

# 6

## ANALYSIS OF COMPANY ACCOUNTS: EVIDENCES FROM THE U.K. & BANGLADESH

### Introduction

It was indicated in Chapter 1 that in order to show the general applicability of cashflow model of analysis accounts of some companies and public corporation/enterprises in Bangladesh will also be analysed besides the analysis done on U.K. companies. For that purpose analysis has been done on Bangladesh Tobacco Co. Ltd. (1976-80), Monno Jutex Industries Ltd. (1979-80), three enterprises belonging to the Bangladesh Chemical Industries Corporation (1976/77-80/81) and Bangladesh Sugar and Food Industries Corporations (1977/78). The first two companies belong to the private sector, the former is a subsidiary of British Tobacco Co. Ltd. of U.K. Rest of the enterprises/corporation belong to the public sector. It should be mentioned here that accounts (Annual Reports) of companies and corporations are not easily available in Bangladesh. Data on these cross-section of manufacturing industry have been analysed in a separate section at the end of this chapter. Further it may be pointed out that although no formal price control system was operating in Bangladesh, there is a prices supervisory body under the Ministry of Commerce which usually confirms price increases by manufacturing units both in the public and private sectors. Something akin to a 'Cost increases justifying price increases' procedure seems to have been in operation in Bangladesh also. Since excepting Philips (Bangladesh) Ltd.\* no other companies/enterprises

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\*Philips has been using replacement cost basis of accounting for its world wide operation for a long time. Some aspects of its accounting policy is discussed subsequently in the chapter.

are known to have used something approaching inflation accounting, it may also be postulated that companies/enterprises financial viability deteriorated sharply in Bangladesh given the relatively higher level of rising prices which prevailed here during the period under review.

The following sections, however, deals with the main stream analysis carried out on U.K. companies for the purpose of the doctoral thesis. In order to accommodate analysis on Bangladeshi companies/enterprises some of the tables containing details of analysed data on U.K. companies have been excluded from this publication.

### Background of Selecting the Companies

A number of studies, including the Price Commission, on the interrelated effects of inflation, price control and taxes on company profitability and financial viability have been reviewed in Chapter 3. These studies, however, were concerned with aggregate results at company sector level, except for that in which Lawson analysed 1974 accounts of one company on a cash flow basis. Since this study was mainly concerned with the nature and effect of the U.K. Price Code, it was decided that an analysis of a limited number of companies, whose activities to a large extent fall within the Price Code, would be more appropriate.

Companies from the food and drink sector appeared to be appropriate to show the impact of price control; because the food and drink sector's export sales were insignificantly low and, as was indicated in Chapter 4, this sector's output prices increased faster than the manufacturing industry and, indeed, other sectors. On the other hand, within the food and drink sector, profit performance varied considerably. Analysing data on matched samples of 20 large enterprises from each subsector, it was observed that, as a percentage of reference levels, net profit margins of companies in the food subsector deteriorated more than in the alcoholic drink subsector. Besides, the experience of individual companies in the former subsector varied much more widely than companies in the latter. While in both subsectors there were cases of enterprises exceeding their reference levels, as a subsector alcoholic drinks appeared to perform far better than the food subsector in net profit margins over the period of control. As indicated in the previous chapter we started with Rank Hovis McDougall (RHM) from the food sector, as it appeared

to be a good example to start with\*. Subsequently Spillers (SP) was added.

To provide a comparative analysis, large companies—Associated Biscuit Manufacturers (ABM), and Associated British Foods (ABF)—were included. Two companies from the drinks industry were also included to show intra-sector differences. These were The Distillers Co. (DIST), and Allied Breweries Ltd. (AB). London Brick Co. (LBC), Associated Portland Cement Manufacturers Ltd. (APC), and Pilkington Brothers (PB), were selected from the brick, cement and glass sector to provide a comparison of inter-sectoral conditions. London Brick Co. exported only between 1% to 2% of its turnover, and until 1975 did not have any overseas operation. Furthermore, two companies, PB and APC, were specially selected because of their *declared policy of providing for the effect of inflation in depreciation charged*. Export sales of products of U.K. manufacturing origin in these two companies was under 20%, though both companies also have had substantial overseas activities. Turner & Newall Ltd. (TN), was included as it was found from the questionnaire survey that the group itself represented a cross-section of manufacturing industry. Its activities are diversified in three main sectors; bricks, glass, cement, etc., chemical and allied products, and metal manufacture and mechanical engineering. It may again be mentioned that 4 of these 10 companies were specifically identified by a trade union publication<sup>2</sup> as domestic-oriented companies in terms of production, as well as investment. These are RHM, SP, DIST & APC. Since persistent demands for price controls generally come from trade union sources, these four companies might serve as a good manifestation of the real profitability in which their interest lies—investment and employment, and more income within the U.K.

Detailed analyses of the annual accounts of companies have been limited to the 10 companies mentioned above. On the other hand, based on the data published by the Department of Trade and Industry on Company Accounts financial performance of the company sector was analysed according to the cash flow model over an extended period, 1965-1975.

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\*Discussed in detail later on in this chapter.

### Time Dimension of the Selected Data Base

The important question that one is to face with regard to the evaluation of the impact of any public programme like price controls was : "What would have been the position without control ?". Following the tradition of what economists call 'comparative statics', it was decided that an examination of the 1970-1976 position of these companies would be sufficient and methodologically valid. This had, in general, provided results for three years after and three years prior to the imposition of the Price Code. About 60 data points had been generated on each of the variables underlying the relationship between historic cost accounting and cash flow accounting.

### Model of Analysis and Results

Annual accounts of the sample companies were analysed according to the total cash flow model presented in Chapter 1 & 5. Since the Price Code was concerned with the pre-tax 'net profit margin' of companies, the results of the data analysed pertaining to that basis have been presented first in the following section.

The data was computed to show net profit margins ( $CNP_j$ ), periodic changes in working capital,  $P_j$ , and the balance as cash flow margins\*. These percentages were computed from data on  $d_j$  (sales),  $CNP_j$  (conventional net profit margin), and  $P_j$  (working capital change), obtained in the process of cash flow analysis. The primary variables, as indicated, were relative price changes and/or growth and price control, while accounting systems could be considered as process variables.

Examination of the results of analysis reveals the following :

1. Out of the ten companies, the proposition that  $CNP_j/d_j > 0$  while  $CFE_j/d_j < 0$  was observed to be true for seven of them, six in 1974 and one in 1975. In the case of these\*\* companies, the magnitude of the increase in working capital,  $P_j$ , was so high that it exceeded the amount of the historic cost net profit after depreciation and interest. For the rest of the three\*\*\*

\*Before cash outflows on  $(L_j - A_j)$ , shortfall between historic cost depreciation and replacement investment, taxes less grants and dividends.

\*\*RHM, SP, ABM, DIST, LBC, APC & PB.

\*\*\*ABF, AB and T&N.

companies, the increase in working capital,  $P_j$ , pre-empted about 75% of  $CNP_j$  in 1974. Incidentally, all of these three companies, Associated British Foods, Allied Breweries, and Turner & Newall, were either multi-nationals and/or engaged in highly diversified activities. Therefore, it could be reasonably expected that on their U.K. operations these companies faced the same conditions as the other seven, i.e. after making only, one of the two necessary corrections, all of these companies real profit in 1974/75 turned into negative.

It will be useful to point out the magnitude of cost omissions arising out of the failure to take cost of working capital into account in the case of three companies from three subsectors of the manufacturing industry. It may be observed that in 1973 RHM's  $CNP/d$  was 5.19%, but this was achieved before charging  $P/d$  of 4.65%. In 1974, the former ratio was reduced to 3.11% but the latter increased to 5.75%. Thus taking these two years together, RHM's real margin was reduced to a negative. Similarly, the DIST's  $CNP/d$  in 1974 increased by 0.18% over 1973 to 15.11% and in 1975 the same was reduced to 11.55%. On the other hand, these margins were achieved before charging  $P/d$  of 11.89% and 12.27% in 1974 and 1975 respectively. Therefore, taking 1974 and 1975 DIST's real margin was barely positive which, as will be shown later on, was not sufficient to cover depreciation shortfall, taxes and dividends. PB's  $CNP/d$  was 17.10% in 1974, but in 1975 this was reduced to 7.51%. Cost of working capital,  $P/d$ , was 5.82% and 10.70% in 1974 and 1975 respectively. It means that in 1975 PB's real margin was -3.19% and combining it with 1974, although produced a positive real margin, but this was again reduced to a deficit after tax payments.

2. The following table (Table 1), provides a comparative performance of total period vs. price control period, based on the percentage changes discussed above for individual years. This table shows the magnitude of the 'erosion' suffered by these companies in their conventional net profit margin as defined in the Price Code, and also contrasts the same with the cash flow margin, (i.e. Price Code margin reduced by cost of working capital increase).

TABLE 1 : COMPARATIVE PERFORMANCE : 1970-76

Name of Companies	Variables	Total Period 6-7 yrs. (%)	Control Period 3 yrs. (%)
1. Rank Hobis McDougall Ltd.	(a) Net profit margin	4.00	3.52
	(b) $\Delta$ Working capital/sales	2.00	2.16
	(c) Cash flow margin	2.00	1.32
2. Spillers Limited	(a) Net profit margin	2.34	2.12
	(b) $\Delta$ Working capital/sales	1.51	1.83
	(c) Cash flow margin	0.83	0.29
3. Associated Biscuit Manufacturers Ltd.	(a) Net profit margin	5.35	5.67
	(b) $\Delta$ Working capital/sales	1.35	1.99
	(c) Cash flow margin	4.00	3.68
4. Associated British Foods	(a) Net profit margin	4.61	4.67
	(b) $\Delta$ Working capital/sales	1.22	1.43
	(c) Cash flow margin	3.39	3.24
5. Distillers Co. Ltd.	(a) Net profit margin	13.00	12.84
	(b) $\Delta$ Working capital/sales	7.40	9.41
	(c) Cash flow margin	5.60	3.43
6. Allied Breweries Ltd.	(a) Net profit margin	8.52	7.45
	(b) $\Delta$ Working capital/sales	2.25	3.19
	(c) Cash flow margin	6.27	4.26
7. London Brick Co.	(a) Net profit margin	14.72	13.39
	(b) $\Delta$ Working capital/sales	0.21	0.14
	(c) Cash flow margin	14.51	13.25
8. Associated Portland Cement Manufacturing Co.	(a) Net profit margin	9.25	8.44
	(b) $\Delta$ Working capital/sales	3.58	5.29
	(c) Cash flow margin	4.67	3.15
9. Pilkington Bros. Ltd.	(a) Net profit margin	11.91	10.99
	(b) $\Delta$ Working capital/sales	5.20	6.00
	(c) Cash flow margin	6.71	4.99
10. Turner & Newall Ltd.	(a) Net profit margin	8.23	7.90
	(b) $\Delta$ Working capital/sales	2.52	2.94
	(c) Cash flow margin	5.71	4.96

Note : (b) above is the unallowed portion of the cost increase expressed as a percentage of sales.

(c) above as defined in the footnote on p. 105.

It may be observed that eight out of the ten companies' conventional net profit margins were "squeezed" by varying rates during the control period, as compared to the total period. For Associated Biscuit Manufacturers, and Associated British Foods, the margin appeared to have increased slightly during the control period. This, of course, does not indicate that they were not affected by price controls. As can be observed, for all of these companies, except LBC, the cash flow margin as defined above was not only significantly lower over the total period, but also seriously reduced during the control period.

The London Brick Company suffered the least erosion among these ten companies, both in terms of accounting and cash flow margins. Its investment in working capital fluctuated widely during the control period. In the years ending 31st December 1973, 1974 and 1975, the value of its working capital change,  $P_j$ , as a percentage of sales were -1.95, 9.87 and -2.08 respectively. However, the real margin which was eroded represents cash flow margin before depreciation shortfall, taxes and dividends. If the level of these margins were so low (we have already shown that for the individual year 1974 it was negative for six, and for one in 1975) during the period of control, it was not difficult to visualise the post-tax conditions of these companies when the historic cost profit was the basis for tax assessment. However, we have presented the effective tax rate on a cash flow basis in the latter part of this chapter.

3. Of the sixty-two working capital changes, 51 were found positive and large, only 11 were barely negative, of which 7 were concentrated in the years 1970 and 1971, when rates of input-output price changes were low. Of the rest, LBC, ABM and T&N each had negative working capital changes in 1975, while, as indicated in the previous paragraph, LBC had the same again in 1973. (See table on p. 109.)
4. Companies appeared to have partially revived their cash flow margins in 1975/76 following the crunch in 1974/75. This was possible basically for two reasons: One was the relaxation in the Price Code with the introduction of Stage IV in December 1974, and the other was reduction of activity. The relaxation

in the Price Code allowed relatively higher prices to be charged as reflected in the recovery of  $CNP_{3/d}$ . Reduction of activity during 1975 and the prospect of its continuation, resulted in relatively lower working capital investment as reflected in the 1975/76 year-end financial statements of these companies. Nonetheless, the magnitude of the pre-emption of historic cost margin into working capital investment remained quite high for DIST, PB, AB, and ABC and was negative for TN, ABM and LBC in the year following the severest crisis.

5. The behaviour of the three elements of working capital may be observed from the following table. Of the 62 stock changes, only in two instances the sign of the first difference was negative, and that was with LBC, once in 1970 and again in 1975. In its Annual Report 1975, it was stated that the company faced problems with the Price Commission. On account of mounting stock profits in the earlier part of the year, its established reference level proved inadequate and the company had to reduce brick prices to comply with the Price Code. The frequencies of the first differences of all three of the components of working capital is presented on the basis of expected sign (+) vs. unexpected sign (-).

**OBSERVED FREQUENCY : SIGN OF FIRST DIFFERENCES**

	Expected	Unexpected	Total
	(+)	(-)	
Stocks	60	2	62
Debtors	52	10	62
Creditors	37	5	62

While all five unexpected cases of creditors were concentrated in the years 1970 or 1971, the ten unexpected cases of debtors were spread over all the years. More than their frequency of changes, it is the magnitude of the changes which are more important from the point of view of corporate financial viability. These are discussed in the following paragraph. However, the behaviour of the observed frequencies confirmed the proposition that during a period of rising relative prices each of the three components of working capital increases year after year. The increase in the value of stock was especially significant. With

the exception of two unexpected signs related to LBC, the proposition that under a FIFO system of inventory valuation, stock appreciation invariably occurs, was observed to be true for the remaining 60 sample points.

6. The following table (Table 2) shows the magnitude of the variables separately, i.e. increase in stocks and change in net debtors, and also the total position, again on a comparative basis. It may be observed that the yearly average value of the increase in stocks during the control period was almost twice its value for the total period for each of the companies. On the same basis, the value of the change in net debtors was higher for four of the companies, whereas Spillers turned from a net creditor into a net debtor, and London Brick Company did the opposite. Four of the companies, TN, ABF, ABM and AB, were clearly net creditors. However, as has already been shown in the percentage analysis of total working capital changes (Table 1), corresponding increase in monetary values were higher for all of the companies during the control period. The implication of this empirical evidence was that, while as a result of the operation of the Price Code, companies were absorbing costs into their real margins, accounting conventions were understating the magnitude of the 'erosion' and showing illusory profits.

During the control period, the annual average investment in working capital for these ten companies amounted to £16.3m. For Distillers and Allied Breweries the amounts were £58.4m. and £23.4m. The four food companies' average investment in working capital was £11.7m. whereas for RHM it was as high as £20.7m. and for ABM it was as low as £2.2m. For the rest of the four companies the average was £9.0m. This explained, to a great extent, the relatively better conventional profit performance of the alcoholic drinks subsector over the food subsector and also by the same measure the food and drink sector as a whole over the rest of the other sectors of the manufacturing industry. Further, it showed why the experience of companies within the food sector varied so widely. It was the inclusion of working capital investment in conventional profit, especially stock appreciation, which not only boosted conventional profit artificially, but also

TABLE 2 : COMPARATIVE PERFORMANCE : 1970-76\*

Name of Companies	Variables	Total Period £m	Yearly Average £m	Control Period £m	Yearly Average £m
1. Rank Hovis McDougall 1970-76, 74-76	(a) Increase in stocks	74.0	10.6	55.5	18.5
	(b) $\Delta$ Net debtors**	8.6	1.2	6.5	2.2
	(c) Total increase in working capital (a + b)***	82.6	11.8	62.0	20.7
2. Spillers Limited 1971-76, 74-76	(a) Increase in stocks	32.5	5.4	23.3	7.8
	(b) $\Delta$ Net debtors	-1.3	-0.2	2.2	0.7
	(c) Total increase in working capital	31.2	5.2	25.5	8.5
3. Associated Biscuit Manufacturers 1970-75, 73-75	(a) Increase in stocks	10.0	1.7	8.3	2.7
	(b) $\Delta$ Net debtors	-2.9	-0.5	-1.6	-0.5
	(c) Total increase in working capital	7.1	1.2	6.7	2.2
4. Associated British Foods 1971-76, 74-76	(a) Increase in stocks	84.8	14.1	60.0	20.0
	(b) $\Delta$ Net debtors	-22.0	-3.7	-14.0	-4.7
	(c) Total increase in working capital	62.8	10.4	46.0	15.3
5. Distillers Co. Ltd. 1970-76, 74-76	(a) Increase in stocks	238.4	34.1	153.6	51.2
	(b) $\Delta$ Net debtors	27.8	4.0	21.6	7.2
	(c) Total increase in working capital	266.2	38.1	175.2	58.4

(Table contd.)

Table 2 (concluded)

Name of Companies	Variables	Total Period £m	Average £m	Period £m	Average £m
6. Allied Breweries Ltd. 1971-76, 74-76	(a) Increase in stocks	106.5	17.7	84.0	28.0
	(b) Net debtors	-25.4	-4.2	-13.9	-4.6
	(c) Total increase in working capital	81.1	13.5	70.1	23.4
7. London Brick Co. Ltd. 1970-75, 73-75	(a) Increase in stocks	4.3	.7	4.2	1.4
	(b) $\Delta$ Net debtors	1.1	.2	-2.0	-.7
	(c) Total increase in working capital	5.4	.9	2.2	0.7
8. Associated Portland Cement Manufactures Ltd. 1970-75, 73-75	(a) Increase in stocks	39.2	6.5	30.8	10.3
	(b) $\Delta$ Net debtors	3.8	.6	6.7	2.2
	(c) Total increase in working capital	43.0	7.1	37.5	12.5
9. Pilkington Bros. Ltd. 1971-76, 74-76	(a) Increase in stocks	41.1	6.8	32.0	10.7
	(b) Net debtors	21.8	3.6	14.3	4.8
	(c) Total increase in working capital	62.9	10.4	46.3	15.5
10. Turner & Newall Ltd. 1970-75, 73-75	(a) Increase in stocks	37.9	6.3	30.3	10.1
	(b) $\Delta$ Net debtors	-9.8	-1.6	-8.9	-3.0
	(c) Total increase in working capital	28.1	4.7	21.4	7.1

\*Financial year, both inclusive

\*\*  $\Delta$  Debtors -  $\Delta$  Creditors

\*\*\* (c) is unallowed cost for the purpose of the Price Code

caused it to vary both within a sector and between sectors of the manufacturing industry.

7. From the cash flow statements of these companies, the relationship between tax payment in any year and net operating cash flow (basically  $n_j - F_j - A_j$ ) before tax was identified and presented in Table 3. For Pilkington Brothers and Associated Portland Cement, the same relationships, i.e. the effective rates of tax payment, was obtained on the basis of  $n_j - F_j - L_j$ , i.e. operating cash flow after interest and historic cost depreciation. As indicated, these two companies were known to have made provision for replacement expenditure in the  $L_j$ 's charged in the profit and loss account. However, compared to depreciation charges computed on the basis of the theoretical model of economic depreciation, the provisions made in the accounts did not appear to be sufficient. Nonetheless, the cases of these two companies served to highlight the fact that effective tax rates were much higher than nominal rates and that taxes were being charged on artificial accounting profit.

It may be observed from the following Table (table 3), that the effective rate of tax paid on net-operating-cash flow exceeded 100% in each of the companies during the period 1974-76. Therefore, after payment of taxes all of these companies ran into large cash flow deficits. In the case of Spillers,  $n_j - F_j - A_j$  was negative even before paying taxes. That is, its operating cash flow was not sufficient to cover interest and replacement expenditure; except in the year 1972, its level of capital expenditure also did not indicate any growth investment comparative to the historic cost depreciation charged in the annual accounts.

The proposition that corporate taxes based on historic cost or conventional profit pose a direct threat to corporate financial viability could be verified from two companies—Pilkington Bros. and Associated Portland Cement Manufacturing Co. These companies claimed to have raised historic cost depreciation to the level of replacement investment. It may be observed in Table 3 that after taking into account the so-called generous tax allowances, the effective tax rate on net operating cash flows (before tax and dividends) exceeded 100% during the control period for both the

companies. Nonetheless, both companies, as well as the other five, paid out large dividends during the period under consideration.\* An examination of the cash flow statements of these companies revealed large borrowings, mostly from banking sources to meet the enormous deficits left in their net operating cash flows. A,

TABLE 3 : COMPARATIVE TAX EFFECT

Names of Companies	Variables	Total period	Control period
1. Pilkington Brothers 1970-76, 74-76	a) $n_j - F_j - L_j$	£m80.9	£m38.5
	b) taxes less grants	£m47.7	£m38.9
	c) b as % of a	59	101
2. Associated Portland Cement Manufacturers 1970-75, 73-75	a) $n_j - F_j - L_j$	£m67.9	£m22.3
	b) taxes less grants	£m51.1	£m33.7
	c) b as % of a	75	151
3. Rank Hovis McDougall 1971-76, 74-76	a) $n_j - F_j - A_j$	59.3	0
	b) taxes less grants	51.6	23.9
	c) b as % of a	87	∞
4. Spillers Limited 1971-75, 74-75	a) $n_j - F_j - A_j$	-14.2	-6.7
	b) taxes paid less grants	15.6	7.1
	c) b as % of a	∞	∞
5. Distillers Limited 1970-76, 74-76	a) $n_j - F_j - A_j$	198.1	42.9
	b) taxes less grants	158.2	74.3
	c) b as % of a	80	175
6. London Brick Company 1970-75, 73-75	a) $n_j - F_j - A_j$	16.6	5.8
	b) taxes less grants	10.5	6.5
	c) b as % of a	63	112
7. Turner and Newall 1970-75, 73-75	a) $n_j - F_j - A_j$	52.3	26.3
	b) taxes less grants	49.8	33.1
	c) b as % of a	95	126

Note 1 : For Company 1 & 2  $L_j$  is assumed to be equal to  $A_j$  because of their accounting policy of charging replacement depreciation.

Note 2 : (c) above is the effective tax rates.

\*As we have analysed the accounts of a large number of listed companies later on in this chapter, the effective tax rates for AB, ABF and ABM were not separately computed.

corollary to this was the tremendous increase in the payments of interest by all the ten companies. This fact appeared to support the proposition made about the incorrect use of historic cost accounting profit figures for the purpose of bank borrowing<sup>3</sup>. Therefore, the possibilities of mis-allocation of resources from the point of view of the banking system could not be ruled out.

### Replacement Investment and Depreciation

For RHM, DIST and TN, there were possibilities that  $A_j$  (capital expenditure) might have included  $R_j$  (growth investment), because the capital expenditure amount was obtained from the figure of addition at cost less cash received on disposals and grants received. If twice the historic cost depreciation is taken as a rough approximation, then none of the four companies mentioned above made any expenditure, which might be truly called  $R_j$  (growth investment) during the period 1973-76. Based on the conceptual framework presented in Chapter 1, establishing the relationship between historic cost depreciation and economic depreciation calculated as annual-capital-charge, an attempt to generate figures by assuming relevant parameters produced multiples in the range of 3 to 5 times. That is, given the U.K. level of inflation, in order for there to be any real growth investment, capital expenditure in any year should have exceeded historic cost depreciation by a multiple of at least three.

In order to calculate economic depreciation by the annuity method one needs information on three variables. These are historic cost of assets, life of assets and cost of capital. If maintenance of capital is to be looked at from the point of view of shareholders of a company, then the relevant cost is the cost of equity capital, which is to be computed according to the assumptions of a *capital asset pricing model*<sup>4</sup>. Lack of information in company accounts about the average life of depreciable assets is a short-coming in this respect. However, these aspects of the problem were considered beyond the scope of this thesis and no further analysis was undertaken.

### The Case of Rank Hovis McDougall in 1974

RHM is a food group which in 1974 employed over 65,000 men and women in its 300 operating companies in the U.K. In 1975 it completed the 100th anniversary of the foundation of the business.

In 1974 the value of its external sales increased by £190m. to £700m. but group profit before tax decreased by £5112,000 to £22,825,000, compared with the previous year. In its annual report most of the fall in profits was attributed to its bakery division which, according to the Chairman, continued to suffer severely from government price control.

It is worthwhile discussing the case of this company from the food sector separately, in view of the suggestion<sup>5</sup> by a member of the Price Commission, that the provision of productivity deduction had 'crucified' the food industry. Besides, the financial year 1974 of the company comprised twelve months, 1st July 1973 to 31st August 1974, in which it bore the full brunt of the price control under favourable market conditions. Therefore, RHM served as a benchmark company to estimate the magnitude of the impact of price control on its conventional accounting profit and corresponding cash flow earning. The only assumption that needed to be made was that in the absence of price control or even in its relaxed presence, RHM could charge a price on its products to realise the same pre-tax margin it had earned in the preceding year, July 1972 to August 1973.

Rank Hovis McDougall	Actual under price control	Adjustment Factor*	Alternative without price control
	£m		£m
1. Turnover, $d_j$	700	(1.02)	714
2. Pre-depreciation profit $e_j = d_j - c_j$	40.5	+14m.	54.5
3. Increase in working capital, $P_j$	40.2	(1.02)	41.0
4. Operating cash flow $n_j = e_j - P_j$	0.3		13.5

\*Pre-tax margin 1974 was about 2% points lower in 1974 over 1973.

It may be observed that in 1974 the pre-depreciation and interest profit of £40.5m. of the company was almost entirely pre-empted by increased investment in working capital.

Since the tax on the extra income of £13.5m would have been payable in the next year, and given that under the dividend control rule it would not have been possible to distribute more than what it had actually distributed, the net cash flow deficit (after

taxes and dividends) of £47.7m. would have been reduced by £13.5m. to £ 34.2m. if there were no price control and the company could maintain its 1973 margins in 1974.

In 1974, RHM's net borrowing from banks was £38.7m. and it paid a total interest of £8.6m., an increase of £4.4m. over the previous year. The company also paid dividends of £8.1m. and tax of £9.6m. in the year 1974, as compared to £4.5m. and £6.9m. respectively in the year 1973. This represented a situation wherein a sum of £26.3m. was paid in interest, taxes and dividends out of borrowed money over and above the £13.5m. distributed to consumers in lower prices. Its total capital expenditure was about twice the amount charged for historic cost depreciation. A multiple of 1.4 of the latter for replacements would still leave over £40m. deficits in cash flow earnings which might have been caused from underpricing of sales.

### **Distribution of Tax Burden and Tax Neutrality**

The data so far analysed indicate that companies' financial viability had been threatened from a two-pronged attack. The operation of the price control produced pressure from the top by preventing the creation of increased value added and at the same time corporate taxes cut it from the bottom. While the operation of these policies on the basis of historic cost accounting produced confiscatory impact it needs to be pointed out that the distribution of the tax burden on companies within the corporate sector was not equitable. The distortion in tax liability occurred because of the non-neutrality of the corporation tax in respect of working capital investment, as well as financing differences among companies. Earlier in our analysis in this chapter, it was observed that although the rate of change in working capital was positive in 60 out of 62 cases, there were significant variations in the magnitude of this among companies. Therefore, the tax burden of working capital intensive companies, as the companies in the food and drink sector, increased relatively more than companies in other sectors where increase in working capital was less. This inequitable distribution of the tax burden on companies both within and between industry

sectors, could have been avoided if working capital investment was made a tax deductible item, as indicated in the arguments presented below.

While Lawson argued for the tax deductibility working capital in a number of papers, including his submission to the Sandilands Committee, subsequently stockbrokers, Phillips and Drew, came out with the same suggestion by way of an amendment to the Morpeth proposals on inflation accounting—Exposure Draft 18<sup>6</sup>. Michael Sumner of the Manchester University Economics Department, also pointed out that symmetrical tax treatment of all working capital investment was an essential precondition for the satisfaction of the important principle of tax neutrality<sup>7</sup>. On the other hand, it might be argued that both the Price Code and the tax system contained a built-in bias against equity capital as a source of finance, because interest on debt capital was an allowable cost and so treated as a tax-deductible expense, whereas dividends on equity capital were not considered as a cost to an enterprise. As mentioned in Chapter 3, authors like R.N. Anthony strongly argued for uniform treatment of cost of debt and cost of equity capital in company accounts, as well as for the purpose of tax and price control. To the extent that companies differed in financing practices, there was a *prima facie* case that companies having less debt relative to equity received unfavourable treatment from both price control and corporate taxes.

To conclude this section of this chapter it may be said that the operation of the price control did not allow companies to earn as much historic cost profit as they were earning during the period 1968-72. Rapid inflation during the period of control 1973-75 and the combinations of a tax system based on historic cost accounting, significantly reduced cash flow earnings, the height of which was reached in 1974 when large deficits were incurred. Financial viability and, for that matter, real profitability of the company sector of British industry had seriously been jeopardised. Therefore, it could be predicted that pursuance of any policy of price controls and/or taxes, based on historic cost or conventional accounting, would continue to be a threat to corporate financial viability under conditions of rising relative price changes and/or growth.

The above conclusion based on the analysis of annual accounts of ten companies from a cross-section of manufacturing industry was again verified by an examination of the data in Table 5 (p. 121) which presents the financial performance of the company sector on a cash flow basis over the period 1965-75. However, Table 4 (p. 120) shows some of the comparative statics of company profitability and financing during the reference level period 1968-1972 and the price control period 1973-75. It was observed that in 1968-72 effective rate of tax paid on a cash flow basis was 43%, whereas in 1973-75 the rate turned out as 87% on almost equal amounts of gross trading profits as shown in column 1. The cash flow after tax was sufficient to pay dividends in 1968-72, whereas it fell short of dividends paid by over £2bn. in 1973-75, columns 8 and 9. In the 1968-72 period rates of inflation were relatively low and stable; it was also known that due to technological factors the prices of capital goods were increasing at still lower rates. Therefore, the difference between capital expenditure and depreciation provisions (Cols. 4 and 5) to a large extent represented growth investments. It showed that the entire amount of external finance obtained from the issue of loan and share capital and bank borrowing was used for cash acquisitions, short term investments and increasing cash balances. It might also be interpreted that companies were accumulating to some extent increased liquid balances, during 1968-72. On the other hand, given that at 1970 prices capital expenditure in manufacturing, distributive and service industries declined during the 1973-75 period<sup>8</sup>, there was a strong possibility that the external finance of £5bn, was to a large extent needed to maintain the financial viability of on-going operations. Therefore, the conclusion that was derived on the basis of analysing the accounts of a small sample of companies proved to be valid from the company sector as a whole. That is, the financial viability of the company sector was threatened by a regime of price control and taxation based on historic cost accounting in times of high inflation. This had brought about a change in the financing mix of companies, something representing cross-substitution of equity capital by debt capital\*, some indication of which might also be obtained from Table 4, which showed that while interest paid in the 1973-75 period was almost equal to the

\*See Table 5 in Chapter 7, p. 149.

TABLE 4 : COMPARATIVE PROFITABILITY AND FINANCING OF COMPANY SECTOR

£ million	Gross trading profits*		Increase in working capital		Operating Cash flows ;		Expenditure on Fixed Assets ;		Depreciation Provisions, etc.		Interest Paid ;		Taxes Paid ;		Effective tax rate		After Dividend		External Financing			
	$\Sigma e_j$	$\Sigma P_j$	$\Sigma K_j - h_j$	$\Sigma A_j + R_j$	$\Sigma L_j$	$\Sigma F_j$	$\Sigma E_j$	$\Sigma I_j$	$\Sigma D_j$	$\Sigma B_j + N_j$	$\Sigma C_j$	$\Sigma G_j$	$\Sigma H_j$	$\Sigma J_j$	$\Sigma M_j$	$\Sigma N_j$	$\Sigma O_j$	$\Sigma P_j$	$\Sigma Q_j$	$\Sigma R_j$	$\Sigma S_j$	
1	2	3=1-2	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	
1. Reference Level	22,180	2,404	19,776	9,800	3,612	1,585	3,624	43%	4,767	4,663	3,276											
Period ; 1968-72																						
2. Price Control	22,259	5,385	16,874	10,426	4,670	1,581	4,218	87%	647	2,797	5,010											
Period ; 1973-75																						

\* After short-term interests.

TABLE 5 : FINANCIAL PERFORMANCE OF THE COMPANY SECTOR—CASH FLOW BASIS

	£ Million										
	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975
Number of Companies	2,198	2,109	1,930	1,829	1,701	1,308	1,239	1,168	1,116	1,084	1,110
Gross Trading income (less short-term interest)	3,391	3,302	3,361	3,900	3,999	3,999	4,575	5,707	7,070	7,371	7,818
Change in Debtors :	-556	-501	-653	-823	-934	-820	+164	-1112	-2,480	-1,715	-1217
Change in Creditors :	+498	+271	+486	+644	+1064	+1,191	+178	-1198	+3,189	+2,919	+1918
Change in inventory :	-543	-319	-310	-453	-815	-817	-306	-763	-2,696	-3685	-1620
Operating cash flow : $k_j-h_j$	2,750	2,753	2,884	3,268	3,314	3,553	4,611	5,030	5,085	4,890	6,899
Expenditure on fixed assets : $A_j+R_j$	1,613	1,529	1,511	1,501	1,944	2,070	2,078	2,207	2,950	3,710	3,766

(Table contd.)

(Table 5 concluded)

depreciation provisions and amounts written off, $L_j$	368	942	955	1,061	1,133	1,188	1,307	1,456	1,691	1,901	2,164
tax payments, $t_j$	932	918	469	601	716	818	771	718	1,197	1,521	1,500
effective tax rates :											
i. $t_j/(k_j - h_j - L_j - F_j)$	54%	50%	27%	31%	38%	40%	26%	23%	41%	62%	36%
ii. $t_j/(k_j - h_j - A_j - R_j - F_j)$	94%	88%	40%	46%	66%	59%	35%	30%	72%	229%	59%
$k_j - h_j - (A_j + R_j) - t_j$	205	306	904	966	654	865	1,762	2,105	938	-331	1,633
dividends, $D_j$	651	607	913	952	957	953	999	802	870	981	946
interest, $F_j$	192	178	206	247	282	306	355	395	480	525	576
external financing :	793	785	1,119	1,119	1,239	1,259	1,354	1,197	1,350	1,506	1,522
$B_j + N_j + M_j$	715	692	584	647	702	777	394	756	1,898	1,931	1,181
Net prop. income	78	93	535	552	537	482	960	441	-548	-425	341

Source: Annual Abstract of Statistics, 1976, and Trade &amp; Industry, 10th June, 1977. H.M.S.O.

amount paid during 1968-72, Col. 4, dividends paid were reduced by about £2bn., Col. 9.

In the next section we present some evidences of the phenomenon presented in the preceding section in the context of Bangladeshi enterprises/corporations.

### Financial Performance of Some Bangladeshi Enterprises and Corporation

#### *Financial Performance of Monno Jutex Industries Ltd.—1979/80*

Monno Jutex Industries Ltd. is an engineering industry in the private sector. Set up in 1978 the company owns and operates a modern integrated plant near Dhaka for manufacturing jute mills spares and accessories. This is the only industry of its kind in Bangladesh producing essential parts and accessories for local consumption by the jute mills. Previously these jute mills parts and accessories (card, gill and reta pins, shuttle covers, loom spindles, bobbin carriers, felt blobs etc.) were imported by spending scarce foreign exchange of the country. In 1979/80 the company went into full production.

According to conventional measure of accounting performance the company's gross and net profit margins were 35.22% and 25.75%; 16.52% and 12.91% respectively in 1978/79 and 1979/80. The company was enjoying tax-holiday and it appeared that being a new company it was charging rather generous amounts as depreciation about 13-14% per annum on the average. Despite all these good accounting figures after adjustment for working capital (item C)\* its profit before depreciation turned into a large deficit. And after deducting almost an amount equal to depreciation charges for addition to fixed assets (item E), its cash flow deficit exceeded the amount of accounting profit shown in its annual reports.

As a private sector company whose shares are also listed and sold at a premium in Dhaka Stock Exchange it had to declare dividend for its closely held shareholders, thus exacerbating the cash flow deficits. The only unusual transaction that seems to have contributed to the excessive deficit is the decrease in creditors rather than an increase. Even if there was some inflow of cash on that account the company's financial condition would have shown no dramatic improvements.

\*Table A on p. 124.

The company claimed to be in a good position with regard to its ability of repayment of long-term loans and its shares of Tk. 100 was being quoted at Tk. 165 in the stock exchange.<sup>9</sup> In fact the company's borrowing from banks increased by about 90% over the previous year and as the data shows in table A this provided the amounts needed for debt servicing, payment to creditors and dividends to shareholders. More importantly the company was not paying any income-tax on its conventional accounting profit. If income tax @ 50% of 'item A' in the table were to be paid, it would simply have forced the company to additional bank borro-

TABLE A : MONNO JUTEX INDUSTRIES LTD.  
CASHFLOW ANALYSIS FOR THE YEAR 1979/80

	Tk. in (000)	
A. Profit before taxes :	2380	
Add Depreciation and amortization charges (895 + 124)	1019	3399
B. Investment in Working Capital :		
i) Increase in stocks	-2311	
ii) ,, ,, Debtors	-2151	
iii) Decrease in Creditors	-1467	-5929.00
D. Operating cashflow (deficit)		-2530.00
E. Addition to fixed assets		-878.00
F. Net operating cashflow (deficit)		-3408.00
*G. Taxes paid		
H. Dividends paid		- 395.00
I. Net deficit		-3803.00
J. Financed from/to :		
i) Decrease in Advances & Deposits	344	
ii) Increase of advance against totals	188	
iii) Decrease in other payables	-359	
iv) Long-term loan paid	-345	-172.00
K. Net Increase in bank borrowings		+3975.00

\*The company is enjoying tax-holiday for a period of 5 years.

wing. As the analysis clearly demonstrates it is going to be extremely difficult for the company to maintain its real financial viability when its tax-holiday period will expire. How can the company repay such massive borrowings from commercial bank? Are the company's shares realistically valued in the stock exchange?

*Project financing* decisions by banks and financial institutions need to be carefully examined in view of the fact that such high accounting profit margins can be associated with huge negative cash flow earnings. It has been mentioned in chapter 3 that the *profit concept* that is relevant here is the cash flow earnings and nothing else. In Bangladesh, although *discounted cash flow* methods are used for project evaluation, there are serious flaws in the way such cash flows are derived including the very crude form of demand and supply estimation. It is, therefore, not surprising that there are large number of bank financed projects which are neither implemented nor survives after implementation to repay debts in time.

#### *Financial Performance of Bangladesh Tobacco Co. Ltd. (BTC)*

BTC manufactures and distribute over 60% of cigarettes consumed in Bangladesh. As already indicated it is a subsidiary of British Tobacco Co. Ltd. Its financial performance for the years 1976-80 may be observed in Table-B. It may be pointed out that until 1978, pre-tax cash flow earnings were negative. Since 1978, the company has been charging much higher amounts of depreciation as a result of revaluation of its fixed assets. Although according to income-tax laws the company could not charge the whole of its higher depreciation as a tax deductible expense, it might have been possible for the company to reflect such higher depreciation in product costing and pricing. Relatively higher amount of revenues thus realised might have helped the company to generate some positive pre-tax cash flow earnings. Taking the five years together the effective tax-rate on cash flow earnings amounted to 140% (k). This along with dividend paid necessitated a net injections of Tk. 997 lacs from external sources, mostly from commercial bank borrowings. During the five years the BTC invested Tk. 483 lacs in fixed assets which was just 1.63 times of the total depreciation charges. Given the rate of inflation experienced in Bangladesh, particularly due to massive devaluation of currency after 1971, it is doubtful if the company was maintaining its physical capacity intact by the 1.63 multiple of depreciation charges invested in fixed assets.

TABLE B : BTC—CASHFLOW ANALYSIS 1976-1980

Items	( Tk. in lakhs )						Total
	1976	1977	1978	1979	1980		
Profit before tax	556	444	568	686	906		3160
Add depreciation	27	30	91	81	68		297
A ) Profit . before depreciation and tax	583	474	659	676	974		3457
B) Periodic working capital Investment/Disinvestment							
a) Stocks	-552	-352	-112	+323	-759		-1452
b) Debtors	+42	+6	-55	-4	-51		-62
c) Liabilities for goods	-130	-41	+13	-20	-12		-190
	-640	-378	-154	+299	-822		-1704
C) Operating cash flow $(A - B)/(A + B)$	-57	87	505	1066	162		1753
D) Addition to fixed assets	-53	-103	-77	-167	-83		-483
E) Pre-tax cash flow earnings $(C - D)/(C + D)$	-110	-16	428	899	69		1270
F) Income Tax paid	-411	-315	-295	-442	-315		-1783
G) Post-Tax Cashflow Earnings $(E - F)/(E + F)$	-521	-331	133	452	-246		-513
H) Dividend paid	-56	-68	-90	-135	-135		-484
I) Cash deficit/surplus (Net)	-577	-399	43	317	-381		-997
J) Increase (Decrease) in loan, over drafts etc.— minus changes in cash and Bank balance	+577	+399	-43	-317	+381		+997
K) Effective Tax rate $(F/E)$	α	α	69%	49%	457%		140%

On the other hand in four out of five years BTC had to invest in working capital large sums amounting to about 50% of its pre-depreciation and tax profits, for the period 1976-80. There is, however, considerable year-to-year variation in the magnitude of pre-emption of the profit figure mentioned above into working capital. In 1976, it was 110%, in 1977 80%, in 1978 23% and 84% in 1980, while there was a disinvestment in 1979 by 44%. There is nothing unusual about such variations, rather this is quite expected as these magnitudes are to a large extent dependent on rising input-output prices and/or growth in volume of business.

It is interesting to note that the company in the face of such adverse financial conditions not only continued to pay dividends but also stepped it up every year upto 1979 when it increased to Tk. 135 lacs from Tk. 56 lacs in 1976. This amounted to an increase of 141% equivalent to an annual increase of 47%. Given the fact that there was not any additional equity financing during this period, there is a *prima facie* case that BTC was paying dividend at significantly higher rates which was not warranted by the depreciation of taka both internally as well as externally.

Perhaps for its own self-interest BTC being a multinational of the U.K. origin did not press for 'inflation accounting' or replacement value accounting in Bangladesh, although it seems to have been maintaining a very cordial relationship with the government through payment of record amount of taxes and duties to the exchequer (widely published in News Papers)<sup>10</sup>. During the five year period the company declared and remitted dividends officially which was close to the amount of its paid up capital, in monetary terms, of course. The point that we want to make is that as a leading and well managed company it could have taken some initiative in introducing the changing accounting policies in Bangladesh based on the experience of its parent company in the U.K. That would definitely have made much more substantive contribution to national development through improved management under inflationary conditions both at micro and macro levels in Bangladesh.

In contrast, *Philips of Netherlands* has been practising some of the principles derived from the latest development in the field

of accounting for its worldwide operations<sup>11</sup>. We mention below a few of them :

- +1) Depreciation is calculated using fixed percentages of the replacement value on the basis of the expected life per category assets. Write downs to the value to the business are included under depreciation.
- +2) Consumption of raw-materials and other elements in the cost of sales are also calculated on the basis of replacement value. Write-downs of stocks to a lower realisable value are charged to the cost of sales.
- +3) Expenditure on research, development, patent licences etc. is charged in the current year to profit and loss account.
- +4) For taxes on profits provisions are made on the basis of this profit figure determined according to the valuation principles mentioned above. In so far as the cost of sales differs from historical cost owing to the use of the replacement value, the tax payable on the difference is charged to the provision made for deferred taxation at the time of revaluation.
- \*5) It was also observed that even in the case of revenue expenses incurred (e.g. salaries and wages) some cost of capital is charged for the period of production and trading cycle. This conforms to the arguments made by Anthony to account for the cost of interest including interest on equity for product costing purposes.

What needs to be emphasized on the basis of the above accounting policies is that there is a conscious effort to hold resources within the business so as to increase profitability and financial viability.

*Financial Performance of Bangladesh Sugar & Food Industries Corporation (BSFIC) for the Year 1977/78*

In 1977-78, 14 Sugar mills, 2 engineering plants, 4 edible oil refineries, 8 oil crushing mills, 5 fish freezing plants, 2 biscuit and bread factories, 3 wheat crushing mills, 2 beverage factories, 2 salt factories, 3 ice and cold storages, 1 cigarette factory and trading

<sup>+</sup> 1-4 has been taken from the Annual Report of Philips for the year 1976.

\* Observed through a visit to their Dhaka Office.

houses were in operation under BSFIC ; a public corporation. "During this financial year the production of almost all the items showed remarkable efficiency and progress."<sup>12</sup> The corporation also achieved remarkable improvements in both export and local sales this year. The total net sales increased by 42% over the previous year ; on the other hand cost of sales increased by 46%. Thus the pre-tax profit was reduced by 38% despite much higher production and sales over those of the last year.<sup>13</sup> Any way the pre-tax profit margins for the year 1976/77 and 1977/78 were 4.25% and 1.84% respectively. In the face of such deteriorating accounting performance it is not understood how the management made such claims as "remarkable efficiency and progress in operation".

Remarkable or not the figures showed at least positive pre-tax margin and it may be observed from following Table C that

TABLE C : BANGLADESH SUGAR & FOOD INDUSTRIES CORPORATION  
(BSFIC)

Cash flow Analysis For The Year 1977-78

		Tk. in Lacs
A.	Pre-tax Profit	352.37
	Add Depreciation	<u>397.30</u>
B.	Profit before depreciation and Tax	759.67
C.	Increase/Decrease in Working Capital	
	1) Increase in inventories	-431.21
	2) " " S. Debtors	-136.51
	3) " " S. Creditors	<u>+979.77</u>
		<u>412.05</u>
D.	Operating cashflow	1171.72
E.	Addition to Fixed Assets	<u>-647.05</u>
F.	Net operating cashflow	<u>524.67</u>
G.	(a) Income Tax Paid	-218.79
	(b) Dividend to Govt.	<u>-493.00</u>
H.	Cashflow surplus/Deficit	<u>-187.12</u>
I.	Financed from/to :	
	(1) Increase in other finance :	91.20
	(2) " " Equity & Grants	43.70
	(3) Decrease in long-term loan (net)	-3.20
	(4) Increase in Advance & Deposits	<u>-33.96</u>
		<u>+97.74</u>
J.	Net Increase in bank borrowing	<u>+89.38</u>
		<u>187.12</u>

the financial condition of the corporation deteriorated much more sharply than was indicated by accounting margins. Contrary to Monno Jutex, the BSFIC however was in a position to obtain fund from sundry creditors at a much higher level which helped to increase operating cash flow (D) rather than (usual) decreasing it from working capital investment. Capital expenditure (E) of the corporation was 1.63 times of historic cost depreciation and thereafter the net operating cash flow (F) was still in surplus. The corporation, however, faced the crunch in (G) income tax and dividends to government, payment of which forced the corporation/enterprises into a deficit of Tk. 187 lacs (H). To meet this deficit the corporation borrowed Tk. 89.38 lacs from commercial banks and the rest was obtained from some other financial inflows including equity and grant of Tk. 43.70 lacs from the government.

The reasons for such high income tax and dividends payments to government were, besides the overstatement of pre-tax earning due to accounting methodology, as follows: "Since the corporation is not allowed to set-off the losses sustained by some enterprises against profits earned by others, the corporation had to pay an amount of Tk.218.79 lacs by way of income-tax on profit",<sup>14</sup> of Tk.352.37 lacs.

The payment of dividends, although had its roots in the overstatement of accounting profit, political-economic drawbacks of nationalized industries encouraged some overzealous ministers in such transfers to national exchequers without understanding the micro as well as macro-economic impact of their actions. On the face of it, one may see such actions as deliberate attempts to cripple public sector enterprises. In absence of proper legal, accounting and financial policies, it is natural that public sector enterprises have been used as fiscal organs of the government overriding other important objectives.

BSFIC at least, made attempts in their own way to report the state of financial affairs in its Annual Report. It was pointed out that due to higher payment of dividend to the Govt. than the overall net profit of the year, the accumulated loss at the end of the year increased by Tk.224.46 lacs and that 96% of the in-

crease in resources used during the year (Tk.1375.48) were obtained from outsiders viz, commercial banks, suppliers and other creditors.

In this connection it is worth pointing out that by 1977/78, the entire equity capital of *Bangladesh Textile Mills Corporation* was wiped out, while the same corporation paid an amount of Tk.55 crores as income-tax and dividends to government during the period 1972/73 to 1977/78<sup>15</sup>. Through custom duties, excise and sales taxes the corporation also paid another Tk. 145 crore to the national exchequer during the same period. Consequently borrowing from commercial banks stood at Tk.95 crores, interest charges on which amounted to about 9-10% of total cost and expenses of the said corporation.

#### *Bangladesh Chemical Industries Corporation (BCIC)*

Arguments and analysis presented in connection with BSFIC (& BTMC) is verified by data on cash flow analysis of three enterprises of BCIC for the period 1976/77 to 1980/81. These enterprises are Bangladesh Paper Products (BPP), Usmania Glass Factory (UGF) and Albert David (AD) a pharmaceutical unit. Five-years' accounts for each of these three enterprises have been analysed according to the cash flow model and presented in following Tables D, E and F. Excepting the year 1977/78 when BPP showed pre-tax loss, in rest of the 14 years all three of the enterprises reported pre-tax profits of varying amounts. Taking the five-years total performance it may be observed that the effective tax rate on cash flow earnings for BPP was 95%, 113% for UGF and 127% for AD as shown by line (12) in each table. As a consequence all three of these enterprises had to rely on funds from outside, viz. commercial banks, suppliers and sometimes from the BCIC, which inturn obtained it from banks and other enterprises. It may be pointed out that of the three Albert David was the most profitable enterprise and for that it had to pay income tax and contribution to Govt. at the highest rate (127%).

There is hardly any need to extend this analysis on the financial performance of the manufacturing industries in Bangladesh. Be it the private sector enterprises or the public sector enterprises/corporation the result of the analysis conclusively demonstrates the

TABLE D : BANGLADESH CHEMICAL INDUSTRIES CORPORATION  
Cashflow Analysis of M/s. Bangladesh Paper Products for the Period 1976/77-1980/81

	Tk. in Lacs					Total
	1976-77	1977-78	1978-79	1979-80	1980-81	
1. Profit Before Taxation	5.40	(2.67)	4.95	30.35	34.60	72.63
Add Depreciation	2.62	2.45	2.72	3.03	3.14	13.96
2. Profit Before Taxation & Depreciation	8.02	(0.22)	7.67	33.38	37.74	86.59
3. Investment in working capital :						
(a) Increase/Decrease in Current Assets	(10.92)	(14.33)	(7.24)	7.07	(56.38)	(81.80)
(b) Increase/Decrease in Current Liabilities	6.80	(7.50)	11.59	19.95	42.37	73.21
	(4.12)	(21.83)	4.35	27.02	(14.01)	(8.59)
4. Operating Cashflow (2-3)/(2+3)	3.90	(22.05)	12.02	60.40	23.73	78.00
5. Investment in Fixed Assets	(1.72)	(2.19)	(8.99)	(2.47)	(1.25)	(16.59)
6. Net Operating Cashflow (4-5)	2.18	(24.24)	3.03	57.93	22.51	61.41
7. Income Tax Paid/Contribution	(3.24)	(20.00)*	(1.39)	(16.69)	19.03	(60.35)
8. Post Tax Deficit/Surplus (6-7)	(1.06)	(44.24)	1.67	41.24	3.48	(1.06)
9. Financed From/To :						
(a) BCIC Current Account	(4.32)	(1.60)	(28.28)	29.95	29.45	25.20
(b) Creditor for other finance	9.92	35.26	33.42	5.71	(101.28)	(16.97)
(c) Advances Deposits & Payments :	(0.08)	0.83	(2.48)	(78.78)	74.77	(5.74)
(d) Foreign Loan	(2.11)	(2.59)	(1.95)	—	—	(6.63)
(e) Bank Loan	(3.17)	5.96	0.87	(0.83)	(7.94)	(5.11)
	(.82)	(6.38)	3.24	(2.71)	(1.52)	(8.19)
10. Changes in Reserves and Adjustment A/Cs	(.33)	4.89	(3.17)	8.71	(0.86)	9.24
11. Net change in cash and Bank balance	1.15	1.49	(0.07)	(6.00)	2.38	1.05
12. Effective tax rate (7/6) %	149%	α	46%	29%	85%	98%

Note : Figures in brackets indicate outflow of cash from the enterprise.

\*Indicates contribution made to the national exchequer.

ANALYSIS OF COMPANY ACCOUNTS

TABLE E : CASHFLOW ANALYSIS OF M/S. USMANIA GLASS FACTORY FOR THE PERIOD 1976/77-1980/81

	Tk. in lacs					
	1976-77	1977-78	1978-79	1979-80	1980-81	Total
1. Profit before taxation	7.40	35.13	44.85	7.79	55.86	151.03
Add : Depreciation	5.52	13.08	14.26	14.24	21.15	68.25
2. Profit before taxation & depreciation	12.92	48.21	59.11	22.03	77.01	219.28
3. Investment in working capital						
a. Increase/Decrease in Current Assets	13.44	(13.76)	(45.48)	(40.37)	(20.15)	(106.32)
b. Increase/Decrease in Current Liabilities	(4.76)	5.46	2.39	(7.68)	6.53	1.89
4. Operating Cashflow (2-3)/(2+3)	8.68	(8.30)	(43.14)	(48.05)	(13.62)	(104.43)
5. Investment in Fixed Assets	21.60	39.91	15.97	(26.02)	63.39	114.85
6. Net Operating Cashflow (4-5)	(0.05)	(2.17)	(22.01)	17.65	(15.60)	(22.18)
7. Income Tax Paid/Contribution	21.55	37.79	(6.04)	(8.37)	47.79	92.67
8. Post Tax Deficit/Surplus (6-7)	(5.00)	(34.02)	(29.66)	(4.29)	(31.74)	(104.71)
9. Post Tax Deficit/Surplus (6-7)	16.55	3.72	(35.70)	(12.66)	16.05	(12.04)
9. Financed by/To :						
a. BCIC Current Account	(7.16)	5.01	48.42	(47.49)	(44.67)	(45.89)
b. Creditor for other finance	21.42	6.99	4.16	32.06	57.19	121.82
c. Advances, Deposits & Payments	3.60	(10.13)	(12.50)	14.61	3.18	(1.24)
d. Govt. Loan	—	—	—	1.21	2.21	3.42
e. Bank loan	(11.33)	(13.38)	5.69	9.01	(25.00)	(35.01)
f. Debentures	(24.28)	1.67	(6.67)	—	—	(29.28)
10. Changes in Reserves & Adjustment A/Cs	(17.75)	(9.84)	39.10	9.40	(7.09)	13.82
11. Net change in Cash & Bank Balance	2.86	3.34	0.26	(1.21)	—	5.25
12. Effective tax rate (7/6) %	23%	90%	α	α	66%	113%

TABLE F: CASHFLOW ANALYSIS OF M/S. BANGLADESH ALBERT DAVID CO. LTD.

	Tk. in lacs					
	1976-77	1977-78	1978-79	1979-80	1980-81	Total
1. Profit before taxation	29.84	45.57	42.64	53.33	52.85	224.23
Add. Depreciation	3.49	5.43	3.14	6.83	7.07	25.96
2. Profit before taxation & depreciation	33.33	51.00	45.78	60.16	59.92	250.19
3. Investment in Working Capital						
a. Increase/Decrease in current assets	(16.07)	20.36	(22.68)	(71.07)	(10.30)	(99.76)
b. Increase/Decrease in current Liabilities	(.05)	19.07	(6.16)	6.71	17.39	36.96
4. Operating Cash flow	(16.12)	39.43	(28.84)	(64.36)	7.09	(62.80)
5. Investment in Fixed Assets	17.21	90.43	16.94	(4.20)	67.01	187.39
6. Net operating cash flow	(5.43)	(10.49)	(8.71)	(15.94)	(8.35)	(48.92)
7. Income Tax Paid/Contribution	11.78	79.94	8.23	(20.14)	58.66	138.47
8. Post-tax surplus/deficit	(6.70)	(47.44)	(31.18)	(32.93)	(58.00)	(176.25)*
9. Financed by/to :	5.08	32.50	(22.95)	(53.07)	(0.66)	(37.78)
a. BCIC Current Account	3.89	19.51	23.97	10.53	3.83	61.73
b. Creditor for other finance	(40.28)	(1.93)	(8.27)	(1.23)	4.94	(30.23)
c. Advance, Deposits & Repayments	4.25	21.98	(33.39)	3.90	(24.17)	(27.43)
d. Bank Loan (Long Term)	24.08	(96.39)	20.00	20.99	34.01	2.69
10. Changes in Reserve & Adjustment a/c	(2.98)	(24.33)	(4.10)	(18.88)	(29.27)	(131.02)
11. Net Charge in cash and Bank Balance	(2.28)	45.29	—	—	—	43.01
12. Effective Tax rate (7/6) (%)	(5.26)	20.96	(4.10)	(18.88)	19.27	11.99
	57%	59%	37%	a	100%	27%

\*Includes over Tk. 41 lacs as contribution made to National Exchequer during the Period (figures within brackets indicates outflow of cash from the enterprise.)

adverse impact of an inappropriate accounting methodology or corporate financial viability. That is, in times of rising input-output prices the use of conventional accounting methodology resulted in transfer of significantly larger amount of cash resources from out of the enterprises through income tax and dividend payments which was not actually generated from their production and trading. Resulting resource gap was met by borrowings mostly from commercial banks by both the private and public sector enterprises.

Attempt has been made in the next two chapters to assess the impact of such misallocation of resources within the flow of funds framework of analysis.

#### Footnotes

1. Price Commission Reports. March/May, 1976.
2. Labour Research, September, 1976.
3. G.H. Lawson and A. W. Stark, *op.cit.*
4. G.H. Lawson and D.G. Bean, *op. cit.*
5. D.C. Hague, "Price Control", MBS Vital Topics Lectures, 1975.
6. G.H. Lawson, "Corporation Tax". The Economist, 19th Feb., 1977.
7. M. Sumner, "Industry", The Guardian, Wed. 24th March, 1976.
8. Trade and Industry, 2nd September, 1977.
9. The company at that time was planning to set up another unit in animal feed stock production. Shares of the newly floated company were also oversubscribed.
10. Somehow the pattern resembles the very early days of East India Company when they demanded for their rights to do business in Bengal in exchange of paying taxes to the then Nowab of Bengal.
11. It might have had some connection with its business in Indonesia and some of the South American countries experiencing very high level of inflation in Nineteen Sixties.
12. Annual Report. 1977-78.
13. *Ibid.*
14. Annual Report 1977/78.
15. BTMC Annual Reports.