THE RELIABILITY OF THE WORKING CAPITAL SECTION OF THE BALANCE SHEET

by *Ernesto P. Pineda**

The working capital segment of the balance sheet is of interest to short term bankers and trade creditors. Its proper presentation is basically governed by Generally Accepted Accounting Principles (GAAP) which are pronouncements of the Philippine Institute of Certified Public Acountants (PICPA) through its Accounting Standard Council (ASC). This paper examines the reliability of this balance sheet segment by studying a number of Audited Financial Statements and interviewing some users.

This paper concludes that the public in general may have some justifications in expressing some doubts on the integrity of audited financial statements through proper compliance to GAAP. It concludes further that the usefulness of audited financial statements may have been limited by inadequate disaggregation of significant items.

INTRODUCTION

Financial statements serve as the major information source on the financial state of a company. Various users, such as investors and both short-term and long-term creditors, use the analysis of these statements as an important input in their investment or lending decisions. As such, the reliability of financial statements is a common critical concern among its "outside" users.

The structure and content of financial statements is, to a large extent, influenced by the accounting practice of a particular area. In the Philippines, the practice of accountancy is governed by "generally accepted accounting principles" which are pronouncements of the Philippine Institute of Certified Public Accountants (PICPA). Made through the Accounting Standards Council (ASC), these "generally accepted accounting principles" provide the basic framework for the preparation of financial statements.[1]

SCOPE AND OBJECTIVES

Investors and long-term creditors are generally more concerned with financial statement information that are income and leverage related since their interest is affected by the net income as well as the firm's financial structure.[2]

Short-term lenders and trade creditors, on the other hand, are more interested in the working capital segment of the balance sheet, i.e., the current asset and current liability accounts. This is based on the fact that the normal satisfaction of their claims comes from the orderly transformation of less liquid current assets to cash or the efficient management of working capital. They need not necessarily wait for the process of cash generation through income realization.

This paper focuses on the latter group of financial statement users whose interest in a company is affected by the relationship of the different working capital items in the balance sheet and the efficiency of the current assets transformation process. It attempts to make a general assessment of the reliability of the working capital segment of the balance sheet in terms of structure and content. Such an assessment will present important implications on the overall reliability of the analysis of working capital as basis for credit decisions by short-term lenders and trade creditors.

*Professor **Ernesto P. Pineda** is the Don Anselmo Trinidad Professor of Business Administration at the University of the Philippines' College of Business Administration.

[1] Preface to Statements of Financial Accounting Standards of the Accounting Standard Council (ASC, July 1983), p.1.

[2] Richard Brealey and Stewart Myers, Principles of Corporate Finance. (New York: McGraw-Hill Book Co., 1981), p.. 548.

SIGNIFICANCE OF THE STUDY

This study was undertaken to achieve a limited set of objectives. First, it serves as a signal to potential users of financial statements of the extent of reliance that may be placed on the analysis of the working capital segment of the audited balance sheet. The study also reports on the extent and nature of compliance of public accounting practitioners with "generally accepted accounting principles" in some aspects of audited financial statements.

Reactions to the results of the study can be elicited from concerned quarters on how to enhance the reliability and usefulness of audited financial statements, particularly, the working capital segment of the balance sheet. The concern should be on the propriety of classification and degree of disaggregation of significant working capital items. Finally, other research areas related to the assessment of the reliability and usefulness of published financial statements can be identified in this study.

METHODOLOGY

This study involved the conduct of the following major activities.

Current pronouncements of the Accounting Standards Council (ASC) were reviewed, particularly the different Statements of Financial Accounting Standards (FAS), on the following four working capital accounts: Cash, Receivables, Inventories, and Current Liabilities.

A review of literature on the underlying rationale for the proper valuation and classification of the four working capital accounts was done. The 1985 and 1986 audited financial statements of some nine companies were assessed in terms of the extent and nature of compliance with the ASC Statements of Financial Standards on the four working capital items. The assessment was made on the following bases: (a) propriety of classification, and (b) adequacy of details presented to allow possible recasting of the working capital segment of the balance sheet.

Finally, interviews with credit officers/analysts of financial institutions were conducted to get clues on the working capital accounts that need special attention. Ten credit officers and analysts from a private commercial bank and a government bank were interviewed for the purpose.

All of the companies selected in the study are engaged in manufacturing and trading activities. In the sample business activities, effective working capital management would be critical to the success of the business. As such, it would be important for short-term lenders and trade creditors of these types of companies to make a meaningful analysis of the working capital segment of the balance sheet. The nine companies whose financial statements were used in the study are: Philex Mining Corporation, Benget Corporation, Mabuhay Vinyl Corporation, Philippine Petrochemical Products, Inc., United Pulp & Paper Company, Bataan Pulp and Paper Mills, Inc., Federal Agricultural Corporation, Reliance Agricultural Corporation, and Hilongos Development Corporation.

Their financial statements were taken from published annual reports and the Securities and Exchange Commission.

THE OPERATING CYCLE CONCEPT

The concept of the "operating cycle" appears to be the most important consideration in determining the balance sheet accounts that should be included in the working capital segment. As such there is a need to briefly discuss the operating cycle concept.

The following basic operating activities comprise the operating cycle of a trading firm:

- Purchase of goods using cash or trade credit
- Sale of goods on credit or on cash basis
- Collection of receivables arising from credits sales
- Payment of trade and other creditors

A manufacturing concern adds one other activity into the operating cycle which is the transformation of raw materials into finished goods to be sold.

As can be noted from the different activities which comprise the operating cycle of a trading or manufacturing concern, the balance sheet items that are affected by the operating cycle are the following working capital accounts: cash, accounts receivable, inventories and current liabilities.[3]

The following examples of how the concept of the operating cycle influences the determination/inclusion of items in the working capital segment of the balance sheet were drawn from the Statements of Accounting Standards issued by ASC. Pertinent povisions are:

1. Withdrawal restrictions on bank deposits will result in the reclassification of this cash from cur-

---

[3] J. M. Smith and K. F. Skousen, Intermediate Accounting, (Cincinnati: Southwestern Publishing Co., 1981), p. 130.

rent assets because such restriction will violate the operating cycle concept.[4]

2. Cash segregated for the liquidation of long-term liabilities should be reclassified from current assets.

3. Loans and Advances to Officers should be reclassified as non-current if collection is unlikely within the year.[5]

4. Spare Parts and Supplies should be reclassified from current assets if these are not to be currently consumed in the production of goods and services.[6]

5. Definition of Current Liabilities should be based on the expectation that it will be liquidated through the use of existing current assets.[7]

In the context of financial statement analysis, a meaningful assessment of the working capital segment of the balance sheet may be done using the simple approach of classifying the components of working capital using a "good" and "bad" framework. Current Asset accounts are classified as "good" while Current Liability items are classified as "bad." This way, the current ratio (Current Assets/Current Liabilities) will easily be understandable to the analyst. A high ratio will be interpreted to be "good" and a low ratio as "bad."[8]

FINDINGS AND OBSERVATIONS

In terms of the significance of the working capital segment, it was noted that the current assets of the nine firms whose financial statements were examined ranged from 35 percent to 60 percent of total assets. However, the current liabilities did not exhibit consistency in magnitude in relation to total liabilities and stockholders' equity. Current assets were mostly accounted for by receivables and inventories.

The result of the interviews with credit officers and analysts revealed that the two accounts in the working capital segment of the balance sheets of manufacturing companies which are often recasted are: "advances to officers and employees" and "spare parts and supplies" inventories. Such a recasting is made by reclassifying these items from current to non-current assets.

[4] Statement of Financial Accounting Standard No. 2 (ASC, July 1983).
[5] Statement of Financial Accounting Standard No. 3 (ASC, July 1983).
[6] Statement of Financial Accounting Standard No. 4 (ASC, July 1983).
[7] Statement of Financial Accounting Standard No. 5 (ASC, July 1983).
[8] Baruch, Lev, Financial Statement Analysis: A New Approach (New Jersey: Prentice-Hall, 1974), p. 34.

Spare parts and supplies

Most of the credit officers/analysts interviewed observed that "spare parts and supplies" should be classified classified as "non-current asset." The reasons cited are their reservations on the physical consumability of spare parts and supplies in the next accounting period and its observed close relationship to fixed assets. Although a few of them classified one-half of the amount of spare parts inventory as "current" and the other half as "non-current", it is interesting to note that not one believed that it was proper to classify spare parts and supplies as "current assets" in the audited balance sheet.

It should likewise be noted that not one among the nine companies examined classified spare parts and supplies as "non-current". Such a difference in the perception of certain financial statement users and the presentation of the item in audited statements could create a significant difference in the calculation of the current ratio. The current ratios of seven companies were computed using the audited statements before and after "spare parts and supplies" was reclassified as "non current assets." The ratios computed are shown in Table 1.

From this sample, the current ratio can be overstated by as much as 64 percent for Philex Mining and Bataan Pulp and Paper, both of which have large balances of materials, parts and supplies. In all of the nine companies, there are substantial differences in current ratios using this evaluation approach.

An examination of the audited statements revealed the lack of details in the income statement to establish the consumability of spare parts and supplies. For example, the Cost of Goods Sold section of the Income Statement does not provide details on the consumption or usage of spare parts and supplies during the period. This will probably explain the arbitrariness with which users reclassify the account, *i.e.,* outright or one-half of the amount is reclassified as "non-current asset". In addition, the more conservative attitude of credit officers/analysts of financial institutions relative to other types of analysts may have contributed to such a treatment. It is generally known that banks have stricter standards for credit worthiness than other types of users.

Advances to Officers and Employees

Another observation which, however, is of significantly lesser magnitude and frequency than that of "Spare Parts and Supplies", is the inclusion of "advances to officers" in the current asset section of the balance sheet. For this purpose, the balance sheets of Bataan Pulp and Paper, Benguet and Federal Agricultural Corporation for 1985 and 1986 were used as examples. It was noted that substantial repayments during the year may not have been effected. This is shown by the increased balances of the account at the end of 1986 as compared to 1985 in most of the sample companies, thus making its inclusion in the "current asset" category doubtful for these companies.

Other Findings

The review of the financial statements of two agricultural firms revealed that the reporting practice in non-traditional operations still needs to conform further to standards. It was observed that in the two companies engaged in piggery projects, sows were classified as "inventory". This is inconsistent with the Statement of FAS No. 4 on the definition of inventories which requires that there must be an intention to sell or to consume. Following this rule, sows could be more properly treated as non-current assets. However, its classification as fixed asset and the subsequent apportionment of cost may be difficult to implement due to the lack of reasonable certainty on the useful lives of sows.

CONCLUSIONS AND RECOMMENDATIONS

Based on the above findings, the public in general may have some justification in expressing some doubts on the integrity of audited financial statements through proper compliance to generally accepted accounting principles. In addition, the usefulness of audited financial statements may have been limited by inadequate disaggregation of significant items like Cost of Goods Sold which could facilitate proper recasting of accounts in order to enhance usefulness of the statements.

As an immediate step, it is suggested that the degree of disaggregation in the "cost of good sold" and "operating expense" segments of the income statement should enable the analyst to evaluate the consumability of spare parts and supplies. For example, information on the usage of spare parts and supplies should be specifically provided. This would allow the classification of the ending balance of spare parts and supplies inventory in excess of the amount consumable over the current period into "non-current assets", to conform with FAS No.4. This would prevent arbitrary recasting of the account by users.

The work that this study attempted to do involved only a segment of the financial statement and focused on limited types of intended users (short-term lenders and trade creditors). In addition, only nine audited financial statements were examined and ten users were interviewed. Despite the limited scope of the study, however, the findings indicate a pattern that tended to cast doubt on the reliability of the working capital segment of the balance sheet. Further research may be done to validate the initial findings of this study by increasing the number of companies, period covered by financial statements and the users. Research should also be undertaken to include the other segments of the Balance Sheet and the Income Statement. Such an expanded investigation would provide an important input to concerned accounting practitioners and the PICPA regarding the degree and nature of compliance of the accounting practitioners with regard to the pronouncements of the Accounting Standard Council.

Table 1. **TABULATION OF SELECTED ACCOUNTS AND CURRENT RATIOS OF SELECTED PHILIPPINE MANUFACTURING COMPANIES**

Company Name	Calendar Year-end	Materials, Parts & Supplies in Inventory and Amounts		Total Current Asset (P 000)	Current Ratio as per Balance Sheet	Current Ratio After Reclassifying Account to Non-Current	Current Ratio as per Balance Sheet
		Account Name	Amount (P 000)				Current Ratio Reclassified
1. Hilongos Development Corporation	1984	materials, spare parts and supplies	10,030	31,203	0.55	0.38	1.45
2. Benguet Corporation	1986	materials and supplies	484,568	1,087,582	1.4	0.97	1.44
3. Philex Mining Corporation	1986	materials and supplies	399,453	1,021,044	3.25	1.98	1.64
4. Bataan Pulp and Paper Mills, Inc.	1987	materials, parts and supplies	50,715	128,048	1.05	0.64	1.64
5. United Pulp and Paper Co., Inc.	1987	spare parts, supplies and others	22,857	143,528	1.66	1.39	1.19
6. Mabuhay Vinyl Corporation	1986	materials and supplies	47,194	212,708	0.46	0.36	1.28
7. Philippine Petro-chemical Products	1986	spare parts and supplies	3,889	51,357	1.0	0.93	1.18

Source: Annual Reports and Financial Statements submitted to SEC.