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Recently, multiple cases of frauds have come to light where shareholders have suffered near permanent loss of their capital because of dubious promoters or management. In addition to financial and business analysis, assessing the quality of management in equally important. Before investing in any company you must evaluate management’s

Competency
Integrity
Management’s competency will influence upside return while Integrity is essential to protect from downside risk.

In this post, we will discuss how to evaluate management’s Integrity.

But how do you judge someone’s integrity when you barely know them. Can a prudent investor really identify such dubious management and avoid getting financially hurt?

Yes, in most of the cases there are some red flags in the financial reports long before management flees the country. Some of the indicators of dubious management and poor Corporate Governance are –

Poor quality of earnings
Excessive management remuneration
Excessive related party transactions
Convolute Company structure
Constant change of auditors
Very high auditor remuneration
Low representation of Independent directors etc.
A skeptic in you might think that company’s auditors or bankers have access to all necessary financial documents but they rarely suspect any irregularity. On the other hand an average investor has only quarterly and annual reports and whatever information management voluntarily disclose. Based on limited information at your disposal, can you really detect management’s frauds?

Well, you cannot. But the good news is, you do not need to detect any fraud. As an investor you are concerned with whether to invest in a company or nor. For that you need to assess if the management is trustworthy. If the management is involved in fraudulent activities, then there are traces of their treachery at different places.

One of India’s leading diamond and jewelry companies and its promoter are constantly in news for all the wrong reasons. We had analyzed this company in 2013, we did not figure out that the company was forging Letter of Undertakings. But we observed [1] that-

The company had high debt, low interest coverage, lack of any internal cash flow generation.
It was completely dependent on borrowings or equity dilution for day to day operations.
Management had overpaid while acquiring a company from related party.
Their Quality of Earnings were poor. They had manipulated earnings by differing expenditure.
In many cases, an increase in gross margin coincided with a drastic rise in inventory and receivables.
So we concluded that this is not a good quality company and it is better to stay away from it.
No matter how smart the management is, there are always some red flags. You may not be able to diagnose the disease, but you can definitely identify the symptoms.

In another company which came under SEBI scanner for alleged price and volume manipulation of its own scrip, scrutiny of shareholding pattern reported at different sources revealed that the company was misreporting its shareholding and was likely manipulating traded volumes on the stock exchange.

You can refer this blog for an in-depth analysis of all issues with this company.

So I will reiterate, although you cannot pinpoint the fraud, the financials leave you enough clues to identify dishonest management behavior.

Some examples-

Aggressive targets
A Sweden based diversified Climate Solutions provider has stated in its Annual Report that-

*“We have concluded that, in the relatively mature market in which we operates, organic*

*growth alone cannot reasonably be expected to meet our overall year-on-year growth target of 20%. We have therefore made clear that organic growth must be complemented by growth through acquisitions that averages 10% a year, which we also believe involves a reasonable element of risk. Since the stock market listing, acquired growth has amounted to an average of 11% annually.”*

If growth is a driving rationale for acquisition, there is a risk of capital misallocation and misreporting.

Unreasonable remuneration packages

When an international company acquired majority stake in an Indian logistics company from erstwhile promoters, one of the terms of sale of shares by the promoters was that, the Company offers onetime retention compensation to the Managing Director. The retention package equal to 4 times his remuneration was paid as his continued employment was considered as the key element of Company’s success. However he resigned from the post of MD in less than a year.

Here shareholders paid the former MD for continuing his service, but he served the company hardly for a year.

Unreasonable Deposits

A company operating pre-schools in India had leased some of the premises from promoters. Securities deposits placed with promoters for lease of corporate office and premises were more than 30 times the annual rents in 2009 and 2010.

It indicates that under the disguise of rent deposits shareholders’ funds were given to promoters free of charge.

High Royalty Rates

Parent companies often charge royalty fees to their subsidiaries for using parent’s trademark and brand. By increasing royalty rates, parent companies can increase their share in total profits at the expense of minority shareholders.

A global FMCG was charging ~3.5% royalty to its Indonesian subsidiary till 2012, however in

Dec 2012, when they renewed the agreement, total fees payable to parent were doubled.

| Fees to Parent | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| As a % of Revenue | 3.6% | 3.3% | 3.4% | 3.3% | 3.2% | 3.4% | 4.5% | 5.6% | 7.0% | 6.9% |

Royalty rates charged by the parent to its other listed subsidiaries are-

| Subsidiary in | % of Sales |
|---|---|
| Indonesia | 7.0% |
| India | 3.2% |
| Pakistan | 3.1% |
| Nigeria | 2.5% |

The parent is charging highest royalty to its Indonesian subsidiary. It also indicates a risk that, in future the parent may elevate royalty rates of other subsidiaries.

Launching products through privately owned company – MNCs operate through listed entities as well as wholly owned subsidiaries in Indian market. If majority of new product launches are through wholly owned companies, minority shareholders of listed entities do not get a chance to participate in growth opportunities.
If you conclude that a company's management is not trustworthy, it is prudent to stay away from such companies, no matter how attractive the stock price or valuation is. Any number, no matter how high when multiplied by a zero results in a zero.

Notes:

Not All that Glitters is Gold ↩