

# thebigpicture

guideposts for the private investor

Week Commencing 7 April 2003

## **Publishing and Subscription Information**

*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 and business evaluation 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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## *thebigpicture's* ACCOUNTING STANDARDS

**Accounting standards should give investors what they need: information to enable considered decisions about the value of companies to which they subscribe their savings.**

There is actually no law or accounting standard which says that company executives must be competent. Nor is there a minimum return objective enshrined in legislation. Much of the upcoming legislation, the plethora of governance standards and revamped accounting practices will simply ensure that companies wasting shareholder funds will conceal the evidence in a prescribed fashion. They do not provide what investors need (see page 4).

*thebigpicture* offers its own accounting standards. Its guideposts to a company putting shareholder funds at risk identify what investors need and what companies should be disclosing to their shareholders.

**No reference to rate of return:** this could mean that the board does not know how to add shareholder value or that the return on the funds employed in the business is inadequate by market standards. In either case, there might be better investment opportunities.

**Reliance on non-operating income:** if the widget maker gets a part of his accounting profit from selling a part of his plant, for example, his profit is not sustainable. Similarly, if a significant proportion of income is derived from investment incomes or gains made from actively speculating on futures or foreign exchange markets, be wary. If non-operating income is from asset revaluations, this is equivalent to booking future income. It is not sustainable.

**Hedging losses:** you cannot make a loss hedging. See the article in *thebigpicture* for the week commencing 9 December 2002. Any company that has to report significant hedging losses is probably incurring a risk which you did not know about when you invested. Even if it claims to be making a profit, be wary. It probably means it is speculating with your funds.

**Acquisitions to boost growth:** acquisitions conceal the sustainable growth rate. High growth companies are continually demonstrating that sustaining growth through acquisition is virtually impossible. Honest companies should be distinguishing between growth from acquisitions and growth from ongoing businesses.

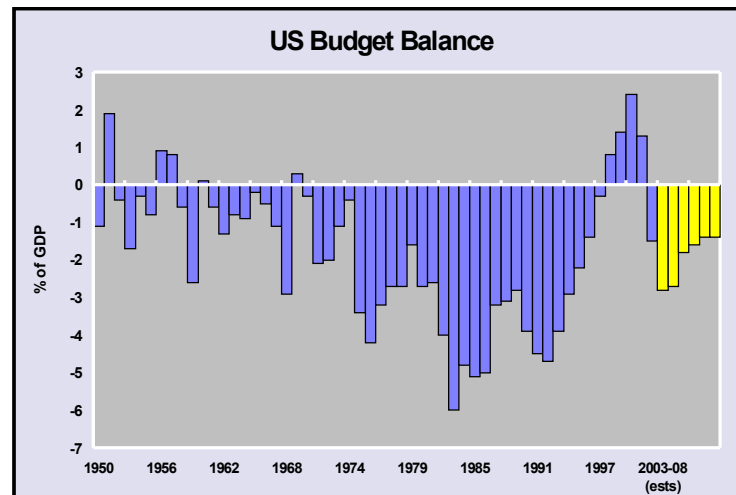
**Booking sales at the end of a reporting period:** companies succumb occasionally to the temptation to boost sales at the end of an accounting period. There are two impacts from this worth noting.

- Higher sales are often driven by extension of more favourable credit terms. This means that cash flow does not match the sales being booked. Check for disparities between the two.
- An artificially high rate of sales in the current period makes it more difficult to achieve growth in the next period. To sustain a growth track will require ever more

thebigpicture's Accounting Standards
Rates of Return
Non-operating Income
Hedging Losses
Growth from Acquisitions
Late Period Sales
Revaluating Assets
Capitalizing Costs
Preferring EBIT
Growing Receivables
Related Parties
Declining Cash
Executive Salaries

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## THE WEEKLY CHART SPOT



Source: US Department of Treasury

*“The prospect of a lengthy period of budget deficits is in sharp contrast to the budgetary prospects barely two years ago.”*

The budget presented to the US Congress by President George W Bush estimated a deficit in fiscal 2004 of US\$307.4 billion which is equivalent to 2.7% of forecast GDP.

Already, there are pressures on this outcome from the war against Iraq for which the administration has requested additional funding. A continuing monitoring, administrative and rebuilding role will almost inevitably require further funds which have not been anticipated in the request before the Congress. There are also worrying emanations from Washington about extending the war to include Syria and Iran (just as there were suggestions at the time of the Afghanistan war that an attack on Iraq would follow).

The prospect of a lengthy period of budget deficits is in sharp contrast to the budgetary prospects barely two years ago. The prolonged economic expansion of the 1990s brought the budget back to balance and there were forecasts of surpluses as far as the eye could see. This proved illusory as the rate of economic growth decelerated and as additional expenditures associated with homeland security and the war against terrorism began to add to the budget spending.

Of course, a budget deficit is no bad thing when the economy is growing below its potential. The budget deficits which prevailed through the 1980s after reaching a peak of 6% of GDP in 1983 were fuelled by the Reagan tax policies which helped drive the subsequent economic expansion and the bull market in stock prices. Some would argue, with the benefit of hindsight, that this went too far but the prospect of continuing deficits does add confidence that policy in the USA is focused firmly on expanding the economy (with all of what that means for profitability and equity market values).

## IRAQ: INTERNATIONAL POLITICAL CONSEQUENCES cont'd

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most of the second half of the twentieth century. NATO which now excludes none is a half-baked institution which serves to keep a US presence in Europe but which hardly reflects the nature of the new world.

No one is seriously suggesting that the UN will cease to exist. It is too large an industry for that to be seriously contemplated in the shorter term. Moreover, despite its historical inability to fulfill the role, there is still a widespread desire for the UN to evolve into an effective global peace-maker and safety valve for international

political tension.

The evidence from recent months does suggest, however, that it is unable to overcome the vested interests of its key decision makers. US attempts to cajole appear to have been counterproductive and papering over disagreements with smart diplomatic language led to an artificial majority and a frustrating stalemate which could only be broken through determined unilateral action. That means that the UN must turn a blind eye to unilateral actions or that some different mechanism is put in place to break deadlocks over multilateral initiatives.

*thebigpicture's* ACCOUNTING STANDARDS CONT'D*(Continued from page 1)*

generous credit terms.

**Revaluing assets:** this often happens when a new chief executive takes over. That is bad enough but be especially wary if it is common practice: repetitive use of one-off charges implies strategic weakness which could be a precursor to corporate failure. Companies revaluing assets usually seek to position the decision as something which places the company on a stronger footing. It is an accounting fiction that this loss of value can be ignored.

Simply admitting in the accounts that value has diminished does not take away from the fact that those funds have been committed permanently by shareholders. Too often, the lower asset values are used to claim that subsequent rates of return have improved. Honesty would demand that the value of the investment be retained in the funds committed by shareholders when calculating returns.

**Capitalizing development costs:** the more you spend, the greater the asset base. This is most noticeable among companies with a high level of research and development spending. Being able to capitalize development expenditure should require a high degree of certainty that revenues will flow in the short term as a consequence of the expenditure. Nonetheless, there are companies listed today which are only 'expecting' revenues in a year or two from (capitalised) expenditures undertaken in the last two years. Even then, the anticipated value flow might not match the expenditure.

**Preferring EBIT:** this says that a company does not like its reported result. In justification, it will say that it is better to talk about the operational performance but there is always a reason. Interest payments rising faster than revenue might mean that a company is buying profit through acquisitions or credit extensions. Higher tax might be a good sign. It normally means higher profits but it is a value outflow for shareholders which cannot be ignored.

**Receivables or inventories are growing faster than revenues:** this is a business which might have some superficial attraction but might be creating little value. A classic example is the wine industry which appeared to have all the elements of an attractive growth industry except that it

required two dollars of investment for every dollar of sales. Strong sales and production growth, which became the focus of market attention, came at the expense of a large funding requirement. It took some time for the re-rating to occur and valuations to be adjusted. But they were.

**Related party or off balance sheet holdings:** this has been a route through which value has been siphoned and the one area to which regulators have given considerable attention. New relationship tests will make off balance sheet holdings harder to achieve. As the new standards are introduced, look for changes which reflect companies having to acknowledge items which they did not previously have on the balance sheet.

**Declining cash:** this is especially important for the smaller companies floated during the 1990s. Many companies were listed with inadequate capital backing and probably expected to raise capital subsequently as it was needed. With capital now scarcer, many are showing parlously low cash levels.

Companies with the equivalent of less than two years' cash on hand at current rates of expenditure should be treated as highly speculative. Be wary of intentions to raise funds. Occasionally, companies foreshadow capital raisings which never eventuate or which deliver far lower outcomes than their continuous disclosure statements would have led investors to expect.

**Executive salaries:** the level is less important than the differential among executives. Publication of executive salaries has done little to prevent corporate excess or company failure because there are no standards against which to judge what an appropriate salary is supposed to be. Some believe that publication leads inexorably to salary inflation.

One thing is clear: the dominant CEO has proved to be incompatible with a sustainable business. One indicator of this is a wide disparity between the salary of the CEO and the salary of other senior executives. For example, a CEO salary which is a multiple of 4-6 times the salary of a direct report might suggest that the business is either too tied to an individual or is risking the departure of other members of the executive team upon which the sustainability of the business is dependent.

*"Much of the upcoming legislation, the plethora of governance standards and revamped accounting practices will simply ensure that companies wasting shareholder funds will conceal the evidence in a prescribed fashion."*

## YOU CAN'T LEGISLATE COMPETENCE

**The focus on audit committee composition and the forms of company accounts as matters of public policy will not necessarily afford greater protection for investors.**

In neglecting the importance of strategic thinking and business implementation skills in determining the performance of companies, policymakers are focusing on matters of second order importance.

The current accounting standards as well as those changes which have been foreshadowed for 2004 to conform to international accounting practices do not generally facilitate the flow of information which investors need.

Four key pieces of information are generally needed by investors for simple valuation purposes:

- a measure of a company's current level of sustainable profits – that is, the level of profitability which could be maintained indefinitely without any addition to the capital employed in the business;
- an assumption about the rate of sustainable growth (or, if different growth paths are expected over different time periods, what those growth paths are

likely to be);

- the quantity of funds which will be needed to sustain the growth which is anticipated; and,
- a target rate of return which defines the minimum performance standards which an investor would be prepared to accept.

Investors must rely on company financial publications for the first three of these. Neither current nor proposed accounting standards require this information to be displayed. The statement of financial performance, from which an investor would ideally like to derive his estimates of the level of sustainable profit, actually combines it with five other elements of profit:

- contributions to profit from businesses which have been discontinued in the past year;
- contributions to profit from businesses which are to be discontinued within the coming year;
- capital contributions arising from the sale of assets;
- effects due to changing valuations of assets; and,
- the value of deferred payments for goods or services.

*“...policymakers are focusing on matters of second order importance.... accounting standards do not generally facilitate the flow of information which investors need.”*

## IRAQ: INTERNATIONAL POLITICAL CONSEQUENCES

**Several of the international institutions which were once regarded as crucial to the well-being of the international community – NATO, the United Nations and the European Union – are revisiting their futures.**

Chris Patten the EU foreign relations commissioner has recognized in undiplomatically blunt language that the EU has failed to represent its member nations in the debate about Iraq. He is, of course, more likely to have sided with the UK but his conclusions and the antics of the French, in particular, have left many wondering whether Europeans can ever hope for the EU to be more than a relatively large market. The prospects of it developing cohesive positions on matters of international

importance appear to have diminished. The chance of it becoming a significant political entity and, therefore, a significant economic entity which might act as a countervailing influence to the USA seems also to be receding.

In practice, a modern realignment of forces appears underway perhaps crudely represented, according to Defense Secretary Donald Rumsfeld, as 'old' Europe and 'new' Europe. Whatever its eventual form, it should not be surprising to see a transition from organizations established in response to needs at the end of the second world war. Many of those institutions have not adjusted to the breakdown of communism and the bipolar world politics which dominated geopolitical thought for

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