

thebigpicture

guideposts for the private investor

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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 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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Accounting: More Changes, Less Clarity

Prospective changes to accounting standards are an upcoming challenge for investors. Parallel sets of accounts for investment decision-making purposes will likely emerge, defeating some of the reasons for making the changes.

The underlying economic performance of a company is best measured by the operating return relative to accumulated funds employed in the business. The proposed changes take us no closer to having these measures stated explicitly on a consistent basis.

Australian companies will be required to report using international accounting standards after 1 January 2005. For some time, Australian authorities had been seeking to 'harmonize' Australian and international standards but are now committed to adopting international standards in their entirety.

These moves have been given added urgency by the recent public debate about probity in accounts. There is a sense, not altogether well-placed, that having international standards will add rigour to what is reported. It will, in any event, ensure that Australian company accounts are directly comparable with those of overseas companies. This, it is argued, will enhance the standing of the Australia equity market within the international investment community.

More sophisticated accounting standards, however, are no substitute for competent management and sound strategy. Where companies have suffered market rejection it has usually been for failure on the latter two fronts rather than the first.

The key question for investors is this: will the changes make company accounts easier

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Accounting Standard Changes: What Are They

There are six areas of proposed changes to accounting standards with the potential to modify an investors view of a company.

Post-employment benefits will be treated differently so that companies record the impact of a defined benefits plan during the period of employment rather than whenever payments have to be made. The balance sheet will have to reflect the difference between the future obligation and the fair value of the plan assets. Variations in this amount will be reflected in the profit statement.

Classification of financial instruments might have to vary. Instruments which had been classified as equity (such as some of the hybrid securities which had become popular in Australia) will be classified as debt whenever there is an ongoing obligation incurred by the company in issuing them. Also the test applied to situations where financial instruments are taken off balance sheet will be stricter so that derecognition of assets will be tougher to achieve where there is some continuing exposure or where there might be obligations to repurchase under some circumstances.

Asset values will be determined with reference to either representative sales prices or the net present value of a future stream of discounted cash flows. This will be tougher

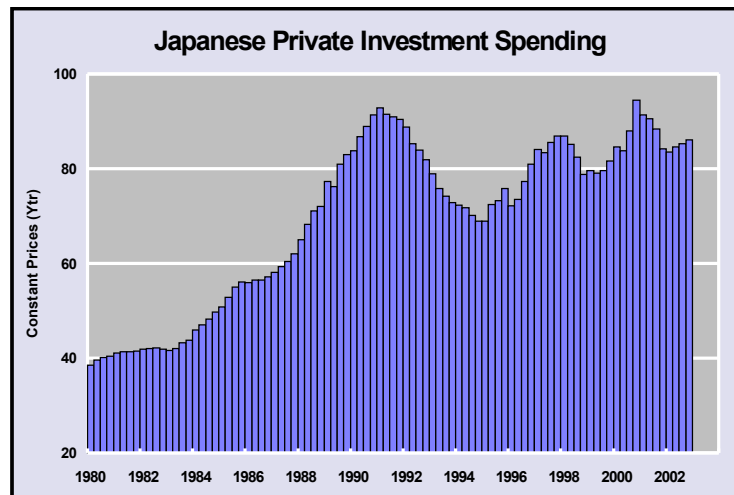
(Continued on page 2)

Accounting Standard Changes

- Post-employment benefits
- Treatment of financial instruments
- Valuing assets
- Disallowing intangibles
- Goodwill not amortized
- Expensing share issues

For a summary see below

THE WEEKLY CHART SPOT



Source: Japanese Cabinet Office

“The investment boom during the 1980s created excess capacity in the domestic economy.... Now the incentive to invest has been further reduced by depressed asset values and a banking system in need of reform.”

The 0.5% increase in Japanese GDP in the December quarter was a much better outcome than the widely anticipated contraction in activity. A better than expected increase in private investment spending boosted overall growth.

Despite the fourth consecutive quarter of economic expansion (after three quarters of contraction), the Japanese economy remains recession prone. Since the beginning of 1995, there have been nine quarters in which the economy has actually contracted. The average annual growth rate over this period has been a meagre 1.4%.

Although private non-residential investment spending rose by 1% in the December quarter, the bigger picture is not encouraging. That investment spending made any contribution to Japanese growth was unusual in recent experience. Having increased at an annual rate of 4.9% through the 1980s, it effectively stalled and, since the beginning of the 1990s, it has failed to increase.

The investment boom during the 1980s created excess capacity in the domestic economy. At the same time, capacity expansions were also being driven in lower cost production centres throughout Asia, partly through Japanese foreign direct investment. Now the incentive to invest has been further reduced by depressed asset values and a banking system in need of reform.

Accounting Standard Changes: What Are They cont'd

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for companies than the recoverable value standard currently applying.

Certain internally generated intangible assets such as brand names and research costs, which are allowed under the existing accounting rules will not be allowed under the international standards.

Goodwill will no longer have to be amortized (although existing amortization will continue). This might facilitate acquisitions by companies which might otherwise be concerned about the earnings dilutive effects of post-acquisition goodwill amortization. However, a broader range of intangibles, such as customer lists, can be identified on acquisition. These will have to be amortized over their useful lives. There will most likely be some pressure to minimize the amount of goodwill and to

maximize the value of other identifiable intangibles.

Impairment in the value of goodwill will require stricter monitoring. Companies will be required to justify carrying values with reference to future cash flows. This will add to investment discipline. In the past, with acquisitions being slipped into the broader organization, there was always a convenient excuse for not reporting on its success or otherwise. Under what is being proposed, a company will have to continue to value the goodwill even in situations where the acquired entity is subsumed into a broader business.

Expensing the value of securities (shares or options) exchanged for goods or services provided or employment will be part of these changes.

Accounting: More Changes, Less Clarity CONT'D

(Continued from page 1)

to understand than under the current accounting regime and more likely to convey the performance of the company accurately?

On these criteria, it is not clear that the changes advance the investor's cause. An investor, reviewing a statement of financial performance, will generally be trying to understand whether the company's most recently reported profit can be maintained and, further, the rate of growth it might be able to sustain. With this information, a company can be valued. The valuation sets a benchmark to guide decisions about whether a stock should be purchased or sold.

In the investor's ideal world, the accounts should refer explicitly to the ongoing operations of the company. For that is the part in which the investment value of the company is being generated. In real life, however, the statement of financial performance will be an agglomeration of:

- ongoing operating performance (in this ideal sense);
- 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.

Changing asset valuations will become a more frequent phenomenon in accounts once the international standards are adopted fully. For this reason, the changes are likely to make stated financial performance more volatile under any given circumstances than it had been in the past.

To cope with this, almost inevitably, analysts will be employed to deconstruct the formal accounts and to restate them in a fashion which is more meaningful for investment decision-making purposes.

Companies, in reporting, will also attempt to strip out the various effects to help make sense of what is published by focusing on what investors need. There is an opportunity in this for unscrupulous man-

agement.

The rush to more rigorously applied (and less discretionary) accounting standards was intended to prevent directors 'pulling the wool over the eyes' of investors. This they used to be able to do by preparing pro-forma accounts which purported to explain what was really happening. The honest director would do this to genuinely assist understanding. The unscrupulous director would use it to obfuscate.

The push to international accounting standards opens the way for (and encourages) alternative sets of accounts which 'better explain' what is hidden by the statutorily determined standards. Therein lies an ongoing risk.

Since the changes are not scheduled to occur until 2005, why worry about them now? For companies, there are many internal system changes which have to be put in place for the deadline to be met. The comparative year will have to be reported on the same basis as the newly reported year. In August 2005, for example, a June reporting company will have to have a set of accounts for 2004/05 and 2003/04. In other words, some preparatory work will need to be carried out during 2003.

Investors will need to be on their guards as outcomes are more precisely calculated since some of the changes are likely to have a radical impact on what is reported.

For example, brand values which will generally be excluded from assets, represented 89.6% and 28.1%, respectively, of the net assets of News Corporation and National Foods at 30 June 2002. At the smaller end of the market, deferred research expenditure and patents accounted for 91.9% of the net assets of biotech start-up Norwood Abbey.

Of course, the underlying financial economics of a company will be exactly the same after the changes as they had been before. So, how much emphasis should be put on the changes? If the answer is none, why go through the agony of changing the standards at all! Presumably, however, the standards will carry some legitimacy and influence decision-making.

Once new accounts have been calculated and without knowing how the market will react, companies will have to make judgments about how the impacts should be acknowledged publicly.

"The push to international accounting standards opens the way for (and encourages) alternative sets of accounts which 'better explain' what is hidden by the statutorily determined standards. Therein lies an ongoing risk."

NO MORE DEBT?

The debate about the closure of the Australian bond market might have been a flight of fancy after all.

As if to demonstrate its conservative fiscal credentials in the past year, the government had pretended that it was on the verge of abolishing government debt.

Somewhat akin to poking the tiger with a stick, it raised an almost uniformly hostile reception from those whose day-to-day activities revolve around generating income from trading government bonds.

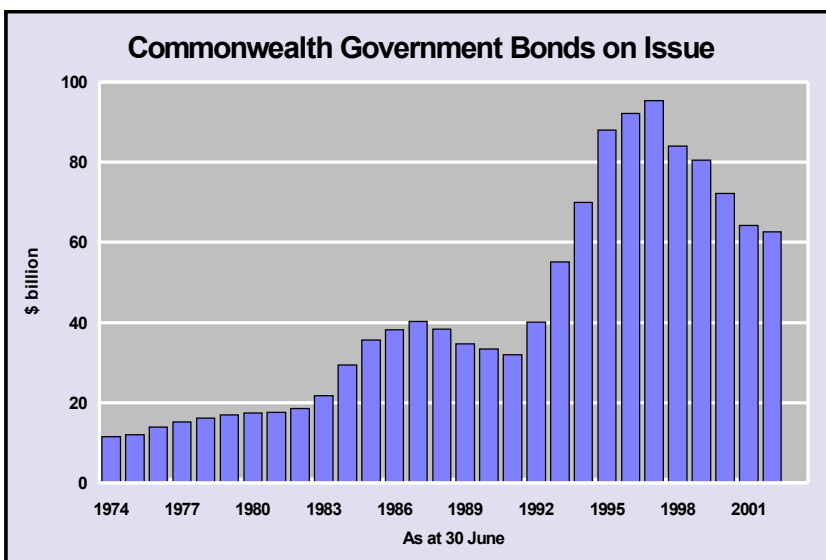
The sale of the remaining government holding in Telstra and exemplary fiscal control were to be the foundations for buying back the \$60 billion in outstanding paper and abolition of the government bond market. If it chose not to repurchase its issued securities, the government would have been forced to buy other financial assets in which to hold its surplus funds. There were suggestions that it could build a portfolio of international bonds and domestic and international equities.

The potential for large trading losses aside, the widespread hostility toward selling Telstra meant that this was a low probability event. Now, with the Telstra share price as low as it is, the chances are even slimmer. And, with the prospect of a Middle East war, there are more pressing matters of national importance to be dealt with.

By the time the Iraqi dictator is dispatched, the national political succession will be underway and, with an election to follow, an issue for which there is very lit-

tle natural constituency will have few defenders.

In any case, the fiscal performance was always overstated. Extra defence spending aside, despite economic growth averaging just under 4% a year for seven years, the government's budget was



barely in surplus. There was nothing ahead to suggest that the actions of the government were going to move any closer to its rhetoric.

Nor did the fiscal fantasy take account of the superannuation obligations which are funded from current revenues. If the government had to fund the liability as it arose (the direction international accounting standards are pushing Australian companies), the need to continue to issue government bonds will have been undiminished.

Also, some of the argument seems to underestimate the efficacy of the market. Certainly, government bonds do represent a benchmark against which all other securities can be priced. However, in their absence, markets will work and other standards are likely to evolve. It might mean, for example, a more active corporate bond market.

“...the fiscal performance was always overstated...despite economic growth averaging just under 4% a year for seven years, the government's budget was barely in surplus....Nor did the fiscal fantasy take account of the superannuation obligations which are funded from current revenues.”

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