REDOVISNING

2163 FINANCIAL STATEMENT ANALYSIS AND VALUATION **Exam 25.1.2014**

Examinator: Professor Minna Martikainen

Instructions to the exam:

Answer total of 5 questions out of 7.

Calculators (own, also programmable ones, and Hanken) are allowed.

Please underline the main points in your answers!!!

1. **(20p)**

   What are seen as two main different strategies for creating competitive advantage presented during the course? Please explain the main ones, and discuss detailed their contents and the ways of creating / affecting competitive advantage. Also analyze how company can create competitive advantage, what capabilities are needed, and what is needed to maintain the created competitive advantage.

2. (20p)

In the class we went thru Finnair case of showing the effects when leased assets are off the balance sheet and how balance sheet and income statement should be adjusted to include the information of leased assets. The case material shows as follows:

On December 31, 2011 and 2010, Finnair reports the following minimum future rental payments:

(€ millions)	December 31, 2011	December 31, 2010
Less than 1 year	65.8	70.2
1–2 years	48.7	62.2
2–3 years	32.6	45.4
3–4 years	29.9	29.9
4–5 years	22.0	27.2
More than 5 years	29.7	47.4
Total	228.7	282.3

Because Finnair does not show the present value of its operating lease commitments, the analyst must decide how to allocate the lump sum values of €29.7 and €47.4 over year 6 and beyond, and estimate a suitable interest rate on the lease debt. It is then possible to compute the present value of the lease payments.

Finnair indicates that its effective annual interest rate on outstanding interest-bearing debt is 2.9 percent and the lease expense reported in 2011 is €69.9 million. Assume that the annual rental payments in the sixth year is equal to the rental payment in the fifth year (€22.0 and €27.2) and the remainder of the lump sum values (€7.7 and €20.2) is due in the seventh year. With a discount rate of 2.9 percent, the present values of the minimum rental payments for the years ended December 31, 2010 and 2011 are as follows:

(€ millions)	December 31, 2011	December 31, 2010
Within one year	63.9	68.2
Over one year	146.5	190.1
Total	210.4	258.3

Given this information, the analyst can make total of 6 adjustments to Finnair's beginning and ending balance sheets, and to its income statement for the year ended December 31, 2011:

The adjusted balance sheets (2010 and 2011) and income statement (2011) are presented as follows:

€(millions)	Adjustments December 31, 2010 Assets	Liabilities	Adjustments December 31, 2011 Assets	Liabilities
Balance sheet				
Non-Current Tangible Assets:				
Beginning capitalization	+258.3 (1)	+258.3 (1)	+258.3 (1)	
New leases			+14.5 (2)	
Annual depreciation			−65.6 (5)	
Non-Current Debt:				
Beginning debt				+258.3 (1)
New leases				+14.5 (2)
Debt repayment				−62.2 (4)
Deferred Tax Liability				−0.9 (6)
Shareholders' Equity				−2.5 (6)
Income statement				
Cost of Sales:				
Lease expense				−69.9 (3)
Depreciation expense				+65.6 (5)
Interest Expense				+7.7 (4)
Tax Expense				−0.9 (6)
Net Profit				−2.5 (6)

These adjustments increase Finnair's fixed assets by 18 and 14 percent in 2010 and 2011, respectively, reducing the company's fixed asset turnover (sales/fixed assets) from the reported value of 144 percent to 122 percent in 2010, and from 154 percent to 135 percent in 2011. Note that an alternative method for calculating depreciation (under item 5) is to assume that the scheduled debt repayments for the first to the seventh year following fiscal 2010 accurately reflect the consumption pattern of the future economic benefits arising from the leased assets. Under this method, which is sometimes referred to as the interest-based or present value method, the depreciation expense for 2011 is €62.2, as calculated under item 4, and the adjustment's effect on Net Profit is zero.

Your task now is to be the analyst, who step by step thru points (1) to (6) forms adjusted balance sheet and income statement information. Please explain what is done and why in every adjustment/correction step.

3. (20p)

Euro Disney and the First Five Steps of Accounting Analysis

ares of Euro Disney Associes S.C.A., which operates, amongst others, the Disneyland Park, Disneyland Hotel, and Davy Crockett Ranch in Paris and holds 99.99 percent of the shares of EDL Hotels S.C.A. EDL Hotels operates all of the Disney Hotels in Paris (except for the Disneyland Hotel and Davy Crockett Ranch).

Euro Disney Associés leases the Disneyland Park (including land) under a finance lease from Euro Disneyland S.N.C., which is owned by (1) a syndicate of banks and financial institutions (83 percent participation) and (2) a wholly-owned subsidiary of US-based The Walt Disney Company (17 percent participation). EDL Hotels S.C.A. rents land to a group of six special-purpose financing companies, who, in turn, own the hotels on the land and lease these hotels back to EDL Hotels. All special-purpose financing companies are fully consolidated in Euro Disney's financial statements, despite the absence of ownership in some cases. This is because, as the company reports in its 2011 annual report, "the substance of the relationship between the group and these financing companies is such that they are effectively controlled by the group." In fact, all special-purpose financing companies are managed by management companies that are directly or indirectly owned by The Walt Disney Company or Euro Disney Associés.

Euro Disney's primary sources of revenue are its two theme parks (entrance fees, merchandise, food and beverage, special events), its seven hotels and Disney Village (room rental, merchandise, food and beverage, dinner shows, convention revenues). Disney Village offers themed dining, entertainment, and shopping facilities. The company has, on average, 13,740 employees annually. The company and its subsidiaries are considered as one French economic and labor unit, regulated by the National Collective Bargaining Agreement signed in 2001 with six out of seven trade unions represented in the unit. The majority of the company's employees (about 90 percent) have a permanent contract. To cope with the seasonal nature of the business, Euro Disney is able to move employees from its theme parks to its hotels and vice versa. Approximately 5 percent of total personnel expenses consist of training costs.

In 2005, after a period of poor performance, Euro Disney began renegotiations with its lenders and The Walt Disney Company, obtained waivers for certain debt covenants and agreed to restructure its financial obligations. As part of the restructuring, the company would issue new share capital, obtain the option to defer certain payments to The Walt Disney Company, and receive authorization for a new investment plan. Further, the company would change its organizational structure to the one described above. Since the restructuring, Euro Disney's debt agreements include debt covenants requiring the company to maintain minimum ratios of adjusted operating income (before depreciation and amortization) to total debt service obligations. The adjusted operating income figure is also used to determine the amount of interest on the company's Walt Disney Studio Park loans and the royalties and management fees payable to The Walt Disney Company. In particular, if actual performance is less than the contractually agreed benchmark, the company can defer the payments of interest, royalties and management fees. The debt covenants also limit the amount of new debt capital that Euro Disney can attract to €50 million.

Euro Disney S.C.A. is publicly listed on the Euronext Paris stock exchange. By the end of 2011, 39.8 percent of its shares were owned by The Walt Disney Company, 10 percent were owned by Prince Alwaleed and 50.2 percent were in the hands of dispersed shareholders. The company has a Supervisory Board with ten members, two of which are representatives of The Walt Disney Company, an audit committee and a nominations committee. Euro Disney S.C.A. as well as both operating companies of Euro Disney S.C.A., i.e., Euro Disney Associes and Euro Disney Hotels, are managed by management company Euro Disney S.A.S. (referred to as the *Gerant*), an indirect wholly-owned subsidiary of The Walt Disney Company. At the end of fiscal year 2011, the CEO of the *Gerant* (Euro Disney S.A.S.) was Philippe Gas, who replaced Karl Holz on September 1, 2008. For the management services provided to the holding and operating companies, the *Gerant* receives management fees. The aggregate compensation for the eight independent Supervisory Board members was €276,041 in 2011. The two representatives of The Walt Disney Company received an annual fixed salary, a bonus, restricted stocks, and stock options from The Walt Disney Company. Philippe Gas' employment contract promised him:

1 An annual salary of €379,673.

2 A discretionary annual bonus based on individual performance relative to the objectives of the company and The Walt Disney Company Parks & Resorts operating segment.

3 Discretionary grants of the company's stock options, The Walt Disney Company's stock options, and The Walt Disney Company's restricted stock.

4 The use of a company car.

In addition to Philippe Gas, the Executive Committee of the *Gerant* consisted of five senior vice presidents and six vice presidents.

Euro Disney reported net losses in 2009, 2010, and 2011. Whereas the company's total revenues increased by 1.8 percent to €1,298 million in 2011, direct operating costs and marketing and sales expenses increased by 4.2 and 2.6 percent, respectively. Euro Disney's operating cash flows amounted to €124.1, €236.7, and €168.7 million in 2009, 2010, and 2011, respectively. In all three years, the cash flows used in investing activities were less than the operating cash flows. In 2011 Euro Disney used part of the surplus of operating over investment cash flows to repay some of its borrowings, thereby reducing the non-current debt to total assets ratio from 67.5 to 67.0 percent. The company's trade receivables to sales ratio decreased from 6.1 percent in 2009 to 5.6 percent in 2011. Liabilities for deferred revenues as a percentage of sales decreased from 2.4 percent in 2009 to 1.2 percent in 2011, after having amounted to 9.0 percent in 2008. The allowance for uncollectible receivables decreased from 3.2 percent (of gross trade receivables) in 2009 to 1.5 percent in 2011; the allowance for inventories obsolescence increased from 8.7 percent (of gross inventories) in 2009 to 9.2 percent in 2011. During fiscal year 2011, Euro Disney did not make any voluntary change in its accounting methods and did not recognize any asset write-offs. Related party transactions consisted primarily of the payment of royalties and management fees to the *Gerant* as well as payments to the *Gerant* to reimburse the direct and indirect costs of the technical and administrative services provided. Euro Disney's tax expense was zero in 2009, 2010, and 2011.

At the end of fiscal year 2011, the company's unused tax loss carry forwards amounted to €1.8 billion and could be carried forward indefinitely. The company's 2011 financial statements received an unqualified audit opinion.

At the end of 2011, Euro Disney's share price was €3.54. The company's average share return since December 31, 2007 had been −21 percent (annually).

1 Identify the key accounting policies (step 1) and primary areas of accounting flexibility (step 2) for Euro Disney.

2 What incentives may influence management's reporting strategy (step 3)?

3 What disclosures would you consider an essential part of the company's annual report, given its key success factors and key accounting policies (step 4)?

4 What potential red flags can you identify (step 5)?

4) (20p)

Describe the theoretical structure how firm value is determined by its profitability and growth. Also describe what factors drive growth and profitability.

5a) (5 p)

Dutch Food retailer Royal Ahold provides the following information on its finance leases in its financial statements for the fiscal year ended January 1, 2012:

Finance lease liabilities are principally for buildings. Terms range from 10 to 25 years and include renewal options if it is reasonably certain, at the inception of the lease, that they will be exercised. At the time of entering into finance lease agreements, the commitments are recorded at their present value using the interest rate implicit in the lease, if this is practicable to determine; if not the interest rate applicable for long-term borrowings is used.

The aggregate amounts of minimum lease liabilities to third parties, under noncancelable finance lease contracts for the next five years and thereafter are as follows:

(€ millions)	**Future minimum lease payments**	**Present value of minimum lease payments**
Within one year	€165	€67
Between one and five years	643	312
After five years	2,003	846
Total	1,916	1,225
Current portion of finance lease liabilities		67
Non-current portion of finance lease liabilities		1,158

What interest rate does Ahold use to capitalize its finance leases?

5 b) (15 points)

On January 1, 2012, Royal Ahold disclosed the following information about its operating lease commitments

(€ millions)	**2007**	**2008**
Within one year	€655	€677
Between one and five years	2,194	2,245
After five years	3,130	3,016
Total	5,979	5,938

Ahold's operating lease expense in 2011 amounted to €635 million. Assume that Ahold records its finance lease liabilities at an interest rate of 8.4 percent. Use this rate to capitalize Ahold's operating leases at January 1, 2011 and 2012.

i. *Record the adjustment to Ahold's balance sheet at the end of 2010 to reflect the capitalization of operating leases.*

ii. *How would this reporting change affect Ahold's income statement in 2011?*

6. Predicting Tesco's 2009/2010 earnings (20p)

On April 21, 2009, UK-based retailer Tesco plc presented its preliminary financial statements for the fiscal year ending on March 31, 2009. The following tables show a selection of Tesco's financial figures for the fiscal years 2007/2008 and 2008/2009 (i.e., the fiscal years ending on March 31, 2008 and 2009, respectively):

Income statement (£ millions)	2008/2009	2007/2008
Sales	54,327	47,298
Operating expenses	(51,121)	(44,507)
Interest expense	(284)	(112)
Investment income	32	124
Tax expense	(788)	(673)
Net profit	**2,166**	**2,130**

Balance sheet (£ millions)	2008/2009	2007/2008
Net working capital	**(4,912)**	**(3,885)**
Non-current tangible assets	23,152	19,787
Non-current intangible assets	4,027	2,336
Other non-current assets	3,469	1,725
Non-interest bearing liabilities	(888)	(954)
Total business assets	**29,760**	**22,894**
Debt	11,910	7,194
Equity	12,938	11,815
Total capital	**24,848**	**19,009**

Other information (£ millions)	2008/2009	2007/2008
Depreciation of non-current tangible assets	1,036	876
Amortization of non-current intangible assets	153	116
Non-current tangible assets at cost	29,844	25,550
Non-current intangible assets at cost	4,790	2,944
Dividends paid	883	792

In addition to disclosing the financial statements, Tesco's management also provided guidance about future investment plans, financing strategies, and performance expectations. In particular, the following information became available to investors and analysts on the publication date:

- In 2008/2009, Tesco opened 9 million square feet of new store space. The retailer plans to open 8 million square feet of new store space in 2009/2010.
- Revenues in 2008/2009 were the revenues of 53 weeks. The fiscal year 2009/2010 will include 52 weeks.
- Group capital expenditure during 2008/2009 was GBP 4.7 billion, a little more than planned (GBP 4.5b) due to currency movements. Tesco's management indicates that capital expenditures in 2009/2010 will be around GBP 3.5 billion. One reason for why capital expenditures can be reduced is that in the current economic downturn, Tesco can buy more new store space for less.
- Tesco's effective tax rate in 2008/2009 was 26.7 percent versus 24.0 percent in 2007/ 2008. The increase in tax rate was primarily the result of one-time tax benefits in 2007/ 2008. Management expects the effective tax rate for 2009/2010 to be around 27 percent.
- In 2008/2009, Tesco was able to realize cost saving of close to GBP 550 million through its Step-Change program. Management expects these cost savings to persist.

- In 2008/2009, Tesco's net finance cost, including the company's return on pension assets, was GBP 284 million. The underlying interest charge was GBP 309 million, up from GBP 159 million in 2007/2008. The weighted average coupon rate of Tesco's debt was 5.6 percent.
- Tesco's debt rose substantially during 2008/2009 as a result of:

1. Increased capital expenditures.
2. An increased pension deficit (GBP 0.65 billion increase).
3. The significant depreciation in the sterling-dollar/euro exchange rates (with a debt impact of approximately GBP 1 billion).

If exchange rates remain stable, management intends to bring down debt by approximately GBP 1 billion during 2009/2010. Further, management disclosed the following information about realized and planned store openings:

(£ millions)	UK	Rest of Europe	Asia	US
2008/2009 (Realized):				
Revenues	38,191	8,862	7,068	206
Operating profit	2,540	479	343	(156)
Square feet store space (× 1,000):				
Beginning-of-year	29,549	22,517	23,363	530
Openings, extensions, adjustments	1,773	3,502	3,006	620
Acquisitions	239	3,015	0	0
Closures/disposals	(276)	(196)	(190)	0
End-of-year	31,285	28,838	26,179	1,150
2009/2010 (Expected):				
Square feet store space (× 1,000):				
Beginning-of-year	31,285	28,838	26,179	1,150
Openings, extensions, adjustments	1,897	2,697	2,733	600
Acquisitions	98	0	0	0
Closures/disposals	(225)	0	(63)	0
End-of-year	33,055	31,535	28,849	1,750

1. Predict Tesco's 2009/2010 sales using the information about the company's store space and revenues (per geographical segment).
2. Predict the 2009/2010 book values of Tesco's non-current assets and working capital using the information about the company's investment plans. Make simplifying assumptions where necessary.
3. During fiscal year 2008/2009, at least two factors influenced Tesco's operating expenses: (a) the increase in depreciation and (b) the cost savings of approximately GBP 550 million. Assume that all other changes in the company's operating profit margin were caused by the economic downturn.
   a. What was the net effect of the downturn on Tesco's operating margins?
   b. Estimate Tesco's 2009/2010 operating expense under the assumption that the effect of the economic downturn fully persists in 2009/2010. (Estimate the company's depreciation and amortization expense separately from the other operating expenses.)
4. Estimate Tesco's 2009/2010 interest expense and debt-to-equity ratio under the assumption that the company reduces its debt in 2009/2010, as planned.
5. What do the above estimates (and your estimate of Tesco's 2009/2010 tax expense) imply for the company's free cash flow to equity holders in 2009/2010? How likely is it that Tesco will be able to reduce its debt in 2009/2010?

7a) (10p)

GlaxoSmithKline is one of the largest pharmaceutical firms in the world, and over an extended period of time in the recent past, it consistently earned higher ROEs than the pharmaceutical industry as a whole. As a pharmaceutical analyst, what factors would you consider to be important in making projections of future ROEs for GlaxoSmithKline? In particular, what factors would lead you to expect GlaxoSmithKline to continue to be a superior performer in its industry, and what factors would lead you to expect GlaxoSmithKline's future performance to revert to that of the industry as a whole?

7b) (10p)

Consider the following two earnings forecasting models:

$$\text{Model: } E_t(EPS_{t+1}) = EPS_t$$

$$\text{Model: } E_t(EPS_{t+1}) = \frac{1}{5}\sum_{i=0}^{4} EPS_{t-i}$$

$E_t(EPS)$ is the expected forecast of earnings per share for year $t + 1$, given information available at t. Model 1 is usually called a random walk model for earnings, whereas Model 2 is called a mean-reverting model. The earnings per share for Telefónica for the period 2000 to 2004 are as follows:

Year	1	2	3	4	5
EPS	€0.61	€0.43	€(1.08)	€0.40	€0.58

a What would be the year 6 forecast for earnings per share for each model?

b Actual earnings per share for Telefónica in year 6 were €0.91. Given this information, what would be the year 7 forecast for earnings per share for each model? Why do the two models generate quite different forecasts? Which do you think would better describe earnings per share patterns? Why?