

CHAPTER 2

THE EVOLUTION OF CORPORATE DISCLOSURE

2.1 Introduction

This chapter contains a brief discussion of the history of corporate disclosure from its first inception during the period from 4000 BC to AD 1000, through the Renaissance and the Industrial Revolution of the Western world to present-day reporting systems. The archaeological approach provides an understanding of the nature of disclosure and the role played by accountants and other individuals in the development and evolution of voluntary disclosure practices.

2.2 The earliest form of informational disclosure

As far back as 4500 BC, the Mesopotamians took the first steps towards financial accounting. Symbols were used to record trading transactions of entrepreneurs on clay tablets of various shapes, shades and sizes, depending on the type of transaction. These tablets were also used as "source documents," as a hole was punched in a corner of the tablet that was attached to the commodity to be dispatched. After the transaction was completed, the tablets were "filed" or stored (Lee 1990:78).

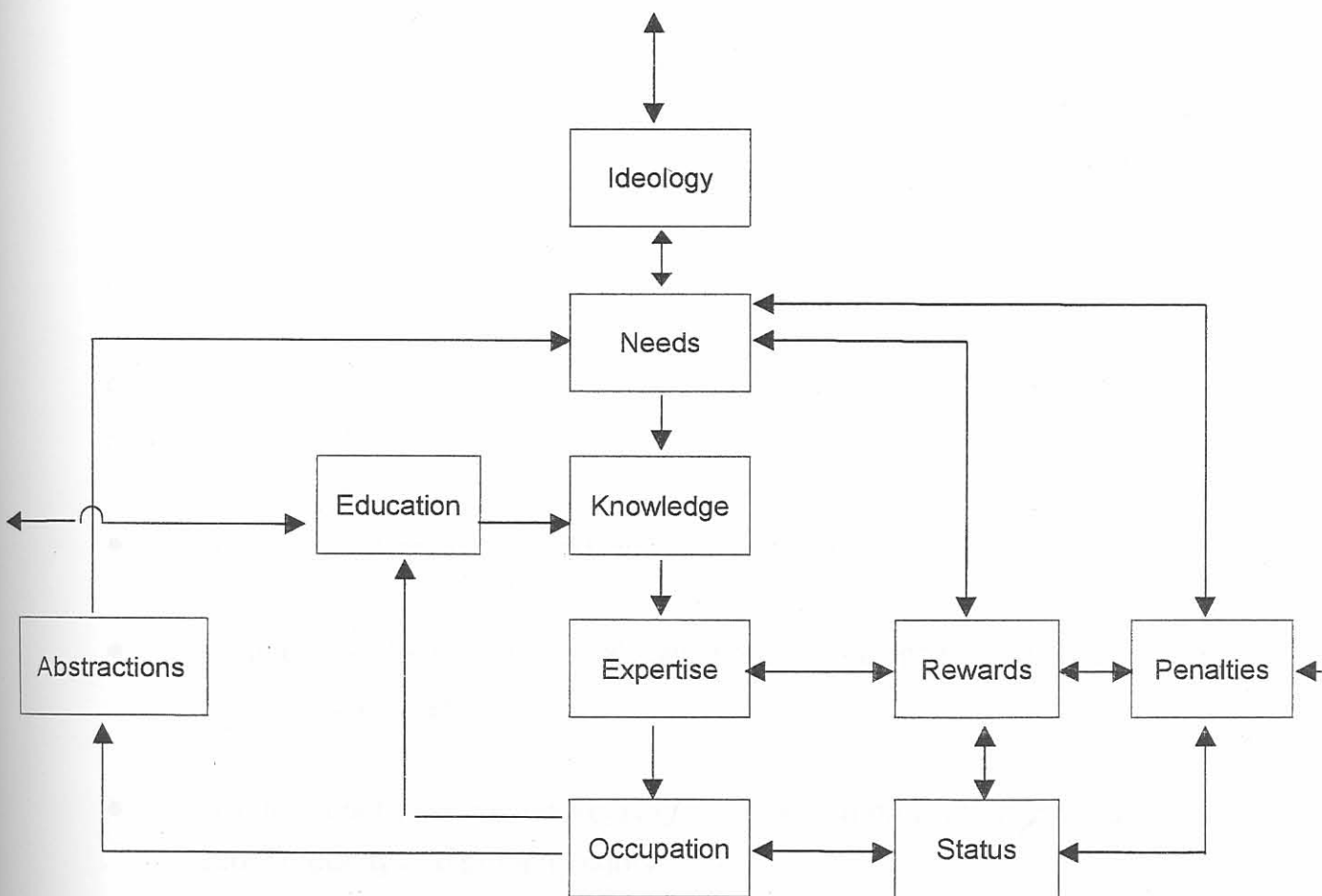
The Babylonian system of notation, dating from 2600 BC, resembled the Roman system which the present-day Arabic system later replaced. For identification and legality, the writer used a personalised seal buried with him upon his death. Educated scribes were instructed to record the transactions and these scribes can be regarded as the predecessors of today's accountants (Chatfield 1968:3 & Lee 1990:80).

It appears that accounting even at its earliest stage required a form of specialized education to understand the meanings of the symbols used to record transactions. The stewardship role of accounting in its earliest form was based on record-keeping or self-reporting by an accountant. The accountant was also the manager or owner, and often

these accounting recordings were subject to verification by a third party, who was either an auditor or the owner.

Figure 2.1 is a representation of the system of accounting in its earliest state (Lee 1990:59). This closed system of self-reporting depicts how the accountant or manager, with the introduction of a formal system of education and training, obtained the necessary knowledge and expertise to maximise rewards and thus his status. However, Lee (1990:62) maintains that the system remained open to its environment, in that new ideas and knowledge were constantly introduced.

Figure 2.1 The occupation of an accountant



Bookkeeping was first described in 1494 when a Franciscan monk, Frater Lucas Bartolomes Pacioli, published his *Summa*. While the *Summa* mainly dealt with algebra, it included a chapter on bookkeeping, namely *De computis et scripturis*. Pacioli's treatise on double-entry bookkeeping was the answer to an insistent economic demand for a standardized system for recording business transactions. Pacioli's aim was to devise a system of bookkeeping to give the trader information about his assets and liabilities at a glance. Pacioli is regarded as the father of modern accounting (Chatfield 1968:14). This system, which was based on the so-called "Method of Venice" and introduced in 1406 (Brown 1968:111), required considerable expertise and training to use. The result was a breakdown of the previous self-reporting closed loop, as the owner-management function was now split. The treatise of Pacioli has been the foundation on which practically all subsequent writings concerning double-entry bookkeeping have been based and consists of a detailed discussion of the memorial, the journal and the ledger.

A second book, dated 1518 and authored by Grammateus, a German mathematician was immediately followed by a third book written by Jerome Garden. Regarding these developments Chatfield (1968:14) concludes that "bookkeeping appeared not as a chance phenomenon, but distinctly in response to a world need" and also directly as a result more and more partnerships being established.

Chatfield (1968:21) identified seven necessary conditions for the existence of the double-entry bookkeeping system, as follows:

- "the art of writing, since bookkeeping is first of all a record;
- arithmetic, since the mechanical aspect of bookkeeping consists of a sequence of simple computations;
- private property, since bookkeeping is concerned only with recording the facts about property and property rights;

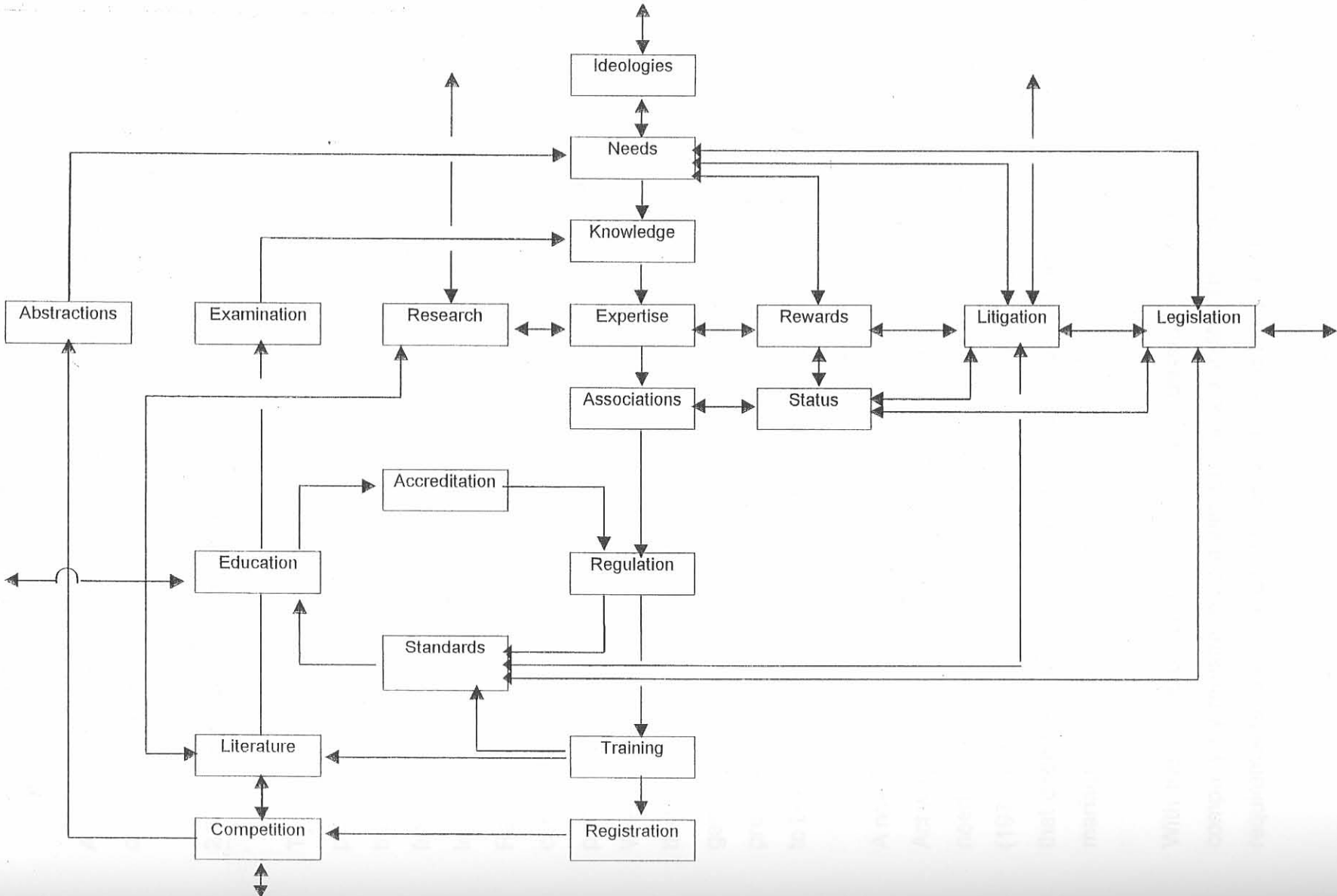
- money, since bookkeeping is unnecessary except as it reduces all transactions in properties or property rights to this common denominator;
- credit, since there would be little impulse to make any record whatever if all exchanges were completed on the spot;
- commerce, since a merely local trade would never have created enough pressure (volume of business) to stimulate men to coordinate diverse ideas into a system; and
- capital, since without capital commerce would be trivial and credit would be inconceivable.”

The idea of establishing a corporate enterprise originated from trade guilds, venture partnerships and the impact of foreign trade. This organisational change resulted in the notion of mutual association with limited liability and the recognition of the going concern concept. Some of the first companies were the Russia Company (chartered in 1555), the East India Company (chartered in 1600), the Hudson's Bay company (chartered in 1670) and the Bank of England (chartered in 1694) Lee (1979:16).

Accountancy theory changed little between 1494 and 1840 considering the fact that no distinction was made between fixed capital and working capital. Only in the mid-nineteenth century, accountants recognised the need for an organized accounting profession. The development of the accounting profession is illustrated in figure 2.2 (Lee 1990:75).

However, this formal system of accounting has resulted in an autopoietic state or “ordered chaos” (Lee 1990:78). In other words, the world of accounting as a social system is exercising selectivity as far as change is concerned, in that it is accepting change which does not alter its state of equilibrium, but rejecting change which has the potential to do so.

Figure 2.2 The Accounting Profession



2.3 The development of disclosure and the emergence of reporting legislation in various countries

A brief discussion of the events that affected the history of financial reporting in various countries follows.

2.3.1 Historical development

The company as a form of business developed out of shortcomings in rules governing partnerships and culminated in the formation of the first recognised company, the East India Company in 1600 (Gover 1975:24). However, as a result of the emergence of fraudulent and corrupt undertakings, the British Parliament passed strict and limiting legislation which dampened the growth of corporations. With the impact of the Industrial Revolution on the economy and the railway boom between 1830 and 1870, British corporations gained strength, and forced the Parliament to pass acts recognising the principle of limited liability and the business entity theory. In one of these acts, the Great Western Railway Act of 1835, recognition was given to investor needs by the provision that half-yearly financial statements had to be presented to the shareholders at the general meeting. This was later replaced by the Railway Regulations Act of 1868, which prescribed a uniform presentation for railway company financial statements. According to Lee (1979:17), this formed the basis for all company reporting up to the mid 1940s.

A new form of corporate structure was introduced in 1844 by the Joint Stock Companies Act which recognised the separation of ownership from active control and as a result the need arose to draft separate reports to the suppliers of capital. According to Lee (1979:15), the traditional stewardship role of directors was based on the assumption that directors were under a moral obligation to periodically report to shareholders on management's use of company resources and achievement of company goals.

With the promulgation of this Act, it was possible for the first time to incorporate a company by registration but with unlimited liability. The Act also extended disclosure requirements, and an audited balance sheet had to be prepared and presented at every

ordinary meeting of shareholders and then filed with the Registrar of Joint Stock Companies. However, there were no minimum disclosure requirements regarding the form and contents of the balance sheet, no mention was made of a profit and loss account and the auditors were not required to be professionally qualified accountants.

This Act was later replaced by the Joint Stock Companies Act of 1856 which introduced general registration with limited liability (Cilliers & Benade 1973:13) and a standard form of the balance sheet, in which the capital, liabilities, property and assets had to be analysed and classified in substantial detail. Company reporting and auditing practices nevertheless remained a purely voluntary action of directors and did not become mandatory until the companies Act of 1908 was introduced. This Act required all public companies to file annual audited balance sheets and introduced the distinction between private and public companies.

During the 1920s, reporting standards declined. Companies were experiencing financial difficulties with the result that compilers of annual reports tended towards a narrow interpretation of statutory reporting obligations. Fortunately this trend was reversed by the British Companies Act of 1929. This Act had a significant influence on financial reporting trends, and for the first time a profit and loss account became compulsory. The Act also required that a distinction be made between fixed and floating assets, and that goodwill and investments in subsidiary companies be stated separately. However, the Act had some limitations. One of the most serious was that it did not provide definitions of either the nature or the requirements, so that companies could omit important items such as depreciation and thereby rendering the statements meaningless. Lee and Parker (1979:282) for example refer to the case of the Cheshire United Salt Co Ltd where a disagreement between the shareholders and the directors resulted in an amendment of the profit and loss account to show proper depreciation. As a result, reported profits decreased by 20%. A further limitation of the Act was related to reserves, as no disclosure of their extent or existence was required.

In 1948, a new Companies Act was promulgated in an attempt to improve reporting standards and arrest the decline that ensued during the post-war years. Some of the

major changes were that group accounts became compulsory, a distinction was required between reserves and provisions, new disclosure requirements were introduced and an auditor's report stating that the accounts were "true and fair" rather than "true and correct" was required.

The Companies Act of 1967 required turnover to be added to the profit and loss account and greatly expanded the information required in the directors' report and notes to the financial statements. The information included the number of employees, charitable and political donations, market values of investments and property and directors' interests had to be disclosed in considerable detail.

There were no references to mandatory accounting standards for the preparation of financial statements in any of the companies acts until 1970. At that time the Institute of Chartered Accountants in England and Wales formed the Accounting Standards Steering Committee, later known as the Accounting Standards Committee, to develop standards for financial reporting. By 1990, this committee had recommended 34 statements on accounting practice.

2.3.2 Present-day voluntary disclosure

2.3.2.1 *The United Kingdom*

The present-day company financial reporting system developed in Britain over a period of 150 years. Nor can it be said to have been completed. Indeed an amended Act was promulgated in 1989, which further formalised presentation and disclosure. The Act requires compliance with accounting standards of the Financial Reporting Council where the Accounting Standards Board issues the standards, the Urgent Issues Task Force deals with urgent matters of interpretation of existing standards and the Review Panel ensures fair presentation of information in financial statements (Van Wijk 1997:3).

2.3.2.2 *The United States of America*

Accounting regulations in the United States of America were mainly based on English company law till 1887 when the American Institute of Accounting was founded. In 1889 the New Jersey Corporation Law was amended to allow companies to make investments in other companies. America was the first country to publish consolidated statements, and example of which is the statements of the U S Steel Corporation, published in 1901 (Robson 1973:45). The Securities and Exchange Commission requires public listed companies to submit financial reports complying with accounting standards issued by the Financial Accounting Standards Board.

2.3.2.3 *Canada*

In terms of the Canada Business Corporation Act, corporate financial statements must be prepared in accordance with the standards of the Canadian Institute of Chartered Accounts (Van Wijk 1997:4).

2.3.2.4 *Australia*

An amendment of the Corporations Act in 1991 made compliance with accounting standards a prerequisite. In addition, directors are required to add information and explanations if they are of the opinion that adherence to the standards would not result in the financial statements providing a true and fair view (Van Wijk 1997:4). Today, financial reports of Australian companies are controlled by the Australian Securities Commission, Australian Accounting Standards Board, Australian Accounting Research Foundation and the Australian Stock Exchange.

2.3.2.5 *New Zealand*

The Financial Reporting Act of 1993 gives legal backing to accounting standards for entities regulated by this Act. The Act requires that financial statements be prepared in compliance with generally accepted accounting practice which is embodied by the

accounting standards issued by the Accounting Standards Review Board. In addition, financial reporting is monitored by the New Zealand Stock Exchange and the New Zealand Society of Accountants.

2.3.3 The Republic of South Africa

The first official legislation relating to companies was the Companies Act No. 46 of 1926, which was based on the Companies Act of 1908 in Britain. It was replaced by a new act in 1939, again following the British lead, namely the promulgation of the British Companies Act of 1929. The new Act amongst others contained a provision requiring holding companies to present the aggregate amount of shares held in subsidiary companies, loans to or from subsidiaries, profit and losses of subsidiaries pertaining to holding companies if not incorporated in group accounts and definitions of “holding”, “subsidiary” and “sub-subsidiary” companies.

The Companies Act of 1952 incorporated further improvements particularly those stemming from the implementation of the Eighth Schedule. This part of the Act prescribed the format and contents of the balance sheet and income statement and made consolidated financial statements compulsory. The 1952 Companies Act was replaced by the 1973 Companies Act No. 61 and the Fourth Schedule was amended in 1992 to incorporate all disclosure requirements contained in statements of generally accepted accounting practice.

2.3.4 International standardization

The International Accounting Standards Committee was formed in July 1973 from 16 accounting bodies from nine countries. Its purpose was to develop and publish a comprehensive set of accounting standards in order to produce high quality financial statements. It also aimed at serving as an international example to encourage improvement and harmonisation of accounting standards set by standard setters of the different member countries. In April 1974 it issued its first exposure draft on disclosure of accounting policies and this first IAS statement was applied from January 1975.

The Urgent Issues Task Force was established in March 1991 to provide guidance on the accounting treatment of new issues, such as goodwill on disposal of a business and accounting for backdated supplemental interest on convertible bonds, restructuring costs and post-retirement benefits other than pensions.

2.4 The influence of the Johannesburg Stock Exchange listing requirements on reporting practices

The Johannesburg Securities Exchange South Africa is referred to throughout this research as the Johannesburg Stock Exchange as the name change only took place in November 2000. The Johannesburg Stock Exchange was established in November 1887 by Benjamin Woollan after the discovery of the Witwatersrand goldfields. It is the largest emerging market in the world and at the end of November 1996, it ranked 16th (by market capitalisation) among the 42 exchanges of the Federation of International Stock Exchanges.

A brief summary of the requirements applicable to companies listed on the main board of the Johannesburg Stock Exchange for the period up to the end of September 2000, are as follows:

- a subscribed capital, excluding re-evaluations of assets, of at least R2 million in the form of not less than one million shares in issue;
- a satisfactory profit history for the preceding three financial years, the last of which reported an audited profit before taxation of at least R1 million;
- a minimum of 10% of each class of equity shares to be held by the public;
- a minimum of 300 public shareholders for equity shares; and
- the minimum initial issue price of shares to be no less than 100 cents per share.

In April 2000, the Johannesburg Stock Exchange brought out new listing requirements to promote international investor confidence in South Africa's equity market and for companies wishing to list on foreign exchanges. The aims were to raise standards of transparency and corporate governance, to bring the JSE in line with international best

practice and to encourage fuller disclosure of shareholders' identities and directors' salaries. The purpose was thus to adhere to international best practice.

The following reforms were implemented between October 2000 and January 2001:

- stricter rules for brokers sponsoring new listings, and listing sponsors are extended to corporate, legal and other advisers;
- the minimum number of shareholders is raised from 300 to 500;
- the minimum public float in listed companies is raised from 10% to 20%;
- disclosure of beneficial interests is now required;
- the directors of new listings will be subject to a fit and proper test and be required to disclose their background;
- companies listed on the main board will have a three-year period to achieve a pretax profit of R8 million from R1 million which was previously required, while new main board listings will have to comply immediately;
- subscribed capital from main board listings is raised to R25 million from R2 million;
- a new growth enterprise market will replace the venture and development capital sectors;
- company directors must disclose share dealings in their companies;
- directors must disclose their remuneration;
- the listing of pyramid companies is banned;
- the listing of N shares will not be allowed;
- listed companies must comply with generally accepted accounting practice;
- financial reports are to include a modified auditors' opinion; and
- companies are no longer required to publish notices in newspapers, and this will be phased in over two years to October 2002 (Business day, 31 August, 2000).

2.5 The influence of financial reporting awards on voluntary disclosure

2.5.1 Awards for best annual reports

A great deal of the impetus for promoting quality financial reporting practices can be attributed to the existence and stimulus of competitions for best reporting practices. Financial reporting awards were traced back over 30 years by Beattie (1988:37) to the United Kingdom, with the first occurring in 1954 when *The Accountant* published the stock exchange awards for the best annual reports issued by United Kingdom public companies. The aim of the annual competition was to encourage public companies to prepare clearer and more informative annual reports and accounts.

In South Africa the Southern African Institute of Chartered Secretaries and Administrators introduced an annual report awards competition, also in 1954. This competition was held biennially to give companies the opportunity to incorporate the adjudicators' recommendations.

The annual reporting award of the South African Institute of Chartered Accountants was aimed at companies listed in the industrial and development capital sectors of the Johannesburg Stock Exchange. Only company reports disclosing more than the following information qualified (Singer 1994:3):

- an unqualified auditor's report;
- a chairman's report;
- a value added statement;
- segment information, where applicable;
- some recognition of the effects of inflation; and
- a cash flow statement as opposed to a source and application of funds statement.

Another competition that had a marked effect on reporting standards in South Africa was the *Top Twenty Annual Report Award* of the Financial Mail which was

conceptualised and initiated in 1964 to mark the magazines fifth birthday. The objective of the competition was to motivate companies to improve their reporting standards. Reports of the time were on the whole totally inadequate. Massey-Ferguson was the leader for five successive years in the field of quality reporting and was later succeeded by Protea Holdings in the sixth year of the competition. In recognition of their achievement, Massey-Ferguson donated a floating trophy, known as the Massey-Ferguson Award for the best report. The system of judging the annual reports remained constant for seven years and was limited to industrial and commercial companies listed on the Johannesburg Stock Exchange.

With the enactment of the 1973 Companies Act, many items of disclosure were made mandatory which improved the overall extent of disclosure in annual reports. In addition, the publication of half-yearly interim reports became compulsory for all listed companies. Over the years, the rules for the Financial Mail competition became more stringent and are adjusted biennially to encourage higher reporting standards. Since 1977 the rules are published annually in the Financial Mail. Copies of the completed score sheets and relevant rules are posted to the respective companies since 1984, for verification and if necessary the score sheets are appropriately amended by the researcher before processing.

As a further incentive to compete for this prestigious award, a role of honour list was introduced in 1986, listing those companies that had won the floating trophy three or more times. Management may influence users' image of the company by referring to their achievements in the various reporting awards competitions in their annual report. In the 1997 (page 8) annual report of President Medical Investments Ltd for instance, the chairman states: "We were pleased to have been recognised by the Financial Mail for their annual accounts award and to be selected as one of the 20 most improved annual reports of all Johannesburg Stock Exchange listed industrial companies. We will endeavour to improve our standard of reporting to our shareholders." The directors of many listed companies have noted that their success in these rankings serve as a useful marketing and financial tool which improves the company's ratings with bankers and prospective investors.

Two more examples of references to competition results illustrate the value and influence of the competition to voluntary disclosure: The preface page of the 1998 annual report of Seardel Investment Corporation Ltd contains the following statement: “Seardel was the winner of the prestigious Institute of Chartered Accountants Annual Financial Statements Reporting Awards Competition in 1984, 1990 and 1991, and was consistently placed in the top 10 of that competition. The Investment Analysts Society of South Africa also adjudged the 1991, 1992, 1993, 1994, 1995 and 1996 reports as the best in their category. In 1995 the Chartered Institute of Secretaries and Administrators, in conjunction with Rapport, elected Seardel’s report as the overall winner and also adjudged the 1996 and 1997 reports as the best in their categories. Seardel has also consistently featured in the top 20 of the Financial Mail annual reports competition and was the overall winner of the competition in 1996.” In their 1997 annual report (page 12), under their compliance with the code of corporate practices and conduct, Morkels Ltd now Fashion Africa Ltd, refer to the fact that “... shareholders are kept informed through formal communication of results at the interim and final stages, but principally through the annual report, which was adjudged by the Financial Mail as the best financial report for three consecutive years from 1991. Having been elected to the ‘roll of honour’, the annual report was no longer eligible for the award, but was still regarded as one of the best of its kind.”

A marketing technique used by companies which could be regarded as a form of voluntary disclosure, is the inclusion of a question and answer section in the annual report which the company anticipates enquiries following the publication of the report or to avoid confrontation. An example is the chairman’s statement in the 1996 annual report of Plate Glass and Shatterprufe Industries Ltd, which contains a seven-page question and answer section. Another technique is to include a transcript of a press meeting in the annual report, such as that of the chairman of Yorkor Ltd in its published annual report of 1996.

In 1969, the Investment Analysts Society introduced an award for best reporting and communication and at their 30th anniversary celebrations in 1999, Billiton won the award for the second time in a row (Business Day 12 August 1999). In the 1998 annual report of Dorbyl Ltd, they referred to winning this competition in 1997.

2.5.2 Awards for employee, environmental and other voluntary reports

In 1991, the Chartered Accountant/Anglo Alpha Employee Report Award was instituted for the company producing the best annual employee report containing financial and other information. The award came about because the prevailing opinion was that employee reports in South Africa demonstrated too much evidence of simply being "down loaded" from the annual report. In other words, insufficient attention was paid to matters of real importance to the employee (Everingham 1994:30).

An interesting development that also took place in 1991, was the establishment of an Environmental Reporting Award Scheme. The scheme was the brain child of the Chartered Association of Certified Accountants in England and the aim was to improve environmental reporting by quoted companies. In 1994 the World Wildlife Fund launched the Environmental Annual Report Award, which was aimed at improving environmental reports, and to encourage businesses in South Africa to report voluntarily and transparently on their environmental performance. The winner of the 1995 award was Umgeni Water and the 1996 award was given to Eskom for their report entitled *Using resources effectively*. Both reports were highly rated for their credibility, open acknowledgment of achievements and weaknesses and details of targets for future years.

The following judging criteria were used:

- *Completeness*: The report should cover the full spectrum of the organisation's environmental performance and impacts, both the good and the bad;
- *Credibility and clarity*: All claims should be objective and be substantiated. Specific information should be given in context to aid credibility, while vague or

- excessively technical information detracts from it;
- *Commitment*: There should be evidence of top level commitment;
- *Continual improvement*: The organisation's should demonstrate a commitment to the ongoing improvement of its environmental performance. This could for example be done by reporting on year-on-year progress against specific objectives and targets;
- *Accountability to the community*: An environmental report should address the organisation's management of its social impact and the methods used to consult interested and affected parties; and
- *Employee awareness and involvement*: The report should reflect the work being done to raise employees' level of environmental awareness and gain their commitment to good environmental management.

The focus has also shifted to the needs of ordinary users as is evidenced by the introduction of an annual report award called Personal Finance in 1998. It is sponsored by a communications company, Plain Business Writing. Its purpose is to recognise excellence in communication in plain language, by studying various documents such as policy documents, promotional material and reports to investors.

2.5.3 Awards by accountancy firms

In 1995, Deloitte & Touche introduced a corporate governance award which is endorsed by the Institute of Directors, the South African Institute of Chartered Accountants and the South African Institute of Chartered Secretaries and Administrators. The first award was presented to NBS Ltd and it was won by Eskom Ltd in 1997.

In 1997, Ernst & Young in conjunction with the University of Cape Town introduced an annual award known as the "Excellence in financial reporting award". The aim was to measure the quality of reporting in terms of four key criteria, namely financial disclosure, performance review, forward-looking information and presentation. The winner for 1997 was Edgars Ltd with South African Breweries Ltd in second place (Business Day, 12 February 1998:19)

The question of whether competitions for best reporting practices affect a company's voluntary disclosure policy was included in section 2.9 of questionnaire A (see Annexure 7) mailed to compilers of corporate reports. The aim was to ascertain whether companies considered these competitions to be meaningful and valuable. The results are included in this chapter as they were relevant at this stage. Table 2.1, shows that 4 (3,5%) of the compilers strongly agreed and 48 (42,5%) agreed that competitions did affect their company's voluntary disclosure policy.

Table 2.1 Compilers' responses to the question: Do competitions for best reporting practices affect your company's voluntary disclosure policy?

Compilers' opinion	No.	%
Strongly agree	4	3.5
Agree	48	42.5
Disagree	45	39.8
Strongly disagree	10	8.8
No opinion or uncertain	6	5.3
Total sample	113	100.0

2.6 Conclusion

The subdivision of ownership and the severance of ownership from control as well as the enormous amounts of fixed capital invested, contributed to the practical and theoretical importance of modern-day accounting. The development of company financial reporting was further influenced by a succession of Companies Acts, particularly in the United Kingdom and the Securities Act of 1933 and the Securities Exchange Act of 1934 in the United States of America. In South Africa the Companies Act of 1973 can be regarded as the most important piece of legislation on reporting and disclosure.

Although South Africa's accounting standards are rated as good as those applied by the Financial Accounting Standards Board in the United States and are often shorter, simpler and more easily applied (Singer & Blumberg, Financial Mail, 8 May 1998:35),

they do not have legal backing. Because of this lack of enforcement, they receive little international recognition. However, the lifting of sanctions has led to increasing pressure on South African companies to produce financial statements based on accounting standards in line with those issued by the International Accounting Standards Committee.

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