NEEDS OF USERS - AN ANALYST'S VIEW

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It is my task to talk to you tonight on the subject of 'Needs of users - an analyst's view'. In doing so I will perhaps give more weight to the need of analysts than to those of other users but I do so in the general belief that the needs of other users for accounting information about the corporate sector run closely parallel to the needs of analysts, although naturally with variations in emphasis and in detail. I should also say that the views expressed are mainly my own and do not necessarily reflect those of the Securities Institute.

I am reminded of a remark by Oliver Cromwell who said (in 1641) 'I can tell you, Sirs, what I would not have : tho' I cannot, what I would'. I can understand what he meant : it is in many respects easier to identify what analysts do not want, than it is to identify their needs of the positive side. With this caveat let me proceed.

Not whole facetiously, I think that the first need of investment analysts is to have plenty of companies left to analyse and we want those companies to be sufficiently healthy and vigorous to be able to play their part in achieving the national goals to which Australians aspire. This will not happen if corporations continue down the path towards being, in someone else's phrase 'underinvested and overborrowed'. However, in view of the fact that the changes now proposed in accounting are reported to be the most radical since modern accounting was first described by Lucio Paceola in 1494, I believe that it is important to ensure that the road now taken is substantially in the right direction. I am a convert to this point of view, having earlier felt that any system which, if accepted by the government and taxation authorities, would relieve the "doomsday machine" problem, was better than the existing system. However, I now feel, Treasury red-herrings notwithstanding, that band-aid repairs to corporate sector cash flows do not necessarily need to wait for a new accounting system, as some recent actions of the British government has demonstrated.

I don't suppose that this audience is likely to dispute that in a commercial community such as ours the participants have a need for meangful accounting information, and that it should be meaningful to and its principles followed by not only direct financial participants such as an investors, lenders, customers and employees, but also by less direct participants such as price regulatory bodies, taxation authorities and so on.

The particular concern of the investment analyst derives from his function as one of the members of this community concerned with the pricing and allocation of resources. It is fair to say that by far the great number of analysts fulfill this function by concerning themselves with the evaluation of securities, and I think it might be profitable to briefly identify what analysts actually do in a day to day sense and to indicate some of the information that they need to function effectively.

As I see it the analyst occupies himself in three major ways. Although they are all related to the same objective and inter-related with each other, it is conceptually useful to consider them separately.

The first function may be termed the measurement of corporate performance. In a short term sense this may be no more than a quick analysis of a company's interim or preliminary final profit result. As profit announcements are probably the most important piece of price sensitive information that a company publishes, and recognising that analysts are, or should be, concerned with the efficient functioning of the securities markets, we need a system that tells us clearly, unequivocally and reasonably quickly what companies' performance has been. We're certainly not getting that now. The key word here is <u>comparability</u>, both as between prior periods and as between other organisations. The Sandilands Committee seems to think that this can be achieved without a constant value unit of account but I personally feel that this feature would be a most desirable one. There needs to be a consistent method of valuation as between time periods, and in addition a reasonably consistent basis of valuation as between companies. I recognise that it is impractical to expect perfection in this latter regard. In a less immediate sense evaluation of results enables analysts to make judgements on the quality of management - its past decisions and present performance. A most important component of this will be an assessment of a company's return on funds employed - its absolute level as well as any change - and also of course the return on shareholders funds, which derives from the relationship between a company's operating return and the financial structure under which it chooses to function. Whilst acknowledging that all improvements in the position of equity, in real terms, can be construed as 'profit', for this purpose I think we do need to be able to sort out as far as possible those that derive from capability and those that derive from circumstance. I recognise that in many cases this clear differentation between operating profit and holding gains will not be possible, but that does not mean that it should not be attempted.

The second function of the analyst is to concern himself with corporate liquidity and solvency and this will also be a concern of many other users.

I think that the main point here is that notwithstanding money's acknowledged deficiencies as a unit of account it is still - by definition - the medium of exchange. The bills have still got to be paid with it. I don't think that analysts needs in this area will be enormously different to those that exist at present, which are that information is needed to judge a company's ability to meet its obligations as they fall due. In this respect I think an expanded source and application of funds statement for the year just passed is important to give a clearer understanding of a company's internal workings, coupled to a more detailed debt repayment schedule which should also be extended to include non-financial corporations. In addition an indication of what new investment is contemplated seems desirable, and there may even be a case for cash-flow forecasts.

The third and possibly most important function of the investment analyst is to try and look into the future. If securities prices are indeed what the theorists say they are, that is the present value of the expected flow of future returns, then what investment analysis is all about is trying to determine what those future returns are likely to be, and deciding whether the implied rate of discount is an appropriate one having regard to risk and so on. However, to quote from Denis Weaver's useful book 'Investment

Analysis' "Forecasting is a hazardous task, and those who practise it must become inured to a lower level of success than would be appropriate in other occupations". I venture to suggest that here in Australia it is even more hazardous than in some other countries, and the major reason for this is the low level of corporate disclosure requirements. In order to be able to do our job as forecasters properly we need a great deal more information as to how companies arrived at their current positions. This is not because we want merely to extrapolate from past data series, but because an understanding of the variables that influenced a company's present position, financially speaking, is of great benefit in estimating where it is likely to go next.

I appreciate that a part of what I have been saying does not, strictly speaking, relate to accounting but rather to disclosure, but the two subjects are closely associated. If we as analysts cannot do our job properly in the context of the existing accounting system because of inadequate disclosure, there is a danger that we could be even worse off under any new system. In this context I think that fairly detailed reconciliation statements in the first year or two of the operation of any new system will be essential for the understanding of individual accounts, and will also have a useful role in educating existing practitioners in the principles and practise of the new system.

Not being an accountant I don't propose to try and offer a detailed solution as to how any new accounting system can meet analysts needs, but I think it may be profitable to indicate my interpretation of how analysts are thinking in some areas. Analysts are concerned with basing their judgements on information which is tolerably close to what may be called economic reality so I think it will be realised that a simple Current Purchasing Power approach is unlikely to appeal to them in principle. CPP perpetuates the fundamental failure of historical cost accounting, which is that - quite apart from the distortion it produces in periods of high inflation - it has been unable to deal with relative changes in price levels on a continuous basis, but rather has had to make do with occasional 'one-off' adjustments. I wouldn't like to say what effect this has had on the allocation of new resources but we can all think of cases where it has concealed and quite possibly caused the inefficient use of existing resources.

If we reject a simple CPP approach we are left with the choice of a number of methods of making specific valuations of assets; in other words a current value approach. I am inclined to the view that in this area we have a choice between two approaches that are likely to be regarded by users at large as realistic possibilities: The Current Value - Proprietorship and the Current Value - Entity schools of thought. Mr. Ronald Mutton has defined the difference between the two rather neatly, I think. I quote "CVA (Proprietorship) means the Current Value Accounting method which claims that differences between general index adjustments and current value adjustments belong to the profit and loss account," whereas "CVA (Entity) means the Current Value Accounting method which claims that those differences have no influence on profit or loss and belong directly to 'capital' ".

The argument for the entity school is attractive, and has been supported by the Society of Investment Analysts in the U.K., and it certainly seems likely to be attractive to company managements. However, I think that it is reasonable for analysts to argue that it is desirable for the corporate sector as a whole to maintain intact its physical capital, but as analysts it is a part of our function to try and identify and profit from relative changes in prices as between one component and another. Analysts are concerned with and represent actual or potential investors. These investors are interested in maximising their returns and wealth consistent with what they regard as an acceptable degree of risk. Their relationship with a company is normally quite divorced from the management of the company, and unlike the management, they are in a much more flexible position as regards their freedom to invest or disinvest. For these reasons I believe that it is more consistent for analysts to support the proprietorship view in the case of individual companies.

The entity approach can effectively be equated with the replacement cost approach, and analysts may have one or two other reservations about this, which I don't have time to discuss at present. Having said that I do recognise that if, like Sandilands we follow Professor Bonbright in defining the value of an asset to its owner as being 'identical' in amount with the adverse value of the entire loss, direct and indirect, that the owner might expect to suffer if he were to be deprived of the Property', then in many cases replacement cost, or written down replacement cost, will be an appropriate method of valuation.

You will have observed that I have up to now carefully avoided the question of gains or losses on monetary items. Sandilands dodged the issue but pointed out that under its system of valuation such gains or losses do accrue to equity even though they are not separately identified, and the same is true of other systems. Speaking personally, I feel that there is a good deal of logic in the approach that says 'we know that in times of inflation lenders lose real wealth when their net interest return is less than the rate of inflation, so let us identify who is gaining it'. I cannot see that it can be terribly good for the system as a whole if the holders of equity consistently 'rip-off' the holders of debt, nor can it be terribly conducive to managerial prudence in respect of gearing. In addition if high interest rates are in part a compensation for capital loss then to that extent income taxes on interest are in fact taxes on wealth held in this form. I think that identifying some of these anomalies will be an important first step towards correcting them.

To summarise briefly then, the needs of analysts as users may be said to be - and I make no apology for the contrived alliteration :-

1. Continued health of the corporate sector
2. Comparability of results
3. Constant value unit of account
4. Capability and circumstance to separate the gains to equity
5. Corporate disclosure; more of it
6. Current value (proprietorship) approach
7. Correction for monetary gains or losses

And perhaps I should add to that list Comprehensibility.

I defer, happily, to the accountants on the panel to provide the catholicon which will meet these needs.