



Whose Audit is it Anyway?

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Are auditors in cahoots with the management of quoted companies when it comes to sanctioning current reporting practices? Do they allow companies to indulge in too much creative accounting? Is there a fundamental conflict of interest for an auditor between his desire to please his clients, his obligations to the users of accounts and his professional code of conduct? These are questions that have occurred to many bewildered investors as the company in which they thought they had a valuable investment suddenly goes into administration or receivership.

The current recession has highlighted the number of companies that relied on creative accounting to survive. Apparently highly successful companies were based on businesses that were not profitable.

Auditors sign a letter stating that the accounts give a true and fair view of the company's situation. However, the following common practices can mislead the unwary investor:

Acquisition provisions

The surest way to create profits after an acquisition is aggressively to write down the value of stock and fixed assets acquired. The resulting unrealised provisions can be taken back into profits at a later date. In some cases the provisions have exceeded the purchase price.

Off-balance sheet joint ventures

During the current economic downturn, it has been common for companies to transfer assets, particularly properties, together with associated debt into off-balance sheet companies where there is supposed to be no recourse to the parent company. This has two effects; it cuts parent company gearing and realises an illusory profit for the company.

Avant-garde financial instruments

In the dying throes of the boom and into the recession, companies have signed up all manner of innovative debt instruments - Euroconvertibles with a put option, multi-option facility syndicated loans, and dollar-denominated cumulative redeemable preference shares. But, for a short term gain in lower financing costs, the company pays a high price in the longer term by giving a guarantee to redeem this finance at a punitive cost. Since a basic accounting rule is that costs and revenues should be recognised when they are

incurred, the true cost of this financing should be recognised in the period that the company enjoys the benefits of this "cheap" capital. Yet few companies make a provision for the redemption of these instruments.

Interest income

A number of major companies have been involved in interest rate speculation. They raise hard currency borrowings at low interest rates and deposit them in soft currencies at high interest rates. The crunch comes when the soft currency depreciates against the hard. Then, a capital loss occurs which companies hide as a charge against reserves.

These practices, even though they receive an unqualified auditor's report, have contributed to a number of spectacular bankruptcies recently. But can we blame the auditors, who have a limited brief to audit the figures presented by a company along guidelines set by the accountancy profession? Or is there something more fundamentally wrong with accounting standards?

Not before time, the Accounting Standards Board is addressing a number of investors' concerns. A recent draft from the Board proposes a formal financial reporting standard, under which companies would have to provide far greater details of expenditure and sources of income.

Other notable changes include:

- (i) Earnings per share (EPS) to be calculated as earnings after extraordinary items.
- (ii) Profits arising through acquisitions or through discontinued activities to be displayed separately.
- (iii) Movements of reserves to appear as a primary financial statement, rather than simply showing up as a note to the balance sheet.
- (iv) Discretionary expenses, like spending on training and advertising to be disclosed separately.

We welcome these proposals. Item (ii) will make it easier to identify whether acquisitive companies are efficient managers or "profitable" asset strippers. Item (iv) will highlight whether profits have been maintained by cutbacks in discretionary spend, at the expense of future profits. Some critics argue that item (i) will inhibit improvements in productivity if restructuring is discouraged by the costs impacting on the EPS figure.

The continuing challenge for the Accounting Standards Board is keeping up with creative accounting and blatant exploitation of loopholes. But why do companies go to such lengths to produce accounts which can bear little semblance to reality? They often argue that it is due to investors' fixation with improvement in the EPS.

It is true that a company which consistently boosts EPS, even at the expense of the balance sheet, is often accorded a higher P/E. The benefit is then two-fold: a higher earnings

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figure valued on a higher multiple. The problem arises when a share price reflects published accounts rather than the real state of the company. If profits were genuine and consistently reported within a given market sector, then it is logical for EPS to drive share price performance. Pressure on fund managers to perform will inevitably translate into pressure for higher EPS growth but investors have the right to expect reported figures to be meaningful. We would encourage quarterly disclosure of EPS, as in the US, which in practice appears to discourage creative accounting and encourage regular meaningful statements, accompanying the figures. But EPS can never give the whole picture. Investors should also analyse net asset value, dividend policy and cash flow, the last of which is less susceptible to manipulation.

Some accountants do not believe that changes in financial reporting are necessary. They claim that the seeds of most bankruptcies were obvious in the relevant Report and Accounts. However, any clues which do exist are often obscure and can be read a number of ways. Indeed for an investment analyst, unravelling some company annual

reports is similar to reading an Agatha Christie novel. All the clues and motives are there but until the last pieces fall into place, often after the receiver has been appointed, the analyst is kept guessing as to what the company is really up to.

At present, equity investors receive much less information on a company than other stakeholders. If banks are concerned about the security of their loan they can commission an accountants report, with full access to the company's private financial information. Since shareholders are increasingly being asked to provide money for so called corporate restructuring, they should be entitled to demand similar full information when the situation requires.

Companies are understandably reluctant to make too much information public because it will fall into the hands of their competitors. But those competitors probably know a lot more already about the company than share analysts, and more disclosure would not be too serious. It is the stamping out of deliberately misleading information which investors need, not disclosure for its own sake.

Our Own Recommendations on Accounting Standards

The points which we would like to see addressed fall into three categories:

1 Specific Accounting Points

- 1.1 A statement of cash balances and debt split by currencies with a statement on the remittability of overseas cash.
- 1.2 Full disclosure of outstanding deferred earn-outs under contingent liabilities.
- 1.3 Application of SSAP 19 (regular valuations for property investment companies) to house-builders.
- 1.4 Further tightening of SSAP 9 (accounting for the profits on long term contracts), which some companies use to mislead investors.
- 1.5 Full disclosure of the reason for, and the financial effect of, sale & lease-backs of any company assets.
- 1.6 A clearer statement of the effects of currency gains/losses within the P&L account/Balance Sheet. Use of 'third column' presentation based on constant exchange rates where foreign currency exposure is significant.
- 1.7 Changes in SSAP 24 to give a more realistic and consistent treatment of pensions in the P&L account/Balance Sheet.

2 General Accounting Improvements

- 2.1 Full disclosure of balance sheet joint ventures in an understandable format.
- 2.2 Disclosure of provisions made in respect of acquisitions in the directors report, and comment on movements in any other provisions.

- 2.3 Publication of tax losses carried forward, allowing investors to identify tax charge movements.
- 2.4 Stricter enforcement of the requirement to state changes in accounting policy and their effect on the accounts.
- 2.5 Detailed statement of unrealised gains/losses, such as currency profits/losses on a portfolio of LDC loans, likely to be carried to the P&L account, or ACT tax credits written off.
- 2.6 Some curb on changes in presentation, eg new divisional structures or a new basis of allocation of central costs.
- 2.7 Brands only to appear in the balance sheet if there are identifiable products and if promotional spend is sufficient to maintain the position of these brands, for example, in line with amortised goodwill.

3 Fundamental Changes

- 3.1 Shorter publishing delay for final accounts.
- 3.2 Selection of auditors to be made by non-executives to resolve conflicts of interest that auditors experience.
- 3.3 Move to quarterly reporting system, as in US, giving investors more timely information, and balance sheet to be included in the half yearly statement.
- 3.4 Disclosure of how director bonuses are related to EPS or pre-tax profits.

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