

# Intermediate Financial Reporting



Lecturers name G. Frost, L. Iuff

and N. Arthur

Date submitted

May 10<sup>th</sup>, 2002

Title of assignment

Case study 2

Student's Name

S.I.D. Number:

**Antonius Andrianto Touw**

**0151837**

adrian2000\_id@yahoo.com

**Ananto Prabowo**

**0166307**

kalemguy@hotmail.com

**Jimmy F. Fakhrudin**

**0144212**

Jfak3767@mail.usyd.edu.au

Faculty of Economics and Business  
2002

## Part 1

### **a. Why would Smorgon Steel Group Limited write down goodwill by \$193 million? Provide reasons and technical references to support your answer**

- Within Australia, *internally* generated goodwill shall *not* be brought into account (AASB 1013.4.1). The reason for this, according to AASB 1013, is that *purchased* goodwill can be measured more objectively rather than *internally* generated goodwill. As AASB 1013.5.1.2 states: Purchased goodwill can be measured more reliably on the basis of the amount paid for it, than can *internally* generated goodwill which is *not* usually capable of being measured reliably. Purchased goodwill is measured as the excess of the cost of acquisition. Pursuant to the article (Australian financial review) Smorgon's company was forced to bid for the entire group of ANI rather than taking over just the assets in which it had an interest. In fact, after ANI was assessed by *Independent* valuer (Spencers corporate). The acquisition cost of ANI exceeded its recoverable amount. Thus the goodwill has to be written down according to its recoverable amount (AASB 1010.5.1).
- The Board of management had the interest, to expense this written-down amount in adjacent year to gain the benefit by increasing earning for the next financial year (Roy Horsburg, the age). Additionally, the increasing earnings in the next financial year would also have the impact to increase the price of ordinary shares. The higher the price of ordinary shares the lesser number of ordinary shares that can be converted by CPS holder. It prevents the CPS holders to convert their shares to become ordinary shares thus; the CPS holders are more attracted to convert their share to become RPS.
- The written down of intangible assets was also justifiable as regards with the economic downturn at that time.

### **b. Under what circumstances would Smorgon Steel Group Limited consider another write-down of goodwill? Provide business and technical reasons to support your answer.**

Smorgon Steel group would consider another write-down of goodwill under the following circumstances:

- Smorgon Steel as a group manages the operation of 16 different brands. The company's policy for another wrote down is probably pursuant to the

rationalisation of those 16 brands to become one smorgon's brand. Thus the company also has to write off some intangible assets (including goodwill), which were previously recognised. Hence, the future economic benefits as relate with those intangible assets are not probable any longer (AASB 1013 .5.1.3).

- Moreover, the board of management also has the objective to focus on the core business by concentrating in steel industry. This policy is in accordance by divesting non-core businesses. The divestitures will likely to further write-down of the goodwill components. The likeliness of future economic benefits deriving from those businesses will no longer in existence (paragraph 40 SAC 4).

## Part 2

### **a. The article from the Age “Iron or Kryptonite” refers to the “dilutive effect” of the Converting Preference Shares. What is meant by this statement and how does it apply to Smorgon Steel Group Limited? Consider management and financial issues.**

Even though Smorgon Steel group is a public listed company. However the majority number of the ordinary share (67%) is still in the hand of Smorgon's family.

In 1999, Smorgon Steel issued approximately 99.3 Million Converting Preference Share (CPS) as part of their financing plan for the acquisition of Australian national Industries Limited. Under the terms of the CPS and assuming an ordinary share price was \$1.00 (as at September 2001 when the article was published). The CPS might be converted into a total of approximately 221 million ordinary shares by 31st march 2002. This amount of converted shares represents of 29% of the existing ordinary shares. In the event of conversion, the Smorgon;s family shares would be diluted from 67 percent to 50 percent approximately and this could probably have an impact of their voting power as well.

Hence, the increasing number of shares as a result of conversion will reduce the earning per share (EPS). It also could cause the decrease of share price resulted by the selling pressure (of increasing number of ordinary shares that is available in the market).

The dilutive effect (as above mentioned) in this context is related to the existing *ordinary* shareholder. The existing ordinary share holders will bear great losses, not only from the reduced percentage number of shares in proportion with respect

to their 'controlling power', but also lowering their earning per share. Furthermore, they have to suffer another loss as a result of lowering share price caused by selling pressure.

**b. What alternative courses of action did the directors of Smorgon Steel Group Limited pursue to change the “dilutive effect” of the Converting Preference Shares? Why did the Directors of Smorgon Steel Group pursue each of these courses of action?**

The board of directors pursued the *first* RPS proposal. However it was unsuccessful because failed to obtain the support of 75% votes in favour of the proposal. Thus, the proposal was defeated.

The alternative course of the Smorgon's directors *to prevent the dilutive effects* is by issuing the revised Reset Preference Share (RPS).

The key features of the RPS are:

- The face value of each RPS is \$2.00
- The RPS dividend will be 8.0% per annum and *fully* franked.
- RPS converts at 5% discount to the price of Ordinary share at the time of conversion.
- RPS are perpetual and incorporate a reset feature that enable RPS holders to request *conversion* into ordinary share or retain their RPS on the new terms offer by the company on the reset dates.
- The company may *repurchase* RPS at 105% of face value, subject to the conversion minimum and maximum.

The revised proposal was successful in acquiring more than 80% votes in favour of RPS. The holder prefer to second proposal due to a material differences to the previous proposal, which include:

- The exchange offer is *voluntary* and will only apply to CPS holders who *choose* to participate (whereas the previous proposal, if approved, would have cancelled **all** CPS).
- As the directors consider it was desirable to encourage participation in the exchange offer by CPS holders since the RPS (like CPS) will pay 8% rate per annum dividend until at least 2005 compared to 7.5% per annum based on previous proposal.

- 111 RPS will be issued for every 100 CPS (rather than 1 for 1 basis under the previous proposal) in order to provide compensation to electing CPS holders for the 10% discount which they would have received on conversion of the CPS;
- The proposal does not involve any cash payment to CPS holders.

The objective for the directors pursued the first and second RPS proposal is to prevent the conversion of CPS to become ordinary shares. The conversion of CPS will increase the number of ordinary shares (dilutive effect) and decrease EPS (earning per share). Hence dilutive effect is probable to reduce the share price caused by selling pressure. Moreover the dilution of shares will have the impact in decreasing the control of majority shareholder (Smorgon's family) in managing this company. In light with management point of view the RPS issuance would hamper the dilutive effect.

**c. Discuss the effects the alternative courses of action have or will have on the financial statement of Smorgon Steel Group Limited?**

Smorgon Steel Group classified their Reset Preference Share (The second successful proposal) as its Shareholder's Equity (Share Capital – Preference Shares) while its related periodic payment (dividend) is treated as a *distributable profit* rather than *expenses*. According to AASB 1033 .4.2.8, the key factor in differentiating a financial liability from equity instrument is the existence of *contractual* obligation, regardless of the manner in which this obligation will be settled. If a financial instrument has the obligation to either deliver cash or another financial instruments unfavourably to the issuer, it could be classified as *financial liability* instrument.

The particular terms of a particular equity or debt security may be different, but it is possible *to structure* particular claims on one type of instrument as *if* the instrument has some characteristics of other type.

The characteristics of the financial instrument in the prospectus that support The Reset Preference Share (RPS) to be classified as **equity** are:

1. The issuer can repurchase (buy back) RPS for 105% of the face value at its option (AASB1033 app 7).

2. Dividend payment is non-cumulative and subject to current distributed profit being available. (AASB 1033 app 25)
3. The dividend is fully franked.
4. RPS is exposed to fair value (AASB 1033.4.2), conversion ratio equals the face value divided by the VWAP (generally, 95% of the volume weighted average sale price of the issuer's ordinary shares sold on ASX), subject to the conversion minimum and maximum.
5. In the event of winding up the company, the RPS holders rank after creditors, but prior to any other classes of shares (AASB 1033. 4.2.1).
6. It is listed at Australian Stock Exchange (ASX) as shares, and has to comply with ASX listing rules.

On the other hand, the RPS does have some characteristics of **debt**, which are:

1. The RPS has a *fixed* rate for dividend (8% per annum) (AASB 1033 app 22)
2. The RPS has *no* voting right (SAC 4, Deegan. C 2002, pg 300).
3. RPS has *no* fixed conversion date. However, The conversion can occur on reset date, on tax event or on trigger event (AASB 1033 app 20).
4. The RPS can be *converted* into the number of ordinary shares. (AASB 1033. app 23, app 20)
5. Smorgon Steel have compulsory liability to pay his liability ("dividend") and if a dividend is not made RPS holder can give notice to convert their RPS into ordinary shares (AASB 1033 app 19).
6. In a winding up of Smorgon steel, RPS holders will be entitled to a return of capital consisting of the face value of the RPS plus any accrued but unpaid dividends (Non-Asset) (AASB 1033 app 19).

The additional debt as a result of the issuance of new securities could breach the debt covenant and may lead to the possible winding up of the company. Moreover, if the securities were defined as 'debt', the associated payment would be treated as interest, which would lead to reduction of reporting profit. We are able to identify that RPS as a financial instrument has six characteristics of debt and six characteristics of equity. Normally, when the debts characteristics are *on a par with* the equity characteristics in a financial instrument. A firm would typically tend to disclose lower level of debt or that is to say that *equity disclosure is preferable*. (C.Deegan, 2002).

## References

CPA Australia and The institute of chartered accountants in Australia, *Accounting handbook 2002*, Prentice Hall, vol.1, 2002.

Deegan, Craig, *Australian Financial Accounting*, Mc Graw Hill-Irvin, third edition, 2002.

Smorgon Steel Group limited Website

<http://www.smorgonsteel.com.au>

The age newspaper

<http://www.theage.com.au>

Australian Financial review

<http://www.afr.com>