

DIVISIONAL DISCLOSURE By Xerxes Y. Zorba

INTRODUCTION

Most companies appear loath to disclose their divisional results. The needs of investors and the usual reasons given for non-disclosure are examined in this article. It is argued by the author that not only is it necessary for the investor to have this information to properly assess his investments, but that those who advocate continuance of the free enterprise system will assist their cause by campaigning for greater disclosure.

INVESTORS' NEEDS

To evaluate a company an investor needs to know the level of profits, the type of business and the calibre of management.

The type of business will give some indication of the risk or certainty of future earnings. If more than one type of business is conducted the importance of each needs to be ascertained. It is possible for a company to have unrelated but volatile activities whose aggregated results give a smooth earnings trend for a period. The riskiness of such a group might not be recognised sufficiently. A divisional profit split will allow for a better assessment of the quality of earnings.

It is perhaps nearly impossible to adequately evaluate the quality of management. However, some attempt must be made because management will often be a major determinant of future earnings. It will be necessary to study the main actions of the management over a period and the results therefrom. In particular, it will be helpful to know where management has concentrated the company's resources and the resultant performance.

The investor will require to know the funds employed in each division and the relevant profits. This will assist in determining whether management is seeking the best returns and overcoming shortcomings. It may show whether retained earnings are being invested satisfactorily; and if they are not, shareholders might seek a maximum dividend payout. It will avoid splendid success in one activity hiding gross incompetence in another. It will make it difficult for management to continue to accept a modest rate of return on certain activities which provide management with additional prestige and perquisites.

REASONS FOR NON-DISCLOSURE

Disclosure of divisional results will assist competitors. Even though competitors will usually know how others in the industry are faring, it is claimed that verification of that intelligence is most helpful. It is held that the interests of shareholders are being enhanced through the company being able to limit competitive pressures.

Many managers will claim it is not possible to show a split of profit sources because of the difficulty in properly allocating overheads and inter-divisional transactions.

Some will argue that many shareholders would "misunderstand" and not use the information properly. Shareholders may not realise that a particular division may give added benefits to other divisions (certainty of supply, outlet for products etc.)

Some will say the information is "private".

Disclosure may deter risk taking because management might not wish to have any failure highlighted.

A major stimulus to innovation is to have a monopoly of a new idea for as long as possible; disclosure could shorten the advantage.

If the rest of the market has overlooked a profitable activity, its attention should not be drawn to it.

Short term results may belie prospects or disclosure a longer term strategy.

Unions will be able to make claims upon the more profitable divisions.

Consumers will be able to complain that some profit margins are too high.

SOME COUNTER ARGUMENTS

Some of the arguments above can be refuted. Some may require legislation to fully overcome managers' concern. In the other instances it can be shown that the public interest is more important.

It is to be hoped that those managers who claim it is difficult to separate profits do in fact know a realistic split-up. Otherwise, it must be expected that the management's financial reporting is grossly inadequate. Additional expense should not be incurred as a well managed company will already have the information.

If additional information could mislead shareholders, management has a clear duty to present that information (and whatever necessary supplementary information) in such a form that it may be easily comprehended.

Management should not be deterred from taking justifiable risks as they should be able to give shareholders a reasonable understanding of the company's intentions, activities, problems and results. This would pre-empt most unfair criticism.

If short term results do not reflect the expected longer term benefits there seems little reason why management should not bring its shareholders into its confidence.

In many cases it is debatable whether competitors would obtain much real benefit from disclosure. This is an area where it would be desirable to legislate to have all enterprises (public, private and unincorporated) disclose their divisional results. Then every enterprise would be in the same position as a single activity company.

If disclosure was to discourage innovation then there would be a case to adjust the patent laws etc.

While unions might be enabled to make certain claims against profitable divisions, the additional information will assist them to better understand the workings of business. In any event, unions will probably have a good idea as to which divisions are doing well. Secrecy will only compound distrust.

If high margins cannot be publicly justified, then from the community's view point it does not seem that they should be maintained. In any case, the P.J.T. or some other government body will no doubt challenge high margins whether publicly disclosed or not. To digress: shareholders are now finding out much more about certain companies through P.J.T. reports.

A small customer or supplier of a conglomerate is at a disadvantage because he does not always realise his importance to the other party, while the conglomerate knows much more about the smaller company.

From a community point of view it should enhance efficiency if competition enters an area which has experienced super-profits.

U.K. tradition has it that publicity is the price of freedom in commercial matters.

Mining companies, which can be most risky investments, are able (or are enabled) to raise capital by giving considerable and frequent information.

LEGISLATION

The U.K. Companies Act requires a statement in the directors report where there are two or more classes of business (which in the opinion of the directors differ substantially from each other) setting out the proportion of turnover of each class and the extent (or approximate extent in the opinion of the directors) of the contribution to profit or loss.

In U.S.A., the S.E.C.'s Form 10-K Regulations S-X require companies to disclose turnover and pre-tax income of classes of business responsible for 15% of turnover or for 10% of turnover in the case of companies with a turnover in excess of \$50m. It is possible for the S.E.C. in particular cases to allow omissions or a different statement.

Australia's Corporation and Securities Industry Bill 1974 provides in S 129 (9) (c) for turnover to be apportioned between each class of business. S 129 (9) (e) provides for compliance with such other requirements as are prescribed. This catch-all provision may enable inclusion of income and assets employed by line of business. If some companies could prove that provision of such information was detrimental to the public benefit one would hope that relief could be granted as in U.S.A.

DISCLOSURE WILL ENHANCE FREE ENTERPRISE

A prime attribute of the free market is that resources are allocated to areas where they can be used most effectively. Any misallocations to less productive activities will cause a decrease in the overall benefit. The best way to ensure that resources are properly utilised is to publicise their allocation and the ensuing results.

Owners and managers have a vested interest in the free enterprise system and would no doubt believe it to be the most efficient method of running much of the economy. We should not encourage those less competent managers who might wish to continue the easy life by hiding their poor performance and thereby reduce the overall efficiency of business.

The community is demanding greater accountability on the part of those who control enterprises. Many are not convinced that free enterprise is working for the benefit of the community. Evidence should be provided to satisfy all interested parties. Investors and managers of companies which are enjoying abnormally high profits will not wish to be publicly scrutinised. However, it will be for the benefit of all investors and managers, as well as the general public, if adequate disclosure is made which encourages healthy competition.

Similar disclosure of performance should be demanded of public enterprises so that inadequacies can be noticed and hopefully, so that remedies be set in train.

ACTION BY SECURITIES INSTITUTE

Most members of the Securities Institute will probably concur with much of the above. They may as individuals do what they can to encourage greater disclosure (even those in banks and insurance companies). Collectively they might propose that the S.I.A. submit reforming recommendations to the various legislative bodies and other interested groups. Even those who benefit from ascertaining undisclosed information by other means should see reason to support greater disclosure.