MAJOR ISSUES IN CORPORATE DISCLOSURE
CHAPTER II

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As discussed in the earlier chapter, the disclosure of corporate information helps the investors in decision making regarding the selection of the best portfolio of their investments, reduces the cost of capital of the company, lessens the fluctuations in the securities markets and affects the rate of capital formation in an economy. However, a number of issues confront the corporate disclosure practices. A search of the available literature on corporate disclosure highlights these issues. These issues happen to be:

* For whom the information is to be disclosed?
* What is the purpose of the information?
* How much information should be disclosed?
* How should the information be disclosed?
* When should the information be disclosed?

2.1 FOR WHOM THE INFORMATION IS TO BE DISCLOSED?

There is no intrinsic value of an information system existing apart from the user and a specific decision context [Beaver (1974)]. The adequacy of a given disclosure can only be determined within the context of a specific identification of users of the information. The identification of users aids in defining user group characteristics, which impinge on the specific types of information to be presented as well as the manner of presentation [Buzby (1974)]. The corporate annual reports are used by a variety of user groups and for diverse purposes listed in Table 2.1. Some users like present and potential investors, creditors and suppliers,
Table 2.1

Corporate Annual Report: Information for Relevant Public Shareholders
(Institutional and Individual)

Trends in market price, dividends, EPS, DPS, future plans, profit and sale product-groupwise, source of financing, rationale for expansion and acquisition, labour relations, pattern of ownership etc.

Investors
(Prospective)

Trends in market price, dividend, future plans, leadership, corporate image, product leadership, government regulation, market share etc.

Public

Corporate responsibility, labour relations, indigenisation, employment opportunities, present and future range of products, regional development, quality of products, composition of management etc.

Creditors

Liquidity, profitability, trends in growth and diversification, composition of capital - present and desirable, sources and uses of funds, corporate image etc.

Government

Adherence to legislation, corporate responsibility, exports, employment and labour relations, indigenisation and collaboration, pattern of ownership, how helping small industries, etc.

Employees

Stock option, pension plans, future plans, corporate image, adherence to legislation and recommendation of wage boards etc.

Consumers

Product range and quality, regularity of supplies, R & D efforts, labour relations, market share, product leadership, research studies etc.

management, tax authorities and customers have direct interest in the information, while others like financial analysts and advisors, stock exchanges, financial press and reporting agencies need information to help those who have a direct interest in the information.

Due to diverse information needs of different users, a general purpose report will not be able to serve the purpose. The most effective and efficient report will be achieved when the dominant user group is singled out as the focal point of the report [Stone (1967)]. Traditionally, investors (both existing and potential) are singled out as the dominant user group [Lal (1985)].

The selection of investors as a target user group is not sufficient, as investors themselves are a heterogeneous group. They may differ with respect to tastes or preferences, wealth, beliefs, access to financial information and skill in interpreting financial information. Individual investors consider the future economic outlook of the company, the quality of management and the future economic outlook of the concerned industry to be the most important factors in investment decision making [Baker and Haslem (1973)]. On the other hand, security analysts tend to show more faith in transaction-based data as opposed to data based on projected transactions [Chandra (1975)]. They consider earnings per share, the amount of revenue and the method used in its recognition and the operating income for the period to be the most important factors [Chandra (1975)]. Significant differences have been found in the information needs of ordinary and technical shareholders [Sharma and Prashar (1991)]. Further, the ability of the different user groups to interpret financial reports varies considerably [Maloo 1986]. The degree of sophistication in annual reports is an unsettled question. One of the
most significant reports on the objectives of financial reporting, 'The Trueblood Committee Report', recommends that an annual report should serve primarily those readers, who have limited authority, ability or resources to obtain information and also who rely on financial statements as their principal source of information about the activities of an enterprise [Sorter and Gans (1974)]. McCormick (1960) also supports the view that the unsophisticated investor should be the focal point of the annual report. According to the Financial Accounting Standards Board (FASB), 'The information should be comprehensive to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence [SFAC 1 (1979)].

Researchers like Mautz and Sharef (1961); Norby and Stone (1972); Baker and Haslem (1973) and Beaver (1978) are of the view that the disclosure should be made for sophisticates. According to Beaver, earlier views of the disclosure process focused on the proverbial 'average investor' unaided by intermediaries and with limited information and interpretative skills. However, there is a growing recognition both on the part of the Securities Exchange Commission (SEC) and the accounting profession that the major users of the financial statements are relatively sophisticates and that disclosure should focus on the professional investment community [Maloo (1986)]. This view is evidenced in the results of the survey of individual investors conducted by Baker and Haslem (1973), which reveals that 62.4 percent of the individual investors questioned by them rated the professional investment community to be the most important source of information, while financial statements as the most important source of information was considered
by only 7.9 percent of them. This means that individual investors rely on financial analysts for their information needs. So, corporate reports should be geared toward fulfilling the needs of professional investors. The modern corporation is too complex to be represented by overly simplified financial statements understandable by average investors. In this process, too much significant information is lost [Norby and Stone (1972)]. To do so would constitute a disservice to the information needs of certain classes of relatively sophisticated investors [Baker and Haslem (1973)]. The content level of financial reports should not be brought down to the lowest common denominator.

The accounting profession faces an increasingly difficult problem in coming up with a suitable form of financial statements that could meet the information needs of both unsophisticated and sophisticated users.

One approach to solve this dilemma could be to prepare a single set of financial statements with separate sections of information for major users [Chandra (1975)]. According to Norby and Stone (1972), the dilemma can be resolved by keying part of the report to the individual investor through summary type financial statements and keying the balance to the professional investor with comprehensive financial statements, notes to the financial statements and detailed discussion.

2.2 WHAT IS THE PURPOSE OF THE INFORMATION?

The need to identify the purpose for which the information is to be disclosed stems from the requirement that the information be relevant [Buzby (1974)]. The Accounting Principles Board (APB) has identified relevance to be the primary qualitative objective of financial reporting.
Information relevant for one purpose may not be relevant for another. So, the need to identify the purpose is evident.

The APB Statement No. 4 *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* (1970) was the first publication which formulated the objectives of financial statements. These objectives can be summarised as follows:

1. The particular objectives of financial statements are to present fairly and in conformity with generally accepted accounting principles, financial position, results of operations and other changes in financial position.

2. The general objectives of financial statements are:

   (a) To provide reliable information about economic resources and obligations of a business enterprise in order to evaluate its strengths and weaknesses, its financing and investment, evaluate its ability to meet its commitments, and show its resource base for growth;

   (b) To provide information about changes in net resources resulting from a business enterprise's profit directed activities in order to show the investors expected dividend return, show the operation' ability to pay creditors and suppliers, provide jobs for employees, pay taxes and generate funds for expansion, provide management with information for planning and control and show its long term profitability;

   (c) to provide financial information useful for estimating the earnings potential of the firm;

   (d) to provide other needed information about changes in economic resources and obligations;
(e) to disclose other information relevant to statement users' needs.

3. The qualitative objectives of financial reporting are as follows:
   i. Relevance
   ii. Understandability
   iii. Verifiability
   iv. Neutrality
   v. Timeliness
   vi. Comparability
   vii. Completeness.

In order to develop the objectives of financial statements, a study group was appointed in 1971 by the American Institute of Certified Public Accountants (AICPA) under the chairmanship of Robert M. Trueblood. The objectives developed by the Trueblood Study Group are as follows:

1. The basic objective of financial statements is to provide information useful for making economic decisions.

2. An objective of financial statements is to serve primarily those users who have limited authority, ability or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise's economic activities.

3. An objective of financial statements is to provide information useful to investors and creditors for predicting, comparing and evaluating potential cash flows to them in terms of amount, timing and related uncertainty.

4. An objective of financial statements is to provide users with information for predicting, comparing and evaluating an enterprise's earning power.
5. An objective of financial statements is to supply information useful in judging management’s ability to utilise enterprise resources effectively in achieving the primary enterprise goal.

6. An objective of financial statements is to provide factual and interpretative information about transactions and other events which is useful for predicting, comparing and evaluating an enterprise's earning power.

7. An objective is to provide a statement of financial position useful for predicting, comparing and evaluating an enterprise’s earning power.

8. An objective is to provide a statement of periodic earnings useful for predicting, comparing and evaluating an enterprise’s earning power.

9. An objective is to provide a statement of financial activities useful for predicting, comparing and evaluating an enterprise’s earning power.

10. An objective of financial statements is to provide information useful for the predictive process.

11. An objective of financial statements for governmental and non-governmental profit organisations is to provide information for evaluating the effectiveness of management of resources in achieving the organisation’s goals.

12. An objective of financial statements is to report on those activities of the enterprise affecting society which can be determined and described or measured and which are important to the role of the enterprise in its social environment.
The Accounting Standards Steering Committee of the Institute of Chartered Accountants of England and Wales published *The Corporate Report* in 1975. The corporate report states that the basic philosophy and starting point of a corporate report is that financial statements should be appropriate to their expected use by potential users.

Probably, the most comprehensive statement on objectives of financial reporting is the SFAC No. 1 (1978) "Objectives of Financial Reporting by Business Enterprises" issued by the FASB. The objectives of financial reporting developed in this statement are as follows.

1. Financial reporting should provide information that is useful to present and potential investors, creditors and other users in making rational investment, credit and similar decisions.

2. Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amount, timing and uncertainty of prospective cash receipts from dividend or interest and the proceeds from the sale, redemption or maturity of securities or loans.

3. Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources and the effects of transactions, events and circumstances that change resources and claims to those resources.

4. Financial reporting should provide information about an enterprise's financial performance during a period.

5. The primary focus of financial reporting is information about an enterprise's performance provided by measures of earning and its components.
6. Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowings and repayment of borrowings, about its capital transactions, including cash dividends and other distribution of enterprise resources to owners and about other factors that may affect an enterprise's liquidity or solvency.

7. Financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners for the use of enterprise resources entrusted to it.

8. Financial reporting should provide information that is useful to managers and creditors in taking decisions in the interest of owners.

The Stamp Report (1980) published by the Canadian Institute of Chartered Accountants mentions the following as the important objectives of financial reporting:

1. One of the primary objectives of published corporate financial reports is to provide an accounting by management to both equity and debt investors, not only a management’s exercise of its stewardship function but also of its success (or otherwise) in achieving the goal of producing a satisfactory economic performance by the enterprise and maintaining it in a strong and healthy financial position.

2. It is an objective of good financial reporting to provide such information in such a form as to minimise uncertainty about the
validity of information and to enable the user to make their own assessment of the risks associated with the enterprise.

The International Accounting Standards Committee in its "Framework for Preparation and Presentation of Financial Statements" (1989) states that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions.

The Accounting Standards Board of the U.K. in its "Statement of Principles" (1991) states that the objective of financial statements is to provide information about the financial position, performance and financial adaptability of an enterprise that is useful to a wide range of users in making economic decisions.

It is evident from the above discussion that different objectives of financial reporting emerge from different statements and reports. But one thing is common. All of these have recognised the importance of financial reporting as a means of providing information useful for users' decision making and have stated this as the primary objective of financial reporting. The APB Statement No. 4 has stressed on information about economic resources/obligations, changes in these resources/obligations and earnings potential of the firm. The Trueblood Study Group emphasises on the information useful for predicting, comparing and evaluating an enterprise's earning power, SFAC 1 stresses on the information about economic resources, financial performance, sources and uses of cash and discharge of management's stewardship responsibility. According to the Stamp Report, the objective of financial reporting is to
inform the investors about the management's performance and to minimize the uncertainty related to the validity of information. The IASC and the ASB stress on information about the financial position, performance and changes in financial position of an enterprise.

Thus, the main objective of corporate disclosure is to provide information to the users in order to assist them to take a variety of decisions.

2.3 HOW MUCH INFORMATION SHOULD BE DISCLOSED?

Over the years, a large number of researchers, study groups and committees have suggested a wide variety of items to be disclosed in an annual report, which leads one to conclude that more quantum of information is always preferable. But this is not always the case [Buzby (1974)]. There are certain factors which put a limit on the desirability of expanded disclosures.

The question of how much information should be disclosed is dependent upon many considerations. Besides the cost of accumulating the information and distributing it to investors less obvious costs must also be taken into consideration, e.g., will disclosure worsen the company's competitive position and thus result in reduced profits [Maloo (1986)]. Beaver (1978) calls for the infusion of an "economic perspective" to corporate disclosure decisions, i.e., costs of disclosure should be compared with its benefits.

The concept of materiality also acts as a constraint on the amount of information to be disclosed. The concept implied that only material information should be reported in accounting reports.

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Another factor which puts limit on the amount of information to be disclosed relates to psychological considerations. An extensive expansion of disclosure may only serve to add further confusion for the users [Buzby (1974)]. Concern has been expressed by many over the information overloading problem in corporate annual reports. This has led to a shift in the emphasis towards Summary Annual Reports (SARs). An SAR is a shareholder report that contains a condensed presentation of a firm's financial statements in a more readable format than the traditional annual report. The most condensed report should be distributed to all readers, with more detailed reports available to others upon request [Razaee and Porter (1988)]. The SAR idea really got off the ground in the USA with the 1981 research project initiated by the Financial Executive Institute's Committee on Corporate Reporting [Razaee and Porter (1988)]. The idea also got popularity in India with the decision of the Ministry of Company Affairs, Government of India in the year 1988 to amend section 219 of the Companies Act, 1956, allowing the companies to prepare abridged profit & loss account and balance sheet. However in May 1995 Securities and Exchange Board of India (SEBI) had directed the stock exchanges to send detailed annual reports rather than the abridged ones.

Shifting back to the process of disclosing information through detailed annual report should not lead one to conclude that the crux of the argument regarding adequate quantum of disclosure does not hold good.

2.4 HOW SHOULD THE INFORMATION BE DISCLOSED?

To be useful, information should be presented in a form which fosters understandability [Buzby (1974)]. Soper and Dolphin (1964)
conclude that reading ease is a vital factor in aiding comprehension of annual reports by readers. Smith and Smith (1971) also find a positive relationship between the readability and the performance of communication function of financial reporting.

Disclosure should be made in the body of formal financial statements to the extent it is practicable [Lal (1985)]. Significant information should not be presented at a place which may be easily overlooked. The first page itself should tell, what the company is all about, what it does, what it believes in, how it has expanded and where it is going [Haggie (1984)].

Care should be taken to ensure that captions are clear. Information must be organised and grouped in some logical manner. The headings, captions and amounts must be supplemented by enough additional data to make their meaning clear [Lal (1985)].

A boring front cover will hardly entice the reader and if the content is colourless badly laid out and difficult to understand, the annual report will have failed [Haggie (1984)]. Creating an annual reports is a vital exercise in communication and public relations so its designing should be given due consideration.

2.5 WHEN SHOULD THE INFORMATION BE DISCLOSED?

If the disclosure of information is to be effective, it must be timely. There is no use of communicating information after it has lost its relevance. The APB in its Statement No. 4 comments that timely financial accounting information is communicated early enough to be used for the economic decisions which it might influence and to avoid delays in the making of those decisions [Buzby (1974)].
The Corporate Report (1975) issued by the Accounting Standards Steering Committee of the Institute of Chartered Accountants in England and Wales observed that if the reports are to be useful, they must possess timeliness as one of the characteristics. The FASB in its SFAC 2 on 'Qualitative Characteristics of Accounting Information' has remarked that timeliness is an ancillary aspect of relevance. If information is not available when it is needed or becomes available only so long after the reported events then it has no value for future action, it lacks relevance and is of little or "no use [FASB (1980)].

Thus different opinions have been expressed by different researchers regarding the various issues confronting the corporate disclosure practices. But, it is commonly agreed that the disclosure in the corporate annual report should primarily be made for the present and potential investors while also keeping in mind the needs of other users; its objective should be to serve the information needs of its users; the information to be disclosed should be adequate; it should be timely and disclosed in an attractive and understandable manner.