

HOOKER CORPORATION: A CASE FOR CASHFLOW REPORTING?

Hooker, arguably one of Australia's premier real-estate developers, collapsed in July 1989. At November 1989 its principal banker, Westpac Banking Corporation, was owed an estimated \$A200 million; the Commonwealth Bank \$A90 million; PNC International \$A66 million; and the State Bank of NSW, Mitsubishi Bank, Citibank, Bank of Nova Scotia, First Fidelity and First Chicago \$A50 million.

It is easy to see, with hindsight, that the confidence of Hooker's bankers had been sorely misplaced. But were there any forewarnings of the impending problems?

Certainly, none would have been apparent from a traditional ratio analysis. But a careful examination of the company's cashflows would probably have suggested that considerable caution was warranted. Indeed, the most striking characteristic of Hooker Corporation during the years before its collapse was its inability to generate cash internally – that is, from operations.

CONVENTIONAL ANALYSIS

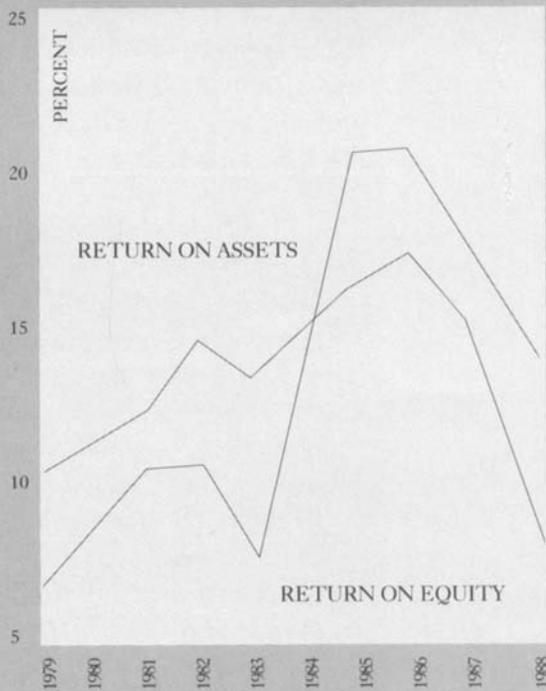
Figures 1, 2 and 3 show Hooker's profitability, liquidity and solvency for the decade before its collapse. The figures are based on the financials, as presented, in each of the respective years.

Return on equity trends upwards for most of the decade, but falls off moderately after 1986. Return on assets shows a similar, if less volatile, pattern. The liquidity ratios are

This study was prepared from public information as a basis for classroom discussion, rather than to illustrate effective handling or otherwise of an administrative situation. It was suggested by an earlier case analysis of the W.T. Grant bankruptcy in the US by James A. Largay III and Clyde P. Stickney, which appeared in the Financial Analysts Journal (July/August 1980).

In the 1988 annual report of Hooker Corporation, the chief financial officer's review of performance contained the following: "The confidence of major banks with regard to Hooker's strategy is reflected in the large increase in banking lines negotiated during the year, with a number of United States and Canadian banks joining the group as lenders."

FIGURE 1: PROFITABILITY RATIOS



relatively stable during the early years and actually show significant improvements up to 1988, the year preceding failure. Leverage improves (ie, decreases) slowly until the year preceding failure. The pronounced drop in 1987 is caused mainly by Hooker's controversial treatment of \$141.4 million deferred profits arising on a liability assumption agreement. If these are treated as a non-current liability (as Hooker was obliged by the National Companies and Securities Commission to do in its 1988 accounts), then leverage in fact increases in both 1987 and 1988.¹ Interest cover, while variable, always exceeds 1x.

NET PROFIT AND CASHFLOWS

Figure 4 plots Hooker's net profit, "funds from operations" according to AAS12 "Statement of Sources and Application of Funds",² and cashflow from

operations. Cashflows have been calculated in accordance with the US standard FAS 95 "Statement of Cash Flows", which is similar in most respects to the recently released AASB 1026 "Statement of Cash Flows". The latter standard becomes binding on Australian companies reporting on or after 30 June 1992. Consistent with US practice, we have classified "interest paid" as an operating item. While the exposure draft preceding AASB 1026 (ED52) proposed classifying "interest paid" as a financing activity, the standard does not commit itself on this issue. Either way, the inferences we draw here are unchanged.³

Note how little additional information, relative to net profit, is conveyed by the funds flow statistic. This visual impression is reinforced by the results of several US studies which show that, over large samples, firms' earnings, earnings with depreciation added back, and funds (working

FIGURE 2: LIQUIDITY RATIOS

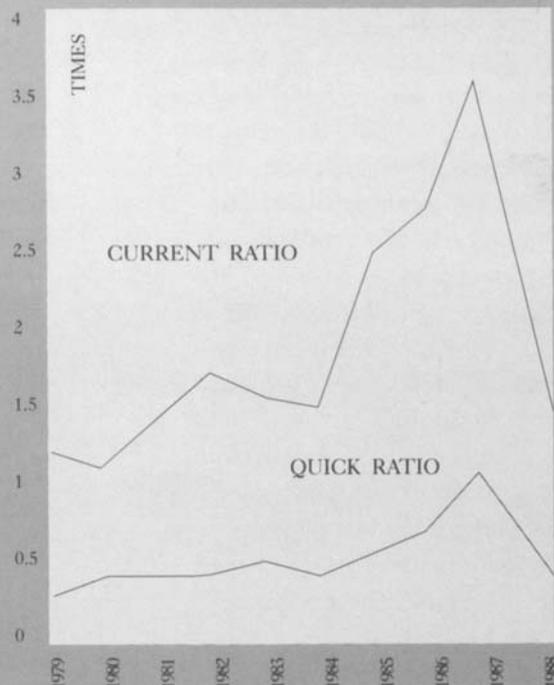
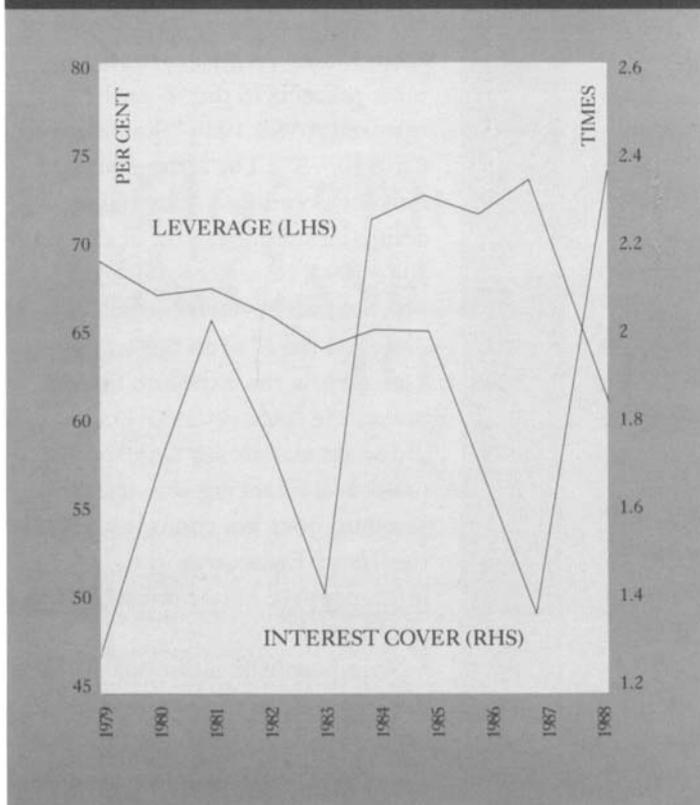


FIGURE 3: SOLVENCY RATIOS



capital) from operations, correlate highly – they tell much the same story. In contrast, cashflow from operations does not – it tells a different story, just as it seems to do here.⁴

The most striking aspect of Figure 4 is Hooker’s inability to generate any significant amounts of cashflow in the decade preceding its collapse. Between 1980 and 1984, net cash generated by operations was, on average, positive but extremely modest. Significantly, in the four years preceding the collapse, operations was a net user of cash. Yet over this time dividends increased dramatically – from about \$10 million to \$34.5 million – and the financing mix was highly unstable.⁵ Hooker’s inability to generate cashflows to fund its distributions should probably have provided its creditors and investors with an early signal of problems. But did it?

As we said at the outset, major creditors seem to have been over-confident about the company. On the other hand, investors (ie, the capital market) appear to have been rather less optimistic. Hooker’s stock-price performance, as shown in Figure 5, suggests that, after adjusting for risk, the company had been significantly underperforming both the market and its industry since 1985 or earlier.

Indeed, Hooker underperformed relative to its industry in about two-thirds of the 59 months before its collapse. Its monthly excess return averaged -1.7% which, on a one-tailed basis, is significantly different from zero at the 10% level ($t = 1.37, p < 0.10$).⁶

SUMMARY

This case-study suggests:

- there is little information in “working capital” concepts of funds beyond that contained in the net profit figure; and
- in the years preceding its collapse, Hooker’s share-price performance was more consistent with its underlying cashflow experience than its reported profits.

While it is difficult to generalise from a sample-size of one, both of these results have been reported in far more sophisticated research

studies, using far larger (United States) samples. Taken together, these results suggest that the AASB’s decision to dispense with AAS12 (ASRB 1007) and replace it with a cashflow statement is appropriate.

Of course, this begs the question of why the cashflow reporting requirements proposed in the 1986 exposure draft amending AAS12 were never implemented.

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NOTES

1 The debt/assets ratios were 63.1% (up from 49.3%) and 73.6% respectively. Note that the increase in 1988 occurs even after asset revaluations of approximately \$100 million.

2 Hooker provided AAS12 statements only for the 1987 and 1988 years. The time-

FIGURE 4: HOOKER CORPORATION LIMITED NET PROFIT, FUNDS (WORKING CAPITAL) AND CASHFLOWS FROM OPERATIONS – 1979-88

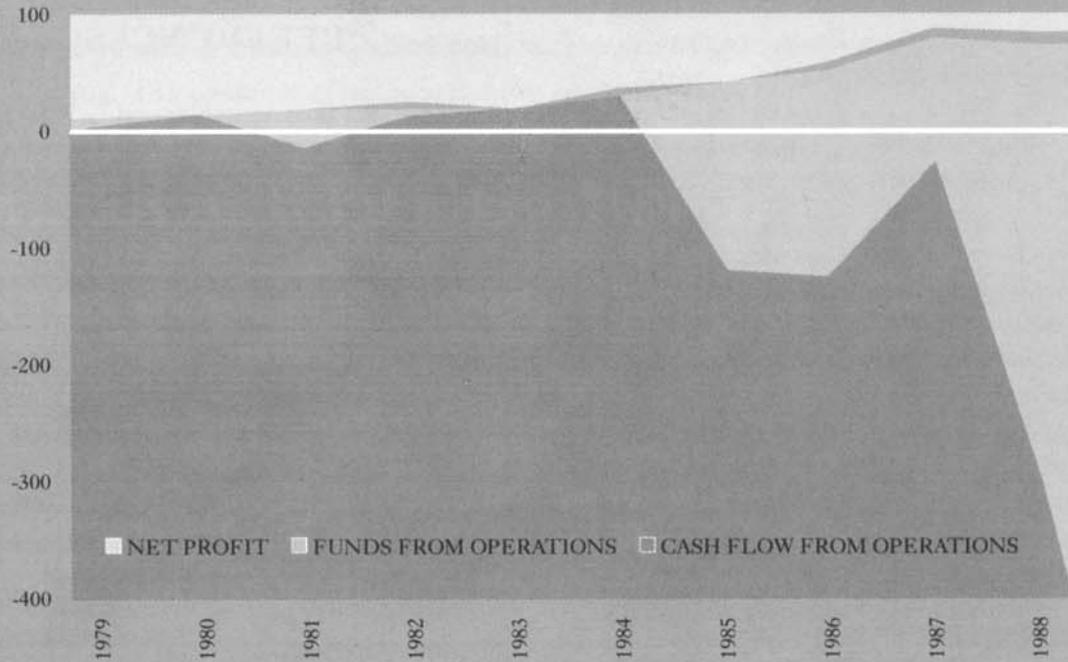
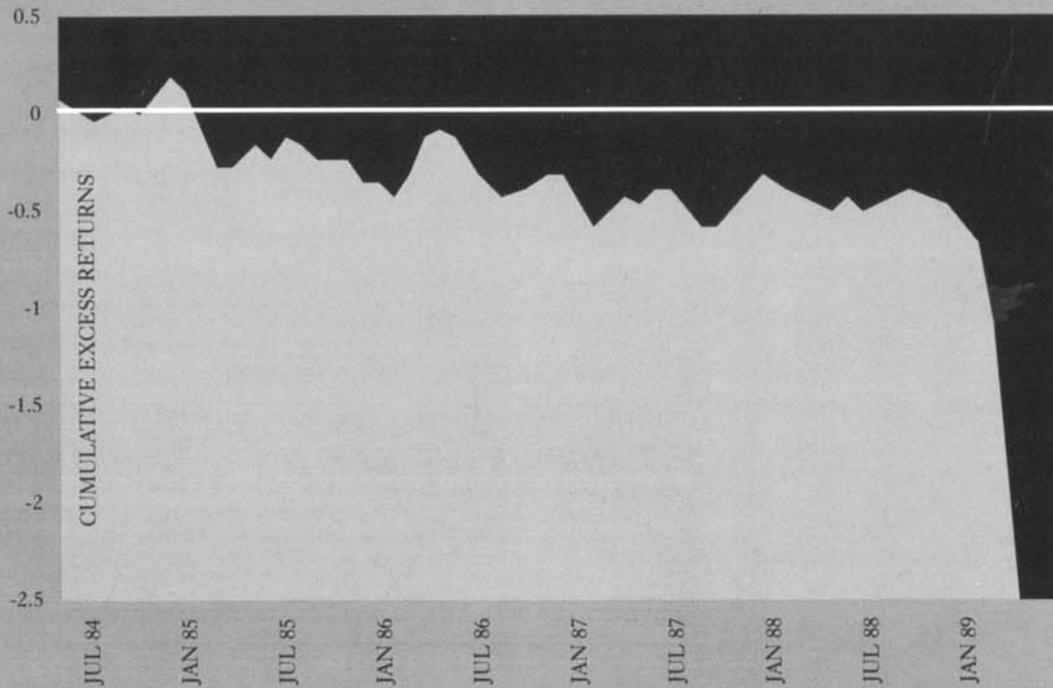


FIGURE 5: HOOKER CORPORATION – EXCESS RETURNS ANALYSIS*



* Cumulative excess returns are calculated as

where
$$CER = \sum_t (r_{it} - r_{ft} - \beta(r_{mt} - r_{ft}))$$

r_{it} = return on Hooker shares in month t (adjusted for dividends and capitalisation changes),
 r_{ft} = monthly return on 13-week treasury notes,
 r_{mt} = monthly return on CRIF equally weighted market portfolio,
 β = an OLS beta estimate over the period July 1984 to January 1989.

series is our estimate of Hooker's funds flow per AAS12.

3 With interest classified as a financing item, cashflows from operations become positive in 1987; otherwise the picture remains very similar.

4 Refer to Bowen, Burgstahler and Daley (1986) and Wilson (1987).

5 Over the interval, dividends paid increased by between 45% and 55% a year until 1988. At the same time, new borrowings were increasing significantly and their composition was switched annually between long-term and short-term. Dramatic increases in both sources occurred in 1988 to fund the ill-fated purchases of four struggling US retailing chains and to provide additional financing for the Colombia and Cincinnati "super-malls".

6 Calculated using the Sharpe-Linter version of the Capital Asset Pricing Model

with a beta of 1.65 (std error = 0.15). Similar results obtain when we simply benchmark Hooker against its industry (with and without the October 1987 crash).

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Bowen, R., D. Burgstahler and L. Daley, "Evidence on the Relationships Between Earnings and Various Measures of Cash Flows", *The Accounting Review*, October 1986, pp. 713-25.

Largay III, J.A. and C.P. Stickney, "Cash Flows, Ratio Analysis and the W.T. Grant Bankruptcy", *Financial Analysts Journal*, July- August 1980, pp. 51-4.

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