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Accounting Gimmickry and Some Seemingly Low Prices

This is a warning about a sizeable number of companies, which have operated somewhat like Ponzi schemes. These companies have been able to show sizeable increase in Profit after Tax, by getting convertible debt in form of Foreign Currency Convertible Bonds (FCCBs). These bonds provided companies with capital and were convertible to equity at prices higher than prevailing prices. The interest payments on these bonds are almost always zero. Higher capital leads to higher profits as there were no interest payments and very little equity dilution. Higher profits lead to higher share prices and still bigger issuance of FCCBs. All this was great till stock prices only moved up and FCCBs were basically treated as form of equity financing. Recently however, with the rapid fall in share prices many companies now face the possibility of paying up for bonds as their share prices are a fraction (sometimes close to 10%) of their conversion prices. There have are two clear issues here:

1. The profit of the companies was overstated as there was no allowance made for payment of interest on FCCBs, in case they were not converted in to equity.
2. Some companies will face the possibility of default, as they are not in position to pay back their FCCBs.

The first issue is faced by most of the companies issuing FCCBs and we will provide an illustration of the same. The second issue is not as big, at least not yet. We leave its discussion to future.

Consider the following illustration:

All figures in Rs Crores

Share Capital and Reserves	1500
Loans	
Unsecured Loans(FCCBs)	1500
Secured Loans	500
Total Capital	3500

Table 1

<i>Income : Current Accounting</i>	
Profit before Interest and Tax	350
Interest	50
Profit before Tax	300
Tax	100
Profit After Tax	200

Table 2

<i>Income: Fair Accounting</i>	
Profit before Interest and Tax	350
Interest	200
Profit before Tax	100
Tax	33
Profit After Tax	67

Table 3

Consider the liability side of balance sheet and few relevant lines in profit and loss account of a company which has issued FCCBs. FCCBs are treated as unsecured loans. The total capital with the Company is Rs 3500 crores. It comprises of Rs 1500 crores of shareholders equity, Rs 500 crores of secured debt and Rs 1500 crores of FCCBs.

The current accounting practices are illustrated in Table 1. No provision has to be made for the fact that FCCBs may not be converted and will lead to payment of interest. Interest payment of Rs 50 crores is made on secured debt. Now consider a scenario in which the FCCBs are not converted. This is the most likely scenario now. We could assume that the effective interest payment would be similar to secured bonds. FCCBs have to be redeemed at a certain price. However, most companies now cannot afford to make such payments. The payment terms will at best be modified and at worst there will be a default. We can reasonably assume that the repayment will include an interest payment at close to secure lending rates. In most cases that will exceed 10%. The end result is that the profit after tax gets reduced by 67%. In other words the profits are overstated by three times. In some cases the profit would turn into a loss. Investors should be careful before investing in companies which have got sizeable capital through FCCBs. The low PE ratios for these companies are misleading as earnings are clearly overstated.