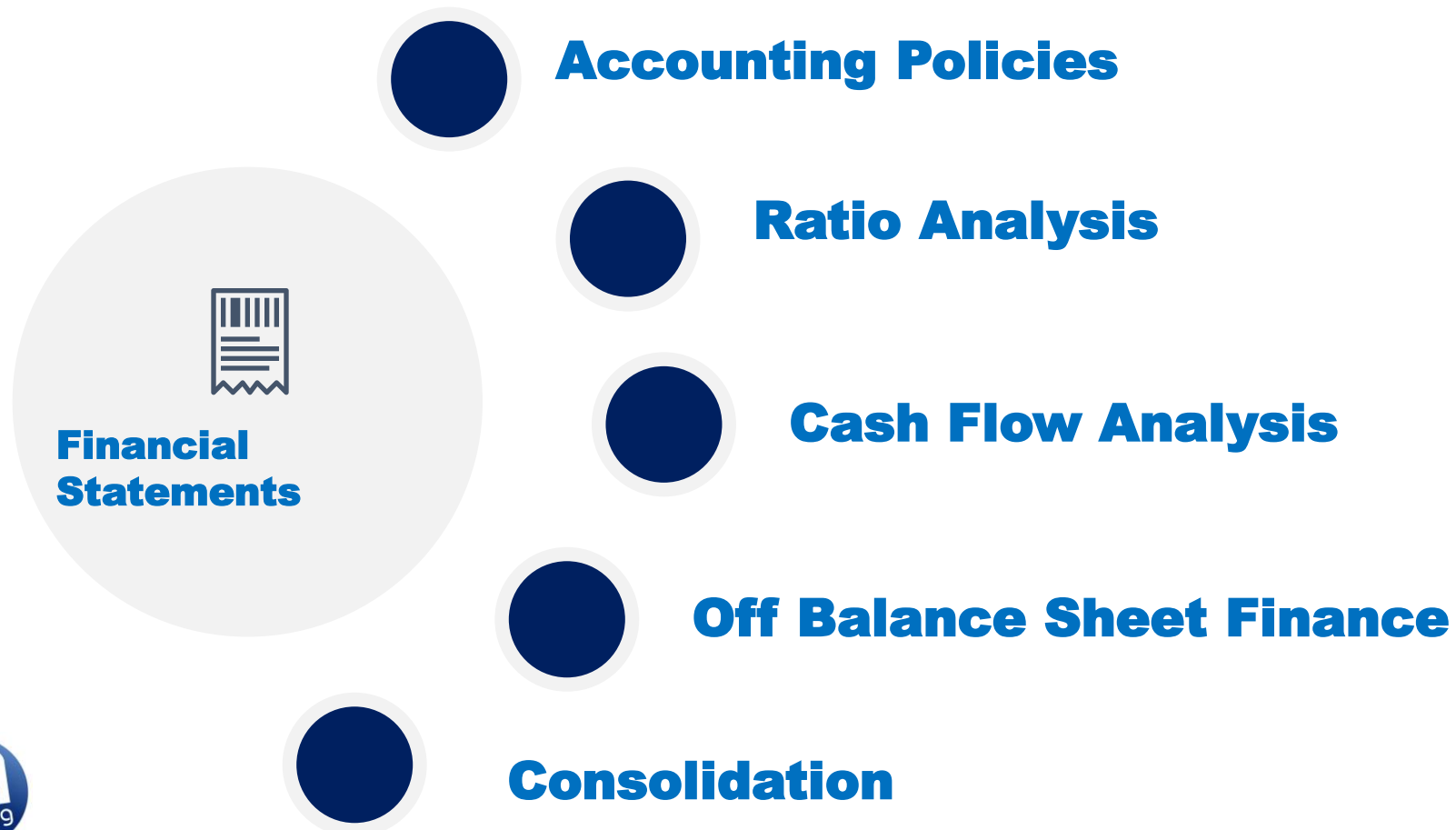


# Part 3: The financial statements and Corporate Credit Analysis

At a time of disruption in the business world can we believe the financial statements?

# There are several aspects to consider in the financial statements and Audit report



# And there needs to be a basis to assess the performance of the business

- Numbers provide a basis for quantitative assessment of how a business is performing through the use of ratios
- Broadly speaking we can split ratios into categories such as
  - Operating performance
  - Asset efficiency
  - Financial performance
    - Debt measures
    - Equity measures

# But can we rely on financial statements to accurately reflect financial performance at a time of rapid and disruptive change?

## Higher risk situations

- **High growth companies in new technology sectors facing ongoing cash deficits as the business builds, high growth companies in general, hyperactive companies, companies making major highly leveraged acquisitions, public companies but with substantial shareholdings by founding shareholders or those operating in industries being disrupted need careful attention**

## Implications for analysing corporate financial performance

- Be alert to signs of creative accounting / “fake financial statements”
- Evaluation of exposures to changes in the operating and / or financial environment
- In addition to evaluating ongoing cash flows and liquidity /access to funding, need to look at other indicators – credit spreads, share prices to get a broader view of the company

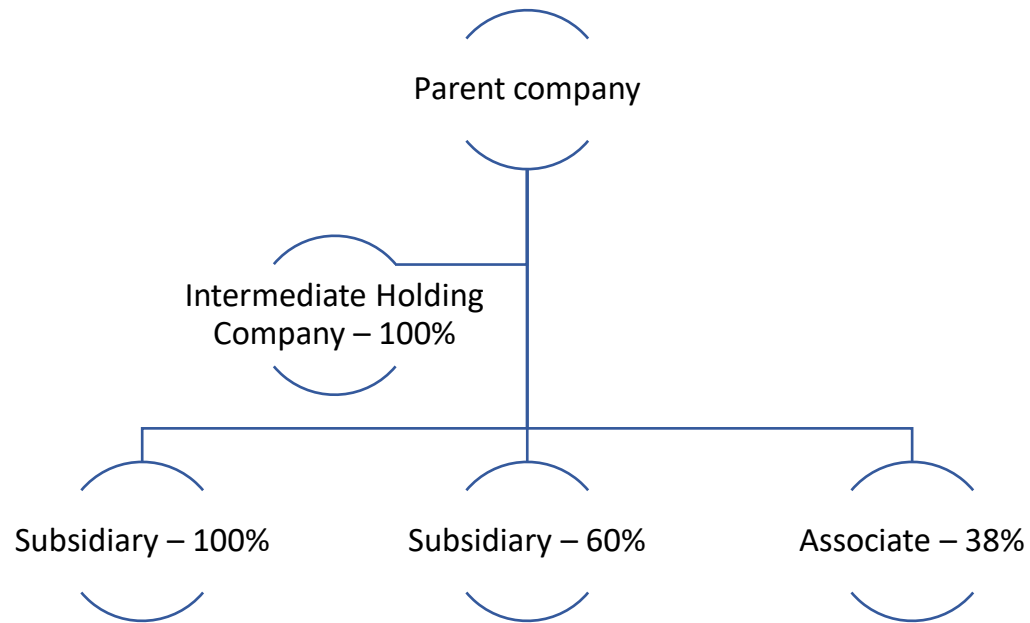
# But what are the most appropriate measures?

- A quantitative assessment of a company's performance is essential, but what are the most appropriate measures given that many financial measures are based on accounting policies which , by their very nature, are flexible
- “Creative accounting is an absolute curse to a civilization. One could argue that double-entry bookkeeping was one of history's great advances. Using accounting for fraud and folly is a disgrace. In a democracy, it often takes a scandal to trigger reform. Enron was the most obvious example of a business culture gone wrong in a long, long time.” Charlie Munger

[http://www.tilsonfunds.com/motley\\_berkshire\\_brkmtg02notes.php3](http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php3)

# Particularly when the structure of a group is complex, it is difficult to assess financial performance

The more complex the corporate structure, the more we should be suspicious about whether the reported financial performance is reliable



# So what are some possible warning signs that a company is aggressive in its financial reporting?

Change in accounting policies

No fully consolidated accounts and significant trading with related companies

Increased earnings but weak / negative cash flows

Regular revaluations of assets

Large exceptional items

Composition of group is constantly changing, making evaluation of underlying profitability and cash flow difficult

Accounting policies which tend to accelerate income

# Creative Accounting – Some additional Possible Warning Signs

Substantial off-balance sheet exposure: operating leases, derivatives and guarantees, performance related risks

Unhedged currency exposures

Large amounts of capitalised interest and expenses

Insufficient provisions ( e.g. pension and healthcare costs, lawsuits, cost overruns on contracts)

Depreciating assets over long periods



# Even cashflow statements can be misleading

- EBITDA is a performance measure with many limitations
- Classification of items (operating costs treated as capital expenditure)
- Underinvestment in the business
- Impact of exceptional items
- Not forward looking
- Operating vs investment vs finance cashflows
- Consolidated vs consolidating cashflows – where is the cash or has it been partly created as a “balancing item” to conceal lack of cash flow?
- Access to cash / near cash financial instruments...cash in restricted accounts
- Currency of cash holdings

# It will be increasingly important to look behind the numbers

- Exposure to large contracts
- Customer concentrations (suppliers and / or purchasers)
- Operating risks (product recalls, legal risks, cost overruns etc)
- Changes in technology
- Political risks
- Social and environmental pressures
- FX and interest rate exposures

# What's next ?

In the next part we will be looking at the implication of rapid and disruptive changes on [capital structuring decisions](#).

In the meantime if you have any comments or suggestions please contact me at [malcolm@m-training.co.uk](mailto:malcolm@m-training.co.uk)