UK Shareholders' Association

The Private Investor Issue 178 · September 2015

Chairman’s Comment

John Hunter

When campaigning on major issues, sometimes it can seem that large amounts of effort over long periods of time lead to nothing very much. But then along comes a week to make it all seem worthwhile.

John Hughman, editor of Investors Chronicle, wrote his first column for FT Money on Saturday August 29. He chose to write on the deficiencies of pooled nominee accounts. In 900 words of succinct prose he dissected the whole disgraceful issue - lack of rights, concealment of the risks, inadequate compensation, suppression of alternatives, misuse of intermediary powers - expressing an emotional distaste for the complicity of the industry on which he reports. He commented...‘[The nominee system] is an indefensible embarrassment to a country that claims to be one of the fairest and most financially advanced in the worlds. I..... am angry now'. He concluded: 'If [the government] are serious about creating a more financially engaged society, a good place to start would be to give private shareholders the full rights they deserve'.

When a journalist of this distinction comments in these terms in a paper of the FT's repute it should ensure, at least, that the issue will not be fudged away as happened, disgracefully, in the drafting of the 2006 Companies Act.

But that was not all. On Thursday the FT's leader came out on the side of the angels in the fight with the International Accounting Standards Board in which UKSA is participating to toughen IFRS 9, the standard which governs banks' accounting for loan losses. Technical stuff; but since it, or its predecessor, allowed the banks to materially misrepresent their position prior to the 2008 crisis, not unimportant.

Let's allow ourselves a bit of self-satisfaction once in a while.

Good luck!
John Hunter

UKSA Contacts

UK Shareholders' Association
Chislehurst Business Centre
1 Bromley Lane
Chislehurst, Kent,
BR7 6LH
Tel: 01689 856691
Reg. Office: Chislehurst Business Centre
Email: uksa@uksa.org.uk

Website: www.uksa.org.uk

National Chairman: John Hunter
chairman@uksa.org.uk

Company Secretary: Elizabeth Baxter
uksa@uksa.org.uk

Membership Secretary: Elizabeth Baxter
01689 856691 membership@uksa.org.uk

Editor: Bill Johnston 00420 415 653 169
william.johnston.k@gmail.com
Domousice 103, 439 68, Czech Republic

Policy Director: Eric Chalker 01732 835 569 policydirector@uksa.org.uk

Regional Contacts:
London & SE: Harry Braund
020 8680 5872
harrycb@gmail.com

Midlands: Peter Wilson 01453 834 486 or 07712 591 032
petertwilson@dsl.pipex.com

North East: Brian Peart 01388 488 419
brianpeart@btinternet.com

North West: Paul Waring 07754 725 493
paul@xk7.net

South West: Peter Wilson 01453 834 486 or 07712 591 032
petertwilson@dsl.pipex.com

Scotland: Volunteer sought

Published by United Kingdom Shareholders' Association Limited
Registered in England no. 4541415

Directors: John Hunter (Chairman), Brian Peart (Deputy Chairman) Harry Braund, Eric Chalker, Martin White.

Advertisements in The Private Investor will be clearly described as such where they are for paid-for products and services from third parties; advertorials will not be accepted. Private Investor will not endorse advertisers and the editorial policy will continue to be independent of the interests of advertisers.

The revenue raised from advertisements will supplement UKSA's funds. UKSA believes that its members are capable of deciding whether an advertised product or service is suitable for their needs. Note that the share-price graphs are courtesy of leading investment website Digital Look www.digitallook.com. Views expressed by contributors are not necessarily those of the editor or of UKSA. Nothing in this newsletter is intended to be or should be interpreted as investment advice, which can only be obtained from persons authorised in accordance with the Financial Services Act 1986 and subsequent legislation. The editor of Private Investor is not a shareholder in any of the companies mentioned in this edition, but a number of UKSA members may be.

All contents © United Kingdom Shareholders' Association Limited

Printers: **rap spiderweb Ltd.**
Clowes Street
Oldham, Lancashire OL9 7LY

In this issue...

UKSA Information	*2*
Communications	*3*
Is Your Company Viable?	*4*
Why I joined UKSA	*5*
Dividend Tax	*6*
Aberdeen Asset Mismanagement	*7*
The London Investor Show/ Share Screening	*8 - 9*
Dutch Investors	*10 -12*
Valuation is the Key	*13 - 15*
Audit Reports - a Buried Treasure	*16 -18*
Business Models	*19*
Letter to the Editor	*20*
UKSA Company Visits	*21 - 22*
Regional Information	*23*
UKSA Meetings' Programme	*24*

Communications

Members without e-mails are increasingly missing out on things. Some things simply cannot be organised by letter. A case in point is that of member Paul Waring who is seeking to get the North West Region really motoring again and plans to start with an initial social event - a lunch for example - for members to meet each other.

Could interested parties e-mail Paul? He can be contacted at paul@xk7.net. He is very much open to suggestion about time and place and would also like to know what your interests are. If he can form a group he would quickly arrange for company meetings along the well-established UKSA lines - note that the North-East has recently accelerated its already formidable programme in this respect.

You know you have to be *persona grata* in the City to get direct access to the big guys. And yet UKSA members can walk right in if they take the trouble. Why don't you?

Here's another good idea. Why don't you emulate John Hunter and write and tell me why you joined UKSA?

Bill Johnston

Alliance Trust Investor Forum

In the July edition I suggested that anyone proposing to attend the Investor Forum on September 29th should get in touch so that we could make ourselves known to one another. Most shareholders should have received their CEO's July blog which, among other things, tells you that the next Investor Forum is on 2 November with registration opening in mid-September. There is nothing to say that this is actually a change from the previously advised date and no reason or apology given for the change. However the result is that I shall be unable to attend. Even so, I can still be a point of contact for anyone who obtains a place and wishes to be able to meet others of our members, and possibly discuss what questions they might put to the platform. If you do get a place and want to take advantage of this my email is roy.colbran@zen.co.uk and phone 020 8654 0314.

As you will have seen, the blog also comments on the disappointing performance for the first six months of this year. Bearing in mind that Elliott gave them only a year before they would consider bringing further pressure, I wonder what this portends for 2016? Incidentally has anyone seen any news of the further independent director who was going to be appointed in consultation with major shareholders?

Roy Colbran

Is Your Company Viable?

You may just recently have noticed some new words appearing in the strategic report of companies you invest in. This new requirement requires companies to look forward and comment on how they see the future for their business. It is becoming known as a 'viability statement'.

In 2011 Vince Cable, then in charge of the Department for Business, Innovation and Skills, asked a well known academic, John Kay, to report on UK Equity Markets and Long Term Decision Making. He came to the conclusion that there needed to be a rebuilding of trust between investors and those who manage money on their behalf. He made several recommendations which he said would require action by not only government but most parties involved.

One strong theme of his was the need to reduce "short termism" and as a part of this he suggested that companies should state how they saw their future. For many years the accounts of companies have been drawn up on what is called the "going concern" assumption. This meant that the values in accounts reflected their worth to an ongoing business and not the values of a fire sale. Kay was asking for more.

This recommendation was picked up by the Financial Reporting Council, the UK regulator of accounting and reporting matters. After much debate in which UKSA amongst many others was involved a new requirement was introduced into the Corporate Governance Code which says: *"Taking account of the company's position and principal risks the directors should explain in the annual report how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate. The directors should state whether they have reasonable expectations that the company will be able to continue in operation and meet its liabilities as they fall due over the period of the assessment, drawing attention to any qualifications or assumptions as necessary."*

One aim of this was to distinguish this requirement from the 'going concern' requirement which is why the term 'viability statement' is now being used. The debate around this requirement recognised that businesses differ and thus it would not be sense to prescribe the period which had to be covered in the statement. Instead it was agreed to ask the directors to decide that period, taking into account their company's business cycle. However, importantly, the directors are asked to justify the period over which they have considered the viability of their company.

It is hoped that this emphasis on a longer period will encourage both boards and investors to also take a longer term view. So if you attend an AGM in the near future look out for this new statement and ask the chairman about it and, in particular, ask how they came to decide on the period the statement covers. UKSA will be interested to have any comments you may have on this.

Roger Collinge

Why I joined UKSA

I first began to save serious money, and learn how to handle it, when I worked in the US and earned a US salary while still retaining thrifty UK spending habits. My US friends regarded investment in the stock market, or some other risk-based enterprise, as the only sensible use of long-term money. My first wife listened to her friends and stuck money in a Vanguard 60:40 account (total expense ratio 0.2%). I learned from both approaches.

In the mid-90s I returned to the UK, a reduced income, and a social environment where conversation about money was not considered chic. However I became familiar with the work of a corporate head office; I experienced the amount of time senior executives had to spend schmoozing the City instead of doing their jobs; I dealt with the regulator on matters of corporate observance; and eventually I retired.

Soon after that my eye was caught by a flier from a major bank. It advertised an investment product which I later learned was called a structured bond. There was something a bit odd about it. It was equity-based with a loss limit, but with a number of unattractive features: capital appreciation capped, no dividend, a fixed 6-year term with no right of early withdrawal and a strange counterparty. Intrigued, I did the maths. It took me about half-an-hour. I determined that it would be impossible to find an investor who would not be better off with a suitable mixture of cash and shares. Therefore any independent financial adviser would not be recommending the bond: any IFA who *was* needed to be disciplined. I wrote to the regulator.

The rest of the story you can guess for yourself: my case went nowhere. But I learned about commission-based ‘advice’; I learned about the size of the financial product market; I learned about the relationship between the regulator and the regulated; I learned about the conflict of interest inherent in financial institutions selling services to businesses they controlled; and I learned about the generally woeful ignorance of a population brainwashed to buy products instead of being taught how to invest.

I became angry. So I looked for an organisation with its heart in the right place, and found UKSA. Through UKSA I have worked for change for the last 12 years. It’s a serious business but I’ve had some fun while doing it.

John Hunter

Dividend Tax

Since our article on the new tax appeared in the July issue, HMRC have issued a factsheet which may be accessed at https://www.gov.uk/government/publications/dividend-allowance-factsheet/dividend-allowance-factsheet ccording to the Association of Tax Technicians this contains a nasty surprise for some people. You will remember that the first £5000 of dividends is an allowance free of the new dividend tax. Some people seem to have got the idea that this was like income received in an ISA and so did not count towards the various tax thresholds, e.g. higher rate tax. To us this seemed most unlikely bearing in mind that this was a tax-raising measure. So it is not unexpected to find clearly stated in the factsheet that dividends within the £5000 allowance still count towards your basic or higher rate bands. In fact, there still appears to be a small advantage which is not mentioned. Hitherto all dividends have been grossed up for the tax credit in considering when the thresholds are reached. So for that purpose £9000 of dividends counted as £10,000. Since there is no longer any question of grossing up this practice has to cease.

Looking at the overall position of dividends for private investors in the UK, a lot of us will remember that for many years unearned income was taxed more highly than earned income. The present situation where only earned income is subject to NI contributions means it is now the other way round. For higher rate taxpayers (and those who would be on higher rate if their ISA dividends were counted) the tax benefits of ISAs are incredibly generous. Altogether then it would be very difficult to justify any kind of campaign against the new tax and I cannot see that it is one likely to get any general sympathy. The worrying thing about it is, of course, that once it has proved to be a useful revenue raiser, future Chancellors will not be able to resist the temptation to increase the rates. Some of us will remember that VAT was 8% for a five-year period soon after it was introduced.

However, there is one aspect that possibly deserves further attention.
The latest survey from the Office of National Statistics shows that they think that 54% of UK quoted ordinary shares are now held by “Rest of the World”. Most of these will presumably not be UK taxpayers. Consequently the only tax that will have been payable in the UK on dividends paid to these holders will be Corporation Tax at 19%, reducing to 18%. There is a Government website that actually says “The UK is unusual in not having an outbound dividend withholding tax” and there is no indication so far of any intention to change this. Thus it looks as though somewhere around half of all the dividends on UK ordinary shares are being paid abroad with minimal contribution to the Exchequer. This is something that our members might well like to point out to their MPs.

Roy Colbran

Aberdeen Asset Mismanagement

as reported by Eric Chalker

This article can be seen as a supplement to *Making the most of AGMs – Part Two*, which appeared in the July issue. It was my intention to write 'part three', but what I discovered when I looked into Aberdeen Asset Management (AAM) is to my mind too interesting to pass over. A month ago, its shares looked attractive, because of the dividend yield. As this was a consequence of a falling share price, was the dividend sustainable I wondered, let alone the board's expectation that it would continue to grow? I found that, in July, the board initiated a promised £100 million share buy-back programme "*to return surplus capital to shareholders*". This ran to August 4, when £50 million had been spent at an overall average price of 365p. The closing price on September 22 was 310p, which on the shares bought back is a loss of over £6 million.

A heavy cloud is hanging over the emerging markets in which AAM has made its name and the consequence is withdrawal of funds, thus causing the share price collapse. Could this have been a surprise to the board? Surely not if any member of it reads the FT, or any other serious reporting of what had begun to happen long before the buy-back was initiated.

Another reason one might have supposed the board would not sanction a share buy-back was the state of the balance sheet. As I pointed out to Roger Cornick, AAM chairman, in a so far unanswered letter sent on August 19, the company's balance sheet is not particularly strong, showing intangibles as 75% of equity last year. Total income was £286.2m, but this was fully consumed by dividends, coupon payments and the previous year's share buy-back. Net operating cash last year was greater than income, at £455.2m, but deducting this year's dividend expectation and the full buy-back commitment, only £109m would be left.

Why was the AAM board so comfortable going into a time it describes as "*global economic and political uncertainty*" with "*operating conditions (expected) to remain challenging*" that it could plan to leave the company with such a small equity cushion? How could the board think last April that £100 million was "*surplus capital*" and what assumptions was it making to justify maintaining this position despite the growing evidence that investors in the markets in which AAM specialises were withdrawing?

But it had a plan. This was to finance the £100 million share buy-back with a £100 million preference share issue paying 5%, announced on June 15. Thus capital which previously cost nothing, now costs £5m pa.

I await Mr Cornick's reply to my letter with great interest.

Once again UKSA is supporting the London Investor Show. This is taking place on October the 23rd at a new venue - **London Novotel Hammersmith**. UKSA member John Mulligan will be giving a talk on STAR (see below). Later he will join a panel of UKSA members chaired by Eric Chalker for a Question & Answer session open to all comers, at 4.15pm in Conference Room 2. The panel of UKSA members has been selected for its diversity of opinion. Visit us at the UKSA stand (D23). UKSA also supports the inaugural Leeds Investor Show on October 15th although we will not have a stand there.

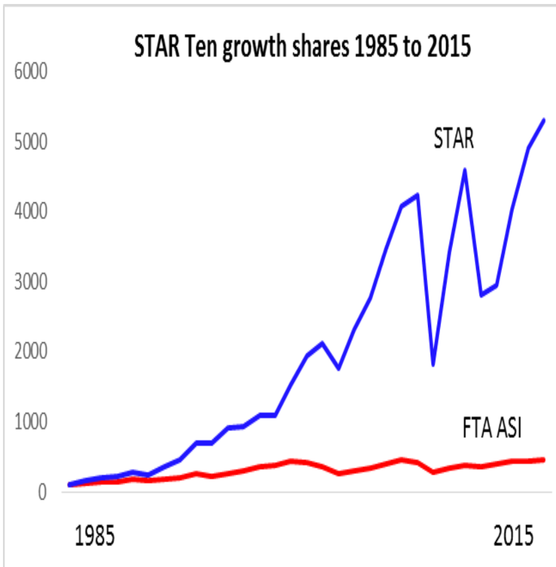
UKSA members can gain access to both shows and all events entirely free. All you have to do is apply on line at http://www.eventdata.co.uk/Forms/Default.aspx?FormRef=LISA5Visitor using the voucher code UKSA. As tickets cost £25 at the door at the London Show this represents a considerable benefit.

Share Screening for UKSA Members

I thought that UKSA members might be interested to know a little about the background to the Share Tracking and Ranking (STAR) share screening methods that I have devised and developed to manage my own share portfolio over the past thirty years.

The rationale behind the development of STAR was my belief that it should be possible to devise a relatively simple mechanical method of picking successful investments and then managing the resultant portfolio. The premise was that above average share price appreciation would emanate from a selection of shares that exhibited the potential for above-average growth in earnings and that were also selling on a below average earnings multiple. This is now known as the Growth at Reasonable Price or (GARP) approach.

As nearly thirty years have elapsed since I first started testing this hypothesis in the late 1980s the process has had a reasonable period within which to prove itself. Although, there have been a few years when the STAR share selections have failed to deliver the desired gains the periods of outperformance have greatly outnumbered the underperforming ones. The result is that this particular brand of value investing has delivered major gains to investors over more than two decades which they have been able to access through a regular monthly newsletter.



The chart summarises the cumulative results achieved by the ten STAR growth shares in the 30 year period from 1985 to 2015. Over this period these selections, rebalanced at the start of each calendar year outperformed the All Share Index by a factor of more than 10 times and in 23 out of the past 30 years. Similarly, but less dramatically, the twenty share selections have outperformed the All Share Index by a factor of 2.5 times and in 15 out of the past 21 years.

So much for the past record. I believe it illustrates that this "growth at a reasonable price" (GARP) strategy works more often than not. However, the record also indicates that it is not infallible and portfolios with these attributes tend to underperform in less bullish periods when investors' animal spirits tend to cower away in the undergrowth and are replaced with bearish cautiousness. Given this caveat I think it is worth delving in more detail into the reasons for the past failings as well as the strengths of these simple investment methods.

To find out more about STAR go to jpm@companynews.co.uk for more information and a free trial subscription to the monthly STAR newsletter. Additional information and press comment about these share screening methods may be found on my website at www.companynews.co.uk/star/index.htm.

John Mulligan

Personal investment from a Dutch perspective

by Helen Gibbons

Individual share ownership

The UK and the Netherlands have many similarities. These extend to personal investment and individual share ownership.

The Netherlands did not experience a wave of privatisations similar to that seen in the UK in the early 1980s. Unlike post-war British governments, the Dutch state had never been a large owner of the means of production. Economic problems flowing from high health and welfare spending nevertheless prompted a government asset sell-off later in the 1980s and 1990s, with railway infrastructure, public energy utilities, post and telecommunications services moving into the private sector. By the mid-2000s, both countries had around 14-17% of their population investing in shares.

In terms of per capita annual investment in quoted shares, Dutch citizens rank highly in Europe, investing €7,750 (in 2013). The comparative figure for the UK is €4,630. After a steep fall in 2008 at the time of the sovereign debt crisis, the Dutch figure has broadly recovered to early-2000s levels, despite financial scandals such as IPO failures, Shell's oil reserve overstatement and the

Helen Gibbons graduated from the University of Cambridge in 1981 with a degree in Modern and Medieval Languages. In the 1980s she worked for Banque Nationale de Paris in the City before taking over the running of the family office equipment business. Since 1991 she has owned a financial translation business focused on the translation of annual reports and other documents from French, Dutch, German and Spanish into English. The work is carried out mainly in Lewes, The Hague and Gibraltar.

Helen is an equity investor and also attends and interprets at company AGMs in the UK and elsewhere in Europe. She has a particular interest in European corporate governance and is a member of UKSA.

Helen Gibbons

ABN Amro acquisition, which caused heavy losses for individual shareholders and dented the attractiveness of the equity market.

Pension funds

As in the UK, the propensity of Dutch investors to acquire equity holdings is strongly influenced by the pension system as an alternative means of asset accumulation. The Netherlands is fortunate in having a sophisticated pension system. The strong tradition of collective risk-sharing resulted in large, sector-based pension funds (for example in the education and health & welfare sectors), which now punch well above their weight in international terms. One of the main players, ABP, even ranked third globally at the end of 2014, with €344 billion of assets under management. It is unsurprising, therefore, that Dutch pension funds are revered by pension industry insiders worldwide. A US actuary attending a pension conference in Amsterdam in the mid-2000s likened his visit to that of a country priest calling at the Vatican.

Fast-forward ten years and some of the lustre has worn off. The 008-2014 financial crisis triggered cuts to pensions already in payment, forced mergers between funds and compelled many providers to undertake hefty 'recovery' programmes to restore their coverage ratio and secure their continued existence. Recent changes to the pension system reflect the harsher environment in which pension funds now operate. The retirement age is being lifted to 67 and a €100,000 cap has been placed on the eligibility of contributions for defined benefits in occupational pension schemes.

Three pillars of retirement income

The Dutch are accustomed to the three-pillar model for retirement income:

- First pillar: state old-age pension under a statutory insurance scheme;
- Second pillar: occupational pension arranged through the employer;
- Third pillar: private retirement savings.

The new restrictions on occupational schemes are likely to shift assets from the second to the third pillar, boosting demand for directly owned listed equities as a way of supplementing retirement savings. It is worth noting that a fourth pillar

is sometimes posited, comprising income from employment after the official retirement age. Buy-to-let property is much less common in the Netherlands than in the UK.

Engagement and activism

Despite – or perhaps because of – the difficulties experienced by pension funds in recent years, members are now kept very well informed of their fund's performance and financial condition. They receive quarterly briefings with the latest data and the board's justification for decisions taken. News of the latest asset-liability coverage ratio is keenly awaited, as it has a direct bearing on pension levels and indexation.

Funds also report at length on their attendance at shareholder meetings, explaining their voting stance and taking soundings among membership on key issues. They are strong proponents of responsible investment and active litigants on ESG (environmental, social and governance) matters, no doubt spurred by the Netherlands' liberal attitude to jurisdiction and openness to US-style class actions. They routinely publish position papers on issues such as shale gas, tobacco, armaments etc. The huge volume of assets under management enables these funds to wield substantial influence far beyond the Netherlands, including in much bigger markets such as the UK and the US.

The result is a high level of investor engagement with pension funds as well as a high level of pension fund engagement with investee companies. This is mirrored by the engagement of Dutch individual investors in listed equities. Individual shareholders in the Netherlands live in a more activist culture. They have also witnessed financial scandals at first hand in recent years. It is no surprise, then, that they adopt a more proactive stance than elsewhere in Europe, spurred by organisations such as VEB, the Dutch Association of Shareholders, which cites its core values as being 'independent', 'critical' and 'combative'.

Helen Gibbons

Valuation is the key

by Malcolm Howard

There are two key elements in buying shares – risk and valuation. As discussed several times before, I do not regard volatility as a measure of risk, but rather that the main risk is the company's ability to generate cash and service its debts. I break companies down into three categories:

- Banks and Insurance companies
- Property companies
- All other companies

Property companies usually have a high amount of debt, but obviously the market value of their properties will be much greater. Now, the risk here is that the property market is cyclical; if companies take on too much debt by overinvesting then they can be in trouble in a downturn. This is what had happened to Land Securities plc in the past which led to the appointment of the current Chief Executive, Robert Noel. His strategy to de-risk the company was to reduce the debt percentage to around 25%. What we mean by this is that debt as a percentage of net assets before debt should be around 25%. This figures below show how this strategy has been achieved.

Land Securities – Debt % ratio at year ended March 31:

2010 - 37.3
2011 - 35.2
2012 - 36.9
2013 - 31.9
2014 - 27.2

So, I value property companies as follows, using Land Securities plc as an example:

Calculation based on year end 31 March 2015 (all figures in pence per share)

Net asset value per share	1,332.8
Less valuation risk (10% of net asset value)	(133.3)
Less debt risk 500.3x0.25x1.0223	(127.9)
Discounted value of earnings (80p, no growth)	632.0
	1,703.6

At the date of writing this piece these shares were valued at 1,255 pence and as my valuation is significantly higher than this, there has to be a flaw.

The answer is that earnings in 2015 were boosted by a profit on the sale of assets (note: changes in unrealised property valuations are ignored) which are unlikely to be repeated. This was pointed out by Mr Noel at the annual UKSA meeting with his company. So, taking this into account the current price seems about right. Now, if we assume the earnings will fall next year the key will be to reassess the valuation. The point is that markets tend to overreact when companies show a decline in earnings, so such valuation could provide a buying opportunity.

Talking about buying opportunities, these occur when the market is in a stress as it is now. The reality is that markets go up and down, as demonstrated by the history of the FTSE 100 indices, at the year end, as below:

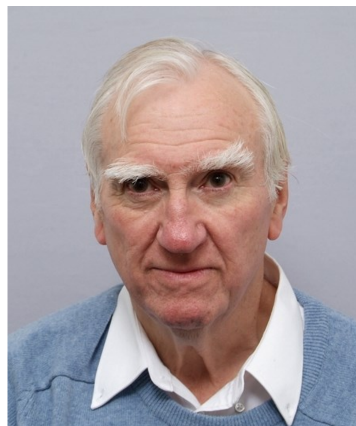
2000 6,222.5	2001 5,217.4	2002 3,940.4	2003 4,476.9	2004 4,814.3
2005 5,618.8	2006 6,220.8	2007 6,456.9	2008 4,434.2	2009 5,412.9
2010 5,899.9	2011 5,572.3	2012 5,897.8	2013 6,749.1	2014 6.566.1

In 2015, the market held relatively steady until the end of May, but the alleged crisis in China caused the market to panic. From May's close of 6,984.4, as I write it is 6,093.1, a decline of 12.8%.

I don't touch banks or insurance companies because I don't understand their accounts, but for all other companies, I have a simple strategy. First, I am only interested in companies where the net inflow from operating activities (from the Cash Flow Statement) exceeds the net income (from the Income Statement). As a general rule for these companies cash generated should be at least 120% of net income and when it isn't it can be because inventories and/or receivables are too high or there is a problem with the pension scheme. If companies pass this test, then they can be valued by comparing the potential growth with the growth built into the share price. If the potential is greater than the actual built in there is a buying opportunity. Of course, it can go wrong when companies fall short of both previous actual growth and potential growth, with Rolls Royce being an example. However, the most important reason for calculating a valuation is to understand when the market has significantly overvalued the company, often because it has been tipped in a newspaper.

I give two examples to demonstrate the point:

At an UKSA meeting in April 2015, a member suggested investing in SDL plc, as it was an innovative company. He said that he had bought into the company at a significantly lower price than 464p, but had seen the share price steadily rise. For Croydon members I analysed the company and wrote: "The current share price assumes over 20% growth, but this does not seem likely. Debtor days are a major worry, as is the worsening cash position". The current price is 370p, down 20%.



Malcolm Howard - former Finance Director

In the January 2015 issue of the Private Investor, I looked at ten companies, with a view to assessing whether or not investing in AIM companies carried a fair amount of risk. There were swings and roundabouts, as shown:

Price at (p)	11/11/13	14/1/15	4/9/15
Dart Group	223	285	502
Blinkx plc	207	26	23

Of the ten companies, I analysed three and rejected them all, two on the ground of risk and the other, shown in bold, on the ground of valuation.

Fairpoint Grp (debtors?)	134	114	175
Northbridge IS (over-valued)	**469**	**392**	**158**
Statpro Grp (accounts doubt)	93	74	70

Reading the above, it can be seen that of the two factors, risk and valuation, the latter is by far the most important. Warren Buffett frequently writes that he likes a falling market because it provides buying opportunities, but we can only take advantage if we can assess what a reasonable price would be.

Malcolm Howard

Audit Reports – a Buried Treasure

We are very grateful to co-authors Jayne Kerr and Gilly Lord of *PricewaterhouseCoopers LLP* for this article. Jayne Kerr is Senior Manager in Assurance, Risk & Quality and Gilly Lord is a Partner and Head of Regulatory Affairs at PwC. They jointly lead the team of professionals dedicated to the implementation and development of their extended audit reports.

Within a very short time frame auditors' reports for UK listed entities have changed dramatically. Up to a couple of years ago, the reports consisted largely of standard language and a pass/fail opinion. Users would pause only to see if there were modifications in the audit report and then move on. Reports were virtually the same for all companies, whatever the entity structure or industry.

Times have changed, and with the revisions to ISA (UK&I) 700 in 2013 that require the auditor to describe the key planning decisions of the audit, their perspective on the risks facing the company and how the audit responded to those risks, suddenly there is something worth reading. In fact, today's reports are packed full of useful information and can often act as a guide to what's particularly important in the financial statements. Moreover, they are now interesting, a hot topic and the subject of discussion like never before! This is not only a UK phenomenon - it's also global, with the EU and international auditing standard-setters introducing enhanced audit report requirements from only next year.

So what is all the fuss, and why should the investor be interested in extended audit reports?

The extended report, as a stand-alone document, provides the auditor's unique perspective on the risks facing the company. In doing so, it should direct the reader to the key areas of judgement in the financial statements. It provides straightforward insight into complex accounting treatments and the impact of material transactions. If done well, it can also be an integral part of the Annual Report as a whole, complementing and linking up with the Audit Committee Report and the principal risk disclosures. The extended audit report also gives insight into the work the auditor has performed, which previously has been something of a mystery.

How to make the most of the extended audit report

Gilly Lord

Areas of focus

The areas of focus (also known as "risks and responses") is probably the most useful section of the extended audit report for the reader. It identifies the areas of the financial statements on which the auditor focused most of their effort and explains the work performed by the auditor in response to these. A good audit report will explain *why* this took so much effort, quantifying the balances involved and highlighting important judgements. It will break down the area into elements based on the associated risk and will describe how the audit addressed each of those elements. A good audit report will highlight events and conditions that have impacted the financial statements and the associated risks, and will direct the reader to that part of the financial statements where they can find out more. It can also provide "micro-views" that the reader can use to understand how easy or difficult the auditor's judgements were and so provide the reader with the basis for a more in-depth discussion with the directors.

Materiality

In layman's terms, materiality is the level at which a misstatement could influence the economic decisions of the users of the financial statements. In an audit, materiality is used to determine where the auditor should focus the audit work and the nature of the work to be performed. It is also used as a benchmark for evaluating any misstatements identified. It is, however, a concept, not an exact science and, as such, is open to professional judgement. Because of this it has been a very difficult area for the outsider to understand.

To combat this, the extended audit report includes an explanation of the materiality the auditor has applied. This helps the reader to better understand one of the most important inputs into the audit process and the thought process behind its determination, which helps to put context around the audit. Ultimately, the explanation of materiality should reduce the expectation gap about what an audit does, and does not involve.

Jayne Kerr

A common materiality benchmark is 5% of profit before tax, which is a generally accepted "norm" for profit-orientated entities. However, often auditors adjust this benchmark to remove the impact of distorting factors, such as non-recurring exceptional items. A good audit report will explain *why* a particular benchmark has been selected and the rationale for any adjustments made.

Scoping

The extended audit report also includes a section on the scope of the audit. This explains how the audit was designed in order to gather sufficient evidence on the financial statements, focusing in particular on the most significant risks of material misstatement. This section is useful as it focuses on how audit evidence was obtained through the work of both group and other auditors and the extent to which audit work has "covered" the account balances. For instance, an auditor could decide that if 90% of revenue has been subject to detailed audit procedures, less detailed work is needed on the remaining 10%. It also provides insight into where the senior members of the audit team spent their time; and in so doing highlighting what might be the more risky and/or complex areas.

The shareholder voice

The extended audit report, if well prepared, is a big step forward in increasing the transparency and trustworthiness of the financial statements. As auditors, we are working hard to make the reports as meaningful and useful as we can so that it can be used by you as a tool to help you navigate the Annual Report, break down the vast amount of information presented and give you a hook for your discussions with the directors.

The audit report is prepared for you, the shareholders. We encourage you to make the most of it by actively engaging with the Audit Committee Chair if there is something you don't understand, agree with or feel is insufficiently covered.

Think of it as buried treasure just waiting to be uncovered!

The Art of Defining Business Models

The Financial Reporting Lab is starting a new project. Its purpose is to assist companies understand what information the investment community values in business model reporting and how that information is used. The Lab expects that the project will explore a number of characteristics, namely:

- definition of 'business model';
- preparation of business model disclosures;
- investor use of business model disclosures; and
- attributes that characterise good business model reporting.

This project is the first of a series which will be examining best practice reporting in the following interrelated areas of disclosure:

- business model reporting;
- principal risk reporting; and
- viability statement reporting.

Our policy team member, Mohammed Amin, has agreed to represent UKSA in this project. Amin (as he likes to be known – see http://www.mohammedamin.com/About_me.html#Why-called-Amin) is keen to involve one or more members in the project, which will involve some exchange of thoughts by email and the occasional meeting at the Financial Reporting Council's offices at London Wall, EC2. Please contact him if this is of interest to you, on mohammed.amin@btinternet.com.

In my opinion, the subject of this Lab project is of above average interest to us as private investors. It is surely essential to any serious investment that the company's intended business is clearly explained and defined, so that investors know what the directors intend to do with the business and can judge the business performance against this. As I wrote in July, under the subject of 'strategy', quoted companies (which does not include the AIM) must now publish 'strategic' reports and these "*must include a description of the company's strategy (and of) its business model*."

Although the subject of company strategy is not part of the Lab's new project, it will be examining the subject in parallel. With Amin, I hope to ensure that UKSA contributes to this as well, so I invite anyone with a particular interest in company strategy to contact me at policydirector@uksa.org.uk.

Eric Chalker, Policy Director

Footnote: I am particularly grateful to Amin, who with some assistance from Peter Parry, has corrected what Wikipedia says about nominee accounts. It had been seriously wrong.

Letter to the Editor

Dear Sir,

I write in response to Eric Chalker's invitation re 'strategy' (page 19 July edition).

Mr Chalker suggests that some company directors haven't a clue about strategy. As someone who in the past as 'Business Planning Manager' has been responsible for 'strategy' I can tell him they do!

There are only two possible strategies a company can adopt:

(1) Pile it high and sell it cheap (Tesco)

(2) Develop superior products and accordingly premium price (Dialog Semiconductor)

I will only invest in those companies I believe adopt strategy (2). This is still possible when companies sell mundane products or services. For example, Paddy Power, being a betting company, is selling the same service as all their competitors, but they differentiate themselves by being innovative. Another example: I used to be a director of a small resin company, so the only possible strategy was (2). We had to develop resins that had special features. One of our resins allowed the subsequent ink to withstand extreme heat and cold, so was used in frozen product packaging (heat - sealing the packaging, cold - stored in the freezer). In the late 1980's this product sold for £2,400 per tonne, with a raw material cost of £300 per tonne. The average margin was 30%.

The reality is that the new Companies Act Regulations making large companies specify their strategy is a complete waste of time that achieves nothing and gobbles up investors' cash. They will all say the same; that they intend to be the best followed by pages of gobbledegook. So all AIM companies, being small, will use strategy (2), but they will not tell the world what strategy they have to beat the competition. If they tell Eric Chalker, then they would have to publish this information. This is not going to happen apart from 'our strategy is to be the best'.

Malcolm Howard

Malcolm - as usual - does not pull his punches. Neither does John Hunter. So watch this space, as they say, for his riposte in our next issue. Editor

UKSA Company Visits

As can be seen on the last page of this issue, the winter programme of company presentations –where UKSA members meet top managements - is in full bloom again. Casting my eye down the list is like contemplating a Christmas stocking bulging with good things - come to think of it there are a couple of Christmas lunches as well that I wouldn't mind attending either.

Two particular items caught my interest.

Premier Farnell is of course a distributor of technology products, electronic system design, maintenance and repair in Europe, the Americas and Asia Pacific. The Company operates in four segments: the Marketing and Distribution Division (MDD), comprising the Americas, Europe and Asia Pacific, and Other Distribution Businesses, and the Industrial Products Division (IPD). The Marketing and Distribution Division predominantly operates in the electronic components distribution market. The Industrial Products Division is engaged in the manufacturing and sale of fire-fighting and emergency response equipment.

Premier Farnell - 6-month share price

The North-East Region has caught the company at a very special time. The former Chief Executive has just left the company and I can't help noticing that his valedictory tribute was rather more blunt than is normally the case when horse and rider of prominent companies part company. At the time of writing his successor has yet to be appointed. Of course the company's operations by the very nature apparently engender a high degree of stability and this no doubt both creates the need and provides the circumstances for the substantial borrowings which it requires in respect of its trading profile. So it is then that the presentation should be replete with greater than normal interest I think. It is due to take place on Wednesday 11th November at two o'clock. If the normal timetable is followed, the interim figures should be posted by then and I urge anyone planning to attend to have a good look at them. This company in its present form was the outcome of a very bold initiative and although it has not been a very easy investment case to call in recent years it has tremendous strength in depth.

Wolseley

Wolseley - 6-month share price

Wolseley is located in Switzerland and is of course a well-known specialist trade distributor of plumbing and heating products and building materials in North America, the United Kingdom and Continental Europe.

Most notably in recent years the fundamental factor influencing the fortunes of the company have been the state of the North American housing market.

Wolseley appears to be hitting its stride again - the most recent figures to hand indicate that on a like-for-like year-on-year revenue expansion of circa 10% the earnings per share are accelerating to a figure somewhat near 20%. Of some note was the comment that UK conditions were 'challenging'.

David Lowe

The Continental European activities are, as you would expect, subject to the general dullness of the region in the wake of the wallowing Euro.

The world in general but one wonders if Wolseley in particular awaits to see what the Americans are going to do about interest rates. Nobody can know of course and nobody can do much about it but one wonders how a giant company like this one (it is capitalised at £10 billion) plans its strategy given the immense effect which it has on a business which - surely - has high fixed costs. There might be some mileage too in asking if the lively programme of bolt-on acquisitions taken in aggregate points in the direction of some strategic planning here too.

Members interested in attending should contact David Lowe on 0208 398 4058 djmlowe@btinternet.com

Regional Information

These events are open to members from all regions, and their guests, unless otherwise indicated. For 'waiting list' events all places are taken but there is a waiting list for cancellations.

LONDON & SOUTH-EAST

All events must be booked in advance via the specific organiser. Future events are shown in this magazine and on the UKSA website. Members from other regions are very welcome. For more information please contact Harry Braund on 020 8680 5872 or email harrycb@gmail.com

Within this region there is a separate Croydon and Purley Group which meets in Croydon, usually on the second Monday of each month, at the Spread Eagle pub, next to the Town Hall. Please contact Tony Birks on 01322 669 120 or by email ahbirks@btinternet.com ,who will confirm actual dates. There is no charge and no booking necessary.

MIDLANDS

For general information, contact Peter Wilson 01453 834 486 or 07712 591 032 or petertwilson@dsl.pipex.com

At the present time no meetings are being arranged specifically for the region, but members are cordially invited to attend meetings in the North or South West regions where they will be made very welcome; or indeed London if that is more convenient.

SOUTH-WEST AND SOUTH WALES

All South-West events must be booked in advance, and are open to all members and their guests subject to availability.

Didmarton: The King's Arms, Didmarton: cost is £22.50, including coffees and lunch. Events are at 10 for 10.30am. To book, contact Peter Wilson 01453 834 486 or 07712 591 032 or petertwilson@dsl.pipex.com

SCOTLAND

Volunteers sought

NORTH-WEST

Paul Waring 07754 725 493 or paul@xk7.net

NORTH-EAST

Advance notice is required for all company visits and lunches. Knaresborough: venue is the Public Library, The Market Place, Knaresborough. For more information (except where stated otherwise), please contact Julian Mole at Julian.mole@btinternet.com or Brian Peart, 01388 488419.

UKSA members who have not attended one of these meetings may not appreciate how valuable they are. They are invariably addressed by one or other of the three principal directors and the information presented is the same as that given to City analysts. For some of those who do attend, these occasions are UKSA's most valuable membership benefit and, for this reason, there is often competition for places.

Event	Location	Date	Type	Contact
Legal & General plc	London	Friday, 2 October 2015 - 14:00pm	**presentation**	Phil Clarke 01689 834479 **pjejclarke@ tiscali.co.uk**
Howdens Joinery Group plc **Gary Rawlinson**	Knaresborough	Wednesday, 7 October 2015 - 1:45pm	**presentation**	Julian Mole **julian.mole@ btinternet.com**
Venture Life Group	Bracknell	Thursday, 22 October 2015 - 12:15pm	**presentation**	**officeatuksa@ gmail.com**
Premier Farnell plc	Leeds	Wednesday, 11 November 2015 - 2:00pm	**presentation**	Julian Mole **julian.mole@ btinternet.com**
Wolseley Group Ltd	London	Wednesday, 25 November 2015 - 11:00am	**presentation**	David Lowe 0208 398 4058 **djmlowe@ btinternet.com**
Regional meeting	Knaresborough	Saturday, 28 November 2015 - 10:00am	**Meeting**	Julian Mole **julian.mole@ btinternet.com**
UKSA South West Christmas meeting	Didmarton	Tuesday, 1 December 2015 (All day)	**Christmas Meeting**	Peter Wilson **petertwilson@ dsl.pipes.com**
Xmas Dinner	York	Tuesday, 8 December 2015 12:00pm	**Xmas Dinner**	Julian Mole **julian.mole@ btinternet.com**

UNITED KINGDOM SHAREHOLDERS' ASSOCIATION
CURRENT UKSA EVENTS