WHAT INVESTORS WANT

An Address by

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The most important information which investors seek in the presentation and disclosure in modern published accounts can be summarised in just two words – future prospects. If there is only one thought you retain from my comments today, it should be this.

Information on the future prospects of a business are required for all actions which an investor can take in regard to his holdings in a publicly traded corporation or unit trust. There are only four basic ways in which an investor can respond to information he receives: –

1) increase his investment ;
2) reduce his holdings;
3) maintain his position or do nothing, and
4) participate in general meetings.

For all these four basic responses, the investor requires information in a form which will allow him to compare the future prospects of the business with all other available alternative investments. Ideally therefore, investors require information on future prospects presented in quantitative form in regard to both the expected changes in the economic value of the securities on issue and the risks perceived by management in these changes eventuating.

Here I would like to emphasise the point that when I talk about changes in economic value from an investors point of view, I mean realised value in the form of cash in hand. Unless an investor obtains cash in hand which he can allocate at his absolute discretion he has not obtained any real economic benefit on a basis which can be meaningfully compared with all his competing investment opportunities.

Now there are two and only two ways an investor can realise economic value in the form of cash from an enterprise. Either he obtains cash from the enterprise itself in the form of dividends or a capital return, or he sells his interest for cash. The sale price itself, however, is ultimately dependent upon the expectations of other investors on the future prospects of obtaining cash from the enterprise as either a going concern or in liquidation.

The most important information an investor requires therefore, is an estimate of the net cashflow available to him in the future which could be obtained on either a going concern or liquidation basis. However, no suggestion that this information is required will be found in the Australian Institute of Managements report on their Annual Reports Awards. Indeed, the only information about the future which the examiners will concern themselves this year are listed in section 4 (f) of the Adjudicators Report for last year. Section 4 (f) reads and I quote: –

> *"New developments, outlook for national economy and trading conditions, comments on research and development, and technological change."*

I suspect that the timidity of the examiners is but the result of Australian conservatism, historical fashions, and professional schizophrenia. My evidence for diagnosing schizophrenia is based on the fact that 75% of last year's A.I.M. examiners were more professionally involved with the production rather than the use of annual reports and so would also have the competence to quantify future prospects in terms of the discounted present value of expected future cashflows. I have every confidence that these very same examiners when advising their corporate employer or client on a new direct investment would seek more information about future prospects than I am suggesting should be provided to the capital markets.

This professional schizophrenia will no doubt continue as long as the consumers of annual reports represent a minority in establishing standards for: the A.I.M.; professional bodies; and even regulatory agencies. While I congratulate the A.I.M. on its excellent initiatives in raising the standards of modern published accounts, I do not believe that any true professional can accept their current standards as at all satisfactory for the capital markets.

Part of the problem faced by the A.I.M. and regulatory agencies has been created I believe by the accounting profession. Even without inflation it is difficult to envisage how present historical cost accounting, C.C.A., C.P.P. or C.V.A. would be of much use in providing realistic estimates to investors of their expected cashflow returns in either a liquidation or on a going concern basis. With inflation, existing accounting doctrines are more likely to be misleading and even dangerous. In these circumstances, many arguments within the profession about accounting standards and their adherence simply indicate that the priorities and concerns of the profession are out of touch with those of the capital markets and society generally.

From my own contact with the profession, regulatory authorities, and many accounting academics, I obtain the impression that their first priority is to seek power and influence in the setting and controlling of standards rather than concern themselves with the relevancy of the standard and its accounting system in the market place.

The COCOA system proposed by Chambers would I believe, provide a useful basis for indicating to investors the net cashflows which could become available to them from a liquidation. To obtain on indication of the net cashflows to the investor on a going concern basis, the COCOA system would need to be used with a cashflow accounting or C.F.A. system such as proposed by myself. I refer to my article *"A Cashflow Accounting and Tax System"* published in the January – March 1979 issue of The Chartered Secretary. Many of the points I made in this article obtained support in this months' issue of The Journal of The Australian Society of Accountants. I refer you to the article by John Miller who is Federal Treasurer of the A.S.A. and Head of the David Syme Business School.

In my suggestion for a C.F.A. system I proposed that the going concern value be added by a way of a note to the accounts which were based on a modified COCOA financial statement. The going concern value being obtained from the Present Value of the longterm cash budgets which would need to implicitly forecast the timing and extent of dividends, rights issues, and capital returns per share. The going concern basis would be revised and reported yearly. By this means the capital markets could assess both the creditability and ability of management from: –

1) Changes in estimates of their going concern basis from year to year;
2) the relationship of the going concern value to the liquidations value of the resources utilised;
3) the relationship between estimated and actual performance from year to year.

The presentation of estimates of future cash returns to investors on either a going concern or liquidation basis do not in themselves provide an adequate basis to compare one enterprise with another. Information on the associated risks are required. In this regard information is required on: –

1) The integrity and competence of management in making future estimates;
2) The ability of management to achieve its performance targets;
3) External factors such as competitive standing, trade agreements, relevant government regulations, technological change and economic conditions.

One may well ask how can investors realistically obtain information on the integrity and competence of management when they must rely on the information provided by management for making their assessment? Directors and management in the private sector are no different from public servants. It is simply not in their self-interest to publish information which could result in the loss of their self-esteem, public status and even their power and positions. Yet the basic rationale for a competitive free enterprise system is that market forces will produce the best results. Markets for votes in electing or disposing of management-like economic markets, require information to be effective.

Accountants in their role of auditors might be useful to some degree in providing information independent of management. However, meaningful changes in the quantity and quality of published information will require, I believe, some very fundamental changes in the legal environment and power structure of private and public sector organisations.

These changes will require a separation of power between those who manage the operations from those who report on operations. Auditors do not really meet this requirement as they are subject to the power of management. While audit committees of the Board of Management may not have complete independence from management they provide an illustration of the sort of fundamental changes required in the structure of organisations which are required to improve the quality and quantity of information available to investors and other stakeholders.

However, even without such fundamental changes in the corporate power structure I believe that it is practical to obtain significant indirect information to help investors assess the integrity and competence of management. One basic approach would be the publication of future prospects in some quantifiable form. This is inherent in my proposals for a CFA system as outlined earlier.

There are many other indirect approaches which might be introduced with the encouragement of the AIM, professional bodies and regulatory agencies. More to illustrate my point than to indicate any priority I put forward the following suggestions: –

1) Publication of all emoluments and benefits received by Directors and senior management;
2) Disclosure of fees, revenues, and other benefits paid to firms in which directors and officers have a material interest or influence;
3) Disclosure of how such benefits were negotiated and how the associated conflicts of interest were managed;
4) Disclosure of all insider trading in corporate securities.

In regard to this latter point it is my view that prior notice should always be given to the public whenever an insider intends to buy or sell securities. This would allow outsiders to compete with, or hedge against, the action of insiders to provide a really competitive market situation. Such qualitative information would be far more valuable to investors than much of the information now being made available to investors in annual reports. Indeed, I believe that modern reports now present too much information. The private sector is now following the public sector practice of confusing the people they are responsible to by 'snowing' them with information, much of it having little real meaning or relevancy. Sometimes the volume of information provided reveals what appear to be inconsistencies. This confuses rather than clarifies the understanding of investors. In other instances quantified information is provided in an ambiguous or inappropriate manner which can mislead investors. I found illustrations of all these points when I reviewed for this address the winner of last years A.I.M. annual report award for competitive business enterprises.

Even as a professional analyst I found the volume of information in the 48 pages of the 1979 Hooker Limited report intimidating. However, only about 1% of the report concerns itself about future prospects and I could not but help find myself reminded of a quotation from Professor C. Northcote Parkinson. I quote from his latest book on the 'Law': –

> *To succeed in the art of communication we must have the wish to communicate, the ability to create trust, a clear idea of what we want to say and finally a sense of style. We must realise that whereas most people want to talk, few of them have anything to say".*
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> *"What organisation men say or write or print often means nothing at all, being merely the bureacratic equivalent of breaking wind. To succeed in the art of communication we have to make a big effort and it is initially an effort of imagination. We have to put ourselves in the position of the people we seek to influence, which is for most of us the most difficult task of all."*

Let me now quote the Hooker report where it concerns itself about the future under the heading 'Present Strategies and the Future' on page 10.

> *"The down turn in the Australian and a number of the world economies during the last five years certainly imposed some disciplines on business – particularly the real estate business. Amongst these was the need to consolidate and rationalise and to adjust one's strategies to the changed conditions and to the lessons learned. These adjustments needed to be made in the knowledge that decisions taken during depressed conditions require almost as much balance as those taken at the height of a boom.*
>
> *The responsibilities and objectives of Hooker are set out earlier in this report. It is felt that stockholders should be informed as to what strategies are in force to bring about the accomplishment of these."*

If one turns to the statement of responsibilities and objectives on page 4 to clarify the above bureaucratic wind breaking we find a number of motherhood statements cluttering up the report.

It is of course easy for an outsider to be critical. We do not have to place ourselves in the position of the corporate managers with all the constraints imposed upon them by their institutions. I am not unaware however, of these constraints. During the 1960's I prepared the annual reports which first won A.I.M. awards for both Development Underwriting Limited, now Entrad and Direct Acceptance Corporation Limited.

In both instances a measure of the productivity of corporate funds was published by division in the form of earnings before interest and tax on funds employed which I shall refer to as the EBIT rate.

The EBIT rate provides a basis for both management and investors to allocate their funds between competing opportunities. As such it is a basic guide for both management and investors on their future plans. This information is only presented in an implicit manner in the 1979 Hooker report. On calculating the EBIT rate for the various divisions I found that on the historical data provided, the Housing division ranked fourth after: Real Estate Agency; Retail Stores; and Sand & Gravel divisions. However, the report states that the first priority is *"to increase FURTHER the Groups Housing construction activities . . ."*. This would on the surface appear to be a misplaced priority. While there could well be a good reason, it is not explained. The wording of their statement on future priorities could also give rise to misunderstanding to the uninitiated as it refers to *"further"* increases in activity whereas the funds employed in the housing division actually decreased from 14.7% to 12.1% over the year. This apparent discrepancy with actual results and future intentions might be explained from sales exceeding production but page 13 reports that both increased together by 23%. Other explanations might be that the 23% was calculated from different bases or that the cost of sales were considerably greater than the cost of production so as to reduce the total funds employed in this division. The end result is that I am not confident that I understand what happened in this division or why it offers the best future prospects, and indeed if Hooker really knew how to analyse and select the direction of its future activities.

The second stated priority for future action in the Hooker report was *"to maintain and further develop geographic diversification in respect of certain of the company's other real estate activities, in the knowledge that the past five years has shown that volatility in the property market varies markedly from place to place and as to time."* A map showing the disposition of funds by divisions and profitability by geographic region would have provided a very effective means to explain and substantiate this priority.

As an example of information which was presented in a way which might be misleading and could well have been omitted I refer to page 23. Here there is a 10 year record of 'Return on average capital'. On the following line there is a history of earnings per share and many readers might think that the return on capital meant the return on shareholders' funds. As an experienced investor and report writer I know that capital can mean quite different things to different people. Also if a company wants to make its performance look better than it was it will use capital in the anachronistic legal sense of paid up capital rather than in the sense of shareholders' capital. A quick calculation soon proved my suspicion that Hooker had so presented the information so as to make their results look better. I could go on, but these points should indicate my concerns.

I do hope that I have provided some constructive criticism from the investors' viewpoint on the reporting standards currently utilised by both management and the accounting profession. I would hope that by listening to people outside the profession accountants can further both their own interest and that of the community.

I wish you all success in this regard so that the views of the lost balloonist no longer make sense. I refer of course to the occasion when the balloonist came down in a strange country and asked the first person he met where he was. The answer was that he was sitting in a basket under a balloon. The balloonist at once knew he had met an accountant as the information provided was true and fair but quite useless.

BOOKS RECEIVED

INVESTMENTS, William F. Sharpe (Prentice-Hall, Inc. 1978)

FUTURES STOCK, Calder, Lindsay and Koch (Castle Books 1980)
A comprehensive text on commodity and financial futures trading written by three Australian financial journalists for the Australian market.