CORPORATE COLLAPSES - 2001 - MINIMISING INVESTMENT RISKS

The collapses of Harris Scarfe, HIH and One.Tel in 2001 and the circumstances surrounding their downfall caution us that the lessons from the 1980s fiascos have not been learned. This should not be surprising because when we don't learn from our mistakes, history often repeats. Worse still, as former New South Wales Premier Nick Greiner ominously warned in June 1997, 'Australia would not reach its full potential' until it absorbed the essence of these messages from the 1980's fallout. He went on to assert that -

'…the real trick for Australia is to establish a commercial society in which entrepreneurs are encouraged, risk takers are applauded and where the individual and collective culture is such that the failures that do occur are honest failures of judgement, rather than the reckless or criminal abuse of other people's trust and money.'

The business debacles mentioned above point out that Australia is still a long way off from reaching its potential. So why hasn't Australia become the kind of 'commercial society' Greiner envisaged? Because some of us, ie businesses, banks, directors, accountants, advisers, regulators, the financial media, and politicians, have failed to acknowledge and adjust to the changes in our technological, political, economic and social worlds. There are two main reasons why this is so.

Firstly, many of us are still doing business the same old-fashioned way, the way we did - when one day was pretty much the same as the next, and - when one's word was one's bond.

Those were the days when the old boy network was in full swing. Assurances were commonly sought from trusted friends, associates or acquaintances especially when they seemed to know more than we did. We believed they would tell us the truth (however that might be defined) and they would want to do the right thing by us. Corroboration, investigation and analysis weren't necessary because we could rely on our gut feel and judgement. There is nothing wrong with this, just as there was nothing wrong with a model T Ford that was a popular form of transport in the good old days. Unfortunately those days are long gone and so too have the model T Fords.

In today's highly complex and rapidly changing world, relying on some one else's word and gut feel does not produce reliable outcomes as One.Tel and other disasters continue to demonstrate. Investment and business proposals such as One.Tel involving financial, technical and strategic issues require detailed and painstaking analysis of current information by capable, knowledgeable people. Using the latest information increases the possibility of detecting material adverse events that could have a vital bearing on the decision.

Secondly, the world today requires different or better skills. Many financial organisations and businesses have long recognised that training and further education is essential to running a successful and sustainable organisation. The reasons are obvious. Since change signifies risks as well as opportunities, old ways are not as effective in producing good outcomes. Effective training and education can result in new ways and culture change.

Many mistakes in bank lending are often the result of not checking things out carefully enough. This may be due to the 'MacDonald's' factor that compromises accuracy and quality for speed. To be sure, money can never be disbursed too quickly to finance seekers. If this holds true for banks, then it certainly sends the rest of the finance community a warning. Don't be rushed into a deal that in your leisure you may regret. It seems that those who lent to Harris Scarfe failed to meticulously examine the most critical line in the retailer's financials – stock.

Some banks used to proclaim that they could finance any worthwhile proposition. It took several years of loan losses to deliver the message that as omniscient and omnipotent as they thought they were, some loan proposals were best left alone. They learned, like their customers (those that survived), to focus and limit their efforts where they could utilise their strengths to their best competitive advantage to produce positive outcomes.

Banks, as Westpac's David Morgan recently stated 'can't be everything to everyone'. So it stands to reason that investors too must be careful about the kinds of investments they contemplate making and how they are generating them. They must restrict their investment activities to investments where they have the inclination, skills, understanding, and time to analyse, monitor and manage the risks.

Investors, particularly large investors, should periodically prepare and review, a business plan that details investment strategy, the types of investment ie loans, equity etc, investment terms, profile of acceptable investment businesses, and how these investments will be managed. The preparation of such a plan clarifies, and concentrates the thought process.

A thorough analysis of the financing proposition involves examining three basic aspects - who is seeking finance, why is the finance being sought and how will the financier get the money (return) back. The purpose of the analysis is to determine whether the risks in the proposition are acceptable and therefore manageable. Most investments, like loans, have to be actively and not passively managed.

Analysis encompasses understanding the big picture - the macros - and checking out the business (the micros). It involves examining past events and looking at future direction. And of course looking at and understanding the numbers – financial statements, sales projections, cash flows, budgets etc.

In the One. Tel saga this wasn't necessary. It should have been obvious to experienced investors and financiers that One.Tel, a start-up business, directed by unproven principals, competing against established players with deep pockets, in rapidly changing global technological markets, had a snow ball in hell chance of survival. In other words, One.Tel should have gotten the quick flick to the rubbish bin.

Investors and banks, however, aren't the only ones who have been caught out by these collapses. The failures of the companies mentioned above have revealed inadequacies in Australia's regulatory regime. A successful regulatory system requires comprehensive disclosure requirements and knowledge of client business and awareness of events, changes and trends in their environments. Effective management of the regulatory system calls for educated, skilled and experienced staff who are carefully selected and continuously trained, adequately resourced and professionally managed.

The demise of companies namely HIH, as well as some small super funds, illustrates how badly out of touch APRA, (Australian Prudential Regulation Authority) is with the market place. This organisation, established in July 1998, is the nation's prudential financial regulator. Its territory encompasses around 85 per cent of the assets in Australia's financial system that consists of banks, life insurers, general insurers, building societies, credit unions and friendly societies and super funds.

APRA, who is supposed to be the guardian of the public's interest, appears more intent to operate on the basis that being 'nice guys' will produce the best outcomes. The HIH fiasco and the ensuing heavy criticism - mainly that APRA didn't do enough to prevent the insurance giant's failure - indicate that this regulator has not got its act right.

The 3 August 01 newspapers, Sydney Morning Herald, the Australian and the Australian Financial Review reported APRA's Graeme Thompson's reply to criticism. He said '…there was nothing APRA could have done in the past couple of years to prevent HIH's insolvency'. Mr Thompson also stated 'we inherited a deeply flawed company.' These comments indicate his lack of understanding of what a regulator's job in the finance sector is or should be.

Of course, it is the responsibility of a business' board of directors and management to successfully operate the business to perpetuity. Achieving success (and this is more easily said than understood) is how a business such as HIH or a bank prevents its demise. Poor performance and/ or embarking on a risky course sets a business on the path to bankruptcy. So, Thompson is right. APRA is not responsible for the daily management of these businesses etc. If the business goes down the gurgler, management and the board are at fault.

But Thompson is also wrong. APRA's main task should be to monitor, assess and report on the riskiness of firms, eg deposit taking financial providers and superannuation funds. Its job is to identify those who are on a risky course, detecting their problems early as possible and seeing that they are appropriately dealt with quickly. The longer a business is left to slide, the more difficult it will be to turn it around as HIH demonstrates.

APRA could have done more and done it sooner than later - or as it turns out – never, hoping the problem would go away. The alarm bells were clearly ringing in HIH's case, but APRA did not take action. Had APRA responded earlier, as it could have and should have, then the financial pain and fall out from HIH's demise would have been less, because there would have been more options and more to work with. Just like cancer, early detection and implementation of appropriate measures have a better chance of success, the quicker they are initiated. Prompt remedial action must be an essential requirement for all regulators and government bodies if they are serious about fixing up problems.

Unfortunately tardiness by Australia's government bodies is commonplace. Coles, Bond and the recent disclosures of tax avoidance or tax minimisation schemes indicate that this is an endemic or perhaps a systemic problem facing government. It undermines credibility of organisations such as ASIC and the ATO and reduces their effectiveness.

Sustainable improvement in the regulatory system, such as shortening the response time, begins with an improvement in attitude and understanding by the regulators' bosses, our politicians. It is they who decide who will lead the various regulatory agencies and it is they who determine what resources will be committed and what their mission will be.

The buck stops with the politicians. If they do not act to improve regulatory organisations, Australia will not realise its potential in global commerce. Failures by our regulators are failures of our political leaders to do their jobs.

Their job is to make our society:
- safe and secure,
- prosperous,
- fair and equitable and
- sustainable

The media, society's eyes, ears, voice and conscience, should be drawing this to their attention. They, along with analysts, have a crucial role to play in establishing a more vibrant business culture. This will occur through the writing, publishing or reporting of more accurate and critical business articles and reports. No legitimate interests are served by biased, unbalanced, submissive reporting which still seems to be more of the rule than the exception.

With the exception of a few journalists, most, judging by the quality of their work (or lack of it) are either very naive or not very knowledgeable. This unfortunately applies to veterans as well as inexperienced journalists. Alan Kohler is a seasoned business writer. Nevertheless his article in the 19 June 01 Australian Financial Review, *Let's all see monthly numbers*, in which he expressed surprise and disappointment at Telstra's performance, indicates his naivete.

He declared '… the profit downgrade from Telstra was a total surprise to everyone…' Kohler, went on to proclaim that it was '…time for everyone connected with the stock market – investors, analysts, regulators – to accept that no corporate senior executive has any idea whatsoever what is going to happen to his or her company's profits in the future, either next month or next year. Profit forecasts are almost entirely useless, beyond giving an idea of how a management team is feeling now'.

Kohler and those analysts who follow his line, for all their know-how have yet to learn not to put too much faith in numbers, be they audited, unaudited or projections. Had they looked behind Telstra's numbers, at the assumptions on which they were based, they may have had a better understanding of the company's ability to achieve its projections.

Secondly, had they had a better knowledge and understanding of Telstra's competitive environment, they would have been in a better position to assess its performance prospects. And had they understood how the numbers were prepared and who prepared them, then they would have had a better idea of how good they were.

Kohler's solution to unreliable projections is to replace them with monthly financial reporting. But monthly financials are like a race caller informing his audience of how the race is going at each furlong. In a race, it's the finish line that counts. In financial statements it's the numbers at the end of the period they are drawn up, that counts.

Speaking about horse racing, Mr Kohler should bear in mind the remarks of popular race goer and businessman, Brian Yuill. In a court trial, Yuill promised that cash would be shown in his accounts at balance date, never mind that it wasn't there at the time.

This is reminiscent of the promises One. Tel kept making as it inexorably progressed to its demise. Its sales, profits and cash never did appear. But that didn't stop the assurances from coming. A harder-nosed approach is also needed today to avoid falling in the trap that befell those hoping for miracles from One.Tel, HIH or Harris Scarfe. The irony of these collapses is they could have been prevented.

If only the media and credit providers had provided more training and skilling of its journalists and analysts.

If only our media moguls had campaigned more strongly for defamation and libel law reforms and if only they had seen that their journalists received more and better training so that better stories could be written.

If only Rupert Murdoch had insisted that One. Tel. investors, hire a CFO rather than the One. Tel principals.

If only the younger Packer could have seen what his father later proclaimed that One. Tel was f*#❖up.

The recent loan and investment losses will be a costly burden for all Australians in that they are likely to lead to a rise in risk aversion and credit contraction. What was once an acceptable risk will be now deemed as 'unbankable' or 'unfinanceable.' Like the person whose hand touched a hot stove and got burned and who now avoids touching any stove, financiers bearing the scars from the recent bad loans etc will be increasingly reluctant to take acceptable risks.

Australia will come closer to realising its potential when the media tells it like it is and our watch dogs police their turf better. To be knowledgeable is to be forearmed. And we will all be forearmed when there is a harder edge in reporting business financial results. Then and only then can we begin to feel confident that ‘the failures that occur are honest failures of judgement, rather than the reckless abuse of other people’s trust and money’. We are all part of the problem and also the solution to creating a more knowledgeable and alert business and investment community.