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CHAPTER 4

VOLUNTARY DISCLOSURE IN CORPORATE REPORTS

4.1 Introduction

The annual report is considered to be the most important document published by a company. To the compiler it is regarded as a powerful marketing tool that can be used to communicate information to the end user. It is perceived world-wide as the primary means for communication of relevant, reliable and understandable financial information to investors for decision-making purposes. Although corporate reports have undergone dramatic transformations during the past decade, there is a growing need for further refinement in the future particularly as a result of the globalisation of capital markets.

The annual report consisting by mandate of the directors' report, financial statements, cash flow statement and auditors' report and is the end result of a company's financial accounting system. Its importance is in part due to the fact that it is the foremost and, method whereby information produced by the accounting process is communicated to various interested constituents. It is thus not surprising that the improvement of annual reports to enhance the decision-making process, has been central to accounting research. The characteristics of financial reporting have been increasingly criticised because corporate reports have failed to provide the required useful, relevant and credible information to investors.

Beattie (1988:37) lists the following improvements in annual reports: an appreciation of aesthetic qualities such as the use of illustrations and graphs; provision of glossaries of financial terms; special purpose reports, such as employee and environmental reports; and an increase in the disclosure in the areas of social responsibility. While, these developments and proposals for reform in the financial reporting environment are significant, they have nevertheless made it more difficult for users to make decisions.

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This is mainly because the immediate effect of the improvements is that users are now continuously confronted with ever increasing mandatory and voluntary information. This bombardment of information on the unsophisticated user, which often requires dissemination by experienced financial analysts, may result in investors becoming indifferent to many sections of the annual report. The end result of the information overload is that annual reports become useless because of irrelevant or unreliable information. Frequently, the annual report is used to improve the corporate image of the company by extending voluntary management disclosures and consequently compilers may place more emphasis on voluntary information than on financial information.

Some of the improvements are as a result of demands by global stock exchanges and financial analysts for which enterprises often equate greater transparency with more information. Annual reports are now bulkier, more complex and therefore more difficult to interpret and understand by users. They in addition present a major challenge to compilers who are constantly being critically scrutinised by the public, media and political parties. Lee (1987:20) argues that the nature and extent of creative accounting today is just as destructive to rational economic decisions as it has been in any other previous form or period.

On the other hand, with exposure to international capital markets, South African companies have been forced to satisfy the information demands of foreign investors and provide them with more transparent, meaningful, reliable and relevant information in annual reports in order to facilitate the distribution of capital, assets and even human resources. There are thus two forces that need to be balanced: The need for more information, on the one hand, and the need for user-friendly disclosure on the other. The continuous pressure to improve, further develop and update corporate disclosure practices in order to harmonise these ever-increasing demands, has resulted in significant progress over the last decade.

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4.2 Objectives of annual reports

A widely accepted objective of annual reports is to provide useful qualitative and quantitative information for decision-making purposes thus allowing both sophisticated and unsophisticated users to form rational expectations about a company's present and future performance. The Financial Accounting Policy Committee (1993:1) believe that financial reporting should be concerned with the presentation of the economic history of specific economic entities and that it is best done when managements are willing to disclose and discuss their strategies, proposed tactics and plans and expected outcomes.

Annual reports give users a sense of security and assurance as to its authenticity. This is substantiated in the Commercial Code published in 1899 in Japan which declared that the underlying objective of financial statements was to protect creditors and current investors (Cooke 1992:229). Annual reports also provide investors with performance data and information on the company's financial standing. The purpose of the annual report is furthermore to provide a valid indication of the wealth created by a company, its value at a point of time or its wider performance over time (Allen 1990:25).

Joubert (1993:4) broadly states the objective of financial reporting as follows: "The communication of relevant and understandable financial and other information for decision making purposes, to users having a reasonable right to such information and who rely on external communications of the enterprise for their information. The reporting function should strive towards maximum benefit for the reporting entity over the long term."

Arnold and his co-authors (1991:4) identify two main purposes: "The first is to provide information to shareholders, lenders and others to appraise past performance in order to form expectations about an organisation's future performance and hence to inform their decisions concerning their relationships with the organisation. The second purpose is to enable the enforcement of contracts, the terms of which include reference to accounting information."

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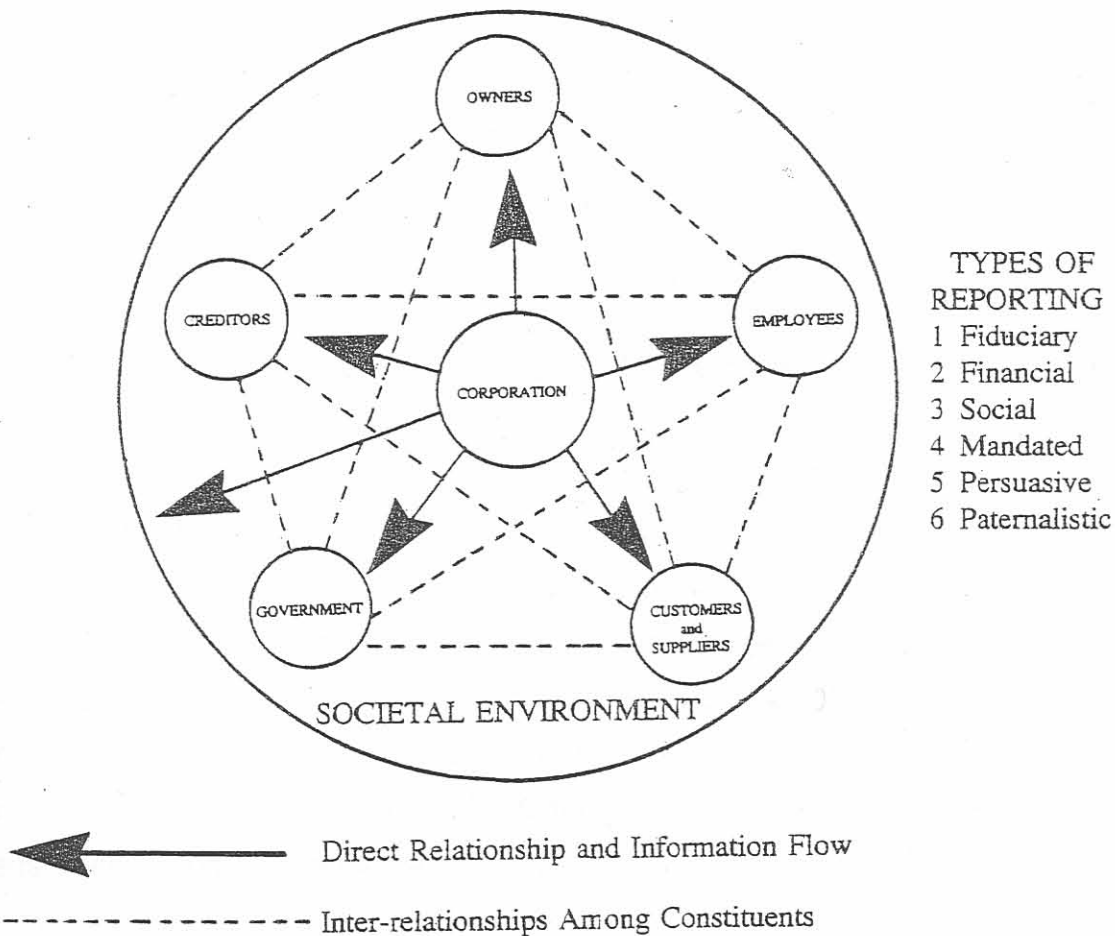
Figure 4.1 depicts a number of types of reporting, namely fiduciary, financial, social, mandated, persuasive and paternalistic (Ogan and Ziebart 1991:393).

Figure 4.1 An interpretive view of corporate reporting



(Source: Ogan & Ziebart 1991)

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Take together, the purposes of financial reporting spelt out in these definitions could be classified into three distinct functions, namely the facilitation of the efficient allocation of capital, assets and other investments; the provision for contractual and *ex post* settling-up mechanisms; and the monitoring of corporate stewardship (Wallman June 1997:114).

4.3 The nature of voluntary disclosure

4.3.1 Definition of disclosure

Disclosure means to expose to view, make known or reveal something. Disclosure of information by a company may thus be regarded as a signal or set of signals from the compiler to potential information users which denote past events in the form of explanations on the one hand and expected probabilities in the form of predictions on the other. According to Gibbens, Richardson and Waterhouse (1992:16) disclosure "is a broad, multi-dimensional array of numbers and words, released at various times of the year in various media and connecting in various ways with other disclosures", and while financial disclosure is defined as "the release outside the organization of information concerning the economic performance, position or prospects of the organization, particularly as measured in monetary terms". Financial disclosure is perceived furthermore as "the result of the application of management decisions and actions to issues, conditioned by a variety of antecedent incentives, institutions and structures" (Gibbens, Richardson & Waterhouse 1992:ix).

4.3.2 Distinction between mandatory disclosure and voluntary disclosure

Disclosure may be classified into two types, namely mandatory and discretionary or voluntary disclosure. Mandatory disclosure refers to those aspects and information that is required by statutes, stock exchanges or standard setters from the accounting profession. Discretionary or voluntary disclosure refers to information made available at the discretion of the company. It is influenced by changing attitudes of society, economic factors and behavioural factors such as the particular corporate personality.

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Voluntary disclosure items may be classified into historical, current and predictive items, depending on whether they are based on the past, present and expected future performance of the company. However, some items may cover all three time dimensions, such as for example earnings per share which is "a historical measure of performance, but may imply limitations on current dividends and may be predictive of future returns" (Gray, Meek & Roberts 1993:211).

Whilst companies are obliged to disclose certain information because of statutory provisions, most are presently voluntarily disclosing more information than is required. Thus historical financial statements are being supplemented with additional key information. Gibbins, Richardson and Waterhouse (1992:5) refer to disclosure as "a response to various incentives, environmental forces, economic issues and regulatory structures, and this response is moulded by the organization's position on disclosure, by internal structures, policies and politics, and by beliefs about the strategic value of disclosure to the organization".

Harrison (1993:74) identifies two types of disclosure policies that companies may adopt, being either a liberal or restrictive disclosure policy. His arguments in favour of a liberal disclosure policy are similar to those put forward by Atiase, Bamber and Freeman (1988:20), namely that it reduces the volatility of the company's share price and helps build credibility with the investment community. In addition, a liberal policy of frequent disclosure discourages the market from overreacting to any single announcement of an important event by the company, which in turn decreases the volatility of the company's share price. Arguments against a liberal disclosure policy are that it is costly and requires a great deal of time and effort and may reveal important information to competitors. Fishman and Hagerty (1989:643) agree that additional disclosure does increase the stability of prices, but the benefits do not justify the costs.

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4.4 The merits and benefits of improved voluntary disclosure

The Companies Act and Accounting Standards normally prescribe minimum disclosure requirements but do not restrict companies in any way from providing additional information. A clear and consistent disclosure policy not only leads to greater shareholder loyalty but also enhances the company's credibility with investors. Such transparency is also reflected in the efficient operation of the capital market.

The benefits of disclosure can be measured in terms of expectations of cash flow consequences and increased share price efficiency. As the questionnaires in this survey did not specifically request respondents to comment on the benefits of additional voluntary disclosure, an extract of findings from the research paper of Eccles and Mavrinac (1995:23) on respondents' ranked impression of potential returns of improved corporate disclosure, is used to clarify this point in table 4.1.

Table 4.1: Survey respondents' ranked impression of potential returns of improved corporate disclosure

Potential returns of improved corporate disclosure	Corporate managers	Financial analysts	Portfolio managers and investors
Increased credibility	5.21	5.51	5.34
Increased share value	4.66	4.65	4.66
Increased number of potential investors	4.64	4.54	4.89
Increased analyst following	4.59	4.68	4.61
Improved access to capital	4.52	4.62	4.77
Increased price-earnings ratios	4.39	4.45	4.48
Decreased share volatility	4.33	4.30	4.54
Increased share liquidity	4.28	4.03	4.34
Improved relations with suppliers	3.67	3.59	4.11
Reduced political regulatory intervention	3.59	3.50	4.30

Responses were collected using a seven-point Likert scale with the following values:
1 = Very strongly disagree
4 = No opinion
7 = Very strongly agree

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All three constituents, namely corporate managers, financial analysts and portfolio managers and investors, ranked increased credibility as having the highest potential return.

SAICA noted that wider disclosure was used for the following reasons:

- to prevent insiders from using information to their advantage;
- to improve the efficiency of the market for an entity's securities;
- to improve investors' control over the management of the corporations;
- to give investors a firmer foundation on which to base their judgments; and
- to enhance the reputation as forward-looking of the entities in question.

4.6 Statutory regulations governing disclosure

No annual report can be deemed perfect or absolute as it is not based on natural laws but on accounting conventions and standards formulated with the purpose of satisfying the different needs and objectives of its users and to assure its quality and reliability of annual reports. The special committee on financial reporting of the American Institute of Certified Public Accountants (1994:3) gave the following reasons for the important role of reporting standards in helping the market mechanism function effectively for the benefit of companies, users and the public:

- standards promote a common understanding of terms and alternatives that facilitate negotiations between users and companies about the content of business reporting;
- standards promote neutral, unbiased reporting which in turn builds credibility and confidences in the capital market place;
- standards improve the comparability of information across companies;
- standards permit audits of information; and
- standards facilitate retrievability of information by organising data according to a specified framework.

Flynn (1985:24) identified four general arguments for standard setting, namely to prevent reporting abuse, to coerce management to disclose, to promote even distribution of information and to prevent suppression of unfavourable information. He further identified the following objectives for statements of generally accepted accounting practice, namely to eliminate undesirable methods, to isolate "best" accounting treatment, to recommend a limited number of acceptable methods, to describe the methods currently used and to prescribe disclosure irrespective of the method used.

Accounting standards promulgated by the FASB and other standard-setting bodies have a twofold purpose, firstly to provide guidelines for managers on how to make accounting decisions and secondly to provide outside investors with a means of interpreting these decisions (Healy and Palepu 1993:3). In addition, the aim of uniform accounting standards is to reduce managers' ability to record similar economic transactions in dissimilar ways either over time or across firms. They suggest that further research should focus on understanding what types of standards are effective in facilitating managers' communication with investors and to settle the question of whether communication is more effective when standards are detailed but rigid, or when broader guidelines are provided that managers considerable reporting discretion.

In South Africa the following are institutional regulations and rules constraining and enabling disclosure:

- the Companies Act, 1973 (Act 61), as amended;
- Generally Accepted Accounting Practice issued by the Accounting Practices Board;
- the listing requirements of the Johannesburg Stock Exchange;
- professional bodies such as the FASB, Institute of Chartered Accountants and the Standing Advisory Committee on Company Law; and
- standard setters.

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As this study deals with information disclosed voluntarily (beyond the levels of disclosure mandated by accounting standard) these legal and other constraints have not been dealt with formally.

Although annual reports have benefited from the regulations imposed on corporations, manipulation of legislation to maximise the bottom line and minimise the gearing ratio has impinged on the credibility and integrity of corporate reporting (Singer 1994:1). The enforcement of more and more regulations makes reporting inflexible and compounds the problem of the communication gap.

4.7 Inadequacies, limitations and problem areas of disclosure

One of the main inadequacies of annual reports is that they do not disclose future plans, budgets or forecasts such as profits, earning per share or cash projections. Neither are the risks and uncertainties facing the company discussed in any detail. The main reason for non-disclosure of future prospects is the reluctance of compilers to commit themselves to a forecast of the future because of the potential for error and the fear of litigation. However, in the United States of America, the enactment of the Private Securities Litigation Reform Act of 1995 has provided a safe harbour for forward-looking information and in so doing improved the quality of financial reporting.

Arnold *et al.* (1991:1) identifies five areas in which the present system of financial reporting is inadequate:

- it is based on historical rather than on current amounts;
- excessive emphasis is placed on a single earnings number;
- not enough attention is paid to the reporting entity's cash or liquidity position;
- it is essentially backward looking, involving the measurement of past performance and current position, and
- the legal form rather than on the economic substance of transactions are emphasised.

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Knutson (1993:68) identified the following seven areas in annual reports that needed to be improved:

- contextual information on strategies, plans and expectations;
- development of a standard for reporting comprehensive income (by the Financial Accounting Standards Board);
- expanded disclosure of disaggregated data on annual and quarterly bases;
- disclosure of current value information for both assets and liabilities;
- development of high financial reporting standards that would be acceptable on a world-wide basis (International Accounting Standards Committee and the International Organization of Securities Commissions);
- simplification and standardisation of accounting rules for the treatment of leases and other executory contracts; and
- recognition that financial statement users are in the best position to judge what financial information is relevant and therefore needs to be disclosed, acknowledging cost/benefit considerations.

In a discussion on the qualitative characteristic of reliability of information namely to be free of error and bias and a faithful representation, Bushman and Indjejikian (1993:765) refer to "distorted accounting information which is characterized as information signals that are biased relative to the expected value of the firm or that measure the value of the firm with error [white noise]". Such bias and noise are representative of many of the inadequacies usually attributed to accounting information.

According to Healy and Palepu (1993:3) distortions in financial reports may be the result of conflicts of interest between managers and shareholders, while imperfect accounting standards and auditing may result in firm misvaluation even in an efficient capital market. They conclude that some firms are misvalued by public capital markets because of information problems. They recommend two potential mechanisms available to the firm's managers to make their financial reports more credible, namely the expansion of voluntary financial disclosure and adoption of appropriate financing policies.

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The competitive dynamics of product and service markets also play a restrictive role in voluntary disclosure policies of companies. Managers are often forced to choose between maximising the corporation's product market advantage by not disclosing information that may harm its competitive position or disclosing information that aids capital markets in the effective valuation of the corporation's shares.

A final limitation is that annual reports in the past were geared to meet the needs of shareholders and not employees and the general public. Companies therefore need to re-examine their reporting contracts with unions and employees and pay more attention to the needs of those groups.

4.8 Factors influencing a company's voluntary disclosure policy

There are many factors and considerations that could influence a company's overall voluntary disclosure policy such as the extent, frequency and method of disclosure; the company's disclosure objectives; the size, listing status, culture and complexity of the company; the size, type and culture of the company's shareholders; the cost of disclosure; the favourableness of the news; and the intensity of competition, earnings margins and rate of return. Three of the major factors, namely the cost, the number of shareholders and listing status will be briefly discussed.

4.8.1 The cost of disclosure in corporate reports

The primary benefit of increased information disclosure is the more effective allocation of capital, nationally and internationally, which in turn is translated into a reduction in the cost of capital. By increasing the level of information disclosure, especially forward-looking information, companies can reduce the cost of capital (Healy & Palepu 1993:3) However, Thompson (1995:21) warns that undisciplined expansion of business reporting may result in large and unnecessary expenses.

The disclosure of voluntary information in annual reports involves additional cost and users' information needs must be weighed up against cost-effective ways of reporting.

The cost of providing each type of information must be balanced by its benefits, being that benefits exceed the cost of providing it.

Unfortunately, there is no accepted technique for measuring these costs and benefits and it is a difficult, complex, subjective and often inaccurate process. According to Malone, Fries and Jones (1993:251) firms that have an economic incentive to provide a broader base of disclosure will do so only when the marginal cost is exceeded by the marginal benefits of additional disclosure.

In a study to examine the cost/benefit perceptions of financial executives in the United Kingdom and the United States, Gray, Radebough and Roberts (1990:84) found that voluntary disclosure items which resulted in major increases in net costs were inflation-adjusted profits, quantified forecasts and narrowly defined segment information. Voluntary disclosure is therefore mainly constrained by the costs involved such as data collection, processing, production and auditing. Indirect costs also play an role, particularly the danger of providing useful information to both existing and potential competitors.

SAICA (1994:39) recognises three primary costs to the company, and ultimately the shareholder, for disclosing more information:

- the cost of developing (gathering, processing and auditing) and disseminating information;
- the cost of litigation attributable to disclosure that is misleading or insufficient; and
- the cost of competitive disadvantage resulting from the disclosure of technological and managerial innovation, strategies, plans and tactics and disaggregated information.

The cost factor is often used as a reason for limiting the extent of voluntary disclosure. Singhvi and Desai (1971:631) came to the conclusion firstly that the cost of accumulating certain information is higher for small companies than for large companies

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mainly because larger companies have a more extensive reporting system. Secondly they concluded that at higher levels of earnings, companies are better able to afford higher disclosure costs, which in turn leads them to reap the benefits of easier marketability of shares and greater ease in financing. The last conclusion was that smaller corporations were likely to endanger their competitive position by extensive disclosure.

In the Jenkins Report of the AICPA (Thompson 1995:21) entitled "Improving business reporting - A customer focus: Meeting the information needs of investors and creditors", the following constraints to limit the costs of reporting were recommended:

a) business reporting should exclude information outside of management's expertise or for which management is not the best source, such as information about competitors;

b) management should not be required to report information that could significantly harm the company's competitive position;

c) management should not be required to provide forecasted financial statements, but rather concentrate on information that would help users to make their own forecasts about the company's financial future;

d) apart from financial statements, management should only report the information that it knows. That is, management should be under no obligation to gather information it does not have, or need, to manage the business;

e) certain elements of business reporting should be presented only if users and management agree on it thus, an element of flexible reporting should be introduced; and

f) companies should not have to expand reporting of forward-looking information until there are more effective deterrents to unwarranted litigation that

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discourages companies from doing so.

Gigler and Hemmer (1998:136) identified two types of costs of voluntary disclosure namely *proprietary costs*, that is, the disclosures could be useful not just to investors but to competitors, and secondly *legal costs*, that is even truthful disclosures could become the object of frivolous lawsuits. When balancing the benefits and costs of voluntary disclosure, "management would publicly disclose up to (or towards) the point where the perceived reduction in the agency costs of equity capital equalled the increased costs of public disclosure to markets and the public domain" according to Holland (1998:30).

Multinational corporations need to provide a wider variety of voluntary disclosure in order to successfully compete for funds on international capital markets and therefore these corporations must examine the cost-benefit trade-off of their voluntary disclosure decisions.

4.8.2 Number of shareholders

From empirical studies, such as that of Singhvi and Desai (1971:132) which empirically tested the relationship between the number of shareholders and extent of disclosure in annual reports, it would seem that the number of shareholders has a significant influence on the voluntary disclosure policy of a company. There are two main reasons for the positive relationship:

- corporations with a larger number of shareholders tend to be more in the public eye and therefore more subject to additional disclosure pressures from stakeholders and analysts; and

- corporations with a larger number of shareholders use fuller disclosure in order to promote the marketability of the shares, and because management is more aware of its stewardship role.

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4.8.3 Listing status

Listing requirements of exchanges globally, has a significant affect on the extent of disclosure. A comparison of the quality and extent of disclosure between listed and unlisted corporations shows very clearly the impact of such listing requirements. This theory is supported by Singhvi and Desai (1971:133) and Cooke (1992).

From the above it should be clear that although numerous factors influence the disclosure policy of a company, cost is the overriding factor. However, the growth of information technology has resulted in a drop of disclosure cost as information becomes easier to access, thus narrowing the information gap. It is estimated that by the end of the 20th century over 200 million people will have access to the internet, which will enhance the flexibility and timeliness of the accounting and reporting system even more. (Wallman 1997:113).

4.9 The management of disclosure in annual reports

In terms of the Companies Act of 1973 it is the responsibility of the directors to prepare the annual report. This *stewardship role* for accounting information is also referred to by Ormrod and Cleaver (1993:431) as the contractual role of financial reporting. They define financial reporting as a stewardship function, in which management acts as the steward to whom suppliers of capital entrust control over their financial resources. The *information role* is seen as a secondary objective to the stewardship function and they are therefore critical of the Accounting Standards Board's statement on the objective of financial statements, namely: "to provide information about the financial position, performance and financial adaptability of an enterprise that is useful to a wide range of users in making economic decisions". As an effective part of the overall management of a company, annual reports should be aligned with the company goals and strategies and in its preparation the cost and benefits, from the inception of the disclosure item to its incorporation in the annual report, should be taken into consideration.

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Gibbens, Richardson and Waterhouse (1992:16) identify the following eight categories of managed disclosures:

- data content (the basic news or data);
- data organisation (e.g. format, classification);
- prior or concurrent interpretation by the discloser;
- medium (e.g. annual report, news release, phone call);
- timing (e.g. date, interval since last disclosure);
- redundancy (e.g. correlation with other disclosures);
- creditability (e.g. whether audited or unaudited); and
- subsequent interpretation by the discloser.

4.10 Disclosure and market efficiency

The quality, extent and informativeness of disclosures in annual reports may help the market mechanism to function efficiently. Arguments put forward by supporters of the efficient market hypotheses such as Fama (1970) is firstly that, earnings follow a random pattern, so that past earnings changes are not predictive of the future and secondly that if past earnings were predictive of future earnings, that past information would already have been discounted in share prices in an efficient market.

Harrison (1993:73) emphasises the fact that the communication policy of a company is of critical importance because of its potential impact on share prices. The Fishman and Hagerty model (1989) showed that market price efficiency is improved by disclosure that is only part of the information input into market prices as there are many other factors influencing share price. Their theory is substantiated by the investigation of Kwon (1993:172) on the variability of share prices associated with the release of voluntary information, which in this case, is inflation-adjusted information. He concluded that the addition of informative material such as inflation-adjusted data, leads to a transition from a coarser to a potentially finer information environment and consequently to less share price stability.

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In examining the types of information that investors choose to observe, Paul (1993:1475) observed that one of the principal functions of stock markets is to provide incentives for users to gather economically relevant information that may impact on the market price of shares. Particularly in view of the major changes taking place in the real world on a global scale, financial reporting information flow is a critical component of our system of capitalism and democracy, for without appropriate information risk would increase dramatically and the cost of capital (Wallman 1995:84).

The matter of the stock market efficiency was central to various studies conducted in the eighties and nineties such as those of Bhana (1995/96) and Healy and Palepu (1993:1). The basis of current empirical research assumes that all equity markets are to a degree efficient and researchers conclude that investors "see through" the limitations of accounting.

In testing the efficiency of the Johannesburg Stock Exchange, Bhana (1995/96:47) concluded that efficiency in securities markets is based on the premise that investors are able to incorporate all relevant information into security prices in a rapid and unbiased manner, with the result that the market reacts to uncertain information in an efficient, if not instantaneous manner. However, the question of how efficient the stock market is, is not the aim of this chapter and for all intents and purposes the stock market will be assumed to be efficient.

The purpose of financial markets is to facilitate the transfer of capital between lenders (those who have an excess of funds) and borrowers (those who need funds for investment purposes) of long- and short-term funds. In an effectively functioning financial market, the premise is that the investors try to achieve their goal of the highest return on their capital with the lowest risk over the long term. On the other hand, the aim of borrowers or users is to make funds productive at the lowest cost. Consequently, both groups rely heavily on the credibility of the annual report as a communication medium.

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According to Knutson (1993:12), information is the lifeblood of a financial market and capital markets are dependent on reliable and relevant financial information to operate efficiently. It is therefore imperative that decision makers perceive the financial reporting system to be sound.

As was mentioned earlier, two of the functions of a stock market are to incorporate relevant information into the price of shares and to provide incentives for investors to obtain all that information. This was tested by Paul (1993:1480) in his study on whether security markets provide investors with the incentive to collect the right type of information. He found that announcements of new information concerning shares are made on a random and independent basis over time. Any malfunction in the information system could lead to loss of corporate credibility and restrict the flow of capital resources. However, if the market is functioning efficiently, the forces of supply and demand will restore the share price to equilibrium as investors adjust the price to incorporate the unbiased effect of new information as it becomes available. Thus it would seem as if pricing efficiency is directly related to the quality of financial reporting and responsible corporate governance.

Most markets are governed by the forces of supply and demand as far as these regulations on the price of shares or commodities are concerned. The price of a share is determined by its intrinsic value, which in turn is influenced by the different "wealth, tastes and beliefs" (Beaver 1981:144) of individuals. However, because authorities regard stock exchange markets as inefficient, Stock Exchange regulations, the Companies Act and accounting standards are effected to enhance the extent of standardised disclosure. The result is an increase in the credibility and comparability of financial reports. Ideally the goal of these regulatory bodies should be to maintain a free market characterised by an equality of information so that all participants trade on equal terms.

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In their explanation on how security prices react to information, Sears and Trennepohl (1993:195) drew the following conclusions:

- investors use information about future events to determine the present price of a security. This theory was substantiated by Hagaman (1994:18) who stated that all future returns derive from future earnings, either as dividends received or capital gains when the investment is sold; and
- because information flows continuously and randomly to the marketplace, investors continuously revise their expectations. Their related bids then result in security prices rising or dropping.

From the above it is clear that an efficient market is dependent on how fast and accurately the information, whether from press releases or other means, is reflected in security prices.

The new automated on-screen trading system or so-called Johannesburg Equities Trading (JET) system, which was introduced on the Johannesburg Stock Exchange in 1996, has enhanced the transparency of the market and transactions are executed more quickly. According to Anderson, president of the Johannesburg Stock Exchange, trade jumped 68% by volume and 88% by value during the first eight months of 1996, compared to 1995 as a result of the JET system and exchange membership increased from 45 to 51 firms from November 1995 to September 1996 (Business Day, 30 September 1996:15).

4.10.1 Basic definitions of market efficiency

Definitions of an efficient market by various authors differ in length and complexity, but in principle an efficient market may be defined as a market in which all new information is quickly interpreted by market participants and the information is immediately incorporated into the market price of shares. Another definition, based on the popular definition of Fama, is that an efficient capital market is one in which security prices correctly reflect all available information (Sears & Trennepohl 1993:195). This implies

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that for a market to be efficient, all available information has already been disseminated and reflected in the share prices. This is known as the efficient market hypothesis, which was originally formulated in the 1960s.

4.10.2 Forms of market efficiency

Market efficiency is a matter of degree and there are three major forms or levels of market efficiency, namely the weak form of the efficient market hypothesis (EMH), the semi-strong form of the EMH and the strong form of the EMH (see Fama 1970; Bodie, Kane & Marcus 1996; and Sears & Trennepohl 1993). However, this subject is a study on its own that has fostered continuous debate and a great deal of controversy and in this research the degree or limit of market efficiency will only be briefly described.

If markets are weak form efficient, such as the Johannesburg Stock Exchange because of the existence of closely held and thinly traded shares (Van Rhijn 1994:7), it implies that all historical information such as past prices and trading volumes are reflected in share prices and that only average profits can be expected. Semi-strong form market efficiency occurs when all publicly available information - such as earnings reports, annual reports, earnings forecasts by analysts and news announcements is reflected in the share price in addition to past prices. The strong form version of an efficient market is the most extreme form of efficiency and encompasses both of the other forms. It reflects all information, both public and private, that is known about the firm and prices adjust instantly to reflect new information. As a result, it does not allow above normal profits to be made from the possession of privileged information that is not public.

4.10.3 The nature and role of efficient capital markets

The function of capital markets is to set share prices and effect share transactions. According to the efficient market hypothesis, information is its lifeblood and is quickly incorporated in share prices. A critical factor for efficient markets, as identified by Sears and Trennepohl (1993:101), is that there should be a flow of free or low cost information to a sufficient number of market participants to ensure that security prices accurately

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reflect the economic value of the securities. With the rise of the proportion of shares owned by large financial institutions, transactions by a single institution may dramatically affect the market price of the shares of a particular company.

4.10.4 Investor behaviour

Hopwood (1976:170) noted that investors in general are efficient processors of information and react to accounting information in an informed manner. He found that investors do not only use the information publicly reported by accountants when evaluating the prospects of companies, and concludes that the annual reports, and increasingly the quarterly and half-yearly reports, may be a part of a complex financial ritual, encouraging and legitimising the appraisal and review of investors' expectations. This theory is substantiated by Hellman (1996:687), who noted that decisions on equity trades should be regarded as continuous processes, rather than single points in time. Furthermore it seems that accounting information is mainly used when an existing idea needs to be quantitatively evaluated. The fact that the performance of a company becomes incorporated in the market price of the company's shares, disciplines managers to pursue activities that will maximise shareholder value.

In section 2, item 2.1 of questionnaires A (annexure 7) and B (annexure 9), compilers and users were asked to state whether they believed that the share prices on the Johannesburg Stock Exchange react immediately to information when it is made public. Table 4.2 reflects the results of the survey.

Table 4.2 **Users' and compilers' responses to the question: Do you believe that share prices on the Johannesburg Stock Exchange react immediately to information made public?**

Response	Compilers		Users	
	No.	%	No.	%
Strongly agree	15	11.6	16	15.7
Agree	77	60.2	62	61.4
Disagree	32	25.0	13	12.9
Strongly disagree	2	1.6	3	3.0
No opinion or uncertain	2	1.6	7	7.0
Total sample	128	100.0	101	100.0

Table 4.2 shows that 11,7% of the compilers strongly agreed and 60,2% agreed that share prices react immediately to such information, while 15,8% of users strongly agreed and 61,4% agreed.

4.10.5 Factors affecting share price volatility

Volatility of share prices is associated with the "informativeness" of information. The relevance of market efficiency to financial reporting is a function of the relationship between market price and information disclosure in financial statements. Information is price sensitive if it will potentially have a significant effect on a company's share price. According to Beaver (1981:142), a securities market is efficient with respect to an information system if and only if the prices act as if everyone observes the signals from that information system.

The practice by companies or security analysts of disclosing price sensitive information to selected groups and not by public announcement was declared as unacceptable by the London Stock Exchange. It published a non mandatory guidance for listed companies to help them communicate effectively with the market and meet their regulatory obligations (Garside 1994:83). The guideline states that a company's principal obligation in avoiding a false market is to ensure that information provided to the market is sufficient, accurate and not misleading.

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The effect of information on security prices is of vital importance to preparers of financial statements and may influence their behaviour in efforts to achieve a desired outcome or goal. In fact, it may lead preparers to manipulate financial statements to achieve their own objectives. For example, preparers of annual reports may create a favourable perception of the reporting company in the eyes of the investment community in order to improve its accessibility to the finance required for carrying on or expanding the business. The share prices of companies are reflections of the performance of the corporations and may affect the remuneration of preparers responsible for the financial statements, specifically in cases where share options or cash payments are linked to increases in share prices.

The following general economic factors affect the market price of shares:

- interest and discount rates of banks and the South African Reserve Bank;
- returns on government stock and corporate bonds;
- money supplies;
- the level of private consumption and personal savings;
- international market factors;
- gross gold and other foreign reserves;
- changes in foreign exchange rates and the gold price;
- the consumer price index; and
- fiscal and monetary policy.

Other factors such as the "January effect", the "weekend or Monday effect" and "public holiday effect" were investigated by Bhana (1994/95:88), and included psychological factors such as investor fads and computerised trading strategies. All these factors were found to affect the share price behaviour and could cause disruptions on the stock market, thus affecting the volatility of the market price and the trading volume of a share.

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Empirical research has concentrated on various factors such as annual earnings announcements and management earnings forecasts. Atiase, Bamber and Freeman (1988:22) reported that security price reactions to the earnings announcements of small companies exceeded those announcements by large companies. He attributed this to the fact that reported earnings constitute a bigger slice of the total "information pie" for small companies than for large companies.

Harrison (1993:74) pointed out that the frequency with which a company communicates with the public, could also have a significant effect on how the market values the company. He added that frequent disclosure promotes a stronger understanding of the company by the market and discourages the market from overreacting to any single announcement. It would therefore also mean that infrequent disclosure of information could be a source of greater volatility in a company's share price, because undue emphasis is then likely to be placed on that single announcement. Certain weak areas in the functioning of capital markets, such as the inadequate disclosure and announcement of price-sensitive information, need to be rectified by encouraging increased communication between companies and the market.

4.10.6 Determining the value of a share

Various methods are used by financial analysts to determine the net worth of a share. For example, *net worth based on historical figures* in the balance sheet is the surplus of total assets over total liabilities, while the *dividend discount model* postulates the value of a share to be the present value of its expected future dividends plus its estimated residual price at some specified future date, discounted at a risk-adjusted rate of return (opportunity cost of capital) (Knutson 1993:17).

Disclosure is an essential component in the effective functioning of a capital market but it can only be efficient if all financial and other information concerning corporate behaviour is freely available. A well-informed market leads to a greater investor confidence. Since its introduction on 7 June 1996, the JET system with on-screen trading facilities has increased market efficiency, leading to enhanced quality of service,

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increased availability of international information, greater flexibility as a result of better matching of transactions and more foreign investors entering the market. Since 18 August 1997, the Stock Exchanges News Service (SENS) and access to the internet and intranet has ensured early and wide dissemination of all information that could be expected to have an effect on the price of securities that trade on the Johannesburg Stock Exchange.

4.11 Conclusion

Every company should compile a specific disclosure policy and strategy, streamlined to meet the needs of the company as well as the needs and preferences of individuals. According to Wallman (1997:103) accounting could be divided into two primary functions, namely "compiling" and "attestation". He suggests that with the advancement in technology (the primary driver of change) and with the current inadequate accounting system, the roles of accountants, auditors, standard setters and regulators should undergo substantial change and their innovation and creativity should not be stifled by inappropriate regulation. If the basic needs of users are taken into consideration and the sophisticated technology currently available is brought into play, a totally different and more flexible accounting system could evolve.

In their planning of a process for improving financial reporting for the year 2002, the FASB (Beresford 1996:6) decided on four strategies:

- to build broader acceptance of their process and its results among their constituents by better utilising their own resources, by making FASB standards easier to understand and implement and by being better communicators;
- to make standard setting more timely and efficient by issuing standards within three years;
- to enhance the financial reporting model as a tool for decision making in a rapidly changing economic and technological environment; and
- to promote the development and acceptance of superior international accounting standards by cooperating with other standard setters in an effort to reduce

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differences in national accounting standards, to strengthen internal policies for international activities and to respond to the recent developments supporting the acceptance of International Accounting Standards Committee standards for cross border filings.

The following items of voluntary information are recommended: a statement of objectives and related strategic plans, a gains statement, information on future prospects, a report on control structure, a report on overall compliance with contracts and applicable laws and regulations, an operations report asserting resources were used efficiently and economically, a goals and objectives report on the progress made during the current year and a fraud deterrence report in which the status of activities preventing fraud is summarised.

Joubert (1993:6) suggests that a possible solution to the problem of reporting to sophisticated and unsophisticated users, would be to compile different reports based on user sophistication. Our present historical system of accounting needs to undergo a revolutionary change if it is to enhance its utility, reliability and credibility.