CHAPTER 3

CONSTITUENTS OF THE FINANCIAL INFORMATION MARKET

3.1 Introduction

Historically, annual reports were compiler-oriented and not user-oriented. Users of financial reports did not play an important part in the preparation of annual reports. Traditionally, users neither voiced their opinions on value reporting nor put pressure on compilers to conform to the changing needs of both financially sophisticated and less financially sophisticated users. Present-day users are more sophisticated and their increased access to electronic databases enables them to perform a higher level of analysis of financial reports. Their survey lead Epstein and Pava (1993:19) to conclude that more sophisticated investors tend to use financial statements more thoroughly than less sophisticated investors. They suggested that compilers should attempt to simplify financial statements so that less sophisticated users might find the annual reports more useful for investment and credit decisions. The implication of these divergent needs is that more attention should be given to the different preferences and needs of users and the information required by them.

In defining useful and relevant information to execute informed decisions, users of annual reports and their compilers must be identified and the extent and nature of their needs must be examined. In respect of users, Ogan and Ziebart (1991:403) point out that corporations are artificial entities created to serve the interests of people. In serving the interests of users, namely to increase earnings and capital, the objectives of compilers of financial statements should be examined to understand the context in which the financial statements are prepared. It is left to the compiler of annual reports to decide whether to take a negative approach and only provide the minimum information required by statute, or positively present the corporation's financial performance in the most favourable way by disclosing more information than the required statutory minimum. However, in striving to satisfy the needs of all stakeholders, annual reports often fail to be of use to any one specific user group.

Necessary changes to improve and evolutionise financial reports so as to adjust to the rapid advance in technology and increased competition, should immediately be implemented. This will also have the effect of enhancing the efficiency of the national and international capital markets. Participants involved in the preparation and utilisation of annual reports should be motivated collectively to introduce reforms in the reporting system that will benefit all stakeholders and bring about increased usefulness of financial reporting.

Ogan and Ziebart (1991:387) contend that the accounting profession, in order to fulfil their public responsibility, must assume a more active role in determining precisely what information the constituents need. They must act as leaders in the quest for enhanced responsibility in the markets for information. Just as Gloeck and de Jager (1993:1) identified the "expectations gap" in the auditing profession in South Africa, the problem of an expectations gap or perhaps a communications gap between the users of information and the compilers of information in annual reports has been identified. Compilers and users need to get together and draft a conceptual framework that will satisfy the different and often conflicting needs of both groups. It is imperative that the accounting profession takes an insightful viewpoint by considering the various constituencies of the firm rather than assuming, myopically, that there exists a single "general" user of financial statement information (Ogan & Ziebart 1991:389).

In order to explore the nature and size of the communications gap, Eccles and Mavrinac (1995:14) conducted a survey in which the attitudes of corporate managers, financial analysts and portfolio managers towards disclosure and communication were examined. Their survey supported critics' contentions that the communications systems of the capital markets are imperfect and that fundamental changes should be made to ensure that information disclosure strategies are incorporated. Their results showed that one third of the managers perceived themselves as working actively to anticipate concerns and questions of external constituencies. This group attempted to maintain a continuous dialogue with analysts and investors. On the other hand, only 6% of the analysts and 4% of portfolio managers believed that companies adopted this strategy. Nearly 40% of the analysts and almost 65% of portfolio managers believed that companies merely complied with legal requirements and only offered additional information if the companies considered it relevant to themselves for the sake of their image.

Various constituencies or stakeholders require information on whether a company is operating effectively and efficiently. These groups base their findings on an examination of annual reports. Therefore these stakeholders should be involved in decisions on what should be disclosed. However, companies will only be able to accomplish this if they know who the users are and what they need.

3.2 Definition of a constituent or user

Gotlob (1985:16) defines the critical constituencies as "those groups within the environment of an organization having the ability to affect the continued well-being (and even survival) of the focal enterprise, either by withholding important resources from the organization or by imposing unilateral sanctions upon it's price".

3.3 Types of users

Individuals may be classified either as financially sophisticated users, such as corporate shareholders, financial analysts, financial representatives of institutions and brokers or financially unsophisticated users, consisting of employees, small investors and the public in general. Sophisticated users require voluntary information of a more technical nature and base their economic decisions on financial ratios and performance figures, whereas the less sophisticated user, who is becoming more prevalent in South Africa, can only interpret information expressed in layman's terms.

Discussion Paper 12, issued in March 1994 by SAICA refers to three user groups. *Primary stakeholders* are those with an ownership interest in the company who have a right to appoint directors of the company and receive reports from them. They are further classified into private investors and institutional investors (SAICA 1994, par.23). *Secondary stakeholders* are those with a financial but not an ownership interest in the company such as loan creditors, employees, business contacts and authorities responsible for the assessment and collection of direct and indirect taxes (SAICA 1994, par.24). Finally, *tertiary stakeholders* are users without a direct financial interest in the company but who are affected by the way in which the company's resources are managed, such as environmentalists (SAICA 1994, par.25).

In a study conducted by the Special Committee on Financial Reporting (1994:8), the AICPA identified the following types of users and their reasons for using financial reports:

Type of user	**Reason for using financial reports**
Investors	Aids in investment decisions
Creditors	Aids in credit decisions
Management and board members	Aids in decisions about managing the business
Employee groups	Helps to understand compensation policies and a company's ability to meet compensation and benefit commitments
Competitors	Helps with evaluation of competitive strengths and weaknesses and business strategy
Regulators	Helps with assessment of compliance with regulations
Academics	Provides data for research
The press	Provides data for articles
Users concerned with social causes	Helps with assessment of a company's involvement in areas of concern

Different researchers have also classified users of annual reports and recognised present and potential investors, creditors and suppliers, employees and customers. Ogan and Ziebart (1991:391-394), on the other hand, identified six groups of constituents, namely society, owners, creditors, employees, government and customers.

Their illustration of the market for corporate information is reproduced in figure 3.1.

3.3.1 Internal users

There are two main groups of internal users, namely directors and top management and auditors. Their needs will be briefly discussed.

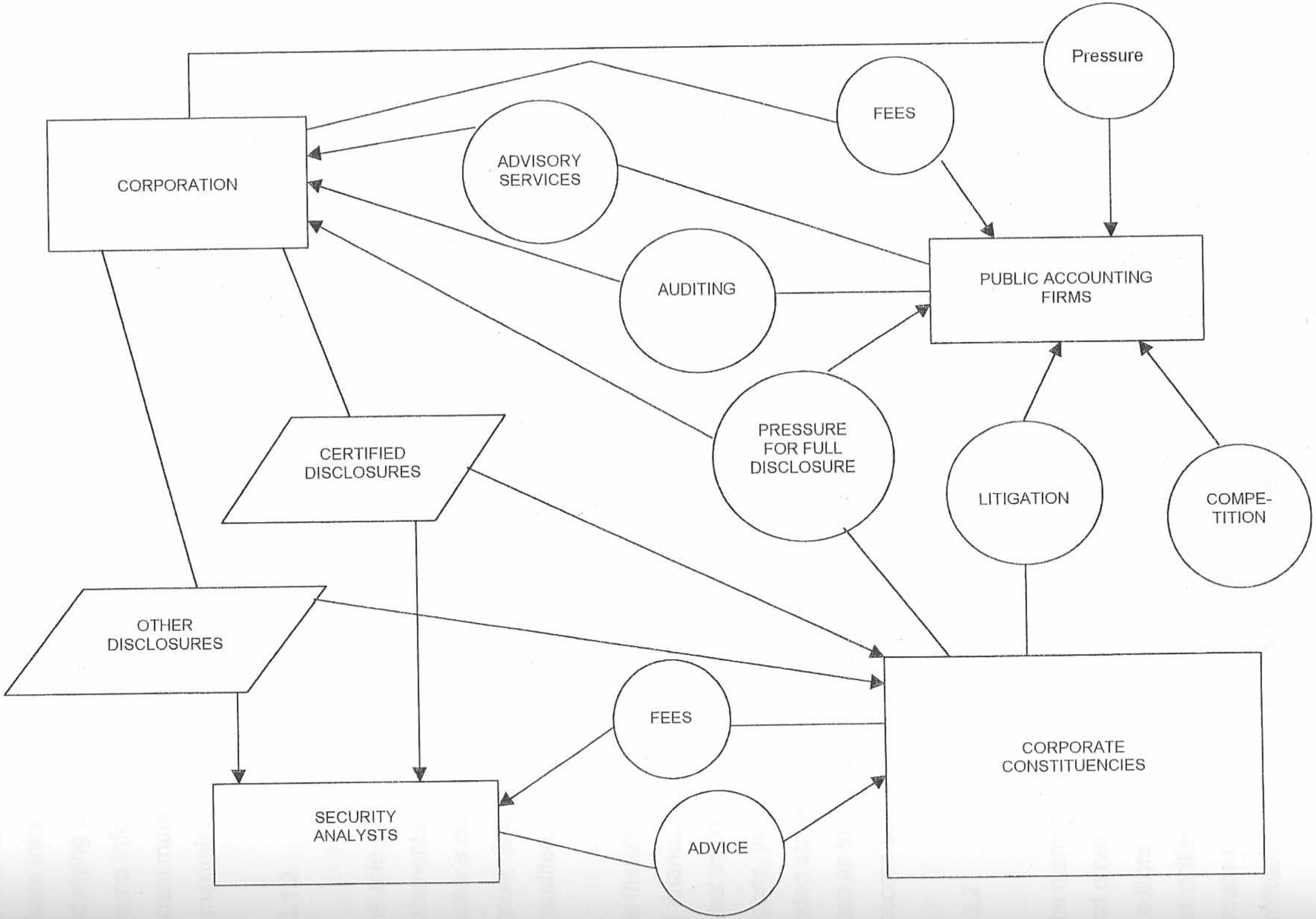
3.3.1.1 Directors and top management

Shareholders of a company appoint the directors who in turn appoint the top management of the company. The competence and independence of the directors and top management is continuously scrutinised and monitored by persons with a vested interest in the business, such as suppliers, employees and customers. Therefore managers continually strive to improve their reputation with external parties by implementing "value-maximising disclosure policies" (Dye 1986:333). However, at the same time they have to bear in mind the trade-off between the achievement of value maximisation and the protection of proprietary information. A questionnaire survey conducted by Hall (1998:153) showed that 44% of the management of the sample companies pursued as their goal value maximising.

Corporate communication processes and disclosure policies are based on corporate strategy, professional norms, price sensitive information, decision processes and internal and external mediators. This disclosure position of the company is influenced by internal and external stimuli, with the responses resulting in a wide variety of disclosure outputs. By developing internal responsiveness to the needs of users, corporations develop positive information systems which maximises the information flows to the market (Holland & Stoner 1996:301).

Figure 3.1

The market for corporate information



Researchers such as Feltham & Xie (1992), have developed models of the interaction between factors that influence managers' voluntary disclosure decisions with regard to private information, such as a firm's future profitability. Three of the most important underlying assumptions of these models are: that the manager cannot disclose that he has no information (Dye 1985), that the informed manager seeks to maximise the current market value of his firm's equity (Verrecchia 1983) and that the manager seeks to maximise the expected end-of-period cash flow to equity holders.

3.3.1.2 Auditors

The role of the auditor is to provide an external and objective report on the annual statements thus acting as a link between directors and shareholders. However, the auditor's opinion on the fair presentation of the financial information is confined to the annual financial statements and most of the voluntary information disclosed is unaudited.

It is therefore suggested (SAICA 19.33) that the auditor's duties be extended to a review all financial information included in annual reports. This will improve the assurance about the relevance and reliability of the entire range of information contained in annual reports, including aspects such as the chairman's report, segmental information, value added statements and ratio analysis. The suggestion is that other public documents, such as interim reports and preliminary announcements issued by companies should become subject to an auditor's review.

3.3.2 External users

The many groups of external users have diverse information needs for decision-making and other purposes. These groups include shareholders, financial analysts, bankers, creditors and suppliers, employees and labour organisations, government and tax authorities, customers, social interest groups and the general public. These diverse groups utilise annual reports for information to measure past performance in terms of profitability and viability in order to evaluate the present position, not only as a basis for future economic predictions, but also for future decisions. Though their needs have in the past not received the necessary attention, despite the fact that each decision they make impacts not only on the individual enterprise, but also the economy as a whole. Therefore each of these user groups and their information needs will be discussed below.

3.3.2.1 Shareholders/owners, investors and potential investors

Arnold and his co-authors (1991:6) reason that improved disclosure may lead to improved shareholder understanding and loyalty. This would in turn provide an environment in which management could concentrate on long-term strategy without being diverted by the need to improve short-term profitability. The improvement in performance that is likely to result, would be of benefit to all. Shareholders who are adequately informed of the risk dynamics and risk management processes of a company are also more likely to remain loyal and supportive to a company experiencing an unstable financial period.

Shareholders require information in order to make decisions on whether to buy, hold or sell their shares in the corporation by assessing the long-term profitability and solvency of the company. Information is also required for decisions on who to vote for as directors, as they are the people who will be held responsible for determining the return on their investment. Communication between shareholders and management is mainly influenced by information obtained from annual reports, investor presentations and technical analysts. The benefit to the company of effective communication with the shareholders is a lower cost of capital as informed shareholders are better able to assess the market value of a share.

When considering the needs of shareholders, that is dividend and capital growth, all shareholders should be considered and not only majority shareholders. Holders of 50% of the issued share capital of a company (plus one share) will, by and large, control the destiny of the company, a fact that investors take into consideration in deciding whether to invest in the company. He quotes the case of Micor Ltd where the directors accepted an offer by a consortium to purchase the core assets of the company: only when a former director pointed out to the minority shareholders that the proposed sale price would only benefit the members of the purchasing consortium (who turned out to be the majority shareholders of the company), did the minority shareholders take steps to defend their position.

3.3.2.2 Financiers and creditors

Bondholders and banks require interest security and information on the ability of the company to service debts and meet its obligations with regard to current or future debt while creditors require a profitable trading relationship. They thus need information on the solvability and liquidity position of the company in order to decide whether to lend funds to the company or not. If risk is minimised as a result of good disclosure policies, the cost of loans and credit facilities will decrease too. Furthermore, suppliers will be attracted by the growth potential and long-term sustainability of the company. In the view of Lee and Parker (1979:277) "legislative provisions are primarily designed to fulfil the needs of the shareholder" while the creditor carries the biggest share of the risk associated with the activities of the company.

Unfortunately, bondholders are not entitled to receive an annual report after the bond has been granted to the company and therefore cannot keep track of the performance of the company. In contrast, banks may demand that they receive a copy of the annual report on an annual basis to enable them to assess the corporation's financial status. Even though banks and creditors are first in line when a company is declared insolvent, they are normally the last to be informed of the insolvency of the company.

On the positive side, the fact that standard setters have assisted in setting of uniform standards with regard to financial ratios and in addition, the maintenance of certain minimum levels of solvability and liquidity, has enabled creditors and lenders to be better informed of their own risk situations. The end result is a more cost-effective allocation of capital and assets.

3.3.2.3 Employees

Corporate managers are realising on the one hand that employees have a greater stake in the company's future performance than the shareholders and on the other hand that employees' information requirements differ from those of investors. Employees are mainly interested in the long-term sustainablility of the company, as this has a bearing on their personal for job security and financial wealth. The ability of the company to provide remuneration, retirement benefits and employment opportunities are also important considerations. Employee reporting is discussed in detail in paragraph 5.9 of chapter 5.

3.3.2.4 Government and official bodies

The government is interested in the contribution that the company is making to the economic growth and stability of the country and its involvement in international markets. It is also responsible for company adherence to its laws concerning taxes, import and export duties and employment regulations.

3.3.2.5 Customers

Customers require information about the quality, price and supply of products and services offered by the company as well as after-sale services and guarantees in order to decide whether to purchase the product or make use of the services rendered by the company. Promotional reporting to attract loyal customers is often found in annual reports in the form of glossy photographs of the products, brand names, geographical areas where the services are rendered and contact points.

3.3.2.6 Financial analysts

Analysts, brokers and portfolio managers are used by investors who have a limited understanding of financial matters. The role of the professional financial analyst is therefore vital and they should be free to voice their opinions on the form and content of annual and interim reports. They are recognised for their ability to critically assess information released by corporations and by their ability to analyse the link between share prices and earnings. They are informed users who form an opinion about the future growth prospects of a corporation and have the ability to assess the value of a security. Although they do use financial statement information, analysts often have access to management and senior executives of corporations. Such personal contact allows them to negotiate additional information, placing them in a superior position with regard to information and giving them a unique insight into corporate dealings.

Investor advisors include analysts from large and small institutions, brokers, accountants, portfolio strategists and industry consultants. Their greater access to information helps them to mitigate misvaluation problems that may arise from imperfect auditing and accounting standards. Healy and Palepu (1993:7) reason that the advantage of financial analysts is that they concentrate on the development of firm- and industry specific knowledge which enables them to assess a firm's current performance and future prospects and provide incremental information to investors for evaluating their securities.

Such advantage stems from the fact that analysts add value in three ways. Firstly, financial analysts assess the quality of a firm's reported numbers and are able to adjust these as they see fit. Secondly, analysts evaluate a firm's current performance by means of ratios, cash flow analysis and incorporate non-financial factors and thirdly, analysts forecast a firm's future prospects and estimate its value using modern finance theory and valuation techniques.

As they continually seek price discrepancies the opinions and recommendations of financial analysts may substantially affect share prices. Brokers are the professionals who deal directly with individuals and institutional investors.

3.3.2.7 Competitors

Competitors require information on the relative strengths and weaknesses of companies in similar lines of business so as to assess their own future market penetration.

3.3.2.8 Society in general

The public is interested in the activities of a corporation, firstly because its financial well-being impacts on the whole economy. Social interest groups, such as environmental lobby groups seek information on company policies with regard to environmental protection, affirmative action, donations and sponsorships, bursaries, housing schemes, loans and training.

In section 2, item 2.5, of questionnaire A (annexure 7) and B (annexure 9) compilers and users were required to choose five most important users of financial reports from a list of 9, and to rank the users in order of importance on a scale of 1 to 5. Tables 3.1 and 3.2 illustrate how compilers and users rank users of corporate reports. According to the responses, 24 (30.8%) users and 40 (35.1%) compilers ranked shareholders as the most important users of financial reports. Users ranked security analysts (23.1%) and stockbrokers (20.5%) in second and third place while compilers ranked institutional investors (28.9%) and stockbrokers (15,8%) in second and third place.

Table 3.1 Users' responses to the question: Who do you regard as the most important users of financial reports?

Users of annual reports	Level of importance										Ranking
	5	%	4	%	3	%	2	%	1	%	
Shareholders (individual investors)	24	30.8	6	7.7	8	10.3	11	14.1	14	17.9	1
Stockbrokers	16	20.5	26	33.3	13	16.7	8	10.3	3	3.8	3
Security analysts	18	23.1	7	9.0	11	14.1	9	11.5	7	9.0	2
Institutional investors	12	15.4	19	24.4	19	24.4	11	14.1	8	10.3	4
Investment bankers and underwriters	2	2.6	7	9.0	12	15.4	13	16.7	15	19.2	6
Bank loan departments	2	2.6	3	3.8	4	5.1	9	11.5	8	10.3	6
Academics	1	1.3	2	2.6	1	1.3	4	5.1	2	2.6	7
Employees and unions	0	0.0	2	2.6	4	5.1	2	2.6	9	11.5	8
Editors of financial periodicals	3	3.8	6	7.7	6	7.7	9	11.5	9	11.5	5
Other, specify	0	0.0	0	0.0	0	0.0	2	2.6	3	3.9	8
Total responses	78	100	78	100	78	100	78	100	78	100	

Scale: 5 = Most important
1 = Least important

Table 3.2 Compilers' responses to the question: Who do you regard as the most important users of financial reports?

Compilers of annual reports	Level of importance										Ranking
	5	%	4	%	3	%	2	%	1	%	
Shareholders (individual investors)	40	35.1	11	9.6	18	15.8	18	15.8	13	11.4	1
Stockbrokers	18	15.8	36	31.6	23	20.2	19	16.7	5	4.4	3
Security analysts	12	10.5	21	18.4	22	19.3	12	10.5	8	7.0	4
Institutional investors	33	28.9	26	22.8	20	17.5	16	14.0	7	6.1	2
Investment bankers and underwriters	3	2.6	4	3.5	14	12.3	13	11.4	24	21.1	6
Bank loan departments	7	6.1	10	8.8	8	7.0	14	12.3	11	9.6	5
Academics	0	0.0	2	1.8	0	0.0	2	1.8	6	5.3	8
Employees and unions	0	0.0	1	0.9	5	4.4	6	5.3	15	13.2	8
Editors of financial periodicals	0	0.0	2	1.8	3	2.6	13	11.4	25	21.9	8
Other, specify	1	0.9	1	0.9	1	0.9	1	0.9	0	0.0	7
Total responses	114	100	114	100	114	100	114	100	114	100	

Scale: 5 = Most important
1 = Least important

3.4 Value relevance of qualitative characteristics of voluntary disclosure to users

The value of information disclosure in annual reports, as an essential component in the effective functioning of capital markets is based on the qualitative characteristics of annual reports. According to Wallman (1995:83) accountants are the "gatekeepers" of financial markets and as such they have the function of assuring the continued utility and integrity of financial reporting. These qualitative characteristics are based on the broad ethical goals of truth, justice, and fairness and consist of:

- relevance, encompassing timeliness and predictive and feedback values for present and potential investors;
- reliability, entailing representational credibility;
- verifiability; and
- comparability.

Users play an important role in the financial reporting process, as they may specify the form, content and extent of the information they require in annual reports and have a right to object if the information does not satisfy their need for relevant, comparable, credible and reliable information. Gigler and Hemmer (1998:121) designed a model to how the qualitative characteristics affect market prices and on the one hand and how these prices respond to the release of audited financial statements, on the other.

According to AC000 issued by the Accounting Standards Board, the four principal qualitative characteristics of voluntary information disclosure that are important in assessing a company's financial position and expected future cash flows are understandability, relevance, reliability and comparability. A brief discussion of these qualitative characteristics follows.

3.4.1 Understandability

When preparing annual reports and deciding on what voluntary information should be disclosed, the compilers assume that the users have a reasonable knowledge and understanding of accounting and business activities and a willingness to study the information with reasonable diligence. The complexity of the information should not be a deciding factor in deciding whether to include the information or not.

Understandability refers to the ability of the various users to interpret the information in the annual report in the same way as the compilers intended it to be interpreted. Therefore, information needs to be disclosed in a format that is accessible to those for whom it was designed.

3.4.2 Relevance

Relevance refers to the usefulness of information in the decision-making process to form predictions about the outcomes of past , present and future events. Kirk and Siegel (1996:55) define relevance as the capacity of information to make a difference in a decision by helping users to form predictions about the outcomes of past, present and future events or to confirm or correct prior expectations. For example, historical cost is often regarded as irrelevant to the decision-making process while current/fair value or net realisable value which is based on subjective estimates and assumptions, is often biased and could therefore be misleading while it is customary for corporations to revalue assets at current market values, very few if any revalue liabilities.

The relevance of voluntary information may be further enhanced by its feedback value or predictive value and its materiality. McBride (1977:20) suggests voluntary information should be both backward-looking, to assist in evaluating past performance, and forward-looking, to assist in assessing future performance.

3.4.3 Reliability

Although financial statements have to conform to generally accepted accounting practice to enhance reliability, there is no unambiguous nor uniform interpretation or application by compilers. Indeed, they may exercise considerable freedom in selecting an accounting procedure to maximise income or alternatively use an income smoothing technique. That this practise is all to common was evidenced in an experiment conducted by Prinsloo, Ramsay-Slogrove and Rowlands (1996). They concluded that profit smoothing is practised extensively in the industrial sector of the Johannesburg Stock Exchange, with the management of companies with a low variability in reported profits being the most likely to use the technique.

Voluntary information is perceived as reliable when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent (Kirk & Siegel 1996:55). However, Lee (1987:20) argues that the apparent insistence of management and reporting accountants that the disclosed information should be expressed in conservative terms, that is to understate rather than overstate, results in a dilution and distortion of the truth.

Reliability is dependent on the quality of internal controls that are in operation and the effective functioning of audit committees. Therefore auditor independence is vitally important to the integrity of financial reporting (Wallman December 1996:96). If users have to sift through and correct information in annual reports, time is wasted and uncertainty of the market's pricing function is increased.

Reliability of voluntary information also depends on verification procedures and management's integrity in the presentation of information. Users want information to be conservative, neutral and unbiased and therefore to them the credibility of information contained in an annual report is a function of the degree to which it is correct, complete and objective.

To be reliable, voluntary disclosed information must faithfully represent the transactions and events it purports to represent, it must be neutral and the disclosure of information must be selected with prudence.

3.4.4 Comparability

Comparability refers to the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena (Flynn 1987:10). Consistency of disclosure is obtained through harmonisation of South African accounting standards with international accounting standards. By limiting choices of alternative accounting treatments and presentational techniques and insisting on consistency, the scope for uncertainty and manipulation is limited. Users require data over periods of five to ten years in order to make inter-firm comparisons and to identify performance trends, which means that the information must relate to the same aspects and have been compiled on the same basis if it is to be comparable. The data should maintain a degree of conformity from period to period, that is accounting policies and treatments should not change.

3.4.5 Timeliness

Timeliness of mandated financial reports plays a critically important role in the utility of financial reports. The Johannesburg Stock Exchange requires all listed companies to report timeously or face various sanctions for non-compliance. A further requirement is that they must report on a continuous basis any information which might materially affect the share price. Only when information is disseminated with speed and accuracy and reaches all constituents simultaneously, may one regard information as useful. If the release of information is delayed or made available to a select user group only, it may lead to dishonest practices, such as insider trading.

Compilers and management normally have real-time information on call whereas the external users have access to aggregated information concerning a company only once a year or to a very abbreviated version on a half-yearly basis. With the present-day advances in technology, corporations can avail themselves of electronic distribution networks to keep users informed on a day-to-day basis. In the United States, computerised systems have been developed for distributing financial information. Two of these are the SEC's Electronic Data Gathering and Retrieval system (EDGAR) or a commercial vendor, such as LEXIS/NEXIS (Wallman 1995:88). In South Africa, Real-Time African Investments Databank (JRaid) is a Java-based financial investment application designed specifically for the corporate market which provides real-time information. It furthermore dynamically updates pricing information via the internet or satellite. Together with McGregor BFA, fundamental and historical data is supplied for ten other African exchanges and top unlisted South African companies. If used effectively, these direct on-line systems will enhance the usefulness and timeliness of information.

Gigler and Hemmer (1998:121) observe that increasing the required frequency of financial reports may increase the ability to explain stock price changes with accounting information while reducing the information efficiency of prices. The latter is a function of the fact that an increase in the frequency of the mandated disclosures, with its concomitant disclosure costs, could make it optimal to eliminate the manager's voluntary disclosures. This could result in the prices becoming a function of the mandatory disclosures only, leading to a strong relationship between price and earnings. This in turn would imply that the relationship between stock prices and earnings would not capture the success with which a particular accounting regime induces price efficiency.

In this study the views of users and compilers were elicited with regard to the extent to which these qualitative characteristics enhance the usefulness of information obtained from corporate annual reports. In section 2, item 2.6 of questionnaire A and questionnaire B, users and compilers were asked to rank four annual report characteristics, namely relevance, reliability, understandability and comparability, on a scale of importance ranging from 1 to 5. The results of the survey are set out in tables 3.3 and 3.4.

Of the four characteristics mentioned, both users 65 (83,3%) and compilers 100 (89,3%) considered reliability to be the most important characteristic while relevance was the second most important characteristic. Understandability and comparability were placed on the same level of importance but only 47 (60,3%) of users and an average of 65 (58,0%) of compilers perceived these characteristics to be very important.

Table 3.3 User perceptions of the importance of corporate report characteristics that enhance the usefulness of information disclosed

Level of importance to users	Relevant		Reliable		Understandable		Comparable	
	No.	%	No.	%	No.	%	No.	%
Very important	54	69,2	65	83,3	47	60,3	47	60,3
Fairly important	22	28,2	10	12,8	25	32,1	20	25,6
Moderately important	52	2,6	2	2,6	5	6,4	9	11,5
Slightly important	0	0	0	0	0	0	1	1,3
Unimportant	0	0	1	1,3	1	1,3	1	1,3
Total	78	100,0	78	100,0	78	100,0	78	100,0

Table 3.4 Compiler perceptions of the importance of corporate report characteristics that enhance the usefulness of information disclosed

Level of importance to compilers	Relevant		Reliable		Understandable		Comparable	
	No.	%	No.	%	No.	%	No.	%
Very important	75	67,0	100	89,3	66	58,9	64	57,1
Fairly important	32	28,6	11	9,8	40	35,7	42	37,5
Moderately important	5	4,5	1	0,9	6	5,4	5	4,5
Slightly important	0	0	0	0	0	0	0	0
Unimportant	0	0	0	0	0	0	1	0,9
Total	112	100,0	112	100,0	112	100,0	112	100,0

3.5 Other sources of voluntary information

Apart from the annual report, there are other information sources available to users such as the following:

- prospectuses;
- company interim reports;
- articles in newspapers and business publications;
- economic periodicals, industry publications and government reports;
- information from financial analysts, brokers, investment advisors;
- personal contact or consultations with management, competitors and customers;
- investment information services such as banks and financial institutions
- electronic information sources such as the internet;
- radio and television;
- company press releases;
- friends who are employees of companies;
- accountants and auditors;
- attorneys; and
- stock exchange reports.

Naturally, not one of the sources mentioned above can encompass all the quantitative and qualitative information required to make a valid investment decision. A survey conducted by the Securities and Exchange Commission in the USA involving individual investors, for example indicated that only 17% relied on their broker's advice in reaching decisions (Cohen, Zinbarg & Zeikel 1987:84) . In the same survey, when questioned on the usefulness of financial statements, 86% found corporate financial statements extremely useful or moderately useful.

Similar results were found in this study when users and compilers were asked how useful they perceived annual and interim reports to be. As shown in table 3.5, the same question was included as question 1.5 in section 1 of questionnaires A and B. In South Africa 83.1% of users and 94,6% of compilers also found annual and interim reports essential, very useful or moderately useful. These results are consistent with those from other countries. In their study on investors, Anderson and Epstein (1996:37) found that 74% of United States respondents, 72% of Australian respondents and 68% of New Zealand respondents found the annual report to be very useful or moderately useful.

Table 3.5 Perceptions of respondents on how useful they find annual and interim reports for investment decisions

Usefulness of annual and interim reports	Users		Compilers	
	No.	%	No.	%
Essential	28	27,7	27	20,9
Very useful	20	19,8	49	38,0
Moderately useful	36	35,6	46	35,7
Of little use	15	14,9	5	3,9
Useless	0	0	1	0,8
No opinion	3	2,5	1	0,8
Total	102	100,0	129	100,0

As a follow-up on this question users and compilers were asked (see section 2, item 2.2 of questionnaires A and B), to list the five most important sources of information they used when making an investment decision and to rank the sources in order of importance. The purpose was to establish whether the needs of users and compilers were being fulfilled and if not, how management could respond to ensure that communication resources were more effective.

The respondents listed a total of 13 sources of information and the results are shown in table 3.6 and table 3.7.

Table 3.6 User responses to the question: Which *five* most important sources of information are used by you when making an investment decisions?

Information source used for investment decisions	Level of importance									
	5	%	4	%	3	%	2	%	1	%
Prospectus of a company	6	5.9	7	6.9	2	2.0	3	3.0	10	9.9
Annual and interim report of a company	18	17.8	17	16.8	13	12.9	17	16.8	10	9.9
Press releases in general and business newspapers	15	14.9	11	10.9	15	14.9	17	16.8	8	7.9
Financial periodicals, e.g. Financial Mail, Finance Week	11	10.9	19	18.8	14	13.9	8	7.9	10	9.9
Financial analysts and stockbrokers	27	26.7	14	13.9	18	17.8	15	14.9	7	6.9
Personal contact with the management/ employees of the company	3	3.0	4	4.0	8	7.9	4	4.0	10	9.9
Investment services of financial institutions	5	5.0	10	9.9	7	6.9	9	8.9	7	6.9
Television and radio announcements	0	0.0	1	1.0	1	1.0	3	3.0	4	4.0
Accountants or auditors	3	3.0	1	1.0	3	3.0	5	5.0	2	2.0
Attorneys	0	0.0	1	1.0	0	0.0	0	0.0	1	1.0
Technical analysis and public forums	1	1.0	3	3.0	3	3.0	4	4.0	7	6.9
Friends, family, tips or rumours	1	1.0	1	1.0	4	4.0	4	4.0	7	6.9
Your own analysis and accumulated information	10	9.9	9	8.9	11	10.9	10	9.9	16	15.8
Other	1	1.0	2	2.0	2	2.0	2	2.0	2	2.0
TOTAL	101	100	101	100	101	100	101	100	101	100

Scale: Most important = 5
Least important = 1

Table 3.7 Compiler responses to the question: Which *five* most important sources of information are used by you when making an investment decision?

Information source used for investment decisions	Level of importance									
	5	%	4	%	3	%	2	%	1	%
Prospectus of a company	13	10.2	5	3.9	4	3.1	3	2.4	10	7.8
Annual and interim report of a company	24	18.8	21	16.5	30	23.6	20	15.7	11	8.7
Press releases in general and business newspapers	10	7.8	19	15.0	17	13.4	20	15.7	20	15.7
Financial periodicals, e.g. Financial Mail, Finance Week	9	7.0	20	15.7	21	16.5	22	17.3	13	10.2
Financial analysts and stockbrokers	43	33.6	28	22.0	17	13.4	14	11.0	6	4.8
Personal contact with the management/employees of a company	9	7.0	7	5.5	9	7.1	11	8.7	9	7.1
Investment services of financial institutions	6	4.7	12	9.4	6	4.7	10	7.9	7	5.5
Television and radio announcements	0	0.0	0	0.0	1	0.8	1	0.8	2	1.6
Accountants or auditors	0	0.0	2	1.6	1	1.8	0	0.0	3	2.4
Attorneys	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0
Technical analysis and public forums	2	1.6	0	0.0	4	3.1	3	2.4	8	6.2
Friends, family, tips or rumours	2	1.6	2	1.6	5	3.9	6	4.7	13	10.2
Your own analysis and accumulated information	9	7.0	10	7.9	12	9.4	16	12.6	23	18.0
No opinion	1	0.8	1	0.8	2	1.6	1	0.8	1	0.8
TOTAL	128	100	128	100	128	100	128	100	128	100

Scale: 5 = Most important
1 = Least important

In establishing whether users and compilers have similar views with regard to the perceived importance of the various sources of information, the data provided in the two tables were compared. Financial analysts and stockbrokers were the main source of information for both users (26.7%) and compilers (33.6%) when making investment decisions, with annual and interim reports (17,8% and 18,8% respectively) as their second most important source of information. Users (14.9%) relied on press releases in general and business newspapers as their third choice while compilers (10.2%) selected the prospectus of the company as their third choice. These findings are consistent with those of Anderson and Epstein (1996:36) who found that shareholders in Australia (45.5%) and New Zealand (38.6%) relied on stockbrokers for making investment decisions.

Results from a similar survey conducted by Flynn (1987:4) indicated that "communication with management" was a sensitive issue when questioning institutional investors on their most important sources of information for making decisions about buying, holding or selling ordinary shares. This may be ascribed to regulations of the Johannesburg Stock Exchanges on insider trading and publication of information, and as a result institutional investors may have downplayed the importance of communication with management as an information source. Chang and Most (1979:75) conducted a similar survey in which the most important and dominant source of information proved to be company announcements and reports.

It is interesting to note the findings of Barker (1998:3) on preferred information sources of finance directors, fund managers and analysts. He found that all three types of respondents were in agreement that the company itself is of central importance as a source of information. For analysts, direct contact with the company provides timely, focused, forward-looking information while fund managers stated that formal meetings offer an opportunity to assess the company's strategy and the ability of management.

In this survey, the matter of the source of information was further refined by adding a further question (in section 2.7 of questionnaires A and B) to determine their opinions on which sections of a corporate report they regarded as the most important. A total of

12 sections were specified and users and compilers were requested to rank the items in order of importance on a scale of 1 to 5. The results are reflected in tables 3.8 and 3.9.

Table 3.8 User responses to the question: Which *five* sections of a corporate report are the most important?

Section of corporate report	Level of importance									
	5	%	4	%	3	%	2	%	1	%
Income statement	27	34.2	26	32.9	10	12.7	4	5.1	3	3.8
Balance sheet	21	26.6	23	29.1	8	10.1	13	16.5	4	5.1
Notes to the statements	2	2.5	4	5.1	18	22.8	14	17.7	7	8.9
Cash flow statement	5	6.3	11	13.9	17	21.5	14	17.7	4	5.1
Value added statement	1	1.3	1	1.3	2	2.5	3	3.8	5	5.2
Current cost statements	0	0.0	0	0.0	2	2.5	1	1.3	4	5.1
Financial highlights	4	5.1	0	0.0	4	5.1	2	2.5	7	8.9
Table of contents	2	2.5	2	2.5	2	2.5	6	7.6	3	3.8
Segmental report	3	3.8	2	2.5	2	2.5	4	5.1	2	2.5
Chairperson's report	7	8.9	4	5.1	5	6.3	9	11.4	15	19.0
Director's report	1	1.3	4	5.1	4	5.1	2	2.5	12	15.2
Auditor's report	6	7.6	2	2.5	5	6.3	7	8.9	13	16.5
Total	79	100	79	100	79	100	79	100	79	100

Scale: 5 = Most important
1 = Least important

Table 3.9 **Compiler responses to the question: Which *five* sections of a corporate report are the most important?**

Section of corporate report	Level of importance									
	5	%	4	%	3	%	2	%	1	%
Income statement	50	44.6	22	19.6	10	8.9	7	6.3	8	7.1
Balance sheet	10	8.9	35	31.2	27	24.1	10	8.9	8	7.1
Notes to the statements	3	2.7	3	2.7	18	14.1	27	24.1	10	8.9
Cash flow statement	15	13.4	21	18.7	15	13.4	14	12.5	10	8.9
Value added statement	0	0.0	0	0.0	2	1.8	3	2.7	7	6.3
Current cost statements	0	0.0	0	0.0	0	0.0	1	0.9	0	0.0
Financial highlights	5	4.5	6	5.4	7	6.3	3	2.7	4	3.6
Table of contents	6	5.4	11	9.8	9	8.0	6	5.4	15	13.4
Segmental report	0	0.0	5	4.5	6	5.4	9	8.0	10	8.9
Chairperson's report	15	13.4	8	7.1	11	9.8	22	19.6	17	15.2
Director's report	3	2.7	1	0.9	4	3.6	5	4.5	14	12.5
Auditor's report	2	1.8	0	0.0	3	2.7	5	4.5	9	8.0
Other	3	2.7	0	0.0	0	0.0	0	0.0	0	0.0
Total	112	100	112	100	112	100	112	100	112	100

Scale: 5 = Most important
1 = Least important

Once again the perceptions of the users and compilers were compared to establish whether the two groups had similar views. Both users (34.2%) and compilers (44.6%) perceived that the income statement to be the most important section of the annual report for investment decisions. However, as second choice users (26.6%) selected the balance sheet while compilers selected the cash flow statement (13.4%) and the chairperson's report (13.4%). In the survey conducted by Flynn (1987:6) he found that institutional investors ranked the balance sheet first and the income statement second, while company management and regulators ranked forecasts as the primary source of information. From these perceptual differences it is clear that compilers place more emphasis on lower priority areas than in those areas that users consider to contain the most useful information.

3.6 Conclusion

In viewing the implications of the limitations of financial statements, Pijper (1993:124) stresses that the reliability of financial statements cannot be taken for granted. Indeed, it is doubtful whether the integrity of financial statements can ever be guaranteed. Compilers of annual reports must realise that financial reporting systems must change if it is to remain relevant to decision making of its users. In their pursuit of reporting excellence, and taking into account the heuristic nature of accounting compilers must furthermore endeavour to satisfy the needs of users.