CONTEMPORARY DEVELOPMENTS IN COMPANY REPORTING - A SHAREHOLDER'S VIEW

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INTRODUCTORY:

Company reporting can never stand still. Not only will there always be changes in legislation and stock exchange requirements and in accounting techniques but also there will always be changes in the scope of company operations and in the needs of shareholders and other users of company accounts.

While no doubt the majority of this audience will consist of accountants, in this paper, which is primarily concerned with companies listed on a stock exchange, both the expressions "Contemporary Developments" and "Company Reporting", have been given a very wide meaning. Investors are generally not concerned whether any particular piece of information emanates from the directors, the management, the company secretary or the outside auditor.

Balance sheets and profit and loss statements as prepared by accountants have usually had a strong historical emphasis, but an investor is, of course, much more concerned with the future than with the past. History may be interesting, but from a shareholder's point of view it is only the starting point for a projection into the future.

Accountants have traditionally presented their reports on a conservative basis - no doubt with the best possible motives. However, the correct yardstick should be neither conservatism nor its opposite - it should be truth.

Section 162(12) of the Uniform Companies Act reads as follows:-

"Every balance-sheet and profit and loss account.... shall be accompanied by a statement signed.... by two directors .... stating that in their .... opinion -

(a) the profit and loss account is drawn up so as to give a true and fair view of the results.... ; and

(b) the balance-sheet is drawn up so as to exhibit a true and fair view of the state of affairs.... "

The interpretation which in practice is given to the words "true and fair view" can be illustrated by sworn evidence which was given at the Australian Broadcasting Control Board's Inquiry in connection with an application for the granting of a third commercial television licence for Sydney (Transcript, 2nd October, 1962, p.2955):

"Kenny, Q.C.: ... and that (the statement required by what is now Section 162(12) in regard to the 30th June, 1959, Annual Report of Electronic Industries Ltd.) was intended to be the truth, was it?

Sir Arthur Warner: Substantially.

Kenny, Q.C.: Was it wholly the truth, or not the truth?

Sir Arthur Warner: Well, I think that in every one of these reports you get a certain amount of salesmanship, you know. It is not up to a Chairman or a director to run his shares down."

It is realised, of course, that different experts can place widely differing interpretations on the same set of circumstances, and recently we have seen major disagreements between the directors of leading companies on the one hand, and a highly reputable firm of auditors on the other. We can look at the particular subject of this dispute, which received a lot of press publicity, at a later stage, but the point should be made straight away that there is no real problem here; the companies concerned have made adequate disclosure and it is up to each analyst to place his own interpretation on the facts as made available.

The principle that auditors should qualify reports in circumstances where accounting and presentation techniques are not clear-cut has much to recommend it, and shareholders cannot but become better informed if in fact they are presented with alternative ways of looking at the same problem. In this context a qualified Auditor's Report should in no way be regarded as a mark of reprobation for the company or as an insult to the directors.

A much more serious point arises with regard to Auditors' Reports, namely, the limitations imposed on frankness by the laws of libel. It would be highly desirable in the interests of the community at large if an Auditor's Report to Shareholders were given the same privileged status as remarks made by shareholders at a company's general meeting.

Company reports serve many purposes, and are designed for the information of many different categories of users - legal and taxation authorities, present and potential creditors, present and potential equity investors, and so forth. Shareholders are interested in company reports for two quite separate reasons, which are discussed in greater detail below. One of these, as mentioned earlier, involves forecasting the future, and the other is concerned with the protection of their present rights as shareholders.

FORECASTING THE FUTURE:

Over the last few years, the format of Company Annual Reports has greatly improved, inspired by greater awareness of the various problems on the part of company directorates and managements and their professional officers. Pressure has also come from outside organisations, including the Australian Institute of Management (which for many years has sponsored an annual award for the best Annual Report), the Universities, the Australian Shareholders' Association, the Australian Society of Security Analysts, the Chartered Institute of Secretaries, the Australian Society of Accountants, and the Institute of Directors. Furthermore, the current Listing Requirements of the Australian Associated Stock Exchanges contain many useful rules and these do not require detailed discussion here.

Comment can be made on the following aspects:

(a) Taxation.

The Provision for Income Tax provides a valuable rough check for investors on the accuracy of the Net Profit figure as struck by the directors. Generally speaking, the amount provided for taxation is likely to be well-judged, as any overstatement of taxable income is needlessly costly to the company, and as any understatement is likely to lead to penalties. Most listed companies now comply with the Australian Associated Stock Exchanges Requirements and allow shareholders to make maximum use of this information by providing a reconciliation between the amount of tax provided and the income tax "prima facie payable" on disclosed profit before tax. Itemisation of the major reasons for any difference (investment allowance; calls on oil or mining shares; past or current tax losses in subsidiaries; rebates in respect of dividends and old series Commonwealth Bonds; etc.) can be most valuable. Explanations should also be given in respect of any material differences between the amounts provided for taxation in the past and the amounts actually required when the assessment is made.

(b) Turnover.

The continued reluctance of some companies to disclose their turnover figures is hard to understand. Obviously, an analyst is very much interested to know whether the variations in profitability arise from changes in sales volume or changes in profit margins per unit. There is no evidence that companies which make proper disclosure in this area have suffered any competitive disadvantage.

(c) Leases.

Companies have always shown amounts which they have borrowed. However, it is possible (and these days not unusual) for companies to use large sums of outside funds obtained by an economically equivalent but legally different device, viz., leasing. Companies should be required to include a note to the balance sheet giving details of annual lease obligations, classified at the very least according to unexpired term.

(d) Depreciation.

It would be helpful if companies showed separately depreciation provisions ranking for tax relief, and provisions not so ranking, with a note explaining the situation.

A very common method of writing down an asset is by level instalments over its expected working life, presumably on the basis that this method of depreciation fits in with the way gross profitability from the asset concerned arises. However, this would appear to overlook the fact that accumulated depreciation provisions are funds usable in the business and thus earning profits. In these circumstances, it would be more logical for depreciation provisions to build up from low amounts early in the life of an asset to higher amounts later on, taking into consideration the compound interest effect.

(e) Operations in several Countries.

Companies listed on Australian stock exchanges include many whose operations are confined to the Commonwealth. In these cases no questions of conversion rates arise. At the other extreme, some companies transact business in a large number of countries and their figures may represent a wide spread of different currencies. In between, there are other companies which operate in a small number of countries, perhaps only in Australia and New Zealand. Having regard to the fact that different tax rates and tax concepts apply in different countries and that devaluations and revaluations of currencies take place periodically, it would seem appropriate in many cases that separate figures should be given either in respect of each country involved or, in the case of companies operating in many different countries, at least in respect of the major countries concerned.

(f) Funds Statements.

It would frequently be of assistance if companies provide a statement showing the source and application of Funds during the year.

(g) Vague Terms.

Phrases in company announcements, such as "sales were in excess of budget" (when no indication of what the budget is, is given) or that "profitability is satisfactory", are quite meaningless and should be avoided.

(h) Years containing 53 Weeks.

Some retailing companies find it convenient to use a weekly cycle and thus present accounts covering usually a 52-week period, but sometimes a 53-week period. Their problems would, of course, be solved by calendar reform (e.g., the adoption of the World Calendar which divides the year into four equal quarters, each consisting of 13 weeks commencing on a Sunday, with inter-calendary "World Days" and "Leap Days" inserted between a Saturday and a Sunday, to make up the necessary 365 or 366 days in the yearly cycle). However, it would seem preferable that companies in this category shouls stick to the 52-week reporting year, even at the expense of a "migrating" end-of-the-year date. The use of 53 weeks' figures involves a non-recurring 2% increase over the corresponding 52-week year. Greater distortions can occur if the profit figures represent 53 weeks' gross profits netted by annual charges no greater than those which would have been used in respect of a 52-week period.

(i) Emergence of Profit.

With some companies, e.g., those engaged in land development, major construction works, credit sales, etc., important questions arise as to whether credit should be taken for profit at the commencement of a transaction or at its conclusion, or progressively over the entire funding period. It is reasonable that each company should adopt a procedure most suitable for its individual circumstances; it is not reasonable that details of the concepts it uses and their effect on the figures should be hidden from shareholders. These should be supplied with sufficient information to enable them to make their own re-calculation of true profit according to their own interpretations.

(j) Quarterly Reports.

There is no great magic in having a year as the accounting period; after all, a year only represents the time taken by the earth to complete one revolution around the sun. For some purposes, the reporting period of one year may well be too short; for others it could be far too long. Most investors would appreciate quarterly reports showing the essential information in a cumulative form from the beginning of the financial year, together with comparative figures covering the corresponding period of the previous financial year.

(k) Current Assets and Current Liabilities.

There is a tendency in some company reports to distort the true working capital position, either by including amongst the current assets long-term assets such as subdivisional land, or by excluding certain current liabilities by showing them under other headings in other parts of the Balance Sheet. Such devices are clearly undesirable.

(l) Adjustments for earlier Years.

Some companies do not distinguish clearly enough between items affecting the current year, which should be taken into account in striking the profit, and retrospective adjustments affecting earlier years, which should not.

(m) Taxation Benefits needing Amortisation.

The Income Tax Act confers a number of special concessions, e.g., the investment allowance for new plant, the effect of which is to confer in one tax year a benefit which more appropriately should be spread over a longer period (e.g., the lifetime of the asset). A similar position arises in the case of companies able to claim depreciation for tax purposes at a faster rate than is appropriate in their own accounts. Appropriate provisions should probably be set up, to ensure that the concessions are amortised correctly; but, whether this is done or not, full disclosure should certainly be made.

(n) Capital Changes.

Company annual reports should give detailed information of all capital changes made during the year, so that (inter alia) average capital employed can be calculated. As it is sometimes difficult in practice to get up-to-date information as to the number of shares on issue at any time (particularly in the case of companies making frequent off-market placements and/or takeovers), official announcements of all capital changes should always be made as soon as they occur.

(o) Property.

In many cases it would be useful to have a list of properties owned or occupied by the company, giving location and book-values, and indicating whether freehold or leasehold. Particulars of the latest valuation (in the former case) or of the terms of the lease (in the latter case) should also be given.

Where property is in the books at cost, a breakdown is desirable between the cost of land, the cost of development, and other costs which may have been capitalised.

(p) Commitments.

Where material, details of likely future capital expenditure as well as of outstanding commitments should be given.

(q) Unusual Accounting Techniques.

If special accounting methods have been adopted to deal with special situations, full explanations should be given.

(r) Pre-Acquisition Profits.

Queries sometimes arise in regard to the treatment of pre-acquisition profits in the case of newly-acquired subsidiaries. Notes commenting on this aspect would be helpful.

(s) Changes in Subsidiaries.

When major subsidiaries have been acquired or disposed of during the year, the "preceding year" figures required by statute become rather useless for comparison purposes. A fresh set of "preceding year" figures embracing the companies consolidated at the current year's balance date would be of advantage.

(t) Substantial Investments.

Special action seems called for in cases where a company owns a substantial but non-controlling interest in one or more other companies, or where the main activity is portfolio investment in other companies. To take credit only for the dividends received instead of a proportionate part of the earnings is legally correct but economically misleading. An appropriate note should give details. Similarly a note to the balance sheet should deal with the plough-back which has accured in respect of the investment since its acquisition. (This device would ensure that similar information is made available whether a company is 50% or 50.01% owned.)

(u) Underwritten Issues.

Companies which have new issues of shares or loan securities underwritten should include in their reports details of the underwriting fee paid and the proportion of the issue (if any) left with the underwriter. They should also be required to state whether tenders were called for the underwriting and whether the tender accepted was the most favourable one.

(v) Inflation.

An historical set of accounts pretending that the dollar had the same value in 1900 as it has today tends to be a pretty meaningless document. Not only will the value of assets be under-stated (thus destroying an important yardstick, viz., the efficiency of the company) but also profitability figures and profitability trends can be hopelessly distorted. Depreciation provisions will tend to be under-stated and hence profit over-stated; apart from this, companies may appear to show profitability in dollar terms when, in point of fact, they may have made a loss in real terms. A detailed discussion of accounting for inflation is obviously outside the scope of this paper, but it is no solution to ignore the subject merely because it is difficult. All companies should supplement their statutory reports, expressed in conventional form, with additional reports presented in a form allowing for inflation. It is better for this purpose to use an index which is known to be only approximately accurate, rather than to be completely inaccurate by using no index at all.

PROTECTION OF SHAREHOLDERS' RIGHTS:

It is a cardinal rule in British democracies that governmental controls should be kept to a minimum. It follows as a corollary that if private enterprise desires to avoid undue government intervention it has an obligation to make maximum disclosure.

Sometimes company boards undertake practices which may be considered undesirable, inequitable or even unethical. A very effective way of discouraging such practices would be to require each company to publish the certain additional information either in the Annual Report or in separate reports to shareholders, stock exchanges and company registration authorities.

Examples include the following:

(a) "Insider" Trading.

Full details should be given of all "insider" trading, together with such explanations as those concerned may desire to give. In this context "insider" trading includes share transactions by company directors and executives as well as by others associated with them such as wives, relatives, controlled companies, etc.. "Insider " trading also extends to dealings in rights and in "Put and Call" Options over the company's shares. To prevent directors and executives from resigning merely to avoid statutory disclosure, the requirements for disclosure should extend to all persons who have held office at any time during the reporting period concerned.

(b) Watering of Capital.

Most companies' Articles give their boards of directors power to deal with unissued shares up to the limit of the authorised capital. Sometimes directors absue this discretion. The company should accordingly report full details of all share issues for cash which were not made on a pro-rata basis to existing shareholders, showing the reason for the issue, the number of shares issued, the date of issue, the price, and the recipients (itemised in the case of large placements to a small number of institutions or associates, or aggregated in the case of placements made through named brokers, or to employees). These particulars should be accompanied by a statement showing the reduction in equity (expressed in cents per share) suffered by the holders of existing shares as a result of the issue.

(c) Rights not taken up.

It should be a cardinal principle that shares arising from rights to new share issues not dealt with by any shareholders should be disposed of by the company and the net proceeds distributed to the members concerned. Where this principle is not observed, company reports should show who the recipients of the shares involved were.

(d) Board Information.

Annual reports should contain fuller details of the company's directors: e.g., their dates of birth, their real occupations (i.e., a description rather more meaningful than "company director"), and details of their technical and academic qualifications, experience and other public directorships. The number of shares held directly or indirectly by each director should also be shown.

(e) Resignations of Directors.

Company reports should include as a privileged communication a statutory declaration by each director who resigns or who does not seek re-election, setting out his true reason for such a course of action.

(f) Management Contracts.

Company reports should give full details of any service contracts involving directors or executives where these involve an unexpired term of more than (say) twelve months.

Details of all outstanding staff options should also be given, showing (in addition to the particulars under the A.A.S.E. Listing Requirements) their dates of issue, and the market price of the shares at those dates compared with the exercise price.

(g) Minority Directors' Reports.

Company Annual Reports are required by law to include a Directors' Report, which in practice must mean a report sanctioned by a majority of the Board. The law should be amended to also require a corresponding "Dissenting Report" from any minority of the directorate which does not subscribe to the majority Report.

Possibly also each director should be required to state whether he is fully apprised of how the company is being managed.

(h) Takeover Aspects.

Company reports should also provide information to allow potential bidders to make properly evaluated takeover offers. It will be realised that insufficient disclosure (e.g., as to asset value or as to true profitability) may deter the making of a takeover offer, the acceptance of which might well be in the shareholders' best interests. Alternatively, insufficient disclosure may cause a bid to be made, but pitched at too low a figure, to the detriment of the shareholders concerned. Sometimes the making of a takeover offer produces "deathbed" revelations from the directors as to the company's "true worth"; shareholders may be pardoned for being slightly sceptical of such statements, which reveal that lies have been told year after year in the past. Possibly it should also be made compulsory for directors to supply an answer to the question - "Have any share issues been made during the last year which would have the effect of reducing the probability that a takeover offer will be made?"

THE RECIPIENTS OF COMPANY REPORTS:

Investors who receive company reports may be highly sophisticated (e.g., professionals, stockbrokers, institutions, security analysts, financial journalists, academics, etc.). But the majority in number (even if not in number of shares held), in the case of most listed companies, will be less-sophisticated investors. These would be considerably assisted if company Annual Reports included five-year tables of key figures, and if they showed dividend and earning rates expressed, not in obsolete percentage terms, but in cents per share. In the case of dividends, it would also be helpful to give information as to the books-closing and dividend-payable dates.

Certain key ratios (also covering the last five years) should also be presented, e.g.

Net Earning Rate on Ordinary Shareholders' Funds.
Gross Earning Rate on Ordinary Shareholders' Funds.
Gross Earning Rate (before Interest) on Total Funds.
Net Tangible Asset Backing in respect of each Security listed.
Dividend and InterestCCover in respect of each Security listed.
Working Capital Ratio.
Earnings as proportion of Turnover.
Stock as proportion of Turnover.
Proprietary Ratio.
Payout Ratio.
Growth Ratios (Turnover, Earnings, Earnings per Share).
Income Tax as proportion of Gross Earnings.
Weighted average number of Ordinary Shares outstanding.

All of these can be calculated by those in the know, but not every recipient of company reports has the necessary ability and in any case it seems unreasonable that thousands of shareholders should spend time performing identical calculations when one calculation, performed by the company (on some clearly-defined uniform statutory basis) would save this unnecessary effort. It would also be helpful to have a summary of share issues made during the five-year period and the range of market prices each year.

SEPARATE LEGISLATION FOR LISTED COMPANIES:

Consideration of the above points, which have dealt mainly with the problems of listed companies, suggests that the philosophy of the present Companies Act, which has virtually the same rules for a $2 family company as for a large public corporation having millions of dollars of shareholders' funds and tens of thousands of shareholders, is inappropriate. Stock exchange requirements for greater disclosure are pretty useless as they involve no effective sanctions. Delisting is a penalty which only hurts shareholders and, in any case, where companies with large active share registers are involved, it is not realistic to expect brokers to deprive themselves of substantial brokerage revenue by this process.

Other provisions which could well be considered in legislation dealing with listed companies include the following:

(a) Post-Meeting Reports.

The Chairman's prepared address is probably best distributed with the Annual Report itself, but a Supplementary Report dealing with questions raised at the Annual Meeting and the Board's replies should be sent out afterwards. This is particularly important in the case of the small minority of companies which are immoral enough to exclude the press from a shareholders' meeting.

(b) Divisional Figures.

Despite the fact that it would be difficult to define in legislative terms what constitutes a distinct division of a company, it would be very useful if conglomerate companies were required to provide essential figures (e.g., those relating to assets, profits, turnover, etc.) by divisions (regardless of whether branches or subsidiary companies are involved).

(c) Accuracy of Company Reports.

The Uniform Companies Act makes it an offence to wilfully make materially false statements in reports or balance sheets required under the Act or in prospectuses. But there appears to be nothing to prevent false or misleading information to be supplied in other documents, e.g., in circulars to shareholders, the press, or the stock exchange. The chairman of one large listed company, which had been making losses for some years, told his shareholders on 20th December, 1968, that "The improving trend towards the company's rehabilitation ... is continuing and will be reflected in the results for the current financial year." Yet the company's interim report to the Stock Exchange covering the six months ended 31st December, 1968, a mere 11 days after the chairman's statement, disclosed a loss for the half year nearly as large as that for the preceding full year (ended 30th June, 1968). The report went on to say that it was expected that the loss for the then current half year (to 30th June, 1969) would be even greater than the loss incurred during the six months ended 31st December, 1968.

(d) Appointment of Auditors.

Theoretically, auditors are appointed by the shareholders, but it would be most unusual for shareholders to appoint auditors not nominated by the directors. This must result in certain pressures which are undesirable, particularly in the case of smaller auditing firms where the loss of a large company account may be of some significance. It might well be better if auditors were selected by a government authority or a professional body and allocated to listed companies by some impartial rotational principle.

(e) Function of Auditors.

The functions of auditors could well be widened, particularly as shareholders have no other convenient impartial investigator able to alert them of troubles. Auditors should be empowered to comment on the business methods of the board and management.

CONCLUSION:

Several final points are worth making:

The first concerns the timing of company reports. It cannot be stressed too much that prompt reporting of developments is essential to preserve a fair market. This does not only apply to obvious things like profit, dividend or new issue announcements, takeovers or mineral discoveries. Prompt announcements of other factors - good or bad - which lend themselves to rumours will help reduce the insidious effects of "insider" trading. Naturally, it is helpful if announcements made during the year are also summarised in the Annual Report.

The second is more general. Company reports should do much more than merely comply with the law and conform to Listing Requirements. An over-all essential - it should hardly be necessary to stress it here, but experience shows that it is - is that nothing which is stated in any company report should be misleading to its recipients.

The third refers to the format of the Annual Report. Companies should not assume that all those who will handle this document know all about the company before they start. A plain statement of what the company does and a few lines of history would be much appreciated by many readers.

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