Disclosure in Company Accounts

by

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The purpose of this article is to stimulate thought on the subject of disclosure by public companies rather than to lay down any rules, as I believe that considerable thought is necessary regarding the use that would be made of information disclosed by public companies. There is some evidence that statutory requirements in this direction have imposed undue burdens on public companies and the purpose is somewhat ill-defined.

In one of the papers to the National Convention of the Australian Society of Accountants held from 9th-12th November, 1966, it was recommended that a summary trading account should be given, even in interim half-yearly reports, showing group sales dissected into Home Sales and Export Sales, together with various "Expense" items, such as Cost of Sales, Operating and Administrative Expenses, Interest on Long Term Debt, Other Interest, etc. In another paper it was recommended that the Managing Director's report should highlight "the turnover of all products and the relationship of these figures to the total market and the gains made". This would seem to suggest that not only would turnover be broken down into rather more detailed product groups, but also that the company should indicate its share of the market!

In "The Investment Analyst" (October, 1965) a schedule was published showing the recommendations which were made on the subject of "What Investors Want From Company Accounts," by Mr. A. F. Murray, Joint Investment Manager of The Prudential Assurance Co. Ltd. Again, disclosure of turnover and other details of the trading account featured fairly extensively and, in particular, Mr. Murray recommended a breakdown of turnover into "subsidiaries, major activities, and countries".

Mention is made at some length of this particular feature of turnover and expense items appearing in the trading account because for some years now there has been repeated requests for details of turnover only in the published reports of public companies. It seems clear to me that recent thinking now goes beyond this and a breakdown of turnover figures is considered desirable. In retrospect, it would be fairly clear that the aggregate turnover of a large industrial complex would be of little value to an investor in determining the likely trend of future profits.

I think it would be reasonable to say that the main concern of investors in public companies would be to make their own appraisal of the likely future trends in profitability, although their concern in this area would vary according to the nature of the security in which they are investing. For example, the investor in a fixed interest security would be more concerned that profit should be stable for the future and that the interest would be adequately covered against any unforeseen downturns in profitability. The investor in equity shares, would probably look for a rising trend in profitability with the prospects of either increases in dividend income, or capital appreciation in the form of increases in the market value of the shares.

The appraisal must be the opinion of the individual analyst and a number of factors would need to be considered, apart from information provided by the particular company. The problem is to decide the statistical information that the company could provide, and which might be regarded as essential for making such an appraisal. The situation could differ in various industry groups and it may well be that there will be no standard pattern to cover all companies.

A few items which have an important bearing on profitability will now be considered.

In dealing with the normal industrial company some thought must be given to the question of the Stock item appearing in the Balance Sheet, and the question must be asked whether a composite figure is satisfactory when the stock will consist of raw materials, work in progress, and finished goods. Equally, consideration must be given to the question of the valuation, particularly of work in progress.

It is necessary to consider the amount which has been provided for income tax, but the question might well be asked whether our concept of attempting to price equity shares on the basis of after tax earnings is a satisfactory one. Any attempt to decide whether the tax provision is a reasonable one is fraught with considerable difficulties today where tax concessions are available in respect of export promotion expenses, for example, and where investment allowances can make for substantial reductions in tax payable.

The matter of a breakdown of sales (and profits and assets employed) raises the question whether consolidated accounts are desirable. It is already apparent that they tend to conceal any adverse trends

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of obtaining support for loan programmes.

It was to be part of the function of each Authority's Sinking Fund to provide open market support. However, with the decline in public response, many Authorities have looked to their Sinking Funds as a source of private loan money and purchases of stock on the open market have come so limited as to be ineffectual. The problem is a cumulative one in that the less public response, the greater the underwriting shortfall, the more discounted stock available and the less relative open market support that can be provided.

The Government agency that would be responsible for open market support is difficult to ascertain. Few, if any, of the State Treasuries would have sufficient funds available for such transactions. However, some method of controlling the yields available on the open market is required and it is possible, given higher interest rates and greater public participation, the individual sinking funds will be in a position to bring about this situation.

In any event, some provision could be introduced for the prior redemption at par of loans in amounts up to a maximum of $10,000 where extenuating circumstances are involved.

The Future of Underwriting

Assuming action is taken to raise Semi-Governmental loan rates to more realistic levels, Authorities must seriously reconsider the merits of underwritten public loans.

Although it is possible, even under current conditions, to achieve a return in excess of 6 per cent from sub-underwriting Semi-Governmental public loans, this result has rarely been achieved. In fact, the current crop of disastrous shortfalls is resulting in sub-underwriters receiving stock on returns far less than are available from private loans, after allowing for the maximum underwriting commission.

It seems probable that sub-underwriters, who invariably come from the ranks of the “30/20” lenders, would be more satisfied with a guaranteed realistic return on Semi-Governmental stock (let us assume 6 per cent per annum under current conditions) than the vagaries of the present underwriting system or the better though still not competitive private loan rates.

Such a move should also benefit the borrowing authority. The present system of public loan underwriting is, in many instances, involving the borrowing Authority in costs, which in relation to the amount raised, are out of all proportion. Taking into account costs of underwriting, printing and promotion and amortising this amount over the average period of the loan raised, the net cost per annum to the borrowing Authority must, in many cases, exceed 7 per cent per annum.

Given the more attractive rates of interest it should be possible for the borrowing Authorities to make public loans without resorting to external underwriting arrangements. The results are likely to be satisfactory and the cost cheaper.

The problems associated with the disposal of heavily discounted shortfall commitments should largely be overcome if the present system of underwriting is abandoned.

Conclusion

The solutions mentioned are by no means exhaustive and explore only some of the avenues open to ease the present Semi-Governmental financial problems.

In some instances, such as a revision of the regulations relating to trustee investments and the removal of stamp duty on the transfer of Semi-Governmental stock, the States can assist themselves. However, as explained, only with the co-operation of the Federal authorities can any real benefit be achieved.

The financing of national works is vital to the economic structure of the country at the present time and by design or default it is the responsibility of certain State authorities to perform part of this work.

The arrangements under which the necessary finance is being raised are inadequate and outdated. It is time for a change.

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Concerned, much more information is needed in relation to each of the various assets in the balance sheet. The investor should be given some idea of the realizable value of these assets and trust deed limitations should be related to what these assets might realize in depressed conditions.

I do not believe that the suggestions that I have offered are in themselves an answer to the questions I have discussed. I think there will come a time when management will have both the resources and the expertise to make the calculations proposed by Donaldson, and it will be possible to allow security analysts and investors the opportunity to judge the calculations before making their decisions as to the soundness of fixed interest securities. Perhaps Donaldson's technique will be more readily used when its application has been made more practicable by refinement and modification.

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That might be occurring in sections of the group.

Finally, there is in my view a great need for more accurate information on the causes of company "failures" in the past. "Failures" in this instance covers "declines" as well as actual bankruptcy. Those cases which have received considerable press publicity in recent years have usually had a flavour of over-borrowing. It would be of great value if members who have had the opportunity of making post-mortems could submit their findings in writing for the Society's library, even if the companies concerned remain anonymous.