

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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GOVERNMENT DISCLOSURE: GETTING WORSE

The disparity between corporate and government disclosure standards has grown starker through the course of Australia's election campaign.

The Treasury and the Department of Finance announced on 10 September, as part of their responsibilities under the so-called charter of budget honesty, that the government has a prospective underlying cash surplus for 2004/05 of \$5.3 billion rather than the \$2.4 billion anticipated in May when the Treasurer presented his budget.

Higher surpluses are also being forecast for the out-years as a consequence of the higher base, strong company profit growth and generally buoyant economic conditions.

The change in likely outcomes had been anticipated with several private economic forecasters suggesting as much following their own analysis of conditions. However, the government had said nothing to confirm the stronger budget balance despite clear evidence that it had known and that some of its own election initiatives were being based on this privileged knowledge.

The government's silence tactically disadvantaged the Opposition since it was unaware of what surplus it could use as a basis for planning its policies. To avoid being characterised as profligate it had to refrain from making tax reduction or expenditure commitments which were contrary to the earlier (and incorrect) budget capacities.

Subsequently, with more up-to-date knowledge to work with, there is little it can do without risking a charge of sloppy work if it changed policies on the run.

But even what has finally been provided through the charter of budget honesty process has been misleading.

The current government does not include the proceeds of the Goods and Services Tax in its revenue estimates. The budget honesty document explicitly acknowledges that the accounts "do not include goods and services tax (GST) collections and equivalent payments to the states and territories, which is a departure from ABS GFS and AAS".

The latter are the relevant accounting and reporting standards based on international practice. Not complying with them has already led the Commonwealth Auditor-General to qualify the government's financial accounts.

The reason for this departure from accepted standards is the government's determination to represent the GST as a state tax and not one raised by the Commonwealth.

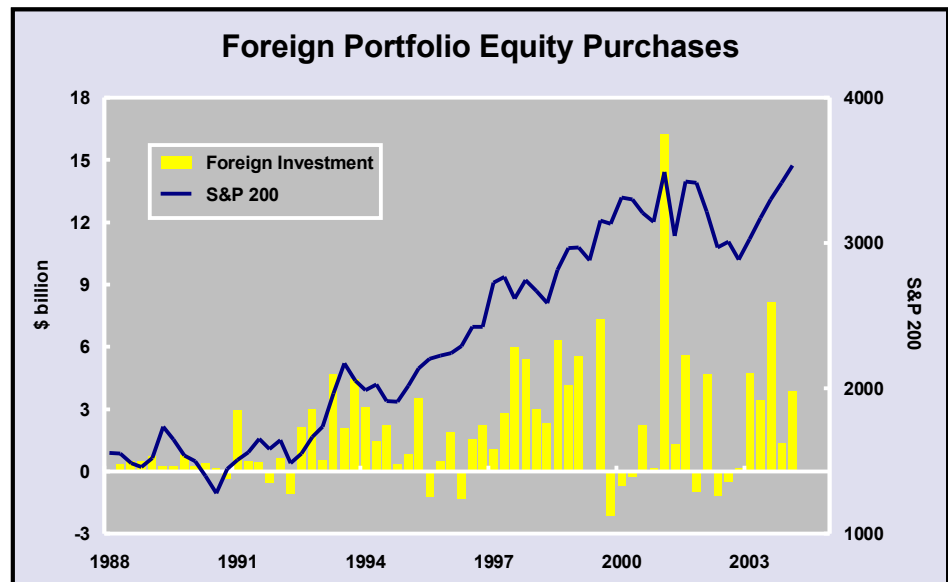
However, the bureaucrats cannot ignore it entirely. Collections are shown in an appendix to the charter of budget honesty documents dealing with payments to state governments. Tables there show that the GST revenue estimate for 2004/05 has gone up from \$34.5 billion at budget time in May to \$36.1 billion now.

If Australian government disclosure was consistent with generally recognised accounting standards, the budget surplus anticipated for 2004/05 would be \$6.9 billion rather than the \$2.4 billion forecast barely four months earlier and rising to \$10 billion in 2007/08. ■

	Underlying cash surplus		Goods & Services Tax	
\$ billion	Budget	Revised	May	Revised
2004/05	2.391	5.3	34.460	36.053
2005/06	1.587	5.1	36.610	38.256
2006/07	3.438	6.9	38.720	40.602
2007/08	4.501	7.9	40.850	43.070

THE WEEKLY CHART SPOT

“By the end of June 2004, the level of foreign investment had more than doubled to 25.4% of the ASX market capitalisation.”



Source: Australian Bureau of Statistics, Standard and Poors

The 35% appreciation in the value of the Australian share market since the first quarter of 2003 has coincided with increased interest in Australian stocks by foreign investors.

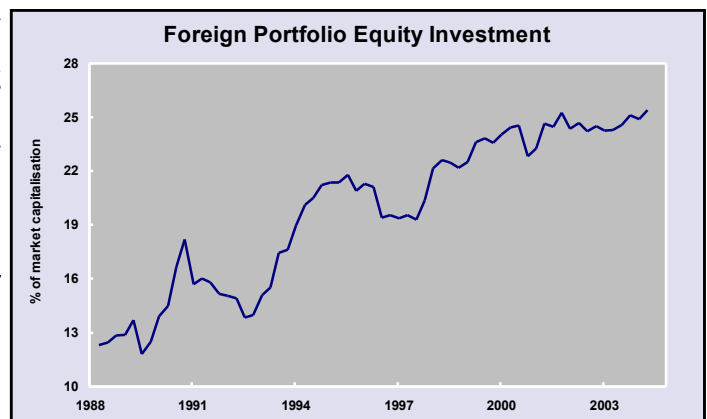
As a general rule, periods of market buoyancy in Australia have coincided with relatively strong offshore demand for Australian equities.

The Australian Bureau of Statistics (ABS) has reported that over the last five completed quarters (i.e. since the first quarter of 2003), purchases of equities by foreigners have amounted to \$21.6 billion, equivalent to 3.3% of the market capitalisation of Australian listed equities at the beginning of the period.

While there is little history of individuals in offshore locations holding Australian equities, it is not unusual for Australia's larger listed companies to have in excess of 30% of their shares held by offshore based institutions.

The proportion of Australian equities being held offshore has risen during the last 15 years. Australian companies have attracted significant foreign interest through their own marketing efforts as well as the efforts of Australian-based intermediaries which developed a strong presence in the major financial centres to attract global fund managers to the Australian equity market.

Based on ABS data, **thebigpicture** has calculated that overseas portfolio holdings of Australian equities were equivalent to 12.3% of the ASX market capitalisation in mid-1988.



Not surprisingly, given the effort put into the task, the awareness of Australian equities has since risen. Moreover, Australia benefited from the emergence of international equity managers in the USA during the 1990s and their reallocation of funds to offshore markets.

By the end of June 2004, the level of foreign investment had more than doubled to 25.4% of the ASX market capitalisation. ■

DO GOVERNANCE RULES MATTER? CONT'D

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However, this study does attempt to be broadly applicable in terms of the indicators taken into consideration and the breadth of companies analysed. Moreover, the data are drawn from a period after the Sarbanes Oxley Act has been in effect in the USA so that it takes account of changes in governance standards.

A New Industry

The promoters of corporate governance standards have benefited so far from being able to play on the nervousness of investors. The corporate governance practices that companies in Australia and the USA are being asked to adopt are a reaction to a very few egregious examples of corporate wrongdoing.

Political leaders in Australia and the USA, wanting to see action following the failure of Enron and HIH, encouraged regulators to come up with ways to prevent any repetition of those failures.

Regulators needed little encouragement to move aggressively since they had completely missed the earlier wrongdoing until shareholder losses had mounted and wanted to recapture some lost credibility.

Company directors in Australia, never noticeably competent at managing their relationships with shareholders, succumbed to the pressure and offered little resistance to the demands being made on them.

Now a corporate governance industry is beginning to flourish. One example is the emergence of corporate governance ratings agencies. They establish criteria against which to judge companies, rate them against these standards and publish the scores.

These agencies are modelling themselves on the rating agencies which act as gatekeepers to the debt capital market. A company cannot get access to funds unless it receives an appropriate rating and its cost of funds reduces as the rating improves. The debt rating agencies charge companies for the ratings they provide.

The governance ratings agencies are looking to push companies toward being measured by their standards. By releasing their results publicly, as some are now doing, they are implicitly threatening companies with the bad press associated with

a poor result.

Implicit in their public reports is advice to investors: eschew low scoring companies and prefer higher scoring ones. They are also implying that management in the former group is somehow failing in its duties.

Based on the available evidence, the corporate governance criteria being used might be as reliable as the latest untested fad diet.

Governance v Performance

Upon reflection, conclusions which throw doubt on the value of the governance practices reviewed should not be a surprise. By and large, the most widely used governance measures encourage patterns of behaviour which do not have any necessary linkage to value outcomes.

The rules have generally been designed so that regulators can measure adherence not because they help change financial performance.

For all the rules about how directors should behave, corporate regulators dance around what constitutes good business performance. Companies are told how to report bad performance. They are not required to identify it and change.

There is ample evidence that well-defined ideas of what constitutes shareholder value combined with disciplined decision-making deliver superior investment returns. A widely recognized case in point in Australia is Wesfarmers.

However, few companies establish explicit targets against which shareholders can measure performance, monitor performance and publicly identify remedial action when targets are not met.

Strangely, those companies which have so noticeably failed their shareholders have also failed to have a strong sense of what constitutes value, often rating size, growth and other targets ahead of critical measures such as returns on funds employed.

Often failed companies would have scored well enough on commonly used behavioural indicators.

Having avoided the question of what constitutes value, regulators were inevitably going to end up dealing with matters of second-order importance. This conclusion is reinforced by the LRT research. ■

“the typical structural indicators of corporate Governance used in academic research and institutional rating services have very limited ability to explain managerial behaviour and organizational performance.”

DO GOVERNANCE RULES MATTER?

Corporate governance strictures seem likely to burden companies without providing compensating investor benefits. That seems to be a conclusion from recent research.

Companies in the USA and Australia are being required to adopt prescribed corporate governance practices by regulators. Prospective benefits for investors are often cited in support of making these standards mandatory.

Going one step further are attempts to have governance practices included in investment decision making. "Analysts, portfolio managers and bankers are using [our product] worldwide as a tool in equity and credit research, to perform risk analysis, manage portfolios, conduct due diligence and support buy/sell decisions", according to one of the leading suppliers of governance analytical services attempting to boost its offering.

To validly use governance behaviour in this context requires some connection to be proven between governance practices and business performance.

Without that, there might be no benefit for shareholders and no basis for investors to prefer one set of governance practices over another.

The Empirical Evidence

A recent paper entitled "Does Corporate Governance Really Matter?" by three academics at the University of Pennsylvania's Wharton School (LRT¹) concluded that "the typical structural indicators of corporate governance used in academic research and institutional rating services have very limited ability to explain managerial behaviour and organizational performance."

This conclusion potentially cuts the ground from under the emerging corporate governance industry throwing into question the value of forcing companies to adopt "good" corporate governance practices.

In the words of the authors, their results imply "either that corporate governance is of modest importance, or the available

indicators of corporate governance are not especially useful."

The LRT approach attempts to deal with a number of the shortcomings of earlier studies which have generated contradictory results.

In framing their study, LRT give the advocates of prescribed corporate governance practices the benefit of the doubt by setting out to show that their measures are meaningful. They structure their study to favour a conclusion of governance having an effect on performance.

In doing so, LRT address the narrow choice of indicators and selective choice of companies in other studies.

LRT statistically derive the most significant combinations of governance indicators from a comprehensive set of measures covering seven governance categories: characteristics of the board of directors, stock ownership by executives and board members, stock ownership by institutions, stock ownership by activist holders, debt and preferred stock holdings, anti-takeover devices and unionisation.

They then apply these new measures to a large sample of firms. The sample represents approximately 70 percent of the market capitalization of the broadly-based Russell 3000 at the end of 2003.

The subsequent statistical analysis showed that governance indicators appear to have little impact on company performance. More disturbing, some of the results contradicted the standard interpretation of the relationship. One such contradiction cited by the authors was that firms with large boards, busy directors and anti-takeover provisions (i.e., "bad governance") tend to have better debt ratings and lower abnormal accruals.

Like all statistical analysis, there can be questions about whether the factors considered are the most pertinent. There can also be questions about the representativeness of the data. Since the data are drawn from a specific period, there might be a risk of data from another period conveying a different conclusion.

(Continued on page 3)

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1. David F Larcker, Scott A Richardson and Irem Tuna, "Does Corporate Governance Really Matter?", The Wharton School, University of Pennsylvania, June 2004