GUIDE TO ANALYSING COMPANIES

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Introduction

THE AIM OF THIS BOOK is to provide an understanding of how to analyse and assess the performance and financial position of a company from the various sources of information available. Financial analysis is as much an art as it is a science. Combine any two figures from an annual report and a ratio is produced; the real skill is in deciding which figures to use, where to find them and how to judge the result.

Before attempting to analyse a company, a sound grasp of financial terminology and presentation is required. Part 1 of this book explains the content and intent of the main financial statements appearing in a company's annual report: the statement of financial position (balance sheet); the income statement (profit and loss account); and the statement of cash flows. Two newcomers, the statement of comprehensive income and the statement of changes in equity, are also covered.

All countries and companies share the basic accounting framework used in the preparation of financial statements, but their presentation is not yet completely standardised. Adjustments may have to be made, but the outline in Part 1 is applicable to most companies and countries. Reference is made to UK and US GAAP (generally accepted accounting principles) as well as the appropriate International Accounting Standards or International Financial Reporting Standards (IAS or IFRS), but there is no attempt at a detailed interpretation of their application. This is an area of study you may move on to after this book.

As far as possible, the examples given have been kept simple in order to emphasise or reinforce the subject matter; once the fundamental theory and practice are grasped there should be no problem in moving to more detailed and sophisticated analysis. In general, the book's examples focus on retail, service and manufacturing companies rather than banks and other financial services companies, which are subject to a different set of legal and reporting requirements.

Part 2 deals with the analysis of the different aspects of corporate performance and position. Three important ground rules apply:

1. Never judge a company on the basis of one year's figures. Always look at three, or, ideally, five years' figures.
2. Never judge a company in isolation. Always compare its performance with others of the same size and/or in the same business sector and/or country.
3. When comparing companies always make sure, as far as you can, that you are comparing like with like – in other words, that the basis of the data being analysed is consistent.

Profit and finance are the two broad strands interwoven in the overall management of successful business organisations today. They also provide the basis for the analysis of a company. Each strand is equally important and both must be followed. Analysing a company's profitability without any reference to its financial position is of little value. Similarly, there is little point in completing a detailed analysis of a company's financial structure without reference to its performance. Profit is not sufficient on its own; a company must have the resources to allow it to continue in business and to flourish.

A common corporate objective is to achieve a level of profit necessary to satisfy shareholders' requirements – to add value to their investment. Without profit there can be no dividend or share value improvements, or reinvestment for future growth and development. A substantial part of this book focuses on various ways of identifying and measuring profitability. Shareholder value is more than just annual profit, and not everything is capable of quantification. Future expectations of a company's performance outweigh its historical track record in determining its share price – which probably offers as good an indicator as any of shareholder satisfaction. Chapter 5 offers some general guidelines for undertaking practical analysis.

When the analysis of a company is completed, the tables in Appendix 1 offer some benchmarks against which the ratios explained in Part 2 can be tested and compared. This reinforces the last lesson of financial analysis: comparison. Producing a series of ratios for one company can be useful in indicating trends in its performance, but it cannot confirm whether this is good, bad or indifferent. That can only be determined by applying the three rules stated earlier.

An important lesson from the downturn in the 1990s and the 2008 global financial crisis is to invest in a company only when you are absolutely certain you understand the business and sector within which it operates. If you cannot see where the profits are coming from, don't invest. If you cannot understand what the company does, don't invest. In all probability it is not a failure of your analytic ability but someone practising corporate legerdemain.

The question of whether to use rules or principles as the basis guidance in the preparation and presentation of financial statements appears to have been answered. Financial reporting now operates under a set of mainly principles-based accounting standards kept on the straight and narrow by additional guidance and professional auditors as necessary. The main objective of the International Accounting Standards Board (IASB) is "to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards", and it is working with the Financial Accounting Standards Board (FASB) towards this.

Despite recent changes, the terminology of accounting and financial reporting remains much the same, though the importance attached to some has changed. Understanding the meaning of the terms "recognition", "fair value", "present value", "faithful representation" and others is essential to reading a set of accounts. This book is not intended to provide a detailed toolkit for financial report preparation but, rather, to give you confidence in using the information contained in an annual report. Throughout the book the FASB or IASB statements and terminologies are selected as being the most appropriate to clarify the item or topic being discussed. This is not a textbook. The aim is to provide you with some confidence in reading the accounts, and moving to the next level in your financial analysis and management competence.

As far as possible the book is written with a light touch. It is not intended to be read from start to finish – dip in as appropriate. If you find a section hard going – move on; it will be my fault not yours.

Companies get their momentum from people, and financial analysis of their activities is an art. Art combined with people should be fun: if it is not, you should leave it to those who enjoy it.

Bob Vause
August 2014

PART 1

Understanding the basics

1 The annual report – and what underlies it

AN ANNUAL REPORT contains two distinct types of information: quantitative – the financial statements; and qualitative – various reports and a management commentary. These are complex documents and often impenetrable – sometimes intentionally so. The increasing volume and detail of legislation, regulation, rules, accounting standards and codes of practice all contribute to this. The annual report tends to be too long and too complex, using mainly financial information that is unhelpful to the average reader. Accountants are acutely aware of these problems.

The main challenge facing the accounting profession is not just to continue to ensure that the balance sheet balances, but also to help companies in the production of an integrated annual report focusing as much on the quality of management's current and future involvement in the social, environmental, economic and ethical aspects of their business as on the bottom line of the income statement.

Each time there is a major corporate fraud or mismanagement, or a severe economic crisis, there is pressure either for a change in the role, duties and responsibilities of auditors or directors, or for the disclosure of additional or more detailed information. Deloitte Touche Tohmatsu, one of the "Big Four" professional services firms, estimated that in 1996 the average company report contained some 45 pages; today it is over 100 pages. In 2012 two UK-based banks, HSBC and Royal Bank of Scotland (RBS), published annual reports of more than 500 pages. A typical listed company can be expected to publish a 150-page report which takes more than two months to prepare and approve. There is ever-increasing emphasis on the internet as a means of paperless communication.

In December 1983 the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Concept (SFAC) 5, “The Recognition and Measurement in Financial Statements of Business Enterprise”, which stated that a full set of financial accounts of a company should consist of statements of:

- financial position at the end of the period;
- earnings in the period;
- comprehensive income for the period;
- cash flows during the period;
- investments by and distributions to owners during the period.

In 2013 the Financial Reporting Council (FRC) issued three Financial Reporting Standards (FRS), which, in effect, replaced all previous UK reporting standards and UK generally accepted accounting principles (GAAP) for non-listed companies. FRS 102 includes a description of the financial statements to be provided. International Accounting Standard (IAS) 1, “Presentation of Financial Statements”, issued in 1997 and reviewed in 2011, was adopted by the International Accounting Standards Board (IASB) in 2001. This requires companies’ annual reports to contain a:

- statement of financial position (balance sheet);
- statement of comprehensive income (profit and loss account);
- statement of changes in equity;
- statement of cash flows.

These four statements will be found in the annual reports of almost all listed companies. There will also be, where appropriate, comparative figures for the previous year. The financial statements produced by US companies follow US GAAP. UK and listed companies will comply with the IASB’s International Financial Reporting Standards (IFRS).

Information on a company’s financial position is mainly derived from the balance sheet and cash flow statement. The three basic accounting elements related to the balance sheet – assets, liabilities and equity – are discussed in Chapter 2. An assessment of company performance will focus on the income statement and the statement of changes in equity. Income and expense, the two basic elements involved in performance measurement from the income statement, are discussed in Chapter 3.

The annual report comprises three elements: narrative reporting, including the strategic report and the directors' report; governance statements, including those from the chairman and the directors' remuneration committee, nominations committee and the audit committee; and the financial statements and allied notes. A typical company annual report will contain:

- summary information or highlights;
- the chairman's statement;
- the chief executive officer's review of the business;
- a strategy review and directors' report;
- a corporate governance statement;
- a directors' remuneration report;
- a statement of directors' responsibilities;
- a nominations committee report;
- an audit committee report;
- an auditor's report;
- the financial statements;
- a statement of accounting policies;
- segmental information;
- a five-year history;
- shareholder information;
- notes to the financial statements.

UK companies should now provide a strategic report – previously there were requirements for the publication of an operating and financial review (OFR) or business review (BR). The strategic report is the equivalent to the management discussion and analysis of financial condition and result of operations (MD&A) statement appearing in US company reports. For UK companies the 2006 Companies Act, as amended in 2013, sets out company financial reporting requirements. Everything is covered, from the maintenance of the necessary financial records, application of accounting standards, the presentation of a "true and fair view" and the necessary audit requirements, to the issue and distribution of the annual report. The act allows companies to continue calling the statement of financial position the balance sheet. It also requires a strategic report to be published detailing company objectives, strategies and performance. You will probably find the full strategic report on a company's website with an edited version included in the annual report. Shareholders who opt not to receive a company's full annual report will often be sent the strategic review as an alternative source of information.

It is recognised that if the cost of collecting the information is greater than the benefit of providing it, it is not worth it. The report is expected to be timely. If information takes too long to collect, the report may lose its relevance. A listed company will normally publish its annual report within two months of the financial year end.

To read and use an annual report effectively, you need some understanding of the broad theory and the framework of financial accounting. In 1966 the American Accounting Association defined accounting as:

> *The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information.*

The mechanics of double entry book-keeping do not need to be mastered. It is extremely unusual for a listed company to run into problems with debit and credit. The book-keeping process required to arrive at a statement of financial position that balances – a balance sheet – can be taken for granted. However, some background might be useful.

Double entry book-keeping

Italy claims to have been the first country in Europe to adopt double entry book-keeping. Luca Pacioli has the accolade of being the first to publish on the subject. In 1494 he wrote *De Computis et Scripturis*. Little is known of him beyond that he was an itinerant mathematics teacher, an unsuccessful gambler and ended up in a monastery. His book included, for the first time, details of the double entry bookkeeping (debits and credits) system being used in Italy.

Under this system, sometimes referred to as "duality", every transaction has two entries in the books of account. Whatever amount is entered on the right-hand side (credit) of one account, the same amount is entered on the left-hand side (debit) of another account. This guarantees that at the end of the financial year it is possible to produce an income statement (profit and loss account) disclosing the profit or loss for the year and a balance sheet (statement of financial position) with assets (debit balances) equalling liabilities (credit balances). If whatever was entered on the left-hand side was also entered on the right-hand side, the total of the two sides of all the accounts must equal each other. The books must balance. In 1673 France had legislation requiring companies to prepare an annual balance sheet. It was not until the industrial revolution that bookkeeping and financial reporting gained real impetus in Europe.

Who publishes accounts?

Every commercial business must prepare a set of accounts in order to agree its tax liability. The term "entity" is now used to describe any company or other business organisation. Even when the entity is a charity or otherwise tax exempt, accounts must still be prepared to allow those interested in its activities to assess the adequacy and probity of the management of its operations and assets. All public or nationalised enterprises are expected to produce and publish accounts in order to report not only to the state but also to the people. Any company in which the public has been invited to become involved must publish an annual report containing a set of financial statements (accounts). All other companies with limited liability submit accounts to the tax authorities each year and file them, thus making them available for public scrutiny.

Limited liability

Most trading companies have limited liability. This was introduced in the 1860s to provide shareholders with some protection against a company's creditors. Shareholders (stockholders) providing a company with capital, through the purchase of stocks and shares, cannot be forced to contribute any further money to the company or its creditors. Having paid the $1 or £1 for a share or unit of stock, they need pay no more. Should the company fail they can lose no more than the $1 or £1 invested; their liability is limited to this amount.

The corporate persona

A company is a legal entity separate from its managers and owners and is referred to as an entity in most accounting standards. It can make contracts, sue and be sued as an individual can. Financial statements are prepared as if the company were an individual. For the purposes of law and accounting, it owns assets and incurs liabilities. This is why the shareholders' stake in a company is shown as a liability. A company's net worth or equity is the amount the company owes to its shareholders. After having realised all assets and repaid all loans and creditors, the last act of a company, before it ceases to exist, is to pay what remains to the shareholders – the net worth of the company.

Private and public companies

A quoted or listed company is one whose shares can be bought and sold on a stock exchange. In the UK this is a public limited company (plc). The term "public" refers to the size of the share capital of the company, so a plc does not necessarily have its shares quoted on the stock exchange. Unquoted limited liability companies have "limited" (ltd) in their name. Most countries provide a distinction between public and private companies. For example, in France it is SARL and SA; Germany AG and GmBH; Italy Spa and Srl; the Netherlands NV and BV; Belgium NV and SPRL; Spain SA and SL. In the US various states have their own requirements, but most commonly "corporation" (Corp or Inc) is used for listed companies.

A quoted company must publish more information than a private company. This is to satisfy legislation and the requirements of the listing stock exchange. A private company cannot offer its shares for sale to the public, so different safeguards and reporting requirements apply compared with those for public or stock exchange listed companies. Private companies can be large organisations. In 2013 in the US there were 100 private companies with annual sales in excess of $4 billion, including Mars ($33 billion), which has "freedom" as one of its five key principles.

Listed companies usually give a preliminary statement of the year's financial performance within a few weeks of the end of their financial year; formal publication of the annual report follows soon after. For private companies, there can often be a considerable delay after the year end before a set of accounts is made public. This can make relevant analysis and comparisons difficult.

Ownership and management

Shareholders or stockholders of a private company are often directly involved in its management, often with members of the family acting as directors. Shareholders of a public company are much less likely to be directly involved in its management. The management of a public company, its directors and managers, is normally clearly separated from the owners of the company, its shareholders. The directors act as stewards of their shareholders' investment in the company and each year report the result of their management and the financial position of the company. In the UK "stewardship" was commonly used to describe the directors' relationship with their shareholders, but problems arose in translating this into other languages. "Accountability" is now the preferred term. At the annual general meeting (AGM) directors present the annual report and accounts to shareholders.

Consolidated accounts

Where one company, the parent company, has a controlling interest in other companies, its subsidiaries, it is necessary to prepare consolidated or group accounts. These incorporate all the activities of all the companies in the group to provide a set of consolidated accounts, including an income statement, statement of financial position and cash flow statement. Since the 1900s, UK and US companies have been required to publish consolidated or group accounts. The Seventh Directive on European harmonisation, revised in 2013, deals with group accounts, and since 1970 they have been mandatory for all EU companies. The objective of a set of consolidated accounts is to ensure that shareholders and others interested in the group of companies have adequate information upon which to assess its operations and financial position. IFRS 3 and IAS 27 deal with business combinations and consolidated financial statements.

In addition to the consolidated statement of financial position, UK groups must provide one for the parent company, though this is often relegated to the notes accompanying the annual report. There is no requirement to provide an income statement. The presentation of a parent statement of financial position is not required in the US.

Non-controlling interest

Where a subsidiary is not 100% owned, the non-controlling interest (NCI), outside or minority interest (MI) – the proportion of the subsidiary owned by those other than the parent company – is shown separately in the financial statements. Inevitably, some problems may arise in identifying ownership and control when there are pyramid structures of shareholdings.

All intra-group trading is eliminated to avoid double counting of profits, so only revenue from dealing with customers outside the group of companies is recognised in the income statement. However, non-controlling interests must be credited with their proportion of any profits flowing from intra-group trading. What remains belongs to the parent company.

Details of subsidiaries

With a group of companies, the annual report should provide full details of all subsidiaries. The name, business, geographic location and the proportion of voting or other shares owned by the parent company should be disclosed. If, during the year, a subsidiary has been sold or otherwise disposed of, details should be reported as part of the notes to the accounts on discontinued operations. Any gain or loss on disposal will also be disclosed separately.