

A 21st century global credit management tool



It is perhaps time to realise that traditional financial analysis is inadequate, argues *Ron Wells*, Credit Manager – London Trading, Russia, Europe, Africa, Middle East & Central Asia Region, for ChevronTexaco Global Trading. Timebombs like Parmalat have shown that new methods such as forensic cashflow analysis may provide a better check against failing companies.

'When the scale of Parmalat's problems emerged, Standard & Poor's (S&P) was forced to downgrade the company's stock from investment grade by eight notches, later abandoning a rating altogether. Investors are wondering if the agency's other ratings are now to be trusted,' *The Sunday Times*, London, 4/01/04.

Ever since the South Sea Bubble burst (the first great stock market crash that took place in England in 1720) authorities and the credit profession have been trying to protect investors and creditors from dishonest and incompetent management. It is beyond doubt that corporate failure is usually due either to fraud or ineptitude. Unfortunately the method of financial analysis and assessment adopted since the 18th century, and continuously refined over the latter half of the 20th century, has repeatedly

failed. Thus the spectacular corporate bankruptcies of recent memory are just the most topical in a long list stretching over more than 200 years. It is perhaps time to realise that traditional financial analysis is inadequate.

Useless methods

Traditional methodology is undoubtedly useful in producing data for the elegant mathematical models favoured by investment gurus, fund managers, and credit derivative traders. However, from the point of view of protecting investors and creditors from rogue management and overpaid dim-witted directors, it is evidently useless.

In banks and companies, the analysis of financial statements has been a fundamental building block of credit decision-making for centuries. The tools and techniques of

financial analysis have been continuously refined. Concurrently additional requirements have been imposed on reporting companies, in an ongoing effort to eliminate abuses.

All of these labours have obviously failed to introduce sufficient transparency to protect investors and creditors. Despite policing by auditors and the authorities, cases involving abuses by management, fraud, and reckless disregard for the interests of investors and creditors are reported with monotonous regularity. The

Parmalat case is just the latest in a string of corporate failures that have cost investors, pension funds, bankers and corporate creditors hundreds of millions.

All these losers relied on traditional financial statement analysis as an essential part of their decision-making process, before risking their money. Bearing in mind that traditional financial statement analysis has repeatedly failed to protect investors and creditors, one must wonder why faith remains in this ineffective paradigm. As an illustration of the impotence of traditional analysis it is noted that Parmalat

issued a €350 million bond in September 2003. This issue was rated 'investment grade' at BBB- by S&P and was underwritten by Deutsche Bank (Parmalat press release 15/09/03).

In December 2003, a mere three months later, it was revealed that Parmalat was bankrupt and as a result of cash shortages it had not paid dairy farmers in northern Italy for the past six months (*The Sunday Times*, 28/12/03). Therefore the bond issue took place about three months after Parmalat commenced defaulting on

“Perhaps if bankers and investors had paid more attention to the state of Parmalat's cashflow, rather than concentrating on traditional financial analysis, they may have avoided being entangled in this scandal”

payments due to suppliers, the dairy farmers. Perhaps if bankers and investors had paid more attention to the state of Parmalat's cashflow, rather than concentrating on traditional financial analysis, they may have avoided being entangled in this scandal.

It has also been recounted – since the bankruptcy came to light – that analysts repeatedly asked why Parmalat reported investing an additional €1.12 billion in 'securities' while simultaneously increasing short and long-term debt by some €458 million in 2002. This was certainly a practice that made little business sense and a clear

signal that all was not well. Sadly, few analysts had the courage to act on this anomaly when Parmalat evaded providing an adequate explanation.

It should be understood that prior to bankruptcy the traditional financial ratios derived from the audited balance sheet and income statement of the Parmalat group gave comfort that, if the company imploded, analysts could plead that they did what was expected. They all analysed the same numbers in the traditional way and all came to the same conclusion, so none of them will be fired. In the analysts' defence it is an evident

paradox that while corporate executives often prove incompetent in managing a successful business, they have extraordinary abilities when it comes to achieving the reporting of satisfactory financial ratios.

Shifting analysis to cashflow

Many professional analysts are now shifting the focus of their financial analysis away from the balance sheet and income statement, to the cashflow statement that is provided with many audited reports. Most debt-issuing companies follow US Generally Accepted Accounting Principles (GAAP) or International Accounting Standards (IAS 7) rules, when they prepare cashflow statements.

It is widely believed that the cashflow statement is not vulnerable to manipulation because these rules have instilled a sense of confidence, since they are designed to ensure transparency and consistency. In fact GAAP and IAS 7 in attempting to ensure consistency often actually create misleading results. In addition, these rules provide corporate management with several opportunities to 'legally' manipulate the key 'operating cashflow' figure.

Cashflow statements are produced by the 'indirect' method in the vast majority of cases. This method requires companies to reconstruct or deduce the amount of cash generated by normal business operations during a period. This is achieved by working backwards from the net income figure. Net income is normally the result of an accrual accounting-based exercise that is very satisfying for accountants. Sadly it is not much use for those interested in understanding whether or not a company will have the means to pay its debts when they fall due. Hence it is necessary to adjust

the net income figure by adding and/or subtracting non-cash items in order to establish the operating cashflow for the period being reported.

As already indicated, many analysts feel that the operating cashflow number produced by a company is reliable, because it is not subject to manipulation in the same way as balance sheet and income statement numbers. It is true that operating cashflow is subject to less manipulation but unhappily it may still be misleading. It is necessary to analyse and adjust any reported operating cashflow (OCF) figures, in order to establish the amount of sustainable operating cashflow (SOCF) a company could produce in the future. Company management will soon realise the new focus of analysts on the cashflow statement, and those executives that are intent on misleading investors and creditors will no doubt take steps to deceive the unwary. Therefore it is potentially dangerous to accept the operating cashflow figure presented in any financial report, without further analysis.

An inexact science

This realisation has seen the recent development of the inexact science of forensic cashflow analysis as an early 21st century tool for credit research.

Every investor, lender or creditor is interested in a target company's ability to generate 'sustainable operating cashflow' from which it will be able to grow the business, pay dividends, and repay its debts when they fall due.

In this respect audited financial statements have always suffered from the fact that they represent income and cash generated in the past, or assets and liabilities existing at a point of time in the past. Naturally the real interest of analysts is in the future so analysts are not well served by financial statement information. Analysts need to know whether

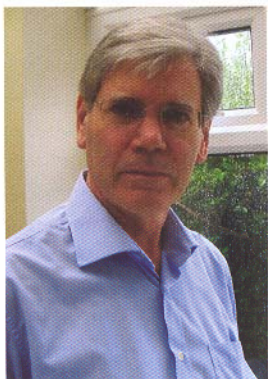
a company will have in-hand the means (the cash) to pay its debts when they fall due in the future, that is the crucial question.

The art of forensic cashflow analysis aims to predict the sustainable operating cashflow (SOCF), and subsequently the free cashflow (FCF) and future liquidity of a company, based on the assumption that the future will more or less resemble the past.

Today, more than ever before, it is hazardous to make the assumption that the future will resemble the past. The outcome of any analysis on that basis must be tempered by a parallel analysis of the relevant change drivers that could impact the target company. Combining these two approaches can produce a useful assessment of the future liquidity position of a company.

It is freely admitted that forensic cashflow analysis is based on uncertain information and some educated guesswork. Hence, in the absence of the information available to company 'insiders', this approach will offend the more meticulous accountants in the credit fraternity. Nevertheless forensic cashflow analysis does produce valuable information upon which to base an investment or credit decision, information that is arguably more useful than that produced by traditional analysis.

Once forensic cashflow analysis is widely adopted in practice, it should prove to be helpful in identifying failing companies in time to take avoiding action. Analysts should embrace forensic cashflow analysis methodology sooner rather than later. Although they will risk the ire of those with a vested interest in traditional financial analysis methods, and the chagrin of those meticulous accountants among us who would rather a method produce a neat conclusion than a useful one.



Ron Wells is the author of Global Credit Management – An Executive Summary, published by John Wiley & Sons. This is a concise but authoritative work that exposes the power of credit. Credit activities that are well managed have the power to drive business success. However, credit management functions are often fragmented across organisations and/or tackled by non-professionals as non-core job functions. The result is the power of credit is shackled, and the organisation forfeits the competitive advantages that flow from excellent credit management.