

Financial Information Analysis

The role of accounting information
in modern society

Third Edition

Philip O'Regan

FINANCIAL INFORMATION ANALYSIS

The role of accounting information in
modern society

Third edition

PHILIP O'REGAN

First published 2016
by Routledge
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

Simultaneously published in the USA and Canada
by Routledge
711 Third Avenue, New York, NY 10017

Routledge is an imprint of the Taylor & Francis Group, an informa business

© 2016 Philip O'Regan

The right of Philip O'Regan to be identified as author of this work has been asserted by him in accordance with sections 77 and 78 of the Copyright, Designs and Patents Act 1988.

All rights reserved. No part of this book may be reprinted or reproduced or utilised in any form or by any electronic, mechanical, or other means, now known or hereafter invented, including photocopying and recording, or in any information storage or retrieval system, without permission in writing from the publishers.

Trademark notice: Product or corporate names may be trademarks or registered trademarks, and are used only for identification and explanation without intent to infringe.

British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library

Library of Congress Cataloging in Publication Data

O'Regan, Philip.

Financial information analysis : the role of accounting information in modern society / Philip O'Regan. -- 3rd edition.

Includes bibliographical references and index.

1. Financial statements. 2. Accounting. I. Title.

HF5681.B2O74 2016

657'.3--dc23

2015012719

ISBN: 978-0-415-69584-8 (hbk)

ISBN: 978-0-415-69585-5 (pbk)

ISBN: 978-1-315-84837-2 (ebk)

Typeset in Minion

by Saxon Graphics Ltd, Derby

FINANCIAL INFORMATION ANALYSIS

The accounting landscape shifted following the era of global financial crisis and accounting information continues to play a vital role. Philip O'Regan's authoritative textbook provides readers with the tools and techniques to fruitfully analyse accounting and financial data.

Updated to reflect changes in corporate governance, regulatory frameworks and IFRS, the text continues to shed light on the growing emphasis placed on the role of accounting information in formulating financial strategy.

Features that add value to this third edition of *Financial Information Analysis* include case studies in every chapter with numerous supporting articles from the major financial presses, questions for review and a comprehensive companion website. This essential textbook is core reading for advanced undergraduate and postgraduate students of finance and accounting.

Philip O'Regan is Senior Lecturer in Accounting and Finance and Dean of the Kemmy Business School at the University of Limerick, Ireland.

FIGURES

6.1(a)	Lenin and Trotsky celebrate the second anniversary of the Russian Revolution in the Red Square. (b) Lenin celebrates, but Trotsky has been airbrushed.	202
6.2	Group structure	204
16.1	Value chain analysis example	542
A.1	Profitability	586

TABLES

1.1	Small and medium company thresholds	38
6.1	IAS 1: illustrative statement of financial position	208
6.2	IAS 1: illustrative statement of comprehensive income, expenses by function	233
6.3	IAS 1: illustrative statement of comprehensive income, expenses by nature	234
6.4	IAS 1: illustrative statement of changes in equity	235
6.5	IAS 7: illustrative statement of cash flows	237
7.1	The use of four successive common-size income statements	260
7.2	Examples of ratios by category	262
9.1	Funding sources	323
11.1	Group structures: simple examples	385
11.2	Group structures: more complicated examples	386
11.3–11.14	Worked examples	391
12.1	Allocating finance costs using the actuarial method	421
12.2	Calculating tax liability	424
12.3	Calculating deferred tax	426
14.1	Example of a value added statement	479
16.1	Constructing a balanced score card	547
17.1	Cumulative NPV of Company B	561
A.1	Ratios, etc.	589

PREFACE



At first glance, it seems obvious that this bird is destined for the dinner table. Two apparently cruel and merciless humans are about to ensure their quest ends successfully. If, however, you are given more information, for instance that this photograph was taken during one of the coldest winters in Europe in recent years, then the event takes on an entirely different perspective. Far from intending to devour the bird, those in the boat are actually trying to free it from the surrounding ice!

Financial information is a little like a photograph – it is essentially information presented from a particular, and often self-interested, perspective. Only when additional contextual information is obtained can the true significance of the information be properly appreciated.

The manner in which this text is structured reflects this insight. At all points readers are reminded of the need to gather additional information in order to properly appreciate the significance of the financial information being interpreted. Just as the information about the cold winter is important in

allowing a proper interpretation of what is happening in the photograph above, additional insights about companies, markets and information dynamics in general will often be critical.

ACCOUNTING INFORMATION AND ACCOUNTANTS

Accounting information plays a crucial role in modern commerce and society. As a consequence, so do accountants. However, in the wake of the recent international financial crisis as well as a number of large frauds and financial scandals, accountants find their role being challenged, and the usefulness of their primary outputs questioned.

The events surrounding the collapse of RBS, Northern Rock, Enron, WorldCom, Parmalat and others have been catalysts for significant changes in the way in which accounting information is viewed by users (such as shareholders and analysts) and regulated by governments and other interested parties. Ironically, the extent and rapidity of these changes are testament to the enduring importance of accounting information in modern society: the capitalist system depends on a reliable and dependable flow of accounting information and, while heavily criticized, few viable alternatives to accounting information have been proposed.

IN PRACTICE

Seeing the wood for the trees, by Sally Percy

Financial reports have earned a bad reputation over the years. Maligned for being too long and cluttered, hard to navigate and stuffed with meaningless marketing speak, these important documents of record have suffered an endless stream of criticism. In 2007 HSBC's 454-page annual report, weighing in at 1.36kg, was even slated as a health and safety risk after Royal Mail banned its postmen from carrying more than 10 at a time for fear of back injuries.

Then the financial crisis hit. Financial reports were held partly responsible for the meltdown in the banking sector, both for disclosing too much and for not disclosing enough about the risks institutions were taking. Four years on, financial reporting remains under the scrutiny of regulators, standard setters, accountancy bodies and the government.

Financial statements may be designed with the interests of investors in mind but they're used by a range of stakeholders. Nevertheless, their shortcomings mean they could be failing to meet the needs of any group of stakeholders fully – investors included. "External reporting is focused largely on investors as opposed to other stakeholder groups and is

mainly historic," says Simon Bittlestone, commercial director at business analyst Metapraxix. "It has little forward-looking financial information on likely future achievement, which is vital for investor decisions. It also often lacks insight and is generally a of numbers with little trend information or context."

... Given the political importance that financial reporting has assumed since the financial crisis, it's no surprise there are efforts to improve it.

Source: *Economia*, 2 November 2014

This importance – acknowledged in this extract, in spite of its flaws – is especially obvious in those environments where accounting is recognized as a primary means of communication. In a world in which more and more people can expect to have to deal with complex financial information, and a growing proportion of the population acquires shares, this importance can only increase.

This text reflects these developments by seeking to address the nature and role of accounting information in modern society. It focuses on one of the principal accounting documents – the annual report – which in the Anglo-American world is normally produced annually by every company. A primary aim of this text is to equip readers with the skills needed to appreciate the information content of this and other accounting documents.

The most significant feature of this text is that it places the discussion and analysis of the information contained in the annual report in as broad a set of contexts as possible. At its most basic this means recognizing that the annual report itself only partly comprises what is traditionally understood to be accounting information, that is financial data in a recognizable financial statement. In fact, reflecting the limited capacity of accounting numbers to communicate the essence of any corporate entity, and responding to the information requirements of an increasingly large range of users, the annual report has become a substantial document containing a wealth of non-accounting information. For example, directors' reports, chairman's statements, commentaries on the environmental impact of corporate activity, as well as information presented in the form of graphs and tables now supplement the basic accounting statements.

IN PRACTICE

While the annual report is often criticized, there are some very good examples of best practice. The following extract identifies the annual reports of BP and Prudential as examples that have sought to respond to political and investor pressure for change. You can find copies of the reports referred to at www.bp.com/en/global/corporate/investors/results-and-reporting.html and www.prudential.co.uk/investors/financial-highlights, respectively.

How to Report Clearly and Concisely, by Julia Irvine

The annual reports of BP and Prudential are being held out by the Financial Reporting Council (FRC) as examples of how companies can achieve clear and concise reporting ...

Prudential's annual report, the FRC says, has changed significantly over the last two years, even though the group has adopted an evolutionary, rather than revolutionary, approach to improving the readability of the content. Nevertheless, the group's business has been described more concisely and the format streamlined to reduce the number of pages in the report by more than 100. In 2011, the annual report stood at 479 pages, a total which was reduced to 399 in 2012 and to 384 in 2013.

... BP faced additional problems in trying to make its annual report clearer and more concise because of its dual listing in the UK and the US. This means that the annual report has to double up as its US filing document. However, involving both UK and US legal teams early in the project proved useful "as they provided great objective challenge." As a result, BP's annual report is now 5% shorter than it was two years ago, down from 303 pages to 288.

Source: *Economia*, 12 August 2014

At another level, this broader contextualization means that issues such as the role of governance cultures, the demand for and supply of accounting information, and the regulatory, legislative and conceptual frameworks within which accounting information emerges are also investigated.

In seeking to broaden our understanding of the information content of the annual report, the text makes liberal use of extracts, quotations and articles from a variety of sources. This is done not only to supplement the narrative with original and incisive comment, but also to introduce readers to insights that often contradict my own viewpoint. The result is that the reader is challenged to confront issues and assimilate varying perspectives, rather than simply adopt one writer's prejudices.

WHAT IS “FINANCIAL INFORMATION ANALYSIS”?

Financial information is presented in various forms. Financial statements, such as the balance sheet, income statement and cash-flow statement that are found in an annual report, are probably the most common means by which financial information is made available.

These are complex documents, constructed according to detailed rules and regulations that reflect the accumulated wisdom of generations of accounting practice. In other words, they can often be extremely difficult to understand. It becomes necessary, therefore, to learn how to “read” them.

As employed in this text, the term “financial information analysis” describes the processes and techniques used to identify and extract the critical information contained within financial statements and any supporting documentation. Thus, insights and skills developed by users of accounting information over many decades form a critical part of this text and are covered in considerable detail.

Significantly, the application of these techniques and processes is not presented as an end in itself. On the contrary, financial information analysis is presented as a more holistic exercise that contributes to an informed and balanced decision-making process. This process includes the application of various analytical techniques and skills. Critically, however, these are considered with reference to the broader strategic, commercial and social contexts that impact every commercial entity. Thus, the needs of a variety of users are considered, while the notion that any one interest group should dictate the financial reporting agenda is challenged.

FUNDAMENTAL ANALYSIS

The perspective, techniques and skills adopted in this text can be broadly grouped under the heading “fundamental analysis”. This is an approach that seeks to analyse and interpret a company by investigating its fundamental financial, strategic and human elements.

This distinguishes it from “technical analysis”, an approach that focuses more on stock-market measures and seeks to find indications of future share performance in historical patterns.

The text is divided into five sections and an appendix as follows.

I CONTEXT

The text begins with an identification and discussion of the various contexts within which corporate financial communication should be considered. The intention is to

challenge readers to consider the various forces and influences that have conjoined to produce financial information in the forms in which it currently emerges.

Separate chapters are devoted to the following topics:

- Regulatory context
- Conceptual context
- Theoretical context
- Governance context

In discussing these, particular attention is paid to international issues and current developments.

II CONTENT

The annual report is a substantial document containing a huge volume of information in various formats, only some of which are recognizably financial in nature. The second section of the text is devoted to a detailed analysis of the reporting and disclosure requirements underpinning what should be included in an annual report.

These requirements are considered under two headings, reflecting the most obvious subdivision in the nature of the information contained in an annual report:

- Annual report: narrative
- Annual report: financial

III ANALYSIS

Since one of the primary functions of the text is to equip readers with the ability to identify and extract the key information from an annual report, a separate section is devoted to explaining one of the more popular and useful means by which this is traditionally achieved – fundamental analysis. Under headings that reflect the principal areas of concern for most large corporate entities, readers are introduced to the main techniques of fundamental analysis and encouraged to use these in analysing financial information. They are also made aware of the limitations of this approach and, most importantly, of the fact that techniques such as these are merely a means to an end.

Reflecting the principal areas of corporate activity, this section includes chapters dealing with the following:

- Fundamental analysis

- Activity and liquidity
- Financing
- Profitability and return on investment

IV ISSUES

This section deals with some of the more complex elements of financial accounting practice as these will need to be understood in order to analyse the financial statements of larger entities. These issues are considered in an international context and accounting practice in the UK is compared with that in the US and several continental European countries.

In addition, readers are alerted to some of the more common creative accounting techniques, as well as developments such as those occurring in the area of corporate social responsibility.

Chapters addressing the following issues are included in this section:

- Business combinations
- Pensions, share options, leases, taxation, and foreign currency
- Creative accounting
- Corporate social responsibility
- International accounting

V STRATEGY AND VALUATION

This is a completely new section comprising two chapters on strategy and business valuation. These additions are in response to feedback on previous editions of this text and reflect the fact that, increasingly, accounting information needs to be approached from a strategic, as distinct from a technical, perspective. Valuation is also presented in this context, exploring various valuation options in the context of strategic acquisition opportunities. This fits perfectly with the overall approach of the text which seeks to place accounting information in its decision-making context.

The two chapters in this final section are:

- Strategy
- Business valuation

APPENDIX

Throughout the text, reference is made to the annual reports of a number of companies. However, particular attention is given to the Debenhams 2014

Annual Report. This is an exemplary annual report, and in Chapters 8, 9 and 10, in particular, it is used as the basis on which ratios and other performance metrics are illustrated.

These are brought together in the Appendix, where an example of a company report based on an analysis of Debenhams is provided. This is updated on an annual basis and these updates are available on the website.

This company report brings together the various skills and contextual understandings gained so far. The purpose is to allow readers to see how these techniques can be applied, and to highlight the fact that the process of interpreting such information involves more than merely the application of these skills.

For reference purposes, you can access the Debenhams Annual Report 2014 at: http://media.corporate-ir.net/media_files/IROL/19/196805/agm2014/annual_report_and_accounts.pdf

UNIQUE FEATURES

This text employs several unique features in communicating the relevance and immediacy of the topic:

- The role of accounting information as an aid to the decision-making process is emphasized.
- The text is based on International Financial Reporting Standards (IFRS), the most widely used international accounting standards.
- Readers are not immediately confronted with masses of technical information. Thus, Section I introduces readers to fundamental theoretical and conceptual issues that need to be considered when approaching accounting information.
- Extracts from newspapers, journals and websites are employed liberally in order to elaborate on points made within the text and, on occasion, to illustrate alternative viewpoints.
- Each chapter starts with learning objectives that set out clearly what is covered.
- “In practice” inserts are used to demonstrate how various regulatory, legislative and other provisions translate into practice.
- “In depth” sections in several chapters direct readers to the text website for more information on topical and/or complex issues relevant to the chapter in question.
- “Review questions” at the end of each chapter enable readers to review the principal elements of the chapter.
- End-of-chapter “Case studies”, often incorporating detailed extracts from other sources, are intended to stimulate discussion as well as allow readers to investigate particular events and companies in more detail.

- Readers are referred to various websites for supplementary reading and information.
- While UK accounting is placed firmly in the Anglo-American context to which it belongs, international comparisons constantly alert readers to the fact that alternative practices and perspectives exist.
- Interpretation is identified as an intuitive process that is assisted by techniques, contextual grounding and experience where the whole is often greater than the sum of the individual parts.
- The interests of stakeholders other than shareholders are considered.

COMPANION WEBSITE

Considerable use is made of the companion website for the text, which can be found at www.routledge.com/cw/oregan. There readers will find additional materials such as:

- “In depth” topics discussed in more detail and supplemented by up-to-date material;
- supplementary materials such as additional computational questions, answers to various questions included in the text and illustrative examples are also available;
- updated company reports;
- regular updates on regulatory and other initiatives that are needed to remain up-to-date.

In addition, lecturers using the book as a course text will find:

- answers to each chapter’s “Review questions”;
- answers to supplementary and other computational questions;
- PowerPoint slides for each chapter.

ACKNOWLEDGEMENTS

I would like to thank Sheila Killian, Ken O'Sullivan, John Heneghan, John McCarthy and Orla Lenihan, who contributed in various ways to this edition.

CONTENTS

<i>List of figures</i>	<i>ix</i>
<i>List of tables</i>	<i>xi</i>
<i>Preface</i>	<i>xiii</i>
<i>Acknowledgements</i>	<i>xxiii</i>
Introduction	1
Section I: Contexts	17
1 Regulatory context	19
2 Conceptual context	49
3 Theoretical context	81
4 Governance context	124
Section II: Content	169
5 Annual report: narrative	171
6 Annual report: financial	202
Section III: Analysis	251
7 Fundamental analysis	253