A STUDY OF CURRENT EVENTS AND IMPLEMENTATION: LA POLAR S.A FINANCIAL SCANDAL AND ITS ECONOMIC CONTRAST BY THE FINANCIAL MASS METHOD

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Abstract

This work aims to deliver a professional and ethical reflection of the social responsibility of any for-profit organization under free competition and healthy economic growth and development of any given country. This is extremely important considering there is always a social responsibility with the market and, above all, with the people. We consider that an ethical crisis ends up creating a financial crisis motivated by bad practices. Thus, we will study this kind of practice carried out by the managers of La Polar S.A. in Chile.

With publicly available information, mainly consolidated financial statements, we are able to apply a new so-called financial analysis method, "financial mass", in which homogeneous monetary aggregates enable to classify the accounting information.

This proposal interprets financial statements, specifically those indexes derived from it, and compares them to traditional indexes. This will allow us to conclude that the company under study showed figures much higher than in the industrial sector. Therefore, with the publicly available information, it is possible to notice the irregularity that would later on impact the Chilean capital market .

Keywords: Index, financial statement, ethics, transparency

Introduction

Seeking to achieve positive results, LA Polar executives began to extend credits to clients with limited income. In addition, they considered the idea of increasing the value of the shares and to not show losses by renegotiating unilaterally the debts of their clients. This left the clients with a higher level of debt but with a higher level of income for the company. This led to a financial scandal and to a loss of credibility of the Controllers of the financial market.

Thus, we ask the following question: Was it possible to predict this concealment?

We assumed that once the scandal was uncovered, the retail company was going to be in the eye of the hurricane and would try to extemporary explain the ex post data.

Our purpose is not to solve the problem nor to diminish the damage that has been done to investor confidence, but to contribute with a different perspective: an alternative to the classical method of financial analysis. Both points of view, the traditional and proposed method, converge in a better interpretation of the figures set out in the financial statements.

Aims

General aim

To measure the financial position of the La Polar SA company by using the proposed method of financial analysis to further compare them with other similar companies (retail) and to determine possible differences in liquidity between the company under study and other companies within the same industry.

Specific aims

1.- Apply the methodology of financial mass to the financial statements of the retail industry in Chile.

2.- Measure and compare, through publicly available information, the specific ratios obtained by applying the financial mass differences underlying the financial information provided by retail companies .

3.- Propose preliminary financial indicators that warn when suspicion of financial irregularities arise.

Methodology

It is an exploratory research with a thorough review of the information of the present case, both in its economic aspects and its impact on national press. The case study is a company that showed excellent figures and was recommended by some stockbrokers as a share title that should be included in an investment portfolio.

In this study, we will review the literature and state of the art analysis and interpretation of accounting figures, considering the traditional methodologies of indexes or ratios as the primary source of analysis.

With the consolidated, published and audited financial statements, we will be able to apply traditional and modern tools of financial analysis. In order to carry this out, we propose new indexes in order to compare them to the indexes of the competitors within the retail industry in Chile.

Limitations of research

When reviewing the state of the art texts and papers in terms of limitations of research, we came across literature that is 30 years old on average specially with regard to financial ratios.

As for the proposed method of analysis, there are no studies nor cases on updated developments.

Theoretical fundamentals

Financial mass method

The methods or traditional tools for the financial statements analysis are the financial indexes; horizontal and vertical analysis; and the state of use and source of funds. There is another methodology called financial mass within the modern methods of analysis.

Financial masses aim to summarize and reclassify all accounting information presented in the financial statements. We will try to put together groups that can establish enough information to have a global view of the financial situation. However in Chile, the financial information is presented in a series of items that makes it impossible to interpret the figures effectively.

In short, it seeks to present a “synthetic snapshot" of the financial situation of the company by grouping products under a common feature. They are all oriented to determine in a comprehensive manner possible stability or imbalances in the financial structure as well as to appreciate the liquidity, solvency and profitability, and serve as a primary step for the analysis of financial ratios.

The Financial Masses of the Balance (Sheet)

The financial masses of the balance are intended to sort into groups the accounting information into units called "masses", separating the structure of investment (assets) and of financing (liabilities) in the short and long term items. This includes separating everything related to the operational cycle in the short-term items, which also considers the financial resources, investments or obligations.

Tradicional Balance Sheet

Current Assets	Current Liabilities
Fixed Assets	Long Term Liabilities
Other Assets	Equity

Proposed Balance Sheet

Cash Financial Assets	Cash Financial Liabilities
Cash Operating Assets	Cash Operating Liabilities
Property/Fixed resources	Permanent Capital

The Proposed Balance Sheet consists of:

Assets:

a) Cash Financial Assets: short-term resources with financial nature.
b) Cash Operating Assets: short-term resources with operational nature.
c) Property/Fixed Resources: long-term resources, which includes fixed and other assets.

Liabilities:

a) Cash Financial Liabilities: short-term (debt) obligations with financial nature.
b) Cash OperatingLiabilities: short-term (debt) obligations with operational nature.
d) Permanent Capital: short-term (debt) obligations, which includes equity and long-term liabilities.

Company's Financial Equilibrium

We can say that long-term financial equilibrium will be achieved when a company has a positive working capital, i.e., when the permanent capital is greater than the assets. This is attributable to what is best in terms of financing the operational cycle (includes property/fixed resources, minimum of safety stock, credit granted to customers and operational cycle) with long-term resources.

Net Working Capital = Permanent Capital – Property/Fixed Resources (1)

(French Version)

Before proceeding with the analysis, it is important to make the following distinction: in terms of results, the working capital has 2 possibilities of calculation. We recommend the French version because it helps us to determine the long-term financial stability (solvency) of the company, taking into consideration that the short-term equilibrium (liquidity) is given by the determination of the net cash.

Net Working Capital = Current Assets – Current Liabilities (2)

(Anglo-Saxon Version)

Moreover, the short-term equilibrium will be achieved when we submit a positive net cash, i.e. when the Cash Financial Assets outdo the Cash Financial Liabilities or when the need for Working Capital is lower than the working capital owned by the company. This is caused by generating sufficient financial resources in the short-term to cover their short-term obligations.

Net Cash = Cash Financial Assets – Cash Financial Liabilities (3)

In addition to the determination of the respective equilibria, we can estimate the resources needed to finance the operational cycle by using the 2 remaining financial masses of the balance sheet.

Need of Working Capital = Cash Operating Assets – Cash Operating Liabilities (4)

Results

LA POLAR S.A.	
CASH FINANCIAL ASSETS	**CASH FINANCIAL LIABILITIES**
80,883,994	191,192,488
CASH OPERATING ASSETS	**CASH OPERATING LIABILITIES**
482,143,824	58,845,379
PROPERTY/FIXED RESOURCES	**PERMANENT CAPITAL**
356,775,078	669,765,029
TOTAL ASSETS	**TOTAL LIABILITIES**
919,802,896	919,802,896

Net Cash	-110,308,494
Need of Working Capital	423,298,445
Working Capital	312,989,951

Margin of Safety Ratio of the Investment	34.03%
Turnover Ratio	8.19

The La Polar S.A. company presents a margin of safety ratio of 34.03% of the investment, which indicates that 1/3 of its total investment goes to the short-term item. The turnover ratio showed an excessive indicator, exceeding the average of the sector.

FALABELLA S.A.	
CASH FINANCIAL ASSETS	**CASH FINANCIAL LIABILITIES**
131,192,212	399,996,822
CASH OPERATING ASSETS	**CASH OPERATING LIABILITIES**
1,621,311,058	832,300,246
PROPERTY/FIXED RESOURCES	**PERMANENT CAPITAL**
4,830,974,184	5,351,180,386
TOTAL ASSETS	**TOTAL LIABILITIES**
6,583,477,454	6,583,477,454

Net Cash	-268,804,610
Need of Working Capital	789,010,812
Working Capital	520,206,202

Margin of Safety Ratio of the Investment	7.90%
Turnover Ratio	1.95

The Falabella S.A. company presents a margin of safety ratio of 7.90% and a turnover ratio of 1.95.

CENCOSUD S.A.	
CASH FINANCIAL ASSETS	**CASH FINANCIAL LIABILITIES**
153,561,612	277,087,004
CASH OPERATING ASSETS	**CASH OPERATING LIABILITIES**
1,391,091,368	1,504,328,034
PROPERTY/FIXED RESOURCES	**PERMANENT CAPITAL**
4,807,880,347	4,571,118,289
TOTAL ASSETS	**TOTAL LIABILITIES**
6,352,533,327	6,352,533,327

Net Cash	-123,525,392
Need of Working Capital	-113,236,666
Working Capital	-236,762,058

Margin of Safety Ratio of the Investment	Not determined
Turnover Ratio	0.92

The Cencosud S.A. company does not show a margin of safety ratio in investment since it is undetermined; however, it has a turnover ratio of 0.92.

HITES S.A.	
CASH FINANCIAL ASSETS	**CASH FINANCIAL LIABILITIES**
11,867,903	24,267,686
CASH OPERATING ASSETS	**CASH OPERATING LIABILITIES**
107,762,505	39,725,496
PROPERTY/FIXED RESOURCES	**PERMANENT CAPITAL**
53,757,331	109,394,557
TOTAL ASSETS	**TOTAL LIABILITIES**
173,387,739	173,387,739

Net Cash	-12,399,783
Need of Working Capital	68,037,009
Working Capital	55,637,226

Margin of Safety Ratio of the Investment	32.09%
Turnover Ratio	2.71

The Hites S.A. company shows a margin of safety ratio of 32.09% of the investment and a turnover ratio of 2.71.

Average Presentation of the Retail Sector

Average of the Economic Sector	
Margin of Safety Ratio of the Investment	24.67%
Turnover Ratio	3.44

The results analysis, with the financial application tools, shows that La Polar S.A. presented an excessive and increased working capital (liquidity increased) in comparison to its competition in its financial statements. Also, it shows a favorable economic outcome caused by a bulky short-term investment that is related to the exploitation of business. This was done by conducting, more than once, unilateral renegotiations with clients, generating a fictitiously increased debt account and a liquid financial statement.

Compared to traditional indexes

For analyzing the liquidity of a company, rates of current ratio and acid test ratio are the most commonly used from the point of view of the traditional method. Current ratio gives less importance to short-term resources and obligations, if we consider this index as a margin of safety ratio to meet short-term commitments.

Before concluding whether the company has liquidity or not, the acid test ratio incorporates an additional element that eliminates the less liquid assets, which corresponds to the stock or inventory in most of the cases.

If the results are positive, we can say that the company has the required margin of safety ratio to meet its current commitments.

The results of the comparative ratios present in both methodologies are shown below:

Company	Margin of Safety Ratio	Turnover Ratio	Current Ratio	Acid Test Ratio
La Polar S.A.	34.03%	8.19	2.25	2.07
Falabella S.A.	7.9%	1.95	1.43	0.96
CENCOSUD	-	0.92	0.86	0.54
HITES	32.09%	2.71	1.86	1.62
Industry Average	24.67%	3.44	1.6	1.3

The current ratio and acid test ratio do not show large deviations with respect to its competitors of similar size; therefore, they do not anticipate possible events.

Conclusion

According to the results, the information clearly indicates that La Polar S.A. presented a rather distant situation than its competitors in terms of liquidity and economic result which obviously delivers some kind of warning of illegal practices and a keen supervision from the Controllers. Therefore, we suggest that it is relevant to monitor the credits that retail companies give and to create new institutions that will oversee the financial practices.

Namely the margin of safety ratio of investment and the turnover ratios in the proposed method of analysis would anticipate at least one situation affecting the company under analysis. Their figures were superior to the industry, particularly the turnover ratio which exceeded more than three times the company that folllows.

If we incorporate traditional techniques of liquidity analysis, we cannot conclude that the company had some type of financial difficulty because their figures are consistent with those shown by the industry. Therefore, the proposed ratios, derived from the method of analysis, predict best the financial scandal that the Chilean financial market suffered whereas their indicators show important differences with its comparable companies.

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