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A NOTE ON THE DISCLOSURE OF RISK FACTORS AND FINANCIAL PROJECTIONS IN NEW EQUITY ISSUE Problem Areas

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In the present day changed scenario of the Indian capital market, a key issue is the disclosure of necessary information about a new equity issue. This paper argues as to why disclosure of projections and risk factors are problem areas in this connection. It then offers solutions on the basis of the Investor-Issuer-Merchant Banker-SEBI approach that seeks to make perfect all the 'four legs' of the capital market.

A. INTRODUCTION

Indian Economy has entered an era of liberalization and is opening up. With this, capital market has been witnessing drastic developments. Two developments are worth mentioning here — first, the capital market is becoming more competitive and second, it is no longer merely a resource mobilizing institution but has also become an institution responsible for efficient channelization of economic resources. These two are healthy and important developments for Indian capital market and disclosure standards and practices about a new issue can play definitely a dominant role in furthering them. Disclosure standards etc. ensure flow of necessary information into the market that makes it more competitive and they allow investors to take "*informed investment decisions*" necessary to increase its allocative efficiency. Thus, disclosure of necessary information about a new issue becomes an important issue in the present day changed scenario of Indian capital market.

Decisions to invest in a new equity issue are made under uncertainty and are risky. Hence, they are mainly based upon two parameters — *return* and *risk* associated with a new issue. To evaluate return and risk, an investor needs necessary information about them; and prospectus and abridge prospectus¹ are main means by which he/she is informed of necessary details and matters in this regard. Though their main function is to inform a prospective investor; yet they also afford an opportunity to directors and

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promoters to impose misrepresentation and frauds on the investing public. The Indian Companies Act, 1956 and SEBI Guidelines now contain a comprehensive set of regulations intended to protect them from such victimization.

Sec. 56 of the Indian Companies Act, 1956 and SEBI's Guidelines for Disclosure and Investor Protection, 1992 determine — What and how to be disclosed necessary information so as to enable investors to take informed decisions and to protect their interest at a reasonable cost to the issuing company. The contents and matters to be specified in an abridge prospectus and a prospectus must be in accordance with Form 2A and Schedule II of the Indian Companies Act, 1956 which were drastically changed during the year, 1991. These changes had required, among other things, the disclosure of necessary information about two important aspects of a company's performance which are :

- one, FUTURE PROSPECTS — expected capacity utilization during the first three years from the date of commencement of production, and the expected year when the company would be able to earn cash profits and net profits; and
- another, MANAGEMENT PERCEPTION OF RISK FACTORS (e.g. sensitivity to foreign exchange rate fluctuations, difficulty in availability of raw materials or in marketing of products, cost/time overrun, etc.).

They are perhaps introduced to influence directly prospective return and risk involved in new issues; and thus provides the investing public an opportunity to make informed and intelligent investment decisions.

B. PROBLEM AREAS : DISCLOSURE OF FINANCIAL PROJECTIONS AND RISK FACTORS

Future prospects in prospectus and abridge prospectus are given in the form of financial projections while management perception of risk factors is highlighted usually as risk factors. It is believed that information about them would improve the quality of investment decisions to new issues. But, at the same time, they may provide new opportunity to directors and promoters to misinform and to impose frauds on public. Our apprehensions in this regard are that they are likely to be misused by the issuing company. In the absence of well-established research conclusions in this respect, our apprehensions are based upon a number of arguments given below.

Possible arguments for why the disclosures of financial projections and risk factors are problem area

a. Return is a positive parameter (i.e. one that attracts) and financial projections are having a direct bearing upon it from a new equity issue. Therefore, there are chances that an issuing company may be tempted to

paint a BLUE SKY² through them. In fact, researches in this regard have proved that such projections are used to paint a future full of promises as large and unexplained variations are found between realized and projected; and hence, their reliability and usefulness have become doubtful.

b. To make investors cautious about financial projections, a caution note like — "*As a matter of abundant caution, the investors are informed that projections made . . . are only indicative and are subject to change . . .*" is added. How far such a note would be effective in transforming an investor's 'imaginary bright picture' made by exaggerated projections into a realistic one is a big question. The fear, in fact, is that unscrupulous directors and promoters may make such a note a *scape-goat* to avoid possible penal actions for making unrealistic projections.

c. It is interesting to observe that these projections are usually based upon — 'What the company wishes/plans to achieve in future'. Such projections are of no use as the information needed by an investor is 'What the company is expected to realize in future through its plans'. Thus, such projections lose their utility to investors.

d. Risk is a negative parameter (i.e. one that discourages) and it is likely that directors and promoters may understate or vaguely state risk factors which remains of no significance. A survey of risk factors stated by issuing companies in recent years may reveal statements like —

- * Government policies relating to product may affect the input cost and consequently, the demand for the company's product.
- * Changes in Government fiscal policy may affect the profitability of the company adversely.
- * The prices of raw material form a major part of the total cost of production. To that extent the profitability of the company is dependent on the price of raw material.
- * The demand for the company's product is subject to market fluctuations.
- * The sanction for power is yet to be received which the company is confident to get.

Such and like statements are too general and too vague to be of any significant consequences to investors. Therefore, the basic purpose to have them is defeated.

e. The Indian Companies Act, 1956 has laid down the necessary skeleton and not the specific details to be disclosed under future prospects and management perceptions of risk factors. Since SEBI has assumed the responsibility to vet each abridge prospectus and prospectus, it becomes necessary to standardize required details to be disclosed in this regard. However, no such well established standards have been evolved so far. But, our survey of a number of abridge prospectuses show that some standard/pattern in such disclosure does exist.

Financial Projections

Companies give financial projections about the following, for next three to five years.

- Capacity utilization
- Sales
- Other incomes
- Gross profit
- Interest
- Depreciation
- Net profit before tax
- Tax
- Net profit after tax
- Dividend
 - Percentage
 - Amount
- Share capital
- Reserves and surplus
- Earnings per share (Rs.) Annualized
- Book value (Rs.)

Companies state also some underlying assumptions about them. Further, it is noted that — some companies give financial projections duly appraised by an appraisal agency; and while others give their own projections. In a recent clarification (i.e. Clarification No. VIII released on Oct. 11, 1993) to Guidelines for Disclosure and Investor Protection, 1992, SEBI has allowed an issuer to give their own financial projections along with those which appraised by an agency together with underlying assumptions and justification for variations, if any. All this is right. But, the problem is more serious when companies give their own projections though they have appraised projections also. Though they give a note to this effect; yet they do not mention any reason thereof and this creates suspicion in the minds of investors. Therefore, such projections fail to fulfill their basic objectives.

Risk Factors

Companies mention risk factors usually related with the following :

- Government policies.
- Domestic and International Market competition and behaviour.
- Foreign exchange market.
- Acquisition of land, procurement of necessary permission, sanctions etc. from various agencies, for instance, electricity board.
- Contingent liabilities.

Some companies make their subjective observations and comments without stating the basis of such comments etc. and they may be highly unrealistic. Further, the basic purpose of abridge prospectus and prospectus is to equip investors with THAT INFORMATION which investors cannot obtain otherwise. But, the information about risk factors related to Government policies, market conditions etc. is very general information and may be obtained from other sources very economically. Therefore, such information is not of much use to investors nor to the issuer as it costs him.

f. To just mention the causes/factors of risk is not sufficient and relevant unless their effects could be determined by an investor on the risk of a new issue and his/her portfolio. In the absence of the 'likelihoods' and 'possible impacts on the company' of such risk factors, none could determine risk involved from such an issue to an investor.

g. The Indian Companies Act, 1956 requires that *the Golden Rule* (which ensures that everything in prospectus must be stated with strict and scrupulous accuracy) must be strictly observed while framing a prospectus otherwise severe consequences have to be borne by the directors and promoters. But, since future is completely unpredictable, it is almost impossible to determine the reasonableness and accuracy of financial projections and risk factors disclosed. Therefore, "misrepresentation" in the disclosure would be hard to be proved and the issuing company may be tempted to take the advantage of this fact.

h. Information about risk and return is obtained mainly through financial projections about a company's performance and risk factors. And, they are main parameters of investment decisions to a new issue. Thus, their disclosure is very SENSITIVE and any slight exaggeration about them is likely to influence an investor's decision considerably. Therefore, their disclosure must be accurate, reasonable and realistic.

The above discussion establishes that the disclosures about financial projections and risk factors are problem areas.

C. SUGGESTIONS

Like the philosophy of MAN-MACHINE SYSTEM, the right approach to tackle any disclosure problem will be INVESTOR-ISSUER-MERCHANT BANKER-SEBI system approach. Perfection of one cannot give the desired results. We need 'perfection of all' approach. Therefore, our ultimate target should be to have well educated investor, honest and responsible issuer, well developed and responsible merchant banker and of course, a well matured leader SEBI, and hence, all should feel concerned about it.

Investor

An investor must feel a responsible element of the capital market and must be able to use effectively his/her *cheque power*. He/she must understand well that investment in equity is a risky proposition and it is he/she who has

to bear the risk and no one else. Investors must make clear from time to time to the concerned authorities 'what information they wish that the issuing company must disclose' because otherwise the authorities may feel constrained. Further, they should try to make their decisions as intelligent as possible and take only calculated risk. SEBI can play an active role in the education of investors and in fact, some attempts have also been made in this direction. For instance, in Jan. 1993, SEBI advised investors as to what factors they should take into account when they invest in primary market and we wish that SEBI would continue its efforts in this direction further.

Issuer

It is felt that the issuer is hesitant in disclosing information about risk factors as they are usually negative aspects of it. However, it is not necessarily true because the issuer may get some advantages out of their disclosure e.g. such disclosure may make things more transparent and thereby increase the confidence of investors, the issuer will make investors' expectations more realistic which would pay ultimately in the long run to the company, and *high risk* is not something unwanted in the market as there may be investors looking for high risk opportunities. Therefore, the issuer should not feel hesitant in disclosing necessary information about risk factors etc. as it is in their long term interest to have necessary transparency in its disclosure.

Merchant Banker

A merchant banker has definitely a prominent role to play in this respect. He provides 'FIRST LINE OF DEFENCE' against any misrepresentation in prospectus and abridge prospectus as he is supposed to issue a certificate of due diligence along with the draft prospectus. SEBI does not consider him merely as an intermediary that has to be registered and regularly monitored rather it looks him as its active partner in the capital market. He must ensure that

- first, disclosures about financial projections and risk factors must be adequate, authentic and accurate;
- second, make sure that his clients are providing only appraised financial projections as far as possible and that too by a well recognized appraisal authority; and
- third, if different interpretations exist, then he must ensure that any interpretation giving benefits to his clients should not result in a loss/cost to investors. Thus, a merchant banker should behave like a matured professional serving his clients well and at the same time does not allow them to create a BLUE SKY through financial projections and risk factors.

SEBI

After the abolition of the Capital Issues (Control) Act, SEBI has assumed the responsibility of protecting investors' interest in the capital market. It has done a great deal in this regard and specially, with regard to disclosure: But, a lot is still to be done. In this regard, we suggest the following.

- To provide an information has a cost. But, with the passage of time this cost is considerably reducing due to developments in the areas of information technology and computing. Therefore, SEBI must review its guidelines on dynamic basis because the information that was uneconomical to issuers earlier may have become economical and thus, can ask them to provide it.
- It is good that an era of no information about risk factors is over. So, we have a beginning and the ideal in it is that investors must have sufficient information so that they are able to quantify risk as a single idea. At present, this ideal may seem to be impossible. But, a day will come that we shall achieve it. With this hope, we expect SEBI to move step by step in this direction asking more and more crisp and objective information to be disclosed gradually.
- At present, the communication of financial projections gives a feel as if such information is certain. SEBI must ensue that they are communicated as uncertain information and to start with SEBI may ask the issuer to give optimistic, pessimistic and most likely estimates about each; only then their true nature will be reflected.
- SEBI should insist upon those risk factors which are internal and those about which investors cannot get information otherwise. General risk factors may not be insisted upon for disclosure.
- Since listing of just only risk factors is not sufficient, the issuer must be asked to disclose chances/likelihood of their occurrences along with their likely impacts on the company. In this regard, we suggest that risk factors should be communicated in the manner that their chances of occurrence along with their impacts and contingent strategy, if any, to reduce their bad effects must be clearly expressed. It may not be possible to quantify the chances and effects but they can be expressed as linguistic variables and some suitable scale can also be developed.
- Finally, SEBI must have a data bank having necessary information about industries and economy so that if a draft prospectus comes for vetting, then it should be capable of verifying the claims of the issuer.

D. CONCLUSION

Disclosures about financial projections and risk factors are some problem areas in the disclosure guidelines. To approach this problem, we suggest

INVESTOR-ISSUER-MERCHANT BANKER-SEBI system approach, that makes perfect all the FOUR LEGS of the capital market. As such some suggestions are made. We are quite optimistic that these problem areas would be vanished soon as the Indian capital market is showing some healthy trends like changed attitudes of the authorities about the philosophy of control, i.e., a change from the bureaucratic controls to market oriented controls. With increased maturity in the FOUR LEGS of the market, we shall find that the issuer is willingly providing authentic and realistic estimates about financial projections and risk factors.

NOTES

1. The concept of abridge prospectus came into force w.e.f. Nov. 1, 1991 and is a memorandum containing such salient features of a prospectus as may be prescribed.
2. In U.S.A., the State laws regulating the sale of new securities to the public are known as BLUE SKY LAWS as they attempt to prevent situations in which nothing but BLUE SKY is promised.