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EVALUATING A COMPANY'S PROGRESS

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Background

There is a current concern that accounting standards in the United Kingdom have been inadequate, thus allowing differing treatments which can distort an objective view of a company's progress. Currently, the newly constituted Accounting Standards Board is reviewing present practice and it clearly does not like what it has seen. Draft rules have therefore been proposed which would substantially increase disclosures, would make a number of mandatory changes to current conventions and would have greater uniformity. There are plenty of other people who are better qualified on the technical accounting issues and therefore I am pleased to be addressing the broader issue of the evaluation of a company's progress. The major "set-piece" communication device is the annual report and accounts which, of course, embraces the statutory financial information and its "half term" equivalent on the half year results.

The Accounts

Investors, creditors, employees and wider interest groups have been comforted by the precision of double entry accounting, the formality of financial statements and the fact that professionally qualified auditors have signed off the accounts as presenting a "true and fair view". No wonder we can all rest easily at night.

City analysts, at least in this country, look deeply into the mysteries behind the company accounts, talk in depth with the top managements of these companies, yet rest heavily on prospective growth in earnings per share, which heavily reflects managements' views about the future.

Individuals who wish to take a view about different companies' progress are faced with indifferent presentations ranging from a dearth of real information to a morass of notes to accounts which will defeat all but the most zealous of analysts.

The Reality

With such an emphasis on earnings per share and with such a variety of accounting opportunities available for exploitation, it is not surprising that profits were stretched and accounts did not reflect the changes in fortunes of different companies. In January 1991, UBS Phillips and Drew published "Accounting for Growth" which highlights differing practices. This excellent publication highlights accounting techniques which enhance earnings per share at the expense of the balance sheet, highlights uneven corporate disclosures and emphasises that insufficient attention is paid to cash flow. Also in the publication they draw attention to quality of earnings by focusing on profits from trading as distinct from "other sources". I would like to mention one or two interesting examples under three headings.

First, some examples on profit and loss account treatments. There are a number of examples recorded but some of the more interesting are: **McCarthy (P6)** who charged £2m to extraordinaries due to the "reassessment of the value of stocks and current assets as a result of new management policies". Many companies have taken profits on the sale of fixed assets through the profit and loss account, often distorting results and often only because the assets were written down through reserves or extraordinaries previously. There have been others like **Tootal (P7)** that sold a stake at a significant profit by phased payments crediting profits rather than taking the total profit as extraordinary.

The second area is the abuse and other use of the balance sheet. UBS Phillips and Drew catalogue off balance sheet finance, deferred consideration in shares and capitalisation of interest costs. We should couple these examples with others where adjustments to reserves are used to avoid charging significant diminution in value through the profit and loss account.

Third, there are examples of a lack of common standards with examples of Coloroll for enormous pre-acquisition write downs (P3) and Polly Peck with major currency mis-matching (P17).

Blame the Auditors

Inevitably, in times of macro-economic difficulty, there were failures because the undue focus on growth of earnings per share did not track the progress of the company. The financial statements did not always show the strength of the company. Further, in this climate and in a relatively small number of cases, fraud and defalcation added to the nightmare. The response was swift and inevitable. We must lay blame on the auditors who, after all, had conspired with such flexible accounting practice and had not discovered or reported upon any fraud. The cynic will argue that auditors' professional indemnity insurance was the prime motivation for such action and this may well be true. There is though, prima-facie evidence of a change in accounting practice being required. I would submit that the solution is not one of increasing complex rules to be rigorously policed by the Accounting Standards Board. The issue is more wide ranging than this and far too important to be left to regulation in this form. I therefore welcome the opportunity of widening the debate to evaluating and communicating upon companies' progress over time.

Moving Forward - The Board's Role

Of course we can neither blame nor rely on the auditors for reporting on the integrity of the stewardship of a company over time. The buck stops with the board who must pay more attention to this issue, how to communicate externally and how they acquit themselves of their duties to shareholders et al.

First, on the wider issue of the Board's role in protecting the integrity of the accounts. We need first to back up a bit and check the composition of the Board. I my view, appropriate corporate governance requires a strong independent presence of non-executive directors led by a Chairman whose role is not amalgamated or confused with that of Chief Executive. The role of Audit Committee should be mandatory, be staffed by non-executives with the Chief Executive and Group Finance Director invited to each meeting. More attention could fruitfully be directed towards the Audit Committee's role and its objectives for each year. There is an opportunity to share best practice here, as many Audit Committees are in their infancy or chaired by inadequately qualified or prepared people. Training is required.

I would like to see both more time devoted to Audit Committees and more teeth given to it to ensure more appropriate reporting. As an example, the Audit Committee could be required to review the accounts before they are signed off. This process would, if required, allow key executives to be summoned to attend, as the Committee would need to sign off on the review and confirm that all salient significant facts have been disclosed. This will take time, with the beneficial side effect which will mean fewer non-executive directorships per head and maybe a higher level of understanding of a particular company's affairs. Non-executives would need to be appropriately remunerated too, differentiating between those who serve on time-consuming committees such as the Audit Committee or perhaps the Remuneration Committee.

Moving Forward - Communication

There are two aspects to this. First, what to disclose and, second, how to present.

A significant forward step would be taken if much greater emphasis was placed on cash flow. My personal management emphasis is strong on cash flow and each of my companies are measured on this key performance criteria. Operational cash flow as a percentage of sales is a key objective and measure of the firm's progress. Therefore, I would like to see greater prominence to the cash flow statement in a form that emphasises cash flow from operations rather than the variety of source and application of funds statements we see published. This statement should receive a primary prominence in the accounts along the style of ED54. To illustrate my point I show in appendices 1 and 2 Polly Peck's published funds flow statement alongside an ED54 cash flow statement. Needless to say, the profit and loss account with the balance sheet would also be provided and I suggest not only with the annual accounts, but also with the interims. I would also like to see higher visibility given to the movements through reserves as a highlighted piece of information instead of scrambling through opaque notes to accounts to try and gain enlightenment.

Next, I would require a brief report from the Audit Committee, covering the work that they have undertaken to ensure the integrity of accounts and to satisfy themselves that all relevant information has, to the best of their knowledge and belief, been provided. They would need to take this duty seriously for there would be a fruitful environment for law suits in the event of nondisclosure or sloppy standards.

The Directors Report or Review of Operations is typically unhelpful in most annual reports because it is a rambling general review of the areas reviewed. In many cases the large part of the report is written three months before the year end and provides little more than filler text to put between the photographs or illustrations which are used to try and make the report more acceptable. This section could be diminished without much loss in knowledge to regular readers. I would much rather that more relevant information was made more readable with emphasise on special interest items which should be disclosed. For example, peak borrowings compared with year end, bank facilities, details of significant off balance sheet items, key changes in shareholders funds, or any shift in strategy. One area that I believe requires more attention, depending on the significance in particular companies, is the treatment of hyper-inflation and resulting currency movements. US GAAP have set standards, yet UK practice is variable. At the very least, the affect of hyper-inflation should be taken out of profits and we should all be very wary if profits are offset by charges against reserves for currency "losses" in countries with hyper-inflation.

No doubt the reader will have his own check list, and indeed I look forward to the results of the study headed by Sir Adrian Cadbury who is reviewing "Corporate Governance - Relations between Boards and Shareholders".

Summary

Recognising that there are loads of experts who can debate technical issues, my role has been to take a wider, more general view. My thesis is that past external company communication has been variable and often inappropriate or even misleading. Change is required, both in content and in emphasis. This will not be achieved by relying solely on toughening rules and giving more teeth to the Accounting Standards Board alone. It is a fundamental shift in onus back to the Board that is required. In my view, this will be assisted by an improved contribution from the Audit Committee, better non-executive director contributions and a more enlightened understanding of the central role of cash flow. I have made a plea for better quality, easily read information, covering movements though reserves, more guidance on accounting policy where hyper-inflation is a significant element, to areas where more helpful information about the statement of financial affairs of a company would be given. The proposed tightening of rules on the use of extraordinaries and exceptionals are a direct response to past company practice which, in many cases, has resorted to abuse. If ever we are to obtain a true and fair view we must, in my view, recognise that this starts with the Board, is practised by the accounting function and only then is reviewed by the auditors.

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SOURCE AND APPLICATION

OF FUNDS

Appendix 1

Polly Peck International PLC and its subsidiaries for the financial year ended 31st December 1989

	Notes		12 months ended 31st December 1989 £ million		16 months ended 31st December 1988 £ million
SOURCE OF FUNDS					
Profit on ordinary activities before taxation			**161.4**		144.1
Adjustment for items not involving the movement of funds: –					
Depreciation and amortisation		**28.9**		19.2	
Provision against other investments		**0.8**		–	
Minority interest		**0.9**		–	
Exchange variances:					
on results of overseas companies		**(1.7)**		(11.6)	
on inter group funding		**(19.3)**		(98.9)	
Related companies share of results less exchange variances		**(0.6)**		–	
Loss on disposal of tangible fixed assets		**1.6**		0.2	
			10.6		(91.1)
TOTAL GENERATED FROM OPERATIONS			**172.0**		53.0
FUNDS FROM OTHER SOURCES					
Bank loans (net)		**686.9**		76.2	
Proceeds on sale of fixed assets		**22.5**		14.9	
Divestments	27	**51.8**		–	
Ordinary shares issued net of loan stock conversions and expenses		**286.3**		181.1	
Guaranteed bond issues net of redemptions and expenses		**37.3**		116.0	
			1,084.8		388.2
			1,256.8		441.2
APPLICATION OF FUNDS					
Acquisitions	27	**582.6**		74.6	
Purchase of tangible assets		**209.0**		156.4	
Purchase of other investments		**17.8**		9.9	
Taxation paid		**12.3**		19.5	
Dividends paid		**18.7**		14.4	
			840.4		274.8
			416.4		166.4
INCREASE (DECREASE) IN WORKING CAPITAL					
Stock and work in progress		**77.4**		60.6	
Debtors		**182.2**		85.6	
Creditors		**28.8**		(49.7)	
			288.4		96.5
INCREASE IN LIQUID FUNDS			**128.0**		69.9

The notes on pages 35 to 55 form part of the financial statements.

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SUGGESTED CONSOLIDATED CASH FLOW STATEMENT
for the year ended 31 December 1989

	1989	1988
Operating activities:		
Profit before tax	161.4	144.1
Adjustment for non-cash items	10.6	(91.1)
Increase in stock	(77.4)	(60.6)
Increase in debtors*	(182.2)	(85.6)
Decrease/increase in creditors*	(28.8)	49.7
Tax paid	(12.3)	(19.5)
CASH FLOW FROM OPERATING ACTIVITIES	(128.7)	(63.0)
Investing activities:		
Acquisitions	(582.6)	(74.6)
Purchase of fixed assets	(209.0)	(156.4)
Purchase of other investments	(17.8)	(9.9)
Proceeds on sale of fixed assets	22.5	14.9
Divestments	51.8	—
CASH FLOW FROM INVESTING ACTIVITIES	(735.1)	(226.0)
Financing activities:		
Increase in short-term borrowings	686.9	76.2
Shares issued	286.3	181.1
Bond issues	37.3	116.0
Dividends paid	(18.7)	(14.4)
CASH FLOW FROM FINANCING ACTIVITIES	991.8	358.9
Net increase in cash and cash equivalents	128.0	69.9

* Assumes that all movements in debtors and creditors relate to operating activities

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