for re-adjudication while directing the refund of the pre-deposit of Rs.18.75 Crores to the Company. The matter is pending before the CCI after completion of the hearing on 22nd January 2016.

DLF

- Employee cost reduced from Rs 349crores to 316crores despite a 20% revenue growth.
- 31.3MnSqft is rented out for Rs 26000MINR(annualized) at a 95% occupancy rate. This equates to Rs 850/Sqft/year or Rs 71/Sqft/month(!!). This with a reinvestment capex of just 5% of rental revenue.
- Investments in infrastructure paying out
  - 16lane road 8.5kms length from Delhi to Golf Course road nearing completion
  - Cybercity metro investments and highway spend
- Consolidated Borrowing costs reduced y-o-y from 11.86%(11.48% standalone) to 11%(10.55% for standalone)
- CSR Spend of 10.4crores is fully spent
- Around 2000 permanent employees of which 18% women
- MD&A section contains details on litigation notably SEBI, COMPAT and P&H court orders. This is material but cannot be fully appreciated from the annual report.
- .

- Possible transfer pricing complexity here-since holding company does NOT account for majority of assets or profits. Below table indicates this. There does not seem negligible risk of tunneling since these key entities are nearly all 100% owned. But this profit split is strange

Consolidated Profit split of DLF Group	Share in Net Assets	Share in Profit/Loss in 2015-16	DLF Ownership
Legal Entity	%	%	
DLF Limited	59%	-139%	Holding Company
DLF Cyber City Developers Limited	21%	177%	100%
DLF Assets Private Limited	5%	113%	100%
DLF Home Developers Private Limited	4%	209%	100%
DLF Info City Developers(Chennai) Limited	12%	-27%	100%
DLF Utilities Limited	-3%	-171%	99.97%
Minority interests	0%	13%	
DLF Commercial Projects Corporation	0%	-23%	100%
DLF Southern Homes Private Limited	0%	-24%	51%
DLF Commercial Developers Limited	6%	-11%	100%
DLF Universal Limited	-2%	-15%	98.49%
Sub Total	101%	101%	
Other entities combined	-1%	-1%	
Overall	100%	100%	

Reliance Industries

- It is not everyone's favourite pastime to open a 400+pg annual report, but I could not resist the urge to read the RIL annual report once it was released. Here goes my takeaways(in no particular order). Those interested can download it from http://www.ril.com/getattachment/56a9a0bd-d1e1-4735-9e8f-ece1e7e71e87/AnnualReport_2015-16.aspx
- As versus prescribed CSR spend of ~56 crores, they have spent ~67 crores. Interestingly, nearly 90% of this is via Reliance Foundation and not directly.
- They have a CFO and a Joint CFO, who earn Rs 14crs and 11crs respectively. The division of work between them is not too clear
- Pg 13 and Pg 53 highlight Reliance's products in everyday life, and the product cycle chemistry. This is a must read for everyone
- Mukesh Ambani has accepted remuneration of ~40% of his approved limit, in an effort to set a personal example for moderation in managerial remuneration.
- Jio's strategy seems similar to Wechat, in my view, considering the wish to integrate payments, communication and ecommerce. Would be interesting if they succeed.
- On reading the ambitious plan for Jio which would account for ~20% of group capital employed, I decided to hunt for reviews of the pilot launch. This link(http://techpp.com/2016/05/26/reliance-jio-apps/) is not very complimentary of the user interface, and therefore apps like Magzter, Netflix could rest easy for some time
- Under Prabir Jha, Reliance had switched to employee friendly initiatives like a 5 day week, RALP etc. But now, there is hardly any mention of HR in the report. While Reliance has a good employee brand (maybe not among IIM graduates but overall), the report could have focused more on building this
- The company is VERY science and technology focused as evident from the space devoted to the discussion.
- Reliance achieved a 7yr high GRM/barrel of $10.8, which it attributes to *The ability to operate at high utilisation levels and switch product slate to suit market conditions enabled RIL to capture margin optimisation opportunities in the market.*
- Under an innovation program GenNexHub, the company encourages startup via incubatio as follows: D*uring the four-month-long programme, GenNext Hub conducts workshops and mentoring sessions for start-ups in the areas of customer development, market traction, operations, product roadmap, fund raising and pitching. It also provides expertise in IP, legal, financial compliance, HR and specific sectorial expertise. GenNext Hub is uniquely positioned as a global programme that helps start-ups think big and grow fast.* This seems inspired by Rocket Internet, since the areas are not too relevant to Reliance.
- The financials were not too insightful but that is only to be expected from a company audited by the Big4.

Tata Power & Adani Power

- Brief Facts
- **Facts in brief**
- Adani and Tata had bidded for coal based power plants respectively with capacities tied up under power purchase agreements (“PPAs”) for twenty five years with substantially fixed tariffs. The PPAs for these plants were made based on the commitments / understanding that domestic coal linkages would be available to meet the fuel requirements. However, adequate coal linkages were not made available due to various reasons not attributable to the respective subsidiary companies. In response to pleas for compensating the losses due to above, the respective state electricity regulators had granted part relief in form of interim compensatory tariffs, however this matter was litigated and has not reached finality as of now.
- **Auditors Report**
- Both the below companies are audited by the same Big 4 auditor Deloitte. Yet on very similar facts and the identical rulings, the companies took a very different view to revenue recognition, and the . Tata Power conservatively chose not to record revenue considering the high stakes involved, while Adani Power decided to record it basis management assessment. Accounting risk is therefore higher in the latter, from an investor perspective. While the statutory auditor has qualified the audit report in Adani possibly for this reason citing it as an internal control weakness, this is more a process rebuke than calling it wrong accounting
- *According to the information and explanations given to us and based on our audit, a material weakness has been identified as at 31st March, 2016 in the Company relating to inadequate internal financial controls over financial reporting in respect of revenue recognition on account of additional tariff claims pending determination by regulator, and final outcome of the litigations.*
- **Takeaway**
- As a veteran reader of annual reports would know, accounts (even audited ones) are subject to several adjustments/interpretations. This is because on the same facts, different people can take the same view. Auditors merely ensure that the management interpretation does not cross canons of incorrectness.

- Company Disclosures
- **Stance taken by Adani Power-Recognize revenue**
- *As per the assessment by the Management, it would not be unreasonable to expect ultimate collection of an equivalent amount as the CT towards relief due to impact of Force Majeure events which is predicated on the legal advice that the CERC may be guided by the principles of restitution / mitigation of the impact of the promulgation of the Indonesian Regulations and non-availability of short supply in determining the extent of impact of Force Majeure events. In view of the aforesaid, the Company has continued to recognise total revenue of H3,374.66 Crores on account of the CT upto 31st March, 2016 (including H674.19 Crores for the year ended 31st March, 2016 and H857.35 Crores for the year ended 31st March, 2015) based on the formula and methodology prescribed by CERC vide its order dated 21st February, 2014 considering the same as the most appropriate basis for measuring impact of the Force Majeure*
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- **Stance Taken by Tata Power-No revenue recognition-Director's report for FY 2015**
- *CGPL has been legally advised that it has a good arguable case. However, in view of the pending appeal as mentioned above and considering that the amounts associated are significant, CGPL has not recognised revenue amounting to ` 757.89 crore for the year ended 31st March, 2015 and ` 1,019.06 crore for the period from 1st April, 2012 to 31st March, 2014.*
- Above stance not expected to change as the company has not recorded this income in the audited accounts for the year ended 31 Mar 2016.

Some useful references

- http://www.drvijaymalik.com/2014/10/selecting-top-stocks-to-buy-part-4_25.html
- http://zerodha.com/varsity/chapter/read-annual-report-company/
- https://www.quora.com/How-do-hedge-fund-managers-look-at-a-companys-financial-statements
- https://www.quora.com/How-do-investors-like-Warren-Buffett-Carl-Icahn-and-David-Einhorn-read-financial-statements