

thebigpicture

guideposts for the private investor

Week Commencing 30 September 2002

thebigpicture news

- The US Fed left interest rates unchanged but cited geopolitical conditions (code for likely loss of oil supplies as soon as President Bush commits to war in the Middle East) as possibly leading to some easing in the future. Of interest, the minutes of the FOMC show two governors dissented from the decision to hold rates unchanged indicating considerable debate within the Fed about the right course to follow.
- Emanations from the US administration indicate a high degree of commitment to a middle east war. Unusually, war (and its adverse impact in growth and markets) might now be the base case rather than the low probability event which everyone normally works to avert.

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial analysis and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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CLERP9: Not What Investors Need

The Treasurer's latest proposed changes to corporate governance practices (nicknamed CLERP9) should not make investors feel more secure about committing funds to public companies. The proposals try to deal with the few horses that have conspicuously bolted, not the many still to escape.

Underpinning the proposals are two misplaced assumptions: that auditors are quasi public servants and that accounting standards fulfill the needs of investors.

Genuine remedial action requires some hard decisions about directors' responsibilities. *thebigpicture* has some guideposts by which to judge progress.

Can the Corporate Law Reform Programme (CLERP9) proposals improve business conduct? To answer, there needs to be a clearer understanding in the public debate about the corporate conduct to which objection is being raised. From the perspective of the private investor, it falls into several categories.

- **Dishonesty:** fraud and deliberately misstated accounts either to mislead the market or for personal gain.
- **Excessive remuneration:** payments out of line with community standards but, more importantly, inconsistent with corporate performance.
- **Poor communication:** companies incapable of explaining their strategy or why results are inconsistent with stated objectives.
- **Inadequate performance appraisal:** responsibility for poor business decisions being avoided and the basis for senior executive appointments or terminations going unexplained.
- **Conflicts of interest:** directors or executives receiving benefits, directly or through private companies, which are not explicitly related to their employment activities.

All these potential concerns are simply the flip side of a company with clear objectives and adding value consistently for shareholders. From a private investor perspective, much is forgiven if corporate financial performance is up to scratch. As *thebigpicture* for the week commencing 26 August showed, there is a very wide disparity in corporate financial performance and resulting market performance.

The Auditor As Public Servant

Much reliance is being placed on the role of the auditor. Where do the auditors fit in all of this? In the context of these issues, their role is probably limited to uncovering or preventing cases of genuine dishonesty. But this is probably only a small part of what concerns investors. And, of course, not only external auditors are responsible for this. Strong internal controls including an internal audit function are also necessary.

Auditors continue to suffer a form of commercial schizophrenia. To whom do they owe their first loyalty: the public which has a vision of auditors as accounting policemen, the company executives who negotiate their fees or their actual employers which had been large business service companies which used their quasi-statutory access and barriers

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Director Accountability
Shareholder Participation

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to entry to generate additional more lucrative fees.

While there are now some constraints being applied on the extent to which these pressures exist (non-audit work is not being proscribed in Australia), the schizophrenia must still be present.

The Value of Financial Statements

Is there a difference between adhering to accounting standards and providing a true and fair view of the company? It depends very much on the questions being asked of the company.

For most investors, the key question is one of future value: what is a sustainable level of income; what is its likely rate of growth; and, how can that be summarized in a single measure of value.

Unfortunately, accounting standards do not address these matters adequately if at all; hence the analyst industry which is there to translate the accounts into something which can be used for investment decision-making.

One example is illustrative. Until recently, accounting standards allowed companies to identify abnormal items in the profit statement. These were usually transactions which had a material impact on asset values but which did not arise from day-to-day business activities. This classification was subject to abuse, some alleged, in that various restructuring charges were often treated as abnormal although restructuring was becoming a part of day-to-day corporate life and pre-abnormal profitability was being misleadingly overstated.

There was, of course, an argument in favour of this treatment: forward looking valuations required analysts to remove one-off items to start from a base of sustainable business activity. Against this, however, was the nagging suspicion that some companies were using the abnormal classification to shunt poor performance to one side. Unsustainable one-off positive outcomes were not being treated similarly.

Now, the accounting standards have been changed to largely remove this discretion. Even a large one-off corporate transaction must be treated as "ordinary" in the statement of financial position. Does this advance the cause of investors? Absolutely not! The financial statements do not reflect their needs and they remain reliant on other forms of disclosure for the information that they really require.

The foreshadowed requirement for expensing executive options is in a similar category. *thebigpicture* covered this in its newsletter for the week commencing 2 September arguing that it was a knee-jerk reaction which fails to come to terms with the fundamental problem. The proposed changes introduce more one-off and non-cash items into the profit statements which further erode the meaning of the headline profit numbers.

The Solution?

In part, it needs to be admitted, that there is not a solution. Many of the issues reflect management competence. This is not uniform across the market. Some managers are more competent (and some less so) than others and there is little protection which can be afforded against this.

It is clear, however, that using accounting standards and the audit profession as the bedrock on which to base reform is misplaced and does little for investor well-being.

thebigpicture believes that the onus for all company conduct should fall more clearly upon the executives and directors and that, if they are part of a public company, their accountability should be more public than it has been.

Company directors, in particular, are in a position to set the moral tone, firstly, through the choice of a chief executive and, then, through dissemination and policing of appropriate business standards to which everyone is expected to adhere.

Some of the most egregious lapses in conduct have occurred because of the failure of moral authority within an organization.

Directors need to have their responsibilities reinforced and, perhaps, codified in ways which have not been contemplated. They are intended as the guardians of the interests of private investors and they should be forced to exercise that function.

Three Reforms

There are three reforms which *thebigpicture* would propose to achieve better outcomes for private investors.

Director Independence. Directors should be truly independent. Aside from a chief executive, all other members of a listed company Board should be non-executive. They should not have been executives, service providers or customers of the company at any stage. Nor should they be associated similarly with any large shareholders. Family members of existing directors should not be acceptable.

Director Accountability. Having established theoretical independence, directors should become practically independent also.

This writer attended more than one AGM last year at which well-known company chairmen would not allow individual directors to address the meeting because, it was argued, the Board had a common position which would be represented to the shareholders by the Chairman.

Caucus solidarity for directors is inappropriate. The law will require that the auditor attend and answer questions at an AGM. Why should not the same requirement be placed on a director?

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In practice, the Chairman and the directors are present at an AGM to represent the company to the shareholders whereas the reverse should be the case: they should be there to report on what they did to ensure that the best interests of the shareholders were being met.

Virtually all are failing to do this. They should not get away with it any longer.

Individual directors should be held accountable and there should be mechanisms to scrutinize them individually. None should be able to hide behind 'caucus solidarity' to avoid being questioned.

Some might argue that this will make an AGM unwieldy but that will only be the case if there is genuine dissatisfaction with the corporate performance.

Shareholder participation. Few shareholders currently exercise their rights mainly because of the preponder-

ance of institutional investors on the register of most of the larger public companies. They do not vote as a rule (although there is growing list of exceptions as they are successively shamed into doing so). And, of course, they have privileged access to companies which individual investors do not have so they typically treat the AGM forum with some contempt. This is an unfair and corrupting influence. Institutions should be required to vote.

This might be practically difficult to achieve. An alternative route to the same outcome is to require a company to have a minimum number of shares voting at an AGM before it can have resolutions passed.

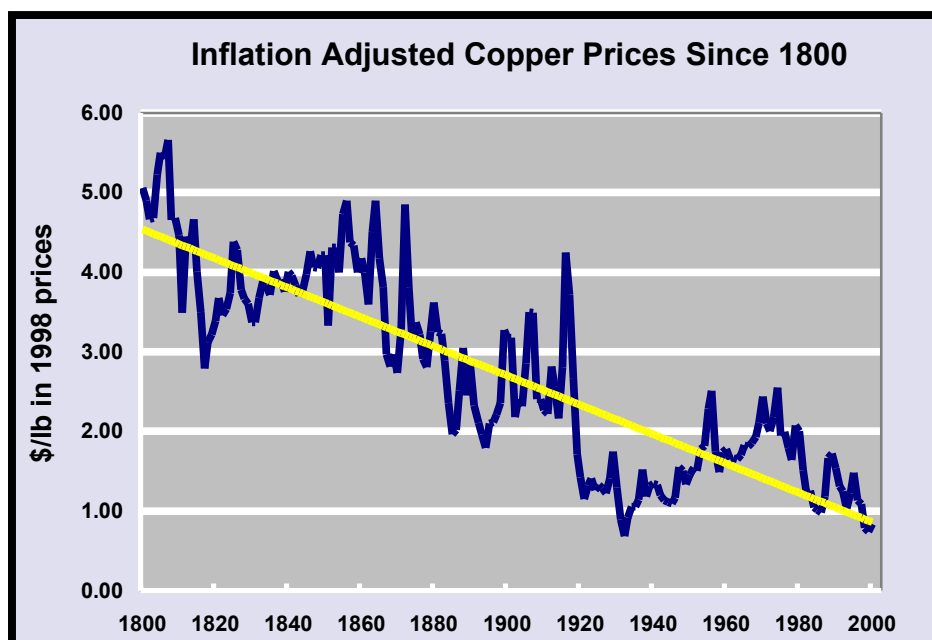
In that way, directors will have to ensure support rather than count on the sham AGM which is so prevalent and in which resolutions are carried through a lack of interest or through only a tiny proportion of the total shares held by supporters, friends and family of an under performing management.

The following is a summary of the principal proposals* contained in CLERP9.

- Audit committees to be required for the 500 largest listed companies.
- The external auditor to be recommended by the audit committee.
- A statement to be required from the audit committee that non-audit services do not compromise auditor independence.
- The external auditors to make an annual declaration of independence to the board of directors.
- Legislative backing to be given to audit standards and oversight of standards to be undertaken by the Financial Reporting Council.
- Audit partners to be rotated every five years.
- The external auditor to be required to attend the annual general meeting and submit to reasonable questions.
- International accounting standards to be adopted from 1 January, 2005.
- Expensing share options to be given the force of law in anticipation of the international accounting standard being adopted, probably by July 2003.
- The penalties for disclosure offences to be increased from \$200,000 to \$1 million.
- ASIC to be given additional powers to oversee disclosure.
- Opportunities for civil recovery of damages to be widened.
- Action to ensure equal access to materially price sensitive information.
- Listed companies to be required to respond to externally generated speculation about their activities.
- Annual disclosure of all directorships held by members of the board currently an in the recent past.
- Protections under the law to be afforded to corporate "whistle blowers".
- A two-year cooling off period to apply for audit partners before accepting directorships or employment with client companies.
- A shareholder council, chaired by the Parliamentary secretary to the Treasurer, to be established and consulted on the needs of retail investors in connection with disclosure-related matters.
- Electronic communication with shareholders to be facilitated.
- Short-form notices of meetings to be facilitated.
- Auditors to be permitted to operate through corporate structures.
- Some limitation on auditor liability to be allowed with a move toward proportionality of liability rather than joint and several liability.

* The list is not necessarily definitive but is intended to highlight where material changes to existing arrangements are being proposed.

Declining Commodity Prices: More Evidence



There is broad evidence of a long term decline in commodity values.

A note in *thebigpicture* for the week commencing 12 August 2002 argued, using a 200 year history of copper prices to illustrate the point, that commodity prices were in a long term decline which limited their attractiveness as possible investment proxies.

The attention of *thebigpicture* has been drawn subsequently to a recent article in the *IMF Staff Papers* (Volume 49 No. 2) entitled "The Long-run Behaviour of Commodity Prices: Small Trends and Big Variability". The authors use *The Economist's* industrial commodity price index between 1862 and 1999 to draw the following conclusions:

- there has been a downward trend in real commodity prices of about one per cent a year over the last 140 years; and,
- there was evidence of a ratcheting up in price volatility over this period with the increase in volatility in the early 1970s due to the increased frequency of large price movements - that is, a fall in the duration of large price cycles.

These research conclusions are consistent with the views contained in *thebigpic-*

ture. In adding their weight, they reinforce the argument behind maintaining a bias against resource sector equity investments.

Three further conclusions can be drawn from the additional IMF findings:

- the long term decline of commodity prices is a broadly based one (*thebigpicture* illustrated it using copper prices) with a similar trend to be found across a broad range of commodity prices;
- the greater likelihood of periodic sharp fluctuations in commodity prices does not affect the trend decline and so is of little consequence for longer term investors; and,
- unless one is able to monitor closely the factors which might create commodity price turning points in the short term, there are substantial (and growing) risks for commodity related investments.

A further point might also be relevant. As the frequency of price cycles increases (within the context of a downward trend), it is likely that markets will become successively less responsive to what are perceived increasingly to be unsustainable price rises.

"[IMF] research conclusions are consistent with the views contained in thebigpicture.....they reinforce the argument behind maintaining a bias against resource sector equity investments."