THE INADEQUACY OF CURRENT LEGISLATION ON CORPORATE DISCLOSURE
Edited by R.G. Lander

It is the view of the Australian Society of Security Analysts that the recent amendments to the States' Companies Acts, while ushering in many desirable changes in disclosure requirements, do not go far enough in a number of important areas. We view these gaps in corporate disclosure legislation as holding Australia back from following the progressive examples of the U.S.A. and the U.K. in corporate reporting. We view the need for amending legislation as being urgent for the undermentioned items.

It is acknowledged that equity and current value accounting are also important areas of disclosure. However, these are major subjects for separate investigation and are not covered by this Review.

1. Sales (Compulsory in U.S.A. and U.K.)

Disclosure of sales should be compulsory for all public companies with the exception of banks, finance companies and other financial institutions such as merchant banks which should state gross trading revenue.

"Sales" should be properly defined as being "less returns, discounts and allowances" and should exclude sales tax and excise duty.

Without knowing sales, the investor cannot calculate profit margins, debt collection periods, stock turnovers, sales to assets ratios, relative sizes of competitors and so on.

Companies should also be required to disclose the value of orders on hand twice yearly.

2. Analysis of Sales and Profit by Division or by Different Classes of Business (Compulsory in U.S.A. and U.K.)

Amendments to the N.S.W. Companies Act go some way towards giving an analysis of group earnings in requiring the profits of each subsidiary to be disclosed. However, with a clear trend towards divisionalisation, this amendment will tend to lose its sting. It is essential for analysts to have insight into the relative significance of various segments of a company, as to sales and profits in order to be able to assess the prospects of such a company.

The phrasing of an appropriate amendment dealing with this problem could well follow the wording of the relevant section of Form 10-k which must be lodged annually with the Securities Exchange Commission of the U.S.A. Section c(1) states the following:

"Information as to lines of business. If the registrant and its subsidiaries are engaged in more than one line of business, state, for each of the registrant's last five fiscal years, or for each fiscal year ending after December 31, 1966, or for each fiscal year the registrant has engaged in business, whichever period is less, the approximate amount or percentage of (i) total sales and revenues, and (ii) income (or loss) before income taxes and extraordinary items, attributable to each line of business which during either of the last two fiscal years accounted for:

(A) 10 per cent or more of the total of sales and revenues,
(B) 10 per cent or more of income before income taxes and extraordinary items computed without deduction of loss resulting from operations of any line of business, or
(C) a loss which equalled or exceeded 10 per cent of the amount of income specified in (B) above;

provided, that if total sales and revenues did not exceed $50,000,000 during either of the last two fiscal years, the percentages specified in (A), (B) and (C) above shall be 15 per cent, instead of 10 per cent.

If it is impracticable to state the contribution to income (or loss) before income taxes and extraordinary items for any line of business, state the contribution thereof to the results of operations most closely approaching such income, together with a brief explanation of the reasons why it is not practicable to state the contribution to such income or loss."

3. Description of Activities

Section 162A (2)(b) of the N.S.W. Companies Act requires directors to include in the annual report the principal activities of the corporations in the group in the course of the financial year and any significant change in the nature of those activities during that period.

The wording of this requirement leaves it up to the individual company to disclose as much or as little as it sees fit. In all probability companies will opt for brevity in describing their activities. Once again we quote the requirements of the S.E.C.'s Form 10-k, as this is clearly a far more precisely worded and more penetrating requirement. Part 1, Item 1 headed "Business" reads as follows:

"(a) Identify the principal products produced and services rendered by the registrant and its subsidiaries, the principal markets for, and methods of distribution of, such products and services. Briefly describe any significant changes in the kinds of products produced or services rendered, or in the markets or methods of distribution, since the beginning of the fiscal year.

(b) If applicable and material for an understanding of the business, and with particular emphasis on significant changes and developments since the beginning of the fiscal year, briefly describe the following:

(1) Competitive conditions in the industry or industries involved and the competitive position of the enterprise.

(2) The dollar amount of backlog of orders believed to be firm, as of the end of the registrant's fiscal year, and as of the end of the preceding fiscal year, together with an indication of the proportion thereof not reasonably expected to be filled within the current fiscal year, any seasonal or other significant aspects of the backlog and the extent to which backlog is significant in the business of the registrant.

(3) The sources and availability of raw materials essential to the business.

(4) The importance and effect of all material patents, licenses, franchises and concessions held.

(5) The estimated dollar amount spent during the last fiscal year on material research activities relating to the development of new products or services or the improvement of existing products or services which was company-sponsored and on that which was customer-sponsored and indicating the approximate number of professional employees engaged full-time in each category of activity during such fiscal year; and,
(6) The number of persons employed by the enterprise."

4. Stocks

Under the amended Ninth Schedule of the N.S.W. Companies Act, stocks and work in progress must be shown separately. This does not appear to go far enough. The S.E.C.'s requirements outlined below covering commercial and industrial companies (Regulation S-X, Article 5(6)) are far more thorough and could well serve as a model for Australian conditions:

"Inventories -- (a) State separately here, or in a footnote referred to herein, if practicable, the major classes of inventory such as (1) finished goods; (2) work in progress; (3) raw materials; and (4) supplies.

-- (b) The basis of determining the amounts shall be stated. If a basis such as "cost", "market", or "cost or market, whichever is lower", is given, there shall also be given, to the extent practicable, a general indication of the method of determining the "cost", or "market": e.g. "average cost", "first-in, first-out" or "last-in, first-out"."}

To give some perspective to the effects of changing from one method to another we have set forth below an extract from the Annual Report of Chrysler Corporation for 1970.

"Effective January 1, 1970 the F.I.F.O. method of inventory valuation has been adopted for inventories previously valued using the L.I.F.O. method. This results in a more uniform valuation method throughout the Corporation and its consolidated subsidiaries and makes the financial statements with respect to inventory valuation comparable with those of the other United States automobile manufacturers. As a result of adopting F.I.F.O. in 1970, the net loss reported is less than it would have been on a L.I.F.O. basis by approximately $20.0 million, or $0.40 a share. Inventory amounts at December 31, 1969 and 1970 are stated higher by approximately $110.0 million and $150.0 million, respectively, than they would have been had the L.I.F.O method been continued."

In fact Chrysler lost $7.6m in 1970 but would have lost $27.6m if it had adhered to L.I.F.O.

Companies should be required to state the value of stock aged 2 years and over.

5. Extraordinary and Abnormal Items

An extraordinary item of profit or loss, defined as an item not connected with the ordinary day to day running of a business, should be dealt with in the profit and loss appropriation account and should not be allowed to affect stated net profit or loss of a company. This means that the taxation and minority interests, if any, germane to the extraordinary item should also be stated below the line. Examples of extraordinary items are profits or losses on the sale of land, investments or subsidiary companies.

An abnormal item of profit or loss, defined as an item resulting from the normal day to day running of a business distinguished only by its relative size or frequency of occurrence, should be treated as part of the stated net profit or loss of a company. Disclosure should be made, however, of the amount of such an abnormal item and of the germane minority interest if any and applicable taxation or tax credit. Examples of abnormal items are profits or losses on the sale of plant and equipment or on currency fluctuations.
6. Minority Interests
The interest of minority shareholders in extraordinary and abnormal items of profit or loss should be disclosed separately.

7. Minority Dividends
Dividends paid and payable to minority shareholders in respect of an income year should be disclosed on an accrual basis, thereby making possible the calculation of retained earnings for groups with outside shareholders.

8. Taxation
The taxation payable on extraordinary and abnormal items of profit should be disclosed separately as should the tax relief where there is an extraordinary or abnormal loss.

9. Costs
Profit and loss accounts should include a cost analysis between cost of sales, selling expense, administration, and other overhead expense. This would highlight those areas of cost which a company may not be controlling satisfactorily.

10. Pollution Costs
Companies should disclose annually the estimated cost of pollution abatement and control which will be obligatory within the foreseeable future.

11. Lease Rentals
Leasing of plant, equipment and property is a form of gearing, the ramifications of which can only be guessed at by analysts in that very few Australian companies disclose Lease Rentals. Without this information it is impossible to calculate the coverage by earnings of prior changes.

12. Interim Reports
Interim reports should disclose actual figures for consolidated sales, depreciation, interest, tax, minority interests and net profit because if percentage movements only are given, the relative significance to the previous year's result of first half and second half consolidated net profits remain hidden.

13. Presentation of Finance Company and Bank Accounts
Finance companies and banks are in the habit of grouping all outstandings together in one category in their balance sheets which implies that the term of such outstandings is homogeneous. We would like to see these companies distinguish between outstandings repayable within one year and those repayable after one year, i.e., "current" and "deferred". Land held for resale should not be included in the schedule showing amounts repayable as this is misleading.

Disclosure of the following items by finance companies and banks would make their reports more meaningful:

- Weighted average term of all borrowings.
- Weighted average term of all outstandings.
- Weighted average interest rate payable on all borrowings.
- Weighted average interest rate charged on outstandings.
- Standby facilities available.

Instead of showing amounts repayable within one year, between 2 and 5 years and after 5 years, we recommend that companies show the amounts repayable by year so that a less approximate picture can be formed as to their financial situation.
14. Takeover Information

Under the Amendments to the N.S.W. Companies Act, companies must simply state the takeover consideration and net tangible assets of each subsidiary acquired and their interest in companies acquired.

At present companies can make acquisitions without disclosing the value of earnings acquired or the record of the company acquired. Analysts are thus in the dark and may never be able to assess the impact of an acquisition on a group's earnings or prospects as the company acquired may be integrated into a division of the parent or operating company before the next balance date.

We consider it essential that data on companies acquired should include a balance sheet at the date of acquisition and a summary of 5 years' profit and loss accounts.

Takeover documents should include a pro-forma consolidated balance sheet incorporating the company to be acquired or being bid for.

This balance sheet should be circulated to shareholders of the offeror company.

Conclusion

Disclosure is an evolutionary process and for this reason the list of items above cannot be viewed as exhaustive. Rather they are the most urgently required section of a much longer catalogue. All the information sought herein should be readily available to management in the course of maintaining adequate financial control.

The better the standards of disclosure, the more efficient will be the stock market.

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SHOULD ANALYSTS EMPHASISE QUALITY RATHER THAN QUANTITY OF FINANCIAL INFORMATION?

By Austin Donnelly, B. Comm. A.C.A.

At the portfolio Management Seminar in February, and in various publications, members of the Society have presented well reasoned cases for listed companies providing more financial information and some information on non-financial matters, such as numbers of employees, etc. In the main, this is very desirable but there is probably a more urgent matter to which analysts should be devoting their attention, namely the quality rather than quantity of financial information.

If I were forced to make a choice on whether the information already presented should be improved in quality, that is in reliability and objectivity, or there should be more information available, I would without hesitation come down on the side of improved quality.

Certainly the additional information suggested could be useful, but as a matter of priority shouldn't we be concentrating first of all on improving the quality of information presented. Before we go to a great deal of trouble in persuading people to give additional information, wouldn't it be nice when we looked at financial statements to feel confident that the profit figures were probably within half a million or a million or so of what would be the objectively measured result. Yet there are many cases in which reported results of Australian companies are hundreds of thousands, or millions of dollars away from figures which should be reported in a more objective measurement.

A few examples quoted in Chapter 21 of my book "Strategic Investing" which is headed "Accounting Risk" illustrate this point - not one cent of share of losses in a joint venture which cost a wellknown Australian group several million dollars was reflected in the earnings of any financial year; provision for depreciation understated by about $1 1/2 million in one wellknown company; all sorts of expenses being written off against capital items or against profits of previous years by a number of companies so that