SOME SHAREHOLDER REACTIONS TO ANNUAL REPORT INFORMATION

by

John K. Courtis†

Professor of Accounting, University of Waterloo, Ontario, Canada

The purpose of this note is to report the results of a small survey into selected behavioural characteristics of private shareholders. In 1982 a mail questionnaire was sent to 93 shareholders of Australian public listed companies. These investors had replied to a previous questionnaire survey, and had volunteered an interest in participating in a further study. The purposes of the questionnaire were twofold: to obtain information about portfolio characteristics, and to gain an indication of the influence of corporate annual report information on investment decision making. Useable replies were received from 32 shareholders, and it is these responses which are examined.

Portfolio Characteristics

Respondent shareholders were found to hold, on average, securities in 23 different public listed companies. The range of ownership for the sample was 2-120 companies, with a median of 18. Because of the structure of the questions it was not possible to determine the extent to which the investments ranged across different industries. Accordingly, it is not possible to argue that these investors practice effective diversification regarding their portfolios of securities. If a portfolio consisting of 16 companies is accepted as a crude cut-off guide to effective diversification, one generous interpretation is that as many as two-thirds of investors may be attempting to minimize the unsystematic risk component of their portfolio. As shown below, however, if this is actually being pursued, such actions do not appear to correspond with any comprehensive understanding of such a concept of risk.

Investors were asked to indicate the perception they hold with regard to risk when undertaking an investment in equities. Loss of principal was given as an answer by 64.5 per cent of respondents; decrease of market price by 19.3 per cent; and non-payment of dividends/interest by the remainder. It appears, at least prima facie, that private shareholders possess some awareness of risk with regard to their investments.

It was less clear, though, how shareholders select and assemble annual report information in assessing the riskiness of an investment. Most respondents made an attempt to provide insights regarding their determination of risk, although as comments show, misunderstanding and confusion appear to exist. Verbatim responses annotated on the questionnaires included such diverse matters as: erratic profits, personal holdings of directors, amount of borrowed capital, comparative turnover, the price earnings ratio, the five year record of earnings, liquidity, gearing, too much enthusiasm in the reports of the chairman or managing director, too rapid expansion, the number of times the dividend is covered by profits, amount of reserves, number of years of payment of dividend, record of share issues, share market/par value ratio, low yield details, and obvious inferior management. Not all shareholders believe that risk can be assessed from annual report information as reflected by remarks such as: almost impossible, I can’t, and assessment is not made from report information but from daily newspapers.

The annual (pre-tax) rate of return expected by investors on their portfolios averaged at a conservative 8.04 per cent. This figure embodies both expected dividends and appreciation of market values. The range of expectations was 2 per cent to 13 per cent. It is likely that responses to a request for an indication of the pre-tax return expected on a portfolio are

† Formerly Associate Professor and Head of the Department of Accounting and Financial Management, University of New England, Armidale, N.S.W.
influenced by current general market movements. Notwithstanding, investors appear to possess quite realistic, if not modest, expectations about the overall yield they expect to obtain from present investments in securities.

Thirty investors responded to a question which asked for an estimate of the current value of their portfolio in securities. The overall sample average was $87,000, and of this amount 70 per cent is held in the form of equities, the remainder being held more or less equally between debentures, unsecured notes and government loans. The most valuable portfolio was $318,000, and there were 19 portfolios valued in excess of $50,000. It appears from these figures that private shareholder portfolios are not trivial in value.

**Annual Report Information**

Two-thirds of respondents claimed corporate annual reports to be of use to them in making an investment decision in securities. Moreover, half of these respondents claimed that they extend their readership to annual reports of companies in which they were interested, but not presently an investor. This evidence indicates that these corporate documents are not dismissed out of hand by their recipients, as is sometimes believed.

Specific information sought by shareholders from annual report disclosures varies considerably. A number of questions requested the identification of particular information disclosures which are perceived to be useful in formulating an investment decision. An orientation question asked investors to write out a description of the most important issue that they seek to answer when reading an annual report. Replies included the viability of the company, profit change, reasons underlying annual performance, future of the company and its industry, asset backing per share, prospects for expansion and future security issues, and dividend rate. These shareholder responses reflect basic concerns regarding corporate profitability and corporate ability to maintain growth.

A related question asked shareholders to identify the most important item of corporate information which generally influences them in investment decision making. Surprisingly, few answers were the same, thereby indicating the diversity of user needs in arriving at a decision. Replies covered a range of interests: cash flow, signs of advancement, amount and type of real estate owned, evidence of future above-normal profits, overall honesty, chairman's forecast, price earnings, record and stability of the directors, and the number of unbroken years of dividend payments.

Advice was also sought about information which was perceived to be important, but which was believed to be not included in annual report disclosures. Again replies were diverse. One group of comments related to directors (and, on occasion, to management). For example, shareholders appear to desire information about the ability and honesty of directors, their qualifications and experience, other directorships held, and their intentions regarding future (and bonus) share issues. Another set of replies focused on expectational factors. For example, how inflation and continued rises in wage costs will affect the company's ability to compete, the realizable value of assets, the consequences of large development projects, and forecasts of future performance. The remaining hodgepodge of replies covered opinions about monthly cash-flow charts, the significance of unsecured convertible notes, costing details and budgets, dividend policy, how companies engaging in competitive activities have fared, revaluation of assets over the past seven years, and the operation of subsidiary companies. Collectively, these replies may provide insights for annual report preparers who are considering either additional voluntary disclosures, or areas warranting clarification and elaboration.

One matter that does not appear to have been realized is that shareholders use selected annual report information in performing their own financial ratios and other calculations. Shareholders claim that they perform a range of calculations covering matters such as: the value of net tangible assets per share, the probable annual sales revenue from proposed future prospects, the share premium and capital revaluation reserves, the actual rate of company tax paid, growth of shareholders funds, the cash at bank and deposit, and the yield experienced from recent dividends received. In addition, there were replies which covered conventional profit and loss and balance sheet financial ratio analysis.

Calculations were motivated by investors in addressing a range of questions, which, in essence, reflect concern about the future profitability and security of the investment. Specific answers included: to see whether the company has adequate reserves for proposed activities; if the yield is below 6 per cent I would check the latest sale price for the shares, and consider selling; will there be a bonus issue in the foreseeable future; some reason for continuing confidence in the quality of current management's work; present solvency; the true value of assets and
whether profit has been conservatively estimated. Of course one can take issue with the sense of many of these replies, and whether separate calculations are indeed necessary.

Other questions sought information about (a) the kinds of annual report disclosures which investors compare between different companies, (b) the specific items of annual report information which would influence an investor to sell or buy more shares, and (c) to list up to three items of annual report financial information that are not understood by investors.

With respect to the first of these questions less than half of the sample respondents appear to compare items of information between annual reports of different companies. Again there appears to be little uniformity in items considered, with comments embracing the chairman’s report, reserves, cash flows, dividend rate, growth of shareholders’ funds, retained profits, freehold property, members of the board, growth of profits over the years, dividend history, acquisitions, asset backing per share, and earnings per share. Albeit slight, this is some evidence of thoughtful comparative analysis.

Specific information which investors believe would influence them to sell their shareholding in a company indicates some ability to indentify (or at least search for) unfavourable attributes. Matters mentioned include: bad cash flow, high debt ratio, drop in asset backing below market value, big change in liabilities/assets ratio, decline in prospects shown in five year summary review, dramatic increase in bad debts, continual losses and doubtful recovery, erratic profit growth, unpalatable business activity, and managerial duplicity, stupidity and incompetence.

Information indentified as influencing investors to buy more of the company’s shares were noted less often and were less clear. The following are some of the comments made: big increase in after-tax profit, forecast of large contracts and new outlets, introduction of well-known experienced directors to Board, takeover potential, bonus issue, indication that firm has overcome past difficulties, a relatively high reserves fund, and strong cash flow.

The final question provided shareholders with the opportunity to list up to three items of annual report financial information which they do not understand. The poor response to this question may indicate that shareholders are either reluctant to admit that they do not understand information, or that they actually believe they understand everything, or that they know so little about some items that they are unable to articulate exactly what it is that they do not understand.

In any event, only 20 per cent of questionnaire respondents attempted to answer this question, and only seven areas of concern were noted: how can companies pay dividends out of reserves, basis of asset valuation, liability for taxation, future income tax benefits, reserves, holding companies, and write-down of investments in subsidiary companies. More carefully prepared footnote disclosures may overcome some of these matters.

**Conclusion**

This small sample of private shareholder responses constitutes an inadequate base for generalizing about portfolio characteristics and the adequacy or otherwise of annual report disclosures. Notwithstanding, it does identify some grass roots concerns, however poorly articulated. We can see from the diverse answers that shareholders are heterogeneous with respect to the kinds of specific information that they read, use and fail to understand. This heterogeneity should be kept uppermost in the minds of annual report preparers. Effective communication will be improved if measures are taken to ensure that the presentation of annual report content responds to the varying degrees of user ability and understanding. Alternatively, or in addition, financial analysts may wish to incorporate some of the matters raised in the paper in their general investment advice to clients. An awareness of portfolio characteristics and shareholder expectations may assist them in this regard.