THE INFLUENCE OF ANALYSTS

By Xenos Yanz Zervos

The Society of Security Analysts has in recent times issued two most useful papers outlining the information that investors would wish to see released by industrial and mining companies. "More Information Please" was published in JASSA in May at which stage it was stated that wide publicity of the views would not be sought until more ideas come forward to enable the Committee to set out the views of the Society as a whole with confidence. The following notes are intended to provide some further comment which might provoke discussion and allow a consensus to be reached, or otherwise to at least air some of the more difficult areas.

It is desirable that analysts communicate their views to accountants - the providers of much of the information. Whereas accountants have traditionally had the reputation of being reactionary, the zephyrs of change are bringing about a more progressive and less narrow breed. Investors' views should be brought to their notice before accounting practice becomes codified. Perhaps some of the recently accepted practices may not accord with analysts' views; for example, the peculiar inclusion of capital profits and losses above the line. The accounting journals contain much discussion on a variety of matters which directly affect analysts and it should benefit all concerned if analysts were to enter into dialogue with accountants.

As the legal profession also appears to play a most significant role in formulating company law and the level of disclosure, analysts should seek to have their views made known to the various legal bodies.

Apart from the various matters raised in "More Information Please", analysts should consider their attitude to equity accounting, pooling of profits in mergers and current value accounting. It should not, of course, be the analysts aim merely to show the highest possible earnings. The compilation of earnings per share figures by companies themselves should also be considered.

(a) <u>Future Tax Provision</u>

The controversy over non-provision for deferred tax and also depreciation of buildings has caused so many auditor's reports to be qualified that qualified auditor's reports have lost nearly all of their previous stigma. From an analyst's viewpoint the appropriate tax charge against current profits would be the future tax payable discounted back at a suitable rate of interest from the expected time of payment to the present time. However, there are difficulties when it is not known for how long tax can be deferred and what discount rate is most appropriate. It is, of course, important that he has been forewarned that the current low tax provision will not continue. Many analysts will choose to ignore the problem and concentrate on pre-tax earnings.

(b) <u>Depreciation of Buildings</u>

Analysts views on this contentious issue may well follow those companies which claim that reductions in building values are being more than offset by rising land values. Is building depreciation an expense against earnings while appreciating land values are capital surpluses? This subject may warrant a sub-committee report?

(c) Profit by Division

"More Information Please" covered this most important aspect regarding the source of profits. From 1973 some companies may find themselves involuntarily giving this information because the recent amendments to the Companies Act will cause the publication of subsidiary company profits. While this information is eventually available at the Companies Office, its gathering is laborious. Hopefully, those companies which operate various divisions through subsidiaries will not now adjust their business to distort the position. It is most inconvenient obtaining accounts of subsidiary companies registered in other states. These should also be made available at the parent's registered office or by the company itself on application.

(d) Equity Accounting

Equity accounting can be likened to being an extension of consolidated accounts to give more adequate information about the sources of the parent company's income and the employment of its funds. British and Australian accountants have released exposure drafts on the subject. Analysts would be well advised to study the draft of the Australian Society of Accountants published last year. If consolidated accounts do not really represent a legal entity, consolidating associated companies (20 - 50% owned) will produce an even less meaningful statement in the legal sense. However, from the analyst's point of view it will probably be a much more accurate reflection of the enterprise. This being so, it would be desirable for pressures to be exerted to legislate for the production of equity accounts in suitable circumstances. There are unfortunately many problems in practice such as the need of common balance dates of associated companies. Consolidated and equity accounts may sometimes confuse a break-up situation but are most suitable for studying a going concern.

(e) Merger Accounting

When the cost of an acquisition exceeds the net tangible asset backing, goodwill is created. This goodwill can sometimes be regarded as the present value of the future stream of above-normal profits being purchased. Should some of these profits (above the line) be used to amortise this goodwill?

Some will argue that in many cases goodwill represents lasting and meaningful value which should not be written off.

If an acquisition is made during the year, only the post acquisition profits are brought to account. This is quite unhelpful for the analyst who wishes to relate a whole years earnings to the end year capital. Analysts should argue for the inclusion of current year pre-acquisition profits as extra-ordinary items above the line. However, what should be done with pre-acquisition losses? Can such losses be ignored if non-recurring?

(f) Banks and Life Offices

The unsatisfactory situation whereby these bodies need not be reporting a true and fair state should be criticised. The recent voluntary disclosures by the National Bank of New Zealand are an example our local companies should follow while waiting for legislation to be introduced.

(g) Price Level Accounting

While analysts are almost unanimous in their desire to know current market values of companies assets, they are probably very dubious regarding practices which affect the profit and loss account, especially as the effect will be to reduce stated profits. Perhaps the economic notion of increase in net worth is what really matters?

Acceptable solutions to the problem do not seem to be forthcoming in the short term, but meantime analysts should give the matter considerable attention.

Work party studies outlining the virtues and difficulties of the C.H.F. and Philips accounting practices could be most informative.

(h) Earnings Per Share

Much use is made of E.P.S. which is probably the most important individual statistic used in the assessment of a stock. It is often necessary to adjust E.P.S. for issues, outstanding options etc. so that a meaningful figure is obtained. To have the company prepare its own E.P.S. figure would save many people a lot of trouble. Unfortunately, as analysts themselves seem to make so many differing adjustments, what is the correct (?) or best method to instruct the secretary or accountant to use?

Statex makes adjustments which are acceptable to many analysts, but as investors require E.P.S. information as soon as results are announced the figures must still be calculated. All the more reason why companies should provide the information.

The method whereby the year's profit is related to average capital is merely a quick approximation which is unsuitable if the job is to be done properly.

Bonus issue adjustments need no explanation.

Monies raised or assets acquired by scrip issued during a period have only contributed to profit since the date of issue. The necessary adjustment is to add to the declared profit that profit which could have been earned in the period up to the issue date. In the case of a cash issue (entitlement or placement) a notional interest rate can be applied - conservatively bank overdraft rate adjusted for tax or more optimistically the rate of profit to shareholders funds. Pre-acquisition profits of business purchases would be added back.

Cash entitlement issues after balance date will adjust E.P.S. by the "bonus content" dilution which is the proportion of old shares to new shares held free after dividend adjustment. This same dilution factor is used, of course, in working back E.P.S. series.

Repayments of capital have caused some peculiar calculations but probably it is best to treat them as reverse issues - notionally use the cash return to purchase additional shares. Where it is apparent that options and convertible notes are likely to be exercised (usually if market price is above conversion price) the denominator of the number of ranking shares is so increased, while the numerator (profit) is increased by the notional earnings on the option payment or the aftertax cost of servicing the convertible notes. Even if it is likely that excercise or conversion will not take place for many years it is proper to so dilute E.P.S.

It will be desirable and probably necessary for a matrix of E.P.S. figures to be produced to give:

basic E.P.S. before extraordinary items
basic E.P.S. after extraordinary items
fully diluted E.P.S. before extraordinary items
fully diluted E.P.S. after extraordinary items

Conclusion

There is much more information that analysts need to have. In campaigning to obtain this greater disclosure they will be well advised to establish a dialogue with other interested professionals such as the accounting and legal fraternities. However, before liaising analysts should themselves be clear as to what they want and why.

The sooner "More Information Please" is promulgated the better.

REVIEWS AND NOTICES

THE AUSTRALIAN COMPANY DIRECTOR

By B.J. McMahon (Rydge Publication) 1972

The position of the company director has not only been greatly effected by recent statutory changes but also by an increasing debate as to his responsibilities to society as well as to the shareholders of his company. The role of the professional director was discussed by Mr. R.H. Routley in an address to the Society (JASSA, June 1971), and Sir John Dunlop considered the relationship between management and board in the 1971 William Queale Memorial Lecture (reviewed in JASSA, February 1972).

"The Australian Company Director" is a text-book rather than the observations of a practitioner, but is a fine addition to the available reading on the role, rights, duties, responsibilities etc. of directors of incorporated companies in this country. It is up-to-date in that it takes the 1971 amendments to the uniform companies acts into account, and its value is widened by its specific references to the directors of private companies and registered clubs.

Some important matters of principle are dealt with rather briefly, and many will feel that matters such as schemes to reduce or avoid taxation and death duties on the part of private company directors detract from the main theme and purpose of the book. Nevertheless it will be very useful for reference and its reading should stimulate the study by directors of the precise provisions of legislation relating to companies and to the securities industry.

As to the future, the author refers to the whole field of company law as now being in a period of intense development. The two main areas of reform since 1961 have emerged as greater disclosure and increased responsibility. We appear to be following American paths but he visualises an Australian Companies Commission dealing with exemptions, prospectuses, dissension between directors and auditors, etc., rather than a Securities Exchange Commission. Finally in his crystal ball he sees a strengthening of the powers of shareholders as against those of directors.