



SECURITIES & INVESTMENT INSTITUTE DIPLOMA

JUNE 2009

CHIEF EXAMINER'S REPORT-

INTERPRETING FINANCIAL STATEMENTS

General comments

There was a wide spread of quality of answers to this exam, with a number of very good papers. Many of the answers to the seen accounts question (1, Stagecoach) were also commendable, with the segment analysis in particular being well done. Many candidates seem to major on calculation whilst a smaller set seem to focus on discussion – good financial analysis is a balance of the two. Some answers seem to imply that the subject is also more mechanistic than it actually is (or should be). There remains evidence of poor time management, the mark allocation is intended to suggest how long should be spent on each question.

Question 1

Part a – Many candidates either wrote a mainly discursive overview, whilst others focused on numbers. A balance is required. Many candidates noted the “return of value” and many also noted the important segments.

Part bi – Ratios were calculated correctly by most and interpretation was fair. Some candidates calculated just basic ratios with few comments. Stagecoach provided financial statements that allowed for quite a number of potential margin or return ratios to be calculated – marks were awarded for all reasonable ratios, but sometimes the discussion didn't match the actual ratio calculated. Marks would have been awarded for any discussion of why exceptional costs had been excluded or included.

Part bii – Apart from a number of candidates not including a gearing ratio, this section was generally well done. Again it is important to comment as well as calculate. A small number of candidates mentioned the covenant issue mentioned on page 13 of the accounts either here or in (d); a handful mentioned the enormity of the off-balance sheet financing.

Part c – ratio calculation was generally excellent and often accompanied with good comments. RoNA or RoTA is always a difficult decision when time is too short to calculate both. Stagecoach provided segmental liabilities so RoNA was possible, though caused a problem for the rail segment. Capital expenditure is also a useful figure for showing where the group is investing and this was mentioned by some.

Part d – Most candidates covered the basic effects on the financial statements. When analysing a company one idea is to check a rating agency website, I realise that there are three companies to analyse before the exam, but knowing Stagecoach is BBB- would have been useful given their dramatic rise in debt..

Part e – Some reasonable discussion on the use of adjusted earnings per share, although many did not highlight the short term nature of this measure. Quite a number of candidates seemed to miss the second part of the question, though others gave good answers.

Question 2

There was a wide range in the quality of answers to question 2.

Part a – This was the best answered part of the question. Whilst EBITDA does avoid some significant management judgement calls, it does not avoid them all (revenue recognition can be an issue for example).

Part b – Quite a few candidate did this well, others appeared to be unable to sort this out. The question asked for operating working capital, which means ignoring cash balances. Marking was lenient on this that included cash, however this then caused problems for part (c).

Part c – Some candidates were able to get this right, others forgot depreciation having shown in their part (a) discussion that they knew it should have been included.

Part d – A variety of answers here.

Question 3

This question was less popular than the other essay (40% chose this one), the average mark was a little lower than that for question 4. Many candidates gave good answers to parts of the question and then let themselves down with poor answers (or ignoring) later parts. Quite a number did not understand the meaning of primary and secondary segments.

Question 4

Answered by 60% of candidates. The opening discussion on the role of standards and choices was generally good. The reasons for allowing companies choices was more mixed and then many candidates only gave one good example of an accounting policy choice rather than two. The problems that accounting policy choice gives the analyst was well answered by some.

Question 5

Most candidates came up with two or more reasons for the difference. Nearly all wrote about growth, less about quality of earnings (or some similar phrase), some mentioned gearing, , less still about risk and only a few mentioned one possibly being a takeover target.

Question 6

Most candidates answered this question well.

Question 7

This question was very well answered with almost every candidate correctly calculating the ratios, stating the effect on cash in terms of direction, rather less giving it a number.

Question 8

Also well answered numerically. Some of the written comments suggested some confusion between cash and profit – (dividends come out of reserves, but require cash to be available to pay them).

Question 9

Some good answers here too. Some candidates seemed to think the company might have a choice of how to deal with this (in theory according to the standard they do not). The final part of the question concerning how the analyst should deal with the disclosure was well answered by some, whilst others did not consider both the short term and long term implications of the write-down.

The following information is provided for solely for the guidance of candidates and should not be read as providing a model answer, nor, in some instances as the only possible response.

Section A

Question 1

This question is based on the Annual Report and Accounts of Stagecoach Group PLC for the year ending 30th April 2008.

- a. Present a numeric and discursive overview of Stagecoach and its development over the last year.

Overview	Stagecoach	
<i>All financial numbers in millions</i>	2008	2007
Turnover	£1,764	£1,505
% change	17%	
Operating Profit	£191	£183
% change	4%	
Profit for the year (earnings)	£249	£277
% change	-10%	
Operating Cashflow	£267	£185
% change	44%	
Capital and Acq. Expenditure	£53	£45
% change	18%	
Total Debt	£598	£350
% change	71%	
Employees	29,548	28,460
% change	4%	

Turnover shows a significant rise which has not been matched by operating profit although sales less operating costs has improved from a loss at this level to a profit. Turnover has increased much more quickly than the level of employment suggesting better productivity (or potentially more contracting out).

Earnings have fallen, but this is due to the sale of a significant part of the business. Underlying earnings appear to have risen. The very positive tax adjustment in 2008 is surely not repeatable and note 8 does not seem to fully explain how this has occurred.

The improvement in cash flow is also largely down to the increase in payables (note 32). Capital expenditure has risen and total debt has increased significantly.

(6 marks)

b. Carry out a ratio analysis of Stagecoach, discussing the meaning and interpretation of the ratios calculated. Focus on the following ratio categories:

i. Performance

Performance	Stagecoach	
	2008	2007
Return on net assets	24.56%	19.25%
Margin over operating costs	1.20%	-3.13%
Net sales margin	10.82%	12.19%
Asset Turnover	2.27	1.58
Sales per Employee	£59,686	£52,867
Profit per Employee	£5,577	£5,847

RONA looks very good and rising. However this company is a little more complex than just running buses and trains at a profit. The negligible margin over operating costs shows that without property, advertising revenue etc. the company is close to break-even. Joint ventures also appear to contribute profits, although we do not know if their source of profits is also from "other activities". Net sales margin appears a healthy 10-12% after these factors

are taken into account, although it has fallen. These numbers could be worked out before or after exceptional.

Asset turnover has improved significantly. A closer look at the balance sheet suggests that much of this improvement is down to re-financing with a fall in cash balances and a rise in short-term borrowings rather than improved asset utilisation (for example more passenger miles per bus per annum). Sales per employee has risen by about 13%, although this is not matched by rising profit per employee.

(12 marks)

Liquidity and Solvency

	2008	2007
Current Ratio	0.83	1.35
Acid Test	0.74	1.32
Interest Cover	4.22	8.86
Gearing	7.39	0.68

All four of these ratios seem less safe than before. A comparison with competitors might reveal more information on the likely associated risks with the reduction in the relative (and absolute) level of shareholder capital in the business.

Interest cover is still reasonable at 4, but an analysis of the maintainability of profit streams would be a sensible next step.

Gearing is now substantial, although this might be seen as a low risk business from a commercial perspective – the Reuters beta is 0.83 – hence increased financial risk may be bearable.

(6 marks)

- c. Analyse the performance of Stagecoach's UK Bus, North America and UK Rail segments in 2007 and 2008. Comment on the relative performance of each segment.

	UK Bus		North America		UK Rail		Total segments	
	2008	2007	2008	2007	2008	2007	2008	2007
Revenue	743.9	690.4	241.9	242.7	777.8	571.5	1,763.6	1,504.6
<i>Rev Growth</i>	8%		0%		36%		17%	
EBITDA	158.6	130.3	37.2	33.5	103.1	79.3	298.9	243.1
EBITA							0.0	0.0
Operating profit	104.4	106.9	20.1	17.9	80.8	67.6	205.3	192.4
Segment assets	634.8	551.3	245.1	226.6	188.0	95.0	1,067.9	872.9
Segment liabilities	116.1	113.1	72.7	61.7	311.7	203.1	500.5	377.9
Revenue (%)	42.2%	45.9%	13.7%	16.1%	44.1%	38.0%		
EBITDA (%)	53.1%	53.6%	12.4%	13.8%	34.5%	32.6%		
Operating profit (%)	50.9%	55.6%	9.8%	9.3%	39.4%	35.1%		
Sales margin	14.0%	15.5%	8.3%	7.4%	10.4%	11.8%	11.6%	12.8%
Gross Asset Turnover	1.17	1.25	0.99	1.07	4.14	6.02	1.65	1.72
Net Asset Turnover	1.43	1.58	1.40	1.47	-6.29	-5.29	3.11	3.04
Return on net assets	20.1%	24.4%	11.7%	10.9%	-65.3%	-62.5%	36.2%	38.9%

The business appears to be becoming a little more UK focused with North American sales stagnant and a significant rise in UK Rail from the awarding of a new franchise. UK bus has the highest margins and is more productive in its use of assets than the North American division. The negative net assets in UK Rail is (I assume) down to the operating lease arrangements on the trains – helpfully Stagecoach categorise debt separately from the divisions. The -65% RONA for UK Rail is off course meaningless with the idea of making money without having invested any capital an excellent one from the shareholders' perspective.

(12 marks)

- d) The report makes numerous references to the 63.0 pence per share return of value to shareholders in May/June 2007. Explain the impact of this on the group's finances. You do not need to explain the detailed mechanics of the transactions.

Having raised substantial sums from the selloff of the London bus operation, Stagecoach then handed back over twice this sum to shareholders via a rather complex share sale and repurchase arrangement. The impact can be seen in the cash flow statement with

redemption of B and C shares and dividends to class C shares amounting to about £680 million. The report states that this has been from the group's current available cash and borrowing arrangements. However, this still means debt is considerably up and shareholders' funds is dramatically down. With a share price of around 190 pence at the time of the "return of value", this was a significant though well signalled windfall for shareholders. A well prepared student might know that Standard & Poor's rate the company as BBB-. The risk level might be acceptable, but is certainly higher than before.

(5 marks)

e) On pages 5 to 7, the company lists five areas of focus for performance. Discuss the profitability section of this report (3.5.2.2) and the advantages and disadvantages of using adjusted earnings per share as a performance measure.

Page 36 states that the exercise of executive share options is dependent upon the outperformance earnings per share over inflation. Also comment on this feature of the remuneration of executives.

The company talks about its long-term focus on increasing value for shareholders (the "return of value" certainly gives credibility to the statement), however provides no indication of any long term measures just presenting Adjusted EpS as a key short-term measure. AdjEpS is targeted to rise faster than inflation, a target met in 2007 and 2008.

If the number of shares is adjusted (something under management control) then AdjEpS is also affected. The number of dividend-ranking shares has fallen and this has been primarily responsible for the 74% rise in the statistic in 2008 against the 18% rise in adjusted profit for the year.

The remuneration report does not make it clear whether the exercise of share options is dependent on EpS or AdjEpS, a good argument could be made for either (less under management control or more appropriate given the seeming problems in predicting tax gains...). Again with the power to change the number of shares being in the hands of directors, this does not seem an entirely appropriate measure.

(4 marks)

Section B

Attempt question 2 and either question 3 or question 4

Question 2

Below are key numbers extracted from the recently published accounts for Orca Orchids plc.

For the year ending 31 December	2008	2007
Turnover	55000	44000
Cost of Sales	<u>-48500</u>	<u>-38500</u>
Gross profit	6500	5500
Administrative costs	<u>-3200</u>	<u>-2800</u>
Operating profit	3300	2700
Net finance costs	-1200	-1200
Tax	<u>-625</u>	<u>-375</u>
Profit for the year	<u>1475</u>	<u>1125</u>
Note above figures include:		
Depreciation	2050	1875
Amortisation	425	400
Impairment	200	0

As at 31 December	2008	2007
Non-current assets	18500	21000
Current assets		
Inventory 6750	4563	
Debtors 7670	5525	
Cash 492	300	
	14912	10388
Current liabilities		
Trade creditors	3425	3076
Long term liabilities		
Long term debt	17000	17000
Provisions	500	300
	<u>12487</u>	<u>11012</u>
Shareholders' fund	<u>12487</u>	<u>11012</u>

- a) Calculate EBITDA for Orca for both 2007 and 2008. Explain why this statistic is often used for assessing performance instead or alongside operating profit.

	2008	2007
Operating profit	3,300	2,700
Add:		
Depreciation	2,050	1,875
Amortisation	425	400
Impairment	200	-
EBITDA	<u>5,975</u>	<u>4,975</u>

EBITDA is said to be closer to cash flow and is unaffected by some (but not all) questionable accounting policies and impact from past decisions that may not affect current operating performance (but ought to affect the level of respect for management).

- b) Calculate the net change in the operating working capital position of the business. Discuss the magnitude of this change in the light of the increase in sales turnover.

Changes in working capital	2008
Increase in inventory	-2187
Increase in debtors	-2145
Increase in trade crds	349
Change	-3983

Sales are up 25%. Operating working capital is up from £7,012 to £10,995 – a rise of 58%. OWC might be expected to rise in line with sales, but this rise seems to be excessive and lack control.

- c) Calculate the Cashflow from Operations for 2008.

	2008
Operating profit	3,300
Add:	
Depreciation	2,050
Amortisation	425
Impairment	<u>200</u>

Changes in working capital	2008
Increase in inventory	-2187
Increase in debtors	-2145
Increase in trade crds	349

Change in provisions	<u>200</u>
Cash generated from operations	4200

- d) What factors other than the Cashflow from Operations explain the change in the cash position of Orca in 2008 compared to 2007.

Interest, taxation and capital investment.

Question 3

You receive an email from a friend who has been considering investing in a company with a wide range of operations. He asks you:

“The annual accounts are 150 pages long. Which parts are really important? Should I bother with the segmental reporting note, for example? And anyway isn't it about to change?”

Required

Write the email in reply to your friend, including the following:

- i) An explanation of the logic and required disclosure of the segmental reporting note

The logic is that the users of accounts would gain from having insights into significant component parts of the business. Prospects for different segments could be quite diverse, and indeed the current standard suggests that this diversity be considered when deciding on the segments.

Required disclosure includes sales, profit, assets and liabilities as well as capital investment and depreciation. Generally companies provide more information than this when the rest of the annual report and website are considered alongside the note.

- ii) An explanation of primary and secondary segment disclosure

Primary segments reflect the most important way of splitting up the business – geographic or product (“line of business”) as company management perceives it. Secondary segments are from an alternative perspective (e.g. usually geographic if primary was LoB). This level of choice has led some to question whether this standard is effectively a voluntary disclosure rather than compulsory.

- iii) A discussion of the key changes in moving to the new standard

The new standard requires companies to disclose the information on top level segments that is presented to the board. This need not conform to IFRS, but must include sales information. Some limited geographical information is still required. The new IFRS14 standard matches the current US standard.

- iv) A discussion of the potential value of utilising the segmental reporting when assessing company value.

It ought to help in fundamental analysis with the greater potential of forecasting the future of each key business segment. Experience suggests that there is always information that the analyst would like to have but is beyond their reach. If segmental reporting is viewed as including all information released by the company on its component parts, then this may be less of a problem.

(15 marks)

Question 4

“Accounting policy choice complicates the task of the financial analyst.”

You work for a firm of analysts and receive a request from a client asking for an explanation of the above quote from a prestigious business daily.

Required

Write a short report replying to the client, including

- i) An explanation of the relationship between accounting standards and accounting policy choices

Accounting standards limit the set of potential accounting policy choices. Auditors provide a further reign on potential (perhaps inappropriate) options.

- ii) An explanation of the reasons for allowing companies some choice in accounting policies.

For economic relevance. If all accounts are produced in exactly the same way it would be easy to compare companies, but it would be the comparison of meaningless numbers. Choice needs to be tempered before it becomes temptation!

- iii) A brief explanation of two areas of accounting policy choice and their potential impact on analysis

Depreciation and stock valuation would seem obvious areas to pick.

Would expect this to include – increasing asset life increases current profit. LIFO would give lower profits than AVCO or FIFO (assuming inflation).

- iv) A discussion of the problems accounting policy choice presents to the analyst.

The need to get involved with detail and not just high level numbers. Thinking through the impact of any changes, perhaps attempting to adjust numbers when comparing two companies with different policies.

(15 marks)

Section C

attempt all questions in this section

Question 5

You are analysing two competing companies in the same sector. Their financial performance over the last year was identical, however one has a Price-Earnings ratio of 25 and the other a Price-Earnings ratio of 20. Briefly outline the potential reasons for this difference.

The co. with PE 25 might have

Better growth prospects

Less risk

More reliable profit streams (perhaps linked to more respected management)

Be the target of a takeover

(4 marks)

Question 6

A senior manager is comparing the performance of two customers, both food retailers. Both have a return on net assets (RONA) of 18%, but one has a sales margin of 6% and the other 3%. He does not understand how RONA can be the same and sales margin so different. Briefly explain this apparent anomaly and the potentially different business models that this implies.

If sales margin is 6% then asset turnover must be 3.

If sales margin is 3% then asset turnover must be 6.

The 6% margin company has invested heavily in a quality environment and customers are therefore willing to pay more.

The 3% margin company has a low investment strategy appealing to the customer purely on price – hence low margins, but good use of assets in generating sales.

(2 marks)

Question 7

A company is considering a change in an accounting policy which will lead to a significant improvement in profit levels compared to the previous year. As the auditor to the company what should you check and what disclosure requirements should you insist on before agreeing the change.

Does the proposed change reflect a change in conditions or is it just an attempt to make profits look better.

You would want the company to adjust the previous year's numbers to be in line with the new policy – hence highlighting the impact to the readers. (2 marks)

Question 8

In order to gain market share, company Z has offered longer credit terms to customers. At the end of 2007 trade debtors were £500 million and sales for the year had been £5,000 million leading to a profit of £200 million. At the end of 2008 trade debtors had risen to £900 million and sales for year had climbed to £6,000 million leading to a profit of £280 million.

Work out the debtor days for 2007 and 2008. If there were no other changes in cash flow from 2007 to 2008 than those detailed above, what would the impact on operating cash flow have been?

Trade debtors 2007 – 36.5 days
2008 - 54.8 days

Debtors has swallowed up £400 million whereas the extra profit might be expected to give only £80 million more cash this year. The sales director would argue that the £400 million in extra debtors is an “investment”.

(4 marks)

Question 9

Some companies publish numerous earnings per share statistics underneath their income statement. Briefly explain the disclosure required by accounting standards and why a company might decide to publish additional information.

The accounting standard requires the profit for the year to be divided by the number of shares in issue. A diluted number, recognising all promised new shares that are likely to be taken up, in the denominator should also be shown. Companies provide alternative versions to separate out items they consider (or want the reader to consider) to distort an appropriate view of the company.

(4 marks)

Question 10

The table below shows information on company Y for last three years.

	2008	2007	2006
Profit for the year	£240,000	£220,000	£200,000
Dividend per share (pence)	22	16	12
Number of shares	1,150,000	1,150,000	1,150,000

Work out the dividend cover for each of the last three years. Comment on the prospects for continuing dividend growth.

