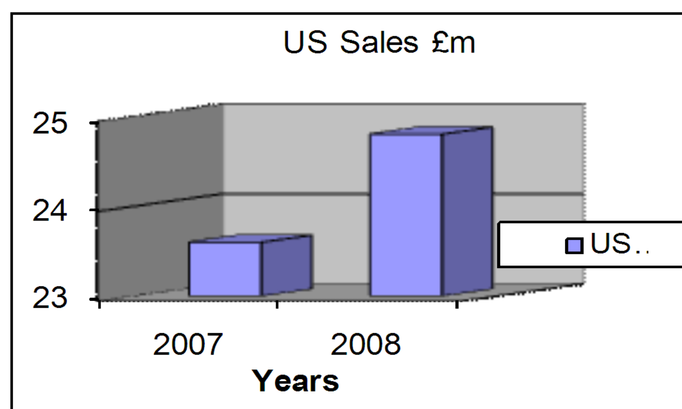
Window Dressing

Specification requirement— Window dressing – the ability of firms to make decisions which affect their apparent performance in their published accounts.

The presentation of the accounts of Limited Companies (both LTDs and PLCs) is supposed to be a science. Rules laid down by statute and the professional accountancy bodies, govern the form and content of accounts, the dates by which accounts must be published and how figures are to be presented within the accounts. But because of the complex nature of business activity and the need for managers and directors to be seen to achieve, the opportunity arises and motivation exists for rules to be bent, reinterpreted or in the worst of cases ignored. This adaptation of the rules to present published accounts in a better light is what is known as 'Window Dressing'.

Methods Of Window Dressing.

Simple methods of Window dressing are relatively easy to achieve, perhaps the most commonly used method is through the presentation of statistics in way that enhances performance. In the example below we see the increase in sales that has occurred in a firms American Division.



This type of presentation disguises performance in a number of ways. Firstly the use of a high base figure for the vertical axis exaggerates the increase, a quick glance gives the impression of a massive improvement in sales performance. But the fact is that sales have only increased by 5%. Secondly by highlighting performance in one market, the firm might be trying to hide poor performance in other markets or divisions. Thirdly the figures take no account of affects of inflation or performance of competitors. A glance at any set of published accounts will confirm that all large businesses are selective in what they highlight and how they present summaries of performance.

All analysts of accounts are aware of this type of practice, so for the true picture the Balance Sheet and Profit and Loss Account need to be examined in detail, and comparisons made against major competitors.

Window dressing extends far beyond simple presentation techniques. Below we examine how figures can be 'massaged', so that they can be misrepresented.

Brand Valuations - Improving the Balance Sheet.

Another method of window dressing is through the use of brand valuations. Brands have become a great deal more valuable in recent times and awareness of this has meant that many firms can adjust the strength of their

Balance Sheets by re-valuing brands. An increase in the value of the brands will increase the paper worth of a company. This revaluation is often carried out to increase the asset value of a company and to defend against take-overs.

If a company was to increase the valuation of it's brands from £200 million to £400 million, then of course it will be much more difficult to take-over the company. The true value of the brands is perhaps in the eye of the beholder, the owner or the bidder.

Hiding the cost of poor investments.
We have seen recently how banks have started to write down the value of their 'toxic assets', creating huge losses in the £billions. Simply understating the level of the losses on assets, will help increase profitability or minimise loss.

Sale and Lease-Back - Improving Liquidity.
Cash flow problems can be solved to by the use of sale and lease-back. This involves the sale of large capital assets and then the leasing back of the same assets so that they are available for use by the company. This method is only normally available to large businesses and typical assets for sale are buildings. It is normal practice for example for department stores to build a new retail outlet and then sell the outlet to a property company or investment fund, and then lease back the use of the store. This practice ensures that enough capital is always available for future developments. We can see then that sale and lease back is a normal business practice but it can be used to improve short-term cash situations and therefore improve current asset ratios and liquidity. If sale and lease-back is carried out for short term liquidity reasons, questions should arise over long term business performance.

The use of Exceptional and Extraordinary items. .
Exceptional items are costs and revenues to the business that arise from normal business activity but are unusual in some way. For example redundancy costs are normally an exceptional item. We can see that these can arise from time to time in any business.

Exceptional revenues can be used for window dressing, these occur when revenues arise that are unusual and unlikely to be repeated. If these are shown as exceptional items there is no problem, but if they are just shown as normal business revenues, then profit levels will be overstated.

Extraordinary items are revenues or costs that occur, but not as a result of normal business activity. They should be highlighted in accounts, and inserted after the calculation of Profit before Interest and Taxation. To include these in normal revenues will again exaggerate business profits.

Is obvious that the correct positioning and titling of this type of revenue is important if accounts are not to be distorted. An example of an extraordinary item could be British Glue selling it's London Headquarters at a price greatly above the Balance Sheet valuation. Obviously the income generated could distort published accounts if not presented in the appropriate manner, that is as an extraordinary item.

Why do firms 'Window Dress'?

- To protect from take-overs – re-valuing assets especially Brands
- To improve share valuations - managers must be seen to perform.
- To encourage shareholder approval - less likelihood of difficult AGM's.
- To increase revenue from take-overs - this can be fraudulent.
- To win or retain institutional investor support - careful use of creative accounting can disguise poor performance trends.
- To retain or gain lines of credit - business creditors are encouraged by strong liquidity.

Window Dressing is a wide-spread practice, it can vary from a presentation of statistics so that a company highlights what it sees as best about it's performance and avoids stressing the worst aspects of the previous years trading, to the disguising of liquidity problems or even fraudulent representation of liabilities.

This gross misrepresentation of debts has been seen with Enron in the US, where $billions of long term liabilities were hidden off balance sheet. British, American and European banks still seem in many cases unable or unwilling to adjust their accounts to show true value of assets for which they massively overpaid.

The reasons behind Window Dressing are often understandable, but greed, self-interest, or fraud all can influence how accounts are presented. Worldcom, a huge telecoms and communications company, again in the US, inflated profits by disguising expenses expenditure as investment in assets – what seemed like a hugely successful and profitable company, had it seems never actually made a profit!

So take accounts as published with a large pinch of salt, even leading fund managers have been, and will continue to be, misled by accounting practices of some large businesses.

Notes