



SECURITIES & INVESTMENT INSTITUTE DIPLOMA

WINTER 2008

CHIEF EXAMINER'S REPORT-

INTERPRETING FINANCIAL STATEMENTS

General comments

Many candidates made a good attempt at this exam. The unseen numeric question (2) was particularly well answered compared to earlier sittings. Many of the answers to the seen accounts question (1, Associated British Foods) were also commendable, the segment analysis in particular was generally well done. There remains evidence of poor time management, the mark allocation is intended to suggest how long should be spent on each question. For example one student wrote five sides of A4 for question 1(a), worth 6 marks and therefore deserving of about 10 minutes.

Question 1

Part a – Many candidates either wrote a mainly discursive overview, whilst others focused on numbers. A balance is required. No candidates referred to ABF's ownership. Many discussed the impact of the acquisitions, which was good.

Part bi – Ratios were calculated correctly by most and interpretation was fair. Some candidates calculated just basic ratios with few comments.

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.

Part c – ratio calculation was generally excellent and often accompanied with good comments. Many candidates missed the final sentence of the question concerning the changing structure of the group.

Part d – The dividend cover was calculated correctly by almost every candidate. The discussion of whether to use the adjusted eps was not so well done by most. Answers ranged from "The IFRS eps is the true number" to "adjusted numbers are always more appropriate". Some recommended caution before using a company-generated number. Adjusted numbers may give a better indication of continuing performance, but should be used with thought and care – perhaps calculating your own preferred eps if necessary.

Part e – Most candidates were unable to explain the calculation of TSR, but many could shed some light on its meaning. Most highlighted ABF's recent underperformance against the FTSE100.

Question 2

Question 2 was generally well answered.

Part a – Return on net assets caused some candidates problems (inappropriate profit figures being chosen to compare with net assets), but other ratios were generally calculated correctly.

Part b – Most candidates explained this well.

Part c – This was less well explained by many.

Part d – Many candidates seemed to have an inbuilt belief that a modest reduction in the current ratio was bad news, though many did still manage to come up with a potentially positive interpretation of the change.

Question 3

This question was less popular than the other essay (38% chose this one), though the average mark was a little higher. The earlier parts of the question were generally answered better than the later parts. Many students had clearly memorised the six features of a development that should be capitalised. The question gave candidates the opportunity to work out a few numbers to inform their discussion but only a couple decided to do this – the intention was that this would provide material for sections (c) and (d).

Question 4

Answered by 62% of candidates. The discussion of why the distinction between profit and cash is important was generally too brief and many candidates appeared unable to explain the common reasons for profit and cash being different (part (b)), with depreciation and working capital items often missing. In (c) I anticipated some defence of profit (accrual) based ratios, but the better candidates provided some cash and EBITDA ratios. This was reasonable, but pointing out that EBITDA and cash flow are not identical would have won extra marks. The valuation discussions varied considerably as did the description of other information that the cash flow statement provides.

Question 5

Most candidates successfully answered this question.

Question 6

Most candidates also correctly answered this question, though a number did not.

Question 7

This was less well answered. Going concern was defined correctly by most, the implications of this principle being questioned were less well addressed.

Question 8

Many candidates gave three problems with interpreting this ratio. Far too many automatically linked a current ratio of less than one with financial problems. All it actually means is that the current liabilities are greater than the current assets. Better candidates discussed the importance of considering the company's industry and business model before jumping to conclusions on bankruptcy.

Question 9

Most were able to explain the concept of capitalising interest, though there seemed some confusion about the implications for the profit and interest cover.

Question 10

Minority interest was understood and explained by most. Regarding whether minority interest should be included in a "return on equity" calculation many wrote "yes" (or "no") without explanation. Better answers made the point that the profit and equity numbers should be consistent – minorities should be in or out of both. The best answer would be that it depends why you are calculating the ratio. A risk of excluding minorities (and, one assumes, not including it in debt either) is that this number escapes all analysis.

Question 11

Many were able to answer this question, increasing stock levels seemed to cause the greatest confusion.

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 Associated British Foods (ABF) for the year ending 15 September 2007.

- a. Present a numeric and discursive overview of ABF and its development over the last year. (6 marks)

Ownership: Wittington Investments Ltd. owns 54.5% of the shares.

Overview	ABF	
	2007	2006
Turnover	6,800	5,996
% increase	13%	
EBITDA	831	728
% increase	14%	
Operating Profit	517	421
	23%	
Profit for the year (earnings)	350	282
	24%	
Operating Cashflow	696	419
Change	66%	

Capital and Acq. Expenditure	559	941
% increase	-41%	
Total Debt	723	707
	2%	
Employees	84636	46703
% increase	81%	

The purchase of a controlling stake in Illovo at the very end of 2006 explains the dramatic increase in employees (even if they are very low paid ones). Difficult to tell how much of the growth is organic, certainly there is retail growth. Acquisition activity was reduced in 2007 and debt is stable.

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

- i. Performance

(12 marks)

<i>Performance</i>	<i>ABF</i>	
	2007	2006
Return on net assets	9.34%	8.74%
Return on NA (pre exceptionals)	9.72%	10.58%
Operating profit margin	7.60%	7.02%
EBITDA margin	12.22%	12.14%

Asset Turnover	1.23	1.24
Sales per Employee	£80	£128
Profit per Employee	£6	£11
Return on Equity	8.69%	7.60%

(not all the above required, but certainly RONA, margin and AT)

All the financial numbers seem fairly stable and gently improving, although 9% RONA and 8% ROE are not that exciting.

The Illovo acquisition has a dramatic effect on employee numbers (it is not quite possible to work out how little they are paid.....)

ii. Liquidity and solvency

(6 marks)

Liquidity and Solvency

	2007	2006
Current Ratio	1.57	1.26
Acid Test	0.97	0.79
Interest Cover	9.40	9.15
Gearing	0.17	0.18

The liquidity ratios are less tight than before – is this an improvement or a waste of capital?

Interest cover and gearing are stable and at safe levels.

- c) Analyse the performance of ABF's grocery, sugar and retail segments in 2006 and 2007. Comment on the changing structure of the group and the implications for future prospects.

(12 marks)

		Grocery	Sugar	Agri	Ingred.	Retail	Central	Elims	Group
Revenue	2007	2,623	1,250	689	795	1,602		-159	6,800
	2006	2,675	766	631	775	1,309		-160	5,996
Operating profit (pre exc)	2007	153	199	18	75	200	-26		619
	2006	185	115	16	82	185	-22		561
Operating profit (post exc)	2007	146	167	19	10	201	-26		517
	2006	180	20	15	47	179	-20		421
Net assets	2007	1,583	1,192	147	818	1,219	-495		4,464
	2006	1,486	1,165	137	926	1,088	-620		4,182
Increase in sales		-1.9%	63.2%	9.2%	2.6%	22.4%			13.4%
Increase in op. profit (pre exc)		-17.3%	73.0%	12.5%	-8.5%	8.1%	18.2%		10.3%
Increase in op. profit (post exc)		-18.9%	735.0%	26.7%	-78.7%	12.3%	30.0%		22.8%
Change in net assets		6.5%	2.3%	7.3%	-11.7%	12.0%	-20.2%		6.7%
Sales margin (pre exc.)	2007	5.8%	15.9%	2.6%	9.4%	12.5%			9.1%
	2006	6.9%	15.0%	2.5%	10.6%	14.1%			9.4%
Sales margin (post exc)	2007	5.6%	13.4%	2.8%	1.3%	12.5%			7.6%
	2006	6.7%	2.6%	2.4%	6.1%	13.7%			7.0%
RONA (pre exc)	2007	9.7%	16.7%	12.2%	9.2%	16.4%	5.3%		13.9%
	2006	12.4%	9.9%	11.7%	8.9%	17.0%	3.5%		13.4%
RONA (post exc)	2007	9.2%	14.0%	12.9%	1.2%	16.5%	5.3%		11.6%
	2006	12.1%	1.7%	10.9%	5.1%	16.5%	3.2%		10.1%
Asset turnover	2007	1.66	1.05	4.69	0.97	1.31	0.00		1.52
	2006	1.80	0.66	4.61	0.84	1.20	0.00		1.43

Revenue %	2007	38.6%	18.4%	10.1%	11.7%	23.6%	0.0%		100.0%
	2006	44.6%	12.8%	10.5%	12.9%	21.8%	0.0%		100.0%
Operating profit (excl exc.)%	2007	24.7%	32.1%	2.9%	12.1%	32.3%	-4.2%		100.0%
	2006	33.0%	20.5%	2.9%	14.6%	33.0%	-3.9%		100.0%

(Bold columns only)

Three main segments.

Background to all three required.

Grocery is relatively high AT, making up for low margins – 2007 was a poor year (the annual report tries to suggest this is mainly about exchange rates, but is rather vague)

Retail is a growing part of the group in revenue terms. AT of 1.3 seems a bit low for the industry margins are 12% but falling. RONA of 16.4% seems fine.

Sugar has grown rapidly (primarily by the Illovo acquisition). Margins seem to be a steady 15%, AT has improved and therefore so has RONA.

Proportionately it is divesting in grocery and moving more into retails and sugar. These are the areas with the highest returns, so this is a sensible attempt to improve earnings for the group in future years.

- d) Calculate and interpret the dividend cover for 2006 and 2007 using the figures on page 48. Discuss whether the adjusted earnings per share on page 01 should be used in the calculation.

(5 marks)

	2007	2006
Dividend Cover	2.39	2.03

Dividend cover has risen a little. A level of 2 seems appropriate for a mature company in a mature industry.

On page 01 an “adjusted” eps of 52.9p is highlighted, as opposed to the IFRS figure of 46.7p. This would increase dividend cover to 2.71, probably giving shareholders a little more security.

A glance at 2006 and 2007 suggests that ABF regularly has some exceptional so being sceptical over ignoring them may well be appropriate.

- e) On page 43 a performance review graph is included as part of the remuneration report. Explain the calculation and meaning of total shareholder return. How has ABF performed compared to the FTSE 100 over the last two years? (4 marks)

TSR adds the gain from an assumed reinvested dividend to any share price gain.

ABF has performed poorly against the FTSE 100. Some companies include a further line of a comparator group of companies (same industry) on the graph – the lack of this leaves the reader thinking that wouldn’t look good either. (The FTSE line is effectively statutory – see remuneration statutory instrument, 2002)

Section B Answer question 2 AND EITHER question 3 OR question 4

Question 2

Below are the abbreviated accounts for Dolphin plc.

Income Statement for the year ending		31/12/2007	31/12/2006
		£	£
Turnover		64000	53000
	Costs	-56800	-49000
Operating profit		7200	4000
	Net interest payable	-2000	-150
Profit before tax		5200	3850
	Tax	-1404	-527
Profit after tax		3796	3323
	Minorities	-300	-275
Profit for group equity holders		3496	3048

Balance Sheet as at		31/12/2007	31/12/2006
		£	£
Non-current assets			
	Intangible	46750	26750
	Tangible	47235	41200
	Total	93985	67950
Current assets			
	Inventory	1250	1050
	Debtors	2450	1800
	Cash	100	100
	Total	3800	2950
less Current liabilities			

D/E	0.37	0.04
D/(D+E)	0.27	0.03
Return on shareholders' funds	5.1%	4.6%

Sales margin has improved substantially (50%)

Interest cover has fallen dramatically, but profit still covers interest more than 3 times.

RONA has improved

Gearing (either calculation is ok) has risen, but is still relatively low

ROSF – modest improvement

- b) Explain why return on net assets has not improved as dramatically as sales margin
(2 marks)

$$SM * AT = RONA$$

Assets have risen dramatically, asset turnover has fallen reducing the impact of the rise in sales margin on RONA

- c) Explain why return on shareholders' funds has not improved as much as return on net assets
(3 marks)

The proportion of operating profit disappearing in interest has risen dramatically (tax has stayed the same).

$$RONA * \text{interest coverage} * \text{tax coverage} = ROSF$$

- d) Calculate and interpret the change in the current ratio and the acid test. Give one reason why the change in liquidity of Dolphin might be good and one reason why it might be detrimental.

(5 marks)

Current ratio	0.88	1.10
Acid test	0.59	0.71

The availability of cash and near cash in proportion to the current liabilities has reduced.

Good? If there was unnecessary investment in working capital before – more efficient use of capital

Bad? If the business model is now too tight and there is likely to be not enough cash available when current liabilities become due.

Question 3

Research and development is a crucial activity for a pharmaceutical company such as GSK plc. The following is GSK's research and development accounting policy.

Research and development

Research and development expenditure is charged to the income statement in the period in which it is incurred. Development expenditure is capitalised when the criteria for recognising an asset are met, usually when a regulatory filing has been made in a major market and approval is considered highly probable. Property, plant and equipment used for research and development is depreciated in accordance with the Group's policy. (GSK Annual Report, 2007, page 95)

In the 2007 financial year GSK had turnover of £22,716 million and recognised a research and development cost of £3,327 million before posting an operating profit of £7,593 million and earnings of £5,214 million. On 9th September 2008, GSK had a market capitalisation of £65 billion.

A client is considering investing in GSK and has emailed you asking for the implications of the research and development policy.

Write an email in reply to the client, including the following:

- i) An outline of the distinction between research costs expensed to the income statement and development costs that are capitalised in the balance sheet.

Unless a set of specific criteria can be met (relating to the high likelihood of the development being revenue generating), the expenditure is expensed whether it is called research or development.

- ii) An explanation of why accountants are averse to capitalising research expenditure.

Research is not capitalised because the outcomes are uncertain both in terms of size and timing (Rolls Royce). Any less conservative approach is thought to be imprudent.

- iii) The implications for the Price Earnings ratio of this accounting policy for GSK and research-intensive companies generally compared to writing off all research and development as it is incurred or capitalising all research and development

PE for GSK = $65/5.214 = 12.5$

Capitalise all research (the extreme position) = (about) 7.6

On the assumption that shareholders think that some of the research will be of some value, then they will be implicitly adjusting profit upwards and actually are only willing to pay a lower multiple than first meets the eye.

- iv) A discussion of the subjectivity introduced into the accounts by these approaches and how an analyst might adjust the published information in order to improve the assessment of the prospects for the company

(15 marks)

The implication for the analyst is that true wealth creation may be understated by the income statement. Interestingly, if the company is mature with stable R&D expenditure this will not be true as the amortising of the intangible asset, if R&D had been capitalised, would be equal to the annual expense after the estimated amortisation life of R&D had been passed.

Some Shareholder value statistics (e.g. EVATM) add back R&D to profit and then amortise, often over 7 years (suspect this is 14 year(?) effective licence and a 50% predicted success rate).

Question 4

IAS7 mandates the publishing of a cash flow statement alongside the income statement and the balance sheet. A client has sent you an email questioning the value of this additional statement and its related notes.

Write an email replying to the client, including

- a) A discussion of the importance in distinguishing between cash and profit

Cash pays the bills. No cash and the company goes bust.

Profit gives a better impression of medium term performance, smoothing out lumpy cash movements.

- b) The common reasons for differences between profit for the period and net cash from operating activities (you may refer to Associated British Foods annual report if you wish)

Working capital (inventory, debtor and trade creditor) changes affect cash and not profit.

Profit is reduced by depreciation, amortisation and impairment, NCOA is not.

Timing of tax

- c) An explanation of the attractiveness of using cash based ratios to assess a company rather than profit based ones.

Profit calculation has required judgment calls by the directors and these may be wrong (and/or biased). "Cash is a fact" (Terry Smith)

- d) A discussion of other the relative merits of cash flow and earnings in the valuing of a company or share.

Capital expenditure – how much was spent in the year, useful for assessing the level of investment (and directors' confidence) in the company – cash speaks more loudly than words! Useful for a cash flow forecast and DCF valuation.

- e) A discussion of other key information that the cash flow statement and related notes provide.

(15 marks)

Net debt position – a useful note.

Financing activity – some of this you could work out from the change in the balance sheets.

Section C

Answer ALL SEVEN questions in this section

Question 5

A company purchased a non-current asset for £20m five years ago with no expected residual value. It has been depreciated on a straight line basis and is thought to have a ten year life. The asset is then sold for £21m. What would be the profit or loss on sale disclosed in the income statement?

(2 marks)

£11m as the carrying value of the asset would be £10m after 5 years

Question 6

Who is responsible for preparing the report and the accounts for a company?

(2 marks)

The directors.

Question 7

If an audit report questions the use of the "Going Concern" principle in the drawing up of a set of accounts, what is that likely to imply?

(2 marks)

It would imply that the auditor is not confident that the company has sufficient financial resources or access to funds to continue in business – i.e. may go bust. The phrase is questioning the valuation basis of non-current assets – that they are being valued for continued use when they ought to be valued as "for sale".

Question 8

If the current ratio is calculated from the face of a published balance sheet, highlight three potential problems with interpreting this number. What does a current ratio of less than one imply about the company's working capital?

(3 marks)

Restricted funds are included in the cash figure

Assumption of the sale and timing of sale of stock is difficult

The liabilities are due at different points in the year.

The meaningfulness of the current ratio is industry dependent.

A current ratio less than one implies that net current assets (WC) is negative, it does not necessarily imply the company is struggling to pay its bills..

Question 9

What are the effects of capitalising interest costs during the construction of a non-current asset on the income statement and the balance sheet? Specifically give the effect on interest cover and profit in the first year this accounting policy is introduced.

(4 marks)

In the year of construction, interest in the income statement is reduced - improving interest cover and profit for shareholders, resulting in a bigger reserve in the balance sheet. The balance sheet is inflated by a matching higher non-current asset figure. In subsequent years, the depreciation of the capitalised interest will increase costs and may reduce profit if no further construction is undertaken or if interest rates fall substantially.

Question 10

BR plc is a quoted company with several substantial trading subsidiaries. The consolidated balance sheet of BR shows "minority interests". Explain the meaning of the balance sheet entry for minority interest. Should it be included in shareholders' funds when calculating return on equity?

(4 marks)

Minority interest is investment by outside shareholders in subsidiaries that are not completely owned by BR. This extracts the proportion of the subsidiary's net assets that do not belong to BR's shareholders.

Include in equity? Depends on your reason for calculating return on equity – it certainly isn't debt. If you are a BR shareholder you should look at your return excluding it.

Question 11

The board of JM plc is considering its accounts for the 2008 financial year. Return on net assets has fallen from 17% to 13%. The following reasons for the decline are put forward.

1. Profit margin declined
2. Stock levels increased
3. Asset turnover rose
4. Depreciation policy for the expected life of the JM's assets was changed from 10 to 12 years.

Which of the above are possible explanations of the decline?

(3 marks)

1 and 2 are possible explanations. 3 is not. 4 may be depending on the relative effect of improved profit verses bigger balance sheet, but it is unlikely.