



NINTH EDITION

INTERPRETING COMPANY REPORTS and ACCOUNTS

Geoffrey Holmes
Alan Sugden
and Paul Gee

FT Prentice Hall
FINANCIAL TIMES

Interpreting Company Reports and Accounts



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Preface

The aim of this book

In the Preface to the first edition we wrote: ‘Given a sound knowledge of the basic components of a balance sheet and profit and loss account, *anybody with a reasonably enquiring mind* can learn a great deal about a company by studying its report and accounts and by comparing it with other companies. We have written this book to provide the basic knowledge required . . .’

The aim remains the same, although there have been significant developments since the first edition was published in 1979.

Accounting Standards

The Accounting Standards Board (ASB), set up in 1990, replaced a Committee which was prone to compromise solutions and had no power to enforce the rules it made.

Under the chairmanship of Sir David Tweedie the ASB has, in the last ten years, introduced a complete new set of rules, Financial Reporting Standards (FRSs), which are listed in Appendix 1. These include the introduction of the cash flow statement, strict rules on accounting for goodwill, and an FRS on derivatives, whose use and the trouble caused by which have grown enormously. The ASB has also issued a *Statement of principles for financial reporting*.

International Accounting Standards

A new urgency has been injected by the European Commission announcement that companies within the EU will have to use International Accounting Standards (IASs) from 2005 in order to list on EU markets. In this edition we have, in a revised Chapter 31, *International accounting comparisons*, included a table showing the main differences between UK and IAS accounting practices.

The Cadbury Committee

The recommendations of the Cadbury Committee and subsequent committees have stimulated requirements for more and more disclosure, some of which have been met by what Sir David Tweedie calls ‘boilerplating’, the use of standard wording that provides no useful information, and tends to clutter up company reports.



Key points

Because of the sheer increase in the volume of information contained in annual reports and accounts we have, in this edition, expanded the inclusion of ‘Key Points’ to help the reader sort out the wheat from the chaff.

Alan Sugden
Paul Gee

Company reports and accounts – an introduction

The purpose of this book

This book is intended as a practical guide to the interpretation of reports and accounts. In it frequent reference is made to the legal, accounting and UK Listing Authority's requirements that accounts have to meet, but this is done in the context of what interesting information to look out for, rather than to show how a set of accounts should be prepared.

Useful guides to *compiling* accounts include:

- *UK and International GAAP: Generally Accepted Accounting Practice* by Ernst & Young, published by Lexis Nexis Tolley
- *GAAP 2004 UK Financial Reporting and Accounting* by Deloitte, published by CCH
- *Manual of Accounting* by PricewaterhouseCoopers, published by Gee Publishing Limited.

The report and accounts

The report and accounts, normally produced annually, is the principal way in which shareholders and others keep themselves informed on the activities, progress and future plans of a company. Its style and content vary somewhat in line with the directors' views on its use as a public relations vehicle. As is permitted by law, a growing number of larger companies, e.g. DIAGEO, produce an annual review and summary financial statement as an alternative to their annual report and accounts, and shareholders may choose which they receive. DIAGEO includes an interesting note in its Review:

DIAGEO *Extract from 2003 Annual Review*

Annual review and summary financial statement

This annual review and the summary financial statement on pages 20 to 22 [not reproduced] do not contain sufficient information to allow as full an understanding of the results and state of affairs of the Group as is provided by the full financial statements, directors' report . . .

To keep employees informed, some companies distribute a summary of their report and accounts to all employees, or include extracts in their house newspaper. Some produce and distribute to shareholders and/or employees a separate 'company profile'. But others argue that any unnecessary disclosure is risky in case the information may be of use to competitors.

Nevertheless, there is a minimum of information that must be disclosed to comply with the law. For example, the annual report and accounts must by law contain four basic components:

1. a directors' report;
2. a profit and loss account;
3. a balance sheet; and
4. an auditors' report.

The form and content of accounts are also subject to Financial Reporting Standards, about which we will have more to say in Chapter 2, and which add to the list of required contents. For example, FRS 1 requires all companies (other than *small* companies) to include a cash flow statement.

In addition, when a company's shares are listed on the Stock Exchange, the report and accounts have to contain further information prescribed by The United Kingdom Listing Authority (UKLA).

For instance, companies listed on the Stock Exchange have to produce a half-yearly or 'interim' report.

Details are to be found in UKLA's book *The Listing Rules*, known in the City as 'The Purple Book'. We say more about the Listing Rules in Chapter 4.

The directors' report

Under the Companies Acts, a directors' report must give a mass of information, some of which is obvious from the accounts anyway, some of which is of comparatively little interest either to shareholders or analysts, and appears to have been motivated by political considerations, e.g. contributions for political purposes, but some of which may be of vital interest and importance to anyone interpreting the accounts, e.g. the review of the year and likely future developments.

Example 1.1 A typical profit and loss account

Profit and loss account for the year ended 31 December 2003

	£000	£000
Turnover		7,200
Cost of sales		<u>3,600</u>
Gross profit		3,600
Distribution costs	1,100	
Administrative expenses	<u>1,300</u>	
		<u>2,400</u>
Other operating income		1,200
		<u>95</u>
Trading or operating profit		1,295
Interest receivable		<u>20</u>
		1,315
Interest payable		<u>100</u>
Pre-tax profit on ordinary activities		1,215
Taxation		<u>415</u>
Profit on ordinary activities after taxation		800
Dividends		<u>560</u>
Profits retained		<u>240</u>

The directors' report must also state the names of the directors and provide details of their shareholdings, provide particulars of significant changes in fixed assets and provide information on important events which have occurred since the end of the year, called '*post balance sheet events*'.

Most companies include a *Chairman's statement* while some include a *Chief Executive's review* as well. Companies are also encouraged to include an *Operating and Financial Review (OFR)*; see Chapter 25.

The profit and loss account

The profit and loss account, also known as the income statement, is a record of the activities of a company for a stated period of time. This period, called the accounting period, is normally a year. Example 1.1 shows a typical profit and loss account; the Terminology box below explains the main terms used.

TERMINOLOGY

Profit and loss account

The **profit and loss account** is a monetary record of the activities of a business during an accounting period, which is normally one year. A balance sheet is drawn up on the last day of the company's accounting period.

Turnover (also called sales) is money received, or to be received, by the business for goods or services sold during the year.

Expenses are costs incurred in producing those goods and services, normally divided into:

- (i) **Cost of sales** i.e. the cost of the goods themselves, e.g. raw materials and wages

Gross profit = Turnover – Cost of sales

- (ii) **Distribution costs** i.e. the cost of getting the goods to the customer
- (iii) **Administrative expenses** i.e. other expenses which cannot be or are not allocated to particular products (i.e. which do not form part of cost of sales) or appear under other headings.

Operating profit or **trading profit** = Turnover – Expenses (i.e. (i) to (iii) above).

Where expenses (i) to (iii) above exceed turnover, the difference is an **operating loss**.

- (iv) **Other operating income** is income and expenses which fall outside (i) to (iii) above, e.g. property income of a trading company, or patent income.
- (v) **Interest paid** on borrowed money (**interest received** represents income from interest on money lent, e.g. deposits at the bank).

Pre-tax profit = Operating profit + (iv) +/- (v)

Dividends are distributions to shareholders, i.e. the company's owners, paid out of profits after tax.

Depreciation is an expense appearing as part of (i) to (iii) above, as appropriate.

The cost of each fixed asset is written off over its expected life. Using the most common method of depreciation, **the straight line method**:

$$\text{Depreciation for the year} = \frac{\text{Cost of asset} - \text{Residual value}}{\text{Expected useful life}}$$

Corresponding figures or 'comparatives' are those for the same item for the preceding accounting period.

Accounts are required to include the figures for two periods, normally those for the year being reported on and corresponding figures ('comparatives') for the preceding year. For simplicity, at this stage we show only figures for the year.

The balance sheet

The balance sheet is a statement of the assets and liabilities of a company at the close of business on a given day, i.e. on the balance sheet date. The balance sheet is always drawn up on the last day of the company's accounting period.

Example 1.2 shows a typical balance sheet; the Terminology box below explains the main terms used in balance sheets.

Example 1.2 A typical balance sheet

Balance sheet as at 31 December 2003

	£000	£000	£000
<i>Fixed assets</i>			
Freehold land and buildings		950	
Fixtures and fittings		175	
Motor vehicles		<u>535</u>	
			1,660
<i>Current assets</i>			
Stock (of goods)		500	
Debtors		1,040	
Cash		<u>5</u>	
			1,545
<i>Less: Current liabilities:</i>			
Creditors due within 1 year:			
Trade creditors	300		
Taxation payable	415		
Dividends payable	560		
Overdraft	<u>90</u>		
			<u>1,365</u>
<i>Net current assets</i>			<u>180</u>
Net assets			<u>1,840</u>
<i>Capital and reserves</i>			
Ordinary share capital			1,000
<i>Reserves:</i>			
Retained profits: b/f		600	
		<u>240</u>	
			<u>840</u>
Ordinary shareholders' funds			<u>1,840</u>

TERMINOLOGY

Balance sheet

A **balance sheet** is a statement of the assets and liabilities and ownership interest of an enterprise at the close of business on the balance sheet date.

Assets are things which a business owns and on which a book value can be placed.

Book value is cost less accumulated depreciation or, if the asset has been revalued, it is the valuation figure less any subsequent depreciation.

Liabilities are amounts owed by a business.

Net assets = All assets – All liabilities.

Fixed assets are assets (like land and buildings, plant and machinery) not held for resale but for use by the business.

Fixed assets can be either **tangible**, from the Latin *tango*, I touch (e.g. motor vehicles, land and buildings) or **intangible**, i.e. not susceptible to touch (e.g. patent rights and trademarks).

Current assets are cash and other assets that the company expects to turn into cash (e.g. stock).

Current liabilities, which are usually described as ‘**Creditors due within one year**’, are the liabilities that the company expects to have to meet within 12 months.

As illustrated in Example 1.2, the modern accounting practice is to show the current liabilities below the current assets and to deduct them from the current assets to produce **net current assets**.

The **members (shareholders)** of a company provide some or all of the finance in the form of **share capital** (that is, they subscribe for shares) in the expectation that the company will make profits, and pay dividends.

Ordinary shareholders’ funds are made up of ordinary share capital and all accumulated reserves.

Financial statements is the term which covers the annual accounts as a whole, i.e. the profit and loss account, balance sheet, cash flow statement and statements forming part of the statutory accounts.

The accounts of a newly-formed company

(The remainder of this chapter provides an introduction to the balance sheet and profit and loss account for those who are not already familiar with them. Experienced readers may like to turn straight to Chapter 2.)

The *balance sheet* is a statement of the assets and liabilities of a company at the close of business on a given day, i.e. on the balance sheet date. The *profit and loss account* is a record of the activities of a company for a given period of time; this period, which is called the accounting period, is normally a year, and the balance sheet always has to be drawn up on the last day of the company’s accounting period.

When a company is formed the *members* (shareholders) subscribe for shares. For example, let us suppose that a company is formed with a share capital of 300,000 ordinary shares with a nominal value of £1 each, and that all the shares are issued at *par* (are issued to members at their nominal value of £1 each). At the same time the directors of the company negotiate with their bank manager to allow the company to overdraw by up to £150,000, i.e. they obtain an overdraft facility of £150,000, although this figure does *not* appear in the accounts. The balance sheet will then look like Example 1.3.

Supposing the company then:

1. buys a freehold shop for £200,000,
2. fits it out for £75,000, and
3. stocks it with £200,000 worth of goods.

It also:

4. buys a van for £10,000.

The shop, the fittings and the van are all paid for with cash, and so are half the goods, but:

5. the other half of the goods is supplied on credit; i.e. the suppliers do not require immediate payment, so they become creditors of the company (*creditors* are people to whom the company owes money);
6. by this time most of the £300,000 capital has been spent, and there is an overdraft: £300,000 – 200,000 – 75,000 – 10,000 – 10,000 = –£85,000. Companies normally have a small amount of cash in hand, even if they have an overdraft. Here it is £5,000, making an overdraft of £90,000.

Example 1.3 The new company’s balance sheet

Liabilities	£	Assets	£
Ordinary share capital	300,000	Cash	300,000

Example 1.4 The balance sheet after purchase of fixed assets and current assets

Liabilities	£	Assets	£
Ordinary share capital	300,000	<i>Fixed assets</i>	
		Freehold land and buildings	200,000 ¹
		Fixtures and fittings	75,000 ²
		Motor vehicles	10,000 ⁴
<i>Current liabilities</i>		<i>Current assets</i>	
Creditors: due within 1 year	100,000 ⁵	Stock (of goods)	200,000 ³
Overdraft	<u>90,000⁶</u>	Cash	<u>5,000⁶</u>
	<u>490,000</u>		<u>490,000</u>

The balance sheet would then look like Example 1.4 (superior figures refer to items in the above list).

Fixed assets are assets held not for resale but for use by the business. *Current assets* are cash and other assets that the company expects to turn into cash (e.g. stock), and *current liabilities*, usually described as *Creditors: due within 1 year*, are all the liabilities that the company expects to have to meet within 12 months. In modern accounting practice the current liabilities are normally shown below the current assets, and the total of the current liabilities is deducted from the total of the current assets to give what is called *net current assets*.

Let us suppose that the company then trades for a year, during which time it:

7. sells goods for £1,200,000 – their cost plus a profit margin, and
8. buys goods for £850,000 in addition to the initial purchase of £200,000 which is called the *opening stock* (except for the first year this is the stock on hand at the end of the previous year).
9. At the end of the year, on the last day of the company's accounting year, there is £250,000 of stock, valued at cost price, on hand. This is called the *closing stock*.
10. Wages and other expenses for the year amount to £280,000.
11. In addition, a provision is made for the wear and tear on fixed assets during the year. This is calculated so that the cost of each fixed asset is written off over its expected life. The provision is called *depreciation* and, using the most common method of depreciation, the 'straight line' method, is calculated as follows:

DEPRECIATION *Straight line method*

$$\text{Depreciation for the year} = \frac{\text{Cost of asset}}{\text{Expected useful life}}$$

For our company the depreciation charge for the year would be worked out as follows:

<i>Fixed asset</i>	<i>Cost</i>	<i>Life</i>	<i>Annual depreciation</i> £
Building	125,000	50 years	2,500
Fittings	75,000	10 years	7,500
Motor van	10,000	5 years	<u>2,000</u>
Depreciation charge for the year ¹¹			<u>12,000</u>

Notice that depreciation is charged only on the cost of the building (here assumed to be £125,000) and not on the value of the land (assumed to be £75,000), because depreciation is provided only on assets with a finite useful life.

Example 1.5 shows how the profit and loss account for the first year's trading would be calculated, assuming corporation tax at 25%.

During the year, in addition to the overdraft facility, the company arranged:

12. a 20-year loan of £100,000 secured on the freehold land and buildings – this is called a mortgage debenture because the lender of the money (the debenture holder) has first claim on the property if the company goes into liquidation.

Example 1.5 The first year's profit and loss account

	£	£	£
Sales (or Turnover)			1,200,000 ⁷
<i>less</i> Cost of goods sold:			
Opening stocks	200,000 ⁸		
Purchases	<u>+850,000⁸</u>		
	1,050,000		
	<u>250,000⁹</u>		
Closing stock			
Cost of goods sold		800,000	
Wages and other expenses		280,000 ¹⁰	
Depreciation		<u>12,000¹¹</u>	
			<u>1,092,000</u>
Profit before tax			108,000
Corporation tax			<u>27,000</u>
Profit after tax			81,000
Dividends (the directors recommend a 10% dividend on the nominal value of the issued share capital)			<u>30,000</u>
Retained profits (to be ploughed back into the company)			<u>51,000</u>

In Example 1.5 the interest on both types of borrowings has, for simplicity, been included in 'Wages and other expenses'. It would normally be shown separately.

Our final illustration (Example 1.6) shows the balance sheet at the end of the year drawn up in the modern way, with the assets less creditors above the capital and reserves, rather than assets on one side and liabilities on the other. Notice that:

13. debtors (customers owing money to the company) owed a total of £80,000;
14. trade creditors were £120,000 – so almost half the stock was being financed by suppliers;
15. fixed assets are shown at cost *less* depreciation to date;
16. the 10% dividend has not yet been paid;
17. net current assets = current assets – current liabilities, i.e. £355,000 – 177,000 = £178,000;
18. *ordinary shareholders' funds* = ordinary share capital issued plus reserves.

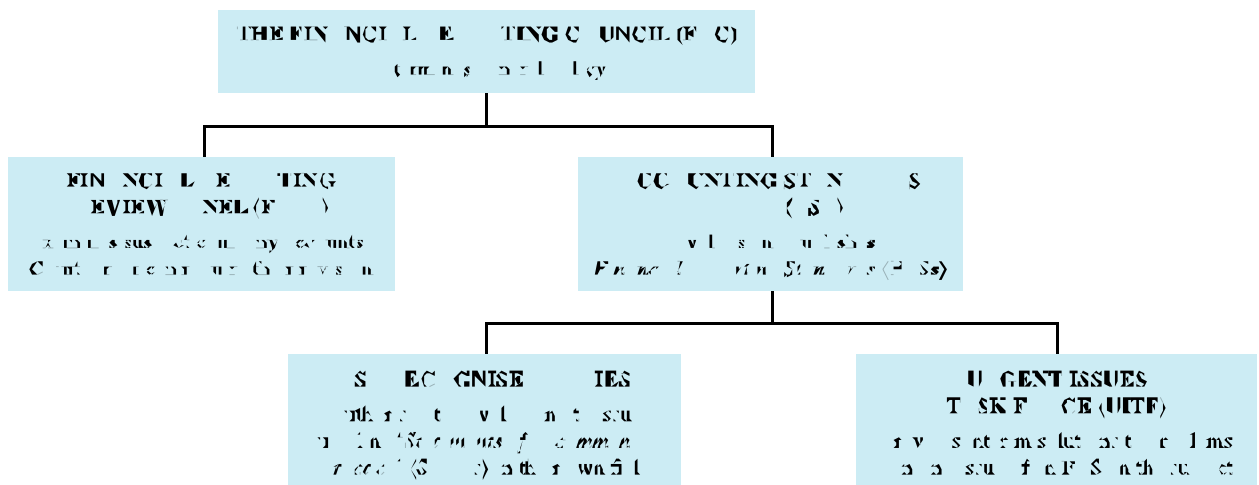
Example 1.6 The balance sheet after the first year's trading

	£	£
<i>Fixed assets</i> ¹⁵		
Freehold land and buildings		197,500 ¹¹
Fixtures and fittings		67,500 ¹¹
Motor vehicles		<u>8,000¹¹</u>
		273,000
<i>Current assets</i>		
Stock	250,000 ⁹	
Debtors	80,000 ¹³	
Cash	<u>25,000</u>	
	355,000	
<i>Current liabilities</i> (or <i>Creditors due within 1 year</i>)		
Trade creditors	120,000 ¹⁴	
Taxation payable	27,000	
Dividend payable	<u>30,000</u>	
	177,000	
<i>Net current assets</i>		<u>178,000</u>
<i>Total assets less current liabilities</i>		451,000
<i>Creditors due after more than 1 year</i>		
Mortgage debenture		<u>100,000¹²</u>
		<u>351,000</u>
<i>Capital and reserves</i>		
Ordinary share capital		300,000
Reserves (retained profits)		<u>51,000</u>
Ordinary shareholders' funds		<u>351,000¹⁸</u>

CHAPTER 2

Financial reporting standards and principles

The present structure



The regime prior to 1990

Until 1990 the Accounting Standards Committee (ASC) was the authority on the treatment and presentation of company accounts.

It was made up of representatives from the main accounting Institutes and Associations in the UK and Ireland, and exercised its authority by issuing Statements of Standard Accounting Practice (SSAPs).

The system had three serious drawbacks:

1. As the unanimous agreement of all members was required before an SSAP was issued, there was often compromise.

2. There were no legal sanctions to compel companies to comply with SSAPs.
3. The ASC's attempt to introduce Current Cost Accounting (CCA) had ended in an ignominious climb down, making a very big dent in the ASC's credibility.

Competition for business was rife between the leading firms of accountants, who became prepared to take a very flexible view of the rules in order to retain their existing clients and acquire new ones.

Barry Riley summed up the situation pretty succinctly in the *Financial Times* in December 1990:

FINANCIAL TIMES *Extract from article on accountants by Barry Riley, 9 December 1990*

Essentially the external auditor has ceased to devote himself primarily to presenting the users of accounts with the truth, but instead has come to help the financial director of his client company to show his results in the best possible light, taking due advantage of all the loopholes.

- corporate governance;
- setting accounting and auditing standards;
- proactively enforcing and monitoring them;
- overseeing the self-regulatory professional bodies.

Two key bodies which report to the FRC are:

- the *Financial Reporting Review Panel (FRRP)*, and
- the *Accounting Standards Board (ASB)*.

The present regime

Following the Dearing Report the government set up a new structure for setting and enforcing accounting standards, headed by the *Financial Reporting Council (FRC)*.

It also included a definition of ‘accounting standards’ in the Companies Act and, where a company’s accounts do not comply with the requirements of the Act, the court is given the power to order the preparation of revised accounts at the expense of the directors. **It is this that gives accounting standards their teeth.**

Implementation of the recommendations of the Dearing Report made a significant improvement in the quality and integrity of financial reporting in the UK.

However, the collapse of ENRON and WORLDCOM in the USA led the government to undertake a wide-ranging review of both accountancy regulation and corporate governance in the UK.

In January 2003, the Secretary of State for Trade and Industry announced that reforms would be introduced in three areas:

- raising standards of corporate governance;
- strengthening the accounting and auditing professions;
- providing for an independent system of regulation for those professions.

The government indicated that this was to be achieved by means of an enhanced role for the Financial Reporting Council, which was to become the ‘*new, single, independent regulator*’.

The Financial Reporting Council (FRC)

The FRC is constituted as a company limited by guarantee, and its constitution provides for a council whose function is to determine general policy.

The FRC has now assumed the functions of the former Accountancy Foundation, and has responsibility for:

The Financial Reporting Review Panel (FRRP)

The FRRP enquires into financial statements where it appears that the requirements of the Companies Act, principally that the financial statements show a true and fair view, might have been breached. The FRRP is autonomous in carrying out its function.

The role of the FRRP is to examine departures from the accounting requirements of the Companies Acts or accounting standards, and, if necessary, to seek an order from the court to remedy them.

Until recently the FRRP did not actively scrutinise accounts unless they were brought to its attention. In future, it will take a proactive role and scrutinise the accounts of larger companies on a sample basis. *Where a company has to revise its accounts, its reputation can be seriously damaged.* For example WIGGINS GROUP had to revise its accounts for the year to 31 March 2000, as the *Daily Telegraph* reported:

WIGGINS GROUP *Extract from Daily Telegraph 8 March 2001*

Wiggins sees profit restated as £10m loss

Wiggins Group, the airport and property manager, yesterday restated its accounts for the second time in six months after regulators intervened.

The new accounts show that the company made a £9.9m pre-tax loss in the year to March 2000 instead of a pre-tax profit of £25.1m.

The restatements mean that Wiggins incurred losses totalling £25.2m in the years 1995 to 2000 rather than making profits of £48.9m as initially recorded.

The Financial Reporting Review Panel said Wiggins had mistakenly booked a £21.5m profit from redeveloping Manston airport, and failed to account for £3m losses from starting an international airport network.

Oliver Iny, Wiggins chief executive, said ‘We did wrong, and we’ve admitted we did so, but it had no impact on the fundamental value of the company . . .’

Now isn't that an interesting point of view?

The article ended 'Wiggins shares fell $\frac{3}{4}$ to $31\frac{1}{4}$ p', and they went on falling, as Figure 2.1 shows.

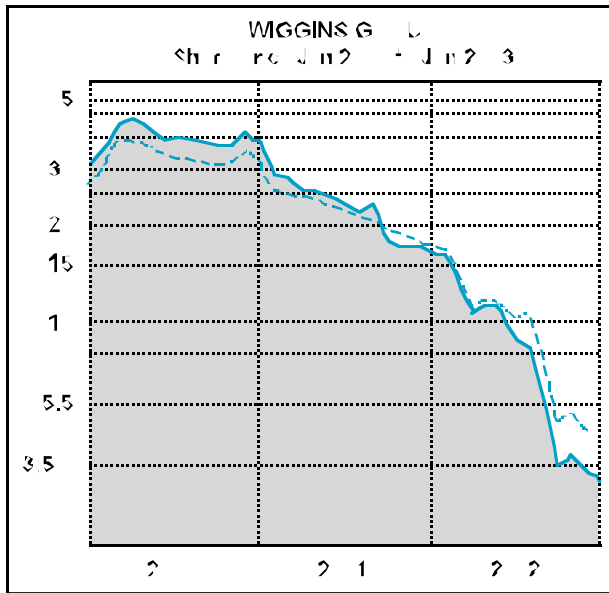


Figure 2.1 Wiggins Group: loss of confidence

The Accounting Standards Board (ASB)

The ASB develops and issues accounting standards and keeps them up to date. An important part of its role now is helping to converge UK standards with standards developed by the International Accounting Standards Board (IASB); see Chapter 31.

The Urgent Issues Task Force (UITF)

The UITF is a sub-committee of the ASB. Its main role is to assist the ASB on emerging issues and on areas where there is evidence of unsatisfactory reporting practice. The UITF issues 'Abstracts' to provide interim guidance pending the issue of, or amendment to, an accounting standard.

Financial Reporting Standards (FRSs)

The Companies Act 1985 includes the definition of 'accounting standards', and requires that directors of

companies (other than most *small* or *medium-sized* companies) disclose in the accounts:

- whether the accounts have been prepared in accordance with applicable accounting standards;
- particulars of any material departure from those standards; and
- the reasons for the departure.

Accounting standards issued by the ASB are known as Financial Reporting Standards (FRSs) and Exposure Drafts as Financial Reporting Exposure Drafts (FREDs).

Where an area is particularly important or controversial, the ASB's practice is to issue a Discussion Paper which, after taking account of comment by interested parties, leads to a FRED.

Twenty-one FRSs have so far been published, including FRS 1, which requires the annual report and accounts to contain a cash flow statement, and FRS 3, which requires a statement of total recognised gains and losses.

In addition, at its first meeting, the ASB unanimously agreed to adopt all the extant SSAPs published by its predecessor, the ASC, thereby giving them statutory clout. The financial reporting standards currently in force are listed in Appendix 1.

Statements of Recommended Practice

Statements of Recommended Practice (SORPs) are developed by bodies recognised by the ASB to provide guidance on the application of accounting standards to specific industries, e.g. the British Bankers' Association's SORP on the treatment of securities. Companies are encouraged to comply with SORPs, but they are not mandatory, unless specifically required by legislation or other regulations.

International accounting standards

Certain aspects of the traditional body of UK accounting principles are, in the words of the ASB, 'becoming increasingly out of step with developments internationally'. To help facilitate international co-operation and harmonisation, the Board is working with other leading national standard-setting bodies, as well as the International Accounting Standards Board (IASB). But 'if the Board is to participate meaningfully and credibly in international debates about financial reporting, it must move closer to the conceptual frameworks of other leading standard-setters'.

For a comparison of UK and International Accounting Standards, see Chapter 31.

Principles of financial reporting

Need for a conceptual framework

One criticism that had for a long time been levelled at UK accounting standards was the absence of agreement on the fundamental principles of accounting and reporting. This made it difficult to produce a consistent and coherent standards framework.

Fundamental accounting concepts

Prior to the formation of the ASB, four fundamental accounting concepts had been laid down by the ASC in SSAP 2 *Disclosure of accounting policies*:

1. The *going concern concept*: the accounts are compiled on the assumption that there is no intention or need to go into liquidation or to curtail the current level of operations significantly.
2. The *accruals (or matching) concept*: revenue and costs are accrued (accounted for) as they are earned or incurred, not as the money is received or paid, and revenue and profits are matched with associated costs and expenses by including them in the same accounting period.
3. The *consistency concept*: accounting treatment of like items is consistent from one period to the next.
4. The *concept of prudence*, which is the overriding concept, demands that:
 - (a) revenue and profits are not anticipated;
 - (b) provision is made for all known liabilities (expenses and losses), whether the amount is known with certainty or has to be estimated.

FRS 18 Accounting policies

FRS 18, which replaced SSAP 2, retains SSAP 2's four concepts, stressing the key status of *going concern* and *accruals*, which play a pervasive role in the selection of accounting policies, but placing less importance on the concepts of *consistency* and *prudence*.

In FRS 18 the key objectives are *relevance*, *reliability*, *comparability* and '*understandability*' (their word, not ours), while:

- consistency is viewed against the objective of comparability, which can be achieved through a combination of consistency and disclosure;
- prudence is viewed against the objective of reliability. FRS 18 emphasises that it is not necessary to exercise prudence where there is no uncertainty.

Statement of Principles for Financial Reporting

The *Statement of principles for financial reporting* (StoP) was published in December 1999.

The ASB took the view that a common set of principles was necessary to achieve further harmonisation in international accounting practice.

For that reason, the UK *Statement of Principles* was based on the International Accounting Standards Committee's *Framework for the Preparation and Presentation of Financial Statements* (the IASC Framework), which was itself derived from the *Statements of Financial Accounting Concepts* issued in the USA by the Financial Accounting Standards Board (FASB).

As well as several fairly obvious truisms – the need for reliability, relevance, consistency, completeness, neutrality and understandability to the user – the StoP also spells out a number of further accounting concepts:

- '*Substance over form*': This concept was introduced by FRS 5. It requires items to be accounted for so as to reflect their commercial substance rather than their legal form, if these differ. For example, where a company is for all practical purposes the owner of an asset, but is not technically the *legal* owner, the asset should be included in the company's balance sheet. This could occur where a company was already deriving virtually all the commercial benefit from an asset, and had an indefinite option to buy it from its owner for a nominal sum (StoP paras. 3.12 and 3.13).
- *Materiality*: If any information is not material it does not have to be included in financial statements (StoP paras. 3.28 to 3.32).

Although the StoP doesn't give a definition of materiality, SSAP 3 *Earnings per share* (subsequently replaced by FRS 14) did so in the context of fully

diluted earnings per share, which only had to be disclosed if dilution was material; dilution of 5% or more was considered material.

A trick we came across in a company that went bust in the early 1990s was to treat its various activities as *divisions* where, in most groups, they would have been *subsidiaries*. This enabled the company to treat quite significant matters as immaterial, as they were under 5% in the context of the whole Group, when they might have reduced the profits of a subsidiary by more, and often much more, than 5%.

- **Comparability:** Users need to be able to compare an entity's financial information over time in order to identify trends in its financial performance and financial position.

They also need to be able to compare the financial information of different entities in order to evaluate their relative financial performance and financial position (StoP paras. 3.20 and 3.21).

In practice comparability over time is distorted unless figures are adjusted to allow for the effects of general inflation. This is demonstrated in Chapter 29.

Comparability over time can also be distorted if a company changes its accounting policies. For example, the videotape hire company CITYVISION, before it was taken over by BLOCKBUSTER, a US company in the same business, revised the estimated useful life of its tape libraries, depreciating them over 30 months instead of 15 months. This increased reported profits by nearly 60%.

Comparability between companies can be distorted if their accounting policies are different; for example, CABLE & WIRELESS and BT depreciate similar equipment over different useful lives.

Comparability between companies can also be distorted by differences in the way assets are financed. For example, a retailer that owns all its outlets cannot be fairly compared with a similar retailer that rents all its outlets, unless the analyst adjusts the figures to allow for the difference. Adjustments are also needed if the companies' financial years are not coterminous.

- **Financial adaptability:** This is a recent concept, defined as a company's ability 'to take effective action to alter the amount and timing of its cash flows so that it can respond to unexpected needs or opportunities' (StoP para. 1.19).

This may include whether the company is in a position to issue more equity, to increase borrowings or to sell off surplus assets.

What financial statements comprise

The annual report of the auditors to the company's shareholders often begins 'We have audited the financial statements on pages xx to yy', i.e. the pages containing the financial statements (but nothing else unless specifically stated).

These include four primary financial statements:

- Profit and loss account
- Statement of total recognised gains and losses
- Balance sheet
- Cash flow statement.

Financial statements also include:

- notes to the financial statements
- statement of accounting policies.

The notes and the primary financial statements form an integrated whole, and should be read as such to obtain a complete picture.

The need to read the notes

The role of the notes is to amplify and explain the primary financial statements, and it can be very misleading to read the primary financial statements in isolation.

Although the 1995 ED said 'disclosure of information in the notes to the financial statements is not a substitute for recognition [in the financial statements], and does not correct or justify a misrepresentation or omission in the primary financial statements' (para. 6.13), some companies have certainly tried it on in the past, and will probably do so in the future. Let us give you two examples from the accounts of now defunct companies:

1. A year or so before its demise the Southampton-based golfing and tennis hotel company LEADING LEISURE's P & L account showed a pre-tax profit of £6.7m. Note 1 to the accounts reported that trading profit generated by the disposal of properties to joint ventures amounted to £10m. Note 12 revealed additions to loans to related companies of £35.8m.

A sceptical analyst might suspect that Leading Leisure had loaned its joint venture partner the money to buy a 50% stake in the properties, and that the price of the

50% stake had been pitched to give Leading Leisure a £10m trading profit.

Amongst other little gems in the notes, note 6 showed an extraordinary item of £1.3m 'Reorganisation and aborted fund raising costs'. There was obviously more than one Doubting Thomas about. In the next 12 months or so the share price fell from 96p to 2p, at which point the shares were suspended. A week later the banks called in administrative receivers.

2. RESORT HOTELS provides our second cautionary tale about the dangers of not reading the notes. As well as running its own hotels, Resort had management contracts to run a number of hotels financed by Business Expansion Schemes (a tax break to encourage investment in young and expanding companies).

Resort charged these BES-financed hotels management fees. The hotels weren't profitable enough to be able to pay the fees. But the unpaid fees were counted as income by Resort, thus bolstering Resort's profits and, at the same time, producing an ever-increasing debtor item of management fees due in Resort's balance sheet. Eventually the bubble burst.

In the last Report and Accounts before its demise, Resort's balance sheet did give a warning clue: an alarming rise in 'Amounts due from managed companies' from £8.646m to £12.987m, an increase of £4.341m.

But you had to read the notes to find out what was actually going on. Note 1 showed a breakdown of turnover between Hotel operations £11.874m and Hotel management fees £4.219m, almost exactly the increase in the amounts due from managed companies.

The objective of financial statements

The objective of financial statements is to provide information about the financial position and performance of an enterprise that is useful to a wide range of users for assessing the stewardship of management and for making economic decisions (StoP Chapter 1).

Users and their information needs

Financial information about the activities and resources of an entity is typically of interest to many people. Although some of these people are able to command the preparation of special purpose financial reports in order to obtain the information they need, the rest – usually the vast

majority – will need to rely on general purpose financial reports (StoP para. 1.1). As the StoP points out, Annual Reports and Accounts and Interim Reports are of interest not only to investors, but to:

- lenders (although banks demand and get a lot more timely and detailed information than is generally available);
- suppliers and other trade creditors (to decide how much credit to allow a company);
- customers (a retailer to assess the financial strength of a potential supplier);
- employees (whether to buy some shares, or to start looking for another job);
- governments and their agencies; and
- the general public (e.g. where a company makes a substantial contribution to a local economy by providing employment and using local suppliers).

What users look for

Economic decisions often require *an evaluation of the enterprise's ability to generate cash* and the timing and certainty of its generation. To do this users focus on the enterprise's (i) financial position, (ii) performance, and (iii) cash flows; and use these in predicting expected cash flows.

The *financial position* of an enterprise encompasses the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. Much, but not all, of the information on financial position needed is *provided by the balance sheet*.

The *performance* of an enterprise comprises the return obtained by the enterprise on the resources it controls, including the cost of its financing. Information on performance is *provided by the profit and loss account and the statement of total recognised gains and losses*.

Recognition

At the heart of any statement of principles lie questions of recognition:

- When exactly *is* something (i) an asset; (ii) a liability? and
- Just when *does* one recognise (i) a gain; (ii) a loss?

For example, a well-known construction and house-building company used to have an accounting policy which said that the profit on building houses should only be recognised when all the houses in a development had been sold. This gave the directors wonderful flexibility: they could (and did) build an estate of say 200 houses, sell 199 of them, and keep one unsold until they wanted to bring the profit on the whole estate into their accounts. This may have been extremely *prudent*, but it was hardly *true and fair*.

Chapter 5 of the StoP deals at length with *recognition in financial statements* (StoP pp. 57–74). Recognition is required if ‘sufficient evidence exists that the new asset or liability has been created . . . and can be measured at a monetary amount with sufficient reliability’ (StoP p. 59).

But, inevitably, there will be scope for subjective judgement of what is ‘*sufficient evidence*’ and what is ‘*sufficient reliability*’, and there will also be variations in the accounting policies of individual companies.

Accounting policies

FRS 18 requires the accounting policies used in the preparation of the accounts to be disclosed. They are usually shown after the accounts proper, either immediately before the notes to the accounts or as the first note. A few companies, like BT, show them at the beginning of the accounts, immediately before the profit and loss account.

As an illustration of accounting policies we have chosen extracts from the notes to the accounts of THE BODY SHOP. Our comments are in square brackets, and the italics are ours.

THE BODY SHOP *Extracts from the notes to the 2003 accounts*

Note 1 Accounting policies

The financial statements have been prepared under the historical cost convention and in accordance with applicable accounting standards . . .

Accounts are prepared to the Saturday nearest the end of February in each year. On that basis the 2003 accounts are prepared for a 52-week period ending 1 March 2003; comparatives are for the 52-week period ended 2 March 2002.

The principal accounting policies are:

Basis of consolidation

. . . The Group uses the *acquisition method* of accounting to consolidate the results of subsidiary undertakings, and the results of subsidiary undertakings are included from the date of acquisition to the date of disposal.

[The other method, the *merger method*, which may only be used in very limited circumstances, takes in the acquired company’s results for the *whole year* in which two companies combine.]

Goodwill

Goodwill arising on the acquisition of a subsidiary or business is the difference between the consideration paid and the fair value of the assets and liabilities acquired.

Goodwill arising on acquisitions *prior to 28 February 1998* was set off directly against reserves and has not been reinstated on implementation of FRS 10.

Positive goodwill arising on acquisitions from *1 March 1998* is capitalised, classified as an asset on the balance sheet and amortised on a straight line basis over its useful economic life up to a presumed maximum of 15 years.

It will be reviewed for impairment at the end of the first full financial year following the acquisition and in other periods if events or changes indicate that the carrying value may not be recoverable.

Any goodwill previously eliminated to reserves will be charged/credited to the profit and loss account on disposal of the related business.

Valuation of investments

Investments held as fixed assets are stated at cost less any provision for impairment.

Depreciation

Depreciation is provided to write off the cost, less estimated residual values, of all tangible fixed assets, except for freehold land, over their expected useful lives . . .

Stocks

Stocks are valued at the lower of cost and net realisable value . . . Net realisable value is based on estimated selling price less further costs to completion and disposal.

The Body Shop International Employee Share Trust

The Company is deemed to have control of the assets, liabilities, income and costs [of the Trust].

These have therefore been included in the financial statements of the Group and Company . . .

Foreign currency

The results of the foreign subsidiaries have been translated using the average of monthly exchange rates . . .

Foreign currency monetary assets and liabilities are translated at the rates ruling at the balance sheet dates and any differences arising are taken to the Profit and Loss account.

Research and development

Research and development expenditure is charged to the Profit and Loss account in the year in which it is incurred.

Etc.

The full significance of the company's accounting policies will become clear in subsequent chapters.



The key purpose of forming a company is to limit the liability of shareholders.

Before the first Companies Act introduced the Company as a separate legal entity in 1862, the *proprietor* of a business had **unlimited liability**. If his business failed, he was personally responsible for settling the debts of the business and, if he had no other means of doing so, could have to sell his home and personal possessions.

Not only was his liability unlimited but, if he took in partners, they would have unlimited liability too.

As the industrial revolution gathered momentum, *individual proprietors* found it increasingly difficult to raise enough capital to keep pace, or to find partners to share the increasing risk. Growth achieved by ploughing back profits was simply too slow.

The limited company

If a limited company goes bust, the shareholders will lose all the money they invested in the company but, providing their shares are fully paid up, will have no further liability. Their liability is **limited** to their investment, and not one penny more.

Incorporation of a company

When a company is formed by incorporation under the Companies Acts a Certificate of Incorporation is issued and the company assumes a legal identity separate from its shareholders.

Before incorporation can take place, a Memorandum of Association and Articles of Association have to be drawn up and filed with the Registrar of Companies in England and Wales or with the Registrar of Companies in Scotland.

Memorandum of Association

The Memorandum lays down the rules which govern the company in its relations with the outside world. It states the name of the company; the country in which the Registered Office will be situated; the objectives of the company (i.e. activities the company may pursue); the authorised share capital; the nominal value of the shares; a list of initial subscribers and whether the liability of members (shareholders) is limited. An example is given in Table B of the First Schedule to the Companies (Tables A to F) Regulations 1985.

Articles of Association

The Articles lay down the internal rules within which the directors run the company. The main items covered are:

- (a) the issue of shares, the rights attaching to each class of share, the consent required for the alteration of the rights of any class of shareholders, and any restrictions on the transfer of shares;
- (b) the procedure for board and general meetings and for altering the authorised share capital;
- (c) the election and retirement of directors, their duties and their powers, including borrowing powers;
- (d) the declaration of dividends;
- (e) the procedure for winding up the company.

A model set of Articles is given in Table A of the Schedule to the Companies (Tables A to F) Regulations 1985.

Members' (shareholders') liability

The liability of members (shareholders) of a company can either be limited by shares or by guarantee, or the liability can be unlimited.

Limited by shares

This is the method normally used for a company engaged in business activities. If the shares are fully paid, the members' liability is limited to the money they have put up: the maximum risk a shareholder runs is to lose all the money he has paid for his shares, and no further claim can be made on him for liabilities incurred by the company. If the shares are only partly paid, shareholders (and to a limited extent former shareholders) can be called upon to subscribe some or all of the unpaid part, but no more than that.

Limited by guarantee

This method is used for charitable and similar organisations, where funds are raised by donations and no shares are issued. The liability is limited to the amount each member personally guarantees, which is the maximum each member may be called upon to pay in the event of liquidation. This form of incorporation is not normally used for a business.

Unlimited

This method is used by professional firms that want the tax advantages of being a company; the members have joint and several liability in the same way as a partnership (each member can individually be held entirely responsible).

Public company

Reference: Companies Act 1985 (CA 1985), Sections 1 (3), 11 and 25.

A public company is defined as one:

- (a) which is limited by shares or guarantee, with a minimum issued share capital of £50,000, or such other sum as specified by statutory instrument (the shares must be at least 25% paid up, with any share premium fully paid up); and
- (b) whose Memorandum states that it is a public company; and
- (c) which has been correctly registered as a public company.

All other companies are private companies.

A public company registered as such on incorporation cannot do business until the Registrar of Companies has issued a certificate that he is satisfied that the share capital requirements have been met.

The name of a public company must in all cases end either with the words 'Public Limited Company' or with the abbreviation 'PLC', neither of which may be preceded by the word 'Limited'.

A public company does not automatically have its shares listed on the Stock Exchange, but the process of obtaining a listing (see Chapter 4) is often referred to as 'going public', as a private company cannot obtain a listing on the Stock Exchange.

Private company

A 'private company' is a company that is not a public company (CA 1985, s. 1 (3)).

A company limited by shares or by guarantee (not being a public company) must have 'Limited' as the last word in its name (CA 1985, s. 25).

Chartered company

Companies may also be established by Royal Charter, the method used before any Companies Acts existed; e.g. the PENINSULAR & ORIENTAL STEAM NAVIGATION COMPANY was incorporated by Royal Charter in 1840. The legal position of a chartered company is similar to that of an incorporated company, except that any change to the Articles involves a petition to the Privy Council.

Small and medium-sized companies

Small and medium-sized companies are defined by the Companies Act 1985 as companies meeting two or more of the following criteria:

	<i>Small company</i>	<i>Medium-sized company</i>
Turnover not exceeding	£5.6m*	£22.8m*
Total assets not exceeding	£2.8m*	£11.4m*
Number of employees not exceeding	50	250

* Updated periodically to take account of inflation.

Small and medium-sized private companies are permitted to file abbreviated accounts but they are still required to send full accounts to their members.

Stock Exchange listing – ‘quoted companies’

In April 2000, responsibility for UK listing was transferred from the Listing Department of the London Stock Exchange (LSE) to the UK Listing Authority (UKLA), a division of the Financial Services Authority (FSA).

UKLA’s Listing Rules are known as ‘The Purple Book’, from the colour of its cover.

Provided that it meets certain criteria, a public company may have its shares and/or debentures, unsecured loan stocks and warrants ‘listed’, i.e. included in The Stock Exchange Official List, so that a market is ‘made’ in the securities. Although it is usual for all the securities of a company to be listed, it is possible for this not to be the case. For example, SAINSBURY’s preference shares were listed for many years before its ordinary shares were offered to the public.

Companies which have securities that are listed are often referred to as ‘quoted companies’, ‘having a quotation’ or ‘being listed’, although it is the company’s securities that are listed, not the company itself. ‘Having a quotation’ is simply the old term for being ‘listed’.

Requirements for listing

The minimum legal requirements that a company has to meet before any of its securities can be listed are contained in the UKLA’s Listing Rules (The Purple Book).

Listing Particulars (prospectus)

Chapter 6 of The Purple Book contains details of the contents of Listing Particulars, which have to be supplied for approval prior to listing, and which have to be included in

any prospectus inviting initial public subscription for the company’s shares.

Companies wishing to have their securities admitted to the LSE’s markets for listed securities have to complete a two-stage admission process: firstly, the securities need to be admitted to the Official List by UKLA; secondly, the securities must be admitted to trading by the LSE.

The Listing Particulars are designed to ensure that the company makes available sufficient information on its history, current position and future prospects to enable the general public to assess the value of the company’s shares as an investment, and they are very comprehensive. The prospectus issued by a company when it goes public is therefore a most valuable source of information.

Minimum size of issue

The UKLA has to satisfy itself that sufficient dealings are likely to take place in the class of security for which application is being made to make a realistic market, and thus justify a listing. The Listing Rules lay down two minimum criteria for listing – the expected market value of the securities for which listing is sought (the expected market price multiplied by the number of shares issued and to be issued: currently a minimum of £700,000 for shares and £200,000 for debt securities), and the proportion of shares to be held by the public (currently 25% of any class of share).

Keeping the public informed

The UKLA also has to ensure that the general public will be kept satisfactorily informed of the company’s activities and progress in the future, and that the shareholders’ interests will be adequately protected: this is done by requiring an

applicant for listing to accept 'Continuing Obligations' as a condition of admission to and subsequent maintenance of listing.

Continuing Obligations

Chapter 9 of The Purple Book deals with the Continuing Obligations of listed companies, designed to protect shareholders and to keep them properly informed. Additional continuing obligations are contained in Chapters 10 to 16.

Companies are required to submit to the UKLA through the company's official sponsors, normally brokers, drafts for approval of all circulars to holders of securities, notices of meetings, forms of proxy and notices by advertisement to holders of bearer securities.

Companies are also required to announce their financial results, dividend declarations, material acquisitions, changes of directors, proposed changes in the nature of the business and any other information necessary to enable holders of the company's listed securities and the public to appraise the position of the company and to avoid the establishment of a false market in its listed securities.

In particular a company must notify the Company Announcements Office, by way of a warning announcement, of information which is likely to lead to substantial movements in the price of its securities if at any time the necessary degree of confidentiality cannot be maintained, or that confidentiality has or may have been breached.

In addition, amongst various requirements on interim reports, proxy voting, registration of securities and several other topics, The Purple Book requires companies to include in the annual report and accounts:

- (a) if the results for the period under review differ by 10% or more from any published forecast or estimate by the company for that period, an explanation of the difference;
- (b) the amount of interest capitalised;
- (c) particulars of the waiving of emoluments by any director, and of the waiving of dividends by any shareholder;
- (d) details of each director's beneficial and non-beneficial interests in the company's shares and options;
- (e) information on holdings, other than by directors, of 3% or more of any class of voting capital;
- (f) details of any authority for the purchase by the company of its own shares, and details of any purchases made otherwise than through the market;
- (g) details of shares issued for cash other than pro rata to existing shareholders;
- (h) where a company has listed shares in issue and is a subsidiary of another company, particulars of the participation by the parent in any placing;
- (i) particulars of significant contracts during the year in which any director is or was materially interested;
- (j) a statement by the directors that the company is a going concern;
- (k) for a company incorporated in the UK, a statement of how it has applied the Principles of the *Combined Code on Corporate Governance* (the 'Appliance' statement) and a statement as to whether or not it has complied throughout the period with the Code (the 'Compliance' statement), which should also specify any departures from the provisions of the Combined Code;
- (l) a report to the shareholders by the Board, containing details of each director's remuneration, share option and pension arrangements.

Listed companies are also expected to issue their report and accounts within six months of their year end, but may apply for the six-month period to be extended if they have significant overseas interests.

Methods of obtaining a listing

Chapter 4 of The Purple Book describes the ways in which a company can obtain a listing. Briefly, they are as follows:

1. Offer for sale

An offer for sale is the most common method of obtaining a listing. Both new and/or existing securities can be offered to the public. The issuing house or the sponsoring broker purchases the securities from existing securities holders and/or from the company, and offers them on to the public at a slightly higher price.

2. Offer for subscription

An invitation is made to the public by, or on behalf of, an issuer to subscribe for new shares or other securities.

3. Offer for sale by tender

This is a variation of methods 1 or 2, in which applicants are invited to bid for securities at or above a minimum issue price. The securities are then all sold at one price, the 'striking price', which may be the highest price at which all the securities can be sold, or a little lower, if this is necessary to ensure a good spread of holders.

4. *Placing*

Securities are placed with specified persons or clients of the sponsor or any securities house assisting in the placing. There is no offer to the public and no general offer to existing holders.

5. *Intermediaries offer*

Securities are offered by, or on behalf of, the issuer to intermediaries for them to allocate to their own clients.

6. *Introduction*

An introduction is used where the company's securities are already widely held and/or are already listed outside the UK, or where a new holding company issues its securities in exchange for those of one or more listed companies; there is no formal offer of securities, but a listing is obtained for existing securities.

Methods 1 to 5 are referred to broadly as 'new issues', because the company's securities are new to the stock market, although only method 2 necessarily involves the issue of any new securities.

Alternative Investment Market

Reference: AIM Rules for Companies.

The Alternative Investment Market, AIM, was set up in 1995 to provide an alternative source of capital and a trading platform for companies unable or unwilling to join the official list.

The entry requirements are less demanding than for a full listing:

- no requirement for a minimum trading record;
- no minimum levels of capitalisation;
- no requirement for any given percentage of the share capital of the company to be in public hands.

Although entry documentation has been kept as simple as possible, entrants to AIM must provide a prospectus or similar document which satisfies the requirements of the Public Offers of Securities Regulations (1995), and audited accounts set out under company law. Companies must arrange for a member firm to support trading. They must also meet certain ongoing obligations including publication of unaudited interim figures and of all directors' dealings.

Price-sensitive information must be published promptly; and trading on AIM is subject to the same level of surveillance and supervision as the official list. AIM has proved extremely popular; a huge variety of companies have joined, with market capitalisations ranging from about £1m to more than £100m.

By the end of 2003 more than 750 companies were trading on AIM.

Share capital

A key point to check is whether shares in a company are widely held or whether the company is under the control of one person, or of a number of people, e.g. family controlled.

The normal means of control is to have at least 50% of the votes. This is simple if there is only one class of share, and each share carries one vote.

But there are complications when there is more than one class, with different voting rights, or there is a 'golden share' which carries an all powerful vote in certain circumstances.



Control

If a company is under the control of one person or group of persons, the other investors can be on a hiding to nothing. Check directors' holdings and look out for any note on substantial shareholdings, e.g.:

MAXWELL COMMUNICATION CORPORATION *Paragraph in the 1990 Report of the Directors*
Substantial shareholdings

As at the date of this report, pursuant to Section 198 of the Companies Act 1985, the Company had been advised of the following interests of 3% or more in the ordinary share capital of the company:

<i>Name</i>	<i>Number of shares</i>	<i>% of issued share capital</i>
Maxwell Foundation and its subsidiaries	202,558,076	31.34%
Robert Maxwell, his family and companies controlled by him and his family	155,912,928	24.14%

In 1990 Maxwell Communication Corporation was one of the world's top ten publishers, capitalised at about £1.4 billion. But the tyrannical management style of the controlling shareholder drove the company into administrative receivership less than two years later.

Authorised and issued share capital

When a company is formed, the authorised share capital and the nominal value of the shares are established and written into the company's Memorandum of Association, and the procedure for increasing the authorised share capital is included in the company's Articles of Association. This usually requires the approval of the shareholders.

Thereafter the directors of the company cannot issue new shares in excess of the authorised number, nor can they issue securities carrying rights to new shares that would exceed that number (e.g. convertibles and warrants: see below).

Both the authorised and the issued share capital are shown in the company's accounts, divided into equity and non-equity shares, e.g.:

BELLWAY Extract from 2003 Group balance sheet

	2003	2002
	£000	£000
Capital and reserves		
Equity share capital		
Ordinary shares	13,926	13,775
Non-equity capital		
Preference shares	<u>20,000</u>	<u>20,000</u>
Called up share capital	<u>33,926</u>	<u>33,775</u>
...		

Details of the authorised share capital are normally shown in a note to the accounts.

Types of share capital

Although all shares are referred to generally as ‘risk capital’, as the shareholders are the first investors to lose if the company fails, the degree of risk can vary within the same company from hardly any more than that of an unsecured lender to highly speculative, with prospects of reward usually varying accordingly.

The main types of share, in increasing order of risk, the order in which they would rank for distribution in the event of liquidation, are:

- (a) preference shares
- (b) ordinary shares
- (c) deferred shares
- (d) warrants to subscribe for shares.

Unlike interest paid on loan capital, distributions of profits to shareholders are not an ‘allowable expense’ for company taxation purposes; i.e. dividends have to be paid out of profits *after* corporation tax has been deducted.

Preference shares

Preference shares carry a fixed rate of dividend, normally payable half-yearly but, unlike the holders of loan capital, who can take action against a company in default of interest payments, preference shareholders have no legal redress if the board of directors decides to recommend that no preference dividends should be paid. However, if no preference dividend is declared for an accounting period, no dividend can be declared on any other type of share for

the period concerned, and the preference shareholders usually become entitled to vote at shareholders’ general meetings. (Provided their dividends are paid, preference shares do not normally carry a vote.)

Varieties of preference shares can include one or a combination of the following features:

- *Cumulative*. If the dividend on a cumulative preference share is not paid on time, payment is postponed rather than omitted. When this happens, the preference dividend is said to be ‘in arrears’, and these arrears have to be paid by the company before any other dividend can be declared. Arrears of cumulative preference dividends must be shown in a note to the accounts.
- *Redeemable*. The shares are repayable, normally at their nominal (par) value, in a given year, e.g. 2002, or when the company chooses within a given period, e.g. 2001/04.
- *Participating*. In addition to receiving a fixed dividend, shareholders participate in an additional dividend, usually a proportion of any ordinary dividend declared.
- *Convertible*. Shareholders have the option of converting their preference shares into ordinary shares within a given period of time, the conversion period.

Where a company has a large proportion of non-equity shares, it is important to check whether a significant number are due for redemption in the near future.

Golden shares

Where nationalised industries were privatised, the government did, in some cases, retain a ‘special rights share’ to prevent takeover. These shares were cancelled after a ruling by the European Court of Justice in 2003.

An example of control by a single share is REUTERS, where there is a single Founders £1 share designed to preserve Reuters’ independence. The share is held by a Trust, and may be used to outvote all ordinary shares if other safeguards fail and there is an attempt to seize control of the company.

Ordinary shares

Ordinary shares usually form the bulk of the share capital of a company. Ordinary shareholders are normally entitled to all the profits remaining after tax and preference dividends have been deducted although, as explained later, not all these attributable profits are likely to be distributed. Ordinary

shareholders are entitled to vote at general meetings, giving them control over the election of directors.

However some companies put a clause in their articles of association to allow them to disenfranchise a shareholder where the shares are held in a nominee name and the nominee holder fails to respond to a request for information on the underlying holder. This protects the company against the building up of anonymous holdings prior to a possible bid.

Under the Companies Act 1985 companies are allowed to issue redeemable ordinary shares, provided they also have shares in issue which are not redeemable; i.e. the share capital of a company cannot consist solely of redeemable shares. A company may now also purchase its own shares, subject to a large number of conditions, including the prior approval of its shareholders (see page 31).

Partly paid shares

When a company raises money, but doesn't need it all at once, for example an oil exploration company with a long drilling programme, it may issue partly paid shares, making calls on the unpaid part as and when required. The buyer of partly paid shares is legally obliged to pay the call(s).

Ordinary stock

Ordinary stock is a historical legacy from the days when every share in issue had to be numbered; some companies used to convert their shares into stock when they became fully paid (as this avoided the bother of numbers), and a few companies continue to use the term.

Ordinary stock can, in theory, be transferred in any monetary amount, while shares can only be bought and sold individually; in practice ordinary stock is normally traded in multiples of £1, so the terms 'ordinary share' and 'ordinary stock' are effectively synonymous.

Non-voting shares

A number of companies have more than one class of share (other than preference shares), with differing rights on voting and/or dividends and/or on liquidation. The most common variation is in voting rights, where a second class of share, identical in all other respects to the ordinary class, either carries no voting rights (usually called N/V or A shares), or carries restricted voting rights (R/V shares).

The trend over the last few years has, however, been towards the abolition of non-voting shares, and it is becoming increasingly difficult (if not actually impossible) to raise new money by the issue of non-voting shares. Several companies, led by MARKS & SPENCER in 1966, and including more recently, in 2000, the construction group JOHN LAING, have enfranchised their non-voting shares, giving scrip (free) issues to voting shareholders by way of compensation, but there are still a few exceptions. For example GLENMORANGIE, the Scotch whisky company, has a two-tier structure in which the founding family retain the majority of the B shares:

GLENMORANGIE Extract from 2003 accounts

Called up share capital	£000
A Ordinary Shares (one vote per share) of 10p each	1,165
B Ordinary Shares (5 votes per share) of 5p each	200

Investing in shares that have fewer votes than another class of share, or have no votes at all, is very much a case of *caveat emptor* (buyer beware).

You may find yourself investing in a company like C.H. BAILEY, where the B ordinary shares, largely family owned, carry 100 times the votes of the more widely held ordinary shares.

The chairman, Mr C.H. Bailey, has taken full advantage of his controlling position by paying himself over £1.4m in the last ten years, while shareholders have had only two dividends in the same period.

The company discourages them from complaining by holding the annual general meeting (AGM) at Alexandra Docks in Newport, Gwent, in the middle of winter, inconveniently close to Christmas. In 2000 it was held on 14 December.

Another company which used to have non-voting shares is the electro-components and power supplies company BULGIN, which also illustrates another key point:



The jigsaw

As with doing a jigsaw (or in any intelligence-gathering organisation), the analyst often needs to put together several pieces of information to get the picture.

A.F. BULGIN Note 23 to the 1997 accounts

Called up share capital	£000
Authorised . . .	
Allotted, called up and fully paid	
2,000,000 Ordinary shares of 5p each	100
26,340,000 A Non-Voting shares of 5p each	<u>1,317</u>
	1,417

Extract from Report of the Directors

Directors and their interests

<i>Beneficial interests</i>	Ordinary	A Ordinary
R.A. Bulgin [Chairman/MD*]	307,200	645,087
R.E. Bulgin	201,800	96,059
G.A. Stone [Company Sec.*]	2,000	5,387
R.A.R. Bulgin	86,200	259,201
C.S. Bulgin (Resigned 29 April 1997)	6,002	21,000
C.M. Leigh [FD*]	2,000	1,000

Non-beneficial interests . . .

* As shown in the list of Directors and Advisers

The Bulgin family directors held a shade over 30% of the voting shares in 1997. Were there any other substantial shareholdings? Yes, and very interesting they were too (as we show next).

A.F. BULGIN Extract from Report of the Directors 1997**Substantial shareholdings**

The Company is advised of the following interests in the issued voting ordinary shares of 5p each at 23 May 1997:

	<i>Ordinary</i>	<i>%</i>
National Westminster Bank Plc (mainly as managing trustees of certain settlements executed by the late Mr A.F. Bulgin)	658,500	32.9
Mars UK Pension Fund	65,000	3.3
Specialist Holdings Limited	260,000	13.0
G.M. Barber	74,500	3.7

Bulgin directors' holdings and the late Mr A.F. Bulgin's settlements together gave voting control.

A.F. BULGIN Note 9 to the 1997 accounts**Directors' emoluments**

	<i>Salary</i>	<i>Benefits</i>	<i>Pension contrib.</i>	<i>Total</i>
	£000	£000	£000	£000
R.A. Bulgin	125	25	50	200
R.E. Bulgin	70	20	57	147
G.A. Stone	66	10	52	128
R.A.R. Bulgin	55	24	10	89
C.S. Bulgin	55	12	6	73
C.M. Leigh	<u>55</u>	<u>20</u>	<u>8</u>	<u>83</u>
	<u>426</u>	<u>111</u>	<u>183</u>	<u>720</u>

The Bulgin share of the total remuneration of the directors was £509,000, more than 70% of the total. Set this against a pre-tax profit for the year of £238,000 and one is led to ask: 'Are the shareholders happy?' and 'What do the non-executive directors think?'

'Has the Company any non-executive directors?' At the 1997 year end the answer was 'No'.

Two were appointed after the year end:

A.F. BULGIN Extract from Report of the Directors

On 17 February 1997 the following non-executive directors were appointed:

J.A.D. Skailes (59) – until he retired, a stockbroker at Vivian Gray . . . taken over by Gerrard & National.

A.S. Winter (50) – a management consultant specialising in corporate finance. Previously a Vice President of investment bankers Bear Stearns and before that of Chase Manhattan Bank.

So something was happening.

The company's stockbrokers are Gerrard Vivian Gray. Stockbrokers largely earn their living by telling clients what they want to hear, not necessarily what they ought to hear. That is rather different from the role of an effective non-executive director, which in four words is to provide 'independent and objective counsel'.

We continued our intelligence gathering:

A.F. BULGIN Extract from Report of the Directors 1997

Results and dividends

The profit for the year after taxation was £151,000 (1996: £691,000). The Directors recommend a final dividend of 0.50 pence per share amounting to £142,000 (1996: £127,000) and that £9,000 (1996: £564,000) be transferred to reserves.

No interim dividend had been paid for some years, so the total dividend increased by 11.8% in a year in which profits fell by 78.1%.

Another substantial shareholder

Turning back to the list of substantial shareholders, we asked ourselves: ‘Who are Specialist Holdings Limited? Where do they come into the picture?’ There is a clue in a note to the accounts:

A.F. BULGIN Note 4 to the 1997 accounts

Net operating expenses	£000
Exceptional administrative expenses comprise:	
Redundancy costs	71
Requisitioned extraordinary meetings costs	55
Defalcation	<u>89</u>
	215

So dissident shareholders have been requisitioning extraordinary general meetings (EGMs). ‘What is the betting’, we asked ourselves, ‘that they included Specialist Holdings Limited – whose 13.0% holding would go a long way to mustering enough votes to requisition an EGM?’ We could not find any amplification in the report and accounts, so we checked elsewhere:

INVESTORS CHRONICLE 17 Jan 1997 ‘Smaller Companies’

Dyson tactics at Bulgin

Electronic components maker A.F. Bulgin will be expected to appoint an independent consultant to examine enfranchising its non-voting shares if, as expected, a seemingly anodyne resolution put forward by dissident shareholder Specialist Holdings is passed at next week’s EGM.

SPECIALIST HOLDINGS are, in fact, renowned for stirring things up in companies, not so much in an altruistic crusade for the fair treatment of non-voting shareholders, but to make money.

We sympathise to some extent with the long-term non-voting shareholders, but they really have only themselves to blame for buying N/V shares in the first place: you do so at your own peril.

Let’s see what disparity in price there is between voting and non-voting shares. It’s no good looking in the *FT*, which typically only shows the N/V price (companies have to pay the *FT* an annual fee to have their share price listed each day, and Bulgin wouldn’t be over keen to publicise the disparity between the two classes of share). The *IC* is more informative:

INVESTORS CHRONICLE 24 Oct 1997 ‘Smaller Companies’

BULGIN

Electronic Components, power supplies

A N/V Ord price: 13¹/₂p Market value: £3.56m
Ord price: 77¹/₂p Market value: £1.77m

But that did not necessarily rule out the non-voting shares as an investment. Something was changing and if one is in on a change before everyone else, it *can* be profitable.

A year later, we read:

A.F. BULGIN Extract from the statement of Mr A. S. Winter [recognise the name?] in the 1998 accounts

Chairman’s Statement

...

Management changes

During the course of the year four members of the Main Board either resigned or retired. A substantial element of the resulting cost savings has been reinvested in the recruitment of new sales and marketing staff at each of the operating companies

...

We are also actively studying the effect of our current capital structure on our share price. Moreover, the current capital structure, by limiting our ability to raise fresh funds on the Stock Market, is likely to prevent us from making a major strategic acquisition. This will become a more pressing matter over the next twelve to twenty four months.

So it came as no surprise when, in June 1999, the Chairman wrote to shareholders:

BULGIN Extracts from letter to shareholders

ENFRANCHISEMENT PROPOSALS

Introduction

. . . institutional investors will not invest in companies which have a two-tier capital structure.

. . . This current limitation on raising new capital makes the company reliant on organic growth.

In order to achieve sustainable growth the Company must have the ability to fund . . . substantial acquisitions with new debt and/or equity.

Summary of the proposals and their effect

. . . for each [voting] share – 13 new [voting] shares . . . 'A' share to be converted into voting shares . . .

If the proposals are approved: the present Ordinary shareholders, who now hold about **7 per cent** of the Company and **100 per cent** of the voting rights, will own about **50.7 per cent** of the Company and of the voting rights . . .

Intentions to vote in favour of the Proposals

The Directors intend to vote in favour . . .

Specialist Holdings and shareholders associated with it have indicated that they intend to vote in favour of the Proposals (13 for 1).

The circular went on to explain that, although an independent adviser had recommended that the bonus issue should be in the range of 5 to 8 new shares for every voting share held, it would not have been possible to obtain the 75% majority for a bonus within that range.

But Specialist Holdings were being too greedy. At a heated meeting the non-voting shareholders firmly rejected the proposals. Nine months later proposals for enfranchisement on a 1 for 8 basis went through unopposed. So the non-voting shareholders were enfranchised in the end, but it was at the cost of substantial dilution, and they nearly got really ripped off by the 13 for 1 proposal.



Be very wary of buying shares that have no voting rights, or have only limited voting rights.

As we said at the beginning, it is a case of *caveat emptor*. The same warning applies to companies where all shares (other than preference shares) carry equal voting rights, and one person effectively controls more than 50% of the votes; other shareholders are relying very heavily on that one person, but at least the controlling shareholder doesn't enjoy power that is disproportionate to his or her stake in the company.

Deferred shares

Another class is the deferred share, where no dividend is payable either:

- (a) until ordinary shareholders' dividends have reached a certain level; or
- (b) until conversion into ordinary shares.

In the 1970s and 1980s, when the top rate of income tax was much higher than the rate of capital gains tax (CGT), there were a number of issues.

For example, in 1989 LONDON MERCHANT SECURITIES made a scrip (capitalisation) issue of 1 Deferred Ordinary share for every 3 Ordinary shares held. The Deferred Ordinary shares do not rank for any dividend but they will be converted automatically into Ordinary shares after the AGM held in 2004.

While the current top rate of UK income tax remains at 40%, the same as CGT, further issues of deferred shares seem unlikely.

Warrants

Warrants 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 normally exercisable only during a given time period, the exercise period, although one or two perpetual warrants have been issued.

Warrants can be issued on their own, for example HANSON used warrants plus cash in its acquisition of Kidde Inc. in 1987, of Consolidated Goldfields in 1989 and of Beazer in 1991.

They can also be issued attached to new issues of loan stock or bonds to give the holder an opportunity of subsequently participating in the equity of the company; the warrant element makes the issue more attractive and is sometimes referred to as the 'sweetener' (see Chapter 6).

Warrants provide a high risk/high reward form of equity investment. For example, if the ordinary shares of a company stood at 100p, warrants with an exercise price of 75p would then be worth a minimum of 25p. If the ordinary shares doubled to 200p then the warrants would be worth a minimum of 125p, a fivefold increase. In practice warrants command a premium over the ordinary price minus exercise price, although this premium tends to fall over the life of the warrant, reaching zero at the end of the exercise period.

Warrants are comparatively rare in the UK. Most recent issues have been made by investment trusts, which have attached them to issues of ordinary shares.

Exercise rights

Details of a warrant's exercise rights should be shown in the report and accounts. For example:

SCHRODER ASIA PACIFIC FUND *Note to 2000 accounts*

Share capital

There were 27,994,495 warrants remaining in issue at 30 September 2000. Each warrant entitles the holder to subscribe for one ordinary share of 10p at a price of 100p, on 31 January in any of the years from 2001 to 2006 inclusive.

Accounting for warrants

FRS 4 *Capital instruments* requires the net proceeds from the issue of warrants to be credited to shareholders' funds (FRS 4 para. 45). See, for example, SCHRODER ASIA PACIFIC FUND below.

SCHRODER ASIA PACIFIC FUND *Note to 2003 accounts*

Warrant Reserve	2003	2002
	£000	£000
	8,702	8,702

In accordance with the accounting standard on Capital Instruments (FRS 4) the premium arising on the issue of shares where there are warrants attached has been apportioned between the shares and the warrants as part of shareholders' funds on the basis of the market value of the shares and warrants as on the first day of dealing. The warrant element is referred to as the 'warrant reserve'.

Warrant price behaviour

Although one or two hefty and rather expensive books have been compiled about warrants, the clearest and most concise explanation we have found of the behaviour of warrant prices in practice is given in Chapter 16 of R.A. Brealey's book *Security Prices in a Competitive Market*.

The book was published by The M.I.T. Press in 1971, following Dick Brealey's statistical work on the behaviour of common stock prices on Wall Street. The chapter on warrants describes the empirical method, based on the graph of Warrant Price divided by Exercise Price plotted against Share Price divided by Exercise Price; i.e. WP/EP against SP/EP.

ADRs

ADRs (American Depositary Receipts) are used in the USA to simplify the holding of securities in non-US companies. The securities purchased on behalf of the American investor are deposited abroad in a custodian bank, and the corresponding ADR certificates are issued by a US depository bank. The ADR bank then acts both as depository and stock transfer agent, dealing with the payment of dividends and the handling of proxies and rights issues for the American investor. ADRs can be unsponsored, normally traded on the Over-The-Counter (OTC) market, or sponsored by the non-US company. Sponsored ADRs can be traded on the New York and American stock exchanges, but the non-US company must register with the Securities and Exchange Commission (SEC) and meet the specific requirements of the exchange, including the filing of an annual report (usually Form 20-F).

Share schemes for directors and employees

A number of companies have encouraged share ownership amongst their staff for many years (e.g. ICI introduced a profit-sharing scheme as long ago as 1954, under which employees received a salary-related allocation of shares each year, according to the profitability of the company), but it is only since the 1970s that governments have actively encouraged wider share participation by the introduction of substantial tax concessions.

Current share incentive arrangements fall into three categories:

1. the granting of options
2. the award of shares
3. phantom share schemes.

Granting of options

Employers grant their employees share options (the right to acquire shares) at a given price, the *exercise price*, at a given future date or period, the *exercise period*.

At the exercise date or during the exercise period, the employees may exercise their options if the exercise price is *below* the share price at the time, but may let the options lapse if the share price in the market is *below* the exercise price.

Options may be granted in various schemes:

- executive share option schemes
- unapproved share option schemes
- Enterprise Management Incentives
- Save-As-You-Earn (SAYE) schemes.

The tax rules are complex, and we can only give readers an overview of the main tax implications.

Executive share option schemes

The Inland Revenue's prior approval is required. Approval will only be given if various conditions are met:

- (a) The exercise price must be not less than the market price at the date of granting.
- (b) The option may only be exercisable between three and ten years of the date of grant.
- (c) The value of the underlying shares at the exercise price must not exceed £30,000 per person.

Tax position: No income tax or National Insurance is payable when the option is exercised except where it is exercised within three years of the exercise of another approved option. On subsequent disposal of the share, normal CGT rules apply.

Unapproved share option schemes

These are not subject to Inland Revenue restrictions, but they do not qualify for any tax concession.

Enterprise Management Incentives (EMI)

Compared with other share option schemes, EMI schemes have very significant tax advantages.

Providing the exercise price was not set below the market price of the shares at the time the option was granted, no employer's National Insurance or employee's income tax will be payable. On subsequent disposal, normal CGT rules apply.

Tax advantaged share options with a market value of up to £100,000 may be granted to any number of employees of a company, subject to a total share value of £3 million.

Save-As-You-Earn (SAYE) share options

SAYE schemes, which require Inland Revenue approval, enable share options to be offered to all employees.

To provide the sum required to exercise their options (exercise price set when the options are granted × number of shares under option), regular deductions are made monthly from the employee's net pay. The monthly contribution must be at least £5 and not more than £250 and deductions must be made for between three and five years.

At the end of the period, employees can choose between exercising their option *or* taking the cash in their SAYE account. Heads they win; tails they can't lose.

Tax position: No income tax or National Insurance is payable when the options are granted or exercised. On the subsequent disposal of shares taken up, normal CGT rules apply.

All employee share ownership plans (AESOPs)

Employers may *give* up to £3,000 worth of shares a year to each employee free of income tax and National Insurance contributions.

Each employee may also buy up to £1,500 worth of shares from their pre-tax salary, free of income tax and National Insurance contributions.

HERCULES PROPERTY SERVICES took three pages of their annual report for 2000 to summarise the main features of AESOP:

HERCULES PROPERTY SERVICES

Summary of main features . . .

There are four different methods of acquiring shares under AESOP permitted by the legislation:

Free shares provided by the Company to employees, up to a limit of £3,000 in any tax year.

Partnership shares purchased by employees out of pre-tax and NIC salary, up to a limit of £125 per month (or 10% of their overall salary, if less).

Matching shares to match employees' purchase of Partnership shares, up to a limit of 2 for each Partnership share purchased.

Dividend shares. Up to £1,500 of dividends paid under AESOP can be reinvested in shares *tax free* each year . . .

Phantom share schemes

These are cash bonus schemes where the performance of the share price determines the amount of the bonus. For example ELECO:

ELECO Extract from Report and Accounts 2000, Remuneration Committee Report

Note 6 Phantom Share Option Scheme

The scheme was devised for J.H.B. Ketteley in connection with his appointment as Executive Chairman . . . An option was granted over a maximum of 1,500,000 notional shares of the Company . . . The exercise of the option gives rise to the payment of a bonus based upon the number of shares notionally acquired, multiplied by the amount by which the market value of one ordinary share exceeds 10 pence.

Performance share plans

In this type of plan, also known as LTIPs (Long Term Incentive Plans), selected executives are granted the right to receive a fixed number of shares in the company at some future date, subject to one or more criteria.

For example, SCHRODERS has a plan in which the number of shares issued at the end of a five-year period depends on where the total shareholder return (TSR) of Schroders' shares rank in the FT-SE 100 Index:

Below 50th place	no shares issued
41st to 50th	40% of the shares issued
31st to 40th	60%
21st to 30th	80%
20th or above	100%.

The issue is also subject to a minimum average post-tax real return on equity of 7.5% per annum.

Employees are liable to income tax on shares received.

LTIPs have been open to criticism firstly because they are complicated and, more importantly, because research has shown that they do little or nothing to enhance the share price. In contrast, with share options, the interests of executives and shareholders coincide.

Summary of schemes

Type (<i>see Note</i>)	Current limit on value of shares awarded per employee
<i>Executive share option</i>	£30,000
Unapproved share option	None
<i>EMI (Options)</i>	£100,000
<i>SAYE share option</i>	£22,968
<i>AESOP (Shares)</i>	£7,500
LTIP (shares)	None

Note: Schemes in italics benefit from tax breaks

The investor's viewpoint

Companies that encourage employee share participation on favourable terms are generally regarded as more likely to prosper than those which do not. In particular, companies that grant options to executive directors and key senior staff, on whose efforts the success of a company largely depends, can expect better than average performance. In short, giving the directors and employees a 'slice of the action' should be regarded as a plus point for investing in a company, providing the directors aren't being too greedy. Avoid companies where the boardroom's total rewards are high in comparison with pre-tax profits.

Effect of inflation

At times of high inflation there is a serious flaw in share schemes for directors and employees:

SHARE SCHEMES *Effect of high inflation*

Options are granted at the current share price of 100p, exercisable in between three and seven years.

After seven years the value of money has halved, and the share price has gone up to 200p. The real value to the shareholder is unchanged, but the option holders have doubled their money.

The fair thing would be to index the exercise price by the RPI.

The issue of further equity

There are three limitations to the issue of further equity:

1. As already mentioned, there must be sufficient share capital authorised.
2. The UK Listing Authority, in its Continuing Obligations for listed companies, forbids the issue of equity, convertibles, warrants or options for cash, other than to the equity shareholders of the company, except with the prior approval of ordinary shareholders in general meeting, and the approval of the Stock Exchange. The Stock Exchange normally restricts issues of equity capital by way of placings to protect the interests of existing shareholders (see The Purple Book, Chapter 9, para. 18), but these restrictions can be relaxed when market conditions or the individual circumstances of a company justify doing so.
3. Section 100 of the Companies Act 1985 prohibits the issue of shares at a discount, i.e. for less than their nominal value.

Rights issues

A rights issue is an issue of new shares offered to shareholders in proportion to their existing holdings at a discount to the current market price. Shareholders who do not wish to subscribe can sell their rights 'nil paid'. The discount varies according to the 'weight' of the rights issue;

1 new share offered for every 8 or 10 shares already held would be regarded as a 'light' issue, probably requiring a discount of not more than 15%, while more than 1-for-4 would be 'heavy' and likely to need nearer 20% discount, or more if the company is in poor health. At these discounts underwriting would be arranged to ensure buyers for any shares not taken up by shareholders, but companies occasionally choose to make a rights issue at very much below the market price, the lowest price normally permitted being the par value of the shares.

The effect on the balance sheet of an issue at par is to add the total nominal value of the shares being issued to the issued share capital, and to show the cash received on the assets side. The expenses of the issue would normally be written off against the share premium account.

If the new shares are issued above par, the nominal value of the shares issued is added to the issued share capital and the difference between the issue price and the nominal price of each new share, i.e. the premium at which the shares were issued, is added to the share premium account.

For example, in 2002 KINGFISHER made a 1 for 1 rights issue of 1,293,642,792 Ordinary 13.75p shares at 155p. The issue added £177.9m to its ordinary share capital (1,293.6m × 13.75p) and £1,827.2m (1,293.6m × 141.25p) less £43.9m issue expenses to the share premium account, as illustrated below.

KINGFISHER *Rights issue*

	<i>Pre-rights</i> £m	<i>Post-rights</i> £m
Issued share capital		
Ordinary share capital	177.9	355.8
Share premium		
Pre-rights	371.9	371.9
Premium on shares issued		1,827.2
Expenses of rights issue		(43.9)
	<u>549.8</u>	<u>2,511.0</u>

There are two methods of dealing with convertible stock in a rights issue. Either the holders are offered new shares on the basis of the number of ordinary shares they would hold on full conversion, or the stock has its conversion terms adjusted to allow for the rights issue, whichever method is laid down in the convertible's trust deed (see Chapter 6). Similarly, either warrant holders are offered new shares or the warrant's terms are adjusted.

Placing and open offer

This method, colloquially known as a placing with claw-back, is an alternative to a rights issue, and is usually done in conjunction with an acquisition. For example, in November 2003, REGENT INNS raised £13m by an open offer to fund the acquisition of further sites with existing late night licenses.

One new ordinary 5p share was offered at 83p on the basis of 1 new share for every 6 ordinary shares held. The issue was underpinned by Panmure, and there was only a 39% take-up.

The main advantage of a placing with open offer is that it either is done at a much tighter discount than a rights issue, under 10%, or can be done when a rights issue would have been difficult if not impossible to underwrite.

The disadvantage is that shareholders who do not want to subscribe cannot sell their rights nil paid.

Scrip issues

A scrip issue, also known as a bonus or capitalisation issue, is a free issue of additional new shares to existing shareholders, made by capitalising reserves. For example, HALMA made a 1-for-3 scrip issue in August 1997. The effect on the balance sheet is shown below.

HALMA Effect of 1-for-3 scrip issue

	<i>Pre-scrip</i> £000	<i>Post-scrip</i> £000
Ordinary share capital	26,919	35,905
Share premium account	2,479	614
Profit and loss account	<u>52,283</u>	<u>45,136</u>
Shareholders' funds	<u>81,681</u>	<u>81,655*</u>

* Fall in shareholders' funds due to £26,000 scrip issue costs, which were charged to the share premium account.

As a scrip issue is basically a bookkeeping transaction, the share price would normally be expected to adjust accordingly (e.g. would fall from 240p to 180p with a 1-for-3), and it is open to debate as to whether scrip issues serve any useful purpose.

The main arguments in favour of scrip issues are the following:

- Scrip issues are popular with the investing public, and therefore enhance share prices. Research shows that shares tend to outperform the market after the announcement of a scrip issue, but that companies make scrip issues only when they are doing well, i.e. when their share price would be expected to outperform just as much without the scrip issue.
- A 'heavy' share price in the market, say over £2, tends to make the shares harder to trade and artificially depresses the price. Scrip issues can be used to scale the price down.
- A scrip issue, being 'paid for' out of reserves, enables retained profits and/or the increased value of assets to be reflected by an increased share capital.
- The rate of dividends, expressed as a percentage of an unrealistically small share capital, can look excessive.
- An issued share capital of at least £1m is needed for trustee status.

The last argument appears to be the only factual one in favour of scrip issues; the remainder are psychological, although only a sound and flourishing company is likely to be able to make substantial scrip issues every few years. HALMA's record illustrates this well: the company also made a 1-for-3 scrip issue in 1985, 1-for-2 scrip issues in 1987 and 1989, and 1-for-3 scrip issues in 1991, 1993 and 1995. Thus an investor who purchased 1,000 Halma shares in 1984 would now have a holding of 9,473 ordinary shares.

The arguments against scrip issues are firstly the administrative costs incurred and secondly the increased risk of the share price subsequently falling close to or below par, thus precluding a rights issue. The cost is small, but reducing the market price can cause serious embarrassment if the company wants, at a later date, to make a rights issue only to find that its share price is too low to do so.

Share splits

Where a company feels its share price is 'heavy' but does not want to capitalise reserves – i.e. it does not want to make a scrip issue – it can split its shares into shares with

a smaller par value. For example, in 2001 MITIE GROUP split its 5p shares, which were standing at around 280p at the time, into 2½p shares, and the share price adjusted to around 140p.

Scrip (stock) dividends

The company allows shareholders to elect to receive new shares, i.e. a *scrip dividend*, in lieu of a cash dividend.

Each shareholder is sent a form of election in advance of each dividend payment, giving them the opportunity to opt for a scrip dividend, although some companies also pay a nominal cash dividend at least once each year in order to preserve ‘wider range’ investment status under the Trustee Investment Act 1961. The number of shares is calculated to give the same value as the net dividend payable, and counts as income, so there is no tax advantage.

Scrip dividends are popular with private shareholders, because they can add to their holding at middle market price without paying stockbrokers’ commission.

From the company’s point of view, it is able to raise additional equity capital from its existing shareholders without the expense of a rights issue.

Further information on shares

Details of shares and debentures issued during the year should be given in a note to the balance sheet. The terms for redemption of all redeemable shares and the details of all outstanding rights to acquire shares either by subscription or conversion should also be given.

In addition, FRS 4 requires a brief summary of the rights of each class of share, other than ordinary shares, to be given, including: (i) the rights to dividends; (ii) date at which redeemable, and amount payable on redemption; (iii) priority and amount receivable on a winding up; (iv) voting rights.

This information will usually make it clear why a class of share has been classified as equity or non-equity, but additional information should be given, if necessary. Where rights vary according to circumstances, these circumstances and the variation should be described (FRS 4, paras. 56–57).

Company purchasing its own shares

Under Sections 162 to 169 of the Companies Act 1985, a company may purchase its own shares, providing it doesn’t buy in all its non-redeemable shares. General authority may be given for market purchases up to a maximum number of shares, within a given price range and within a maximum of 18 months from the date the resolution is passed.

Most companies pass a resolution each year at their AGM giving the directors authority, until the next AGM, to purchase the company’s shares, normally up to a maximum of 10% of the shares issued at up to 5% above the middle market price.

Where a company wishes to purchase shares outside the market, the transaction must be authorised in advance by a special resolution. For example in December 1992 FROGMORE ESTATES called an EGM to authorise the purchase of 13.1% of its issued share capital from another property company at a discount of around 7% to the market price. The EGM was required firstly because the purchase was by private treaty, i.e. ‘off-market’, and secondly because the purchase was of more than 10% of its issued share capital, the maximum of the general authority approved at the previous AGM.

To protect investors, Chapter 15 of the UK Listing Authority’s ‘Purple Book’ lays down various rules about the purchase of own securities.

Several property companies, including FROGMORE, took advantage of the 1985 Act to purchase their ordinary shares at a price below asset value, thus increasing the asset value of the remaining shares. More recently there has been a spate of companies falling over themselves to return ‘spare cash’ to their shareholders. This can be done

- (a) *either* by a company buying its own shares. (Prior to 1 December 2003, shares purchased in this way had to be cancelled. However, from that date, listed companies may buy their own shares and hold them in Treasury without cancelling them. These shares may then be issued or sold at a later date.); *or*
- (b) by, in effect, giving cash back to shareholders. In order to avoid the returned cash being treated as a distribution for tax purposes, the return is achieved by a bonus issue of B shares, which are then redeemed by the company, *or*
- (c) by a combination of (a) and (b), which is what W.H. SMITH did:

W.H. SMITH GROUP Circular to shareholders April 1998**Proposed Return of Capital to Shareholders**

On 30 March 1998 the Company announced that it had successfully completed the sale of Waterstone's [a chain of bookshops] for £300m and that it proposed to return approximately £250m of capital to shareholders.

Approximately £153m will be returned by way of a bonus issue of one B share for each Existing Ordinary Share. The Company will subsequently offer to redeem the B shares. The balance of the £250m is intended to be returned to Shareholders by way of a rolling programme of on-market purchases.

Reduction of share capital

Under Section 135 of the Companies Act 1985 a company may, with court approval, reduce its share capital in any way and, in particular, may:

- reduce or extinguish liability on share capital not fully paid up;
- cancel any paid-up share capital which is lost or unrepresented by available assets; and
- repay any paid-up share capital in excess of its requirements.

Where the net assets no longer exceed the paid-up value of the issued share capital, the reserves will appear negative in the balance sheet.

Take, for example, a company which has 1 million £1 ordinary shares in issue and negative reserves of £831,000. It might, with court approval, reduce its capital to 1¹/₂ million 25p shares and eliminate share premium account to remove the accumulated losses (see Example 5.1).

Example 5.1 Effect of share capital reduction on the balance sheet

	<i>Before reduction</i>	<i>After reduction</i>
	£000	£000
Issued share capital	1,000	375
Share premium account	206	–
Other reserves	<u>(831)</u>	<u>–</u>
Shareholders' funds	<u>375</u>	<u>375</u>

Arrangements and reconstructions

A company may make an arrangement with its creditors or shareholders. One possibility is a reorganisation of the company's share capital by consolidation of different classes and/or division into different classes, under Section 425 of the Companies Act 1985.

A meeting has to be called for each class of creditor or shareholder concerned, at which a resolution to make the arrangement requires at least three-fourths by value of those present and voting to vote in favour; after subsequent sanction by the court, the arrangement is then registered with the Registrar of Companies and becomes binding on all creditors and shareholders concerned.

Documentation in connection with arrangements and reconstructions is generally both lengthy and complex but it often provides 'new' material, i.e. information which was never reported in the accounts. But most shareholders are so disappointed by the outcome of their original investment that they devote neither the time nor the trouble to study the information and so, possibly, to learn by the mistake.

Reserves**Where reserves come from**

Reserves can arise in several ways:

- by the accumulation of profits, either by retained profits from the profit and loss account or from the sale of assets;
- by the issue of shares at a premium, i.e. at more than their nominal value: the issue can be either for cash or as consideration (payment) in an acquisition;
- by the issue of warrants;
- by upward revaluation of assets (see pages 61–3);
- by the acquisition of assets at below their balance sheet value.

They can be reduced by losses, share issue and share redemption expenses, revaluation deficits and the writing off of goodwill. In addition, foreign currency translation differences are taken direct to reserves (see Chapter 23).

The balance sheet formats in Schedule 4 of the Companies Act 1985 require reserves to be shown in three main subdivisions:

Share premium account,
Revaluation reserve, and
Other reserves.

Reserves should not include provision for deferred taxation, or any other provision.

Capital and revenue reserves

Under Section 264 (2) of the Companies Act 1985, a company's *undistributable reserves* are:

- the share premium account;
- the capital redemption reserve;
- unrealised profits (i.e. the revaluation reserve);
- any other reserve that a company is prohibited from distributing by its memorandum or articles.

Share premium account

Reference: Companies Act 1985, s. 130.

When shares are issued at a premium over their nominal value, the premium element must, by law, be credited to the share premium account, unless the rules of merger accounting apply (see page 188).

The share premium account has to be shown separately on the balance sheet and no part may be paid out to shareholders except on liquidation or under a capital reduction scheme authorised by the court.

It is permissible, however:

- to capitalise the share premium account to pay up unissued shares for distribution to shareholders as a scrip issue (otherwise known as a bonus or capitalisation issue), for instance:

	£
Ordinary share capital	100,000
Share premium account	85,000
Company makes 1-for-2 scrip issue:	
Ordinary share capital	150,000
Share premium account	35,000

- to charge to the share premium account
 - the preliminary expenses of forming a company,
 - the expenses and commissions incurred in any issue of shares.

Revaluation reserve

The surplus (or shortfall) on the revaluation of assets should be credited (or debited) to a separate reserve, the

revaluation reserve. The amount of the revaluation reserve shall be shown 'under a separate sub-heading in the position given for the item "revaluation reserve" in the balance sheet formats, *but need not be shown under that name*' (our italics; CA 1985, Sch. 4, para. 34).

Capital redemption reserve

Shares may only be redeemed or purchased by the 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 issued share capital is diminished must, by law, be transferred to a reserve, called the capital redemption reserve. This reserve is shown separately under Other reserves. The idea behind the law is to prevent a company's overall share capital plus non-distributable reserves from being reduced when share capital is repaid: the reserve can never be distributed except upon liquidation or in a capital reduction scheme, but it can be capitalised by a bonus issue, as in Example 5.2.

Example 5.2 Capital redemption reserve

1. Initial position:

<i>Issued share capital</i>	£
30,000 £1 Redeemable preference shares	30,000
100,000 £1 Ordinary shares	<u>100,000</u>
	130,000

<i>Reserves</i>	
Revenue reserve (retained profits)	75,000

2. Company then uses retained profits to redeem all the preference shares:

<i>Issued share capital</i>	£
100,000 £1 Ordinary shares	<u>100,000</u>
	100,000

<i>Reserves</i>	
Capital redemption reserve	30,000
Revenue reserve (retained profits)	45,000

3. Company then decides to make a 3-for-10 scrip issue, which brings the issued share capital back to £130,000.

<i>Issued share capital</i>	£
130,000 £1 Ordinary shares	<u>130,000</u>
	130,000

<i>Reserves</i>	
Revenue reserve (retained profits)	45,000

The advantages of borrowing

If a company confidently expects that its return on capital (i.e. the trading profit expressed as a percentage of the capital the company employs) will exceed the cost of borrowing, then borrowing will increase the profit attributable to the ordinary shareholders. There are, however, various limitations on the amount a company can borrow, which we will discuss later in this chapter, and borrowing also increases risk.

The risk of borrowing

The risk of borrowing is twofold: firstly the interest on most borrowings has to be paid promptly when due (unlike dividends on shares, which can be deferred or omitted altogether) and secondly most borrowings have to be repaid

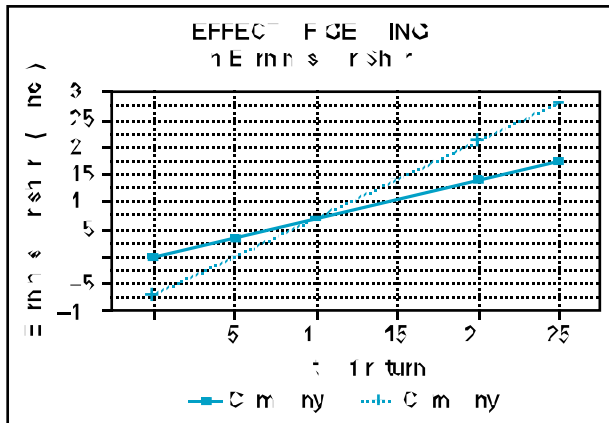
by a certain date (unlike most share capital, which is only repayable on liquidation).

In a poor year, interest charges can drastically reduce the pre-tax profits of a heavily borrowing company. Take, for example, two companies that are identical except that one, Company A, is financed entirely by shareholders while the other, Company B, is financed half by shareholders and half by borrowing, which bears a rate of interest of 10% per annum.

The table in Example 6.1 below shows the profitability of the two companies with varying rates of return on capital employed: in an average year Company B earns 15% on money borrowed at 10%, and so gains 5% on £2,000,000, adding £100,000 to pre-tax profits. This extra profit, after tax, adds 3.5p to the earnings attributable to each of the 2,000,000 shares that Company B has issued, making the earnings per share 14.0p compared with 10.5p for Company A.

Example 6.1 Financing by share capital and by borrowing

	Company A			Company B		
	£4,000,000			£2,000,000		
Issued equity (£1 shares)	£4,000,000			£2,000,000		
Borrowings (10% interest)	Nil			£2,000,000		
	<i>Good</i>	<i>Average</i>	<i>Poor</i>	<i>Good</i>	<i>Average</i>	<i>Poor</i>
	<i>year</i>	<i>year</i>	<i>year</i>	<i>year</i>	<i>year</i>	<i>year</i>
Rate of return	25%	15%	5%	25%	15%	5%
	£000	£000	£000	£000	£000	£000
Trading profit	1,000	600	200	1,000	600	200
Interest	–	–	–	200	200	200
Pre-tax profit	1,000	600	200	800	400	0
Taxation (30%)	300	180	60	240	120	0
Profit after tax	700	420	140	560	280	0
Earnings per share	17.5p	10.5p	3.5p	28.0p	14.0p	0p



In a good year the advantage of borrowing will enhance Company B's earnings per share even more (28p compared with 17.5p for Company A) but in a poor year, as our table shows, all the trading profit is used servicing the borrowings of Company B, while Company A still manages to earn £140,000 after tax for its shareholders.

The point at which the two companies do equally well as far as their shareholders are concerned is shown in the graph above. Their earnings per share are both 6.7p when the return on capital employed is 10% per annum; as one would expect, borrowing at 10% to earn 10% neither adds to nor detracts from Company B's profits. As the graph also shows, borrowing makes a company's profits more volatile and the risk of borrowing is further increased when money is borrowed at a variable rate of interest (e.g. on overdraft). If interest rates had risen above 10% in our example's 'poor year', Company B would have actually made a loss.

We will come back to the effects of borrowing later in this chapter, but let us now look in detail at various types of borrowing.

Types of borrowing

There are many ways in which a company can borrow money, the main characteristics of different types of debt being:

- (a) the length of time for which the money is borrowed;
- (b) the rate of interest paid;
- (c) the security offered to the lender by way of charges on the assets of the company;

- (d) the negotiability of the debt instrument (i.e. does the lender receive a piece of paper which he can sell if he wishes to disinvest before the date of repayment?);
- (e) the flexibility to the company and to the lender in the timing of borrowing and repayment;
- (f) any deferred equity option given to the lender.

A company's borrowings fall broadly into three categories:

1. Debentures and unsecured loan stock, issued on the UK market, and bonds, issued on the Eurobond and other markets. These can be held by the general public, and can be bought and sold in the same way as shares.
2. Loans from banks and other financial institutions.
3. Bank overdrafts (described in Chapter 13).

Categories 1 and 2 are shown separately in the balance sheet, with a note describing the terms on which each loan is repayable and the rate of interest, dividing them into secured and unsecured loans.

An analysis of the maturity of debt should be given, showing amounts falling due:

- (a) in one year or less, or on demand;
- (b) between one and two years;
- (c) between two and five years; and
- (d) in five years or more.



A loan which is soon due for repayment may significantly weaken a company's position.

This can be a very serious threat to a company that is already short of funds if it is likely to have any difficulty refinancing the loan.

Security given to the lender

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 (£100 units) or debenture stock (usually units of £1); if not it is unsecured loan stock (ULS), and these are the two main types of loan capital raised in the UK from the general public (often referred to as corporate bonds).

Debentures

Debentures can be secured by fixed and/or floating charges described below, the most common type of debenture being one that is secured on specific land or buildings, sometimes called a mortgage debenture.

Fixed charge

A fixed charge is similar to a mortgage on a house. The company enters into a debenture deed which places a charge on specific identifiable assets. This gives the debenture holder a legal interest in the assets concerned as security for the loan, and the company cannot then dispose of them unless the debenture holder releases the charge (which he is unlikely to do unless offered some equally good alternative security). If the company defaults or falls into arrears on interest payments or capital repayments, the debenture holder can either:

- (a) appoint a receiver to receive any income from the assets (e.g. rents); or
- (b) foreclose, i.e. take possession and sell the assets, using the proceeds of the sale to repay the debenture holders in full; any surplus remaining is then paid to the company, but if the proceeds of selling the assets charged are insufficient to repay the debenture holders in full, the debenture holders then rank equally with unsecured creditors for the shortfall.

Floating charge

This is a general charge on the assets of a company. But the debenture holder has no legal interest in the assets unless and until an event specified in the debenture deed occurs; e.g. if the company goes into liquidation or ceases trading, or falls behind with interest payments or capital repayments, or exceeds specified borrowing limits. In the event of default the debenture holder can then appoint a Receiver, who takes physical possession of the assets of the company. The Receiver can also be appointed as the Manager or a separate Manager can be appointed to continue running the company, or the Receiver can sell off the assets; the former course is adopted if possible, because a company can normally be sold as a going concern for more than the break-up value.

The ranking of ULS and bonds

In a liquidation the holders of unsecured loan stock and bonds rank equally with other unsecured creditors, that is

after debenture holders and preferential creditors (tax, rates and certain obligations to employees). In practice trade creditors often restrict a company to 'cash with order' terms if they see it running into difficulties, and to that extent ULS and bonds tend to rank behind suppliers.

Typical characteristics of debentures and ULS

Interest

Most debentures, ULS and bonds carry a fixed annual rate of interest (known loosely as the 'coupon') which is payable (normally half-yearly) regardless of the company's profitability. Interest is deductible before the company is assessed for tax, i.e. it is an allowable expense for tax purposes, and therefore costs the company less than the same amount paid out in dividends on shares.

Redemption

Each issue is normally for a given term, and is repayable at the end of the term (at the redemption date) or, where there is a redemption period (e.g. 2006/08), it is repayable when the company chooses within that period. A few irredeemable stocks do exist, but they are rare, except in the case of water companies.

Liquidation

In the event of liquidation, debenture holders are entitled to repayment in full from the proceeds of disposal of the charged assets. Then the ULS and bond holders and other unsecured creditors, and the fixed charge debenture holders if not already fully satisfied, rank equally after preferential creditors, and have to be repaid before the shareholders are entitled to anything.

The trust deed

Where a debenture, loan stock or bond is to be issued to more than a very small number of holders, and particularly when it is going to be listed, a trustee or trustees are appointed to represent the holders collectively, and the company enters into a trust deed rather than a debenture deed.

For listing, the UK Listing Authority requires that at least one trustee must be a trust corporation which has no interest in or relation to the company which might conflict

with the position of the trustee. A large insurance company or the specialist LAW DEBENTURE CORPORATION is often appointed as trustee.

The deed contains all the details of the issue, except the issue price, including:

- (a) details of fixed and floating charges, together with provision for substitution (securing further assets to replace secured assets which the company may subsequently wish to dispose of during the term of the loan). Provision may also be made for topping up (securing further assets if the value of secured assets falls below a given limit);
- (b) redemption price and redemption date or period, and details of any sinking fund;
- (c) conditions under which the company may repurchase in the market, by tender and from individual holders;
- (d) redemption price in the event of liquidation;
- (e) conditions for further pari passu (equal ranking) issues, restrictions on prior borrowings and, for ULS and bonds, overall borrowing limits;
- (f) minimum transferable unit;
- (g) powers to approve modifications to the terms and conditions.

The trust deed may also include restrictive clauses:

- (h) to prevent the nature of the company's business being changed; this is known as a 'Tickler' clause, after the celebrated case of the jam manufacturer who was taken to court by the holders of an unsecured loan stock;
- (i) to prevent major disposals of the company's assets – a 'disposals' clause;
- (j) to restrict the transfer of assets between charging subsidiaries (those within the charging group, i.e. included in the charge on assets) and other subsidiaries – sometimes known as a 'ring fence' clause.

Accounting for finance costs

There are three elements to finance costs. The first is the interest payable each year. The second and third are the issue expenses and the difference between the issue price and the amount payable on redemption, i.e. the premium or discount on issue if redeemable at par. These two are amortised and charged against profits at a constant rate over the life of the debt instrument.

So the carrying amount, the amount at which the debt instrument is shown in the balance sheet at any time, starts off as the net proceeds of the issue and ends up at the redemption date as the amount payable on redemption.

Repurchase of debt

Where the cost of repurchase or early settlement of debt differs from the carrying amount in the balance sheet, the difference is taken to the profit and loss account in the accounting period of repurchase or early settlement.

Deep discount issues

Some companies issue loan capital at a substantial discount to par value in order to reduce the coupon, i.e. to reduce the amount of interest they have to pay during the life of the security concerned. The investor is compensated for receiving less interest by getting back appreciably more than he or she paid when the security is redeemed.

For tax purposes, a *deep discount security* is one:

- (a) where the discount on issue represents more than 15% of the capital amount payable on redemption; or
- (b) where the discount is 15% or less but exceeds half the number of complete years between issue and redemption.

The income element is calculated as the percentage rate at which the issue price would have to grow on a compound basis over each income period to equal the redemption price at the date of redemption. The income element is treated as income of the holder and as a deductible expense of the issuer, as AVIVA shows in its accounting policies.

AVIVA Extract from accounting policies 2003

Subordinated debt and debenture loans

Subordinated debt and borrowings issued at a discount are included in the balance sheets at their proceeds, net of other expenses, together with amortised discount to the balance sheet date. The discount, amortised on a compound basis, and expenses are charged to loan interest in the profit and loss account over the term of the relevant instrument.

Sinking funds

Some debenture and loan stock issues make provision for part or all of the stock to be redeemed gradually over a period of time by means of a sinking fund, e.g. LAND SECURITIES' mortgage debentures.

The normal method for a sinking fund to redeem stock is by annual or six-monthly drawings (lotteries of stock certificate numbers), with the company in some cases having the option of purchasing stock in the market if it can do so at or below the drawing price. The company may also be allowed to invite holders to tender stock for redemption.

There are three types of sinking fund:

1. *Original concept – no early redemptions*

The sinking fund or redemption reserve fund, as originally conceived, was a fund into which a company put a given sum each year, the money being invested in government or other safe fixed interest securities rather than being used to make early redemptions. The sums, together with interest earned, went on accumulating in the balance sheet year by year until the redemption date. This method is now rarely used.

2. *Non-cumulative*

Each year in which the sinking fund is in operation the company normally sets aside enough cash to redeem a fixed amount of stock, expressed as a given percentage of the total issue, and uses it to redeem stock on or by the date of the second interest payment (see Example 6.2).

Example 6.2 Non-cumulative sinking fund

A 25-year stock with a 2% sinking fund starting at the end of the fifth year would be redeemed at the rate of 2% per annum at the end of years 5 to 24, leaving 60% of the stock to be redeemed at redemption date.

Provided redemptions each year are by drawings at par, the average life of a stock can be calculated by working out the average life of the stock redeemed by the sinking fund, in this case 14½ years, and then weighting it by the percentage redeemed by the sinking fund, in this case 40%:

$$\text{Average life} = \frac{(14.5 \times 40\%) + (25 \times 60\%)}{100\%}$$

3. *Cumulative*

In a cumulative sinking fund the cash used for redemption each year is variable and normally consists of a fixed amount of cash plus the amount of interest saved by prior redemption (see Example 6.3 below).

Yields

The yield on an irredeemable security is the gross amount of income received per annum divided by the market price of the security. Redeemable securities have two yields, their running yield and their gross redemption yield.

Example 6.3 Cumulative sinking fund

If our previous example had been a £10m issue of a 25-year stock with a 10% coupon and a cumulative sinking fund starting at the end of year 5, and with all redemptions made by drawings at par, the annual redemptions would be

End of year	Fixed amount of cash £	Variable amount (interest saved) £	Stock redeemed in year £	Total stock redeemed £	Stock remaining £
4	Nil	Nil	Nil	Nil	10,000,000
5	200,000	Nil	200,000	200,000	9,800,000
6	200,000	20,000	220,000	420,000	9,580,000
7	200,000	42,000	242,000	662,000	9,338,000
8	200,000	66,200	266,200	928,200	9,071,800

and so on. The average life can be calculated by time-weighting each year's redemption, e.g. 200,000 × 5 years plus 220,000 × 6 years, etc. ÷ 10,000,000. However, if redemptions are made by purchases in the market or by tender at below the redemption price, the amount redeemed will be greater, the amount of interest subsequently saved will be larger and the whole process of redemption will accelerate.

Running yield

The running yield is the same as the yield on an irredeemable security: it measures income and is concerned purely with the annual gross interest and the price of the stock; for instance, an 8% unsecured loan stock issued at £98% will yield $8\% \div 0.98 = 8.16\%$ at the issue price, or a $4\frac{1}{2}\%$ debenture purchased at £50% will give the purchaser a yield of 9%, ignoring purchase expenses.

Redemption yield

The gross redemption yield is rather more complicated, as it measures 'total return'; i.e. it takes into account both the stream of income and any capital gain (or loss) on redemption. It is not just the sum of the running yield and the capital gain per annum, but is obtained by discounting the future interest payments and the redemption value at a rate that makes their combined *present value* equal to the current price of the stock. (The concept of discounting to obtain present value is explained in Appendix 2.) The rate required to do this is the gross redemption yield (see Example 6.4).

Typical gross redemption yields for a well secured debenture are $\frac{3}{4}\%$ to $1\frac{1}{2}\%$ above the yield on the equivalent gilt-edged security (i.e. a UK government stock of similar life and coupon), and 1% up to 5% or more for ULS, depending very much on the quality of the company and the amount of prior borrowings (borrowings that would rank ahead in a liquidation).

Net redemption yields (i.e. the yields after tax) vary with the individual holder's rate of income tax payable on the stream of interest payments and the rate of tax on any capital gain on redemption.

Redemption date

When a stock has a final redemption period, e.g. 2006/08, it is assumed in computing redemption yields that the company will choose the earliest date for redemption, 2006, if the stock is currently standing above par, otherwise the latest date, 2008. When there is a sinking fund which allows redemptions only by drawings, the average life can be calculated accurately and should therefore be used as the number of years to redemption in calculating redemption yields. However, if the company is allowed to redeem by purchase in the market or by inviting tenders, the stockholder can no longer be sure

Example 6.4 Gross redemption yield

A 6% debenture due for redemption at £105% in 4 years' time is standing in the market at £90. Interest is payable in the normal manner, half-yearly in arrears (at the end of each 6 months). The present value of the stock is the sum of the present values of the 8 future 6-monthly interest payments discounted at $(1 + i)$ per half year (where i expressed as a decimal = gross redemption yield).

$$\frac{3}{(1+i)^{0.5}} + \frac{3}{(1+i)^{1.0}} + \dots + \frac{3}{(1+i)^{4.0}}$$

plus the present value of the sum received on redemption in 4 years' time:

$$\frac{105}{(1+i)}$$

Solving for i by trial and error:

Value of i	Present value of income	Present value of redemption	Total
10% =	19.48 +	71.72 =	£91.20
11% =	19.09 +	69.15 =	£88.24

Inspection suggests that the gross redemption yield on a market price of £90 is about $10\frac{1}{2}\%$, and a more accurate figure can be obtained by further manual calculation or by computer. Alternatively, the yield can be obtained from Bond Tables.

that early drawings at par will take place, and the average life is therefore ignored.

Bonds

A bond is the generic name given to loan capital raised in the Eurobond market and in the US and other domestic markets. Issues in the Eurobond market may be denominated in sterling or in a foreign currency, and are normally of between 7 and 10 years' duration.

The Eurobond market began with the issue of Euro-dollar bonds – US\$ denominated securities issued outside the USA. It now encompasses offshore issues in a variety of currencies, but it is still mainly a US\$ market. An increasing number of UK companies make use of this market, e.g. PEARSON:

PEARSON Note to the 2003 accounts**Borrowings by instrument**

<i>Unsecured (£ million)</i>	2003	2002
9.5% Sterling Bonds 2004	108	120
6.125% Eurobonds 2007	343	370
4.625% Euro Bonds	348	338
10.5% Sterling Bonds 2008	100	100
7% Global Dollar Bonds 2011	278	310
7% Sterling Bonds 2014	235	250
...		

Notes and loan notes

These are promissory notes issued to one or a small number of other companies or individuals, and are normally of between 1 and 10 years' maturity on issue. They are often issued to individuals in an acquisition in lieu of cash to defer the individuals' liability to capital gains tax.

Commercial paper (CP)

This is a short-term loan vehicle between the borrower (the issuer) and the purchaser (the investor); the issuer can sell direct to the investor or use banks as intermediaries.

Commercial paper takes the form of negotiable unsecured promissory notes. In the sterling CP market notes have a maximum maturity on issue of 1 year and a minimum of 7 days; they are usually for £1/2m or £1m. Although short-term, CP is often bought as part of a company's medium-term borrowing programme, backed by medium-term banking facilities, e.g. RIO TINTO:

RIO TINTO Note on short-term borrowings

	2003 US\$m
SHORT-TERM BORROWINGS	
Unsecured	
...	
Commercial paper	1,687

In accordance with FRS 4, all commercial paper is classified as short-term borrowings although US\$1,100 million is backed by medium-term facilities. Under US and Australian GAAP the US\$1,100 million would be grouped within non-current borrowings.

We agree with the US and Australian view. The notes are bearer securities issued at a discount to allow for interest, i.e. there is no separate payment of interest.

Rates are very competitive for companies with good credit ratings; commercial paper is easy to administer and costs are low.

By far the largest CP market is in the USA, where about \$550 billion is outstanding.

The amount a company can borrow

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

- Its borrowing powers.* The directors' borrowing powers are normally limited by a company's Articles of Association, and cannot be altered except with the approval of shareholders at a general meeting. Borrowing powers are usually expressed as a multiple of shareholders' funds (issued share capital plus reserves, excluding intangible assets such as goodwill, although some companies, e.g. CADBURY SCHWEPPEES, now include purchased goodwill in defining the directors' borrowing powers).
- Restrictions imposed by existing borrowings.* The terms of the trust deeds of existing loan capital may restrict or preclude the company from further borrowing. In particular the terms of an unsecured loan stock may include a clause preventing the company from issuing loans that rank ahead of the stock concerned, and unduly restrictive clauses are often the reasons for companies redeeming loan capital in advance of the normal redemption date.
- The lender's requirement for capital and income covers.*
- The lender's general opinion* of the company and its overall borrowing position.

Capital and income covers

These are two standard measures that the intending purchaser of a debenture or loan stock may use to assess the security of his or her investment.

The *capital* or asset cover can be calculated in two ways, on a simple basis or on a 'rolled-up' basis.

Using the simple basis, the cover is the total capital less all prior-ranking stocks, divided by the issued amount of the stock in question. Using the 'rolled-up' basis, the cover is

Example 6.5 Capital cover

<i>Capital</i>	<i>Amount</i>	<i>Cumulative total</i>	<i>Simple cover</i>	<i>Rolled-up cover</i>
	£000	£000		
6% Debenture	15,000	15,000	4.0	4.0
8% ULS	10,000			
10% ULS	5,000	30,000	3.0	2.0
Ordinary shares	12,000			
Reserves (less goodwill)	18,000	<u>60,000</u>		
Total capital		<u>60,000</u>		

Example 6.6 Income cover

A company has £5.76m of earnings before interest and tax, and the following loan capital, with the ULS and the CULS ranking equally:

<i>Nominal value of issue</i>	<i>Annual interest</i>	<i>Cumulative interest</i>	<i>Times covered</i>	<i>Priority percentage</i>
£12m of 6% Debenture	£0.72m	£0.72m	8.0	0–12 ¹ / ₂ %
£10m of 8% ULS	£0.80m			
£8m of 5% CULS	£0.40m	£1.92m	3.0	12 ¹ / ₂ –33 ¹ / ₃ %

the total capital divided by the stock in question plus all prior-ranking stocks.

As Example 6.5, above, shows, the two equal-ranking ULS issues are three times covered on a simple basis (£60m total capital less £15m prior-ranking debenture, divided by the total of £15m ULS), but only twice covered on a rolled-up basis. The more conservative rolled-up basis is normally used for assessing capital covers.

For a floating charge debenture a rolled-up capital cover of at least 3 or 4 is expected by the lender, and 2¹/₂ times is the normal minimum for an unsecured loan stock, but both depend on the quality of the assets, i.e. the likely realisable value of the assets on the open market in the event of a liquidation.

The *income cover* is normally worked out on a rolled-up rather than a simple basis: i.e. it is the number of times the interest on a stock plus the interest on any prior-ranking stocks could be paid out of profits before interest and tax. This cover can also be expressed as a priority percentage, showing the percentile ranking of a stock's interest, with earnings before interest and tax representing 100% (see Example 6.6 above).

Convertible loan capital

Convertible loan capital, which is usually convertible unsecured loan stock (CULS) or convertible bonds rather than convertible debentures, entitles the holder to convert into ordinary shares of the company if he or she so wishes (see also convertible preference shares, Chapter 5).

The coupon on a convertible is usually much lower than the coupon needed for the issue of a straight unsecured loan stock with no conversion rights. This is because a convertible is normally regarded by the market as deferred equity, valued on the basis of the market value of the shares received on conversion plus the additional income enjoyed before conversion (the coupon on issue being higher than the yield on the ordinary shares).

Because convertibles are a form of deferred equity, listed companies can issue them without shareholders' prior approval only as a rights issue or as part or all of the consideration in an acquisition. In a takeover situation the bidder can use a suitably pitched convertible to provide the shareholders of the company being acquired with a higher initial income than they would receive from an

A good indication of the likely market price of a convertible can be obtained by discounting the future income advantage to present value and adding it to the market value of the underlying equity. One caveat to this method is that if the price of the ordinary shares is very depressed, the price of the convertible in the market can become mainly dependent on its value as a fixed-interest security, particularly if the conversion period has not long to run.

Convertibles with 'put' options

In the euphoria before the market fall in October 1987, several companies were so confident that their share price was going on up for ever that they agreed to the innovation suggested by fee-hungry US investment banks to include a 'put' option in the terms of their convertibles. This 'put' option gave the convertible bond holders the option to redeem after four or five years at a substantial premium, which was calculated to give a specified gross redemption yield.

From an investor's point of view, an early 'put' option is a 'heads I win, tails I can't lose' situation (unless the company goes bust). But from a company's point of view it is asking for trouble: if the ordinary share price is depressed when the date for exercising the 'put' option approaches, it is unlikely to be a good time for the company to have to redeem the convertible.

In addition, the market may become worried about whether the company has the financial resources to meet the repayment; this may further depress the share price, increasing the likelihood of investors exercising their 'put' options, e.g. the fashion retailer NEXT.

Next had one £50m and one £100m convertible with conversion prices of 286p and 430p respectively, and 'put' options to redeem in 1992. Next's share price peaked in 1987 at 378p, but fell to under 100p in 1989 as the company was hit by the recession and moved into loss. By this time the market became anxious about whether Next could fund redemption, and the share price tumbled to 6½p at one point.

Next did survive, but only by selling off its mail order subsidiary Grattan in 1991 to pay for the 'put' options which were, of course, exercised. As the result of Next and several other companies burning their fingers badly, the drawbacks of 'put' options are now well appreciated, and companies issuing convertibles have stopped giving them. However, they may appear again in the euphoria of the next roaring bull market; if they do – beware.

Warrants

A warrant gives the holder the right to subscribe at a fixed price for shares in a company at some future date. Where a company is reluctant to raise loan capital, e.g. when very high long-term interest rates prevail, or investors are reluctant to commit themselves to purely fixed-interest securities, loan capital can be raised with a lower coupon by attaching warrants to issues of stock.

Warrants issued in this way are normally detachable and exercisable as soon as the stock to which they are attached is fully paid, and in some issues stock can be surrendered at its nominal value as an alternative to cash payment when the warrants are exercised.

For accounting purposes, when a debt instrument is issued with warrants attached, the proceeds of the issue should be allocated between the debt and the warrants (FRS 4, para. 22).

In a takeover situation, warrants can provide a more flexible way for the bidder to give loan stock an equity interest than convertibles, because the number of warrants, sometimes called the equity 'kicker', can be varied as the company wishes, while the quantity of ordinary shares to which convertible holders are entitled is defined within a narrow range by the limit the market will accept on the conversion premium.

On the other hand, a drawback to warrants is that they will seldom be exercised until close to the final exercise date, because they are bought by investors who want the gearing they provide, so the future flow of money into the company's equity is more chancy than with a convertible.

Mezzanine finance

Mezzanine finance is the term used to describe a form of finance that lies between straight debt and share capital. It is used in situations, e.g. management buy-outs (MBOs) and institutional purchases, where the amount of debt that can be raised is limited, and the amount of cash available to subscribe for shares is insufficient to make up the total required.

It is usually in the form of a loan that ranks after the normal debt (the 'senior' debt) and, because of the higher risk, bears a higher rate of interest and either carries an option to convert part of the loan into equity or has a warrant to subscribe for equity.

For example in BBA's sale of its automotive products businesses in the spring of 1995, the purchase by the new company AUTOMOTIVE PRODUCTS GROUP LTD was arranged by leading venture capital company CINVEN, financed as follows:

AUTOMOTIVE PRODUCTS GROUP *Financing of institutional purchase*

	£000	
Senior debt	90,000	(Note 1)
Mezzanine finance	20,000	(Note 2)
Senior management investment	1,244	
Cinven investment	62,956	(Note 3)
Opening revolving credit	<u>4,435</u>	
	<u>£178,635</u>	

Notes:

1. Medium-term loan at 2% over LIBOR, reducing to 1.5% providing certain profit targets are met. Final repayment date December 2001.
2. 8-year term loan at 3.5% over LIBOR. Carries warrants to subscribe for an additional 9% of the ordinary share capital.
3. Equity underwritten by Cinven's clients, who also underwrote a further £1.5m share offer to the remaining employees.

Highly geared (leveraged) deals are high risk; hence the need for the mezzanine debt to have an equity 'sweetener'.

Complex capital issues

There is almost no limit to the ingenuity of companies and their financial advisers in devising innovative terms for the issue of loan capital. In addition to the deep discount bonds and convertibles with 'put' options that we have described, complex capital issues include:

- (a) *Stepped interest bonds*, where the interest payable increases by fixed steps over the life of the bond, e.g. CANARY WHARF's £120m stepped fixed interest tranche (part) of a £555m first mortgage debenture, where interest was paid at 5% until October 1999. From October 1999 the interest then increases in steps to 9.535%, which is payable from October 2006. In these cases the profit and loss account should be charged at a constant rate computed over the anticipated life of

the bond, irrespective of the amount of interest paid each year (FRS 4, para. 28).

- (b) *Bonds with variable payments*, where the interest payments and the amount payable on redemption are adjusted by the Retail Price Index or some other index. An annual charge should be made against profits to reflect the variations caused by the movement in the relevant index during the year (FRS 4, para. 31), e.g. AWG's £150m 4.125% Index Linked Loan Stock 2020, where the value of the capital and interest elements are linked to movements in the Retail Price Index.

Off balance sheet financing

The problem of what became known as 'off balance sheet financing' became evident in the 1980s. In that period a number of complex arrangements were developed which, if accounted for in accordance with their legal form, resulted in accounts that did not report the commercial effect of the arrangement; in particular, they did not show the finance as a liability on the balance sheet.

This was, of course, precisely what the devisers of these schemes intended. These developments raised fundamental questions about the nature of assets and liabilities and when they should be included in the balance sheet – questions which, lacking a fundamental theory of accounts, the accountancy profession found it difficult to answer. Although generally termed 'off balance sheet' some of the transactions also affected the profit and loss account and/or the cash flow statement.

Substance over form

In response to the problem, the concept of 'substance over form' was developed. Freely translated this means 'report the substance of the transaction and ignore the legal position. Accounts should reflect the reality of the situation.' This led to the publication of FRS 5.

FRS 5 Reporting the substance of transactions

We cover FRS 5 in this chapter, on the ground that it is largely concerned with borrowing, but it applies to all transactions or arrangements of a reporting entity whose financial statements are intended to give a true and fair view except:

- (a) forward contracts and futures (such as the use of foreign currencies or commodities);
- (b) foreign exchange and interest rate swaps;
- (c) contracts where a net amount will be paid or received based on the movement in a price or an index (called 'contracts for differences');
- (d) expenditure commitments (such as purchase commitments) and orders placed, until the earlier of delivery or payment;
- (e) employment contracts.

Essentially the Standard is very simple: 'A reporting entity's financial statements should report the substance of the transactions into which it has entered. In determining the substance of a transaction, all its aspects and implications should be identified and greater weight given to those more likely to have commercial effect in practice.'

The effect of FRS 5 can be considerable in individual companies: GUS used to include finance advances and related unearned service charges in its sales figures. When, in 1995, in compliance with FRS 5, it excluded them, the reported figure for turnover was reduced by £700m. The accounting policy is now:

GUS Accounting policies 2003

Instalment and hire purchase debtors

The gross margin from sales on extended credit terms is recognised at the time of sale. The finance charges relating to these sales are included in the profit and loss account as and when instalments are received. The income in the Finance Division under instalment agreements is credited to the profit and loss account in proportion to the reducing balances outstanding.

Quasi-subsidiaries

Under FRS 5 a quasi-subsidiary is 'a company, trust, partnership or other vehicle that, though not fulfilling the definition of a subsidiary, is directly or indirectly controlled by the reporting entity and gives benefits for that entity that are in substance no different from those that would arise were the vehicle a subsidiary'.

'Where the entity has a quasi-subsidiary, the substance of the transactions entered into by the quasi-subsidiary should be reported in the consolidated financial statements.'

BRITISH AIRWAYS accounts explain in a note:

BRITISH AIRWAYS Note on Accounting Policies 2003

Basis of consolidation

Where an entity, though not fulfilling the legal definition of a subsidiary, gives rise to benefits for the Group that are, in substance, no different than those that would arise were that entity a subsidiary, that entity is classified as a quasi-subsidiary.

In determining whether the Group has the ability to enjoy the benefits arising . . . regard is given as to which party is exposed to the risks inherent in the benefits and which party, in practice, carries substantially all the risks and rewards of ownership. The group currently accounts for its investment in the London Eye Company Ltd. as a quasi-subsidiary.

Sale and leaseback

Sale and leaseback is an arrangement where the owner of an asset, typically a property, sells the asset and then leases it back. Under FRS 5, the accounting treatment of the transaction will depend on its substance:

- If the 'seller' retains the risks and rewards of ownership (e.g. would benefit/suffer from any subsequent increase/decrease in the value of the property) **the transaction is treated as a financing transaction.**

The property would remain on the seller's balance sheet, and the cash received would be regarded as a loan.

- On the other hand, if the 'purchaser' benefits from any subsequent increase in value, and the seller pays rentals subject to periodic review, **the transaction is treated as a sale.**

The property would be removed from the seller's balance sheet, and the profit/loss on sale would be taken to the seller's profit and loss account.

Linked presentation

The FRS employs a 'linked presentation' to deal with a limited class of non-recourse finance arrangements (including most securitisations) which shows, on the face of the balance sheet, the finance deducted from the gross amount of the asset it finances. Strict conditions attaching to its use

require, inter alia, that the finance is repaid from the asset it finances and that there is no provision for the asset to be kept on repayment.

It will be seen that FRS 5 is very broadly drawn and should bring disclosure or put an end to most if not all existing forms of off balance sheet finance. But merchant banks and other financial advisors have long earned substantial fees from devising this sort of scheme and will not give up easily.

Other aspects of FRS 5

FRS 5 *Reporting the substance of transactions* covers a number of other transactions. Three important ones are consignment stocks, dealt with in Chapter 10, debt factoring, discussed in Chapter 11, and revenue recognition, discussed in Chapter 30.

Gearing ratios

Financial ratios fall into two broad groups, gearing ratios and liquidity ratios.

Gearing is concerned with the proportion of capital employed that is borrowed, the proportion provided by shareholders' funds and the relationship between the two, while liquidity ratios (see page 108) are concerned with the company's cash position.

Financial gearing

Financial gearing can be defined in a multiplicity of ways, the two most common being:

- the Debt/Equity ratio, shown as Borrowings/Shareholders' Funds in the *Investors Chronicle*, and called 'leverage' in the USA and elsewhere; and
- the percentage of capital employed represented by borrowings.

Whatever method is used to compute gearing, a company with 'low gearing' is one financed predominantly by equity, whereas a 'highly geared' company is one which relies on borrowings for a significant proportion of its capital.

To illustrate (see Example 6.8), let us take the bottom half of three different companies' balance sheets, adjusting

Example 6.8 Calculation of gearing and Debt/Equity ratios

	Company		
	A	B	C
	£000	£000	£000
Ordinary share capital	600	500	250
Reserves	<u>850</u>	<u>550</u>	<u>300</u>
Ordinary shareholders' funds	[A] 1,450	1,050	550
Redeemable preference share capital (3.5%)	[B] —	100	—
Minorities	[C] 150	150	150
Provisions	400	400	400
Loan stock (10%)	[D] —	150	400
Overdraft (currently 12%)	[E] —	<u>150</u>	<u>500</u>
Capital employed	[F] <u>2,000</u>	<u>2,000</u>	<u>2,000</u>
	A	B	C
Debt/Equity (Leverage) =			
$\left(\frac{B + D + E}{A + C} \right)$	0%	33%	128%
Debt/Capital Employed =			
$\left(\frac{B + D + E}{F} \right)$	0%	20%	45%
Gearing	None	Low	High

[B] The treatment of preference shares is a problem: although they are not debt they do carry a *fixed* rate of dividend that is payable ahead of ordinary dividends. On balance we favour treating them as debt if redeemable in the reasonably near future, say in less than 10 years, but otherwise as equity when looking at capital (because it would be misleading to ascribe the same Debt/Equity ratio to a company with, say, 60 debt/40 equity as one with 60 pref./40 equity).

[C] Minorities have been included as equity in the calculation of Debt/Equity ratios, on the assumption that minority interests in subsidiaries are all pure (non-redeemable) equity.

them to include bank overdraft and any other borrowings falling due within one year (these are normally netted off against current assets in a company's balance sheet, but are just as much a part of capital employed as long-term borrowings are). As you can see, Debt/Equity ratio is a more sensitive measurement of gearing than Debt/Capital Employed, and it also gives a better indication of the effect

of gearing on equity income, known across the Atlantic as the ‘leverage effect’.

Leverage effect

The effect of leverage can be expressed as a ratio: percentage change in earnings available to ordinary shareholders brought about by a 1% change in earnings before interest and tax (EBIT).

Suppose each of the three companies in Example 6.9 has a Return On Capital Employed (ROCE) of 10%, and that the rate of corporation tax is 30%; then earnings before interest and tax (EBIT) will be as shown in Example 6.9.

Leverage, of course, works both ways; if EBIT fell by 50% then earnings available to ordinary shareholders would fall to £70,000 (Company A) and to £43,400 (Company B); and Company C would be on the point of making a loss.

Example 6.9 Calculation of leverage effect

	Company		
	A	B	C
	£000	£000	£000
EBIT	200.00	200.00	200.00
<i>Less</i>			
Loan stock interest	–	(15.00)	(40.00)
Interest on overdraft	–	(18.00)	(60.00)
Pre-tax profits	200.00	167.00	100.00
Tax at 30%	(60.00)	(50.10)	(30.00)
Profits after tax	140.00	116.90	70.00
Preference dividends	–	3.50	–
Available for minorities and ordinary shareholders	[G] 140.00	113.40	70.00
1% change in EBIT	2.00	2.00	2.00
Tax	0.60	0.60	0.60
Available for minorities and ordinary shareholders	[H] + 1.40	+ 1.40	+ 1.40
Leverage ratio			
$\frac{H}{G} \times 100$	1.00	1.23	2.00

Interest rate sensitivity

A simple calculation can be made to see the sensitivity of a company’s profits to interest rates: if, in Example 6.9, the rate charged on overdrafts rose to 16% (or fell to 8%), Company C’s pre-tax profit would be reduced (or increased) by 20%.

Operational gearing

In assessing what level of financial gearing might be reasonable for a company, we must first look at the volatility of profits. This depends to a large extent on the sensitivity of profits to turnover, which we will call operational gearing (although the term ‘operational gearing’ is sometimes used in the sense of overall gearing to include the effects of financial gearing as well).

The operational gearing of a company can be described as the ratio of the percentage change of trading profit which results from 1% change in turnover, and depends on the relationship between fixed costs, variable costs and net profit, where fixed costs are costs that are incurred regardless of turnover, and variable costs are directly proportional to turnover:

$$\text{Operational gearing} = \frac{\text{Turnover} - \text{Variable costs}}{\text{Trading profit}}$$

or

$$\frac{\text{Trading profit} + \text{Fixed costs}}{\text{Trading profit}}$$

Example 6.10 demonstrates this.

Profit/volume chart

The effect of gearing can also be illustrated graphically on a ‘profit/volume chart’, as shown in Example 6.11. A profit/volume chart is constructed by plotting two points:

1. trading profit against actual turnover;
2. fixed costs against zero turnover;

and joining the two points together. The point where this line crosses the horizontal ‘zero profit’ line represents the level of turnover at which the company ‘breaks even’, i.e. makes neither a profit nor a loss. The steeper the gradient of the line the higher the operational gearing of the company.

Example 6.10 Effects of operational gearing

	Turnover	Fixed costs	Variable costs	Trading profit	Operational gearing
	£m	£m	£m	£m	
Company D	100	20	70	10	3:1 ((100 - 70):10)
Company E	100	70	20	10	8:1 ((100 - 20):10)

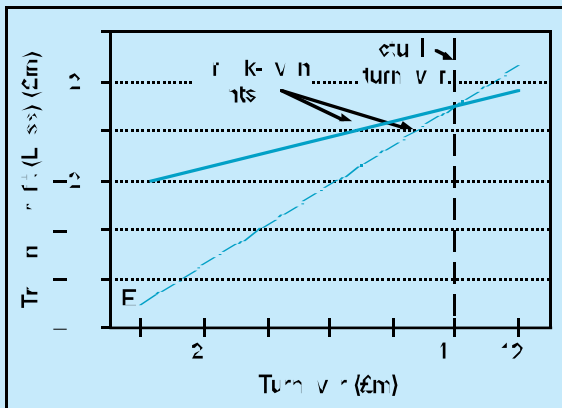
If turnover increases by 10%:

	£m	£m	£m	£m	Change in profits
Company D	110	20	77	13	+ 30%
Company E	110	70	22	18	+ 80%

This is fine for both D and E, especially for E, which is much more highly geared operationally than D. But, as with high financial gearing, high operational gearing works against a company when turnover falls. Assume a 10% fall in turnover:

	£m	£m	£m	£m	Change in profits
Company D	90	20	63	7	- 30%
Company E	90	70	18	2	- 80%

Example 6.11 Profit/volume chart



$$\text{Company E} = 70 \times \frac{100}{100 - 20} = \text{£}87.50\text{m}$$

Aggravating the problem

It is fairly obvious that a company with high operational gearing aggravates the problem by gearing up financially. Suppose, for instance, that Company E has borrowings that incurred interest charges of £3m p.a.; Example 6.12 shows the effect on profits.

Example 6.12 Effect of high financial gearing coupled with high operational gearing

Turnover	Net trading profit	Interest charges	Pre-tax profits
£m	£m	£m	£m
100	10	3	7
110	18	3	15
90	2	3	-1

The break-even point can also be calculated:

Break-even turnover

$$= \text{Fixed costs} \times \frac{\text{Turnover}}{\text{Turnover} - \text{Variable costs}}$$

e.g. Company D = $20 \times \frac{100}{100 - 70} = \text{£}66.67\text{m}$

But the directors of a property company with mainly completed developments let to substantial clients will know that they have an assured rental income coming in

each quarter, and they would not be considered imprudent to borrow heavily (i.e. gear up) provided the level of interest payments plus running expenses could not exceed the stream of rental income. We say 'could not exceed', because one of the ways property companies get into trouble is by borrowing short-term with a variable interest rate (e.g. on bank overdraft), rather than at a fixed rate; they then get caught out when interest rates go up faster than rental income.

Fixed charges cover

This is a very useful ratio, not often shown in company reports and accounts. An exception is W H SMITH.

W H SMITH Extracts from Financial review 2003 and from Notes to the 2003 accounts

Fixed charges cover

A key measure of financial strength for the businesses is fixed charges cover. The fixed charges comprise operating leases, property taxes, other property costs and interest. They were covered 1.4 times by profits before fixed charges (2002; 1.5 times).

Note 11 Fixed charges cover

	2003	2002
	£m	£m
Interest expense (income)	4	(8)
Operating lease rentals	206	207
Property taxes	36	36
Other property costs	<u>13</u>	<u>15</u>
Total fixed charges	259	250
Profit before tax	<u>102</u>	<u>117</u>
Profit before tax and fixed charges	<u>361</u>	<u>367</u>
Fixed charges cover	<u>1.4</u>	<u>1.5</u>

Fixed charges cover is calculated by dividing profit before tax and fixed charges by total fixed charges.

Schedule 4 to the Companies Act 1985 requires fixed assets to be presented in the balance sheet under three headings: intangible assets, tangible assets and investments. We deal with the intangible assets in this chapter, with tangible fixed assets in Chapter 8 and with investments in Chapter 9.

Intangible fixed assets

Intangible fixed assets comprise:

- (a) capitalised development costs;
- (b) what we will call 'rights' (e.g. licences, concessions, patents and trademarks); and
- (c) purchased goodwill.

Capitalised development costs

Under SSAP 13 *Accounting for research and development* all expenditure on R & D should normally be written off in the year in which it is incurred.

However, where development is for clearly defined projects on which expenditure is separately identifiable and for which commercial success is reasonably certain, companies may if they wish defer charging development expenditure 'to the extent that its recovery can reasonably be regarded as assured'. Capitalised development expenditure should be separately disclosed. However the trend amongst companies which capitalise development is to change to the more prudent policy of immediate write-off. For example ML LABORATORIES:

ML LABORATORIES *Extracts from 1998 Directors' report and accounts*

Research & Development

The Group is engaged in the research into, and the development of, a diverse portfolio of pharmaceutical, medical and other novel products.

During the year the Group has changed its accounting policy of capitalisation and subsequent amortisation to one of immediate write-off. Full details of this change are in notes 1 and . . .

The loss for the year [£8,442,697] is stated after charging research and development expenditure of £7,719,642.

Note 1. Change in accounting policy

The comparative results for the year to 30 September 1997 have been adjusted as follows:

	£
Profit as originally reported	683,810
Change in treatment of R & D	(5,671,095)
Restatement of minority interest	<u>437,427</u>
Loss as restated	<u>(4,549,858)</u>

TERMINOLOGY

Fixed assets

Assets are things which a business owns and on which a value can be placed.

Fixed assets are assets held not for resale but for use by the business. Schedule 4 to the Companies Act 1985 requires fixed assets to be presented in the balance sheet under three headings:

- intangible assets,
- tangible assets, and
- investments.

Rights

Intangible assets purchased separately from a business, i.e. not part of an acquisition, should be capitalised at cost. They include:

- (a) copyright and similar publishing rights
- (b) licenses
- (c) patents
- (d) trademarks.

Copyright and similar publishing rights

Copyrights provide the holder with the exclusive right to produce copies of, and control over, an original musical, artistic or literary work. For literary (including compilations and computer programs), dramatic, musical and artistic works, copyright expires 70 years from the end of the calendar year in which the author died. The sums involved can be considerable. For example EMI GROUP's balance sheet at the year end 31 March 2003 showed music copyrights of £451.2m after a £39.0m amortisation charge for the period.

Licences

Licences are agreements that a company enters into with government or with a third party which enable it to carry out certain trading functions. Examples are brewers which

operate licensed premises, or bookmakers, who are required to obtain a licence for each bookmaking shop.

Companies may also purchase licences which allow them to use software or technology developed by third parties, and licences from government authorities, as with VODAFONE:

VODAFONE Extracts from 2003 accounts

Note 2 Accounting policies

OTHER INTANGIBLE FIXED ASSETS

Purchased intangible fixed assets, including licence fees, are capitalised at cost.

Network licence costs are amortised over the periods of the licences. Amortisation is charged from commencement of service of the network. The annual charge is calculated in proportion to the capacity of the network during the start up period and on a straight line basis thereafter.

Note 11 Intangible fixed assets

	<i>Licence and spectrum fees £m</i>
<i>Cost</i>	
1 April 2002	14,339
Exchange movements	936
Additions	145
Reclassifications	(41)
31 March 2003	<u>15,379</u>
<i>Amortisation</i>	
1 April 2002	90
Exchange movements	(6)
Charge for the year	53
Reclassifications	(10)
31 March 2003	<u>127</u>
<i>Net book value</i>	
31 March 2003	15,252
31 March 2002	14,249

Patents and trademarks

A patent is in effect a document granted by the government assuring an inventor of the sole right to make, use and sell his or her invention for a determined period. For example LATCHWAYS, a small producer and distributor of industrial safety products, is heavily dependent on world-wide patents to protect its inventions. The 2003 balance sheet showed patents, trademarks and designs of £436,000, and details were contained in a note:

LATCHWAYS Note to the 2003 accounts**Intangible fixed assets***Patents, trademarks and registered designs*

	£000
Cost	
At 1 April 2002	604
Additions in the year	80
At 31 March 2003	<u>684</u>
Amortisation	
At 1 April 2002	198
Charge for the year	50
At 31 March 2003	<u>248</u>
Net book value	
At 31 March 2003	436
At 31 March 2002	406

Registering a trademark provides legal protection to the name or symbol used to differentiate the products supplied by a manufacturer or authorised distributor from those of competing manufacturers and dealers. Given their identifiable cost and their value to businesses over long periods in terms of income stream generation, it is not unreasonable to capitalise those costs and amortise them over their useful lives; but that decision is one for the directors.

Purchased goodwill

The difference between the fair value of the consideration paid for an acquired entity and the aggregate of the fair values of that entity's identifiable assets and liabilities is termed purchased goodwill. For example ML LABORATORIES:

ML LABORATORIES Note to the 2000 accounts**Note 1. Acquisitions**

During the year the Company acquired a new subsidiary, Cobra Therapeutic Limited . . .

Net book value and fair value of net assets

	£
Tangible fixed assets	964,504
Debtors	253,887
Cash	4,389,095
Creditors	<u>(1,169,359)</u>
	<u>4,438,127</u>
Fair value of share consideration	10,059,194
Costs of acquisition	<u>300,000</u>
	<u>10,359,194</u>
Goodwill	<u>5,921,067</u>

Purchased goodwill – old rules

Until the end of 1998 the normal way of dealing with purchased goodwill was to write it off immediately against reserves.

This was thoroughly unsatisfactory for two main reasons:

1. Millions and millions of pounds of shareholders' money disappeared from the balance sheet without trace. Well, almost without trace: the Companies Act required the cumulative amount of goodwill written off against reserves to be shown in the accounts.

But it was usually put in some obscure note, and very few analysts paid any attention to it, except when an acquisition was subsequently disposed of, where the goodwill written off in the acquisition had to be reinstated. This often turned a handsome profit on disposal into a thumping loss.
2. Reducing the size of shareholders' funds played merry hell with some ratios. Two key ones that most investors still clung to with touching, almost childlike, faith were Return On Capital Employed (ROCE), and Gearing (Debt to Equity ratio). Due to 'immediate write-off', both were often grossly misleading.

Hardly surprising, when some companies actually reported negative shareholders' funds.

Purchased goodwill – FRSs 10 and 11

Under FRS 10 *Goodwill and intangible assets* and FRS 11 *Impairment of fixed assets and goodwill*, purchased goodwill and intangible assets must be capitalised and either

- (a) amortised over their useful economic lives, or
- (b) where their useful economic lives exceed 20 years, or they are not amortised, their value must be reviewed annually for impairment.

CADBURY SCHWEPPE'S Extract from accounting policies 2003**(p) Intangibles and goodwill**

Intangibles represent significant owned brands acquired since 1985 valued at historical cost. No amortisation is charged as the annual results reflect significant expenditure in support of these brands and the carrying values are reviewed on an annual basis for any impairment in value.

Under transitional arrangements, any goodwill which had previously been written off to reserves could remain there, until such time as the related business is disposed of.

Companies have, however, the option to reinstate as an asset old goodwill previously written off to reserves. If they do this, either all old goodwill or all post-FRS 7 goodwill should be reinstated.

Impairment

FRS 11 *Impairment of fixed assets and goodwill* requires assets not to be recorded in the balance sheet at more than their *recoverable amount*, which is the higher of:

- net realisable value – what an asset could be sold for, and
- value in use – the present value of the cash flows which the asset is expected to generate.

FRS 11 only requires assets to be reviewed for impairment, that is for a reduction in their recoverable amount below book value, in specific circumstances. For goodwill or other intangibles, these are:

1. When goodwill or intangibles appear in the balance sheet and are not amortised over 20 years or less.
2. Where there are indicators of impairment that suggest that the company's assets may not be fully recoverable, e.g. persistent operating losses; negative operating cash flows; a significant fall in an asset's market value; an asset being physically damaged, or becoming obsolete; a significant adverse change in the competitive or regulatory environment; a reorganisation; or even loss of key employees.
3. Where an acquisition took place in the previous year, a review should take place at the end of the first full year following the acquisition.

Past impairment losses can only be reversed subsequently if the recovery in value is due to the reversal of the reason which gave rise to the impairment in the first place. So previous impairment losses will rarely be reversed.

The standard applies not only to any goodwill that is recognised as an asset but to most fixed assets, except derivatives and oil exploration expenditure.

TERMINOLOGY

Intangible fixed assets

Intangible fixed assets are non-monetary fixed assets that have no physical substance but are identifiable and are controlled by the entity (company) through legal rights or physical custody.

They include:

- purchased goodwill
- capitalised development costs
- concessions, patents, licences, trademarks and similar rights and assets.

Purchased goodwill represents the difference between the consideration paid for an acquisition and the aggregate of the fair values of that acquisition's net assets.

Fair value is the amount at which an asset could be exchanged in an arm's length transaction between informed and willing parties, other than in a forced or liquidation sale.

Positive goodwill arises when the consideration exceeds the aggregate fair values of the identifiable assets and liabilities. **Negative goodwill** arises when the aggregate fair values exceed the consideration paid.

Carrying value is simply another term for book value (which avoids suggesting that the balance sheet is a valuation statement).

Impairment is a reduction in the recoverable amount of an asset below its carrying value.

Recoverable amount is the higher of net realisable value of an asset and its value in use.

The **useful economic life** of an intangible asset is the period over which the entity expects to derive economic benefit from it. The useful economic life of purchased goodwill is the period over which the value of the underlying business is expected to exceed the values of its identifiable net assets.

Value in use is the present value of the future cash flows obtainable as a result of an asset's continued use, including those resulting from its ultimate disposal.

Reference: FRS 15 *Tangible fixed assets*

Tangible fixed assets

Tangible fixed assets are items used in a company to earn revenue. They may include:

- land and buildings
- plant and machinery
- fixtures, fittings and tools
- vehicles
- office and computer equipment.

Depreciation

Depreciation is a measure of the loss of value of an asset due to use, the passage of time and obsolescence, including the amortisation of fixed assets whose useful economic life is predetermined (e.g. leases) and depletion of wasting assets. Consider this example from BLUE CIRCLE:

BLUE CIRCLE INDUSTRIES *Accounting policies 2000*

Depreciation

Depreciation is provided from the date of original use or subsequent valuation by equal annual amounts over the estimated lives of the assets, except for freehold and leasehold mineral lands where it is provided on the basis of tonnage extracted.

Traditionally fixed assets are shown in the balance sheet at cost less accumulated depreciation to date (i.e. at net book value). This book value is not, and does not purport to be

in any sense, a valuation, though fixed assets, particularly land and buildings, are often revalued. In UK practice, sometimes, but by no means always, the valuation is taken into the books.

Companies Act requirements

The requirements of the Companies Act 1985 with regard to fixed assets are complex. In summary:

COMPANIES ACT REQUIREMENTS

Tangible fixed assets

Accounting bases

Fixed assets may be shown on

- a historical cost basis, *or*
- at valuation.

Historical cost

Assets are stated in the balance sheet at depreciated actual cost. Amounts must be shown under the following headings:

- (i) cost;
- (ii) cumulative provision for depreciation;
- (iii) book (or carrying) value (i minus ii).

At valuation

The amount included must be shown, together with the years and amounts of the valuations. If valued

during the year, the names of the valuers and the basis of valuation must be given (see page 62 on QUEENS MOAT HOUSES). Historical cost details must also be given.

Modified historical cost

In practice, UK companies frequently adopt the **modified historical cost convention**, under which historical cost is employed, but certain assets are revalued.

Under all bases

1. Assets should be classified under headings appropriate to the business.
2. Land must be analysed into freehold, long (over 50 years unexpired) and short leaseholds.
3. Details must be given of *acquisitions* and *disposals* made during the year.

FRS 15 requires companies to disclose the method of depreciation used for each category of asset, together with the effective useful lives assumed.

Rates of depreciation

The following are typical rates (using the straight line method of depreciation, described below):

Freehold land	Nil
Freehold buildings	2% = 50-year life
Leasehold property:	
Long leases (over 50 years)	2% = 50 years
Short leases	Over life of the lease
Tenants' improvements	Over life of the lease
Plant and machinery	10% = 10 years
Vehicles	20% = 5 years
Ships, according to type	4–10% = 10–25 years
Furniture and equipment	10% = 10 years

Where there is a wide range of estimated useful lives within a single classification, some companies also show an *average life*, which is much more informative. An example is CABLE & WIRELESS:

CABLE & WIRELESS Accounting policies 2003

Tangible fixed assets and depreciation

	<i>Lives</i>	<i>Average</i>
Cables	Up to 20 years	15 years
Network equipment	3 to 25 years	8 years
Ducting	40 years	40 years

Subnormal depreciation charges

Where a company charges a subnormal rate of depreciation, or does not charge depreciation on assets (other than freehold land), it will report higher pre-tax profits than it would otherwise have done.

For example, a few companies in the retail sector, for example KINGFISHER, used not to provide depreciation on their freehold and long leasehold properties, and explained why in their accounts:

KINGFISHER Note on accounting policies 2000

Depreciation

Depreciation of fixed assets is provided where it is necessary to reflect a reduction from book value to estimated residual value over the useful life of the asset . . . It is the Group's policy to maintain its properties in a state of good repair to prolong their useful lives. The directors consider that, in the case of freehold and long leasehold properties occupied by the group, the estimated residual values at the end of their useful economic lives . . . are not materially different from their current carrying values. The lives of these properties and their residual values are such that no provision for depreciation is considered necessary. Any permanent diminution is charged to the profit and loss account . . .

Analysts sometimes make allowances for differing depreciation policies when making comparisons between companies.

Useful economic life

Determination of useful economic life (the period over which the present owner expects to derive economic benefit from the asset's use) is a matter for management and

depends on business circumstances. For example, the Chairman's Statement of THE JERSEY ELECTRICITY COMPANY refers to a site redevelopment that will allow relocation of the company's head office and provision of commercial retail and other office space. A note to the accounts discloses that the site has been examined in relation to FRS 11 *Impairment of fixed assets and goodwill*. As a result of this examination, depreciation has been accelerated to ensure that the assets will be written off during the development period. As a consequence, additional depreciation of £0.7m has been charged in 1998. It seems that this charge relates principally to buildings which will be demolished to allow completion of the development.

Where depreciation is shown in the accounts

Depreciation appears in several places. HALMA, in the extracts shown below, provides an example of what a good set of accounts shows:

- the note on *Accounting policies*;
- Note 3 and Note 22: the depreciation charge for the year;
- Note 11: disposals and the cumulative amount of depreciation to date;
- Note 11 also illustrates several other requirements of the Companies Act 1985, e.g. the analysis of land into freehold, long leasehold and short leasehold:

HALMA Extracts from the 2003 accounts

Accounting policies:

Tangible fixed assets and depreciation

Tangible fixed assets are stated at cost less provisions for impairment and depreciation which, with the exception of freehold land which is not depreciated, is provided on all tangible fixed assets on the straight line method, each item being written off over its estimated life.

The principal annual rates used for this purpose are:

Freehold buildings	2%
Leasehold properties	
more than 50 years unexpired	2%
less than 50 years unexpired	Period of lease
Plant, machinery and equipment	8% to 20%
Motor vehicles	20%
Short-life tooling	33 ¹ / ₃ %

Note 11

Fixed assets – tangible assets

Group

Cost	Group	Land and buildings			Plant, equipment & vehicles	Total
		Freehold properties	Long leases	Short leases		
At 30 March 2002		21,449	1,355	2,478	60,915	86,197
Assets of businesses acquired		4,713	–	51	3,217	7,981
Additions at cost		2,401	93	305	8,458	11,257
Disposals		(1,246)	–	(178)	(4,694)	(6,118)
Exchange adjustments		186	–	(33)	(806)	(653)
At 29 March 2003	(a)	<u>27,503</u>	<u>1,448</u>	<u>2,623</u>	<u>67,090</u>	<u>98,664</u>
Accumulated depreciation						
At 29 March 2003	(b)	<u>4,420</u>	<u>319</u>	<u>1,357</u>	<u>42,685</u>	<u>48,781</u>
Net book amounts						
At 29 March 2003	(a–b)	23,083	1,129	1,266	24,405	49,883

Note 3 to the profit and loss account:

	2003	2002
	£000	£000
Operating profit is arrived at after charging:		
Depreciation	7,554	7,371

Note 22 Reconciliation of operating profit to net cash inflow from operating activities:

Operating profit	42,865	45,721
...		
Depreciation	7,554	7,371

Depreciation methods

The most common method or basis of depreciation, used by over 80% of major companies, is the straight line (or fixed instalment) method.

Other methods include:

- (a) the declining (or reducing) balance method;
- (b) the sum of the years' digits method;
- (c) the renewals method;
- (d) the production unit method;
- (e) the annuity method;
- (f) the sinking fund method.

As will be seen, the different methods of depreciation affect:

- (i) net asset values
- (ii) net profit
- (iii) return on capital employed.

The straight line or fixed instalment method

Depreciation under the fixed instalment method is computed as follows (see also Example 8.1 below):

$$\text{Annual depreciation} = \frac{\text{Cost} - \text{Residual value}}{\text{Useful economic life}}$$

Example 8.1 Straight line depreciation

If a machine having a useful economic life of five years is purchased for £10,000, and is expected to have a residual value of £1,000 at the end of that life, depreciation will be:

$$\frac{£10,000 - £1,000}{5} = \frac{£9,000}{5} = £1,800 \text{ per annum}$$

and the accounts will show:

End of year	Depreciation for the year (shown in the P & L account)	Cost	Provision for depreciation to date		Net book value
			← shown in the balance sheet →		
	£	£	£	£	£
1	1,800	10,000	1,800	8,200	
2	1,800	10,000	3,600	6,400	
3	1,800	10,000	5,400	4,600	
4	1,800	10,000	7,200	2,800	
5	1,800	10,000	9,000	1,000	

TERMINOLOGY

Tangible fixed assets

Tangible fixed assets are long-lived assets held for the purpose, directly or indirectly, of earning revenue. They include not only items like **plant and machinery**, which are actually used to provide the product, but assets used to house or support operations, such as **land, buildings, furniture, computer equipment and motor vehicles**.

They may be owned by the company or financed by finance leases.

Depreciation is the measure of the cost or revalued amount of the economic benefits of the asset that have been *consumed* during the period.

Consumption includes the wearing out, using up or other reduction in the useful economic life of a tangible fixed asset whether arising from use, effluxion of time or obsolescence through changes either in technology or in demand for the goods and services produced by the asset.

Useful economic life of a tangible fixed asset is the period over which the company expects to derive economic benefit from that asset.

Residual value is the realisable value of an asset at the end of its useful economic life.

The straight line method is ideal where the service provided by the asset continues unabated throughout its useful economic life, as might be the case with a 21-year lease of a building. It is the method generally used whenever the equal allocation of cost provides a reasonably fair measure of the asset's service, e.g., for buildings, plant, machinery, equipment, vehicles and patents. A key advantage is that it is easy to calculate, and conceptually simple to understand.

The reducing balance method

The reducing balance (or declining balance) method used to be the most popular method of depreciation; but, except for tax purposes, it has largely been supplanted in recent years by the straight line method.

Under the reducing balance method, the annual depreciation charge represents a fixed percentage of the net book value brought forward (i.e. cost less accumulated depreciation). The calculation of the annual charge is simple enough once the appropriate percentage has been determined, but this requires the use of tables or a calculator:

$$\text{Depreciation rate} = 1 - (\text{Residual value} \div \text{Cost})^{1/n}$$

where n = useful economic life in years and depreciation rate is a decimal.

Example 8.2 illustrates the calculation.

Among the disadvantages of the reducing balance method are these:

- most users do not calculate the rate appropriate to each particular item of plant, but use standard percentages, which tend to be too low rather than too high;
- unless notional adjustments are made to cost and residual value, it is impossible to calculate satisfactorily a reducing balance rate if the residual value is nil: the net book value can never get to nil, as it can only be reduced by a proportion each year;
- even if the asset is assigned a nominal scrap value (say £1 so that it is not overlooked in the books) or if there is some residual value but it is small in relation to cost, the method is unlikely to be satisfactory without notional adjustments, because it leads to such high charges in the early years, as Example 8.3 shows.

The sum of the years' digits method

The sum of the (years') digits method is not commonly found in the UK, though it is used a good deal as a method of allowing accelerated depreciation in the USA (where accounting depreciation, provided it is computed by an acceptable method, is used for tax purposes too). It is occasionally found in the UK in connection with activities like leasing which involve heavy outlays in early years.

Example 8.2 Reducing balance depreciation

The rate for the machine in Example 8.1 would be computed as follows:

$$\text{Depreciation rate (as a decimal)} = 1 - (£1,000/£10,000)^{1/5} = 1 - 0.631 = 0.369 \text{ (i.e. 36.9\%)}$$

Thus the rate to apply is 36.9%.

<i>End of year</i>	<i>Depreciation for the year (shown in the P & L account)</i>	<i>Cost</i>	<i>Provision for depreciation to date</i>	<i>Net book value</i>
	£	£	£	£
1	3,690	10,000	3,690	6,310
2	2,328	10,000	6,018	3,982
3	1,470	10,000	7,488	2,512
4	927	10,000	8,415	1,585
5	585	10,000	9,000	1,000

Example 8.3 Reducing balance depreciation, small residual value

Taking our previous example of plant costing £10,000, but with a residual value of £200 instead of £1,000, we get:

Year	Depreciation with residual value	
	£200	£1,000
	£	£
1	5,425	3,690
2	2,482	2,328
3	1,135	1,470
4	520	927
5	<u>238</u>	<u>585</u>
Accumulated depreciation at the end of year 5	<u>9,800</u>	<u>9,000</u>
Residual value	<u>200</u>	<u>1,000</u>

In this method, the cost less any residual value is divided by the sum of the years' digits to give what, for the purpose of this explanation, may be termed a unit of depreciation. In the last year of expected life, one unit of depreciation is provided; in the next to last, two; in the one before that, three; and so on.

The sum of the years' digits is simply the sum of the series: $(1 + 2 + 3 + 4 \dots + n)$, where n represents the expected life of the asset.

The formula for computing the sum of the digits is $n(n + 1) / 2$, where n is the number of years. Thus, to apply the sum of the digits to an asset having a life of 5 years, the divisor (i.e. the sum of the years' digits) is $5(5 + 1) / 2 = 15$, and the first year's depreciation is $5/15$ of (cost minus residual value), the second year's $4/15$, and so on. See Example 8.4.

Comparison of methods

It is interesting to compare the balance sheet value of this asset year by year under sum of the digits (SD) with the value under the straight line (SL) and the reducing balance methods (RB£1,000 for a residual value of £1,000 and RB£200 for one of £200), as shown in Example 8.5 overleaf.

The value under the sum of the digits method is reduced in decreasing steps, year by year, reaching residual value at the end of the asset's expected life, regardless of the size of the residual value, if any.

The renewals method

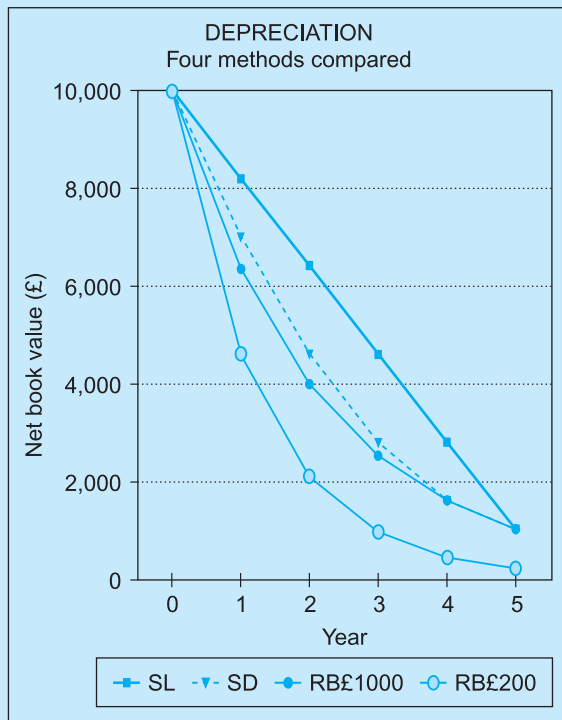
Definable major assets or components within an infrastructure or network with determinable finite lives should be treated separately and depreciated over their useful economic lives.

For the remaining tangible fixed assets within the system or network, renewals accounting may be used as a method of estimating depreciation (FRS 15, para. 97).

Example 8.4 Sum of the years' digits method of depreciation

Taking our example of a machine costing £10,000, with an estimated life of 5 years and a residual value estimated at £1,000: the sum of the year's digits is 15, and a unit of depreciation is thus $(£10,000 - £1,000) \div 15 = £600$, so:

End of year	Depreciation for the year (shown in the P & L account)	Cost	Provision for depreciation to date	Net book value
	£	£	£	£
1	3,000	10,000	3,000	7,000
2	2,400	10,000	5,400	4,600
3	1,800	10,000	7,200	2,800
4	1,200	10,000	8,400	1,600
5	600	10,000	9,000	1,000

Example 8.5 Balance sheet values compared for four methods of depreciation

Where renewals accounting is adopted, the level of annual expenditure required to maintain the operating capacity of the infrastructure asset is treated as the depreciation charged for the period (FRS 15, para. 98). For example the SOUTH STAFFORDSHIRE GROUP:

SOUTH STAFFORDSHIRE GROUP Accounting policies 2000**Infrastructure assets**

Infrastructure assets comprise a network of systems that, as a whole, is intended to be maintained in perpetuity at a specified level of service by the continuing replacement and refurbishment of its components . . .

The depreciation charge for infrastructure assets is the level of annual expenditure required to maintain the operating capability of the network . . .

Change in expected useful life

The useful economic life of a tangible fixed asset is reviewed as part of the normal end of period reporting procedures. If it is revised, the carrying amount of the tangible fixed asset at the date of revision should be depreciated over the revised life (FRS 15, para. 93).

Changes in useful life can have a significant effect on profits. For example STORM, the cartoon character licensing group, changed its accounting policy on film costs in its 1992 accounts to reflect a change in group strategy, as the chairman explained.

STORM GROUP Extract from Chairman's statement

It was decided that Storm would no longer utilise its own funds to invest in animated cartoon film productions . . . all production work would be funded from commissions, external funding or pre-sales revenue.

As a result of this change in strategic focus, the Board elected to adopt a revised accounting policy in respect of film costs and to write them off to the profit and loss account as incurred. The total sum involved was £2.289m, of which £1.538m was charged in 1992 and the balance treated as a prior year item.

The effect of the change in accounting policy was the major cause of the group reporting a pre-tax loss of £2.1m. But the chairman's statement went on to say:

STORM GROUP Second extract from Chairman's statement

It is, however, vitally important to emphasise that the write-off of film production costs should not be seen to detract from the inherent value of the animation programmes to which they relate. Animated cartoons have traditionally generated revenues over a long period . . .

Storm claimed that the revised policy had been adopted on the grounds of prudence, but does it necessarily provide 'a true and fair view'? Future profits will be enhanced by hundreds of thousands of pounds per annum for several years, because animation programmes will no longer have to be depreciated.

Writing down of asset values

As explained in Chapter 7, FRS 11 *Impairment of fixed assets and goodwill* calls for the writing down of fixed assets if they are judged to have become permanently impaired. The standard introduced the implication that assets must be stated in the balance sheet at amounts that are expected to earn at least a satisfactory rate of return. Companies earning a poor rate of return, even though profitable, should write down their assets (see page 53 regarding impairment reviews).

The useful economic life of a tangible fixed asset should be reviewed at the end of each reporting period and revised if expectations are significantly different from previous estimates. If a useful economic life is revised, the carrying amount of the tangible fixed asset at the date of revision should be depreciated over the revised remaining useful economic life (FRS 15, para. 93).

What is more, where the residual value is material the review has to take account of reasonably expected technological changes based on prices prevailing at the date of acquisition (or revaluation). A change in its estimated residual value should be accounted for prospectively over the asset's remaining useful economic life, except to the extent that the asset has been impaired at the balance sheet date (FRS 15, para. 95).

Changing method

A change from one method of providing depreciation to another is permissible only on the grounds that the new method will give a fairer presentation of the results and of the financial position. Such a change does not, however, constitute a change of accounting policy; it does not give rise to an exceptional item: the carrying amount of the tangible fixed asset is depreciated using the revised method over the remaining useful economic life, beginning in the period in which the change is made (FRS 15, para. 82).

Freehold land and buildings

Traditionally, neither freehold land nor buildings were depreciated, though the majority of companies had been depreciating freehold buildings in years before accounting standards were introduced.

Under FRS 15 companies are normally required to depreciate freehold and long leasehold buildings.

If, however, no depreciation charge is made on the grounds that it would be immaterial, or on the grounds that the estimated remaining useful life of the asset is over 50 years, tangible fixed assets should be reviewed for impairment at the end of each reporting period.

The revaluation of assets

Background

Under historical cost accounting, assets appear at cost less depreciation, and they are not revalued to show their current worth to the company. But because of the effects of inflation, the practice grew up in the UK of revaluing assets, particularly freehold land and buildings, from time to time.

Indeed, Sch. 7 para. 1 of the Companies Act 1985 requires the difference between the market value of property assets and the balance sheet amount to be disclosed in the directors' report if, in the opinion of the directors, it is significant. UK companies thus face the choice; they must either

- (a) incorporate any revaluation in the accounts, or
- (b) disclose it in the directors' report.

Where assets are revalued and the revaluation is incorporated in the accounts, both 'sides' of the balance sheet are affected, and depreciation from then on is based on the revalued amounts, as Example 8.6 illustrates.

Example 8.6 Effects of revaluation

A company has freehold land which cost £1.0m and buildings which cost £4.2m, have a useful life of 50 years and were 10 years old on 31 December 1999. Depreciation to that date would therefore be 2% p.a. for 10 years on £4.2m = £840,000, so the balance sheet would show:

	£m
Freehold land and buildings at cost	5.200
less depreciation to date	<u>0.840</u>
Book value at 31 December 1999	<u>4.360</u>

On 1 January 2000 the land was revalued at £3.8m and the buildings at £8.1m. After the revaluation the

accounts would show freehold land and buildings at the valuation figure of £11.9m, an increase of £7.54m. On the other side of the balance sheet the reserves would normally be increased by £7.54m. (If, however, the company has entered into a binding agreement to sell the buildings, FRS 19 para. 14 requires a provision to be made out of the revaluation surplus for the tax which would be payable on disposal, and this would be credited to deferred tax, the remainder of the surplus being credited to reserves.)

The 2000 accounts would be required to disclose the basis of valuation used and the name or qualification of the valuer (CA 1985, Sch. 4, para. 43 (b)).

The revaluation will affect the company in several ways:

1. The annual depreciation charge on the buildings, based on the new value and the current estimate of the remaining useful life (40 years), will increase from £84,000 to £202,500 (2½% p.a. on £8.1m), thus directly reducing the pre-tax profits by £118,500 in each future year.
2. The overall profitability of the company, as measured by the ratio Return On Capital Employed (ROCE, described in Chapter 16), will also appear to deteriorate because the capital employed will have increased by £7.54m. For instance, if the company in our example went on to make £3m before interest and tax in 2000, and had £20m capital employed before the revaluation, the 2000 return on capital employed would be:

<i>No revaluation</i>	<i>Revaluation</i>
$\frac{3,118,500}{20,000,000} = 15.6\%$	$\frac{3,000,000}{27,540,000} = 10.9\%$

3. The borrowing powers of most companies are expressed as a multiple of share capital and reserves, so the increase in reserves will raise the borrowing limits, and improve the capital cover of existing lenders.
4. The higher property value may give more scope for borrowing on mortgage.
5. The increase in reserves will also increase the n.a.v., the net asset value per share.

The arguments for and against valuations

On the one hand, valuations can produce figures that fluctuate wildly, and a lot may depend on the valuer, and whether he thinks his client wants a 'very full' valuation or a parsimonious one. He who pays the valuer calls the tune.

For example, at the end of 1991 the hotel group QUEENS MOAT HOUSES had its properties independently valued by a well-known firm of chartered surveyors at a figure of £2,000 million.

At the end of the following year a different but equally reputable firm of chartered surveyors valued the same portfolio of hotels at £861 million.

The *new* chairman explained what had happened:

QUEENS MOAT HOUSES *Extract from Chairman's statement*

At 31 December 1991, the group's properties were valued by Weatherall Green & Smith (WGS) at £2.0 billion, a valuation which was incorporated in the 1991 audited balance sheet . . .

In June the previous board appointed Jones Lang Wootton (JLW) to value the group's hotel portfolio in place of WGS. They have valued the portfolio of properties as at 31 December 1992 at £861 million . . .

After careful consideration the board accepted the JLW valuation and it has been incorporated into the group's balance sheet at 31 December 1992. In the UK and Continental Europe there was considerable hotel expansion in the late 1980s fuelled by the abundant availability of capital. Circumstances have changed materially over the past few years and the recent market place for hotels in the UK has been dominated by distressed sale values. On the continent, the declining profitability has lagged the UK but the market place has shown similar adverse developments. It is this adverse context of declining profitability and limited purchasers' interest in hotels in which the valuation has been prepared . . .

On the other hand, as the chairman of the ASB, Sir David Tweedie, has pointed out, it is nonsense to have a property shown in the balance sheet at £10m if the bank, valuing it at £50m, has accepted it as security for a £40m loan.

We rather agree with Sir Adrian Cadbury, who said at his last AGM as chairman of CADBURY SCHWEPES that the only time the real value of a brand [or any other asset] is known is when it changes hands.

FRS 15 *Tangible fixed assets*

The ASB has grasped the nettle somewhat cautiously. Under FRS 15, revaluing tangible fixed assets remains optional.

But, where a policy of revaluation is adopted, it must be applied to a whole class of assets and the valuations kept up to date. This will generally be achieved by a five-yearly full valuation of an asset with a qualified external valuer, and an interim valuation in year 3. Valuations in the intervening years are only required where there is likely to have been a material change in value.

Revaluation gains should be recognised in the profit and loss account only to the extent that they reverse valuation losses on the same asset that were previously recognised in the profit and loss account. All other revaluation gains should be recognised in the statement of total recognised gains and losses (FRS 15, para. 63).

Revaluation losses caused by a clear loss of economic benefit should be recognised in the profit and loss account. Other revaluation losses should normally be recognised in the statement of total recognised gains and losses until the carrying amount reaches its depreciated historical cost (FRS 15, para. 65).

Sales and other disposals of fixed assets

Where fixed assets are disposed of for an amount which is greater (or less) than their book value, the profit or loss on disposal should be shown separately on the face of the profit and loss account after operating profit and before interest, and attributed to continuing or discontinued operations (FRS 3, paras. 19 and 20), e.g. TESCO:

TESCO Extract from profit and loss account 2003

	2003	2002
	£m	£m
Operating profit	1,484	1,322
Share of operating profit of joint ventures and associates	70	42
Net loss on disposal of fixed assets	(13)	(10)
Profit on ordinary activities before interest and taxation	1,541	1,354
Net interest payable	<u>(180)</u>	<u>(153)</u>
Profit on ordinary activities before taxation	1,361	1,201

Where assets which have been revalued are subsequently disposed of, the gains or losses are to be calculated against the carrying value (valuation amount less any subsequent depreciation).

Investment properties

Currently, while FRS 15 requires annual depreciation charges to be made on fixed assets, and makes it clear that an increase in the value of a fixed asset does not remove the necessity to charge depreciation, a different treatment is applied to fixed assets held as disposable investments.

Under SSAP 19, 'investment properties' (i.e. properties held as investments rather than for use in a manufacturing or commercial process) are not depreciated, but are revalued each year at their open market value, and the valuation is reflected in the balance sheet. Changes in the value of investment properties should be treated as a movement on an 'investment property revaluation reserve'. The cumulative amounts credited to reserve can be very large; see leading property company LAND SECURITIES on the next page. If, however, there is a fall in value that exceeds the balance in the investment property revaluation reserve, the excess should be charged to the profit and loss account; i.e. the reserve cannot 'go negative'.

Government grants

Reference: SSAP 4 *Accounting for government grants*

Capital-based grants

Capital-based grants are grants made as a contribution towards specific expenditure on fixed assets. SSAP 4 requires capital-based grants to be credited to revenue (i.e. to the profit and loss account) over the expected useful life of the asset concerned.

Revenue-based grants

These include grants to finance the general activities of an enterprise over a specific period, which SSAP 4 requires to be credited to the profit and loss account in the period in which they are paid.

LAND SECURITIES Extracts from notes to 2003 financial statements**2. Accounting policies**

(h) *Depreciation and Amortisation* In accordance with SSAP 19, depreciation is not provided on investment properties that are held as freeholds or on leases having more than 20 years unexpired . . .

Accounting standards require properties to be included in the financial statements at their open market value.

**Note 12 Investment properties
(including development programme assets)**

	Freehold £m	Leasehold		Total £m
		Over 50 years to run £m	Under 50 years to run £m	
At 1 April 2002; at valuation	5,717.7	2,020.9	61.4	7,800.0
Additions	289.8	187.7	0.8	478.3
Sales	(225.3)	(169.1)	(1.7)	(396.1)
	5,782.2	2,039.5	60.5	7,882.2
Unrealised deficit on valuation	(22.3)	(25.6)	(10.4)	(58.3)
At 31 March 2003; at valuation	<u>5,759.9</u>	<u>2,013.9</u>	<u>50.1</u>	<u>7,823.9</u>

Note 26 (extract) Reserves

	Share premium account £m	Capital redemption reserve £m	Revaluation reserve £m	Other reserves £m	Profit and loss account £m	Total £m
GROUP						
At 1 April 2002	—	—	3,376.9	901.3	1,234.1	5,512.3
Premium arising on issue of shares	12.9					12.9
Purchase and cancellation of own shares	—	0.1			(5.1)	(5.0)
Unrealised deficit on valuation of investment properties			(56.8)			(56.8)
Realised on disposal of investment properties			(281.2)		281.2	
...						
Retained profit for the year	—	—	—	—	62.5	62.5
At 31 March 2003	<u>12.9</u>	<u>0.1</u>	<u>3,038.9</u>	<u>901.3</u>	<u>1,572.7</u>	<u>5,525.9</u>

RMC GROUP Extract from accounting policies 2003**Grants**

Grants received from governments and other agencies, where they relate to expenditure on fixed assets or are to finance the activities of the group over a number of years, are recognised in the profit and loss account over the expected useful economic lives of the related assets or over that number of years, and to the extent not so recognised are treated as deferred income.

Grants which are intended to give immediate financial support or assistance or which are made to reimburse costs incurred are included in the profit and loss account so as to match with those costs in the period in which they become receivable.

Where the amounts involved are material, grants will appear:

- separately in the profit and loss account or notes as a contribution to profit; and
- in the balance note on creditors and deferred income.

Hybrid grants

With some grants, e.g. Regional Selective Investment Grants, which are made to help generate jobs in Assisted Areas, it is debatable whether they should be treated as capital grants or as revenue grants.

Ratios

Ratios may be useful in looking at a manufacturing company's *tangible fixed assets*. For example, on plant and machinery:

Question 1: **Is it being kept well renewed?**

$$\text{Ratio 1} = \frac{\text{Additions each year}}{\text{Annual depreciation charge}}$$

Question 2: **Is it reasonably up to date?**

$$\text{Ratio 2} = \frac{\text{Cumulative depreciation}}{\text{Cumulative cost}}$$

For example LOCKER GROUP (see below):

Ratio 1, line (d) / line (k)

shows an increasing amount being spent each year on additions, compared with the annual depreciation charge.

Ratio 2, line (m) / line (f)

shows that cumulative depreciation is becoming a larger percentage of cumulative cost.

But ratios can be much more interesting if looked at in the context of what's happening in the company. For example, the 1996 column of the table shows that the Locker Group made a very large acquisition in that year.

The company acquired was called Pentre, and it was, in fact, a reverse takeover, in which the Chairman and the Chief Executive of Pentre (both founder directors of Pentre, aged 44 and 48 respectively) replaced Locker's elderly Chairman and its Chief Executive.

It is interesting to look at Ratio 2 of Pentre when acquired, and of Locker at the beginning of 1996:

£000		<i>Pentre</i>	<i>Locker</i>
Cu. Depreciation	=	3,966	5,100
Cumulative cost		10,078	8,256
Ratio 2		39.4%	61.8%

LOCKER GROUP Plant and equipment

Year to 31 Mar:	1996	1997	1998	1999	2000
	£000	£000	£000	£000	£000
Cost					
(a) At beginning of year	8,256	18,983	19,653	19,627	21,633
(b) Exchange differences	272	(808)	(948)	21	(346)
(c) Subsidiary acquired	10,078	—	—	760	—
(d) Additions	611	1,855	1,543	1,847	2,307
(e) Disposals	(234)	(377)	(621)	(622)	(975)
(f) At end of year	<u>18,983</u>	<u>19,653</u>	<u>19,627</u>	<u>21,633</u>	<u>22,619</u>
Depreciation					
(g) At beginning of year	5,100	9,917	10,755	11,162	12,637
(h) Exchange differences	149	(439)	(545)	9	(226)
(j) Subsidiary acquired	3,966	—	—	436	—
(k) Depreciation charge for year	880	1,573	1,490	1,587	1,736
(l) Disposals	(178)	(296)	(538)	(557)	(666)
(m) At end of year	<u>9,917</u>	<u>10,755</u>	<u>11,162</u>	<u>12,637</u>	<u>13,481</u>
Ratios					
(d/k) Additions / Depreciation charge	69.4%	117.9%	103.6%	116.4%	132.9%
(m/f) Cu. depreciation / Cu. Cost	52.2%	54.7%	56.9%	58.4%	59.6%
(l/e) Disposals: Depreciation / Cost	76.1%	78.5%	86.6%	89.5%	68.3%

In other words, Pentre's plant and equipment was pretty up to date, while Locker's was getting a bit old, like the previous chairman.

Many companies in the service sectors have no significant amount of tangible fixed assets but where they do, for example with hotels, these ratios may be useful. For example the London restaurant chain GROUPE CHEZ GERARD:

GROUPE CHEZ GERARD *Fixtures and fittings*

<i>Year end</i>	<i>Cumulative cost</i> £000	<i>Cumulative depreciation</i> £000	<i>Percentage depreciated</i>
1994	1,323	944	71.4%
1995	1,533	1,085	70.8%
1996	1,980	1,271	64.2%
1997	3,049	1,586	52.0%
1998	4,050	2,031	50.1%

The improving trend was due partly to the opening of new restaurants, with brand new fixtures and fittings.

Types of investment

Investments may be fixed assets or current assets. This chapter considers only investments which are fixed assets, i.e. held long-term, rather than for resale or as a temporary store of value.

Fixed asset investments fall into four categories:

1. investment in subsidiaries
2. investment in associates
3. investment in joint ventures
4. other investments.

Investment in subsidiaries

In simple terms, a subsidiary undertaking is a company, partnership, or unincorporated association, where the company owning the investment (the holding company) is able to control the board of directors, either by virtue of its voting power or in some other way. A holding company is

required by law to produce group accounts, in which the profits, assets and liabilities of the subsidiary are combined with those of the holding company, as described in detail in Chapters 20 and 21.

A company which is a holding company thus publishes two balance sheets: one for the company itself and a group balance sheet. This is demonstrated in the extract from the accounts of RMC shown below. The figures in the columns headed Parent are for investments owned directly by RMC itself.

The composition of *group* figures, which are clearly quite different, is explained in Chapters 20 to 22.

Investment in associates

Where an investing company or group holds a *participating interest* in a company and *exercises significant influence*, that company is deemed to be an **associate**.

A *participating interest* is an interest held by the investor on a long-term basis to secure a contribution to its

RMC note to the 2003 accounts

Note 13 Fixed asset investments

	Parent		Group	
	2003 £m	2002 £m	2003 £m	2002 £m
Group undertakings	2,796.9	2,832.3	–	–
Joint ventures	0.9	3.6	61.1	77.5
Associated undertakings	–	–	38.5	70.9
Other investments	1.7	1.7	6.4	4.8
Total	2,799.5	2,837.6	106.0	153.2

activities by the exercise of control or influence. A holding of 20% or more is presumed to be a participating interest unless shown to the contrary.

To *exercise significant influence* the investor must be actively involved and influential in the making of policy decisions on strategic issues: e.g. on the expansion or contraction of the business, and on dividend policy.

Associates are covered in detail in Chapter 22.

Investments in joint ventures

Where the investor holds a long-term interest in a company and shares control under a contractual arrangement, that company is deemed to be a **joint venture**.

Joint ventures are covered in detail in Chapter 22.

Other fixed asset investments

Whereas at first sight it may seem that these will consist entirely of investments of less than 20% this is not always the case. However, where a company has a holding of 20% or more in another undertaking, but does not treat it as an associated undertaking or as a participating interest, it should explain why. For example:

TT ELECTRONICS *Extract from note to 2003 accounts*

Fixed asset investments

TT electronics plc owns 24.4% of the equity share capital of Pressac plc. In 2003 TT electronics plc did not exercise significant influence over the financial or operating policies of Pressac plc and this holding was accounted for as an investment.

Other investments may include works of art (as with CORDIANT, formerly SAATCHI & SAATCHI). Investments in works of art, other than by art dealers, should be viewed with distinct suspicion; directors should not indulge their artistic tastes with shareholders' money. In the past this has sometimes been a warning sign of an arrogant top management.

They may also include life assurance policies and the company's own shares held for employee share option schemes e.g. DIAGEO:

DIAGEO *Extracts from the notes to the 2003 accounts*

14. Fixed assets – investments

Investment in associates comprises the cost of shares, less goodwill written off on acquisitions prior to 1 July 1998, of £2,619 million plus the group's share of acquisition reserves of £415 million.

- (a) **General Mills Inc** included in associates is the group's 79 million shares . . . valuing the group's interest at \$3,745 million (£2,270 million).
- (b) **Moët Hennessy** . . .
- (c) **Investment in other associates** . . .
- (d) **Investment in own shares** At 30 June 2003 investment in own shares comprised 42.8 million in respect of long term incentive plans . . . and 2.2 million in respect of savings-related share option schemes. The market value of these shares at 30 June 2003 was £291 million.

TERMINOLOGY

Fixed asset investments

Fixed asset investments fall into four categories:

- investments in subsidiaries
- investments in associates
- investments in joint ventures
- other investments.

A **subsidiary undertaking** is a company, partnership, or unincorporated association, where the company owning the investment (the **holding company**) is able to control the board of directors, either by virtue of its voting power or in some other way.

A holding company and its subsidiaries are termed a **group**.

An **associate** is an investment where the investor holds a participating interest and actually exercises significant influence.

A **joint venture** is an investment where the investor holds a long-term interest, and shares control under a contractual arrangement.

A **participating interest** is an interest held by the investing group or company on a long-term basis to secure a contribution to its activities by the exercise of control or influence. A holding of 20% or more of the shares of an undertaking is presumed to be a participating interest unless the contrary is shown.

Other investments should be shown separately:

- (g) other loans;
- (h) own shares.

KINGFISHER *Extract from note to 2003 accounts*

Fixed asset investments

<i>Other Investments</i>	<i>Listed in the UK</i>	<i>Listed Overseas</i>	<i>Unlisted</i>
	£m	£m	£m
At 2 February 2002	0.4	4.0	6.1
Additions	—	—	3.4
Disposals and write-off	(0.2)	—	(0.4)
Effect of foreign exchange rate changes	—	<u>0.2</u>	<u>0.3</u>
At 1 February 2003	<u>0.2</u>	<u>4.2</u>	<u>9.4</u>

The aggregate market value should also be shown where it differs from cost (CA 1985, Sch. 4, para. 45). Unlisted investments should be shown at cost or valuation.

Disclosures on significant holdings

Where *either* a company holds 20% or more of any class of share in another company, *or* the book value of the holding is more than one-fifth of the other company's assets, the accounts must show

- the name of the other company;
- country of incorporation if not Great Britain;
- if unincorporated, the address of the business;
- identity of each class of share held;
- the proportion held.

Balance sheet presentation

The Companies Act 1985 requires that where investments are shown as fixed assets, a further breakdown should be given, if individual amounts are material, either in the balance sheet itself or in notes:

- (a) shares in group undertakings;
- (b) loans to group undertakings;
- (c) interests in associated undertakings;
- (d) other participating interests;
- (e) loans to undertakings at (c) and (d);
- (f) other investments other than loans;

Points to watch

A holding may indicate

- the possibility of an eventual bid, particularly if the holder is predatory by nature;
- a blocking position taken by the holder to protect its trade interests from the risk of the company concerned being taken over by some (larger) competitor.

There is no hard and fast rule about which is which, and a holding could indicate a blocking position pending a possible bid in the distant future.

In this context it is worth checking whether directors have substantial holdings and, if so, whether any are nearing retirement age.

If the holding is of 20% or more and the company is not treated as an associate, the chances are probably more in favour of a bid than a blocking position – the unwelcome holder of a substantial stake being unlikely to be given a seat on the board.

If the holding is of 25% or more the holder is in the strong position of being able to block any arrangements and reconstructions that the company might wish to make with creditors and members under Section 425 of the Companies Act 1985, which requires three-fourths to vote in favour.

Interlocking holdings

Where a number of companies under the same management have substantial holdings in each other or in another company, the holdings may be entirely innocent; but interlocking holdings can give scope for manipulation to the detriment of outside shareholders and should be viewed with caution.

A classic illustration of the dangers of interlocking holdings was provided by the affairs of several companies in the LOWSON GROUP, which came under investigation by the Department of Trade in 1973.

The appointed inspectors found that a number of defaults in the management 'were knowingly committed by Sir Denys [Lowson] and constituted grave mismanagement of the affairs of the companies concerned' and that

in some transactions ‘his motive was to obtain a very substantial gain for himself and his family’.



Take care where a chairman or chief executive’s private interests seem difficult to distinguish from those of the group he or she manages.

As Robert Maxwell showed in connection with PERGAMON and MAXWELL COMMUNICATION CORPORATION, danger lies in wait for shareholders, employees and pensioners, and for the reputations and profits of city institutions and auditors alike, once private and public interests become intertwined.

We have more to say about related party transactions in Chapter 22.

Different classes of stock

Most manufacturing companies have traditionally shown stocks as a single figure under current assets, described either as 'stocks', as 'inventories' or as 'stocks and work in progress', but these terms cover three very different classes of asset:

- (a) items in the state in which they were purchased; these include raw materials to be used in manufacture, components to be incorporated in the product and consumable stores (such as paint and oil) which will be used in making it;
- (b) items in an intermediate stage of completion ('work in progress', or in the USA 'work in process');
- (c) finished goods.

For wholesalers and retailers, stocks are almost entirely goods purchased for resale.

Subclassification

The balance sheet formats in Sch. 4 of the Companies Act 1985 require stocks to be analysed under the following subheadings:

- (a) raw materials and consumables;
- (b) work in progress;
- (c) finished goods and goods for resale;
- (d) payments on account (for items of stock not yet received).

SSAP 9 calls for the accounts to show the subclassification of stocks and work in progress 'in a manner which

is appropriate to the business and so as to indicate the amounts held in each of the main categories'. For example, GLENMORANGIE's stock is mostly whisky:

GLENMORANGIE Note to the 2003 accounts

15 Stocks

	2003 £000	2002 £000
Group		
Whisky	74,034	69,520
Other stocks	<u>3,291</u>	<u>2,589</u>
	<u>77,325</u>	<u>72,109</u>

The matching principle

Expenditure on stocks which remain unsold or unconsumed at the balance sheet date (or upon work in progress which is incomplete) is carried forward into the following period and set against the revenue from the stocks when it arises. This is an application of what accountants term the matching principle, i.e. matching cost and revenue in the year in which the revenue arises rather than charging the cost in the year in which it is incurred.

Dead stock

Stocks and work in progress should be valued at the lower of cost and net realisable value, and any irrecoverable cost (e.g. due to deterioration or obsolescence) should be charged to revenue.

Allowing 'dead' stock to be carried forward at cost is a classic way of boosting profits.

Consistency

The method of valuing stock should be consistent, and most sets of accounts include a brief statement in the notes on how stocks have been valued:

THE BODY SHOP *Extract from accounting policies 2003*

Stocks are valued at the lower of cost and net realisable value. Cost is calculated as follows:

Raw materials	Cost of purchase on a first-in first-out basis.
Work in progress and finished goods	Cost of raw materials and labour together with attributable overheads.

Net realisable value is based on estimated selling price less further costs to completion and disposal.

DIAGEO *Extract from accounting policies 2003*

Stocks are stated at the lower of cost and net realisable value. Cost includes raw materials, direct labour and expenses, and an appropriate proportion of production and other overheads.

A particular point to look for is any statement of a change in the basis between year ends and, when one is made, why, and whether any indication is given of how much difference the change has made to the year-end stock figure and, hence, to profits.

The importance of stock valuation

The accurate valuation of stock on a consistent basis is important, because quite small percentage variations can very significantly affect profits (see Example 10.1).

Problems in valuing stock

Three main problems arise in valuing stock:

- the price to be used if an item has been supplied at varying prices;
- the value added in manufacture both to incomplete items (work in progress) and to completed items (finished goods);
- the assessment of net realisable value.

Example 10.1 Stock valuation

	£000	£000
Sales		2,000
Cost of goods sold:		
Opening stock	600	
Purchases in period	<u>1,500</u>	
	2,100	
Closing stock	<u>400</u>	<u>1,700</u>
		300
Wages, overheads, etc.		<u>200</u>
Operating profit		<u>100</u>

Had the opening stock been overstated by 10% (at £660,000) and the closing stock undervalued by 10% (at £360,000), the cost of goods sold would appear £100,000 higher and the operating profit would have been wiped out.

Stocks in a large retail business

Having defined the main principles and problems, let us now look at stocks in practice, beginning with the control of stocks in a large retail business, where virtually all stocks are goods purchased for resale and the complications of work in progress (WIP) and finished goods do not arise.

The central management of most supermarkets controls the efficiency and honesty of local stores by charging goods out to those stores at selling price, and by maintaining overall stock control accounts in terms of selling price by broad product groups. By suitably analysing takings it will then be possible, for each of these product groups, to compare theoretical stock with actual stock:

Opening stock at selling price	+	Deliveries at selling price	-	Takings	=	Theoretical closing stock at selling price
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With this sort of operation, it is usual for the purpose of monthly, quarterly, half-yearly and annual accounts to deduct from the value of stock at selling price the normal gross profit margin:

TESCO Extract from accounting policies 2003

Stocks comprise goods held for resale and properties held for, or in the course of, development and are valued at the lower of cost and net realisable value. Stocks in stores are calculated at retail prices and reduced by appropriate margins to the lower of cost and net realisable value.

SSAP 9 requires that before such a figure is used for the purposes of the annual accounts, it be tested to ensure that it gives a 'reasonable approximation of the actual cost'.

Stocks in a manufacturing business

Most manufacturing businesses employ a system of cost accounting. They do so:

- (a) as an aid to price fixing, so that they can charge the customer with the materials used and the time actually taken to complete the job – as is the case with a motor repair garage, or jobbing builder;
- (b) in order to provide the estimating department with information on which to base future estimates or tenders; and/or
- (c) as a means of controlling operating efficiency.

The type of record employed varies widely, from a few scribbles on the back of an envelope, to a cost system parallel to the normal financial system, reconciled with it but not part of it, right up to a completely integral cost and financial accounting system. In all but the first of these there is normally some form of stock record.

Methods of pricing issues from stock

Several different methods of pricing issues from stock are commonly employed, and the value of the stock remaining depends to some extent on the pricing method used.

FIFO (First In, First Out)

Good storekeeping demands that goods should, so far as is possible, be used in the order in which they are received; it merely assumes for accounting purposes that the normal rules of good storekeeping have been followed.

Average or weighted average price

When an organisation receives a number of deliveries during an accounting period at a series of different prices, it is reasonable to take the average price or, for more accuracy, the weighted average price.

Replacement cost and NIFO (Next In, First Out)

In the past, items in stock were occasionally stated in the accounts at replacement cost when this was lower than both cost and net realisable value. The effect of this was to increase the cost of goods sold for the period, and thus reduce reported profits. The statement of stocks at the lowest of cost, net realisable value and replacement cost is not (under SSAP 9) an acceptable basis of stock valuation.

LIFO (Last In, First Out)

Another method of valuation, permitted by the Companies Acts and commonplace in the USA but unacceptable under SSAP 9, is the last in, first out (LIFO) basis in which issues are charged at the latest price at which they could conceivably have come. This has the advantage of charging the customer with the most recent price; but in the balance sheet stocks appear at the price of the earliest delivery from which they could have arisen. The basic rule of good storekeeping is (in theory only) reversed, and goods received latest are assumed to be used first.

Thus, in a time of rising prices LIFO has the effect of:

- (a) showing stocks in the balance sheet at a cost appropriate not to recent purchases but to those many months or even years earlier; and, consequently,
- (b) reducing profit made on holding stock.

Taxation of stock profits

Suppose that a company has an opening stock of raw materials of £10m at the beginning of the year. At the end of the year the closing stock comprises exactly the same material quantities as the opening stock but, because of inflation and/or rising commodity prices, the value under FIFO has risen to £11m:

Opening stock of raw materials	£10,000,000
Closing stock of raw materials	<u>11,000,000</u>
Increase in value of stock	<u>1,000,000</u>

This increase in value of £1m reduces the cost of goods sold by £1m, which adds £1m to pre-tax profit. This stock profit, although unrealised, bears corporation tax at 30% = £300,000 tax, which has to be paid even though the physical amount of stock is unchanged.

Requirements of the Companies Act 1985 and of SSAP 9 on stocks and WIP

The Companies Act 1985 allows the use of FIFO, LIFO, weighted average price or any other similar method to be used for fungible assets (assets substantially indistinguishable from one another) but, where the amount shown differs materially from the replacement cost (or the most recent purchase price or production cost), the amount of that difference must be disclosed (Sch. 4, para. 27).

The inclusion of overheads in cost

It was at one time accepted that companies should be free to choose whether to value work in progress and finished goods

- (a) at prime cost: that is to say, to exclude all overheads; or
- (b) at variable (or marginal) cost: that is to say to exclude all fixed overheads, but include prime cost plus variable overheads; or
- (c) at the full cost of purchase plus the cost of conversion (including fixed overheads too).

The Companies Act 1985 and SSAP 9 both regard (c) as the only proper method. The classification of overheads between fixed and variable is regarded as an unsuitable one for determining whether or not they should be included in the cost of conversion: the dividing line is too imprecise.

Costs of general management, as distinct from functional management, are excluded unless directly related to current production (as they may be to some extent in smaller companies), but the Companies Act 1985 does allow a reasonable proportion of interest on capital borrowed to finance production costs to be included in the value of stock; however, if this is done the amount must be disclosed (Sch. 4, para. 26).

Net realisable value

Net realisable value is 'the actual or estimated selling price (net of trade but before settlement discounts) less:

- (a) all further costs to completion; and
- (b) all costs to be incurred in marketing, selling and distributing'.

Consignment stocks

Consignment stocks are stocks held by one party, *the dealer*, but legally owned by another party, *the manufacturer*. The terms of the agreement between them give the dealer the right to sell the stock in the normal course of his business or, at *his* option, to return it unsold to the legal owner.

FRS 5 *Reporting the substance of transactions* requires the agreement to be analysed to decide how it actually works in practice.

If it can be shown that the benefits and risks remain with the manufacturer until transfer of legal title, the stock will not be included in the dealer's balance sheet. For example CAFFYNS:

CAFFYNS Note to the 2003 accounts

Note 14 Stocks

	2003 £000	2002 £000
Group		
Vehicles	11,229	12,557
...		
Vehicles on consignment	5,510	6,756
...		
	<u>19,725</u>	<u>23,629</u>

In addition, non-interest bearing consignment vehicles excluded from the company balance sheet at 31 March 2003 had a cost of £772,000 (2000 – £1,003,000)

The danger of rising stocks

Although SSAP 9's requirement to include production overheads in arriving at the cost of finished goods gives a fair picture when stocks are being maintained at prudent levels

TERMINOLOGY

Stocks

Cost, in relation to stocks, is expenditure which is incurred in the normal course of business in bringing the product or service to its present location and condition. It includes, in addition to cost of purchase, costs of conversion that are appropriate to that location and condition.

Cost of purchase comprises purchase price including import duties, transport and handling costs and any other directly attributable costs, less trade discounts, rebates and subsidies.

Cost of conversion comprises:

- (a) costs which are specifically attributable to units of production, e.g. direct labour, direct expenses and sub-contracted work;
- (b) production overheads;
- (c) other overheads, if any, attributable in the particular circumstances of the business to bringing the product or service to its present location and condition.

Production overheads are overheads incurred in respect of materials, labour or services for production, based on the normal level of activity, taking one year with another.

Net realisable value is the actual or estimated selling price (net of trade but before settlement discounts) less:

- (a) all further costs to completion; and
- (b) all costs to be incurred in marketing, selling and distributing.

Unit cost is the cost of purchasing or manufacturing identifiable units of stock.

Average price is the price computed by dividing the total cost of the item by the total number of units. This average price may be arrived at by means of continuous calculation, a periodic calculation or a moving periodic calculation.

FIFO (first in, first out) represents the calculation of the cost of stocks on the basis that quantities in hand represent the latest purchases or production.

LIFO (last in, first out) represents the calculation of the cost of stocks on the basis that quantities in hand represent the earliest purchases or production.

Replacement cost is the cost at which an identical asset could be purchased or manufactured.

in relation to demand, when a manufacturer leaves production unchanged in periods of lower demand their inclusion can produce unduly optimistic profits (see Example 10.2). In practice, the profit from full production would be likely to be reduced by interest charges to finance carrying increased stock, but even so management may try to bolster profits in the short term by continuing high production in the face of falling demand. Rising stocks unmatched by rising turnover may give some warning here, and this can be monitored by the ratio stocks/turnover.

Example 10.2 Rising stocks

A company with a single-product factory faces a year in which demand is forecast to fall by 30% due to an economic recession.

Production overheads (rent of factory, etc.) = £1m
 Production capacity = 100,000 units per annum
 Variable costs = £10 per unit
 Selling price = £25 per unit
 Sales last year = 100,000 units

The management is faced with the decision of whether

- (a) to continue at full production, hoping that demand will pick up sharply the following year if not sooner, and that it possibly won't fall quite as sharply as forecast; or
- (b) to cut production by up to 30%.

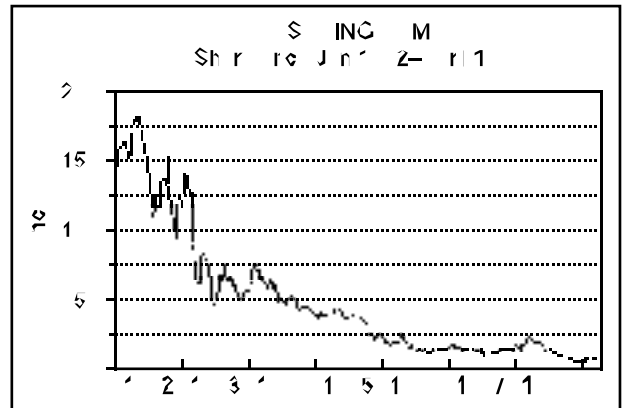
Under SSAP 9, assuming demand does fall by 30%, the figures that will be reported at the end of the year under these two choices will be:

	(a) Full production Units	(b) Production cut by 30% Units
Opening stock	20,000	20,000
Units manufactured	<u>100,000</u>	<u>70,000</u>
Units sold	<u>120,000</u>	<u>90,000</u>
Closing stock	<u>50,000</u>	<u>20,000</u>
Fixed costs	1,000,000	1,000,000
Variable costs (£10 per unit)	<u>1,000,000</u>	<u>700,000</u>
Total costs	<u>2,000,000</u>	<u>1,700,000</u>
Costs per unit manufactured	£20	£24.285
Profit and loss account		
	£	£
Sales (£25 per unit)	<u>1,750,000</u>	<u>1,750,000</u>
Cost of goods sold:		
Opening stock (£20 per unit)	400,000	400,000
Cost of units manufactured	2,000,000	1,700,000
less Closing stock by FIFO method	<u>1,000,000</u>	<u>485,700</u>
	<u>(£20)</u>	<u>(£24.285)</u>
Cost of goods sold	<u>1,400,000</u>	<u>1,614,300</u>
Gross (or Trading) profit	<u>350,000</u>	<u>135,700</u>

NOTE: A watchful auditor would require to be satisfied (i) as to the net realisable value of the closing stock under (a); and (ii) that the requirements of SSAP 9 regarding spreading of overheads on the basis of 'normal production' were met.

SPRING RAM Extract from chairman's statement 1991

A most satisfying result was achieved for the year under review, despite a generally very difficult economic climate. Group profits before tax advanced to a record £37.6m (1990 £30.1m), an increase of 25% on the previous year. Consolidated turnover of £194.2m (1990 £145.3m) . . . Earnings per share were 7.1p (1990 5.4p).



The example below is of a rising stocks/turnover ratio giving warning of trouble. It illustrates two key points. See if you can spot them.

But in market conditions described by the chief executive of one housebuilder, BELLWINCH, as 'certainly the worst in post-war years', Spring Ram's results seemed too good to be true. The sharp rise in the ratio 'finished goods and goods for resale/turnover', to the unprecedented level of 13.5%, was a warning signal. (See below.)

SPRING RAM Extracts from 1987-1991 accounts

	1987	1988	1989	1990	1991
	£000	£000	£000	£000	£000
Turnover	60,785	85,173	121,017	145,285	194,173
Stocks					
Raw materials	3,296	6,386	8,035	8,813	12,984
Work in progress	297	927	1,160	1,277	1,787
Finished goods and goods for resale	<u>4,508</u>	<u>10,041</u>	<u>10,984</u>	<u>15,019</u>	<u>26,255</u>
Total stocks	<u>8,101</u>	<u>17,354</u>	<u>20,179</u>	<u>25,109</u>	<u>41,026</u>
Ratios (%)					
Raw materials/turnover	5.4	7.5	6.6	6.1	6.7
WIP/turnover	0.5	1.1	1.0	0.9	0.9
Finished goods and goods for resale/turnover	<u>7.4</u>	<u>11.8</u>	<u>9.1</u>	<u>10.3</u>	<u>13.5</u>
Total stocks/turnover	<u>13.3</u>	<u>20.4</u>	<u>16.7</u>	<u>17.3</u>	<u>21.1</u>

The 1992 interim results showed further growth in turnover, profits and earnings per share. It wasn't until the week before the 1992 final figures were due to be announced that Spring Ram issued a profit warning and asked for its shares to be suspended.

Profits at a bathroom manufacturing subsidiary had been overstated by £5.6m, mainly through the inflation of stock values and sales.



Key point 1

When a sector of the market is going through hard times, and the management of a company in that sector tells you 'we are going to buck the trend', be highly sceptical. Our experience is that they are about to run into very serious trouble.



Key point 2

If a company's results seem too good to be true, don't believe them.

LONG-TERM CONTRACTS

A long-term contract is defined by SSAP 9 as 'a contract entered into for manufacture or building of a single substantial entity or the provision of a service where the time taken to manufacture, build or provide is such that a substantial proportion of all such contract work will extend for a period exceeding one year'.

Shipbuilders, constructional engineers and the like frequently engage in long-term contracts. Because of the length of time such contracts take to complete, to defer taking profit into account until completion would result in the profit and loss account reflecting not a true and fair view of the activity of the company during the year, but rather the results of those contracts which, by the accident of time, were completed by the year end.

It is normal with long-term contracts to have an arrangement under which the contractor receives payment on account on the basis of the 'work certified' by an architect or surveyor. Traditionally, there are two ways of computing the profit to be taken. The 'work certified' is an essential

piece of information whichever of the two ways of arriving at the profit to date is adopted.

Under the first method, profit to date is computed as follows:

$$\begin{array}{r r r r r} \text{Work} & & \text{Costs} & & \\ \text{certified} & - & \text{incurred on} & = & \text{Profit} \\ \text{at balance} & & \text{contract} & & \text{to date} \\ \text{sheet date} & & \text{to date} & & \end{array}$$

The second method takes the overall profit expected:

$$\begin{array}{r r r r r} & & \text{Total costs} & & \text{Total} \\ & & \text{incurred on} & - & \text{estimated} \\ \text{Total} & - & \text{contract to} & - & \text{further costs} \\ \text{contract} & & \text{date} & & \text{to completion} \\ \text{price} & & & & \end{array}$$

and multiplies it by $\frac{\text{Work certified to date}}{\text{Total contract price}}$

to arrive at the profit to date.

If the first formula is used it is still necessary to have regard to the costs likely to be incurred in completing the job, for it is clearly wrong to take a profit on the first stage of a contract if the profit is likely to be lost at a later stage. In either case, in considering future costs, it is necessary to allow for likely increases in wages and salaries, in the price of raw materials and in general overheads, in so far as these items are not recoverable from the customer under the terms of the contract: inflation can play havoc with the profitability of fixed-price or inadequately protected contracts, as many companies have learned to their cost.

In neither case is it usual to take up the entire profit to date. Some companies take only two-thirds, others only three-quarters.

Many multiply by a further fraction:

$$\frac{\text{Amount received}}{\text{Work certified to date}}$$

Where the customer is entitled (as is usually the case) to retain, say, 10% of the amount certified as 'retention monies', so as to ensure satisfactory rectification of any defects; the use of this further fraction of, in this case, nine-tenths, has the effect of disregarding that part of the profit appropriate to the amount retained.

The amount reflected in the year's profit and loss account will be the appropriate proportion of the total profit by

reference to the work done to date, less any profit already taken up in prior years on the contracts still on hand. The aim of using a multiplying factor of two-thirds or three-quarters is to ensure that unless the remaining work on a contract is disastrous, some profit remains to be taken when the contract is finally completed.

The second formula relies on an estimate of future costs and is therefore open to subjective judgement. Results should be viewed with caution if the overall profitability margin is estimated to be higher than the margin to date; i.e. if the second formula allows a higher profit to be taken now than the first formula would allow (see Example 10.3).

Example 10.3 Long-term contracts: COMMERCIAL CONTRACTS LTD

COMMERCIAL CONTRACTS LTD is engaged in a long-term bridge-building contract.

		£000
Work certified to 31 December 2003	W	1,250
Total contract price	P	2,000
Costs incurred on contract to 31 December 2003	C	1,025
Estimated further costs to completion	E	575
Amount received from customer by 31 December 2003	R	1,125
Profit taken on the contract in 2002	T	45

The company takes up three-quarters of the profit earned to date, reduced by the fraction:

Amount received to date ÷ Work certified to date.

What profit will be taken up on the contract in 2003?

Using the first formula:

Profit to date = $W - C = £225,000$

Of which $\frac{3}{4} \times R \div W = \frac{3}{4} \times 1,125,000 \div 1,250,000 = 67\frac{1}{2}\%$ (£151,875) will be taken as profit by 31 December 2003.

But £45,000 of this was taken up in 2002, so only £106,875 remains to be taken in 2003.

Using the second formula:

Profit to date = $(P - C - E) \times W \div P = (£2,000,000 - £1,025,000 - £575,000) \times 1,250,000 \div 2,000,000 = £250,000$.

Of this £250,000 profit, 67½% will be taken up (as before), i.e. £168,750, less the £45,000 already taken up in 2002 = £123,750.

The difference between the two figures for profit to date is due to the difference between the profit margin on that part of the contract completed to date (£225,000 on £1,250,000 in the first formula = 18%) and that estimated on the contract as a whole (£400,000 on £2 million in the second formula = 20%).

SSAP 9 requirements on long-term contracts

In the past, accounting treatment of long-term contracts has varied enormously from company to company. BOVIS, for example, in its 1972 accounts noted that 'no provision is made for anticipated future losses' and a year later had to be rescued by P & O. At the other end of the scale companies like JOHN LAING pursued policies of extreme prudence: all losses were taken when they were foreseen, but no account was taken of profits on contracts unfinished at the end of the year.

SSAP 9 requires that 'The amount at which long-term contract work in progress is stated in periodic financial statements should be cost plus any attributable profit, less any foreseeable losses and progress payments received and receivable', and the amount of attributable profit included should be disclosed. Attributable profits on contracts are, however, only required to be taken up when 'it is considered that their outcome can be assessed with reasonable certainty before their conclusion'; if the outcome cannot be reasonably assessed, 'it is prudent not to take up any profit', so management is still left with a certain latitude, and the key point to watch for is undue anticipation of profits.

SSAP 9 also requires balance sheets to show how the amount included for long-term contracts is reached by stating:

- the amount of work in progress at cost plus attributable profit (i.e. profit or loss taken to date), less foreseeable losses;
- cash received and receivable at the accounting date as progress payments on account of contracts in progress, as Example 10.4 illustrates.

Example 10.4 Long-term contracts: COMMERCIAL CONTRACTS LTD (continued)

If the bridge contract we discussed in Example 10.3 was the only contract of Commercial Contracts Ltd to appear in the balance sheet at 31 December 2003, and if the first formula was used, it would appear in the balance sheet as follows:

	£000	£000
Work in progress, at cost		
plus Profit taken to date	1,176	
Less Cash received from customer	<u>1,125</u>	

KBC ADVANCED TECHNOLOGIES, which provides profit improvement services to the hydrocarbon and energy industries world-wide, provides an actual example:

KBC ADVANCED TECHNOLOGIES *Extracts from 2002 accounts*

Accounting policies

Long-term contracts

Turnover on long-term contracts is recognised using the percentage-of-completion method. Under this method revenues recorded represent the aggregate of costs incurred during the year and a portion of estimated profit . . .

Anticipated losses on contracts are charged to income in their entirety when the losses become evident.

Note 12 Work in progress

	2002	2001
This comprises:	£000	£000
Revenue recognised	21,142	17,209
Less: amounts invoiced	(17,681)	(13,572)
	<u>3,461</u>	<u>3,637</u>

In the accounts, work in progress is included under debtors and creditors under the following headings:

Amounts recoverable on contracts	4,465	4,302
Payments on account	(1,004)	(665)
	<u>3,461</u>	<u>3,637</u>

Stock ratios

Except when stocks are built up in anticipation of sharp price rises, well-run companies usually try to carry the minimum stock needed for the satisfactory running of their business. They do so:

- (a) to minimise interest charges on the money tied up in stocks;
- (b) to save unnecessary storage costs (including pilferage); and
- (c) to reduce the risk of being left with goods that can't be sold due to deterioration, becoming obsolete or going out of fashion.

Although some distortion can occur with accelerating growth, because stock is a year-end figure while sales occur throughout the year (on average several months earlier), a rising stock ratio without any special reason is regarded as bad news, reflecting lack of demand for goods and/or poor stock control.

Stocks/Turnover ratio

The most generally used stock ratio (as shown in our Spring Ram example on page 76) is

$$\frac{\text{Stocks}}{\text{Turnover}} \text{ expressed as a percentage}$$

Stocks/Turnover ratios vary enormously with the nature of a business. At one end of the scale, and apart from advertising agencies and other service industries, ready-mixed concrete companies probably have one of the lowest Stocks/Turnover figures of any industry: aggregates are extracted from the ground when required and the product is delivered the same day, so all that is needed in stock is a supply of fresh cement and fuel, giving a typical Stocks/Turnover figure of 5%. At the other end of the scale a company which maintains depots of finished goods and replacement parts world-wide, such as a power transmission and mechanical handling systems manufacturer, can reasonably be expected to have a ratio as high as 35% in order to maintain a first-class service to its customers all over the world. Nevertheless, a high ratio in comparison to similar companies is undesirable.

For an average manufacturing company a Stocks/Turnover ratio of around 15–20% would be reasonable, increasing the larger and more complex the goods made; for instance, an aircraft manufacturer might have stocks and work in progress representing 30–35% of turnover and this level could be subject to sharp fluctuations, depending on whether completed aircraft had been delivered to clients just before or just after the end of the year; in contrast, a company making a limited range of nuts and bolts could probably run on a few weeks' stock, though if supplies were subject to interruption and/or shortages it might be prudent to carry more raw materials, and if orders tended to be erratic a higher stock of finished goods would be needed.

Stocks/Cost of sales ratio

P & L accounts using Format 1 (see page 118) show the *cost of sales*. Where this is available it can be used to compute the average amount of stock held during the year, which can be expressed as so many months' stock, or so many days' stock. Many analysts take the average of the opening and closing stocks, which has a smoothing effect, and dampens the effect of a major change in stocks over the period.

$$\text{Stock (months)} = \frac{(\text{Opening stock} + \text{Closing stock}) \div 2}{\text{Cost of sales}} \times 12$$

$$\text{Stock (days)} = \frac{(\text{Opening stock} + \text{Closing stock}) \div 2}{\text{Cost of sales}} \times 365$$

Cost of sales/Stock ratio

The previous ratio can be inverted, Cost of sales/Stock, to give the number of times the stock has been turned over in the year, the **stockturn**:

$$\text{Stockturn} = \frac{\text{Cost of sales}}{(\text{Opening stock} + \text{Closing stock}) \div 2}$$

Example 10.5 Calculation of stock ratios

Extracted from accounts:

	1998	1999	2000
	£m	£m	£m
Year-end stock	2.10	2.20	3.00
Sales		10.00	12.00
Cost of sales		7.50	8.00

Ratios:

Stocks/Sales		22.0%	25.0%
Stock (days)		104.6 days	118.6 days
Stockturn		3.49 ×	3.08 ×

Trade debtors and other debtors

Introduction

Debtors (also known as ‘receivables’) are a current asset, representing amounts owing to the business.

The Companies Act 1985 requires debtors to be subdivided into:

- trade debtors – those arising from the sale of goods on credit;
- amounts owed by group undertakings – see Chapter 20;
- amounts owed by undertakings in which the company has a participating interest – see Chapter 22;
- other debtors – e.g. debts due from the sale of fixed assets or investments; and
- prepayments and accrued income – e.g. rent or rates paid in advance.

The amount falling due after more than one year should be shown separately for each item included under debtors. Other items which may be found shown separately under debtors (and which are not trade debtors for the purpose of computing collection ratios) include

- (a) corporation tax recoverable (in respect of loss relief, etc. – see Chapter 17);
- (b) deferred taxation (see Chapter 17);
- (c) pension prepayments (see Chapter 16);
- (d) amounts receivable under finance leases (see Chapter 15);
- (e) loan notes (see Chapter 6).

Most companies show a single figure for debtors in their balance sheet, and give the required details in a note, as illustrated here.

THE BODY SHOP *Extract from note to the accounts*

Debtors	2003 £m	2002 £m
Amounts receivable within one year		
Trade debtors	25.5	28.0
Other debtors	5.8	12.1
Prepayments	<u>5.5</u>	<u>6.8</u>
	36.8	46.9
Amounts receivable after more than one year		
Other debtors*	<u>7.1</u>	<u>6.6</u>
	<u>43.9</u>	<u>53.5</u>

* Included in ‘Other debtors’ is £6.0 million relating to the deferred payment arrangement on the sale of the manufacturing division to Creative Outsourcing Solutions International Ltd.

Bad debts and doubtful debtors

The granting of credit inevitably involves some risk that the debtor will fail to pay, that is, will become a bad debt. When a business recognises that a debt is bad, the debt is written off to the profit and loss account. That is to say, the balance appearing as ‘debtors’ falls by the amount of the debt, and ‘bad debts’ appears as an expense. But this expense is shown separately in the published accounts only if the amount is material.

In addition, it is normal to set up a ‘provision for doubtful debtors’. To do so a charge is made to the profit and loss account and, in the balance sheet, the cumulative provision for doubtful debtors is deducted from the total debtors. It is disclosed separately in the published accounts

only if it is material. A provision for doubtful debtors may be specific, that is to say where management estimate the probable loss, studying each debt in turn; for instance, there is a 10% probability that Tin Pott plc will fail to pay its debt of £121,000, and they must therefore provide £12,100; or it may be general, e.g. 2½% of total debtors; or a combination of the two.

The importance of debtors

Companies such as supermarket chains, whose turnover is almost entirely for cash, will have very few debtors; the figure appearing in the balance sheet is likely to be largely prepayments and non-trade debtors. Trade debtors may have little significance. SAINSBURY, for example, with sales excluding VAT of £17,430m, showed trade debtors of a mere £116m in its 2003 accounts. At the other extreme are companies whose entire turnover is on credit terms, in which case very large amounts of working capital may be tied up in debtors. Here the efficiency with which credit accounts are handled, and the timing of the taking of profit where payments are by instalment, are of considerable interest to the analyst.

Debt collection period

The ratio Trade debtors/Sales can be used to monitor a company's credit control. Logically it should be sales including VAT, because the debtors include VAT, but the VAT inclusive figure is not usually available.

Analysts often feel that a more meaningful measure is that expressed in terms of time, as the debt collection period (or, simply, the collection period) in days or months:

$$\text{Debt collection period (days)} = \frac{\text{Trade debtors}}{\text{Sales}} \times 365$$

$$\text{Debt collection period (months)} = \frac{\text{Trade debtors}}{\text{Sales}} \times 12$$

But it may be expressed simply as a percentage of sales:

$$\frac{\text{Trade debtors}}{\text{Sales}} \times 100$$

For example, given Trade debtors of £8.219m and Sales of £50m:

$$\text{Collection period} = \frac{£8.219\text{m}}{£50\text{m}} \times 365 = 60 \text{ days}$$

$$\text{Collection period} = \frac{£8.219\text{m}}{£50\text{m}} \times 12 = 1.97 \text{ months}$$

$$\frac{\text{Trade debtors}}{\text{Sales}} = \frac{£8.219\text{m}}{£50\text{m}} \times 100 = 16.4\%$$

Trade debtors/Sales has the advantage of stating the percentage of the year's sales which were outstanding at the balance sheet date (which is correct) rather than suggesting that the business's debtors represent 60 days' sales (which we cannot say).

Apart from 'strictly cash' businesses like supermarkets, with virtually zero debtors, normal terms tend to be payment at the end of the month following delivery, so with 100% prompt payment the average credit given would be between 6 and 7 weeks, making debtors about 12% of turnover. In practice, a figure of 15–20% is quite normal although some companies may, as a matter of policy, give more generous credit in order to give themselves a competitive edge, while others may factor their debts (see pages 86–7) and so possibly show abnormally low debtors.

A falling collection period is generally a good sign – an indication of effective financial control – but it could reflect a desperate need for cash, involving extra discounts for cash and undue pressure on customers.

On the other hand, a marked rise in the ratio can be a warning signal. For example BOOSEY & HAWKES:

BOOSEY & HAWKES Extracts from 1999 accounts

	1999 £000	1998 £000
Profit and loss account		
Turnover	96,766	98,895
Note on debtors		
Trade debtors	25,568	20,699
Ratio (calculated)		
$\frac{\text{Trade Debtors}}{\text{Turnover}} =$	26.4%	20.9%

The huge jump in the ratio suggested that there might be 'something nasty in the woodshed'. And so there was:

BOOSEY & HAWKES Extracts from 2000 Interim report

CHAIRMAN'S STATEMENT

...

North American bad debt provision

Earlier this year the Board made a decision to investigate possible securitisation of trade debt . . . As part of this process, we instigated a review of the sales ledger of our Chicago-based distribution company, Boosey & Hawkes Musical Instruments Inc. The results of this review indicated that, for the past two years, the level of bad debt provisioning was significantly inadequate and that some of these debts are irrecoverable.

. . . the directors have made a provision of £3.52m which has been fully charged as an exceptional item. Further investigations are being conducted into the levels of stock . . .

The Chairman commented: 'Having regard to the underlying trading performance of the Group and our confidence for the remainder of the year the directors have declared an interim dividend of 2.395p (1999: 2.395p)'.

But his confidence was misplaced. There was worse to come:

BOOSEY & HAWKES Extracts from Trading statement November 2000

...

These investigations [conducted by Ernst & Young, the Group's auditors] are now nearing completion. A write-down of a further £10m will be required, which has arisen mainly in the areas of stock and prepayments as a result of a long series of misleading and incorrect accounting entries . . . The personnel responsible have been dismissed and the evidence supporting a legal action against them is being evaluated . . . A final dividend is therefore unlikely to be paid.

What we would like to know

The analyst can tell comparatively little about debtors unless a significant proportion of debtors are due after more than one year or unless the company discloses more than the minimum information required by law. Among the things which one would like to find out (and should be

on the look out for any hint about in the chairman's statement or financial review) are the following:

1. Is an undue proportion due from one major customer, or from customers in one industry?
2. Would failure of one or two customers have a material effect upon the company's future?
3. What is the age pattern of debtors? Are some unduly old?
4. Is there adequate provision for bad and doubtful debts?
5. Are any of the debts which fall due after more than one year very long-term in nature? In the UK debtors appear at their face value regardless of when they are due. In the USA, if a debt is not due within one year, it is usually necessary to discount it, i.e. to take account of imputed interest. Thus, a debt of \$1m due three years hence might appear, taking interest into account at 10%, as \$751,300.

Factors affecting the debt collection period

A short debt collection period is, other things being equal, preferable to a longer one; but as with many ratios one has to qualify this general principle. For by restricting credit and selling entirely for cash, a business can have a zero debt collection period; but if this drives its customers into the arms of competitors it is scarcely an improvement so far as the business as a whole is concerned. Subject to that qualification, any improvement in collection period, since it represents a reduction in overall debtors, means that more capital is available for other purposes, or that there is less need to borrow money from the bank.

At first sight it may seem that an increase in collection period represents a fall in the efficiency of the debt collection section. This is likely to be the case, but it is not necessarily so. The debt collection period may increase (decrease) between one period and another for a number of reasons:

- if there is a policy change with regard to:
 - (a) credit terms to existing customers; if, e.g., the board of directors, to obtain a valuable order from a major customer, offers two months' credit instead of one;
 - (b) the granting of credit; for instance, if potential customers whose credit ratings were formerly insufficient for them to be granted credit, are granted credit – for such customers are unlikely to be among the fastest payers;

- where there is poor credit management or accounts administration, e.g.:
 - (a) if credit is given to unsatisfactory customers;
 - (b) if the invoicing section falls behind; customers will not pay until they receive an invoice and, in general, pay at a fixed time determined by the date on which they receive it, e.g. at the end of the month in which they receive the invoice;
 - (c) if statements are late – while some businesses ignore statements, others wait until they receive one;
 - (d) if there is no consistent follow-up of overdue debts, by letter and/or telephone, or as a last resort in person;
- if a subsidiary with an atypical debt collection period is disposed of or acquired, e.g. BASS's sale of the CORAL betting business and over 300 managed pubs in 1998 increased the group's debt collection period by several days;
- if factoring or invoice discounting is introduced or discontinued (see pages 86–8).

Although it is necessary for most businesses to offer some credit, any unnecessary credit is bad management because it ties up money which (normally) earns no return, and which is subject to increased risk. Customers who are short of money, and who find that they can order things from a company without having to pay for them at the end of the month, tend to place more and more of their orders with that company; if they later go into liquidation, they may do so owing a hefty amount.

Debtors due after more than one year

Traditionally, liabilities were regarded as current if they were expected to fall due within one year. Similarly, assets were treated as current if it was expected that they would be turned into cash within one year. The Companies Act 1985 changed that. Debtors are shown under current assets whenever they fall due, though the amount falling due after more than one year is required to be shown separately for each item. The inconsistency is clearly evident in the accounts of MARKS & SPENCER (below) where the figure of £1,610.2m for net current assets in 2003 included as a

current asset the item 'Debtors: Receivable after more than one year £1.547.5m':

MARKS & SPENCER Group balance sheet 2003

	2003	2002
	£m	£m
...		
Current assets		
Stocks	361.8	325.3
Debtors		
Receivable within one year	907.9	952.1
Receivable after more than a year	1,547.5	1,667.2
Investments	304.0	272.7
Cash at bank and in hand	<u>167.9</u>	<u>543.4</u>
	3,289.1	3,760.7
Current liabilities		
Creditors: due within one year	<u>(1,678.9)</u>	<u>(1,750.8)</u>
Net current assets/(liabilities)	<u>1,610.2</u>	<u>2,009.9</u>

The Act does not require the breakdown of Debtors to be shown on the face of the balance sheet (as M&S does), but UITF Abstract 4 requires this where the amount is material in the context of net current assets. But the misdescription 'net current assets' usually remains, leading the unwary to compute a false current ratio (see page 109).

Where long-term debtors seem an important factor in assessing a group's future, considerable research may be necessary. Companies are sometimes so keen to get rid of an unprofitable activity (perhaps an unwanted part of an acquisition) that they will sell to anybody who is willing to take the activity off their hands, regardless of their financial weakness, and give them extended credit.

And it's not unknown for companies to guarantee borrowings the acquirer has made to help finance the deal, which is simply asking for trouble (see pages 114–15 on contingent liabilities). Debts which persist long after a subsidiary is sold should raise suspicions.

Assets held for resale

These are treated as *current assets*, as REGENT INNS shows:

REGENT INNS Extract from 2003 consolidated balance sheet

	Note	2003 £000	2002 £000
Current assets			
Assets to be sold	14	4,078	6,069
Stocks . . .			

Note 14. Assets held for resale

The following assets were held for resale at period end:

	2003 £000	2002 £000
Unbranded pub venues	4,078	6,069

It would be worth asking if the pub venues were surplus in a reorganisation, or after acquisitions. In addition, is the £4,078,000 a carry forward from 2002's figure of £6,069,000? If so, is there a problem in finding buyers?

Hire-purchase and credit sale transactions

Reference: SSAP 21 *Accounting for leases and hire purchase contracts*

Definitions

A *hire-purchase transaction* is a transaction in which the hirer agrees to hire goods from their owner in return for paying (usually) a deposit and a series of weekly, monthly, quarterly or yearly payments. The intention is that when the hiring period comes to an end, the ownership of the goods will pass to the hirer, sometimes on the payment of a nominal sum, sometimes with the final instalment; ownership, therefore, does not pass to the hirer until all payments have been made.

A *credit sale* is an outright sale (usually by a retailer) where payment by instalments is agreed in writing as a condition of the sale. Under a credit sale arrangement the property in the goods passes immediately to the purchaser, who becomes the owner of the goods, but payment is required to be made over a period.

Interest is normally charged by the seller both in credit sale and hire-purchase arrangements; the great difference between them is that in a credit sale the 'purchaser' owns

the goods from the outset, whereas in the case of a hire-purchase sale, they do not become his until the final payment is made. Thus the seller cannot reclaim the goods in the case of a credit sale if the purchaser defaults, whereas, subject to the terms of the agreement and the law on hire purchase, he can in the case of a hire-purchase transaction.

Amounts due under credit sale transactions are debtors, and normally appear with other trade debtors, though they may be shown separately. In the case of a hire-purchase transaction, there has, strictly speaking, been no sale, and the goods involved are still an asset of the seller; but, adopting the principle of 'substance over form', most companies refer to 'hire-purchase debtors' or 'instalments due under hire-purchase agreements'.

Timing of profit taking

Whether the sale is a credit sale or on hire purchase, there are two elements of profit: the profit on the sale of the goods themselves and interest upon the amounts outstanding. There are a number of ways in which these two forms of profit can be spread over the accounting periods involved; but essentially these break down into two methods:

1. Take all the profit on the sale immediately, and spread only the interest element.
2. Spread both the profit on the sale and the interest over the life of the agreement.

Although method 1 is permissible for credit sales, method 2 is the more prudent. Method 1 is not recommended for hire purchase, as the goods have not actually been sold.

Where a credit sale is made on truly 'interest free' terms, there is no interest to spread, though logically there is an interest cost so far as the selling company is concerned. This is not normally taken into account, though it could be, by taking into account imputed interest. But it is always necessary to make provision for collection costs. Such a provision might, for instance, be 10% of the credit sale account debtors outstanding on balance sheet date.

The rule of 78

Finance companies frequently apply the 'rule of 78' in spreading either the interest alone, or the whole profit and interest, over the life of the agreement. This is simply a

form of the 'sum of the years' digits method' already discussed in connection with depreciation in Chapter 8. What happens is this: the period of the agreement is set down in months (or it could be weeks in the case of a weekly agreement, or years where payments were on an annual basis), and the sum of the digits represents the sum of $1 + 2 + 3 + 4 \dots$ to n , where n is that number of months (or weeks or years). It is called the rule of 78 because for a year's agreement, the sum of $1 + 2 + 3 + \dots + 12$ is 78. Any interest charge is then spread as follows (in this case a year's agreement):

First month 12/78 of total interest
 Second month 11/78
 Third month 10/78
 . . . Twelfth month 1/78.

Many companies take the profit immediately and spread the interest in respect of hire-purchase transactions, though it was at one time considered more prudent to spread both profit and interest over the life of the transaction (see Example 11.1), rather than to take profit at the outset. This could be said to be an example of 'substance over form' (see page 44).

The rule of 78 is a simple, though not totally accurate, way of spreading interest or profit over the period of an agreement. Some companies use more sophisticated techniques, spreading interest or profit by what is termed the 'actuarial method', taking into account interest (at the true effective rate payable) on the balance outstanding period by period.

Hire-purchase information given in accounts

A good set of accounts will give quite a lot of information on hire-purchase and credit sale business, e.g. how profit is taken and how interest is brought in. See GUS on next page.

Some companies (like GUS) arrange for some or all of their credit sales and hire-purchase transactions to be handled by a separate finance company, so that they receive payment for goods at once and thus reduce their requirements for working capital.

In the absence of any provision for recourse by the finance company, the amounts outstanding are then of no concern to the selling company and do not appear in its accounts. Transactions which potentially involve recourse

Example 11.1 Taking of profit on hire-purchase transactions

The hire-purchase trading account of DEFERRALS LTD for 1999 is as follows:

Hire-purchase sales	£120,000
less Cost of goods sold	<u>80,000</u>
Gross profit on HP sales ($33\frac{1}{3}\%$)	<u>£40,000</u>
Receipts from 1999 HP sales =	£36,000
Profit to be taken in 1999	
$£36,000 \times 33\frac{1}{3}\%$ profit margin =	£12,000
Provision for unearned profit carried forward on 1999 HP sales = $£40,000 - £12,000 =$	£28,000
HP sales in 1999	£120,000
less Cash received	<u>36,000</u>
	84,000
less Provision for unearned profit	<u>28,000</u>
Hire-purchase debtors (from 1999 sales)	<u>£56,000</u>

If, say, £63,000 is received in 1999 in respect of transactions from 1998 and £42,000 from 1997, when the profit margins were 30% and 35% respectively, the total profit from HP sales to be taken in 1999 would be:

From 1999	£12,000
From 1998 (30% of £63,000)	18,900
From 1997 (35% of £42,000)	<u>14,700</u>
Total profit	<u>£45,600</u>

to the seller are required by FRS 5 *Reporting the substance of transactions* to be accounted for (a) as a debtor; and (b) as a corresponding liability.

Factoring

Factoring involves the sale of a company's trade debtors to a factoring house. Factoring houses offer three facilities:

1. The provision of finance for working capital.
2. A credit management and sales accounting service.
3. Bad debt protection.

GUS Information on hire purchase

Note 18. Debtors	2003 <i>Due within one year</i> £m	2003 <i>Due after more than one year</i> £m	2002 <i>Due within one year</i> £m	2002 <i>Due after more than one year</i> £m
Trade debtors:				
Instalment and hire purchase debtors	198	53	129	39
Provision for unearned finance charges	<u>(26)</u>	<u>(6)</u>	<u>(21)</u>	<u>(6)</u>
	172	47	108	33
Instalment debtors	842	153	862	148
Other trade debtors	<u>528</u>	<u>52</u>	<u>462</u>	<u>6</u>
Total trade debtors	1,542	252	1,432	187

Accounting policies*Instalment and hire purchase debtors*

The gross margin from sales on extended credit terms is recognised at the time of sale. The finance charges relating to these sales are included in the profit as and when instalments are received. The income in the Finance Division under instalment agreements is credited to the profit and loss account in proportion to the reducing balances outstanding.

The provision of finance

This is the main reason why companies use factoring. The factor assesses the client's trade debtors and agrees the level of 'prepayment' that he will provide; this is normally between 70% and 80% of the value of the invoices. The client may then sell his existing trade debts to the factor and receive prepayment immediately; the debtors are informed that the debts have been factored, and are asked to make payment direct to the factor.

All new invoices then carry an assignment notice, asking the debtors to make payment direct to the factor. Copies of all invoices are sent to the factor, who will make the agreed prepayment. If the agreed level of finance is 75%, the client will receive the balance of 25%, less the factor's charges, as his debtors settle each invoice. The factor provides credit advice and runs the sales ledger, sending statements and reminders.

Service charge

A service charge is made, usually between 1% and 3%, depending on the number of customers and invoices involved. The factor also makes a finance charge on any funds drawn under the prepayment arrangement, usually at

rates similar to bank overdraft rates of interest. Because factoring finance is based on the trade debtors, it fluctuates automatically with the level of business, and is thus more flexible than an overdraft.

Bad debt protection

There are two types of factoring agreement: 'with recourse' and 'without recourse' to the client. Under a with recourse agreement, the client takes the risk of bad debts, and the factor will pass the debt back to his client if the debtor has not paid within 90 or 120 days.

Most factors offer bad debt protection as an optional extra, providing cover on all *approved* invoices. The cover is for 100%, which compares favourably with the 80% offered by most credit insurance companies. Factors usually add between $\frac{1}{4}\%$ and $\frac{3}{4}\%$ to their service charge for bad debt protection, depending on the industry involved.

International factoring

An increasing proportion of British goods go to Western Europe, North America and other markets. Many exporters use factors primarily to obtain credit advice and bad debt protection, although prepayment finance is available.

Factors handling exports send correspondence and make telephone calls in the language of overseas customers, and know the local business practices; this usually enables them to obtain faster collection of export debts.

Invoice discounting

This is similar to factoring except that, under an invoice discounting arrangement, the client continues to run his sales ledger and collect the payments, which he banks to the account of the discounting company. When each debtor's payment is banked, the discounter deducts the prepayment already made to the client, plus charges, and pays the balance into the client's bank account.

Most invoice discounting agreements are with recourse, i.e. the client takes the risk of bad debts. Because the client goes on running the ledger and collecting payments, it is sometimes called *confidential invoice discounting*.

Factoring in the accounts

In the past it has not always been possible to tell from the accounts whether a company was using factoring or invoice discounting. However, under FRS 5 *Reporting the substance of transactions*, companies are normally required to disclose factoring and invoice discounting and the degree of debt protection.

Debt factoring is considered in Application Note C of FRS 5, which also covers invoice discounting. Accounting treatment depends upon the precise terms of the contract. If the debts are sold at a fixed price, with no recourse, the seller has no further interest in the debts which no longer appear in the balance sheet; but an interest charge will normally appear in the profit and loss account. See, for instance, PIC INTERNATIONAL:

PIC INTERNATIONAL *Extract from 1998 accounts*

Note 4 Interest

	1998	1997
	£m	£m
Interest payable and similar charges:		
On bank loans and overdrafts	15.2	20.6
Non recourse finance	1.4	2.0

In respect of the prior year non recourse finance, the Group was not obliged to support any losses and did not intend to do so. The providers of this finance . . . confirmed that they would not seek recourse from the Group.

However, when the factor or invoice discounter has full recourse in the event of bad debts, the substance of the transaction is that the company is taking all the risk, and the factor or invoice discounter is merely providing finance. The company's accounts would therefore show (where £80m was advanced by a factor, with full recourse, on debtors of £100m):

	£m
<i>Current assets:</i>	
Debtors	100
<i>Current liabilities:</i>	
Finance from factor	80

rather than debtors of £20m, as was long the case.

Linked presentation

What is termed a linked presentation may be adopted where there is limited recourse by the factor (FRS 5, paras. 26–28). The accounts of plant hire company ASHTEAD provide an illustration:

ASHTEAD GROUP *Extract from 2003 accounts*

15 Debtors	2003
	£m
Trade debtors subject to non-recourse financing	88.0
Less non-recourse financing received	(57.5)
	30.5
Other trade debtors	2.8
Prepayments and accrued income	13.5
	<u>46.8</u>

Current asset investments; cash at bank and in hand

Types of investment

As explained in Chapter 9, investments may be held as fixed assets or as current assets. This chapter considers only investments which are current assets, i.e. held short-term, either for resale or as a temporary store of value; and not intended for use on a continuing basis in the company's activities.

Types of current asset investment

Current asset investments include:

1. Short-term government and other listed securities:
 - (a) intended to be held to maturity;
 - (b) not intended to be held to maturity (but for trading).
2. Certificates of deposit.
3. Certificates of tax deposit.
4. Commercial paper.
5. Short-term deposits, e.g. money market deposits.
6. Short-term local authority bonds.
7. Options.
8. Other unlisted investments.

Accounting for current asset investments

A current asset investment is initially recorded at its purchase cost, including expenses, and is normally included in the balance sheet at the lower of cost and net realisable value. It must be written down to its net realisable value at the balance sheet date if that is less than its cost, and the loss taken to the P & L account. If at a subsequent balance

sheet date the net realisable value has increased again, that higher value (up to the purchase cost) must be taken as the balance sheet value and any increase credited to the P & L account.

Under the Companies Act 1985 historical cost principles can be replaced by alternative accounting rules to allow for revaluations. The provisions allow investments of any description to be shown either at market value determined at the date of their last valuation or at a value ('fair value') determined on any basis which appears to the directors to be appropriate in the circumstances of the company. The method of valuation and the reasons for adopting it must be shown in the notes to the accounts.

In theory this makes a variety of treatments possible, including the occasionally used practice known as *marking to market*, where investments are written up to market value and the profit taken to the profit and loss account. So any note in the accounting policies on current asset investments should be read carefully. For example GLAXOSMITHKLINE:

GLAXOSMITHKLINE *Extract from the note on accounting policies in the 2003 accounts*

Current asset investments

Current asset investments are stated at the lower of cost and net realisable value.

In the case of securities acquired at a significant premium or discount to maturity value, and intended to be held to redemption, cost is adjusted to amortise the premium or discount over the life to maturity of the security. Floating rate bonds are stated at cost . . .

Equity investments are included as current assets when regarded as available for sale.

Current asset investments in practice

Many listed companies only have cash and short-term deposits. Some, like THE BODY SHOP, seem to prefer to hold cash. But there are groups which do have very large amounts of current asset investments, e.g.:

GLAXOSMITHKLINE *Extracts from the 2003 accounts*

Note 25 Net debt

	2003	2002
	£m	£m
Liquid investments	2,493	1,256
Cash at bank	<u>962</u>	<u>1,052</u>
	<u>3,455</u>	<u>2,308</u>

At the balance sheet date the Group's liquid investments had an aggregate market value of £2,509 million (2002 – £1,264 million).

Some companies, like REUTERS, draw a distinction between government securities and other listed investments and, within unlisted securities, between CDs (certificates of deposit), term deposits and other investments:

REUTERS GROUP *Extract from the notes to the 2003 accounts*

Note 19. Short-term investments		2003	2002
		£m	£m
Listed			
Government securities:	UK	10	23
	Overseas	18	29
Other deposits:	Overseas	<u>109</u>	<u>329</u>
		<u>137</u>	<u>381</u>
Unlisted			
Certificates of deposit		1	2
Term deposits:	UK	47	47
	Overseas	32	29
Other deposits:	UK	24	4
	Overseas	<u>381</u>	<u>107</u>
		<u>485</u>	<u>189</u>
Total short-term investments		<u>622</u>	<u>570</u>

Significance of short-term investments

Cash rich companies like GLAXOSMITHKLINE and REUTERS have a significant part of their assets in short-term

investments, but they are not central to the operation of the company.

But in a few companies they are. For example C.H. BAILEY, a company we have mentioned before in the context of voting and non-voting shares (see page 22):

C.H. BAILEY *Extracts from 2000 accounts*

Group balance sheet	2000	1999
	£	£
Fixed assets . . .		
Current assets:		
Stocks and WIP	75,279	165,443
Debtors	794,737	762,625
Current investments	7,821,838	7,816,789
Cash at bank and in hand	<u>748,407</u>	<u>859,950</u>
	9,440,261	9,604,807
. . .		
Net assets	15,789,974	15,821,829

In 2000 the Group made a pre-tax loss of £265,661, while income from current asset investments was reported as £351,754, and profit from sale of investments £673,521.

As we pointed out earlier, the controlling shareholder of a company can do very much what he likes within his own personal feifdom. Many do, though some less patently than others.

Availability of short-term investments

Do not assume that current asset investments are necessarily available to meet current liabilities; read the small print, e.g. TATE & LYLE:

TATE & LYLE *Note from 2003 accounts*

Current asset investments	2003	2002
	£m	£m
Listed on overseas exchanges	30	31
Loans, short-term deposits and unlisted fixed interest securities	<u>97</u>	<u>32</u>
	<u>127</u>	<u>63</u>

Cash at bank and in hand

The last item among current assets in the standard formats is Cash at bank and in hand. Apart from this, the

Companies Acts contain no specific requirements on cash balances; and while the sums involved can be considerable, most companies do not explain the amount shown either by way of note or in their accounting policies:

DIAGEO Extract from the consolidated balance sheet as at 30 June 2003

	2003 £million	2002 £million
...		
Cash at bank and liquid resources	1,191	1,596
...		

Cash at bank and in hand forms part of Cash as defined in FRS 1. It is closely related to Current asset investments; indeed while many companies previously treated deposits as Current asset investments, others treated them as bank balances.

Cash at bank and in hand is shown on the face of the balance sheet, but the formats are inconsistent: loans and overdrafts, as we shall see in Chapter 13, are relegated to a note.

Where a group has both credit balances and overdrafts with the same bank, the question arises as to the extent to which one can be set off against the other (and how this

should be reflected in the accounts). Many groups have cash pooling arrangements with their bank.

Guidance on offsetting is provided by FRS 5 *Reporting the substance of transactions*.

Disclosure requirements

Disclosure requirements, which are the same whether an investment is a fixed asset or a current asset, are as follows:

1. the amount relating to listed investments;
2. the aggregate market value of listed investments must be shown if different from the book value, and the stock exchange value if it is less than the market value;
3. various details must be provided where the investment is 'significant', i.e. where:

either it is 20% or more of the nominal value of the shares of that class in the investee,
or it represents more than 20% of the investor's own assets; the details to be disclosed are:

- (a) the name of the investee;
- (b) its country of incorporation (if outside Great Britain), and
- (c) a description of the investment and the proportion of each class of share held.

Bank facilities

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

- by overdrawing on its current account;
- by loans; and
- by the use of acceptance credits.

The bank normally agrees with a company the maximum amount that can be borrowed under each method, and this is called granting a facility. For example, a company that has the bank's permission to run an overdraft of up to £1m has overdraft facilities for that amount.

What is shown in the balance sheet is, however, only the amount actually borrowed from the bank at the balance sheet date, although the average amount overdrawn during the year can be estimated from the interest charged to the profit and loss account.

FRS 13 requires borrowing facilities available to a company to be disclosed, e.g. NATIONAL GRID TRANSCO:

NATIONAL GRID TRANSCO 2003 accounts

Note 21 Financial instruments

At 31 March 2003 the Group had . . .

Undrawn committed borrowing facilities

Expiring:	£m
in one year or less	1,155
in more than 1 year, but not more than 2 years	966
in more than 2 years	<u>980</u>
	<u>3,101</u>

Of the unused facilities, £2,135m were being held as backup to commercial paper and similar borrowings. The remainder was available as additional backup to commercial paper and for other general corporate purposes.

Bank loans and overdrafts fall in the formats under the headings Creditors: amounts falling due within one year and Creditors: amounts falling due after more than one year, and are often grouped with finance leases.

Where security has been given (see page 35), the amounts secured and a general indication of the security must be stated, e.g. ICI:

ICI Extract from note to 2003 accounts

20. Loans	Repayment dates	2003 £m	2002 £m
Secured loans:			
US dollars	2004	6	98
Other currencies	2004/2006	<u>41</u>	<u>72</u>
Total secured		<u>47</u>	<u>170</u>
Secured by fixed charge – bank loans		23	17
– other		–	1
Secured by floating charge – bank loans		7	132
– other		<u>17</u>	<u>20</u>
		<u>47</u>	<u>170</u>

For each item the following amounts must be shown separately:

- amounts payable otherwise than by instalments five years hence;

- (b) those payable by instalment, any of which are due more than five years hence;
 (c) the total of such instalments.

In addition listed companies must disclose amounts which are payable between one and two years, and those payable between two and five years. ICI more than meet this requirement, disclosing year by year up to five years:

ICI Extract from note to 2003 accounts		
Loan maturities	2003	2002
...	£m	£m
Total loans		
Loans or instalments thereof repayable:		
After 5 years from balance sheet date	312	44
From 4 to 5 years	287	470
From 3 to 4 years	427	187
From 2 to 3 years	181	135
From 1 to 2 years	<u>146</u>	<u>527</u>
Total due after more than one year	1,353	1,363
Total due within one year	<u>534</u>	<u>500</u>
Total loans	<u>1,887</u>	<u>1,863</u>

Where any part of the debt is repayable after more than five years, the terms of repayment and rates of interest payable should be shown. If the information is excessive, a general indication of terms and rates of interest is permitted.

Overdrafts

The traditional method of clearing bank lending is to allow customers to overdraw on their current accounts. It was originally designed to cover fluctuations in the company's cash during the year and gives the company complete flexibility of drawing within a given limit, which is normally reviewed annually.

Bank advances on overdraft are technically repayable on demand and, although this is seldom enforced, the bank when granting overdraft facilities may expect the customer to produce budgets and cash flow forecasts to show the purposes for which the facilities are intended and the plans for eventual repayment. Bank lending on overdraft is traditionally short-term in character, designed to cover fluctuations in working capital requirements rather than to provide permanent capital for the company.

When long-term interest rates were driven high by inflation, few finance directors were willing to commit their companies to long-term fixed interest rate debt, especially if they expected interest rates to fall in due course. Instead they resorted more and more to borrowing from their banks, where interest on an overdraft is charged at an agreed percentage over the clearing bank's base rate (see below), which they hoped would average less than the long-term rate at the time, and where the company is free to reduce its borrowing whenever it wishes. Although it is now quite common for companies to finance a large part of their working capital in this way, clearing banks are usually reluctant to let companies increase their overdraft ad lib, even against a floating charge, preferring their clients to convert any 'hard-core' borrowing that has built up on overdraft into loans (see under bank facilities on page 92).

The cost of borrowing on overdraft

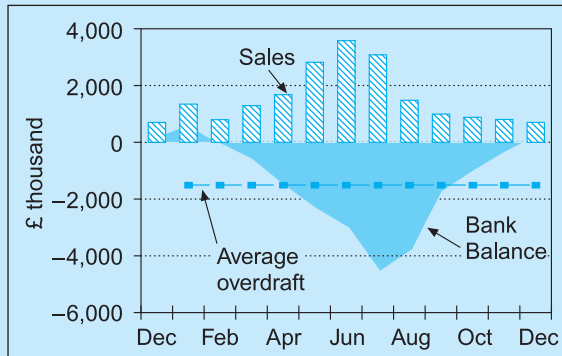
The interest a company has to pay on its overdraft is usually set at a given percentage above its bank's base rate, depending on the standing of the customer; a financially stable, medium-sized company might pay a fixed 1½% above base.

The base rate, the datum on which the rates of interest are based, is adjusted up and down to reflect fluctuations in short-term interest rates. Each bank sets its own base rate, though in practice the clearing banks' base rates keep very much in line with each other.

Fluctuations in amount

As we have said, the overdraft figure given in the balance sheet is the amount the overdraft facility is being used at the year end. Companies normally choose their year end to fall when business is at its slackest, and the balance sheet figure is most unlikely to be the maximum amount the company has overdrawn during the year.

For example, a company in a seasonal business, with peak sales in the summer, could be expected to build up stocks from early spring and to carry high debtors across the summer. With an annual turnover of, say, £15m, £200,000 in the bank at its year end (31 December) and £120,000 bank interest paid (reflecting an average overdraft of £1.5m during the year, bearing interest on average at 8%), the amount the company was actually overdrawn during the year would be likely to fluctuate with the sales cycle as shown in Example 13.1.

Example 13.1 Annual fluctuation in sales and overdraft

In practice, profit on sales and depreciation on assets would accumulate during the year, steadily improving the overdraft position, but sharp increases would be expected with the payment of dividends and corporation tax, and capital expenditure would also have an immediate effect on the overdraft position.

Vulnerability

Companies which rely heavily on borrowing on overdraft and on floating-rate loans (see below) are vulnerable to rising interest rates, particularly if their profit margins are small, and those which let their overdrafts steadily increase year by year without raising further equity or fixed-interest capital are steadily increasing their interest rate risk. Another hazard of financing on overdraft is that the amount a bank can lend has in the past been subject to Bank of England controls, which were tightened from time to time without much warning.

Banks are also liable to restrict credit on their own account when they find themselves up against their own overall lending limits or having lent too heavily in the particular sector in which the company operates. As credit restrictions often come when conditions are unfavourable for capital raising, a company which is financed extensively by overdraft can all too easily find its operations severely constrained by its immediate cash position.

Bank loans

The simplest type of bank loan is one where the full amount is drawn by the borrower at the outset and is repaid in one lump sum at the end of the period. The duration (or 'term') of the loan is seldom more than seven years but, unlike an overdraft, a bank loan cannot be called in before the end of the term unless the borrower defaults on any condition attached to the loan.

Interest is charged either at a fixed rate or, more frequently, at a floating rate: an agreed percentage over base rate, or over London Inter-Bank Offer Rate (LIBOR). Where LIBOR is used, an interest period is agreed between the borrower and the bank, and the bank then, on the first day of each interest period, determines the rate at which deposits are being offered in the inter-bank market for the relevant period.

For example, if a rate of $\frac{1}{2}\%$ over LIBOR and a three-month interest period have been agreed and the three-month LIBOR rate is 5.7% at the start of the period, the borrower will pay 6.2% for the next three months, and the rate will then be redetermined. Banks frequently allow borrowers to vary their choice of interest period – one month, three months or six months – during the life of a loan.

Where the borrower does not need all the money at once, the bank may allow the loan to be drawn down in tranches (specified instalments). Repayments may also be arranged in instalments, which may often be a stipulation of the lender; banks like to see money coming back gradually to make repayment easier for the borrower and to give early warning of a borrower getting into difficulties over repayment. Details of drawing down and repayment are agreed in advance, together with the rate of interest payable and the security to be given, although any of these features can be altered subsequently by mutual agreement.

Security

Bank loans are sometimes secured on assets acquired by the loan or on other assets of the company, but a floating charge is more usual. If the loan is not secured at all, the company may be required to give a *negative pledge*, i.e. to undertake not to give security to any new or existing creditor or to borrow further amounts under existing security without the bank's prior agreement in writing.

Flexible loan facilities

There is an increasing trend, particularly in European banking, to provide companies with more flexible financing than term loans by granting loan facilities, usually for periods of between three and five years. Drawing down (usually with a minimum limit on any one drawing) can be allowed at any time given a little notice, repayment is flexible, and subsequent redrawing is often allowed, but the borrower will be charged for this flexibility by a commitment commission payable on any unused portion of the facility for as long as the facility is left open. Facilities giving this flexibility are called revolving, and can be single- or multi-currency, e.g. UNIQ:

UNIQ Extract from note to 2003 accounts

18 Borrowings and Finance Leases

...

At 31 March 2003, the Group had revolving credit facilities of £132.7m (2002: £230.0m) of which £28.5m was drawn down, under which it may repay amounts borrowed at its option while retaining the flexibility to re-borrow under the facilities. These facilities expire on 30 June 2004.

Bills of exchange

Definition

A bill of exchange is, briefly, an order in writing from one person (the *drawer*) to another (the *drawee*) requiring the drawee to pay a specified sum of money on a given date. When the drawee signs the bill he becomes the *acceptor* of the bill, and the person to whom the money is to be paid is the *payee*. The main legislation on bills is contained in the Bills of Exchange Act 1882, and their use in practice is clearly and concisely described in a book, *The Bill on London*, produced by Gillett Brothers, one of the discount houses.

Primary purpose

The primary purpose of a bill of exchange 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 reach him, or later.

In these circumstances A, the supplier of goods to B, would draw a bill of exchange for the goods, which B 'accepts', acknowledging the debt and promising payment at some future date, often three months ahead. Bills of this type are called trade bills.

A can then sell the bill to a third party, C, at a discount to the face value of the bill; and C in turn can endorse it and sell it on to D. In this case if B subsequently defaults, D can claim payment from A, and if A also defaults D can then claim on C.

Alternatively A can retain the bill, which gives a legal right to payment at a given date in the future (the date of maturity), or the bill can be deposited at a bank as a security against borrowings.

Balance sheet presentation

If Company A's year ends before the bill has reached maturity, then:

- (a) if A still holds the bill, it would be shown separately under Current assets as Bills receivable or included in Debtors; or
- (b) if A discounted the bill, traditionally it would not appear in the balance sheet, but would be shown as a contingent liability recognising the possibility that B may subsequently default. FRS 5 *Reporting the substance of transactions* has changed that. Most companies now show bills of exchange discounted as a liability until the time for payment has passed (i.e. there has been no recourse).

In Company B's balance sheet the outstanding bill would be shown under creditors as a bill of exchange payable.

Discounting

When a bill of exchange is discounted, i.e. sold to a third party at a discount to its face value, this is usually done through one of the discount houses, which will trade it in the money market. The discount on a trade bill depends on prevailing interest rates, on the creditworthiness of the drawer, the acceptor and any subsequent endorsers, and on the nature of the underlying transaction. In the case of

a bank bill, that is one where a bank is the acceptor of the bill, or has endorsed it, the discount rate will be less than on a trade bill. The finest rates are obtained in discounting bills drawn against exports or imports and accepted by 'eligible banks' (i.e. those banks whose acceptances are eligible for rediscount at the Bank of England).

When it was in a tight spot in 1998 engineering group BRUNEL made extensive use of discounting:

BRUNEL HOLDINGS *Extract from note to 1998 accounts*

18. Creditors	1998 £000
Amounts falling due within one year:	
Bank loans and overdrafts	4,957
Payments received on account	3,807
Trade creditors	13,789
Bills of exchange discounted with recourse	2,794
Proposed dividends	1,302
...	

Acceptance credits

Many eligible banks specialise in accepting bills for customers. They provide this type of short-term finance by granting the client an acceptance credit facility up to a given limit for an agreed period, and the client can then draw bills of exchange on the bank as he wishes, provided the running total of bills outstanding does not exceed the prescribed limit (i.e. it is a revolving credit facility). The bank 'accepts' the bills, which can then be discounted in the money market at the finest rate, and the customer receives the proceeds of the sale, less the acceptance commission he has to pay to the accepting house (normally between $\frac{3}{8}\%$ and $\frac{1}{2}\%$ p.a. for good-quality borrowers). When the bill falls due for payment (usually three months later), the customer pays the bank the full face value of the bill and the bank in turn honours the bill when it is presented by the eventual purchaser. The bank has to honour the bill even if the customer defaults, because it had 'accepted' responsibility for meeting the bill when it fell due. The acceptance of bills by banks is related to commercial transactions, either specifically matched or linked to the general volume of business, so that the bills are self-liquidating.

Unlike an overdraft, the interest on discounted bills is paid in advance by the deduction of discount charges from

the face value of the bill and, in addition, if the bills have been accepted by a bank, the company will also have to pay the acceptance commission in advance. In spite of these extra costs, variations of interest rates often make the use of acceptance credit facilities cheaper than an overdraft or a bank loan.

The future obligation of a company to provide cash cover to meet bills that have yet to mature under an acceptance credit facility must, if material, be shown separately in a company's balance sheet under Creditors as 'Bills of exchange payable' as illustrated by BRUNEL HOLDINGS.

The big picture

As we have seen in this chapter, amounts borrowed from the bank do not normally appear on the face of the balance sheet but fall within Creditors as Amounts due within one year or Amounts due after more than one year, and are detailed in the notes to the balance sheet.

There is thus no netting of amounts owed by banks and amounts owing to banks; but while this might be important to an economist, as such it is not particularly significant either to the company or to analysts or investors.

The key question is:



Is there enough cash or credit available to meet the debts and obligations of the business when they fall due?

The balance sheet and the notes to it do not answer either of these questions.

This is largely due to the UK system of operating with an overdraft. Although theoretically an overdraft is repayable on demand, in practice a limit is agreed for a specific time and normally adhered to by the bank. But as we have seen, that limit does not have to be disclosed. If it is not disclosed, one has no way of assessing how much is available.

Imagine two companies, A and B, much the same size. Each owes wages and other creditors due tomorrow £1.5m. A has an overdraft of £27m, B has £1m in the bank. At first sight, B looks more solvent than A. But if A has an overdraft limit of £50m, £23m of which remains unused,

and B, having a poor reputation for past dealings and a low credit rating, cannot raise an overdraft or borrow elsewhere, we would not normally be able to tell from the balance sheet.

'Going concern' assurances required in the directors' report or the corporate governance statement (see page 233) offer a safeguard, although a somewhat limited one.

Cash flow statements

Chapter 19 is devoted to FRS 1 *Cash flow statements*. Nevertheless, because of its close relationship to the content of this chapter, it is perhaps right to say a few words here.

Cash is defined in FRS 1 to be:

- (a) cash in hand and deposits repayable on demand with any qualifying financial institution (i.e. an entity that as part of its business receives deposits or other repayable funds and grants credits for its own account); less

- (b) overdrafts from any qualifying financial institution repayable on demand.

To qualify as 'cash' the deposits must be capable of being withdrawn at any time without notice and without penalty. They count as 'on demand' if a maturity or period of notice of not more than 24 hours or one working day has been agreed. Cash includes cash in hand and deposits denominated in foreign currencies.

It will be seen that the definition of 'cash' for the purposes of FRS 1 is extremely narrow.

This chapter has looked at something quite different: at all forms of bank borrowing, not just those that count as negative 'cash' for purposes of FRS 1.

Nevertheless, FRS 1 does also take in the big picture. It requires (para. 33) a note reconciling the movement of cash in the period with the movement in net debt (i.e. all capital instruments which are classified as liabilities under FRS 4 *Capital instruments* plus related derivatives and obligations under finance leases). And this reconciliation provides another place to look for information on bank borrowings and debt more generally. ►

The Body Shop's reconciliation below shows how a company which had debt rising to £48.2m at the beginning of one year [A] fell to a net debt of £22.2m at the end of the following year [B].

Below the reconciliation, the *Analysis of changes in net debt* shows Debts due within one year almost unchanged, from £46.5m at the beginning of the year [C] to £45.9m at the end of the year [D].

THE BODY SHOP *Extracts from 2003 accounts*

Consolidated cash flow statement

	2003	2002
	£m	£m
For the 52 weeks ended 1 March 2003		
Net cash inflow from operating activities	51.5	44.7
...		
Increase/(decrease) in cash	7.9	(3.8)

Reconciliation of Net Cash Flow to Movement in Net Debt

	2003	2002
	£m	£m
Increase/(decrease) in cash in the year	7.9	(3.8)
Cash (inflow)/outflow from (increase)/decrease in debt and lease financing	(2.6)	12.0
Cash (inflow)/outflow from increase/(decrease) in liquid resources	<u>12.6</u>	<u>(4.2)</u>
Decrease in net debt resulting from cash flows	17.9	4.0
Redeemable convertible loan notes	1.3	1.4
Translation difference	<u>1.8</u>	<u>(0.4)</u>
Decrease in net debt in year	21.0	5.0
Opening net debt	(43.2)	(48.2)[A]
Closing net debt	[B](22.2)	(43.2)

Note 22 Analysis of changes in net debt

	<i>At 3 March</i>	<i>Cash</i>	<i>Exchange</i>	<i>Other</i>	<i>At 1</i>
	<i>2002</i>	<i>flows</i>	<i>movements</i>	<i>non-cash</i>	<i>March</i>
	£m	£m	£m	£m	£m
Cash in hand, at bank	5.5	7.9	(0.1)	—	13.3
Bank overdraft	<u>(0.4)</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>(0.4)</u>
	<u>5.1</u>	<u>7.9</u>	<u>(0.1)</u>	<u>—</u>	<u>12.9</u>
Debt due within one year	[C] (46.5)	(2.4)	1.7	1.3	(45.9)[D]
Debt due over one year	<u>(1.8)</u>	<u>0.5</u>	<u>0.2</u>	<u>(0.7)</u>	<u>(1.8)</u>
	<u>(48.3)</u>	<u>(1.9)</u>	<u>1.9</u>	<u>0.6</u>	<u>(47.7)</u>
Short-term deposits	<u>—</u>	<u>12.6</u>	<u>—</u>	<u>—</u>	<u>12.6</u>
Total	(43.2)	18.6	1.8	0.6	(22.2)

Derivatives and other financial instruments

Introduction

The complexity of this subject is reflected by the length of FRS 13 *Derivatives and other financial instruments*. Complete with its Summary and its Appendices, it runs to 165 pages.

Disclosure requirements depend on whether you are a Bank (Part B), an Other financial institution (Part C), or neither (Part A). Parts B and C are, appropriately, printed on pink paper.

In this chapter we will concentrate on non-financial institutions, and the disclosures required of them, which fall broadly into:

- *Narrative Disclosures*, usually contained in the Operating and Financial Review (OFR) or the Directors' report; and
- *Numerical Disclosures* in the notes to the accounts.

Derivatives can seriously damage your wealth

Although much of the business done by companies in this market is for the prudent reduction of risk – primarily interest rate risk, currency risk and commodity risk – much is sheer speculation: the unacceptable face of capitalism, doubled and redoubled.

Let us be quite clear about two things:

1. In business school parlance, derivatives are a 'zero sum game'. If anybody is going to 'make a bomb', somebody else is going to 'lose a bomb'. The overall outcome is zero.
2. This is cowboy country. As the *Daily Telegraph* reported on 6 October 1995:

DAILY TELEGRAPH Extracts from article by Banking correspondent

P & G accuses Bankers Trust of racketeering

Proctor & Gamble . . . alleges that 'a culture of greed and duplicity', permeated through Bankers Trust. 'Fraud was so pervasive Bankers Trust employees used the acronym ROF – short for rip-off factor – to describe one method of fleecing clients.'

. . .

Proctor and Gamble highlights one taped conversation in which a Bankers Trust employee describes a deal he has just concluded with the company as 'a massive gravy train' . . .

Another tape related to massive profits made by Bankers Trust on a leveraged derivatives transaction sold to Proctor & Gamble. 'They would never know,' said one saleswoman. 'They would never be able to know how much money was taken out of that.' A colleague replied 'Never, no way. That's the beauty of Bankers Trust.'

'Funny business, you know,' said one salesman in a taped conversation. 'Lure people into that calm and then just totally f*** them.'

Definition of a derivative

A derivative financial instrument is a financial instrument that derives its value from the price or rate of some underlying item.

Underlying items include equities, bonds, commodities, interest rates, exchange rates and stock market and other indices.

They include futures, options, forward contracts, interest rate and currency swaps, interest rate caps, collars and

floors, forward interest rate agreements, and commitments to purchase shares or bonds (FRS 13, para. 2).

Risk management and derivative trading

Most large companies, and particularly multinationals, use derivatives to reduce exposure to various types of risk. This is a perfectly normal and usually fairly safe activity, providing you choose your counterparties carefully; i.e. don't deal with cowboys.

Other companies also *trade* in derivatives; this can be a very dangerous activity unless it is

- run by experienced and responsible staff, and
- tightly controlled.

Disclosure requirements

FRS 13 requires both narrative and numerical disclosures on the use of financial instruments.

Narrative disclosures

GLAXOSMITHKLINE makes it clear that it wouldn't touch derivatives trading with a bargepole:

GLAXOSMITHKLINE 2003 accounting policies

Derivative financial instruments

- The group does not hold or issue derivative financial instruments for trading purposes.
- Derivative financial instruments are used to manage exposure to market risks from treasury operations. The derivative contracts are treated from inception as an economic hedge . . .
- Currency swaps and forward exchange contracts are used to fix the value of the related asset or liability in the contract currency . . .
- Interest differentials under interest swap agreements are recognised . . . by adjustment of interest expense over the life of the agreement.

SHELL, on the other hand, has always been in the business of trading in oil, as its full name, Shell Transport & Trading implies, and has a huge depth of experience in the management of trading:

SHELL TRANSPORT AND TRADING *Extract from 2002 Operational and financial review*

Treasury and trading risks

. . . Apart from forward foreign exchange contracts to meet known commitments, the use of derivative financial instruments by most Group companies is not permitted by their treasury policy.

Some Group companies operate as *traders* in crude oil, natural gas, oil products and other energy-related products, using commodity swaps, options and futures as a means of managing price and timing risks . . . the use of derivative instruments is generally confined to specialist oil and gas trading and central treasury organisations which have appropriate skills, experience . . .

Numerical disclosures show how the company's objectives and policies were implemented in the period and provide supplementary information for evaluating significant or potentially significant exposures: see page 103.

Common types of derivative

The most common types of derivative that the ordinary investor is likely to come across are:

- (a) options;
- (b) futures and forward contracts; and
- (c) currency and interest rate swaps.

An *options contract* is a contract giving the holder the right, but not the obligation, to buy ('call'), or sell ('put') a specified underlying asset at a pre-agreed price, at either a fixed point in the future (European-style), or a time chosen by the holder up to maturity (American-style). Options are available in exchange-traded (e.g. on LIFFE, the London International Financial Futures Exchange) and over-the-counter (OTC) markets (shorthand for anywhere else, between any two parties).

A *futures contract* on the other hand is an agreement (obligation) to buy or sell a given quantity of a particular asset, at a specified future date, at a pre-agreed price. Futures contracts have standard delivery dates, trading units, terms and conditions.

In a *forward contract* the purchaser and its counterparty are obligated to trade a security or other asset at a specified date in the future. The price paid for the security or asset is

either agreed upon at the time the contract is entered into, or determined at delivery. Forward contracts are generally traded over-the-counter.

In a *currency swap* a company borrows foreign currency for a given period, and lends the equivalent sterling for the same period. In an *interest rate swap* the company swaps a fixed rate of interest with a bank for a floating rate, or vice versa.

While these are the most common types of derivative that ordinary investors are likely to come across, the range of derivatives possible is limited only by the imagination of investment banks. New types of derivative are being created all the time.

It is convenient to classify derivatives as either

- (a) commodity related, or
- (b) financial.

Commodity related derivatives

Manufacturers whose business depends upon a particular key commodity (like sugar or cocoa) may well 'hedge', i.e. buy or sell options or futures contracts or employ forward contracts to fix the price of the underlying raw material, or the sales proceeds of a product.

TATE & LYLE discloses its policy on commodity derivatives in its OFR:

TATE & LYLE Extract from 2003 Operating and financial review

Commodities

Derivatives are used to hedge movements in the future prices of commodities in those domestic and international markets where the Group buys and sells sugar and maize.

Commodity futures and options are used to hedge inventories and the costs of raw materials for unpriced and prospective contracts not covered by forward product sales.

The options and futures hedging contracts generally mature within one year and are all with organised exchanges.

TATE & LYLE added in a note to the accounts: 'Changes in the fair value of instruments used as hedges are not recognised in the financial statements until the hedged

position matures.' This is known as *hedge accounting* (FRS 13, para. 58).

In other words, whatever the total cost of acquiring the raw material this way, that is its 'cost'; and whatever the net sales proceeds are as a result of the future, those are the sales proceeds.

Providing the management lays down limits to the amount of hedging, and has control systems in place to ensure that these limits are not exceeded without permission, then hedging is a perfectly normal and reasonable business activity.

Where things go wrong is when you get a *rogue trader*. This happened some years ago in a chocolate manufacturer, where a commodity dealer started to gamble on cocoa futures and went way beyond the company's requirement for cocoa, thinking he could make a lot of money for the company.

When it was noticed that he was over the limits set for him, management stood over him while he closed all his positions. The moment they were out of the room, he opened them all up again.

When he was finally rumbled, a very substantial loss was incurred covering all his positions. In the aftermath of this débâcle the company's share price fell by more than 80%.

Reducing the risks of trading in derivatives

One secret of good management with any trading or dealing in derivatives is to ensure that the functions of confirmation and of settlement are kept entirely separate from the dealing department. In the celebrated case of currency swaps that brought down BARINGS, all these functions in Barings' Singapore office came under one person: Leeson.

Investors should also be wary when a company's dealers are 'earning' huge bonuses. Greed comes before a fall.

Financial derivatives

Companies have traditionally borrowed in foreign currencies to help finance overseas investment and reduce exposure to currency risk. In this modern day and age the mobility of capital in most of the developed countries of the world (exchange controls are still prevalent in Less Developed Countries (LDCs)), along with the increasing sophistication of the financial markets, has led to the

development of a wide range of financial instruments to hedge against both currency and interest rate risk.

It no longer follows that you borrow French francs long-term at fixed rates of interest to finance long-term investment in France; it may be advantageous to borrow variable rate in sterling and do a currency swap and an interest rate swap.

Currency swaps

A currency swap is, in effect, the same as a reciprocating or back-to-back loan: the company borrows foreign currency for a given period and, in the same transaction, lends an equivalent amount of sterling for the same period.

For example, a UK company wants to borrow US dollars, but also wants to avoid the currency risk on the principal amount borrowed, i.e. it wants to hedge the currency risk. So it raises, say, £100m by a seven-year 10% Eurobond issue and swaps it for seven years with a bank for, say, \$160m at 7½%. During the seven years the company pays interest to the bank in dollars at 7½% per annum on the \$160m and the bank pays interest to the company in sterling at 10% per annum on the £100m. At the end of the seven years the swap is reversed, so the company gets its £100m back regardless of the sterling/US\$ exchange rate and in time to redeem the Eurobond issue.

Currency swaps normally appear either in a note to the accounts or in the financial review, e.g. BP:

BP Extract from financial review 2003

Financial risk management

...
The main underlying economic currency of the group's cash flows is the US dollar. BP's foreign exchange management policy is to minimise economic and material transactional exposures arising from currency movements against the US dollar... In addition, most group borrowings are in US dollars...

Interest rate swaps

An interest rate swap can be used by a company to protect itself against the impact of adverse fluctuations in interest rates on the interest charge it has to pay on its floating rate

debt. The company agrees a fixed rate with the bank on a nominal sum for a given period; the company then pays the bank the fixed rate and the bank pays the company the floating rate; as, for example, GLAXOSMITHKLINE:

GLAXOSMITHKLINE Extract from note to the 2003 accounts

32. Financial instruments and related disclosures Interest rate risk management

To manage the fixed/floating interest rate profile of debt, the Group had several interest rate swaps outstanding with commercial banks at 31 December 2003.

When used in conjunction with a currency swap, an interest rate swap enables a company to lock in at a fixed rate of interest in one currency to cover floating-rate interest charges in another currency.

Companies may also use interest rate swaps in the reverse direction to reduce the proportion of their fixed-rate interest charges if they take the view that interest rates will fall. In neither case is there any transfer of principal.

The swap market has grown in recent years for another reason: to exploit the differences that exist between the fixed rate and the extremely competitive floating-rate credit markets in order to reduce the cost of borrowing, as illustrated in Example 14.1 on the next page.

Interest rate caps

Another way for a company with floating-rate debt to hedge against increases in interest rates is to buy a *cap*. A cap is a contract in which a counterparty, in exchange for a one-time premium, agrees to pay the bond issuer if an interest rate index rises above a certain percentage rate, known as the cap or *strike rate*. It is also called a *ceiling*.

The advantage of a cap over an interest rate swap from floating to fixed is that a cap not only protects the company from the effect of rising interest rates, but allows it to benefit from any fall in interest rates.

A *collar* is the simultaneous purchase of a cap and sale of a floor by the issuer, in which it trades any benefits from a potential fall in the interest rate index for protection against an excessive rise. Under a collar agreement, the issuer defines a specific range for its interest rate payments.

Example 14.1 Use of swaps to reduce the cost of borrowing

Two companies both want to borrow money for five years. One has an AAA Standard & Poor's credit rating and wants to borrow floating rate, while the other, rated BBB, wants to borrow fixed. Market conditions are:

Company rating	AAA	BBB
Cost of 5-year fixed rate bond	10%	11½%
Cost of 5-year bank loan	LIBOR + ⅛%	LIBOR + ⅝%
Cost of a swap:		
Company pays	LIBOR	10½%
Company receives	10¾%	LIBOR

The AAA company, wanting to borrow floating, would issue 5-year bonds at 10% and swap; cost of borrowing floating = 10% + LIBOR – 10¾% = LIBOR – ¾% compared with the 5-year bank loan's cost of LIBOR + ⅛%.

Similarly the BBB company, wanting to borrow at a fixed rate, would take out a bank loan at LIBOR + ⅝% and swap; cost of borrowing fixed = LIBOR + ⅝% – LIBOR + 10½% = 11⅛%, which is cheaper than issuing bonds at 11½%.

Caps and collars protect issuers from having to pay higher interest rates on variable rate debt if market rates increase beyond the cap rate.

A *floor* is the mirror image of a ceiling. With a floor contract, the bond issuer receives an up-front fee from a counterparty. If the interest rate index falls below the floor or strike level, the issuer makes payments to the counterparty. Similarly to a cap agreement, if the floating index rate does not fall below the strike level, the issuer pays nothing.

One company that uses a mixture of swaps, options, futures and forward rate agreements is SHELL:

SHELL Note to the 2002 accounts**28 Financial instruments**

...

Some Group companies enter into derivatives such as interest rate swaps/forward rate agreements to manage interest rate exposure. . . .

Foreign exchange derivatives, such as forward exchange contracts, and currency swaps/options are

used by some Group companies to manage foreign exchange risks. Commodity swaps, options and futures are used . . .

The estimated fair value and carrying amount of derivatives held by Group companies at 31 December is as follows:

	\$million
Interest rate swaps/forward rate agreements	169
Fwd exch. contracts, currency swaps/options	(88)
Commodity swaps, options and futures	<u>119</u>
	<u>200</u>

Numerical disclosures

These give an overall picture of a company's currency and interest rate exposure, as TATE & LYLE's accounts shown on the next page illustrate.

Counterparty risk

Companies which use derivatives are subject to *counterparty risk*, i.e. the risk that the counterparty defaults. The counterparty is simply the party with which one does the transaction.

Some companies with large exposure to derivatives, like REUTERS, describe the risk:

REUTERS Note to the 2003 accounts**12. Derivatives and other financial instruments Hedging**

All derivative instruments are unsecured. However, Reuters does not anticipate non-performance by the counterparties who are all banks with recognised long-term credit ratings of 'A3/A' or higher.

Concern about derivatives

What is disturbing about derivatives is that:

1. It is likely that anyone who today has funds invested will, usually unwittingly, be indirectly exposed to derivatives. Many major companies use them in one way or another; investment trusts, unit trusts and pension funds employ them in an effort either to protect themselves or to boost returns; so do some local authorities.

TATE & LYLE Note to the 2003 accounts**34. Currency and interest rate exposure of financial assets and liabilities**

After taking into account the various interest rate and cross currency interest rate swaps entered into by the Group, the currency and interest rate exposure of the financial liabilities of the Group was:

At 31 March 2003	<i>Fixed rate</i>	<i>Floating rate</i>	<i>Non-interest bearing</i>	<i>Total</i>
	£m	£m	£m	£m
Sterling	50	2	2	54
US Dollars	294	(168)	–	126
Canadian Dollars	–	1	–	1
Euro	155	308	1	464
Others	–	–	–	–
Total	<u>499</u>	<u>143</u>	<u>3</u>	<u>645</u>
of which – gross borrowings	499	143	1	643
– non-equity shares	–	–	<u>2</u>	<u>2</u>
Total	<u>499</u>	<u>143</u>	<u>3</u>	<u>645</u>

Interest rates	<i>Average interest rate of fixed rate liabilities</i>	<i>Average years to maturity of fixed rate liabilities</i>	<i>Average years to maturity of non-interest bearing liabilities</i>
Sterling	6.5%	9.2	–
US Dollars	4.9%	2.6	
Euro	<u>5.7%</u>	<u>3.4</u>	<u>2.2</u>
Average	<u>5.6%</u>	<u>4.8</u>	<u>2.2</u>

2. The sums involved are astronomical. For instance, BARCLAYS alone reported that at the end of 2003 it held or had issued:

	<i>Contract or underlying principal amount</i>
	£m
Foreign exchange derivatives	482,712
Interest rate derivatives	3,477,444
Equity and stock index derivatives	65,431
Commodity derivatives	44,402

3. Dealings are international and controls have yet to be agreed internationally.

There has been a series of derivative-based disasters in various countries – BARINGS was no isolated case – which have alerted management to the risks, but there is still plenty of ignorance around.

How can you blame the ignorant when a team of ‘big hitters’, as they call them in the USA, including the winner of a Nobel Prize for his research work on derivatives, set up an outfit called LTCM, Long Term Credit Management, got backing to the tune of \$600 billion, turned out in practice to be Short-term Catastrophic Asset Mismanagement (SCAM), but a scam of such gigantic proportions that it had to be rescued by the Fed (the US Federal Reserve Bank).

But why bother with derivatives?

You may well ask ‘Why do companies go to all this trouble to complicate matters, when they would probably do just as well in the long run to carry the risk themselves?’ Good question. Plenty of companies would agree with you, e.g. RIO TINTO:

RIO TINTO Extract from 2003 financial review**Exchange rates, reporting currencies and currency exposure**

. . . the Group does not generally believe that active currency hedging would provide long term benefits to shareholders . . .

. . . the Group does not generally believe a commodity price hedging programme would provide long term benefit to shareholders.

We can think of three reasons why companies and others use derivatives:

1. The real professionals, like SHELL and TATE & LYLE, have an enormous amount of in-house expertise and long experience of making profits on trading.
2. Although year-on-year currency risk and interest rate risk would probably be a case of swings and roundabouts, companies prefer to minimise the risk of a big hiccup in their reported profits. Investors don't like them, and in a bad year a sharp drop in profits due to adverse movements in currencies and/or interest rates could leave a company open to predators.
3. There is much international competition in banking these days and the traditional business of taking deposits and lending is much less profitable than it used to be. So bankers turn to other means of earning a crust and *some* aren't too particular how they do it.

Benefits of disclosure

There is a great deal of work involved in collecting and disclosing the information required by FRS 13, and the information is likely to be beyond the average investor. But the very process of collecting and reviewing the required information brings to the attention of directors and managers the nature and amount of risk which the company is running, and helps them meet their responsibilities. And most of the problems we have seen over derivatives, whether financial or commodity-based, have been due to weakness of controls and lack of higher management attention.

Recognition and measurement

This aspect of derivatives is not presently covered by a UK standard. Developments in this area are referred to in Chapter 33.

Creditors, provisions, contingent liabilities and contingent assets

Creditors

Presentation

Most companies use balance sheet Format 1 (set out in the Companies Act 1985), which nets out Creditors falling due within one year (also known as Current liabilities) against Current assets to produce Net current assets (liabilities).

Amounts falling due after one year are then deducted from Total assets less current liabilities to give Net assets; see the example from THE BODY SHOP opposite.

Types of creditor

The following items are required to be shown, if material:

- debenture loans (see Chapter 6);
- bank loans and overdrafts (see Chapter 13);
- payments received on account;
- trade creditors;
- bills of exchange payable (see Chapter 13);
- amounts owed to group undertakings (see Chapter 20);
- amounts owed to undertakings in which the company has a participating interest (see Chapter 22);
- other creditors, including taxation and social security;
- accruals and deferred income.

Details of creditors are usually given in the notes rather than in the balance sheet itself.

THE BODY SHOP *Extract from 2003 Group balance sheet*

	Note	2003 £m	2002 £m
Fixed assets			
Intangible assets		34.7	37.7
Tangible assets		67.8	74.4
Investments		<u>4.7</u>	<u>4.7</u>
		<u>107.2</u>	<u>116.8</u>
Current assets			
Stocks		49.1	52.2
Debtors		36.8	46.9
Debts due after more than one year		7.1	6.6
Cash at bank and in hand		<u>25.9</u>	<u>5.5</u>
		118.9	111.2
Creditors: amounts falling due within one year			
Redeemable convertible loan notes	16	(96.9)	(99.5)
		<u>—</u>	<u>(1.4)</u>
		<u>96.9</u>	<u>100.9</u>
Net current assets		<u>22.0</u>	<u>10.3</u>
Total assets less current liabilities		129.2	127.1
Creditors, amounts falling due after more than one year	17	(1.6)	(1.8)
Provisions for liabilities and charges		<u>(1.6)</u>	<u>(1.3)</u>
[Net assets]		<u>126.0</u>	<u>124.0</u>

THE BODY SHOP Extract from 2003 accounts

16. Creditors: Amounts falling due within one year		
	2003	2002
	£m	£m
USA loans	0.3	0.2
Bank loan	45.6	44.9
Bank overdraft	0.4	0.3
Obligations under finance leases	0.2	—
Trade creditors	12.2	16.3
Corporation tax	5.0	4.7
Other taxes, social security costs	5.6	3.4
Proposed dividend	7.7	7.6
Other creditors	5.7	5.8
Accruals	<u>14.2</u>	<u>16.3</u>
	<u>96.9</u>	<u>99.5</u>

Note 17 (not shown) is mainly concerned with bank and other loans falling due after more than one year.

Trade creditors represent money owed for goods supplied. The size of Trade creditors shows the extent to which suppliers are financing a company's business. For example, TESCO's suppliers finance not only its stock and debtors, but also its money market investments, earning interest for Tesco, not for its suppliers:

TESCO Extracts from 2003 accounts

TESCO Extracts from 2003 accounts		
	2003	2002
	£m	£m
Current assets		
Stocks	1,140	929
Debtors	662	454
Investments	239	225
Cash at bank and in hand	<u>399</u>	<u>445</u>
	<u>2,440</u>	<u>2,053</u>
Creditors: Amounts falling due within one year		
...		
Trade creditors	2,196	1,830

Taxation and social security are each shown separately. Taxation due within 12 months will normally include one year's corporation tax (but see Chapter 17 re large companies) and any foreign tax due.

An **accrual** is an apportionment of a known or determinable future liability in respect of a service already partly

received. Thus, a business paying rent of £60,000 half-yearly in arrears on 30 June and 31 December would, if it had an accounting year ending 30 November, show an accrual of £50,000 (the five months' rent from 1 July to 30 November unpaid at the end of its accounting year).

Dividends proposed: the directors' report must state any amount which the directors recommend be paid by way of dividend. Although the company cannot, in law, pay these proposed dividends until they have been approved at the annual general meeting, companies always show them as a liability.

Also under Creditors may appear various items that are not in the example from THE BODY SHOP:

Deferred income is money received by or due to the company but not yet earned. Companies like VODAFONE GROUP (see below) which take a month's rental in advance may well have greater accruals and deferred income than trade creditors.

VODAFONE GROUP Note to the 2003 accounts

18. Creditors: Amounts falling due within one year		
	2003	2002
	£m	£m
Bank loans and overdrafts	1,078	1,219
Commercial paper	245	—
Finance leases	107	100
Trade creditors	2,497	3,335
Amounts owed to associated undertakings	13	10
Taxation	4,137	3,107
Other taxes and social security costs	855	509
Other creditors	1,342	1,485
Accruals and deferred income	3,407	3,179
Proposed dividend	<u>611</u>	<u>511</u>
	<u>14,293</u>	<u>13,455</u>

Other types of borrowing which include bonds, loan notes and commercial paper (see Chapter 6).

Deposits: in addition to deposits in respect of a contemplated purchase (included under payments received on account), deposits may have been charged where goods have been despatched in containers, drums, barrels or boxes, to ensure their return. The container, etc., remains part of the stock of the despatching company until it becomes apparent

that it will not be returned, e.g. when the return period has elapsed, when it is treated as having been sold.

In financial companies, where deposits are a major item, representing money deposited to earn interest, they are shown as a separate heading.

Payments received on account arise where a *customer* is asked as a sign of good faith to deposit money in respect of a contemplated purchase. If the purchase goes through, the deposit becomes a part payment and ceases to appear under creditors. Should the sale not be consummated, the deposit would normally be returned, though it could conceivably be forfeited in certain circumstances.

- Secondly, if it is not kept under control, the business will eat up more cash than it should.

Some types of business are well placed with working capital. Supermarkets do particularly well, as illustrated by the TESCO example we showed on the previous page. In contrast, in a sector like building materials, you may find the company *has* to keep large stocks in order to provide a really good service to its customers world-wide, and to give them plenty of credit to be competitive. For example the printing group ST IVES:

ST IVES Working capital ratio 2002

	2002	2001
	£m	£m
Stocks	15.444	21.134
+ Trade debtors	61.952	77.974
– Trade creditors	(32.630)	(38.830)
Working capital	44.766	60.278
Turnover	466.806	498.154
Working capital ratio	9.6%	12.1%

Had the working capital ratio remained at the 2001 level in 2002, the amount tied up in working capital would have been $£466.806m \times 0.121 = £56.483m$, rather than $£44.766m$. Having $£11.717m$ less tied up has saved over $£0.5m$ interest on borrowings.

Working capital and liquidity ratios

Now that we have described stocks, debtors and creditors, this may be a good place to deal with working capital, the working capital ratio, and liquidity ratios.



Watch the working capital ratio.

The working capital ratio is important for two reasons:

- Firstly, if it is high, expansion of the business, especially rapid expansion, is going to gobble up cash like crazy.

Let's see how well THE BODY SHOP has controlled its figure over the last eight years:

THE BODY SHOP Working capital 1996 to 2003

Year end	1996	1997	1998	1999	2000	2001	2002	2003
	£m	£m	£m	£m	£m	£m	£m	£m
Stocks	37.6	34.8	47.7	38.6	44.7	51.3	52.2	49.1
+ Trade debtors	27.5	31.7	31.3	27.8	30.3	30.3	28.0	25.5
– Trade creditors	<u>7.7</u>	<u>10.2</u>	<u>11.0</u>	<u>13.0</u>	<u>20.5</u>	<u>10.7</u>	<u>16.3</u>	<u>12.2</u>
Working capital	<u>57.4</u>	<u>56.3</u>	<u>68.0</u>	<u>53.4</u>	<u>54.5</u>	<u>70.9</u>	<u>63.9</u>	<u>62.4</u>
Turnover (Sales)	256.5	270.8	293.1	303.7	330.1	374.1	379.6	378.2
RATIOS								
Stocks/Sales	14.7%	12.9%	16.3%	12.7%	13.5%	13.7%	13.8%	13.0%
Trade debtors/Sales	10.7%	11.7%	10.7%	9.2%	9.2%	8.1%	7.4%	6.7%
Trade creditors/Sales	<u>3.0%</u>	<u>3.8%</u>	<u>3.8%</u>	<u>4.3%</u>	<u>6.2%</u>	<u>2.9%</u>	<u>4.3%</u>	<u>3.2%</u>
Working capital/Sales	<u>22.4%</u>	<u>20.8%</u>	<u>23.2%</u>	<u>17.6%</u>	<u>16.5%</u>	<u>19.0%</u>	<u>16.8%</u>	<u>16.5%</u>

Comment on The Body Shop's ratios

Stocks/Sales

In 1998 the ratio jumped sharply to 16.3%. If stocks had increased in 1998 in line with the increase in sales, they would have been £37.7m at the 1998 year end, instead of £47.7m.

The company had plenty of cash at the year end, so the £10m extra stock wasn't increasing the overdraft. But even so it could have earned a useful £0.5m on deposit. Stock levels returned to a more normal level in the following years.

Trade creditors/Sales

This ratio is small, suggesting that The Body Shop pays its suppliers more quickly than most.

Working capital/Sales

After peaking at 23.2% in 1998, this overall ratio was brought well below 20% by new management.

Liquidity ratios

The two ratios most commonly used in assessing a company's liquidity are concerned with current assets (stocks and WIP, debtors and cash) and current liabilities (creditors, bank overdraft and any debts due to be settled within the next 12 months):

1. Current ratio

$$= \frac{\text{Current assets}}{\text{Current liabilities}}$$

2. Quick ratio

$$= \frac{\text{Current assets} - \text{Stock}}{\text{Current liabilities}}$$

The Companies Act 1985 requires all amounts owing by the company to be included under creditors, with amounts due within one year and after one year being shown separately. When they can be identified, provisions for amounts due within one year should be included in current liabilities.

Current ratio

The current ratio is a broad indicator of a company's short-term financial position: a ratio of more than 1 indicates a surplus of current assets over current liabilities. A current ratio of 2 or more used to be regarded as prudent in order to maintain creditworthiness, but in recent years a figure of about 1.5 has become quite normal, and a higher figure isn't necessarily a good sign: it may be due to excessive stocks or debtors, or it may mean that the directors are sitting on an unduly large amount of cash which could be more profitably invested.

When looking at an individual company's current ratio, there is no simple rule of thumb on what the company's ratio 'ought' to be, because it so much depends on a number of different factors, including the following:

1. *The nature of the company's business.* If large stocks and the giving of generous credit terms are normal to the business, the current ratio needs to be higher than the general average, whereas a retail business with only cash sales, no work in progress and stocks financed mainly by suppliers (i.e. with creditors being a large item) may be expected to have a lower than average current ratio.
2. *The quality of the current assets.* Stocks, for example, may be readily saleable, e.g. gold, or virtually unsaleable, e.g. half-completed houses in a property slump.
3. *The imminence of current liabilities.* A large loan due for repayment very soon could be embarrassing. It would be acutely embarrassing if gearing was already very high, there was no scope for an equity issue and neither cash nor further overdraft facilities were available. Even that is not perhaps as embarrassing as being unable to pay the wages next week, and next week's wages do not, of course, appear in the balance sheet.
The key factor is whether a company has scope for further borrowings or is right up against its limits.
4. *The volatility of working capital requirements.* A company with a highly seasonal business pattern, for instance a Christmas card manufacturer or a UK holiday camp operator, may well make use of a much higher average level of borrowings during the year than the balance sheet shows, particularly as companies usually arrange their year end to coincide with low stocks and/or a low level of activity. When the interest charge in the P & L account is disproportionately large in comparison to the borrowings shown in

the balance sheet, this is a clear indication that borrowings during the year have been significantly higher than at the year end.

Because of these individual factors, the most informative feature of a current ratio is its normal level and any trend from year to year. A drop below normal levels is worth investigating, and a continuing decline is a warning signal that should not be ignored.

Quick ratio or acid test

As we have said, not all current assets are readily convertible into cash to meet debts; in particular stocks and work in progress may be able to be run down a certain amount, but not eliminated if the business is to continue. The quick ratio recognises this by excluding stocks from current assets and applies the 'acid test' of what would happen if the company had to settle up with all its creditors and debtors straight away: if the quick ratio is less than 1 it would be unable to do so.

Some companies whose normal terms of trade allow them to sell goods for cash before paying for them habitually operate with a quick ratio of well under 1 (0.2 is typical for a supermarket); so it is a poorer than average figure compared with other companies in the same industry, coupled with a declining trend, that signals possible trouble ahead. A feature that a low and declining ratio often highlights is a rising overdraft: the question then is, 'Are their bankers happy?' Fears in this direction may be allayed by a statement in the annual report about operating well within the facilities available, or by a statement at the time that new money is raised confirming that working capital will be adequate.

A large difference between the current ratio and the quick ratio is an indication of large stocks:

$$\text{Current ratio} - \text{Quick ratio} = \frac{\text{Stocks}}{\text{Current liabilities}}$$

Bathroom and kitchen unit manufacturer SPRING RAM, which has had a very chequered time over a ten-year period, provides an interesting example:

THE SPRING RAM CORPORATION *Current ratio and Quick ratio*

	1990	1991	1992	1993	1994	1995	1996	1997
	£m	£m	£m	£m	£m	£m	£m	£m
Current assets	91.1	128.8	128.0	91.3	109.5	130.1	83.8	72.1
Current liabilities	54.9	79.4	95.1	90.5	65.7	105.1	70.6	72.2
Current ratio	1.66	1.62	1.35	1.01	1.67	1.24	1.20	1.29
Stocks	25.1	41.0	52.4	45.4	47.7	64.7	38.8	33.1
Current assets – Stock	66.0	87.8	75.6	45.9	61.8	65.4	45.0	37.0
Quick ratio	1.20	1.11	0.79	0.51	0.94	0.62	0.64	0.51
See Note	1	2	3	4				

NOTES:

1. *Chairman's statement:*

Bonus issue The strength of the Group's balance sheet is such that, on 26 April 1991, shareholders approved a one for one bonus issue, the fifth since flotation in 1983 . . .

Management The number and quality of the Corporation's management teams continues to grow. There are now 47 directors managing 16 autonomous operating companies.

2. Stock increased by more than 60%, although Turnover was marginally down from £194m to £191m. Invested £37.1m in buildings and plant. Spent £12.8m on Stag furniture acquisition.

3. *New chairman's statement:* The five months of 1993 since the new team was installed have been used to stabilise the financial position of the company . . . severe recession in the UK housing market. Prompt action was necessary to eliminate the excessive decentralization which had led both to the Group's businesses competing with each other and to the duplication of overheads and stockholdings . . . the number of businesses operated by the company was reduced from 22 to 11.

4. Rescue rights issue; 2 for 9 to raise £42.1m net.

We would like to tell you that, after the rescue rights issue, the company was soon restored to good health. Sadly not. As the ratios continue to indicate, this company is still a sick chick. Its share price bottomed at 4p, down from 188p in the heyday of the first chairman.

The wounds were deep. Due to the unbounded optimism of the first chairman in the face of a recession, the company had gone from cash at bank of £45.8m at the beginning of 1992 into net bank borrowings of £37.8m by the end of August 1993.

But worse still was the damage done to the integrity of the company by some serious creative accounting. As the *Investors Chronicle* wisely warned its readers:

INVESTORS CHRONICLE Extract from 26 March 1993

Battered Ram

Cautious investors would be right to avoid Spring Ram shares until credibility is restored.

Investors have good reason to be angry with the former market darling Spring Ram . . .

First there was last November's debacle at Balterley Bathrooms. The problem is believed to have been the result of huge pressure on the divisional finance director to perform. He apparently overvalued stocks to produce the figures that head office wanted to see.

Although the group sought to reassure shareholders that this was an isolated incident this week's shocks have undermined its attempt.

Last week, trading in its shares was suspended ahead of a profit warning. Management blamed more stringent accounting policies.

Provisions

Reference: FRS 12 *Provisions, contingent liabilities and contingent assets*

Background

Before FRS 12 the making of provisions gave imaginative companies enormous scope for enhancing profits. All you had to do was this:

- Year 1 make a huge provision, so large that analysts would ignore it in their calculation of that year's earnings per share, and forget about it in subsequent years.

- Year 2 and in subsequent years, offset against the provision costs that you would prefer not to hit the profit and loss account, until such times as the 'kitty' is used up.
- Then scratch around for another suitable provision.

The two classics were ICI's provision of several hundred million for 'Restructuring' and UNILEVER's £800m for 'Entry into Europe'.

We are sure that both these companies were scrupulous in choosing what costs to offset against these jumbo provisions, but the scope for creative accountancy was enormous. FRS 12 severely curtails the scope for this particular dodge.

Definition

A *provision* is a liability that is of uncertain timing or amount. A provision should be recognised when a company has an obligation which it will probably be required to settle, and a reliable estimate can be made of the amount of the obligation. Unless these conditions can be met, no provision should be recognised.

A 'provision' (as defined by CA 1985) is either:

- (a) any amount written off by way of providing for depreciation or diminution in the value of assets (in which case it is deducted from the fixed asset); or
- (b) any amount retained to provide for any liability or loss which is either likely to be incurred, or certain to be incurred but uncertain as to the amount or as to the date on which it will arise (it then appears among provisions for liabilities and charges).

FRS 12 (see below) sets out more demanding conditions than those in (b) above, and it is those in FRS 12 which have to be applied in practice.

Provisions for liabilities and charges are frequently made for:

- (a) pensions and similar obligations (see page 127);
- (b) taxation, including deferred taxation (see Chapter 17); and
- (c) other provisions.

Pension schemes can be either funded, i.e. contributions paid away to separate funds (see page 127), or unfunded. In an unfunded scheme, which is the norm in some foreign countries, the company makes a provision for future liabilities in its accounts.

Particulars should also be given of any pension commitments for which no provision has been made.

The item Taxation will normally only include deferred taxation (see Chapter 17), as other taxation will be shown under Creditors, unless the amount is uncertain.

When to make provisions

Under FRS 12 a provision – a liability that is of uncertain timing or amount – should *only* be recognised when:

- a company has an *obligation* which it will probably be required to settle; and
- a *reliable estimate* can be made of the amount of the obligation.

Unless these conditions can be met, no provision should be recognised. A provision should be *used* only for expenditure for which the provision was originally recognised.

Annual review and disclosure

Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate.

If it is no longer probable that a transfer of economic benefits will be required to settle the obligation, i.e. if it looks as though the company is no longer likely to have to cough up, the provision should be reversed.

As SMITHS GROUP (see below) illustrates, the company's annual report should disclose:

- the carrying amount at the beginning and end of the period;
- additional provisions made in the period, including increases to existing provisions;
- amounts used (i.e. incurred and charged against the provision) during the period; and unused amounts reversed during the period.

SMITHS GROUP *Extract from notes to the 2003 accounts*

Note 24, Provisions for liabilities and charges

	At 1/8/02 £m	Exchange adjustments £m	Profit and loss account		Acquisitions £m	Utilisation £m	Disposals £m	At 31/7/03 £m
			Provisions £m	Releases £m				
Service guarantees and product liability	34.7	0.5	28.2	[5.0]	11.9	[19.2]	(2.0)	49.1
Reorganisation	37.1	0.1	–	[1.9]		[20.9]	(0.4)	14.0
Property	20.0	–	5.8	[5.5]		[2.9]	(0.3)	17.1
Litigation	<u>18.3</u>	<u>0.2</u>	<u>6.9</u>	<u>[2.6]</u>	<u>2.1</u>	<u>[2.7]</u>	–	<u>22.2</u>
	110.1	<u>0.8</u>	<u>40.9</u>	<u>[15.0]</u>	<u>14.0</u>	<u>[45.7]</u>	<u>(2.7)</u>	<u>102.4</u>
Deferred taxation	<u>3.7</u>							<u>13.6</u>
Total provisions	<u>113.8</u>							<u>116.0</u>

Service guarantees and product liability

Service guarantees and warranties over the company's products typically cover periods of between one and three years. Provision is made for the likely cost of after-sales support based on the recent past experience of individual businesses.

Reorganisation

Significant parts of the company's operations, especially in Aerospace and Sealing Solutions, have been undergoing a phased restructuring programme. Full provision is made for reorganisation approved and committed by the end of each financial year. This year's residual balance relates mainly to Aerospace.

Property

As stated in the Accounting Policies . . . where a property is vacant, or sub-let under terms such that rental income is insufficient to meet all outgoings, the company provides for the expected future shortfall up to termination of

the lease. Provision is also made for the cost of reinstatement work on leased properties where there is an obligation under the lease, and the costs can be reasonably estimated. Where evidence of contamination is found on property in the company's occupation, provision is made for estimated remedial costs pending action on the affected site. Provisions totalling £5.5m were released following a reassessment of certain future obligations.

Litigation

The company has on occasion been required to take legal action to protect its patents and other business intellectual property rights against infringement, and to similarly defend itself against proceedings brought by other parties. Provision is made for the expected fees and associated costs, based on professional advice as to the likely duration of each case. Provisions totalling £2.6m were released relating to litigation settled at less than the expected cost.

Provisioning – the main areas

Provisions can involve huge sums of money. The main areas are:

- Environmental (SHELL, \$5.2 billion)
- Restructuring (UNILEVER, €445m)
- Litigation (GKN, £266m).

SHELL Note to the 2002 accounts

Decommissioning and restoration costs

For the purpose of calculating provisions for decommissioning and restoration costs, estimated total ultimate liabilities of \$5.2 billion at December 31 2002 (2001: \$4.4 billion) were used. Such estimates are subject to various regulatory and technological developments.

UNILEVER Note to the 2003 accounts

19 Restructuring and other provisions

Provisions are recognised when either a legal or a constructive obligation, as a result of a past event, exists at the balance sheet date and where the amount of the obligation can be reasonably estimated.

	€ million	€ million
	2003	2002
Restructuring provisions	445	633
Other provisions . . .		

Restructuring provisions at the end of 2003 relate to the Path to Growth initiative described in Note 4 on page 86. These amounted to €0.4 billion, the cash impact of which is expected to be . . .

GKN Note to the 1997 accounts

Provisions for liabilities and charges

	1997	1996
	£m	£m
Deferred taxation	2	7
Post-retirement and other provisions	174	173
Meineke litigation	<u>266</u>	<u>270</u>
	<u>442</u>	<u>450</u>

Meineke litigation

In the interests of prudence an exceptional litigation provision of \$270m was made in the 1996 accounts following a judgment of the US District Court, Charlotte, North Carolina in respect of claims brought by certain of its franchisees against Meineke Discount Muffler Shops Inc. (owned by one of GKN's subsidiaries) alleging breach of contract and fiduciary duty . . . by Meineke . . . appeal with the US Court of Appeal . . .

The movement on the provision represents legal costs incurred in the year.

So GKN's lawyers took a cool \$4m off the company in 1997. Litigation is a serious hazard in doing business in the USA. (Rumour has it that US pharmaceutical and cosmetic companies are using lawyers rather than rats for testing new products. This is for two reasons: firstly there are more of them – and secondly you are less likely to get attached to them.)

Other areas include:

- Warranties
- Onerous leases
- Overhaul of items on operating leases.

- A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are necessarily entailed by the restructuring.
- A restructuring provision does not include such costs as: (a) retraining or relocating continuing staff; (b) marketing; or (c) investment in new systems and new distribution networks.
- No obligation arises for the sale of an operation until the company is committed to the sale i.e. there is a binding sale agreement.

Other accounting standards on provisions

Where another FRS or an SSAP deals with a more specific type of provision, that standard applies, rather than FRS 12. These include:

- long-term contracts (SSAP 9, see page 77);
- deferred tax (FRS 19, see page 140);
- leases (SSAP 21, see pages 116–17);
- pension costs (SSAP 24 and FRS 17, see pages 127–9).

Other uses of the term ‘provision’

The term ‘provision’ may also be used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets, and are not covered by FRS 12.

What does all this mean to the investor?

Prior to FRS 12 the recognition (making) of a provision was based on management’s intention, or possible intention, of making expenditures, rather than on any legal or moral obligation to do so.

In particular, as we have mentioned, there was the use of what Sir David Tweedie, when chairman of the ASB, called ‘*big bath*’ accounting. Several years of future expenditure, including items related to continuing operations, and possibly a sum to cover unforeseen costs, would be heaped together into one large provision, which would be reported as an exceptional item.

This gave enormous scope for earnings to be ‘*smoothed*’: large fluctuations in reported earnings being avoided by provisions being released in lean years.

The new rules should make management much more accountable. The hope is that companies will keep shareholders more closely informed about provisions and exceptional expenditure. Companies which haven’t already adopted the Operational and Financial Review should do so to help achieve this better communication.

The danger is that management will become less inclined to ‘grasp nettles’ in continuing operations, for fear of causing a ‘blip’ in reported profits.

Contingent liabilities and contingent assets

Definition

A contingent liability is a potential liability which had not materialised by the date of the balance sheet. By their nature, contingent liabilities are insufficiently concrete to warrant specific provision being made for them in the accounts, and none is in fact made. However, the Companies Act 1985 requires a company to disclose by way of note or otherwise:

- (a) any arrears of cumulative dividends (para. 49);
- (b) particulars of any charge on the assets of the company to secure the liabilities of any other person, including, where practicable, the amount secured (para. 50 (1));
- (c) the legal nature of any other contingent liabilities not provided for, the estimated amount of those liabilities, and any security given (para. 50 (2)).

Examples of contingent liabilities

Typical contingent liabilities include:

- (a) bills of exchange discounted with bankers (where an FRS 5 linked presentation is not used (see page 45));
- (b) guarantees given to banks and other parties;
- (c) potential liabilities on claims (whether by court action or otherwise);
- (d) goods sold under warranty or guarantee;
- (e) any uncalled liability on shares held as investments (i.e. the unpaid portion of partly paid shares held).

Contingencies frequently arise in respect of an acquisition as the result of an ‘earn-out’, where part of the consideration is based on future profits.

Litigation, impending litigation and threatened litigation are popular breeding grounds for contingent liabilities; e.g. BP:

BP Note to the 2003 accounts

39. Contingent liabilities

Approximately 200 lawsuits were filed . . . arising out of the Exxon Valdez oil spill in Prince William Sound in March 1989.

Most of these suits named Exxon, Alyeska Pipeline Service Company (Alyeska), which operates the oil terminal at Valdez, and other oil companies which own Alyeska . . . BP owns a 47% interest in Alyeska . . .

Exxon has indicated that it may file a claim for contribution against Alyeska for a portion of the costs and damages which it has incurred.

How an oil terminal operator can be held responsible for a tanker running aground is way beyond our comprehension (unless Alyeska provided the pilot), but in the USA it seems they'll try anything.

As explained below, companies are also required to disclose 'commitments'. It is often quite difficult to decide just what is a commitment and what a contingent liability; and many groups, like ICI, treat them in a single note.

ICI Extract from note to the 2003 accounts

39. Commitments and contingent liabilities

The Group's 50% interest in Teesside Gas Transportation Ltd (TGT) was sold, during 1996, to a subsidiary of its other shareholder Enron Europe Ltd (**Enron**) which is currently in administration.

TGT contracted with the owners of a distribution network for pipeline capacity for North Sea gas and the commitment is guaranteed severally on a 50:50 basis by ICI and Enron. (The present value of the commitment guaranteed by ICI is estimated at £146m.) . . . (the parent company) Enron Corp. sought Chapter 11 bankruptcy protection in the USA on 2 December 2001.

The significance of contingent liabilities

In many cases notes on contingent liabilities are of no real significance, for no liability is expected to arise, and none does. Occasionally, however, they are very important indeed, and points to watch for are a sharp rise in the total sums involved, and liabilities that may arise outside the normal course of business.



To guarantee the liabilities of someone, or some company, over which one has no control entails undue risk, and calls into question the management's judgement if the sums involved are significant.

In particular, experience suggests that any contingent liability in respect of a subsidiary that has been disposed of can be extremely dangerous. For example, when COLOROLL took over JOHN CROWTHER it accepted more than £20m of contingent liabilities in order to help the MBO of Crowther's clothing interests, which it wanted to be shot of.

COLOROLL Note to the accounts

Contingent liabilities

At 31 March 1989 the group had contingent liabilities in connection with the following matters:

- (a) the sale with recourse of £7,500,000 of redeemable preference shares and £14,250,000 senior and subordinated loan notes in RESPONSE GROUP LTD which were received as part consideration for the sale of the clothing interests of JOHN CROWTHER GROUP PLC;
- (b) the guarantee of borrowings and other bank facilities of . . .

In February 1990 the Response Group called in the receivers, and Coloroll followed four months later!

Guaranteeing the borrowings of associated undertakings or joint ventures may also be dangerous.

Capital commitments

The Companies Act 1985 requires that, where practicable, the aggregate amounts or estimated amounts, if they are material, of contracts for capital expenditure (not already provided for) be shown by way of note. For example RANK:

RANK Extract from note to the 2003 accounts

32. Commitments

Future capital expenditure

At 31 December 2003 commitments for capital expenditure amounted to £35.6m (2002 £24.1m).

Such a note provides some indication of the extent to which the directors plan to expand (or replace) the facilities of the group, and thus of the potential call upon its cash resources. It should be read in conjunction with the directors' report and chairman's statement and any press announcements by the company, but it is not a particularly helpful guide to future cash flows unless it gives some information on timing. Although the sums involved are material, it is impossible to tell from RANK's note how long the various facilities to which it is committed will take to build or deliver, and when payments will fall due.

Other financial commitments

The Companies Act 1985 requires particulars to be given of any other financial commitments which have not been provided for and which are relevant to assessing the company's state of affairs (Sch. 4, para. 50 (5)). This requirement covers such things as leasing commitments and long-term contracts, where the sums involved can be very large indeed, as illustrated by SHELL TRANSPORT AND TRADING'S note on commitments, shown here:

SHELL TRANSPORT AND TRADING Note to the 2002 accounts

16. Commitments

(a) Leasing arrangements

The future minimum lease payments under operating leases and capital leases, and the present value of net minimum capital lease payments at 31 December 2002 were as follows:

	<i>Operating leases</i>	\$ million <i>Capital leases</i>
2003	1,906	91
2004	1,192	52
2005	806	51
2006	647	49
2007	512	56
2008 and after	<u>3,553</u>	<u>495</u>
Total minimum payments	<u>8,616</u>	<u>794</u>

...

The figures above for operating lease payments represent minimum commitments existing at December 31, 2002 and are not a forecast of future total rental expense.

The distinction between operating leases and capital (finance) leases is explained below.

Leases

SSAP 21 *Accounting for leases and hire purchase contracts* divides leases into two types, finance leases and operating leases, and requires quite different accounting treatment for each type.

A *finance lease* is defined as a lease which transfers substantially all the risks and rewards of ownership of an asset to the lessee. All other leases are *operating leases*.

Finance leases: the lessee

Prior to SSAP 21 a company could enter into a finance lease instead of borrowing the money to purchase an asset, and neither the asset nor the commitment to pay leasing charges would appear in the balance sheet. This was an example of what was known as 'off balance sheet financing', which produced 'hidden gearing', as the company had effectively geared itself up just as much as if it had borrowed the money to purchase the asset, except that it had to pay leasing charges rather than paying interest and bearing depreciation charges.

SSAP 21 requires a finance lease to be recorded in the balance sheet of the lessee as an asset and as an obligation to pay future rentals. The initial sum to be recorded both as an asset and as a liability is the present value of the minimum lease payments, which is derived by discounting them at the interest rate implicit in the lease. The method of accounting is illustrated in Example 15.1.

Example 15.1 Accounting for a finance lease

A company acquires a small computer system on a finance lease. Lease payments are £10,000 p.a. for 5 years, with an option to continue the lease for a further 5 years at £1,000 p.a. Payments are made annually in advance, i.e. the first payment is made on taking delivery of the computer. The interest rate implicit in the lease is 10%, and the estimated useful life of the system is 5 years.

The present value of the minimum lease payments discounted at 10% p.a. can be calculated using the table Present value of 1 in n years' time in Appendix 2:

Payment date	Present value of 1 (from table)	Present value of £10,000 payment £
On delivery	1.000	10,000
In 1 year	0.909	9,090
In 2 years	0.826	8,260
In 3 years	0.751	7,510
In 4 years	0.683	6,830
Present value of minimum lease payments		£41,690

The computer system will thus be recorded as an asset of £41,690 and the liability for future rental payments will also be recorded as £41,690. After the first year:

- The asset will be depreciated over the shorter of the lease term (the initial period plus any further option period, i.e. a total of 10 years in this case), and its expected useful life (5 years). Annual depreciation charge on a straight line basis is therefore one-fifth of £41,690 = £8,338, reducing the asset value to £33,352.
- The present value of the remaining minimum lease payments is recomputed. There is no longer a payment due in 4 years' time (£6,830 in our table above), so the present value of future payments is now £41,690 – 6,830 = £34,860. £6,830 is deducted from the future liability and the remaining £3,170 of the £10,000 payment made on delivery is shown as interest paid.

These calculations would then be repeated each subsequent year as shown in Example 15.2.

Finance leases: the lessor

In the past the practice of 'front-ending', taking a high proportion of the profits on a lease in the first year, has

Example 15.2 Accounting for a finance lease – subsequent years

End of year	Balance sheet		P & L account	
	Asset value £	Remaining payments £	Interest charge £	Depreciation charge £
1	33,352	34,860	3,170	8,338
2	25,014	27,350	2,490	8,338
3	16,676	19,090	1,740	8,338
4	8,338	10,000	910	8,338
5	Nil	Nil	Nil	8,338

got a number of companies into serious difficulties, e.g. SOUND DIFFUSION, which went into liquidation primarily as a result of taking 60% of profits on leasing electrical equipment – telephone switchboards, fire-alarm and public-address systems – in the first year.

Under SSAP 21, front-ending is not allowed. The amount due under a finance lease should be recorded as a debtor at the net investment after provisions for bad and doubtful rentals, etc., and the earnings in each period should be allocated to give a constant rate of return on the lessor's net investment (SSAP 21, paras. 38 and 39).

Operating leases

An operating lease is normally for a period substantially shorter than the expected useful life of an asset; i.e. the lessor retains most of the risks and rewards of ownership.

Under an operating lease the lease rentals are simply charged in the profit and loss account of the lessee as they arise. Leased assets and the liability for future payments do not appear in the balance sheet, even though companies can enter into operating leases of several years' length, as in the extract from SHELL TRANSPORT AND TRADING's accounts illustrated on page 116.

While SSAP 21 sets out the distinction between an operating lease and a finance lease, FRS 5, *Reporting the substance of transactions*, looks behind the lease at the nature of the underlying transaction.

Introduction

As described briefly in Chapter 1, the profit and loss account is a score-card of how the company did in the period reported on, normally the last year. The Companies Act 1985 offers companies the choice of four profit and loss account formats:

- Formats 1 and 2 are ‘modern’ single-page vertical formats;
- Formats 3 and 4 are ‘traditional’ two-sided formats, common in the UK until 50 years ago, still used in Europe and elsewhere, but rarely found among listed UK companies. They will not be considered further.

The upper parts of Formats 1 and 2 are shown in Examples 16.1 and 16.2 respectively. The difference between them is the way they show operating costs:

- Format 1 breaks down operating costs by function:
 - Cost of sales* (which will include all costs of production, such as factory wages, materials and manufacturing overheads, including depreciation of machinery);
 - Distribution costs* (costs incurred in getting the goods to the customer);
 - Administrative expenses* (e.g. office expenses, directors’ and auditors’ fees).
- Format 2 breaks down operating costs into:
 - Raw materials and consumables*
 - Staff costs* Wages and salaries; Social security costs; Other pension costs
 - Depreciation* and other amounts written off fixed assets
 - Other external charges*
 - Change in stock* of finished goods and work in progress.

Example 16.1 Profit and loss account: Format 1

	£000	£000
Turnover		7,200
Cost of sales		<u>3,600</u>
Gross profit		3,600
Distribution costs	1,100	
Administrative expenses	<u>900</u>	
		<u>2,000</u>
Other operating income		<u>1,600</u>
		50
[Operating or Trading profit]		1,650
Income from interests in associated undertakings		30
Income from other participating interests		10
Income from other fixed asset investments		5
Other interest receivable		<u>120</u>
		1,815
Amounts written off investments	15	
Interest payable	<u>600</u>	
		<u>615</u>
[Profit on ordinary activities before tax]		1,200

The formats reflect the disclosure requirements of the European Union Fourth Directive as incorporated in Schedule 4 of the Companies Act 1985. Items in square brackets have been included because they are important to the analyst, although they do not actually appear in the formats in Schedule 4. Most companies now adopt Format 1, though some use a combination of Formats 1 and 2.

Example 16.2 Profit and loss account: Format 2

	£000	£000
Turnover		7,200
Changes in stocks of finished goods and work in progress	160	
Other operating income	50	<u>210</u>
		7,410
Raw materials and consumables	1,700	
Other external charges	1,120	
Staff costs		
Wages and salaries	2,050	
Social security costs	300	
Other pension costs	120	
Depreciation and other amounts written off tangible and intangible fixed assets	400	
Other operating charges	<u>70</u>	
		<u>5,760</u>
[Operating or Trading profit]		1,650
Income from interests in associated undertakings		30
Income from other participating interests		10
Income from other fixed asset investments		5
Other interest receivable		<u>120</u>
		1,815
Amounts written off investments	15	
Interest payable	<u>600</u>	
		<u>615</u>
[Profit on ordinary activities before tax]		1,200

Comparatively few companies adopt Format 2. One which does, but puts most of the detail in the notes to its accounts (see page 120), is SYGEN INTERNATIONAL, the profit and loss account of which is shown below. We look at SYGEN INTERNATIONAL again later in this chapter in connection with audit fees, interest paid and Research and Development.

Turnover

Turnover would seem to be a straightforward figure, but it is not. It is open to a good deal of fiddling, dodges such as including a large deal before contracts have been exchanged, as we will discuss in detail in Chapter 30 *Accounting practices*.

Profit before taxation

As shown in Examples 16.1 and 16.2:

- trading profit, *plus*
- income from interests in associated undertakings and from other participating interests (see Chapter 22), *plus*
- income from other investments and other interest receivable, *less*
- interest payable and any amounts written off investments,
- leaves the profit before tax, or 'pre-tax profit'.

SYGEN INTERNATIONAL Extract from group profit and loss account for the year ended 30 June 2003

	<i>Operations before exceptional items</i>	<i>Exceptional items</i>	2003	2002
	£m	£m	£m	£m
Turnover				
Continuing operations				
Group and share of joint ventures	143.2	—		175.3
less: share of joint ventures	<u>(10.5)</u>	—		<u>(10.6)</u>
Group turnover	<u>132.7</u>	—		<u>164.7</u>
Group operating profit (Note 4 – see next page)	4.7	4.6	9.3	11.1
Share of operating profit of joint ventures	<u>0.3</u>	—	<u>0.3</u>	<u>1.1</u>
Total operating profit	5.0	4.6	9.6	12.2
Fundamental restructuring				
– Sale and closure of businesses	—	(2.2)	(2.2)	(2.9)
– Other consequential income	—	(0.8)	(0.8)	1.9
Net interest receivable	<u>0.4</u>	<u>0.1</u>	<u>0.5</u>	<u>1.5</u>
Profit/(loss) on ordinary activities before tax	<u>5.4</u>	<u>1.7</u>	<u>7.1</u>	<u>12.7</u>

SYGEN INTERNATIONAL is one of a growing number of companies which show the information required by one or other of the formats laid down not on the face of the profit and loss account but in the notes.

SYGEN INTERNATIONAL Extract from note 4 to the accounts for the year ended 30 June 2003

4. Group operating profit

	<i>Continuing operations 2003 £m</i>	<i>Continuing operations 2002 £m</i>
Turnover	<u>132.7</u>	<u>164.7</u>
Charges		
Change in stocks of work in progress	(0.5)	(1.9)
Raw materials and consumables	56.8	78.2
Other external charges	33.3	35.5
Staff costs (note 9b – not shown)	30.5	33.0
Depreciation and amortisation	6.1	6.3
Hire of plant and machinery	0.8	1.4
Other operating lease rentals	<u>2.1</u>	<u>2.0</u>
Total charges	<u>129.1</u>	<u>154.5</u>
Income		
Reimbursement by insurers for Livestock loss	0.5	
Lost profits	4.1	
Other operating income	<u>1.1</u>	<u>0.9</u>
Total income	<u>5.7</u>	<u>0.9</u>
Group operating profit	9.3	11.1

The three parts

Whatever format is used, the profit and loss account (sometimes referred to as the revenue account or statement of income) can conveniently be divided into three parts which show

- how the profit (or loss) was earned;
- how much was taken by taxation;
- what happened to the profit (or loss) that was left after taxation.

This chapter covers the first part. Chapter 17 is devoted to taxation and Chapter 18 considers profit after tax, dividends and earnings per share.

Additional disclosures

Profit and loss accounts of listed companies are rarely quite as simple as those shown in Examples 16.1 and 16.2.

The formats do not cover everything. Additional disclosures are required by

- (a) the Companies Act itself;
- (b) accounting standards; and
- (c) UK Listing Authority (UKLA)'s Listing Rules

We focus separately on each of these in the sections which follow. Examples later in this chapter and in the chapters which follow illustrate

- (a) how accounting standards and the requirements of UKLA affect the profit and loss account; and
- (b) the use which the investor and analyst can make of that information.

Disclosures required by the Companies Act

Turnover

Turnover 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 adding VAT and other sales-based taxes). Companies are required by the standard formats of the Companies Act 1985 to disclose turnover (i.e. total sales) in their profit and loss account. The following must also be given:

- (a) Under Sch. 4, para. 55(1), if a company carried on two or more classes of business during the year which in the directors' opinion differ substantially from each other, it should describe the classes and show each one's turnover and pre-tax profit.
- (b) If in the year a company supplied geographical markets which in the directors' opinion differ substantially, the turnover attributable to each should be stated (Sch. 4, para. 55(2)).

However, this information need not be disclosed if, in the opinion of the directors, it would be seriously prejudicial to the interests of the company to do so; but the fact that it has not been disclosed must be stated (Sch. 4, para. 55(5)).

Segmental reporting (SSAP 25) is considered later in this chapter (see pages 136–7).

Other items in the profit and loss account

The Companies Act 1985 requires that the following be shown separately in the profit and loss account or in the notes:

1. **Directors' emoluments:** Schedule 6 of CA 1985 requires:

- (a) aggregate, for all directors, of each of: emoluments (salaries, fees and bonuses); gains on exercise of share options; amounts in respect of long-term incentive schemes; employers' pension contributions under money purchase (defined contribution) schemes;
- (b) number of directors accruing benefits under each of money purchase schemes and defined benefit (final salary) schemes;
- (c) details of emoluments of highest paid director where aggregate of items in (a) above, excluding employers' pension contributions, exceeds £200,000;
- (d) aggregate of excess retirement benefits;
- (e) aggregate amount of compensation for loss of office;
- (f) sums paid to third parties in respect of directors' services.

Note: The UKLA Listing rules require fully listed companies to provide detailed information on each director – see Chapter 26.

2. **Particulars of staff:** the average number employed during the year, and the aggregate amounts of their (a) wages and salaries, (b) social security costs, (c) other pension costs (CA 1985, Sch. 4, para. 56).
3. **Auditors' remuneration** in their capacity as such, including expenses. Remuneration for services other than those of auditors should be shown separately (CA 1985, s. 390A and 390B).

A sharp increase in the auditors' remuneration (i.e. more than merely keeping pace with inflation) may be an indication of difficulties; for example SOCK SHOP paid their auditors £60,000 for the 17 months ended 28 February 1989 compared with £10,000 for the previous year, and went into receivership in 1990. Or to take a recent example:

SYGEN INTERNATIONAL *Extract from note 4 to the accounts for the year ended 30 June 2003*

	2003	2002
	£m	£m
Statutory audit	0.4	0.5
Tax compliance and advisory	0.4	0.7
Other non-audit	<u>0.1</u>	<u>0.1</u>
	0.9	1.3

Tax compliance and advisory fees relate to work in respect of statutory tax compliance, general tax advice and other tax advice for the Group's fundamental restructuring which took place in 1998.

4. **Depreciation** and diminution in value of fixed assets (see Chapter 8). In Format 1 depreciation is not shown as a separate item, but in all formats the amount provided during the year will be found in the note on fixed assets.
5. **Interest paid:** the Companies Act 1985 (Sch. 4, para. 53(2)) requires the disclosure of the interest paid on bank loans and overdrafts, on loans repayable within five years and on other loans. Most companies show a single figure in their profit and loss account, giving details in a note which may include: (i) some netting out of interest received; (ii) discount amortisation of deep discount bonds; (iii) interest capitalised and other adjustments; as, for example the note explaining 'net interest' in SYGEN INTERNATIONAL's 2003 accounts:

SYGEN INTERNATIONAL *Extracts from the accounts for the year to 30 June 2003*

Note 5 Interest	2003	2002
	£m	£m
Interest payable and similar charges:		
On bank loans and overdrafts	(0.1)	(0.4)
Other interest payable	–	(0.3)
Unwind of discount on surplus property provision	(0.3)	(0.3)
Interest receivable	<u>0.9</u>	<u>2.5</u>
Net interest receivable	<u>0.5</u>	<u>1.5</u>

Net interest receivable for the year ended 30 June 2002 includes exceptional interest receivable of £1.0m, relating to tax refunds from prior year tax returns in connection with the disposal of certain businesses in 1998.

Although all this information may be shown on the face of the profit and loss account, it rarely is. In general one finds it early in the notes to the accounts, in a note entitled something like 'Profit on ordinary activities before tax', though there is then usually a separate note on employment costs and/or directors' emoluments.

Parent company profit and loss account

If, at the end of a financial year, a company is a parent company, group accounts have to be prepared as well as individual accounts for the parent company (CA 1985, s. 227).

As will be explained in Chapter 20, group accounts comprise a consolidated balance sheet and profit and loss account dealing with the parent company and its subsidiary undertakings.

Under Section 230 (3) of the Companies Act 1985, the parent company's profit and loss account may be omitted from the consolidated accounts providing the parent company's balance sheet shows the parent company's profit or loss for the year. Since most listed companies are holding companies, i.e. have subsidiaries, in practice one seldom if ever sees the parent company's own profit and loss account; one sees only the profit and loss account of the group.

Disclosures required by accounting standards

A large number of accounting and financial reporting standards require the disclosure of information in the profit and loss account or the notes:

1. Segmental reporting

SSAP 25 *Segmental reporting* requires companies which have two or more classes of business or which operate in two or more geographical segments to report turnover (differentiating between external sales and sales to other segments), pre-tax profits and net assets for each class of business and for each geographical segment. A separate section of this chapter (pages 136–7) is devoted to the requirements of SSAP 25.

2. Research and development

SSAP 13 *Research and development* requires all expenditure on **research** to be charged to the P & L account in the

same year. **Development** costs are normally charged to the P & L account in the same year, but providing there is a clearly defined project that is technically and commercially viable, and the related expenditure is separately identifiable, development expenditure may be capitalised and written off to the P & L account over a number of years.

SYGEN INTERNATIONAL *Extract from note 4 to the accounts for the year ended 30 June 2003*

Research and development expenditure This amounted to £7.7m (£6.9m).

3. Operating lease rentals

SSAP 21 *Lease and hire purchase contracts* requires rentals on operating leases to be charged to the P & L account on a straight line basis over the term of the lease.

4. Pension costs

SSAP 24 *Accounting for pension costs*, issued in 1988, required:

- (a) *Defined contribution* (money purchase) schemes – contributions payable by the company to the pension scheme are charged to the P & L account.
- (b) *Defined benefit* (final salary) schemes – the costs of the scheme are charged to the P & L account so as to spread the cost of pensions over the employees' expected working lives with the company.

In November 2000, the Accounting Standards Board issued FRS 17 *Retirement benefits*. Following a potentially lengthy transitional period, this Standard will eventually replace SSAP 24.

See pages 127–9 for a summary of the requirements of SSAP 24 and FRS 17.

5. Investment income

Under FRS 16 *Current tax*, dividends received from UK resident companies are shown at the actual amount received or receivable.

6. Substance over form

The influence of FRS 5 *Reporting the substance of transactions* has been considered in Chapters 6, 11, 12 and 13.

7. Foreign exchange

SSAP 20 *Foreign currency translation* gives a choice on the treatment of foreign currencies. In a group with overseas subsidiaries, profit and loss account items may be translated using either the *average rate* for the accounting period or the *closing rate*. The method chosen should be applied consistently.

As explained in Chapter 23, whether the average rate or the closing rate is used can make a considerable difference to reported profit.

8. Subsidiaries and groups

FRS 2 *Accounting for subsidiary undertakings*, FRS 6 *Acquisitions and mergers*, FRS 7 *Fair values in acquisition accounting*, FRS 10 *Goodwill and intangible assets*, and FRS 11 *Impairment of fixed assets and goodwill* all affect the P & L account in one way or another; see Chapters 20 and 21.

9. Associated undertakings

'Income from interests in associated undertakings' and 'Income from other participating interests' both appear in the formats but FRS 9 *Associates and joint ventures* calls for additional disclosures as explained in Chapter 22.

10. Provisions

The making of provisions and utilisation of provisions made in earlier years both affect profits. This is covered by FRS 12 *Provisions, contingent liabilities and contingent assets*. See Chapter 15.

11. Exceptional and prior year items

FRS 3 *Reporting financial performance* is concerned, amongst other things, with items disclosed as exceptional or prior year. It will be considered later in this chapter.

Disclosures required by the UKLA Listing Rules

Purple Book requirements

Several Purple Book requirements (see Chapter 4) concern the profit and loss account:

- if the results for the period under review differ by 10% or more from any published forecast or estimate by the company for that period, an explanation of the difference must be given;
- a statement is required of the amount of interest capitalised;

ST IVES Extract from Directors' Remuneration Report 2003

	Basic salary	Bonus	Benefits in kind	Pension contributions (Note 1)	Total remuneration	
	£000	£000	£000	£000	2003 £000	2002 £000
<i>Executive</i>						
Wayne Angstrom	197.0	—	14.3	6.1	217.4	239.8
Brian Edwards	239.4	—	21.1	—	260.5	248.5
Miles Emley	261.9	—	16.0	76.9	354.8	344.6
Raymond Morley	176.0	—	0.6	—	176.6	176.0
<i>Non-executive</i>						
Lorraine Baldrey	20.0	—	—	—	20.0	20.0
Graham Menzies	20.0	—	—	—	20.0	20.0
David Wilbraham	<u>25.0</u>	—	—	—	25.0	<u>20.0</u>
	<u>939.3</u>	—	<u>52.0</u>	<u>83.0</u>	1,074.3	<u>1,068.9</u>

Miles Emley is the highest paid director.

Notes

- Pension contributions shown under individual directors' remuneration are in respect of money-purchase schemes only. In the case of Miles Emley the sum includes a salary payment of £19,473 (2002, £17,117) in addition to basic pay . . .

- (c) particulars must be given of the waiving of emoluments by any director, and of the waiving of dividends by any shareholder;
- (d) details of remuneration for *each director* must be given. See ST IVES on page 123.

Effect of accounting policies on profitability

Accounting policies

The company's accounting policies, which usually appear either as 'Note 1' to the accounts or as a separate statement, should be read carefully to see if there are any unusual features that might affect the company's reported profits.

Abnormal accounting policies which can materially alter the reported profits include:

1. *Valuation of stock.* The higher the value of stocks at the end of the period, the lower the cost of goods sold and the higher the profits. Stock valuation is to an extent subjective, so that when times are hard there is a temptation for management at the worst to inflate figures or at best simply to look through rose coloured spectacles at items which may prove to be unsaleable. To do this is to improve current results at the expense of the future.
2. *Depreciation.* The lower the charge for depreciation in a particular year, the higher the book value of fixed assets carried forward and the higher the profits. For example THORNTONS, the chocolate manufacturer and retailer, changed its policy on depreciation in 2000 and showed the effect of the change in a note:

THORNTONS Note on Accounting policies 2000

Tangible fixed assets and depreciation

... Following a change in strategic emphasis, which will result in fewer shop refits and shop openings, the useful life of Retail fixtures and fittings has been extended from 4 to 5 years. The effect in the period has been to reduce the depreciation charge for the Group by £1,966,000.

Without this change, Profit on ordinary activities before tax would have fallen from £11.085 million in 1999 to £3.546 million in 2000, rather than the reported figure of £5.512 million – a fall of 68% rather than a reported fall of 50%.

Thorntons had expanded their retail chain too fast, and were having to slow down. The new Chief Executive was refreshingly candid:

THORNTONS Extract from Annual report 2000

Chief Executive's review

Clearly we know that mistakes have been made in the past, but we understand how they arose and what we have to do to prevent their reoccurrence. . . . our marketing and NPD investment was poorly targeted and uncoordinated . . . over ambitious sales expectations for Easter . . .

Selection of an appropriate method of depreciation, the estimation of the useful life of an asset, and its residual value are all matters for management judgement (FRS 15, paras. 77, 93 and 95). This may differ from company to company.

3. *Capitalising expenditure.* All expenditure incurred by a company must either add to the value of the assets in the balance sheet or be charged in the profit and loss account. In the sense that it would otherwise be a charge against profits, any amount that can be capitalised will increase profits directly by the amount capitalised at the expense of the profits in future years, when increased capital values will require increased depreciation.

What is it reasonable to capitalise?

Items which are sometimes capitalised include:

- research and development;
- finance costs;
- starting-up costs.

Research and development

As explained earlier, under SSAP 13 *Research and development* all expenditure on research and development should normally be written off in the year in which it is incurred. However, where development is for clearly defined projects on which expenditure is separately identifiable and for which commercial success is reasonably certain, companies may if they wish defer charging development expenditure 'to the extent that its recovery can reasonably be regarded as assured'. Capitalised development expenditure should be separately disclosed.

Finance costs

Capitalising interest on a project during construction is a normal and reasonable practice provided interest is not capitalised outside the planned time-scale of the project. There are, indeed, strong arguments in favour of capitalisation:

- (i) finance costs are not intrinsically different from other directly attributable costs of constructing a tangible fixed asset;
- (ii) capitalising finance costs results in a tangible fixed asset cost that more closely matches the market price of completed assets;
- (iii) treating the finance costs as an expense distorts the choice between purchasing and constructing a tangible fixed asset;
- (iv) the accounts are more likely to reflect the true success or failure of the project.

The ASB would like to make capitalisation of interest mandatory but was influenced by the argument that ‘if capitalisation is to become mandatory, in theory notional interest should also be capitalised’. Otherwise, capitalisation of finance costs results in the same type of asset having a different book value, depending on the method of financing adopted by the enterprise. It is inconsistent to allow debt-funded entities to include interest costs in the cost of an asset, whilst prohibiting equity-funded entities from reflecting similarly the cost of capital in the cost of an asset.

But ‘notional interest’ would certainly be contentious. In the absence of international agreement, the ASB has maintained the optional capitalisation of finance costs (Appendix IV to FRS 15 *Tangible fixed assets*).

But FRS 15 tightens the rules. If a policy of capitalisation is adopted:

1. It must be consistently applied to all finance costs directly attributable to the construction of tangible assets.
2. The amount capitalised in any period may not exceed finance costs incurred in that period, so notional interest may not be capitalised.
3. Capitalised finance costs must be ‘directly attributable’, i.e. they must be incremental, avoidable if there had been no expenditure on the asset.
4. Finance costs are to be capitalised gross, i.e. before the deduction of any tax relief attributed.

5. All finance costs, as defined by FRS 4 *Capital instruments*, have to be capitalised, not just the interest on the debt. This means that issue costs that are deducted in arriving at the net proceeds of the debt instrument will be capitalised to the extent that they form part of the finance charge.
6. If a company borrows funds specifically to construct an asset, the costs to be capitalised are the actual finance costs during the period.
7. If the project has been financed from the company’s general borrowings, a detailed calculation method is laid down.
8. Capitalisation should begin when:
 - (a) finance costs are being incurred;
 - (b) expenditures for the asset are being incurred; and
 - (c) activities that are necessary to get the asset ready for use are in progress. Necessary activities can, in fact, start before the physical construction of the asset, for example technical and administrative costs such as obtaining permits.
9. Capitalisation must cease when the asset’s physical construction is complete and ready for use, even if it has not yet been brought into use.

Stopping companies from continuing to capitalise interest after completion closes a loophole used widely in the past whenever properties have proved harder to let than was originally expected.

LAND SECURITIES, easily the largest of all UK property companies, is unaffected, because it is also probably the most prudent:

LAND SECURITIES *Accounting policies 2003*

Investment properties Capitalisation of interest

Gross interest associated with direct expenditure on properties under development or undergoing major refurbishments is capitalised . . .

Interest is capitalised as from the commencement of the development work until the date of practical completion.

The capitalisation of finance costs is suspended, however, if there are prolonged periods when development activity is interrupted.

Most UK listed property companies do capitalise interest, and may need to revise their accounting policies. For example, the well-respected property company HELICAL BAR:

HELICAL BAR *Note to Accounting policies 1999*

Interest capitalised on development properties

Interest costs incurred on development properties are capitalised until the earliest of:

- the date when the development becomes fully let;
- the date when the income exceeds outgoings;
- a date within two years of completion to allow for letting

The note to Helical Bar's 2000 accounts showed that the group had changed the third criterion above to 'the date of completion of the development'. The note added that the change, made to adopt the requirements of FRS 15, has had no material effect on the group.

Starting-up costs

FRS 15 does not permit capitalisation of start-up costs unless 'the asset is available for use but incapable of operating at normal levels without such a start-up or commissioning period'. The costs of a commissioning period, necessary for running in of machinery or testing equipment, may be capitalised as part of the cost of the asset. But costs incurred when demand is low, for example in a new hotel or bookstore, do not meet the definition of being 'directly attributable': they have been incurred after physical completion and they are not necessary in order to use the asset.

In the past companies have sometimes capitalised starting-up costs when (or because) they were expanding faster than was prudent. When the new project failed to live up to expectations the company ran into serious trouble. SOCK SHOP provides a good example.

SOCK SHOP *Extracts from the 1988–89 accounts*

Accounting policies

Overseas subsidiary set-up costs

Costs incurred in establishing overseas operations in the first year are capitalised as intangible assets and amortised over 4 years on a straight-line basis commencing at the end of the first year.

<i>Intangible assets</i>	£000
Overseas subsidiary set-up costs:	
At beginning of period	–
Additions	<u>354</u>
At end of period	<u>354</u>

The capitalising of £354,000 was not, in itself, significant: it only represented 8% of reported pre-tax profits of £4.32m; but the overseas expansion proved disastrous: less than a year later the company

- reported an interim loss of £3.97m;
- announced heavy write-offs on the closure of 17 loss-making US outlets;
- went into receivership.

Changes of accounting policy

FRS 18 *Accounting policies* requires companies to flag up clear details of accounting policy changes:

- a brief explanation of why each new accounting policy is thought more appropriate;
- a prior year adjustment involving restatement of the previous year's figures (or a reason why this is not practicable);
- an indication of the effect of the change on the results for the current period (or a reason why this is not practicable).

Changes in accounting policies can have a dramatic effect on reported profits or losses, and result in a prior period adjustment (see page 159) as we showed in relation to ML LABORATORIES on page 50.

Often there will be no choice: the change of accounting policy is required by financial reporting standards. But it does help if exactly what is happening is spelled out:



Some companies change their accounting policies for no convincing reason other than to boost profits.

If this is spotted it is a danger signal, as with REGALIAN PROPERTIES:

REGALIAN PROPERTIES Note to the 1998 accounts**Change in Accounting Policy**

The newly adopted accounting policy provides that sales and profits will be recognised when . . . the Group is contractually entitled to issue a notice requiring the purchaser to complete.

The effects of the change in policy are as follows:

	<i>Turnover</i>	<i>Profit</i>
	<i>£000</i>	<i>before tax</i>
	<i>£000</i>	<i>£000</i>
1998 – Prior accounting policy	40,167	2,629
Effect of change	<u>17,812</u>	<u>4,083</u>
1998 – As reported in accounts	<u>57,979</u>	<u>6,712</u>

Changes of presentation

Companies also change their minds upon how certain transactions should be treated and there is nothing sinister or unusual about that. They may not even tell you provided they consider the change is not ‘material’ and the auditors agree. AVIVA includes details in a note on Changes in accounting policy:

AVIVA Note to the 2003 accounts**3 Changes in accounting policy**

(a) Additional value of . . .

(b) **Presentational changes**

(i) in . . .

(ii) The Group’s wealth management result was previously shown separately, but is now shown as part of the result from non-insurance operations. The result reclassified in 2003 is nil ((2002: loss of £30 million).

Retirement benefits

SSAP 24 *Accounting for pension costs* requires the employer to ‘recognise the expected cost of providing pensions on a systematic and rational basis’ over the period of employment. Cash accounting is not permitted, and companies are required to disclose detailed information on their pension arrangements.

In November 2000 the ASB issued FRS 17 *Retirement benefits* which comes fully into force for accounting periods beginning on or after 1 January 2005, although earlier adoption is encouraged.

In view of the complexity of FRS 17, and the problems of gathering together information for disclosure purposes, the ASB has given companies the option of phasing in the new Standard over a long transitional period.

In view of the lengthy transitional period, we will cover the requirements of both SSAP 24 and FRS 17.

Types of pension scheme

Pension schemes can be either funded or unfunded:

- In a *funded* scheme, the company’s contributions (and the employees’ contributions if it is a ‘contributory’ rather than a ‘non-contributory’ scheme) are paid away to be invested externally to meet future pension liabilities, and the assets of the scheme are held in trust outside the company.
- In an *unfunded* scheme, which is the norm in some foreign countries, the company makes a provision for future liabilities in its accounts.

There are three types of pension scheme in the UK:

1. The State Second Pension. Companies pay the employer contribution and have no further liability.
2. Defined contribution schemes.
3. Defined benefit schemes.

Defined contribution schemes and defined benefit schemes are invariably funded.

Defined contribution schemes

In a defined contribution or ‘money purchase’ scheme, the employer has no obligation beyond payment of the contributions he has agreed to make. The benefits may vary with the performance of the investments purchased by the contributions, but this risk is borne by the employees.

The cost of providing pensions is thus straightforward: it is the amount of contribution due for the period, and will be charged against profits, e.g. TESCO:

TESCO Note on pension commitments 2003**26. Pensions**

...

The Group operates a number of schemes worldwide, the majority of which are defined contribution schemes. The contributions payable for non-UK schemes of £8m (2002, £7m) have been fully expensed against profits in the current year

- the accounting policy and, if different, the funding policy and any resulting provisions or prepayments;
- the pension cost charge and the reasons for any significant change from the previous year;
- details of the expected effects on future costs of any material changes in pension arrangements.

Because several schemes are often involved, sometimes in several countries, notes on pensions can be exceedingly long and complex. Most tend to be in narrative form, e.g. TESCO:

TESCO Note on pension commitments 2003**Pension commitments**

The principal plan within the Group is the Tesco plc pension scheme, which is a funded defined benefit pension scheme in the UK, the assets of which are held as a segregated fund and administered by trustees. The total profit and loss charge of UK schemes to the Group was £114m (2002 – £97m).

An independent actuary . . . carried out the latest actuarial assessment of the scheme at 31 March 2002 . . . The key assumptions made were:

Rate of return on investments	6.75%
Rate of increase in salaries	4%
Rate of increase in pensions	2.5%

. . . the market value of the scheme's assets was £1,576m and the actuarial value represented 91% of the benefits that had accrued to members . . . The actuarial shortfall of £159m will be met by increased contributions over the period of 10 years, being the expected average service lifetime of employed members. . . .

The Group operates a number of schemes worldwide, the majority of which are defined contribution schemes. . . .

A defined benefit scheme operates in the Republic of Ireland. At the latest actuarial valuation . . .

Smaller companies tend to run this type of scheme, or to contribute to SERPS or to employees' own Personal Pension Plans, in order to avoid taking on any open-ended future commitment. Indeed, a number of larger companies have in recent years closed defined benefit schemes and moved to defined contribution schemes to avoid this liability.

Defined benefit schemes

In a defined benefit or 'final salary' scheme, the pensions to be paid depend on the employees' pay, normally the pay in the final year of employment, so the employer's liability is open-ended.

Because of the complexities of estimating the contributions needed to provide for pensions based on wages or salaries often many years hence, consulting actuaries are used to carry out periodic valuations, usually every three years, and to determine the contribution rate required.

Where an actuarial valuation reveals a material deficiency or surplus in a defined benefit scheme, SSAP 24 requires that it should normally be taken into account by adjusting the current and future costs in the accounts over the remaining service lives of the current employees, or over the average life. See SSAP 24, paras. 81 to 83 for exceptions.

Actuaries use a number of techniques and assumptions in arriving at a valuation, and they do not all use the same ones. SSAP 24 explains the terminology, e.g. 'attained age' or 'projected unit' method. Where there are changes to the actuarial assumptions, or to the valuation method or to the benefits of the scheme, their effect on pension costs should also be spread over the remaining service lives or average life.

The disclosure requirements of SSAP 24 are very extensive. Items of particular interest to the analyst are:

TESCO is among a growing number of companies that operate a scheme offering post-retirement healthcare benefits. The cost of providing for these benefits is usually accounted for on a basis similar to that used for defined benefit pension schemes. Companies listed in the USA are required to disclose the provision for such schemes, which can be massive, e.g. SHELL in its 2002 accounts provided \$2,445m in respect of unfunded post-retirement benefits other than pensions.

What to look for

What is important to the analyst is:

- the regular cost of pensions, which represents a very long-term obligation;
- variations from regular cost, the reasons for them, and the time over which they are likely to persist;
- changes in actuarial assumptions, and the reasons for them;
- changes in benefits and their probable future cost;
- any very substantial increase in salary (often to a departing chief executive subject to a final salary scheme);
- any unfunded liability;
- any significant unexplained prepayment to the pension fund;
- investment of the pension fund in assets used by the company.

A tabular presentation often makes funding assumptions easier to understand and interpret and goes some way to bring out that:

- Pension funding is a very long-term business.
- It is necessary to make assumptions about matters which are very difficult to predict (e.g. the rate of inflation over, say, the next 30–40 years, mortality over that period, and the performance of the stock market as a whole, and that of the fund's investment managers in particular).
- Benefits payable tend to improve over time.

Problems faced by actuaries and pension funds

On 2 July 1997 the Chancellor announced that 'payment of tax credits will be abolished for charitable companies on dividends paid on or after today'. This completely changed one key long-term assumption made by all funds: the assumed return on investments.

The National Association of Pension Funds (NAPF)'s Chairman estimated at the time that the Chancellor's move would require UK pension schemes to contribute an extra £50bn over the next 10 years. He went on: 'Even Robert Maxwell only took £400m.' The changes in the tax system could not have come at a more unfortunate time. Pension schemes are still relatively new. For the last 20–30 years, as funds built up, contributions, in general, exceeded outgoings. Only recently have we begun to see mature funds

in which pensions and other benefits being paid exceed the contributions coming in, increasing the fund's dependence on investment income.

Wide-awake companies like DIAGEO asked their actuaries what effect all this is likely to have. They seem undismayed.

DIAGEO Extract from Note 5 to the 2003 accounts

(i) **SSAP 24 disclosures** . . . The principal plans are in the UK, Ireland, the US and Canada. All valuations were performed by independent actuaries using the projected unit method to determine pension costs. The principal assumptions were: real rate of return on assets 4% . . . real annual increase in wages and salaries 2.0% to 2.5% . . . real rate of future dividend growth for UK equities 1% . . . and pension increases approximately in line with inflation . . . The actuarial value of the assets of those plans at 30 June 2002 was sufficient to cover approximately 123% of the benefits that have accrued.

Disclosure of information

By law most types of pension scheme must, within seven months after the end of the scheme year, make available an annual report, including audited accounts. Trustees who fail to do this are guilty of a criminal offence, and liable to a fine. A SORP, *Financial reports of pension schemes*, reflects the accounting requirements.

FRS 17 Retirement benefits

SSAP 24 was criticised on a number of grounds:

- it allowed preparers of accounts too many options, resulting in inconsistency in accounting practice;
- it resulted in poor disclosures, thus preventing users from making informed judgements on how companies had accounted for pension cost issues;
- it resulted in balance sheet prepayments and provisions which were almost impossible to explain or to interpret.

FRS 17 addresses these criticisms by introducing major changes in accounting and disclosure requirements for *defined benefit* pension schemes.

There are no changes in the requirements for *defined contribution* schemes.

The full requirements of FRS 17 will be reflected in the balance sheet, the profit and loss account, and the statement of total recognised gains and losses, as well as in the notes.

Key points are:

- Full actuarial valuations of pension scheme liabilities will be required at least three-yearly, with updates in other years.
- The balance sheet will include one-line items for pension fund asset (assuming a surplus) and pension fund reserve. The pension fund asset is the amount by which the total value of the scheme assets exceeds the present value of the scheme liabilities.
- The profit and loss account will include two charges or credits:
 - (1) operating profit will be charged with current service cost and past service cost;
 - (2) finance income will be credited (debited) with the amount by which the expected return on scheme assets exceeds (falls short of) the interest on pension scheme liabilities.
- The statement of total recognised gains and losses will pick up actuarial gains and losses.
- Movement in surplus or deficit in schemes over the period will be analysed with reconciliation of surplus / deficit to the balance sheet asset / liability.
- A company will have to build up to a five-year statistical summary.

Main points of interest for users of accounts will be:

- The balance sheet will show the pension scheme's surplus or deficit to the extent that the employer company expects to benefit or suffer from it.
- The profit and loss account will show the ongoing service cost, interest cost and expected return on assets.
- The statement of total recognised gains and losses will record and reflect market fluctuations in interest rates and share prices.
- A trend picture will be highlighted by the disclosure of a five-year history of actuarial gains and losses – making users aware of when actuarial assumptions are consistently not being met.

Exceptional items

Basic purpose of the profit and loss account

There are two conflicting views of the basic purpose of the profit and loss account:

- (a) the current operating performance concept;
- (b) the all-inclusive concept.

(a) Current operating performance concept

Advocates of the current operating performance concept believe that the profit and loss account should be designed to disclose the earnings of the business which arise from the *normal operating activities* during the period being reported upon; anything exceptional, extraordinary or relating to prior years, and the effects of accounting changes, would be excluded.

A profit and loss account prepared in this way facilitates comparison both with those of the same business for earlier periods and with those of other companies for the current period.

(b) All-inclusive concept

Advocates of the all-inclusive concept, on the other hand, believe that the profit and loss account should include *all transactions* which bring about a net increase or decrease in net tangible assets during the current period, apart from dividend distributions and transactions such as the issue of shares.

There has been a shift of opinion towards the all-inclusive concept during the past few years, not only in the UK but also in the USA and Canada, although none of these countries adopts a pure all-inclusive basis.

Is it extraordinary or exceptional?

Prior to FRS 3 *Reporting financial performance*, published in 1993, companies were allowed to show *extraordinary items* 'below the line' in their profit and loss account, i.e. below the figure for profit attributable to ordinary shareholders, on which earnings per share were calculated, while *exceptional items* came 'above the line'.

This led to widespread abuse: companies tended to classify unusual losses as extraordinary and unusual profits as exceptional, in order to enhance their reported earnings per share. In some cases the questionable classifications of items more than doubled reported profits, e.g. in 1990 the hotel group STAKIS reported a pre-tax profit of £30.6m which included gains on the sale of properties of £18.5m. (Management was replaced in 1991.)

In order to stop what had probably become the most widespread form of creative accounting, FRS 3 not only produced a much tighter definition of an extraordinary item, so as to make them extremely rare, but also requires extraordinary (as well as exceptional) items to be included in the calculation of earnings per share.

FRS 3 definition

Extraordinary items are ‘Material items possessing a high degree of abnormality which arise from events or transactions that fall outside the ordinary activities of the reporting entity and which are not expected to recur. They do not include exceptional items nor do they include prior period items merely because they relate to a prior period’ (FRS 3, para. 6).

In practice extraordinary items are now virtually extinct.

Exceptional items are ‘Material items which derive from events or transactions that fall within the ordinary activities of the reporting entity and which individually or, of a similar type, in aggregate, need to be disclosed by virtue of their size or incidence if the financial statements are to give a true and fair view’ (FRS 3, para. 5).

One consequence of FRS 3 is that profits before taxation now have to include large ‘one-off’ items. This has led to much increased volatility, in some cases even turning a profit into a loss.

FRS 3 has not met with universal approval either among companies or analysts. Although the computation of earnings per share is explained in Chapter 18, this is nevertheless an appropriate point to consider the adjustments which analysts make. In order to focus on the profitability of the normal trading operations of a company (i.e. to move nearer to a current operating performance basis as described above), the Institute of Investment Management and Research (IIMR) has developed a standard approach to reported profits, which eliminates capital transactions and abnormal items. This produces what are called the *headline earnings*.

‘Headline’ or ‘normalised’ earnings

Headline earnings exclude the following items:

1. Profits or losses on the sale or termination of an operation.
2. Profits or losses on the disposal of fixed assets.
3. Expropriation of assets.
4. Amortisation of goodwill.
5. Bid defence costs.
6. Diminution in the value of fixed assets.
7. Profit or loss on the capital reorganisation of long-term debt.
8. Profits or losses on the disposal of trade investments.

The IIMR approach, focusing on the trading activities of a company, has been followed by most leading stock-brokers, to produce what are termed *normalised earnings*, but with some variations.

The main variation between brokers is that some follow the IIMR recommendation to include ‘costs of a fundamental reorganisation or restructuring having a material effect on the nature and focus of the reporting entity’s operations’ (one of the items shown separately below operating profit), while others exclude it on the grounds of abnormality and of being unlikely to recur.

The trouble with excluding it is that doing so encourages companies to classify relatively minor reorganisations as ‘fundamental’ in order to avoid the costs reducing ‘normalised’ profits and earnings per share.

The other problems with adjusting or ‘normalising’ earnings are taxation and minority interests. With the three items that have to be disclosed separately after operating profit (sale or termination of an operation, fundamental reorganisation and restructuring, and disposal of fixed assets), FRS 3 requires relevant information on the effect of these items on the tax charge and on any minority interests (see Chapters 20 and 21) to be shown.

With the other items listed by the IIMR for stripping out, e.g. expropriation of assets, the effect on the tax charge may have to be estimated by the analysts. And the effect on minorities will not be known unless disclosed by the company.

FRS 3 Reporting financial performance

Besides greatly increasing the number and amount of items appearing on the face of the profit and loss account

as exceptional, FRS 3 introduced two new and valuable features to the profit and loss account:

1. **Subdivision of results** down to operating profit level into Continuing operations; Acquisitions (considered in Chapters 20 and 21); and Discontinued operations.
2. **Separate disclosure**, after operating profit and before interest, of three important items:
 - (a) profits or losses on the sale or termination of an operation,
 - (b) costs of a fundamental reorganisation or restructuring having a material effect on the nature and focus of the reporting entity's operations, and
 - (c) profits or losses on the disposal of fixed assets.

Items (a), (b) and (c) are sometimes referred to as 'the paragraph 20 items', because they are contained in para. 20 of FRS 3.

The way exceptional items might be handled is illustrated in two examples in FRS 3:

- a single-column format, and
- a multi-column format.

Comparative figures

The analysis of comparative figures between continuing and discontinued operations is not required on the face of the profit and loss account. Nevertheless, experience suggests that most companies do show it there.

Whichever method is employed, the composition of the comparative figures needs to be understood. As para. 64 of the Explanations to FRS 3 explains:

To aid comparison, the comparative figures in respect of the profit and loss account should be based on the status of an operation in the financial statements of the period under review and should, therefore, include in the continuing category only the results of those operations included in the current period's continuing operations. . . . the comparative figures for discontinued operations will include both amounts relating to operations discontinued in the previous period and amounts relating to operations discontinued in the period under review, which in the previous period would have been included as part of continuing operations.

Ratios

Most well-run companies of any size make extensive use of ratios internally, to monitor and ensure the efficient running of each division or activity.

In addition to the published report and accounts of a group, resort can be made to Companies House for accounts filed by subsidiaries, although these can be misleading

- if goods and services have been transferred within the group at unrealistic prices; or
- if major adjustments have been made on consolidation.

In any case, the accounts of subsidiaries are often not filed at Companies House until some time after the group accounts have been published.

Horizontal analysis

The simplest method of comparing one year's figures with another involves working out the percentage change from the previous year of each main component of the accounts, as with BRANDON HIRE, a company which employs the single-column format to display the effects of acquisitions in its profit and loss account.

Percentage changes in themselves may reveal a certain amount about a company's performance, but, like many ratios, they are of most value in prompting further enquiry. For example: What did Brandon Hire acquire in 1999? Why was the 23.0% margin so much higher than Brandon's own 13.5%?

Are they in areas where Brandon could expand?

BRANDON HIRE *Extract from 1999 P & L account*

	1999	1998
	£000	£000
Turnover		
Tool hire – Continuing operations	21,907	16,859
Acquisitions	<u>1,596</u>	<u>3,465</u>
	23,503	20,324
Catering hire		
– Discontinued operations	<u>–</u>	<u>7,381</u>
	<u>23,503</u>	<u>27,705</u>
Operating profit		
Continuing operations	2,947	2,252
Acquisitions	<u>367</u>	<u>596</u>
Total operating profit	<u>3,314</u>	<u>2,848</u>

BRANDON HIRE Year-on-Year analysis**Continuing operations**

Turnover 1999/1998	21,907/20,324	=	+7.8%
Operating profit	2,848/2,947	=	+3.5%
Margins 1998	2,252/16,859	=	13.4%
1999	2,947/21,907	=	13.5%

Acquisitions

Margins 1998	596/3,465	=	17.2%
1999	367/1,596	=	23.0%

Comment

The company is making some high margin acquisitions, but they are relatively small, and will have little impact unless they can be expanded.

Vertical analysis

Year-on-year comparisons can be thought of as working across the page, comparing each item with the previous year to get the percentage change, or looking at several years to see the trend of an item.

If we work vertically, calling the total 100, we can construct what are termed 'common size' statements giving a percentage breakdown of an account item.

The advantages of this method are, firstly, that the items are reduced to a common scale for inter-company comparisons and, secondly, that changes in the financial structure of a company stand out more clearly.

Vertical analysis can be used over several years to show how the sales/profitability pattern or financial structure of a company is changing.

Operating ratios

The three main operating ratios are:

1. Profit margin.
2. Return on capital employed.
3. Sales to capital employed.

$$1. \text{ Profit margin} = \frac{\text{Trading profit}}{\text{Sales}} \text{ as a \%}$$

where:

Trading profit = profit before interest charges and tax. Investment income and the company's share of the profits of associated undertakings are not included.

Sales (Turnover) = Sales (excluding VAT and excluding transactions within the group).

This ratio gives what analysts term the profit margin on sales; a normal figure for a manufacturing industry would be between 8% and 10%, while high volume/low margin activities like food retailing can run satisfactorily at around 3%. This profit margin is not the same thing as the gross profit margin (the difference between selling price and the cost of sales, expressed as a percentage of selling price), which can be obtained only if the company reports cost of sales (as BRANDON HIRE does, in a note to the accounts).

Unusually low margins can be set deliberately by management to increase market share or can be caused by expansion costs, e.g. new product launching, but in general depressed margins suggest poor performance.

Somewhat better than average margins are normally a sign of good management, but unusually high margins may mean that the company is 'making a packet' and will attract competition unless there are barriers to entry (e.g. huge initial capital costs, high technology, patents or other special advantages enjoyed by the company).

The converse also applies: if a company has lower margins than others in the same sector, there is scope for improvement. For example, between 1985 and 1993 TESCO managed to more than double its margins as it shifted away from the 'pile it high and sell it cheap' philosophy of its founder, the late Sir Jack Cohen, towards SAINSBURY's quality image and better margins. As the table below shows, neither is now finding it easy to maintain margins, let alone to continue to increase them, and SAINSBURY's have tumbled.

Example 16.3 Comparison of margins

Year ended	1985	1993	1997	2002
TESCO	2.7%	6.5%	5.6%	5.6%
SAINSBURY	5.1%	8.1%	5.2%	4.1%

Trading profit margins are also important in that both management and investment analysts usually base their forecasts of future profitability on projected turnover figures multiplied by estimated future margins.

An alternative definition of trading profit, used by Datastream and some analysts, is before deducting depreciation, the argument being that different depreciation policies distort inter-company comparisons. If this approach is used, then trading profit should also be before deducting rental

charges, to bring a company that leases rather than owns plant and premises on to a comparable basis. Our view is that depreciation is a cost and should be deducted in any calculation of profit; we therefore prefer to deal with cases where a company's depreciation charge seems unduly low (or high) by making an adjustment, rather than by adding back every company's depreciation charge. Datastream also excludes exceptional items.

$$2. \quad \frac{\text{Return on capital employed}}{\text{Trading profit}} = \frac{\text{Capital employed}}{\text{Capital employed}}$$

Return on Capital Employed (ROCE), expressed as a percentage, is a traditional measure of profitability for several reasons:

- a low return on capital employed can easily be wiped out in a downturn;
- if the figure is lower than the cost of borrowing, increased borrowings will reduce earnings per share (e.p.s.) unless the extra money can be used in areas where the ROCE is higher than the cost of borrowing;
- it serves as a guide to the company in assessing possible acquisitions and in starting up new activities – if their *potential* ROCE isn't attractive, they should be avoided;
- similarly, a persistently low ROCE for any part of the business suggests it could be a candidate for disposal if it isn't an integral part of the business.

ROCE can be calculated either for the company overall or for its trading activities:

Capital employed (in trading) = Share capital + reserves + all borrowing including obligations under finance leases, bank overdraft + minority interests + provisions – associates and investments. Government grants are not included.

Capital employed (overall) Associates and investments are not deducted, while the overall profit figure includes income from investments and the company's share of the profits of associated companies, in addition to trading profit.

However, ROCE can be seriously distorted by intangible fixed assets and by purchased goodwill that has been written off directly to reserves (immediate write-off). Ideally, purchased goodwill that was written off direct to reserves should be added back in calculating ROCE, but FRS 10 does not require this in the accounts; and information which would allow analysts to do this for themselves is not always available.

We suggest that intangible items shown in the balance sheet should be included in capital employed at their cost less any subsequent amortisation; e.g. patents, newspaper titles and brand names that have been purchased, but not newspaper titles and brand names that have been built up internally. As Sir Adrian Cadbury said, after RHM had put £678m of brands at valuation in its balance sheet: 'The market value of a company's brands can only be established objectively when their ownership is transferred. Any other form of valuation is by definition subjective.'

The figure for capital employed should, strictly speaking, be the average capital employed during the year, but for simplicity's sake it is normally satisfactory to use the capital employed at the end of the year unless there have been major changes. Some companies label the total at the bottom of their balance sheet as 'capital employed' (BRANDON HIRE shows Equity shareholders' funds). But using the balance sheet total can be deceptive, in that bank overdrafts and loans repayable within 12 months are netted out against current assets, giving a company that has perhaps an embarrassingly large short-term debt a better ROCE than a company whose debt is more prudently funded long-term.

Another variation used by some analysts is to deduct any cash from the overdraft or, where a company has a net cash position, to deduct net cash in calculating capital employed. Netting out cash against overdraft can be justified where cash and overdraft are both with the same bank and the bank is known to calculate interest on the net figure (overdraft – cash), but in general we accept the figures used for the purposes of FRS 5 *Reporting the substance of transactions* and FRS 1 *Cash flow statements*.

If a company feels it prudent to operate with a large cash margin it should be measured accordingly, and if the company's cash is locked up somewhere (e.g. if it has arisen from retaining profits overseas to avoid UK taxation) the situation should be reflected in the ratio.

Any upward revaluation of property is likely to reduce ROCE in two ways:

- (a) it will increase capital employed (the surplus on revaluation being credited to capital reserve), and
- (b) it will probably increase the depreciation charge, and thus reduce profits.

See Chapter 8 regarding valuations under FRS 15 *Tangible fixed assets*.

3. Sales Capital employed in trading

expressed as a multiple.

Improving the return on capital employed

A rising Sales/Capital employed ratio usually indicates an improvement in performance, i.e. the amount of business being done is increasing in relation to the capital base, but beware of an improvement in the ratio achieved when a company fails to keep its plant and machinery up to date; depreciation will steadily reduce the capital base and improve the ratio without any improvement in sales. Beware, too, of any rapid increase in the ratio, which may well be a warning signal of *overtrading*, i.e. trying to do too much business with too little capital.

In inter-company comparisons care should be taken to compare like with like: the ratio can be misleading unless the operations of the companies concerned are similar in their activities as well as in their products. For example, a television manufacturing group which is vertically integrated (makes the tubes, electronic circuits and the cabinets and then puts them together) will have much more capital employed than a company which merely assembles bought-in components.

A better measure of performance might be that of value added compared with capital employed, but value added is rarely included in published information.

The three ratios are, of course, interrelated:

$$\frac{\text{Trading profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Capital employed}} = \frac{\text{Trading profit}}{\text{Capital employed}}$$

as seen from BRANDON HIRE:

BRANDON HIRE Extracts from 1999 accounts		
	1999	1998
	£000	£000
Sales (Turnover)	23,503	20,324
Operating profit	3,314	2,848
Capital employed	20,592	20,948
BRANDON HIRE Ratios		
Profit margin	14.1%	14.0%
Return on capital employed	16.1%	13.6%
Sales/Capital employed	1.14	0.97

In 1999 Brandon Hire managed to do more business than in 1998 on slightly less capital employed, with maintained margins.

The ratio Trading profit/Capital employed helps to illustrate the four ways in which management can improve this ratio:

1. by increasing the first factor by:
 - (a) reducing costs or
 - (b) raising prices,

to produce higher profit margins;
2. by increasing the second factor by:
 - (a) increasing sales or
 - (b) reducing capital employed,

so raising volume of output per £1 of capital.

A healthy way of improving profitability is to dispose of low profitability/high capital parts of the business, provided this can be done without adversely affecting the remainder.

Massaging the figures

There was another way of producing the same optical effect other than by running down capital investment: by leasing rather than buying plant and machinery (or by selling and leasing back fixed assets already owned), but this loophole has largely been closed by SSAP 21 *Accounting for leases and hire purchase contracts*, which requires companies to capitalise financial leases in their balance sheet (see Chapter 15).

Two other ways in which companies used to be able to reduce their apparent capital employed were by factoring their debtors and by off balance sheet financing of stock. FRS 5 *Reporting the substance of transactions* requires both the debtors and the stock to remain on the balance sheet unless the risks and rewards have been transferred to the other party; i.e. unless the factor has no recourse to the company on bad debts, and the company has no obligation to repurchase the stock.

Segmental reporting

Accounting standard

SSAP 25 *Segmental reporting* requires companies which have two or more classes of business or which operate in two or more geographical segments to report turnover, profit and net assets for each class of business and for each geographical segment: e.g. DIAGEO (see below).

Analysis of profitability

The analyst can work on a segmental analysis, calculating various ratios and using them to compare performance between classes of business and between geographical areas.

Return on capital employed (ROCE) is widely used internally for management decisions, but for the external analyst the ratio can have serious problems because of:

1. The different ways in which companies define capital employed.
2. The huge amounts of purchased goodwill that companies wrote off under earlier accounting rules (see Chapter 20).
3. The differences in the ways companies allocate central overheads and finance costs.

For these reasons many analysts no longer use ROCE, focusing instead on margins.

For example DIAGEO's margins (Operating profit/Turnover), using the figures in the table below, show:

DIAGEO Extract from a note to the accounts for the year ended 30 June 2003

Segmental information by class of business

	<i>Discontinued operations</i>				<i>Total £million</i>
	<i>Premium drinks £ million</i>	<i>Other £million</i>	<i>Packaged food £million</i>	<i>Quick service restaurants £million</i>	
2003					
Turnover	8,961	–	–	479	9,440
Operating profit before exceptional items	1,976	–	–	53	2,029
Exceptional items charged to operating profit	(168)	–	–	–	(168)
Operating profit	1,808	–	–	53	1,861
...					
2002					
Turnover	8,704	–	1,455	1,123	11,282
Operating profit before exceptional items	1,766	–	184	156	2,106
Exceptional items charged to operating profit	(432)	–	–	(21)	(453)
Operating profit	1,334	–	184	135	1,653
...					

Geographical information

	<i>Great Britain £million</i>	<i>Rest of Europe £million</i>	<i>North America £million</i>	<i>Asia Pacific £million</i>	<i>Latin America £million</i>	<i>Rest of World £million</i>	<i>Total £million</i>
2003							
Turnover	1,472	2,568	3,159	1,008	481	752	9,440
Operating profit	158	431	713	243	135	181	1,861
...							
2002							
Turnover	1,601	2,603	4,717	1,001	639	721	11,282
Operating profit	151	511	426	229	188	148	1,653

DIAGEO Margins in 2002 and 2003

	2003	2002	Change
Class of business			
Premium drinks	20.2%	15.3%	13.2%
<i>Discontinued operations</i>			
Packaged food	–	12.6%	–
Quick service restaurants	11.1%	12.0%	(7.5%)
Geographical area			
Great Britain	10.7%	9.4%	13.8%
Rest of Europe	16.8%	19.6%	(14.3%)
North America	22.6%	9.0%	151.1%
Asia Pacific	24.1%	22.9%	5.2%
Latin America	28.1%	29.4%	(4.4%)
OVERALL	19.7%	14.6%	34.0%

At the same time note should be taken of the Chairman's statement, the Chief Executive's report or review of operations and/or Financial review as, in a good set of accounts, these will contain comment on marked changes, they may indicate strategy, and they may give further details. e.g. DIAGEO:

DIAGEO Extracts from 2003 report**Chairman's statement**

...

there are signs of returning consumer confidence in North America. US consumers are the engine which drives the economy for consumer goods. If they are confident then we have cause to be so.

Chief Executive's review

...

we completed our exit from food by the sale of Burger King. Our determination to acquire Seagram's spirits and win brands has been well rewarded. That transaction has generated significant value for Diageo, and is already delivering very high quality returns in an industry where further consolidation is widely anticipated.

Non-disclosure

Segmental information need not be disclosed if doing so is considered by the directors to be seriously prejudicial to the interests of the company, e.g.:

WATERMARK Note to the 2000 accounts**Segmental analysis**

In the opinion of the directors the segmental reporting of results would be seriously prejudicial to the business and accordingly it has not been disclosed.

Introduction

A UK resident company is liable to Corporation Tax (CT) on its income and capital gains, and until 5 April 1999 had to pay advance corporation tax (ACT) when it distributed dividends. If it has income taxable abroad, it will also suffer overseas tax. All this appears in the profit and loss account under the heading 'Taxation'.

VAT, Excise Duty, employee PAYE and other forms of taxation that the company may bear or be involved in are not normally shown (e.g. POWERGEN showed only by way of note that its figures for tax charge 'exclude the exceptional windfall tax of £266m, of which the first instalment of £133m was paid in December 1997').

Tax in the profit and loss account

Schedule 4 of the Companies Act 1985 requires taxation to be shown in the profit and loss account under three headings:

1. Tax on profit or loss on ordinary activities.
2. Tax on extraordinary profit or loss.
3. Other taxes not shown under the above.

The notes to the accounts should give details of the basis of computation, any special circumstances affecting the tax liability, and under para. 54(3):

- (a) the amount of UK corporation tax;
- (b) the extent of double taxation relief;
- (c) the amount of UK income tax; and
- (d) the amount of foreign tax charged to revenue.

The notes may also include details of:

- (e) irrecoverable ACT;
- (f) over/under-provision for prior years' taxation;
- (g) deferred taxation;
- (h) taxation on share of profit on associated undertakings.

Air charter company AIR PARTNER's P & L account illustrates a tax charge where overseas taxation is involved:

AIR PARTNER note to the 2000 accounts

7. Tax on profit on ordinary activities

	2000	1999
	£000	£000
The tax charge is based on the profit for the year and comprises:		
UK corporation tax	762	714
Prior year	(50)	(25)
Double taxation relief	(89)	—
Overseas taxation	<u>278</u>	<u>268</u>
	<u>901</u>	<u>957</u>

The taxation charge represents an effective tax rate of 33.8% (1999: 34.5%) compared to the applicable charging rate of 30.0% (1999: 30.7%) as a result of certain disallowable expenses and the higher rates of tax payable by some of the foreign subsidiary companies.

Tax in the balance sheet

In the balance sheet taxation will appear:

1. Under *Creditors falling due within one year*: the amount falling due within one year will, typically, include one

year's corporation tax, and any foreign tax due. Large companies (i.e. those with taxable profits of £1.5m or more) are required to make quarterly payments (due on the fourteenth day of months 7, 10, 13 and 16 following the start of the accounting period).

2. **Under provisions:** any provision for deferred taxation (see pages 140–1) and any provision for other taxation, shown separately (CA 1985, Sch. 4, para. 47).

Tax in the cash flow statement

FRS 1 *Cash flow statements* lays down that the cash flow statement should list cash flows for the period classified under eight standard headings, the third of which is 'Taxation'. In the past this item has normally represented one year's payment of corporation tax (that for the previous tax year) and, in the case of a group with foreign activities, one year's overseas tax (usually shown separately).



Is the tax charge 'normal'?

If not, WHY NOT?

The tax charge shown in the profit and loss account is unlikely to be 'normal', i.e. what the layman might expect, namely, pre-tax profits \times average rate of corporation tax during the company's accounting year. It is important to understand why this is the case.

The amount of corporation tax payable does not depend purely on the company's pre-tax profit figure. The tax charge varies not only because of differences that arise between the taxable profit and the profit shown in the company's accounts (the 'book profit'), but because of differences in the rate charged on particular types of income.

The differences fall into two categories:

1. **Timing differences**, where the company may be liable to pay the full rate of tax at some time, but not in the year being reported upon (see below).
2. **Permanent differences** where expenses are disallowed or income is tax-free or is taxed at a rate other than that of UK corporation tax (see pages 142–4).

One of the most important examples of a *timing* difference is capital expenditure, where capital allowances are allowed for tax purposes, but depreciation is charged for accounts purposes.

Example of a timing difference

A company pays less corporation tax than normal if the capital allowances received for the year are greater than the amount the company provides for depreciation, as Example 17.1 shows.

Advance corporation tax from earlier years

Prior to 5 April 1999 a company, when it paid dividends to its shareholders, had to hand over to the Inland Revenue *advance corporation tax* (ACT).

ACT was part payment of the company's Corporation Tax liability for the period in which the dividend was paid. (The remaining corporation tax payable was referred to as *mainstream corporation tax*.)

Example 17.1 Depreciation and capital allowances

If a large company invested £1m in plant and machinery in 2001 and used straight line depreciation spread over an expected 10-year life, the capital allowances and depreciation would be:

	<i>Capital allowances</i>	<i>Depreciation</i>
	£	£
2001	250,000	100,000
2002	187,500	100,000
2003	140,625	100,000
2004	105,469	100,000
2005	79,102	100,000
2006	59,326	100,000
2007	44,495	100,000
2008	33,371	100,000
2009	25,028	100,000
2010	<u>75,084</u>	<u>100,000</u>
	1,000,000	1,000,000

Note: This assumes that trading ceased in 2010 and that the plant and machinery had no residual value. If the company continued trading, the allowances would continue ad infinitum at 25% a year on the declining balance, i.e. £18,771 in 2010, £14,078 in 2011 . . . £334 in the year 2024, and so on.

The advantage of the reducing balance method is that it simplifies calculations.

If the company made taxable trading profits before capital allowances of £2m in each of the ten years and we ignore all other allowances for the purpose of

illustration, the corporation tax payable, assuming a 30% rate throughout, would be:

	<i>Taxable profit</i> £	<i>Corporation tax liability</i> £
2001	1,750,000	525,000
2002	1,812,500	543,750
2003	1,859,375	557,813
2004	1,894,531	568,359
2005	1,920,898	576,269
2006	1,940,674	582,202
2007	1,955,505	586,651
2008	1,966,629	589,989
2009	1,974,972	592,492
2010	<u>1,924,916</u>	(Note 1) <u>577,475</u>
	<u>19,000,000</u>	(Note 2) <u>5,700,000</u>

Notes:

1. Assuming trading ceases in 2010 and the plant and machinery has no residual value, to give capital allowances of £75,084 that year.
2. The reported profit before tax each year would be £1,900,000 (£2m less £100,000 depreciation), so the total taxable profit over the 10 years would be the same as the total reported profit, and the total tax payable would be the same as a tax charge of 30% each year on reported profit.

Although ACT was abolished on 6 April 1999, some companies have ACT relating to earlier periods which they were unable to offset against the overall corporation tax liability because of offset restrictions. For tax purposes, this ACT can be carried forward indefinitely.

Where companies consider that ACT will be recoverable in a future accounting period, it may be included in the balance sheet as a debtor provided it can satisfy a number of demanding conditions (see FRS 16 *Current tax* and FRS 19 *Deferred tax*).

Depreciation and capital allowances

Different classes of asset have long been treated quite differently for tax and accounting purposes.

For some, like office buildings, there is no allowance at all for tax purposes for depreciation, or in Revenue terms: no 'capital allowances' are available, except in Enterprise Zones. Others have been treated generously (e.g. plant and machinery), and some more harshly, e.g. motor vehicles costing more than £12,000.

'Pooling'

The cost of all plant and machinery is put into a 'pool'. Each year the total in the pool qualifies for a 25% writing down allowance, on a reducing balance basis.

New assets are added to the pool at cost and the proceeds of asset disposals are deducted from the pool.

The advantage of the *reducing balance* method is simplicity: assets in the pool do not have to be accounted for individually.

Tax years

The *fiscal* (or *income tax*) *year* runs from 6 April of one year to 5 April the following year and is referred to by stating both years, e.g. *income tax year* 2003/2004 is the year from 6 April 2003 to 5 April 2004.

The *financial year* (FY), used for corporation tax purposes, runs from 1 April to 31 March and is referred to by the year in which it *starts*, e.g. *financial year* 2004 is the year from 1 April 2004 to 31 March 2005.

Rates of corporation tax

There are two rates of corporation tax, the *standard rate* and the *small companies rate*. 'Small companies' in this context are those with taxable profits (income and capital gains) not exceeding £300,000 in the year.

There is marginal relief for companies with profits of between £300,000 and £1.5 million.

When corporation tax rates are set

The rates for each financial year are normally set in the Budget the previous November.

For the financial year 2004 the *standard rate* has been set at 30%, and the *small companies rate* at 19%.

Deferred taxation

Timing differences

The annual *depreciation charge* on an asset is determined by the company's accounting policy. The annual *capital allowance* on an asset is determined by the Chancellor of

the Exchequer, and applied by the Inland Revenue. The two are seldom the same.

The difference is called a *timing difference*, as we have illustrated in Example 17.1.

Purpose of deferred tax

The purpose of deferred tax is to remove the effect that any timing differences would otherwise have on the annual tax charge.

Companies make a transfer to a *deferred tax provision* of an amount equal to the difference between

- the corporation tax actually payable on the company's taxable trading profit and
- the tax that would have been payable if the taxable trading profit had been the same as the accounting profit.

Accounting for deferred tax

The accounting rules for the treatment of deferred tax are in FRS 19 *Deferred tax*.

FRS 19 was issued in December 2000, and superseded SSAP 15.

Definition of deferred tax

Deferred tax is the estimated future tax consequences of transactions and events recognised in the financial statements of the current and previous periods (FRS 19, para. 2).

Deferred tax is required to be recognised for all timing differences that have originated but not reversed by the balance sheet date.

Example 17.2 shows how deferred tax appears in the accounts.

Other timing differences

In addition to differences between capital allowances and depreciation, FRS 19 covers:

- Pension liabilities accrued in the accounts, but only allowed for tax when contributions are paid.
- Interest costs and development cost capitalised in the accounts, but allowed for tax purposes.
- Fixed assets revalued in the accounts; the gain only taxable when the asset is sold.

Example 17.2 Deferred tax in the accounts

An engineering company buys £2 million of plant and machinery at the beginning of the company's year, so:

1. For corporation tax purposes the company is entitled to a Writing Down Allowance (WDA) of 25% per annum on a reducing balance basis: £500,000 in Year 1, £375,000 in Year 2,
2. The company depreciates the plant and machinery on a straight line basis over 10 years, i.e. £200,000 each year.

The originating timing difference in Year 1 is £300,000 (£500,000 – £200,000). With a corporation tax rate of 30%, the deferred tax provision required by FRS 19 is £90,000, with a corresponding charge to the P & L account for deferred tax provided.

Year 1's accounts would show:

Profit and Loss account	£000
Pre-tax profit	1,200
Taxation (see Note 1)	<u>360</u>
Profit after tax	<u>840</u>
Note 1	£000
Corporation tax payable = 0.3(1200 + 200 – 500)	270
Transfer to Provision for deferred tax	<u>90</u>
Total tax charge (£1.2 million at 30%)	<u>360</u>

STAGECOACH GROUP Note from the 2003 accounts

Note 7 Taxation on (loss)/profit on ordinary activities

(a) Analysis of charge in the year	2003 £m	2002 £m
Current tax:		
UK corporation tax at 30% (2002: 30%)	24.7	12.6
Share of joint ventures' current tax	2.4	0.2
Share of associates' current tax	0.3	3.1
Foreign tax (current year)	3.2	2.8
Foreign tax (adjustments in respect of prior periods)	<u>(3.6)</u>	<u>(0.3)</u>
Total current tax	<u>27.0</u>	<u>18.4</u>
Deferred tax:		
Origination and reversal of timing differences	(4.0)	(1.8)
Adjustments in respect of prior years	<u>2.0</u>	<u>(1.6)</u>
Total deferred tax	<u>(2.0)</u>	<u>(3.4)</u>
Tax on (loss)/profit on ordinary activities	<u>25.0</u>	<u>15.0</u>

(b) Factors affecting tax charge for the year

	2003 £m	2002 £m
(Loss)/profit on ordinary activities	(500.2)	42.0
(Loss)/profit on ordinary activities multiplied by standard rate of corporation tax in the UK of 30%	(150.1)	12.6
Effects of:		
Goodwill amortisation	7.7	11.6
Impairment loss	172.5	Nil
Non-deductible expenditure	4.4	0.7
Capital allowances for period in excess of depreciation	(4.3)	(7.1)
Losses not utilised	(2.1)	4.1
Movement in general provisions and other short-term timing differences	5.6	2.8
Foreign taxes differences	(3.1)	(4.8)
Adjustments to tax charges in respect of prior periods	(3.6)	(1.5)
Current tax charge for the year (note 7(a))	27.0	18.4

(c) Factors that may affect future tax charges

No provision has been made for deferred tax on rollover gains. The total amount unprovided for is £3.3m (2002: £3.3m).

No deferred tax is recognised on the unremitted earnings of overseas subsidiaries, associates and joint ventures unless a binding agreement exists at the balance sheet date to remit such earnings in the future.

Deferred tax assets in respect of corporation tax losses carried forward within UK companies are provided against where the recoverability is in doubt.

- Tax losses carried forward from previous years and used to reduce taxable profits.

Rollover relief

If a company disposes of a building (or other qualifying assets e.g. a ship or an aircraft) at a profit and purchases another, it can obtain what is known as ‘*rollover relief*’ by electing to have the gain arising on the disposal deducted from the cost of the new building rather than paying tax on it (see Example 17.3).

FRS 19 para. 15 requires that ‘Deferred tax should not be recognised on timing differences . . . if . . . it is more

Example 17.3 Rollover relief

Freehold premises with a cost for tax purposes of £9m are sold for £15m, producing a chargeable gain of £6m. At the same time, if the company buys new premises for £18m, it can defer payment of tax on the gain of £6m by electing to deduct the gain from the cost of the new building.

However, if the new premises are subsequently sold for, say £26m, tax would be assessed on the gain of £26m – (£18m – £6m) = £14m.

likely than not that the taxable gain will be rolled over, being charged to tax only if and when the assets into which the gain has been rolled over are sold.’

Reasons for ‘abnormal’ tax charges

Despite full provision being made for deferred taxation, differences remain between the tax charge and what might be expected bearing in mind the pre-tax profits and the normal rate of corporation tax. For instance, small companies pay corporation tax on income at a lower rate (see page 140).

Adjustments to previous years

Where tax on profits of an earlier period proves to be more or less than previously provided, FRS 3 requires that this should be included in the profit and loss account, and the effect stated if material (most companies show it by way of note; see, e.g., AIR PARTNER on page 138).

Permanent differences

Permanent ‘differences’ in tax charge, the effects of which are not offset by provisions for deferred tax, include the following items:

1. Disallowed expenses

Some items, such as the cost of entertaining customers, are charged by companies to their profit and loss account properly reducing pre-tax profits, but are not allowed as

expenses by the Taxes Act in calculating taxable profits. This causes the tax charge to appear higher than 'normal'.

2. Capital gains

Tax payable on capital gains is included in the Corporation Tax charge. For example, if a company's sole taxable profit for the year arose from the £4m sale of freehold land costing £3m, and the indexation allowance was £400,000, the chargeable gain would be only £600,000.

The profit and loss account would show:

	£000
Pre-tax profit	1,000
Taxation (30% on £600,000)	<u>180</u>
Profit after tax	<u>820</u>

and the apparent rate of tax would be 18%.

3. Loans

Gains on loans are not normally subject to corporation tax, and losses on loans are not deductible as expenses. For example, if a company issued a loan stock at £99% and subsequently bought it in for cancellation at £95%, neither the £1% loss on issue nor the £5% gain on repurchase would be included in the calculation of the company's corporation tax charge. However, in 'deep discount' issues (see page 37), the 'income element' is an allowable expense.

4. Losses

Where a company makes a loss, it may carry that loss back for a limited period to recover corporation tax previously paid or, failing that, can carry the loss forward indefinitely to offset against future profits. However

- Capital losses, for example the loss on sale of fixed assets, cannot normally be offset against trading profits.
- Losses by UK-resident subsidiaries cannot be offset against profits elsewhere in the group unless the subsidiary is at least 75% owned by the parent company (but the provisions are complex). If the loss-making subsidiary is less than 75% owned (so that group relief is unavailable), the group's tax charge will appear abnormally high, but the losses can be carried forward

within the subsidiary and, if and when it returns to profitability, subsequently matched against future profits of that subsidiary. The effect on the group's tax charge will then be reversed.

- The losses of a subsidiary in one country cannot be offset against the profits of subsidiaries in other countries, and this can result in an abnormally high tax charge, as THE BODY SHOP illustrated in 1998:

THE BODY SHOP 1998 accounts

Consolidated profit and loss account 1998

	£m
Profit on ordinary activities before tax	38.0
Taxation (Note 7)	<u>(15.2)</u>
Profit for the financial year after tax	<u>22.8</u>

Note 7 Taxation

	1998
	£m
The charge consists of:	
UK corporation tax	12.4
Deferred tax	2.3
Overseas tax	<u>0.5</u>
	<u>15.2</u>

The effective tax rate is higher than the standard UK corporation tax of 31% as a result of the losses of the US subsidiary in the year of approximately £11.5m which are not available for relief in the year.

Information on losses carried forward should be given either in a note on taxation or in a note on deferred taxation e.g. PILKINGTON TILE:

PILKINGTON TILE GROUP Note to the 2000 accounts

7. Tax on profit on ordinary activities

	2000	1999
	£000	£000
Current year UK corporation tax	820	569
Less prior year over-provision	<u>(103)</u>	<u>—</u>
	<u>717</u>	<u>569</u>

The effective corporation tax rate of 21.7% is lower than the expected rate of 30% due to the utilisation of tax losses brought forward.

Tax losses within the Group, relating to continuing operations, of £1,127,000 (1999 – £3,825,815) are carried forward.

Some companies give details of when tax credits expire, e.g. BOC GROUP:

BOC GROUP Note to the 2003 accounts

4e) Unused tax credits

...

On a consolidated basis, the Group has net operating loss carryforwards of £51.7 million. If not offset against taxable income, these losses will expire as follows:

Year	Net operating loss £m
2004	8.4
2005	—
2006	0.4
2007	—
Thereafter, or no expiry date	42.9

5. Overseas income

Overseas income presents special problems:

- Overseas income of non-resident subsidiaries is not generally liable to UK taxation; it bears only foreign tax. The foreign tax may be at a higher or lower rate than UK corporation tax. In particular some countries, such as Ireland, give foreign companies several years of tax holidays to encourage them to set up subsidiaries there.
- Dividends, interest or royalties remitted to the UK from certain countries, including the USA, may bear a further 'withholding tax'.
- Overseas income of a UK-resident company is liable to UK tax whether remitted or not.
- Double taxation relief (DTR) is given for overseas tax on income liable to UK tax, so dividends paid to the UK by overseas subsidiaries normally bear no UK tax if the foreign tax has already been borne at a rate equal to or greater than UK corporation tax. If the foreign tax is lower, only the difference is payable in the UK, but in both cases this is only true for foreign taxes of an income nature (taxes of a capital nature do not qualify for relief). Example 17.4 illustrates the way in which double taxation relief is applied.

Example 17.4 Double taxation relief

A UK holding company does not trade, but has one overseas subsidiary whose profit and loss account is:

	£000
Pre-tax profits	10,000
Tax paid at 25%	<u>2,500</u>
	7,500
Dividends	<u>3,000</u>
Retentions	<u>4,500</u>

The UK holding company's £3,000,000 dividends are subject to 10% withholding tax (£300,000) on remittance, so the UK company actually receives £2,700,000. For UK tax purposes the dividend received by the holding company is grossed up:

	£000
Dividend from subsidiary	3,000
Associated foreign tax at 25%	<u>1,000</u>
Gross income from subsidiary	<u>4,000</u>
UK tax is: corporation tax 30% on £4,000,000	1,200
less DTR, which is the lesser of:	
(a) Tax paid on £2,700,000 net £1,000,000 + £300,000 = £1,300,000	
(b) UK CT liability of £1,200,000	<u>1,200</u>
Tax payable in the UK	<u>0</u>

The UK holding company's profit and loss account would show:

	£000	£000
Pre-tax profits		10,000
Taxation		
UK corporation tax	1,200	
less double tax relief	<u>1,200</u>	
Overseas tax	2,500	
Withholding tax	<u>300</u>	<u>2,800</u>
Profit after tax		<u>7,200</u>

6. Exceptional items

Under FRS 3, exceptional items should, as explained in Chapter 16, be credited or charged in arriving at the profit or loss on ordinary activities under the statutory format headings to which they relate, and attributed to continuing or discontinued operations as appropriate.

Certain items, including provisions in respect of them, have under para. 20 of FRS 3 to be shown separately on the face of the profit and loss account after operating profit and before interest, again under the appropriate heading of continuing or discontinued operations, namely:

- (a) profits or losses on the sale or termination of an operation;
- (b) costs of a fundamental reorganisation or restructuring having a material effect on the nature and focus of the reporting entity's operations; and
- (c) profits or losses on the disposal of fixed assets.

Relevant information regarding the effect of these items on the taxation charge and, in the case of consolidated financial statements, any minority interests should both be shown in a note to the profit and loss account. As a minimum the related tax and the minority interest should both be shown in aggregate, but if the effect of the tax and minority interests differs for the various categories of items further information should be given, where practicable, to assist users in assessing the impact of the different items on the net profit or loss attributable to shareholders.

The effective tax rate

FRS 19 requires disclosure of a reconciliation of the current tax charge reported in the profit and loss account, with the charge which would result from applying the relevant standard rate of tax to the reported profit. This reconciliation will highlight reasons for abnormal tax charges.

The reconciliation may be presented in monetary terms (see DIAGEO) or in percentage terms (see W S ATKINS).

DIAGEO Note to the 2003 accounts

9. Taxation

Analysis of taxation charge in the year

	2003 £million	2002 £million
Current tax		
UK corporation tax at 30%	10	28
Less: Double taxation relief	–	(7)
Overseas corporation tax	298	398
Share of taxes of associates	138	87
Adjustments for prior periods	<u>21</u>	<u>(6)</u>
Total current tax	<u>467</u>	<u>500</u>
Deferred tax		
United Kingdom	(31)	(49)
Overseas	20	95
Adjustments for prior periods	<u>31</u>	<u>86</u>
Total deferred tax	<u>20</u>	<u>132</u>
Total taxation	<u>487</u>	<u>632</u>

W S ATKINS Note to 2003 accounts

8. Taxation on profit on ordinary activities

...

The tax charge on adjusted profit on ordinary activities is £3.5m (2002: £9.7m), an effective tax rate of 18.5% (2002: 25.5%).

The variation between this rate and the UK corporation tax rate is explained as follows:

	2003 %	2002 %
UK corporation tax rate	30.0	30.0
Effect of:		
Pension credit	(3.6)	(1.5)
Accelerated capital allowances	4.9	(4.2)
Overseas timing differences	(1.0)	(2.3)
Other timing differences	(3.7)	2.8
Permanent differences	3.0	2.4
Other differences	(0.3)	(1.5)
Non-UK activities	<u>2.5</u>	<u>–</u>
Sub total	31.8	25.7
Adjustment in respect of prior years	<u>(3.2)</u>	<u>(3.4)</u>
Total current tax	28.6	22.3
Movement in deferred tax	<u>(10.1)</u>	<u>3.2</u>
Total tax based on adjusted profit	<u>18.5</u>	<u>25.5</u>

Profit after tax, dividends and earnings per share

PROFITS AFTER TAX

The pecking order

Minority interest, then

Any arrears of cumulative preference dividends, then
Cumulative preference dividends for the period, then
Preference dividends for the period, then
Ordinary dividends

That's the right order.

How many got it right?

After all these have been deducted, what is left is called *Retained earnings*. This is money kept in the company to help finance growth or reduce debt.

Profit after tax

The ordinary shareholders, who usually provide the bulk of a company's share capital, and are most at risk, are entitled to all the profits after tax *after* the deduction of:

- *Minority interests*
- *Arrears of cumulative preference share dividends*
- *Cumulative preference dividends for the period*
- *Preference dividends for the period.*

Minority interests: As explained in detail in Chapter 20, minority interests occur when a group has one or more subsidiaries, the shares in which are only partly owned by the group.

Where the other ('minority') shareholders in the 'partially owned' subsidiary are equity shareholders they are entitled

to a share in the profit or loss of *that subsidiary*; their share, called 'equity minority interests', has to be deducted in arriving at the profit attributable to the group's shareholders.

Dividends attaching to any 'non-equity minority interests' also have to be deducted (i.e. dividends on externally owned preference shares of a subsidiary).

Preference dividends and any arrears of cumulative preference dividends have to be met before any ordinary dividends can be declared.

The amount remaining after these deductions is called the *Profit attributable to ordinary shareholders*.

Profit attributable to ordinary shareholders

Ordinary dividends are paid out of this attributable profit, leaving *Retained earnings*. Retained earnings are kept in the company to help finance growth and/or reduce debt. The following extract from the accounts of the house builder BELLWAY illustrates the 'pecking order'.

BELLWAY Profit after tax: the 'pecking order' for 2002

	2002
Profit and loss account	£000
...	
Profit after tax	87,900
(1) Minority interests	<u>1</u>
Profit attributable to shareholders	87,901
Dividends	
(2) Preference dividends	<u>(1,900)</u>
Profit attrib. to Ord. Shareholders	86,001
(3) Ordinary dividends	<u>(17,372)</u>
(4) Retained profit for the year	<u>68,629</u>

Dividends

In deciding what profits to distribute the directors of a company should have in mind:

- (a) the company's cash position (considered in Chapter 19);
- (b) what is prudent;
- (c) what is legally permissible.

Ideally, directors should choose the lowest of these three figures.

What is prudent?

In deciding what would be prudent, directors should weigh up the cost of raising capital in various ways. Is it, for instance, better to borrow (i.e. increase the gearing) rather than ask equity shareholders to contribute more towards the net assets of the company? And, if equity shareholders are to be called upon to provide more, should they be asked to do so by means of a rights issue, in which case each shareholder has the choice of whether to take up, or sell, his or her rights; or should profits be 'retained', in which case the individual shareholder has no choice?

Unfortunately, the picture is confused by inflation and the present, historical cost, method of accounting. With no inflation (or an inflation accounting system recognised for tax purposes) a company would, in theory, be able to distribute its earnings and still maintain its assets in real terms. With inflation most companies need to retain a proportion of their earnings as calculated by historical cost accounting in order to maintain their assets in real terms (but more of that in Chapter 29).

Having decided how much it is necessary to retain in order to continue the existing scale of operations, and how much should be retained out of profits in order to expand the scale of operations, the directors should look at what remains.

Ideally, a company should pay a regular, but somewhat increasing, dividend. For example, from a market point of view, it is preferable to pay: 8.0p; 9.0p; 9.0p; 9.0p; 9.5p; 10.0p; rather than 8.0p; 12.0p; 10.5p; 4.0p; 10.0p; 10.0p – though both represent the same total sum in dividends over the six years – because investors who need steady income will avoid companies which are erratic dividend payers, and because a cut in dividend undermines confidence in the company's future. In other words, the directors of a company should think twice before paying a dividend

this year which they may not be able to maintain, or setting a pattern of growth in the rate of dividend which could not reasonably be continued for the foreseeable future. For if they do either of these things, they are liable to disappoint shareholder expectations, to damage their market rating and to see their share price slashed if their dividend has to be cut or the rate of dividend growth cannot be sustained.

What is legally permissible

Companies are allowed to distribute only the aggregate of accumulated realised profits not previously distributed or capitalised less accumulated realised losses not previously written off in a reduction or reorganisation of capital (CA 1985, s. 263). The word 'realised' is not defined in the Act, but FRS 18 says that profits should be included in the profit and loss account 'only when realised in the form either of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty'.

In addition, a public company may pay a dividend only if the net assets of the company after payment of the dividend are not less than the aggregate of its called-up share capital and undistributable reserves (s. 264(1)). Undistributable reserves are defined in Section 264(3) as:

- (a) share premium account;
- (b) capital redemption reserve;
- (c) accumulated unrealised profits not capitalised less accumulated unrealised losses not previously written off in a capital reduction or reorganisation;
- (d) any reserve which the company's Memorandum or Articles prohibits being distributed.

This requirement means that public companies now have to cover net losses (whether realised or not) from realised profits before paying a dividend.

Where the company's audit report has been qualified, the auditor must provide a statement in writing as to whether the qualification is material in deciding whether the distribution would be a breach of the Act, before any distribution can be made.

Preference dividends

As explained on page 21:

- preference shares carry a fixed rate of dividend, normally payable half-yearly;

- preference shareholders have no legal redress if the board of directors decides to recommend that no preference dividends should be paid;
- if no preference dividend is declared for an accounting period, no dividend can be declared on any other type of share for the period concerned, and the preference shareholders usually become entitled to vote at shareholders' general meetings;
- if the dividend on a cumulative preference share is not paid on time, payment is postponed rather than omitted and the preference dividend is said to be 'in arrears', and these arrears have to be paid before any other dividend can be declared. Arrears of cumulative preference dividends must be shown in a note to the accounts.

Company articles on dividend distribution

Most companies lay down their own rules for dividend distribution in their Articles by adopting Articles 102 to 108 of Table A to the Companies Act 1985 (the model set of Company Articles).

Accounting treatment

Under UK practice, any dividends the directors *recommend* should be shown:

- in the profit and loss account, together with any interim dividend already paid (CA 1985, Sch. 4, para. 51(3));
- in the balance sheet as a liability.

In many other countries, including the USA, dividends only appear in the accounts when *approved* by the shareholders.

Dividends *paid* during the accounting period appear in a separate section of the cash flow statement.

Interim dividends

Interim dividends can be declared by the directors without reference to the shareholders, but by convention they do not normally exceed half the anticipated total for the year.

However, if the latest audited accounts disclose a 'non-distributable' position or if the level of accumulated profits has fallen significantly, interim accounts must be prepared to justify the payment of an interim dividend (CA 1985, s. 272). Interim dividends appear in the profit and loss

account as a distribution, and either in the balance sheet as a liability if the company has not paid the interim dividend by the end of the accounting period or in the cash flow statement as a payment.

Earnings per share



Earnings per share (e.p.s.) – a key measure, but open to abuse

Earnings per share (e.p.s.) is a key measure of a company's profitability each year. It is a measure of its ability to pay dividends, and is the most widely used measure of 'growth'. But it is open to abuse.

Background

As we explained in Chapter 16, the previous rules required '*Exceptional items*' to be included in the calculation of e.p.s., and '*Extraordinary items*' to be excluded.

The definitions of these two items were open to a variety of interpretations, and led to widespread abuse: companies tended to classify unusual losses as extraordinary (excluded) and unusual profits as exceptional (included), in order to enhance their reported earnings per share.

ASB curbs 'enhancement' of e.p.s.

Action was taken to reduce the scope for creative accounting by the issue of two Financial Reporting Standards:

1. FRS 3 *Reporting financial performance* required extraordinary (as well as exceptional) items to be included in the calculation of 'Profit attributable to ordinary shareholders'. This was followed by
2. FRS 14 *Earnings per share*, requiring the total profit attributable to ordinary shareholders to be used in the calculation of **Basic e.p.s.**:

$$\frac{\text{Profit attributable to ordinary shareholders}}{\text{Weighted average number of ordinary shares in issue}}$$

Misleading use of the word 'basic'

What FRS 14 was actually doing was following the 'all-inclusive' concept we described on page 130.

In our view it would have been a great deal clearer to call it '*All-inclusive e.p.s.*', which is *what it is*, rather than '*Basic e.p.s.*' which, in the ordinary sense of the word 'basic', is *what it isn't*.

Company's own figures for e.p.s.

Companies are free to show their own version of earnings per share but, if they do so, they must provide a reconciliation to the 'Basic e.p.s.' figure (FRS 14, para. 74).

The ASB took the view that, if everything was included, then companies could make whatever adjustments they wished, to produce the '*Company's own e.p.s.*'.

Given the details of the adjustments, analysts would be able to judge whether the Company's own e.p.s. was a fair 'normalised' figure and, if not, to make their own adjustments.

Let's look at an example, KINGFISHER, where one or two of the adjustments are questionable:

KINGFISHER Note on e.p.s. in the 2003 accounts

	<i>Earnings</i> £millions	<i>Per share</i> amount pence
....		
Basic earnings per share	169.7	8.0
Effect of exceptionals		
Operating exceptional items	51.6	2.4
Demerger costs	11.8	0.6
Loss on sale of operations	228.4	10.8
(Profit) on disposal of fixed assets	(143.0)	(6.7)
Tax impact on exceptional items	24.6	1.2
Minority share of exceptional items	(1.3)	(0.1)
Acquisition goodwill amortisation	<u>11.7</u>	<u>0.5</u>
Basic – adjusted e.p.s.	<u>353.5</u>	<u>16.7</u>

Although the IIMR (Institute of Investment Management and Research) approach excludes bid defence costs, as the

company didn't choose to be bid for, it does not allow the costs of actions a company chooses to make, i.e. costs of a failed merger or takeover bid, to be excluded.

Similarly IIMR would not allow start-up costs to be excluded.

And companies do not always clearly distinguish basic, FRS 3, earnings per share from their own preferred version. Take, for instance, THE RANK GROUP (see page 150). After the deduction of minority interests [A], and preference dividends [C] and [D] (*Note 7*), Rank's profit and loss account shows three figures for 2003 e.p.s.:

[H]	19.2p	before exceptional items
[I]	(4.9p)	exceptional items per share
[J]	14.3p	after exceptional items.

The basic earnings per share [J] represent actual performance, i.e. how much per share was actually available to pay ordinary dividends and provide some retained earnings to plough back into the company.

In fact Rank's 14.3p was only just enough to pay the ordinary dividends of 13.9p, [E] plus [F], leaving only £1.8m to plough back: [G] to be transferred to reserves.

Had the group *not* incurred exceptional items of (4.9p) per share [I], it would have had 19.2p per share, [H], enough to pay dividends of 13.9p per share, leaving 5.3p per share of retained earnings.

Note 8 *Earnings per Ordinary share* (see page 151) shows the calculation of [J].

Amortisation

FRS 10 *Goodwill and intangible assets* complicates matters by allowing two methods of accounting:

- (a) to retain the assets in the balance sheet at cost with an annual review for impairment; *or*
- (b) to amortise them over a finite period, usually a maximum of 20 years.

Some companies using method (b), particularly those with a large amount of goodwill from acquisitions on their balance sheet, have taken to showing e.p.s. both before and after amortisation, e.g. WASTE RECYCLING:

WASTE RECYCLING Earnings per share

Profit and loss account	1999	1998
...	£000	£000
Profit for the financial year	7,127	6,847
Dividends	(4,100)	(1,404)
Retained profit	<u>3,027</u>	<u>5,443</u>
Earnings per share	6.7p	13.8p
Adjusted earnings per share (note 9)	<u>17.3p</u>	<u>13.8p</u>

Note 9 Earnings per ordinary share

...
In order to show results from operating activities on a comparable basis an adjusted earnings per ordinary share has been calculated which excludes goodwill amortisation of £11,361,000 (1998 – £nil) from earnings.

Consolidated balance sheet

	1999	1998
	£000	£000
FIXED ASSETS		
Intangible assets	261,423	–
Tangible assets	129,887	52,325
...		

THE RANK GROUP Extract from Note 7 to the 2003 accounts**7 Dividends and other appropriations**

		2003	2002
		£m	£m
<i>Convertible preference shares</i> <i>– non-equity</i>			
Dividends payable for the period [C]	17.1	18.8	
Provision for redemption premium [D]	–	<u>2.2</u>	
	<u>17.1</u>	<u>21.0</u>	
<i>Ordinary shares – equity</i>			
Interim declared of 4.6p per share [E]	27.3	26.1	
Final proposed of 9.3p per share [F]	<u>55.5</u>	<u>52.1</u>	
	<u>82.8</u>	<u>78.2</u>	

Going for growth . . .

In the fourth edition of this book we gave an interesting example of a company whose pre-tax profits had *grown* by 41.9% p.a. between 1984 and 1988, but whose e.p.s. had *fallen* by 8.3% p.a. The company was MAXWELL

THE RANK GROUP Group profit and loss account 2003**Group Profit and Loss Account for the year ended 31 December 2003**

	2003			2002		
	Before exceptional items Note	Exceptional items £m	Total £m	Before exceptional items £m	Exceptional items £m	Total £m
...						
Profit (loss) on ordinary activities after tax	133.1	(31.9)	101.2	140.5	(1.7)	138.8
Equity minority interests [A]	<u>(2.3)</u>	<u>2.8</u>	<u>0.5</u>	<u>(2.1)</u>	<u>–</u>	<u>(2.1)</u>
Profit (loss) for the financial year [B]	130.8	(29.1)	101.7	138.4	(1.7)	136.7
Dividends and other appropriations						
Preference – non-equity [C] and [D] 7	(17.1)	–	(17.1)	(21.0)	–	(21.0)
Ordinary – equity [E] and [F] 7	<u>(82.8)</u>	<u>–</u>	<u>(82.8)</u>	<u>(78.2)</u>	<u>–</u>	<u>(78.2)</u>
Transfer to (from) reserves	<u>30.9</u>	<u>(29.1)</u>	<u>[G] 1.8</u>	<u>39.2</u>	<u>(1.7)</u>	<u>37.5</u>
Earnings (loss) per Ordinary share	8	19.2p	14.3p	19.9p	(0.3)p	19.6p
		[H]	[I]			[J]

THE RANK GROUP Extract from Note 8 to the 2003 accounts**8 Earnings per Ordinary share**

Basic earnings (£m) [B] – ([C] + [D])	84.6	115.7
Weighted average number of Ordinary shares (m) – basic	592.3	589.2
Basic e.p.s.	14.3p	19.6p

Diluted earnings (£m)	85.4	115.7
Weighted average number of Ordinary shares (m) – diluted	618.5	592.4
Diluted earnings per share	13.8p	19.5p

COMMUNICATION CORPORATION, and we said: ‘chairman Robert Maxwell’s stated goal was to become “a global information and communications corporation before the end of the decade with annual revenues of £3–5 billion, with profits growth to match”. Maxwell’s sales in the period had grown from £266.5m to over £1bn, at an annual rate of 42.9% with profits growth almost to match, but this was achieved by the profligate use of paper, and earnings per share suffered accordingly.’

As subsequent events confirmed, companies which go for growth regardless of e.p.s. are best avoided. But the fact that an acquisition for paper makes e.p.s. grow at a slower rate than profits does not necessarily mean that acquisitions for paper are bad for e.p.s. It all depends on whether the e.p.s. are higher with the acquisition than they would have been without it (as they are in Example 18.1).

The effect of acquisitions on earnings per share

Buying earnings cheaply enables a company to boost its e.p.s. when its own earnings are static, or even falling. Suppose in Example 18.1 that the attributable profits of the company were expected to fall the following year to £912,000, despite the recently acquired business performing satisfactorily. The company finds another victim (Example 18.2).

‘But,’ you may say, ‘how did the company in Example 18.2 manage to get the shareholders of the second acquisition to accept 2.4 million shares for attributable earnings of £468,000, which is 19.5p per share, far higher than the e.p.s. of the acquiring company?’ And well may you ask – the secret is in ‘market rating’.

Example 18.1 Acquisition for paper

	<i>Existing company</i>	<i>Acquisition</i>	<i>Company post-acquisition</i>
Attributable profit	800,000	200,000	1,000,000
Issued equity (shares)	8,000,000		
Vendor consideration (shares)		1,600,000	
Resulting equity (shares)			9,600,000
e.p.s.	10.0p		10.4p

In this case 1.6m shares are issued for a company bringing in £200,000 at the attributable profit level, or 12.5p for each new share, which is higher than the e.p.s. of the existing company, so the e.p.s. of the company, post-acquisition, are improved. Had the acquiring company paid more than 2m shares for the acquisition, its earnings per share would have fallen.

Example 18.2 Further acquisition

	<i>Present company</i>	<i>Second acquisition</i>	<i>Resulting company</i>
Attributable profits (£)	912,000	468,000	1,380,000
Issued equity (shares)	9,600,000		
Vendor consideration (shares)		2,400,000	
Resulting equity (shares)			12,000,000
e.p.s.	9.5p		11.5p

Market rating – the PER

The measure of a company's market rating is its Price Earnings Ratio (P/E ratio, PE ratio or PER):

$$\text{Price earnings ratio} = \frac{\text{Market price per ordinary share}}{\text{Basic earnings per share}}$$

It is normal to take the previous day's middle market price of the ordinary share divided by the earnings per share. Analysts and newspapers often take not the basic earnings per share but normalised e.p.s. (see below), so watch with care.

The PER one can expect depends mainly on four things:

- the overall level of the stock market;
- the industry in which the company operates;
- the company's record; and
- the market's view of the company's prospects.

In an average market the PER of the average company in an average sector might be around 12, with high quality 'blue chips' like BOOTS or MARKS & SPENCER standing on a PER of around 15 and small glamour growth stocks on 20 or more, while companies in an unfashionable sector might be on a multiple of only 8.

We say more about PERs in the section 'Investment ratios' on pages 160–1.

Wonder growth by acquisition

There is nothing fundamentally wrong with improving a company's earnings per share by acquisition, and it can be beneficial all round if there is some industrial or commercial logic involved, i.e. if the acquired company's business fits in with the acquiring company's existing activities or employs common skills and technology, or if the acquirer can provide improved management and financial resources. However, the practice was open to abuse, especially in bull markets.

Enter the 'whiz-kid' (known as a 'gunslinger' on the other side of the Atlantic), who might proceed as follows:

1. Acquire control of a company that has a listing on the Stock Exchange, but little else, e.g. the DEMISED TEA COMPANY, known in the jargon as a 'shell'.
2. Reverse the shell into an unlisted company, thus giving his victim the benefit of a ready market for his shares and himself the benefit of a company with real assets.

3. Sell off some of the assets, particularly property that is ripe for development. He doesn't lose any sleep over the fact that closing a factory throws 200 people out of work, as the office block that will replace it will house twice that number of civil servants in the department recently set up to encourage investment in industry; this 'asset-stripping' process is essential to provide the cash to gain control of his next victim.

4. By now the earnings per share of the Demised Tea Company, since renamed ANGLO-TRIUMPH ASSETS, have shown remarkable growth, albeit from a very low base (it's very easy to double profits of next-to-nothing), the bull market has conveniently started and the press has noticed him.

He projects a suitable image of dynamic young management, talking to them earnestly about the need for British industry to obtain a fair return on assets, and his photograph appears in the financial sections of the Sunday papers. The 'whiz-kid' has arrived.

5. His share price responds to press comment, putting his 'go-go' company on a PER of 15 or 20; he continues to acquire companies, but now uses shares rather than cash, thus continually boosting his e.p.s., as we have shown.

6. Following press adulation, he broadens out into TV financial panels, seminar platforms, and after-dinner speeches; the bull market is now raging. Anglo-Triumph features regularly as an 'up stock' in the price changes table in the FT as the PER climbs towards 30. Deals follow apace, and Anglo-Triumph thrusts ahead, acquiring a huge conglomeration of businesses in an ever-widening range of mainly unrelated activities – it may be shoes, or ships or sealing-wax, but it's certainly Alice in Wonderland.

7. The moment of truth. The bull market, after a final glorious wave of euphoria, tops out. Profits in Anglo-Triumph's businesses turn down as little or nothing has been done to improve their management. Asset-stripping becomes politically unacceptable, and the word 'conglomerate' is coined to describe hotch potch outfits like Anglo-Triumph.

Down goes Anglo-Triumph's share price, and with it the market rating; without a high Price Earnings Ratio the company can no longer boost profits by acquisition, and the game is up.

Whether the whole edifice of Anglo-Triumph collapses completely or it becomes just another lowly rated ex-glamour

stock depends on the financial structure of the company. If it has geared up (i.e. has built up debt, on which interest has to be paid), and hasn't the cash to service the debt, the company will probably be forced into liquidation unless some sympathetic banker (possibly embarrassed by the prospect of disclosing a huge loss if the company goes under) decides to tide things over until 'hopefully' better times.

Two things, both of which are required by FRS 3, do much to prevent this happening today. They are:

- (i) the publication of earnings per share; and
- (ii) the subdivision of results down to operating profit level into continuing operations, acquisitions and discontinued operations, both of which have made this sort of behaviour much more transparent.

Normalised and company e.p.s.

As described on pages 131 and 149, the IIMR (which has since become UKSIP – the UK Society of Investment Professionals) developed a standard approach, focusing on the trading activities of a company, to produce *Headline earnings* and, from that figure, *Normalised earnings per share*.

This approach has been followed by the *Financial Times*, using normalised e.p.s. in calculating figures for the P/E column in their London share price pages, and is generally used in the City, though with individual variations. One or two companies also used to use it in their annual accounts, for example KBC ADVANCED TECHNOLOGIES:

KBC ADVANCED TECHNOLOGIES IIMR earnings

	2000	1999
Profit and loss account	£000	£000
...		
Profit on ord. activities after tax	2,210	4,989
Dividends – equity interests	(1,869)	(1,871)
Retained profit for the period	<u>341</u>	<u>3,118</u>
Earnings per share (pence)		
– basic	Note 8 4.65	10.50
– diluted	4.58	10.17
– basic on IIMR earnings	4.65	6.36

Note 8

...
The basic IIMR earnings per share excludes profit made on the sale of a business . . .

Most, like THE RANK GROUP (see page 150), seem to ignore the IIMR, and to prefer their own version.

As FRS 3 makes clear, basic earnings per share are only a starting point. No one number can encapsulate everything about a company's performance. It is up to the analyst to decide which, if any, of these bases provides the best view of normal earnings; or whether to make his or her own adjustments in calculating 'normalised' earnings. But the current position in which the scorer (accountant/auditor) adopts one set of rules (basic earnings), the commentator (analyst) another (IIMR or normalised), and the players (management) choose for themselves (company's own figures), is scarcely satisfactory.

Investigating trends

It is frequently a worthwhile exercise to set alongside one another, growth in:

- (a) turnover;
- (b) profit before tax;
- (c) earnings per share;
- (d) dividend per share.

If they are wildly different, the cause should be investigated. In the sixth edition we looked at MITIE GROUP, a relatively small cleaning and maintenance contractor, saying that it was 'taking advantage of the trend towards outsourcing such services' while at the same time expanding by making a series of small acquisitions.

As we said in the sixth edition, growth [in 1990–1995] had been spectacular:

- turnover increase had averaged 51% per annum;
- profits had almost kept pace at 48% per annum;
- because of acquisitions for paper, e.p.s. had grown at an average of only 22% per annum;
- from a very low base (and covered nine times) dividends had increased at an average of 43% p.a.

So shareholders certainly did not complain.

We decided to follow up the story. As will be seen from Example 18.3, the very rapid growth in turnover slowed down to around 20% p.a., there had been a consolidation in profitability, falling to 34% p.a. between 1995 and 2000, and then to 20%, with e.p.s. and dividend growth also slowing.

MITIE GROUP Group statistical record 1995 to 2003 (extracts)

	2003	2002	2001	2000	1999	1998	1997	1996	1995
	£000	£000	£000	£000	£000	£000	£000	£000	£000
Turnover	565,840	518,852	415,375	346,514	264,455	236,293	209,425	161,149	125,183
Profit on ordinary activities before taxation	34,113	30,997	25,148	19,758	14,542	11,100	8,210	6,302	4,571
Earnings per share	7.3p	6.8p	5.1p	4.3p	3.3p	2.6p	2.0p	1.6p	1.2p
Dividend per share	1.9p	1.6p	1.25p	1.0p	0.8p	0.6p	0.5p	0.4p	0.3p

Earnings and Dividend per share figures have been restated to reflect the subdivision of shares in 1998 and 2001. The results of merger accounted acquisitions are reflected in full in the year of acquisition and subsequent years but only the year prior to acquisition has been restated on a comparable basis.

Example 18.3 MITIE GROUP Average growth rate per annum

	<i>Average increase per annum</i>		
	1990–1995	1995–2000	2000–2003
Turnover	51%	22%	18%
Profit on ordinary activities before tax	48%	34%	20%
Earnings per share	22%	29%	19%
Dividend per share	43%	27%	24%

There was also a much greater dependence on partly owned subsidiaries: minorities as a percentage of equity shareholders' funds increased from 5.4% in 1995 to 26.6% in 2000 (not shown).

However spectacular a company's growth is, it must slow down as the company gets bigger, or management will be in danger of losing control.

Adjustments to basic earnings per share**When the number of shares in issue changes**

If a company issues new ordinary shares (or redeems ordinary shares) during the year, the basic e.p.s. for that year have to be calculated using the time-weighted average number of shares in issue during the year, and those of previous years have to be adjusted to allow for any bonus element in the share issue.

FRS 14 *Earnings per share* describes in detail the method of adjustment to be used by companies for each type of issue:

1. Share split

Use the year-end figure for number of shares, and apply a factor to previous years' e.p.s. to put them on a comparable basis. For a split of 1 old share into z new shares it is $1/z$ (see Example 18.4).

Example 18.4 Effect of share split on e.p.s.

In September 1998 MITIE GROUP had an issued share capital of ordinary shares of 5p each. In 2001 each 5p share was split into two ordinary shares of 2½p each. The factor to be applied to previous years' earnings was ½.

2. Scrip (bonus or capitalisation) issue

Use the year-end figure for number of shares, and apply a factor to previous years' e.p.s. to put them on a comparable basis. For a scrip issue of y shares for every x shares held, the factor is $x \div (x + y)$ (see Example 18.5).

Example 18.5 Effect of scrip issue on e.p.s.

Let us suppose that UNIVERSAL plc is a company whose year ends on 31 December. At the end of 1999 the issued share capital was £4.0m, of which £1m was in 3½% preference shares and £3m was the equity share capital of 12m ordinary shares of 25p each. No new shares were issued in 2000. Profits after tax and minority interests were £995,000. So the attributable profits reported in 2000 would be: £995,000 – £35,000 = £960,000 and the e.p.s.: £960,000 ÷ 12m = 8.00p. No adjustments would be required to previous years' e.p.s.

In 2001 the company made a 1-for-3 scrip issue and profits after tax and minority interests increased from £0.995m to £1.235m.

Attributable to ordinary would be: £1.235m – £35,000 = £1.200m and earnings per share for 2001 would be £1.200m ÷ 16m = 7.5p which, at first sight, appear to be down on the previous year, but 2000's figure of 8p has to be adjusted by a factor of $3 \div (3 + 1)$ to make it comparable with 2001: $\frac{3}{4}$ of 8p = 6p.

3. Shares issued in an acquisition

Shares issued in an acquisition are assumed to have been issued at market price (even if the shares issued, the 'vendor consideration', were placed at a discount at that time). The weighted average number of shares in issue during the year is calculated and used for working out the e.p.s. (see Example 18.6).

4. Rights issue

A rights issue is regarded as being partly an issue at the market price and partly a scrip issue (the bonus element); the e.p.s. of previous years are adjusted by the factor appropriate to the bonus element in the same way as a scrip issue (Example 18.7).

If, instead of being made on the first day of the company's year (as in Example 18.7), a rights issue is made

Example 18.6 Effect of acquisition issue on e.p.s.

On 1 April 2002 Universal had in issue 16m ordinary shares of 25p each. That day it acquired another company and issued 2m new fully paid 25p ordinary shares in payment (an acquisition 'for paper').

At the year end, the profits of the new subsidiary for the period 1 April to 31 December 2002 were included in Universal's consolidated profit and loss account and the weighted average number of shares in issue during the year was calculated:

$$\frac{(16m \times 3) + (18m \times 9)}{12} = 17.5m$$

If profits at the attributable level were £1.4m that would give earnings per share for 2002 of:

$$£1.4m \div 17.5m = 8.0p.$$

There would be no adjustment to the e.p.s. of earlier periods.

Example 18.7 Effect of rights issue on first day of company's year on e.p.s.

Let us suppose Universal, which had in issue 18m ordinary shares of 25p each on 1 January 2003, made a rights issue on the basis of one new share for every 4 shares held at a price of 80p per share, against a market price of 100p on the last day the old shares were quoted cum-rights. The number of shares in issue would become 22.5m and the issue would have the same effect as a 1-for-5 at 100p, followed by a 1-for-24 scrip issue. The factor for adjusting the e.p.s. for previous years is thus $24/(1 + 24)$, which can be calculated in more complicated cases using the formula:

$$\frac{\text{Theoretical ex-rights (xr) price}}{\text{Actual cum-rights price on the last day of quotation cum-rights}}$$

where the Theoretical xr price is, in this case, 1 share at 80p plus 4 old shares at 100p each = 5 shares for 480p = 96p, and $96/100 = 24/25$.

On the basis that the e.p.s. reported previously were:

2000	6.0p
2001	7.5p
2002	8.0p

comparative figures for earnings for earlier years would be:

2000	5.76p
2001	7.20p
2002	7.68p

If the profits attributable to ordinary were £1.710m in 2003, the e.p.s. for that year would be: £1.710m ÷ 22.5m = 7.6p.

during the company's year, the calculation of the bonus element and the factor for adjusting previous years' e.p.s. is just the same but, in addition, the weighted average number of shares in issue during the year has to be calculated (see Example 18.8).

Example 18.8 Rights issue (during company's year)

If Universal (see Example 18.7) had made its 1-for-4 rights issue on 1 September 2003, then the number of shares at the beginning of the year would be adjusted by the reciprocal of the e.p.s. factor and the calculation to find the weighted average is:

$$\left[18\text{m} \times \frac{25}{24} \times \frac{8}{12} \right] + \left[22.5\text{m} \times \frac{4}{12} \right] = 20\text{m shares}$$

which would give e.p.s. of 8.55p for the year 2003, rather than 7.6p.

Adjusting the number of shares in issue during the first 8 months of 2003 by 25/24 allows for the bonus element of the rights issue, i.e. it puts the shares in issue at the beginning of the year on the same basis as the shares in issue at the end of the year.

5. Share consolidations

A consolidation of shares reduces the number of ordinary shares outstanding without a reduction in resources. The number of ordinary shares outstanding before the event is adjusted for the proportionate change in the number of ordinary shares outstanding as if the event had occurred at the beginning of the earliest period reported.

But no adjustment is made to the number of ordinary shares outstanding before the event where a share consolidation is combined with a special dividend and the overall commercial effect in terms of net assets, earnings and number of shares is of a repurchase at fair value (see Example 18.9).

6. Repurchase of shares for cash

Where a company repurchases its own shares during the period this affects the weighted average number of shares outstanding, i.e. it works exactly like an issue in respect of an acquisition but in reverse (see Example 18.10).

Example 18.9 Share consolidation

At 31 December 2003 Universal (see Example 18.8) had in issue 22.5m ordinary shares of 25p each.

It reported basic earnings per share of:

2000	5.76p
2001	7.20p
2002	7.68p
2003	8.55p

If on 1 July 2004 it performed a share consolidation, consolidating each four ordinary shares of 25p each into one ordinary share of £1 (leaving it with 5,625,000 shares of £1 each); and if profits attributable to ordinary for 2004 were £1,968,750; earnings per share 2004 would be £1,968,750 ÷ 5,625,000 = 35.00p and the earnings for earlier years would be adjusted to 4 times their earlier amount:

	<i>As originally reported</i>	<i>As reported in 2004</i>
2000	5.76p	23.04p
2001	7.20p	28.80p
2002	7.68p	30.72p
2003	8.55p	34.20p

Example 18.10 Repurchase of shares for cash

If on 30 June 2005 Universal (see Example 18.9) repurchased 4,625,000 ordinary shares out of its issued capital of 5,625,000 ordinary shares of £1 each leaving it with 1m ordinary shares of £1 each, and if profits attributable to ordinary in that year were £993,750, the weighted average number of shares in issue would be (working in months):

$$((6 \times 5,625,000) + (6 \times 1,000,000)) \div 12 = 3,312,500$$

and the e.p.s for 2005 would be £993,750 ÷ 3,312,500 = 30.0p.

Earnings of past years would not be recomputed.

Shares held by a group member

Company shares in issue that are held by a group member and are not cancelled are treated as if they were cancelled for earnings per share purposes and excluded from the calculation. Shares that are held by an employee share ownership plan (ESOP) trust and reflected in the company

balance sheet as assets of the company are similarly to be treated as if they were cancelled for this purpose until such time as they vest unconditionally in the employees.

Diluted earnings per share

Causes of dilution

This is a subject that has, over the years, grown ever more complicated. It's probably best explained by starting twenty years ago, when there were three types of *potentially dilutive* securities:

1. Convertible preference shares
2. Convertible debentures, loan stock and bonds
3. Warrants.

Calculation of diluted e.p.s.

Assumptions: (a) all convertibles converted
(b) all warrants exercised.

Calculation: for each class of security in turn:

- (a) *In the P&L account add* the benefit the company would derive from conversion or exercise:
 1. the saving on preference dividends,
 2. interest saved on convertible debt, and
 3. receipt of the exercise price of the warrants.
- (b) *To the number of shares in issue add*, in each case, the extra number of ordinary shares that would be created by conversion or exercise.
- (c) Calculate the diluted earnings per share:

$$\text{Diluted eps} = \frac{\text{Higher earnings due to (a)}}{\text{Higher number of shares due to (b)}}$$

Where any conversion or exercise would increase or have no effect on e.p.s. it was ignored.

And on options we took the view that any dilution was probably more than balanced by the incentive the options gave the directors and employees to improve performance.

In the second issue of the book, published in 1982, we wrote:

'Strictly speaking, options granted and partly paid shares issued to directors and employees under executive schemes produce potential dilution of equity earning, in the same way as warrants, but in practice they are usually sufficiently small in relation to the company's issued equity to be ignored.'

Not any more they ain't!

Growth in share incentive schemes

Since the 1980s the use of share options and other equity-related incentives has spread a great deal. It has spread wider amongst employees by SAYE and profit-sharing schemes encouraged by generous tax concessions, and has spread thicker by more and more incentives for management.

Share greed

Although in most cases directors and senior management incentives have been reasonable in a market-driven society, the tabloid press finds that greedy management makes good copy. And there's plenty of good copy.

The worst case we have come across, let's call it SHAREGREED plc, was a small listed company, where a sheaf of options were granted to Board members with an exercise price of 25p.

When the share price subsequently fell heavily, the original options were cancelled and new options were granted with an exercise price of 5p. None were ever exercised, because the Board's greed was well matched by its incompetence.

Growth in the complexity of schemes

In an increasingly competitive world, companies have felt obliged to introduce increasingly generous and complex schemes like LTIPs, described on page 28. In doing so they have been egged on by remuneration consultants and headhunters.

Too complicated to be readily understood, these schemes haven't necessarily been in the best interest of shareholders and can backfire on the intended beneficiaries.

FRS 14 Earnings per share**Definitions**

Basic earnings per share is a measure of past performance, calculated by dividing the net profit or loss attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period.

Diluted earnings per share adjusts basic e.p.s. to give effect to potential ordinary shares outstanding during the period. Only potential ordinary shares that are *dilutive* should be included.

Presentation

The basic and diluted e.p.s. should be presented, with equal prominence, on the face of the balance sheet.

Figures used in the calculation of diluted e.p.s. should be shown, with a reconciliation to the figures used for calculating basic e.p.s.

See CABLE & WIRELESS below.

- (a) share option schemes not related to performance
- (b) schemes related to performance, e.g. LTIPs
- (c) contingently issuable shares e.g. shares which will be issued as deferred consideration in an acquisition, providing future profit thresholds are reached.

Points to watch on incentive schemes for directors and senior management

We still take the view that the e.p.s. dilution caused by these schemes (seldom more than 1% or 2%) is usually outweighed by the improved performance they encourage, but there are a couple of points to watch:

1. Beware schemes where the interests of the scheme's beneficiaries are not in line with the interests of the shareholders, e.g. generous handouts of shares depending on criteria not directly related to the share price being met.
2. Be very wary of management who move the goalposts.

Statement of total recognised gains and losses

The statement of total recognised gains and losses (STRGL) is a primary financial statement introduced by FRS 3. Its purpose is to highlight any items which even if they were very significant would otherwise only appear in a note to

Further examples of dilution

As well as the potentially dilutive securities we have already described, FRS 14 gives further examples of potential dilution and how to calculate it:

CABLE & WIRELESS extract from 2003 profit and loss account, and Note 14

Consolidated profit and loss account

	Note	2003	2002
Basic (loss)/earnings per share	14	(280.4p)	(181.2p)
Basic (loss)/earnings per share before exceptional items and goodwill amortisation	14	(18.0p)	(8.4p)
Diluted (loss)/earnings per share		(280.4p)	(181.2p)

Note 14 (Loss)/earnings per share

	2003	2002
	£m	£m
(Loss)/profit for the financial year attributable to shareholders	(6,533)	(4,954)
Diluted (loss)/profit for the financial year attributable to shareholders	(6,533)	(4,954)
Weighted average number of shares in issue	2,329,814,506	2,733,445,915
Dilution effect of share options	6,494,406	1,296,950
Diluted weighted average number of shares	<u>2,336,308,912</u>	<u>2,734,742,865</u>

EMI GROUP Interim statement 2003**Statement of total recognised gains and losses for the six months ended 30 September 2003 (unaudited)**

	Six months ended 30 Sep 2003		Six months ended 30 Sep 2002	
	£m	£m	£m	£m
Profit for the period:		8.8		138.4
Currency retranslation – Group	11.1		7.1	
Currency retranslation – Joint venture and associates	(0.2)		(0.2)	
Other recognised gains		<u>10.9</u>		<u>6.9</u>
Total recognised gains and losses relating to the period		<u>19.7</u>		<u>145.3</u>

the accounts. For example, POLLY PECK took an adverse exchange rate variance of £170.3m on net investment overseas direct to reserves in 1988, a year in which it only made an operating profit of £156.9m. The exchange variance was due largely to borrowing in Deutschmarks and Swiss francs, where interest rates were low, while keeping money on deposit in very soft Turkish lira. The very high interest received on the soft currency deposits was credited to the profit and loss account, while the capital loss was taken straight to reserves, together with the increase in the sterling value of DM and SFr borrowings. This portent of disaster was missed by some analysts and by most shareholders, but would have been obvious from a STRGL.

The statement of total recognised gains and losses shows the extent to which shareholders' funds have increased or decreased from all gains and losses recognised in the period. It normally appears either immediately after the profit and loss account or after the cash flow statement.

EMI GROUP (above) shows it between the balance sheet and the cash flow statement.

As shown by EMI such statements normally begin with the profit for the financial year (or 'period').

Other items commonly found include:

- Surpluses (deficits) on the revaluation of fixed assets;
- Currency translation differences (see Chapter 23);
- Prior period adjustments.

Prior period adjustments

Material prior period items which are the result of

- (a) changes in accounting policies, or
- (b) the correction of fundamental errors,

are treated as 'prior period adjustments'.

It is a fundamental accounting concept that there is consistency of accounting treatment within each accounting period and from one period to the next. A change in accounting policy may therefore be made only if it can be justified on the grounds that the new policy is preferable to the one it replaces because it will give a fairer presentation of the result and of the financial position of a reporting entity (Explanation to FRS 3, para. 62).

EMI GROUP Note to Interim statement 1998

9. Prior period adjustments. As explained in Note 1 Basis of preparation, FRS 9 *Associates and Joint Ventures*, FRS 10 *Goodwill and Intangible Assets* and FRS 12 *Provisions, Contingent Assets and Contingent Liabilities* were adopted with effect from 1 April 1998. In addition, the accounting treatment for our 50% holding in Jobete was changed from an associate to a subsidiary.

To reflect these changes in accounting policies and accounting treatment, the comparatives for the six months ended 30 September 1997 and the opening balances for the current reporting period have been restated as follows:

Copyrights:

...

Investments: associates

...

Provisions:

...

Following a change in accounting policy, the amounts for the current and corresponding periods should be restated on the basis of the new policies. The cumulative adjustments should also be noted at the foot of the statement of total recognised gains and losses of the current period and included in the reconciliation of movements in shareholders' funds of the corresponding period in order to highlight for users the effect of the adjustments.

Financial statistics in historical summaries

FRS 3 does not refer to historical summaries, but where prior period adjustments are made good accounting requires that information given in such summaries be restated, and many, but not all, companies do this.

FRS 14 does have regard to such summaries. In order to give a fair comparison over the period of any historical summary presented, the basic and diluted earnings per share figures need to be restated for subsequent changes in capital not involving full consideration at fair value (i.e. bonus issues, bonus elements in other issues or repurchases, share splits and share consolidations). The resultant earnings per share figures are described as restated and under FRS 14 are to be clearly distinguished from other non-adjusted data.

Equity dividends set out in the form of pence per share are to be adjusted similarly.

Movements in shareholders' funds

FRS 3 also requires (para. 28) companies to provide a note reconciling the opening and closing totals of shareholders' funds for the period. Often this follows the statement of total recognised gains and losses but sometimes it is found in the note on reserves.

Typically the change in shareholders' funds which it discloses represents:

- (a) Transfer from profit and loss account, i.e.
 - (i) profit attributable to shareholders, less
 - (ii) dividends;
- (b) unrealised profit (deficit) on revaluation of fixed assets (normally properties);
- (c) currency translation differences;

- (d) new share capital subscribed (net);
- (e) goodwill on disposals written back;
- (f) purchase of own shares;
- (g) prior year adjustments.

Investment ratios

These are the ratios used by investors when deciding whether a share should be bought, sold or held. Most of them relate to the current price of the share, and therefore vary from day to day. The two most popular ones are the Price Earnings Ratio (PER), already mentioned, and the dividend yield.

The Price Earnings Ratio (PER)

$$\text{Price Earnings ratio} = \frac{\text{Market price per ordinary share}}{\text{Basic earnings per share}}$$

where market price = the middle market price, which is the average of the prices at which shares can be sold or bought on an investor's behalf (the market maker's bid and offer prices respectively). The analyst will normally calculate two price earnings ratios: the 'historical PER', using last year's e.p.s., and the 'prospective PER', using his estimate of e.p.s. for the current year; he may also project his earnings estimates to produce a PER based on possible earnings for the following year.

What the PER represents

One way of looking at the PER is to regard it as the number of years' earnings per share represented by the share price, i.e. x years' purchase of e.p.s., but this assumes static e.p.s., while in practice the PER reflects the market's view of the company's growth potential, the business risks involved and the dividend policy. For example, a company recovering from a break-even situation, with zero e.p.s. last year, will have a historical PER of infinity but may have a prospective PER of 12 based on expectations of modest profits for the current year, falling to 6 next year if a full recovery is achieved.

The PER of a company also depends not only on the company itself, but on the industry in which it operates and, of course, on the level of the stock market, which tends

to rise more than reported profits when the business cycle swings up and to fall more than profits in a downturn.

The Actuaries Share Indices table published in the *Financial Times* every day except Mondays also gives the PER for each industry group and subsection, so any historical PER calculated for a company can be compared with its sector and with the market as a whole (see Example 18.11). The result of comparing it with the market as a whole (usually with the FTSE All-Share PER) is called the PER Relative:

$$\text{PER Relative} = \frac{\text{PER of Company}}{\text{PER of Market}}$$

Example 18.11 Historical and prospective PER

Suppose the fully taxed normalised e.p.s. calculated from a company's latest report and accounts, published two to three months after the year has ended, are 8.0p. The analyst is expecting profits to rise by about 27% in the current year, and for there to be a disproportionately higher charge for minorities (because one partly owned subsidiary is making a hefty contribution to the improved profits). He therefore estimates that e.p.s. will rise a little less than profits, to about 10.0p.

The current share price is 120p, so last year's e.p.s. = 8p; current year e.p.s. = 10p; historical PER = 15.0; prospective PER = 12.0.

This provides a quick indication of whether a company is highly or lowly rated, although differences in the treatment of tax by individual companies do cause some distortion here, so most analysts use e.p.s. calculated on a full tax charge to compare PERs within a sector.

In general a high historic PER compared with the industry group suggests either that the company is a leader in its sector or that the share is overvalued, while a low PER suggests a poor company or an undervalued share. In each case check to see if the prospective PER is moving back into line with the sector, as a historic PER that is out of line may be due to expectations of an above average rise in profits for the current year (in which case the historic PER will be higher than average), or to poor results being expected (which would be consistent with a low PER).

Another useful rule of thumb is to be wary when a PER goes much above 20. The company may well be a glamour stock due for a tumble or, if it is the PER of

a very sound high-quality company, the market itself may be in for a fall. One exception here is the property sector, where PERs are normally very high because property companies tend to be highly geared and use most of their rental income to service their debt, leaving tiny e.p.s.; investors normally buy property company shares more for their prospects of capital appreciation than for their current earnings.

Price earnings growth factor (PEG)

The price earnings growth factor (PEG) is a yardstick introduced by Jim Slater in his very readable book *The Zulu Principle*, which is full of useful advice for the private investor. The PEG is a measure of whether a share looks overrated or underrated:

$$\text{PEG} = \frac{\text{Price earnings ratio}}{\text{Prospective growth in e.p.s.}}$$

Where the PER is appreciably higher than the prospective growth rate (i.e. PEG well over 1.0), the shares are likely to be expensive. Conversely a PEG of between 0.5 and 0.7 means that the prospective growth rate isn't fully reflected in the PER, and the shares look attractive.

Dividend policy and the PER

As the price of a share is influenced both by the e.p.s. and the dividend, a company's dividend policy affects the P/E ratio.

Some companies pay tiny dividends and plough back most of their profits to finance further growth. Shares in these companies may enjoy a glamour rating while everything is going well, but the rating is vulnerable to any serious setback in profits, as there is little yield to support the price.

Blue chip companies like to pay a reasonable dividend and to increase it each year to counteract the effects of inflation and reflect long-term growth; and that is what the shareholders expect, particularly those who are retired and need income from their investments. This means that major companies usually pay out between 30% and 40% of attributable profits, retaining a substantial amount to reinvest for future growth and to avoid having to cut the dividend in lean years. For example BRITISH AIRWAYS

maintained its dividend in 1991, when profits had more than halved, but the dividend was still covered.

If a company pays out much more than 50% in dividends it suggests it has gone ex-growth; it also runs a higher risk of having to cut its dividend in hard times (which tends to be very unpopular with investors) and, in times of high inflation, a company distributing a large proportion of its reported profits (calculated on a historical cost basis) will tend to lose credibility.

Dividend yield

Dividend yields are now generally based on the net amount received.

Dividend yield (%) =

$$\frac{\text{Net dividend in pence per share} \times 100}{\text{Ordinary share price in pence}}$$

Dividend cover

$$\text{Cover} = \frac{\text{e.p.s.}}{\text{Net dividends per share}}$$

(See Example 18.12.)

Example 18.12 Calculation of dividend cover

In year 2000 Cover plc had profits attributable to ordinary of £1.240m. 20m ordinary shares of £1 each were in issue throughout the year. The company paid total ordinary dividends of 2.3p per share net.

Basic earnings per share will be $\frac{£1.240\text{m}}{20\text{m}} = 6.2\text{p}$. Cover = $6.2 \div 2.3 = 2.7$.

Payout ratio

The payout ratio is the reciprocal of the dividend cover. It indicates the extent to which the attributable profits are distributed to ordinary shareholders. An equally valid measure is the amount retained by the company as a percentage of the attributable profit. (See Example 18.13.)

Example 18.13 Calculation of payout ratio

Basic earnings per share will be $\frac{£1.240\text{m}}{20\text{m}} = 6.2\text{p}$.

Cover = $6.2 \div 2.3 = 2.7$.

Payout ratio = $1 \div \text{Cover} = 1 \div 2.70 = 0.37$ or 37%.

The payout ratio could equally well be computed: $(20\text{m} \times 2.3\text{p}) \div 1.240\text{m} = 0.37$ or 37%.

Overview of the cash flow statement and related notes



A company which runs into heavy losses often makes a recovery. But if it runs out of cash (and credit) it will rarely get a second chance.

The finance director's viewpoint

This is how the FD of a large and successful FTSE 100 company explained it to us:

- **Starting point:** You start off with a kitty of *pre-tax profit* plus *depreciation* (depreciation is added back because it has been deducted in the P & L account, but no cash is paid out).
- **Other money coming in:** *Cash* that may come in from time to time to swell the kitty, like the proceeds of disposals.
- **'No choice' expenditure:** You have to *pay tax* (though increases in deferred tax, charged to the P & L account but not paid to the Inland Revenue, will *add* to the kitty). And you have to *pay interest* on the company's borrowings.
- **Virtually 'no choice' expenditure: Dividends:** although there is no legal obligation to declare a dividend, shareholders will normally expect to be paid an at least maintained one, with a modest increase if profits are up. If the company is in good health financially, any Board that cuts or passes a dividend without a very good reason does so at its peril, unless the directors have control, or are backed by a controlling shareholder.
- **What's left in the kitty is: What the Board is free to spend.**

Common sense would tell you that this is the company's *Free Cash Flow (FCF)*, but there are differing opinions on the definition of FCF, which we will discuss later in this chapter.

CASH FLOW STATEMENTS

The requirements of FRS 1

FRS 1 lays down a clearly defined overall format: the cash flow statement should list cash flows for the period, classified under eight standard headings in the following order:

- (a) operating activities (using either the direct or indirect method, as explained on page 167);
- (b) returns on investments and servicing of finance;
- (c) taxation;
- (d) capital expenditure and financial investment;
- (e) acquisitions and disposals;
- (f) equity dividends paid;
- (g) management of liquid resources;
- (h) financing.

The last two headings can be shown in a single section provided a separate subtotal is given for each heading.

Individual categories of inflows and outflows under the standard headings should be disclosed separately either in the cash flow statement or in a note to it unless they are allowed to be shown net.

ABBEYCREST Extract from 2003 accounts**Note 23. Reconciliation of operating profit to net cash inflow from operating activities**

		Group	
		2003	2002
		£000	£000
Operating profit	[A]	1,723	4,124
Depreciation		1,961	1,883
Amortisation of goodwill	[B]	233	224
Loss (profit) on sale of tangible fixed assets, etc.		53	26
(Increase)/decrease in stocks	} Working capital	4,077	(9,558)
(Increase)/decrease in debtors		1,937	(1,131)
(Decrease)/increase in creditors		(3,858)	6,245
Net cash inflow from operating activities	[C]	6,126	1,813

A real example

Let's look at a real example, ABBEYCREST, a listed company which had been experiencing some difficulties in 2002.

ABBEYCREST Chairman's Interim Statement

The results for the half-year have been dominated by the reassessment of various provisions . . . and by events at our manufacturing operation in Thailand . . . substantial loss for the half year.

In addition our supply chain management is currently the subject of review [which] will benefit the company through lower stock requirements next year and consequent lower borrowings.

Begin, as our FTSE 100 FD did, with operating profit [A], and depreciation (and amortisation) [B], which appear at the top of ABBEYCREST's Note 23 on *Reconciliation of operating profit to net cash flow from operating activities*, shown above.

The next thing to notice in Abbeycrest's reconciliation statement is that, in 2002, the *Operating profit* [A] plus *Depreciation* [B] totalled just over £6m, but the *Net cash inflow from operating activities* [C] was only £1.813m. The main reason sticks out like a sore thumb: Stocks up £9.558m – a bit out of control?

In 2003 stocks were reduced by £4.077m, and working capital by £2.156m, compared with an increase in working capital of £4.444m in 2002.

ABBEYCREST Extract from 2003 accounts**Consolidated cash flow statement**

		2003	2002
		£000	£000
Net cash inflow from operating activities	[D]	6,126	1,813
Returns on investment and servicing of finance	[E]	(2,468)	(2,080)
Taxation	[F]	(456)	(918)
Capital expenditure and financial investment	[G]	(2,809)	(1,158)
Acquisitions	[H]	–	(723)
Equity dividends paid	[I]	(1,045)	(1,627)
Cash (outflow)/inflow before financing		(652)	(4,693)
Financing	[J]	2,437	(321)
(Decrease)/increase in cash in the year	[L]	1,785	(5,014)

ABBEYCREST Note to the 2003 accounts**Note 24. Analysis of cash flows**

	Group	
	2003	2002
	£000	£000
Returns on investment and servicing of finance		
Interest received	241	220
Interest paid	(2,556)	(2,298)
Interest element of finance lease rental payments	(2)	(2)
Dividend paid to minority interest	(151)	—
Net cash outflow for returns on investments and servicing of finance	[E] (2,468)	(2,080)
Capital expenditure and financial investment		
Purchase of tangible fixed assets	(3,080)	(1,291)
Sale of tangible fixed assets	271	133
Net cash outflow for capital expenditure and financial investment	[G] (2,809)	(1,158)
Acquisitions		
Purchase of shares from minority interests in subsidiaries	—	(1,127)
Cash from sale of investments	—	404
Net cash outflow for acquisitions	[H] —	(723)
Financing		
Issue of ordinary share capital	[J] 10	3
New secured loan	[K] 6,500	—
Repayment of secured loan	[K] (650)	(300)
Repayment of loan notes	[K] (3,399)	—
Capital element of finance lease rental payments	[K] (24)	(24)
Net cash inflow (outflow) from financing	[M] 2,437	(321)



Watch the working capital. If it isn't kept under firm control it will gobble up the company's cash like a hungry alligator.

To move on, the *bottom line* of the reconciliation statement [C] provides the *top line* of the cash flow statement, [D].

In Abbeycrest's cash flow statement the difference in the top line [D] between 2002 and 2003 is (in £000) 4,313 but the difference in the bottom line [L] is 6,799, which is 2,486 more. Analysts should ask themselves 'Why the difference?'

There were several reasons:

- [G] Capex in 2003 was £2.809m v £1,158m in 2002;
- [H] No acquisitions in 2003 v £0.723m in 2002;
- [I] Lower dividend in 2003 (no Interim was paid).

But the principal reason was:

- [J] the refinancing in 2003, a net £2.437m.

Note 24 gives the details: a new £6.5m secured loan replaced a much smaller secured loan and £3.399m repayment of short-term loan notes – a much more satisfactory longer-term financing.

Reconciliation of net cash flow to net debt

FRS1 requires a note reconciling the movement of cash in the period to the movement in net debt, to be shown either with (but not as part of) the cash flow statement, or in a note. Abbeycrest shows its reconciliation in Note 26.

ABBEYCREST Note to the 2003 accounts

Note 25. Analysis of net debt	[R]	[S]	[T]	[U]	[V]
1 March			Exchange	Non-cash	28 February
2002		Cashflow	movement	movement	2003
	£000	£000	£000	£000	£000
Cash at bank and in hand	5,286	2,702	(71)	–	7,917
Overdrafts	(25,335)	(917)	–	–	(26,252)
	(20,049)	[L] 1,785	(71)	–	(18,335)
Debt due after one year	–	(4,550)	–	–	(4,550)
Debt due within one year	–	(1,300)	–	–	(1,300)
Loan notes	(3,399)	3,399	–	–	–
Finance leases	(54)	24	–	(28)	(58)
	(3,453)	[M] (2,427)	[O] –	[N] (28)	(5,908)
Net debt	[P] (23,502)	(642)	(71)	(28)	[Q] (24,243)

ABBEYCREST Note to the 2003 accounts**Note 26. Reconciliation of net cash flow to movement in net debt**

	2003
	£000
Increase in cash in the year	[L] 1,785
Cash inflow from increase in debt and lease financing	[M] (2,427)
	(642)
New finance leases	(28)
Exchange differences	(71)
	(741)
Net debt at beginning of year	(23,502)
Net debt at end of year	(24,243)

[U] Other non-cash changes, and recognition of changes in market value.

TERMINOLOGY**Cash flow statements**

Cash is cash in hand and deposits repayable on demand *less* overdrafts repayable on demand; i.e. they can be withdrawn at any time and without penalty. Cash includes cash and deposits denominated in foreign currencies.

Liquid resources are current asset investments held as readily disposable stores of value. To be **readily disposable** an investment must be one that:

- is disposable without curtailing or disrupting its company's business; and
- is *either* readily convertible into known amounts of cash at or close to its carrying amount, *or* traded in an active market.

Analysis of net debt

FRS1 requires a note analysing the movement in net debt during the period, to be shown separately, either adjoining the cash flow statement, or in a Note. Abbeycrest's analysis, is shown in Note 25.

The changes in net debt should be analysed from the opening [R] to the closing component amounts [V], showing separately, where material, changes resulting from:

- [S] The cash flows
- [T] Exchange movement

Acquisitions and disposals

A note to the cash flow statement should show a summary of the effects of acquisitions and disposals of subsidiary undertakings, indicating how much of the consideration comprised cash (see TT ELECTRONICS below).

TT ELECTRONICS Note to the 2003 financial statements**27. Acquisitions**

(a) The group acquired Optek Technology, a sensor manufacturer, on 3 December 2003

Assets acquired

	Book value £million	Valuation adjust's £million	Fair value £million
Tangible fixed assets	4.9	0.3	5.2
Stocks	3.2	–	3.2
Debtors	4.7	–	4.7
Cash	0.4	–	0.4
Trade and other creditors	(4.7)	–	(4.7)
Deferred tax	<u>1.2</u>	<u>(0.1)</u>	<u>1.1</u>
Total net assets	9.7	0.2	9.9
Goodwill			<u>20.7</u>
Cost of acquisition			<u>30.6</u>

...

Satisfied by

	£million
Consideration – cash	30.3
Costs – cash	<u>0.3</u>
	<u>30.6</u>

(b) ...

Non-cash items and restrictions on transfer

Material transactions which do not result in movements of cash of the reporting company should be disclosed in the notes to the cash flow statement if disclosure is necessary for an understanding of the underlying transactions.

The direct and indirect methods

These are the two methods for reporting net cash flow from operating activities.

As we saw in the extract from Abbeycrest's accounts, Note 23 on page 164, the **indirect method** starts with *Operating profit* and adjusts it for depreciation and other non-cash credits and charges to get to *Net cash flow from operating activities*.

The **direct method**, on the other hand, gets to *Net cash flow from operating activities* by adding up all operating cash receipts and payments. As illustrated in the MARKS & SPENCER extract below, these include

- [A] Receipts from customers,
- [B] Payments to suppliers and
- [C] Payments to and on behalf of employees.

MARKS & SPENCER Consolidated cash flow information for the year ended 31 March 2001

Cash flow statement		2001 £m	2000 £m
Operating activities			
Received from customers	[A]	7,967.8	7,989.9
Payment to suppliers	[B]	(5,240.7)	(5,357.1)
Payment to and on behalf of employees	[C]	(1,089.8)	(1,138.3)
Other payments		<u>(930.6)</u>	<u>(803.8)</u>
Cash flow from operating activities before exceptional item		706.7	690.7
Exceptional operating cash outflow	Note 28 (below)	<u>(30.3)</u>	<u>(49.2)</u>
Cash inflow from operating activities		676.4	641.5
...			
Note 28. Analysis of cash flows given in the cash flow statement		2001	2000
...		£m	£m
Exceptional operating cash flows			
UK redundancy costs paid		(29.5)	(44.7)
European restructuring costs paid		<u>(0.8)</u>	<u>(4.5)</u>
Exceptional operating cash outflow		<u>(30.3)</u>	<u>(49.2)</u>

FRS 1 encourages companies to use the direct method but not many do so, because it means providing *extra* information; companies using the direct method *also* have to produce a reconciliation between *Operating profit* and *Net cash flow from operations* i.e. the same information as with the indirect method.

It is a pity that the direct method is not compulsory, as it shows the *actual size* of the cash flows in a company, giving a much better feel of the scale of operations than the indirect method's netted off figures.

Restrictions on remittability

Where restrictions prevent the transfer of cash from one part of the business or group to another, a note to the cash flow statement should specify the amounts and explain the circumstances.

CADBURY SCHWEPPEs, shown below, does not specify the amounts because they have 'no material adverse impact':

CADBURY SCHWEPPEs *Extract from OFR 2000*

Capital structure and resources

...
While there are exchange control restrictions which affect the ability of certain of the Group's subsidiaries to transfer funds to the Group, the operations affected by such restrictions are not material to the Group as a whole and the Group does not believe such restrictions have had or will have any material adverse impact on the Group as a whole or the ability of the Group to meet its cash flow requirements.

Limitations of cash flow statements

A cash flow statement is a record of historical facts. It will record expenditure upon additional plant and machinery, but can express no opinion upon whether the expenditure was necessary, or will be profitable.

Similarly it may show an expansion of stocks (or debtors), but it does not tell us whether this was due to

- poor stock or production control;
- inability to sell the finished product; or

- a deliberate act of policy, because of a feared shortage of supply, a potential price rise, or the need to build up stocks of a new model (or product) before it is launched.

Furthermore, in the case of increased debtors, it will not tell us whether it is

- the debtors who are slow to pay; or
- the credit policy which has changed; or
- the accounts department has fallen behind with invoicing; or because
- they merely represent the expansion of turnover.

It will show how new capital was raised, but not whether it was raised in the best way, nor indeed whether it really needed to be raised at all or if the need could have been avoided by better asset control.

When companies have large amounts of cash, the cash flow statement does not tell us where the cash is. Only if it is locked up in an overseas subsidiary, perhaps deposited in an obscure currency in an obscure country (like Turkish Cyprus as was the case with POLLY PECK), where it cannot be remitted to the UK, can we expect to be told – by which time it may well be too late.

Where there are large amounts of both cash and borrowings, the cash flow statement does not tell us why the company does not use the cash to reduce its debts. There may be several reasons:

1. It may be better to borrow in the USA, where corporation tax is higher than in the UK, and to keep deposits in the UK.
2. The cash may not have been remitted, to avoid having to pay tax on remitting it.
3. The company may have borrowed cheaply longer-term or have favourable facilities and be 'round tripping' – borrowing at a lower rate and taking advantage of higher current interest rates to lend money back at a profit.

Borrowing facilities

Some years ago, companies used to be reluctant to disclose details of their *unused* borrowing facilities, for fear, perhaps, that if they subsequently reached the limits, they would not want to disclose 'unused facilities – Nil'.

Nowadays, FRS 13 (see Chapter 14) requires listed companies to disclose details. An example is LONMIN:

LONMIN Note from the 2003 accounts**Undrawn committed borrowing facilities**

	2003	2002
	\$m	\$m
Expiring in one year or less	178	178
Expiring in more than one year but not more than two years	182	–
Expiring in more than two years	<u>177</u>	<u>87</u>
	<u>537</u>	<u>265</u>

Although it is prudent to have plenty of financial elbow room, *it is not a good idea* for a company to have very large unused facilities in place if it has had to pay its bankers a hefty arrangement fee for setting up the facility and is paying an ongoing annual ‘*Commitment commission*’ on the unused amount.

Take, for example, BOOTS the Chemist:

BOOTS Extract from 2003 Financial Review**Liquidity and funding**

The company has good access to the capital markets due to its strong credit ratings from Moody’s and Standard & Poor’s . . .

The group has credit facilities with 7 banks, which mature in 2004, £462m of which remain undrawn. Short-term needs are met from uncommitted bank lines.

It would be helpful to the shareholder to know the underlying strategy; if the undrawn £462m is part of what is known in the City as a ‘*War chest*’ to fund acquisitions being planned, then Boots’ reticence is understandable. When a takeover has been announced, a company can be more informative, e.g. the Ready Mixed Concrete group RMC:

RMC Extract from note to 2003 accounts**Note 29. Derivatives and other financial instruments
d) Borrowing facilities**

The group has undrawn, committed, borrowing facilities at 31 December as follows:

	2003	2002
	£m	£m
Expiring in more than one year but not more than two years	–	–
Expiring in more than two years	<u>374.6</u>	<u>539.1</u>
Total	<u>374.6</u>	<u>539.1</u>

A cash flow statement may highlight a deteriorating situation, but does not tell the reader:

- just how close a company is to the limit of its facilities;
- whether it is in danger of breaching any of its borrowing covenants;
- whether the company’s bankers are getting nervous, or are still confident of its recovery.

And, of course, it only shows the cash flows for the year which ended some months ago and, as we saw in the recession in the early 1990s, liquidity problems can and do arise very quickly.

Cash requirements

There are three main areas to look at in identifying cash requirements:

1. **Repayment of existing loans** due in the next year or two, including convertible loans whose conversion rights are unlikely to be exercised.
2. **Increase in working capital.** Working capital tends, in an inflationary period and/or when a business expands, to rise roughly in line with turnover. It is useful therefore to use the Working capital/Sales ratio to establish the relationship between working capital and sales.

Working capital to sales =

$$\frac{(\text{Stock} + \text{Trade debtors}) - \text{Trade creditors}}{\text{Sales}}$$

A company with a low working capital ratio should find it easier to grow than a company with a high working capital ratio, like ABBEYCREST, on the next page. ABBEYCREST exercised strict discipline on working capital in 2003: stock was cut by more than £2m, debtors were reduced by £2.5m and trade creditors were increased by nearly £1m.

This cut its Working capital/Sales ratio from 65% in 2002 to 54% in 2003, reducing working capital by more than £5m.

ABBEYCREST Working capital ratio

	2003		2002
	£000		£000
Stock	32,200		36,398
+ Trade debtors	16,039		18,481
– Trade creditors	<u>(5,547)</u>		<u>(4,602)</u>
= Working capital	<u>42,692</u>		<u>50,277</u>
YoY decrease in working capital	(7,585)		
Sales	98,840	[A]	91,475
YoY increase in sales (£000)	7,365	[B]	
Working capital/Sales ratio (%)	43.19		54.96 [C]
YoY decrease in Wcap ratio (%)	11.77	[D]	
– due to increased sales (£000)	4,048	[B] × [C]	
– due to decrease in ratio (£000)	<u>(11,623)</u>	[A] × [D]	
	<u>(7,585)</u>		

Compare that with TESCO:

TESCO Working capital ratio

	2003	2002
	£m	£m
Stocks	1,140	929
+ Trade debtors	–	–
– Trade creditors	<u>2,196</u>	<u>1,830</u>
= Negative Working capital	<u>(1,056)</u>	<u>(901)</u>
Sales	26,337	23,653
Working capital/Sales ratio (%)	(4.0)	(3.8)

to expand; for example the international mining company RIO TINTO:

RIO TINTO Working capital ratio

	2003	2002
	US\$m	US\$m
Inventories	1,783	1,502
+ Trade debtors	1,266	1,176
– Trade creditors	<u>(737)</u>	<u>(584)</u>
= Positive Working capital	<u>2,312</u>	<u>2,094</u>
Sales	9,228	8,443
Working capital/Sales ratio (%)	25.1	24.8



Requirements for additional working capital for expansion

Any business that can sell goods to its customers for cash *before* it has to pay for those goods, won't need any additional working capital for expansion; rather the reverse.

Conversely, companies that have to carry large amounts of stock, work in progress and finished goods at their own expense will need additional working capital if they want

3. **Capital expenditure requirements.** This is likely to be a rough estimate, unless the company discloses details of both amounts and timing of planned Capex. Points to check:

(a) **Note on capital commitments, e.g.:**

ABBEYCREST 2003 accounts

There was no Note on capital commitments. Capex was cut out to reduce debt.

(b) Cash flow statement, e.g.:

ABBEYCREST Note to Group cash flow statement		
	2003	2002
	£000	£000
Capital expenditure		
Payments to acquire tangible fixed assets	(3,080)	(1,291)
Receipts from sale of tangible fixed assets	271	133
...		

(c) Comments in the annual report, e.g.:

ABBEYCREST Chairman's report 2003	
Prospects	
... The improvements that have been achieved in the operation and control of the Group are already bearing fruit. The commercial advantages and growth potential of Abbeycrest Thailand's new gold jewellery factory will be felt in the current financial year as will the concentration of production ...	

Our comments

If sales increase by, say, 15% in 2004 and the 2003 Working capital/Sales ratio remains unchanged, Abbeycrest will require $£53.786 \times 0.15 = £8\text{m}$ more working capital.

Cash shortfall

If the net cash flow looks like falling short of the cash requirements we have identified, then the company may have to

- increase its overdraft (but is it at the limit of its facilities? – we probably don't know);
- borrow longer-term (can it do so within its borrowing limits?);
- make a rights issue (is its share price at least 20% above par, is it at least a year and preferably two years since its last rights issue, and are market conditions suitable?);
- acquire a more liquid and/or less highly geared company for paper (i.e. bid for another company using shares);

- sell some assets (has it any listed investments which could be sold, or has it any activities which could be sold off without seriously affecting the business?);
- sell and lease back some of the properties used in the business (has it any unmortgaged properties?);
- cut back on capital expenditure that has not already been put out to contract;
- tighten credit and stock control;
- reduce or omit the ordinary dividend, and possibly even the preference dividend too.

If the company takes none of these steps it will run into an overtrading situation, which is likely to precipitate a cash crisis unless, as a last resort, it:

- reduces its level of trading.

Cash flow – definitions and ratios**Free cash flow (FCF)**

As discussed at the beginning of this chapter, common sense would suggest that *free cash flow* is 'What the Board is **free** to spend' once all obligatory and virtually obligatory payments had been made. And this is how STAGECOACH presented it, as shown below:

STAGECOACH GROUP Extract from 2003 accounts		
	2003	2002
	£m	£m
Consolidated cash flow statement		
Net cash inflow from operating activities	272.2	259.9
Dividends from joint ventures and associates	5.3	5.0
...		
Net cash outflow from returns on investments and servicing of finance	(51.9)	(60.9)
Taxation	(7.8)	(16.7)
...		
Free cash flow	217.8	184.3

Free cash flow comprises net cash inflow from operating activities, dividends from joint ventures and associates, net cash outflow from returns on investments and servicing of finance, and taxation.

However, a large number of companies don't even mention FCF, while others have their 'Own brand' definitions.

CADBURY SCHWEPPEs deducts *Net capital expenditure* as well as *Interest, Tax* and *Dividends* to arrive at FCF, while W. H. SMITH deducts *Dividends* after FCF.

But the company showing the most individuality on *free cash flow* must surely be BOOTS:

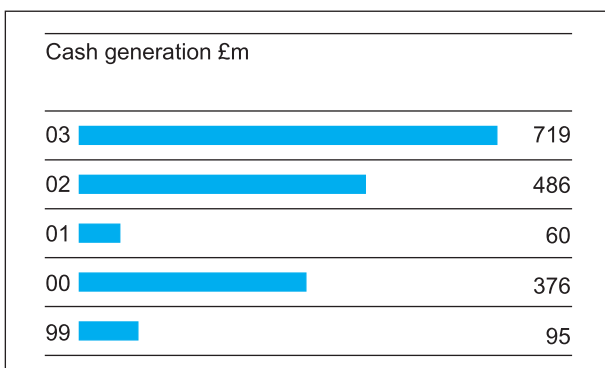
BOOTS Extract from Financial review 2003

The following summary of cash flow demonstrates the company's ability consistently to generate **free cash flow**.

Free cash flow is defined as the cash flow available to all providers of capital.

Summary of cash flows	£m 2003	£m 2002
Operating cash flows before exceptionals	590	792
Exceptional operating cash flows	(8)	(29)
Acquisitions/disposals of businesses	358	4
Purchase of fixed assets	(146)	(172)
Disposal of fixed assets	119	62
Disposal of own shares	3	8
Taxation paid	(197)	(139)
Free cash flow	719	486
...		

The following chart shows the amounts of free cash flow generated by the group for each of the last five years.



Authors' comments on free cash flow

On page 173 is an edited version of Boots' *Group financial record 2003* using 'common sense' to produce bottom line values of [f] the free cash flow in the years 1999 to 2003.

Boots' common sense free cash flow has been steady, as you would expect of this prosperous 'household name' retailer.

Boots' 'own brand' definition, on the other hand, produces a 53% fall in its 'Own brand' of free cash flow in 1999, followed by a 296% rise in 2000.

Cash flow ratios

Cash flow can be given *per share*:

$$\text{Cash flow per share} = \frac{\text{(Attributable profits plus depreciation)}}{\text{Number of ordinary shares in issue}}$$

The definition used by REFS (see page 247) is:

$$\text{Cash flow per share} = \frac{\text{(Cash flow from operating activities + return on investments and servicing of finance - Taxation paid)}}{\text{Weighted average number of ordinary shares in issue during the period}}$$

Capex per share can then be compared with Cash flow per share. If this is done in terms of 'common sense' free cash flow, it will show how much of their 'disposable income' the Board is spending on capital investment.

To show ABBEYCREST'S *Free Cash Flow* in 2002 and 2003, we take Abbeycrest's Consolidated cash flow statement on page 164 and rearrange it as shown on the next page. This also shows how the free cash flow was spent:

- **In 2002** Cash flow from operations plummeted to £1.8m, less than interest paid; FCF went negative (£2.8m), while Capex and an acquisition left the company with a (£5m) deficit.
- **In 2003** Cash flow from operations recovered to £6.1m, and FCF to £2.1m. Capex was 30% more than this, but a new secured loan (less repayments) improved the cash position by nearly £1.8m.

BOOTS Edited extract from Group financial record 2003

Cash flow statement	Authors' Notes	2003 £m	2002 £m	2001 £m	2000 £m	1999 £m
a Cash inflow from operating activities		582.3	722.4	664.4	753.7	601.9
b Net interest received/(Paid)		75.0	40.7	(22.6)	(9.8)	(24.9)
c Taxation		(196.7)	(139.2)	(167.4)	(154.4)	(112.4)
d = a +/- b - c	1	460.4	623.9	474.4	589.5	464.6
e Equity dividends paid		(238.3)	(234.5)	(224.0)	(216.3)	(207.1)
f = d - e	2	222.3	389.4	250.4	373.2	257.5

Authors' notes

1. Often called 'Gross cash flow'
2. Often called 'Net cash flow'

ABBEYCREST Consolidated Cash Flow Statement 2003. Sequence of items rearranged

	2003 £000	FCF	2002 £000
Net cash flow from operating activities	6,126		1,813
Net interest paid	(2,468)		(2,080)
Taxation	[F] (456)		(918)
Equity dividends paid	(1,045)		(1,627)
Common sense free cash flow	2,157	100%	(2,812)
<i>Less:</i>			
Capital expenditure and financial investment	(2,809)	(130%)	(1,158)
Acquisitions and disposals	—	—	(723)
Cash(outflow)/inflow before financing	(652)	(30%)	(4,693)
Financing – (new loan note, etc.)	2,437	113%	(321)
(Decrease)/Increase in cash in the year	1,785	83%	(5,014)

ABBEYCREST Consolidated cash flow statement for the 6 months ended 31 August 2003

	6 months to 31 August 2003 £000	6 months to 31 August 2002 £000	Year to 28 February 2003 £000
Net cash (outflow)/inflow from operating activities	[A] (5,935)	[B] (12,014)	6,126
Returns on investments and servicing of finance	(773)	(1,016)	(2,468)
Taxation	(47)	(46)	[C] (456)
Capital expenditure and financial investment	(156)	(1,367)	(2,809)
Acquisitions and disposals	—	—	—
Equity dividends paid	(247)	(1,144)	(1,045)
Cash outflow before financing	(7,158)	(15,587)	(652)
Financing . . .			

'Sherlock Holmes' approach to cash flow

We call it the Sherlock Holmes approach because the cash flow statement often contains clues: clues on questions to ask, and where to look for the answers.

We will round off this chapter with examples of clues we found in ABBEYCREST's interim report for the 6 months ending 31 August 2003, shown on the previous page.

Clue No. 1

[A] Almost £6m net cash outflow from operating activities! Golly gumdrops, the company must be haemorrhaging cash. No, hang on a minute, [B] there was a £12 million outflow in H1/02. Could it be a seasonal business?

Look back at the Directors' annual report:

ABBEYCREST Directors' report 2003**Principal activity**

The principal activity of the group is the design, manufacture and distribution of gold and silver jewellery.

As the company manufactures, it may be building stock for Christmas. Details of changes in working capital will be in a note:

ABBEYCREST Interim cash flow statement**Note 1 Reconciliation of operating profit to net cash (outflow)/inflow from operating activities**

...
Increase in stocks (£000) (2,981)

This compares with (9,417) two years ago.

Does the Chairman make any comment on stocks?

ABBEYCREST Chairman's interim statement**Review of activities**

... Disposal of the excess stocks identified twelve months ago has continued well, with the emphasis being on addressing the more difficult stock to dispose of.

Clue No. 2

Why was £456,000 tax [C] paid in 2003, although Note 8 to the profit and loss account, below, showed a tax credit of £132,000 ?

Remember that a cash flow statement shows the amount of tax actually paid in the period, rather than the tax charge for the period, so it looks as though the previous year (2002) was profitable, but 2003 was not.

ABBEYCREST Extract from the 2003 accounts

	2003
	£000
Note 8 Tax on profit on ord. activities	
UK Corporation tax	(69)
Foreign tax	257
Deferred tax	(331)
Tax charge in respect of the current year	(143)
Adjustment in respect of prior years	<u>11</u>
Total tax charge (credit)	(132)

Snippets of information

Always be on the lookout for snippets of information: they can be very important. In ABBEYCREST's case the last paragraph of the Chairman's statement in the Interim report to 31 August 2003 states:

ABBEYCREST Extract from Chairman's statement in the Interim report to 31 August 2003

... I am pleased to announce that I intend to split the roles of Chairman and Chief Executive ... with effect from 1 March 2004.

Research we did some years ago showed that 60% of Listed and USM companies that went bust had a combined Chairman and Chief Executive, compared with 45% of USM companies that survived, and less than 35% of listed companies.

Our view is that it is the duty of the Chairman to replace the Chief Executive if he's not up to the job. This is rather difficult if he's one and the same person.

Interests in another company

If a company, A, wishes to obtain an interest in the activities of another company, B, it may do so in three ways:

1. by buying some or all of the *assets* of B;
2. by buying *shares* in B;
3. by *making a bid* for B.

Buying assets of company B

If company A only wishes to acquire some or all of the assets of company B, it may do so either by paying cash or by paying in shares of company A; the latter is an example of a vendor consideration issue of shares described in Chapter 18.

Example 20.1 below illustrates acquiring all the assets of a company, rather than the company itself. Note that, in the example, Company B remains an independent company.

Example 20.1 Acquisition of assets by share issue

Let us suppose that, at 31 December 2004, the balance sheets of A and B were:

	A	B
	£000	£000
Ordinary share capital	800	80
Reserves	<u>280</u>	<u>340</u>
	<u>1,080</u>	<u>420</u>
Net assets	<u>1,080</u>	<u>420</u>

Suppose A purchases the net assets of B by the issue to company B of 600,000 £1 ordinary shares (valued at par at the time).

Company A's balance sheet at that date would become:

	£000
Ordinary share capital	1,400
Reserves	<u>280</u>
	<u>1,680</u>
Net assets (£1,080,000 + £420,000)	1,500
Goodwill (£600,000 – £420,000)	<u>180</u>
	<u>1,680</u>

Company B's balance sheet after A's purchase would show:

	£000
Ordinary share capital	80
Reserves (£340,000 + £180,000 profit on realisation of net assets)	<u>520</u>
	<u>600</u>
Investment at cost	<u>600</u>

Company B would not cease to exist; it would become an investment holding company.

Had A's shares been listed and had they been standing at, say, 300p at the time, A might have issued 200,000 £1 ordinary shares, and A's balance sheet after the purchase would then have been:

	£000
Ordinary share capital	1,000
Share premium account	400
Other reserves	<u>280</u>
	<u>1,680</u>
Net assets	1,500
Goodwill	<u>180</u>
	<u>1,680</u>

Buying some shares in company B

There are four possibilities:

1. If A acquires less than 3% of the equity of B, A's balance sheet would show the purchase as an investment (see Chapter 9).
2. If A acquires 3% or more of the equity of B, the purchaser would still show the purchase as an investment, but would be obliged by Section 134 of the Companies Act 1989 to declare its interest.
3. If A acquires 20% or more of the equity of B, and is allowed by B to participate in the major policy decisions of B, usually by holding a seat on B's board, then A should treat B as an associated undertaking (see Chapter 22).
4. If A acquires 30% or more of the voting rights of B, or if A in any period of 12 months adds more than 2% to an existing holding of between 30% and 50% in B, then Rules 9.1 and 9.5 of the Takeover Code oblige A to make a bid for the remainder of the equity of B at a price not less than the highest price A paid for any B shares within the preceding 12 months.

Making a takeover bid for company B

Company A may offer the shareholders of B either cash or 'paper' (i.e. shares and/or loan stock and/or warrants of A). If A has already gone over the 30% limit or has added more than 2% in 12 months to a holding of 30–50%, the offer must be in cash or be accompanied by a cash alternative. If the bid results in A acquiring 90% or more of the shares of B that it did not already own, A may force the remaining B shareholders to accept the bid using the procedure laid down in Section 428 of the Companies Act 1985.

The remainder of this chapter is concerned with cases where Company A acquires control of company B.



Two ways of accounting

There are two ways of accounting for an acquisition:

1. Acquisition accounting, and
2. Merger accounting.

The two methods are entirely different and give quite different results in the group accounts.

FRS 6 Acquisitions and mergers

FRS 6 restricts the use of merger accounting to those business combinations where the use of acquisition accounting would not properly reflect the true nature of the combination. Acquisition accounting is to be used for all business combinations where a party can be identified as having the role of an acquirer. Because acquisition accounting is the usual method, and by far the more common method, we assume acquisition accounting in this chapter, leaving a detailed discussion of the two methods, acquisition accounting and merger accounting, to Chapter 21.

First the reader needs to understand:

- (a) what holding companies, subsidiaries and groups are;
- (b) how group accounts (or consolidated accounts) work.

Holding companies, subsidiaries and groups

Some definitions

Under CA 1985, an undertaking is the *parent undertaking* of another undertaking (a *subsidiary undertaking*) if any of the following apply:

- (i) it holds a majority of the voting rights in the undertaking;
- (ii) it is a member of the undertaking and has the right to appoint or remove directors holding a majority of the voting rights at meetings of the board on all, or substantially all, matters;
- (iii) it has the right to exercise a dominant influence over the undertaking:
 - (a) by virtue of provisions contained in the undertaking's memorandum or articles; or
 - (b) by virtue of a control contract in writing and of a kind authorised by the Memorandum or Articles and permitted by the law under which the undertaking is established;
 - (c) it is a member of the undertaking and controls alone, pursuant to an agreement with other shareholders, a majority of the voting rights in the undertaking;
 - (d) it has a participating interest in the undertaking and it actually exercises a dominant influence over the undertaking; or it and the undertaking are managed on a unified basis.

A *wholly owned subsidiary* is one in which all the share capital is held either by the holding company or by other wholly owned subsidiaries.

A *partially owned subsidiary* is one in which some of the share capital is owned outside the group. For an illustration of these terms, see Example 20.2. A parent undertaking is also often termed the *holding company*, and, as we have seen, a holding company and its subsidiaries are referred to as a *group*.

Example 20.2 Partially and wholly owned subsidiaries

H is the holding company of a group of companies, and is incorporated in Great Britain.

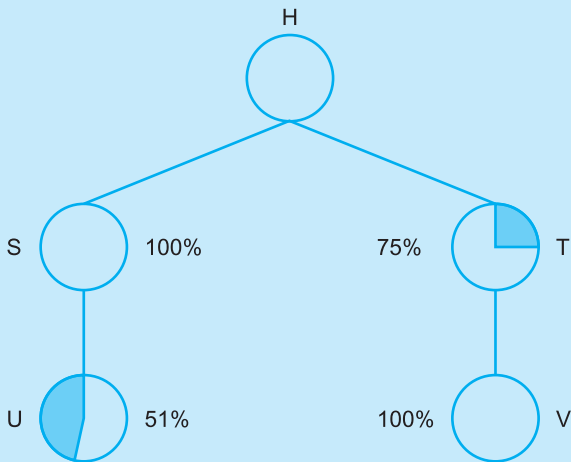
H holds 100,000 of the 100,000 ordinary shares of S

H holds 7,500 of the 10,000 ordinary shares of T

S holds 5,100 of the 10,000 ordinary shares of U

T holds 1,000 of the 1,000 ordinary shares of V

The H group may be depicted thus:



In law, the parent of a subsidiary is the parent of its subsidiary.

The H group consists of:

- H's wholly owned subsidiary S
- H's partially owned listed subsidiary T (in which there is a 25% minority)
- T's wholly owned subsidiary V (which in law is also a subsidiary of H, but colloquially a partially owned subsubsidiary of H)
- S's partially owned subsidiary U (in which there is a 49% minority).

In the past, all these relationships depended on voting control, but over the years the ingenuity of companies and their financial advisors to facilitate operation overseas, or in an attempt to keep companies off balance sheet (to hide either their liabilities or true profitability or their tendency to be loss-making), or simply to avoid tax, led to numerous devices which kept companies outside the group for purposes of the consolidated accounts. The Companies Act 1985 and FRS 2 *Accounting for subsidiary undertakings* have done much to prevent this.

Group accounts

If, at the end of a financial year, a company is a parent company, group accounts have to be prepared as well as individual accounts for the parent company (CA 1985, s. 227), although small and medium-sized private groups are exempt from this (CA 1985, s. 248). Group accounts comprise:

- a consolidated balance sheet; and
- a profit and loss account dealing with the parent company and its subsidiary undertakings.

Additional information

If the matters required to be included in group or individual company accounts would not be sufficient to give a true and fair view, the Act requires that 'the necessary additional information shall be given'.

Consolidated accounts

The consolidated balance sheet

In simple terms a consolidated balance sheet shows all the assets and all the liabilities of all group companies whether wholly owned or partially owned. Where a partially owned subsidiary exists, its shareholders' funds are provided partly by the holding company and partly by the minority.

To illustrate the basic principles of consolidated accounts let us take the case of a holding company, H, with a partially owned subsidiary, S, and imagine that we wish to prepare the consolidated balance sheet for the

H GROUP at 31 December 2003. H paid £340,000 cash for 200,000 of the 250,000 £1 ordinary shares of S on 1 January 1996.

The balance sheet of S at acquisition was:

S Balance sheet at 1 January 2001		£000
Fixed assets:		
Freehold land and buildings		120
Plant and machinery		<u>146</u>
		266
Net current assets		<u>169</u>
		<u>435</u>
Ordinary share capital		250
Reserves		<u>85</u>
Ordinary shareholders' funds		335
7% Debenture		<u>100</u>
		<u>435</u>
H and S Balance sheets at 31 December 2003		
	H	S
	£000	£000
Fixed assets:		
Freehold land and buildings	150	120
Plant and machinery	250	<u>180</u>
	400	300
Shares in S	340	–
Net current assets	<u>360</u>	<u>200</u>
	<u>1,100</u>	<u>500</u>
Ordinary share capital	500	250
Reserves	<u>480</u>	<u>150</u>
Ordinary shareholders' funds	980	400
10% Unsecured loan stock	120	–
7% Debenture	<u>–</u>	<u>100</u>
	<u>1,100</u>	<u>500</u>

There are six steps to consolidating the two companies' balance sheets at 31 December 2003:

1. *Ascertain the goodwill* by comparing the cost to H of its investment in S with H's share of the equity shareholders' funds of S at the date of acquisition. The goodwill will be:

	£000	£000
Purchase consideration		340
Holding company's share of ordinary shareholders' funds at date of acquisition:		
4/5 of Ordinary share capital	200	
4/5 of Reserves	<u>68</u>	<u>268</u>
Goodwill		<u>72</u>

Note that:

- Any pre-acquisition profits of S which have not already been distributed will form part of that company's reserves, and are thus represented by equity shareholders' funds taken into account in computing goodwill.
- Any distribution by S after it is acquired by H which is made out of pre-acquisition profits (i.e. reserves existing at acquisition) must be credited not to the profit and loss account of H as income, but to the asset account 'Investment in S' as a reduction of the purchase price of that investment. The goodwill does not change.

2. *Compute the holding company's share* of the undistributed post-acquisition profits of the subsidiary.

This equals the holding company's proportion of the change in reserves since the date of acquisition:

$$\frac{200,000}{250,000} \times (£150,000 - £85,000) = £52,000$$

This, added to the holding company's own reserves, represents the reserves of the group which will appear in the consolidated balance sheet:

$$£52,000 + £480,000 = £532,000$$

3. *Compute minority interests* in the net assets of S:

$$\text{Minority interests} = \text{Minority proportion} \times \text{Equity shareholders' funds of S at 31 December 2003}$$

The minority interest in the equity shareholders' funds of S is:

$$\frac{50,000}{250,000} \times £400,000 = £80,000$$

4. Draw up the consolidated balance sheet:

- (i) insert as share capital the share capital of the holding company;
- (ii) insert the figures already computed for
 - goodwill (see 1 above) and
 - minority interests (see 3 above);
- (iii) show as 'reserves' the total of the reserves of the holding company and the post-acquisition reserves of the subsidiary applicable to the holding company (see 2 above).

5. *Cancel out any inter-company balances*: the aim of the consolidated balance sheet is to show a true and fair view of the state of affairs of the group as a whole. Inter-company balances (where an item represents an asset of one group company and a liability of another) must be cancelled out since they do not concern outsiders. Thus, if S owes H on current account £10,000, this £10,000 will appear as an asset in H's own balance sheet, and as a liability in that of S, but it will not appear at all in the consolidated balance sheet.

6. *Consolidate*: add together like items (e.g. add freehold land and buildings of the holding company and freehold land and buildings of the subsidiary) and show the group totals in the consolidated balance sheet. Omit, in so doing, the share capital of the subsidiary, reserves, and the investment in the subsidiary, which have already been taken into account in steps 1 to 3.

It will be seen (Example 20.3) that only the share capital of the holding company appears in the consolidated balance sheet. The share capital of the subsidiary has disappeared, one-fifth of it becoming part of 'minority interests' while the other four-fifths (£200,000), together with H's share of S's reserves on acquisition (£68,000) and the goodwill (£72,000) balance out the removal of H's balance sheet item 'shares in S' (£340,000).

Goodwill on consolidation arising prior to 1998

For accounting periods ending before 23 December 1998 companies could choose between two significantly different accounting policies:

Example 20.3 H GROUP Consolidated balance sheet at 31 December 1998: Goodwill treated as a fixed asset

	£000
Fixed assets:	
Goodwill	72
Freehold land and buildings	270
Plant and machinery	<u>430</u>
	772
Net current assets	<u>560</u>
	<u>1,332</u>
Ordinary share capital	500
Reserves	<u>532</u>
Ordinary shareholders' funds	1,032
Minority interests	80
H's 10% ULS	120
S's 7% Debenture	<u>100</u>
	<u>1,332</u>

- to write goodwill off immediately against reserves – thus goodwill never appeared either in the balance sheet or in the profit and loss account;
- to include goodwill in the balance sheet as an intangible fixed asset – this goodwill would be amortised over a period of usually 20 years, with the amortisation charge included in the profit and loss account and reflected in the operating profit for the year.

In practice, most UK companies chose the first option of immediate write-off against reserves, to avoid their reported profits being reduced by amortisation.

When FRS 10 was introduced (see below), any goodwill *subsequently arising* had to be included in the balance sheet as an intangible fixed asset.

FRS 10 allowed companies to leave their 'old' goodwill written off against reserves rather than reinstating it on the balance sheet. In practice, most companies did *not* bring 'old' goodwill back on to the balance sheet. The effect of this may be significant where large acquisitions had taken place prior to 1998. But the Companies Act 1985 does require companies to show the cumulative amount of 'old' goodwill written off against reserves, and not reinstated, although the figure is not always as easy to find as it is in KINGFISHER's accounts:

KINGFISHER Extract from 2003 accounts**Note 30. Reserves**

The cumulative amount of goodwill written off directly to reserves is £1,230.3m (2002: £1,230.3m).

...

Although FRS 10 allowed any goodwill which had previously been written off to reserves to remain written off, it also required that if a business to which written-off goodwill relates is subsequently sold or closed, that goodwill must be written back in the calculation of gain or loss on disposal.

One company that did reinstate goodwill that had been written off was REED ELSEVIER, amortising it as it would have been had the new accounting policy always applied. As a result Reed Elsevier's amortisation charge has been higher than most – see extract from the Group's 2003 report and accounts on page 181.

Like most companies that amortise goodwill, Reed Elsevier shows e.p.s. both *before* and *after* amortisation.

Goodwill on consolidation arising after 1998

Under FRS 10 *Goodwill and intangible assets* and FRS 11 *Impairment of fixed assets and goodwill*, purchased goodwill must be capitalised and either

- (a) amortised over its useful economic life; or
- (b) where useful economic life exceeds 20 years, or it is not amortised, its value must be reviewed annually for impairment. See KINGFISHER'S and REED ELSEVIER'S accounting policies.

KINGFISHER Extract from the 2003 accounts [Edited]**Note 1. Accounting policies**

...

Goodwill

Goodwill arising on all acquisitions **prior to 31 January 1998** remains eliminated against reserves. On the subsequent disposal of the business to which it relates, this goodwill will be charged in the profit and loss account.

Goodwill arising on acquisitions **since 31 January 1998** is included in the balance sheet at cost less

accumulated amortisation and any provisions for impairment. Goodwill, which represents the difference between the purchase consideration and the fair value of the net assets acquired, is capitalised and amortised on a straight line basis over a period which represents the directors' estimate of its useful economic life.

Where goodwill is regarded as having an indefinite life it is not amortised. The estimated useful economic life is regarded as indefinite where goodwill is capable of continued measurement and the durability of the acquired business can be demonstrated. Where goodwill is not amortised, an *annual impairment review* is performed and any impairment charged to the profit and loss account.

... With the exception of Castorama S.C.A., BUT S.A. and Hombach Holding A.G., all acquisitions since 31 January 1998 are considered by the directors to have an estimated useful economic life of up to 20 years.

... The directors consider that each of these businesses (Castorama S.C.A., BUT S.A. and Hombach Holding A.G.) have a proven ability to maintain their market leading positions over a long period and will adapt successfully to any foreseeable technological or customer-led changes and that barriers to entry into their markets exist, such that the businesses and their related goodwill will prove to be durable.

...

REED ELSEVIER Annual report 2003**Accounting policies****Goodwill and intangible assets**

On the acquisition of a subsidiary, associate, joint venture or business, the purchase consideration is allocated between the underlying net tangible and intangible assets on a fair value basis, with any excess purchase consideration representing goodwill.

Acquired goodwill and intangible assets are capitalised and amortised systematically over their estimated useful lives to a maximum of **40 years**, subject to annual impairment review.

For the majority of acquired goodwill and intangible assets, the maximum estimated useful life is 20 years, which is the rebuttable presumption under UK GAAP.

[This means that the maximum is 20 years unless a company rebuts the 20 years maximum by showing why it should be longer, as Reed Elsevier does:]

In view of the longevity of certain of the goodwill and intangible assets relating to acquired science and medical and educational publishing businesses, this presumption has been rebutted in respect of these assets and a maximum estimated useful life of 40 years determined . . .

Intangible assets comprise publishing rights and titles, exhibition rights and other intangible assets, which are stated at fair value on acquisition and are not subsequently revalued.

Under transitional arrangements, any goodwill which had previously been written off to reserves could remain there, until such time as the related business is disposed of (the policy adopted by KINGFISHER).

Companies have, however, the option to reinstate as an asset old goodwill previously written off to reserves. If they do this, either all 'old goodwill' or all 'post-FRS 7 goodwill' should be reinstated. REED ELSEVIER below reinstated all old goodwill, amortised as it would have been had the new accounting policy always applied.

REED ELSEVIER Note to the 2003 accounts

Note 13. Goodwill and intangible assets

Cost (£m)	Intangible		Total
	Goodwill	assets	
At 1 January 2003	4,527	4,311	8,838
Acquisitions	93	136	229
Disposals of businesses	(62)	(74)	(136)
Exchange translation differences	<u>(308)</u>	<u>(282)</u>	<u>(590)</u>
At 31 December 2003	<u>4,250</u>	<u>4,091</u>	<u>8,341</u>
Accumulated amortisation			
At 1 January 2003	1,717	1,307	3,024
Disposals of businesses	(53)	(48)	(101)
Charge for the year	257	185	442
Exchange translation differences	<u>(108)</u>	<u>(69)</u>	<u>(177)</u>
At 31 December 2003	<u>1,813</u>	<u>1,375</u>	<u>3,188</u>
Net book amount			
At 1 January 2003	2,810	3,004	5,814
At 31 December 2003	2,437	2,716	5,153

At 31 December 2003, the weighted average remaining estimated useful life of goodwill and intangible assets was 24 years (2002: 25 years).

REED ELSEVIER Extracts from combined report and accounts for the year ended 31 December 2003

	2003	2002
Combined profit and loss account	£m	£m
Gross profit	3,161	3,226
Operating expenses:		
Before amortisation and exceptional items	(2,002)	(2,113)
Amortisation of goodwill and intangible assets	(442)	(524)
Exceptional items [Reorganisation and acquisition related costs]	<u>(72)</u>	<u>(99)</u>
Operating profit [before joint ventures]	645	490
...		
Financial highlights		
...		
Reported earnings per share	13.4p	7.0p
Adjusted earnings per share [before the amortisation of goodwill and intangible assets]	31.2p	28.5p
Dividend per share	12.0p	11.2p

Few companies reinstated pre-FRS 10 goodwill. As a result, UK GAAP remain out of step with International Accounting Standards (see Chapter 31); and ratios based on either earnings (which are after *some* amortisation of goodwill) or net asset values (which may include all goodwill (amortised) or some goodwill (and the cut-off date will vary from company to company) or no goodwill (if it is all prior to FRS 10)) are distorted.

The consolidated profit and loss account

Consolidated profit and loss accounts follow the same pattern as described for single companies at the beginning of Chapter 16, except that if the group contains partially owned subsidiaries, the minority interests in the profits of those subsidiaries have to be deducted at the after-tax level. Continuing with our example (see page 178) of H owning four-fifths of the £250,000 ordinary share capital of S, let us suppose that at the beginning of 1997, S issued 30,000 £17% preference shares to a third party as part payment for a fixed asset, and that the pre-tax profits and tax charges of H and S for that year were as shown here:

	<i>H</i>	<i>S</i>	<i>Total</i>
	£	£	£
Profit before tax	72,000	51,200	123,200
Corporation tax at 25%	<u>18,000</u>	<u>12,800</u>	<u>30,800</u>
Profit after tax	<u>54,000</u>	<u>38,400</u>	<u>92,400</u>

The combined pre-tax profit, tax and profit after tax will be shown in the group's consolidated profit and loss account.

Calculation of minority interests

The minority interests in the profits after tax of S will then be computed as follows:

	<i>S</i>	<i>Minority interests</i>
	£	£
Profit before tax	51,200	
less corporation tax	<u>12,800</u>	
Profit after tax	38,400	
less Preference dividends	<u>2,100</u>	2,100
Attributable to ordinary shareholders	<u>36,300</u>	$\times \frac{1}{5} = 7,260$
Minority interests total		<u>9,360</u>

It is this sum of £9,360 which will be deducted as 'minority interests' from the profit after tax in the consolidated profit and loss account.

Appropriations of the subsidiary

Suppose, for instance, that S proposed a single ordinary dividend of 4p for 2002. Then the profit attributable to S's ordinary shareholders would be appropriated as follows:

	<i>Total</i>	<i>Minorities</i>	<i>H</i>
Attributable	36,300	7,260	29,040
Proposed dividend of 4.0p per share	<u>10,000</u>	<u>2,000</u>	<u>8,000</u>
Retentions	<u>26,300</u>	<u>5,260</u>	<u>21,040</u>

H's share of the proposed dividend (£8,000) would also appear, as dividends receivable, in the holding company's accounts, and the two figures would cancel out on consolidation. The dividends payable to minority shareholders

(£2,000) would be charged (behind the scenes) against the minority interests deducted on consolidation, and the minorities' share of the retentions (£9,360 – £2,100 preference dividends – £2,000 ordinary dividends = £5,260) added to the consolidated balance sheet item 'minority interests'.

The group profit and loss account

Suppose H Group declared dividends of £25,000 for the year. The group profit and loss account would then show:

	£
Profit before tax	123,200
Taxation	<u>(30,800)</u>
Profit after tax	92,400
Minority interests	<u>(9,360)</u>
	83,040
Dividends	<u>(25,000)</u>
Retentions	<u>58,040</u>

Retained profit

The group's retained profit of £58,040 would be carried forward partly in the holding company's accounts:

	£
H's profit after tax	54,000
H's dividends from S	8,000
less Dividends paid by H	<u>(25,000)</u>
	<u>37,000</u>

The remainder, £21,040 (see previous column), would be carried forward in S's accounts, being H's share of S's retentions.

Some companies show where the retained profits of the group are being carried forward either in the profit and loss account or in a note to the accounts.

Unrealised profits on stocks

It frequently happens that one group company supplies another company within the group with goods in the ordinary course of trade; indeed, this sort of trading link may often be at the very heart of the existence of the group

in the first place. But where one group company has made a profit on the supply of goods to another group company and those goods, or some of them, remain in stock at the end of the accounting year, a problem arises and, although nothing can normally be gleaned from the accounts, the procedure for consolidation is designed to prevent a group's profits being artificially inflated by sales within the group.

Parent company's own balance sheet

Subsidiaries are normally shown in the parent company's own balance sheet at cost less any amounts written off, but some companies show them at their underlying net asset value, i.e. they use the equity method of accounting (see pages 193–4), which includes the investment at cost plus the parent company's share of the post-acquisition retained profits and reserves.

Parent company's own profit and loss account

Under Section 230(3) of the Companies Act 1985, the parent company's profit and loss account may be omitted from the consolidated accounts providing the parent company's balance sheet shows the parent company's profit or loss for the year, as is shown by TT ELECTRONICS below. In practice one seldom if ever sees the parent company's own profit and loss account.

TT ELECTRONICS *Extract from note 25 to the 2003 accounts*

In accordance with the exemption allowed by Section 230 of the Companies Act 1985, the Company has not presented its own profit and loss account. A profit of £14.9 million (2002: £5.2 million) has been dealt with in the financial statements of the Company.

Accounting periods and dates

The financial statements of all subsidiary undertakings to be used in preparing the consolidated financial statements should, wherever practicable, be prepared to the same financial year end and for the same accounting period as those of the parent undertaking of the group (FRS 2, para. 42).

Where the financial year of a subsidiary undertaking differs from that of the parent of the group, interim financial statements should be prepared to the date of the parent's year end. If it is not practicable to use such interim financial statements, the financial statements of the subsidiary for its last financial year should be used, providing that year ended not more than three months before the relevant year end of the parent undertaking of the group.

Further statutory requirements

Emoluments of directors

Directors' emoluments and other details required by the Companies Act 1985 only have to be shown in respect of directors of the parent company, but all their remuneration from the group has to be included (e.g. fees they receive for being directors of subsidiaries).

These requirements have to be met by each subsidiary in its own accounts, which are not normally published but do have to be filed at Companies House.

Information on subsidiaries

The Companies Act 1985 requires a company to disclose the following for each of its subsidiaries:

- the subsidiary's name;
- if incorporated outside Great Britain, the country of incorporation;
- if unincorporated, the address of its principal place of business.

Introduction

As we explained in Chapter 20, in the UK there are two methods of accounting for acquisitions (or business combinations):

1. Acquisition accounting, and
2. Merger accounting.

The rules for both methods are set out in FRS 6 *Acquisitions and mergers*, which restricts the use of merger accounting to rare situations (see page 188).

Acquisition accounting should be used for the majority of business combinations where a party can be identified as having the role of an acquirer.

Acquisition accounting

In Chapter 20 we also considered the principles of acquisition accounting. We look now at some of the detailed requirements of financial reporting standards.

Year of acquisition or disposal

In acquisition accounting, when a subsidiary is acquired (or disposed of) during the accounting period, the results of the subsidiary are included from the effective date of acquisition (or to the effective date of disposal), e.g. RMC GROUP:

RMC GROUP *Extract from accounting policies 2003*

Group accounts

The Group accounts comprise the audited accounts of the parent company and all its subsidiary undertakings made up to 31st December . . .

Where subsidiary undertakings, joint ventures and associated undertakings are acquired or disposed of during the year, the Group profit and loss account reflects their results from the date of acquisition or to the date of disposal.

Purchased goodwill

FRS 10 defines purchased goodwill as the *difference* between

- (a) the cost of the business that has been acquired, and
- (b) the fair value of its identifiable assets less liabilities.

Purchased goodwill is sometimes described as '*goodwill on consolidation*'.

Determining fair values

FRS 7, *Fair values in acquisition accounting*, contains detailed rules for arriving at the cost of the business, as well as the fair value of the assets and liabilities.

Fair value rules■ **Tangible fixed asset:**

- (a) market value, if assets similar in type and condition are bought and sold on a open market; or
- (b) depreciated replacement cost, reflecting the acquired business's normal buying process and the sources of supply and prices available to it.

The fair value should not exceed the asset's recoverable amount.

■ **Intangible fixed asset** recognised in the accounts: replacement cost, normally its estimated market value.■ **Stocks**, including commodity stocks:

- (a) where trading is on a market in which the acquired business participates as both a buyer and a seller – current market prices;
- (b) other stocks, and work in progress – should be valued at the lower of replacement cost and net realisable value.

■ **Quoted investments:** market price, adjusted if necessary for unusual price fluctuations or for the size of the holdings.

The fair values of monetary assets and liabilities (including provisions) should take into account the amounts expected to be received or paid, and their timing and, if significant, be discounted to present value.

Assets at the date of acquisition

The identifiable assets less liabilities of the acquired business (affecting the consequent goodwill calculation) should be those that existed at the date of acquisition, and should *not* reflect

- (a) changes in asset values/liabilities resulting from the acquirer's intentions or future actions;
- (b) impairments or other changes resulting from events subsequent to the acquisition;
- (c) provisions for future operating losses or reorganisation costs to be incurred as a result of the acquisition (even if these were reflected in the purchase price).

The message from FRS 7 is clear – the effects of the above should be reflected in the group's operating profit/loss for the period after acquisition.

Provisional fair values

If possible, the identification and valuation of assets and liabilities should be completed by the date on which the accounts relating to the year of acquisition are approved by the directors.

CELLTECH Extract from Note 21 to 2001 accounts: Acquisition of subsidiary undertakings**(i) Medeva****Fair value adjustments**

On 26 January 2000, the Group acquired Medeva PLC. Given the size and complexity of the acquisition, the fair values established in 2000 were provisional and gave rise to goodwill of £615.5m. The fair values have since been finalised and are presented below.

The assets and liabilities of Medeva acquired as follows:	Provisional value	Adjustments	Fair value
	£m	£m	£m
Fixed assets – tangible	67.7	2.8	70.5
Stocks	24.1	–	24.1
Debtors	71.3	2.1	73.4
Equity investments	15.1	(1.6)	13.5
Cash	17.0	–	17.0
Creditors	(145.2)	(1.4)	(146.6)
Loans and finance leases	(108.9)	–	(108.9)
Provisions for liabilities	(28.9)	(5.6)	(34.5)
Net assets acquired	(17.6)	(2.9)	(20.5)
Original goodwill			615.5
Adjustments (as above)			2.9
Goodwill – final			618.4

WASTE RECYCLING Extract from note to the financial statements, year ended 31 December 1999**Note 28 Acquisitions***(a) Yorkshire Environmental Global Waste Management (YEGWM)*

On 29 January 1999 the Company acquired the business of YEGWM for a total consideration of £181,278,000. Additionally, acquisition expenses of £1,601,000 were incurred. The results of YEGWM were as follows:

	[B] Date of acquisition to 31 December 1999 £000	[A] 1 January 1999 to date of acquisition £000
Turnover	59,962	6,535
Cost of sales	(44,743)	(5,540)
Administrative expenses	(3,751)	(706)
Operating profit	<u>11,468</u>	289
Taxation		<u>(98)</u>
Profit after taxation		191
Minority interests		<u>(59)</u>
Retained profit		<u>132</u>

[C] The profit after taxation for the preceding financial year ended 31 December 1998 was £4,709,000.

The following table analyses the book value of the major categories of assets and liabilities acquired:

[D]	<i>Book value at date of acquisition</i> £000	<i>Accounting policy alignment</i> £000	<i>Revaluation adjustments</i> £000	[E] <i>Provisional fair value of net assets</i> £000
Tangible fixed assets	48,372	(2,336)	(5,403) ⁽¹⁾	40,633
Debtors	11,147	–	(131) ⁽²⁾	11,016
Cash balances	8,217	–	–	8,217
Creditors and accruals	(11,810)	–	(1,465) ⁽³⁾	(13,275)
Borrowings	(10,850)	–	–	(10,850)
Deferred taxation	2,594	(2,709)	–	(115)
Provisions	(13,452)	2,616	–	(10,836)
Minority interests	<u>(553)</u>	<u>–</u>	<u>–</u>	<u>(553)</u>
Net assets acquired	<u>33,665</u>	<u>(2,429)</u>	<u>(6,999)</u>	24,237
[F] Goodwill				<u>158,642</u>
Consideration				<u>182,879</u>
Satisfied by				
[G] Shares				181,278
Acquisition costs				<u>1,601</u>
				<u>182,879</u>

(1) This adjustment represents a revision of the book values of landfill sites to reflect market royalty rates and the permanent impairment of the values of certain other fixed assets.

(2) Additional bad debt provision.

(3) Additional corporation tax provision and accruals for additional liabilities identified.

[H] . . . The provisional fair values represent the Directors' current estimates of the net assets acquired. However, in accordance with FRS7, the values may be revised as further information becomes available.

Where this is not possible, *provisional* valuations should be made. If necessary, these should be amended in the accounts of the following year with a corresponding adjustment to goodwill: see the CELLTECH extract on page 185.

Subsequent disposals

The relevant date of disposal of a subsidiary is the date when the former parent relinquishes control.

The group's gain or loss on disposal is calculated by comparing the carrying amount of the net assets, including any related goodwill not previously written off through the profit and loss account, with any proceeds received.

Pre-FRS 10 goodwill that has been written off direct to reserves *must* be included.

Disclosure requirements

The disclosure requirements for business combinations accounted for as acquisitions are listed in paras. 23–35 of FRS 6 *Acquisitions and mergers*.

If the acquisition is a '*substantial acquisition*', there are further disclosure requirements (FRS 6 paras. 36–37).

Substantial acquisitions

For *listed* companies a '*substantial acquisition*' is a Class 1 transaction (see page 243). For *other* companies it is, broadly, where the net assets or operating profits of the acquired company exceed 15% of those of the acquirer.

Example of a substantial acquisition

For example, in 1999 WASTE RECYCLING made two major acquisitions from the Kelda group (formerly Yorkshire Water), which tripled Waste's turnover.

A note to Waste's accounts on the larger of the two acquisitions, shown opposite, illustrates the main disclosures for a substantial acquisition:

[A] A summarised profit and loss account of the acquired company from the beginning of its financial year to the date of acquisition.

[B] The post-acquisition results of the acquired company should be disclosed separately, where they have a major impact.

[C] The profit after tax and minorities for the acquired company's previous financial year.

[D] A table of book values and fair value adjustments, analysed as shown opposite.

[E] Where fair values can only be determined on a provisional basis at the end of the accounting period, this should be stated, and the reasons should be given.

[F] The amount of '*Purchased goodwill*' arising (in Waste's case £158.6 million).

[G] Details of the consideration given, including any deferred or contingent consideration (none in Waste's case).

[H] Waste will have to disclose and explain any subsequent material adjustments.

Post balance sheet events

Where a material acquisition or disposal takes place shortly after the balance sheet date, it will be a post balance sheet event requiring disclosure under SSAP 17 *Accounting for post balance sheet events*. For example NATIONAL GRID:

NATIONAL GRID *Note to the 2002 accounts*

Note 31 Post balance sheet event

On 22 April 2002 the Boards of National Grid Group and Lattice Group unanimously agreed and announced the terms of a recommended merger. Under the terms of the merger National Grid shareholders will retain their shares in National Grid (to be renamed National Grid Transco) and Lattice shareholders will receive 0.375 National Grid Transco shares for each Lattice share.

On completion of the merger, National Grid shareholders will hold approximately 57.3 per cent and Lattice shareholders will hold approximately 42.7 per cent of the issued share capital . . .

It is intended to account for the merger in accordance with merger accounting principles.

Merger accounting

Introduction

With the introduction of FRS 6 *Acquisitions and Mergers*, the use of merger accounting has become quite rare. The FRS restricts its use to business combinations where, by meeting strict criteria (see box in the next column), the two companies concerned can demonstrate that the combination is a genuine merger, not a takeover by one of the other, e.g. BP's merger with AMOCO, illustrated on the next page.

The mechanics of merger accounting

Under merger accounting the following occur:

1. The assets and liabilities of both companies are incorporated into the group accounts at book value. They are not required to be adjusted to fair value on consolidation, though appropriate adjustments are made to achieve uniformity of accounting policies.
2. The pre-acquisition reserves of the merging companies are not capitalised, but are available to the enlarged group.
3. The shares issued as consideration are recorded at their nominal value (so there is no share premium, and no goodwill arises on consolidation).
4. If the total nominal value of the shares issued is more than the total value of the shares of the merged company, the difference is deducted from group reserves. If the total value is less, the shortfall becomes a non-distributable reserve. The merger expenses are not included as part of this adjustment, but charged through the profit and loss account.
5. At the subsequent year end, the consolidated profit and loss account takes in the turnover, costs and profits of all merging companies for a full year.

Profits in the year of merger

The consolidated profit and loss account should include the profits (or losses) of all merged entities for the entire period, i.e. without adjustment for that part of the period prior to the merger. Corresponding amounts should be presented as if the companies had been combined throughout the previous period.

MERGER ACCOUNTING

Criteria

Under FRS 6, a business combination should be accounted for using merger accounting *if, and only if*:

- (a) the use of merger accounting is not prohibited by the Companies Act 1985; and
- (b) the combination meets certain criteria:
 - (i) no party to the combination is portrayed as either acquirer or acquired;
 - (ii) all parties to the combination participate in establishing the management structure for the combined entity and in selecting the management personnel, and such decisions are made on the basis of a consensus;
 - (iii) the relative sizes of the combining entities are not so disparate that one party effectively dominates the combined entity merely by virtue of its relative size;
 - (iv) the consideration must be all or virtually all equity;
 - (v) no equity shareholder of any of the combining entities must retain any material interest in only one part of the combined entity.

FRS 6 extends the requirements of the Companies Act 1985 somewhat. In particular, it requires:

1. An analysis of the principal components of the current year's profit and loss account and statements of recognised gains and losses into:
 - (i) amounts relating to the merged entity for the period after the merger; and
 - (ii) for each party to the merger, amounts relating to the period up to the merger.
2. An analysis between the parties to the merger of the principal components of the profit and loss account and statements of total recognised gains and losses for the previous financial year: see BP AMOCO on the next page.

3. The composition and fair value of the consideration given by the issuing company and its subsidiary undertakings.
4. The nature and amount of significant accounting adjustments made to the net assets of any party to the merger to achieve consistency of accounting policies.
5. A statement of the adjustments to consolidated reserves resulting from the merger.

BP AMOCO *Brief extract from 1998 accounts*

Note 45 Merger accounting

The financial statements have been prepared using the merger method of accounting in relation to the merger of BP and Amoco.

Under merger accounting the results and cash flows of BP and Amoco are combined from the beginning of the financial period in which the merger occurred . . .

The merger became effective on 31 December 1998. Income statements for each company for the year ended 31 December 1998 are presented below, together with their respective balance sheets at 31 December 1998.

Income statement

	<i>Amoco</i> <i>UK GAAP</i>	\$ million <i>BP</i>
Historical cost profit	1,582	4,314
Interest expense	<u>473</u>	<u>580</u>
Profit before taxation	1,109	3,734
Taxation . . .		

Balance sheet

Fixed assets		
Intangible assets	735	2,302
Tangible assets	23,345	31,120
Investments . . .		

Statement of total recognised gains and losses

Profit for the year	732	2,528
Currency translation differences	<u>30</u>	<u>25</u>
Total recognized gains and losses	<u>762</u>	<u>2,553</u>

The actual note is more than three pages long, giving ample information on the merger.

Comparison of accounting methods

Finally in this chapter, Example 21.1 below shows the balance sheet of a business combination produced firstly by merger accounting and secondly by acquisition accounting.

Example 21.1 Business combination – a comparison of merger accounting and acquisition accounting

Before the combination

At 31 December 2000 the balance sheets of companies A and B were:

	A	B
Ordinary share capital	£000 800	£000 80
Reserves	<u>280</u>	<u>340</u>
	<u>1,080</u>	<u>420</u>
Net assets	<u>1,080</u>	<u>420</u>

Company A combined with Company B

Company A issues 200,000 new A £1 ordinary shares (standing at 300p each, a premium of 200p above par value) in exchange for the entire share capital of B.

In acquisition accounting, the fair value of the net assets of B is assessed as £480,000, compared with the book value of £420,000, an increase (*uplift*) of £60,000. In merger accounting there is no fair value adjustment.

After the businesses had combined

The consolidated balance sheet of A Group (A + B) would appear, under the two different methods of accounting, as:

	<u>Merger</u>		<u>Acquisition</u>	
	Note	£000	Note	£000
Ordinary £1 shares	1	1,000	1	1,000
Share premium account		–	2	400
Distributable reserves	3	<u>500</u>	4	<u>280</u>
		<u>1,500</u>		<u>1,680</u>
Net assets (excl. goodwill)	5	1,500	6	1,560
Goodwill		—	7	<u>120</u>
		<u>1,500</u>		<u>1,680</u>

Notes:

1. Company A's original £800,000 share capital plus the £200,000 shares A issued.
2. The premium of 200p per share on the 200,000 shares Company A issued.
3. Computed as follows:

	£000
distributable reserves of A	280
distributable reserves of B	<u>340</u>
	620

less the excess of the nominal value of the shares issued (£200,000) over the nominal value of the shares in B (£80,000)	(120)
	<u>500</u>

4. Distributable reserves = reserves of Company A (£280,000), plus the increase in Company B's reserves since acquisition (£Nil, as the acquisition has only just taken place).
5. Net assets of Company A (£1,080,000) plus net assets of Company B (£420,000).
6. Under acquisition accounting, the net assets of B were taken at fair value of £480,000, rather than at book value of £420,000.
7. Goodwill is the amount by which the cost of the investment (£600,000) exceeds the fair value of the net assets acquired (£480,000).

Associates, joint ventures and related parties

Introduction

Companies Act definitions

The Companies Act 1985 includes the terms: a *participating interest in an undertaking*, and an *associated undertaking*.

Undertakings include partnerships and unincorporated associations carrying on a trade or business as well as companies.

An *interest* includes convertible securities and options as well as shares.

A *participating interest* is an interest held by the investing group or company on a long-term basis to secure a contribution to its activities by the exercise of control or influence. A holding by group companies of 20% or more of the shares of an undertaking is presumed to be a participating interest unless the contrary is shown.

An *associated undertaking* is an undertaking (other than a subsidiary or a joint venture) in which the investing group or company has a participating interest and over whose operating and financial policy it exercises a *significant* influence.

Accounting standards

FRS 9 *Associates and joint ventures* contains the rules on accounting for associates and joint ventures.

It recognises five types of interest:

1. A subsidiary (which we considered in Chapters 20 and 21; see also FRS 2);
2. a joint arrangement that is not an entity;
3. a joint venture;

4. an associate;
5. a simple investment (which we considered in Chapters 9 and 12).

This chapter deals with types 2, 3 and 4.

Joint arrangement that is not an entity

Where two or more entities, e.g. companies, participate in an arrangement to carry on part of their trade, that arrangement falls under this heading unless it carries on a trade or business of its own.

A joint arrangement will not be an entity if it is no more than a cost- or risk-sharing means of carrying out a process in the participants' trades or businesses – e.g. a joint marketing or distribution network or a shared production facility.

A joint arrangement carrying out a single project (as, for example, occurs in the construction industry) tends to fall under this head, but the nature of such a joint arrangement may change over time – e.g., a pipeline operated as a joint arrangement that initially provided a service only directly to the participants may develop into a pipeline business providing services to others.

Each party to a joint arrangement that is not an entity should account for its own share of the assets, liabilities and cash flows in the joint arrangement, measured according to the terms of that arrangement.

Joint venture

Where the investor holds a long-term interest and shares control under a contractual arrangement that arrangement is referred to as a joint venture.

DIAGEO Extract from 2000 accounts**Consolidated profit and loss account**

		Year ended 30 June 2003			Year ended 30 June 2002			
	Notes	<i>Before exceptional items</i> £ million	<i>Exceptional items</i> £ million	<i>Total</i> £ million	<i>Before exceptional items</i> £ million	<i>Exceptional items</i> £ million	<i>Total</i> £ million	
Turnover	[A]	2	9,440	–	9,440	11,282	–	11,282
Operating costs		4	(7,411)	(168)	(7,579)	(9,176)	453	(9,629)
Operating profit		2	2,029	(168)	1,861	2,106	(453)	1,653
Share of associates' profits	[B][D]	6	478	(21)	457	324	(41)	283
	[C]		2,507	(189)	2,318	2,430	(494)	1,936
Disposal of fixed assets		7	–	(43)	(43)	–	(22)	(22)
Sale of businesses		7	–	(1,270)	(1,270)	–	821	821
Interest payable (net)	[E]	8	(351)	–	(351)	(399)	–	(399)
Pre-tax profit			2,156	(1,502)	654	2,031	305	2,336
Taxation	[F]	9	(539)	52	(487)	(511)	(121)	(632)
Profit after tax			1,617	(1,450)	167	1,520	184	1,704

Note 6 Associates

		2003 £ million	2002 £ million
Share of operating profit before exceptional items	[B]	478	324
Share of exceptional items	[D]	(21)	(41)
Share of interest payable (net)	[E]	(72)	(64)
Share of taxation	[F]	(138)	(87)
Equity minority interests		(1)	(1)
Dividends received by the group	[G]	(60)	(87)
Share of profits retained by associates	[H]	186	44
...			

Consolidated statement of total recognised gains and losses

		Year ended 30 June 2003 £ million	Year ended 30 June 2002 £ million
(Loss)/profit for the year – group		(170)	1,486
Profit for the year – associates	[I]	246	131
		76	1,617
Exchange adjustments . . .			

Consolidated balance sheet

	Notes	30 June 2003 £ million	30 June 2002 £ million
Fixed assets			
Intangible assets		4,288	5,434
Tangible assets		1,974	2,545
Investment in associates	[J]	3,034	2,899
Other investments		447	284
Current assets . . .		9,743	11,162

The joint venture agreement can override the rights normally conferred by ownership interests with the effect that:

- acting together, the venturers can control the venture and there are procedures for such joint action;
- each venturer has (implicitly or explicitly) a veto over strategic policy decisions.

Associates

Definition


Where the investor holds a *participating interest* and exercises *significant influence* the entity is an *associate*. This covers cases where the investor

- has a *long-term interest* and
- is actively involved, and influential, in the direction of its investee through its participation in policy decisions covering the aspects of policy relevant to the investor, including decisions on strategic issues such as
 - (a) the expansion or contraction of the business, participation in other entities or changes in products, markets and activities of its investee;
 - (b) determining the balance between dividend and reinvestment.

The investor should include its associates in its consolidated financial statements using what is called *the equity method* of accounting.

The equity method

Under the equity method:

1.  **Turnover does not include the turnover of associates.**

See [A] in the DIAGEO consolidated profit and loss account on the opposite page.

Where a group wishes to give an indication of the relative size of associates, it may give the associates'

turnover in a note, or include it in an overall figure, provided the group's share of its associates' turnover is clearly distinguished.

For example, RIO TINTO includes its share of associates' (and joint ventures') turnover in *Gross turnover*, and then deducts them both to arrive at *Consolidated turnover*:

RIO TINTO Extract from 2003 accounts

	2003 US\$m	2002 US\$m
Profit and loss account		
Gross turnover (including share of joint ventures and associates)	11,755	10,828
Share of joint ventures' turnover	(1,820)	(1,662)
Share of associates' turnover	(707)	(723)
Consolidated turnover	9,228	8,443
...		

2. The group's share of its associates' operating results should be included immediately after group operating profit, [B].
3. Any amortisation or write-down of goodwill arising in associates should then be charged [DIAGEO had none].
4. The group's share of any exceptional items [D] should be shown separately. DIAGEO does so in a note:

DIAGEO Extract from note to 2003 accounts

Note 7 Exceptional items

...
Share of profits of associates The group's share of exceptional items in respect of associates comprised restructuring costs of £18 million incurred by General Mills and £3 million in respect of Moët Hennessy.

5. Below the level of trading profit [C], the group's share of the relevant amount for associates should be included within the amounts for the group, but may be shown separately in the notes: [D] and Note 7 (above); Interest payable [E] and Note 8 (not shown); Taxation [F] and Note 9 (not shown).

DIAGEO also shows details in *Note 6 Associates* (on the opposite page), together with *Dividends received by the Group* [G] and *Share of profits retained by associates* [H].



A group's share of associates' profits is only available to the group when it is paid out by the associates as dividends.

6. The group's share of the gains and losses of its associates should be included in the *Consolidated statement of total recognised gains and losses*, and should be shown separately under each heading, if material. See [I] on page 192.

Note that [I] = [G] + [H].

7. In the *Consolidated balance sheet* the group's share of the net assets of its associates should be included, and separately disclosed. Diageo has included it in *Investments* [J] giving details in Note 14, shown below.

DIAGEO Extract from 2003 accounts

Note 14 Fixed assets – Investments

	<i>Investment in associates</i> £ million	<i>Total</i> £ million
Cost		
At 30 June 2002	2,909	3,246
Exchange adjustments	(68)	(73)
Additions	63	304
Share of retained profits	186	192
Disposals	<u>(55)</u>	<u>(129)</u>
At 30 June 2003	<u>3,035</u>	<u>3,540</u>
Provisions/amortisation		
At 30 June 2002	10	63
Amortisation of own shares	–	27
Created	–	7
Disposals	(9)	(38)
At 30 June 2003	1	59
Net book value		
At 30 June 2003	3,034	3,481
At 30 June 2002	2,899	3,183

8. The *cash flow statement* should include cash flows between the group and its associates, [K] and [L]:

DIAGEO Extract from 2003 accounts

Consolidated cash flow statement

	2003 £m	2002 £m
Net cash inflow from operating activities	1,970	2,008
Dividends received from associates	[K] 60	87
...		
Purchase of subsidiaries	(137)	(3,592)
Sale of subsidiaries and businesses	912	5,100
Sale of options on associates	[L] 58	–
...		

9. Goodwill arising on the group's acquisition of its associates, less any amortisation or write-down, should be included in the carrying amount for associates but should be disclosed separately.

Interest held on a long-term basis

For an interest to be an associate the investor must have a long-term interest, i.e. the interest must be held other than exclusively with a view to subsequent resale. An interest held exclusively with a view to subsequent resale is:

- an interest for which a purchaser has been identified or is being sought, and which is reasonably expected to be disposed of within approximately one year of its date of acquisition; or
- an interest that was acquired as a result of the enforcement of a security, unless the interest has become part of the continuing activities of the group or the holder acts as if it intends the interest to become so.

Significant influence

For an investment to be an associate, its investor must exercise (not simply *be in a position to exercise*) significant influence over the investee's operating and financial policies. The investor needs an agreement or understanding, formal or informal, with its associate to provide the basis for its significant influence. An investor exercising significant influence will be directly involved in the operating and financial policies of its associate rather than passively awaiting the outcome of its investee's policies.

Active involvement in the operating and financial policies of an associate requires inter alia that *the investor should have a voice in decisions on strategic issues* such as determining the balance between dividend and reinvestment.

The investor's involvement in its associate is usually achieved through nomination to the board of directors (or its equivalent) but may result from any arrangement that allows the investor to participate effectively in policy-making decisions.

It is unlikely that an investor can exercise significant influence unless it has a substantial basis of voting power. A holding of 20% or more of the voting rights in another entity *suggests, but does not ensure*, that the investor exercises significant influence over that entity (FRS 9, para. 16).

Joint ventures

Definition

Where the investor holds a long-term interest and shares control under a contractual arrangement that arrangement is referred to as a *joint venture*.

The joint venture agreement can override the rights normally conferred by ownership interests with the effect that:

- acting together, the venturers can control the venture and there are procedures for such joint action;
- each venturer has (implicitly or explicitly) a veto over strategic policy decisions.

There is usually a procedure for settling disputes between venturers and, possibly, for terminating the joint venture.

The venturer should use the *gross equity method* to account for the joint venture.

Gross equity method

Under what is termed the gross equity method, all the amounts included under the equity method (see page 193) have to be shown and, in addition:

- (a) *in the consolidated profit and loss account*, the venturer's share of their operating profit, [A] in the GUS illustration below, distinguished from that of the group, and
- (b) *on the face of the group balance sheet*, the venturer's share of the gross assets, [B] in the GUS illustration below, and the gross liabilities [C] of its joint ventures.

GUS Extracts from the 2003 accounts

Consolidated profit and loss account

	Notes	2003 £m	2002 £m
Operating profit – continuing operations		452	381
Share of operating profit of BL Universal PLC (Joint venture)	[A]	26	25
Share of operating profit of associated undertakings		44	33
Loss on sale of fixed asset investments in continuing operations		—	(2)
Trading profit		522	437
...			

Group balance sheet

	Notes	2003 £m	2003 £m	2002 £m	2002 £m
Fixed assets					
Goodwill			2,436		1,422
Other intangible assets			178		192
Tangible assets			1,043		847
Investment in joint venture					
Share of gross assets	[B]	405		416	
Share of gross liabilities	[C]	(277)		(308)	
	[D]	128		108	
Loans to joint venture		82		87	
			210		195
...					

Had it not been for the requirement to use the gross equity method, GUS would have shown the investment in BL Universal in 2003 as £128m (2002 £108m) [D] rather than spelling out the very substantial gross assets and liabilities involved.

This was often the case where there was a joint venture between the owners of land and builders/developers.

Where the venturer conducts a major part of its business through joint ventures, it may show fuller information provided all amounts are distinguished from those of the group (see Note 15 below).

GUS Extract from a note to the 2003 accounts

Note 15 Investment in joint venture

	Shares £m	Loans £m	Total £m
<i>Cost or valuation</i>			
At 1 April 2002	108	87	195
Share of profit after taxation	5	–	5
Share of revaluation of investment properties	15	–	15
Repayment of loans	–	(5)	(5)
<i>At 31 March 2003</i>	<u>128</u>	<u>82</u>	<u>210</u>

The Group holds 50% of the ordinary share capital of BL Universal PLC. The Group's share of cumulative retained profits at 31 March 2003 is £22m (2002 £17m) and its share of turnover for the year, excluded from Group turnover, is £30.9m 2002.

The consolidated balance sheet of BL Universal PLC is as follows:

	2003 £m	2002 £m
Fixed assets	795	813
Current assets	26	19
Creditors – amounts falling due within one year	(56)	(72)
Creditors – amounts falling due after more than one year	(506)	(541)
Shareholders' funds	<u>259</u>	<u>219</u>
Attributable to the Group	<u>128</u>	<u>108</u>

Proportional consolidation

It has been a long-standing practice in certain industries (e.g. oil exploration, engineering and construction) to account for certain types of joint venture using proportional

consolidation; and this is recognised by the Companies Act. Proportional consolidation involves adding the investor's share of the joint venture to each line of the consolidated profit and loss account and balance sheet. This is not the same as consolidation of, say, a minority interest in a subsidiary, where what is added line by line is the whole of the subsidiary's figure (the minority interest being taken out separately).

IAS 31 (International Accounting Standard 31) *Financial reporting of interests in joint ventures* does not recommend the use of the equity method, on the grounds that proportional consolidation better reflects the substance and economic reality of a venturer's interest in a jointly-controlled entity. The ASB believes that it can be misleading to represent each venturer's joint control of a joint venture – which allows it to direct the operating and financial policies of the joint venture only with the consent of the other venturers – as being in substance equivalent to its having sole control of its share of each of that entity's assets, liabilities and cash flows. FRS 9 abolishes proportional consolidation, but the accounting treatment for joint arrangements which are not an entity is, arithmetically, virtually identical to proportional consolidation.



Joint ventures are often a means of sharing risks where the risks are particularly high. The amounts involved can be considerable, and the effects of failure – spectacular.

Related parties

ASB warning

To quote the Press Notice released by the Accounting Standards Board on the publication of FRED 8 (subsequently superseded by FRS 8, *Related party disclosures*):



'Related party transactions have been a feature of a number of financial scandals in recent years, many of which have had in common the dominance of the company by a powerful chief executive who was also involved with the related party.'

The italics are ours. Analysts should be particularly wary of companies where the posts of chairman and of chief executive are held by one person.

Disclosure rules

Schedule 5 of the Companies Act 1985 contains requirements for the disclosure of related undertakings, and Chapters 11 and 12 of the UK Listing Authority's *Listing Rules* define related party transactions and lay down requirements on disclosure.

FRS 8 *Related party disclosures* extends the definition of related parties and increases the disclosure requirement.

It requires a company to disclose all material transactions with related parties, i.e. parties having a relationship (control or influence) that affects the independence of either the reporting entity or the other party and could have a significant effect on the financial position and operating results of the reporting entity. There are a number of exceptions, e.g. pension contributions paid to a pension fund.

Ultimate controlling party

Regardless of whether or not there have been transactions during the year, financial statements must disclose the name of the company's ultimate controlling party. For companies within widely-held public groups, this will be the holding company.

For all other companies, the directors must look beyond the corporate structure to name the controlling interests. There may even be cases where the ultimate controlling party cannot be identified: if so, that fact must be disclosed.

Who is a related party?

The definition of related parties in the FRS is widely drawn. It includes, in addition to the more obvious relationships, such as ultimate and intermediate parent undertakings, subsidiaries and fellow subsidiaries, associates and joint ventures, directors of the reporting entity, pension funds, key management, members of the close family of any party in this list, and partnerships, companies, trusts and other entities in which any individual in the list or their close family has a controlling interest. Entities managed by the reporting entity under management contracts come within the definition of related parties. 'Close family' includes family members, or members of the same household,

'who may be expected to influence or be influenced . . .'. This clearly includes adult children as well as minors and **would have made the late Robert Maxwell's children related parties.**

Subject to certain exemptions, transactions with related parties have to be disclosed even if no consideration passes.

Related parties are considered in two groups:

1. those that are deemed to be related; and
2. those where a related party relationship is presumed.

The existence of '*deemed*' related party relationships cannot be rebutted; all material transactions with directors, group members, associates and joint ventures must normally be disclosed.

The existence of a '*presumed*' relationship can be rebutted (and transactions need not therefore be disclosed) if it can be demonstrated that the relevant party does not exercise significant influence over the entity's financial and operating policies.

Disclosures

Not only are related parties potentially numerous, the required disclosures are also lengthy:

- (a) names of the transacting related parties;
- (b) description of the relationship and the transactions;
- (c) amounts involved;
- (d) balances with the related parties at the balance sheet date, including provisions made and amounts written off such balances; and
- (e) any other elements necessary for an understanding of the financial statements.

Just how useful disclosures about related parties are to the average investor remains to be seen:

- They are often extremely complicated;
- Their significance is difficult to assess;
- Nevertheless, they largely remove the excuse 'if only I had known, I would not have bought into the company'.

Consider, for example, TARSUS GROUP, the consolidated profit and loss account of which is shown on the next page. Start by trying to decide what happened to the group in 1997–98. We will comment and then gradually add further information.

TARSUS GROUP Consolidated profit and loss account for 1998**Consolidated profit and loss account for the year ended 31 December 1998**

	Notes [A]	Before Exceptional Items £000	Exceptional Items £000	1998 12 months Total £000	1997 8 months Total £000
TURNOVER – acquisitions		4,784	–	4,784	–
– discontinued operations	[B]	702	–	702	563
Operating costs		5,486 (4,562)	– (402)	5,486 (4,964)	563 (539)
OPERATING PROFIT – acquisitions		1,008	(402)	606	–
– discontinued operations		(84)	–	(84)	24
Goodwill amortisation		924 (180)	(402) –	522 (180)	24 –
Loss on disposal of discontinued operation . . .		744 –	(402) (3,404)	342 (3,404)	24 –
Profit/(loss) on ordinary activities before interest . . .		744	(3,806)	(3,062)	24

The first thing that strikes one is that 1997 represented an eight-month accounting period [A]. There is always a reason for an odd length period.

The second thing is that turnover in 1997 consisted entirely of discontinued activities [B]; this means that the entire nature of the business changed completely between 1997 and 1998.

We looked at the directors' report for clues.

The related party mention led us to:

TARSUS GROUP Extract from the directors' report 1998**Close company status**

The company is a close company within the meaning of the Income and Corporation Taxes Act 1988. There has been no change in this respect since the end of the financial year.

TARSUS GROUP Extract from the directors' report 1998**Principal activities, etc.**

The principal activity of the Group since 25 June 1998 has been the ownership, organisation and management of exhibitions, conferences, related trade publications and new media.

Prior to 25 June 1998 the Group was principally engaged in design, publishing, marketing and computer related activities. These businesses were sold on 25 June 1998 to Glowdown Ltd, a company controlled by Philip O'Donnell, a director of the company.

Since 25 June 1998 the Group has developed new and existing events and publications and has acquired business media companies with growth potential.

And that in turn led us to:

TARSUS GROUP Extract from the directors' report 1998**Substantial shareholdings**

At 24 February 1999 the Company had been notified of the following discloseable interests in its issued ordinary share capital pursuant to section 198 Companies Act 1985:

	Number of Ordinary Shares	Percentage
N D Buch	6,229,171	26.7
C A Smith	5,000,000	21.4
P O'Donnell	3,828,159	16.4

We studied the note on related party transactions.

TARSUS GROUP Note 23 to the 1998 accounts

23. Related party transactions

During the year the Group disposed of the subsidiary BBB Design Ltd to Glowdown Ltd, a company controlled by P. O'Donnell, a director of the Company. The consideration was £346,000 satisfied in cash. An adjustment may be made to the consideration depending upon the outcome of certain litigation claims as referred to in note . . .

The Company acquired the Labelex Group of companies in June 1998. One of the Labelex vendors was C. Smith, a director of the Company. The initial combined consideration paid was £4.3m and an estimated deferred consideration of £850,000 in respect of the results for the two years ended 31 December 1998. A further deferred consideration payment may be made in 2000 based on the results of Tarsus Publishing Ltd for the year ended 31 December 1999

capped at £250,000. Lease agreements were entered into, at the time of the Labelex acquisition, between Tarsus Exhibitions Ltd, the Labelex Ltd Retirement and Death Benefit Scheme (C. Smith's pension fund) and C. Smith, for the property situated at 129-131 Southlands Road, Bromley. The term of the lease is for five years with an option to break after three years for a combined annual rental of £34,000.

An acquisition search agreement was entered into between the Company and Mayfield Media Strategies Ltd, a company controlled by S. Monnington, a director of the Company. Under the agreement Mayfield Media Strategies Ltd is entitled to receive fees for acquisition search work and further fees for successful acquisitions introduced. The fees paid under this agreement to S. Monnington in 1998 amounted to £33,510.

The fees paid to N. D. Buch (£12,500), S. A. Monnington (£20,000) and B. T. R. Scruby (£3,750) as Directors of the Company are paid to companies controlled by these Directors namely . . .

TARSUS GROUP Extract from note 4 to the 1998 accounts

4. Acquisitions

The Group made three acquisitions during the year for a total consideration of £7,761,000, of which £1,216,000 is deferred. These acquisitions resulted in goodwill of £9,413,000 before amortisation. From the date of acquisition to 31 December 1998 the acquisitions contributed £4,784,000 to turnover and £1,008,000 to operating profit before interest, goodwill amortisation, exceptional items and taxation.

All of these purchases have been accounted for as acquisitions. The fair value of the Group's identifiable assets and liabilities at the acquisition date (including goodwill) were:

Labelex Group	<i>Book value</i> £000	<i>Consistency of accounting</i> [X] policies £000	<i>Other</i> £000	<i>Total</i> £000
Net liabilities acquired				
Goodwill	175	—	(175)	—
Tangible fixed assets	226	(36)	—	190
Cash	1,500	—	—	1,500
Debtors	2,702	28	—	2,730
Creditors	(5,501)	(20)	(20)	(5,541)
Provisions	—	—	(485)	(485)
Negative net assets [Y]	<u>(898)</u>	<u>(28)</u>	<u>(680)</u>	<u>(1,606)</u>
Goodwill on acquisition				<u>7,247</u>
				<u>5,641</u>
Satisfied by: Cash				1,450
Shares allotted				2,500
Deferred purchase consideration [Z]				1,100
Costs of acquisition				<u>591</u>
				<u>5,641</u>

We are not criticising these accounts. Far from it: they provide a model of modern disclosure, leaving the individual investor to decide whether this is the right group for him.

The note on acquisitions is lengthy, so we reproduce only part of it. We do so for two reasons: firstly it shows just how much information is available on related party transactions; and secondly it demonstrates how acquisition accounting works including:

- [X] the accounting adjustments made on an acquisition;
- [Y] the calculation of goodwill in a case where the net assets are negative; and
- [Z] a business purchase satisfied by a complex structure of consideration including deferred terms.

Introduction

Floating exchange rates bring both accounting problems and operating problems. This chapter will deal first with the accounting problems, and then look at what companies do to mitigate the adverse effects that currency fluctuations may have on their operations.

Accounting problems

The main problem

The main accounting problem is the rate (or rates) of exchange to be used in translating the accounts of foreign subsidiaries, associates and branches, which are kept in foreign currencies, into sterling when producing the consolidated accounts of a group.

The choice lies between:

- (a) the *closing rate*: the spot rate of exchange at the balance sheet date;
- (b) the *average rate* of exchange during the period; and
- (c) the *historical rate*: the spot rate of exchange at the date of the transaction.

Various methods of translation use different combinations of these rates.

The UK accounting standard

SSAP 20 *Foreign currency translation* is concerned with:

- (a) *individual companies* which enter directly into business transactions denominated in foreign currencies, and
- (b) *groups* which conduct foreign operations through subsidiaries, associated undertakings or branches whose operations are based in a country other than that of the investing company, and whose accounting records are maintained in a currency other than that of the investing company.

Individual companies

When a company enters into transactions denominated in a foreign currency (i.e. a currency other than that in which the company's accounts are kept), SSAP 20 requires that they should normally be translated at the rate ruling at the date of each transaction, i.e. at the spot rate.

In the accounts of the individual company:

- (a) *Non-monetary assets*, e.g. plant and machinery, will already be carried in the accounts in the company's reporting currency, having been translated at the time of acquisition.
- (b) *Foreign equity investments*, being non-monetary assets, are normally shown at the rate of exchange ruling at the time the investment was made but, where financed by foreign currency borrowings, they may be translated at the closing rate. Any exchange differences on the investments are then taken to reserves, where the exchange differences on the foreign borrowings may be offset against them (SSAP 20, para. 51).
- (c) *Monetary assets and liabilities denominated in foreign currencies* should be translated at the closing rate.

- (d) All *exchange differences*, except those in (b) above, should be reported as part of the profit or loss for the year, e.g. differences arising from variations in exchange rates between the dates of invoicing in a foreign currency and the dates of payment. It is comparatively rare for such differences to be 'material' and nothing is normally disclosed.

Example 23.1 illustrates the treatment of four simple transactions involving foreign currency.

Example 23.1 Treatment of foreign transactions by an individual company

ABLE is a hypothetical UK company whose accounting year ends on 31 December. During the year, Able:

	<i>Rate of exchange</i>
(i) Purchases hock from a West German company, Weinburger GmbH, on 31 October for €20,000	£1 = €1.6
Pays Weinburger GmbH on 30 November	£1 = €1.52
Goods remain in stock at 31 December	
(ii) Sells cider to Prague and Pilsen, a Czech company, for 420,000 Koruna	£1 = 42 Koruna (Crowns)
Debt remains unpaid at 31 December	
(iii) Borrows on long-term loan from a Swiss bank SFr750,000 on 1 April	£1 = SFr3.0
(iv) Purchases plant and machinery from a US company for \$480,000 on 15 August	£1 = US\$1.50
Pays on 30 September	£1 = US\$1.60

On 31 December exchange rates are:

£1 = €1.475
 £1 = 42 Koruna
 £1 = SFr2.50
 £1 = US\$1.55

The company maintains its bank account in sterling and buys or sells foreign exchange as needed on the spot market.

Under SSAP 20 the transactions of Able will be treated as follows:

- (i) The purchase will be recorded at the rate ruling on 31 October, £1 = €1.6. The hock will appear in stock at a book cost of £12,500 and the eventual cost of sales will also be £12,500. When the account is paid, the rate has fallen to £1 = €1.52, so it is necessary to pay £13,158 to buy the necessary currency.
 An exchange loss of £658 (£13,158 – £12,500) will be charged to the profit and loss account for the year.
- (ii) The sale is translated at the rate ruling at the date of the transaction, £1 = FFr10.50, giving £10,000. At the end of the year, the debtor is a monetary item and translated at the closing rate, £1 = 40 Koruna = £10,500.
 The resulting exchange gain of £500 (£10,500 – £10,000) will be credited to the profit and loss account for the year.
- (iii) The loan will initially be translated at the transaction rate of £1 = SFr3.00, i.e. as £250,000. At the year end the loan will be translated at the closing rate £1 = SFr2.50, i.e. as £300,000.
 The exchange loss of £50,000 (£300,000 – £250,000) may be treated as 'financing' and *may be* disclosed separately as part of 'other interest receivable/payable and similar income/expense'.
- (iv) The fixed asset will be translated at the transaction rate of £1 = \$1.50, i.e. as £320,000. The asset will continue to appear at this cost unless it is revalued. Depreciation will be charged on £320,000. Payment for the machine will take (at £1 = \$1.60) £300,000.
 The gain of £20,000 (£320,000 – £300,000) will be credited to the profit and loss account for the year and will appear separately if considered material.

In Able's statement of accounting policies, the treatment of these purchases and sales would be explained in a note similar to that in ML LABORATORIES' accounts, illustrated below.

ML LABORATORIES *Extract from accounting policies 2003*

Foreign currency translation

Foreign currency transactions are translated into sterling at the rate prevailing at the date of the transaction. Assets and liabilities at the year end are translated into sterling at the rate prevailing at the balance sheet date. The resulting exchange differences are dealt with in the profit and loss account.

Group accounts

Where a company has foreign subsidiaries, associates, joint ventures or branches, the ‘closing rate net investment method’ is normally used in translating local currency financial statements. Under this method:

- (a) *Balance sheet* items should be translated into the currency of the holding company at the ‘closing rate’ (the spot rate on the balance sheet date). Where this year’s closing rate differs from the previous year’s closing rate, the differences arising from the retranslation of the opening *net investment* at this year’s closing rate should be taken to reserves and will appear in both the statement of recognised gains and losses and the movements in shareholders’ funds (see pages 158–60).

The *net investment* is the holding company’s proportion of the subsidiary or associates’ share capital and reserves. Long-term indebtedness between members of the group should be treated as part of the net

investment. The translation process is illustrated in Example 23.2.

- (b) *Profit and loss account* items should be translated using either the average rate for the accounting period or the closing rate and the method chosen should be applied consistently.

Any difference between translation at the average rate and the closing rate should be taken to reserves.

The rate used can make a considerable difference to the reported profit; e.g. if a German subsidiary made a profit of €13.5m during a year in which the rate of exchange fell from €1.55 = £1 at the beginning of the year to €1.35 = £1 at the end of the year, averaging €1.5 = £1 because most of the fall occurred in the last three months, on an average basis the group accounts would include German profits of €9m; on a closing rate basis they would include £10m.

If the closing rate method is used, no difference will arise between the profit or loss in sterling terms used for profit

Example 23.2 Translation of an overseas subsidiary’s accounts

On 31 December 2000, INJECTION MOULDERS PLC acquired a small foreign manufacturing company, RURITANIAN PLASTICS, to expand its operations into Ruritania, and paid asset value, 60m Ruritanian dollars (R\$), for it. At the time the exchange rate was R\$10 = £1, so the sterling cost was £6m.

During the first year of operation as a subsidiary Ruritanian Plastics made a profit after tax of R\$10m, and the R\$ fell to R\$12.5 = £1. Ruritanian Plastics’ actual and translated balance sheets for 2000 (R\$10 = £1) and 2001 (R\$12.5 = £1) were:

Year ended 31 December	2000		2001	
	R\$m	£000	R\$m	£000
Fixed assets	100	10,000	100	8,000
Current assets	<u>20</u>	<u>2,000</u>	<u>32</u>	<u>2,560</u>
	<u>120</u>	<u>12,000</u>	<u>132</u>	<u>10,560</u>
5 year State loan	50	5,000	50	4,000
Current liabilities	<u>10</u>	<u>1,000</u>	<u>12</u>	<u>960</u>
	<u>60</u>	<u>6,000</u>	<u>62</u>	<u>4,960</u>
Shareholders’ funds	<u>60</u>	<u>6,000</u>	<u>70</u>	<u>5,600</u>

The difference between the opening net equity of R\$60m translated at R\$10 = £1 (the closing rate in the 2000 accounts) and at R\$12.5 = £1 (the 2001 closing rate) is £6m – £4.8m = £1.2m, which would be taken from group reserves at 31 December 2001 as an exchange translation difference.

The profit of R\$10m (represented in the absence of any capital input or dividends by the difference between opening and closing shareholders’ funds) has been translated in the group accounts at the closing rate of R\$12.5 = £1 to produce £0.8m.

The fall in sterling terms in the net equity of Ruritanian Plastics from £6m to £5.6m is made up of the exchange translation loss of £1.2m less the £0.8m profit for 2001, i.e. £0.4m.

and loss account purposes, and the result of translation for balance sheet purposes. If the average rate is used there will be a difference, which should be recorded as a movement on reserves. The method used should be stated in the accounts. The advantage of using the average rate is that the translated results correspond more nearly to those given by management accounts prepared (say) on a monthly basis. Indeed to reflect those results even better, DIAGEO uses the *weighted* average rate of exchange (on the basis that it takes account of seasonal fluctuations in profitability):

DIAGEO Accounting policies 2003

Foreign currencies

The profit and loss accounts and cash flows of overseas subsidiaries and associates are translated into sterling at weighted average rates of exchange, other than substantial exceptional items which are translated at the rate on the date of the transaction. The adjustment to closing rates is taken to reserves.

...

- (c) *Foreign exchange borrowings*: where borrowings have been used to finance equity investment in foreign subsidiaries or associates, differences arising on their translation (at the closing rate) due to currency movements during the period may be offset against differences arising from the retranslation of the opening net investment, as is explained by SYGEN INTERNATIONAL (see below).

SYGEN INTERNATIONAL Extract from accounting policies 2003

(h) Foreign currencies

The results of overseas subsidiaries are translated into sterling at average exchange rates and assets and liabilities are translated using rates at the balance sheet date. Exchange differences which arise on translation are dealt with through reserves.

Differences arising on the translation of foreign currency borrowings which hedge group equity investments in foreign enterprises are taken directly to reserves to the extent of corresponding exchange differences on translation of the related net investment. The tax on those exchange differences which are taken directly to reserves is also recorded as a direct movement on reserves.

...

Hyperinflation

Urgent Issues Task Force (UITF) Abstract 9 is concerned with accounting for operations in hyperinflationary economies. The Abstract requires adjustments to be made when incorporating operations in hyperinflationary economies into consolidated accounts where the distortions caused by hyperinflation are such as to affect the true and fair view given by the accounts. In any event, adjustments are required where the cumulative inflation rate over three years is approaching or exceeds 100% (a level widely accepted internationally as an appropriate criterion). The Abstract discusses acceptable methods of handling the problem, one of which is to translate the results of operations in hyperinflationary economies using a relatively stable currency as the functional currency.

One group which operates in countries suffering very high rates of inflation, even hyperinflation, is LONMIN (formerly LONRHO) (see page 207).

Where restrictions prevent the transfer of cash from one part of the business or group to another, a note to the cash flow statement should specify the amounts involved and explain the circumstances (see page 167).

The temporal method

Where, and only where, the trade of a subsidiary is a direct extension of the trade of a holding company, e.g. a subsidiary acting purely as a selling agency in a foreign country, the temporal method of translation should be used in consolidation:

- (a) all transactions should be translated at the rate ruling on the transaction date or at an average rate for a period if this is not materially different;
- (b) non-monetary assets should not normally be retranslated at the balance sheet date;
- (c) monetary assets and liabilities should be retranslated at the closing rate; and
- (d) all exchange gains and losses should be taken to the profit and loss account as part of the profit and loss from ordinary activities.

Current UK practice

A growing number of companies use the average rate rather than the closing rate in translating overseas profits, and state which method is used in their accounting policies.

Mitigating the effect of currency fluctuations

Exchange rate movements are difficult to predict.

Examples 23.3–23.5 show the range of the UK's main trading currencies against sterling over the last ten years.

Currency	High	Low	Range
Euro	1.27	1.72	78p–58p
US \$	1.42	1.85	70p–54p
Yen	135	237	0.74p–0.42p

The way in which companies have sought to protect themselves against the effect of these and other currency fluctuations, both on their earnings and on their balance sheets, is explained in Chapter 14.

Although selling currency forward does protect the sterling value of future foreign income, doing so can have adverse effects if the foreign currency then strengthens rather than weakens. For example, if a UK motor manufacturer covers the US dollar forward, when its European competitors do not, and the US dollar strengthens, they

will have scope for cutting their prices in the USA, while UK manufacturers will not.

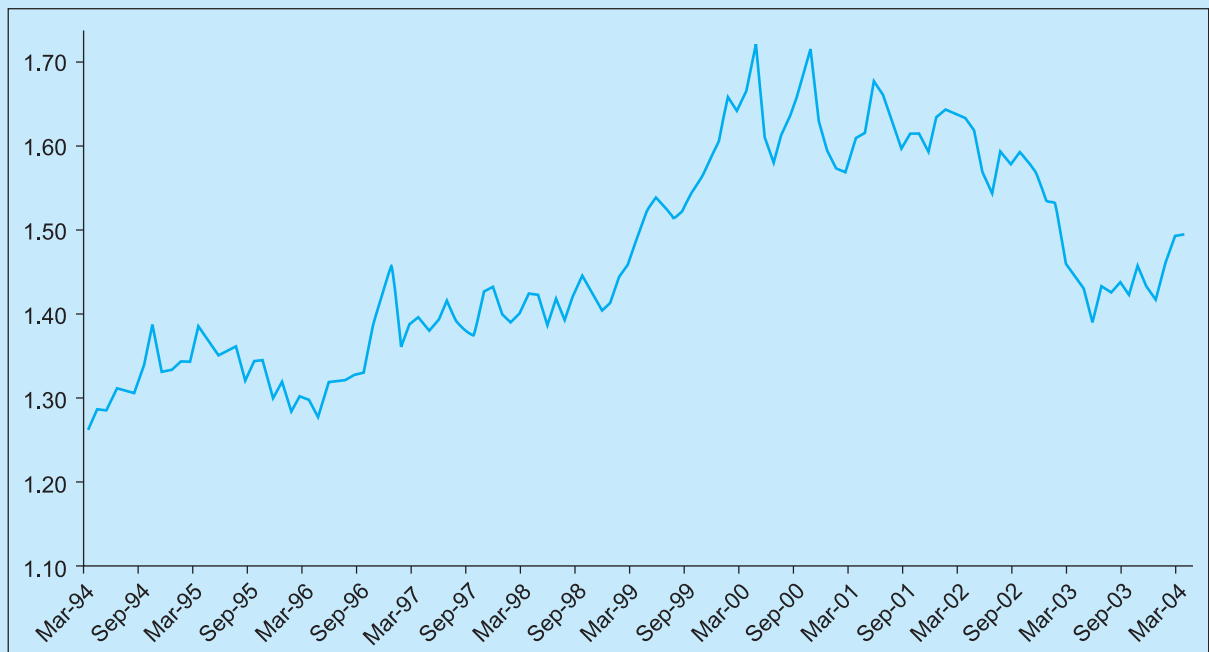
Protecting the balance sheet can be done in a variety of ways, the most obvious one being to borrow in the foreign currency. If the foreign subsidiary does the borrowing, the net equity investment in the subsidiary will be reduced. If the parent company borrows in the foreign currency and switches it into sterling, it will have a gain (or loss) to offset against any loss (or gain) on translating the net equity investment of the foreign subsidiary. If interest rates in sterling are higher than those in the foreign currency the parent company will also make a profit on the differential.



Beware of companies that trade in currency futures, unless they have in-house expertise, tight controls, and a deep pocket.

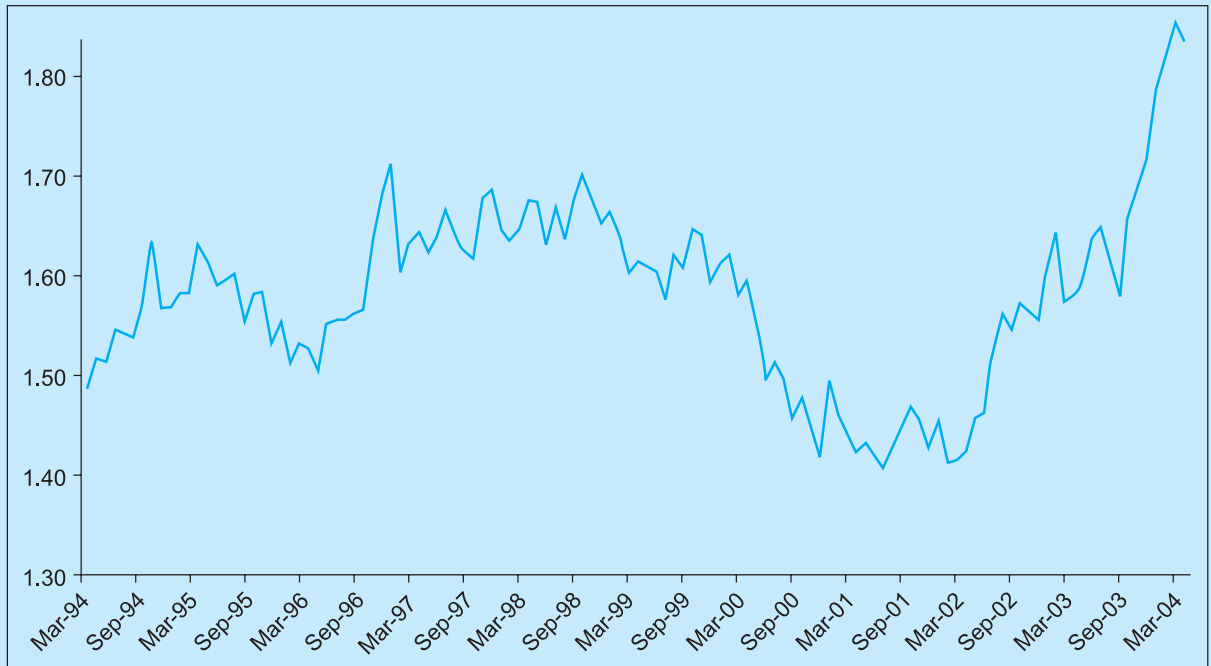
Remember BARINGS, a merchant bank with an impeccable reputation, brought down by failure of management to control a rogue trader in Singapore.

Example 23.3 Euro/£Stg exchange rate



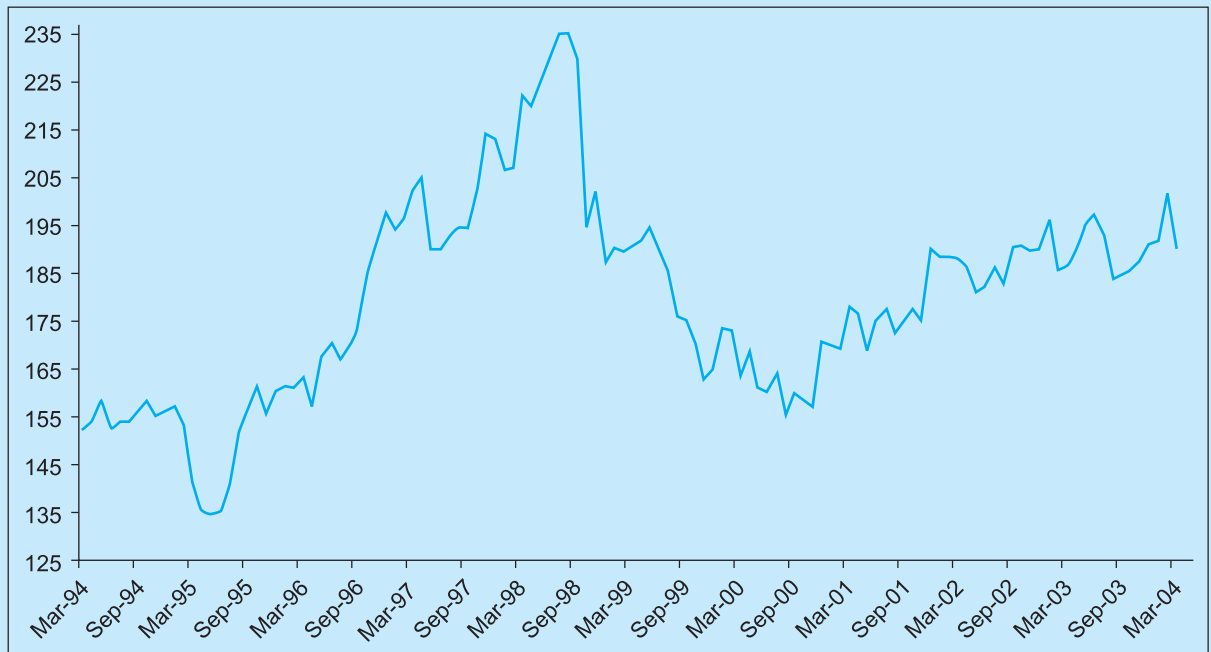
Source: Factset

Example 23.4 US\$/£Stg exchange rate



Source: Factset

Example 23.5 The Yen/£Stg exchange rate



Source: Factset

What the analyst should study

As has been seen, information about foreign currency tends to be scattered around in reports and accounts. A suggested sequence for the analyst to follow is:

1. Accounting policies on foreign currencies

Check that, as required by SSAP 20, differences on unmatched foreign borrowings are dealt with in the P & L account and not taken direct to reserves. Before SSAP 20, some companies borrowed in a hard currency, e.g. Deutschmarks or Swiss francs, to reduce their cost of borrowing for investment in the UK. The lower interest rates (broadly reflecting the lower expectations of inflation) increased the companies' profits and, when the foreign currency inevitably strengthened, they debited the increase in the sterling value of their borrowings direct to reserves. This method of enhancing the profits was short-sighted and often very costly. For example the WEIR Group managed to lose £3.6m on a DM denominated loan originally worth £6.3m, and the loss would have been even greater if the company hadn't arranged early repayment.

Note also if there has been any change in accounting policy, as this can be a way of enhancing the year's results.

There seems nothing strange or changed about LONMIN's accounting policies, but the rate changes during 2002–03 could have given more cause for worry.

LONMIN Accounting policies 2003

Foreign currencies

Subsidiaries that keep their accounts in currencies other than their functional currency remeasure them into the functional currency by the temporal method prior to consolidation. This results in non-monetary assets and liabilities being recorded at their historical cost expressed in the functional currency whilst monetary assets and liabilities are stated at the closing exchange rate. Differences on translation are included in the profit and loss account.

The principal US dollar exchange rates used in the financial statements, expressed as the foreign currency value of one US dollar, are as follows:

	2003	2002
Average exchange rates:		
Sterling	0.62	0.68
South African rand	7.88	10.65
Zimbabwe dollar	1,000.00	415.97

	2003	2002
Closing exchange rates:		
Sterling	0.60	0.64
South African rand	6.97	10.54
Zimbabwe dollar	1,000.00	640.00

But information is never all in one place:

LONMIN Note to the 2003 accounts

Note 2 Group operating profit

...

Group operating profit is stated after charging/(crediting):

	2003	2002
	\$m	\$m
Operating lease charges	1	1
Depreciation charges	46	39
Foreign Exchange profits	(6)	–
...		

2. Note analysing operating profit

It is here that differences arising from variations in exchange rates between the dates of invoicing in a foreign currency and the dates of payment, and on monetary items, should be (but are not always) shown where material. Most companies, including LONMIN, show nothing.

3. Statement of recognised gains and losses and movements in shareholders' funds

Check whether the adjustments for currency fluctuations are material in relation to (i) the profit for the financial year and (ii) the transfer (from profit and loss account) to reserves.

LONMIN Statement of total consolidated recognised gains and losses 2003

Statement of total consolidated recognised gains and losses for the year ended 30 September

	2003	2002
	\$m	\$m
Profit for the year – Group	75	187
– Associates	(1)	(2)
Total recognised (losses)/gains relating to the year	<u>74</u>	<u>185</u>

LONMIN Reconciliation of movement in equity interests**Reconciliation of movement in equity interests for the year ended 30 September**

	2003	2002
	\$m	\$m
Total recognised (losses)/gains relating to the year	74	185
Dividends	(101)	(101)
	(27)	84
Capital return	–	(361)
Share buyback	–	(128)
Shares issued on exercise of share options	–	3
Net (reduction)/increase in equity interests in the year	(27)	(402)
Equity interests at 1 October	675	1,077
Equity interests at 30 September	648	675

4. *If exchange adjustments found are large*

Look for further information elsewhere. Wherever a balance sheet or cash flow statement note explains the change in an accounting item over the year, e.g. fixed assets, provisions or cash, if foreign currency is involved there may be a 'Currency translation difference'. It is here that depositing money in a soft depreciating currency (as POLLY PECK did) or borrowing (at a low rate of interest) in appreciating currency (as WEIR, mentioned above, did) would come to light.

5. *The reconciliation of group operating profit to net cash flow from operations*

The reconciliation of group operating profit to net cash flow from operations does not usually show any exchange translation differences, but it may. This is likely to happen where a group translates 'profits, losses and cash flows' from overseas subsidiaries at average rate rather than closing rate (as TT ELECTRONICS did in its 2003 accounts).

TT ELECTRONICS Extract from reconciliation of group operating profit to net cash flow from operating activities

	2003	2002
	£million	£million
...		
Exchange translation differences	(1.1)	(3.6)
...		

6. *Again, if the figures seem significant . . .*

Look for comments in the Financial Review, if there is one, or in the chairman's statement or possibly in the directors' report, or even elsewhere in the notes. Where exchange rates have a significant effect, further information may include tables of exchange rates.

7. *Study the note on contingent liabilities*

Most companies did not in the past consider the potential liability in relation to swaps. But the note on contingent liabilities may today provide interesting information.

8. *Study any note on derivative financial instruments*

FRS 13 *Derivatives and other financial instruments* (see page 99) calls for a good deal of information on the use being made of derivatives and similar financial instruments. BP included more than a page on the matter in its accounts.

9. *Look for any indication of significant exchange rate changes having an effect on profitability*

Look also for any indication of the risks/costs/benefits of using financial instruments.

Activities on a global scale inevitably involve many types of risk. Few companies spell this out quite so clearly or at such length as BP. Their annual report for 2003 illustrates the complexity of the subject (the italics are ours).

BP Extracts from the financial review 2003**Financial risk management**

The group co-ordinates certain key activities on a *global basis* in order to optimise its financial position and performance. These include the *management of the currency*, maturity and interest rate profile of finance debt, cash . . .

Market risk

Market risk is the possibility that *changes in currency exchange rates*, interest rates or oil, natural gas and power prices will adversely affect the value of the group's financial assets, liabilities or expected future cash flows . . .

Currency exchange rates

Fluctuations in exchange rates can have significant effects on the group's reported profit. The effects of most exchange rate fluctuations are absorbed in

business operating results through changing cost competitiveness, lags in market adjustment to movement in rates, and conversion differences accounted for on specific transactions. For this reason *the total effect of exchange rate fluctuations is not identifiable separately in the group's reported profit*. The main underlying economic currency of the group's cash flows is the US dollar. This is because BP's major products are priced internationally in US dollars. BP's *foreign exchange management policy is to minimise economic and significant transactional exposures arising from currency movements against the US dollar*. The group co-ordinates the handling of foreign exchange risks centrally, by netting off naturally occurring opposite exposures whenever possible, to reduce the risks, and then dealing with any material residual foreign exchange risks.

Interest rates

...
The group is exposed predominantly to US dollar LIBOR (London Inter-Bank Offer Rate) interest rates as *borrowings are mainly denominated in, or are swapped into, US dollars*.

10. Consider the state of any overseas economies

Probably equally if not more important for the profitability of foreign operations than a weak exchange rate is the state of the economy in the foreign countries concerned. If the weak exchange rate reflects a weak economy, then adverse trading conditions may be more damaging for profits than translation.

LONMIN Extract from 2003 Financial Review

Analysis of results

...
gold mining operations in Zimbabwe were sold
...
Costs in US dollars were higher than in 2002 due to a combination of the strengthening in the South African rand average exchange rate of 26% and higher smelting costs following the explosion of the new smelter in December 2002.
...

BP Extracts from Note to 2003 accounts on Derivatives

25. Derivative financial instruments

In the normal course of business the group is a party to derivatives with **off balance sheet risk**, primarily to manage its exposure to foreign currency exchange rates and to interest rates, including the management of the balance between floating rate and fixed rate debt.

The group also manages certain of its exposures to movements in oil, natural gas and power prices. In addition **the group trades derivatives** in conjunction with these risk management activities.

Risk management

Gains and losses on derivatives used for risk management purposes are deferred and recognised in earnings or adjustments to carrying amounts when the underlying debt matures or the hedged transaction occurs. . . .

The unrecognised and carried forward gains and losses on derivatives used for hedging are shown in the following table:

	Unrecognised			Carried forward in the balance sheet		
	Gains	Losses	Total	Gains	Losses	Total
Gains and losses at 1 January 2003	526	(450)	76	352	(28)	324
of which accounted for in income in 2003	96	(51)	45	200	(14)	186
Gains and losses at 31 December 2003	331	(130)	201	1,003	(425)	578
of which accounted for in income in 2002	98	(28)	70	438	(75)	363
Gains and losses at 1 January 2002 . . .						

Historical summaries

Variations in form and content

In 1964 the Chairman of the Stock Exchange wrote to the chairmen of all listed companies asking for various items of information to be included in their reports and accounts. One of the items which 'might be included' was 'Tables of relevant comparative figures for the past ten years'.

Apart from this request, listed companies are under no obligation to provide any form of historical summary: there is no FRS or SSAP, and no uniformity of content, layout, or period covered, and some smaller companies don't bother.

The majority of companies give a five-year summary; most of the remainder show ten years, although a few choose a different period, usually for a specific reason; e.g. LONRHO's 'Financial Record' for many years went right back to 1961, the year their then chief executive, Tiny Rowland, joined the company. Renamed LONMIN, the group now shows only five years.

Because there is, as yet, no standard on historical summaries, the content varies enormously. For example, PROTHERICS, the result of a merger between two tiny biotechnology companies, Therapeutic Antibodies Inc. and

Proteus International plc, in September 1999, show only two basic items in the table below.

But, if read in conjunction with the Chairman's statement: '*in the last six months of the year to 31 March 2003, the company traded profitably*', the figures suggest that Protherics may well be a company worth following.

Of course, Protherics had no earnings per share or dividends to report: most companies give rather more information, and some give a great deal more.

GLAXOSMITHKLINE, for instance, devotes three pages to its five-year record, as well as six pages of quarterly trends for the most recent year. Some companies include information of particular relevance to their type of business; e.g. TESCO, in their five-year record (see opposite), show the number of stores, total sales area, and a number of other statistics which provide the reader with growth ratios some of which are not available from the accounts.

Have a look at TESCO's five-year record. Do you think that *Turnover per employee* and *Profit per employee* have grown satisfactorily between 1999 and 2003?

BP is among a number of oil companies which give useful statistics, including statistics on refinery throughput, crude oil and natural gas reserves, capital expenditure and acquisition, and is among companies which now provide historical cash flow data.

PROTHERICS *Annual Report 2003*

Financial Summary

	2003	2002	2001	2000	1999
	£000	£000	£000	£000	£000
Turnover	11,270	7,924	4,186	1,598	2,847
(Loss)/profit on ordinary activities after taxation	(238)	2,867	(6,206)	(15,454)	(13,017)

TESCO Extracts from five-year record

	1999	2000	2001	2002	2003	
...						
Operating margin¹	[A]					
UK	5.8%	5.9%	6.0%	6.0%	6.0%	
Rest of Europe	4.1%	3.7%	4.0%	4.1%	5.2%	
Asia	(1.3)%	(0.2)%	0.5%	2.1%	3.5%	
Total Group	5.6%	5.5%	5.6%	5.6%	5.7%	
...						
Return on shareholders' funds ⁵	[B]	21.3%	20.9%	22.7%	23.2%	23.3%
Return on capital employed ⁶	[B]	17.2%	16.1%	16.6%	16.1%	15.3%
UK retail productivity	[C]					
Turnover per employee	151,138	156,427	161,161	165,348	162,457	
Profit per employee	8,771	9,160	9,649	10,002	9,748	
Wages per employee	15,271	15,600	16,087	16,821	17,020	
UK retail statistics						
Number of stores	639	659	692	729	1,982	
Total sales area – 000 sq ft	15,975	16,895	17,965	18,822	21,829	
Average store size (sales area – sq ft) ⁸	25,627	26,641	27,636	28,576	29,455	
Full-time equivalent employees ⁹	104,772	108,409	113,998	121,272	133,051	
...						

Tesco's Notes to above summary

- Operating margin is based on turnover exclusive of VAT
- ...
- Underlying profit divided by average shareholders' funds
- Profit divided by average capital employed excluding net debt
- ...
- Average store size excludes Express and TS stores
- Based on average number of full-time equivalent employees in the UK

Our comments on Tesco's five-year record 1999–2003

[A] UK on a plateau. Rest of Europe improving. Asia turned profitable in 2001

[B] All unreliable, due to *Immediate write-off* of goodwill prior to FRS 10, and *not* reinstated

[C] UK retail productivity, adjusted for inflation. In £ of 1999:

	1999	2000	2001	2002	2003
RPI in February (see Appendix 3)	163.7	167.5	172.0	173.8	179.3
Factor to divide by each year	1.000	1.023	1.051	1.062	1.095
Turnover per employee	151,138	152,910	153,340	155,695	148,362
Profit per employee	8,771	8,954	9,180	9,418	8,902
Wages per employee	15,271	15,249	15,306	15,839	15,543

In real terms, wages per employee actually fell in 2000 and 2003

There is a growing tendency for companies to omit the normal table of historical information altogether in favour of often colourful diagrams of a few salient items. TAY HOMES, in its annual report for 2000, devoted half a page to presenting six items of basic information in six clever little blue-washed diagrams in a way that didn't immediately draw attention to the large losses made in the previous year, nor to nil dividends in 1999 and 2000.

The majority of listed companies manage to show between 25 and 35 items in a single-page five-year record.

A few companies, like WATERMARK, provide no historical information at all.

No FRS planned

A Financial Reporting Standard would be welcome on historical summaries, but because they fall outside the statutory accounts, there appear to be no plans for one.

The main difficulty facing the shareholder or analyst who tries to interpret a five- or ten-year summary is lack of consistency. We will consider this under five heads:

1. Inflation;
2. Changes in accounting standards;
3. Accounting changes made by the company;
4. Changes in the business environment;
5. Changes in the composition of the group.

Inflation

It used to be reasonable to regard a pound sterling today as the same as a pound last year and a pound next year. Inflation has made this concept of a stable currency (referred to in the US as the *uniform dollar concept*) seriously misleading.

To read a ten-year record as though currency were stable is to obtain a false picture, and would be just as misleading as the company chairman who makes much of 'yet another year of record profits' when they have advanced a mere 2% compared with a 3% or 4% rate of inflation.

We show, in the TESCO example on page 211, how, by adjusting by the RPI, the effects of inflation can be stripped out.

Changes in accounting standards

The first of the Accounting Standards Board's standards, FRS 1 *Cash flow statements*, was published in September

1991. We are now up to FRS 19 in force, and there is hardly an area of company accounts that hasn't been affected by one or more of these standards.

Take, for instance, goodwill. FRS 10 *Goodwill and intangible assets* requires goodwill arising in accounts periods ending after 23 December 1998 to be capitalised and amortised (see page 52). This change has affected most groups, since most had previously chosen to account for goodwill by *immediate write-off against reserves*, which was (absurdly) the *officially preferred method* before FRS 10.

Companies may, under FRS 10, choose to reinstate goodwill previously written off as though it had been capitalised and amortised throughout. In this case a five- or ten-year summary could, and probably would, show comparable figures throughout. But the ASB 'does not require reinstatement', and the large majority of listed companies have not done so.

For example TESCO:

TESCO Extracts from 2003 accounts

Note on accounting policies

Goodwill

Goodwill arising from transactions entered into after 1 March 1998 is capitalised and amortised on a straight line basis over its useful economic life, up to a maximum of 20 years.

All goodwill entered into prior to 1 March 1998 has been written off to reserves.

Note 11 Intangible fixed assets

	2003	2002
	£m	£m
Net carrying value		
At 22 February 2003	890	154

Note 24 Reserves

...

The cumulative goodwill written off against the reserves of the Group as at 22 February 2003 amounted to £718m (2002 – £718m).

Prior to FRS 10, Return On Capital Employed (ROCE) and similar ratios were often considerably inflated in acquisitive companies by *immediate write-off* of goodwill. And these ratios will continue to be inflated in the historical summaries of companies like Tesco (with £718m written off against reserves) for many years to come.

Accounting changes made by the company

Accounting changes made by the company can make a significant difference to reported profits.

Take, for example, ML LABORATORIES' change of accounting policy on Research and Development from capitalisation and subsequent amortisation to write-off as incurred (see page 50), or THORNTONS, the Derbyshire-based chocolate manufacturer and retailer, which changed the expected useful life of its shop-fits to reflect an operational change of policy:

THORNTONS *Finance director's review 2000*

Accounting standards and policy changes

...

Our change in strategic emphasis will result in a slower shop-opening programme and fewer shop refits, which means that capital investments already made will last longer.

We have, therefore, revised the depreciation policy on fixtures and fittings from four to five years. The net impact on profit is a gain of almost £2 million this year, and we expect a net gain of £1 million next.

Almost £2 million was a significant amount in a year when pre-tax profit halved from £11 million to £5.5 million and the company, under new management, was wisely cutting back on capital expenditure.

Changes in the business environment

Changes may be imposed on the company: for example, changes in the rate and/or method of taxation, as was the case with the reduction of ACT in the 1990s and its subsequent abolition.

Changes in the composition of the group

Where a group either grows other than internally or deliberately gets rid of activities, year-on-year comparability is bound to be affected. The changes can be carried out in several ways:

1. Acquisitions
2. Disposals
3. Termination of a specific activity

Acquisitions

FRS 3 *Reporting financial performance* requires profit and loss account figures down to the operating profit level to be split *inter alia* into (a) continuing activities and (b) acquisitions.

Few companies do this in any five- or ten-year summary, simply lumping the figures together as continuing activities. You can safely assume that data represent total sales from all activities including new activities developed internally and acquisitions and that the operating profits include such activities. We discuss the rules on new acquisitions on page 184.

Continuing and discontinued operations

As explained on pages 131–2, FRS 3 requires the subdivision in the profit and loss account of results down to operating profit level into continuing operations, acquisitions and discontinued operations.

It also requires separate disclosure, after operating profit and before interest, of:

- profits or losses on the sale or termination of an operation;
- costs of a fundamental reorganisation or restructuring having a material effect on the nature and focus of the reporting entity's operations; and
- profits or losses on the disposal of fixed assets.

The FRS does not mention five- or ten-year summaries, which therefore do not *have* to do this.

Most but not all do divide turnover and operating profit into those from continuing operations and those from discontinued operations. Most do not show profits or losses on the disposal of fixed assets.

In a simple case (like that of BENSONS CRISPS on the next page) one has little difficulty seeing what happened and when. In 1994, the entire business was unprofitable at the operating profit level; and operations with a turnover of £5.501m discontinued in that year are said to have lost £880,000.

In more complex cases (such as ALLDAYS, shown on page 214) it may be difficult to tell whether there has been one disposal or several over a period of years.

ALLDAYS' turnover figures would be consistent with there having been just one discontinuance of activities (in

BENSONS CRISPS *Extract from five-year record 1998***Summarised profit and loss accounts**

	1998 £000	1997 £000	1996 £000	1995 £000	1994 £000
Turnover					
Continuing operations	38,011	34,514	32,797	31,184	30,182
Discontinued operation	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>5,501</u>
	38,011	34,514	32,797	31,184	35,683
Operating profit/(loss)					
Continuing operations	3,332	2,875	2,544	928	(2,690)
Discontinued operation	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>(880)</u>
	3,332	2,875	2,544	928	(3,570)
...					

ALLDAYS *Extract from five-year record 1998***Five year record**

	1998 £000	1997 £000	1996 £000	1995 £000	1994 £000
Turnover:					
Continuing operations	493,826	455,801	410,427	378,925	348,894
Discontinued operations	<u>203,832</u>	<u>181,705</u>	<u>166,175</u>	<u>118,911</u>	<u>91,676</u>
Total turnover	<u>697,658</u>	<u>637,506</u>	<u>576,602</u>	<u>497,836</u>	<u>440,570</u>
Operating profit before exceptional items:					
Continuing operations					
Alldays:	14,720	19,492	15,064	12,086	7,949
Trademarket	<u>590</u>	<u>1,518</u>	<u>1,650</u>	<u>1,602</u>	<u>1,940</u>
Total – continuing operations	<u>15,310</u>	<u>21,010</u>	<u>16,714</u>	<u>13,688</u>	<u>9,889</u>
Discontinued operations					
W&P Foodservice	3,434	4,582	4,031	3,389	2,281
Wholesaling activity	—	—	2,754	3,261	3,840
Other	<u>—</u>	<u>—</u>	<u>427</u>	<u>427</u>	<u>427</u>
Total – discontinued operations	<u>3,434</u>	<u>4,582</u>	<u>7,212</u>	<u>7,077</u>	<u>6,548</u>
Total operating profit before exceptional items	18,744	25,592	23,926	20,765	16,437

1998). The analysis of operating profit makes it clear that there was an earlier discontinuance; and that the figures for 1996 and earlier represent both sets of activities since discontinued.

Just as there is little consistency in *what* is disclosed in a historical summary, there is no one order of *columns* which may, as in the ALLDAYS example, run in reverse

chronological order from left to right (showing the most recent figures first), or may run in the other direction (as with BRUNEL HOLDINGS).

Brunel has seen a gradual whittling away of operations but, after years of painful restructuring, the group may now possibly be out of the wood. In the words of the present chairman, appointed a little over two years ago:

BRUNEL HOLDINGS *Extract from 2000 report and accounts*

Five Year Record	1996	1997	1998	1999	2000
Turnover (£m)					
Continuing operations	73.3	77.2	77.3	65.5	72.0
Discontinued operations	<u>115.0</u>	<u>65.0</u>	<u>22.4</u>	<u>6.6</u>	—
Total	<u>188.3</u>	<u>142.2</u>	<u>99.7</u>	<u>72.1</u>	<u>72.0</u>
Operating profit (£m)					
Continuing operations	4.6	5.3	2.9	(6.9)	0.4
Discontinued operations	<u>2.4</u>	<u>2.1</u>	—	<u>(0.5)</u>	—
Total	<u>7.0</u>	<u>7.4</u>	<u>2.9</u>	<u>(7.4)</u>	<u>0.4</u>

BRUNEL HOLDINGS *Extract from Chairman's 2000 statement***Prospects**

Today, Brunel is a more tightly controlled, more disciplined and more focused Group. We view the next twelve months with a sense of quiet optimism.

ALLDAYS, on the other hand, has run into deep trouble:

ALLDAYS *Extract from Directors' 2000 report***Results and dividends**

The consolidated profit and loss account, set out on page 16, shows a retained loss after interest, tax and exceptional charges of £65,276,000 (1999: loss of £90,659,000). [and, surprise surprise] The directors do not recommend the payment of a dividend (1999: nil).

Alldays no longer includes a five-year record in its annual report and accounts.



When a company omits or reduces the information that it provided last year, always ask yourself

'Why?'

If you can find no good reason, treat it as a warning signal.

The first time we came across this was many years ago, but it's a good example nevertheless (if you live long enough, you will have seen it all before):

BURMAH OIL *Details of ship chartering*

£ million

1971

Tanker in-charters	204
Tanker out-charters	127

1972

Tanker in-charters had been lumped in with other contractual commitments in a total of £470 million, and the note went on to say that 'a substantial part of these commitments is already matched by tanker out-charters and other long term arrangements'.

1973/74

When the tanker charter market subsequently collapsed, Burmah's unmatched in-charter commitments ran up huge losses for the company and it had to be rescued by the Bank of England.

This was a classic example of a rogue trader bringing a company down. The person running Burmah's tanker chartering at the time was, we vaguely recall, a gentleman called Culukundis who, after the disaster, didn't feel he'd done anything wrong.

But to get back to Alldays, there was a good reason for omitting the five-year review. A new chairman and a new chief executive had been appointed towards the end of 1999, and five of the 'old guard' directors had since left. We presume the new team wanted to disassociate themselves from the (very murky) past.

Ratios



The key to using ratios is selectivity, not saturation.

Choice of ratios

With the profit and loss account, balance sheet and cash flow statement each containing a minimum of 10 to 20 items, the scope for comparing one item with another is enormous, so it is important to be selective, both to limit the calculations required and, more importantly, to make the presentation of the selected ratios simple and readily understandable. No decision maker wants a jungle of figures, so the ratios chosen should be the key ones, logically grouped.

Ratios can conveniently be divided into

- *operating ratios*, which are concerned with how the company is trading, and take no account of how the company is financed;

- *financial ratios*, which measure the financial structure of the company and show how it relates to the trading activities;
- *investment ratios*, which relate the number of ordinary shares and their market price to the profits, dividends and assets of the company.

Some companies include a table of key ratios in their report and accounts, and a few, like UNILEVER, opposite explain their definitions. This sort of table can be useful for looking at trends within the company concerned but, if you have the time and want to make inter-company comparisons, it may be preferable to work out your own ratios by a standard method.

In describing these ratios we give what we regard as the most useful and practical definition of each component.

Although there is an increasing trend towards standardisation, individual analysts do not always agree on definitions, while companies do not all define ratio components in the same way.

Why capital-based ratios are unreliable

Ratios like ROCE, Debt/Equity and Return on shareholders' funds have been distorted by inflation, which has made Historical Cost (HC) values increasingly irrelevant. As David Tweedie (until recently the chairman of the ASB) pointed out, to show a building at its HC of £20m when the bank had taken it as security for a £60m loan is clearly neither true nor fair.

And, more importantly in companies with an acquisitive history, the *immediate write-off* method of accounting for purchased goodwill has made millions and millions of pounds of shareholders' money simply disappear from the balance sheet, reducing shareholders' funds and thus increasing the return on them.

AS UNILEVER pointed out in a note to its five-year record, shown below, 'Return on shareholders' equity is substantially influenced' by the Group's policy, prior to 1998, of *immediate write-off*, and 'Return on capital employed and net gearing are also influenced but to a lesser extent.'

Earnings per share

Here we are spoilt for choice. You can have basic e.p.s., IIMR e.p.s. (UKSIP now, I suppose), and any 'Own Brand' e.p.s. a company or broking house likes to define. Of course

MAIN RATIOS

Indexed by type

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Price/Earnings ratio (P/E or PER)	160

* Unreliable

UNILEVER Extract from Five-year record

	€million 2003	€million 2002	€million 2001	€million 2000	€million 1999
Key ratios					
Return on invested capital (%) (Note 1)	12.5	9.8	8.7	6.2	16.5
Net profit margin	6.5	4.4	3.3	2.2	6.7
Net interest cover (times) (Note 2)	6.7	4.5	3.1	5.0	308.0
Adjustment for depreciation and amortisation	2.8	2.5	1.8	3.2	85.9
Net interest cover based on EBITDA (times)	9.5	7.0	4.9	8.2	393.9
Ratio of earnings to fixed charges (times)	4.6	3.6	2.6	3.1	8.0
Funds from operations . . .					

Note 1 . . . Invested capital is the sum of tangible fixed assets and fixed investments, working capital, goodwill and intangible assets at gross book value and *cumulative goodwill written off directly to reserves under an earlier accounting policy*.

Note 2 [Authors' note]: The very large figure for interest cover (times) in 1999 is due to a very small figure for interest paid.

David Tweedie was right to make it all-inclusive – so it couldn't easily be fudged.

But it's a shame that the ASB decided to call it '*Basic*', which it isn't, rather than '*All-inclusive*', which it is. A serious and misleading misuse of the English language. If you aren't sure, ask yourself 'Is my "basic" salary all-inclusive?' We doubt it except, possibly, in a roaring bear market.

How e.p.s. can be 'smoothed' a little

In the years BT (Before Tweedie) there was a great deal of scope for fudging the figures. Now there is much less, but still some. To help e.p.s. up/(down) a company can:

- Decrease (increase) various provisions, for bad debt etc.
- Be slack (strict) on writing down old or surplus stock.
- Put intangible assets on the balance sheet, but don't depreciate, do annual impairment reviews instead.
- When reviewing annually, be optimistic (pessimistic) about the value of each intangible.
- Extend (shorten) '*useful lives*' to reduce (increase) the depreciation charge.
- Defer (accelerate) bringing home profits from overseas to reduce (increase) tax on remission.

Now some of these measures may be taken in good faith e.g. THORNTONS, as a matter of policy, increasing the number of years between retail outlet refurbishments from

four to five (see page 213). And it's always a good idea to be rather more 'prudent' in good years, but the analyst and investor should watch out for signs of profit enhancement, which may include:

- Plausible rather than reasonable reasons for a change in accounting policies or practices.
- Threats of being taken over, a galvanising reason for reporting, or forecasting the best profits you can.
- Reporting profits only a whisker above last year's results. The company may have strained every muscle to avoid a fall in profits, particularly if it has an unbroken record. Using up all the company's 'spare fat' in one year makes it more likely that the company will fall out of bed the following year if trading conditions don't improve.

Two modern ratios

Before we move on from ratios we would like to consider two relatively new ones:

1. **Fixed charges cover;**
2. **Total return to shareholders.**

Older hands will remember the way property development companies went down like ninepins in 1989–90, when the UK property market virtually dried up.

Those that survived, as at least one shrewd property analyst had predicted, were the ones that had sufficient rental income to cover their fixed costs until times got better.

Whether this experience gave W.H. SMITH the idea we do not know, but we like the ratio they have come up with:

Fixed charges cover

Other companies may use the ratio internally, but this is the only company we have spotted publishing it in the annual report and accounts:

W.H. SMITH Extract from 2000 accounts		
Note 11 Fixed charges cover		
	2000	1999
	£m	£m
Interest income	(6)	(14)
Operating lease rentals	154	141
Property taxes	32	30
Other property costs	<u>11</u>	<u>9</u>
Total fixed charges	191	166
Profit before tax	<u>140</u>	<u>134</u>
Profit before tax and fixed charges	<u>331</u>	<u>300</u>
Fixed charges cover	<u>1.7x</u>	<u>1.8x</u>

Fixed charges cover is calculated by dividing profit before tax and fixed charges by total fixed charges

W.H. Smith also includes the fixed charge cover in its five-year summary.

Total return to shareholders

This has become popular in more recent years for use as a criterion for extra remuneration to directors and senior managers, for example BOOTS:

BOOTS Extract from 2003 report

Financial review

...

Total shareholder return (TSR) of the company over the last five years compared with those of our peer companies were as follows:

Five years to 31st March 2003	%
1 Smith & Nephew	123.9
2 Alliance UniChem	24.0
3 Reckitt Benckiser	21.4
4 Tesco	13.1
5 GUS	(17.1)
6 Debenhams	(17.4)
7 Boots	(24.0)
8 WH Smith	(24.2)
9 Kingfisher	(35.6)
10 Marks & Spencer	(37.8)
11 J Sainsbury	(39.3)

Debenhams replaced SmithKlineBeecham but appears as a peer company for the first time as it has completed five years as a listed company. Position seven this year is an improvement of two places compared with last year. Our five-year TSR of (24.0)% represents (5.3)% on an annualised basis. Over a ten-year period our equivalent annualised return was 5.7%.

Although this is a good way of comparing companies it is hardly original; the concept of total return has been central to UK portfolio performance measurement since 1971 or earlier. And it is too historic to be of any great value to the analyst.

What we naively don't understand is why bonuses should be handed out during a bear market, when the share price and shareholders are taking a thrashing.



We are highly distrustful of incentive schemes which do not align the interests of directors and senior management with the interests of shareholders.

Trends

It is frequently a worthwhile, even profitable, exercise to set alongside one another, growth in:

- (a) turnover;
- (b) profit before tax;
- (c) earnings per share;
- (d) dividend per share.

If they are wildly different, the cause should be investigated. In the sixth edition we looked at MITIE GROUP, a relatively small cleaning and maintenance contractor, saying that it was 'taking advantage of the trend towards out-sourcing such services' while at the same time expanding by making a series of small acquisitions.

As is shown in the first extract below, from Mitie's 1995 group statistical record, growth between 1990 and 1995 was spectacular:

- turnover was up almost 703% in five years;
- pre-tax profit (up 604%) had nearly kept pace; but
- because of acquisitions for paper (issuing new Mitie shares to the vendor, rather than paying cash), e.p.s. had only grown 165%;
- from a very low base, and nine times covered, dividends had increased 500%, which must have pleased the long-term shareholders.

Taking a subsequent period, 1996 to 2000, shown in the second extract overleaf:

- the growth in turnover had slowed down a little, but still an impressive increase of 115% in four years;
- profit before tax, up 205%, grew almost twice as fast as sales;
- the increase in e.p.s. of 153% was quite a lot less than the rise in pre-tax profit, due to acquisitions for paper;
- dividends grew by 150%, roughly in line with e.p.s.;
- dividend cover had remained at around $4 \times$ throughout the five years. The low payout ratio of around 25% left 75% invested in the group to help finance Mitie's continued growth.

In other words the group was exhibiting ratios typical of a highly profitable, but more mature group.

Common size statement

Another way of looking at these figures is to draw up a *Common size statement*. All the earliest year's values are rebased at 100 and each subsequent year's value for each item is divided by the increase in the Retail Price Index (RPI); see overleaf.

MITIE GROUP *Extract from Group statistical record 1995*

	1995	1994	1993	1992	1991	1990	Increase
	£000	£000	£000	£000	£000	£000	1990–1995
Turnover	125,183	101,732	72,994	52,276	32,699	15,594	702.8%
Profit on ordinary activities before taxation	4,571	3,361	2,402	1,808	1,231	649	604.3%
...							
Earnings per share	12.2p	8.5p	6.6p	5.8p	5.5p	4.6p	165.2%
Dividend per share	3.0p	2.25p	1.75p	1.375p	1.0p	0.5p	500.0%

Earnings and Dividend per share figures have been re-stated to reflect the sub-division of shares referred to in Note

...

The results of merger accounted acquisitions are reflected in full in the year of acquisition and subsequent years but only the year prior to acquisition has been re-stated on a comparable basis.

MITIE GROUP *Extract from Group statistical record*

	2000	1999	1998	1997	1996	Increase
	£000	£000	£000	£000	£000	1996–2000
Turnover	346,514	264,455	236,293	209,425	161,149	115.0%
Profit on ordinary activities before taxation	19,240	14,508	11,110	8,210	6,302	205.3%
...						
Earnings per share	8.1p	6.5p	5.1p	4.0p	3.2p	153.1%
Dividend per share	2.0p	1.6p	1.2p	1.0p	0.8p	150.0%

Earnings and Dividend per share figures have been re-stated to reflect the sub-division of shares in 1997 and 1998

...

MITIE GROUP *Common size statement 1996–2000 and Average annual growth*

	2000	1999	1998	1997	1996	Average growth p.a.
Turnover	215.0	164.4	146.6	130.0	100.0	21.1%
Profit on ordinary activities before tax	305.3	230.2	176.2	130.3	100.0	32.2%
...						
Earnings per share	253.1	203.1	159.4	115.0	100.0	26.1%
Dividend per share	250.0	200.0	150.0	125.0	100.0	25.8%

Chairman's statement, operating and financial reviews and directors' report

In this chapter we look at what can be learned from those parts of the report of a company which are not strictly part of the accounts. The directors' report has long been part of the reporting system and is required by the Companies Act 1985. The other documents covered in this chapter, e.g. the Chairman's Statement, the Operating (or operational) Review, and the Financial Review, are relatively new and not required by the Companies Act.

Sequence of study of a report and accounts

It is difficult to lay down a set of rules as to the best order in which to study a report and accounts, and each individual will – indeed should – develop his or her own method. The important thing is not to miss information regardless of where it is presented.

One stockbroker tells us he always goes straight to the directors' holdings to see if they are reducing their holdings! Indeed, one co-author maintains on file details of all directors' share transactions in their own companies and spends a few minutes each week studying them.

That the directors have sharply reduced their holdings in the company certainly tends to be a warning sign – but it is unwise for a director (or any other investor) to have too many eggs in one basket – so reductions are not necessarily a warning signal – an individual director may have special, personal, financial needs at a particular time.

Similarly, an increase in directors' holdings tends to be encouraging particularly where a company's shares seem undervalued or under pressure, but directors can and do get it wrong, personally as well as commercially, pouring good money after bad even when it is their own.

Major own-share activity on the part of one or more directors does, however, focus attention: something seems to be happening. One needs to find out what.

It is certainly helpful to start by glancing at the chairman's statement and the directors' report simply to see whether anything has occurred which would invalidate a straightforward comparison between one year and another. If, for instance, a major acquisition took place early in the year under review, almost all operating and financial ratios are likely to have been affected. This does not mean that the ratios are useless: simply that the analyst must bear in mind that change in composition every time he compares one ratio with another.

Having then studied the accounts (a process we will discuss in detail in Chapter 30) and having examined any segmental analysis of turnover and pre-tax profits between classes of business and any geographical analysis of turnover and trading results outside the UK, the reader will have a good idea of how the company has fared in the past year, but little idea why (except in the context of happening to know that it was a good, average or bad year for the industry or industries in which the company operates), and little idea of how the company is likely to do in the current year and beyond. It is to the Chairman's Statement and the Operating Review, if there is one, that we should look for this information.

The Chairman's Statement

Companies are not required to publish a chairman's statement, but listed companies invariably do. In the case of companies which believe in keeping shareholders well informed, the Chairman's Statement will usually contain comment on:

- (a) overall trading conditions during the period, current climate and general outlook;
- (b) the performance achieved by each activity, current trading and future prospects;
- (c) items of special interest (e.g. closures and new ventures);
- (d) changes in the board;
- (e) company strategy and plans for the future.

Study the Chairman's Statement, not only for what it says, but also for what it does not, where one is left to read between the lines. We find it's useful to read through the whole statement highlighting with a marking pen key phrases and points of interest as we go, before getting down to any detailed analysis.

Review of operations

A growing number of companies produce, sometimes instead of a Chairman's Statement but more commonly in addition to one, either a Chief Executive's Review or an Operating Review.

Where these documents exist, and even the more enlightened and/or investment-hungry smaller companies publish them too, they provide a vital part of the information package, often avoiding the stilted form and language of the directors' report and shedding additional light on information in the accounts.

Typically, where one or more of these documents exist in addition to a Chairman's Statement, that document is devoted largely to overall performance, plans and strategy, while the detailed review of operations, usually division by division, is left to the Chief Executive's Review and/or Operational Review. It is here that one learns in detail what the various parts of the group do, where, and how, the group's various markets are shaping, and where the focus of management attention lies. Statistics and graphs often present useful information on this and on trends over the years.

Financial Review

The Accounting Standards Board's Best Practice Statement, *Operating and Financial Review*, recommends listed companies to provide supplementary information in the form of an Operating and Financial Review (OFR).

Additionally the DTI's recent Company Law Review proposes a statutory requirement for listed companies to include an OFR in the full annual report.

The Operating Review (or Review of Operations) was referred to above.

The main purpose of the Financial Review part of an OFR is to explain the accounts and to shed light on financial performance and strategy:

- Why did interest payable rise (or fall) so much year on year?
- What exactly do the exceptional items represent?
- Why does the effective tax rate differ from the rate of UK corporation tax?
- Where does the group keep its main cash reserves – the UK? If not, why there?
- What has happened to gearing, and why?
- What was the capital expenditure during the year actually used for? How much more is needed to complete the group's plans, and where is it coming from? (Is it in place?)
- How was (is) the group affected by exchange rates and interest rates?
- Risk management, with comment on:
 - (a) treasury risk management;
 - (b) liquidity risk;
 - (c) finance and interest rate risk;
 - (d) currency risk;
 - (e) commodity risk;
 - (f) credit risk.
- Which recent accounting standards have been adopted for the first time in the accounts?

Where a financial review is included, it should be regarded by analysts as being, to all intents and purposes, part of the accounts, and studied as such.

Environmental reports

In recent years there has been a growth in environmental reporting in the UK. More and more companies now include information on environmental issues in their annual reports and accounts and there are now over 50 dedicated environmental reports available.

The scope of environmental matters covered is wide; perhaps 20 separate issues are discussed. Some of these are obvious and covered by most of the reports, e.g. waste, emissions, use of natural resources, energy usage and recycling. Others, like the decommissioning of oil rigs, are problems specific to particular industry groups.

Until such time as environmental reporting has matured to the stage where there is a substantial amount of historical information and a free flow of information on environmental matters, the usefulness of any information to shareholders and analysts is limited. Nevertheless, environmental issues cannot be ignored. The costs of a major environmental disaster or of decommissioning could mortally wound all but the largest groups.

Legal claims, particularly in the US, may run back many years; may be covered by insurance or uncovered; and the courts seem unpredictable, not to say wild, in their assessment of damages. Any note on contingent liabilities in this area needs to be studied with care (see pages 114–15).

Estimating current year profits

A rough estimate of profits for the current year can be constructed (for each activity which is separately reported on) by quantifying the chairman's comments (and those by the chief executive and finance director in related reports – for simplicity we will refer to the chairman), bearing in mind prevailing conditions and prospects for the industry concerned; e.g. POLYGON HOLDINGS PLC (see Example 25.1 below).

The chairman may also give an overall indication, e.g. Polygon Holdings' turnover in the first three months of the current year has been 22% higher than the same period last year, the paper division's order-book is now four months, compared with one month last year, and, despite constant pressure on margins and the increasing ineptitude of government, the outlook for the group is encouraging.

'Outlook encouraging' sounds to us like a 20–25% increase in pre-tax profits, i.e. to £4.3–£4.5m, pointing to the middle of the range we constructed division by division.

Other points to bear in mind in making a profits estimate are these:

1. Loss-makers discontinued will not only eliminate the loss but should, in addition, improve liquidity (and thus reduce interest charges, assuming there is an overdraft). But have all terminal losses been provided for?
2. What is the chairman's previous record? Has he been accurate, cautious, unduly optimistic – erratic? Have past assurances of better times ahead remained unfulfilled?
3. Remember, too, that one of the chairman's most important jobs is to maintain general confidence in the company, so he is likely to concentrate on the good points and only touch briefly or remain silent on the weaker aspects of the company. Here it is a good idea to jot down questions one would like the answer to, even if the analyst or shareholder is unlikely to have the opportunity of putting them to the company, because it focuses the mind and helps to establish what the chairman hasn't revealed and whether any unexplained area is likely to be significant. Good questions to ask oneself are (i) 'What are the company's main problems?' and (ii) 'What is being done about them?'
4. Beware of vague statements, such as:
 - (a) 'Turnover in the first ten weeks of the current year has exceeded the corresponding figure for last year.' It could be 1% ahead in value because inflation more than covered the 4% drop which occurred in volume.

Example 25.1 Estimating current year profits: POLYGON HOLDINGS PLC

Activity	Industrial climate	Chairman's remarks	Previous year £m	Reported year £m	Estimate of current year £m
Building	Continued recession	'Further decline inevitable'	1.0	0.8	0.5–0.6
Paper	Cyclical upturn	'Marked improvement'	2.2	1.8	2.4–2.8
Bookmaking	One of the UK's few growth industries	'Continued progress'	1.0	1.2	1.4–1.5
Plastic extrusions	Demand flat	'Market share increasing but lower margins'	0.6	0.75	0.6–0.8
Interest charges	Rates down 2%	'Improvement in liquidity likely'	<u>-0.8</u>	<u>-1.0</u>	<u>-0.8</u>
		Pre-tax total	<u>4.0</u>	<u>3.55</u>	<u>4.1–4.9</u>

- (b) 'Unforeseen difficulties have occurred in . . . and a provision of £1.3m has been made.' Unless there is some indication of the likely overall cost of overcoming these difficulties, or of abandoning the activity altogether, the company should be assumed to have an open-ended loss-maker on its hands.

Longer-term prospects

The chairman of a company should be continually looking to the future and, unless he and his board have good sound ideas on where the future growth in profits is likely to come from, and are steering the company in that direction, then above-average profits growth is unlikely. Although there must, of course, be some restrictions on what a chairman discloses about plans for the future, because of competition, he will usually include some indication of where he thinks the company is going in his annual statement.

A good past growth record is clearly encouraging (a no-growth company is likely to stay a no-growth company unless the management or the management's attitude changes), but what indications are there of future growth? Possibilities to look for are the following:

1. **Better margins on existing business.** This is an unreliable source of growth unless the company *either*
 - (a) has some very strong competitive advantage, such as patents or lucrative long-term contracts, or
 - (b) has spent large sums of money building up brand images and carving out market share, and is now beginning to reap the benefits;

even then the profits growth will only last until the patents expire, the long-term contracts run out or the brand images tarnish.
2. **Further expansion of existing activities within the UK.** Is there any scope for this, or is the company in a position like BOOTS or W.H. SMITH, with a store in every town of any size, or like PILKINGTON, with 90% of the UK glass market?
3. **Diversification within the UK.** This was BOOTS' answer to its saturation problem with chemist shops: it widened the range of goods sold to include records and tapes, hi-fi, cameras, binoculars, even sandwiches. BOOTS was using its retailing expertise in wider product ranges,

rather than going into some totally unrelated activity, and there does need to be some logic in diversifications or they can come very badly unstuck.

4. **Acquisition within the UK.** Has the company got a successful record of acquisitions, or would this method of growth be new to it (and therefore more risky)? This was part of W.H. SMITH's solution for further growth: in 1986 it took over the recorded music chain OUR PRICE, with 130 outlets, added 40 music outlets it already had and by 1990, with further acquisitions, built the chain up to around 300 outlets.
5. **Exports.** Is the product suitable for export, or would transport costs make competitiveness overseas unlikely or impossible (e.g. bricks)? Does the company export already, is it a significant amount, and is it growing? The chairman may report that 'exports are 80% up on last year', but if this is an increase from 0.1% to 0.18% of turnover, it is hardly thrilling, and one should be wary of the chairman whose efforts to paint a rosy picture involve misleading statements like that, which should in honesty be qualified by some phrase like 'albeit from a very low base'.
6. **Are there opportunities for overseas growth** like W.H. SMITH's acquisition of the US news and gifts chain ELSON, specialising in shops in hotels and airports, or PILKINGTON putting down float-glass plants overseas, either on its own or in joint ventures, or by licensing the process to foreign glass manufacturers? There are, however, a good many hazards in opening up operations abroad, apart from the initial expense: different business ethics and practices, language, law, accounting and tax systems, and so on. For manufacturing abroad, cost levels and exchange rates may change over time, so that what today looks a good investment may prove otherwise in years to come if the cost of living rises faster in that country than elsewhere.
7. **Is the company spending money on, and attaching importance to, developing new products?** This is particularly important for pharmaceutical companies; GLAXOSMITHKLINE, for instance, in 2003 reported £2,791m spent on research and development, representing 13.0% of the group's turnover.

Although any manufacturing company that isn't developing new products is almost certainly going downhill, it is also bad news if the chairman is always eulogising about new products that never come to anything: the company's track record on product development should be checked.

8. *Is the company ploughing profits back?* Profits in most industries cannot expand beyond a given point unless the asset base (needed to support the trading needed to generate the profits) is also expanded. There is a limit to gearing up, while acquisitions and rights issues don't necessarily enhance e.p.s.: only steady ploughback gives scope for steady growth in e.p.s.

In the context of future growth, it is also worth checking press cuttings for stories on the company, which often contain glimpses of the company's thoughts on the future (many people use the FT McCarthy press cutting service).

Information on the quality of management

Returning to the business of assessing the strength of the management, perhaps the most encouraging facet is when the chairman admits to a mistake or to being caught wrong-footed, and reports what is being or has been done about it. A classic example comes from the 'rag trade': the chairman's statement for WEARWELL in 1976, a year in which trading results had fallen from £1m profit to £28,000 loss on turnover down from £7.1m to £6.2m and with over £¹/₂m in terminal losses, contained the following comments:

WEARWELL Extracts from chairman's report 1976

... in 1973 we operated what was basically a cash and carry operation. [In 1974 and 1975 the company made two acquisitions for cash and we] found ourselves in the business of building up stock and financing customers for considerable periods ... sales not as buoyant as expected ... liquidity difficulties in the opening weeks of 1976 instituted immediate measures, namely:

1. Closure of the mail order supply business which has required the financing of substantial stocks.
2. Cutting out much of the credit business with chain stores.
3. The waiver by directors of a substantial part of their salary entitlement together with a waiver of between 94.0% and 99.9% of their total entitlement to the interim dividend.
4. Strenuous efforts were made to liquidate stocks.

... your company operates now only in the cash and carry type business which is where your management has proved its expertise.

Wearwell's drastic action paid off. The company just managed to get out of the red in 1977, and from then on pre-tax profits grew steadily; five years later the chairman, Asil Nadir (of POLLY PECK fame, the group which Wearwell subsequently joined) was able to report pre-tax profits in excess of £4m.

Wearwell's shareholders had a bumpy ride: from an Offer for Sale price of 30p (adjusted for subsequent scrip and rights issues) in July 1973 they saw the ordinary share price fall to a low of 8p in November 1976, and received no dividends at all in 1977 and 1978. But if they got out in time (i.e. before Polly Peck bit the dust) they were amply rewarded: in 1984 Wearwell merged with Polly Peck, whose chairman was also Mr Asil Nadir. The deal gave Wearwell shareholders 53 Polly Peck shares for every 100 Wearwell, valuing Wearwell's ordinary shares at 164p each: twenty times the 1976 level.

In contrast, the chairman of a housebuilding company reported proudly in 1974 that 'notwithstanding all these problems [the three-day week, the shortage of mortgage funds, rising interest rates and increases in building costs] your company increased its turnover to a new record level'. The turnover had risen from £25.4m to almost £44m on an equity base of less than £2m net of goodwill and after writing £8.7m off the value of the land bank, by then in the books at a mere £24.4m plus £23.4m work in progress. Apart from the feeling that the chairman was steering his company straight for the eye of a financial typhoon, and his failure to even mention the year's pre-tax loss of £6.3m in his statement, there were a number of fairly conspicuous danger signals scattered around the report:

- (a) the notice of the AGM included a resolution to appoint a top London firm of accountants to be joint auditors with the existing provincial firm of auditors;
- (b) the directors' report contained a little paragraph on 'financial arrangements', which revealed that the group's bankers had agreed to 'roll up' interest on group borrowings.

But perhaps the most telling fact was an omission: the group's habit of including a historical summary (which in the previous year's accounts had shown a seven-year progression in pre-tax profits from £142,000 to over £7m) had been discontinued! The fall into loss was too painful to face. Liquidation followed quite shortly afterwards.

The directors' report

Contents

The contents of the directors' report fall broadly into three categories:

- *Information required by law* – the statutory requirements – a mass of information some of which is obvious from the accounts anyway, some of which is of comparatively little interest to the analyst (but appears to have been motivated by political considerations, e.g. contributions for political purposes), but some of which may be of vital interest and importance to anyone interpreting the accounts, e.g. the review of the year and likely future developments.
- *Information required by the UK Listing Authority*, which we described in Chapter 4, some of which overlaps the statutory requirements.
- *Voluntary information* – additional information and commentary which the company wants to include: this is usually concerned with the events of the past year, current trading and future plans and prospects.

Voluntary information is, these days, normally contained mainly or wholly in the chairman's statement or the operating review or similar reports, leaving the directors' report to be largely a catalogue of compulsory details. But if there is no chairman's statement and, as we said earlier, there is no compulsion for a chairman to report separately from the board of directors, any voluntary information will be included in the directors' report.

Statutory requirements

Under the Companies Act, a directors' report must give the following information:

- (i) a fair review of the development of the business during the year, together with an indication of likely future developments and of research and development activities;
- (ii) the names of the directors and details of their interests (shareholdings);
- (iii) details of company's own shares acquired by the company during the year;

- (iv) important events affecting the company which have occurred since the end of the year; see also post balance sheet events, pages 229–30;
- (v) details of political or charitable contributions, if over £200 in the year.

During a recent slump, it was suggested that some companies, often leading companies, were bringing problems to their suppliers by delaying payment. As a consequence directors of public companies and their large subsidiaries are required to give details of policies for the payment of suppliers in the following year.

Such statements tend to be bland and of little use to the analyst. MARKS & SPENCER's note is slightly more interesting than most.

MARKS & SPENCER Directors' report 2003

Creditor payment policy

For all trade creditors it is the Group's policy to:

- agree the terms of payment with that supplier
- ensure that suppliers are aware of the terms
- pay in accordance with its obligations . . .
- general merchandise is automatically paid for 11 days from the end of the week of delivery
- food is paid for 13 days from end of week of delivery (on timely receipt of accurate invoice)
- distribution suppliers are paid monthly . . .

This makes the point, and it is worth remembering: figures (e.g. bank balances and ratios) at balance sheet date are not necessarily typical of those the rest of the year.

An analyst would certainly find more revealing a report by a junior member of the accounts department of a food company whose products are on every supermarket's shelves that instructions are frequently given by the managing director to 'call for a copy invoice – that will keep them happy for another couple of weeks'.

Control of the company

It is always worth checking whether a company is a 'bid prospect'. If an acquisition-minded company has a substantial holding, this can explain why the company's shares are looking overrated or expensive in comparison with other similar companies.

On the other hand, if the company is under the control of its directors or if the directors' interests are substantial although not controlling, the dividend policy is likely to be conservative. In addition, growth will probably be limited to ploughing back profits, because directors or the controlling shareholders are unlikely to be in a position to take up their entitlement in a rights issue, and because acquisitions for paper would dilute their control.

However, if the principal director shareholder is nearing retirement, with no obvious successor (check list of shareholders for family names of the next generation, and remember that new issue prospectuses give directors' ages), then an agreed bid could well be in store.

The board of directors

This is, perhaps, an opportune time to discuss the board. Although many companies are built up primarily through the efforts of a single person, a one-man band is a potentially dangerous situation. He's going to present a succession problem in due course, and what would happen if he had a heart attack tomorrow? And, if he's egocentric, he may surround himself with yes-men and come an awful cropper with 'his' company, as Tomkins illustrates (see next column).

Investors prefer a top management *team*: it is, for example, preferable not to combine the posts of chairman and managing director, and to have a separate finance director, and to have at least five board members. We were (and probably, today, the market would be) unhappy with the statement of one chairman/MD: 'Apart from overall control of the Group's affairs, I shall have particular responsibility for financial control, and investigating possible acquisitions by the company.'

Non-executive directors

We have long liked the inclusion of a few non-executive directors. This is now a requirement of the Combined Code on Corporate Governance – one which most companies accept though a few loudly proclaim their disagreement.

Non-executive directors are valuable provided, and only provided, they:

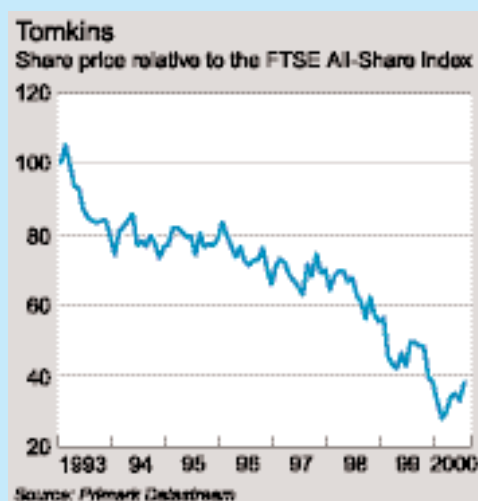
- (a) are of a healthily independent disposition;
- (b) devote sufficient time to the company to have a good grasp of its affairs (i.e. to know what's going on);

FINANCIAL TIMES *Extract from LEX column, 1 July 2000*



Tomkins

Tomkins is, belatedly, doing some sensible things: improving corporate governance, buying back its unloved shares and – when it actually happens – selling Rank Hovis McDougall. What a shame the conglomerate did not do all this three or four years ago. Greg Hutchings is finally giving up his dual role as chairman and chief executive. Bringing in a non-executive chairman and putting some heavyweight outsiders on the board is good news. The company will start listening to its shareholders now. Though, with the stubborn Mr Hutchings continuing as chief executive, more than a few investors will continue to give Tomkins a wide berth.



Selling RHM is long overdue. It was a disastrous acquisition. Tomkins shares have underperformed the market by 60 per cent since it acquired the food group in 1992. . . .

It is very hard to see this phoenix rising from the flames.

- (c) are prepared to make a stand/resign if they disagree on important issues; and
- (d) bring relevant experience to the boardroom.

Even so, history suggests that non-executive directors provide little protection from a dominant chairman/chief executive.

Where a company has been in difficulties or has become complacent, the effects of a change in the top management should be followed closely. It often marks the beginning of an upturn in a company's fortunes; e.g. the appointment of Eugene Anderson as chief executive of JOHNSON MATTHEY after a disastrous foray into banking and the appointment of Derek Birkin as chief executive of RTZ after several years of little or no real growth in e.p.s.

It is well worth checking on the track record of new management and, if you can, going to the AGM to meet them.

Internal controls and looking to the future

Terms which often figure in accounts, directors' reports and chairmen's statements are: estimates, forecasts and budgets. Not only do business decisions depend upon estimates, forecasts and budgets, so do interim statements and annual accounts. The future cannot be foretold with certainty, but managers have to try.

But it is not just the future that has to be estimated. Some information about the past (e.g. a detailed breakdown of a competitor's local sales; or a detailed analysis of a potential acquisition's cost and revenue structure) may not be available at all. Even where information about the past was potentially available, it may not have been collected. Or it may have been collected, e.g. as part of a computerised sales system, but never analysed.

In all such cases resort is frequently had to estimation. Sometimes this may be based on a limited sample; often it is largely or entirely unsupported.

Management can be criticised:

- for not using information which was obtainable;
- for failing to undertake research;
- for conducting it sloppily; or
- for drawing incorrect or unwise conclusions.

It is often necessary to look forward, i.e. to make forecasts, e.g. when acquiring new plant, entering a new line of business, or expanding in a particular direction. It is fair to criticise managers if they have clearly been over-optimistic, or have failed to do their homework. But it is wrong to criticise managers for *trying* to forecast the future.

No manager can expect, or be expected, to be right 100% of the time.

TERMINOLOGY

Estimates, forecasts and budgets

An **estimate** is a judgement (i.e. an opinion) as to the amount, or quantity, of something, e.g. sales, expenses or profit, often, but not necessarily, made before the event. It is of necessity approximate. The accuracy of an estimate depends upon (i) the skill of the estimator; and (ii) the accuracy with which the facts upon which it is based are known or can be forecast.

A **forecast** is simply a prediction. But the term **profit forecast** has a special meaning. A profit forecast is a formal statement drawn up in connection with a bid (see Chapter 28).

A **budget** is a formal **plan**, i.e. a statement of intentions. Most companies budget as a regular annual exercise; but where one or more factors change significantly, a **revised budget** is prepared. More usually, a system of continually **reforecasting** the current year is employed. This terminology is clearer: the budget remains the budget; the forecast represents current expectations.

A budget is a formal plan. Logically, it too needs to be based on forecasts: indeed, on a mutually consistent group of forecasts and plans. Too often, in an attempt to meet market expectations, budgets are imposed from above without proper regard to consistency.

Combined Code on Corporate Governance

Another factor influencing reports and accounts is the Combined Code on Corporate Governance (see Chapter 26).

Statements published in compliance with that Code are supposedly designed to shed light on internal controls and systems, and refer to the forecasting, budgeting, reporting and control structure which lies behind the annual accounts and has a marked influence upon them.

Consider GEORGE WIMPEY:

GEORGE WIMPEY – Extract from Corporate Governance 2003

...

Internal Control

The Board has overall responsibility for the Group's system of internal control and for reviewing its effectiveness. The implementation and maintenance of the risk management and internal control systems is the responsibility of the Executive Directors and senior management. It is recognised that the system is designed to manage rather than eliminate the risk of failure to achieve business objectives. Consequently it can only provide reasonable and not absolute assurance against material mis-statement or loss. The system has been in place throughout the period and is regularly reviewed within the Turnbull guidance on Internal Control.

...

The Board has reviewed in detail the areas of major risk that the Group faces in its operations as documented in the Group Risk Schedule. This Schedule ...

The Group seeks to maintain high standards of business conduct and operates under an established internal control framework, which can be described as follows:

Organisational structure

The Group operates through a number of operating businesses, each with its own management board. Clear reporting lines and delegated authorities are in place. ...

Land purchase and investment appraisal

There are clearly defined policies and procedures for the purchase of land and for capital expenditure ...

Development activity

There is a comprehensive framework for managing and controlling all site related activity. This includes comprehensive Health and Safety procedures, regular performance monitoring and clear accountability on customer satisfaction.

Financial and Operating Reporting

There is a comprehensive budgeting system with an annual budget approved by the Board. Profit and cash forecasts are prepared and reviewed on a monthly basis.

... Particular emphasis is placed on cash flow ...

Control Self Assessment

During 2004 improved procedures will be in place which will require each business to represent on

a regular basis, through a formal Control Self Assessment process, its compliance with the core policies and key controls governing the Group.

Treasury

The principal Treasury related risks, decisions and control processes are documented. The Treasury committee consisting of ... meets quarterly to consider Treasury related issues, decisions and control processes.

All the above are subject to ongoing internal Audit review ...

That looks like a good system. But in the recent past (if not still today) many organisations:

- (i) reported to management cumulative, year-to-date, 'actuals' and compared these with the budget to date (thus failing to focus specifically on the results of each individual month or quarter);
- (ii) tried to hold to the budget even when it was patently outdated (i.e. no longer achievable);
- (iii) failed to reforecast the expected annual results;
- (iv) lacked a continuous inventory system;
- (v) often prepared no balance sheet at the end of the month or quarter (and, if they did, fell back upon estimates, budgets and forecasts rather than using 'hard' accounting data);
- (vi) failed even to consider cash flows in the succeeding period.

We are not convinced that the Combined Code has done much to prevent this.

Under the Combined Code of Best Practice directors are also called upon to report that the business is a going concern. We cover this in Chapter 26.

Post balance sheet events

It might be thought that, since a company's report and accounts reflect the state of affairs at the balance sheet date, events arising after that date would be excluded, but this is not entirely the case: post balance sheet events (events occurring between the balance sheet date and the date the accounts are approved by the board) should be reflected or disclosed if they are important.

FRS 21 *Events after the balance sheet date* distinguishes between two types of post balance sheet event: (i) Adjusting events; (ii) Non-adjusting events.

Adjusting events

Adjusting events are post balance sheet events which provide additional evidence of conditions existing at the balance sheet date. The accounts should be adjusted accordingly, but separate disclosure is not normally required.

Typical adjusting events include:

- the subsequent determination of the purchase price of a fixed asset purchased or sold before the year end;
- a property valuation which provides evidence of an impairment in value;
- receipt of the financial statements or other information regarding an unlisted company which provides evidence of a permanent diminution of value of a long-term investment;
- the receipt of evidence that the previous estimate of accrued profit on a long-term contract was materially inaccurate.

Where any subsequent events indicate that the ‘going concern’ concept should not have been applied to the company or to a material part of it, the accounts should also be adjusted accordingly.

Non-adjusting events

Non-adjusting events are post balance sheet events which concern conditions which did not exist at the balance sheet date. The events should be disclosed together, if practicable, with an estimate of the financial effect, e.g. MEDEVA:

MEDEVA Note 27 to 1998 accounts

27. Post balance sheet events

...

On 4 February 1999 Medeva signed an agreement to dispose of the Group’s Swiss manufacturing operations to RSP Pharma AG (‘RSP’), a company owned by the local management team. Details of this transaction are set out in the Operating and Financial Review on page . . .

Although FRS 21 calls for the disclosure of post balance sheet events in the financial statements,

- (i) there is normally no ‘pointer’ to any such note in the accounts, i.e. it is ‘stand alone’, so it is necessary to read the notes in their entirety and not rely on references to them elsewhere in the accounts;
- (ii) non-adjusting events tend also to be mentioned or further detail given in the Chairman’s Statement, Financial Review or Review of Operations. For example MEDEVA told more about the RSP deal in its Operating and Financial Review.

MEDEVA Extract from the operating and financial review 1998

On 5 February 1999 the conditional disposal of the Swiss manufacturing operations to RSP Pharma AG (‘RSP’), a company owned by the local management team, was announced. The transaction is expected to be effective by 23 April 1999. The assets being disposed of consist of the manufacturing facility and products and certain development projects. In 1998 these assets generated sales of £6.7m (1997: £5.9m) and an operating loss of £0.2m (1997: loss £0.3m). These assets are being sold to RSP at their net asset value of £3.9m and thus no gain or loss will be generated on this disposal. Medeva will receive an initial payment of £1.7m, with the balance payable over a maximum period of 12 years, depending on the profitability of RSP. As part of the deal Medeva will also retain the rights to earn royalties on certain products RSP plan to develop, mainly Purepa, a concentrated, modified fish oil product. Medeva has also entered into an agreement to acquire a 20% investment in RSP at a cost of £0.7m.

Window dressing

One method of improving the appearance of a company’s accounts was to borrow short-term money, perhaps just overnight, in order to bump up liquidity at the balance sheet date, a trick that was particularly popular amongst fringe bankers in the early 1970s.

FRS 21 endeavours to preclude this and similar types of cosmetic operation by requiring the disclosure of ‘the reversal or maturity after the year end of transactions entered into before the year end, the substance of which was primarily to alter the appearance of the company’s balance sheet’.

This requirement does not prevent this type of window dressing, but it certainly discourages auditors from being party to deliberate deception.

Corporate governance and the auditors' report

Corporate governance

Background

Corporate governance, the system by which companies are managed and controlled, has existed since the creation of the first company.

However, it was the publication of the Cadbury Committee's Code of Best Practice in 1992 that focused particular attention on it. Interest was reinforced by a series of incompetencies and scandals which had made it clear that assumptions on the part of investors of the competence and honesty of boards of directors were, in some cases, misplaced.

The Cadbury Committee Report was followed in 1994 by the Greenbury Committee Report on directors' remuneration. Shortly after this, the Hampel Committee published a report recommending that directors should review the effectiveness of all internal controls, financial and otherwise. Subsequent guidance on internal controls was published in September 1999 in the Turnbull Report.

In July 2003, the Financial Reporting Council issued a revised version of the Combined Code on Corporate Governance. This revised version reflects the publication of yet more reports:

- 'Review of the role and effectiveness of non-executive directors' (the Higgs Report);
- 'Audit committees – combined code guidance' (the Smith Report).

The UK Listing Authority has incorporated the Combined Code in an Appendix to the Listing Rules.

The Combined Code

The UK Listing Authority's Combined Code contains 17 principles of good governance and 48 code provisions which are applicable to listed companies. It is in four parts:

- A – Directors
- B – Directors' remuneration
- C – Accountability and audit
- D – Relations with shareholders.

The directors are required in their report to state how the principles of the code have been applied. But the required information, which we will not list in detail, may be found almost anywhere in the report and accounts.

ROYALBLUE Extract from Corporate Governance Statement 2003

Compliance with the Combined Code

Royalblue is committed to high standards of corporate governance. In respect of the year ended 31st December 2003 the company has complied with The Principles of Good Governance set out by the Financial Services Authority in Section 1 of the Combined Code with the exception that there was only one independent non-executive director. A search for two non-executive directors has been initiated. The Board believes that it is well advanced in meeting the additional corporate governance requirements for the reporting period that commenced on 1st January 2004.

Much of the information required is of background interest only and does not assist one in interpreting the accounts proper. For example:

ROYALBLUE Extract from Corporate Governance Statement 2003**The Board**

The company is controlled through the Board which at 31st December 2003 comprised the Chairman, two executive directors and three non-executive directors. The Board meets formally on a regular basis to review trading performance and forecasts, to review strategy, policy and risk and to oversee appropriate shareholder reporting . . .

The Board is responsible for the Group's system of corporate governance. The Board delegates operational control to the executive directors.

A procedure exists to allow directors to seek independent legal advice in respect of their duties at the company's expense where the circumstances are appropriate. All directors have access to the Company Secretary for his advice and services. The following committees deal with specific aspects of the Group's affairs:

Audit Committee . . .
Remuneration Committee . . .
Nominations Committee . . .

One gains some reassurance from descriptions of internal controls, while at the same time recalling banks, merchant banks, local authorities and major listed companies which firmly believed that they had appropriate controls in place only to find, to their cost, that they had not worked.

ROYALBLUE Extract from Corporate Governance Statement 2003**Internal control**

The Board is ultimately responsible for the Group's system of internal control and for reviewing its effectiveness. However, such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can provide only reasonable and not absolute assurance against material misstatement or loss.

The Combined Code requires that directors review the effectiveness of the Group's system of internal controls, including those of an operational and compliance nature, as well as internal financial controls.

The Board is of the view that there is an ongoing process for identifying, evaluating and managing the Group's significant risks and that this has been

in place for the period under review and up to the date of approval of the Annual Report. The Board's agenda includes a regular item for consideration of risk and control, and any actions that may be considered necessary, and it receives reports thereon from the executive directors. There is a formal schedule of matters reserved for the decision of the Board that covers key areas of the Group's affairs. The schedule includes activities such as acquisitions and disposals, material financial commitments and the release of price sensitive information.

Management is responsible for the identification and evaluation of significant risks applicable to their areas of business together with the design and operation of suitable internal controls. These risks are assessed on a continual basis and may be associated with a variety of internal or external sources including competition, control breakdowns, disruption in information systems, natural catastrophe and regulatory requirements. A process of control assessment and reporting is established and defined in the Group's Quality Management System. This system is independently audited to ISO quality standard 9001: 2000 on a regular basis.

A comprehensive budgetary process is completed once a year and is reviewed and approved by the Board. Re-forecasts are prepared on a monthly basis throughout the year. The operating results are reported monthly to the Board and compared to the budget and latest forecast as appropriate. The company reports to its shareholders twice a year.

Investors expect, indeed are entitled to expect, the directors of companies in which they invest to conduct the companies' affairs properly, efficiently and honestly. Cadbury was set up because some boards failed to meet those expectations. What the reports the Combined Code requires tell investors, if anything, is less important than what they tell directors. By focusing their attention on their own performance and methods of working, and compelling them to state in writing their procedures, directors cannot avoid being made conscious of what is expected of them.

Audit committees

Section C of the Combined Code (Accountability and Audit) includes a requirement that the audit committee should comprise at least three independent non-executives

(two for smaller companies). This part of the Code also sets out a number of matters which fall within the audit committee's ambit.

These include *whistle blowing* – the procedures for whistle blowing by the company's employees, e.g. RMC GROUP:

RMC GROUP Report on Corporate Governance

Whistle blowing

In accordance with the new Combined Code, the Audit Committee Terms of Reference require the committee to review arrangements by which staff of the Group may, in confidence, raise concerns about possible improprieties in matters of financial reporting and other matters. . . .

The company is in the process of introducing a Group-wide 'Whistle Blowing' programme . . .

The programme, which will be introduced in 2004, will be run by a third-party organisation and will use a 24-hour free phone service.

Going concern

As explained in Chapter 2, FRS 18 *Accounting policies* requires a company to prepare its financial statements on a going concern basis unless:

- the company is being liquidated or has ceased trading, or
- the directors have no realistic alternative but to liquidate the company or to cease trading.

Under the Listing Rules the report must include a statement by the directors that the company is a going concern. The statement normally appears in the report on corporate governance where there is one, or in the directors' report if there is not, but it can be in the financial review or statement of directors' responsibilities.

That the company is a going concern is of obvious importance to all who deal with it; but any suggestion that it might not be could result in its early demise. Once again what matters is that the directors should give thought to the morrow. The statement tends to be a simple formal statement. ROYALBLUE is more explicit than most:

ROYALBLUE Extract from Corporate Governance Statement 2003

Going concern

Having reviewed the future plans and projections for the business, the directors believe that the company and its subsidiary undertakings have adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the financial statements.

Auditors' review

In addition to their audit of a listed company's financial statements, auditors are required by the Code to review the directors' statements concerning the company's compliance with the Combined Code.

NATIONAL GRID TRANSCO Extract from the auditors' report 2003

Respective responsibilities of Directors and Auditors

The Directors' responsibilities for preparing the Annual Report, the Form 20-F, the directors' remuneration report and the accounts in accordance with applicable United Kingdom law and accounting standards and the requirements of the US Securities and Exchange Commission are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the accounts in accordance with relevant legal and regulatory requirements, United Kingdom Auditing Standards . . .

We report to you our opinion as to whether the accounts give a true and fair view and . . . have been properly prepared in accordance with the United Kingdom Companies Act 1985. We also report to you if, in our opinion, the Directors' report is not consistent with the financial statements, if the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and transactions is not disclosed.

We read the other information contained in the Annual Report and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the accounts.

We review whether the corporate governance statement reflects the Company's compliance with the seven provisions of the Combined Code specified for our review by the Listing Rules of the FSA, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or to form an opinion on the effectiveness of the Company's or Group's corporate governance procedures or its risk and control procedures.

Remuneration Report

The Listing Rules require listed companies to include a report to the shareholders by the board of directors.

This report must deal with:

- company policy;
- remuneration of each director analysed between salary, fees, benefits in kind, bonuses and compensation for loss of office (with total amount for the previous year), presented in tabular form;
- share option information for each director;
- details of long-term incentive schemes;
- details of service contracts with a notice period exceeding one year;
- company policy on granting of options or share award schemes;
- pension benefits for each director;
- arrangements for non-executive directors.

The resultant report tends to be long and detailed – that of CADBURY SCHWEPPEs in its 2003 report running to fifteen pages. Typically the report details:

- composition of the Remuneration Committee
- remuneration policy
- annual incentive awards
- share option schemes
- long-term incentive plan
- retirement benefits
- share schemes
- service agreements
- external appointments policy
- non-executive directors
- directors' emoluments.

There is an obvious overlap with information required in the directors' report. This tends to be overcome by a cross reference in the directors' report. The information provided is often interesting, but it is doubtful if it sheds much light on the accounts and their interpretation. One paragraph of CADBURY SCHWEPPEs' report does perhaps deserve comment:

CADBURY SCHWEPPEs Extract from the 2003 report

Report on Directors' Remuneration . . . Executive Directors – Outside Appointments

The Company recognises the benefits to the individual and to the Company of involvement by Executive Directors of the Company as Non-Executive Directors in companies outside the Cadbury Schweppes group. Subject to certain conditions and unless otherwise determined by the Board, each Executive Director is permitted to accept only one appointment as a Non-Executive Director in another company. The Executive Director is permitted to retain any fees paid for such service.

When, in other groups, one reads that the chief executive, X, is president of the Institute of . . . , a member of the . . . Committee, and of the Council of . . . , and a non-executive director of A, B and C, one does somehow wonder about his time commitments, or even his commitment to the group. On the other hand, the man or woman who joins a group at 20 and never works anywhere else can scarcely be said to have the breadth of experience necessary to direct a public company.

The auditors' report

Appointment of auditors

Every company is required to appoint at each annual general meeting an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next AGM.

Auditors' access to information

Under the Companies Act 1985 it is an offence for a director or company secretary to give false or misleading

information to auditors, and auditors of holding companies have the right to obtain information about subsidiary companies which they themselves do not audit.

The auditor has a right of access at all times to the books and accounts and vouchers of the company and to require from the officers of the company such information and explanations as he thinks necessary for the performance of his duty. He has the right to attend any general meeting, and to be heard thereat on any part of the business of the meeting which concerns him as auditor.

Scope of the report

The auditors are required to report to the members (i.e. to the shareholders) whether in their opinion the profit and loss account and the balance sheet, and any group accounts, have been properly prepared in accordance with the Companies Act and all relevant accounting standards, and give a true and fair view of the profit and state of affairs of the company or group.

If they are of the opinion that proper accounting records have not been kept, or that the accounts are not in agreement with the books, or if they are unable to obtain all the information and explanations necessary for their audit, they must state the fact in their report; i.e. they must qualify their report.

The Auditing Practices Board (APB)

The APB was formed to develop auditing practice in the UK and the Republic of Ireland.

The APB's most important role is to establish and publish statements of the principles and procedures with which auditors are expected to comply.

The pronouncements of the APB fall into three principal categories:

1. Statements of Auditing Standards (SASs)
2. Practice notes
3. Bulletins.

Auditors who do not comply with Auditing Standards when performing company or other audits in Great Britain make themselves liable to regulatory action by the recognised supervisory body (RSB) with which they are registered. Practice notes and Bulletins are persuasive rather than prescriptive. However, they indicate what is regarded as good practice.

Statement of Auditing Standards 600

Statement of Auditing Standards 600 (SAS 600), *Auditors' reports on financial statements*, requires that auditors' reports on financial statements contain:

- a title identifying the person or persons to whom the report is addressed;
- an introductory paragraph identifying the financial statements audited;
- separate sections, appropriately headed, dealing with
 - (a) respective responsibilities of directors (or equivalent persons) and auditors;
 - (b) the basis of the auditors' opinion;
 - (c) the auditors' opinion on the financial statements;
- the manuscript or printed signature of the auditors; and
- the date of the auditors' report.

Responsibilities of directors and auditors

SAS 600 requires auditors to distinguish between their responsibilities and those of the directors. This is usually achieved by including:

- a statement of directors' responsibilities, either as a separate statement or as part of the directors' report (see example below), and
- a statement of respective responsibilities within the audit report (see text above).

NATIONAL GRID TRANSCO Extract from the director's report 2003

Statement of Directors' responsibilities for preparing the accounts

The Directors are required by the Companies Act 1985 to prepare accounts for each financial year which give a true and fair view of the state of affairs of the Company and of the Group as at the end of the financial year and of the profit and loss of the Group for the financial year.

The Directors consider that in preparing the accounts (detailed in the following sections. Principal accounting policies, Accounts and Notes to the accounts), the Company has used appropriate accounting policies, consistently applied and

supported by reasonable and prudent judgements and estimates and all applicable accounting standards have been followed.

The Directors have responsibility for ensuring that the Company keeps accounting records which disclose with reasonable accuracy the financial position of the Company and of the Group and which enables them to ensure that the financial statements comply with the Companies Act 1985.

The Directors have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and to detect fraud and other irregularities.

The Directors, having prepared the financial statements, have requested the Auditors to take whatever steps and to undertake whatever inspections they consider to be appropriate for the purposes of enabling them to give their audit report.

The Directors confirm that the Audit Committee continues to review the adequacy of the system of internal financial controls adopted by the Group.

Auditors' report

The content of the auditors' report is determined by the Companies Act 1985 and various requirements of the Auditing Practices Board. Following APB guidance in January 2001, UK company audit reports should refer to United Kingdom law, accounting standards and auditing standards. An example of wording follows:

NATIONAL GRID TRANSCO *Extract from the annual report for 2003*

Independent Auditors' report to the members of National Grid Transco plc

We have audited the accounts which comprise the Group Profit and Loss Account, the Balance Sheets, the Group Cash Flow Statement, the Group Statement of Total Recognised Gains and Losses, and the related notes.

We have also audited the disclosures required . . . in the Directors' Remuneration Report . . .

Respective responsibilities of Directors and Auditors [See NATIONAL GRID TRANSCO extract on page 233.]

Basis of audit opinion

We conducted our audit in accordance with auditing standards issued by the United Kingdom Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. . . . It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the accounts, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the accounts are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion the financial statements give a true and fair view of the state of affairs of the Company and the Group at 31 March 2003 and the profit and cash flows of the Group for the year then ended and have been properly prepared in accordance with the United Kingdom Companies Act 1985: . . .

PricewaterhouseCoopers
Chartered Accountants and Registered Auditors
London
20 May 2003

The auditors' opinion

An auditors' report 'should contain a clear expression of opinion on the financial statements' (SAS 600.5).

That opinion may be unqualified (as was the report to shareholders of NATIONAL GRID TRANSCO illustrated above) or qualified.

A *qualified* opinion is issued when either

- (a) there is a limitation on the scope of the auditors' examination; or
- (b) the auditor disagrees with the treatment or disclosure of a matter in the financial statements. (See Example 26.1.)

Example 26.1 A qualified opinion where there is disagreement**Qualified opinion arising from disagreement about accounting treatment**

Included in the debtors shown on the balance sheet is an amount of £y due from a company which has ceased trading. XYZ plc has no security for this debt. In our opinion the company is unlikely to receive any payment and a provision of £y should have been made, reducing the profit before tax and net assets by that amount.

Except for the absence of this provision . . . give a true and fair view . . .

SSL A qualified opinion where there is limitation of scope. Extract from Auditors' report 2001**Limitation of scope**

. . . we have been unable to obtain sufficient evidence to form an opinion of the appropriateness or completeness of the prior period adjustments, or on the attribution of the transactions or write-offs identified between the current and prior periods.

In certain cases the documentary evidence to determine both the recognition and the timing of certain sales, sales returns, credits to customers and write-offs is either incomplete or unavailable.

Many of the key management responsible for the transactions in question are no longer with the Group. On the basis of legal advice . . .

Adverse opinion

An adverse opinion is issued when the effect of disagreement is so material or pervasive that the auditors conclude that the financial statements are seriously misleading, i.e. that they did not give a true and fair view. (See Example 26.2.)

Disclaimer of opinion

A disclaimer of opinion is expressed when the possible effect of a limitation on scope is so material or pervasive that the auditors have been unable to obtain sufficient evidence to support, and accordingly are unable to express, an opinion on the financial statements (see Example 26.3).

Example 26.2 An adverse opinion**Adverse opinion**

As more fully explained in Note . . . no provision has been made for losses expected to arise on certain long-term contracts currently in progress, as the directors consider that such losses should be off-set against amounts receivable on other long-term contracts. In our opinion, provision should be made for foreseeable losses on individual contracts as required by SSAP 9. If losses had been so recognised, the effect would have been to reduce the profit before and after tax for the year . . . and the contract work in progress at 31 December 19 . . . by £x.

In view of the effect of the failure to provide for the losses, in our opinion the financial statements do not give a true and fair view . . .

Example 26.3 A disclaimer

. . . However, the evidence available to us was limited because we were appointed auditors on . . . and in consequence we were unable to carry out auditing procedures necessary to obtain adequate assurance regarding the quantities and condition of stock and work in progress appearing in the balance sheet at £z. Any adjustment to this figure would have a consequential effect on the profit for the year.

Disclaimer on view given by financial statements

Because of the possible effect of the limitation in evidence available to us, we are unable to form an opinion as to whether the financial statements give a true and fair view . . .

Fundamental uncertainty

Where an inherent uncertainty exists which in the auditors' opinion is fundamental and is adequately accounted for and disclosed in the accounts, auditors include an explanatory paragraph in their report, making it clear that their opinion is not qualified. Such opinions are comparatively rare, so we look back for an example (see below) to JARVIS's 2000 accounts. This is emphasis: the auditors are simply drawing attention to something already fully covered in the accounts.

JARVIS 2000 Accounts: an unqualified opinion with fundamental uncertainty**Fundamental uncertainty**

In forming our opinion, we have considered the adequacy of the disclosures made in Note 19 to the accounts concerning variations and other entitlements claimed by the Group on certain long term contracts. An aggregate amount of some £15.0 million is included within turnover and debtors in respect of these claims. There is uncertainty as to the amounts at which these claims will be settled. Depending on the outcome of negotiations with the customers, there could be a material effect on the results and financial position disclosed in the accounts.

Our opinion is not qualified in this respect.

But the degree of uncertainty about the outcome of a future event and its potential impact on the view given by the financial statements may be very great. In such a case a disclaimer of opinion is appropriate.

Going concern assumption

The Combined Code calls upon directors to report that the business is a going concern. For example, CHARTERHOUSE COMMUNICATIONS, which had had a capital reduction in 2002:

CHARTERHOUSE COMMUNICATIONS Extract from Group balance sheet 2003

	2003 £000	2002 £000
Capital and reserves		
Called up share capital	1,233	1,233
Share premium account	–	6,757
Merger reserve	–	1,650
Special reserve	589	–
Profit and loss account	<u>534</u>	(6,874)
Equity shareholders' funds	<u>2,356</u>	<u>2,766</u>

(The loss for 2003 was £410,000)

The paragraph in the directors' report on going concern described the situation:

CHARTERHOUSE COMMUNICATIONS Extract from the Directors' report 2003**Going concern**

Following a twelve-month capital repayment holiday, the Group recommenced repayments of its bank loan in June 2003 . . . Payment of interest continued to be made when due. The overdraft facility was reduced to £1.6 million in June 2003.

The Group has prepared profit and cash flow forecasts which are necessarily dependent on the trading performance of the business. Such is the level of uncertainty inherent in predicting future trading that in the opinion of the directors the Group may periodically breach the overdraft limit. The ability of the Group to continue to trade is dependent on the bank's willingness to maintain its support in such circumstances and to renew the facility in May 2004.

The directors consider that despite these circumstances the Group has the support of the bank and it is appropriate to prepare the financial statements on a going concern basis.

What do the auditors have to say about this?

CHARTERHOUSE COMMUNICATIONS Extract from the Auditors' report 2003**Fundamental uncertainty**

In forming our opinion we have considered the adequacy of the disclosures made in the financial statements concerning the uncertainty about the future funding of the Group's operations.

The financial statements have been prepared on a going concern basis, the validity of which depends on the continued support of the Group's bank should the Group breach its agreed overdraft facility of £1.6 million . . .

Our opinion is not qualified in this respect.

There is also an interesting item in the Chairman's statement:

CHARTERHOUSE COMMUNICATIONS Extract from the Chairman's statement 2003**Financing**

. . .

In place of a commitment fee, the bank has asked for and is to be issued with an option to subscribe for 1.23 million shares at 10.5p.

This should encourage the bank to continue their support, even though the current share price is below 5p, down from a high of 82p in 2000.

UK Listing Rules

The rules reflect the European Union Directive on Interim Reports, which requires each listed company to prepare a report on its activities and profit and loss for the first six months of each financial year.

INTERIM REPORTS

ASB Statement of Best Practice

This statement is intended for voluntary use.

It suggests that Interim Reports should be drawn up employing the same principles and practices as those used for annual reporting.

They should *include*:

- (a) a narrative commentary;
- (b) summarised profit and loss account;
- (c) balance sheet;
- (d) cash flow statement;
- (e) a statement of total recognised gains and losses, where relevant.

And should *provide* details of:

- (a) acquisitions and discontinued operations
- (b) segmental information
- (c) exceptional items
- (d) comparative figures for the corresponding interim period and for the previous full financial year.

Companies are encouraged to make their interim reports available with 60 days of the interim period end.

The rules also require that the report *either* be sent to shareholders *or* be inserted in at least one national newspaper, not later than 4 months after the end of the period.

Auditors' review

One of the recommendations of the Cadbury Report on Corporate Governance was that interim reports should be reviewed by the Company's auditors.

The review process, which is '**best practice**' rather than mandatory, is described in a Bulletin *Review of Interim Financial Information*, issued by the Auditing Practices Board.

Many smaller companies and some larger ones, e.g. the hotel group HILTON (market capitalisation £3.5 billion), don't have their interim reports reviewed, and it is open to debate as to whether the benefits of a review justify the costs.

In those companies where the auditor *has* reviewed the interim information, his report will appear in the company's interim report. The prescribed format of the report is, in some people's views, both long winded and pedantic. For example, the Review report by the auditors to the Ready Mix Concrete Group RMC takes up more than half a page of A4, and gets its own page. Here is an abridged version:

RMC Extract from Review report by the auditors

Introduction

We have been instructed by the Company to review the financial information which comprises . . . We have read the other information contained in the Interim Statement and considered whether it contains any apparent misstatements or material inconsistencies with the financial information.

Directors' responsibilities

The Interim Statement . . . is the responsibility of, and has been approved by the Directors. The Listing Rules of the FSA, require that the accounting policies and presentation applied to the interim figures should be consistent with those applied in preparing the preceding annual accounts except where any changes, and the reasons for them, are disclosed.

Review work performed

We conducted our review in accordance with the guidance contained in Bulletin 1999/4 issued by the Auditing Practices Board . . .

A review consists principally of making enquiries of Group management and applying analytical procedures. . . . A review excludes audit procedures such as . . . It is substantially less in scope than an audit . . . and therefore provides a lower level of assurance than an audit. Accordingly we do not express an audit opinion . . .

Review conclusion

On the basis of our review we are not aware of any material modifications that should be made to the financial information as presented for the six months ended 30 June 2003.

Chartered Accountants

London
5 September 2003

With so many disclaimers in the report, the boards of some companies may decide that an auditors' review is hardly worth the candle.

Accounting policies

The ASB Statement expects interim reports to be prepared on the basis of accounting policies used in the previous annual accounts. Where there has been any change, this should be spelt out, e.g. DIAGEO:

DIAGEO Note to the Interim Statement 2004**1. New accounting policies**

The group has adopted the reporting requirements of FRS 17 – Retirement benefits . . . from 1 July 2003. The financial information included in this interim statement also complies with . . . the amendment to FRS 5 – Reporting the substance of transactions.

Major transactions

Although not specifically mentioned, it is clearly desirable that interim statements should report other major transactions such as the redemption or conversion of shares or the purchase of a company's own shares and their subsequent cancellation, e.g.:

DIAGEO Note to the interim statement 1999**8. Repurchase of shares**

In July 1998, 3m B shares were redeemed at a cost of £15m. On 1 August 1998, the company converted the remaining B shares into 12m ordinary shares at a price of 725 pence per share. In October 1998, the company purchased, and subsequently cancelled, 10.5m ordinary shares at an average price of 555 pence per share for an aggregate consideration of £59m.

Exceptional items

As explained earlier, interim statements are not audited, and in the past, when they were not reviewed either, it is possible that the stringent look which is given to the balance sheet at the end of the year, and the consequent making of adequate provisions, did not occur at the half-year. It perhaps still does not, and this tends to mean that adverse exceptional items are somewhat more likely to be included in the second half of a year than in the first half. But where they are found in the first half year figures they may be material as is demonstrated by DIAGEO:

DIAGEO Note to the interim statement 2003**3. Exceptional items**

	<i>Six months ended 31 Dec 2003</i>	<i>Six months ended 31 Dec 2002</i>
	£m	£m
Operating costs		
Seagram integration	(19)	(89)
Guinness UDV integration	–	(15)
	<u>(19)</u>	<u>(104)</u>

Half year on half year comparisons

It is obvious that a careful item by item comparison of this year's interim figures (H1/Year 2) with last year's interim figures (H1/Year 1) will help with assessing how the company is doing. It should also prompt questions about the cause of any sudden jump.

But it is rather less obvious that the same comparison should be made of H2/Year 2 with H2/Year 1, because companies hardly ever publish their second half figures.



H2 = (Full year – H1)

Second half figures have to be calculated, but the effort can be very worthwhile, revealing information that might otherwise be overlooked.

For example, LOCKER GROUP, where the Chairman's statement in the annual report to 31 March 2000 did not

mention that the Group had plunged into loss in the second half, but this is easily deduced:

LOCKER GROUP *Second half results*

Operating profit reported	£000
Six months to 30 September 1999	1,758
Year ended 31 March 2000	<u>482</u>
Operating loss in second half, deduced	(1,276)

Seasonal businesses

According to the ASB 'Fluctuating revenues of seasonal businesses are generally understood by the marketplace and it is appropriate to report them as they arise'. What, in the past, may have been less well known, is the effect on the balance sheet and cash flow statement (which traditionally were not disclosed) e.g. THORNTONS:

THORNTONS *Half yearly fluctuations due to seasonality*

	<i>Reported</i>		<i>Deduced</i>
	H1 2003 28 weeks to 11 January 2003 £000	Full year 2003 52 weeks to 26 June 2003 £000	H2 2003 24 weeks to 26 June 2003 £000
Consolidated profit and loss account			
Turnover	104,684	167,095	62,411
H1 and H2 adjusted to 26 weeks	97,206		67,612
Operating profit	12,698	9,444	(3,254)
Margin	12.1%	5.7%	Zilch
Consolidated balance sheet			
Cash at bank and in hand	15,471	4,522	
Bank loans (etc.) due within one year	(11,155)	(7,915)	
Consolidated cash flow statement			
Cash inflow from operating activities	21,414	24,860	3,446

H2 and H1 compared

Operating profit in H2 was about £15.9m lower than H1. The knock-on effect in the balance sheet was a fall of about £10.9m in cash, with short-term loans and overdraft falling by only £3.2m.

H1's Christmas sales dominate, in spite of H2's Easter eggs.

Company strategy

The Chairman, in his Statement in the 2003 annual report, said '... high temperatures during the final week before Easter and the hottest June since 1976 seriously depressed sales over Easter and Father's Day.' The company usually breaks even in H2.



Keep your eyes open!

Investors and analysts should recognise that the annual report and accounts of a company represent only a part, albeit a key part, of the total information available to them, and they should not neglect other sources. For convenience the other sources can be divided into:

- (a) information the company provides;
- (b) external information.

Information provided by the company

The main sources of information from the company itself, apart from the annual report and accounts, are:

- (a) half-yearly (and in a few cases quarterly) reports, considered in Chapter 27;
- (b) prospectuses;
- (c) circulars;
- (d) form 20-F (if listed in the USA);
- (e) company newsletters and magazines;
- (f) catalogues and sales information literature;
- (g) annual meetings;
- (h) company visits.

Prospectuses and listing particulars

When a company offers shares or debentures for sale to the general public it is obliged in law to issue a prospectus.

When a company ‘goes public’ – that is, when its shares gain a listing on the Stock Exchange (see Chapter 4) – its prospectus has to include all the information required for listing (see the UK Listing Authority’s *Listing Rules*, Chapter 6: ‘Contents of Listing Particulars’), and so the prospectus is about the most comprehensive document a company ever produces about itself. The normal layout used is as follows:

1. Details of the offer, share capital and indebtedness.
2. Details of the company’s directors, secretary, auditors, financial advisers, solicitors, bankers and stockbrokers.
3. Description of the company, giving:
 - an introduction and a brief history;
 - a comprehensive description of its business;
 - information on the management and staff;
 - details of the company’s premises;
 - the use to be made of the proceeds of the issue (where any new shares are being issued);
 - the earnings record, with a forecast for the current year’s profits and intended dividends;
 - the company’s plans and prospects for the future.
4. The accountants’ report, containing a table of the last three years’ profit and loss accounts and cash flow statements and the latest balance sheet.
5. Various statutory and general information on share capital and options, on the Articles of Association, on subsidiary and associated companies, directors’ interests and service agreements, taxation clearances, material contracts, and any pending litigation.

On other occasions of shares being offered to the general public either directly, as in a secondary offer for sale of

existing shares already listed, or indirectly, as in a rights issue of new shares of a company whose existing securities are already listed, much less information is required; nevertheless, the prospectus of a secondary offer or the circular letter to shareholders produced for a rights issue can be a useful source of up-to-date information on a company.

Circulars on acquisitions and disposals

Chapter 10 of The Purple Book divides transactions into classes, as shown in Example 28.1 below.

When a listed company makes a Class 1 transaction (i.e. equivalent to 25% or more of the existing company), shareholders have to be sent a circular giving full details;

alternatively, if the company is making a takeover bid, they can be sent a copy of the offer document, provided the offer document includes all the information required for circulars on acquisitions (as contained in Chapter 10 of The Purple Book). In either case the information provides the analyst with useful details of any major additions to or realisations of the company's assets.

Where there is a Class 1 transaction or reverse takeover, it must be subject to shareholders' approval, and the acquiring company will normally be treated as a new applicant for listing.

Circulars also have to be sent to shareholders for transactions with related parties (those involving a director or substantial shareholder, past or present); these can be of considerable interest if the transactions are large and/or

Example 28.1 Criteria for classification of transactions

<i>Class</i>	<i>Size of acquisition or disposal (A)</i>	<i>Ratios in relation to acquiring or disposing company (B)</i>	<i>UKLA requirements</i>
	Gross assets (i.e. fixed assets plus current assets)	to listed company's gross assets	
	Pre-tax profits	to listed company's pre-tax profit	
	Turnover	to listed company's turnover	
	Consideration given or received	to listed company's market capitalisation	
Class 1		Transaction is Class 1 if any of the four ratios (A)/(B) is 25% or over	Company must inform the Company Announcements Office (CAO) and send circular to shareholders. Shareholders' approval required.
Class 2	as above	Class 2 if any ratio is 5% or more but none is 25% or more	Company must notify CAO
Class 3	as above	Class 3 if all ratios less than 5%	Company must notify CAO if listing is being sought for securities in consideration
Reverse takeover	as above	Reverse takeover is acquisition by a listed company of a business, an unlisted company or assets where any percentage is 100% or more or which would result in a fundamental change in the business or in a change in board or voting control of the listed company	On announcement of a reverse takeover, suspend listing, prepare Class 1 Circular, obtain prior approval of shareholders and (where company wishes to be listed) prepare listing particulars as if new applicant.

A fifth ratio applies to acquisitions only – namely the gross capital of the company or business being acquired (widely defined to include consideration given plus shares and debt security not being acquired plus all other non-current liabilities plus any net current liabilities) divided by the market capitalisation of the listed company.

if there is any question of sharp practice, but the majority are fairly mundane, produced mainly to ensure that shareholders' interests are scrupulously protected (see Chapter 11 of *The Purple Book*).

Documents issued in a contested bid

When the management of a company defends a bid, it has to make the best possible case for the company's continued independence and, in doing so, it will often be rather more forthcoming about the company's future plans and prospects than it normally is in the annual report. Analysts should therefore find it worth reading any documents that a company has issued in successfully contesting a bid. It is also interesting to see whether a company subsequently lives up to any rosy picture it may have painted of its future at the time of the bid.

The detail provided often far exceeds that in published accounts. ENTERPRISE OIL's offer to purchase/prospectus in respect of LASMO in April 1994 ran to 259 pages.

Related party transactions

Where transactions involve a director or involve an associate of a director, past director, substantial shareholder or past substantial shareholder, the Stock Exchange should be consulted beforehand. A circular to shareholders and their consent in general meeting is required unless the transaction is 'small' (all ratios less than 0.25%). See pages 196–200 regarding FRS 8 *Related party disclosures*.

Company newsletters and magazines

An increasing number of companies now produce a house magazine or newsletter for employees, and many produce a 'report to employees' summarising the company's results for the year, often presenting the information in charts or diagrams.

These publications can be very helpful in giving the analyst (as well as the employee) a better feel for the company, and they may contain information that is not included in the accounts.

Companies producing an annual newsletter or report to employees may also send copies to shareholders to ensure that information given to employees is also made available to the shareholders, but where newsletters are

published more frequently or where a large group has several subsidiaries, each of which has its own separate newsletter, they are unlikely to be distributed to investors. If the analyst can lay his hands on them he may gain a better insight into the various activities of the company and pick up facts that are not generally available.

Company websites

Most companies have websites and these can be useful sources of recent news and may provide information not available, or not easily available, elsewhere (e.g. the text of press releases, preliminary announcements, new product details, etc.). Some sites are more obviously investor-orientated than others; and a number offer a free newsletter, or provide their employee newsletter on Internet request. Others offer a free company news service via the Internet.

Form 20-F

This is the annual report that UK and other 'foreign' companies have to file with the Securities and Exchange Commission (SEC) if their shares are listed in the USA. Most companies supply copies to shareholders on request. BP used to offer to do so in their annual report but their accounts now include Form 20-F information.

Companies which are listed in the US normally provide additional information in their accounts on the differences between their accounts, following UK GAAP, and similar accounts prepared under US GAAP. The differences can be quite startling.

Catalogues and sales information literature

The shareholder or analyst who really wants to know a company should study its catalogues and sales literature for evidence of pricing policy, marketing ability, and changes in product range, quality or design.

Failure to adapt to changing circumstances is an early sign of sleepy management. Innovation may be essential if the company is to keep moving – but not every management is capable of thinking up new ideas and of putting them into practice. Promotional literature on new products can sometimes indicate the potential for success.

Annual General Meeting

When all is going well, annual meetings tend to be sparsely attended. This is a pity, because they provide an opportunity for investors and analysts to seek and obtain further information about the company.

The routine business of an AGM is:

- (a) to receive the report and accounts;
- (b) to declare a dividend;
- (c) to elect directors;
- (d) to appoint auditors;
- (e) to transact any other ordinary business.

The chairman will often take the opportunity to make a statement on current trading and/or to amplify the statement he made in the annual report. This is usually done before the routine business, sometimes to pre-empt hostile questions.

Any ordinary shareholder may attend the AGM and speak. Normally his best opportunity to obtain information is upon the motion considering the accounts. If the information he seeks is reasonable (e.g. not of a confidential nature or likely to be of more value to the competition than to members) and he does not obtain a satisfactory answer, he should press the point and state publicly his dissatisfaction. He may find he has more support than he expects.

Generally, directors are prepared to answer all reasonable questions when times are good, but become guarded when the situation is unsatisfactory. If this occurs, the individual shareholder may find that he can obtain the information during informal discussion after the meeting.

Company visits

Companies differ widely in their attitude to company visits by analysts and/or shareholders. Most major companies welcome the interest of both and arrange from time to time group visits at which plans and prospects are discussed in depth, and those interested are able to seek further information.

When making a visit ask yourself:

- Is there any evidence of cut-back, of falling sales and growing stocks or of maintenance delayed to save cash?
- Is the workforce contented – or are labour relations uneasy?

- Do they look efficient – or is there a general atmosphere of chaos?
- Do people appear forthcoming, or are they hiding something?
- Do management appear enthusiastic? ... the sort of people you could trust?

It is also worth asking management whether it is experiencing any difficulties. Good management is usually prepared to talk about the problems facing the company, and to explain the action being taken to overcome them. But companies have to be careful not to provide those visiting with price-sensitive information which has not first been released to the market.



Always ask about the competition

The replies will help to show whether the management has a practical and realistic attitude to the business environment in which it operates, and may well provide useful information about other companies in the industry. We well remember on one company visit, in reply to a question about a competitor, the chairman simply remarked 'that company is structured for disaster'. It did indeed go bust a year later.

External information

There is a vast range of external information useful to the analyst who wishes to make a study in depth of a particular company, group or industrial sector.

We list sources which we personally find useful and, where we find it helpful, their website.

The Registrar of Companies

The Registration Department of the Department of Trade and Industry has offices at Companies House, 55–71 City Road, London EC1Y 1BB, at Crown Way, Cardiff CF4 3UZ (Information Centre Tel 0870 33 33 636) and in Birmingham, Leeds, Manchester, Edinburgh and Glasgow.

Rules for filing accounts

Section 244 of the Companies Act 1985 requires a company to lay its annual report and accounts before its members in general meeting and to deliver them to the Registrar within certain time limits fixed by reference to its accounting year end. The limit for a UK public company is seven months, which can be extended by three months if the company has interests outside the UK.

The UK Listing Authority requires listed companies to issue an annual report and accounts within six months of the end of the financial year being reported on (The Purple Book, Chapter 12, para. 42), but this may be extended for companies with significant overseas interests.

Other information to be filed

Companies are also required to file with the Registrar:

- (a) copies of their Memorandum and Articles of Association, and details of any changes;
- (b) the address of the registered office, and the place at which the company's registers are kept, if not at the registered office;
- (c) details of the company's share capital and debentures;
- (d) details of each mortgage and charge on the assets of the company;
- (e) a list of the directors and secretary and any changes.

In addition, Section 363 of the Companies Act 1985 requires a company to file an *annual return*, which contains a summary of (b) to (e) above and a list of past and present members. Every third year the list must be a complete list of persons holding shares or stock in the company; in the intervening years only changes need be given, but in each year the return must show anyone whose name has appeared on the register as holding shares or stock in the company at any time since the last return. It is therefore possible to find out if anyone has been a registered shareholder at any time, however short the period of ownership, although nominee names may hide the beneficial owner.

Microfiche records

Companies House holds the public records of more than one million companies. Members of the public making a standard search of a company record are provided with a microfiche copy of information held.

Companies House Direct

Companies House Direct provides on-line information direct to your PC and is a fast, accurate and inexpensive way of obtaining up-to-date information from Companies House.

Available to subscribers, it brings the Companies House database directly to one's personal computer. It gives direct access to the names and addresses of company directors and secretaries, with their appointments history since 1991; lists of documents filed by companies; dates of accounts and annual returns filed, and details of disqualified directors since 1986. You can also select images of accounts (registered since March 1995) for on-line viewing, printing or downloading to your PC. Microfiche ordering facilities are provided, including the option to order up to 20 microfiches at a time.

Counter staff at any of the offices can answer any general enquiries about Companies House Direct. For more specific queries and for demonstration and subscription details, contact the Companies House Direct Help Desk (0845 757 3991).

Analysing a group

Most group accounts contain a general breakdown of their activities, but much more detail can sometimes be obtained by examining the accounts which each subsidiary and associated company has to file at Companies House.

Further information

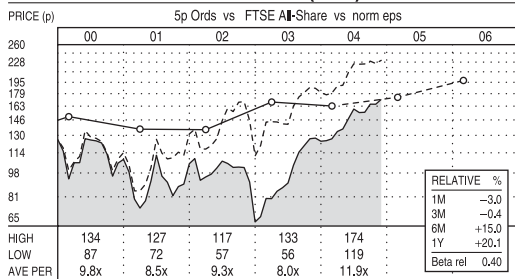
Companies House publishes a large number of helpful information leaflets on its services and on company law and practice. A good starting point is CHN32 *Products and services information and price list* (free from any of their offices) – <http://www.companieshouse.gov.uk/>.

Newspapers and journals

The *Financial Times*, daily, and the *Investors Chronicle*, weekly, are required reading for any investor or analyst who wants to keep abreast of the market and of news about individual companies.

There are numerous journals, newsletters and tip sheets which vary greatly in quality but which may point one in the direction of a company worth investigating further.

BODY SHOP INTERNATIONAL (THE)



EPIC: BOS BLMBG: BOS

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4-NOV-04 **169p**

ACTIVITIES ANALYSIS (04AR)

	T/O	Pr
Skin & haircare products	% 100	100
UK & Ireland	% 34	16
Americas	% 33	31
Europe, Middle East & Africa	% 19	23
Asia Pacific	% 14	30

market cap £356m
position 327th
index FTSE Mid 250
norm eps (pr) 14.6p
turnover (04AR) £381m
pretax (04AR) £28.5m

DY (pr) % 3.44

PER (pr) x 11.6
PEG f na
GR (pr) % 11.6
ROCE % 26.1
MARGIN % 8.97

GEAR % 6.94

PBV x 2.86
PTBV x 3.73
PCF x 10.6
PSR x 0.90
PRR x 64.4

nav ps (04AR) 59.2p
net cash ps (04AR) na

SECTOR: General Retailers. ACTIVITIES: Development and sale of skin and hair care products.

DIRS: A D P Bellamy (ch), P Saunders (ceo), J M J Keenan*, Irene Miller*, R de Waal*, T G Roddick*, Dame Anita Roddick OBE DBE*.
HEAD & REG OFF: Watersmead, Littlehampton, West Sussex, BN17 6LS, United Kingdom. Tel: (01903) 731500. Fax: (01903) 726250.
REGISTRAR: Lloyds TSB Registrars. Tel: (0870) 600 3964

BROKERS: Hoare Govett Ltd. AUDITORS: BDO Stoy Hayward LLP.

INTERIM: (14-Oct-04) 1/2 yr to 28 Aug 04. T/O £179m (£170m). Pre tax profit £8.30m (£9.10m). EPS 3.20p (3.30p). Int div 1.90p (1.90p).
OUTLOOK: (29-Apr-04) AR: ch & ceo - "Continued weakness of the US Dollar will have an impact on our results in the coming year, affecting both transactions and transaction of overseas profit. Despite this, we still expect another year of progress". (24-Jun-04) Ann: "Nonetheless we continue to believe we will have a satisfactory year, in line with market expectations". (14-Oct-04) Int: ce - "...we expect to deliver another year of progress in line with market expectations".

NEWSFLOW: (24-Jun-04) Ann: The company announced the acquisition of 75 per cent of Mighty Ocean Company Ltd, a private company, which operates The Body Shop head franchise business in Hong Kong and Macau, for a cash consideration of £9.40m and the issue by the company of 1.04m new Ords. (7-Jul-04) Ann: The company will be promoted in the FTSE 250 with effect from 12 July 2004. (23-Jul-04) Ann: The company announces the completion of the purchase of the assets and the business of the head franchisee in Canada, 94272 Canada Ltd for a consideration of £10.6m.

SHARE CAPITAL, HOLDINGS, DEALINGS

210m 5p Ords (Maj 38.7%, Dirs 30.4% [dj]).

IB McGlenn	% 21.8
Fidelity Intl Ltd	% 9.00 4-
WE Fin & Servs - dup C	% 4.64
Aeon Co Ltd	% 3.20
A D P Bellamy (ch)	% 3.55
P Saunders (ceo)	k 100
J M J Keenan*	k 70.0 1+
R de Waal* - dup C	% 4.64
T G Roddick* - dup A	% 10.6 3-
Irene Miller*	k 200

	year ended 28 Feb	2000	2001	2002	2003	2004	2005E	2006E
turnover	£m	330	374	380	381	381		
depreciation	£m	13.4	20.6	16.3	16.3	15.3		
int paid (net)	£m	1.50	4.40	3.60	3.90	1.80		
FRS3 pretax	£m	28.8	12.8	11.6	20.4	28.5		
norm pretax	£m	32.5	23.5	26.5	32.6	32.4	35.3	41.6
turnover ps	£	1.73	1.96	1.95	1.91	1.89		
op margin	%	10.3	7.46	7.93	9.58	8.97		
ROCE	%	27.1	18.8	22.4	26.0	26.1		
ROE	%	18.1	16.6	16.2	20.2	18.6		
FRS3 eps	p	9.60	4.90	2.80	6.80	10.6		
norm eps	p	11.5	10.5	10.4	12.9	12.5	13.4	15.2
norm eps growth	%	+20.0	-9.19	-0.38	+23.6	-3.02	+6.92	+13.7
tax rate	%	36	27	54	33	24	23	23
norm per	x					13.5	12.6	11.1
provisional peg	f							
cash flow ps	p	10.6	2.99	19.4	20.6	16.0		
capex ps	p	6.07	7.51	9.95	4.80	5.20		
dividend ps	p	5.70	5.70	5.70	5.70	5.74	5.74	5.85
dps growth	%	-	-	-	-	+0.67	+2.01	
dividend yield	%					3.37	3.40	3.46
dividend cover	x	2.02	1.84	1.83	2.26	2.19	2.33	2.60
shrhlders funds	£m	121	122	124	126	135		
net borrowings	£m	17.8	48.2	43.1	22.2	9.40		
net curr assets	£m	19.4	14.7	10.3	22.0	39.1		
ntav ps	p	46.3	41.4	42.5	44.5	45.3		

Broker	Date	Rec	2005 ESTIMATES			2006 ESTIMATES			GEARING, COVER (04AR)	
			Pretax £m	Eps p	Dps p	Pretax £m	Eps p	Dps p	intangibles %	Incl Excl %
ABN AMRO	8-Jul-04	BUY	33.8 +	13.2 +	5.70	38.2 +	14.1 +	5.70	net gearing	6.94 9.06
Oriel Securities	24-Sep-04	BUY	38.0	14.3 -	5.70	45.5	17.1 -	5.70	cash	13.0 17.0
Seymour Pierce	14-Oct-04	OUTP	35.2	13.6 +	6.00	41.5	15.4	6.50	gross gearing	19.9 26.0
Baird	18-Oct-04	OUTP	35.4	13.3 +	5.80	41.7 -	15.0 -	6.10 +	under 5 yrs	19.9 26.0
		Consensus	35.3	13.4	5.74	41.6	15.2	5.85	under 1 yr	19.3 25.2
		1M change	-0.00	+0.27	+0.01	-0.37	-0.12	+0.05	quick ratio	r 0.82
		3M change	-0.18	+0.17	+0.01	-1.87	-0.83	+0.05	current ratio	r 1.54
									interest cover	x 15.1

KEY DATES

next AR year end 28-Feb-05
int xd (1.90p) 4-Dec-02
fin xd (3.80p) 4-Jun-03
int xd (1.90p) 3-Dec-03
year end 28-Feb-04
annual report 29-Apr-04
fin xd (3.80p) 2-Jun-04
agm 24-Jun-04
int results 14-Oct-04
int xd (1.90p) 1-Dec-04

H S Financial Publishing

H S Financial Publishing Ltd (phone 020 7278 7769, website www.hsfinancial.com), Arnold House, 36–41 Hollywell Lane, London EC2A 3SF is one of the leading suppliers of business information and investment data on UK registered quoted companies. A team of analysts collect, collate and analyse data from primary sources to maintain the Hemmington Scott Corporate Information Database. From this database a number of equity products are generated.

Jointly devised by Jim Slater and Hemmington Scott Publishing, *REFS* (*Really Essential Financial Statistics*) draws upon his experience as a successful private investor, putting together all the key statistics and ratios needed by investors seeking growth and value.

As the Body Shop illustration on the previous page shows, in a single source one can find:

- individual brokers' estimates from over 50 contributing research houses plus the consensus estimate;
- detailed five-year financials plus two years' estimates;
- listing of all directors and their shareholdings;
- company contact details;
- activities;
- concise coverage of events, announcements and changes affecting the company in the last 12 months;
- all the usual key performance statistics and value indicators and many more, such as:
 - Price earnings growth rate
 - Price to book value
 - Price to cash flow
 - Price to sales
 - Price to research
 - Net cash per share.

Definitions of all the ratios and terms used in *REFS* are supplied and are available from their website which also

provides enlightening information on Jim Slater's investment philosophy and strategy – www.companyrefs.com.

On the Internet

A number of City institutions and services have web pages; and a great deal of helpful information is readily available free. The number of sites grows daily but among the more useful at the time of writing are detailed below.

Accounting standards and financial reporting

The Financial Reporting Council (FRC)'s website (www.frc.org.uk) contains information relating to the Accounting Standards Board (ASB), the Urgent Issues Task Force (UITF), and the Financial Reporting Review Panel (FRRP).

For those interested in standards internationally, the home page of the International Accounting Standards Board (IASB) is www.iasb.org.

City and general news

The *Financial Times* provides news, prices, and an excellent information service. You can obtain the current annual/interim report of any company annotated with ♣ in the newspaper or the London Share Price Service by phoning 020 8391 6000, or ordering through the Internet <http://ft.ar.wilink.com>. Reports will be posted the next working day subject to availability. An instant snapshot of key financial and fundamental information on more than 11,000 listed companies world-wide is available, free. There is also a useful glossary and set of ratio definitions – <http://www.financialtimes.co.uk>.

Introduction

In the 1970s, when inflation was galloping along in double figures (see Example 29.1), two fruitless attempts were made to introduce inflation accounting.

The first method, *Current Purchasing Power (CPP) accounting*, which simply adjusted figures for the rise in the Retail Price Index, was eminently sensible. It was also the accounting profession’s proposed system.

But the government, apparently fearful of runaway inflation if everything was indexed, rejected CPP and appointed a committee headed by Francis Sandilands to find something better.

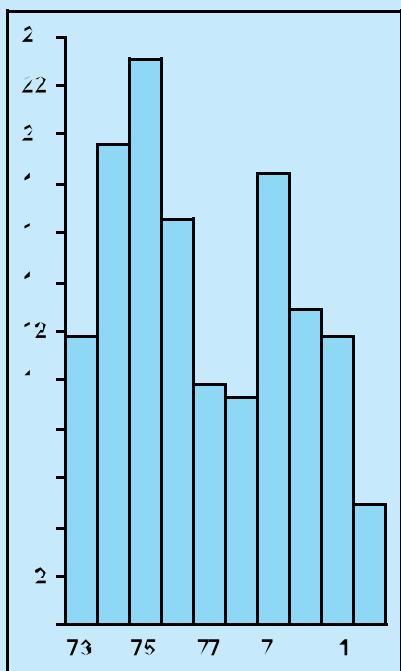
The Sandilands committee came up with a different system, *Current Cost Accounting (CCA)*, which was very complicated (even the step-by-step guide *CCA the Easy Way* ran to 145 pages of A4) and proved unworkable in practice, and CCA ended up in the bin. Francis Sandilands was knighted.

Because both these methods have been tried and abandoned, there is a temptation to treat the subject of inflation as irrelevant. Dormant might be a better word: if the Chancellor fails to keep the lid on inflation, or some future government resorts to government’s old tricks of promising the earth, and paying for it by printing money, then the whole subject will be back on the agenda.

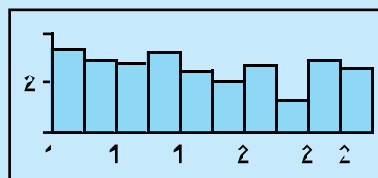
But even with inflation bumbling along at 2% or 3%, as it has for the last ten years (see Example 29.2, which is on the same scale as Example 29.1), sterling has lost 23% of its value between 1994 and 2003.

The shortcomings of historical cost (HC) accounting apply at even quite modest rates of inflation.

Example 29.1 Inflation per annum 1973–1982



Example 29.2 Inflation per annum 1994–2003



Historical cost (HC) accounting

HC accounting with stable prices

In a time of stable prices, the historical cost system works well. What an asset cost is seldom in dispute, and although the directors have to assess the expected useful lives of fixed assets, and their likely residual value, there is limited scope for subjective judgement.

Furthermore, the quality of historical cost accounts has steadily improved over the years, largely thanks to the efforts of the ASB, which has considerably reduced the number of options available.

Though problems do still remain, few other than accounting theorists would seriously suggest that historical cost be abandoned as the basis of accounting in periods of little or no inflation.

But inflation may creep up again. If it does, it will be important to understand the weaknesses of HC accounting.

HC accounting with inflation

In a period of 'inflation', historical cost accounting has five main weaknesses:

1. *Depreciation is inadequate for the replacement of fixed assets.*

Historical cost accounting seeks to write off the cost of fixed assets over their effective lives. In a period of stable prices, sufficient cash could be set aside over the life of an asset to replace it at its original cost. In times of inflation, insufficient is provided in this way to enable the business to replace its assets. For example, where an asset is written off on a straight line basis over ten years, the total provisions for depreciation as a percentage of cost (in constant pounds) are:

<i>Inflation rate</i>	<i>Depreciation as % of cost</i>
5%	79.1%
10%	64.4%
15%	53.8%

2. *Cost of sales is understated.*

In historical cost accounts, stock consumed and sold is charged against sales at its original cost, rather than at

the cost of replacing it. But, in order to retain the same stock level, the company has to finance the difference entirely out of profits after tax. This is perhaps most easily understood if we add a few figures. Assume that the company has in stock items which cost £4,000. It sells them for £6,000, incurring overheads of £1,600, and replaces them at a cost of £4,400. Corporation tax is payable at, say, 30%.

HC accounts will say that the company has made a profit of £400 (£6,000 – £4,000 – £1,600) on which it will pay corporation tax of £120, leaving a net profit after tax of £280. But out of this the company has to meet the additional cost of replacement (£400), so it will be left with minus £120.

3. *Need for increase in other working capital is not recognised.*

In most companies, amounts for debtors are greater than those for creditors, so, on an unchanged volume of business, 'debtors minus creditors' increases with inflation, requiring extra money to be provided for working capital. Historical cost accounts fail to recognise that this extra working capital has to be provided out of profits after tax to maintain the operating capacity of a business.

4. *Borrowing benefits are not shown.*

Borrowings are shown in monetary terms, and if nothing is repaid, and nothing further is borrowed, borrowings appear stable. This is a distortion of the picture, because a gain has been made at the expense of the lender (since in real terms the value of the loan has declined).

5. *Year-on-year figures are not comparable.*

In addition to being overstated due to

- (a) inadequate provision for depreciation,
- (b) understated cost of sales, and
- (c) no provision for increase in other working capital,

profits are stated in terms of money which has itself declined in value. Similarly, sales and dividends are not comparable with those of other years, because they are expressed in pounds of different purchasing power.



Key point

The reporting of profits in inflated pounds gives a far too rosy impression of growth in profitability

- This lulls both managers and shareholders into thinking that their company is doing much better than it really is;
- It encourages unions and employees to expect wage increases that are unmatched by real (as opposed to reported) profit growth; and
- It encourages government measures that are harmful to the long-term prosperity of companies, e.g. price controls or excess profits tax made on a completely false impression of profitability.

It is somewhat difficult, without making proper adjustment, even in times of modest inflation, to estimate profits, earnings and dividends, and their trend in real terms, as is shown by THE BODY SHOP below.

To allow for inflation it is necessary to restate these figures at the price levels ruling at a particular point in time. Two obvious points are 1999 (the beginning of the five years) or 2003 (the end). We have chosen to convert

everything to 1999 prices, using the February index for each year.

Not only do the adjusted figures look less promising, the year-on-year change looks much less happy. We see, for instance, that in real terms:

- turnover fell between 2001 and 2003
- dividends fell 9% in real terms between 1999 and 2003

The impact of modest inflation

It is worth looking in more detail at the impact that even quite modest rates of inflation have on the value of money if they persist for several years. See Example 29.3 overleaf.

Between 1960 and 2000 inflation averaged a touch over 6.9% compound; but it was extremely variable in rate (from a low of 1.3% p.a. to a peak of over 25%); and it was throughout that period very difficult to predict what the rate of inflation would be a year later.

It wasn't always like this. Prior to the Second World War prices had changed surprisingly little in a hundred years. By 1940, prices were a shade over twice their 1840 level.

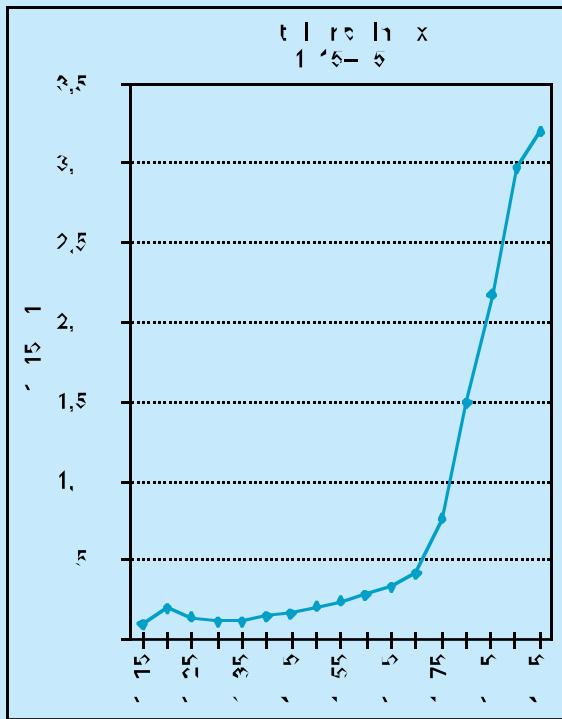
But, as Example 29.4 overleaf shows, the effect of inflation on the value of money since 1940 and, in particular, since 1970, has been staggering.

THE BODY SHOP *Extract from Group Five Year Summary 2003*

	2003 £m	2002 £m	2001 £m	2000 £m	1999 £m
As reported					
Turnover (excluding exceptional turnover)	378.2	379.6	374.1	330.1	303.7
Operating profit (before exceptional items)	26.9	26.7	29.4	33.0	24.6
Earnings per ordinary share (excluding exceptionals)	7.5p	7.8p	9.5p	10.7p	7.0p
Dividends per share	5.7p	5.7p	5.7p	5.7p	5.7p
Adjustment factors					
RPI February (company's year end)	179.3	173.8	172.0	167.5	163.7
Factor to adjust to £1999	0.913	0.942	0.952	0.977	1.000
Adjusted figures					
Turnover (excluding exceptional turnover)	345.3	357.6	356.1	322.5	303.7
Operating profit (before exceptional items)	24.6	25.2	28.0	32.2	24.6
Earnings per ordinary share excluding exceptionals	6.8p	7.3p	9.0p	10.5p	7.0p
Dividends per share	5.2p	5.4p	5.4p	5.6p	5.7p

Example 29.3 Effect of inflation on the value of £1

Annual rate of inflation	After 5 years	After 10 years	After 20 years
2½%	88.3p	78.1p	61.0p
5%	78.3p	61.3p	37.6p
7½%	69.6p	48.5p	29.5p

Example 29.4 The RPI at 5-year intervals (1915 = 100)**The effect of inflation on the investor in fixed-interest stocks**

Anyone who bought £100 of Government, irredeemable, 3½% War Loan when it stood at par in the 1940s by 2004 saw it standing at about 72, which reflected interest rates and inflationary expectations at the time. If one adjusted the original £100 by the subsequent movement in the RPI (which was about 28 times its 1940 level), and expressed £100 in 2004 pounds, one got about £2,800. In real terms the investor had lost over 97% of his capital: horrifying! Since then, interest rates have fallen and inflationary expectations are much less.

In 1940 the RPI was 6.6 (taking 1987 = 100) and in March 2004 was 184.6 which represents an increase of 2,697%.

Appendix 3 provides tables showing the effect of inflation in the UK on the Retail Price Index.

The future if high (over 10%) inflation returns

Until the purpose of inflation accounting is agreed no system of inflation accounting is likely to be introduced successfully.

Consequently, HC accounts will continue

- to lull many managers and shareholders into thinking that their companies are doing better (sometimes considerably better) than they really are, and
- to encourage unions and employees to seek wage increases that are not justified by real (as opposed to reported) profits.

Furthermore, unless the system so developed produces accounts acceptable to the Inland Revenue for tax purposes and which become the *only* accounts a company produces, there will continue to be a problem. The production of *two* sets of accounts will always pose the question 'Which one is to be believed?'

Accounting practices – cause for concern?

Revenue recognition

A good place to start fiddling

As the *Financial Times* put it in July 2001:

FINANCIAL TIMES *Extract from the LEX column 9 July 2001*



... If you want to defraud investors by fiddling your company accounts, there are few better places to start than the field of revenue recognition.

A subsequent *FT* article, published on 13 August 2002, warmed to the theme:

FINANCIAL TIMES *Extract from Accounting article by Robert Howell 13 August 2002*



One of the most basic issues is revenue recognition ... many of the recent failures stem from this issue.

ENRON, acting as a broker between sellers and buyers of energy, took sales credit for the total size of the transaction, rather than only the fee involved, which made the company's size and growth rate look much stronger than it really was.

GLOBAL CROSSING and QWEST COMMUNICATIONS, among other companies, bought and sold capacity from each other and took sales credit at both ends, overstating both companies' revenue.

No UK accounting standard

The old IASC issued IAS 18 *Revenue* as long ago as 1982 (revised in 1993), but it wasn't until November 2003 that

the ASB issued Application Note G *Revenue recognition*, and Mary Keegan, ASB Chairman at the time, commented that 'Recent reports of questionable practice have highlighted the need for us to set out best practice'.

Revenue recognition problems

Aspects of revenue recognition which have caused particular concern in recent years include:

1. Taking the profit on a large deal before contracts have been exchanged.
2. Booking sales as soon as an order has been placed.
3. Using sales promotions to boost the top line.
4. Adding concessionaires' sales to the turnover of the main store.
5. Showing turnover at full transaction value when acting in an agency capacity.
6. Including annual support and maintenance revenue in full in the year of receipt.
7. Sales returns.
8. Long-term contracts.

Revenue recognition examples

1. Taking the profit on a large deal before contracts have been exchanged

In the absence of an accounting standard dealing with revenue recognition, the Financial Reporting Review Panel has had to consider this issue on a number of occasions. The most notable of these concerned the accounts of the WIGGINS GROUP for each of the five years to 31 March 2000:

WIGGINS GROUP Extract from Press Notice 65**Revenue recognition**

It is the company's accounting policy to recognise revenue in respect of commercial property sales on exchange of contract . . . One of the contracts was conditional upon the company obtaining planning permission on terms satisfactory to the purchaser without which he had certain rights not to proceed.

A second contract had the appearance of a financing transaction rather than an outright sale which, under FRS 5, should not be recognised until the risks and rewards of ownership pass at a future date.

In the particular circumstances, the panel was of the view that neither contract could be recognised in the 2000 accounts.

The directors subsequently agreed to revise the previously published accounts in line with the Panel's views.

2. Booking sales as soon as an order has been placed

This is an old chestnut. Under the practice sometimes referred to as *pre-despatching*, goods were recorded as sold as soon as the order was placed. This caused problems, particularly in the retail sector.

A 'cause celebre' was ALLIED CARPETS, which referred in its 1998 accounts to 'a breakdown of financial controls in respect of sales recognition procedures'. The cumulative effect of the error was an overstatement of sales of £6.4m.

Another example was the furniture group MFI which, in its 1999 accounts, changed its accounting policy on turnover:

MFI Extract from 1999 accounts**Accounting policies**

...

During the period the sales recognition policy of MFI Furniture Centres Limited was changed from recognising sales on an order basis to a despatch basis. Prior to the adoption of this accounting policy MFI Furniture Centres Limited recognised sales in full, together with the retail element of the profit, at the time the customer placed the order and paid the deposit . . .

The effect of the change was to reduce the company's net assets at year end 24 April 1999 by £19.2m.

Application Note G, subsequently issued by the ASB in November 2003, limits the circumstances where sales can be booked before the goods have been physically delivered. These rules, dealing with 'Bill and hold sales', would not have been satisfied by MFI's old sales recognition policy.

3. Using sales promotions to boost the top line

Accountancy Age commented on the likely effect of Application Note G on this practice:

ACCOUNTANCY AGE December 2003

. . . Supermarkets and big stores than run 'two-for-one' offers will only be able to record the revenue actually taken, rather than use the notional value of the goods sold.

BIG FOOD GROUP (formerly ICELAND) is an example of a company which changed its accounting policy:

BIG FOOD GROUP Extract from 2002 accounts**Accounting policies**

...

Following the implementation of FRS 18, the Group has reviewed its accounting policies.

The only significant effect is to restate the comparative amounts for turnover and cost of sales by £329.2m for the 65 weeks ended 31 March 2001, reflecting the Group's revised policy of excluding sales incentives from turnover.

Turnover and cost of sales for the 52 weeks ended 29 March 2002 would have been £293.3m higher without the change in policy.

4. Adding concessionaires' sales to the turnover of the main store

Application Note G included an example of a department store which provided space for concessionaires to sell products and which received a fixed amount of rental income in consideration. The Application Note stated that the department store should *not* include within its turnover the value of the concessionaires' sales.

In December 2003, *Accountancy Age* noted that the MERCHANT RETAIL GROUP's interim turnover was £51.4m compared with £60.7m on the previous 'industry basis'.

5. Showing turnover at full transaction value when acting in an agency capacity

Where the seller is acting as principal, turnover should be based on gross amount received or receivable.

However where the seller is acting as agent, turnover reported should be based on commission receivable in return for the seller's services.

Application Note G stops, for example, the previous practice of some Internet retailers of booking, say, £1,000 of revenues and costs of £900, for earning £100 commission on the sale of a £1,000 flight provided by a travel company for which the Internet retailer was acting as agent.

EBOOKERS is an example of a company which changed its accounting policy *prior to* the issue of Application Note G:

EBOOKERS Extract from 2002 accounts

Accounting policies

During the year the presentation of negotiated fare turnover has been changed from a gross to a net basis.

Negotiated fare tickets are tickets that are bought by the Group or other independent third parties to fulfil existing commitments to the Group's customers.

... all turnover is now recorded at the margin earned rather than the amount invoiced to customers.

6. Including annual support and maintenance revenue in full in the year of receipt

Until recently several companies would include revenue in full in the year of receipt, even though some of the revenue related to the provision of services after the balance sheet date.

Adverse press comment (followed in some cases by a falling share price) caused some companies to reconsider their accounting policy, e.g. NETCALL:

NETCALL Extract from 2003 accounts

Note 3 Prior year adjustment

During the year the group changed its accounting policy for maintenance and support income for the first year of a supply agreement. Previously this income had been recognised in full upon installation of the system.

The current policy is to spread the first year support and maintenance income over the year rather than in full upon installation . . . a prior year adjustment has been made.

7. Sales returns

The terms of contractual arrangements may allow customers to return goods that they have purchased.

Application Note G requires the sales value of estimated returns to be excluded from turnover, and estimates of returns should be reviewed at each balance sheet date. See, for example, PROTHERICS:

PROTHERICS Extract from accounting policies 2003

Turnover

Turnover represents amounts receivable in respect of the sales of goods and services, license agreements and intellectual property to customers during the year, net of trade discounts and value added tax.

Turnover is partly recognised upon the shipment of products to the distributor with further amounts being recognised in accordance with the contractual terms upon the shipment to the end user.

Certain medical products sold by the Group can be returned should they remain unused by the expiry date and provision is made for these items. Turnover is stated net of these provisions.

8. Long-term contracts

Long-term Contracts are covered in Chapter 10 (pages 77–9). Because contractors' margins are often thin, and the sums involved may be very large, this can be an area for disagreement between company and auditor, but their differences are normally settled behind closed doors. Not so JARVIS:

FINANCIAL TIMES Article of 15 July 2000
by Charles Batchelor



PwC wins costs against Jarvis

Jarvis, the rail maintenance company, took 'an aggressive approach to the recognition of the income and profits on long-term contracts', against the advice of its auditors, a High Court judge said yesterday.

Mr Justice Lightman ordered Jarvis to pay the full legal costs of PwC, its former auditors . . . From the date of its appointment as auditor in 1996, PwC had differences with Jarvis over how income should be recognised in its accounts, Mr Justice Lightman said.

These differences became acute in relation to the March 1999 accounts. 'Jarvis wished to include two claims totalling £15.2m which PwC could not satisfy themselves were sufficiently certain of recovery . . . without actual payment or acknowledgement by Railtrack that the sum was due.

'Ultimately, when PwC threatened to qualify their audit report unless Jarvis excluded £12m, Jarvis reluctantly agreed to exclude this sum. PwC were plainly correct in the line they took for, when Jarvis finally settled accounts with Railtrack, Jarvis had to write off this £12m and a further £6.8m besides.'

Pulling out all the stops

Some years ago, we were invited to drinks by a friend in the next village, where we met an executive of a FTSE 250's subsidiary. It was near the company's year end, so we asked, 'How's business?' He replied: 'Head office have just told us to pull out all the stops.'

The FTSE 250's results came out a few months later, with profits a whisker above the previous year. But a downturn in the industry had, in fact, started several months earlier, and the following year the profits of the FTSE 250 company (with no 'fat' left) fell sharply.

In another case, a company rolled up interest on previously rolled-up interest, to achieve marginally higher profits, again with a subsequent tumble.



Be wary when a company's results are only just ahead of the previous year.

There are a number of ways a company can enhance its performance in the short term. Here are a few of them:

1. Stock valuation
2. Provisions
3. Sales.

Stocktaking

Example 10.1 in Chapter 10 showed how quite small variations in the valuation of opening stock and closing stock could have a large impact on a company's reported profits.

The ratio to watch is:

Finished goods
Turnover

For example the Leeds-based listed company ABBEYCREST, which designs, manufactures and distributes gold and silver jewellery:

ABBEYCREST Extracts from annual reports

Year ending February	1999	2000	2001	2002	2003
	£000	£000	£000	£000	£000
Turnover	63,429	70,063	78,801	91,475	98,840
Raw materials and WIP	3,300	4,366	8,017	7,446	4,344
Finished goods	14,069	15,303	18,842	28,952	27,856
Total stock	17,369	19,669	26,859	36,398	32,200
<u>Finished goods</u>					
Turnover	22.2%	21.8%	23.9%	31.7%	28.2%

Had the Finished Goods/Turnover ratio in 2002 been the same as 1999 (22.2%), *Finished goods* would have been $\pounds 91.475\text{m} \times 0.222 = \pounds 20.307\text{m}$, or about $\pounds 8.6\text{m}$ less than it actually was.

ABBEYCREST realised that, in a period of quite rapid growth, Stocks had risen faster than Turnover. This led the Chairman to take action, which he described in the 2002/03 Interim report:

The obsolete stock issues have been addressed by the establishment of a dedicated trading team to ensure that the stock can be disposed of quickly in the most cash-generative manner possible.

And in the Interims a year later:

Disposal of the excess stocks identified twelve months ago, has continued well, with the emphasis being on addressing the more difficult stock to dispose of. Due to this policy, scrapping in the first half of this financial year has equalled the total for the whole financial year 2002/03.



Finished goods rising faster than Turnover is a warning signal.

Provisions

Apart from deferred tax, provisions relies to a certain extent on the judgement of management.

For example, in 2002 and 2003 the exhibitions group TARSUS had been busy restructuring, including the disposal of its none-core stand alone magazine businesses, and the 2003 accounts showed:

TARSUS GROUP Extract from 2003 accounts

22. Provisions for liabilities and charges

	2003	2002
	£000	£000
Restructuring provisions		
At 1 January	1,199	1,154
Charged to profit and loss account	421	3,762
Paid/Utilised in year	(1,062)	(3,717)
	<u>558</u>	<u>1,199</u>

In 2003, TARSUS reported an Operating profit of $\pounds 307,000$ from continuing operations, and an Operating loss of $\pounds 582,000$ from discontinued operations; so the provisions were quite significant.

No doubt Tarsus management used its judgement and experience in making and using provisions, but a hard pressed management might employ a certain amount of flexibility.

Sales

What would you make of a company that reported the following:

WHICHCO Extracts from 2001 accounts

	2001	2000
	£m	£m
Turnover	649.3	646.1
Trade debtors	227.5	185.4

[There has been hardly any increase in Turnover, but a huge jump in Trade debtors; as the ratio shows.]

Trade debtors	=	35.0%	28.7%
Turnover			

The explanation came in the *Investors Chronicle*:

INVESTORS CHRONICLE 1 June 2001

News analysis

Investors in healthcare group SSL International have once again been forced to stretch the boundaries of their patience . . . an external investigation by KPMG had concluded that $\pounds 63\text{m}$ -worth of excess stock was held by its customers . . .

The problem stems from trade loading, an aggressive sales technique. The report also concluded that sales and profits in the 25 months to 31 March 2001 were overstated by $\pounds 25\text{m}$.

Several heads rolled in the boardroom, and the new chairman subsequently reported that the practice of providing incentives for customers to purchase excess stock at the end of financial periods – a practice known as trade loading – had ceased.

Introduction

Harmonisation in Europe

Progress since 1990

On the UK domestic front, the ASB has corrected a number of serious weaknesses in the UK rules, bringing the UK much closer to US and international practice.

These corrections included:

- replacing the old '*Sources and application of funds statement*' with the much more useful and easy to understand '*Cash flow statement*';
- removing the ludicrous 'preferred method' of dealing with purchased goodwill, *immediate write-off straight to reserves*, that made a complete nonsense of **ROCE** (Return On Capital Employed). See our article 'Big black hole of British accounting' in the May 1994 edition of *The Professional Investor*.

On the world scene, global business is demanding global accounting standards.

In Europe, in June 2000, the European Commission announced that companies within the EU would have to use IASs from 2005 onwards in order to list on EU markets.

Contents of this chapter

This chapter is divided into three sections:

1. Movement towards harmonisation of accounting standards within the EU.
2. A comparison between UK GAAP and IFRS over a number of key accounting areas.
3. What lies ahead?

European Commission

In June 2000 the European Commission announced that companies listed on EU markets would have to adopt International Accounting Standards for accounting periods commencing on or after 1 January 2005.

International Accounting Standards

The International Accounting Standards Board (IASB) is the body responsible for issuing international accounting standards.

The IASB has adopted the standards produced by its predecessor, the International Accounting Standards Committee (IASC), which have an **IAS** prefix; while those issued by the IASB have an **IFRS** (International Financial Reporting Standard) prefix – see Appendix 5.

The IASB has responded rapidly to the 2005 deadline. In the 12 months up to 31 March 2004, the IASB has issued 13 revised standards, 4 substantially revised standards, and 5 new style IFRSs.

UK companies preparing accounts for periods commencing on or after 1 January 2005 will be expected to comply with all international standards in place at 31 March 2004.

Impact of IFRS

UK listed companies are now assessing the likely impact of changing from UK GAAP to IFRS.

Several larger companies are currently highlighting the likely impact of IFRS, e.g. UNILEVER:

UNILEVER Extract from 2003 Financial Review**International Financial Reporting Standards**

Unilever will adopt International Financial Reporting Standards (IFRS) with effect from 1 January 2005.

The implementation of IFRS is a major change process for which we have established a project team and are dedicating considerable resource.

The impact of the change to IFRS on our reported capital and reserves and on reported net profit is being assessed.

In particular, our current accounting policies for retirement benefits, financial instruments, goodwill and intangible assets, biological assets, deferred taxes and proposed dividends differ from IFRS.

Comparison of UK GAAP and IFRS

Comparison of UK GAAP and IFRS		
Topic	UK GAAP Treatment	IFRS Treatment
Performance reporting	FRS 3 requires a Statement of Total Recognised Gains and Losses (STRGL)	IAS 1 requires a statement of changes in equity but would allow STRGL to be used
Exceptional items	FRS3 includes definitions for exceptional items	IAS 8 does not use the term 'exceptional item' but requires separate disclosure of material items
Extraordinary items	In theory allowed by FRS 3, but in practice extinct	IAS 1 prohibits use of extraordinary items
Dividends paid and proposed	Equity and preference dividends (paid and proposed) are to be included in the profit and loss account	Equity dividends paid must be dealt with in the statement of changes in equity. <i>Equity dividends declared after the balance sheet date shall not be recognised as a liability at that date, but must be disclosed by way of a note</i>
Revenue recognition	There is no UK standard, but the ASB has issued an Application Note to FRS 5	IAS 18, <i>Revenue</i> , includes detailed requirements and guidance
Cash flow statements	FRS 1 requires cash flow statements to be grouped under nine subheadings The statement should reconcile to 'cash'	IAS 7 requires cash flow statements to be grouped under only three subheadings. The statement should reconcile to 'cash and cash equivalents'
Financial instruments – recognition and measurement	No comprehensive standard, but some aspects covered by FRS 4 and SSAP 20	Covered comprehensively by IAS 39, which requires fair value accounting, with all gains and losses recognised in the profit and loss account

Topic	UK GAAP Treatment	IFRS Treatment
Financial instruments – presentation and disclosure	Some aspects covered by FRS 4 and FRS 13 Preference shares are share capital	Covered comprehensively by IAS 32 Preference shares are either share capital or liabilities, according to their substance
	Convertible loan stock is a liability until conversion takes place	Convertible carrying amount allocated between liability and equity, and presented separately
Deferred tax	Normally not provided on revaluation surpluses or on gains on disposal with rollover relief Tax reconciliation to ‘current tax’	Deferred tax must be provided on these ‘temporary differences’ Reconciliation to current plus deferred tax
Retirement benefits	FRS 17 requires all actuarial gains and losses to be taken direct to reserves (presented in STRGL)	IAS 19 requires gains and losses to be taken to P & L account, either immediately or spread over a period
Goodwill	FRS 10 gives choice: systematic amortisation and annual impairment review	<i>IFRS prohibits systematic amortisation</i> but requires annual impairment review
Research & Development	Where ‘development cost criteria’ satisfied, choice between capitalisation and immediate write-off	Where IAS 38 criteria satisfied, <i>capitalisation is mandatory</i>
Investment properties	Treatment complicated	Treatment very complicated

Several larger companies are giving an indication in their 2004 accounts of the likely impact of IFRS, in line with the recommendations of the Committee of European Securities Regulators, e.g. HANSON:

HANSON Extract from Accounting Policies 2003 (edited)

International Financial Reporting Standards

The Group is required under European legislation to adopt International Financial Reporting Standards (IFRS), also known as International Accounting Standards, from January 1, 2005. As a global business the group is supportive of moves to harmonise international accounting standards . . . The adoption of IFRS will first apply to the group’s financial statements for the half year ending June 30, 2005.

The key differences between UK GAAP and IFRS are:

Derivative instruments and hedging activities

The group enters into derivative instruments to limit the exposure to interest rate and foreign exchange risks.

- Under UK GAAP, these instruments are measured at cost and accounted for as hedges, whereby gains and losses are deferred until the underlying transaction occurs.
- Under IFRS, derivative instruments can be recognised on the balance sheet at fair value, although in order to achieve hedge accounting, certain criteria must be established regarding documentation, designation and effectiveness of the hedge.

Pensions and other post-retirement benefits

- Under UK GAAP, the cost of providing pension and other post-retirement benefits is charged to the Profit and Loss account over employee service lives in accordance with SSAP 24.
- Under IFRS, pension and other post-retirement benefit plan assets and liabilities are carried at their fair value at the balance sheet date.

Deferred taxation

- Under UK GAAP, deferred taxation is provided on all timing differences, except:
 - (a) those that relate to valuations where no sale is in process, or
 - (b) where it is probable that rollover relief or losses will be applied to the gain and also
 - (c) to the remittance of retained earnings of overseas subsidiaries, except where no dividends have been accrued as receivable at the balance sheet date.
- Under IFRS, deferred taxation is provided on all differences between the book and tax bases of assets and liabilities, except from those arising from goodwill that is not deductible for tax purposes, or the initial recognition of assets and liabilities from a transaction that is not a business combination and affects neither accounting nor taxable profit when the transaction occurs.

Goodwill and asset impairment

- Under UK GAAP goodwill is carried on the balance sheet and either:
 - (a) amortised on a straight line basis, normally assumed to be no more than 20 years, *or*
 - (b) assets are reviewed annually for impairment.
- Under current IFRS proposals, goodwill will not be amortised, but will be reviewed both annually and where an indicator of impairment exists.

What lies ahead?**Recent developments**

At the end of March 2004, the IASB published the final pieces in the IAS regulatory jigsaw, with which companies adopting IAS in 2005 will be expected to comply.

The new or substantially revised standards deal with:

- Financial instruments (IAS 32 and 39)
- Impairment (IAS 36)
- Intangibles (IAS 38)
- Business combinations (IFRS 3)
- Non-current assets held for resale and discontinued operations (IFRS 5)
- Insurance contracts (IFRS 4).

A list of current standards is set out in Appendix 5.

Forthcoming projects

Several crucial issues will be coming up in the next few years, with new standards expected on:

- Revenue recognition
- Performance reporting (comprehensive income statement)
- Leasing
- Retirement benefits
- Revaluations.

The first three of these are pursued in Chapter 33.

What will happen to UK GAAP?

In March 2004, the ASB published its proposals for converging UK GAAP with IAS: a phased approach, with existing UK standards being replaced over time with equivalent standards based on IAS.

The ASB has emphasised that 'in the medium term there is no case for the use of two sets of standards in the UK'. (See also Chapter 33.)

Convergence with US GAAP

Much of the harmonisation debate has focused on the EU. Equally important (and some would argue more important) is the harmonisation between EU members and US GAAP.

On 29 October 2002, the US Financial Accounting Standards Board (FASB) and the IASB issued a joint press release, referring to the issue of a *memorandum of understanding* marking a significant step towards formalising their commitment to the convergence of US and international accounting standards.

The two bodies have agreed to undertake a short-term project aiming at removing some of the differences between US GAAP and IFRS/IAS, and subsequently to remove remaining differences.

Conclusions

The year 2005 is a starting point. Development will continue after this date, with significant changes expected on key issues such as performance reporting, revenue recognition and lease accounting. But it will be some years before there is full harmonisation between IFRS and US GAAP: there is a great deal of change ahead.

Introduction

In the previous two editions of this book we looked at the erratic record of THE BODY SHOP under the remarkable leadership of Anita Roddick. Anita has now entrusted the business management of her company to a very experienced and able executive. As a result THE BODY SHOP is making steady but rather less interesting progress.

So for this edition we have chosen an AIM (Alternative Investment Market) company, CHARTERHOUSE COMMUNICATIONS, which has already had an exciting but at times perilous record since it joined AIM in 1996.

Since AIM was launched in June 1995, well over 1,000 companies have been listed on it. At 1 May 2004, 95 had gone on to a full listing and 212 had dropped out (i.e. taken over, delisted at their own request or gone into receivership). There are currently 809 companies on AIM, so there is plenty of choice.

AIM is a high risk/high reward area. The downside is 100%, but the upside can be much more.

Charterhouse Communications

[Note: The authors' comments are in square brackets.]

Question 1: What does the company do?

The first paragraph of the Directors' report gives the *Principal Activities*: 'The Group is principally a publisher

of personal finance and mortgage related magazines and directories for private investors and professional advisers in the UK and overseas.'

The Annual Report also gives a list and detailed descriptions of Charterhouse's publications under the headings:

- Private and Professional Investment Publications
- Business-to-Business Directories
- Mortgage Publications
- Treasury and Banking.

[We note that the highly successful *REFS (Really Essential Financial Statistics)* is among the investment publications.]

Question 2: How large is Charterhouse?

Monday's *FT* gives Market Capitalisation, or you can work it out.

$$\begin{aligned} \text{Market Cap} &= \text{Called up share capital} \\ &\quad \times \text{Current share price} \\ &= 123,344,631 \text{ Ord 1p shares} \times 4\frac{1}{4}\text{p} \\ &= \text{£}5.2\text{m} \end{aligned}$$

(Details of Share capital: see Note 17 to the Accounts.)

Question 3: Recent history?

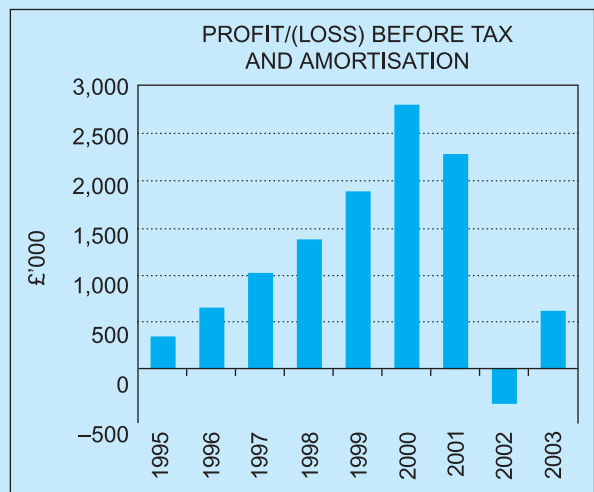
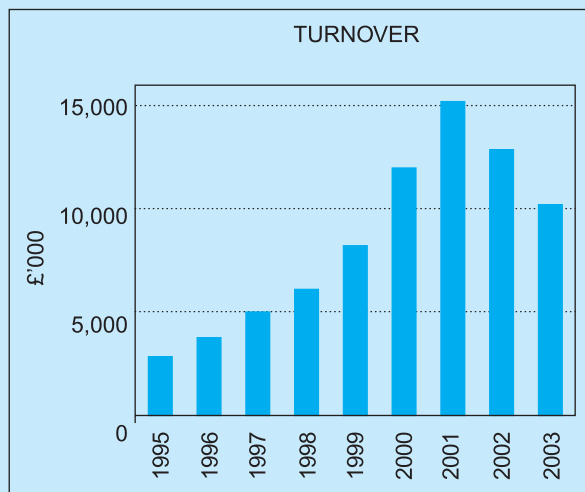
The annual report contains *Financial Highlights* since Charterhouse came to the market:

Financial Highlights

Group revenues and results for the last nine years are as shown:

1995	1996	1997	1998	1999	2000	2001	2002	2003
£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Turnover								
2,809	3,698	4,985	6,099	8,207	12,068	15,206	12,858	10,235
Profit/(loss) before tax								
346	665	1,023	905	1,386	2,053	1,237	(9,340)	(266)
Profit/(loss) before tax and amortisation								
346	665	1,023	1,381	1,892	2,815	2,272	(356)	619

The basis for showing results before the amortisation of goodwill and intangible assets is set out under 'Presentation of Group Results' in the Directors' Report.

**Question 4: Does anyone have control?**

Here we need to look at directors' holdings and substantial shareholders:

CHARTERHOUSE Extract from 2003 Directors' report**Directors and their share interests**

...		
B W Rowbotham	1,075,000	0.90%
I H Elliott	11,475,042	9.30%
G C Gamble	11,281,801	9.13%
R S Leighton	4,020,000	3.26%
M R Shipman	1,388,686	<u>1.08%</u>
		<u>22.86%</u>

[Percentage holdings not given, calculated by authors.]

Substantial shareholdings

... interests of 3% or more:

Friends Ivory & Sime	12.79%
Co-operation Retirement Benefit Fund	7.34%
Nigel Wray	6.30%
Charles Walton	3.39%

Question 5: Who are Wray and Walton?

[If they both team up with the Directors they will have over 25%, enough to block any capital reorganisation.]

With holdings that size, they may have been directors previously. Let's see what we can find out by trawling through the press cuttings from back copies of the *Investors Chronicle*.

INVESTORS CHRONICLE *Cuttings since 1998***3 April 1998**

Charterhouse was formed in 1988 as a management buyout from Publishing Holdings, under the direction of its two leading lights MD Ivan Elliott and publishing director Geoffrey Gamble . . . Charterhouse is seasonally loaded towards the second half, largely as a result of heavy personal finance advertising ahead of the end of the tax year.

[Company year end is May.]

9 October 1998

With increased competition in financial services, *What Mortgage?*, *What Investment?* and other organs may benefit from higher advertising.

18 December 1998

In August Charterhouse paid £550,000 cash for Brand & Co. Brand sells business books and distributes publications – the Stationery Office accounts for a quarter of its revenue.

It was hardly a major deal but not a major cost either, as Brand brought with it £200,000 of cash and a £100,000 freehold property.

It also turned in profit of £120,000 in the year to end-October 1997 and, not surprisingly, ‘will be immediately earnings enhancing’ for Charterhouse.

25 June 1999

Bid talks have ended at financial magazine publisher Charterhouse Communications.

24 September 1999

Final results £1.39m pre-tax (£0.91m). Advertising revenues were buoyant. There are funds available for acquisitions.

[Going to burn a hole in their pocket?]

18 February 2000

Interims £0.34m (£0.28m). Consistent growth record is being maintained. New website should be profitable by the end of the year. Results only included £88,000 from Home Study Company *Independent Research Services*. The £8.4m acquisition is expected to enhance earnings per share this year by 16%.

[It did burn a hole in their pocket.]

Post-results profit taking knocked 12p off the shares, leaving them at 68p.

10 March 2000**Directors' dealings**

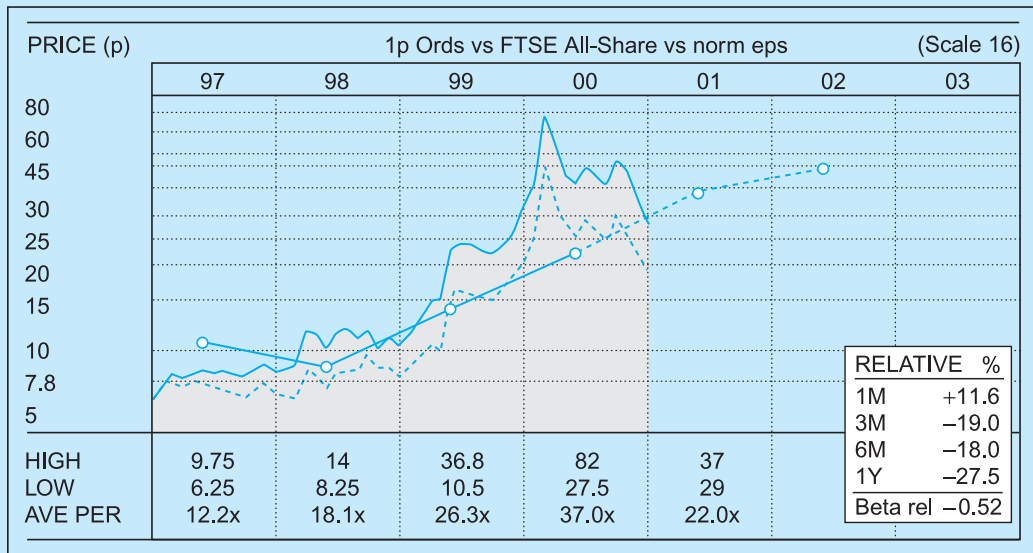
Charterhouse Communications

Director	Position	Shares	New holding
B W Rowbotham	ch	500,000	1,050,000
G Gamble	md	1,991,241	10,796,801
M R Shipman	fd & cs	1,000,000	1,338,686
Christine Santry		169,400	400,000

All sales were made on 25/2/00, all at 77p.

[FD sold more than 42% of his holding. Let's have a look at the share price graph from *REFS*.]

CHARTERHOUSE COMMUNICATIONS

INVESTORS CHRONICLE (*cuttings continued*)**22 September 2000**

Record results for the year to 31 May 2000 were assisted by organic growth and earnings-enhancing acquisitions . . .

With a strong product offering, at 45p it looks good value.

20 October 2000**smaller company tips****Charterhouse Communications****BUY** at 43½p

. . . Charterhouse has grown steadily, rocketing to a high of 82p a share earlier this year . . . While its price has fallen back to 43½p, the company's acquisition strategy looks set to ensure that it continues to move in the right direction by maximising its resources across a range of products . . . this looks like a good time to buy. [The directors didn't think so.]

16 February 2001

Half year results: Pre-tax profits £0.66m (£0.68m). Price 26p. Long awaited acquisition of HS Publishing failed to halt a collapse in sentiment as the Group will fail to meet expectations for the full year.

[The following week the MD did put a toe in the water, buying 85,000 shares at prices between 22p and 24p, with more directors' purchases further down. The MD caught the bottom two years later, buying 250,000 shares at 1p each.]

12 December 2003

CHARTERHOUSE'S 2002-03 RESULTS would have been a lot worse but for its six mortgage publications (the previous year included an exceptional goodwill amortisation charge of £7.84m).

Reduced marketing of the *Successful Personal Investment* part-work also hit sales.

The company has obviously paid far too much for some of its acquisitions. Let's return to see what it's done to the P & L account and balance sheet:

CHARTERHOUSE 2003 Profit & Loss account

	2003 £000	2002 £000
Turnover	10,235	12,858
Cost of sales	(6,629)	(9,251)
Gross profit	3,606	3,607
Administrative expenses		
Amortisation of goodwill and intangible assets	(885)	(1,144)
Exceptional amortisation	–	(7,840)
Other administrative expenses	(2,580)	(3,550)
	(3,465)	(12,534)
Operating profit/loss	141	(8,927)
...		
(Loss) for the financial year	(410)	(9,322)

Oh dear, the balance sheet has come apart at the seams, and a capital reorganisation scheme has been needed to remove the £6.874m deficit from the profit and loss account in the balance sheet in the next column.

CHARTERHOUSE Extract from 2003 Balance Sheet

	2003 £000	2002 £000
Capital and reserves		
Called up share capital	1,233	1,233
Share premium account	–	6,757
Merger reserve	–	1,650
Special reserve	589	–
Profit and loss account [*]	534	(6,874)
Equity shareholders' funds	2,356	2,766

[* Dividends have to be paid out of earnings, so dividends can't be paid while the profit & loss account remains in the red.]

The finances of Charterhouse are looking precarious, and the Auditors have qualified their report:

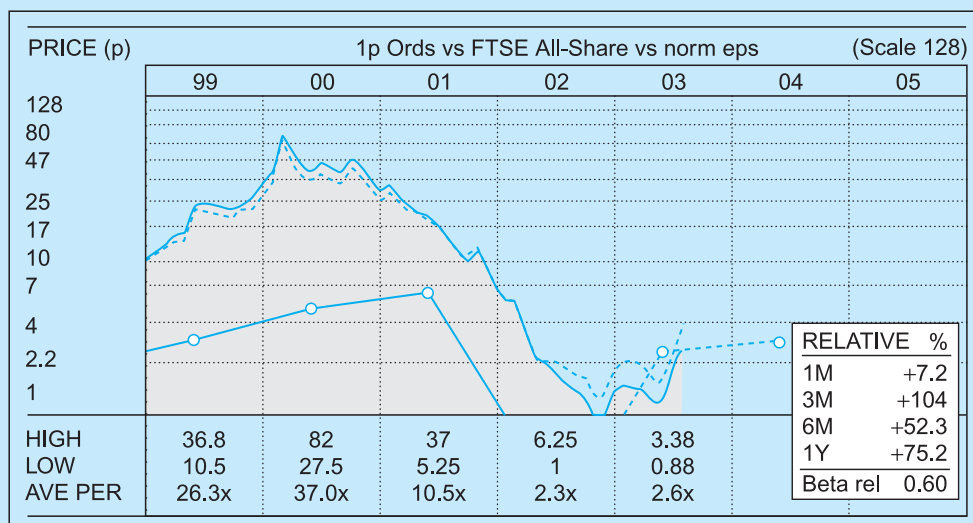
CHARTERHOUSE Auditors' report 2003

Fundamental uncertainty

In forming our opinion we have considered the adequacy of the disclosures made in the financial statements concerning the uncertainty about the future funding of the Group's operations. The financial statements have been prepared on a going concern basis, the validity of which depends upon the continued support of the Group's bank should the Group breach its agreed overdraft facility of £1.6m. . . .

As one might expect, the share price has taken a hammering:

CHARTERHOUSE COMMUNICATIONS



Since then the interim results for the six months ending 30 November 2003 have come out, showing a loss after tax of £270,000, but this includes an amortisation charge of £440,000, which would not have been needed under IAS rules.

A footnote to the P&L account shows:

Retained profit before amortisation **170** (000)

Any other information?

There is one point of particular interest to note from the Chairman's annual statement:

In place of a commitment fee, the bank has asked for and is to be issued with an option to subscribe for 1.23 million shares at 10¹/₂p.

Summary

- Costs have been contained – Other administrative expenses in 2003 were (£2.58m) compared with (£3.55m) in 2002.

- At the interim stage the company was just about holding its own.
- There are some very good publications in the company's portfolio.
- Only an upturn in the stockmarket (or a bid) can improve the situation significantly.
- The bank thinks it's worth having a few options, rather than a commitment commission.

Conclusion

We'd really like to find out more about the management, those two large private shareholders, and what the trade thinks of Charterhouse. We would like to go to the next AGM. (It's almost invariably worth while going to the AGM of a company in which you are interested.)

But if you want a flutter straight away:

2 to 1 you'll make money

After all, the MD's name is Gamble!

This chapter is divided into four sections:

1. Introduction
2. Financial Reporting Standards coming into force:
 - FRS 17 *Retirement benefits*
 - FRS 5 *Reporting the substance of transactions* – Application Note G
 - FRS 20 *Share based payment*
 - FRS 21 *Events after the balance sheet date*.
3. The Accounting Standards Board's work list:
 - Financial instruments
 - Earnings per share
 - Capital instruments.
4. The comprehensive income statement.

Introduction

The Accounting Standards Board (ASB)

Although the ASB has done a great deal to make accounts more informative, and to close loopholes, the overall position of company reporting is less than ideal for two reasons:

1. There are too many rule makers (until everybody is on International Accounting Standards).
2. There is too much corporate governance.

Too many rule makers

In the 1950s and 1960s company accounts only had to comply with the Companies Act 1948 and, for listed companies, the Stock Exchange's Listing Rules as well.

Now we have European Directives as well as company law, the Listing Rules have fallen under the remit of the Financial Services Authority, and we have also had:

- Cadbury on corporate governance;
- Greenbury on directors' remuneration;
- Hampel sweeping up after Cadbury and Greenbury;
- Turnbull on internal control;
- Smith on audit committees;
- Higgs on non-executive directors.

In addition, the Financial Reporting Review Panel has been asked to take a proactive rather than a reactive role in examining company reports and accounts, i.e. the Panel is going to look for needles in haystacks rather than examining needles that have been brought to their attention by interested parties. It will be interesting to see what, if anything, their random searches find.

Company law

In our seventh edition we commented: *Company law is in a mess . . . long overdue for consolidation.*

We are glad to report that the Department of Trade and Industry has now completed a review of company law, and has indicated that new legislation will be enacted during 2004, taking account of the adoption of International Accounting Standards during 2005.

Corporate governance

In the 1950s, the annual report of a major listed company like MARKS & SPENCER consisted of eight 10" × 7" pages, including a page for the Notice of Meeting: see extract from Marks & Spencer's 1950 report and accounts below.

Last year M&S's report and accounts, fairly slender compared with some, included:

- six pages of Corporate Governance report, and
- seven pages of Remuneration report.

A lot of these thirteen pages are what Sir David Tweedie, when he was chairman of the ASB, used to call 'boiler plating' – standard forms of words – you just get the right 'plate' and rivet it on.

The auditor's report, although only one page, is worth mentioning. These days it is keen to point out the responsibility of the directors for preparing the accounts, a reaction to the auditors always being blamed in the past if a company went bust. It also begins: 'Independent auditors' report to the members of Marks and Spencer Group p.l.c.' Independent?

MARKS & SPENCER *Extract from 1950 Report & Accounts*

Directors

Sir Simon Marks, D.Sc., Chairman and Joint Managing Director; **Israel M. Sieff, B.Com.**, Vice-Chairman and Joint Managing Director; **J. Edward Sieff**, Assistant Managing Director; **Harry Sacher, M.A.**; **Norman Laski, M.A.**; **A.E. Lees**; **C.E. Benson, C.B.E., D.S.O.**; **Rt. Hon. L.S. Amery, C.H.**; **W.F. Norris**; **M.D. Sieff**.

Secretary: B.W. Goodman, A.C.A.

Registered Office: Michael House, 82, Baker Street, London, W. 1.

* * * * *

Report of the Directors

The Directors have pleasure in submitting to the Shareholders the annexed Statement of Accounts for the year ended 31st March, 1950.

	1950	1949
	£	£
PROFIT		
The profit before providing for Taxation amounts to which after making provision for Taxation of	4,651,102	4,193,335
	<u>2,530,000</u>	<u>2,350,000</u>
leaves a balance of	2,121,102	1,843,335
to which must be added a transfer from Taxation Provision of	100,000	–
and the amount brought forward from last year of	<u>2,593,874</u>	<u>1,576,689</u>
making a total available for distribution of	<u>£4,814,976</u>	<u>£3,420,024</u>
APPROPRIATIONS		
After making the following appropriations –		
Allocation to Staff Benevolent and Pensions Fund	50,000	50,000
Transfer to Debenture Redemption Reserve	21,900	20,700
The Dividends, less Income Tax, on the –		
10% Cumulative Preference Shares for the year to 31st March, 1950	19,250	19,250
7% Cumulative Preference Shares for the year to 31st December, 1949	38,500	38,500
and an Interim Dividend of 15% on the Ordinary and 'A' Ordinary Shares	178,481	174,425
The Directors recommend the payment of a Final Dividend of 45% less Income Tax on the Ordinary and 'A' Ordinary Shares (payable on the 1st July, 1950) making a total distribution of 60% less Income Tax for the year	535,444	523,275
leaving to be carried forward	<u>3,971,401</u>	<u>2,593,874</u>
	<u>£4,814,976</u>	<u>£3,420,024</u>

Source: Marks & Spencer's Archives

One City analyst summed it up nicely: ‘All the rules on earth won’t stop the Maxwells of this world. All they do is add to the costs of the honest.’

Financial Reporting Standards coming into force

2004

The requirements of Application Note G (to FRS 5 *Reporting the substance of transactions*) on revenue recognition came into force for December 2003 year ends onwards. See Chapter 30.

2005

- FRS 17 *Retirement benefits*
- FRS 20 *Share based payment*
- FRS 21 *Events after the balance sheet date*

Other standards expected to be issued by the ASB and to be in force for December 2005 year ends include:

- Financial instruments
- Earnings per share
- Capital instruments.

FRS 17 *Retirement benefits*

The original implementation date for FRS 17 was put back pending developments on IAS 19 *Employee benefits*. As a result, only a few UK listed companies have fully implemented the standard, which brings the FRS 17 numbers on to the face of the balance sheet, P & L account and statement of total recognised gains and losses (STRGL).

Most companies have continued with SSAP 24, with additional memorandum information required by FRS 17, but all companies will have to implement FRS 17 in full for December 2005 year ends onwards.

FRS 20 *Share based payment*

This standard deals with situations where shares or share options are granted to:

- directors, senior executives and other employees as part of their remuneration package, and
- suppliers, for goods and services.

Unlike UITF 17, there is no exemption for ‘All employees’ and similar plans where all qualifying employees have the opportunity to buy a specified number of shares at a discounted price.

FRS 20 will be mandatory for listed companies for 2005 year ends, and for unlisted companies for 2006 year ends.

FRS 21 *Events after the balance sheet date*

The ASB has issued this revised standard to bring the UK in line with EC Directives and IAS rules.

The Companies Act 1985 will be amended so that companies will not be allowed to include dividends proposed but not yet approved as a liability at the year end.

The Accounting Standards Board’s work list

Financial instruments

Financial instruments can rapidly transform the risk profile of a group in a way that is not apparent under present reporting practices.

For example, a derivative acquired for nil cost (and so not recognised in the balance sheet under historical cost accounting) can be used to convert a dollar floating rate liability into a sterling fixed rate liability.

Where sales are expected to occur next year in a foreign currency, a derivative may be used to ‘hedge’ the risk that the foreign currency may weaken meanwhile. If the foreign currency does weaken, the hedge will have positive value, but if the foreign currency weakens the hedge will have negative value.

In both cases, the value of the derivative can change very significantly, so that it represents a substantial asset or liability by the year end. Under present rules, these gains or losses are often not reported until they are realised.

FRS 13 *Derivatives and other financial instruments* did not deal with the difficult question of how financial instruments should be measured (i.e. historical cost or fair value) or whether hedge accounting should be allowed.

The IASB has issued two standards on financial instruments: IAS 39 on *Recognition and measurement* and IAS 32 on *Disclosure and presentation*.

The ASB proposes to issue a new standard in 2004, effective for 2005 accounts of *listed* companies.

Earnings per share

The ASB is planning to introduce a new standard, based on IAS 33 *Earnings per share*, to replace FRS 14. This is not expected to require any significant change to current UK reporting practice.

Capital instruments

Changes will be made to the Companies Act 1985 to bring the UK into line with EC Directives. One consequence of this is that redeemable preference shares will be reclassified as liabilities. FRS 4 *Capital instruments* will be amended accordingly.

2006

The ASB has announced that it proposes to replace FRS 8 *Related party disclosures* with a standard based on IAS 24 of the same name.

Business combinations

In March 2004, the IASB issued IFRS 3 *Business combinations*, which contains a number of changes to existing practice, including:

- The abolition of merger accounting (apart from mergers that are effectively group reconstructions which will be covered in a later IFRS).
- *A prohibition on the amortisation of goodwill*: Goodwill will remain in the balance sheet at cost, and will be subject to an annual impairment test.
- 'Negative goodwill' will be treated as a gain in the profit and loss account as soon as it is recognised.

Apart from those adopting IAS in 2005, IFRS 3 is not expected to apply to UK companies in the short term.

Leases

The ASB and other standard setters regard present rules as deficient, because they omit material assets and liabilities arising from operating lease contracts.

Furthermore, the ASB believes that the 'all or nothing' approach of SSAP 21 to the capitalisation of leased assets does not adequately reflect the complexity of some modern transactions.

The current thinking of the IASB and other standard setters is that new standards should be developed, removing the distinction between finance and operating leases. All material rights and obligations arising under lease contracts would then be capitalised.

The comprehensive income statement

In December 2000 the ASB issued FRED 22 *Revision of FRS 3, Reporting financial performance*.

FRED 22 proposed replacing the P & L account and the statement of total recognised gains and losses (STRGL) with a single statement, the *comprehensive income statement*.

Subsequently, the IASB gave priority to its project 'Reporting Comprehensive Income', and it was agreed that the IASB proposals should be developed in partnership between the IASB and the ASB.

Main focus

The main focus of the project is the development of a single comprehensive statement of income that would report *all* recognised income and expenses (*irrespective of whether 'realised' or 'unrealised'*).

Format

The latest version of the proposed statement, which is shown in Example 33.1, divides into four main categories:

1. Business
2. Financing
3. Tax
4. Discontinued operations.

The statement also adds a further category for cash flow hedges (IAS 39).

Example 33.1 International Accounting Standards Board *Comprehensive Income Statement*

Illustrative example of proposed format for reporting comprehensive income
(Extract from IASB project summary, September 2003)

	Total	Before remeasurements	Remeasurements	Possible examples*
Revenue	1000	1000	–	
Write-down of accounts receivable	(10)	–	(10)	Bad debt write-off
Cost of sales	(400)	(340)	(60)	Inventory write-down
Selling, general, admin	(250)	(200)	(50)	Increase in provisions
Operating profit	340			
Disposal gain/loss	100	–	100	Sale of fixed assets
PPE revaluation	150	–	150	Fixed asset revaluation
Investment property	–	–	–	Fair value changes
Goodwill	(100)	–	(100)	Goodwill impairment
FX gain/loss on net investment	(50)		(50)	
Other Business Profit	100			
Income from associates	50	50	–	
Equity investments	(60)	–	(60)	Decrease in fair value
Debt investments	20	5	15	Increase in fair value
Pension assets	(150)	–	(150)	
Financial Income	(140)			
Business Profit	300			
Interest on liabilities	(80)	(120)	40	
Pension financing expenses	(120)	(200)	80	
Financing expense	(200)			
Tax	(30)			
Discontinued operations	(10)	(5)	(5)	
Cash flow hedges	50		50	
Comprehensive Income	110			

* Added to original IASB illustration for purposes of explanation.

Remeasurements

An important feature of the IASB project's proposed format are the three columns:

1. Total
2. Before remeasurements
3. Remeasurements.

[We'd prefer to see the Total column to the right of the Remeasurements column.]

Remeasurements are defined as revisions of prices or estimates that change the carrying value of assets and liabilities; e.g. Fixed asset revaluations; Impairment of tangible fixed assets; Pension actuarial gain and losses; Fair value changes in financial instruments; Impairment of goodwill.

[The proposal encourages subjective judgement, which isn't usually a good thing.]

Appendices

Appendix 1 – Current Financial Reporting Standards and Exposure Drafts

The following Standards, UITF Abstracts and Exposure Drafts were current on 30 September 2004:

Standards		<i>Date of Issue</i>			
ASB	Foreword to accounting standards	Jun 1993	FRS 13	Derivatives and other financial instruments	Sep 1998
FRS 1	Cash flow statements (revised Oct 1996)	Sep 1991	FRS 14	Earnings per share	Oct 1998
FRS 2	Accounting for subsidiary undertakings	Jul 1992	FRS 15	Tangible fixed assets	Feb 1999
FRS 3	Reporting financial performance (amended Jun 1993 regarding insurance companies)	Oct 1992	FRS 16	Current tax	Dec 1999
FRS 4	Capital instruments	Dec 1993	FRS 17	Retirement benefits	Dec 2000
FRS 5	Reporting the substance of transactions (amended re insurance broking transactions Dec 1994 and regarding private finance initiative and similar contracts Sep 1998)	Apr 1994	FRS 18	Accounting policies	Dec 2000
FRS 6	Acquisitions and mergers (amended Nov 1997 and Dec 1998)	Sep 1994	FRS 19	Deferred tax	Dec 2000
FRS 7	Fair values in acquisition accounting	Sep 1994	FRS 20	Share based payment	Apr 2004
FRS 8	Related party disclosures	Oct 1995	FRS 21	Events after the balance sheet date	May 2004
FRS 9	Associates and joint ventures	Nov 1997	FRSSE	Financial reporting standard for smaller entities	Dec 2001
FRS 10	Goodwill and intangible assets	Dec 1997	Urgent Issues Task Force (UITF)		
FRS 11	Impairment of fixed assets and goodwill	Jul 1998	ASB	Foreword to UITF Abstracts	Feb 1994
FRS 12	Provisions, contingent liabilities and contingent assets	Sep 1998	<i>Abstract</i>		
			<i>No.:</i>		
			4	Presentation of long-term debtors in current assets	Jul 1992
			5	Transfers from current assets to fixed assets	Jul 1992
			7	True and fair view override disclosures	Dec 1992
			9	Accounting for operations in hyper-inflationary economies	Jun 1993
			10	Disclosure of directors' share options	Sep 1994
			11	Capital instruments: issuer call options	Sep 1994
			14	Disclosure of changes in accounting policy	Nov 1995
			15	Disclosure of substantial acquisitions (revised Feb 1999)	Jan 1996
			17	Employee share schemes (revised Dec 2003)	May 1997

19	Tax on gains and losses that hedge an investment in a foreign enterprise	Feb 1998	FRED 29	Property, plant and equipment	May 2002
21	Accounting issues arising from the proposed introduction of the euro	Mar 1998	FRED 30	Financial Instruments: Disclosures and presentation; Recognition and measurement	Jun 2002
22	Accounting for acquisition of a Lloyd's business	Jun 1998	FRED 32	Disposal of non-current assets and presentation of discontinued operations	Jul 2003
23	Application of the transitional rules in FRS 15	May 2000	FRED 33	Financial instruments: disclosure	Jul 2004
24	Accounting for start-up costs	Jun 2000	FRED 34	Life assurance	Jul 2004
25	National Insurance contributions on share option gains	Jul 2000	Discussion Papers		
26	Barter transactions for advertising	Nov 2000	Leases – implementation of a new approach		Dec 1999
27	Revisions to estimates of the useful economic life of goodwill and intangible assets	Dec 2000	Revenue recognition		Jul 2001
28	Operating lease incentives	Feb 2001	Non-mandatory statements		
29	Website development costs	Feb 2001	Interim reports		Sep 1997
30	Date of award to employees of shares or rights to shares	Mar 2001	Preliminary announcements		Jul 1998
31	Exchanges of businesses or other non-monetary assets for an interest in a subsidiary, joint venture or associate	Oct 2001	Operating and financial review		Jan 2003
32	Employee benefit trusts and other intermediate payment arrangements	Dec 2001	ASB Statement of Principles		
33	Obligations in capital instruments	Feb 2002	Statement of principles for financial reporting		Dec 1999
34	Pre-contract costs	May 2002	Accounting Standards Committee		
35	Death in service and incapacity benefits	May 2002	The following standards issued by the ASC continue in force:		
36	Contracts for sales of capacity	Mar 2003	SSAP 4	Accounting for government grants (revised Jul 1990)	Apr 1974
37	Purchases and sales of own shares	Oct 2003	SSAP 5	Accounting for value added tax	Apr 1974
38	Accounting for ESOP trusts	Dec 2003	SSAP 9	Stocks and long-term contracts (Part 6 added Aug 1980, revised Sep 1988)	May 1975
Exposure Drafts			SSAP 13	Accounting for research and development (revised Jan 1989)	Dec 1977
FRED 22	Revision of FRS 3, Reporting financial performance	Dec 2000	SSAP 17	Accounting for post balance sheet events (superseded by FRS 21 for Dec 2005 year ends onwards)	Aug 1980
FRED 23	Financial instruments: Hedge accounting	May 2002	SSAP 19	Accounting for investment properties (amended Jul 1994)	Nov 1981
FRED 24	The effects of foreign exchange rates; Financial reporting in hyperinflationary economies	May 2002	SSAP 20	Foreign currency translation	Apr 1983
FRED 25	Related party disclosures	May 2002	SSAP 21	Accounting for leases and hire purchase contracts (amended Feb 1997)	Aug 1984
FRED 26	Earnings per share	May 2002	SSAP 25	Segmental reporting	Jun 1990
FRED 28	Inventories; Construction and service contracts	May 2002			

Appendix 2 – Present value

£1 received in a year's time is worth less than £1 received today, because £1 available today could be invested to earn interest for the next 12 months. If £1 now could be invested at a rate of interest i (expressed as a decimal), it would be worth $£(1 + i)$ in a year's time. If the $£(1 + i)$ at the end of the year was left invested, it would be worth $£(1 + i) \times (1 + i) = £(1 + i)^2$ at the end of the second year, and $£(1 + i)^3$ at the end of the third year, and so on; i.e. it would earn compound interest at the rate of i per annum.

Present value is like compound interest in reverse: the value of £1 received in a year's time is worth $£1 \div (1 + i)$ now, and £1 in two years' time is worth $£1 \div (1 + i)^2$ now, and so on. For example, if i (known as the discount rate) is 10% p.a., then the present value of £1 received in a year's time is $£1 \div (1 + 0.10) = £0.9091$. Similarly the present value of receiving £1 in two years' time is:

$$£1 \div (1 + 0.10)^2 = £0.8264$$

and £1 in three years' time is:

$$£1 \div (1.10)^3 = £0.7513,$$

and £1 in n years' time is $£1 \div (1.10)^n$.

Tables of *present values* are available for various rates of interest and periods of years. The table below is a very simplified and abbreviated version.

Present value tables refer to the value of 1, rather than the value of £1, because they can be used for any currency: the 1 may be \$1, €1 or 1 of any other currency you care to name.

The present value concept (which is also the basis of discounted cash flow, DCF) can be applied to any streams

of future income and to repayments of capital. For example, £20 nominal of 5% loan stock redeemable in three years would be worth the interest payments of £1 at the end of each year plus the £20 in three years' time, all discounted at 10% per annum, to give a present value of:

$$\begin{aligned} & \frac{£1}{(1.1)^1} + \frac{£1}{(1.1)^2} + \frac{£1}{(1.1)^3} + \frac{£20}{(1.1)^3} \\ & = £(0.909 + 0.826 + 0.751 + 15.026) = £17.512 \end{aligned}$$

The calculation of the present value of a steady stream of income can be assisted by the use of annuity tables, an annuity of 1 for n years simply being an annual payment of 1 for n years; such a table is set out below.

In our previous example, the present value of £1 per annum for three years, discounted at 10%, could have been obtained from the annuity table: three years at 10% = 2.487.

In practice, interest on fixed-interest securities is usually paid half-yearly in arrears (i.e. at the end of each half-year), and so the half-yearly discount rate, which is the square root $(1 + i)$, is used to discount each half-yearly interest payment. For example, £100 of 5% Loan Stock with three years to redemption, discounted at 10% per annum, would have a present value of:

$$\begin{aligned} & \frac{250}{(\sqrt{1.10})} + \frac{250}{(\sqrt{1.10})^2} + \dots + \frac{250}{(\sqrt{1.10})^6} + \frac{10}{(1.10)^3} \\ & = 2.3837 + 2.2728 + \dots + 1.8784 + 75.1315 \\ & = £87.8734. \end{aligned}$$

Annuity table: present value of 1 in n years' time

n	1%	2%	3%	4%	5%	10%	15%
1	0.990	0.980	0.971	0.962	0.952	0.909	0.870
2	0.980	0.961	0.943	0.925	0.907	0.826	0.756
3	0.971	0.942	0.915	0.889	0.864	0.751	0.658
4	0.961	0.924	0.889	0.855	0.822	0.683	0.572
5	0.951	0.906	0.863	0.822	0.784	0.621	0.497
10	0.905	0.820	0.744	0.676	0.614	0.386	0.247
20	0.820	0.673	0.554	0.456	0.377	0.149	0.061

Annuity table: present value of an annuity of 1 for n years*Rate of interest (the discount rate)*

n	1%	2%	3%	4%	5%	10%	15%
1	0.990	0.980	0.971	0.962	0.952	0.909	0.870
2	1.970	1.942	1.913	1.886	1.860	1.736	1.626
3	2.941	2.884	2.829	2.775	2.723	2.487	2.283
4	3.902	3.808	3.717	3.630	3.546	3.170	2.855
5	4.853	4.713	4.580	4.452	4.329	3.791	3.352
10	9.471	8.983	8.530	8.111	7.722	6.145	5.019
15	13.865	12.849	11.938	11.118	10.380	7.606	5.847

Appendix 4 – Problems and solutions

Problem 1.1

Elcho (Mosssdale) Ltd is a small company manufacturing a simple safety device. Chairman and managing director, Mr Charles Farnesbarn, is offered a two-year contract by JQB, a do-it-yourself chain, which would double the current production and turnover of the company. It would be necessary to acquire additional plant and machinery costing £60,000. To do this, Farnesbarn seeks overdraft facilities from the company’s bankers. Currently, the company has an overdraft limit of £50,000 and Farnesbarn is seeking to increase this to £110,000.

Profit after tax to turnover is running at 2.6%, so Farnesbarn is looking for profits to increase by, perhaps, £25,000 per annum. He presents his bank manager with accounts for the last trading year – see alongside. Although such facilities would earn the bank 3% or 4% over base rate on the amount outstanding, the bank manager is of a mind to reject Farnesbarn’s request. Suggest three reasons why that might be so.

For solutions to problems, see below, pages 288–300.

Problem 2.1

State the four fundamental accounting concepts previously referred to in SSAP 2, and indicate how their status has changed under FRS 18.

Problem 3.1

How would you tell whether a company was (a) a public or (b) a private limited company; or (c) was one limited by guarantee; or (d) was an unlimited company?

Problem 4.1

From an investor’s point of view, what are the advantages and disadvantages of a quote driven market, compared with an order driven market?

Problem 5.1

Q is the wholly owned subsidiary of X Group, a listed company. Q’s share capital includes 100m £1 3.5%

ELCHO (MOSSDALE) LTD

Profit and loss account for last year

	£	£
Turnover		600,000
Cost of sales (including depreciation £10,000)		<u>460,000</u>
Gross profit		140,000
Distribution costs:		
Depreciation of motor vehicles	5,000	
Petrol, insurance and maintenance		<u>11,900</u>
		16,900
Administrative expenses:	£	
Rent and rates	43,300	
Wages	50,000	
Insurance	2,500	
Printing etc.	1,450	
Legal expenses etc.	<u>1,300</u>	
		<u>98,550</u>
		<u>115,450</u>
Trading or operating profit		24,550
Interest payable		<u>2,000</u>
Pre-tax profit on ordinary activities		22,550
Corporation tax		<u>6,765</u>
Net profit after tax		<u>15,785</u>

Balance sheet at end of last year

<i>Fixed assets</i>		
Plant and machinery	40,000	
Motor vehicles	<u>20,000</u>	
		60,000
<i>Current assets</i>		
Stock (raw materials, work in progress and finished goods)	100,000	
Debtors	65,000	
Cash	<u>650</u>	
		165,650
<i>Less: Current liabilities:</i>		
Trade creditors	45,000	
Corporation tax	6,765	
Overdraft	<u>41,385</u>	
		<u>93,150</u>
		72,500
Net assets		<u>132,500</u>
<i>Ordinary share capital</i>		100,000
<i>Reserves:</i>		
Profit and loss account:		
Balance b/f	16,715	
Profit for the year retained	<u>15,785</u>	
		<u>32,500</u>
Ordinary shareholders’ funds		<u>132,500</u>

cumulative preference shares. You hold 10,000 £1 cumulative preference shares. Is X bound to pay the dividend on your shares?

Problem 6.1

Grouch Group is seeking to dispose of one of its less profitable subsidiaries to management (as a management buy-out). The asking price is £10m. The management team plans to form a company, Hopeful plc, and is prepared to invest £2m in the form of ordinary share capital; and a venture capital company has offered to put up either (i) £8m as a medium-term loan at 10% fixed; or (ii) £6m as a medium-term loan at 9% fixed and £2m in the form of ordinary share capital.

A business plan suggests that Hopeful will produce profits before interest of from £750,000 to £1,400,000. Ignoring tax, (a) calculate the profits available to management on their investment under scenarios (i) and (ii) for the range of profits projected; (b) depict this in a chart; (c) calculate the return earned (i) by management and (ii) by the venture capital company on the same bases.

Problem 7.1

This refers to ML Laboratories (see example on page 50). By changing its policy on R & D from capitalisation and amortisation to immediate write-off, ML increased a loss of £0.72m in 1998 into one of £8.44m, and restated 1997 as a £4.55m loss rather than a £0.68m profit.

Immediate write-off is undoubtedly more prudent, but do you think it gives a more realistic view of a company's performance? ML's share price doubled in 12 months after two years of apparently heavy losses. What can the private shareholder do to understand why?

Problem 8.1

Fleetwood has a fleet of 20 identical Ajax 1.6 litre motor cars purchased as follows:

1 January 1998	5 at	£10,000
1 January 1999	5 at	£11,000
1 January 2000	5 at	£12,000
1 January 2001	5 at	£12,500

Useful economic life is four years at the end of which sales proceeds are expected to be 40% of cost. These are the only motor vehicles.

Show the balance sheet item 'Motor vehicles' and its make-up as at 31 December 2001.

Problem 9.1

Companies hold fixed asset investments for a variety of reasons.

- Suggest five possible reasons; and
- Explain why it is important for the reader of accounts to have as clear an idea as possible of the reasons for any significant holding.

Problem 10.1

You are given the following extract from a group's accounts:

15. Stocks		
	2002	2001
	£m	£m
Raw materials and consumables	0.1	0.2
Finished goods and goods for resale	28.2	26.0
Residential developments		
Land	1,004.5	835.6
Development and construction costs	507.8	419.6
Commercial, industrial and mixed development properties	<u>166.4</u>	<u>160.0</u>
	<u>1,707.0</u>	<u>1,441.4</u>

- Provide a brief description of the group.
- What do the figures suggest? Where would you look for confirmation (or otherwise) of your hypothesis?
- Imagine that Land included an estate which cost £56m, which, six months later, the group no longer plans to develop, but which it proposes to hold as a fixed asset investment. Suitably sized parcels of the estate will be offered to other developers subject to long leases. The estate is included above at cost; but its realisable value is now estimated to be only £40m. How should the proposed change be handled in next year's accounts; and why?

Problem 11.1

THE BODY SHOP		
	2001	2000
	£m	£m
Turnover	374.1	330.1
Trade debtors	30.3	30.3

Use this fact together with the information on page 81 to calculate, for each year:

- (i) the collection period in months;
- (ii) the ratio Trade debtors/Sales as a percentage.

Comment briefly.

Problem 12.1

Companies hold current asset investments for a variety of reasons. You are asked: (a) to suggest five possible reasons; and (b) to explain why it is important for the reader of accounts to have a clear idea of the reasons for any significant holding.

Problem 13.1

Consider the example of BRUNEL HOLDINGS below.

Note A shows ‘Net cash outflow from operating activities (465)’. Note B, the reconciliation of net cash flow, starts with the bottom line of the cash flow statement: ‘Increase in cash 18,117’, and ends with ‘Net debt (8,027)’.

The change in net debt from (26,310), the closing figure in 1997, to (8,027) is then analysed in Note C, which shows a reduction in overdraft of more than £20m.

Apart from finance leases, there was no new financing during the year.

1. What was the net change in finance leases in 1998?
2. What was the figure for bills of exchange discounted in the 1996 and 1997 balance sheet? – see note on Brunel’s creditors on page 96.

BRUNEL HOLDINGS Notes to the 1990 group cash flow statement

A. Reconciliation of operating profit to net cash (outflow)/inflow from operating activities

...

B. Reconciliation of net cash flow to movement in net debt

	1998	1997
	£000	£000
Increase in cash in period	18,117	2,208
Reduction in lease finance	372	767
Increase in bills of exchange discounted	<u>(1,193)</u>	<u>(613)</u>
Change in net debt from cash flows	17,296	2,362
Finance leases disposed of with subsidiaries	1,454	1,079
New finance leases	(465)	(972)
Translation difference	<u>(2)</u>	<u>(5)</u>
Movement in net debt in period	18,283	2,464
Net debt at 1 July	<u>(26,310)</u>	<u>(28,774)</u>
Net debt at 30 June	<u>(8,027)</u>	<u>(26,310)</u>

C. Analysis of net debt

...

Problem 14.1

Just before Christmas, a fund manager decides that he would like to purchase £10m of UK stocks, but the funds will not be available until February.

The FT-SE 100 Index stands at 4,000 at the end of December and he is looking for it to rise 5% over the next month. The fund manager wants to limit the price he has to pay in the future to a value of 4,100.

The fund manager decides to purchase 250 (£10m ÷ (4,000 × (£10))) March 4,000 calls for 100. Each contract represents £10 per index point movement.

1. What is his initial outlay?
2. What is the maximum amount risked by the manager?
3. If on 15 February it becomes clear that the £10m will not after all be available but the market has risen to 4,155, what can the investment manager do?

Problem 15.1

- (a) Distinguish clearly between:
- an accrual and a provision;
 - income in advance and a deposit;
 - a commitment and a contingent liability.
- (b) Provide examples of each.
- (c) Explain the significance of each to an analyst seeking:
- to estimate a group's future cash flows/liquidity;
 - to consider its viability in the medium term.

Problem 16.1

Study note 3 to the accounts of QUEENSBOROUGH for the year 1998, reproduced below and in the next column.

- (a) Compute as a percentage the year-on-year change overall and for each segment of QUEENSBOROUGH's turnover, profit before tax and capital employed.
- (b) Using vertical analysis, compare segmentally that company's turnover, profit before tax and net assets in 1997 and 1998.

Net assets by class of business

	1998	1997
	£000	£000
Day visitor attractions – UK	12,122	11,206
Caravan parks – UK	27,366	25,407
Caravan parks – France	5,985	1,844
Hotel – UK	10,290	10,258
Restaurants – UK	<u>817</u>	<u>—</u>
Net operating assets	56,580	48,715
Unallocated net assets/(liabilities)		
Fixed asset investments	33	144
Head office fixed assets	90	78
Head office debtors	1,241	404
Head office creditors	(1,816)	(855)
Cash and deposits	579	697
Borrowings	<u>(24,557)</u>	<u>(22,335)</u>
Net assets	<u>32,150</u>	<u>26,848</u>

Included in the figures are the following amounts in respect of acquisitions during the financial year:

	£000	£000
	Turnover	Profit/(loss) before tax
Caravan parks – UK	764	268
Caravan parks – France	679	48
Restaurants – UK	<u>79</u>	<u>(174)</u>
Total since date of acquisitions	<u>1,514</u>	<u>142</u>

QUEENSBOROUGH Extracts from the accounts for the year ended 31 January 1998

3. Segmental analysis by class of business

The analysis by class of business of the group's turnover, profit before taxation and net assets is set out below.

The group's turnover and profit before taxation principally arise in the United Kingdom. All sales are external and turnover by geographical destination is not materially different to turnover by origin.

Class of business	1998	1997	1998	1997
	£000	£000	£000	£000
	Turnover	Turnover	Profit before taxation	Profit before taxation
Day visitor attractions – UK	8,071	7,524	1,748	1,761
Caravan parks – UK	20,997	16,393	3,403	2,460
Caravan parks – France	1,358	616	38	101
Hotel – UK	6,073	5,795	1,510	1,304
Restaurants – UK	<u>71</u>	<u>—</u>	<u>(174)</u>	<u>—</u>
	<u>36,570</u>	<u>30,328</u>	6,525	5,626
Associated undertaking			—	15
Net interest payable			(2,138)	(1,792)
Central costs			(792)	(626)
Profit on sale of surplus properties			<u>—</u>	<u>363</u>
Profit before taxation			<u>3,595</u>	<u>3,586</u>

- (c) Use the information provided to produce a brief summary describing the company’s activities, and the changes which occurred in 1998.
- (d) Compute the return on the net assets employed for 1997 and 1998. To what extent do you consider this company’s ROCE to be a valid indicator of its progress?

Problem 17.1

Examining the report and accounts of a group, you find that the effective rate of tax (i.e. taxation as a percentage of pre-tax profits) is:

- (a) much less, or
- (b) much greater,

than the normal rate of UK corporation tax.

Suggest in each case why this might be so. Where would you look for further information? Why is this important?

Problem 18.1

The basic earnings per share of a listed company, PG, in 2001 are stated to be 71.4p.

1. How would you expect this figure to have been calculated?
2. How might you use the figure of earnings per share, i.e. with what might you compare it?
3. What other types of e.p.s. are likely to be found in published accounts, and why?

Problem 19.1

Given these extracts from the 1995 accounts of CORDIANT, explain in simple terms why the cash generated by operations was so much less in 1995 than in 1994:

Consolidated statement of cash flows:			
Year ended		31 Dec 1995	31 Dec 1994
	Note	£m	£m
Net cash inflow from operating activities	16	16.6	58.9

Note 16

16. Reconciliation of operating profit to net cash inflow from operating activities

	Year ended 31 Dec 1995	Year ended 31 Dec 1994
	£m	£m
Operating profit	28.3	44.5
Depreciation	25.7	25.7
(Profit) loss on sale of tangible fixed assets	(1.5)	0.2
Increase in work in progress	(9.4)	(8.0)
Increase in debtors	(54.8)	(77.8)
Increase in creditors	38.6	86.1
Utilisation of property provisions	(10.3)	(11.8)
Net cash inflow from operating activities	<u>16.6</u>	<u>58.9</u>

Problem 20.1

Throughout 2001, the Bear Bones Group had three subsidiaries:

- Brown Bear, a 75% owned Canadian company;
- Bear Huggs, a Scottish company 50% owned by Bear Bones which is in a position to direct the financial and operating policies of Bear Huggs;
- Bear Pitts, a wholly owned subsidiary company registered in England.

No shares other than ordinary shares were in issue.

1. Explain clearly what the components of the Sales figure in the group accounts will be.
2. The group profit and loss account shows an operating profit of £13.456m. What proportion of Bear Huggs’ operating profit will this include?
3. In the note on the group profit and loss account item Taxation appears ‘Foreign Tax £0.123’. What will this represent?
4. In the group profit and loss account is deducted ‘Minority interests £0.321m’. Explain what the figure represents.
5. Bear Huggs proposed dividends of £3m in 2001. How much of this will appear under the heading ‘Dividends proposed’ in the group profit and loss account?
6. In the balance sheet appears, ‘Minority interests £34,190,000’. What does that represent?

Problem 21.1

You are provided with this extract from the 1996 accounts of GIBBON GROUP.

Consolidated profit and loss account for the year ended 31 March 1996

	<i>Continuing operations</i>	<i>Acqui- sitions</i>	<i>Total</i>	
	1996	1996	1996	1995
	£000	£000	£000	£000
Turnover	28,612	381	28,993	27,447
Cost of sales	(18,137)	(206)	(18,343)	(16,676)
Gross profit	10,475	175	10,650	10,771
Distribution costs	(3,839)	(12)	(3,851)	(4,090)
Administrative expenses	(4,006)	(99)	(4,105)	(4,281)
	2,630	64	2,694	2,400
Other operating income	91	—	91	102
Operating profit	2,721	64	2,785	2,502

During the year the group purchased two subsidiaries, the assets and liabilities of which were (in total) as follows:

	<i>Book value</i>	<i>Fair value</i>
	£000	£000
Fixed assets	382	258
Stocks	295	255
Debtors	272	272
Cash at bank and in hand	153	153
Creditors	(911)	(911)
	191	27

The purchase consideration was satisfied by:

	£000
Cash	767
Issue of shares (10p ordinary shares with a nominal value of £22,000)	400
Deferred consideration – cash	251
Deferred consideration – shares to be issued	150
	<u>1,568</u>

The subsidiaries acquired had £153,000 in the bank. The share issues met the conditions in Sections 131–134 of the Companies Act 1985.

1. Did the transactions represent acquisitions or mergers in the terms of FRS 6?
2. Compute the goodwill which arose during the year.
3. What net outflow would appear in the group cash flow statement under the heading Purchase of subsidiaries?
4. What amount would be credited in respect of these transactions:

- (a) to share premium account;
- (b) to merger reserve?

5. You are asked whether the ‘acquisitions’ were successful. What important information, which the group was required to give, and in fact did, is not provided above but would be necessary to assess the companies’ profitability?

Problem 22.1

Given the extract from Note 18 to the 1998 accounts of TAY HOMES, reproduced opposite, explain:

1. Why the group item ‘Investments in subsidiary undertakings’ is zero, when that for the company is £314,000 in both 1997 and 1998.
2. What a quasi-subsiary is and the difference in treatment between Taygate Showhomes Ltd and Britannia New Homes (Scotland) Ltd.
3. Why the company item ‘Investments in associated undertaking’ is zero in both years.
4. What ‘Deficiency in net assets of associated undertaking’ represents and the significance of the increase between 1997 and 1998.
5. What the ‘Loan to associated undertaking’ represents.

Does this raise questions in your mind?

Problem 23.1

Pie in the Sky plc is a UK listed company. Its accounting policies include:

Exchange rates

Exchange rates used to translate overseas profits and currency assets and liabilities (other than shares held by the parent company in overseas companies) are the rates ruling at the balance sheet date.

TAY HOMES Extract from note 18 to the 1998 accounts

	Group		Company	
	1998 £000	1997 £000	1998 £000	1997 £000
18. Fixed Asset Investments				
Investments in subsidiary undertakings:				
Shareholdings at cost	—	—	314	314
Loans to subsidiary undertakings	—	—	40	40
	—	—	354	354
Investments in unlisted companies:				
Shareholdings at cost (see . . .)	54	54	4	4
	54	54	358	358
Investments in associated undertaking:				
Loan to associated undertaking	2,332	2,096	—	—
Deficiency in net assets of associated undertaking	(272)	(181)	—	—
	2,060	1,915	—	—
	2,114	1,969	358	358

The Company has the following Ordinary share investments in subsidiary undertakings, all of which are included within the consolidated accounts using the acquisition method of accounting: . . . Tay Homes (Scotland) Ltd (registered in Scotland) (Residential, Estate Developers and Builders) . . . ; Taygate Showhomes Ltd (50% owned quasi-subsidiary) (Showhouse Licensing) . . . The directors consider that the Group participates substantially in the benefits and risks associated with Taygate Showhomes Ltd and hence the undertaking should be regarded as a quasi-subsidiary . . .

The Group has the following joint venture associated undertaking which is 50% owned by Tay Homes (Scotland) Ltd: Britannia New Homes (Scotland) Ltd. (registered in Scotland) (Residential Estate Development).

Currency gains and losses

Currency gains and losses are included in operating profit or investment income as appropriate except that the difference arising on the retranslation of the group's share, at the beginning of the year, of the net assets of overseas subsidiaries, associated companies and branches is treated as a movement in reserves.

In fact it has just one subsidiary, and no associated companies or branches. That subsidiary is Beyond (1994), a wholly owned subsidiary operating in a remote island group, the Beyond Islands, the currency of which is the Bac.

The Beyond Islands are largely undiscovered as a tourist destination and Beyond (1994) trades entirely within the islands. Pie in the Sky plc invested 10m Bacs in ordinary shares in Beyond (1994) at the time of its formation on 1 January 1994. No dividends have been paid; and no cash has been remitted in either direction.

The Bac is a somewhat unstable currency. Rates of exchange have been:

1 January 1994	1.00 Bac = £1.
31 December 1998	2.00 Bacs = £1.
31 December 1999	2.40 Bacs = £1.
31 December 2000	3.00 Bacs = £1.

You are provided with the balance sheet for Beyond (1994) as at 31 December 2000 shown overleaf.

1. What amount would be included in Pie in the Sky's group accounts to represent the contribution to group profit of Beyond (1994) (a) in 1999; and (b) in 2000?
2. What currency translation difference would appear in the statement of total gains and losses of the group for 2000, and what would be the comparative figure in respect of 1999?

Ignore taxation.

BEYOND (1994) Balance sheet as at 31 December 2000

	Note	2000 Bacs m	1999 Bacs m
<i>Fixed assets</i>			
Freehold land and buildings		6.0	6.0
Plant and machinery, fixtures and fittings		<u>12.0</u>	<u>10.0</u>
		<u>18.0</u>	<u>16.0</u>
<i>Current assets</i>			
Stocks		13.5	11.1
Debtors		23.3	21.0
Cash at Bank		<u>11.0</u>	<u>0.7</u>
		47.8	32.8
<i>Less: Current liabilities:</i>			
Creditors: due within 1 year		<u>15.0</u>	<u>11.0</u>
Net current assets		<u>32.8</u>	<u>22.8</u>
Net assets		<u>50.8</u>	<u>38.8</u>
Ordinary share capital		10.0	10.0
<i>Reserves:</i>			
Profit and loss account	1	<u>40.8</u>	<u>28.8</u>
		<u>50.8</u>	<u>38.8</u>
NOTE 1:			
Profit and loss account:			
Balance at 1 January		28.8	21.6
Profit for the year		<u>12.0</u>	<u>7.2</u>
Balance at 31 December		<u>40.8</u>	<u>28.8</u>

Problem 24.1

Given the extracts below from the five-year summary of a group, provide a short commentary.

Extracts from 5-year summary

	1996 £m	1995 £m	1994 £m	1993 £m	1992 £m
Turnover	1,083.6	1,079.1	1,045.5	1,139.3	1,179.8
Profit from retail operations	102.0	87.2	65.2	43.0	10.0
Exceptional items	1.2	—	(6.4)	(31.4)	—
Profit for the financial year	74.6	61.6	38.9	0.4	10.8
Earnings per share	17.8p	14.8p	9.4p	0.1p	2.6p
Dividend per share	7.2p	6.3p	5.5p	5.0p	5.0p
Total net assets	532.0	484.2	447.3	423.9	438.3
Number of stores	435	433	431	425	736
Net selling space (000 sq ft)	5,268	5,005	4,815	4,704	6,452

Problem 25.1

A company which is the holding company of a group involved in a diverse range of activities from computer services to foundries, and door manufacture to motor dealerships, reported in 1995 as a result of Cadbury:

Corporate governance

...

Formal procedures in respect of matters reserved to the Board and authorisation levels have been established during the year. Guidelines for Directors' access to independent professional advice, and for the appointment of non-executive Directors have not yet been formalised.

What purpose is served by such a statement?

Problem 26.1

1. What do you understand by 'a going concern'?
2. What responsibilities do
 - (a) directors
 - (b) auditors
 have in relation to this?
3. Why does it matter to investors?

Problem 27.1

Given the extract opposite from Note 10 to the 2003/04 interim statement of DIXONS GROUP, compute (a) the operating profit and (b) net cash (outflow)/inflow from operating activities for the 24 weeks to 3 May 2003. Comment on what you find.

DIXONS Note to the Interim Statement 2003/04**10. Reconciliation of operating profit to net cash inflow (outflow) from operating activities**

	28 weeks to 15 Nov 2003 £million	28 weeks to 9 Nov 2002 £million	52 weeks to 3 May 2003 £million
Operating profit	102.4	89.4	278.4
Depreciation	64.9	60.5	118.2
Amortisation of goodwill and own shares	2.4	2.4	4.2
Share of profit of associated undertaking	–	(2.0)	(2.0)
Profit on disposal of fixed assets	(7.7)	(6.3)	(9.8)
Net (utilization of)/additions to provisions and impairment	(6.4)	(1.1)	9.2
(Increase)/decrease in stocks	(335.6)	(230.8)	(25.1)
(Increase)/decrease in debtors	(12.3)	(20.5)	17.9
Increase/(decrease) in creditors	<u>320.2</u>	<u>104.7</u>	<u>(50.6)</u>
	<u>127.9</u>	<u>(3.7)</u>	<u>340.4</u>

Problem 28.1

Share prices are used by investors and analysts for a variety of purposes.

1. Name four widely used ratios based on the market price(s) of equity shares.
2. Suggest four other ways in which an investor or analyst might use the price history of a share.
3. Explain four ways of obtaining share prices and suggest the advantages of each.

Problem 31.1

Where a company is listed both in the UK and in the US, why might the note explaining differences in GAAP between the two countries be of interest:

- (a) to an analyst;
- (b) to a US investor;
- (c) to a student of accounting theory?

Solution 1.1 Elcho (Mosssdale)

Three reasons why the bank might reject Farnesbarn's request:

1. An extra £60,000 is not enough.

The bank manager is likely to say to himself: 'They are asking for £60,000. Let us see how much they really need.'

	£	£
A. New machine		60,000
B. Current overdraft limit	50,000	
Overdraft at balance sheet date	48,150	
This must bring difficulties; to be safe, they really need another, say,		10,000
C. Working capital:		
Additional raw material stock, say,	5,000	
Finished goods, say	12,000	
Debtors, say 2 months	<u>100,000</u>	
	117,000	
Less: Additional creditors, say,	<u>40,000</u>	
That looks like		<u>77,000</u>
A total of		<u>£147,000</u>

These figures certainly won't be accurate, but one thing one can say for certain is that £60,000 is not enough.

Trawling for information (and watching carefully his customer's reaction), the bank manager might well ask:

- How is the present limit working?
- What are delivery arrangements . . . are you going to be holding much stock for them?
- What about payment terms? How long credit have they asked for?

On the other hand, he might simply say to himself: 'Either they haven't done their homework; or they know full well that they need more and they plan to break the news as a nasty shock later.'

Neither scenario is likely to commend the proposition to him.

2. Farnesbarn's profit estimate seems to be based on simplistic logic:

'On turnover of £600,000 per annum we make £15,785 after tax', he seems to suggest. 'If we double sales we should make twice that.'

But that ignores:

- (i) the price to be paid by JQB (which is likely to be less (possibly much less) than that paid by smaller customers for the same items). If the price paid is substantially less than other people pay, sales *volume* (hence the total material and labour costs) is going to be more than double with a doubling of turnover;
- (ii) the cost structure of the business, i.e. the variability of cost (see Chapter 10); hence:
- (iii) the profit margin (or profit) likely to be achieved (almost certainly different from that on existing business);
- (iv) the additional interest which would be payable at 15%.

Either (i) Farnesbarn has not got the necessary information; or (ii) he does not see its significance; or (iii) both.

And that certainly will not have impressed the bank.

3. JQB:

- Undue dependence on one customer is risky. There is no sign that Farnesbarn recognises this.
- Has Farnesbarn investigated JQB?
He does not say so; but he would earn a black mark if he had not.
- The bank will almost certainly know more (or be in a position to find out more) about JQB's credit standing than Farnesbarn. They may also know things about JQB's trading methods which Farnesbarn may not, e.g. that after the first couple of years the contract price is likely to be driven down so hard that the business becomes unprofitable.
- Can JQB break the contract for any reason, e.g. late delivery, poor workmanship? i.e. what are the risks involved? Is Farnesbarn aware of them?

Other possible reasons:

- **The bank manager may himself be under pressure.**
He may be limited in what he can lend in certain business areas; and he will have a limit to his discretion beyond which he must seek head office approval.

- **The history of Elcho's past dealings** with the bank may not make the proposal one which he should be seen to endorse, e.g. the overdraft was nearly at limit at balance sheet date. Is there a history of bounced cheques; or requests to bend the limit to pay wages etc.?
- **Elcho's assets** do not provide very convincing security. In any case, lending to the company will be based less on its assets than on its forecast future trading. And Farnesbarn does not appear to have done his homework. His forecast is therefore unlikely to be accurate, and that would worry any banker.
- **What happens at the end of two years?**
How likely is it that the contract will continue at a similar level of profitability?
If not, can the output from the new plant and machinery be sold elsewhere at a profit?
Or is it special purpose plant? Might it be necessary to sell it (at well below book value?), to write it down sharply or even write it off altogether?

Solution 2.1

The fundamental accounting concepts are those broad basic assumptions which underlie the periodic financial accounts of business enterprises. Under SSAP 2 the four following fundamental concepts (the relative importance of which varies according to the circumstances of the particular case) are seen as having general acceptability:

- (a) the '*going concern*' concept: the enterprise will continue in operational existence for the foreseeable future. This means in particular that the profit and loss account and balance sheet assume no intention or necessity to liquidate or curtail significantly the scale of operation;
 - (b) the '*accruals*' concept: revenue and costs are accrued (that is, recognised as they are earned or incurred, not as money is received or paid), matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the profit and loss account of the period to which they relate; provided that where the accruals concept is inconsistent with the '*prudence*' concept (paragraph (d) below), the latter prevails. The accruals concept implies that the profit and loss account reflects changes in the amount of net assets that arise out of the transactions of the relevant period (other than distributions or
- (c) the '*consistency*' concept: there is consistency of accounting treatment of like items within each accounting period and from one period to the next;
 - (d) the concept of '*prudence*': revenue and profits are not anticipated, but are recognised by inclusion in the profit and loss account only when realised in the form either of cash or of other assets, the ultimate cash realisation of which can be assessed with reasonable certainty; provision is made for all known liabilities.
- FRS 18 refers to the above concepts but has made significant changes to their relative status for financial reporting purposes.
- Both the going concern concept and the accruals concept retain their key roles. FRS 18 refers to them as playing a 'pervasive role in financial statements, and hence in the selection of accounting policies'.
- However, the concepts of consistency and prudence have been downgraded:
- (a) Companies are now required to review their accounting policies on a regular basis, making changes wherever appropriate. Consequently FRS 18 places the emphasis on comparability stating that '*... comparability can usually be achieved through a combination of consistency and disclosure ...*'.
 - (b) Prudence is to be considered in relation to the key objective of '*reliability*'. Financial information is regarded as reliable if it can satisfy a number of criteria including that '*under conditions of uncertainty, it has been prudently prepared ...*'. However, FRS 18 emphasises that it is not necessary to exercise prudence where there is no uncertainty, and that prudence should not be used as a reason for creating excessive provisions or deliberately overstating losses.

Solution 3.1

One can tell whether a company is (a) a public or (b) a private limited company from its name. A company whose name ends 'plc' or 'PLC' or Public Limited Company is

a public company; one whose name ends with 'Ltd' or 'Limited' is a private company.

One cannot tell from its name alone whether a company is limited by shares or limited by guarantee; it is necessary to study the company's memorandum of association.

And it is quite difficult to tell whether a business with a name like 'Home Wreckers' is a business name of an individual or a partnership or an unlimited company. If it is an unlimited company it will be possible to inspect its file at Companies House and study its memorandum. Such companies are quite rare.

Solution 4.1

In a bid driven market there are market makers, who have to quote bid and offer prices during the trading day in all the shares in which they deal. They are then obliged to buy at the bid price and to sell at the offer price in the size (amount of shares) they have indicated, or any lesser amount. For less actively traded shares the size may only be a nominal amount, say 1,000 shares.

The market maker makes a profit by buying at the bid price and selling at the offer price; the difference between the two is known as the spread.

In an order driven market there are no market makers: buyers and sellers are matched at the same price.

Solution 6.1

(a) and (c) Profits before interest	£	£	£	£	£	£	£	£
	750,000	800,000	900,000	1,000,000	1,100,000	1,200,000	1,300,000	1,400,000
Scenario (i)								
Interest at 10% on £8m	800,000	800,000	800,000	800,000	800,000	800,000	800,000	800,000
Return earned by venture capital company (%)	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
Profits available to management	(50,000)	0	100,000	200,000	300,000	400,000	500,000	600,000
Return earned by management (%)	-2.50%	0.00%	5.00%	10.00%	15.00%	20.00%	25.00%	30.00%
Scenario (ii)								
Interest at 9% on £6m	540,000	540,000	540,000	540,000	540,000	540,000	540,000	540,000
Profits due to equity owned by venture capital company	105,000	130,000	180,000	230,000	280,000	330,000	380,000	430,000
Total to venture capital company	645,000	670,000	720,000	770,000	820,000	870,000	920,000	970,000
Return earned by venture capital company (%)	8.06%	8.38%	9.00%	9.63%	10.25%	10.88%	11.50%	12.13%
Profits available to management	105,000	130,000	180,000	230,000	280,000	330,000	380,000	430,000
Return earned by management (%)	5.25%	6.50%	9.00%	11.50%	14.00%	16.50%	19.00%	21.50%

To an investor the advantage of a quote driven market is that there should always be a market in which he can deal, although the size may be limited. In an order driven market the investor avoids the cost of the spread, but he can only buy if there are sellers, and vice versa.

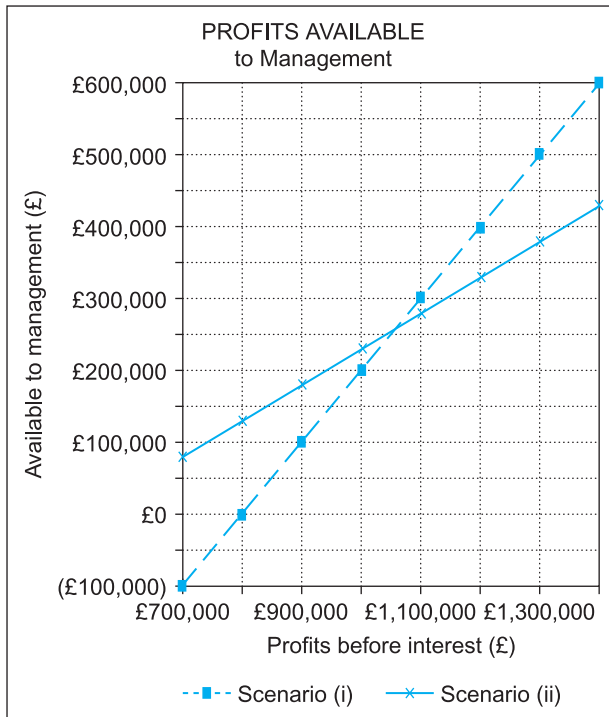
Solution 5.1

Preference shares carry a fixed rate of dividend, but unlike the holders of loan capital, who can take action against a company in default of interest payments, preference shareholders have no legal redress if the board of directors decides to recommend that no preference dividends should be paid.

However, if no preference dividend is declared for an accounting period, no dividend can be declared on any other type of share for the period concerned, so the subsidiary cannot pay an ordinary dividend to its holding company.

Cases have arisen where, though the subsidiary is very profitable, the holding company says it wishes to retain those profits, and no dividends, preference or ordinary, have been paid for a number of years. In these circumstances the preference shareholders may become entitled to vote at shareholders' general meetings. But this is little comfort, unless it gives them a majority of the votes, which is unlikely.

(b)



Solution 7.1

ML Laboratories apparently took a last opportunity to move from what was an FRS 10 basis to a treatment which would no longer be permitted under FRS 10. Whether that was a good idea we leave the reader to decide.

Solution 8.1

Fleetwood: Balance Sheet as at 31 December 2001

	Note	2001 £	2000 £
Fixed assets:			
...			
Motor vehicles	1	145,375	117,000
Notes:			
1. Fixed assets	Cost	Depreciation to date	Net
	£	£	£
Motor vehicles			
2001	227,500	82,125	145,375
2000	165,000	48,000	117,000

Solution 9.1

- (i) Companies hold fixed asset investments for a variety of reasons, among them:
 - (a) as a consequence of acquiring control of other companies (i.e. subsidiaries) and ‘running them’;
 - (b) as a way of entering into some sort of joint operation (i.e. a joint venture or consortium);
 - (c) as an investment to generate income (as an investment trust does);
 - (d) for protection, e.g. life policies on senior employees;
 - (e) as a means of gaining a foothold (a prelude to a possible bid);
 - (f) for self-aggrandisement on the part of the directors, e.g. works of art.

- (ii) It is important for the reader of accounts to have a clear idea of the reasons for any significant holding:
 - (a) to understand how the holding and income from it will be treated in the accounts. As will be seen, the treatment of subsidiaries is quite different from that of associated companies;
 - (b) to predict future actions on the part of the board (e.g. a bid);
 - (c) to judge board behaviour (pictures, racehorses, yachts and aircraft may not be the most profitable use of funds).

Solution 10.1

- (i) The items (a) land and (b) development and construction costs suggest these are the accounts of a group engaged in construction and residential property development; but there appears also to be activity in commercial, industrial and mixed development property.
- (ii) The figures suggest that there was an expansion of the land bank; and that development costs in progress grew 21% either:
 - (a) because of stock building to meet a perceived **improvement** in the market; or
 - (b) because of stock was unsold because of a **deterioration** in the market for residential property.

It should be possible to identify which of these is the probable cause by studying:

- the directors' report;
- the chairman's statement;
- any financial review;
- notes to the accounts, in particular any analysis of turnover and profit;
- the cash flow statement.

The accounts are, in fact, those of TAYLOR WOODROW for 2002. Their financial review explained:

Housing

The housing businesses located in the United Kingdom, North America, Spain and Gibraltar all had a successful 2002 . . .

Construction

Taylor Woodrow Construction has continued its good performance . . .

- (iii) The issue of transfers from current assets to fixed assets was considered by the UITF which, in July 1992, issued Abstract 5, *Transfers from current assets to fixed assets*.

The UITF was concerned, in the then current economic climate, that 'companies could avoid charging the profit and loss account with write-downs to net realisable value arising on unsold trading assets. This could be done by transferring the relevant assets from current assets to fixed assets at above net realisable value, as a result of which any later write-down might be debited to revaluation reserve.'

The UITF agreed that in respect of such transfers, the current asset accounting rules should be applied up to the effective date of transfer (the date of management's change of intent). The transfer should then be made at the lower of cost and net realisable value. Thus the land that cost £56m should be transferred to fixed assets at £40m, and the shortfall charged to the profit and loss account.

Solution 11.1

	2001	2000
	£m	£m
Turnover	374.1	330.1
Trade debtors	30.3	30.3
(i) Collection period (months)	0.97	1.10
(ii) Trade debtors/Sales	8.1%	9.2%

These two ratios are closely related. Indeed (i) is 12/100 of (ii), so they inevitably move in the same way. Some people may find one easier to understand than the other. It is correct to say that 'At the balance sheet date in 2001, debtors equalled 0.97 months' average sales' but not that 'Debtors consisted of the last 0.97 months' sales' and not that 'customers take 0.97 months to pay'.

Whichever yardstick one takes, debt collection appears to have improved by roughly 12%.

In the case of THE BODY SHOP, the figures are somewhat more difficult to interpret than is usually the case because the business is partly a normal retail operation and partly a franchise one; and trade debtors are mostly, if not entirely, franchisees whereas turnover is the sum of sales to franchisees and the sales from own shops. The figures provided do not show whether there was a change in the make-up of turnover, i.e. whether there were more sales via franchisees, the same, or less.

Solution 12.1

- (a) Possible reasons why companies hold current asset investments include:
- (i) to set aside (and earn interest on) money later required to pay taxation;
 - (ii) to save towards a planned expansion, refurbishment, or reorganisation;
 - (iii) to cover contingencies (e.g. a shortfall in receipts);
 - (iv) to assure potential joint venture partners that the company, while not in the same league in size terms as they are, can fund its share of future operations (found for example in oil exploration and development);
 - (v) as a more general store of value;
 - (vi) to earn income (there being no better use of funds in the short term);

- (vii) where required under the terms of a contract, or by statute, as with insurance funds;
- (viii) where the group acts as its own insurer (because cover is impossible to obtain or prohibitively expensive, e.g. certain types of disaster cover), as large sums could be needed urgently.
- (b) It is important for the reader of accounts to have a clear idea of the reasons for any significant holding of current asset investments because:
- Money which is tied up (under, say, (vii) or (viii) above) is not available to support general operations.
 - Money set aside for a purpose (e.g. taxation) is earmarked.
 - If money currently earning income is used for non-income-generating activities, income will fall.
 - If large sums of money are invested:
 - (a) has management clear plans as to their use? or
 - (b) has the business become a 'cash cow', a generator of cash which it cannot itself usefully employ?
 - (c) is management simply sitting on money that it does not know what to do with (black mark!)?

Solution 13.1

1.		£000
	Reduction in lease finance	(372)
	Finance leases disposed of	(1,454)
	New finance leases	<u>465</u>
	Net change (reduction)	<u>(1,361)</u>
2.	Bills of exchange discounted per 1998 balance sheet	2,794
	less increase during 1998	<u>(1,193)</u>
	Bills of exchange discounted which would have appeared in the 1997 balance sheet	1,601
	less increase during 1997	<u>(613)</u>
	Bills of exchange discounted which would have appeared in the 1996 balance sheet	<u>988</u>

Solution 14.1

1. The initial outlay is

$(250 \times 100 \times £10)$.
2. That is also the maximum amount risked.
3. If the index rises to 4,155, the fund manager can sell the option back to the market realising a profit of £137,500 ($55 \times 250 \times £10$). With over a month left to expiry there would also be some time value left, say 25 index points. In this case the manager would sell the options back to the market for 180 index points, an overall profit of £200,000 ($80 \times 250 \times £10$).

Solution 15.1

- (a) (i) An accrual is a known liability where there is no uncertainty as to either the timing or the amount of the future expenditure required in settlement.

By contrast, a provision is a liability of uncertain timing or amount. Whilst the Companies Act 1985 contains a definition of provision, companies must also satisfy the required conditions in FRS 12 before a provision may be recognised in the balance sheet. The two key conditions are:

- the company has an obligation which it will probably be required to settle, and
 - a reliable estimate can be made of the amount of the obligation.
- (ii) Income in advance represents income received which at the date of the balance sheet had not been earned; whereas a deposit either represents money paid by a customer/client as an earnest (or a sign) of good faith or, in the case of a financial institution, customers' money which earns interest for them.
- (iii) A commitment is a financial obligation which a company has already contracted for but which does not satisfy the criteria to be recognised as a provision.

A contingent liability is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence of one

or more uncertain future events that are not wholly within the company's control. A contingent liability may also relate to a present obligation that arises from a past event but which is not recognised in the balance sheet because it does not satisfy all the conditions set out in FRS 12.

(b) Examples:

- (i) Of an accrual: rent of £24,000 per annum payable quarterly in arrear on 31 March, 30 June etc. Company makes up its accounts to 30 April 1999, having paid rent up to 31 March. Rent of £2,000 (i.e. one month) will be accrued.

Of a provision: a restructuring provision representing expenditure which is to be incurred on a major reorganisation which was publicly announced prior to the balance sheet date.

- (ii) Of income in advance: a magazine publisher receives prepayment in respect of annual subscriptions to journals. At the end of the year £213,000 represents journals to be supplied in future years.
- (iii) Of a commitment: capital expenditure contracted for at the balance sheet date to the extent that this has not been provided for in the accounts; exposed foreign currency commitments; commitments under operating lease agreements.

Of a contingent liability: guarantee of bank borrowings; pending legal action against the company.

- (c) In seeking to estimate the effect on a company's future cash flows and its viability in the medium term:

- (i) Accruals are rarely of much significance. As to provisions, their background and adequacy should be considered, as well as their size, what calls they will bring on the company and when.
- (ii) There is a tendency for companies hard-pressed for cash to spend what is in effect other people's money. In an ideal world deposits would be banked separately in a 'client/customer account', and never used for purposes of the company until such times as they were earned. This is not an ideal world. Solicitors and travel agents may work like that; other businesses tend not to. For example, a magazine publisher selling discounted three-year subscriptions would be in trouble if he spent receipts in the year they were received; he would then be relying on future receipts to provide copies to people who had already paid for them, in much the same way governments were able, in the early years of schemes, to treat pensions on a pay as you go basis; but once a large pensioner population built up, the costs escalated and there were no funds to fall back on.
- (iii) Capital commitments require financing. The wise finance director ensures that this is planned and negotiated in advance. Some even explain what has been done in the financial review.

Solution 16.1

QUEENSBOROUGH

(a) Year-on-year change overall and for each segment

<i>Class of business</i>	<i>Growth in turnover including acquisitions</i>	<i>Growth in profit before taxation including acquisitions</i>	<i>Growth in turnover excluding acquisitions</i>	<i>Growth in profit before taxation excluding acquisitions</i>	<i>Growth in net assets 1998/1997</i>
Day visitor attractions – UK	7.27	–0.74	7.27	–0.74	8.17
Caravan parks – UK	28.09	38.33	23.42	27.44	7.71
Caravan parks – France	120.45	–62.38	10.23	–109.90	224.57
Hotel – UK	4.80	15.80	4.80	15.80	0.31
Restaurants – UK					Infinite
Overall	20.58	15.98	15.59	13.46	16.14

(b) Vertical analysis of turnover, profit before tax and net assets in 1997 and 1998

Class of business	Including acquisitions				Excluding acquisitions			
	Turnover	Turnover	Profit before tax	Profit before tax	Turnover	Profit before tax	Net assets	Net assets
	1998	1997	1998	1997	1998	1998	1998	1997
Day visitor								
attractions – UK	22.07	24.81	26.79	31.30	23.02	27.39	21.42	23.00
Caravan parks – UK	57.42	54.05	52.15	43.73	57.72	49.11	48.37	52.15
Caravan parks – France	3.71	2.03	0.58	1.80	1.94	-0.16	10.58	3.79
Hotel – UK	16.61	19.11	23.14	23.18	17.32	23.66	18.19	21.06
Restaurants – UK	0.19		-2.66				1.44	
	<u>100.00</u>	<u>100.00</u>	<u>100.00</u>	<u>100.00</u>	<u>100.00</u>	<u>100.00</u>	<u>100.00</u>	<u>100.00</u>

(c) Brief summary describing the company's activities, and the changes which occurred in 1998.

QUEENSBOROUGH is a relatively small company in the leisure and hotels sector. At the time of writing there were 61 listed companies in the sector, and it was 47th in terms of market capitalisation. That being the case, market for its shares was narrow and its share price behaved erratically, halving or doubling in the course of a day or so.

Prior to 1998 its business consisted of caravan parks in the UK and to a much lesser extent in France; day visitor attractions in the UK, and a hotel in the UK. During 1998 the company made at least two acquisitions:

- some UK restaurants which have still to prove profitable and
- more caravan parks in both the UK and France (the scale of the French operations trebled in 1998).

In other words it is a company expanding in an area in which it has experience.

Although net assets only grew 16% overall, the big expansion was in caravan parks – France (225%) and restaurants – UK which did not exist before.

In considering growth in turnover and growth in profit before tax one can either include or exclude the effect of the acquisitions. Including them, turnover increased by about 21%, and profit before tax a little less (16%). Excluding them, turnover would have increased 16% and the profit before tax, 13%.

More than half the turnover in each year came from caravan parks – UK and that is where over 50% of the profits before tax are earned. Almost 11% of the assets are

tied up in caravan parks – France, but less than 4% of the turnover came from there; but we have to ask how much of the holiday season in France was post-acquisition?

(d) Is ROCE a valid indicator of its progress?

On the basis that the profit before tax in 1998 was £3.595m (1997 £3.586m) and that capital employed is represented by net assets of £32.150m in 1998 (1997 £26.848m), the return on capital employed appears to have fallen from 13.4% in 1997 to 11.2% in 1998. But that fails to recognise: (i) goodwill written off during this and previous years, just under £3m; (ii) that only part of a year's profit/loss was included as regards the businesses acquired. Note 20 reveals that the two companies acquired *lost* £415,000 in the part year before they were acquired.

Solution 17.1

The effective rate of tax (i.e. taxation as a percentage of pre-tax profits) might be: (a) much less, or (b) much greater, than the normal rate of UK corporation tax because of:

Cause	Effect
Adjustments to previous years	(a) or (b)
Disallowed expenses	(b)
Capital gains	(a)
Loans	(b)
Losses and loss relief	(a) or (b)
Overseas income	(a) or (b)
Exceptional items	(a) or (b)

An abnormal tax charge should be explained in the note on taxation.

An abnormal tax charge is important because it directly affects after-tax profits, and hence earnings per share, the P/E ratio and cover. And, less obviously, the effect is not proportionate. For example, take a company with pre-tax profits of £100m which has 1000m 10p ordinary shares. If the effective tax rate is 30%, tax is £30m and the after-tax profit £70m. Were that rate to increase (because, say, a greater proportion was earned overseas and subject to higher rates of tax) to 35%, the after-tax profits would fall (on the same income) to £65m, i.e. by $5/70 = 7.14\%$.

Solution 18.1

- Earnings per share (e.p.s.) are the amount of profit on ordinary activities, after tax and all other charges, that has been earned for each ordinary share:

$$\text{e.p.s.} = \frac{\text{Profit attributable to ordinary shareholders}}{\text{Number of ordinary shares in issue}}$$

Adjustments are necessary where there is

- a scrip (bonus) issue or share split, or
- an issue of shares in an acquisition, or
- a rights issue

during the period. These adjustments are explained on page 154.

- One might use the e.p.s. figure:
 - in computing a price earnings ratio;
 - to compute cover or dividend payout ratio;
 - in assessing earnings growth;
 - as a basis in estimating future earnings.
- Where dilution may arise (because of, say, convertibles, warrants or options) it may be necessary to show the fully diluted earnings.
- Some companies compute their own preferred versions (as well) because they feel their method of calculating earnings provides better comparability (or because they do not like hefty charges for exceptional items reducing their apparent earnings) or show earnings on an IIMR basis (for much the same reasons).

Solution 19.1

The 1995 net cash inflow from operating activities of CORDIANT was less than that in 1994 because:

- The two principal components of cash inflow from operations tend to be:
 - Operating profit: which was only £28.3m, against £44.5m in 1994; and
 - Depreciation: unchanged at £25.7m.
- But cash flow is also affected by increased working capital demands:
 - Increase in work in progress (£9.4m in 1995; £8.0m in 1994);
 - Increase in debtors (£54.8m in 1995, £77.8m in 1994); and while the increase in creditors £38.6m operated in the reverse direction, it was far less than the increase of £86.1m the previous year. Had the increase in creditors been only £38.6m in 1994, the working capital requirement would have been £47.5m greater, and the cash generated from operations not £58.9m but £11.4m.
- In each year property provisions were utilised (£10.3m in 1995 and £11.8m in 1994). These had already been charged against the profits of earlier years, but the cash was not spent until 1995 and 1994 respectively.

Solution 20.1

BEAR BONES GROUP

- Sales in the group profit and loss account will consist of the entire sales of all four companies added together.
- The operating profit appearing in the group profit and loss account will consist of the entire operating profit of all four companies added together.
- Since only Brown Bear is a foreign company it is likely that the foreign tax represents Canadian tax on Brown Bear's profits; but attempts have been made by foreign countries (like India) to tax profits deemed to have been made by companies exporting to the country concerned; so it could represent a tax on any of the companies.
- Minority interests £321,000 will represent 25% of the after-tax profits of Brown Bear translated into £; plus 50% of the after-tax profits of Bear Huggs.

5. The item ‘Dividends proposed’, appearing in the group profit and loss account, will represent the dividends proposed by Bear Bones Group. It will not include any dividends paid by Bear Huggs.
 6. The item ‘Minority interests £34,190,000’ appearing in the group balance sheet will consist of 50% of the net assets of Bear Huggs plus 25% of the net assets of Brown Bear.
4. The amount credited in respect of these transactions:
 - (a) to share premium account would be nil because the share issues met the conditions in Sections 131–134 of the Companies Act 1985;
 - (b) to merger reserve would be £400,000, less £22,000 credited to share capital = £378,000.

Solution 21.1
GIBBON GROUP

1. The transactions represented acquisitions under the terms of FRS 6, otherwise the whole of the profits of all companies involved would appear as continuing operations, there would have been no Acquisitions column, and the figures for 1995 would have been shown as ‘restated’.
2. Consideration was:

	£000
Cash	767
Issue of shares	400
Deferred consideration – cash	251
Deferred consideration – shares to be issued	<u>150</u>
Total	<u>1,568</u>
Total consideration	1,568
Assets acquired were:	
	<i>Fair value</i>
	£000
Fixed assets	258
Stocks	255
Debtors	272
Cash at bank and in hand	153
Creditors	<u>(911)</u>
	<u>27</u>
Goodwill (pre-FRS 10)	<u>1,541</u>

3. Analysis of the net outflow of cash in respect of the acquisition of . . .

	£000
Cash consideration	767
Cash acquired	<u>(153)</u>
Net outflow	<u>614</u>

5. To assess the companies’ profitability we would need to know when the acquisitions took place. One of the two companies involved was acquired on 2 January 1996 and the other on 9 February 1996; so they contributed nearly 3 months’ and nearly 2 months’ profits respectively. So, in a full year one is looking not at £64,000, but at perhaps $5 \times £64,000 = £320,000$. Looks like a bargain.

Solution 22.1

1. The company column is always zero in the case of subsidiaries. As explained in step 6 on page 179, the process of consolidation requires one to omit the share capital of the subsidiary, reserves, and the investment in the subsidiary, which have already been taken into account in steps 1 to 3.
2. A quasi-sub subsidiary is ‘a company, trust, partnership or other vehicle that, though not fulfilling the definition of a subsidiary, is directly or indirectly controlled by the reporting entity and gives benefits for that entity that are in substance no different from those that would arise were the vehicle a subsidiary’.

A 50% owned quasi-sub subsidiary is treated in the group accounts just as though it were a subsidiary, i.e. 100% of the value of its assets and liabilities is included and 100% of its operating profit appears in group operating profit, whereas a 50% associate (like Britannia New Homes (Scotland) Ltd) is not consolidated. The group’s share of its operating profit does not appear in group operating profit but on a line immediately below; and it is the share of the profit, not the whole profit.
3. The company item ‘Investments in associated undertaking’ is zero in both years because the investment is held not by the holding company but by Tay Homes (Scotland) Ltd.
4. ‘Deficiency in net assets of associated undertaking’ represents Tay Homes’ share of the excess of liabilities over assets of Britannia New Homes (Scotland) Ltd. The

change between 1997 and 1998 represents the group's share of the loss of Britannia New Homes (Scotland) Ltd in 1998.

5. The item 'Loan to associated undertaking' represents the entire amount of a loan made by the Group to its associate (not just the group share).

The 'Deficiency in net assets of associated undertaking' (£272,000 in 1998; £181,000 in 1997) represents the cost of the shares in the associate less the group's share of losses of the associated company. That is to say, losses have wiped out not only its share of earlier profits (if any) but its investment too.

One is left asking:

- How long has this been going on?
- Is there a liability to other joint venturers or the bank?
- How secure is the loan to the joint venture?

Solution 23.1

1. (a) Beyond (1994) made profit for the year 1999 of 7.200m Bacs. This would be translated in the 1999 accounts at the closing rate of 2.400 Bacs = £1, that is as £3.000m.
- (b) Beyond (1994) made profit for the year 2000 of 12.000m Bacs. In the 2000 accounts, this would be translated at the closing rate of 3.00 Bacs = £1, that is as £4.000m.
2. At 31 December 1999 Pie in the Sky plc had a net investment in Beyond (1994) of 38.800m Bacs. In the 1999 accounts this would have been translated at 2.4 Bacs = £1, i.e. as £16.167m. Retranslated at the 2000 rate of 3.00 Bacs = £1 this becomes £12.933m. The difference between £16.167m and £12.933m represents an unfavourable translation difference in 2000 of £3.833m (allowing for rounding).

At 31 December 1998 Pie in the Sky plc had a net investment in Beyond (1994) of 31.600m Bacs. In the 1998 accounts this would have been translated at 2.0 Bacs = £1 i.e. as £15.800m. Retranslated at the 1999 rate of 2.400 Bacs = £1 this becomes £13.167m. The difference between £15.800m and £13.167m represents an unfavourable translation difference in 1999 of £2.633m.

So the entry in the statement of total gains and losses for 2000 would be:

	2000	1999
	£m	£m
Currency translation differences	(3.833)	(2.633)

Solution 24.1

- The first clue is the reference to 'stores'. This is a fairly substantial store company with just over 400 stores (averaging 12,350 sq ft). It was in fact STOREHOUSE which previously owned BHS and Mothercare.
- A major change occurred in 1993:
 - (a) The number of stores fell from 736 to 425.
 - (b) There were exceptional items in both 1993 and 1994 (£31.4m and £6.4m respectively). This looks like the closure or sale of stores.
 - (c) The dividend of 5p against earnings of 2.6p in 1992 suggests there was a marked drop in profitability around that time.

- Turnover was drifting sideways (it increased in the last two years from £1,045.5m to £1,083.6m, i.e. by 3.6%, and in the last year by 0.4%, which did not keep up with inflation).
- That was despite adding two new stores in each year and 263,000 sq ft of selling space in the last year.
- Profit margins, however, improved markedly, year by year:

	%
1992	0.85
1993	3.77
1994	6.24
1995	8.08
1996	9.41

Solution 25.1

The statements required by Cadbury (and more recently by the Combined Code) probably are not very useful to readers of accounts. Their principal purpose seems to be to educate boards of directors in their responsibilities. It is for instance difficult to believe that a group with a diverse range of activities (almost certainly spread over a number of separate locations) could operate efficiently without managers knowing what they alone could decide and what needed board approval; and what their spending approval limits were.

Solution 26.1

1. A going concern is a company or other enterprise which does not intend or need either:
 - to go into liquidation or
 - to curtail the current level of operations significantly.
2. (a) The directors are responsible for making appropriate enquiries to satisfy themselves that company and group have adequate resource to continue in operational existence for the foreseeable future before continuing to adopt the going concern basis of accounting;
- (b) It is the auditors' responsibility to form an independent opinion on the financial statements. Were they to consider the company was not a going concern the accounts would present a true and fair view only if they were prepared on a 'gone concern' basis and provided adequate explanations – otherwise the auditors would qualify their report.
3. The matter is important to investors because the value of shares in a break-up is only a fraction of that as a going concern. Typically the yield on an equity investment is far less than that on fixed-interest securities for the simple reason that equities are expected to grow in value (to provide a hedge against inflation). A business which ceases to be a going concern is certainly not a hedge against inflation. It is a dead duck.

Solution 27.1

DIXONS Note to the Interim Statement 2003/04**Workings: deducing figures for 24 weeks to 3 May 2003**

	28 weeks to 15 Nov 2003 £million	28 weeks to 9 Nov 2002 £million	52 weeks to 3 May 2003 £million	24 weeks to 3 May 2003 £million
Operating profit	102.4	89.4	278.4	189.0
Depreciation	64.9	60.5	118.2	57.7
Amortisation of goodwill and own shares	2.4	2.4	4.2	1.8
Share of profit of associated undertaking	–	(2.0)	(2.0)	–
Profit on disposal of fixed assets	(7.7)	(6.3)	(9.8)	(3.5)
Net (utilization of)/additions to provisions and impairment	(6.4)	(1.1)	9.2	10.3
(Increase)/decrease in stocks	(335.6)	(230.8)	(25.1)	205.7
(Increase)/decrease in debtors	(12.3)	(20.5)	17.9	38.4
Increase/(decrease) in creditors	320.2	104.7	(50.6)	(155.3)
	<u>127.9</u>	<u>(3.7)</u>	<u>340.4</u>	<u>344.1</u>

Solutions:	28 weeks to 15 Nov 2003 £million	28 weeks to 9 Nov 2002 £million	52 weeks to 3 May 2003 £million	24 weeks to 3 May 2003 £million
(a) Operating profit	102.4	89.4	278.4	189.0
(b) Net cash inflow/(outflow)	127.9	(3.7)	340.4	344.1

Comment:

It seems that in cash flow terms Dixons is highly seasonal. From May to early November 2002 the net cash flow from operating activities was negative (taking the average of the two years, around £100m outflow); whereas from November to April (which of course includes Christmas) it was highly positive (in 2002/03 the cash inflow was £344.1m net).

In part this is because operating profits are seasonal (£89.4m in the first half of 2002/03 against £189.0m in the second half). But it is the stocks, debtors and creditors which create much of the cash flow seasonality: increasing sharply in the first half and falling back again in the second.

Solution 28.1

1. Four widely used ratios based on the market price(s) of equity shares are:

- (a) Dividend yield (%) = (Net dividend in pence per share ÷ Ordinary share price in pence) × 100.
- (b) Price/Earnings Ratio (P/E ratio or PER), which is the market price of the ordinary share divided by the earnings per share

i.e. $PER = \text{Share price} \div \text{e.p.s.}$

- (c) Price earnings growth factor (PEG) is a yardstick introduced by Jim Slater in *The Zulu Principle*. The PEG is a measure of whether a share looks over-rated or underrated:

$PEG = \text{Price/Earnings ratio} \div \text{Prospective growth rate of e.p.s.}$

- (d) Increase (decrease) in price (normally the closing price) on the day, week, month or year:

$(\text{Share price at end of period} \div \text{Share price at end of previous period} \times 100) - 100\%$

2. Four other ways in which an investor or analyst might use the price history of a share are:

- to draw a chart depicting the share's price behaviour;
- to compare the behaviour of an individual share against (a) the FT-SE 100 or (b) the All-Share Index;
- to compare the behaviour of an individual share with that of its sector index or of another share in the same sector;
- to value the portfolio for any purpose, e.g. inheritance tax purposes or to project the capital gains tax that would be payable on the sale of a holding.

3. Four ways of obtaining share prices are:

- Look up the price in the City pages of the *FT* or of any good daily paper. Where a daily paper is already purchased or is available in a library, this involves no additional cost; but it is tiresome to keep track of a large number of prices.
- Look the price up on teletext (this again involves no additional cost assuming one has a TV with teletext) or use a teletext board in a PC (once purchased, with appropriate software this will update prices automatically at a stated time daily, free; and it is possible to watch prices during the day updated every couple of hours).
- Download prices from a modem-based service like Prestel or watch them live using that service.
- Purchase data from a data source, say, weekly on disk or CD-ROM.

Solution 31.1

Where a company is listed both in the UK and in the US, the note explaining differences in GAAP between the two countries will be of interest:

- (a) **to an analyst** because: it sheds further light on certain types of transaction; it enables him to use actual figures rather than make his own estimates of, say, full provision for deferred tax; information in respect of goodwill written off in past periods direct to reserve may enable him to compute a reliable return on capital employed; he may well prefer the US treatment of pension costs to that of the UK.
- (b) **to a US investor** because he is familiar with US GAAP but not with UK GAAP.
- (c) **to a student of accounting theory** because: where US GAAP and UK GAAP differ it is questionable whether both can be 'right'; as international trade and co-operation increase, there is a tendency for the GAAPs of industrialised and major trading nations in particular to move ever closer, i.e. 'it is likely to happen here too'.

Appendix 5 – International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS)

As at 30 September 2004

Number	Title
IAS 1	Presentation of financial statements
IAS 2	Inventories
IAS 7	Cash flow statements
IAS 8	Accounting policies, changes in accounting estimates and errors
IAS 10	Events after the balance sheet date
IAS 11	Construction contracts
IAS 12	Income taxes
IAS 14	Segment reporting
IAS 16	Property, plant and equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee benefits
IAS 20	Accounting for government grants and disclosure of government assistance
IAS 21	The effect of changes in foreign exchange rates
IAS 22	Business combinations (superseded by IFRS 3)
IAS 23	Borrowing costs
IAS 24	Related party disclosures
IAS 26	Accounting and reporting by retirement benefit plans
IAS 27	Consolidated financial statements and accounting for investments in subsidiaries
IAS 28	Accounting for investments in associates
IAS 29	Financial reporting in hyperinflationary economies
IAS 30	Disclosures in the financial statements of banks and similar financial institutions
IAS 31	Financial reporting of interests in joint ventures
IAS 32	Financial instruments: Disclosure and presentation
IAS 33	Earnings per share
IAS 34	Interim financial reporting
IAS 35	Discontinuing operations (superseded by IFRS 5)
IAS 36	Impairment of assets
IAS 37	Provisions, contingent liabilities and contingent assets
IAS 38	Intangible assets
IAS 39	Financial instruments: Recognition and measurement
IAS 40	Investment property
IAS 41	Agriculture
Number	Title
IFRS 1	First-time adoption of IFRSs
IFRS 2	Share-based payment
IFRS 3	Business combinations
IFRS 4	Insurance contracts
IFRS 5	Non-current assets held for sale and discontinued operations

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