European Project To.Be.E.Ewc

VS/2014/0356 - phase WP4 Local workshops

Rome, 9 July - Stockholm, 23 Sep - Amsterdam, 05 Oct - La Valletta, 30 Oct - Bucuresti, 10 Nov. 2015

Fundamentals on Companies/Groups accounting policies
Contents proposal for micro manuals devoted to EWC employee representatives

Anna Maria Romano

This project is co-funded by the European Union

Table of contents

Assets and liabilities aren't nearly as sexy as bargaining.

Carefully analyzed, they can tell us a lot about a company's fundamentals.

The Snapshot of Health. It doesn't tell the whole story: It’s not a magic wand

No indicator in general has any meaning on its own, and must be compared with something else

This project is co-funded by the European Union

1. Documentary evidence of the financial statement

a) Report on operations

b) Balance Sheet or Statement of Financial Position

c) Income Statement

d) Statement of the Comprehensive Income

e) Changes in Equity Statement

f) Cash Flow Statement

g) Notes to the financial statements

2. Company group

2.1 A “company group” distinguishes itself for:

- the existence of a plurality of undertakings;
- a direct or indirect control by a single economic subject;
- a unity of aims.

2.2 This single subject has to draft a report of the “consolidated balance”, to provide information on the patrimonial and financial structure, and on the formation of the comprehensive economic result.

2.3 The company that exerts its control on the others is known as head company or holding.

2.4 The group is composed by a number of companies.

2.5 A financial holding is a company whose company objective is the acquisition of partecipations.

3. Nature of the Group

3.1 Influences the behavior and the aims pursued by the companies that are part of it.

3.2 It is necessary to assess the nature of the majority company:

a) Public/Private = Based on the nature of the juridical and economic subject

b) Financial = the relation among subsidiary companies and holding are of a financial nature, performing different kind of activities

c) Economic = the relation among subsidiary companies and holding are of an economic/technical nature at various levels of production

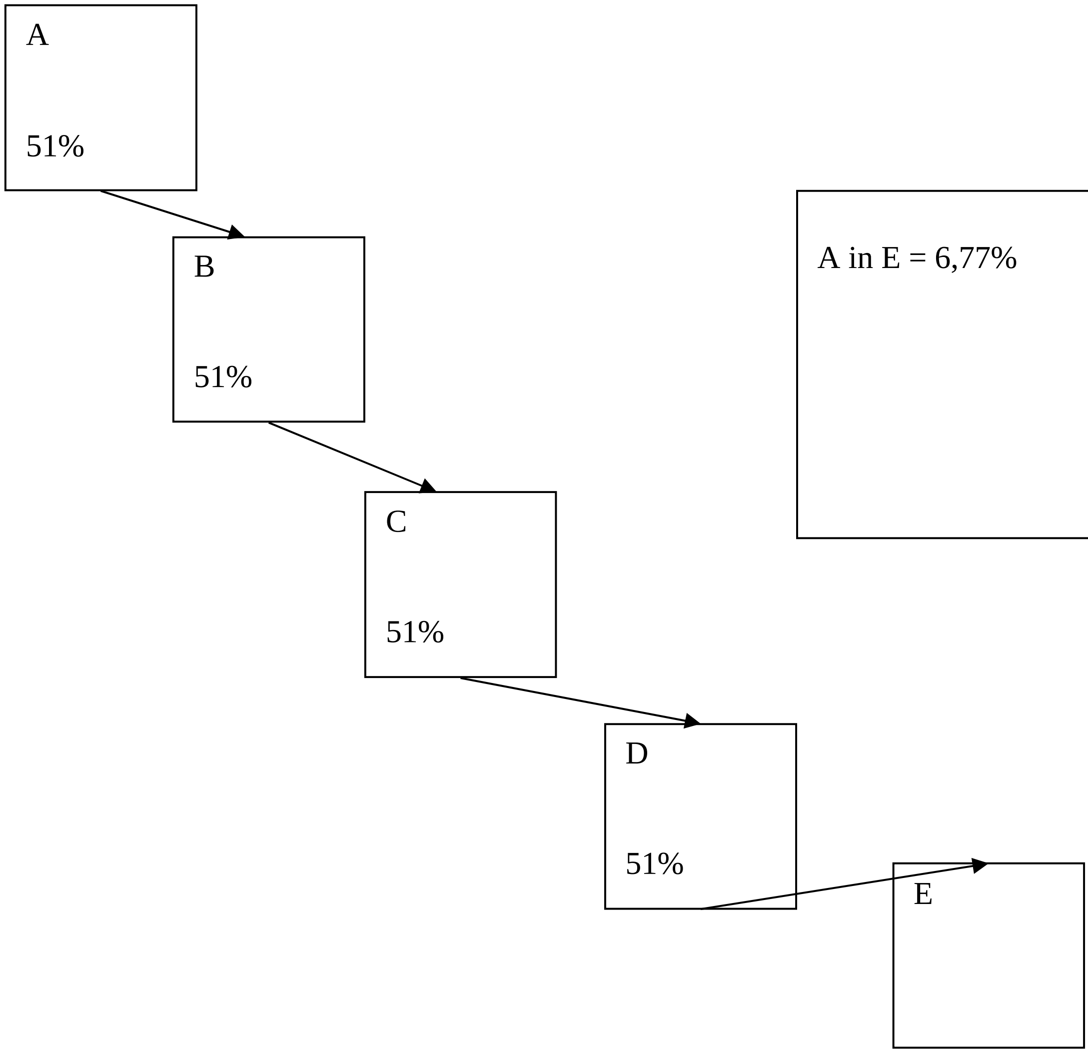
d) Horizontal integration = companies perform homogeneous activities within the same sector

e) Vertical integration = companies perform complementary activities, that are different parts of the same productive cycle

f) Conglomerate = Companies operate in diversified sectors


KRAFT
Coca-Cola
PEPSICO
Kellogg's
MARS
Nestlé
P&G
Johnson & Johnson
Unilever
WRIGLEY
GLACÉAU
QUAKER
Yum!
Cadbury
L'ORÉAL
$$$

3.1 But who manages the group ?



A in E = 6,77%

ì

4. Consolidated Financial Statement

4.1 Must be presented by any "controlling entity" an entity that controls one or more companies

4.2 Must be drafted observing the "accounting principles":

-IAS/IFRS (International Account Standard/International Financial Reporting Standards), used in over 110 countries (including in the EU)

(http://www.iasplus.com/en/standards)

-US GAAP (Generally Accepted Accounting Principles), used in the USA.

4.3 As any other financial statement, the accounting effects of a company operation must be observed at the moment of their economic maturity and NOT at that of their monetary manifestation (accrual basis)

4.4 It considers the “company group” as a single entity and registers only the relations between “company group” and external economic system

4.5 The companies that must be considered for the drafting of the “consolidated financial statement” are part of the “consolidation area”.

4.6 All those items that represent operations between the companies of the group are eliminated:

a) debts and credits among group companies;

b) purchases or sales of goods and services among group companies;

c) interests and dividends related with operations occurred within the group;

d) participations in companies of the group and relative fractions of net assets of these.

5. Scope of consolidation

5.1 The "scope of consolidation" includes all those companies whose financial statements must be taken in account when drafting the "consolidated financial statement".

5.2 The parent company must present the "consolidated balance" which includes all companies under its control (controlled, subsidiaries).

5.3 Control is defined as the power of the parent company to determine the administrative and management decisions of a company and to reap the relative benefits (a concept that was redefined and expanded since 2013).

5.4 The holding must consolidate all national and foreign controlled companies, regardless of their activities.

6. Analysis of the scope of consolidation

6.1 Identifying the scope of consolidation:

- allows to identify the core business of the group

- provides information on the complexity, nature, international ties and level of integration and degree of heterogeneity of performed activities

6.2 The study of its evolution allows to assess the strategic decisions of the holding, in terms of:

a) acquisitions, develop/abandonment of strategic business areas

b) changes in the level of company and/or financial integration

7. The questions that guide us when reading a financial statement

a) Is the group growing or in decline? In general, is the group producing wealth?

b) Is the growth/decline of an "operative" nature (sales, income) or "structural" (investments, operators,…)?

c) What is the contribution of the various managements (core business, atypical management, financial management, extraordinary management)?

d) What is the economic performance of the various segments (geographical and/or business) of the Group?

e) Where is it growing/decreasing? Where is it earning/loosing?

f) What is the performance of market shares in the various segments?

g) What is the performance of the Group investments? Are they of industrial or financial nature?

h) Were there important disinvestments? Which?

i) Were participations in new companies acquired?

j) Were company participations sold?

k) What is the debt load of the Group?

l) What is the nature of the debt (investments, acquisitions, lack of cash, low self-funding, …)?

m) What is the role of the means provided by the associates?

n) Does the Core Business produce cash flows?

o) Is management trying to "cook the books"?

8. ENOUGH?

- Of course, these are very involved questions, and there are literally hundreds of others you might have about a group.
- Think of fundamental analysis as a toolbox to help you answer this questions
- Importance of the role: sometimes we could need external experts
- A financial Statement analysis is a complex operation that makes use of mainly quantitative techniques of data elaboration, with which studies on financial statements (comparison of figures in time and space) are done to obtain information on the management and on the company. Through the comparative budget analysis of the various elements available, we may reach a "judgment" on the health of the company.
- Through the rework of financial statements, many indicators may be established.

Therefore, the calculation of balance sheet indicators requires a good knowledge of the classification techniques of these indicators.

It is too complicated for a brief glossary!

Let's take the figures provided by the companies, but let's try to be aware of the meaning.

Always read the notes to the financial statements. They provide more in-depth information on a wide range of figures reported in the three financial statements.

No indicator in general has any meaning on its own, and must be compared with something else:

- ✓ to the same indicator in the previous years
- ✓ to the same indicator in similar environments
- ✓ to the same indicator in different geographical areas

Financial ratios are mathematical calculations using figures mainly from the financial statements, and they are used to gain an idea of a company's valuation and financial performance

The ratios are compared on an absolute basis, in which there are threshold values

Valuation ratios are also compared to the historical values of the ratio for the company, along with comparisons to competitors and the overall market itself.

therefore generic indicators, that may give some insight, but must be considered carefully.

In some cases it Is possible to give some generic indications.

9. Numbers or informations?

examples:

9.1 Acid test (Solvency– Liquidity): immediate solvency indicator

$$AT = \frac{\text{Immediate liquidity}}{\text{Short term liabilities}} =$$

9.2 **Quick Ratio**: (important that this is positive, negative values show an unbalanced capacity to face immediate debts)

$$QR = \frac{\text{Immediate and deferred liquidity}}{\text{Current liabilities}} > 1$$

9.3 Leverage:

$$\text{LEVERAGE} = \frac{\text{Own capital + Third party}}{\text{Own capital}} =$$

LEVERAGE = 1	Indipendenza finanziaria (non ci sono debiti)
1,5 < LEVERAGE <2	Struttura finanziaria buona
2 < LEVERAGE < 3	Struttura finanziaria con tendenza allo squilibrio
LEVERAGE > 3	Struttura finanziaria squilibrata

There is no magic wand to assess the health of a company only from its debt level, but we may say that, on average, if the ratio starts to reach values between 1 and 2, the company is currently in a state of balance regarding funding sources, while if the level reached is above 2, the company must be considered undercapitalized (own capital is insufficient).

The higher the indicator, the higher the debt load. GOOD?

Pay attention to Credit Crunch

9.4 **Analysis of group profitability**

Instrumental for the durability and autonomy of the group

Profitability indicators allow to observe the capacity of a company to produce profit and generate resources.
Such indicators are useful both for investors, that may calculate an economic return for their investment, and in general to analyze the reliability of a company, assigning to it a specific rating.

9.4.1 **ROI (Return on Investment) – Core business**

Represents the profitability of the core business compared to all investments done in it.

Operating income

ROI = ---------------------- %

Total uses

9.4.2 **ROE (Return on Equity – comprehensive efficiency and effectiveness) = Profitability of invested capital**

Tells us the yield of € 100 of capital invested in the company by the associates.

$$\text{ROE} = \frac{\text{Net profit}}{\text{Own capital}}\ \%$$

9.4.3 **ROS (Return on Sales)**

Expresses the percentage of gross income in terms of operating result on 100 net sales. The indicator is more satisfactory the higher it is. The ROS increases when revenues increase and costs decrease (<u>WARNING! Here labor is a COST…for us it is a RESOURCE</u>)

$$ROS = \frac{\text{Operating income}}{\text{Revenues from sales}} \%$$

9.4.5 **ROT (Return on Turnover) Ratio of task rotation**

Level of plant usage and how **dynamic the company is on the market**. ROT expresses the number of times that the invested capital returns as sales in an administrative year. If the indicatori s 12, it means that the invested capital return as sales once a month. The indicator increases with an equal amount of invested capital, in relation to the increase of sales volume.

$$ROT = \frac{\text{Revenues from sales}}{\text{Total uses}} \quad \%$$

9.5 **Productivity Analysis** What does productivity of labour mean? For companies, it is definable with a simple quantitative formula. However, from a worker's point of view, there is much more than this. What influences every single budget item from a labor point of view? (E.g.: wellness on the working place, safety of the working place, balance of working and living time, appropriate training, correct time management,…) This is a key topic.

$$\text{Average turnover per employee} = \frac{\text{Revenues from sales}}{\text{Num. of employees}}$$

$$\text{Human factor performance} = \frac{\text{Value of production (added value)}}{\text{Num. of employees}}$$

$$\text{Average cost per employee} = \frac{\text{Cost of Labor}}{\text{Num. of employees}}$$

$$\text{Human factor incidence} = \frac{\text{Cost of labor}}{\text{Revenues from sales}}$$

9.6 **Cost Income**

An indicator used by banks, shows the relation between operative costs (such as administrative expenses, expenses for employees and properties) and the earning margin.

10. “Company words”

Statement of financial Position

Activities (Uses) (assets)

Liabilities

Equity

Income Statement

Revenues

Expenses

Statement of Cash Flow Highlights the annual variations in cash and cash equivalent, identifying the area that generated them:

- cash flows from operating activities
- cash flows from investment activities
- cash flows from financial activities

Operative earnings The operative earnings are an intermediate economic result, also called operative income, operative margin or result, and is relative only to the core business of a company, and therefore is not tied to earnings components: financial, non-characteristic, extraordinary, fiscal.

EBITDA (*Earnings Before Interest, Taxes, Depreciation and Amortization*)) is a profitability indicator that highlights profits of a company based only on its core business, without considering interests (financial management), taxes (fiscal management), depreciation of goods and amortization. It indicates the productive efficiency of a company.

Earnings margin: it's an item that is present in the economic report of a bank. Based on the IFRS/IAS standard and according to Basilea, it is defined as the sum of net earnings before interests and net earnings after interests, and must be calculated before any reserve (for example for interest on arrears), operative expenses, including payment to outsourced service suppliers (while it includes payments to the bank for such services), it must exclude profits or losses caused by shares of the banking book, and for irregular or extraordinary batches, the income deriving from insurances.

Economic Value Added, EVA the value that the productive factors used by the company, the capital and labor have "added" to the input gained externally, to obtain a specific production

Productivity: very roughly the relation between the amount of output and that of one or more inputs used in the productive process.

Cash Flow Represents a measure of company self funding

Fair Value Usually fair value is the market price. Even if there are circumstances where the market price does not correspond to the fv, the market price is generally accepted.