

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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thebigpicture Economics
ABN 71 040 787 936
PO Box 333, Malvern
Vic 3144

COMPANY REPORTING: TOO MANY RULES

With June year end companies having to report annual results by 31 August, a mountain of corporate financial information from listed companies became available in the past few weeks. Tighter reporting rules might not be assisting investors as they should.

One challenge for investors and their advisers is to assimilate the large volume of information included in company accounts and delivered within a three week window. This would be hard enough if they were delivered in an investor friendly format.

Unfortunately, despite the resources being committed to developing and policing accounting standards, they have been of limited help in giving investors what they need.

Among their needs in analyzing the investment attractiveness of any company is a clear understanding of what is sustainable profit. In reported profit, accounting standards require inclusion of an amalgam of cash and non-cash items. There is net income from ongoing operating businesses, as you would want, but also proceeds from asset sales, non-cash asset revaluations, provisions for future activities, adjustments to past activities and income from businesses no longer held.

The mishmash going to make up reported profit ensures that its value for investors is greatly diminished.

Another example of investor-unfriendly reporting is the absence of any requirement in the accounting standards for companies to describe rates of return, the underpinning of any successful business. And if companies, commendably, do use such a measure there are no standard definitions.

A growing proportion of companies are releasing more sophisticated commentaries to accompany their accounts as a way to explain how investors should interpret their formal reports.

Standard practice is now for these to be lodged with the ASX (rather than offered only to institutional investors and analysts as they once were) for public use. This is an aid but also adds to the volume of material.

All of this means that financial advisers seeking to make judgements about individual companies to enable them to advise clients are placed in a quandary: commit to a burdensome research capacity or put clients in the hands of others.

And, of course, this plays into the hands of the larger brokers and fund managers who do have the analytical resources. Since access to those resources is generally tagged to specific products, their generic investment products and advisory services gain market share at the expense of those produced independently and tailored to client needs. Ultimately, how information is delivered affects the structure of the financial advisory industry.

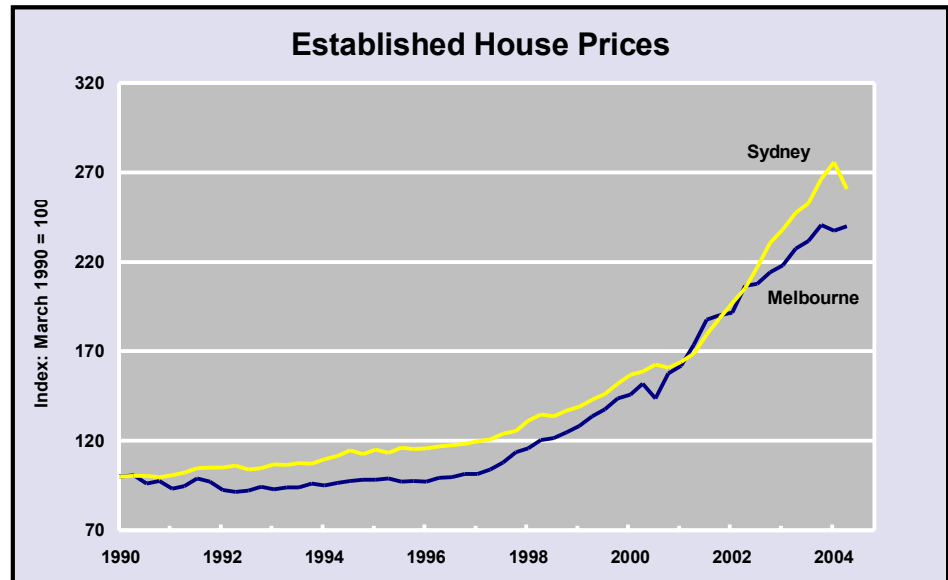
A more streamlined way of delivering the key pieces of financial data would be ideal. More radically, there is some argument for flexibility in how companies present their accounts. If the market works, companies that reported in a way which facilitated investor understanding would be rewarded and those that reported poorly would be disadvantaged because they would lose shareholders.

“As more user friendly alternatives to statutory accounts become more accessible, there must be some tendency for the credibility of the statutory version to be eroded.”

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THE WEEKLY CHART SPOT

“The housing price series are perhaps some of the most emotionally charged statistics released by the ABS. They summarise wealth movements for a large proportion of the Australian population and are used as indicators of likely interest rate movements by commentators.”



Source: Australian Bureau of Statistics

Housing price movements in Sydney and Melbourne are signaling that the peak in the market has been reached for the time being.

The Australian Bureau of Statistics (ABS) has reported that prices of established houses in Sydney fell by 5.4% in the June quarter. Melbourne prices rose by 1.0% after having fallen by 1.3% in the March quarter. Prices in both locations are now thought to be about 5½% higher than they were a year ago but lower than they were in the December quarter of 2003.

Since 2000, the average rate of price increase has been 12.7% a year in Sydney and 12.4% in Melbourne compared with 10 year average increases of 8.6% and 9.5%, respectively.

The housing price series are perhaps some of the most emotionally charged statistics released by the ABS. They summarise wealth movements for a large proportion of the Australian population and are used as indicators of likely interest rate movements by commentators.

However, housing price changes are notoriously difficult to measure. Unlike motor vehicles, say, for which sales of like quality goods are relatively frequent, there can be large disparities in the quality of established housing sold from period to period. In a measure of city-wide price movements, there can also be differences in the geographic composition of sales from one period to the next affecting the average outcomes.

The ABS goes to some trouble to minimize the effects of quality and geographic changes to make its measures more reliable sources of statistics than others which are published occasionally.

Nonetheless, it is hard to judge whether a fall in the index is due to sales of like quality houses happening at lower prices or higher priced houses being kept out of the market. The latter might occur if anticipated selling prices are significantly lower than for the same quality houses in earlier periods.

Similarly, there might be houses put on the market which are not sold because the asking price is higher than the market is prepared to pay. Such a potential transaction is ignored in compiling price indexes rather than treated as a zero outcome or, more reasonably, have the highest bid price included in the index.

In a weakening market, the averages could understate the actual deterioration in underlying market conditions. That being so, the market for established houses in the two principal capitals could be somewhat weaker than the official statistics are suggesting. ■

COMPANY REPORTING: TOO MANY RULES CONT'D

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Of course, the reason companies are not given such discretion is the overriding fear by policy makers of the damage that may be caused by the renegade amongst them. There might be just one every ten years which will take advantage of the system to mislead, defraud and bilk unwary investors.

Public policy weights this risk highly: better to have accounts that are generally unhelpful to everyone than risk these periodic crises.

This principle might be counterproductive. With so many companies now releasing presentations of what their accounts really mean, they are effectively saying 'look here and not at what we are obliged to produce'.

As more user friendly alternatives to statutory accounts become more accessible, there must be some tendency for the credibility of the regulated version to be eroded at the expense of the former.

As this happens, the risk of companies using the unregulated parallel accounts to mislead rises. That is not to say that dishonesty becomes widespread. It does not need to. We have seen how much damage can be done to the credibility of markets by just a few out of many thousands of companies listed in the USA and Australia, for example, attempting to mislead shareholders.

Improving the investor friendliness of the statutory accounts to more fully meet their needs might help avert this risk emerging as competitive offerings undermine the regulated reporting system. ■

US BUDGET RULE TO ADD DISCIPLINE CONT'D

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cally or socially beneficial spending, rules which deal arbitrarily with programmes might lead to inefficient allocation of government and community resources.

Against these arguments is the practical appeal. It might be better to forgo the ideal to avoid jeopardizing essential outcomes with wide-ranging global benefits.

Another practical reason for rules to be contemplated is the reducing flexibility in US government spending.

Over the past forty years, the proportion of spending in the US budget which is subject to annual review has fallen from around two-thirds to under 40%. This has happened as the importance of age-based entitlements which are legislated and not subject to annual review, for example, have risen relative to other spending authorized in the annual budget.

Unless Congress is prepared to eliminate or modify entitlements such as those to health care, the burden of deficit reduction will have to be carried by a diminishing proportion of government expenditures, all of which will have some level of political support.

Even ardent supporters of deficit reduction in the Congress have been reluctant in the past to initiate spending cuts which detrimentally affect their constituents or groups with whom they might want to curry favour.

When everyone is forced to start giving up something, however, the political consequences are sometimes easier to manage. In practice, politicians might be more likely to accept deficit reduction through rule making despite its lack of appeal to the economic purists because the political fallout may be more manageable for them.

Explicit rules about the required future track of the deficit will also provide some solace to financial markets.

Presumably nothing will happen until after the upcoming presidential and congressional elections. However, now that the Fed chairman has thrown his weight behind the idea of having some sort of rule, momentum might gather once the election has finished and the newly elected politicians begin to set their agendas for the coming year.

For Australia, signs that spending rules are likely to be adopted in the USA could be important. They will flag that the Australian dollar is less likely to appreciate against the US dollar (which is what Australian exporters want to see) and that US interest rates will be relatively stable.

With Australia's bond yields likely to be driven by what happens to US yields, the transition to lower deficits is likely to be of far greater significance to interest rates in Australia than which party is elected here in October. ■

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US BUDGET RULE TO ADD DISCIPLINE

The US Congress might have to think about adopting formal rules to keep the US budget deficit under control. Alan Greenspan's attempt to put this on the political agenda last week might be more important for Australian interest rates than who wins the local election.

The testimony last week of the Federal Reserve Board Chairman, Alan Greenspan, before the US House of Representatives Committee on the Budget was generally optimistic in tone despite some mis-

improve, the deficit is more likely to decline than to increase in the year ahead", he said.

Such a change in direction implies less downward pressure on the US dollar as the supply of US dollar securities (in the form of government bonds) will more closely match demand. That way, too, interest rate pressures will be less than they otherwise would have been and equity markets will be more buoyant.

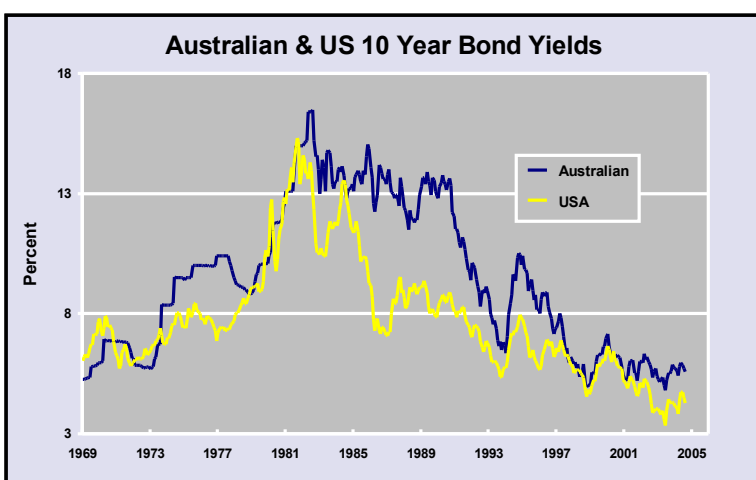
In any case, history suggests grounds for optimism about the capacity of the US to keep the budget from going beyond the limits of market tolerance despite it having come close on some occasions.

During the 1990s, a prolonged period of strong productivity growth delivered higher revenue outcomes for the US government which rapidly shrank the budget deficit.

Through this and in earlier periods, the US Congress also averted the potential of growing deficits by adopting rules which either imposed limits on the size of allowable deficits or required savings to be legislated before additional spending commitments could be incurred.

Many economists argue that artificial limits or rules are undesirable. In the case of deficits, they do not take adequate account of the economic cycle. Alternating use of deficit and surplus spending for economic stabilisation purposes would not be permitted removing an important economic policy tool.

Rules requiring expenditures to have offsetting savings often mean that existing expenditures with the least political support are jeopardized whatever their merits. Since politically popular spending might not always coincide with economi-



givings expressed about the size of the budget deficit in the longer term.

Of course, for the Fed chairman to convey any other sentiment would have frightened financial markets hanging on his every word. They seem to have factored a relatively optimistic outlook into their pricing and any change in view would most likely have a dramatic adverse effect.

The Congressional Budget Office expects the US budget deficit to reach US\$422 billion in the fiscal year just ending, a better outcome than the US\$521 billion forecast when the budget was first presented last year but a record, nonetheless.

Government officials, Congress and financial markets have appeared unworried by this prospect. Part of the reason is that official forecasts still have the deficit peaking this year. This is a view with which Chairman Greenspan seemed to concur. "With the economy continuing to

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