NEW ZEALAND'S OVERSEAS INVESTMENT REGIME

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The benefits of overseas investment in New Zealand and open financial markets have been urged on us all. The foreign investment regime deals with both land and corporate investment. Here, I want to cover the corporate investment aspects.

We are already aware of the costs to New Zealanders of bailing out companies like Air New Zealand and TranzRail. Their functions are important to New Zealand's economy, and they cost New Zealanders dearly. Both companies had been asset-stripped, and we are now seeing an insider trading case being taken against some of those involved in TranzRail. This experience gives little assurance that our corporate investment regime is sufficiently robust to protect New Zealanders from exploitation and yet we are going even further with the overseas investment regime. I think we are moving too fast with inadequate awareness of the risks involved.

One of my key concerns about this proposed overseas investment regime extension is that it relies on assumptions about financial markets that don't necessarily hold.

The underlying theoretical idea about financial markets is that open competitive global financial markets provide an all-important role of allocating resources in the world economy and, thus, benefit us all. In other words, the financial markets function as a sort of middleman for everything. The risks and dangers of such open financial markets seldom receive acknowledgement. I want to comment a little on those tonight.

Financial market efficiency?

The efficiency with which financial markets allocate resources has long been exaggerated; and the weaknesses underplayed. Few countries can hope to have the assumed perfect financial market where no single shareholder or group of shareholders can dominate investee companies, and where information is freely available and understood. New Zealand certainly does not. It is known as having a "thin" market or "thin" share trading environment. A thin market in any company's shares exists when a few major shareholders control a sufficient number of a company's shares to be able to control or significantly influence board and management decisions.

Particular dangers emerge in a thin market and, given this country's previous experience with asset-stripping and now, it seems, insider trading, I want to explain one danger. The dominant shareholdes in a thin market are not necessarily interested in a company investment in the longer term and should not be assumed so. They may prefer to asset-strip the company and then move on, and we have seen and are seeing that with foreign investors, the likes of TranzRail and Air New Zealand exemplifying the damaging effects on us. Typically, the asset-stripping is accompanied by quite fancy financial reporting practices to conceal from others the real effect of the asset-stripping on the company. This is where the information availability and understandability assumption breaks down and I'll comment a little more on that later.

Once a company has been asset-stripped, and the major investors are planning to move on, there can be a period of share price hyping while those major shareholders who may have greater knowledge sell their shares. Crudely put, in Wall Street terminology, this process is known as "pump and dump" because the share price is pumped up while the more knowledgeable shareholders dump their shares on unsuspecting smaller investors.

I have particular concerns about Telecom at the moment because of the way in which the shares are being hyped as a good buy and the rapidly changing shareholding profiles. Telecom was one of our early SOE privatisations. From 1991, its shareholdings were dominated by US investors, followed by investors from Europe and Asia. In 2002, just 13% of Telecom's shareholding was held by Australians and New Zealanders. More recently, a significant pattern change in Telecom's shareholding has emerged.

By 31 July 2004, New Zealanders held 26% of Telecom's shares, Australians, 21%, North American investors 26%, and British, Asian and European investors 27%. In financial terms, this pattern change is massive. In the quarter ended 31 July 2004 alone, it involved more than $900 million of shares transferred from foreign hands to New Zealand and/or Australian hands. Telecom's share price has been over $6 for a couple of weeks now, and locals continue to snap up the shares. Why?

Well, the shares are being pumped openly as a good buy, with the result, it seems, that the share price is rising and demand for the shares has increased. Also, the company is reporting improved profits and has announced larger dividend payouts that could easily exceed these reported profits.

But there's also evidence of fancy financial reporting practices, and I've commented on a couple of those in a Watchdog article due out shortly.

A question always worth asking is why larger foreign investors are dumping such attractive shares. An alternative way of putting this is to question whether analyst trumpeting, like that of ABN AMRO, and Telecom's rising share price and changing shareholder pattern should be regarded as ominous, rather than positive, signs. Will we soon find ourselves bailing out Telecom?

Information availability and understandability

Having commented on pump and dump, it is worth going back to the information availability and understandability assumption about financial market efficiency. Pump and dump relies on the new investors, who may indeed have the financial reports, not understanding them even though the financial markets theories assume they do understand. With close scrutiny, some asset stripping and fancy accounting tricks can be seen in financial reports, but it requires a high level of very detailed analysis to find them. Having information available, and understanding the information, is two different things. Financial reporting is very important in our proposed financial market economy and this is why the review of the Financial Reporting Act is related to, and occurring alongside, the review of the overseas investment regime we're discussing tonight.

The idea about information availability and financial reporting is that the audited financial reports prepared by companies are certified as "true and fair", and therefore that investors should have confidence in them. Investors might not need to worry about understanding, but simply take comfort from knowing that company financial reports are prepared and audited in accordance with what is known as generally accepted accounting practices, (abbreviated to GAAP). This GAAP is defined and developed by the accounting profession, which claims that it develops these "best practices" in the public interest. There's a problem here for investors though because the validity, credibility and legitimacy of GAAP and the associated audit certification is somewhat exaggerated.

The nature of GAAP itself and how it is developed should raise one set of concerns for investors. For example, the funding of the major accounting bodies that decide what GAAP is comes from transnational corporations, major stock exchanges and global accounting firms. Worse, because GAAP is enforceable through the Financial Reporting Act, it becomes, in effect, public policy and yet this aspect of public policy development is removed from elected politicians and granted by legislation to these closed and narrow interest groups. A common view is that the groups controlling policy processes such as this are the ones who stand to benefit from them, hence my comments about the funding of these policy processes. Because GAAP seems so technical, or at least is specified in technical sounding jargon, it can be difficult for laypeople and even professionals to appreciate that some of the so-called "best practices" developed as GAAP may be self-serving.

Another set of concerns about GAAP and audit certification relates to the auditors, and the sometimes compromised relationship between auditors and company management. Officially, the company management is responsible for the preparation of financial reports, and the auditors are appointed by the shareholders to act as watchdogs reporting to all shareholders. The problem is that executive compensation packages give the company management every incentive to find ways to report a rosy picture, and the management frequently employs the auditors to undertake consultancy work. For example, Telecom's 2004 annual reports reveal that its auditor, KPMG, is also Telecom's tax adviser and accounting policy adviser. For all the claims made today about good governance, compromised arrangements such as this didn't end after Enron. Dare it be said in such blunt terms – the relationship between a company's management and its auditor earning consultancy fees can be such that the auditor may be more interested in helping management earn big bonuses (and the auditors continue to earn big consultancy fees) than acting as watchdogs for shareholders. The auditors audit their own work.

So how can investors have confidence in the information contained in audited financial reports that they have but don't necessarily understand, and which have been prepared according to practices that sound technical but conceal vested interests? Typically, those seeking confidence might look to the share market analyst community for advice and comment on company financial information and operations. This raises a few further concerns because the analyst community may itself be compromised and fail to perform as expected. Again, using Telecom as an example, companies like ABN AMRO and JP Morgan seem to be acting on both sides, both involved in financial placement deals for Telecom - which would earn them big fees - and involved in advising potential investors, and promoting investment in Telecom in the process. No doubt they will claim Chinese walls which prevent information from being passed across within the analyst company, but they leave open the perception of compromise.

Even if a Chinese wall does exist and function, another problem with analysts exists in New Zealand because we seem to lack a competent analyst community prepared or able to scrutinise financial reports and comment early or in depth. Frequently, the advice offered is taken direct from a small publication which summarises a few basic numbers taken from the published financial reports. That isn't analysis.

It gets worse because some analysts today like to promote the simplistic idea that a good company will maximise profits at all times, and those profits will increase over time; and that the company will maximise returns to shareholders in the form of dividends. That few, if any, companies can hope to maintain such a pattern honestly and survive seems to go unmentioned in the analyst community. A company that does not produce such a pattern may expect to be punished with a reduced share price, while a company that does produce it is likely to be rewarded with a higher share price.

Simplistic ideas such as this can be very damaging. Especially when profits are inflated to meet the increasing profit trend expectations, and dividends are linked to a specified percentage of reported profits, the company may not have the resources to meet its dividend commitments. This idea actually promotes asset-stripping as the company's management attempts to produce the expected reported results, and maximise its own bonuses, using various means that have little to do with anything of real commercial substance or benefit to New Zealand, even though they may bring about the bigger bonuses for management and bigger consultancy fees for the auditors.

Summary

The benefits of overseas investment in New Zealand are being urged on us all, but agreement that it will bring benefits requires a level of faith in the underlying financial market assumptions. As a close observer of financial reporting standard-setting and corporate reporting, I have little to no faith in those assumptions and I have outlined some of my concerns. We have a thin market and we are well aware of the detrimental effects of asset stripping processes. We are vulnerable to "pump and dump" activities in a thin market and there is little to protect New Zealanders from predatory practices. Access to information is essential in such a market environment and yet the understandability of that information is a problem and I'm ver concerned about the general lack of investment community interrogation of major companies' practices, the woeful lack of analyst scrutiny, and the hitherto toothless Securities Commission. Continued compromised relationships between company management and those market operators who should provide some investor protection are apparent.

One of my biggest concerns relates to physical infrastructure held in companies that New Zealanders should not allow just to be asset-stripped and left to rot. If New Zealanders want continued access to that infrastructure, they will be left to bail out the mess and we've already experienced this. If this regime proceeds, how long will it be before we see that with our electricity generation and lines companies? Our roads? Our waste disposal? Our water supply? And so on. In addition, the manner in which our forestry industry has been carved up shows a gradual transition of the country into nothing more than an exporter of almost raw primary products. How is this good for the country?