

**DIVISIONAL DISCLOSURE -  
AN INDUSTRY VIEW**  
— Comment by  
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INTRODUCTION

Before I worked in manufacturing industry I was a security analyst, and I therefore appreciate and understand the thinking behind Xerves Y Zorba's article in the May/June edition of 'JASSA'. I feel, however, that readers should be alerted to some of the problems of divisional disclosure, problems which received only a wave of acknowledgement in the article. The use to which divisional results would actually be put is unclear, but in this article I have assumed that the investor would like to compare the division's results with -

- (a) its own past and future;
- (b) similar divisions in other companies.

I deal first with two general problems.

GENERAL PROBLEMS

1. Stock Exchange Disclosure

Quite rightly, the Stock Exchange strives to maintain a market in which anyone can be as fully informed as anyone else, provided he is prepared to seek out published material. To overcome the problems of leaks, responsible public companies keep their financial results known to the minimum possible number of people.

On the other hand, it is desirable, if only for morale reasons, to keep employees up to date with their company's progress. An employee is no longer an assembly line robot: he likes to enjoy the satisfaction of seeing good results posted month by month or, on the other hand, to know why such stringent cost cutting measures are necessary.

For companies with a divisional structure it is possible to give employees of a division a regular idea of their progress in financial terms, and dollar signs are what count in the long run.

Introduction of new requirements demanding public disclosure of divisional results would effectively prevent all but a handful of employees in the corporation from knowing what profit progress was being made until after disclosure to the Stock Exchange. The greater the number of people privy to information, the greater the risks of leaks, and therefore the greater the risk of censure by the investing public.

2. Change of Structure

The second general problem would arise every time there was an organisation change. Manufacturing corporations might move from production to market orientation, or to a mix of the two. Similarly, service corporations might move from geographical divisions to marketing divisions, and so on. Such changes are necessary from

time to time, if only to prevent ossification in the structure. In such a case, for comparison of one division with its past and its future, would XYZ require corporations to provide adjusted figures?

SPECIFIC ARGUMENTS

XYZ made some specific points and counter arguments to which I now turn.

1. Assistance to competitors

The value of divisional figures to a competitor would depend entirely on the composition of that division. For example, if a division in one company made only colour television sets while its main competitor's division made colour TV, black and white TV, mobile and car radios, and electric meters, it is not difficult to see which company would derive greater benefits from his competitor's disclosure. Hence, the legislation enforcing disclosure by all enterprises, for which XYZ calls, would also presumably have to enforce homogeneity in the various divisions of the companies in order for analysts to have a true comparison, and for nobody to derive unfair advantage. I suspect that appropriate legislation would be impossible to draft.

2. Difficulty of allocating overheads

XYZ is correct in saying that overheads can and should be allocated for management control purposes. But this allocation must, as XYZ would I am sure acknowledge, be done on an arbitrary basis by management. Auditors are employed to verify consolidated results but, unless they have verified (at considerable expense) the arbitrary allocation of head office expenses to divisions, they would be most unlikely to express an opinion on the accuracy of divisional results. This would then lessen the value of comparing company A's nut and bolt division with company B's nut and bolt division. Moreover, it would allow management of either company to 'cook their books' by allocating a disproportionately high or low expense to that division for competitive purposes.

3. Shareholders would misunderstand

I have found that however much care you take in preparing a document, speech or letter, somebody will always misunderstand it! But even if we leave that, hopefully small, group of leaders out of our discussion, there is the more difficult task of explaining modern accounts. BHP's latest report and accounts included one page on accounting policies, followed by thirteen pages of notes. Despite these notes, I wonder how many BHP shareholders understand tax effect accounting, for example I do not see this as an obstacle to divisional disclosure, but do the bulk of shareholders really want the information they are now getting, let alone additional information?

To develop this thought further for a moment. The idea of two sets of accounts - one for all shareholders, and one more detailed set designed especially for analysts and available on application - should, perhaps, be reconsidered.

Futurologists are currently talking of requiring

companies to report not only on financial results but also on employment, pollution/environmental controls, social/community roles, and so on. Will we, one day, revert to a simple basic statement of results, with ancillary reports on specific topics available on request to those who are interested?

#### 4. Supernormal profits

I must first pick up XYZ's comments on two points of detail. He suggests that the damage resulting from disclosure of high profits from innovation should be protected by patent. I remind him that by no means all innovation is patentable, particularly if the idea, while ingenious and profitable, is not distinctly different.

He then suggests that 'the PJT or some other government body will, no doubt, challenge high margins whether publicly disclosed or not.' Until its recent instruction from the Prime Minister in the BHP case, the PJT gave no inkling that it even understood the role of profits in the private sector. Based on its performance to date, it could not be regarded as competent to challenge high margins. The only effective way to challenge high margins is, as XYZ later says, competition. In this field the Trade Practices Commission and Industries Assistance Commission should be the government instruments promoting competition, and divisional disclosure to those bodies could well be a method.

#### 5. Union claims

What union leaders say in public does not give grounds for confidence that they understand the distinction between absolute profits in terms of dollars and profitability in percentage terms. Indeed, in my experience, very few people in the community as a whole understand the distinction or appreciate how low profitability really is.

A year or so ago the managing director of one of Australia's listed public companies was talking to administrative staff at a social get-together at the end of the day. He asked them how much profit in each dollar of sales the company had made the previous full year. Guesses ranged from 9 cents to 33½ cents. The actual figures were - after tax 4.3% and before tax 7.8%.

Enlightened companies and non profit organisations, such as the IPA, are doing their best to put the record straight on this subject, but it will inevitably be a long process. Until union leaders generally demonstrate that they understand the distinction between profits and profitability, is it reasonable to assert that divisional disclosure 'will assist them to better understand the workings of business?'

#### 6. Small customers and suppliers

XYZ said that small customers or suppliers of a conglomerate were at a disadvantage on a trading basis because of their ignorance of the profit situation of the division with which they were dealing. Is this good or bad, and why?

#### 7. Mining companies

Surely there is a big distinction between mining companies and industrial companies from the

point of view of disclosure? Mining companies -

- (a) have exclusive leases over specified ore bodies;
- (b) produce minerals known to man for centuries;
- (c) do not invent new products or services;
- (d) have little control over day to day prices of their products;
- (e) frequently have a guaranteed market because of a long term contract.

Much wider disclosure of results by mining companies has therefore always been possible, because competitors cannot influence raw material supply; there is no need to plan for supernormal profits on new products; and they cannot adjust their prices to take advantage of market situations.

#### PURPOSE OF DISCLOSURE

I am in favour of greater disclosure by corporations of what they are doing. They provide employment for 75% of the workforce, and are a major factor in the lives of most of us.

However, I see the main purpose of this disclosure at this stage as educating the public, including most of the workforce, on some or all of the following -

- (a) the role of profits in the private sector
  - in allocating resources;
  - in financing expansion;
  - in rewarding investment.
- (b) the distinction between profit and profiteering;
- (c) the distinction between profit and profitability;
- (d) the justification for 'supernormal' profits in certain areas;
- (e) corporate action with regard to community problems (e.g. pollution, conservation, alcoholism, education).

When there is such fundamental ignorance in the community, I wonder whether we will achieve anything worthwhile with the divisional disclosure proposed by XYZ.

#### SUMMARY

While I do not condemn divisional disclosure as such, I have tried to suggest that there are problems attached which could well hinder rather than improve the public's understanding of the role of the private sector. Divisional results could well require a further page full of notes emphasising their drawbacks, especially in those cases where the activities are not as different as oil and steel. For the time being I think that members of the Securities Institute and readers of this journal should be more concerned with the fundamental problem of explaining business to the uninformed public. In the present environment this seems to me to take precedence over divisional disclosure if we want to preserve the free enterprise system in Australia.