Chapter 2

Summary of financial statements

Introduction

This is not a treatise on financial analysis, but rather a consideration of the interrelations existing between the various components of the balance sheet and income statement and financial ratios which it is essential to understand in the preparation of cash flow forecasting.

In particular, we are concerned with the interrelationships existing between the income statement, balance sheet, and various financial ratios summarizing their interrelationships, and which can be manipulated with ‘cash drivers’ to project key accounts.

We therefore touch upon these topics as they relate to the manipulations required in effecting financial analysis.

The accounting process is divided into two basic elements, recording and reporting of financial information. The emergence of the large-scale limited liability company has been the single most important factor stimulating the need for financial reports. The larger and more complex the company, the more remote the management can become from day-to-day operations, and the more reliant they have to become on accounting information. In addition, the company that borrows money will need to demonstrate its financial solidity to its bankers, and financial statements are used by bankers and others as part of the basis for lending decisions.

In recent years, there has been recognition that there may be a large number of different parties with a legitimate interest in a company's performance:

- the equity investors – existing and potential shareholders
- the loan creditors – including existing and potential holders of debentures and loan stock, and providers of short-term unsecured loans and finance
- the company's bankers
- the company's employees
- the analysts/advisers – this will include financial analysts and journalists, economists, researchers, stockbrokers etc.
- customers, trade creditors and suppliers
- tax authorities, supervisory bodies, local authorities
- the general public – including taxpayers, consumers, political parties, and consumer and environmental groups.

Each of the groups will have a common interest in the financial statements of a company, but will use the information as the basis for different types

Table 2.1 Comparison between continental European and Anglo-Saxon accounting systems

	Continental European	*Anglo-Saxon*
Capital markets	Mainly from banking sector	Mainly stock markets
Culture	State-focussed	Individualistic
Legal system	Law provides detailed accounting rules	Rules from standard setting bodies
Fiscal system	Accounting/tax closely connected	Accounting not influenced by tax rules
Examples of countries	Belgium Germany France Italy Japan Switzerland	Australia Great Britain Ireland The Netherlands Singapore USA
Users of information	Creditors, taxman, investors	Notably investors
Accounting principles	Prudence	True and fair principle dominates

of decisions. There are differences in the amount of financial information made available to each of these groups, caused by different legal requirements and the company's management decisions as to what they wish to make available.

The annual report and accounts

The publication of an annual report and accounts by a company supposedly provides its shareholders and others with a means to keep themselves informed on the activities and financial position of the company.

The style and content of the annual report and accounts will vary from company to company, depending on the directors' design ideas and the financial resources available for the printing and designing of the report. Many companies will use their report and accounts as a marketing tool. However, there is a minimum amount of information that the law requires a company to print in the report and accounts. These requirements include four basic components:

1 The directors' report
2 A report by the company's auditors
3 A balance sheet and a profit and loss account
4 A statement of accounting policies and notes to the accounts.

Companies that are listed on the London Stock Exchange have to also produce a half-yearly interim report, and their annual report and accounts have to contain more information than do those of unlisted companies.

Under the Companies Acts, directors have a legal responsibility to prepare and publish accounts that give a 'true and fair' view of their company's financial affairs. The legal requirements currently in force are contained within the Companies Acts 1985 and 1989.

With reference to the Company's Act, the accounts must be delivered to the Registrar within a time limit fixed by reference to its accounting year end. The limit for a public company is seven months from its accounting year end. The Stock Exchange requires listed companies to issue an annual report within six months of the date of their financial year end.

Companies are also required to file with the Registrar the following information:

- copies of their Memorandum and Articles of Association, and details of subsequent changes
- the address of their registered office, and the place at which the company's registers are kept (e.g. a rented bedsit at Land's End)
- details of the company's share capital and debentures
- details of each mortgage and charge on the assets of the company
- a list of the directors and secretary, and any changes.

Statements of standard accounting practice, and financial reporting standards

There are various methods available for valuing and accounting for the different business assets (what the company owns) and liabilities (what the company owes). It is important that the company should state which policies have been employed, in order to enable the reader correctly to interpret the company's financial statements. The way a company's assets are valued can have a direct impact on profits. In the UK, accounting regulations operate under a specific regime:

The *Accounting Standards Committee* (ASC) was set up in 1970, and issued *25 Statements of Standard Accounting Practice* (SSAP).

The *Accounting Standards Board* replaced the ASC in 1990. The ASB adopted all of the SSAP, and in addition have been issuing further accounting standards, which are known as *Financial Reporting Standards* (FRS).

SSAP and FRS are guidelines for the production of company financial statements by accountants and the company, and some of their recommendations have been incorporated into the Companies Acts and have the force of law.

SSAP2 relates to the disclosure of accounting policies. It aims to ensure that companies prepare their accounts in accordance with certain fundamental accounting 'concepts', which it specifies. Companies report which accounting 'policies' they have chosen from the accounting bases available for the purpose of valuing the assets and liabilities that appear in their accounts.

Company accounts are based on the following four premises:

1 *The going concern concept.* This assumes that the company will continue in business for the foreseeable future. The main effect of this assumption is that the liquidation value of fixed assets (which may be significantly different from the book value) may be ignored.
2 *The accruals (or matching) concept.* This requires that the revenues be matched with related expenses when measuring profit, and that revenues and expenses be included in the profit and loss account as they are earned and incurred rather than when they are received and paid.
3 *The consistency concept.* This requires the company to use the same accounting policies for valuing similar assets both within the accounting period and during consecutive accounting periods.
4 *The prudency concept.* This states that companies should not anticipate profits, but requires them to provide for all foreseeable losses.

'Accounting policies' is the term used to describe the accounting methods chosen by a particular company for the purposes of valuing assets and liabilities. The main provisions of SSAP2 are given statutory backing by the Companies Act 1985. The accounting policies on which a company's accounts are based are shown at the beginning of the notes to the accounts, and typically will include the basis of accounting for:

- sales
- deferred taxation
- depreciation of fixed assets
- investment grants
- research and development
- stocks and work in progress
- extraordinary items
- translation of foreign currencies.

There are at least three important points of interaction between the profit and loss account and the balance sheet where if abnormal accounting policies are used they can materially alter the company's reported profits:

1 *Valuation of stock* – the higher the value at the end of the accounting period, the lower the cost of goods sold and therefore the higher the profit.
2 *Depreciation* – the lower the charge for depreciation in the accounting period, the higher the book value of assets carried forward and the higher the reported profits.
3 *Capitalizing expenditure* – all expenditure incurred by the company must either add to the total asset value in the balance sheet or be charged in the profit and loss account. Any amounts that can be capitalized will increase profits directly, as this would otherwise be a charge against profits. There will be an increased profit today against future years, when the higher capital value of fixed assets will require a higher depreciation charge and therefore reduce profits. Items that are sometimes capitalized include research and development costs, interest incurred on projects during construction, and start-up costs (e.g. advertising and promotional costs associated with launching a new product).

Consequences of fraudulent manipulation of accounts

If the company overstates its profits in the accounting period, it may be difficult to sustain them in the future. Once a company starts to cook the books, it becomes even more necessary to continue to do so in future.

Such practices are euphemistically known as 'creative accounting', although a more accurate description is manipulating the accounts or fraudulent accounting. It is sad to say that to carry this deception off, two parties need to play the game – the company and the company's auditors. Often the company's auditors participate in the deception since they feel they must please the client in order to keep the lucrative accounting business, as well as to be considered for even more lucrative consulting services! Accountants failing to please the client obviously will not be selected for lucrative consulting assignments. Hence the entire process of the auditing of financial statements by auditors could be considered to be compromised by commercial conflicts of interest.

Industry sources have admitted as much, saying that the accounting profession has lost its credibility and reliability and is in a state of dysfunction. Useful additional reading on this is provided by *Accounting for Growth*, by Terry Smith (see Suggested Reading).

The auditors' report

Every company is required to appoint at each of their annual general meetings an auditor to hold office from the date of that meeting until the next annual general meeting. This will usually be a firm of accountants.

The Companies Act 1985 made it an offence for a director or company secretary of a company to give false or misleading statements to their auditors.

The auditors are required to report to the shareholders of the company whether, in their opinion, the balance sheet, profit and loss and other financial statements have been properly prepared in accordance with legislation, and whether these give a true and fair view of the profitability and state of affairs of the company. If the auditors feel that the accounts have not been properly prepared, that the records do not accord with fact and/or they have not been able to obtain all the information that they need in order to give an informed opinion, they must state this in their report; this is known as qualifying the audit report.

It is important to note that the auditors' report does not certify the accuracy of the accounts, but expresses the opinion that the accounts show a true and fair view of the company.

An auditors' report should contain a clear expression of opinion on a company's financial statements. The opinion will be unqualified (i.e. everything appears to be in order as laid down by the Institute of Chartered Accountants Audit Policies) or qualified.

A qualified opinion is expressed by the auditors when either there is a limitation on the scope of the auditors examination of the company's accounts and affairs, or the auditor disagrees with the way a matter has been treated or disclosed in the financial statements.

An adverse opinion is expressed by the auditors if their disagreement with the company is so material or pervasive that they feel that the company's accounts are seriously misleading and do not give a true and fair view of the company's situation.

A disclaimer of opinion is expressed by the auditors when the possible effect of a limitation on the scope of the audit is so material that the auditors have been unable to obtain sufficient material to support or express any opinion on the financial statements.

Fundamental uncertainty is where an inherent uncertainty exists which in the auditors' opinion is fundamental and is adequately accounted for and disclosed in the accounts. Here, auditors will include an explanatory paragraph in their report, making it clear that their opinion is not qualified by this.

The balance sheet

The balance sheet (see Figure 2.1) is one of the basic components of the company's report and accounts. It is a statement of the assets (what the company owns) and liabilities (what the company owes) of a company at the close of business on a stated date – 'the balance sheet date'.

The balance sheet shows:

- how cash is invested in the business
- how the assets are balanced with the liabilities
- how the company is financed.

Table 2.2 provides an example of the balance sheet as you are likely to encounter it in a 'spreadsheet'. Spreadsheets recast heterogeneous company account presentations into a standardized format to facilitate analysis and manipulation by analysts into forecasting models and peer group analysis.

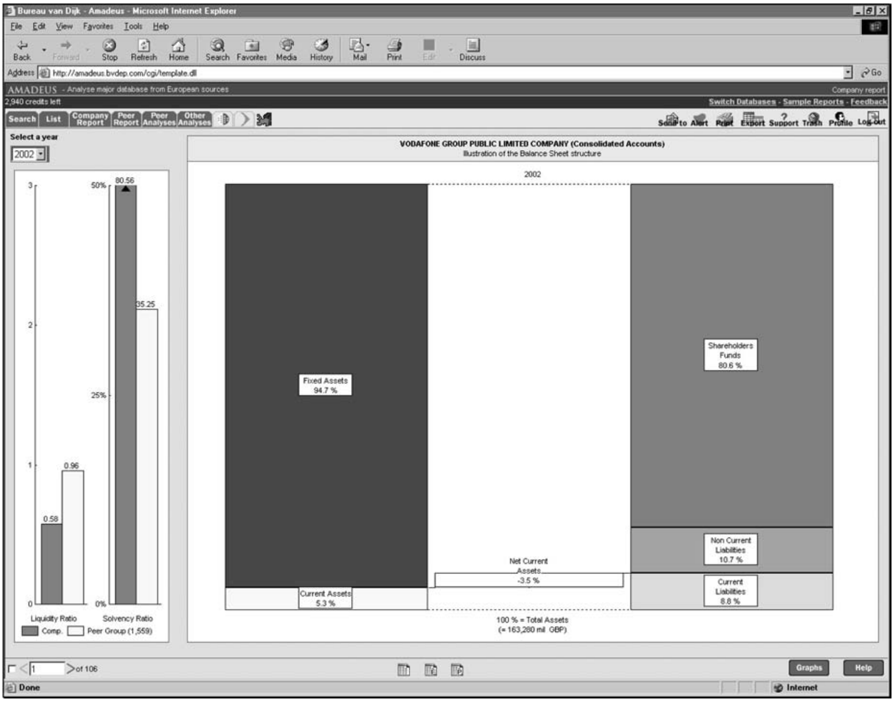

Figure 2.1 Simple balance sheet
Source: Bureau Van Dijk, AMADEUS 2004

Assets and liabilities

Assets

On the assets side we have fixed assets, which are the tangible assets that the company has bought and can be such things as a factory or office premises, machinery, tables and chairs and motor vehicles.

Also on the assets side of the balance sheet is a heading for current assets. These are assets that the company expects to turn into cash within 12 months from the balance sheet date. They can include stocks of goods and also cash deposits.

The balance sheet will always balance – that is, the figure for total liabilities must always be the same as for total assets. If not, something has been missed or wrongly accounted for.

Table 2.2 Balance sheet as a spreadsheet

NAME:	IT Services			
LOCATION:	England			
BUSINESS:	Manufacturing			
AUDITOR:	XYZ	FYE	31 DEC	
CONSOLIDATED:	Consol, €	€ (000)		
ASSETS	**2000**	**2001**	**2002**	**2003**
Cash	133	921	227	186
Marketable Securities				
Accounts Receivable – Trade	106,613	116,128	132,292	141,819
Accounts Receivable – Other				
Sundry Current Assets				
Inventory	34,986	30,466	44,883	43,956
Raw Materials				
Work in Progress				
Finished Goods				
Other				
CURRENT ASSETS	**141,732**	**147,515**	**177,402**	**185,961**
Land, Buildings, Equipment	1,228,115	1,356,033	1,553,581	1,675,825
Leased Assets	71,150	77,441		
Plant in Construction				
Accumulated Depreciation	−69,062	−140,637	−215,322	−301,728
TOTAL OTHER GENERAL ASSETS	**1,230,203**	**1,292,837**	**1,338,259**	**1,374,097**
Quoted Investments				
Unquoted Investments				
Invest in Associated Companies				
Loans to Associated Companies				
Prepaid Expenses				
Sundry Assets				
Goodwill				
Other				
TOTAL ASSETS	**1,371,935**	**1,440,352**	**1,515,661**	**1,560,058**
LIABILITIES				
Bank Loans and O/Ds				
Other ST Debt				
CPLTD				
CPLO				

(*continued*)

Customer Prepayment				
Accounts Payable	140,964	125,885	134,330	125,835
Accrued Expenses	152,132	142,550	137,866	139,555
Income Tax Payable				
Dividends Payable				
Due to Affiliates				
Sundry CL 1				
Sundry CL 2				
CURRENT LIABILITIES	**293,096**	**268,435**	**272,196**	**265,390**
Long Term Debt	826,231	943,612	1,023,407	1,058,017
Subordinated Debt				
Total Long Term Debt	826,231	943,612	1,023,407	1,058,017
Other Creditors				
TOTAL LIABILITIES	**1,119,327**	**1,212,047**	**1,295,603**	**1,323,407**
Deferred Taxes				
Minority Interest				
Common Stock	335,315	335,315	335,315	335,315
Preferred Stock				
Capital Surplus				
Revaluation Reserve				
Legal Reserve				
FX − Translation Reserve				
Retained Earnings	−82,707	−107,010	−115,257	−98,664
NET WORTH	**252,608**	**228,305**	**220,058**	**236,651**
TOTAL LIABILITIES & NET WORTH	**1,371,935**	**1,440,352**	**1,515,661**	**1,560,058**
Cross-check (TA-TL)	0	0	0	0
Contingent Liabilities:				

NAME:	IT Services			
LOCATION:	England			
BUSINESS:	Manufacturing			
AUDITOR:	XYZ FYE 31 DEC			
CONSOLIDATED:	Consol, € € (000)			

PROFIT & LOSS	**2000**	**2001**	**2002**	**2003**
NET SALES	493,308	467,106	516,063	553,192
Cost of Sales	440,885	360,035	376,538	370,681
Depreciation	69,062	71,575	74,685	86,432
Amortization of Goodwill				
Capital Grants	−52,872	−39,412	−51,984	−41,865
GROSS PROFIT	**36,233**	**74,908**	**116,824**	**137,944**
SGA	−17,345			
NET OPERATING PROFIT	**53,578**	**74,908**	**116,824**	**137,944**
Net Interest Expense	135,606	123,202	128,760	125,628
Interest Income				
Prov Dbt Recv				
Equity Income	−8,090	−6,600	−7,092	−3,935
	−648	−46		
NPBT	**−73,290**	**−41,648**	**−4,844**	**16,251**
Provision for Income Tax				
Deferred Tax Provision				
NPAT	**−73,290**	**−41,648**	**−4,844**	**16,251**
Unusual Items:				
FX Gains/Losses	9,373	−21,222	6,508	−342
Unrealized F/X Gain/Loss		9,744	1,256	
Realiz Profits of Rel Co				
Reval Reserve				
Sundry Res	44	−5,867	−4,361	
Goodwill on Consol				
Unexplained Adjustment				
NPAUI	**−82,707**	**−24,303**	**−8,247**	**16,593**
Dividends – Common				
– Preferred				
Min Int Expense				
RETAINED EARNINGS	**−82,707**	**−24,303**	**−8,247**	**16,593**
Changes in Net Worth				
Stock Sold		0	0	0
Purch Own Stock				
Chg. in Cap Surplus		0	0	0
Chg. in FX Reserve		0	0	0
Chg. in Reserves		0	0	0
Other		0	0	0
INCREASE IN NET WORTH	**−82,707**	**−24,303**	**−8,247**	**16,593**
Cross Check RE:	–	0	0	0
Cross Check NW:	–	0	0	0

(*continued*)

NAME:	IT Services		
LOCATION:	England		
BUSINESS:	Manufacturing		
AUDITOR:	XYZ	FYE	31 DEC
CONSOLIDATED:	Consol, €	€ (000)	

FACT SHEET	2000	2001	2002	2003
ROE (%)	−29.01%	−18.24%	−2.20%	6.87%
ROS (%)	−14.86%	−8.92%	−0.94%	2.94%
ATO	0.36	0.32	0.34	0.35
ALEV	5.43	6.31	6.89	6.59
Sales (M/MM)	493308	467106	516063	553192
Chg. in Sales (%)	#N/A	−5.3%	10.5%	7.2%
CGS/S (%)	89.4%	77.1%	73.0%	67.0%
GPM (%)	7.3%	16.0%	22.6%	24.9%
SGA/S (%)	0.0%	0.0%	0.0%	0.0%
NOP/S (%)	10.9%	16.0%	22.6%	24.9%
TIE	0.4	0.6	0.9	1.1
IE/Av. FD (%)	16.41%	13.92%	13.09%	12.07%
NPBT/S (%)	−14.9%	−8.9%	−0.9%	2.9%
Inc. Taxes/NPBT (%)	#N/A	#N/A	#N/A	0.0%
NPAT/S (%)	−14.9%	−8.9%	−0.9%	2.9%
NPAUI/S (%)	−16.8%	−5.2%	−1.6%	3.0%
Div./NPAT (%)	0.0%	0.0%	0.0%	0.0%
Work. Investment	−151497	−121841	−95021	−79615
Chg. in WI (%)	#N/A	#N/A	#N/A	#N/A
WI/S (%)	−30.7%	−26.1%	−18.4%	−14.4%
AR DOH	79	91	94	94
INV DOH	29	31	44	43
RM DOH	0	0	0	0
WIP DOH	0	0	0	0
FG DOH	0	0	0	0
AP DOH	117	128	130	124
AE DOH	126	145	134	137
Av. GP T/O	6.93	6.29	13.33	#N/A
Av. NP T/O	236.26	#N/A	#N/A	#N/A
Av. GP/DepExp.	1.38	1.04	0.52	#N/A
Av. AccDep./DepExp.	1.34	1.46	2.38	2.99
Av. NP/DepExp.	0.04	#N/A	#N/A	#N/A
Current Ratio	0.48	0.55	0.65	0.70
Quick Ratio	0.36	0.44	0.49	0.54
Coverage Ratio	0.13	0.12	0.14	0.14
CMB Leverage	4.43	5.31	5.89	5.59
% of Total Footings:				
STD (+CPLTD + CPLO)	0.0%	0.0%	0.0%	0.0%
Spont. Fin.	21.4%	18.6%	18.0%	17.0%
LTD	60.2%	65.5%	67.5%	67.8%
Grey Area	0.0%	0.0%	0.0%	0.0%
Equity	18.4%	15.9%	14.5%	15.2%
CA	10.3%	10.2%	11.7%	11.9%
Net Plant	89.7%	89.8%	88.3%	88.1%
Other	0.0%	0.0%	0.0%	0.0%
Asset Cover (TA − TSL/TA)	18.4%	15.9%	14.5%	15.2%
WC Adequacy (WC/CA)	−106.8%	−82.0%	−53.4%	−42.7%
Reliance on Inventory	532.6%	496.9%	311.2%	280.7%
Change in WC (%)	#N/A	#N/A	#N/A	#N/A

NAME:	IT Services		
LOCATION:	England		
BUSINESS:	Manufacturing		
AUDITOR:	XYZ	FYE	31 DEC
CONSOLIDATED:	Consol, €	€ (000)	

CASH FLOW	**2001**	**2002**	**2003**
NPAUI: NET PROFIT AFTER UNUSUAL ITEMS	**−24,303**	**−8,247**	**16,593**
+ Interest Expense	123,202	128,760	125,628
Unusual: Plant	−21,222	6,508	−342
Investment	9,744	1,256	0
FX − Adj.	0	0	0
Other (1 + 2)	−5,867	−4,361	0
Other (3 + 4 + 5)	0	0	0
− Interest Income	0	0	0
− Dividend Income	−46	0	0
− Equity Income	−6,600	−7,092	−3,935
− Commission Income	0	0	0
Sundry Inc./Exp.	0	0	0
Prov. f. Income Tax	0	0	0
− Income Tax Paid	0	0	0
+ Prov. f. Def. Tax	0	0	0
− Def. Tax Paid	0	0	0
− ITC (Gov't Grants)	0	0	0
NOPAT: NORMALIZED OPERATING PROFIT AFTER TAX	**74,908**	**116,824**	**137,944**
+ Depreciation	71,575	74,685	86,432
+ Amort. of Goodwill	0	0	0
+ Prov. f. Dbtf. Rec.	0	0	0
COPAT: CASH OPERATING PROFIT AFTER TAX	**146,483**	**191,509**	**224,376**
Gross (Net) A/Rec.	−9,515	−16,164	−9,527
− A/Rec. charged off	0	0	0
Inventory	4,520	−14,417	927
Cust. Prepayments	0	0	0
Acc./Payable	−15,079	8,445	−8,495
Accrued Expenses	−9,582	−4,684	1,689
Chg. Work. Inv.	−29,656	−26,820	−15,406
Prepaid Expenses	0	0	0
Due to Affiliates	0	0	0
Sundry C.A.	0	0	0
Sundry C.L. (1 + 2)	0	0	0

(*continued*)

CACO: CASH AFTER CURRENT OPERATIONS	**116,827**	**164,689**	**208,970**
− Interest Expense	−123,202	−128,760	−125,628
− CPLTD (incl. CPLO)	0	0	0
= Finan. Payments	−123,202	−128,760	−125,628
CBLTU: CASH BEFORE LONG TERM USES	**−6,375**	**35,929**	**83,342**
− Net Pl. Expend.	−112,987	−126,615	−121,928
Investments	−3,144	5,836	3,935
+ Interest Income	0	0	0
+ Dividend Income	46	0	0
Sundry Inc./Exp.	0	0	0
Market. Secur. + Dep.	0	0	0
Due from Affiliates	0	0	0
Sundry NCA	0	0	0
Sundry NCL	0	0	0
Unusual: all other	5,867	4,361	0
+ ITC (Gov't Grants)	0	0	0
CBF: CASH BEFORE FINANCING	**−116,593**	**−80,489**	**−34,651**
Short Term Debt	0	0	0
Long Term Debt	117,381	79,795	34,610
Minority Interest	0	0	0
Grey Area	0	0	0
FX − Translation G/L	0	0	0
− Dividends paid	0	0	0
Chg. in Net Worth	0	0	0
Change in Cash	**788**	**−694**	**−41**
Cash Account	**−788**	**694**	**41**
ADDITIONAL FIGURES:	**2001**	**2002**	**2003**
NOPAT/FP	0.61	0.91	1.10
NOPAT/(FP + DIV.)	0.61	0.91	1.10
FREE CASH FLOW	−48294	−11936	12316
FREE CF (after Div.)	−48294	−11936	12316
GROWTH FUNDED INTERNALLY	0.0%	0.0%	24.2%
G.F.I. (after Div.)	0.0%	0.0%	24.2%
YEARS TO SERVICE RATIO	#N/A	#N/A	85.9
Y.T.S. (after Div.)	#N/A	#N/A	85.9

Liabilities

On the liabilities side, we have a breakdown of the funding sources of the company.

When a company is formed, its members subscribe for shares – that is, they give money to the company in return for certificates which state that they own a certain percentage of the company. For example, in our simple balance sheet there is a figure of €335,315 shown as share capital. The cash raised by issuing these shares will be used in the business to buy fixed assets, such as an office or factory for the company's operations, machinery and motor cars, and to buy stock ready to start trading.

The share capital may not in itself be enough to pay all of the company's initial costs and to enable it to start trading. In our example balance sheet, there is a liability headed 'overdraft'.

The directors have negotiated credit terms with the suppliers of their raw materials and stock – i.e. the suppliers do not require immediate payment and become creditors of the company. To recap, creditors are people to whom the company owes money.

Therefore, on the liabilities side of the balance sheet we have:

- Share capital, put into the business by the shareholders
- Creditors, to whom the company owes money
- An overdraft facility representing money owed to the bank by the company.

Summary

We have taken a brief look at the assets and liabilities side of our simple balance sheet. We can summarize the balance sheet, as depicted in the preceding spreadsheet, as follows:

- *Fixed assets* show capital (funds) that is tied up on a long-term basis, i.e. assets that are not quickly and easily realizable. Tangible assets are the assets used in the operation of the business, and may include land, buildings, plant and machinery. Intangible assets may comprise goodwill, patents and licences, rights, monopolies, contracts and databases.

- *Current assets* can be readily converted into cash within a short period, normally one year.
- *Stocks* – reported profits are affected by the valuation a company places on its stock, as high value produces high profits. Accountants therefore insist that stocks are valued at the lower of cost or net realizable value.
- *Current liabilities* are debts due for payment in less than one year. These include bank overdrafts and payment to suppliers, and expiring loans.
- *Long-term liabilities* are debts that need not be repaid within one year. These may include bank loans and mortgages.
- *Called up share capital* represents the number of shares that have been issued by a company. (If trading ceased, any money left over after settlement of all of the company's other liabilities would be distributed amongst the shareholders *pro rata* according to the number of shares that each of them holds.)
- *Share premium* is the difference between the nominal (face) value of a share and the amount at which it is offered for sale to shareholders. Successful companies issue shares at a premium to their nominal value.
- *Revaluation reserve* – assets valued, such as land, may actually be worth more than their original cost. The difference between these two figures is the revaluation reserve – it is not profit that the company has actually realized in cash terms, and therefore is not distributable to shareholders.
- *Profit and loss account figure*. This is the sum total of profits accumulated by the business and retained for use in the growth and expansion of the business.
- *Shareholders' funds* is the owner's equity.
- *Notes* – several of the figures given in the balance sheet will be explained in more detail in the notes that appear towards the end of the accounts.

Debtors

Debtors (also known as accounts receivable) are a current asset, and represent amounts owed to the company. The balance sheet formats as prescribed in the Companies Act 1985 require the company to split their debtors figure into the following categories:

- *Trade debtors* – debts owed to the company arising from sale of goods to customers of the company on credit terms.
- *Amounts owed by group companies* – these amounts will represent inter-group trading activities, i.e. sums owed to the company by its parent company (if it is not itself the parent company), fellow subsidiaries or subsidiaries of its own.
- *Amounts owed by companies and other institutions in which the company has a participating interest* – that is, debts owed to the company by institution(s) in which the company has a holding of 20% or more of that institution's shares.
- *Other debtors* – for example, debts due to the company from the sale of fixed assets or investments.
- *Prepayments and accrued income* – for example, rent and rates paid by the company in advance.

Most companies will show a single figure for debtors in their balance sheet, but then break down the various categories in the notes section of their accounts.

Companies will have different debtor profiles. Supermarket chains will have very little showing in their accounts in the way of debtors, as most of their sales will be for cash; any debtors shown in their accounts are likely to be non-trade or prepayments. Other companies may conduct most or all of their trade on credit terms, and will have large debtor balances.

Some key questions to ask about debtors include:

- Customer concentration – is there too much reliance on one customer, or on one major industry? What would be the consequences to the company if it was to lose a major client? Unfortunately, in some instances the company will grant credit to a customer only to find that payment is not forthcoming.
- What is the age pattern of the debtors? Are some very old debts?
- Is there adequate provision for bad and doubtful debts?
- What is the company's credit granting policy (see Tables 2.3 and 2.4)?

Table 2.3 Country factors – terms of trade

Country	*Average payment terms (days)*
Finland	24
Denmark	35
Germany	38
Australia	43
UK	50
Ireland	59
France	64
Spain	73
Italy	84

Table 2.4 Industry factors – credit periods (days)

Industry	*1997 Q3*	*1996 Q4*	*1995 Q4*
Leisure and hotels	23	23	20
Building and construction	28	30	28
Breweries	35	35	38
Oil	42	48	43
Textiles and clothing	46	49	51
Builders' materials	49	53	46
Pharmaceuticals	60	69	61
Printing, paper, and packaging	61	66	64

Source: CCN Corporate Health Check.

Creditors

Creditors (also known as accounts payable) are those to whom the company owes money – for example, suppliers of raw material, who have given the company credit period in which to pay and are shown as liabilities in the balance sheet. They include the following categories:

- *Trade creditors* – suppliers to whom the company owes money. The size of the trade creditors figure will reflect the extent to which suppliers are financing the company's business. It is useful to compare debtor and creditor days to see if there is any serious imbalance between them. For example, if the company's credit period is 30 days then it is paying its bills in a 30-day period, but at the same time if it is giving 100 days' credit this could produce very serious cash flow problems for the company, and indicate a serious deficiency in the company's debt collection procedures – and very possibly bad debts.

- *Debenture (secured) loans* – when a company wishes to issue loan capital, it can offer the lender some specific security on the loan. If it does so, the loan is called a debenture, or debenture stock.
- *Bank loans and overdrafts.*
- *Payments received on account* – e.g. deposits from customers paid in advance for work which the company is undertaking or will undertake.
- *Bills of exchange payable* – a way of raising short-term capital for the company. A bill of exchange is used to finance the sale of goods when the seller wishes to obtain payment at the time the goods are despatched to the buyer, and the buyer wants to defer payment until the goods are received (or later). A bill of exchange payable in a company's creditors would indicate that the company has purchased goods and has accepted a bill of exchange acknowledging its debt to the supplier and promising to pay at some future time.
- *Amounts owed to group companies* – amounts owed to institutions in which the company has a participating interest.
- *Other creditors* – including tax and social security, which are shown separately.
- *Accruals* – apportionments of a known future liability in respect of a service which the company has already partly received.
- *Deferred income* – money received by or due to the company, which has not yet been earned.
- *Dividends proposed* – although the company cannot pay proposed dividends until they have been approved at the Annual General Meeting, these are always shown as a liability.

Stock and work in progress

Traditionally companies have shown stocks as a single figure under current assets, described as 'stocks' or 'inventories' or 'stocks and work in progress'. However, whichever term is used it covers three very different classes of assets:

1 *Raw materials* – components, consumables (such as paint and oil) used in the making of a product
2 *Work in progress* – items in the process of being turned from raw materials into the finished product
3 *Finished goods* – those either complete or purchased for resale.

The accurate valuation of stock on a consistent basis is crucially important to the company, because quite small variations can have a significant effect on the profits it reports. There are three main problems in valuing stock:

1 The price to be used if an item has been supplied during the year at varying prices
2 The value that is added to the item during the manufacturing process
3 Assessment of what the net realizable value of the items will be.

There are a number of different methods used to put a value on stock, of which the following are examples of the most commonly used:

- *First-in-first-out (FIFO).* This method of stock pricing assumes for accounting purposes that the stock has been used in the order in which it was received by the company. Therefore, if there have been price rises the stock which has not been used will probably be that which was purchased by the company at the higher price, and it can be valued accordingly.
- *Average or weighted average price.* Where a company receives a number of stock deliveries during an accounting period at different prices, the average price, or weighted average price, will be used.
- *Standard price.* Some businesses will employ a standard cost system. They predetermine for each item that they manufacture the price that should be paid for material, wages and so on. Materials issued from store are priced at a standard cost, as are work in progress and finished goods. Any variances from standard are written off as operating losses (or profits) at the time they occur. As long as the standard price fairly represents the average cost of the material in stock, it can be used for accounting purposes.

Borrowing as shown in a company's accounts

A company's borrowings will broadly fall into three categories:

1 Debentures and unsecured loan stock and bonds, which can be bought and sold in the same way as shares in a company, and can be held by the general public
2 Loans from financial institutions
3 Bank overdrafts.

The former two categories of borrowings are shown separately in the balance sheet, and in the notes to the accounts there will be descriptions of the terms under which each loan is repayable, the rates of interest applicable on each loan, and whether they are secured or unsecured. The bank overdraft is shown under the current liabilities heading in the balance sheet, although this only tells us the balance utilized – not the full extent of the facility available to the company from the bank.

The amount that a company can borrow may be limited by the following:

- The company's borrowing powers as limited by its Articles of Association (the internal rules upon which the directors run the company, which are filed with the Registrar of Companies when the company is first established)
- Restrictions imposed by existing borrowings – terms of existing loan agreements may preclude the company from borrowing further
- The lender's requirement for capital and income cover
- The lender's general opinion of the company and its overall borrowing position.

Banking facilities

There are three main methods by which a company can borrow money from a bank:

1 *Overdrawing its current account against an agreed overdraft facility*. Bank advances on the overdraft are technically repayable upon demand by

the bank, and can leave the company vulnerable to increases in interest rates. However, they are a simple method by which to fund day-to-day working capital requirements, and the balance overdrawn is shown under current liabilities in the company's balance sheet.

2 *Bank loans*. These are shown in the balance sheet under two headings; one in current liabilities, which shows the amount of principal due to be repaid under bank loans within the next 12 months (CPLTD or current portion of long-term debt), and the balance under long-term liabilities, which shows the amount due to be repaid after 12 months.
3 *Bills of exchange under an Acceptance Credit facility*. The primary purpose of the bill of exchange as a funding instrument is to finance the sale of goods when the seller or exporter wishes to obtain payment at the time the goods are despatched, and the buyer or importer wants to defer payment until the goods arrive, or later. In these circumstances, company A, the supplier of the goods to company B, will draw up a bill of exchange for the goods which company B will accept as representing the debt to company A which is payable at some future time.

Fixed assets

The Companies Act 1985 requires fixed assets to be set out in the balance sheet under three headings:

1 *Intangible fixed assets*, which will include such items as patents and trademarks, brand names, goodwill, concessions, and capitalized development costs. 'Goodwill' is the amount by which the value of a business as a whole exceeds the balance sheet value of its individual assets less liabilities. It is normally only recognized in the accounts of a company when it acquires another business, and it relates to the amount that the purchasing company has paid for the company being purchased over and above its balance sheet value.
2 *Tangible fixed assets*, which are assets with a long working life that have not been bought by the company for resale purposes in the ordinary course of their business, but for the purposes (directly or indirectly) of revenue generation. They will include items such as machinery on which the company's product is made, land on which the head office

or factories are based, buildings such as the offices and factories, and motor vehicles (lorries, sales representatives cars etc.).

3 *Investments*, which fall into four categories:
- Investment in subsidiary companies.
- Investment in associated undertakings.
- Participating interests (these are interests held by the company on a long-term basis to secure a contribution to its activities by the exercise of control or influence over another party or parties). This would involve a holding of 20% or more of the shares of another institution. A participating interest becomes an interest in an associated undertaking if the company exercises a significant degree of influence over the operating and financial policy of the company in which it has a participating interest.
- Other investments, which are share holdings in other companies that are none of the above, but which the company feels is a good investment for it and will bring a good return.

Depreciation

This is a measure of the loss of value of an asset due to use, the passage of time and obsolescence (obsolescence is particularly a problem in the field of high technology, such as computers and electronic equipment). This includes the amortization of fixed assets that have a pre-determined future life, and the depletion of wasting assets.

Factors affecting the depreciation of an asset will include the original cost of the asset, the estimated life of the asset, the method of depreciation calculation used, and the likely residual value. Depreciation methods include straight line, reducing balance, and the sum of digits. Straight line is the most commonly used method.

Book value

Traditionally, fixed assets are shown in the balance sheet at cost less aggregate depreciation to date – this is known as the net book value. This is not in any sense a true valuation of the worth of the asset today; it will require a professional valuation under today's market constraints.

Authorized and issued share capital

When a company is formed, the authorized share capital and the nominal value of its shares are written into the company's Memorandum of Association. Both the authorized and the issued share capital are shown in the company's accounts.

There are several different types of share capital, which carry different levels of risk dependent upon where they would rank for distribution in the event of liquidation of the company. The types of share capital, in ascending order of risk, are:

- *Preference (or non-equity) shares.* Preference shares earn a fixed rate of dividend, which is normally payable half-yearly, but preference shareholders have no right of legal redress against the directors of the company if they decide that no preference dividend should be paid. However, if no preference dividend is paid for an accounting period, then no other share dividend can be declared for the accounting period concerned. Varieties of preference shares can include one or a combination of the following features.
- *Convertible shares*, where shareholders have the option of converting their preference shares into ordinary shares within a given period of time (the conversion period).
- *Ordinary shares*, which comprise the main part of the share capital of a company. Ordinary shareholders are entitled to vote at the company's general meetings, giving them a say in company decisions – including the appointment of directors. They are entitled to the profits of the company that remain after tax and preference dividends have been deducted.
- *Deferred shares* form a class of share on which a dividend is not payable until ordinary shareholders' dividends have reached a certain level, or until the deferred shares have themselves been converted into ordinary shares.
- *Warrants* to subscribe for shares are transferable options granted by the company to purchase new shares from the company at a given price, called the 'exercise price'. The warrant is exercisable only during a specified time period, called the 'exercise period'.

Reserves

Reserves can arise via:

- accumulation of profits, from trading and from the sale of assets
- issue of shares at a premium, i.e. at more than their nominal value
- issue of warrants
- upward revaluation of assets
- acquisition of assets at below their balance sheet value.

Reserves can be reduced by losses, share issue and share redemption expenses, revaluation expenses, revaluation deficits, and the writing off of goodwill.

The Companies Act 1985 requires reserves to be shown under three main headings:

1 *Share premium account* – when shares are issued at a premium over their nominal value, the premium element must be credited to the share premium account. The share premium account has to be shown separately on the balance sheet, and may not be paid out to shareholders except on liquidation or under a capital reduction scheme.
2 *Revaluation reserve* (unrealized profits) – the surplus (or shortfall) on the revaluation of assets should be credited (or debited) to a separate reserve, the revaluation reserve.
3 *Other reserves* prohibited from distribution by the company's memorandum articles include capital redemption reserves. Shares may be redeemed or purchased by a company out of distributable profits or out of the proceeds of a new issue of shares. Where redemption or purchase is out of distributable profits, an amount equal to the amount by which the company's share capital is diminished must be set aside by the company in a reserve called the capital redemption reserve. This is shown separately under 'Other reserves'.

The profit and loss account

The profit and loss account is also one of the basic components of the company's report and accounts. It is a record of the trading activities of a company for a given period of time. This period is called the accounting period, and is normally a year. The balance sheet is always drawn up on the last day of the company's accounting period.

The profit and loss account:

- compares revenue for the year against the cost of goods sold and other expenses, disclosing the profit or loss made
- measures the current performance of the business and shows turnover and expenses
- reveals the pre-tax profit or loss figure, which is an important pointer to the overall efficiency of the company.

The profit and loss account will show three things; how the profit (or loss) was earned, how much was taken in taxation, and what happened to the profit (or loss) after taxation was deducted.

Turnover

This is the amount derived from the provision of goods and services falling within the company's ordinary activities, after deduction of trade discounts and before addition of VAT and other sales-based taxes.

Under the Companies Act, the following information must also be given by the company relating to its turnover:

- If the company has carried on two or more classes of business during the year that, in the directors' opinion, differ substantially from each other, it should describe the classes of business and split out each businesses' turnover and pre-tax profits
- If in the accounting period the company supplied goods and services to different geographical markets, the amount of turnover attributable to each market should also be stated.

SSAP 25 requires companies which have two or more classes of business or which operate in two or more different geographical markets to report separately each market's turnover, pre-tax profits and net assets.

To summarize, the profit and loss account performs three functions:

1 It shows how much profit has been earned by the company, and whether this is sufficient to cover the dividends and to provide for expansion of the business
2 It explains how the reported balance of profit was computed
3 It shows how the reported profit has been distributed and what has been retained.

Problems with financial statements and auditors

It is important to note that there are several difficulties in using the information in a company's financial statements:

- There is no complete and comprehensive set of accounting standards. For example, in the same industry a transaction can be presented in several ways, all in accordance with FRS. The analyst should be aware of the way a company is presenting its accounts.
- Financial statements represent the work of two parties – the directors/management, and the auditors – with differing interests. There will be differences of opinion that must be reconciled to the satisfaction of both parties.
- Published financial statements are prepared for a wide audience. In addition to the shareholders, the annual report is targeted towards institutional investors, analysts, employees and the public.
- Accounting involves approximations – for example, it is difficult to value assets such as partially finished 'work in progress', or provisions for bad or doubtful debts.
- There are different methods of valuing assets. Current assets such as receivables, less provisions for doubtful debts, are often estimates. Likewise, stock/inventories can be valued in a number of different ways – LIFO (Last In, First Out), FIFO (First In, First Out), WACC (weighted average cost method), etc.
- In accounting, there are honest differences of opinion. There are also ambiguities that enable companies to manipulate accounts and misrepresent the true and fair state of their company, and often the

auditors collude with the company in signing off on financial statements known to be misleading if not outright fraudulent. The analyst should be aware that these exist, and that accounting in recent years has become unreliable. This is not only a breakdown in accounting practice, but indeed goes to the very heart of the ethos of accounting.
- Accounting terminology can vary. For example, income statement, profit and loss statement, statement of income and retained earnings and operating statement are all different ways of referring to the same statement; stock can be called inventory, and debtors either receivables or accounts receivable. It is important to be familiar with the general characteristics of the accounting language.
- Accounting has evolved by convention and tradition over time, and that there are many anomalies and differences of opinion in the practice. Accounting attempts to quantify the approximate and, at times, unquantifiable.

To this traditional list must be added the impact of new developments witnessed in the USA with Enron (merely the first of a baker's dozen of scandals), and in the EU with Parmalat.

Financial statements are hardly likely to explain fraudulent activities, how or why (for example) a company has several offshore special purpose vehicles (SPVs), and whether these are part of the company's business operations or speculative – indeed illegal – structures designed to evade regulation and taxation laws. The names of the Enron SPVs tell us something about the mentalities of the executives who set them up. Some of the partnerships were named after characters from Star Wars, such as Chewbacca (Chewco) and Jedi (Joint Energy Development Investments). Others were called Braveheart, Raptor, Porcupine and Condor.

What is surprising in these developments is the banality of the deception. It seems that a great many other companies are doing the same thing, and not only in the USA – as the Parmalat saga testifies.

This begs a host of questions: Why did Enron's accountants and lawyers approve of these activities? Why did Parmalat's auditors not see the 5 billion euro 'hole' in the company's accounts for 10 years? Incompetence seems too tame an accusation to level at repeated audit teams over a decade. The word ‘corruption’ comes to mind.

Wall Street is now ridden with fears that other companies have overstated earnings because of similarly misleading accounting practices that were devised by the major accounting and law firms. The SEC is investigating Global Crossing. The stocks of companies such as Worldcom, Reliant Services, the Irish drug firm Elan, and even General Electric have been falling in price for fear they will have to restate earnings as scrutiny of corporate books increases.

The former chief accountant of the SEC, Lynn Turner, estimates that investors have seen company stock prices fall by $200 billion as earnings have been restated because of what were deemed accounting errors. He finds the number of companies that have had to restate earnings has doubled since 1997 (‘Accounting in crisis’, *Business Week*, 28 January 2002). Similarly, economists at the Levy Forecasting Center in Chappaqua, New York, believe that profits nationwide may be overstated on average by 20%.

Such developments render the traditional task of financial analysis effectively obsolete, and new, perhaps more intuitive and judgmental or psychological elements may have to be factored into the analytical process given the dearth of reliable quantifiable data.

The sad fact is that the accounting profession has proven itself to be more concerned about fostering a ‘positive and dynamic can-do spirit’ within its bright young things in order to chase business and feed itself into more lucrative consulting business, than in applying accounting principles effectively. The result is that the accounting profession, as well as the financial statements it audits, has lost all credibility and the word ‘Andersen’ has become a joke. The exorcizing of government, the deregulation and the emancipation of ‘limits’ on business are the very forces that will undermine its credibility and expose the foundations of financial statements for all to see.

The Powers Report is especially harsh on Arthur Andersen. It states that Andersen ‘did not communicate the essence of the transactions in a sufficiently clear fashion to enable a reader of the financial statements to understand what was going on'. The Powers Report also finds that Andersen had an integral part as consultants in creating the Raptor partnerships, earning nearly $6 million in fees on these and related partnerships alone.

The basic question arising from the Enron scandal is whether accounting statements can be required to reflect the true economic condition of the companies. In many companies, including Enron, there was at best a pretence of this, and often not even that. Perhaps the best overall reform, as Partnoy (1999) suggests, might be to adopt legislation to make corporations, their officers and their directors legally liable should the general requirement that disclosure must reflect the economic reality of a company be violated. Treasury Secretary O'Neill has proposed that executives should not be allowed to have insurance to cover any such liability, but few believe the White House will support his rather off-the-cuff proposal.

It is therefore important to bear these realities in mind when number-crunching a spreadsheet, and wondering about the true significance behind a change in an inventory turnover ratio from 57 to 64 days or the speed-up in days' receivables from 37 to 34 days.

Conclusion

The purpose of company financial information is to enable effective credit decisions to be made, so that costly lending errors can be avoided. It is important therefore that information is reliable. Consider the essential information that is obtained directly from members of senior management, such as the CEO or finance director. How reliable is this information?

In Enron, for example, the Senior Manager was Kenneth Lay and the Finance Director was Jeffrey Skilling, who in his testimony to Congress suffered from an acute loss of memory most atypical of a normal CFOs performance (he repeated 'I do not recall' 28 times during his testimony). Despite the fact that 27 Enron managers have been charged with fraud and 9 have pleaded guilty, Lay and Skilling have yet (as of February 2004) to be brought into court on charges related to Enron's implosion (*Houston Chronicle*, 13 February 2004). In Europe, such CEOs have included Asil Nadir (following the collapse in the 1990s of the publicly quoted company Polly Peck Plc) and Ruiz-Mateus of Spain. Following the collapse of Polly Peck, Nadir sought refuge in the illegitimate state of Turkish North Cyprus, from where he cannot be extradited for having perpetrated corporate fraud in the UK.[1] Likewise, Ruiz-Mateus absconded to Argentina while the Spanish government combed over the ashes of the collapsed RUMASA group.[2]

In Italy, Parmalat hid a 15 billion euro 'hole' in its accounts from its auditors for 10 years by providing a forged photocopy of a deposit certificate with the pasted-on logo of an offshore subsidiary of a US bank.[3] It begs the question, what sort of audit guidelines did the company have in its audit procedures manual, and were they being followed or not?

It is normal to consider how accurate such information is likely to be both during a best-case scenario (inflating corporate performance to please share and rating analysts) and in a worst-case scenario (hiding the fraud). Moreover, it is worth considering whether the company's auditors are colluding in the fraud in an effort to retain profitable business and indeed sell more profitable 'consulting' business (for example, many of the fraudulent mechanisms present in Enron were designed by Andersen, its auditors, and the supporting documentary evidence was destroyed by Andersen after it received a subpoena from the Securities and Exchange Commission).[4]

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[1] Asil Nadir, the Polly Peck tycoon who fled to northern Cyprus in 1993 to avoid charges involving theft totalling £34 m, yesterday astonished friends, Turkish politicians and the serious fraud office by pledging to return to Britain to clear his name. (Nils Pratley, *The Guardian*, 3 September 2003)

[2] Peter Gooch, *Valencia Life Magazine*.

[3] The Commission's complaint, filed in the US District Court in the Southern District of New York, alleges that Parmalat engaged in one of the largest and most brazen corporate financial frauds in history (SEC Litigation Release No. 18527, 30 December 2003). After fraudulently certifying 8 billion euros ($10 billion) in assets in their company's balance sheet, Parmalat entered bankruptcy protection last week and founder and former CEO Calisto Tanzi fled the country. He subsequently returned and was immediately detained by police. The scandal and its aftermath continue to unfold, and Parmalat is being called 'the Europe Enron' for its massive fraud and illegal business practices (see the forged deposit certificate in Annex 6.1 to the Release.

[4] FT.Com, Q&A: 'Enron finds itself in a Washington circus', Adrian Michaels, Gerard Baker and Peter Thal Larsen, 13 February 2002.

Since it is impossible to certify all accounts as having been properly audited, prudency dictates that these audited statements be considered as failing to satisfy the requirements of mission-critical reliability.

These audit shortcomings have further knock-on effects, not only on the quality of financial statements but also on the relevance of credit ratings issued by the credit rating agencies, since they rely on them for issuing such ratings and cheerfully admit that they do not question the validity of accounting statements since this is the auditor's job.[5]

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[5] 'When asked by Committee staff whether they considered as a qualitative factor in their analysis whether the company was engaging in aggressive accounting, the agencies indicated that they rely on the auditors' work. This was consistent with their testimony at the hearing. In the Committee staff interviews, the credit rating analysts resisted staff's suggestion that a company's accounting methods should be part of their analysis, because even when financial statements comply with Generally Accepted Accounting Principles (GAAP), they nevertheless may not present all the information an investor would want to know, or all the information a credit rater would want to know. This is troubling, because the fact that a company may be using the flexibility of GAAP to hide problems should be a consideration, particularly if the credit raters take a long-term view' (Financial Oversight of Enron: The SEC and Private-Sector Watchdogs Report of the Staff to the Senate Committee on Governmental Affairs; 8 October 2002).