ASHLEY BURROWES FCA AND
ROBERT JINKENS IN THE US

US investment patterns changing with times

Investment patterns in the US are rapidly changing in this elongated recession.

Bull markets have been defined as "An extended period of generally rising prices in an individual item …, a group of items …, or the market as a whole." Conversely a bear market is defined as "An extended period of general price declines in an individual security or other asset …, or the securities of the market as a whole" (Scott, 2003)[1]. Thus, if a diversified portfolio is representative of the market as a whole, then its value will increase in a bull market and decrease in a bear market. Further, if a person has a well-diversified portfolio, its value should increase in a bull market. It would only be the unlucky who lost in such a situation.

TURBULENCE

What happens, however, when markets change – particularly in turbulent fiscal times as at present? If a market changes from bear to bull, investors' attitudes probably don't change very much. After all, those who might have been losing money now should be making money. But when markets become bearish, attitudes do change.

CONFUSION

People who probably were making money probably start losing money. Will these investors be complacent? Probably not, but there does not appear to be a commonly agreed upon opinion about what they will do.

Recently US investors were asked about their investment strategy in this elongated recession. A significant number, 30%, indicated they have changed how they evaluate investments. Of these respondents, 36% indicated they more closely monitored the fundamentals (present value and other accounting and financial techniques taught in universities), while 47% indicated they more closely monitored financial trends. Sixty-four percent of those who explained how they had changed indicated this was a move away from using financial fundamentals to using financial trends to evaluate investments, and the other 36% indicated the exact opposite. That is, they had changed from using trends to using fundamentals.

CHARTING GAINS

The findings reveal that there is a tendency toward using trends such as charts more than using fundamentals, and there is almost total confusion about how to evaluate investments. There are two key ways of

evaluating investments – fundamentals and trends. There appears to be movement back and forth between these mostly opposed mindsets of evaluating investments.

IN SEARCH OF RETURNS

Many investors have taken their marbles out of the market to play in another sandbox, so to speak. As investors are only able to get a puny interest rate on a six-month Certificate of Deposit (circa 0.6% or a five-year CD yielding 1.7%), once again they are enticed to speculative gain investments, such as real estate. Property prices across the US are depressed after the great spate of repossessions which unfortunately seem to have started up again. Those dispossessed property owners are putting pressure on rental prices, but the supply of apartments also almost ceased business along with most other construction over the last few years.

Investment predictions are a minefield at the moment. The US central bank, the Federal Reserve, is "threatening" to print more greenbacks as we get closer to the presidential election. Coincidence? The confusing factor is that the economy is flush with money, as revealed by the low interest rate yields mentioned above. Will the new greenbacks stimulate consumers or investors, or both? Whoever wins the election we predict there will be belt-tightening shortly afterwards.

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INTERNAL CONTROL LAPSE

Westpac Culprits

In August 2012 the notorious Rotorua couple, Gao and Hurring, were dispensed justice by the Rotorua District Court for their 2009 flight from New Zealand with around $10m of Westpac funds that had been erroneously been credited to their bank account.

Judge Phillip Cooper said Gao's level of culpability was high. He said the money recovered was not as a result of any co-operation by Gao but by extensive efforts by the bank which were continuing.

Judge Cooper said the starting point for Gao was six-and-a-half years' jail but he reduced it to four years and seven months, giving Gao credit for his guilty plea and the time he spent in custody in Hong Kong.

Judge Cooper considered Hurring's role to be significantly less than Gao's and the starting point was 18 months' jail, which he converted to nine months' home detention[2].

The saga[3] of the flight overseas by the couple was well documented in the 2009 media in NZ, as was the use of Interpol.

Accountability

In the USA this is an era of public scrutiny for banks who have been major recipients of the biggest bailout by a government. Banks are viewed suspiciously as they dispossess many taxpayers of their homes. While Westpac was not a beneficiary of the bailout it does have its Alternative Deposit Receipts (ADRs) listed in the NYSE.

The blame so far has fallen on the teller[4] and the culprits with little or no accounting by Westpac for operating deficient internal controls. The auditor's report for 2009 stated that Westpac was following the Committee on Sponsoring Organizations (COSO), aka the Treadway Commission recommendations on internal controls. Westpac made a similar error the next year, although not of the proportions of the Gao and Hurring debacle. The bank's unwillingness to explain, in fact, did the opposite of extricating them from fault. Their unwillingness to explain reveals a possible pattern of weakness.

This is at odds with the Westpac recognition of reputational risk in the 2009 Annual report:

"Reputational damage could harm our business and prospects.Various issues may give rise to reputational risk and cause harm to our business and our prospects. These issues... [could] harm our reputation among our customers and our investors in the marketplace."

Materiality

Banks should not only protect investors but also secondary stakeholders. The public relies extensively on the banking system. Banks are in a position of fiduciary trust. Overall it appears that the bank and the auditors considered the errors not worthy of specific mention. However accounting materiality has two domains – quantitative and qualitative.

It is the latter that is addressed here. It requires more judgement than the quantitative domain and therefore

requires management and auditor environmental awareness and the repercussions on reputation among stakeholders.

On a quantitative domain the media disclosure of the $10m loss was not even covered by the company except for a vague note that may cover the loss which noted that New Zealand impairment losses increased $A323m in 2009 over the 2008 figure.

We urge Westpac, with ADRs listed on the NYSE, and the banks auditors to become thoroughly conversant with a long standing SEC pronouncement[5]:

"A misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity"[6] is more likely to be material to investors than a misstatement in a segment that management has not identified as especially important. In assessing the materiality of misstatements in segment information – as with materiality generally – situations may arise in practice where the auditor will conclude that a matter relating to segment information is qualitatively material even though, in his or her judgment, it is quantitatively immaterial to the financial statements taken as a whole."

An often quoted article on materiality judgment and the audit expectations gap (AEG), addresses the aspect that Westpac and PWC failed to consider caused by the non-disclosure of materiality and risk thresholds and criteria in the financial reports for this embattled industry

> *... disclosing cornerstone concepts, such as materiality and risk judgments, in financial reports enhances users' understanding of the limitations of information contained therein; and second, expanding the wording in audit reports reduces the AEG and enhances users' understanding of the objectives and limitations of an audit. In supporting the validity of these premises, it is concluded that the disclosure of materiality and risk judgments in financial reports may reduce the AEG.*

The above points need to resonate with Westpac and PWC in the future.

CONCLUSION

While we conclude that Westpac may be following the letter of the law, de minimis that it is, we encourage Westpac and PWC to adopt a more transparent policy on defalcations and show some contrition with the spirit of Sarbanes-Oxley Act and the SEC qualitative concept of materiality. Both this Act of Congress and the SEC are bastions of protecting the public interest – and should be a rallying call for the bank and its auditors.

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