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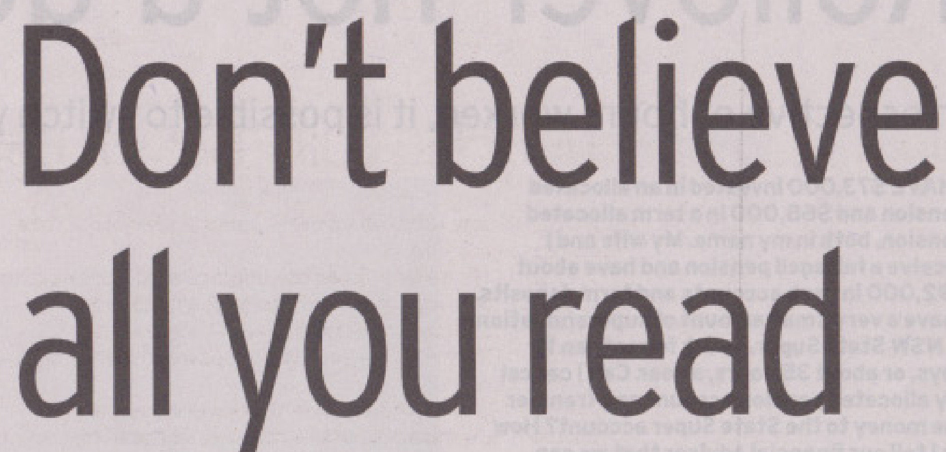

Don't believe all you read

On balance, there's a lot that appears in a company's books that's simply not worth bothering about, writes **David Potts.**

For a good read, your typical balance sheet wouldn't rank among the best sellers but it can keep you in suspense – even after you've read it. You can skip whole chapters, too, like the directors' report, for instance, without losing the plot. Better still, read from the back.

That's where you'll find most of the action, under the deceptively innocuous "notes to the financial statements". Unfortunately, these can run to hundreds of pages but there are only a few that you need worry about, which I'm coming to.

Funnily enough, perhaps the least-useful figures are in what we call the profit and loss account but accountants call the income statement.

You can see from the panel below at profit can mean many things, least of all the truth. As the adage goes, profit is opinion and cash is fact.

"History has shown at various times that people overstate revenues or book profits too early or understate expenses by capitalising them," says the senior policy adviser in financial reporting at CPA Australia, Mark Shine.

You also need to look out for one-offs and take into account, so to speak, the fact that assets are valued at market prices and are likely to recover over time.

The cash flow statement is where you'll find the main plot before the twists and turns in the notes.

Go straight to the last line – net cash flow. It's the pre-tax profit less one-offs and book entries such as depreciation or goodwill.

As always in reading financial statements, just as important as the latest figure is where it's come from. Often it's the trend rather than the update that counts. Compare it with the previous year and you've got in a nutshell how the company has done.

Leading analyst Roger Montgomery goes further and digs out the previous year's statement just to make sure the old figure is still the same.

"The previous year's accounts can be restated but you'll only learn that from a note on page 95 or whatever," he says.

When looking at cash flow, he also subtracts borrowings or capital raisings and adds back any dividends paid.

> ## 'Cash flow cuts through all the shenanigans.'
> ROGER MONTGOMERY, analyst.

After all, borrowing more doesn't always mean the business is growing.

It can also mean it's shrinking.

"Cash flow cuts through all the shenanigans," Montgomery says.

Next is the balance sheet, usually the source of most of the notes that follow.

It's a snapshot at 5pm on June 30, or whenever the balance date is, but the notes won't tell you how representative that is.

A lot can happen on June 29 or July 1, such as manipulating the figures, which is politely known as window dressing.

Watch out for small companies using director loans to prop up the balance sheet and reduce the amount of debt on the day, says a private client adviser at Reynolds Stockbrokers, Michael Heffernan.

The other problem is inventories. "I've never seen an auditor chasing a truck down the Hume Highway to check that the gear in it hasn't been counted twice," Montgomery says.

So-called intangible assets, which are things you can't see or hold, played a large part in the downfall of ABC Learning Centres.

The worst area of abuse is goodwill applied to a takeover.

This lets a company that has paid too much book the excess as goodwill, an intangible asset.

The more it pays, the more goodwill it can generate.

"It's called goodwill no matter how stupid the company was," Montgomery points out.

Spotting an embellished bottom line

A PROFIT by any other name may not be one at all. Getting to the bottom of the bottom line isn't easy without knowing some of the tricks of the game.

Top of the list is what companies like to call "normalised earnings".

At first blush this is the corporate equivalent of seasonally adjusted statistics produced by the Bureau of Statistics.

But it bears more resemblance to the statistical discrepancy, used to fill the holes created by the other figures.

Often they're called "pro forma" earnings, using the cover of Latin to lend a ring of authenticity.

Certainly some one-off costs can give a misleading impression of the underlying profit, as do some odd accounting practices.

But why are pro forma earnings invariably higher than the original? Besides, it's questionable to assume that costs due to restructuring are one-off when they're a reality of business.

"Many business analysts regard restructuring and its costs as part of the normal life cycle of any business," corporate watchdog ASIC says on its website.

Companies will also argue a write-down of asset values should be ignored because they aren't part of the business. Really?

Chances are they've been written down because the business is ailing or paid too much for them in the first place. Either way, it's going to affect future profitability.

Another subterfuge popular with struggling companies is to report their earnings before this, that, and the other thing. What's left can be a very inflated profit.

Taking out interest and tax payments as well as amortisation and depreciation – known by its acronym EBITDA – will show you whether the business is becoming more efficient but little else.

Although depreciation isn't a cash outlay, ignoring it will make a company's sales over cost margin seem higher than it is.

There's not a lot of goodwill about treating goodwill, the intangible value of a business, either.

Goodwill is the difference between what is paid for a business and its book value. But it needs to be written down over time.

ABC Learning Centres went the other way, revaluing its goodwill based on estimates of future cash flow, which boosted what turned out not to be real profits.

No wonder, then, by the time it collapsed 70 per cent of the value of ABC's assets didn't exist.

Debt-led collapses an ugly chapter in corporate history

NOBODY saw Australia's most spectacular corporate collapses coming.

From HIH and One.Tel at the beginning of the decade to ABC Learning Centres at the end, with Babcock & Brown and Allco Financial Group in between, not to mention Centro's close call, disaster wasn't obvious from their accounts.

In the US, the corporate failures were even bigger, naturally, culminating in the collapse of the investment bank Lehman Brothers, which almost pulled down the entire global financial system.

Its fall from grace can be explained by dodgy book-keeping, where billions in borrowings were transformed by derivatives nobody understood into what might loosely be called, ahem, assets.

But that doesn't explain the others.

How can a company that looks so sound on paper end up collapsing?

Easy – too much debt. But it's how they came to run up so much, or managed not to set off alarm bells, that holds the lessons.

The three causes of collapse are over gearing, or not being able to meet the interest on borrowings which could be quite reasonable, or having a bad business says Elio D'Amato, managing director of Lincoln Indicators.

In reality Babcock & Brown wasn't over geared; it's problem was "it never earned an operating cent, everything was from investments," he says.

"As soon as the investment market turned down its profits were smashed."

One.Tel and HIH were good businesses that showed the dangers of a domineering chief executive.

The telco One.Tel was a runaway success with a fatal flaw.

It overlooked the rather fundamental point that if you sell something you should be paid for it.

So while the accounts suggested a strong cash position, this was more wishful thinking than money in the bank.

One.Tel forgot to bill its customers. Or rather its computer tried to and failed. Unfortunately its suppliers were much more on the ball.

HIH, an insurer, set its premiums too low, which generated impressive revenue growth but did not carry enough reserves. The result was an inflated profit figure that was not obvious from the accounts.

It went under owing more than $5 billion.

Its liquidators said its financial position was far worse than the balance sheet showed because it overvalued assets and underestimated liabilities.

More recent collapses have been a variation on the debt theme. It wasn't so much a problem of growing too fast as paying – and borrowing – too much for acquisitions.

Just three months before its collapse the financier-turned-fund manager Allco had paid too much for Rubicon and was caught out by the global liquidity squeeze, so it couldn't refinance maturing debt.

The two tree-planting schemes, Great Southern and Timbercorp, were glorified Ponzi schemes with an upfront tax deduction thrown in.

They were built on debt and needed new investors, or bigger loans, just to stay solvent since their trees weren't going to produce any revenue for years.

The collapse of ABC Learning Centres has become a textbook case, or rather a DVD, on what can go wrong.

"Debt, a crisis of liquidity and inflated asset values all spelt the end for ABC Learning," says Alex Malley, chief executive of peak accounting body CPA Australia, which produced a DVD, called the *ABC of a Corporate Collapse*, as a case study for students around the world.

He also has reservations about the shareholders' equity figure, which is the difference between the company's assets and liabilities.

This is supposed to be what would be left over for shareholders in a liquidation.

"It's a mistake to look at it that way," Montgomery says.

"You won't get that value for the inventory, you won't be able to sell all the assets and, as the Timbercorp collapse showed, you can't collect from all the debtors."

Still, the equity figure is essential for calculating two revealing ratios. In fact, you don't even have to calculate them since they're published on most online broking websites.

One is the debt to equity ratio. That's debt divided by shareholders' equity – both taken off the balance sheet – and shows a company's indebtedness and so level of risk. In this market, debt is death. You want the company to own more than it owes.

Although there isn't a rigid rule about the right amount of debt to carry, for anything other than a multinational giant or a bank a ratio of debt to equity above 30 per cent is considered to be risky.

Another test is the "interest cover", which is how much profit goes to debt repayments.

It's calculated by taking the pre-tax profit before interest divided by the interest payable.

To be on the safe side, the ratio should be more than three so that less than one-third of the profit is eaten up by interest payments.

The other ratio is the return on equity: net profit divided by shareholders' equity.

This is one you need to watch over time but it should be at least above the yield on a risk-free 10-year bond, which is about 5.5 per cent.

But it's the notes that are the real page turners of financial statements. That's where, for instance, you'll discover "related party transactions", which is accountingspeak for strange goings on.

A trade with a related party – such as with one of the company's own directors, which is a lot more common than you might think and perfectly legal if it's declared – can produce all sorts of possibilities.

Certainly, a company buying assets from a director is never a good look.

Another ploy is delaying fee payments to make the balance sheet look better.

There can also be all sorts of strange inter-company loans.

Even more salacious, the notes will show you what executives are being paid.

You'll also find who the major shareholders are and how much skin the directors have in the game.

Contingent liabilities, if a value is put on them, can also be an eye opener.

And check out the dividend payout ratio. This is the proportion of earnings paid out in dividends.

The higher it is, the less likely the dividend can be maintained in a profit slump.

Remember there are some things you'll never glean from the accounts, such as whether a company is late making its payroll tax payments, which would be a sign of financial distress.

As a postscript, there are other sources for this information anyway.

Under the continuous disclosure rules, there's a wealth of information being released that appears on the company's website or an online broking site.

"There's often further useful information in the reports of briefings to analysts," Shine says.