

# Corporate reporting case study diageo plc



## **1. Information about the company**

Diageo, formed in 1997, from the merger of Guinness PLC and Grand Metropolitan PLC, is a multinational company, trading in over 180 markets across the world, listed on both the London Stock Exchange (DGE) and the New York Stock Exchange (DEO). It is the world's leading premium drinks business.

The company contains 24, 270 employees worldwide with offices in around 80 countries. Company takes up about 30% global markets, and holds world's top 20 brands include: Smirnoff, Johnnie Walker, Captain Morgan, Baileys, J&B, José Cuervo, Tanqueray, Guinness, Crown Royal, Beaulieu Vineyard and Sterling Vineyards wines, and Bushmills Irish whiskey.

Key numbers for fiscal year ending June, 2009:

Sales: \$15, 378. 0M

One year growth: (4. 7%)

Net income: \$2, 849. 0M

Income growth: (10. 6%)

Source: Answers (2009) Diageo: Information from answers

## **2. Competitive Environment**

### **1¼% Industry Competition Overview**

The world drink market is broadly exploited in the mature markets. Among the competitors, the most successful are Pernod Ricard Group, Majestic Wine

PLC, Bacardi & Company Limited, Brown-Forman Corporation, Fortune Brands, Inc. Diageo PLC holds 30 per cent of the total drink market.

## **2¼% Globalisation and Mergers & Acquisitions**

There is a rapid growth in international trade and increasing globalisation of Liquor industry. The main competitions focus on the emerging market and expanding the global market shares by mergers and acquisitions. Pernod Ricard and Fortune Brands jointly buyout the world's second largest spirits company Doumic in UK. In order to precedence over its competitors, the company speeds up mergers and acquisitions internationally.

## **3¼% Legislation and Economic Environment**

The EU will enact legislation to uniform the standards for wine production. Regulation is also rapidly developing in emerging markets, which may compounds some difficulties in taking up the emerging market.

Economic crisis had a deep impact on the pattern of alcohol manufacturing competition, which had a varied impact on Diageo's brand performance and parts of the brands' sales fell significantly.

## **Evaluation of Financial Statements**

The Corporation's financial position is evaluated by ratio analysis, horizontal analysis and vertical analysis, which is measured by using FinSAS, according to the Income Statements and Balance Sheets, compared with another biggest drink manufacture-Majestic Wine PLC.

## **1. Ratio Analysis**

The value of the firm is determined by its profitability and growth. In ratio analysis, I compare the ratios of the Diageo PLC for six years and compare the group with another firm in the same industry. The objective of ratio analysis regarding to the firm's financial position is to evaluate the effective of the group's policies in operating management, investment management, financial strategy and dividend policy.

### **1) Overall Profitability Assessment**

The ROE is a comprehensive indicator of firm's performance. The ROE of Diageo shows a significant increase from 2007 to 2009, from 33.94% to 43.78%, much higher than its competitor in UK. On average over long periods, large publicly traded firms in the U. S. generate ROE in the range of 11 to 13 percent. The ROE of Diageo is stable at a relatively high level around 30% to 50%. That indicates the managers are suitable performed in employing the funds invested by the firm's shareholders to generate returns. Diageo's strategies of focusing on profit improvement, such as acquisitions, restructuring initiatives and targeting at emerging markets, gains positive results.

### **2) Operating Management Assessment**

The Gross Profit Ratio and EBIT Margin show the profitability of company's operating activities.

The figures above show that the Gross Profit Ratio and EBIT Margin of Diageo are much higher than Majestic Wine plc, indicating a seriously competition in the economic situation. Both ratios of Diageo decreased slightly to 1.59%

and 1.28% from 2008 to 2009 due to the impact of economic downturn, especially in Spain and Ireland. However, both ratios maintained at a relatively high level, validating the company's stated intention in its annual report of focusing on profitability. Diageo has grown profits in the mature markets and made great advances in emerging markets by volume, by net sales, and by operating profit.

### **3) Financial Management Assessment**

The level of Diageo's financial leverage is slightly higher than Majestic's and increased significantly from 2006 to 2009. Financial leverage increases the Group's ROE as long as the cost of the liabilities is less than the return from investing these funds. What we should pay attention to is that while a firm's shareholders can potentially benefit from financial leverage, it can also increase their risk.

### **4) Investment Ratio Assessment**

The DPS of Diageo increased steadily from 2005 to 2009, which reflects a stable dividend policy. Reported EPS growth increases by 10% in the recession period. The profits come from two restructuring initiatives in the year, which generate £160 million of cost reductions in all, and from the Exchange rate movements which increase net sales by £1,095 million.

### **5) Liquidity Ratio Assessment**

The above ratios attempt to measure the firm's ability to repay its current liabilities, i. e. short-term solvency. The Current Ratio of Diageo is significantly outstanding than Majestic's, about 1.35 on average. Diageo's inventory situation from 2005 to 2009 was uncomfortable when measured in

terms of quick ratio, which is too low (less than 1) for manufactory industry. Diageo paid less attention to improve the inventory management.

## **6) Financial Strength Assessment**

A company's financial leverage is also influenced by its debt financing policy. The Diageo's Debt Ratio and D/E Ratio are higher than its competitor's, and its D/E Ratio increased significantly from 2006 to 2009. From the tables above, we can find out that Diageo relies on debt to some extent. It is optimal for firms to use debt in their capital structure for its low costs. However, too much reliance on debt financing is potentially costly to the firm's shareholders. Furthermore, Diageo will face financial distress if it defaults on the interest and principal payments.

## **2. Horizontal Analysis**

Sales were increasing significantly from 2005 to 2009, especially in 2009, reflecting the contribution from brand's outstanding performance in Asia Pacific and Europe, which offsets the impact by the weakness in North America. The operational progress and foreign exchange benefits stated by annual report also increase its net sales.

The increase of Cost of Good Sales is more than Sales increase for the accounting period, which means that it costs more to sell the product than we actually made.

The growth of Operating Expense exceeds the growth of Gross Profit by 18.53%. This means that our sales exceeded the expenses, and the company gains the money.

Income Tax Expense exception, other items on the income statement are increase, which indicates a decline in profitability of the company.

The increase of Net Income results in the change for EPS on LSE and DEO.

### **3. Vertical Analysis**

The proportion of COGS increased from 2005 to 2009 by 2.28%, which shows the direct effect on the company's Gross Profit. The decrease of the proportion of Operating Income and the increase of proportion of Interest Expense results in the slightly decline of Net Income.

### **2) Capital Structure analysis**

The total long-term liabilities of Diageo PLC take more than half parts of its capital structure both in 2008 and 2009. Its capital structure is far more risky than the Majestic Wine PLC which contains large proportion of equity and current liabilities. Under the risk-based capital structure, low liquidity enhances the Diageo's financial risk. On the other hand, the non-current assets, which gain high level of return, take up a large proportion, so the profitability of the company has also been improved.

### **Conclusion**

Diageo's strategy is to generate consistent top line growth while enhancing its operating margins and return on invested capital. The company seeks out selective acquisitions to support brands growth which strengthen its market position in both United Kingdom and abroad.

In the future, according to the company's strategy, Diageo looks for the opportunities in emerging markets, such as Brazil, Russia, India and China.

Annual report reveals that the Company's credit risk comes from financial instruments and business activities. Diageo minimizes its financial credit risk through the application of risk management policies approved and monitored by the board. Trade and other receivables exposures are managed locally in the operating units where they arise and credit limits are set as deemed appropriate for the customer. There is no concentration of credit risk with respect to trade and other receivables as the group has a large number of customers which are internationally dispersed[1].

Although the corporate gains stable profitability, it has several financial management limitations. Its capital structure contains too many long-term debts and inefficient inventory management may add the liquidity risk.

## **SECTION B**

Corporate GovernanceThe goal of Corporate Governance is to solve the agency problem and create sustainable shareholder's wealth. The corporate governance practices of Diageo PLC mainly include: internal control by board of directors and remuneration policy.

Key to committees[2]

1. Audit
2. Executive (comprising senior management)
3. Nomination
4. Remuneration



Comes from the figures above and corporate governance report, the board has an appropriate structure and directorship.

The size of board is appropriate, in which case, the decision making and internal control are effective and can make sure all the directors are participating in the significant affairs.

Good balance between executive and non-executive directors. There are fewer executive directors and more non-executive directors. Putting the outside directors into the committees can prevent manager conspiracy plundering the shareholders' profits.

The Board Committees are constructed clearly according to their functions, which plays a positive effect to the board: 1) Define the functions of board of directors. 2) The directors can access to company information more easily. 3) In favor of non-executive directors of the company's affairs involvement.

The company has experienced experts serving on their board. The executive directors have a plenty of experience in the drink business, supported by a wide range of financial and technical experience of the non-executive directors.

## 2) Independence

The Non-Executive Directors play an important part in corporate accountability and governance through their membership of sub-committees: Audit Committee, Executive Committee, Nomination Committee and Remuneration Committee, which improves the board's independence.

The non-executive directors have a particular responsibility for ensuring that the business strategies proposed are fully discussed and critically reviewed. This enables the directors to promote the success of the company for the benefit of its shareholders as a whole,[3]

## **2. Remuneration Committee**

### 1) The composition of Remuneration Committee

The Remuneration Committee consists of Diageo's non-executive directors, all of whom are independent. In that case, the committee members have no financial interests about themselves conflicting with shareholders, which reinforce the committee's independence.

### 2) Responsibilities for the corporate governance

The responsibilities of the Committee include[4]:

Making recommendations to the board on remuneration policy as applied to the executive directors and the executive committee.

Setting, reviewing and approving individual remuneration arrangements for the chairman, executive directors and executive committee members including terms and conditions of employment.

Determining arrangements in relation to termination of employment of each executive director and other designated senior executives; and

Making recommendations to the board concerning the introduction of any new share incentive plans which require approval by shareholders.

## Types of Main Executive Compensation[5]:

**Base Salary:** The Committee takes base salary into the consideration of the value created by individual, performance and the external market data.

**Annual Bonus:** Incentives year on year delivery of short term performance goals. Cash bonuses were earned by other senior managers for achieving relevant performance targets for the financial year.

**Share Options:** Incentives three-year earnings growth above a minimum threshold. Provides focus on increasing Diageo's share price over the medium to longer term, however, may increase the manipulating of accounting profits.

**Performance share awards:** Provides focus on delivering superior returns to shareholders.

**Pension:** Provides competitive post-retirement benefits.

**Long Term Incentive Plan (LTIP):** These awards vest three years after grant and are subject to satisfying the appropriate performance criteria over the relevant three year performance period. This policy can prevent manager focusing on manipulating short-term earning.

## **Ownership Structure**

Diageo Plc is incorporated as a public limited company in England and Wales. It is listed on the London Stock Exchange, as DGE, and on the New York Stock Exchange, as DEO.

The Ownership Structure of Diageo PLC is classified into Block-Holders Ownership. Capital Group Companies, Inc. are the only major shareholders, with 123 million ordinary shares (4.01% of the issued ordinary share capital) and no different voting rights. No other major shareholders are listed in Diageo's Annual Report.

## **Audit Independence**

### 1. The audit report opinion[6]

The financial statements give the objective and fair description of the Group's affairs at 30 June 2009 and its profit for the year then ended.

The statements have been prepared accordance with IFRS.

The statements have been prepared accordance with the requirements of the Companies Act 2006 and Article 4 of the IAS Regulation.

### 2. Assurance

The independent auditor provides a positive assurance. It gives the audit opinions that the financial statements meet the requirement of IFRS, Companies Act and IAS Regulation. The mentioned above can improve the independence of external auditing.

### 3. Non-audit services[7]

The group has a policy on the use of the external auditor for non-audit services, which is reviewed annually, most recently in June 2009.

These pre-approved non-audit service categories may be summarized as follows:

Accounting advice, employee benefit plan audits, and audit. or other attestation services, not otherwise prohibited;

due diligence and other support in respect of acquisitions, disposals, training and other business initiatives; and

Certain specified tax services, including tax compliance, tax planning and related implementation advice in relation to acquisitions, disposals and other reorganizations.

All the non-audit services are under the supervision of audit committee which avoids the interest conflict while audit and non-audit services are provided by external group audit simultaneously.

## **Audit Committee**

### 1. The main features and characteristics

Composition: Exclusively Independent Non-Executive Directors.

Assurance: Financial reporting is evaluated by the Audit Committee.

Background of committee members: The corporate requires at least one committee member is a financial expert.

The term of office: The term of office of members should not be too long, generally 3 years.

### 2. The role in enhancing the credibility of the published information

<https://assignbuster.com/corporate-reporting-case-study-diageo-plc/>

The audit committee takes the following responsibilities:

Monitor internal control and risk management throughout the Group.

Review the objectivity of the interim and annual financial statements including a review of the significant financial reporting judgments contained in them, before submission to the full board.

Monitor the effectiveness of the global audit and risk function.

Critically review the group's policies and practices concerning business conduct and ethics.

Monitor the company's relationship with the external auditor, including its independence and management's response to any major external audit recommendations.

According to the mentioned above, audit committee can monitor the key financial and operational risky areas, review the fairness and effectiveness of internal control system, and oversight of external audit and internal audit on the implementation of the recommendations of internal control through the internal audit functions.

### 3. The role in enhancing the independence of the external auditor[8]

In reviewing the independence of the external auditor, the audit committee considered a number of factors. These include: the standing, experience and tenure of the external audit director; the nature and level of services provided by the external auditor; and confirmation from the external auditor.

The audit committee established the policy to reinforce the independence of external auditors.

The provision of any service must be approved by the audit committee.

The fees generated from non-audit services are under the supervision of audit committee.

Consulting work cannot be performed for audit clients.

## **Voluntary Disclosures**

### 1. The evaluation of voluntary disclosure[9]

#### Environmental disclosure

The Company's Environmental Statement provides a detailed description of environmental policy regarding to the improvement in environmental performance, energy and greenhouse gases, Water management, Brands, packaging and innovation, Supply chain, Research and transfer of technology, Hazardous substances, and Emergency response.

#### Social disclosure

Diageo PLC makes a real contribution to creating a positive role for alcohol in society, minimizing the harm from misuse and promoting the social benefits of responsible drinking.

The company's investing in employee development increases the capability of its workforce, creates value and spreads wealth through the community.

The company sets some policies about safety at work, employees' health, employees' capability and development.

#### Ethical disclosure

The liquor has a negative impact on people's health, and the Diageo not only focuses on the markets expanding but also give a positive guidance to the public.

#### 2. Three main potential impacts

The Company contributes to the wider community through their involvement in corporate citizenship, volunteering and charitable activities, which gain positive impact on corporate reputation.

One of the most significant impacts of its business on local economies is to provide employment.

The occupational health and safety of employees is a high priority, which enhances the motivation and performance of employees.