University of Pretoria etd – Myburgh J E 2006

CHAPTER 5

VOLUNTARY DISCLOSED ITEMS PERCEIVED AS PRICE-INFORMATIVE

5.1 Introduction

This chapter identifies the nature and characteristics of voluntary disclosed items in annual reports. It is not a comprehensive study of all the voluntary disclosed items that may possibly be disclosed, but rather reviews those items that are regarded to be price-informative to both compilers and users. As was stated in chapter 3, information disclosed in annual reports should be relevant, reliable and if possible, measurable. Voluntary disclosed items may not always be measurable, but are deemed useful to the investment decision maker because of their dynamic nature.

In the discussion of the different voluntary disclosed items, the following aspects, where relevant, are investigated:

- identification of the item and a brief discussion of its historical background; and
- prior research on the voluntary disclosed item.

5.2 Biographical profile of the board of directors and top management

It is only during the last decade that theoretical research and analyses have been carried out on reputation building by executives and top management of corporations. As a result of this research, investigators came to realise that investment policies of corporations are significantly influenced by the incentives of top management to build on their own reputations as well as that of the corporation. Arnold *et al.* (1991:6) observed that "some managers are taking the view that their shares are undervalued by a market obsessed with short-term changes in single earnings figures, and a growing

University of Pretoria etd – Myburgh J E 2006

number of entrepreneurs are seeing a return to private ownership as the only means to sustain long-term growth".

The AICPA concluded from a survey that "quality of management did not emerge as one of the important types of information... Although management quality is extremely important to investors, they believe they can best understand it by evaluating performance, reputation, market position and other company characteristics. In other words, management quality is an inherent and inseparable aspect of the other types of information." This perception contrasts with the findings of Hirshleifer (1993:146) concerning managerial reputation and corporate investment decisions: he found that managers tended to manipulate investment decisions in an effort to influence perceptions about themselves or their company. He furthermore found a clear effect on investment decisions, in that reputational considerations will affect the price at which the firm can raise capital, hire employees and sell its products. This confirmed by the fact that head hunting that is, the employment of a management team respected by investors, has become a common and accepted practise of companies.

In addition, management does have an influence on the user's understanding of the data, as they are the people who interpret and analyse the data provided in the annual report. The chairman's statement or directors' report are prime examples and the interpretations send messages which may alter the perceptions of decision makers regarding the accompanying data. Take for example ratios disclosed in the table of statistics: Definitions may be added as may an analyses of the actual results, and as well as an outline of management goals. All these aspects will impinge on the interpretation of the user who would normally use his interpretation of the ratios on generally accepted standard measurements.

Voluntary information in respect of the quality, experience, calibre and composition of the board of directors and top management may be deemed useful for the prospective investors - after all, they are entrusting their funds to the abilities and creditability of these persons.

University of Pretoria etd – Myburgh J E 2006

The following additional information may be provided:

- the age or date of birth of the directors and top management;
- the present position held in the company or a brief history of their progress in the company;
- academic and other qualifications or experience;
- directorships held in other companies;
- the date of the original appointment or length of term of appointment;
- shares held in the company by the directors or top management;
- photographs; and
- financial incentives, often in the form of compensation schemes and share options, offered to directors and top management.

5.3 Size and nature of shareholdings

It is important to disclose information on the ownership and control of the company so as to provide the investor equity group with a firmer foundation on which to base their investment decisions. Keasey and Wright (1993:293) refer to insider (controlled by shareholders) and outsider (controlled by managers and divisional managers) controlled companies. The greater the percentage shares held by outsiders, the greater the chances are that the goals of the shareholder are not aligned with those of management.

The traditional entrepreneur, representing owner, capital provider, decision maker as well as risk bearer, has virtually disappeared as a result of the formation of large corporate enterprises. This separation of corporate ownership and control has given rise to a conflict of interests between the stakeholders of large companies and the management of these companies. While the value-maximising goals and activities of management may tend to depart from the interests of the other stakeholders (shareholders, employees, creditors, clients, the government and the public in general), performance activities of management are reflected and incorporated in the market price of a company's shares.

University of Pretoria etd – Myburgh J E 2006

Extensive research had been conducted in South Africa, (see eg. Cohen & Uliana, 1990:7) on the agency theory. This is a body of theory dealing with the analysis of the control of incentive conflicts in contractual relations. The agency theory problem also arose as a result of listed South African companies on the whole being controlled by conglomerates and holding companies. In this regard Healy and Palepu (1993:6) noted that financial communication problems are mitigated if the firm's ownership is concentrated in a few hands and if these large shareholders actively participate in the corporate governance process.

In South Africa, the industrial sector of the Johannesburg Stock Exchange is divided into conglomerate controlled, owner controlled and foreign controlled groupings. In addressing the needs of all stakeholders by promoting application of the guidelines of the King Report, the Johannesburg Stock Exchange is encouraging wider share ownership through share incentive plans introduced by listed companies. As far as the company itself is concerned, the Cadbury Report (1992) recommended that the role and functions of the chairman and chief executive officer be separated to prevent too large a concentration of power in the hands of one director. Features of corporate governance structures are frequently complicated by the size and complex nature of organisations.

Definitions of corporate control put forward by Cohen and Uliana (1990:11) are the following:

- an *owner controlled company* may be defined as an entity that has at least one individual shareholder or closely related group, such as a family or members of a board of directors, who owns a minimum of 25% of that company's equity share capital;
- a *conglomerate controlled company* may be defined as an entity where a minimum of 25% of its equity share capital is owned by a conglomerate group; and
- a *foreign controlled company* is defined as an entity operating in South Africa that has at least one foreign shareholder owning a minimum of 25% of that company's equity share capital.

5.4 Table of comparative statistics

Statistical information is not mandatory but its inclusion enhances the understandability of financial statements and is often used for quick references. In a survey conducted by Benjamin and Stanga in 1977 (1977:189), comparative data were ranked as being the most essential information item for making an investment decision by financial analysts and for a term loan decision by bankers. Statistical tables are designed to accommodate unsophisticated investors that have difficulty in understanding annual reports, and therefore it is essential that the information contained in the statistical table be relevant and reliable. Users should be warned to take into account the effects of inflation on earlier reported figures, if these are not restated.

Eight items were selected from various published tables of statistics, based on their importance relative to investment decisions. These items were turnover figures, number of shares issued, net asset value per share, profitability, liquidity, solvability and productivity ratios, definition of ratios, number of employees, Johannesburg Stock Exchange statistics and comparison of the share price with the industry index.

5.5 Corporate governance

There has been a great deal of research and debate on the subject of corporate governance and management accountability, particularly as to whether this should be regarded as the primary purpose of financial reporting. For more than a decade, pressure from the public for greater corporate accountability and more credible and transparent financial reporting has dramatically influenced the roles of and relationship between boards of directors, shareholders, auditors and management. This has culminated in a revolutionary new concept, namely corporate governance.

Corporate governance has evolved into a complex form of disclosure of profound importance. While it enhances the image, credibility and reputation of corporations, it also explicitly recognises the roles played by each class of stakeholder, whether

University of Pretoria etd – Myburgh J E 2006

primary, secondary or tertiary. As a result of these changes corporate governance is now taken seriously by the corporate world and has become an important part of the annual report. It is a form of voluntary disclosure which entails structured communication with shareholders.

5.5.1 Definition of corporate governance

The primary aim of corporate governance is to tighten control over inefficient managers, thereby protecting all stakeholders and at the same time increasing the level of confidence in corporate reporting. Keasey and Wright (1993:301) view corporate governance as a "multi-faceted activity with each of the facets reinforcing the others" and define accountability as "involving the monitoring, evaluation and control of organisational agents to ensure that they behave in the interests of shareholders and other stakeholders".

Anderson (1995:2) refers to corporate governance as the whole system by which companies are managed and controlled with the flow of financial information between management and the shareholders, and the auditing of that information by external auditors lying at the heart of the system of corporate governance and accountability. According to Delorme (1993:42), corporate governance should encompass all the principles that guide those entrusted with the management of corporations and that govern their relations with those from whom they solicit capital and to whom they are thus accountable. He also emphasises the distinction between the responsibilities of the board of directors and the chief executive officer: the board of directors is mainly responsible for corporate governance, while management is responsible for corporate management. As defined in the Cadbury Report (1992:15), corporate governance is the system by which companies are directed and controlled. Effective corporate governance could thus be defined as the improvement of the board/management partnership to enhance stakeholder value.

University of Pretoria etd – Myburgh J E 2006

5.5.2 Objectives of corporate governance

The annual report is the instrument by means of which managers inform constituents about the successful performance of their stewardship functions and fiduciary duties. Communication between all parties involved in the preparation of the annual report will enhance the quality of financial reporting over time. Accountability reporting should be aimed at identifying who is accountable, to whom and for what. In assessing the quality of accountability of managers, the fairness and efficiency of management should be reviewed taking into account the ethical and societal concerns of corporate governance. Managers should provide reasons for their actions, state their achievement objectives, disclose their performance standards performance results and finally explain any material deviation from planned results.

In the 1995 annual report of Adcock Ingram Ltd (1995:31) it is stated that the primary objective of any code of corporate governance must be "to ensure that directors and managers, to whom the running of large corporations has been entrusted by the shareholders, carry out their responsibilities faithfully, placing the interests of the corporation ahead of their own. In addition, such a code should establish structures and processes to evidence that management are meeting their responsibilities". This is a clear and succinct explanation of the objectives of corporate governance.

5.5.3 Background of corporate governance

The process of establishing corporate governance standards was first initiated by Sir Adrian Cadbury in May 1991. In December 1992 the Committee on the Financial Aspects of Corporate Governance published a report known as the Cadbury Report with recommendations focusing on the control and reporting functions of boards, and on the role of the auditor. The Committee's objective was to improve the standards of corporate governance and the level of confidence in financial reporting and auditing by providing a clear presentation of the respective responsibilities of those involved (Cadbury Report 1992:15).

University of Pretoria etd – Myburgh J E 2006

The Committee based their recommendations on the principles of the Code of Best Practice, namely openness, integrity and accountability. All listed companies on the London Stock Exchange were obliged to comply with these principles or identify and give reasons for any areas of non-compliance. The arguments for compliance with the Code was that a clear understanding of responsibilities and an open approach by boards of directors would contribute to the efficient operation of capital markets. It would also mean that less reliance would be placed on statutory measures and legislation with regard to corporate governance.

In South Africa, the King Committee was constituted during June 1993 under the aegis of the Institute of Directors in Southern Africa (IOD) and the chairmanship of Mervyn King. Its mission was to prepare a code of best practice for corporate governance and business ethics encapsulating recommendations of the Cadbury Report, but incorporating aspects unique to the South African business environment, such as affirmative action. The King Report on Corporate Governance was published during November 1994. On the basis of this report the Johannesburg Stock Exchange issued a new listing requirement in respect of corporate governance, which was mandatory for companies with financial years commencing after 30 June 1995. The requirement is that quoted companies had to report on their level of compliance or non-compliance with the King Report's Code of Corporate Practices and Conduct. The primary motivation for compliance with the King Report was that companies whose standards of corporate governance are high, are more likely to gain the confidence of investors and support for the development of their businesses (Cadbury 1992:13).

KPMG has conducted two surveys on the disclosure of corporate governance practices of South African listed companies. These surveys had the following aims:

- to determine the extent of compliance with the disclosure practices recommended in the King Report;
- to establish the disclosure practices of the top 100 companies compared to other listed companies;

University of Pretoria etd – Myburgh J E 2006

- to compare the difference in the level of disclosure between the first year (1996/1997) of compulsory corporate governance reporting with the previous year during which such reporting was "voluntary"; and

- to provide corporations with an objective yardstick for measuring their own disclosure performance against that of other listed companies (KPMG 1996/1997:1-8)

The survey highlighted the fact was that of the Top 100 companies ranked according to market capitalisation on 10 July 1997, 83% provided a list of compliance and non-compliance aspects, 9% disclosed an inadequate general statement, and 4% made no mention of corporate governance. Furthermore, a break-down of the elements of corporate governance in accordance with the King Report revealed a very low level of disclosure.

In 1995 the Deloitte and Touche introduced a corporate governance award competition with the primary aim of recognising achievement for good governance practices by South Africa's private and public organisations.

5.5.4 Items discussed in corporate governance reports

As the King Report which provides most guidelines on corporate governance, and is generally accepted as the most authoritative on this topic, the following sections are largely based on its criteria. Although environmental issues does form part of corporate governance, it has become such an important subject that it will be discussed under a separate heading (see paragraph 5.10) on environmental reporting.

University of Pretoria etd – Myburgh J E 2006

5.5.4.1 Financial statements

In this section of the corporate governance report, the extent of compliance with GAAP, statements issued by the South African Institute of Chartered Accountants and the International Accounting Standards Committee are discussed. It also includes the responsibility of management to provide information in the annual report with integrity and objectivity. The growth in international capital markets and renewed international interest and investment opportunities in South Africa as a result of the democratisation here has heightened the need for comparability of accounting practices around the world. This is also dealt with in this section of the report.

5.5.4.2 Chairman and board of directors

According to the King Report the roles of chairman and chief executive officer should preferably be separated, and the chairman should be a non-executive director. It recommends a unitary board structure that retains full and effective control in monitoring management and requires that the board meets at least once a quarter. The Report also provides guidelines for directors with regard to their duties and responsibilities, emphasising the principles of duty of good faith and duty of care and skill.

5.5.4.3 Internal control

Democratic accountability as opposed to bureaucratic controls and the concept of organisational effectiveness is of vital importance to accountants as it forms the ultimate criterion for the design and implementation of accounting management information systems for control. Management is responsible for establishing and maintaining a cost-effective system of internal controls so as to provide reasonable assurance that transactions are executed and recorded in accordance with established policies and procedures. This in turn ensures the integrity and reliability of those financial records on which the financial statements are based.

University of Pretoria etd – Myburgh J E 2006

The internal control system is the main line of defence against fraudulent financial reporting. Parties who demand uniform and effective standards for internal accounting control are: external auditors; management; audit committees; stockholders; government; and society as a whole.

The following internal accounting control measures could be implemented:

- planning controls;
- implementing controls;
- analytical controls; and
- an exposure management framework consisting of
  - exposure identification,
  - senior management planning and policy formulation,
  - policy implementation,
  - monitoring and evaluation of internal controls, and
  - checklists, cross-company reviews, and defalcation reporting procedures (Cadbury Report 1992:41).

5.5.4.4 Committees

Committees act as vigilantes over the corporation and are effective control mechanisms for examining in depth certain issues and making recommendations to the board of directors and management. Five committees are discussed briefly, namely the executive, management resources, retirement funds, remuneration committee, and independent audit committees.

(a) Executive committee

The executive committee is responsible to the Board for recommending the corporation's policies and strategies and their subsequent implementation. It deals with all executive business of the corporation not specifically reserved for the board, and co-ordinates and monitors the use of resources to achieve the

University of Pretoria etd – Myburgh J E 2006

aims of the corporation. Sub committees of the executive committee may be used, such as an administration committee, which is responsible for attending to the routine administrative matters of the corporation, once the principles have been approved by the executive committee.

(b) Management resources committee

The purpose of the management resources committee is to determine the remuneration of the company's senior executives by taking into consideration the success of each individual in meeting his or her objectives.

(c) Retirement funds committee

This committee is responsible for reviewing the company's policies and practices relating to the various retirement schemes for the benefit of employees. It therefore reviews rule changes and benefit improvements and authorises the establishment and termination of schemes.

(d) Remuneration or compensation committee

According to the best practice requirement of the King Report, the remuneration committee should consist mainly of non-executive directors and be chaired by a non-executive director. Its primary purpose is to determine and revise the remuneration and terms of employment of executive directors and senior employees of the company and to submit recommendations to the board. Activist shareholders are exploring strategies that would make executive compensation a key issue in the corporate governance arena. The Securities and Exchange Commission (SEC) is allowing compensation issues to be put to shareholder votes and thereby is encouraging corporate accountability of remuneration to executives.

University of Pretoria etd – Myburgh J E 2006

The purpose of the remuneration committee is to attract, motivate and retain high calibre executives by ensuring their rewards are competitive and linked to both individual and business performance. Directors' packages are reviewed each year to ensure that they are in line with the company's business objectives and the creation of shareholder value. The committee is responsible for establishing reward criteria for various performance goals and bonuses in agreement with these strategies.

Items that should be covered in the report of the remuneration committee include details of the emoluments of directors (in terms of Section 297 of the Companies Act), disclosure of salaries and fees, benefits, profit-sharing schemes, profit-related incentive schemes, notional share option schemes, pensions and contracts.

In formulating the remuneration policy of the company, various limitations may complicate the task. For instance, it may be difficult to structure a compensation package that accurately measures the performance level of the individual executives, if the activities of those individuals cannot be easily defined or separated.

(e) Independent audit committee

The main function of auditors is to vouch for the credibility of annual reports. The primary role of the external auditors, who appointed by the board of directors, is to provide the shareholders with an external and objective check on the directors' financial statements. However, on the one hand a company has the right to choose the auditor, negotiate the size of the fee and make use of and pay for other management services offered by the auditor and on the other hand the auditor has the right to set rules and enforce them. Such an interactive relationship puts pressure on the credibility of the appointed auditors and has resulted in constituent groups demanding that companies appoint independent audit committees.

University of Pretoria etd – Myburgh J E 2006

The credibility of the appointed auditors is also the most important criterium affecting the effectiveness of the audit committees. In 1978 it became a New York Stock Exchange requirement that all listed companies must have audit committees composed solely of independent directors. The critical role of the auditor in ensuring the integrity of United States company financial reports was confirmed by the report of the American Treadway Commission in 1987 (Cadbury Report 1992:27).

Broadly speaking, the purpose of the audit committee is to review internal accounting controls as well as auditing and financial reporting matters, including pending litigation and specific disclosures in the financial statements, and to review major audit recommendations. Its objective is to assist management in the effective discharge of its responsibilities. The scope of the internal audit function includes reviews of the reliability and integrity of financial and operating information, the systems of internal control, the means of safeguarding assets, the efficient management of the company's resources and the effective conduct of its operations. It provides a forum through which both the external and internal auditors report to the board of directors.

The Cadbury Report recommended that this committee consist of a minimum of three members, who should be non-executive directors. They should be responsible for developing tighter accounting standards and establishing guidelines for rotating audit partners. In South Africa the King Report also recommended that the audit committee meet at least twice but preferably three times a year and be attended by the head of internal audit, the external audit partner and the financial director. The head of the internal audit department and the external auditors should have unrestricted access to the chairman of the audit committee and are required to bring all significant findings to the attention of the committee. The committee should in turn be free to consult independent professional experts.

University of Pretoria etd – Myburgh J E 2006

The Public Oversight Board recommended that corporate governance responsibilities of independent auditors should not only include a review of the acceptability of a company's financial reporting, but also an assessment of its quality. Such assessment should be based on the appropriateness, aggressiveness or conservatism of estimates and elective accounting principles or methods, as well as the clarity of disclosures (Kirk & Siegel 1996:53). The intention was to have an informed audit committee and board of directors that would understand the quality of a company's financial reporting.

Companies should disclose the names of the members and chairman of the audit committee. To sum up, the primary responsibilities of the audit committee include a review of the following:

- annual financial statements with the external auditors prior to their approval by the board;
- co-ordination of audit coverage between internal and external auditors;
- accounting policies and practices adopted, or any changes made or contemplated;
- transactions which are significant and not a normal part of the company's business;
- effectiveness and adequacy of the internal and external control audit function and system;
- interim financial information;
- effectiveness and scope of the annual audit plan and results of the annual audit; and
- effectiveness of management information and other systems of internal control.

University of Pretoria etd – Myburgh J E 2006

5.5.4.5 Management reporting

Management reports include the preparation of annual budgets and strategic plans of all operating divisions. Comparisons are made between budgeted projections and actual performance figures and reported regularly. Profit projections and forecast cash flows are updated and working capital and borrowing levels monitored on an ongoing basis.

5.5.4.6 Ethics

Free enterprise demands ethical behaviour on a national and international level and that a company is accountable for the highest standards of ethical behaviour. Consequently, directors and employees themselves are required to maintain the highest ethical standards and ensure that business practices are conducted in a manner which is beyond reproach. A company should disclose or make available a formal code of business conduct based on the King Report recommendations on best practice, that it follows in the control and reporting functions of the board of directors.

According to Armstrong (1995:19) the code of ethics adopted by a company should:

- commit an organisation to the highest standards of behaviour;
- be developed in such a way that it infuses its culture in all its stakeholders;
- receive total commitment from the board and chief executive officer; and
- be sufficiently detailed to provide a reasonably clear guideline for the benefit of all its employees of the organisation concerned.

A statement on ethics in the annual report of Fraser Alexander Ltd (1995:27), reads as follows: "The group is committed to the highest standards of integrity, behaviour and ethics in dealing with all its stakeholders, including its directors, managers, employees, customers, suppliers, competitors, investors, financiers and society at large."

University of Pretoria etd – Myburgh J E 2006

5.5.4.7 Affirmative action

An area that is currently receiving attention in South Africa is affirmative action programmes, which are aimed at increasing the number of previously disadvantaged persons on all managerial levels. With regard to affirmative action, the Adcock Ingram Ltd annual report (1995:31) disclosed the following: "The company is committed to providing equal opportunities to all its employees regardless of their ethnic origins or gender. It has also embarked on various programmes to ensure that its employee profile will be more representative of the demographics of the country."

A survey conducted in 1998 by KPMG (Business day, 26 February 1998) showed that 63 of the top 100 listed companies and 38 other companies out of the total sample of 200 companies referred to, or described their affirmative action plan, compared with respectively 56 and 28 during the previous year. The figures are expected to increase radically in the light of the Employment Equity Bill, which will monitor the progress of companies in implementing equitable employment practices.

5.5.4.8 Going concern

The fact that directors should satisfy themselves that the business is a going concern, that is, that they have a reasonable expectation that it will continue to operate, led to a recommendation by the Cadbury Committee that directors should state in the report and accounts that the business is a going concern, with supporting assumptions or qualifications as necessary. The auditors should furthermore also report on this statement.

5.5.4.9 Worker participation

The following statement, taken from the annual report of C G Smith Foods Ltd (1995:44) is typical of the disclosure on worker participation made by companies. It discloses that the group of companies "employs a variety of participative structures on issues which affect employees directly and materially, and which are designed to achieve good

University of Pretoria etd – Myburgh J E 2006

employer/employee relations through effective sharing of relevant information, consultation and the identifications and resolution of conflict. These structures embrace goals relating to productivity, career security, legitimacy and identification with the Group. Goals will be achieved through various organisations processes which already exist or may be developed". Worker participation in the governance of a company has improved as a result of the Labour Relations Act, which promotes such participation through workplace forums and other structures.

5.5.4.10 Fraud

Public confidence in the reliability of information in annual reports has been corroded by illegal financial activities and poor disclosure practices. In the United States of America, the independent auditor's responsibility to detect fraud has prompted the AICPA to endorse the Financial Fraud Detection and Disclosure Act of 1993. It felt that the Act would bolster public confidence in financial reporting systems, as it requires auditors to provide earlier public notification of possible misconduct.

The following are three main requirements of the Financial Fraud Detection and Disclosure Act (New York State Society of Certified Public Accountants, 1993:9):

- it obliges auditors to take reasonable steps to detect illegalities that have a material impact on a company's financial statements;
- it requires auditors to inform management of any such lapses and, if no remedial action is taken, to take the matter to the company's board of directors; and
- it requires an auditor to report the matter to the SEC following such notice to the board.

5.5.4.11 Insider trading

In 1998, there were some companies, such as Nampak Ltd (1998:34) and Iscor Ltd

University of Pretoria etd – Myburgh J E 2006

(1998:49) that mentioned insider trading or disclosed their policy on price-sensitive information under corporate governance. The following example was extracted from the annual reports of Renaissance Retail Group Ltd (1998:6):

> "Group employees may not deal, directly or indirectly, in Renaissance shares on the basis of unpublished price-sensitive information regarding the business or affairs of the Group. No direct or management official may trade in Renaissance shares during embargo periods determined by the Board. This includes the period between the end of reporting periods and announcements of financial and operating results for such reporting periods, and other embargo periods such as prior to the release of price-sensitive information."

The news service, *Sens* was introduced by the Johannesburg Stock Exchange to curb insider trading by compelling companies to release price-sensitive information simultaneously to all investors. However, the limited reach of *Sens* disadvantaged the small investor, who relies upon the media. The solution to insider trading prevention may lie in an amendment of the Companies Act, so that companies are required to disclose beneficial ownership and major share dealings (Business Day, 1 June 1998).

5.5.4.12 Conclusion

It is essential that the code of ethics and corporate governance practised by companies be continuously reviewed and its implementation actively monitored by a permanent committee comprised of shareholders, management, workers and professional bodies. Armstrong (1995:20) emphasises the importance of a code of corporate practice and conduct, specifically when taking into account the dynamic socio-political environment of South Africa.

Greater importance should be placed on the qualitative as opposed to the quantitative issues of corporate governance and Professor Katz (1998:35) recommends that companies focus on the promotion of the following values:

University of Pretoria etd – Myburgh J E 2006

- the creation of an environment in which entrepreneurial flair and vision can flourish;
- attention to innovation;
- attention to succession planning; and
- attention to the interest of all stakeholders and not only those of shareholders.

5.6 Segment reporting

Segmental reporting emerged in the 1960s in the United States as a result of companies increasing in size, diversifying their activities and operating multi-nationally. Users and analysts found it very difficult to assess the profitability, future growth and risk to the various segments of these expanding companies if the information on the various segments simply formed part of the overall financial statements.

Following the voluntary disclosure of segmental reporting by a number of American companies, a statement on segment reporting (SFAS 14) was issued in 1976 by the FASB and adopted in 1981 as an international statement. It was revised in 1997 to incorporate requirements dealing with enterprise risks and prospective returns of such company segments so that industry segment reporting would approximate users' needs. Two major areas of concern were identified by the Financial Accounting Standards Committee, both stemming from the fact that the criteria of SFAS 14 were too vague and imprecise. As a result companies could in the first place exploit this flexibility and imprecision to obfuscate operating information by defining reportable segments too broadly. Secondly, it lead to inconsistency from one reporting period to the next, because of varying definitions by companies for reportable segments (Barth *et al.* 1994:75).

Segmental information provides users with information that could assist them with the assessment of these diversified operations of the company with regard to assets employed, profit contribution, turnover or other operating revenue and geographical areas where the operations take place. It thus equips the investor and analyst with information that could be used to predict growth and profit prospects. The "potential"

University of Pretoria etd – Myburgh J E 2006

usefulness and importance of disaggregated financial information to users and analysts has emerged from a number of empirical studies and surveys, such as those of Kochanek (1974), Barth *et al.* (1994), Cardillo (1994) and Boatsman, Behen and Patz (1993). Investors also use segmental reporting for risk assessment and a reduction of uncertainty, for forecasting future earnings and for reducing security price fluctuations. Users, too, have found that segment information is extremely useful and, indeed, vital and integral in their analyses, have exerted pressure on compilers of annual reports to disclose more information on a segmental basis.

In South Africa AC 115 *Reporting financial information by segment* was issued in 1986 and a revised statement, *Segment reporting* was issued in 1998. The aim of this statement, which is based on IAS 14 (revised), is to help users of financial statements to

- better understand the enterprise's past performance;
- better assess the enterprise's risks and returns; and
- make better informed judgements about the enterprise as a whole.

Boatsman, Behen and Patz (1993:62) observed that disclosure of the geographical composition of earnings is potentially valuable information from an investment point of view: Such earnings from different locales may differ in risk and/or persistence and would therefore be capitalised differentially and he concluded that geographical segment disclosures are therefore useful for the valuation of common stock.

5.6.1 Definition of a segment

An industry segment should be easy to identify and precisely and objectively specified. Huddart (1992:30) believes it is a matter of professional judgment, and should be left in the hands of the firm and its auditors. However, it has become apparent that if the decision of segment identification is left to the discretion of management, management define their segments so broadly that the information is misleading and mis-representational. Therefore additional guidance from the accounting standard-setting

University of Pretoria etd – Myburgh J E 2006

bodies was required on how that judgement should be exercised.

The revised AC 115 specifies three types of segments of an enterprise, namely business, geographical and reportable segments, and defines them as follows:

- a *business segment* is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments.
- a *geographical segment* is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment, and that is subject to risks and returns that are different from those of components operating in other economic environments.
- a *reportable segment* is either a business or geographical segment as identified by means of the foregoing definitions, for which segment information must be disclosed in terms of the statement.

Segmental reporting is also referred to as line-of-business reporting, or disaggregated reporting (Huddart 1992:29). Definitions of segments vary as a result of the classification basis, depending for instance on whether it is based on revenue, expenses, results, assets, liabilities or accounting policies. (SAICA AC 115, par.17)

The IASC defines a business segment as a distinguishable component of an enterprise that is engaged in providing a product or service, or a group of related products or services, that generates significant revenue from external customers, and that is subject to risks and rewards that are different from those of other business segments.

For this purpose, a segment generates significant revenue from external customers if

a) the greatest part of the segment's revenue is derived from sales to external customers; or

University of Pretoria etd – Myburgh J E 2006

b) the segment's revenue from sales to external customers comprises 10% or more of total enterprise revenue.

From the above it would seem that accounting standards governing segmental reporting are widely adopted throughout the world and fairly uniform in their requirements (Hemus, Everingham & Sonnenberg 1994:4). A segment of a business may also be defined as a distinguishable component of an enterprise engaged in providing a product or service, primarily to customers outside the enterprise or in operations in a country, or within a particular geographical area as may be appropriate to the particular circumstances of the enterprise.

The AICPA study on user needs for information (Jenkins Report, 1994:24) showed that users use information about the company's operating activities to understand the relationship between those activities and the company's financial results, which in turn helps them to predict the financial impact of trends and to identify opportunities and risks that could result from those activities. It also enables them to identify companies that may be affected by the trends. Two economic consequences or benefits of segmental reporting are that segmental information:

- improves the accuracy of users' assessments of future sales, earnings, dividends, and capital gains forecasts; and
- improves users' assessments of risk.

The above consequences were supported by the study of Kochanek (1974:258) who investigated the effects of segmental financial disclosure by diversified corporations on earnings predictability and share price volatility. The evidence suggested that external financial reports containing segmental data do provide a useful source of information to investors in appraising the investment potential of a diversified corporation's shares.

University of Pretoria etd – Myburgh J E 2006

5.7 The value added statement or statement of wealth created

The value added statement benefits all stakeholders and should therefore form an integral part of the annual report and acquire equal status to the income statement, balance sheet and cash flow statement. The statement depicts how wealth was created and how it was distributed, giving the user a broader perspective of the company's risk situation and performance.

In the new South Africa, with its changing socio-economic environment, annual reports should not only be prepared for the financially literate members of the community but also to satisfy the requirements of a much broader audience. Regardless of their backgrounds and circumstances, these users all share a common objective with every corporation, namely to add value and create wealth. The contribution the company has made to the wealth of the South African economy as a whole should received greater priority and disclosure should not concentrate only on the profit made by the company and which benefits solely the owners.

As the meaning of the concept "added value" implies, this aspects deals with the value added for the customer and in so doing the creation of economic wealth that can be shared by all stakeholders. The purpose of the value added statement shows the link between wealth creation and wealth distribution. The objective of the value added statement is thus to report on the allocation of value between the various stakeholders.

The value added statement contributes to the usefulness of annual reports in that it is an easy statement to interpret aimed specifically at the layman, especially when it is presented diagrammatically. This statement contains information for all user groups and not only one specific group. The only group for whom the value added statement does not reveal sufficient information, is the employees apart from the fact of the burden of salaries and wages is carried by the company.

Although a separate report is preferable, value added information may be incorporated in the income statement. Miller (1991:223) suggests that a subtotal in the income

University of Pretoria etd – Myburgh J E 2006

statement for value added will serve the purpose of putting profits into perspective.

5.7.1 The format of the value added statement

Apart from The Corporate Report (ICAEW 1975) which was issued in the United Kingdom and a statement of recommended accounting practice, which was issued by the Singapore Society of Accountants in 1984, there are no statutory requirements or standards dealing with the format of the value added statement. The value added statement usually consists of two sections, namely one dealing with wealth added and the other with wealth distributed. The amounts above the value added line are receivables from customers and suppliers, while those below the line are the amounts payable to employees, government, and providers of financial resources. These amounts are stated in the order in which the contributors are entitled to share in value added.

Wealth added consists of the following:

- sales, that is income received from the sale of services or products net of valued added tax in accordance with AC 111;
- cost of sales, that is money paid to suppliers for raw materials and services is subtracted;
- employee benefits, such as salaries (including tax), wages, pensions, medical and retirement benefits, related costs, employment costs, labour costs, bonuses, commissions, welfare and fringe benefits;
- providers of capital, namely the ordinary and preference shareholders, lenders of finance to the company and operating lease payments; and
- retentions, which include retained income, depreciation, minorities' share of earnings and deferred tax.

University of Pretoria etd – Myburgh J E 2006

Wealth distribution consists of the following:

- salaries and wages to employees;
- payments of interest;
- payments to the government for taxation;
- payment of dividends to shareholders; and
- funds retained for future growth.

Stainbank (1997:69) found a great deal of diversity in the terminology, presentation and treatment of value added statements. As a result comparability between companies was limited. She recommended that a cash value added statement be used to solve the problem as it does not lend itself to such diversity of interpretation by companies.

5.8 Inflation reporting

The first principles of price adjustments in accounting were formulated in Holland during the First World War by a Prof. Theodore Limperg and the first company to apply these principles was the electronic giant, Philips, in 1946 (Vorster, Koen & Koornhof 1999:559). The basic principle underlying Limperg's theory was that the cost of an article is equal to the amount to be paid at the time of selling the article, and that it bears no relationship to the historical cost of the article.

To be of value to investors, a method of accounting for the effects of inflation should be generally accepted, widely implemented in practice, and yield meaningful results. It should furthermore allow valid comparisons of real performance between companies. Many listed companies in South Africa refrain from publishing inflation adjusted financial statements, because they are of the opinion that this principle is not yet widely accepted and there is no consensus on the application method.

Investors in shares also seek protection from inflation over the long term and therefore expect an additional return over and above the capital gain and dividends to compensate for the effects of inflation. Many traditional investors believe that shares

University of Pretoria etd – Myburgh J E 2006

were a good hedge against inflation because of the correlation between share prices and the cost of living and consequently invested a portion of their retirement funds in the stock exchange. According to Tinc and West (1979:512) this belief is supported by three propositions. The first is that the price of outputs of goods and services can be expected to increase with the general level of prices. The second is that wage rates are more "sluggish" and tend to lag behind price increases and finally, because price increases are on the whole not fully anticipated, holders of shares benefit at the expense of firms' creditors.

These suppositions were further researched by Elikai, Moriarity & Ayres (1993:218) and Kwon (1993), who both concluded that current cost information leads to improved investment decisions over historical cost when the realised and unrealised components are separately disclosed. In hyper inflationary economies, operating profits are overstated because operating assets and inventories are not taken into account at replacement value. Therefore investors cannot accept reported earnings at face value during periods of rapid inflation (Bhana 1992:124). It would thus seem that the demand for current value information is valid and that such information can prove useful to decision makers.

5.8.1 Advantages of inflation adjusted accounting

Comparisons over a number of years are impossible unless inflation adjusted statements are used. Certain adjustments on reported figures must be first be made to remove, as it were, the external factors that caused the change in market values.

The following reasons could be put forward in favour of inflation adjusted financial statements:

- they provide an estimate of a company's economic or market value;
- such statements disclose both realised and unrealised gains and losses;
- they provide a more timely indication of the effect of changes on the value of a corporation's assets; and

University of Pretoria etd – Myburgh J E 2006

- they provide a consistent benchmark for establishing historical trends.

5.8.2 Disadvantages of inflation adjusted accounting

Most criticism is centred around the fact that market value varies from day to day and is continually being revised. Thus by the time the information in an annual report, which reflects market values at balance sheet date, and takes two to three months to publish reaches the user, it is already out of date. However, others see this as an advantage as the information is only slightly out of date and it is more relevant and comparable with other companies not using inflation accounting.

A further problem is the changing face of what was traditionally defined as an asset. An asset is shown in the balance sheet only if it complies with the following recognition criteria: it is an economic resource that the enterprise controls, it holds a future economic benefit for the enterprise and it exists as a result of a transaction that took place in the past. As a result of valuation difficulties and not meeting all the criteria for recognition, many intangible or so-called "soft" assets do not appear in the balance sheet. This omission obviously distorts the long-term utility of the financial statements.

The following are reasons for not favouring inflation adjusted financial statements:

- the market value is subjectively determined and open to measurement errors;
- it is difficult to assess a company's future performance and prospects by means of market value;
- the market value becomes outdated very quickly;
- market values are not always readily available; and
- users do not understand the current cost data that are presented.

5.8.3 Statutory requirements

In the United States of America, the Securities and Exchange Commission released Accounting Series no. 190 in March 1976 which require replacement cost disclosures.

University of Pretoria etd – Myburgh J E 2006

Information on the current costs of financial resources thus had to augment that provided in historical cost. Kwon (1993:175) noted that the intention of AS No. 190 was to provide information that would assist users to better understand the current costs of operating the business. The empirical results of his survey on the informativeness to capital market participants of mandated inflation-adjusted data, provided evidence of increased stock price variability relating to the first mandatory replacement cost disclosures relative to the prior year. This phenomena was more pronounced for medium and large firms compared to small firms.

The Securities and Exchange Commission replaced ASR No. 190 issued with Statement No. 33 on financial reporting and changing prices, which was issued by the Financial Accounting Standards Board (FASB) in September 1979. In terms of this statement large public corporations had to supplement their financial statements with inflation-adjusted data. It was however withdrawn in 1987 because security analysts were ignoring the inflation-adjusted statements. FAS 107, which was issued by the FASB with effect from 1992, requires disclosure of the market value of financial instrument assets and related liabilities.

In South Africa, the first guideline on inflation accounting was issued in August 1978 by SAICA. The recommendations of AC 201, *Disclosure of effects of changing prices on financial results*, were based on a combination of the replacement value theory and the application of the general purchasing power technique. However, its recommendations were not compulsory and because the adjustments resulted in lower profit figures and were not recognised by the tax authorities, few companies applied it. Lack of compliance with AC 201 resulted in the issue of ED 77, *Disclosure of current value information in financial statements*, in September 1989. This document proposed current value financial statements using present value, market value, replacement cost or indexed historical cost. However, it too had a minimal impact on inflation reporting and has subsequently been withdrawn.

In general, financial statements are prepared using the historical cost method, whereby assets and liabilities are recorded at their original cost. Assets are usually only reported

at market price in cases where the market price is lower than the historical cost price according to AC 123 applicable from January 1995. The result is an understatement of assets which divulges important information on asset impairments.

5.9 Employee and social reporting

In support of the credibility of the capitalistic system, and in striving to bridge the gap of understanding between first and third world groups, nationally and internationally, corporations must be held accountable for imparting relevant and understandable information to all parties sharing in the wealth created by the corporation, and specifically to the employee. Corporate social disclosure came about as a result of two assumptions, the first being that the corporation is not merely a maximiser of shareholder wealth but and active member of society (Lynn 1992:105) and the second that employees are invaluable assets to every organisation and its success depends largely on the skills and dedication of its employees.

Wallman (1995:85) stresses that service firms are the fastest growing segment of the South African economy and the most important assets of these firms are the intellectual capacity and physical skills of their employees, but these assets are not found anywhere on the balance sheet. Corporations are expected to make a contribution to the prosperity of society as a whole, in addition to providing a return to its shareholders and therefore the corporation should be held accountable to the workforce as well as to the stakeholders. Employees have a vested interest in the long-term growth and profitability of the corporation and a right to relevant information.

Schuitema (November 1988:337) examined changing trends in industrial relations and identified three fronts in response to the growing power of the unions and labour disruption, namely participative management, share participation and employee communications. He refers to participative action as "wooing the workforce to the ranks of management and owners", and warns that unless the workforce fully understands its valid, traditional role in an enterprise, it would be a waste of time to encourage participative management or ownership.

5.9.1 Historical background

Traditionally, employees were viewed by corporations as an expense item on the income statement, which had to be minimised in order to maximise profits. This view led to conflict between management and employees and social reporting concentrated mainly on problems that could result in labour strikes and increased wage demands. However, the introduction of the value added statement helped to enhance an awareness amongst both management and employees of labour as a valuable asset and not merely as a cost. Management's task no longer centred on solving problems, but on ensuring that the enterprise generates as much wealth as possible for maximum distribution to the workforce, as well as to the other stakeholders.

Demands for full corporate social reporting materialised in the 1970s, specifically in the United States of America where a number of surveys were conducted to determine the extent of corporate social disclosure. Social reporting practices of companies vary across countries, as evidenced from a 28 country survey of Roberts (1987:2). He concluded that the extent of social reporting is influenced by economic, political, legal and social factors unique to the various countries and noted that there was little or no consensus on what precisely is meant by the concept social information.

Employee reporting gained ground in the United Kingdom during the 1970s, when the Accounting Standards Committee published their Corporate Report. British companies lead the field in the number of employee reports produced, but not necessarily in effectiveness of communication (Schuitema December 1988:375). Disclosure of employee information was covered under various sections, ranging from an employee report to a social report and a statement of social responsibility.

Ogan and Ziebart (1991:391) described social reporting as the corporation's efforts towards fulfilling its general and specific obligations to society, and defines paternalistic reporting as corporate communications with employees. Social factors may affect investment decisions and may result in financial institutions investing solely in ethically sound or good companies. According to Beattie (1988:36) the characteristics of such

University of Pretoria etd – Myburgh J E 2006

companies included maintaining high employee welfare standards, environmental awareness, committed to community involvement and offering charitable donations. The extent of disclosure is dependent on management's opinion of the relevance and importance of this information in the decision making of and negotiations with employees.

5.9.2 Contents of employee reports

If it is to satisfy the needs of employees, quantitative and qualitative corporate social information must be disclosed in annual reports. Quantitative information includes aspects such as the following:

- number of employees, average or year-end figures including a breakdown based on geographical area, line of business, function/occupation, product-based divisions, gender and disabled persons;
- turnover per employee in rand;
- fixed assets per employee in rand;
- employment cost per employee in rand;
- wealth created per employee in rand;;
- wealth distributed to employees;
- wealth reinvested;
- pension costs;
- medical aid schemes;
- bursary schemes and donations to educational, research and social institutions;
- contributions to charities;
- employee remuneration;
- labour turnover rates;
- accident rate;
- absenteeism;
- cost of training and number of employees trained;
- cost of reconstruction and development programmes;
- production days or hours lost due to strikes or stoppages;

University of Pretoria etd – Myburgh J E 2006

- number or cost of redundancies;
- total wage bill divided into occupational categories; and
- assistance with housing facilities and the provision of subsidised housing loans.

Qualitative or non-numerical information disclosed in annual reports covers the following aspects:

- training policy;
- community involvement, such as provision of sports and recreational facilities;
- health and safety;
- trade union relations and strikes;
- share participation schemes;
- statement of appreciation for employees' efforts;
- employment policies;
- affirmative action;
- reconstruction and development programmes; and
- redundancy policy.

There are no specific disclosure requirements for social reporting and therefore the lack of standardisation makes comparisons difficult.

5.10 Environmental reporting

Every business has an impact on the environment, and although environmental reporting or so-called green reporting is not directly related to the financial performance of a company and is not mandatory, dissemination of the company's environmental policies and actions may impact upon its share price. Companies are presently being scrutinised and judged on the social awareness and impact of their actions on the environment.

University of Pretoria etd – Myburgh J E 2006

Bebbington, Thomson and Walters (1994:109) undertook a mail questionnaire survey which proved that accountants have low levels of involvement in their company's environmental activities and are relatively unaware of environmental issues. They apparently have little interest in incorporating this into corporate reports, which explains the absence of environmental accounting in practice. The survey aimed at exploring the extent to which accountants are involved in their organisation's environmental agenda, and developing "environmental accounting" and finally to shed some light on why accountants are not responding to the calls from the profession, business and politics.

As international investors contribute to the capital markets of South Africa, increased pressure is placed on South African companies to conform to international environmental standard, such as the ISO 14000 issued by the International Standards Organisation in Switzerland as well as a guideline by the South African Institute of Chartered Accountants issued in 1997. The concept of "ethical" business where investors shun companies with close links with oppressive regimes, that exploit live animals or are involved in contentious areas such as tobacco, gambling and armaments, has come to exercise a strong influence on business decisions (Beattie 1988:36). For example, a Canadian company called MD Management, and which is a financial subsidiary of the Canadian Medical Association, sold its entire Rembrandt Group shareholding because the company came to believe it was unethical to invest in tobacco firms. The vice-president instructed all its investment managers to refrain from purchasing securities of companies involved in the manufacture of tobacco products.

The South African National Council Against Smoking stated that the Canadian group's decision was part of a global trend not to invest in tobacco companies. In 1993, the South African Community Growth Fund rejected support from Rembrandt Ltd and the United Tobacco Company Ltd on the grounds that it was socially irresponsible to invest in tobacco (Business Day, 30 April 1996:3).

University of Pretoria etd – Myburgh J E 2006

5.10.1 Statutory requirements

In 1991, the Chartered Association of Certified Accountants in England introduced a competition, known as the Environmental Reporting Award Scheme (ERAS) to encourage the development of corporate environmental reporting as there were no standards or legislation governing environmental reporting in the United Kingdom. Other international organisations that have made recommendations or guidelines are the Canadian Institute of Chartered Accountants in 1993, the Institute of Chartered Accountants in England and Wales in 1992 and the United Nations in 1998 (De Villiers, 1996:73).

In South Africa, there is no specific section of the Companies Act on disclosure requirements for environmental reporting, which could mainly be ascribed to the difficulty of quantifying the information. Disclosure is thus voluntary and limited. Furthermore, GAAP requires separate disclosure only if the environmental event or contingency has financial implications that would not produce a "true and fair reflection" in accordance with the conceptual accounting framework. Environmental aspects vary considerably across different companies and industries, and are often deemed not applicable or irrelevant to some industries such as the retail sectors.

De Villiers (1996:202) recommends that companies follow the guidelines below for corporate environmental reporting:

- a descriptive overview of the major environmental risks and impacts of the organisation;
- the environmental policy of the organisation;
- measurable targets, in physical units and rand amounts where applicable, based on the environmental policy (e.g. emissions);
- performance against environmental targets and comparative figures from the previous period;
- accounting policies for recording liabilities, provisions, contingent liabilities and catastrophe reserves;

University of Pretoria etd – Myburgh J E 2006

- environmental costs (energy, waste handling, treatment and disposal, legal compliance, packaging, fines, rehabilitation, recycling, etc.) per category, charged to operating expenses during the period;
- rand amounts of environmental liabilities, contingent liabilities and reserves established during the current period;
- government environmental grants received;
- likely effect of environmental policy on future capital investment and earnings;
- environmental litigation in which the organisation is currently involved; and
- independent third party attestation of all environmental reporting.

Legislation regarding compulsory environmental reporting may result from pressure from constituents demanding disclosure whether positive or negative (De Villiers & Vorster, 1995:61).

5.11 Money exchanges with the government

There is a close and continuing relationship between companies and the government and local authorities, in that companies utilise community facilities and services provided by authorities and in addition have direct financial dealings with them. The flow of funds between companies and the government in the form of payments for taxation, pay as you earn (PAYE), value added tax (VAT), levies, rates and other payments, and receipts in the form of subsidies, are not always disclosed in the financial statements.

These amounts could be substantial and it is often useful if companies include a "statement of money exchanges with government" in their annual reports, showing the following items:

- current company tax payments;
- deferred tax;
- PAYE collected and paid over;
- VAT collected and paid over;
- rates and levies paid to local authorities;

University of Pretoria etd – Myburgh J E 2006

- customs and excise duties;
- payments for licenses issued by government and local authorities;
- receipts in the form of cash government grants or subsidies; and
- secondary tax on companies.

5.12 Voluntary disclosure in interim reports

There is a great need for the development of standardised practices to serve as guidelines for the preparation of interim reports in South Africa. The need arose from the interpretation of the Companies Act requirement in article 303 that interim reports should "fairly present" the business and operations of a company during the first six months of its financial year and the results thereof.

Ottterman and Koen (1992:31) identified two interpretations of this requirement. The first supports the discrete approach which maintains that fair presentation relates only on the interim period and thus gives priority to the prudence principle. The second is the integral approach which focuses on the interim period in the context of the entire financial year and gives priority to the matching principle. Based on the results of their survey, Otterman and Koen (1992:41) concluded that these two approaches gave rise to different results when preparing interim reports. The survey revealed that 81,2% of the 48 industrial quoted companies surveyed preferred to use the discrete approach, the reasons being that the same principles are applied to the interim report as are applied to the annual statements, and subjectivity is reduced and comparability enhanced because fewer estimates need to be made when allocating costs and income. Knutson (1993:58), too, recommended that in interim reporting, the integral rather than the discrete method be used.

University of Pretoria etd – Myburgh J E 2006

5.12.1 The purpose of interim reports

The purpose of the interim report should compliment that of the annual report, namely to guarantee the provision of information concerning the financial position and performance of the corporation on a regular basis, so that the various users may satisfy their decision making needs. Ultimately this would promote the efficiency of the capital market by reducing the volatility of prices. In addition, the interim report may also help investors in forming their expectations about the future prospects of enterprises.

5.12.2 Frequency of interim reports

The Johannesburg Stock Exchange (Listing requirements of the JSE 1986: Section II, 18-23) requires all listed companies to publish half-yearly reports while the New York Stock Exchange requires the publication of quarterly reports. A study of the annual and quarterly reports of 190 United States companies by Al-Darayseh and Brown (1992:24) to determine the accuracy of the financial data issued annually and quarterly, showed that the quarterly data was on the whole not as accurate as the annual data. One explanation is that the interim reports are not subject to review by the auditor.

The question which is often asked is whether interim reports should be published on a quarterly basis or only half-yearly as presently the case in South Africa and whether rolling 12 months to date information should be presented on a quarterly basis. Knutson (1993:54-55) points out that quarterly reports are vital as they are indicators of progress and status and also important source of information for projecting the future. A second argument in favour of quarterly reports is that it limits insider trading as the information is disseminated to the public and does not slowly filter down from a host of privileged persons. Lastly, the annual and interim reports are often the only sources of information available to the individual investor.

Conversely, many compilers view quarterly reporting as unnecessary as it encourages a short-term analysis of a company, which could increase the volatility of the share price. Further arguments against frequent interim reports is that in striving to achieve

University of Pretoria etd – Myburgh J E 2006

published short-term targets and rewards for short-term performance, management often resort to fraudulent practices and lose sight of the long-term plans. Investors, on the other hand, do not consider seasonality of business operations when making investment decisions. If quarterly reports are published, the fourth quarter is often used to correct errors made in previous interim reports and these adjustments may weaken the creditability of quarterly reports.

However, in view of the fact that users constantly strive to obtain additional information, the following three reasons for promoting quarterly reports were cited by SAICA (1994:25):

- quarterly reporting helps users with a longer term focus to detect changes in long-term trends on a timely basis;

- such reporting provides for an orderly dissemination of reliable information and users need not rely on rumours or less reliable information; and

- it reduces problems of trading on inside information by simultaneously disseminating information to all market participants.

5.13 Conclusion

Although the fact that voluntary disclosure should be credible and verifiable and is often assumed, voluntary disclosure can be incrementally value relevant over mandatorily reported information. However, voluntary disclosure strategies are dependent on various factors such as cost constraints, share price effects, investor perceptions and attitudes effecting and reducing risk.