Ten things you need to know about published accounts

Ian Marcousé provides a framework of ten finance concepts to aid your revision

1 Balance sheet

A listing of all a firm's assets and liabilities at a point in time.

Example: an individual's balance sheet would show all they own minus all they owe, thereby showing their net worth (their effective wealth).

Advantage: the way it sets out assets and liabilities helps show a company's financial strengths and weaknesses.

Disadvantage: because it is drawn up on a single day, it is possible to window-dress the data to mask financial problems temporarily.

2 Capital employed

The value of all the long-term capital that is financing the business:

Share capital + Reserves + Non-current liabilities

Example: in 2015 Ted Baker plc had £11.5 million of share capital and £129 million of reserves, making £140.5 million of 'total equity'. It had no non-current liabilities so its capital employed was also £140.5 million.

Advantage: two of the most important ratios are return on capital employed (ROCE) and gearing. Both require capital employed, which goes on the bottom of each formula.

Disadvantage: because it is so important, some companies try to manipulate capital employed, typically by shrinking it so that the ROCE percentage looks more impressive.

3 Current ratio

A measure of a company's liquidity:

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

Example: a ratio of 0.55 means the firm has 55p of short-term assets to cover each pound of short-term debts. That would be poor liquidity.

Advantage: it gives a vital insight into a company's short-term financial health.

Disadvantage: the current ratio includes stock/inventory, which can be hard to sell in an economic downturn or if fashion turns against the business, so true liquidity may be worse than it appears.

4 Gearing

The extent to which a company is financed by borrowed money (debt).

Example: on 1 August 2015 John Lewis was financed by £4.3 billion of capital employed, out of which £2.5 billion was long-term debt (non-current liabilities). Gearing was 58.2% — rather too high.

Advantage: gearing gives a warning about possible future financial difficulties if the ratio is over 50%.

Disadvantage: those that borrow too much make themselves vulnerable to unexpected shocks.

5 Income statement

This shows the revenues and operating costs for a business over a trading period (usually a 12-month financial year). Small firms use the traditional term: **profit and loss (P&L) account**.

Example: in the half year to 1 August 2015 John Lewis generated £4,547 million of revenue offset by £4,402 million of operating costs, yielding a £145 million operating profit.

Advantage: places last year's figures alongside this year's, making it easy to see the company's ups and downs.

Disadvantage: many accounting scandals have related to the precise end to the trading period. Companies such as Tesco have sped up revenue recognition while delaying supplier payments. This flatters short-term profits artificially.

6 Operating profit margins

Profits after deduction of all operating costs taken as a percentage of the company's total revenue.

Example: in 2014 Aldi UK made operating profits of £260 million out of £6.9 billion of sales — an operating profit margin of 3.77%.

Advantage: an operating profit margin can be compared with rivals (Waitrose made 3.87% in that time period) or can be compared with previous years (in 2013 Aldi's margin was 5.15%, so its 2014 expansion was at the expense of profitability).

Disadvantage: as Tesco found in 2014, good-looking profit margins can turn sour surprisingly quickly. The key is to make sure the business is trading well.

7 Profit quality

High-quality profit is generated by ongoing, repeatable trading. Low-quality profit is a one-off and therefore not to be repeated.

Examples: high quality: profits increase 15% because of rising demand from the USA; low quality: selling your headquarters (cost: £20 million) for £100 million and moving somewhere cheaper.

Advantage: considering profit quality makes you check whether the income statement contains 'exceptional' items that boost operating profits in a distorting manner.

Disadvantage: it can be difficult to know whether profit is long-term or one-off. In the example above, rising demand this year may fade next year if the USA finds something new.

8 Return on capital employed

Operating profit as a percentage of the company's capital employed.

Example: in 2015 Ted Baker plc made an operating profit of £49.8 million. Its capital employed was £140.5 million, so its ROCE was:

$$\frac{\text{£49.8 million}}{\text{£140.5 million}} \times 100 = 35.4\%$$

Advantage: shows the financial efficiency of the business. An ROCE of 35.4% at a time when no bank would pay as much as 3% on savings means that Ted Baker's profitability is hugely impressive.

Disadvantage: because City analysts focus on ROCE, there's a big temptation for directors to massage this figure upwards, especially by selling off assets and shrinking the capital employed figure.

9 Corporation tax

The sum owed to the government in settlement of the company's corporation (profit) tax liabilities as set out in the income statement.

Example: in 2015 Ted Baker plc had a pre-tax profit figure of £48.8 million, on which it paid corporation tax of £12.9 million. Year after year Ted Baker pays its corporation tax without any sign of tax avoidance. Others do not.

Advantage: calculating whether a company is paying an appropriate amount of tax gives an insight into whether it is focused on making a contribution to society, or distracted by cunning tax plans.

Disadvantage: Apple's accounts show what appear to be 'proper' tax payments, but by keeping its revenues outside the USA it avoids actually paying those bills, so the tax figure is misleading.

10 Working capital

The day-to-day finance for running the business.

Formula: Current assets – Current liabilities

Example: on 1 August 2015 John Lewis had £1,195 million of current assets and £1,550 million of current liabilities. So its working capital was *minus* £355 million.

Advantage: knowing working capital ensures that you have the day-to-day finance you need to take advantage of short-term opportunities.

Disadvantage: grocery retailers are especially prone to operating with negative working capital. This implies that they are confident they can delay paying their suppliers if necessary — possibly John Lewis shouldn't be doing things this way.

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