

## ARTICLE FOR FINANCIAL NEWS – “TALKING POINT”

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Regulators rarely comment on company reports. So, when the chief executive of the Financial Services Authority, Hector Sants, recently complained that some companies might be misleading, investors should take note. He explained that companies have become too good at “framing” their disclosures, so that investors just focus on the information that companies choose to give them. Directors can be guilty of diverting attention from disappointing numbers, and presenting too rosy a view overall. How can investors find out the truth about underlying performance?

Investors make important decisions based on annual reports. Yet, studies show that analysis is strongly influenced by whether information is presented in a positive or negative framework. Putting an optimistic spin on things is so common in some fields, such as politics, that we almost come to expect it. In those areas, we are rightly suspicious of what we are told. But, in company reporting where we expect plain speaking, our guard may be down. We expect company boards to give an unbiased and candid report of business performance, and are not alert to the dangers.

Given tough accounting standards and heavy regulation, few would question the audited numbers in company reports. Yet, surprisingly some other parts of annual reports might not be all that they seem. Chairmen have wide discretion on how they describe “achievements”, and can largely emphasise what they wish. If audited numbers are disappointing, investors’ focus might be diverted by highlighting more favourable figures created by management.

The methods used by some to persuade investors that a company’s management is performing are rooted in psychology. Humans are fallible, and their understanding of something can depend very much on exactly how it is presented. Boards know that first impressions matter – people rarely let what they find out later shift their judgements too much. Companies make use of framing by

setting a context for investors to read company reports, with “guidance” at the start.

Annual reports of most major companies now run to well over 100 pages. Few shareholders will work through all the detailed audited numbers, with footnotes that are usually towards the end of the report. That gives a lot of scope for careful presentation of initial information, including summaries and carefully chosen language.

The two key ways in which reports can mislead are through excessively optimistic language and by frequent use of adjustments to the audited figures. In combination, they can dominate the chairman’s statement and chief executive’s report. Investors should be suspicious when they see the term “adjustment”, as it usually indicates the profits being discussed are not the true audited figure, but something that is typically more favourable to management. Asterisks are usually another sign of “improvements” to numbers.

The overall effect of all this alteration and optimism can easily be overlooked in a lengthy report. For example, in some major companies, there are two sets of numbers; the real statutory ones and “business performance”. Business performance excludes costs and flatters results. Adjustments can even turn a fall in earnings per share into a claimed gain. It is usually the adjusted figures that are given early prominence in company reports.

Framing is not just about putting a gloss on results, it can have a direct impact on management rewards. Growth in adjusted earnings per share has become the incentive of choice for many FTSE 100 executives. However, a falling share price can mean the stockmarket sees through this, recognising that the profit adjustments are simply not cash in the bank.

Numbers are just one part of the problem. Optimistic language can create an even more subtle bias. The actual words used in company reporting do matter, although little

analysis is typically made of this. However, word search techniques now allow this to be measured more objectively. In the chairmen's statements of some major companies, words like *success*, *strong* and *good* appear ten times as frequently as *poor*, *bad* and *weak*.

Changes in governance and new international accounting standards do not seem to have produced the candour and consistency in reporting that shareholders want. Careful and objective analysis of accounts is needed. Hector Sants has raised an important issue that should be recognised by investors.

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