

CHAPTER 1

INTRODUCTION

1.1 Background

In order to make rational investment decisions, users of corporate annual and interim reports require an extensive range of financial and non-financial information, whether mandatory or voluntary, in order to assess the market value of an investment in shares. Rath (1977:36) describes accounting as a socio-techno-economic process which is highly influenced by the environment. He argues that the basic objective of an accounting system is to provide information that presents the true financial picture of a company which will enable users of financial statements to make wise investment decisions.

In South Africa, the extent of current traditional methods of financial reporting is restricted to a mandatory form of accountability by the directors to the users, that is shareholders and investors, of corporate annual reports. This form of disclosure decreases the value relevance of accounting information. Furthermore, the current system of financial reporting presents mainly historical and factual financial information, neglecting relevant economic, political, environmental, ethical and social issues. Such issues are usually not recorded or covered in annual corporate reports, as they are regarded as immeasurable in monetary terms. Gray (1994:27) noted that accounting should be a social rather than a strictly economic concept and that a broader concept of accountability would recognise a wide range of groups or individuals with potential rights to information.

The voluntary disclosure policies of companies tend to be controversial and companies need to make decisions in favour of or against the disclosure of certain informative items. The annual report of a corporation is a potentially powerful mechanism for

imparting the superior knowledge and expertise of top management regarding the corporation's present and future strategies and operations to outside investors. It follows therefore that management are in a position to enhance the effectiveness of their chosen tool of communication, namely the annual report, by developing and improving voluntary disclosure policies and strategies that have a positive impact on the company's standing, as perceived by investors, and, as a consequence, influence the market price of the company's shares. However, reporting excellence is no guarantee of a favourable market rating by investors, particularly if financial performance is weak. Hence, there is a great deal of controversy as to whether a company's voluntary disclosure policy has any impact on its share prices.

What types of voluntary information should be disclosed? And how does this disclosure affect the market price? Gray (1994:33) proposed the development of a reformed system of voluntary information disclosure which is decision critical in satisfying the needs of those it is serving by making an impact on the users' wealth arising from capital gain (whether man made or natural). Employees, customers, the community and society have a right to financial and non-financial information and if they voice their opinions and apply pressure on compilers of annual reports, a more valuable form of accountability and stewardship would emerge. Kim (1993:747) deduced from his model that there is no optimal voluntary disclosure policy. This can mainly be ascribed to the heterogeneous nature of shareholders. He believes that firstly, better informed shareholders prefer less disclosure than their less well-informed counterparts and secondly they have different risk tolerances. Enterprises, too, have to weigh up the adverse risk-sharing effect against the beneficial cost-saving effect that disclosure has on shareholders. They then have to balance this against information acquisition cost functions.

1.2 Objectives and scope of the study

The usefulness and value of the voluntary or discretionary disclosures made in the annual reports of South African listed companies, measured in terms of its impact on share prices, is continually subjected to extensive research. The main focus and

objective of the research presented in this study was to examine the extent and importance of voluntary disclosure practices in the annual reports of corporations, thereby contributing to and complementing previous studies.

Obviously, voluntary disclosure is a huge field of study and it would have been practically impossible to include all areas of voluntary disclosure. Therefore this study of the desirability and importance of voluntary information disclosure in corporate reports was limited to only certain aspects of voluntary disclosure and the nature of those aspects. This study also did not attempt to deal with issues on accounting method choice or address information made available through any other formal or informal external communications media, such as press releases, brochures, exhibition stands, newsletters, product launches, event management, packaging or advertising.

The purpose of this research was, firstly to briefly review the evolution of corporate disclosure in general in annual and interim reports, secondly to highlight and define the concept of voluntary information disclosure, thirdly to outline the historical development of voluntary disclosure items and, finally to analyse its current-day extent and importance as well as its effect on share prices.

To achieve these objectives, the study was conducted in two parts. In the first part, the actual extent of voluntary disclosure in practice is examined and empirically tested to show the association between firm characteristics and level of disclosure. In the second part of this study, the results of an empirical investigation into the importance and price informativeness of voluntary disclosure as perceived by compilers and users of annual reports, is presented. The investigation takes the form of a perception survey, in which the opinions of compilers and users were obtained by means of a postal questionnaire. The survey was performed in order to substantiate whether the needs of investors are met by the extent of disclosure of companies.

1.2.1 Hypotheses formulation

The research tests the hypothesis that there is an association between firm characteristics, market price volatility and the extent of voluntary information disclosure in the annual and interim reports of listed industrial companies on the Johannesburg Stock Exchange. The research addresses the question of whether identifiable and measurable factors can be associated with the extent to which firms disclose voluntary information. Independent variables such as the structural and performance characteristics of companies were used to explain differences in the levels of voluntary disclosure. A stepwise regression model is used to determine which variables best explain the extent of voluntary disclosure and its association with share prices.

The following aspects were discussed in the testing of the hypotheses:

- the technical theory of voluntary disclosure in annual reports;
- past and current voluntary disclosure practices of South African listed companies;
- evaluation and extent of current voluntary disclosure techniques;
- perceptions of compilers and users regarding the price informative value of voluntary disclosure in annual reports and interim reports; and
- proposals for enriched alternatives.

1.3 Methodology and data base

The data and research methodology are discussed fully in chapter 7 and the empirical results and their implications are discussed in chapters 8 and 9. Briefly, the extent of both quantitative and qualitative voluntary disclosure, was measured by means of a weighted index of disclosure items similar to ones used in the studies of, amongst others, Cerf (1961), Singhvi and Desai (1971), Buzby (1974, 1975), McNally, Eng and Hasseldine (1982), Firer and Meth (1986), and Malone, Fries and Jones (1993). The annual reports of 188 companies were examined in order to identify and evaluate various voluntary disclosure items provided by companies. The disclosure items were

then evaluated by financial directors, being the compilers of annual reports and users to determine their perceptions of the importance of each disclosure item in an investment decision. Compilers and users of annual reports were approached so as to validate any material differences that might have arisen from cross-sectional data analysis.

The study included the following steps:

- identification of voluntary disclosure items and discussion of their importance to investors;
- review of prior research and relevant literature on voluntary disclosure by corporations;
- development and preparation of an annual and interim report evaluation scoresheet aimed at examining the extent of voluntary disclosure in annual reports published by industrial companies listed on the Johannesburg Stock Exchange from 1993 to 1998;
- design and drafting of questionnaires that were sent out to compilers (financial directors) and users (shareholders and security analysts) to determine their perceptions of the relative importance of each voluntarily disclosed item and its effect on the market price of a company's shares;
- testing of the research hypotheses by implementing a multiple stepwise regression and correlation analysis; and
- drawing of conclusions and making recommendations.

1.4 The importance of the study

Electronic access to business information via links between providers of capital and the data bases of companies for instance on the internet, has revolutionized the dissemination of information and reduced the informative value of annual reports. Unless the present company reporting model, is improved, the annual report will lose its information relevance completely.

The research conclusions of this study may help compilers of annual reports to formulate effective voluntary disclosure policies which would in turn serve to improve communication. The recommendations may help accounting standard setters to prioritise the information items required by users.

1.5 Limitations of the study

For the purposes of this study, only companies listed in the industrial sector of the Johannesburg Stock Exchange was used, because the reporting policies and requirements of mining, banks and insurance companies are not comparable with those of industrial companies. The databank of the Bureau of Financial Analysis of the University of Pretoria was used as the primary source of information.

1.6 The structure of the study

The following is a synopsis of the 10 chapters of this study:

Chapter 1 Introduction

This chapter covers the objectives and scope of the study, the research methodology, the importance of the research, limitations and the structure of the study.

Chapter 2 The evolution of corporate disclosure

This chapter focuses on the earliest forms of financial disclosure, the historical development and emergence of reporting legislation world-wide and the influence of the Johannesburg Stock Exchange and reporting awards on voluntary disclosure practices.

Chapter 3 Constituents in the financial information market

The informational needs of internal and external users of annual reports are investigated.

Chapter 4 Voluntary disclosure in corporate annual reports

The nature, characteristics, benefits and cost of voluntary disclosure are examined. Aspects of market efficiency, investor behaviour and factors affecting share price volatility are identified.

Chapter 5 Voluntary disclosed items perceived as price-informative to compilers and users

Voluntary disclosed items used in the survey are identified in this chapter and their importance is discussed.

Chapter 6 Prior research on voluntary disclosure in corporate reports

A literature study was conducted to ascertain the extent of previous studies on voluntary disclosure and the methodology implemented and to evaluate the findings of the various studies. These past empirical studies formed the basis of further research on this debate.

Chapter 7 Research methodology

In this chapter the research methodologies employed in the two studies are discussed more fully with the focus, firstly on the design and development of the disclosure index used to measure the extent of voluntary disclosure and secondly on the two questionnaires used to extract the perceptions of users and compilers of the price-informative value of voluntary disclosed items in corporate reports. Selection criteria

for the sample groups are detailed and the response rate is discussed. Hypotheses are stated, followed by a discussion of the statistical analysis used to test the hypotheses.

Chapter 8 Results of the first empirical study

The research findings of the first empirical study are presented and conclusions are reached.

Chapter 9 Results of the second empirical study

The research findings of the second empirical study are analysed and conclusions are reached.

Chapter 10 Summary of conclusions and recommendations

This chapter contains a brief summary of the preceding work as well as recommendations. Future research areas are also identified that could fruitfully be researched further.

1.7 Conclusion

The goal of this study is to make a meaningful contribution and add value to the future development and fundamental reform of voluntary disclosure practices of listed industrial companies in South Africa. In order to satisfy the growing information needs of users and compilers of annual reports of the 21st century, greater emphasis must be placed on the usefulness, value and relevance of annual reports. However, there is a fine balance between the provision of useful information and an information overload. Therefore future accounting standard setters will have to be wary of falling into the trap of changing voluntary items into requirements. Such a situation would contribute to disclosure overload without adding value to annual reports.