

Investor information requirements and disclosure in annual reports

Abstract

This study investigates the extent to which the non-statutory information requirements of investors are being met by current disclosure practices in the annual reports of South African companies. A disclosure index was developed to establish South African investors' information requirements. As was the case in a number of overseas studies, little correlation was found between the investors' information requirements and the disclosure of such information in annual reports.

Introduction

When making the decision to buy, sell or hold equities, investors use diverse information sources which may include annual reports, press coverage, stockbrokers, advisory services and friends. Studies have been undertaken to rank the various information sources^{1, 2, 3}. While not all studies have shown the annual report to be the single most important information source, it is both an important primary source of information and also an important secondary source.

The importance of investors as an annual report user group was highlighted in an early review of the relevant literature by Carsberg, Hope & Scapens⁴, published in 1974, and also by The Corporate Report⁵ which identified equity investors as one of seven user groups. It follows, therefore, that the extent to which investor related information items are disclosed in annual reports is important to that user group.

The price investors will pay for a share is dictated by their expectations of future cash flows. The riskier these flows are perceived to be, the higher the return that investors will require and the lower the price they will be prepared to pay.

The more information investors have at their disposal at the time the investment decision is made, therefore, the lower should be the risk they perceive. It could, thus, be argued that, within the bounds of that information which it may be considered prudent for a company not to release to its competitors for strategic reasons, the more information investors have, especially with respect to future prospects, the higher they would set the company's share price.

As minimum levels of disclosure in annual reports are governed by statute and other regulations, a number of approaches could be used to establish whether or not investor information requirements were being met. One could either ask investors (in some suitable manner) for their total information requirements (inclusive of minimum disclosure items) or ask them for their additional information needs given the minimum disclosure requirements. In either case, these information requirements would then be compared to actual disclosure practices.

In South Africa, disclosure is regulated by the Companies Act, No 61 of 1973, as amended, by Statements of Generally Accepted Accounting Practice issued by the Accounting Practices Board and by rulings of The Johannesburg Stock Exchange. Of course, the amount of information

provided voluntarily by companies does vary widely, and is often well in excess of that required by law or regulation. Research has been undertaken in a number of countries (eg Canada⁶, New Zealand⁷, the UK^{8, 9} and the US^{10, 11}) with a view to measuring the extent of this voluntary disclosure, and the type of information investors seek in annual reports.

This paper addresses the question of whether or not the needs of the investor user group is being met by the current disclosure practices in the annual reports of listed South African companies.

Disclosure index

As part of this research, a disclosure index was developed which was designed to measure the level of voluntary disclosure of relevant investor information in annual reports. In the context of the study, a disclosure index may be defined as a weighted list of voluntary information items which reflect the perceived importance by investors of the disclosure of such information items in a firm's annual report.

It follows that the information items comprising the index should be considered relevant for making an investment decision and that the disclosure of the information items should be appropriate in the firm's annual report. Information items would be excluded from the index where their disclosure in annual reports is required in terms of statute or other regulations.

In order to take into account the fact that all items are not necessarily of equal importance a numerical weighting is attached to each item. The weighting is based on the weights allocated to each information item by a sample of investors.

In order to obtain a suitable list of voluntary disclosure items, award winning South African corporate annual reports were studied. In addition, the relevant literature (eg Amernic⁶, Barret¹², Buzby^{10, 13}, Chandra¹⁴, Choi¹⁵, Firth^{8, 9}, McNally et al⁷ and Singhvi and Desai¹¹) was reviewed and a list constructed of possible investor related information items which could appear in annual reports. The final list of 49 information items was established after:

- Eliminating all the information items required to be disclosed in firm annual reports in terms of the Companies Act, Statements of Generally Accepted Accounting Practice or The Johannesburg Stock Exchange rules, applicable during the period 1979 to 1983.
- Eliminating the information items common to less than 3 of the 10 indices examined.
- Eliminating those information items which would be considered inapplicable to companies whose activities included a significant proportion of manufacturing.
- Including all the information items which comprised the Firth index⁸.

As the index was to be composed of voluntary information items, it was necessary to exclude all those items

normally disclosed in annual reports in terms of the various regulations. An information item covering depreciation was included in the list since Statement AC 106 (Depreciation Accounting) issued under the authority of the Accounting Practices Board only became effective on 1 January 1983. The five-year restriction was necessary as this research was part of a larger study, one of the objectives of which was to establish changes in the voluntary disclosure practices of firms over the period 1979 to 1983.

Eliminating information items from the list which had been included in some earlier indices but where there had been limited consensus amongst the researchers as to their inclusion enabled the number of information items to be reduced to a manageable number.

In order to render the results comparable with previous studies, which had focused on manufacturing orientated companies, items which were not relevant to such companies were eliminated.

As a significant proportion of the published literature in this field is by Firth^{8, 9, 16, 17, 18}, all the items in his index, which are not statutory requirements in South Africa, were included in the list of items. Also, the wording used by Firth for the common information items was retained so as to facilitate the comparison of the results of the two studies.

A questionnaire consisting of the 49 information items was drawn up and was sent under a covering letter to a sample of annual report users, with a request that they weigh each of the items appearing in the questionnaire on a 5 point scale. The aim of the scale was to establish how important investment analysts thought it was that the information items should appear in company annual reports. The scoring ranged from 1 to 5, where 1 meant that the information item was relatively unimportant while 5 meant that the item's inclusion in the annual report was very important. This method of scoring the information items for their importance was similar to the methods used by Buzby¹⁰, Chandra¹⁴, Firth⁹ and McNally et al⁷.

The selection of a group of users of corporate annual reports was facilitated by the Investment Analysts Society of Southern Africa which consented to the use of its mailing list for the purposes of this research.

The questionnaire was sent to all 395 members of the Society resident in South Africa. The response rate of 35% (representing 137 usable replies) was acceptable and similar to the response rates of 26%, 38% and 44% obtained by Buzby¹⁰, Firth⁹ and McNally et al⁷ to their questionnaires

In order to test whether the results obtained were biased due to the respondents and non-respondents belonging to different populations, the test suggested by Oppenheim¹⁹ and previously used in similar surveys^{7, 9, 10} was applied. This test uses late respondents to the questionnaire as surrogates for non-respondents and compares their responses to the individual questionnaire items with the responses of the early respondents¹⁹.

Two test means were calculated for the responses to each information item. Firstly, one using the 12 earliest replies and, secondly, one using the 12 latest. These two means for the responses to each information item were compared for significant differences (at the 0,05 level) using a t-test.

An analysis of the t statistic signs revealed 23 positive t statistics, 22 negative and 4 zero. In addition, there was a significant difference between the test means for only

one information item. These results indicate the lack of a significant non-response bias and it was, therefore, felt that the results of the survey could be generalised at least to the population of South African investment analysts.

Selection of sample of annual reports

The 1983 annual reports of all 36 firms which satisfied the following selection criteria were evaluated. The selection criteria being:

- Since an objective of the overall study was to measure changes in disclosure levels of corporate reporting over a five-year time period, the firm should have been listed on the JSE throughout the five-year period. This would eliminate any possible bias arising from changes in disclosure practices due to changes in listing status.
- The volume of shares traded in each of the years 1979 to 1983 should exceed 250 000²⁰. Trading efficiency was necessary to perform any future beta-related tests on the data.
- One of the main activities of the firm should be manufacturing. Mining, finance, retail, insurance and property firms were excluded.
- Reliable betas for the shares should be available as it was proposed to extend the study by attempting to correlate risk and disclosure.

Data analysis

The weight to be assigned to each information item was obtained by calculating the arithmetic mean of the responses of the 137 respondents. This approach was similar to the methods used by Buzby¹⁰, Chandra¹⁴, Firth⁹, and McNally⁷.

The annual reports of each firm were evaluated using a mark sheet drawn up from the questionnaire sent to the investment analysts. The items on the questionnaire fell broadly into three categories:

- Category 1 consisted of those self contained items whose presence or absence in the annual report could be easily ascertained, such as the allowance for doubtful debts.
- Category 2 were those items where different degrees of disclosure were possible and an element of judgement was necessary to evaluate the precise level of disclosure. For example, a specific forecast of the following year's profit or EPS would receive a full credit. However, a general indication of the direction of the following year's profit or EPS would receive only a partial credit.
- Category 3 were those items which could be analysed into sub-sets of information. The firms received full credit where all the sub-sets of the item were disclosed. A proportional credit was, however, allocated for less than full disclosure.

A problem arises in that not all items in the index are relevant to each firm in every year. For example, details of mergers and acquisitions would not be applicable where no such event had occurred during the particular financial year examined. To cater for such situations two scores were calculated, the first measuring the maximum level of disclosure which could be made and the second measuring the actual disclosure.

The extent to which each information item was disclosed in the annual reports was measured by the percentage of the actual to the maximum potential score for firms dis-

closing that particular item. A score of 100 would mean that all firms fully disclosed the item whereas a 0 would mean total non-disclosure.

Comparison between actual and desired disclosure

Table 1 lists the index items in order of 1983 disclosure level together with their rankings in terms of perceived investor importance. These two lists of rankings were tested for association using the Spearman rank correlation coefficient. The result of 0,13 indicates little positive correlation between the actual and desired disclosure of individual items. Similar conclusions were drawn by Buzby¹⁰, Firth⁹ and McNally⁷.

The areas of agreement in terms of a relatively high level of disclosure and a high investor ranking included a description of major products/services, discussion of the firm's results for the past year with reasons for changes, discussion of the major factors which will affect the next year's results and information on mergers and acquisitions.

The assigning of a score to items such as "description of major products/services" was rather subjective and it is felt that, in retrospect, the high score achieved by the sample companies in this area may have been due to the setting of too low an evaluation standard.

Areas where disclosure was limited and the item was deemed to have little importance, included inflation related information and statements concerning taxation.

High disclosure but low importance was attached to the functional responsibilities of senior management, the historical summary of the price range of ordinary shares, the number and type of ordinary shareholders and the names and salaries of senior management (while no annual report disclosed the salaries of its senior management, the disclosure of names was extremely high). Since equal weight was given to each part of the item, ie to the names and the salaries, the relatively high level of disclosure of the items was in fact somewhat misleading.

Low disclosure but relatively high importance was attached to cash projections and a statement of transactions in foreign currency.

These observations bear out the finding that there was little correlation between the level of disclosure of items and their perceived relative importance. The preparers of the financial statements, therefore, did not seem to be meeting the non-statutory informational requirements of investors.

This situation, which is certainly not unique to South Africa^{7, 8, 9, 10}, has a number of possible causes. Firth⁸ studied the perceived importance, in the eyes of various groups, of information item disclosure in annual reports in the United Kingdom. He found that the importance rating by finance directors and auditors was similar. Also, the ratings by financial analysts and bank loan officers were similar. There were, however, significant differences in the importance ratings of the above two groups. The preparer and user groups of financial statements were, therefore, at odds with different perceptions as to what was important with regard to disclosure.

A second reason is the competitive advantage to be gained/maintained by not revealing information to existing or potential competitors. The belief is that the less information these parties have the less effective will be their competition.

Thirdly, there are direct costs associated with providing additional information in the annual report. Where the information items can be culled from internal management

reports, the costs are likely to be relatively insignificant. However, for other items, it is believed that the costs of accumulating the data can vary enormously. For example, accumulating the information for a historical summary of the share price or the number and type of ordinary shareholders would be relatively inexpensive, while the valuation of a firm's fixed assets could be costly.

Alternatively, some might argue that the lack of correlation could arise from the possibly unrealistic underlying assumptions of disclosure indices. Dhaliwal²¹ has criticised these assumptions and two of his arguments could have a bearing here. First, it is possible that analysts are unable to perceive the relative importance of the different information items. This argument is probably only applicable to those items of lesser importance as a relatively high level of consensus (ie low standard deviations) was found amongst the investors for those items considered most important. Second, the relative importance of the disclosure of a particular item may be related to the disclosure/non-disclosure of other items. This problem is to some extent limited by the careful selection of items for inclusion in the index and by requesting the analysts to weigh the items bearing in mind that the inclusion of each additional item in the annual report requires extra costs on the part of the company.

Finally, it is possible that some firms are merely ignorant of, or indifferent to, investors' information requirements.

Since modern financial theory associates value with the present value of expected future cash flows, one may anticipate that investors would rate highly items of information which have a direct bearing on the assessment of future cash flows. The items which fit into this category are:

- Discussion of major factors which will influence next year's results including an indication of the firm's relationship to its industry and the economy.
- Statement of future dividends/dividend policies.
- Forecast of next year's profits or EPS.
- Capital expenditure – narrative and quantitative data on expenditure in past year and planned expenditure.
- Statement of rate of return required by the company on its projects.
- Cash projections, one to five years.

This is, in fact, the case with all six items in this category being ranked in the top third of the index. The average ranking of these items was 6,5 as perceived by the investors, yet only 24 in terms of actual disclosure.

It is difficult to explain the relatively low level of actual disclosure of these items in terms of either the costs associated with capturing the information, or their strategic importance to competitors. It may, of course, be the result of the reluctance of management to commit themselves to a forecast of the future because of the potential for error. However, management should be in a better position than any investor to make a future projection and one could, therefore, recommend to companies that efforts be made to increase disclosure in these areas. This should result in a meaningful impact on investor uncertainty and, thus, market value.

Conclusions

The objective of this study was to examine the extent to which the non-statutory information requirements of investors was being met by current disclosure practices in the annual reports of listed South African companies.

While the results of this survey cannot be statistically applied to all the industrial firms listed on the JSE (the annual reports of all firms satisfying the selection criteria were analysed rather than those of a random sample of firms) it is, nevertheless, believed that the conclusions reached regarding the extent of voluntary disclosure are probably applicable to all such firms.

A disclosure index was developed to establish South African investors' information requirements. The extent to which this information was disclosed in firms' annual reports was measured and compared to a sample of investors' perceptions as to the importance of the information.

As in other countries, it was found that there was little positive correlation between investor information requirements and the disclosure of such information in annual reports. Possible causes highlighted were a difference in perceptions regarding the importance of information items, competitive strategies and the cost of providing information.

Table 1: The rankings of information items in terms of firm disclosure and by investors

Index items	Firm disclosure	Investor ranking
Description of major products/services	1,0	9,0
Discussion of the firm's results for the past year with reasons for changes	2,0	1,0
Functional responsibilities of senior management	3,0	42,0
Group structure	4,5	17,5
Discussion of the major factors which will influence next year's results	4,5	2,0
Historical summary of price range of ordinary shares	6,5	48,0
Information on major industry trends	6,5	15,0
Historical summary of important operating and financial data	8,0	19,0
Number and type of ordinary shareholders	9,0	40,0
Information on mergers and acquisitions	10,0	7,0
Statement of value added/wealth created	11,0	33,0
Names and salaries of senior management	12,0	49,0
Statement of objectives	13,0	9,0
Capital expenditure – narrative/quantitative/past/planned	14,0	5,5
Current resale value/valuation/insurance value of fixed assets	15,5	20,0
Depreciation method used and rates or useful lives of assets	15,5	21,5
Information on corporate social responsibility	17,0	46,0
Statement of future dividends/dividend policy	18,0	3,0
Directors' functional responsibilities and major outside affiliations	19,0	39,0
Breakdown of earnings by major product lines, customer classes and geographic locations	20,0	12,0

Index items	Firm disclosure	Investor ranking
Forecast of next year's profits or EPS	21,0	4,0
Inflation adjusted accounts as supplementary statement	22,0	32,0
Breakdown of sales revenue by major product lines, customer classes and geographic locations	23,0	16,0
Indication of employee morale	24,0	34,0
Brief narrative history of the firm	25,0	44,0
Discussion of the impact of inflation on the financial results	26,0	29,0
Expenditure on human resources	27,0	45,0
Description of major plants/warehouses/properties	28,0	37,0
Measure of physical level of output and capacity utilisation	29,0	17,5
Money value of firm's order backlog	32,0	21,5
Allowance for doubtful debts	32,0	27,0
Number and type of employees	32,0	43,0
Research and development	32,0	26,0
Description of marketing network for finished goods	32,0	41,0
Extent of dependence on major customers	35,0	13,0
Share of market in major product/service areas	36,5	9,0
Index of quantity of sales	36,5	31,0
Advertising and publicity	38,0	47,0
Index of sales prices	40,5	36,0
Index of raw material prices	40,5	35,0
Statement of rate of return required by the firm on its projects	40,5	11,0
Statements concerning taxation, etc	40,5	38,0
Cost of goods sold	46,0	25,0
Breakdown of expenses into fixed and variable components	46,0	24,0
Market value of inventory	46,0	23,0
Statement of transactions in foreign currency	46,0	5,5
Summary of the age of debtors at the balance sheet date	46,0	28,0
Amount and detailed breakdown of expenses	46,0	30,0
Cash projections one to five years	46,0	14,0

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