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A CONSIDERATION OF CORPORATE DISCLOSURE FROM THE GLOBAL VIEWPOINT

by

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ABSTRACT

Interest in the question of adequate corporate disclosure has never been greater than in recent years. Among the factors contributing to this increase in interest are the postwar trend of corporations to develop into the more complex conglomerates, the growing participation of institutional investors and the rising role of the financial analysts.

The institutional investors, financial analysts, other shareholder groups, employees, credit grantors, professional organisations, Securities and Exchange Commissions, as well as others, are interested in disclosure on a more disaggregative basis by corporations to meet their diverse and sometimes overlapping needs for information. The rationale of adequate corporate disclosure is examined from the viewpoints of these different parties at interest.

A related consideration is the accounting problem of materiality. It is suggested that an explicit guideline would provide a common approach in the interpretation and application of the materiality concept, thereby ensuring that a more consistent disclosure practice is followed.

Unlike the interested external parties, who are only concerned with the informational aspect of corporate disclosure, management, however, must also consider its motivational, competitive, legal and cost implications. As would be expected, the general reaction of corporate management is one of opposition to more extensive disclosure.

In the light of the foregoing considerations, a structure of factors relevant to estimate the present net worth of the estimated future benefits of and future costs of full corporate disclosure is presented, using as a model the technique of the value concept.

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CHAPTER ONE

INTRODUCTION

Corporate disclosure emerges as an issue which commands increasing attention and continuing debate following the advent of the corporation as a common form of business organisation. In a sole proprietorship which is characterised by the owner's direct involvement in the affairs of his business, viz., as entrepreneur in the day-to-day conduct of the business and as provider of his own capital, there may be really no reason and the owner is under no obligation to any party to disclose any business information. Likewise, the need for information disclosure may also be minimal in respect of partnerships because, in most instances, the partners themselves are in active participation; if not, they are usually personally available to observe how their contributions of capital are being managed.

But with the widespread growth of the corporation as a predominant form of business enterprise, new circumstances and conditions are introduced to the traditional business environment. Thus, in the corporate structure, ownership and control are no longer vested in a single individual or a small group of individuals. Rather, ownership in a corporation may be spread over many thousands of 'owners' who are apt to be widely dispersed throughout a country. Clearly, such an unwieldy group is not likely to exercise the function of management effectively. Hence, the control and the operation of such corporate businesses have become the responsibility of professional managers. With this being the case, it is clear that the question of corporate disclosure must be one of central importance because the absentee owners would need to be adequately informed about their companies' activities and progress. A survey of the available literature, however, seems to suggest that not enough pertinent corporate information is being disclosed, and that which is disclosed, is being presented in such aggregative form that its utility is but limited.

Ripley is believed to have made one of the earliest references to the question of corporate disclosure. Thus he observes that (I):

> ...... The sudden advent of widespread popular ownership of corporations since the World War has created entirely new circumstances and conditions in the business world. Main Street and Wall Street have come to cross one another at right angles --- Main Street, our synonym for this phenomenon of widespread ownership, and Wall Street as applied to the well-known aggregation of financial and directional power in

> our great capital centers. This intersection of interest, so often at cross purposes, is marked by an imminent danger of collision at the junction point of ownership and management...... Our American business affairs, insofar as they have assumed the corporate form through this recent growth in public ownership[a], are still largely carried on in twilight.

Since then, substantial progress has been noted in the direction of more and better disclosure of corporate information.[b] A classic example of this development is in connection with the disclosure of sales and cost of goods sold in the income statement. Thus it might be observed that at one time, it was common practice not to divulge such information[c] (2). Today, however, ommission of such items would certainly render corporate disclosure not even minimally adequate.

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[a] It should be noted that public ownership in this context, as used by Ripley, means simply wide dispersion of ownership among the thousands of scattered stockholders, and must not be confused with the idea associated with public undertakings.

[b] See, for example, Anita I. Tyra, "Financial Disclosure Problems In The United States," The Accountant's Magazine, May I970, p. 20I.

[c] Indeed this is still true in the case of the Swiss experience:

"Swiss corporations tend to publish a 'netted' profit and loss statement; sales and cost of goods sold are omitted, and the statement begins with gross margin on sales. The reason generally given is the belief that

In spite of the advances made in the disclosure of desirable information, pressure on corporations to disclose their operations even more extensively has never been greater than it is in recent years. Two major developments have contributed to this additional pressure (3):

(a) Increasing Complexity Of Business Organisations: The growing trend of businesses in the postwar era to expand through a series of mergers and acquisitions has resulted in business combinations which are neither horizontal nor vertical[d]; they represent, instead, diversified companies with interests in industries which may have nothing in common or which are only remotely related. Thus, according to the United States Federal Trade Commission figures, no less than 70 per cent of all important

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disclosure of sales and cost of goods sold would tend to affect adversely the existence and prosperity of many Swiss companies."

Quoted from Marcel F. Kohler and Adolph Mataz, "Swiss Financial Reporting And Auditing Practices," Abacus, August, 1968, p. 7.

[d] It is interesting to note that there has been a significant change in the type of merger from that of an earlier period. The earlier mergers have been described as either horizontal or vertical. A horizontal merger is one in which companies producing identical or complementary products are joined together into an integrated enterprise. In a vertical merger, integration is achieved with suppliers or distributors. Both are restricted in the United States, however, under the Clayton Act. This may be one of the reasons behind the popularity of the current brand of business combinations. See, for example, James M. and P. Jeanne Patterson, "Conglomerates: The Legal Issues," Business Horizons, February, 1968, p. 39.

mergers and acquisitions between I960 and I965 were of the nature of diversified companies, and only I3 per cent were horizontal (4).

The significance of this development from the standpoint of corporate disclosure is the consequent loss of corporate identification with any specific industry. This means to say that, insofar as disclosure is on a total company basis, which is therefore aggregative, interested parties may find limited usefulness from such corporate information. Because of this, they are urging diversified companies to report in greater detail than these companies seem prepared to divulge.

(b) Growing Importance Of Institutional Investors And The Role Of Financial Analysts: The other major development in recent years has been the increasing participation by institutional investors viz., mutual funds, pension funds, insurance companies, foundations, etc. By reason of the size of their investments, it is needless to say how important it is that there should be adequate disclosure of corporate information to enable them to locate the best opportunities.

Accompanying the growth of institutional investors has been an increase in the number and importance of financial analysts (5). The highly significant role of the analysts is observed by Silberman when he writes that (6):

> ...... In part, this coming of age of the analyst stems from the new public-relations consciousness of American business. Primarily, however, it reflects the analyst's growing power and influence over stock prices and investment decisions as a result of the tremendous post-war growth of pension funds, mutual funds, personal trusts, and the like. Last year financial institutions accounted for over half of all net purchases of common stock. Analysts may swing as much as $30 million into or out of a stock through recommendations to their firm's individuals or institutional accounts. Such men can truthfully be said to be among the most powerful men in Wall Street.

PARTIES AT INTEREST

As would be expected, diverse groups are interested in the activities of the corporate enterprise. They are, among others, the stockholders, financial institutions, professional analysts, credit grantors, employees, customers, governmental and other regulatory agencies, and, of course, the management itself.

Clearly, with such a broad spectrum of interested parties, it is reasonable to expect that there would be some overlapping of interests. Thus, for example, a governmental regulatory body may be interested in adequate disclosure, by corporations, of information about their activities so that the public interest can be served. "But this direct involvement of representatives of government may be reflected also as indirect interests of all responsible citizens who are included in the other categories of interested parties."(7)

On the other hand, a conflict of interests may also be evident between interested external parties and corporate management. Thus, the desire of outsiders for more extensive and more detailed disclosure to meet their diverse informational needs is frequently in conflict with the desire of management to maintain secrecy. It follows, therefore, that in considering the rationale of full disclosure, the cost implications of such disclosure should also be recognised.

PURPOSE OF STUDY

The purpose of this study is to appraise critically from a global viewpoint the rationale of full disclosure of corporate information. In attempting to make this evaluation, it is proposed to employ as a model the technique of the value concept which seeks to estimate present worth by the discounting of estimated future inflows and outflows of values. This model, as applied to the purpose of this study, means there will be an attempt, hypothetically, to present a structure of factors relevant to estimate the present net worth of the estimated future benefits of and future costs of full disclosure.

LIMITATIONS AND SCOPE OF STUDY

The use of the technique of the value concept has limitations largely because some of the possible future benefits of and possible future costs of full disclosure are not easily amenable to measurement in monetary terms. Thus, subjective considerations may have a significant bearing upon the final results. They refer to the assumptions made about such factors as the rate of discount, the expected flows of benefits and of costs of full disclosure. Thus, given a different set of assumptions for these factors, the conclusion drawn may well be different or even contradictory, subject to whether the discounted benefits of full disclosure outweigh the discounted costs or vice versa.

However, as the present effort is confined to a theorectical exposition, the actual mechanics of ascertaining the net benefit or the net cost by resorting to some quantitative techniques is outside the scope of this study. The value concept technique is proposed in this study only insofar as it is employed to explain the rationale of behaviour of the parties at interest regarding the question of corporate disclosure.

In the context of this study also, the meaning of disclosure is confined to that aspect of corporate reporting which is concerned with the presentation of descriptive or supplemental data. No attempt will be made to examine the form and arrangement of the formal statements or the wording therein. But their importance in facilitating understanding by statement readers should not be overlooked.[e]

RESEARCH METHODOLOGY

The material for this study is drawn primarily from secondary sources. These include books, journals, reviews, business magazines, and theses, both published and unpublished, relating to the subject of corporate disclosure. Pronouncements by various authorities, legal and professional, provide another useful source material for this study.

CHAPTER ORGANISATION

Chapter Two is devoted primarily to a consideration of the possible benefit aspects of corporate disclosure from the viewpoints of the different parties at interest. The difficulty in defining "full disclosure" will first be discussed.

Chapter Three turns to the accounting problem of materiality and points out the importance of explicit guidelines for making materiality decisions, on the premise that the lack of a common approach in the interpretation

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[e] See, for example, Fred J. Soper and Robert Dolphin, Jr., "Readability And Corporate Annual Reports," Accounting Review, April, 1964, pp. 358-362; also, J.E.Smith and N.P.Smith, "Readability In Financial Reporting," Accounting Review, July, 197I, pp. 552-56I.

and application of the materiality concept may also be responsible for the present inadequacy in disclosure of corporate information.

Chapter Four focusses attention on the possible cost effects that may result from full disclosure. The meaning of the term "cost", as used in this study, is first explained.

Chapter Five attempts to place in juxtaposition the consideration of benefits and costs of full disclosure which have been examined in the preceding chapters, and to subject these considerations to evaluation by the proposed value concept technique.

Chapter Six ties together the material covered in the earlier chapters and summarizes the entire discussion.

Footnotes

I
William Z. Ripley, Main Street And Wall Street, (Boston: Little, Brown & Co., 1926), as quoted by J.L.Fox in "Useful Comparability In Financial Reporting," Journal of Accountancy, December, 1964, p. 46.

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W.W.Cooper, N.Dopuch, and T.F.Keller, "Budgetary Disclosure And Other Suggestions For Improving Accounting Reports," Accounting Review, October, 1968, p. 645, footnote 2I.

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R.W.Haack, "Viewpoints In Corporate Disclosure," Financial Executive, February, 1969, p. 20.

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Gilbert Burck, "The Multi-Market Corporation," Fortune, February, 1967, p. I3I.

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Robert K. Mautz, Financial Reporting By Diversified Companies, Financial Executives Research Foundation, New York, 1968, pp. 85-86.

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Charles E. Silberman, "Wall Street's Influential Analysts," Fortune, January, 1957, p. 3, p. I27, as quoted by Charles T. Horngren in "Disclosure: 1957," Accounting Review, October, 1957, p. 598.

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Alfred Rappaport, Peter A. Firmin, Stephen A. Zeff, Public Reporting By Conglomerates, (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1968), p. II4.

CHAPTER TWO

RATIONALE OF FULL DISCLOSURE

Implicit in the demands for more extensive corporate disclosure by the many segments of society is clearly a recognition that the information, which a corporation is presently disclosing and ought to be disclosing, must have some utility to these interested parties. The utility of this information may be judged according to whether it appropriately meets their needs for information.

It is the purpose of this chapter, therefore, to elaborate on some of the more important needs, in particular those which concern the prospective investors, securities analysts, stockholders, society at large, and governmental agencies, and to suggest the benefits that may be derived from full corporate disclosure. But before proceeding to do this, however, it may be appropriate to discuss the meaning of "full disclosure" and the difficulty of defining it in specific terms.

DIFFICULTY IN DEFINING FULL DISCLOSURE

Admittedly, it is not an easy task to formulate a generally acceptable definition of full disclosure.[a] Broadly, however, it may be possible to distinguish two main approaches that are usually adopted in efforts to define the meaning of disclosure (I):

(a) Disclosure may be positively conceived in the sense that it directs attention to the importance of a sufficiency of corporate information in the financial statements, as might be suggested in the following definition (2):

> ...... Disclosure is that intangible measure of the adequacy of the descriptive and supplemental information in financial statements.

(b) Disclosure may be negatively conceived because emphasis is here directed to the consequences that might result if desirable information is withheld or inadequately disclosed. An example reflecting this point of view is that (3)

> ...... disclosure requires the revelation of information which, if withheld, might influence a prospective creditor's decision to loan funds or a prospective investor's decision to buy securities.

It is observed, however, that frequently the defi-

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[a] Webster's Third New International Dictionary defines "disclose" as meaning "to open up to general knowledge; to expose to view; to make known; to divulge." p. 645.

nitions of disclosure are too generally expressed to be helpful as guidelines. The comment of Griffin and Williams is pertinent (4):

> ...... The definitions of the disclosure concept tend to expose much of its essential nature; yet, they offer little directional aid in establishing the dimensions or scope of this responsibility in financial reporting. They fail to provide guidance and support for methods of attaining desirable accounting objectives.

Nevertheless, it is generally agreed that the needs of users should be a controlling factor in the question of corporate disclosure.[b] The dilemma lies in identifying the vast complex of users and what specific information is desired (5). Thus, Werntz appropriately poses the following questions, the answers to which might provide a meaning of fair[c] disclosure (6):

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b But, as Lee contends, the informational contents of the financial statements have never been adequately related to user needs and requirements...... The guideline adopted has mainly appeared to be that further disclosure should be made because it is presumed to be 'helpful', or because it is presumed to be 'useful'. However, the questions 'helpful and useful to whom?' and 'for what purpose?' have never been asked, let alone answered. T. A.Lee, "Utility And Relevance --- The Search For Reliable Financial Accounting Information," Accounting and Business Research, Summer, I97I, pp. 242-243.

c In recent years a number of expressions have gained popular usage in accounting and business literature which attempts to describe the disclosure concept. These expressions are "adequate disclosure", "fair disclo-

...... This dilemma involves all sorts of subsidiary questions, such as: who will be using the information; how sophisticated in such matters shall we assume our audience to be; what is the modicum of data that it is fair to assume the average reader would believe important; should enough data be given so that all or a majority of readers would say the disclosure is adequate, even if half of such readers would say there was too much given?

It should also be noted that disclosure must not be looked upon as a static concept. This is clearly pointed out in the following citations:

(a) ...... These boundaries (of disclosure) may never be final. The economic conditions which affect the stewardship relationships are in a constant state of flux, thus requiring a constant revaluation of the extent to which the formalised reporting structure actually discloses the appropriate economic data (7).

(b) ...... Disclosure is not a one-time-only situation for a single item on the financial statements. It is a concept which

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sure", and "full disclosure". As noted by Hendriksen (8), "adequate disclosure implies a minimum amount of disclosure congruous with the negative objective of making the statements not misleading. Fair and full disclosure are more positive concepts. Fair disclosure implies an ethical objective of providing equal treatment for all potential readers. Full disclosure implies the presentation of all relevant information. However, appropriate disclosure of information significant to investors and others should be adequate, fair and full. There is no real difference among these concepts if they are used in the proper context." In this study, therefore, no differentiation among the various terms will be made.

> permeates the statements. It must be considered again for every item each time the financial statements are prepared. Each presentation is a new situation of that time; each presentation has a new set of circumstances (9).

Thus, it can be seen, in the light of the foregoing discussion, that full disclosure may be easily stated but it is difficult to define in concrete terms. A reconsideration of the meaning of full corporate disclosure will be made in chapter five following discussion of the different viewpoints regarding disclosure.

BASIS FOR MAKING INFORMED INVESTMENT DECISIONS

Of the many external users of corporate reports, probably the most influential group is that represented by existing and prospective investors together with their advisers, the financial analysts, in view of their contributions to corporate capital. The American Accounting Association's Committee on Concepts and Standards, in their report, also asserts that "the underlying determinant of adequacy of disclosure in published financial reports is their usefulness in making decisions, particularly with respect to investment problems." (IO)

The decisions that an investor may have to consider are primarily concerned with retaining, increasing, or disposing of his investments. What should be the appropriate decision to make, however, would depend on his appraisal of the different investment opportunities.

Thus, an investor may first have to assess, for each investment alternative, the expected benefits as may be derived from estimated future dividends and capital gains, and then to compare these potential benefits with the costs of ownership as expressed by the market price of stock. This will provide some indication of the estimated future profitability of, and hence, the projected rate of return on, each alternative use of his capital. Needless to say, assuming that all else remains the same, the investor should invest in the corporation that is expected to yield the highest rate of return.

Mautz lists six company characteristics which have been regarded by investors as providing a useful guide to making investment decisions. (II) These are, in order of importance (I2): growth potential; managerial ability; profitability; financial condition; stability; and financial policy. Of these characteristics, the first three are by far relatively more important.

The growth potential of a company is indicated by the following information (I3):

> growth of major markets; rate of growth --- earnings per share; research and development expenditures; rate of growth --- market

share; rate of growth --- gross revenue; rate of growth --- net income; rate of growth --- total assets.

The managerial ability of a company is revealed by (I4):

growth of company; reputation of key personnel; return on common equity; ratio of net income before interest on invested capital; financial condition; net income; market performance of stocks.

Indicators of the profitability of a company are (I5):

return on common equity; net income/sales; return on total assets; gross profit/sales; amount of operating profit; sales/total assets; amount of net income; increase in book value/share; increase in market value/ share.

Further, investors are interested in future-oriented information, so it has been suggested that there should also be disclosure of a company's future plans and expectations (I6). According to Birnberg and Dopuch, "management must provide the investor with information on three types of expectations" (I7:

(a) Prospects for the economy.

(b) Prospects for the industry and the enterprise as a member of that subset.

(c) The specific expectations which underlie the major investments made in resources and the projects undertaken in attempting to achieve the enterprise's goals.

Lev and Schwartz propose that business enterprises should disclose human capital values in the financial statements as well. "The relevance of this information lies in the fact that it concerns organizational changes in the firm's labour force hitherto not reported by accountants." (I8) It might be observed that, in Mautz's study, it is stated that a knowledge of management performance is an important guide to making investment decisions. Hence, it would seem that reporting human capital values, as Lev and Schwartz have suggested, might provide valuable information. In fact, in their paper, they argue cogently the merits of human capital reporting to investors and management, and even suggest a practical measurement technique by which human capital values may be incorporated in the financial statements (I9).

Clearly, disclosure of the types of information indicated above would be necessary to enable an investor to adequately evaluate a company's prospects, and thereby to make investment decisions on a more informed basis.

But the current practice in corporate disclosure is considered inadequate from an investor's point of view. For example, research and development costs, advertising expenses, future plans and expectations, breakdown of sales and profit, among other items, are commonly not disclosed, although they may be relevant and useful to informed decision-making.

Much of the criticism concerning inadequate corporate disclosure, however, is focused on the reporting by conglomerate companies.[d] Such companies are engaged in operations in widely diversified industries which are likely to differ in terms of profitability, risk, and growth potential. As industry-wide price-earnings ratios are affected by these factors, it follows that these ratios may also vary among the different industries. Surely, such information is pertinent to investors but it may not be revealed if conglomerate companies are to report only the consolidated results of operations for the over-all business activity. In other words, the "overall financial reports preclude judgements of the various industries in which the conglomerate operates, and limit investment analysis to the behaviour of the firm as a whole and of its management." (20) This may well result in erroneous evaluation made by securities analysts and investors, of the investment worth of the conglomerate.

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[d] Robert K. Mautz defines a conglomerate as follows:

> A conglomerate company is one which is so managerially decentralized, so lacks operational integration, or has so diversified markets that it may experience rates of profitability, degrees of risk, and opportunities for growth, which vary within the company to such an extent that an investor requires information about these variations in order to make informed decisions.

The following example by Arkus-Duntov serves to illustrate how conglomerate disclosure on a total company basis does not permit the making of informed decisions (2I):

> ...... one may take the case of a $I billion "conglomerate" company and, if one could have dissected its operations, one would have found that it had a division having a product distinctly unrelated to the main, historical business of the company and that this division contributed only 5% to gross revenue but 30% to profits. These profits resulted not from the outstanding performance of the particular division but, rather, from the very poor performance of the main business of the company. These facts, however, were not available in published reports and could not have been determined at that time unless one were on the 'inside' or had the benefit of inside information. An investment in the company, therefore, had to be considered on the basis of wholly inadequate information.

In summing up, from the point of view of investors and securities analysts, a rationale of adequate corporate disclosure is clearly that it provides a basis for the making of informed investment decisions. In this way, investments may be directed to where they are expected to generate the greatest rate of return to the investors.

ALLOCATION OF RESOURCES

From the point of view of capital allocation, funds are considered to be allocated to their most efficient economic use if they are directed to points of highest profitability. Thus this is consistent with an investor's criterion of allocating capital which, as indicated in the preceding section, is based on a comparison of the estimated future profitability of capital among its various alternative uses. Clearly, efficient allocation of capital resources is implied since investments are made on the basis of the greatest expected rate of return. In other words, "purchasing shares of the company expected to have the highest rate of return is tantamount to allocating capital to its best use from the point of view of the market and the investor."[e] (22) In fact, it may be stated that the decisions regarding investments by investors, management, and governments are, in the ultimate analysis, resource allocation decisions.

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[e] George M. Scott further elaborates on this point thus:

> A stock market, by interposing a market mechanism between an investor and companies, introduces the second-level variable of stock movements which are independent of the real operating prospects of companies. This introduces certain complexities into the straightforward analysis presented. However, in general, and particularly in the long run, the result is the same --- the most efficient firms providing the products or services most in demand will be the ones able to secure outside equity capital from the stock market. This can still be considered as allocating capital to its "best use" in a market and investor sense.

See George M. Scott, Accounting And Developing Nations, Graduate School of Business Administration, University of Washington, Seattle, 1970, p. 50.

In a private enterprise economy, the capital market provides the medium through which capital resources may be allocated among the competing investment opportunities. But the development of a proper capital market must surely depend on a free flow of broadly-based savings into the market, and this may be encouraged by creating investor confidence through adequate disclosure of corporate information. Thus, Enthoven points out (23):

> ...... Corporate reporting and disclosure of information to the financial community plays an important part in building investor confidence and interest and stimulating the development of capital markets ...... many countries have no proper capital market precisely because there is no financial reporting of a nature to generate investor confidence.

Further, if the market is to function efficiently as an allocator of capital resources, there should be adequate corporate information disclosed so that individual investment decisions can be made based upon it. For, clearly, "the collective investment judgement that emerges from the markets is only as good as the individual judgements that are fed into it. The more information that is made available, the better the markets will function in performing their important social task." (24)

On the other hand, if there is inadequate disclosure, according to Cohen, in his discussion of conglomerate reporting (25),

> ...... there may be serious erosion of our capital markets as efficient allocators of corporate resources and of public savings when large enterprises are combined under common management not because their actual operations go well together but because their financial statements look good together.

In the same vein, Rose points out how scarce capital resources may be mis-employed as a result of too much diversification. Thus, as reported in the Economist (26):

> ...... Diversification may lead to the greater protection of the interests of the managers, while the interests of the owners would have been better served by a higher rate of distribution (of dividends), from which they could diversify their own interests privately ...... The (market) "system" in fact contains a built-in bias whereby excessive resources may be channelled towards existing established firms which can rely on self-financing --- and which can potray any increase in earnings as an achievement --- at the expense of those that rely on new issues, even though the latter may have the more promising prospects of securing a high return on those resources.

Hence, Rose advocates greater corporate disclosure of information so that stockholders and financial analysts may be able to identify those situations where capital resources are being misallocated (27). Moreover, he argues, "only with adequate publicity can the proponents of the market system of allocating capital resources claim that the system leads to a better allocation of resources than would be secured by central direction." (28)

The question of efficient allocation of economic resources, particularly with respect to capital, is especially important to the governments of less developed countries upon whom largely rests the responsibility for their countries' economic development. One of the major impediments to the development of these countries, for example, is the scarcity of capital. Clearly, if resources for development are limited, then the need to utilise the available resources most profitably becomes all the more important.

Scott contends that this may be achieved by means of greater disclosure of information by corporations in the private sector. Thus, such corporate information as the maximum production capacity and actual production, if they are made available, may be useful for determining "the opportunity cost of idle capacity" (29) or, as Mueller puts it, for measuring "the waste of resources." (30) In this way, the governments in these countries would be able to "determine the extent to which particular sectors could expand without further investment allocations ...... Or, the government could circulate this information back to private sectors as another index of opportunity --- if firms in the industry have excess capacity, there may be little opportunity for new investment." (3I)

It is clear, from the foregoing discussion, that extensive corporate disclosure is desirable to encourage the development of the capital market, and thereby to assist in a better allocation of capital resources. It is also clear that, if the resource allocation decisions of investors, management, and governments are made on the basis of inadequate information, as is often the case in the less developed countries with their low level of accounting development, then "the probability of misdirected effort, wasted resources, and economic loss is increased."(32)

NEED FOR CAPITAL

One of the main characteristics of the private enterprise economy is perhaps its broad base of financial resources. Obviously, the emergence of the corporation as a form of business enterprise has made this possible. Thus, by means of floating shares or issuing of bonds and debentures, the capacity of a corporation to tap huge accumulations of capital from widely dispersed sources is almost unlimited. Mahon points out that, by investing this capital in plant and equipment, as well as in working capital funds, it enables the corporation to contribute importantly to the increase in the volume of output and productivity of American industry (33).

In the United States, corporate capital is provided by some thirty million stockholders while another one hundred million are estimated to have contributed indirectly through investing in institutions, viz., banks, insurance companies, pension funds, mutual funds, etc. (34) Together, they represent a considerable proportion of the American public and, as providers of a scarce productive resource, they must certainly play a dominant role in affecting the future of business enterprise and the progress of the private-enterprise economy (which is in fact corporation-dominated).

Admittedly, one may argue on the grounds that, since ownership is divorced from management, there may be some weakening of control by existing stockholders over their past contributions of capital and that, corporations are increasingly relying upon retained earnings as an important source of funds. Nevertheless, it cannot be denied that corporations must still continue to depend on external sources to meet their future capital needs for expansion and other operations.

While theorectically a corporation may raise any amount of capital required to support its volume of operations, in practice the amount of capital it is able to attract is closely related to the extent of corporate disclosure. This is not an unreasonable assumption for, clearly, "the willingness of the multitude of distant investors to supply the capital must rest to a large extent on their confidence that, when the corporate financial report arrives, it will contain a full and fair presentation of the financial position of the corporation and the results of its operations --- good or bad." (35)

The same thoughts were probably better expressed by Carey as follows (36):

> ...... A satisfactory system for communicating financial and other economic data is an essential condition for the accumulation of capital from widespread sources in single enterprises, that is, for a successful industrial economy. Persons who have an interest in resources are in various stages of remoteness from them and from the factors affecting them. The greater this remoteness, the greater the need for communication of data...... In fact, without assurance of reliable economic data, the remote investor or creditor probably would not supply capital to the enterprise.

The importance of adequate corporate disclosure in relation to a corporation's need for capital is also clearly implied by Scott in his discussion of external reporting in developing nations (37):

> ...... External reporting in developing nations often provide little information relevant to investment decisions, and investors are uncertain about the reliability of the information given. As a consequence, investors are disinclined to provide the capital needed in an expanding economy.

Singhvi, in his discussion of corporate disclosure in India, provides a good example.[f] (38) He observes that foreign enterprises in India tend to disclose more extensively and this explains, in part at least, the over-subscription of issues of these companies. On the other hand, domestic Indian enterprises disclose only scantily about their operations; consequently, Indian investors tend to avoid committing their funds in such companies.

Through adequate corporate disclosure, a corporation may not only be able to attract equity capital relatively more easily, as is suggested in the foregoing discussion, it may also be able to obtain loan capital at a much lower cost vis-a-vis another corporation which maintains a policy of information secrecy, given that all other things remain the same. In this connection, the line of reasoning as put forward by Summers[g] will be the basis of the discussion that follows (39).

Thus, if the information disclosed in an audited published report provides a guide to credit grantors in

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[f] See also Surendra Singhvi, "India's Feeble Financial Statements," Columbia Journal of World Business, November-December, 1967, pp. 55-60.

[g] It should be noted that, in point of fact, Summers uses the terms, "good financial statements" and "bad financial statements". However, it may be interpreted from the context to mean, in effect, "adequate disclosure" and "inadequate disclosure" respectively.

making lending decisions, then clearly, where disclosure is considered inadequate, credit grantors will be less informed, or to put it in another way, they are said to be more ignorant with regard to a corporation's activities. It is this ignorance, on account of inadequate disclosure of corporate information, which gives rise to uncertainty regarding the borrowing corporation's ability to later discharge its debt obligations. This means that, if a loan is extended to a corporation which discloses relatively little information, the credit grantor would expect a higher return which, in part, represents a compensation for uncertainty. Of course, each credit grantor has a maximum acceptable risk. Where the risk is greater than this, he may not consider the loan regardless of the return.

This ignorance thus can be bought at a price --- a higher cost to the corporation for its loan capital. Assuming that the goal of the corporation is to maximize its profits, then it would naturally want to minimize its costs. This means paying the lowest possible prices for the resources it must acquire as operational inputs, one of which is obviously capital. This would be likely the case if a corporation makes available more information for, with more extensive corporate disclosure, the less return will be expected by credit grantors purely as a compensation for uncertainty.

The advantage to a corporation of full disclosure is thus clear from the point of view of its need for capital. First, equity capital may be raised more easily and second, loan capital may be obtained more cheaply, assuming other things being equal.

STABILITY IN SECURITIES MARKET

Any unusual activity which results in wild fluctuations in the prices of a corporation's stock is undoubtedly unhealthy to the corporation in particular, and to the securities market and the economy in general, especially when this happens to the stock of a major corporation. Thus, a more rational level of stock prices is required if greater stability in the securities market is to be achieved.

Stigler explains that "price dispersion is a manifestation --- and, indeed, it is a measure --- of ignorance in the market." (40) Clearly, ignorance in the market is a consequence of inadequate disclosure for, if there is adequate disclosure of corporate information, market ignorance may be minimized and, consequently, the price dispersion is likely to be narrower. This has been demonstrated empirically in a study by Singhvi and Desai (41).

Friend and Herman point out the merit of full disclosure in this connection as follows (42):

...... With full disclosure we would expect less drastic shifts in estimates of expected profitability of a given issue as a result of the greater initial level of economic information (and, presumably, the reduction in the possibility of surprises from this source), a greater scope for scientific investment analysis, a diminished reliance on and use of rumour, and a reduction in the scale of manipulative practices.

Thus, fluctuations in the security prices are likely to be smaller than in the absence of adequate information; implicitly, this means greater stability for the securities market.

It might also be noted that dislocations in the securities markets which led to the great stock market crash in 1929 and which resulted in heavy losses to many investors was, in part, attributable to the lack of proper disclosure by corporations (43). Thus, Bissell observes that (44):

...... At that time public knowledge of corporate happenings was almost non-existent, and trained professional interpretation was not generally available to the public. Accordingly, there was no effective way to prevent dislocations in securities markets from tips and rumours. To contribute to a return to the circumstances of those days by substantially reducing the flow of appropriate corporate information is unconscionable.

The same observation was also made by Kohler and Mataz in respect of Swiss disclosure practices (45):

> ...... Present accounting and disclosure practices, and the freedom of management from external scrutiny, may have been contributory to some of the spectacular financial crises and failures of Swiss companies. In recent years several medium-sized companies have been found, unexpectedly in difficulties...... Such events have led to panic sales on the exchanges ...... It is widely believed that fuller disclosure would have made possible earlier detection of difficulties and earlier corrective measures.

The question of timely disclosure is especially important in considering stability in the securities market. Major developments relating to a corporation do not necessarily take place at the same time as when the corporation's annual report is being prepared. So it may be necessary for the corporation to disclose any such news before the annual report is issued. Thus, by timely disclosure is meant immediacy in the dissemination of corporate information where such information is expected to have a serious impact on the current market prices of securities.

Examples of major developments in a corporation that are likely to affect the trading activity of the corporation's stock and market stability, and therefore require timely disclosure, are (46):

(a) Sharp changes in earnings outlook;

(b) Dividend declarations;

(c) Mergers and major acquisitions;

(d) Breakthroughs in research, product development, or product technology;

(e) Awards of major contracts;

(f) Major changes in asset values, including natural resources discovery;

(g) Changes in top management.

Clearly, these are significant events which can have an important bearing on a corporation's future profitability and which, therefore, are likely to influence the current stock prices. But timely disclosure, by checking against rumours and speculative dealings, "ensures that current market prices are based on up-to-date information that has been made available to both buyer and seller." (47)

By withholding the types of information mentioned above or delaying their disclosure, a corporation may encourage the creating of what is termed as an "insider group." Burson defines an insider as (48):

> ...... anyone with significant, confidential information about a corporation. This certainly includes top or middle management. It should also include the corporation's legal counsel, public relations counsel, certified public accountants, and other consultants, inside and out.

It may be added that, in some cases, an influential group of stockholders, usually major stockholders, may also have preferential access to inside information. Moreover, corporate management may tend to favour some financial analysts over others in the disclosure of important information, especially those analysts "who have created good impressions via favourable company write-ups." (49)

It is reasonable to expect that anyone of these insiders may take advantage of the valuable information about a corporation, by buying up additional or disposing of his existing stock, according to the corporation's earnings prospects in the light of the new developments. Surely, such "trading advantages for the favoured few and confidence of the entire investing public are not compatible." (50) In fact, by their manipulations of the stocks, it is likely that they may undermine investor confidence and stability in the securities market. But it must be admitted that inside information will always be available to some people; hence, timely disclosure is so important.

Feurstein's reference to the American securities markets sums up very well the case for timely and adequate corporate disclosure. He observes that, because of the more extensive disclosure practised by corporations in the United States, American securities markets are relatively more stable and more active vis-a-vis those elsewhere and, for this reason, they are able to attract a large volume of foreign investment capital into the country. Thus,

> ...... Last year, for example, net purchases of United States equity securities by foreigners were $2.269 billion. It is no accident that the healthiest securities markets and the greatest degree of public participation are found in the United States, where disclosure concepts are most effectively administered (5I).

ACCOUNTING FOR STEWARDSHIP

Since, in the corporate form of business enterprise, active control and direction of the corporation are vested in the board of directors and management whereas the owners (i.e. stockholders) merely provide the essential capital resources, there is thus established a fiduciary relationship between them. In other words, the board of directors and management are acting as stewards for the stockholders in the administration of corporate assets which have been acquired out of the capital supplied by the stockholders.

Thus, Bevis writes (52):

> ...... Society (meaning the widely-dispersed stockholders) has, in general, assigned to corporate directors and management the responsibility of employing resources gainfully; after dele-

> gating commensurate discretionary authority over the utilization of capital, society expects, and receives, the accounting to which it is entitled.

That is to say, in accounting for this stewardship, the directors and management are required to report to the absentee stockholders on the affairs of the corporation. It is therefore not surprising that, historically, financial statements have been regarded as a report of stewardship to the stockholders by management for the assets, capital, and business entrusted to its care.

Cohen points out, in his discussion of conglomerate reporting, the importance of this accounting for stewardship as a safeguard of the interests of the stockholders. Quoting him (53):

> ...... It (divisional disclosure) serves as an important control on corporate managers by requiring them to justify the results of their stewardship. There may be diversified companies which are maintaining low-profit or money-losing operations which would not be persuasive to stockholders ...... and requiring separate disclosure might well result in the improvement or elimination of the substandard operation, to the ultimate benefit of the stockholders.

Thus, it is reasonable to conclude that, by management's accounting for stewardship through full disclosure in annual reports, stockholders are better assured that their contributions of capital are being properly utilized to their benefit.

SAVINGS ON TIME AND EXPENSE

Under the provisions of the Securities and Exchange Commission in the United States, all listed corporations are required to disclose information to (a) the commission through what is described as IO-K reports, and (b) stockholders as well as others, in conventional audited annual reports. Empirical studies (54) conducted, however, have concluded that important divergences in disclosure exist between the two sets of reports, and that in general, the reports filed with the S.E.C. tend to contain more details and therefore, are more informative vis-a-vis the stockholders' reports. A number of reasons have been suggested by way of explanation (55):

(a) As a result of the diversity of generally accepted accounting practices, accounting methods prescribed by the S.E.C. may well be different from those subscribed to by a firm's public accountants.

(b) The S.E.C. forms request far more detailed data, disclosure of which is mandatory.

(c) Differences and difficulties in interpretation and application of the concept of materiality[h] have also led to ommissions in published reports.

(d) Most corporations are inclined to the view that the less information that is disclosed, the less exposed they are to the risk of litigation.[i]

Since information disclosed in the IO-K reports is more comprehensive, it is to be expected that these reports are preferred by the most specialised securities analysts, the most thorough investor information services, competitors, public accounting firms, academic researchers, and individuals (56). But although the reports are available to all, they are unfortunately not easily accessible.[j] As pointed out by Albrecht, public inspection of these

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[h] This will be discussed in greater detail in the following chapter.

[i] See infra, pp. IO4-IO5.

[j] Mueller makes a similar comment with regard to accounting practices in West Germany. German companies are required to write annual business reports which are intended partly to explain the financial statements. But, as Mueller observes, absolute disclosure duties exist only for financial statements. While annual business reports significantly elaborate on these statements, they need not be made public beyond availability for inspection by stockholders...... Therefore, the communication of "disclosed" financial data is limited, because the annual business report does not necessarily become public information. See Gerhard G. Mueller, Accounting Practices In West Germany, International Business Series, Number 4, Faculty Research and Publications, College of Business Administration, University of Washington, Seattle, United States, I964, p. 32.

reports is restricted to only four cities, viz., Washington, D.C., New York, Chicago and San Francisco (57). This means that it is not always possible nor convenient for, say, an analyst or a prospective investor, to visit any one of these locations. Thus, the following comment by Savage is pertinent (58):

> .... Another piece of information not usually available to us, unless we consult the IO-K reports to the S.E.C., is the amount of rentals paid. This may not be significant in many cases, but, where it is, it should not be necessary for us to go to the expense and inconvenience of securing the information from reports made to government bodies.

As another illustration, in India, it is reported that banks appoint their own valuers to value not only fixed assets but even inventory (59). Jaggi therefore argues that expenditure on extra valuation procedures by banks could be avoided under certain circumstances if the disclosure in the financial statements were adequate and reliable (60).

Clearly then, if annual reports to stockholders, etc., have the same extent of disclosure of information as in the reports to the S.E.C.,[k] the need to consult

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[k] It is observed by Hobgood, however, that:

"In October I970, the S.E.C. ruled that compathe latter would be obviated, and thereby much unnecessary expense and inconvenience would be saved.[1]

CORPORATE DISCLOSURE LEGISLATION

Although the trend[m] in recent years has been towards better and greater disclosure by corporations, it is not sufficient to depend entirely on voluntary disclosure to ensure further progress in this direction. Nor is it in the best public interest to leave the decision on disclosure completely with the corporations since the financial report is so important, as is evident by "the increased number of economic sectors citing their dependence thereon." (6I) Thus Wilcox warns that (62):

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nies must now break down their sales and earnings by 'lines of business' and report these on I970's IO-K reports. While the S.E.C. does not require that these same disclosures be made in the company's report to stockholders, it is apparent from a review of I970 reports that many companies have already opted to include similar disclosures in stockholder reports."

See George Hobgood, "Segmental Disclosure In I970 Annual Reports," <u>Financial Executive</u>, August, I97I, pp. I8-22.

[1] There is also an additional argument advocating harmony in reporting to both the stockholders, etc., and the S.E.C. It is claimed that, if the IO-K reports are only available in the four cities mentioned, analysts in these cities will certainly be given an undue advantage over those elsewhere in the United States. That means a kind of "insider group" is created. The adverse effects of insider trading on market prices of securities have already been pointed out (See <u>supra</u>, pp. 34-35).

> ...... it is not always safe to leave business to its own devices; experience has shown that its freedom will sometimes be abused ...... These abuses have not characterised all business at all times, but they have occurred with sufficient frequency to justify the imposition of controls. Regulation is clearly required, not only to protect the investor, the worker, the customer, and the community at large against the unscrupulous businessman, but also to protect the honest businessman against his dishonest competitor.

The importance of the public interest in corporate disclosure is evident from the following statements of the United States Securities and Exchange Commission (63):

> (a) ...... It is our judgement, and we so find, that disclosure of the information respecting the registrant's gross sales and cost of goods sold is in the public interest, and that such information should be made available to the public.
>
> (b) ...... It is clear that the (Securities Exchange) Act contemplates publicity of corporate financial reports to insure the maintenance of fair dealings in the purchase

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For further details, see for example, the surveys of annual reports by George Hobgood in the Financial Executive: "Voluntary Disclosure In 1957 Annual Reports," June, 1968, pp. 81-84; "Voluntary Disclosure In 1968 Annual Reports," August, 1969, pp. 64-69; "Increased Disclosure In 1969 Corporate Annual Reports," August, 1970, pp. 24-33; "Segmented Disclosure In 1970 Annual Reports," August, 1971, pp. 18-22.

> and sale of securities not only for the benefit of the investing public, but as well for the protection of banks in which loans are collateralled by such securities.

If adequate disclosure of corporate financial reports is a matter of public interest, then regulation on corporate reporting appears necessary. Thus Cowan explains the desirability of corporate disclosure legislation as follows (64):

> ......If in a society the financing of business enterprise, the investment choices of the citizens, and the direction of the economic resources of the community, are influenced to an important extent by the external reports of companies, then the State has to see that adequate standards of reporting are adhered to.

But it is important to note that any such legislation should provide broad guidelines as opposed to detailed regulations. The disadvantage of too detailed and too rigid legislation is clearly pointed out by Scott (65):

> ...... The result of detailed and rigid legislation would almost certainly be rigid accounting and reporting practices, even when business practices change throughout the business community. Not only would accounting fail to change as its environment changed, but also the very rigidity of this accounting would tend to impede the

adoption of more modern business practices and management techniques essential to economic development.

It is thus not surprising that legislative requirements in the United States relating to corporate disclosure are the minimum[n] necessary for the protection of the public interest. In fact, "the Securities and Exchange Commission has been reluctant to exercise to the fullest its legal power and has always maintained a policy of maximum cooperation with the AICPA[o] on matters relating to financial reporting." (66)

Scott, however, cites an important exception to flexibility in reporting legislation and this applies to disclosure of critical financial events. Quoting him further (67):

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[n] Holzer, however, with reference to corporate reporting in West Germany, notes the danger of companies using the minimum standard of disclosure as provided by law as the accepted standard:

"The law was intended to establish minimum standards of disclosure; however, there are only a very few instances in which corporations have gone beyond the minimum requirements and disclosed additional information. It appears that the legal requirements, instead of indicating a minimum standard of disclosure, have come to be accepted as <u>the</u> standard." (underscoring original).

See H.P.Holzer, "Corporate Financial Reporting In West Germany," <u>Accounting Review</u>, July, 1959, p. 402.

[o] This refers to the American Institute of Certified Public Accountants. The other influential accounting body in the United States is the American Accounting Association.

> ...... Firms in some developing nations are secretive about some aspects of their operations, usually fearing that the information will be used to their detriment by competition or government. However, certain information such as that related to investments in other firms, pending lawsuits, management emoluments, and subsidiary earnings, is necessary for investors to make rational decisions. Legislation should require detailed disclosure of these kinds of information.

Needless to say, corporations in the advanced countries are subject to the same kind of disclosure requirements for these types of information.

In Canada, financial reporting legislation is clearly stipulated in the Canadian Corporations Act, I968. Thus, under Section II6 of the Act, the following disclosure requirements are specified (68):

(a) a financial statement made up of

  (i) a statement of profit and loss;
  (ii) a statement of surplus;
  (iii) a balance sheet;

(b) a report of the auditor to the shareholders;

(c) further information respecting the financial position of the company as the charter or by-law of the company requires.

Details of the information to be disclosed in the various financial statements are also clearly spelt out in Sections II7, II8 and II9 of the same Act (69).

In the United States, except in regulated industries, federal legislation relating directly to company accounting was almost non-existent until the financial crisis in the I930s following the stock market crash (70):

> ...... The stock market crash of I929 signalized the greatest world-wide economic slump of that time...... It dramatized fragrant abuses and excesses of an undisciplined stock market, and the public was victimized through ignorance. Among those speculative abuses were speculation on thin IO per cent margins, "bucket shop" operations, stock market pools, undue advantages from "insider's information", and bear raids which characterized the predatory speculator. Such practices were unethical, illicit and not in the public interest as we think today (7I).

In order to protect investor interests against any fraudulent practices by corporations, as well as the economy from unstable influences arising from improper and inadequate corporate reporting, so the Securities Act of I933, and the Securities and Exchange Act of I934 came into being. Aspects of these Acts which relate to disclosure of information are Regulation S-X (under the I933 Act) (72), Regulation I3A --- Reports of Issuers of Listed Securities, Regulation I4, Schedule I4A --- Information Required in Proxy Statement, and Schedule I4B --- Information to be Included in Statements Filed by or on behalf of a Participant (other than the issuer) in a Proxy Statement, all of which are incorporated in the I934 Act (73).

An important result of the I934 Act is the establishment of the Securities and Exchange Commission (S.E.C.) as a permanent government agency which is responsible for implementing the two Acts. In this regard, the S.E.C. has contributed significantly to the improvement in corporate disclosure by American companies. Thus, "the S.E.C. requirements ...... (have) forced United States companies to reveal their financial positions in far more detail and with greater comparability than was previously the custom." (74)

In Britain, legislation on corporate disclosure is embodied in the Companies Act, 1967.[p] This most recent Act has stipulated more stringent disclosure requirements, as for example,

> ...... British companies must now report consolidated sales and earnings, broken down by product groups. They must disclose the value of exports, "directors' emoluments," and their shareholdings and inside dealings, as well as sums contributed to charities and political parties. Private firms are now subject to disclosure requirements for the first time. All enterprises must reveal holdings of IO per cent or more in other companies (75).

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[p] For an expanded discussion of the Act, see: John B. Inglis, "The British Companies Act Of I967," Journal of Accountancy, January, I968, pp. 42-45; and J.F.Flower, "Accounting In Britain And The New Companies Act," Canadian Chartered Accountant, February, I968, pp. II3-II5.

It is interesting to note, however, that the early legislation on disclosure appears to have been motivated by very different reasons. As indicated earlier, the American Acts of 1933 and 1934 are intended to protect investors and others against company fraud[q], to prevent manipulation and rigging of the stock market, and to eliminate the evils of excessive speculation. The same reasons seem to underlie the early British Companies Act, as the following citation from De Bedts suggests (76):

> ...... With the dispersion of ownership into numerous hands, the joint-stock company revealed itself as not only a valuable instrument for financing new industries and colonization but as an ingeniously irresponsible device for defrauding that portion of the public eager to invest its surplus wealth ...... The "Bubble Act" of 1720, passed by a Parliament exceedingly aware of the contemporary wave of suicides, ruination, and imprisonment of high officials, caused a setback in corporate development overcome only by the industrial growth of the following century. Additional protection for the investors through the principle of disclosure and the imposition of penalties against violators was included in the Companies Act of 1844. Various amendments to the Companies Act, which became the English corporation code as well, continually expanded the prospectus requirements and liability provisions into the twentieth-century version of the Act.

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[q] See, for example, the Ultramares case and the McKesson & Robbins case, in John H. Myers, Auditing Cases, (Northwestern University Press: 1964), pp. 25-42.

In contrast, the present focus of interest in disclosure is on better investment decision-making. Hence, stricter disclosure rules, as in the recent British Companies Act of 1967, are designed to compel companies to disclose more fully, so that investors may be better informed as to what return different industries and different firms can earn on their capital. Investors will then have a better basis on which to make their decisions.

An editorial comment in London's Financial Times thus notes that "the emphasis of company legislation is changing and has now swung decisively away from the prevention of fraud to the discouragement of inefficiency." (77) Clearly, avoidance of inefficiency is dependent upon the making of more informed investment decisions based on full corporate disclosure.

SUMMARY

In this chapter, an attempt is made to establish the rationale of adequate corporate disclosure of information. In the light of this discussion, it is clear that the needs of the different parties at interest may be appropriately served if adequate information about corporate affairs is made available to them. In other words, there are likely benefits to be derived from full disclosure of corporate information:

(a) Full disclosure, by providing a basis for making informed investment decisions, enables investors to direct their investments to where they may expect the highest rate of return. By implication, this leads to a more efficient allocation of the nation's resources.

(b) Full disclosure, by creating investor confidence, stimulates the development of the capital market. The importance of the capital market in meeting the capital requirements of corporations in a private-enterprise economy needs no emphasis.

(c) Full disclosure enables corporations to raise capital at a more reasonable cost.

(d) Full and timely disclosure, by eliminating "insider trading" and excessive speculative dealings, contributes towards greater stability in the securities markets.

(e) Full disclosure is desirable for management's accounting for stewardship.

(f) Full disclosure in annual reports obviates the inconvenience, expense, and difficulty of obtaining the information in other ways.

(g) Full disclosure is necessary to safeguard the public interest against any fraudulent practices by corporations, hence the objective of corporate disclosure legislation.

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70 George M. Scott, *op. cit.*, p. II4.

7I Harold M. Gartley, "Full Disclosure Policy Widens," *Financial Executive*, November, I963, p. 46.

72 United States Securities and Exchange Commission, *Regulation S-X Under The Securities Act Of I933*, Washington, D.C.: U.S. Government Printing Office, I962).

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74 George M. Scott, *op. cit.*, p. II5.

75 Robert Ball, "Declining Of Concealing The Figures," *Fortune*, September I5, I967, p. I66.

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CHAPTER THREE

THE ACCOUNTING PROBLEM OF MATERIALITY IN DISCLOSURE

Corporate disclosure of information requires that the masses of accounting and non-accounting data must be first classified and summarised in such a way that they will be meaningful and useful to the external parties at interest. For one reason, even in the absence of relatively trivial items, published corporate reports are already difficult to comprehend and analyse. Consequently, when every small detail is included, this may only increase the difficulty of understanding and analysis. Nor does more information necessarily mean greater disclosure for, the indiscriminate adding of information in corporate reports may cause essential facts to be buried among a mass of insignificant details.

In deciding how corporate data may be classified and to what extent they may be aggregated, which are important to the question of adequate disclosure, the accounting concept of materiality may provide a guide. But the problem arises regarding the interpretation and application of the materiality concept. That is, although "the concept of materiality inevitably enters into the determination of the disclosure to be made under any given set of circumstances," (I) its interpretation and application, however, are not based on a common set of criteria. This theme is enlarged upon in this chapter.

Also, an editorial comment reflects concern that the materiality concept is not receiving sufficient attention (2):

> ...... Useful discussions of the materiality problem in the literature of accounting are unfortunately scarce. In this period of renewed evaluation of basic concepts of accounting, and increased public attention focused on financial statements, materiality should receive major attention.

MEANING OF MATERIALITY[a]

Clearly, if considerations of materiality are fundamental to the proper presentation and reporting of accounting data, the meaning of materiality must be fully

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[a] Snavely observes the distinction between "materiality" and "relevance". According to him, an item of information may be relevant to a particular decision but this does not mean that all relevant information need be disclosed unless such information is at the same time material in amount. For this reason, Hendriksen treats materiality as a constraint on relevance meaning by this accounting information can only be relevant if it is materially relevant. In this study, relevance is used in the Hendriksen sense. See Howard J. Snavely, Accounting Information Criteria", Accounting Review, April, I967; also, Eldon S. Hendriksen, Accounting Theory, (Homewood, Illinois: Richard D. Irwin, Inc., I969), p. I06.

understood by all those responsible for preparing financial reports.

Dohr's Definition Of Materiality: A survey of the available literature appears to indicate that the concept of materiality is not easily susceptible to precise definition. Nevertheless, the following definition by Dohr is presented for consideration (3):

> A statement, fact, or item is material, if given full consideration to the surrounding circumstances, as they exist at the time, it is of such a nature that its disclosure, or the method of treating it, would be likely to influence or "make a difference" in the judgement and conduct of a reasonable person.

Thus, Dohr's definition may provide accountants with a meaning of materiality in relation to corporate disclosure. According to his meaning of materiality then, there seem to be three related considerations which must enter into the making of a materiality decision:

(a) The question of materiality must be decided with reference to the surrounding circumstances relating to an item in question.

> For example, a $IOO,OOO mis-statement of inventory in the usual annual report of a sizeable company may not be material. However, if such mis-statement reduced working capital below an amount required by a loan indenture and caused the entire

balance of the loan to become payable, it would be material (4).

(b) Whether an item is, or is not, material must be based on the point of view of a reasonable person or an average prudent investor, as user of the financial statements, and not based on the viewpoint of an accountant who prepares these statements.

(c) Accordingly, a materiality decision must involve consideration of its likely effect on the judgement and conduct of the reasonable person or average prudent investor; that is to say, he must not be led into making misleading conclusions as a result of non-disclosure, mis-statement, or ommission, of an item which, in his opinion, is material.

It is not difficult to see that accountants are still faced with problems, because they will have to identify who is this reasonable person or average prudent investor, and to determine under what circumstances an item is material and under what circumstances it is not material.

Statements On Materiality By Officially-Constituted Bodies: Pronouncements by official accounting bodies regarding materiality have also not been too instructive, as these are, almost always, expressed in very general terms. Thus, according to one AICPA Accounting Research Bulletin, it is stated that (5):

> ...... the Committee contemplates that its opinion will have application only to items material and significant in the relative circumstances. It considers that items of little or no significance may be dealt with as expediency may suggest.

The CICA[b] Accounting and Auditing Research Committee, in making a similar pronouncement, dismisses the materiality question in a few sentences which are given in the preface of its Handbook (6).

The statement issued by the Council of The Institute of Chartered Accountants in England and Wales, is probably the most comprehensive of the official pronouncements relating to materiality (7). Most significantly, it indicates the various circumstances in which the question of materiality may arise, and it also suggests the factors that will have to be considered whenever the term "material" is applied to any item. Although this may be a more detailed statement on materiality, the Council makes clear in its

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[b] This refers to the Canadian Institute of Chartered Accountants.

introduction that no precise definition is proposed (8):

> ...... The use of the word "material" in relation to accounting matters is intended to give scope to a reasonably wide interpretation according to a variety of circumstances which can arise. It is not possible or desirable therefore to give a precise definition of such an expression.

According to the United States Securities and Exchange Commission, under its Regualtion S-X, the term "material" is explained as follows (9):

> ...... The term "material", when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the securities registered.

Just who is the "average prudent investor", and what is meant by "reasonably ...... informed", however, are not defined nor can they be easily defined. As before, interpretation of their "exact" meanings appears to be the responsibility of the individual accountant.

Some numerical guidelines for making materiality decisions are, however, laid down in the Commission's Regulation S-X. As an example, it is stipulated that any addition to fixed assets, if they exceed 5 per cent of the total assets, must be analysed. But this and similar requirements are intended primarily to deal with disclosure in reports to be filed with the Commission, and not with materiality questions in financial statements with stockholders. A possible explanation for practicing accountants not applying these same guidelines to the latter is the arbitrary manner in which they are established; consequently, these standards are not based on considerations such as those suggested by Dohr for the making of materiality decisions.

Materiality Of Items Considered In The Aggregate: Dohr's definition of materiality, however, does not consider the cumulative effects of a large number of small items. Thus, while such items, when taken separately, may not be materially significant, this may not be necessarily true if they are considered in the aggregate. Clearly, if they are material in total, then their disclosure would be desirable. Hicks cites the following example which illustrates this point (IO):

> ...... Suppose that two extraneous gains, each equal to 7 per cent of net income determined without them, are being considered for possible exclusion from net income. Quite possibly these items, taken individually, would not be considered material. To include them in net income, however, would increase the reported figure by I4 per cent, a difference much more likely to represent materiality ...... Clearly, then, such items should be considered in the aggregate.

Materiality Of Special Items: While the amount of an item (or the aggregated amount of a collection of related small items) must be considered in determining its materiality, there may be circumstances in which, because of the nature of the item, disclosure might be necessary, regardless of the amount. An example of such an item is "loans to officers". The special relationship between these individuals and the disclosing company makes disclosure of such transactions necessary, but "such instances, while important when they occur, are rather uncommon." (II) Nevertheless, it should be clear that "the determination of the materiality of an item involves a consideration both of quantitative and qualitative aspects." (I2)

MEASUREMENT OF MATERIALITY

According to current applications of the materiality concept, at least two possible measures are noted which are described as follows (I3):

(a) Absolute Measure: Materiality is measured here, using as the point of cutoff, a fixed amount of dollars for each item or for each category of items. Thus an item is material if its absolute dollar amount is, say, x dollars or above, and immaterial if it is below x dollars.

(b) Relative Measure: In this case, an item under consideration is expressed in relationship to some appropriate basis of comparison; usually, this is a significantly related item on the financial statements. This relationship is commonly stated as a percentage. For example, an item is material if it is y per cent of, say, net income.

An empirical study conducted by Woolsey (I4) suggests that the relative measure is favoured compared to actual dollar amounts in determining materiality. In fact, the statement on materiality issued by the English Institute indicates that "materiality can only be considered in relative terms." (I5)

The problem with the absolute measure is that the size of a business unit may affect decisions on materiality. Thus, a small absolute amount may well be very material from the standpoint of a small firm, whereas a much larger amount may still not be material in the case of a very large enterprise. If the absolute measure is used, therefore, there may be difficulty in establishing the appropriate quantity of dollars that would apply to all firms.

This is not to say that there are no problems to be encountered in the percentage method. What percentage to apply and what related item to select certainly pose difficulties. But these may be resolved, in part at least, if it can be established who is this average prudent investor, and how a materiality decision may influence his judgement; these difficulties have been indicated in the preceding section.

A more serious difficulty associated with the relative measure is the unstable nature of the base used for measuring materiality, especially so when that base is current net income. For example, if the base is IO per cent of current net income, it may well be that an item of a given amount is regarded as material in one year since net income for that year happens to be low, but as immaterial in the next year if a considerably high net income is earned. "Thus, a lack of consistency in reporting may lead to erroneous comparisons among several years and erroneous predictions based on apparent trends." (I6) Proper disclosure, therefore, requires that the base for determining materiality must be stable.

Instead of using current net income as the base, the "gross profit on sales" may be considered more appropriate because percentage variations of gross profit between one year and another are much less; thus, it may be a relatively more stable base to use vis-a-vis that of current net income.

Carman Blough, on the other hand, suggests that "in judging the materiality of an amount, it should be considered in relation to the net income of the company over a period of years." (I7) Bernstein adds that a five-year average should be adequate for this purpose, so long as the income figure to be used is representative of a recent earnings level (I8).

Summing up, although there may be difficulties, as well, in using the relative measure to determine materiality, it is, nevertheless, generally considered to be a more reasonable method than to determine materiality in terms of absolute amounts.

ROLE OF JUDGEMENT IN DETERMINING MATERIALITY

The significance of objectivity in the reporting of accounting data cannot be over-stressed. As Paton and Littleton pointed out (I9):

> ...... Verifiable, objective evidence has therefore become an important element in accounting and a necessary adjunct to the proper execution of the accounting function of supplying dependable information.

Yet, as the preceding discussions showed, there appears to be no "generally accepted" or officially pronounced guidelines by which materiality can be approached objectively. It has been suggested that this absence of guidelines "merely serves to emphasize the fact that the problem involved is largely a matter of judgement to be exercised in the light of the then-existing surrounding circumstances." (20)

That judgement plays an important part in the question of materiality is clearly suggested from the following considerations:

(a) Since decisions on materiality cannot be made in a vacuum, but must be based on the surrounding circumstances, it is evident that the exercise of judgement is inevitable, for circumstances are subject to change and also, these circumstances cannot be easily described within a set of given rules.

(b) The professional judgement of an accountant is also required to judge the effect of his materiality decision on the opinion and conduct of an average prúdent investor with regard to the financial statements.

(c) The lack of a consensus among accountants on who is the average prudent investor is, probably, partly a result of differences of judgement. For example, one holds the view that such a person is to be found among "the approximately I8 million American stockholders." (2I) Another believes that materiality decisions must be made with investment professionals in mind such as the financial analysts (22). Yet another refers to the "standard reader", who, in his judgement, is a person between the uninformed and the expert (23).

(d) Clearly, if the above considerations which must enter into the making of a materiality decision requires the exercise of judgement, then it follows that selecting the basis of comparison and deciding whether a given percentage relationship establishes materiality, must inevitably also be based on judgement.

The comment by Carman Blough aptly sums up the importance of judgement in the question of materiality (24):

> ...... The question of what is material has puzzled a great many people over a great many years, yet nobody is prepared to define it so that it does not ultimately rest on someone's judgement.

NEED FOR SPECIFIC GUIDELINES

It must be admitted that it can never be possible to resolve the problem of materiality on an entirely objective basis. Inevitably, personal judgement will always play a part in decisions on materiality. But, at the same time, to submit all materiality decisions to the professional judgement of individual accountants is not a satisfactory solution either. The reason is that, "although theorectically two qualified accountants should reach the same decision as to the materiality of a given item, in practice opinions are sometimes exactly opposite even though all the surrounding circumstances are known to both." (25)

Therefore, if the application of judgement must be a necessary part of the materiality decision-making process, and also, since the judgements by accountants are subject to substantial variations, it seems appropriate that there should be established some form of objective standards with which to guide the application of that judgement (26). It may also be possible, through well-defined guidelines, to narrow down the area where judgement is at present being exercised. This point is illustrated in the subsequent section when some suggested guidelines by various writers are reviewed.

Thus, by requiring that judgement is made within the framework of these guidelines, accountants are more likely to arrive at the same materiality decision for the same type of situation. In other words, there is likely to be greater consistency in the treatment of the materiality question. This is important because differences of disclosure in the financial statements of corporations today would seem to be attributable, in part at least, to the lack of a common approach in the interpretation and application of the concept of materiality.

Turning to the feasibility of developing these guidelines, the empirical study by Woolsey indicates that "there was enough uniformity in the respondents' answers to suggest that it might be practicable to establish for each type of materiality decision a centralised bracket (usually the most important related factor as a base) with upper and lower limits to aid the accountant or auditor in reaching his primary decision on materiality." (27) This is elaborated in the following section.

SOME SUGGESTED GUIDELINES TO MATERIALITY

Although the need for objective standards to materiality measurement is recognised by a majority of writers on the subject, there is, however, no general agreement on what should be the appropriate guidelines. As a result, various guidelines have been suggested. Nevertheless, it is observed that, most commonly, they are:

(a) Single Percentage Guideline: This is based on the relative measure that was explained earlier. Only a single point of cut-off will be used as the guideline. For example, Hylton suggests that the criterion for measuring the materiality of a balance-sheet item should be 5 per cent of its related total; for an item on the income statement, he recommends a cut-off point of 2 per cent of gross profit on sales (28).

It might be noted that the single percentage guideline is also applied to determine what should be adequate informative disclosure for reporting of conglomerate companies. Thus, Mautz has "recommended that conglomerates report both sales and relative contribution to corporate net income for any segment of their business generating I5 per cent or more of gross sales revenue." (29) The United States Securities and Exchange Commission, however, proposed a IO per cent guideline (30).

It is not difficult to see the shortcomings of the above guideline. First, the guideline seems to disregard totally the element of judgement that, as already pointed out, must inevitably enter into a materiality decision. Second, it is extremely difficult to justify why, say, 2 per cent of gross profit on sales should be accepted as material, but one of, say, I.9 per cent should be regarded as immaterial.

(b) <u>Percentage Range Guideline</u>: This is also based on the notion of relative materiality but, in this case, the guideline consists of two cut-off points, an upper cut-off point above which an item should be considered material, and a lower cut-off point below which the item would be regarded as immaterial.

Woolsey sets out the guideline as follows (3I):

(i) A base (the most important factor with which the item in question will be compared).

(ii) An area of doubt (expressed as a percentage of the base). Items below the lower limit of the area would be considered immaterial and those above would be considered material. Bor the given circumstances, items between the limits could be considered either material or not material.

(iii) Where appropriate, the percentage in the area of doubt should be changed on an objective basis if surrounding circumstances were substantially different from the standard case situation.

Thus, according to the results of his analysis of the response to his case-study questionaires, by practising accountants, securities analysts, investment bankers, etc., Woolsey suggests a border zone of 5 to I5 per cent of the current year's income before tax as the guideline for determining the materiality of income statement items (32).

The advantages of establishing such a border zone or area of doubt are apparent. First, this guideline recognises the need for the exercise of judgement and that there can never be complete objectivity in arriving at materiality decisions, as would be implied by the single percentage guideline. Within the zone of doubt, therefore, materiality must be judged on the basis of the surrounding circumstances. Second, by using a border zone, it is possible to restrict the area of judgement to a narrow range of 5 to I5 per cent as stated above and, in this way, "it provides the (accounting) profession and the users of financial statements with a known and explicitly stated norm." (33).

Bernstein is also in favour of using the percentage guideline for the advantages just cited (34). But the findings of his empirical research seem to suggest a border zone of IO to I5 per cent of average net income (five-year average) as the points of cut-off. It is observed that Bernstein uses the average net income as the base; the advantage of this has already been noted.

<u>Other Suggestions:</u> Patterson believes that, in developing criteria for materiality, one should take into consideration, as well, the economic environment surrounding the business enterprise. He explains why, given identical figures, a IO per cent factor of materiality would

apply in one case and yet, in another case, it should be I5 per cent (35):

> ...... The differentiating element would be the nature of business and the economic environment in which it operates. For instance, we would expect a financial institution to be able to define its assets, liabilities, and net income more accurately than a commodity wholesaler. The difference in the degree of accuracy would not be attributable to the condition of the accounting records but rather to the surrounding economic environment.

But it can be argued that, whenever a judgement has to be made in the light of the "surrounding circumstances" (assuming, of course, the percentage range materiality guideline is used), it must inevitably include consideration of the economic environment.

Reininga, however, is opposed to establishing specific standards for materiality. Hence, his suggestion would seem to leave much scope for the exercise of judgement though, it should be noted that, in his case, the judgement would have a more objective basis than otherwise would be the case.

Thus, according to Reininga, a solution to the materiality problem may be found by an analysis of specific cases to determine the judgemental or thought processes involved (36). In this way, he argues, how and why particular materiality decisions are made may be better understood. In other words, he suggests that decisions on materiality should be written up and documented; this information will then be made available to other practicing accountants for evaluation.

> ...... The idea of writing up the details and facts involved is especially appropos for the solution of the problems surrounding the materiality concept. How else can we learn what is important to contemplate, to weigh or to consider when we are pondering over a materiality decision? How else can we learn what are the generally accepted practices? (37)

A series of <u>actual</u> case studies along the lines suggested by Reininga, in the opinion of this writer, might also be useful as a basis, in addition to others, for determining what should be the border zone.

From the foregoing discussion, therefore, it would seem that an appropriate guideline should make allowance for the exercise of judgement while, at the same time, it should provide for a certain degree of objectivity in materiality measurement, considering the importance of the materiality question in the evaluation of adequate disclosure. Accordingly, the percentage range guideline which takes into consideration both of these factors would seem to have much merit, at least conceptually, as a materiality guideline. The practical difficulties are recognised like establishing what should be the cut-off points, but these might be resolved through more extensive research on this question of materiality.

SUMMARY

It is clear that materiality is closely related to disclosure, for adequate disclosure requires that only material items that are likely to influence the conduct and judgement of an average prudent investor, should be disclosed, whereas immaterial items which might clutter up the financial statements, should not be disclosed.

The difficulty, however, lies in determining what is material and what is not material. The absence of official guidelines on materiality suggests that this problem is far from resolved. As a result, present practice seems to place much reliance upon the professional judgement of the practicing accountant for determining materiality.

The wide range in judgement among accountants regarding the materiality of an item points to the need for specific guidelines so that materiality decisions can be made on a more objective basis. Of the various guidelines mentioned, probably the percentage range materiality guideline would be most appropriate for reasons already stated. An explicit guideline would provide a common approach in the interpretation and application of the materiality concept which, in turn would contribute toward better disclosure insofar as inadequate disclosure is a result of not understanding clearly what is meant by materiality.

Footnotes

I Michael N. Chetkovich, "Standards Of Disclosure And Their Development," Journal of Accountancy, December, I955, p. 50.

2 Editorial, "Materiality," Journal of Accountancy, April, I964, p. 36.

3 James L. Dohr, "Materiality: What Does It Mean In Accounting?" Journal of Accountancy, July, I950, p. 56.

4 Joseph J. Hyde, "Materiality Defined," (Correspondence), Journal of Accountancy, November, I96I, p. 36.

5 Accounting Research Bulletin, No. 43, I953, American Institute of Certified Public Accountants, p. 9.

6 CICA Handbook, The Canadian Institute of Chartered Accountants, 250 Bloor Street East, Toronto 5, p. 8.

7 The Interpretation Of "Material" In Relation To Accountants, The Institute of Chartered Accountants in England and Wales, I968. See The Accountant, July 27th, I968, pp. II6-II7.

8 Ibid.

9 United States Securities and Exchange Commission, Regulation S-X, Paragraph I.02.

IO Ernest L. Hicks,"Materiality", Journal of Accounting Research, Vol. 2, No. 2, I964, p. I67.

II Ibid., p. I64.

I2 Michael N. Chetkovich, op. cit., p. II.

I3 Delmer P. Hylton, "Some Comments On Materiality," Journal of Accountancy, September, I96I, p. 62.

I4
Sam M. Woolsey, "Development Of Criteria To Guide The Accountant In Judging Materiality," Journal of Accountancy, February, I954, pp. I67-I73.

I5
The Institute of Chartered Accountants in England and Wales, I968, op. cit., para. 7.

I6
Eldon S. Hendriksen, Accounting Theory, (Homewood, Illinois: Richard D. Irwin, Inc., Revised Edition, I968), Chapter I9, p. 563.

I7
Carmen G. Blough, "Some Suggested Criteria For Determining 'Materiality'", Journal of Accountancy, (Current Accounting and Auditing Problems Section), July, I950, p. 353.

I8
Leopold A. Bernstein, "The Concept of Materiality," Accounting Review, January, I967, p. 89.

I9
W.A.Paton and A.C.Littleton, An Introduction To Corporate Accounting Standards, American Accounting Association Monograph No. 3, I940, p. I8.

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James L. Dohr, op. cit., p. 54.

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Ernest L. Hicks, op. cit., p. I60.

22
See, for example, Donald Rappaport, "Materiality," Journal of Accountancy, April, I964, p. 42.

23
Michael N. Chetkovich, op. cit., p. 49.

24
Carman G. Blough, "What Is Net Income? And Why?" The Virginia Accountant, October, I949, p. I3, as quoted by Ernest L. Hicks, op. cit., p. I70.

25
Sam M. Woolsey, "Judging Materiality In Determining Requirements For Full Disclosure," Journal of Accountancy, December, I954, p. 750.

26
Ibid.

27
Ibid.

28
Delmer P. Hylton, *op. cit.*, p. 64.

29
See, for example, Paul A. Pacter, "Conglomerate Reporting --- The Debate Continues," *Journal of Accountancy*, March, I969, p. 24.

30
Ibid., p. 26.

3I
Sam M. Woolsey, "Objective Bases For Making Materiality Decisions," *The Accountant*, October I2th, I968, p. 478.

32
See Footnote I2, p. I70.

33
Leopold A. Bernstein, *op. cit.*, p. 93.

34
Ibid.

35
Robert G. Patterson, "Materiality And The Economic Environment," *Accounting Review*, October, I967, pp. 772-774.

36
Warren Reininga, "The Unknown Materiality Concept," *Journal of Accountancy*, February, I968, pp. 30-35.

37
Ibid., p. 34.

CHAPTER FOUR

"COST" EFFECTS OF FULL DISCLOSURE

By providing objective bases for making materiality decisions, while important in the question of corporate disclosure, does not, however, imply that a corporation will necessarily or willingly disclose fully information about its activities. This is in spite of the possible benefits, which have been considered in chapter two, that might accrue to the different interested outsiders and, indeed, to corporate management as well. In fact, the corporate viewpoint would seem to be that full disclosure of corporate information might not be in the corporation's best interests. Hence, management is, in general, reluctant to divulge more information than what would be required by law which, as has been noted, usually provides for only minimum disclosure.

In this chapter, therefore, the rationale of thinking by corporate management will be examined as regards their opposition to full disclosure. Specifically, the focus will be on what possible "cost" effects, in particular from the corporate viewpoint, may result from such disclosure.

MEANING OF "COST"

It should be pointed out that the term "cost", as used in this context, has a wider meaning than just the explicit cost as it is more commonly understood. Thus, by "cost", in discussing the cost effects of full disclosure, is meant:

(a) actual cost, viz., the expenses that are actually incurred in additional data collection, classification and presentation.

(b) possible future cost, for example, cost to management in meeting trade union demands for improved wages, and cost arising out of legal action instituted against the management.

(c) social cost, for example, loss of incentive for technological innovation, and risk of misinterpretation of corporate information which results in mis-investment of the nation's scarce capital resources.

(d) injury to the competitive position of a disclosing enterprise which, by reducing its profit-making capability, may affect its expansion plans, dividends distributed, and the market valuations for its securities.

INJURY TO COMPETITIVE POSITION OF DISCLOSING CORPORATION

Much of the opposition to full disclosure of business information by corporate management is based on the hypothesis that such disclosure might have to include what may be described as a corporation's strategic information. By strategic information is meant any business information which accords or may accord the possessor an advantage over his competitors who do not have such information. Specific examples are future plans and expectations, industrial processes, research and development data, sales or gross profits by products, or expenditures by types of advertising. Clearly, from the corporate point of view, such information, if given public exposure, might cause the reporting corporation to lose its competitive advantage or, to put it in another way, might result in possible competitive injury to the corporation.

In a private-enterprise, profit-oriented economy where competition is a fact of life, survival of a business enterprise and its capacity to make profit (which is in fact the rationale for its existence) must certainly be dependent upon its ability to compete. However, in order to have the strength to compete and to maximize profits, (and, in this way, increase dividends as well as enhance the market value of a corporation's stock), withholding of strategic information by a corporation might appear to be reasonable, for this may be one means by which the corporation would be able to have an advantage over its competitors. In other words, it is possible to make out a case that full disclosure may be competitively harmful to a corporation and that, therefore, some secrecy of corporate information may be desirable for the corporation to maintain its competitiveness vis-a-vis its rivals.

Competitive Risk In Disaggregative Disclosure: Disclosure in specific, detailed or disaggregative form which has been urged by interested outsiders as a basis for conglomerate reporting, is said to "aid competitors in determining when, how, and in what areas to apply pressure, which could reduce the competitive advantage that the reporting company otherwise would have." (I)

As an example, a company might have developed a new process for manufacturing a certain product more economically and, in this way, it is able to report a profit higher than normal for that product line. It is apparent that this disclosure of its profitability would make it vulnerable to increased competition. A competitor might be induced to direct its efforts to improving its own methods and techniques, and then to enter into stronger competition with the company's product.

As another example, a company might report a profit less than normal or even a loss for a product line because of high initial research, development, and start-up costs in connection with a new product. This disclosure could invite competitors into the field sooner than they would otherwise.

Concern has also been expressed by corporate executives in American industries that disclosure on a disaggregative basis might reveal valuable information to foreign competitors, especially because many foreign companies do not publish such data nor are they subject to disclosure requirements to the extent comparable to those in the United States. Hence, it would seem that export-oriented American corporations would be placed at a competitive disadvantage vis-a-vis their foreign rivals. The following comment of an American executive is pertinent (2):

> ...... Another source of objection to product line profit reporting is that competitors --- particularly foreign competitors --- would react to the company's detriment. American chemical companies are engaged in world-wide competition; foreign competitors give no profit figures and cannot be made to do so. This is a very important consideration to our company.

Other arguments against more detailed disclosure are reflected in the following comments by corporate executives (3):

> (a) ...... We would be concerned about revealing information to competitors. This is important in our industry because of bidding on government contracts.
>
> (b) ...... We operate in IO different industries. In some of these industries, we compete with family controlled companies that do not have to report publicly. In these industries we perform a service which is fee-negotiated. We would be in an unfair position in negotiating contracts.

Summing up, if disclosure is desired to be specific and in detail or on a disaggregative basis, it would seem that strategic information might be revealed to competitors about (4):

(a) profitable or unprofitable products,

(b) plans for new products or entries into new markets,

(c) apparent weaknesses which might induce competitors to increase their own efforts to take advantage of the weaknesses,

(d) the existence of advantages not otherwise indicated.

<u>Possible Effects On Profit Position And Stockholders' Investments</u>: If competitors are furnished with valuable information regarding profit opportunities, which undoubtedly they would exploit, given the profit motive of all business enterprises, the profit position of the

reporting company might be impaired. This is a reasonable fear by management because, assuming that the market demand for a product remains the same, the entry of new competitors and/or the intensification of efforts by existing competitors might divert part of that demand away from the product of the disclosing company, resulting in diminution of profits for the latter.

The adverse impact of reduced profits on the stockholders would also be evident, namely: (a) dividends might have to be curtailed or deferred, (b) there might be a lower market value for their company's stock. Hence, it appears that, in this case, "the interests of the stockholders might best be served by withholding financial information." (5) In other words, if disclosure of any information would result in the reporting company hurting its competitive position and, consequently, failing to maximize profits for its stockholders, it would seem that non-disclosure or disclosure only in aggregative form at the most might be justified.

Empirical Support For Some Information Secrecy: Empirical support for the above may be quoted from a recent survey conducted to ascertain the reactions of corporate executives to full disclosure, and the part played by secrecy in meeting business competition (6). The findings revealed that:

(a) corporate executives have no objection to disclosure in aggregative form of such information as goals, objectives and policies, future expectations, and the current economic position of their enterprises, but they are strongly opposed to such information being divulged in specific, detailed or disaggregative form,

(b) secrecy of certain information is necessary for a business enterprise to maintain its competitiveness vis-a-vis its rivals.

Industry-line Reporting By Conglomerates Less Likely To Be A Competitive Risk: As disclosure on an aggregative basis is not likely to affect the competitiveness of a company, so in some quarters, the opinion is held that conglomerate reporting ought to be "limited to industry lines and not extended to the more detailed product lines."(7) It is implied here, of course, that disclosure by industry is still in aggregative form, a not unreasonable assumption when compared to disclosure by products.

By way of illustration, Olin Mathieson Chemical Corporation reported, in dollars and in percentages of total income, the revenues and net after-tax income of each of its different industries, as follows(8):

Revenues ($ in millions)	I966	%	I965	%
Chemicals	282.4	25.3	250.4	26.7
Metals	237.9	2I.3	I8I.4	I9.3
Winchester, Western	I67.9	I5.0	II8.9	I2.7
Forest Products, Fine Paper and Film	I82.4	I6.3	I6I.9	I7.3
Squibb	246.5	22.I	225.7	24.0
Total	$I,II7.I	I00.0	$938.3	I00.0

Net After-tax Income Contribution

Chemicals	20%
Metals	I8
Winchester, Western	I7
Forest Products, Fine Paper and Film	2I
Squibb	24

It can be observed that competitors may still "not know any more about Olin's cost of the various Amino-Phas grades of mixed fertilizers (chemicals), or of Olin brass strip (metals), or about the Centennial '66 rifle (Winchester-Western), or the Marksman 500 can (Forest Products, Paper and Film), or about a bottle of Sweeta (Squibb), than they did before." (9) The competitive position of the company is not impaired as would be likely if more detailed disclosure is desired. In other words, "reporting by industry eliminates most if not all fears about revealing strategic product information." (IO)

If there must have to be disclosure, therefore, it would seem that aggregative disclosure is what corporate management would be prepared to volunteer, as this is less likely to expose the disclosing corporation to competitive risks. Given the choice, obviously corporate management would prefer not to disclose any strategic information at all, even in aggregative form, since it always regards such information as proprietary or as "trade secrets".

<u>Need For Evidence Of Anticipated Injury To Competitive Position</u>: Although there may be a possibility of injury to the competitive position of a reporting company by too-detailed or disaggregative disclosure, it is, however, held by some that "fear as to possible future harm is not to be regarded as sufficient to justify the withholding of accounting information." (II) It is imperative that management must first of all substantiate that material damage is likely to occur (I2).

That there must be reliable evidence of anticipated injury to justify suppression of information is also observed in the following pronouncement by the Securities and Exchange Commission in the United States (I3):

> ...... It is patent, of course, that tangible proof of the injury feared is not required in this type of proceeding. At the same time, however, it is necessary that the registrant establishes by proof the factual basis from which an inference of future harm can reasonably be drawn. A statement of the assertions and fears of the management in the absence of a showing that a reasonable basis exists is not sufficient.

Summary: In summing up, full disclosure, if it includes the divulgence of strategic or proprietary information, would seem to be competitively damaging to a disclosing enterprise. Hence, it may be desirable to maintain some information secrecy. But before suppressing any useful information, corporate management would have to first of all satisfy that such information would definitely constitute a competitive risk if made public.

DISINCENTIVE EFFECT ON INNOVATION AND RISK-TAKING

The importance of innovation as a contributor to increased productivity and economic growth in the free private-enterprise economy can hardly be over-stressed. By innovation is meant "an economic act by which a new product or a new service or a new production or merchandising method is introduced to actual use." (I4) It is apparent that a decision to innovate must be based on the expectation that this would lead to greater efficiency (that is, reduction in costs) and thus, would raise the level of profits for a corporation and its owners. With improved efficiency, a likely increase in productivity would also be expected.

Considering the economic environment of private-enterprise where production and marketing decisions are made by a multitude of individual corporations, efficiency and productivity must inevitably be the preoccupation of management. In fact, "rivalry between corporations centres on management teams that compete with one another to find ways of cutting costs, increasing volume, modifying old products and introducing new ones." (I5) Clearly, then, innovation is essential to achieving efficiency and higher productivity in a corporation, and to maintaining the corporation's competitiveness vis-a-vis its rivals.

Innovation may arise from advances achieved in research and development within an individual corporation. The activities which give rise to innovation require forward planning and a commitment of large amounts of resources. The results of such developmental efforts may be apparent only in the long run; usually, these are not realised until much outlay has been incurred on research. Those corporations which are successful in achieving innovation and hence, greater efficiency and higher productivity, are rewarded with increased profits. But not all such activities result in successful innovation. Thus, implicitly, an innovating corporation is always the one which is prepared to bear any risk of loss resulting from unsuccessful innovation.

Clearly, because an innovating corporation must incur large investments in resources for the purpose of innovation and also must face the risk that its efforts may not be successful, it would be strongly opposed to divulging any information as, for example, the results of its own research and product development, marketing strategies, and other strategic information generated within the corporation which would give it an advantage over competitors. Such information, if divulged, would surely be exposed for the benefit of competitors at its expense. Hence, it would seem that full corporate disclosure might have disincentive effects on corporations to innovate and to take risks.

An empirical study also concluded that (I6):

> ...... Full disclosure of information by business enterprises is not compatible with the competitive free private-enterprising economy. According to them, if there was full disclosure of all the relevant and material information about the competing enterprises, then one "best" way of marketing, production, financing, etc., would probably develop and the entrepreneurial spirit of free private enterprising would probably be smothered because the incentive to innovate in the hope for greater

> profits would be lost. Full disclosure of information might thus eliminate whatever benefits have accrued or are expected to arise from the competitive system of the free-enterprise economy.

In a highly competitive economy, management also needs the utmost flexibility to decide what should be the best long-term interests of stockholders. For this reason, management is fearful that full disclosure might lead stockholders to emphasize short-run profits, and so might subject management to undue criticism if this objective is not met. Continuing this argument, "management might be reluctant to undertake relatively high-risk projects or projects with high long-term profit potential but possible short-term losses." (I7)

> ...... The possible consequences of such an attitude are serious. Long-term benefit to stockholders would be sacrificed for current profitability ...... Any reduction in the risk-taking propensity of corporate management would inevitably work against the national economic growth objectives. (I8)

Full disclosure, therefore, might be opposed on the grounds that it might discourage innovation and the propensity to take risks by corporations for, when this happens, productivity and economic growth would be adversely affected, thus resulting in a social loss to society.

RISKS OF MISINTERPRETATION ARISING FROM EXTENSIVE DISCLOSURE

Areas Of Possible Misunderstanding: Clearly, the objective of disaggregative disclosure should be to enhance the value of accounting information to enable better decisions to be made based upon it. However, it should be recognised that it is no easy task to disclose, in substantial detail, corporate information, without, at the same time, being subject to the risk that such detailed disclosure might not be meaningful and, indeed, could be misleading to users. A reason for this is that there are still, at present, areas of accounting where complete objectivity in the treatment of accounting data has not been, and may probably never be, established. In such instances, the preparer of the corporate report may have to rely, at best, upon subjective judgement and hence, unless the judgemental basis is clearly understood by the information users, they might well draw totally erroneous conclusions from the accounting information.

The following are illustrative of how possible misinterpretations may arise if there is to be disaggregative disclosure; these examples would have particular reference to segmental or product-line reporting by conglomerate corporations[a]:

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[a] This is not to suggest that the risks of mis-

(a) <u>Allocation Of Common Costs</u>: In any conglomerate enterprise, as is also true of any multi-product company within each industry, certain common costs or joint costs may be incurred, but the benefits of which accrue to the business as a whole and not to a specific product or a segment of the business organisation. Examples of the more significant common costs are: (i) general and administrative expenses, (ii) research and development costs, (iii) financing costs, for example, interest, (iv) institutional advertising, and (v) federal and other income-taxes.

Clearly, if the above costs are not traceable directly to a specific product or a business segment, then surely to disclose any information on a product-line or segmental basis would necessitate an allocation of these common costs to the various products or segments, and this is, at best, arbitrary, depending upon management's judgement of the relative importance of the different product-lines or segments, as well as various other factors.

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understanding are only inherent in expanded conglomerate reporting. Misleading interpretations may also be likely in non-conglomerate corporations, that is, in companies operating within an industry or unitary companies having only one product-line, if too-detailed disclosure is desired. On the other hand, it would appear that the risks would be more apparent with regard to disaggregative conglomerate disclosure as compared to the other cases.

It follows that unawareness of the arbitrary allocations of costs among products or segments could result in very misleading conclusions by information users about the relative profitability of the various products or segments. Moreover, disclosing, as well, of the basis upon which these common costs are allocated may involve so much explanatory material which may itself be a source of confusion, and besides, it would most likely detract from the usefulness of the corporate report, since it may obscure the essential data therein. This is clearly pointed out by the United States Securities and Exchange Commission, as follows (19):

> ...... Nor was the usefulness of the statements increased by the fact that pages and pages of footnotes to the statements and comments in the auditors' reports sought to explain the results of the idiosyncrasies and gyrations of practice which went into the making of the statements. Indeed, the multitude of footnotes and explanations were in themselves sources of confusion.

Therefore, the more common costs there are that have to be allocated, and if these costs are significant, as well, in terms of their effect on net income, the greater is the risk that too-detailed disclosure might result in misleading interpretations by users.

(b) <u>Transfer Pricing</u>: This arises from intra-company transfers of materials and services. Thus, a division of a company may produce a product which is not only sold to an outside market, but is also transferred to another division of the company for use as a raw material. In the case of the intra-company transfer, the problem, therefore, is how to determine its transaction price. It is not difficult to see that the transfer price used will have an influence on the relative profitability between the transferor division and the transferee division, with consequent misleading interpretations by outside parties.

It is tempting to suggest that transfer prices should reflect the opportunity costs which, in effect, means that they ought to be based on open market prices, but this is not always possible, for "there are a great number of intra-company transfers for which no readily available open market transaction exists as a standard against which to measure the price used." (20)

Solomons and Mautz, on the other hand, are in favour of pricing inter-divisional sales on the basis of cost (2I). But still, this does not eliminate the possibility that misleading inferences may be drawn regarding the relative profitability between divisions. Thus, according to Chetkovich (22), the alternative to inter-divisional sale is sale on the open market. This means that the transferor division's "profitability" will be adversely affected since its product is priced at cost, while the transferee division will benefit in the process. "Management is in a position to recognise this possible inequity and may, for its purposes, use some other method of transfer pricing to better measure the relative performances of the two divisions. However, the investor probably will not be able to make a similar distinction." (23)

Currently, management is using various pricing techniques for intra-company transactions, frequently even within the same company (24). Hence, it would seem desirable to disclose the pricing bases as well, but, as in the disclosure of cost allocation methods, this might be further confusing to the average statement user.

(c) Rate Of Return On Investment Statistics: The suggestion has also been made that it is incomplete to show only a breakdown of the income statement, if product-line or segmental disclosure is to be meaningful, and that it may be misleading unless there is additional disclosure showing the rate of return on investment for the various product lines or segments (25). Thus, Rappaport cites the following example (26):

> ...... For example, stockholders could significantly misinterpret a report that a product line contributed 50 per cent of the sales but made only 5 per cent of the net profit if the report did not also inform them that the investment in that product line was very small relatively and that the inventory turned over weekly or perhaps even daily.

In other words, expanded disclosure should include, as well, a segmented balance sheet, but obviously this is no easy task, for it is difficult to establish rational bases by which to allocate assets and liabilities to the different segments. The results could well be misleading and might also be easily misinterpreted by users.

It has also been pointed out that "there is considerable debate over the relative validity of the various means of computing the rate of return for the total entity, let alone its segments ...... and the publications of such information, even with explanatory disclosure, could be more misleading than informative." (27)

(d) <u>Disclosure Of Future Plans And Expectations</u>: Not unexpectedly, an extension of corporate disclosure should include information regarding the future plans and expectations of management. Its relevance to meeting the needs of especially investors has been pointed out in chapter two.

Although it is difficult to dispute its relevance to investor decision-making, management is, nevertheless, opposed to disclosure of future plans and expectations because, among other reasons, they are not reliable. The reliability of such data is questionable on two grounds.

In the first place, it is contended that the future is speculative, is fraught with uncertainties, and involves too many variables for consideration.[b] Hence, any extrapolation of accounting information into the future, even by applying the most sophisticated forecasting technique, would be at best, estimates. While management is aware of the limitations and accordingly, uses such information with circumspection, users' understanding, on the other hand, of the many estimates involved in budgets and forecasts is limited; consequently, they might regard these figures as being absolute and hence, would be easily misled.

In the second place, "accountants generally refrain from reporting budgets relating to future periods to external users on the ground that the information is not sufficiently verifiable, although it might be highly relevant to external users' needs." (28)

Effect On Resource Allocation: It appears that extended information disclosure can cut both ways in respect of effective allocation of resources. The point was made in chapter two that, by additional corporate disclosure, investors are enabled to make better decisions, resulting in a more efficient allocation of their capital resources.

On the other hand, as can be observed in the foregoing discussion, management asserts that expanded disclosure would require the making of estimates, assumptions, and arbitrary allocations and, as a consequence, might result in misleading a user or confusing him with excessive detail. If investment decisions are made on the basis of improper interpretation and evaluation of expanded information, clearly resources would not be allocated according to their most effective uses. This mis-investment of capital resources would then represent a social loss to society.

Hence, it would seem that the point should also be noted that too-detailed disclosure of corporate information might be detrimental not only to the corporation itself but to the whole economy as well, if this results in mis-allocation of the nation's capital resources.

Legal Liability: If management is ultimately held responsible for ensuring that the financial statements which it publishes, are reliable and comprehensible, it seems logical that management should express concern about any extensive disclosure which, because of serious allocation problems, might reduce the reliability and understandability of the corporate information, and there-

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[b] Daily, however, hypothesised that it might be possible to report forecasted information. For a discussion of the technique he employs, see R. Austin Daily, "The Feasibility Of Reporting Forecasted Information," Accounting Review, October, 1971, pp. 686-692.

by, exposes the management to unnecessary legal risks, and possible future costs.

The risk of legal action against management may also arise in other ways. For example, detailed disclosure of research and development costs, if they do not generate any profitable returns, could very well invite stockholder suits for mismanagement (29). It is also suggested that the detailed information disclosed may have competitive value and consequently, "stockholders may be able to hold responsible the executives of the disclosing corporation for any damage to their interests." (30)

It would seem that, if additional information may be misleading and if management must be safeguarded against the possibility of litigation (and resulting costs), detailed disclosure will have to be "enshrouded in qualifications, definitions and caveats" (3I); clearly, comprehensibility is not improved as a result.

<u>Reaction From Customers</u>: Apart from being affected by cost allocations and arbitrary transfer prices, the relative profitability of the various products of a corporation may also be attributable to such factors as competitive environment, capital investment, research and product development expenditures, as well as other factors. Unless this is clearly understood, customers might well draw misleading conclusions about the level of profit earned by a

given product.

As Mautz observed, the profits derived for a given product may not be a fair indication of actual profits (32). He cites the example that, "past research and development costs of substantial amounts may have already been written off, thus the company's reported earnings on a product may not be a fair reflection of its actual long-range profits." (33)

A customer who is unaware of the aforementioned factors, therefore, might be misled into thinking that the company is over-charging and is making monopoly profits, and accordingly, might pressure for a reduction in product price, to the detriment of the interests of the company.

Reactions From Other Interested Parties: As well as the above possible adverse impact on the reporting company, possible unfavourable reactions may also be met from government anti-trust agencies, labour organisations, tax authorities, and even from the company's own stockholders.

Thus, from an anti-trust point of view, a company may be guilty of the unfair practice of cross-subsidization, that is to say, the profits of one segment may be used to subsidize efforts in another segment which operates in a more competitive environment (34). Although such a possibility cannot be discounted, it should also be recognised that segmental profits may not reflect the true profitability because, as pointed out, arbitrary allocations of costs, etc., may be necessary.

Similarly, the difficulty of an objective determination of segmental profitability may not be fully understood and consequently, employees through their labour organisations may press for improved wages, which could add to the future production costs of the disclosing company; tax authorities may harass the company with queries; and the company's stockholders may pressure for higher dividend payments. Considering the growing trend toward a greater use of internal financing by companies, it is clear that a higher dividend distribution may not always be in the long-range interest of either the company or its stockholders because additional capital resources are needed for further research and future expansions.

ACTUAL COST OF DATA COLLECTION, CLASSIFICATION, AND PRESENTATION

No-one can deny that, if disclosure is to be useful, raw data must first be collected and organised in a meaningful form; hence, a monetary cost will have to be incurred in the process. It follows, therefore, that the more details are required for disclosure, the more will probably be the cost of supplying the additional data.

New records, reports, and additional personnel may be necessary; possibly, the cost may also include an additional audit fee (35).

The point was made, however, that in fact not much additional cost is incurred because a good deal of detailed information is being accumulated by management anyway for internal use. In a sense, this may be true but, from the viewpoint of management, a distinction must be made between information that is intended for managerial purposes and information that is disclosed to external users. Accordingly, the following arguments can be adduced as rebuttal:

(a) Data that are prepared for managerial use do not expose management to legal risks as published data do.

(b) In using such internal data, management is aware of its limitations.

(c) By stating that internal data can be put to external use, an implicit assumption is made that additional disclosure would "follow as closely as possible the needs of corporate management for internal information systems." (36). In this way, a minimum of reclassification may be required and hence, additional disclosure will not entail considerable extra cost of preparation.

But, as Chetkovich comments, "the presumption that information most useful to management is best likely to serve the investor requires careful study. It can be argued very cogently that the management objective of best allocating and managing the resources of a company requires information considerably different in character from that required by an investor for best allocating and managing his investment resources."[c] (37)

Clearly, if this is the case, then reorganisation and presentation of data which would meet external user needs cannot be said to involve little additional cost.

However, it would seem that this cost argument used by management as a defence against more complete disclosure, might lose its force when use of the computer to compile the necessary data for reporting purposes, become widespread. In this connection, Commissioner Wheat also notes the development of the "microfiche", a small card containing photographic impressions of from 60 to a thousand or more printed pages (38). Thus, according to Wheat, financial information from corporate reports could be

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[c] For an expanded discussion of this, see Robert K. Mautz, "Conglomerate Reporting And Data Reliability," Financial Executive, September, I967, pp. 25-35.

recorded on such cards and made available promptly and inexpensively to those who need them.

Apart from the actual additional cost of preparation, corporate management also emphasizes that much of the executives' time may have to be spent in responding to queries arising from the additional disclosure (39). One may look upon this as an implicit cost to management for, otherwise, the time could have been utilised in planning for the company's future.

Summing up, generating additional information to meet the requirements for more disclosure can only be achieved through incurring additional costs and this "might, in the context of cost-benefit analysis, be detrimental to the stockholder," (40) and, of course, to management as well.

SUMMARY

It is thus observed that a more extensive disclosure of corporate information is not, however, without any possible 'cost' effects:

(a) Extensive disclosure may result in the divulgence of information which management deems to be its "trade secrets", to the detriment of its company's competitive position and hence, profit-making capability. Stockholders would also suffer reduced dividends and lower market valuations for their securities.

(b) Extensive disclosure may weaken management's incentive to innovate and to take risks, both of which are necessary to achieve economic growth under the private-enterprise economic system, as well as to foster competition. The long-term welfare of stockholders may also be adversely affected.

(c) Extensive disclosure may not be meaningful since it may require estimates, assumptions and arbitrary allocations, which, indeed, may be misleading unless interpreted by experts; "the reasonable man", "the average prudent investor" or "the reasonably informed reader" is not likely to be one. There is, therefore, a risk that there may be adverse effects arising from possible misleading interpretations by interested parties.

(d) Extensive disclosure may entail additional costs of preparation which may well be considerable, especially when it may be desirable to reorganise the data developed for managerial applications, to suit external user needs.

Footnotes

[1] Joseph B. Lanterman, "How To Resolve The Financial Reporting Controversy," Financial Executive, December, 1966, p. 46.

[2] Morton Backer and Walter B. MacFarland, External Reporting For Segments Of A Business, National Association of Accountants, 1968, p. 83.

[3] Ibid.

[4] Robert K. Mautz, Financial Reporting By Diversified Companies, Financial Executives Research Foundation, New York, 1968, p. 150.

[5] Charles T. Horngren, "Disclosure: 1957", Accounting Review, October, 1957, p. 603.

[6] See Huang Hua Chai, The Role Of Secrecy In Meeting Business Competition, Unpublished Master Thesis, University of British Columbia, 1969.

[7] Martin Mellman, "Profitability Disclosure By 'Conglomerate' Companies," New York Certified Public Accountant, August, 1967, pp. 595-602.

[8] Thomas E. Lynch, "Diversified Reporting," Financial Analysts Journal, November-December, 1968, p. 69.

[9] Loc. cit.

[10] Ibid., pp. 67-73.

[11] C.H.Griffin and T.H.Williams, "Measuring Adequate Disclosure," Journal of Accountancy, April, 1960, p. 46.

I2 Morton Backer and Walter B. MacFarland, op. cit., p. 85.

I3 American Sumatra Tobacco Corporation, 7 SEC I052 (I940), as quoted by C.H.Griffin and T.H.Williams, op. cit., p. 46.

I4 This is the meaning of innovation as Joseph Schumpeter used the term. See Max Ways, "Anti-trust In An Era Of Radical Change," Fortune, March, I966, p. 22I.

I5 Ibid.

I6 Huang Hua Chai, op. cit., p. 95.

I7 This is the view expressed by a corporate executive in a survey. Quoted by Robert K. Mautz, op. cit., p. 6I.

I8 Loc. cit.

I9 Associated Gas And Electrical Company, II SEC I026 (I942), as quoted by C.H.Griffin and T.H.Williams, op. cit., pp. 44-45.

20 Robert K. Mautz, op. cit., p. 37.

2I See David Solomons, Divisional Performance And Control, Financial Executives Research Foundation, I965. See also Robert K. Mautz, op. cit., pp. 37-38.

22 Michael N. Chetkovich, "Accounting Problems And Some Proposed Solutions --- Comments," in Public Reporting By Conglomerates edited by Alfred Rappaport, Peter A. Firmin, and Stephen A. Zeff, (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., I968), p. I08.

23 Loc. cit.

24 Robert K. Mautz, op. cit., p. 36.

25
See, for example, A.A.Sommer, Jr., "Conglomerate Disclosure: Friend Or Foe?" in Financial Accounting Theory II, edited by Thomas F. Keller and Stephen A. Zeff, (New York: McGraw-Hill, I969), p. 224; Louis H. Rappaport, "Problems In Product Line Reporting," Lybrand Journal, Vol. 48, Nos. I & 2, I967, p. 7; David Solomons, "Accounting Problems And Some Proposed Solutions," in Public Reporting By Conglomerates, op. cit., p. I02.

26
Louis H. Rappaport, op. cit., p. 7.

27
Michael N. Chetkovich, op. cit., p. I09.

28
American Accounting Association, as quoted in "Should The CPAs Opinion Be Extended To Include Forecasts?" by John J. Willingham, Charles H. Smith and Martin H. Taylor, Financial Executive, September, I970, p. 88.

29
A.A.Sommer, op. cit., p. 223.

30
Robert K. Mautz, op. cit., p. 73.

3I
A.A.Sommer, op. cit., p. 224.

32
Robert K. Mautz, op. cit., p. 70.

33
Ibid.

34
John M. Blair, "Antitrust Implications Of Conglomerate Reporting," in Public Reporting By Conglomerates, op. cit., pp. 25-36.

35
Robert K. Mautz, op. cit., p. 73.

36
Alfred Rappaport, Peter A. Firmin, Stephen A. Zeff, Public Reporting By Conglomerates,(Englewood Cliffs, New Jersey: Prentice-Hall, Inc., I968) p. I24.

37 Michael N. Chetkovich, _op. cit._, p. I07.

38 Editor's Notebook, _Journal of Accountancy_, September, I968, pp. 33-34.

39 Robert K. Mautz, _op. cit._, p. 74.

40 Alfred Rappaport, Peter A. Firmin, Stephen A. Zeff, _op. cit._, p. I24.

CHAPTER FIVE

AN EVALUATION USING THE VALUE CONCEPT APPROACH

In the discussions in the preceding chapters, the viewpoints of the different parties at interest in the question of corporate disclosure were presented. In general, two diametrically opposed points of view could be noted. On the one hand, there appears to be a strong case for full disclosure of corporate information considering the possible benefits that such disclosure may accrue to the interested external parties. On the other hand, taking the standpoint of corporate management, full disclosure is opposed on the ground that it operates to the detriment of the enterprise; suppression of some information would seem to be desirable.

Thus the technique of the value concept has been proposed in this study as a framework within which the question of disclosure may be considered. The explanation of this approach is the subject-matter of the present chapter. Only the theorectical aspect of the approach will be considered.

Before proceeding to do this, however, it is desirable to reconsider the concept of full disclosure in the light of the discussions of the different viewpoints regarding disclosure. This is necessary because the use of the value concept approach would require that full disclosure is first made clear.

AN OPERATIONAL MEANING OF FULL DISCLOSURE

It is evident, from the preceding chapters where the reactions of the different interests were considered, that the question of full corporate disclosure has been variously interpreted. Thus, some external interests as, for example, some financial analysts, tended to look upon full disclosure in a wider perspective. This means to say that, if there is full disclosure, then "there should be little in the way of restrictions upon the information available to them ...... No one had a right to deny them the information which they felt they needed to perform their analytical functions satisfactorily." (I)

Similarly, there were those among the corporate management group who were strongly opposed to full disclosure because, by interpreting full disclosure in the broadest sense, this would result in injury to the competitive position of their enterprises. Mautz thus comments on this difference in interpretation of "additional disclosure" among corporate executives, in his empirical study regarding conglomerate reporting (2):

> ...... It should be pointed out that in responding to this particular question (of competitive disadvantage), companies were reacting to an unknown contingency, that is, they had no way of knowing at this point what the "additional disclosures" might be. Some obviously interpreted these as involving a significant degree of detailed product information and reacted accordingly. Others may have been much more moderate in their expectations and, therefore, much less fearful of the consequences.

Proprietary Information: In a review of the literature on disclosure, it is observed that various terms have been employed by different writers to describe that category of information pertaining to a firm the disclosure of which would be competitively harmful and also would have an inhibitive effect on innovation. This type of information is thus variously described as "proprietary" information, "sensitive" information, "strategic" information, "confidential" information, "competitive" information, or simply, "trade secrets." The definition of "trade secrets" is given as follows (3):

> "Trade secret means and includes any confidential technical or other confidential business information, regardless of whether it is in written or other tangible form, which is not generally available to the public, and which gives one who uses it an advantage

over competitors who do not know or
use it."

Clearly, this implies that such information must have been generated from within the firm through its own research and other innovative activities and, therefore, must be in the nature of proprietary secrets. The following list shows the items of information which are generally regarded as proprietary or confidential[a]:

<u>Confidential Technical Information</u>

Formulas

Production processes

Patterns

Engineering designs and specifications

Methods of administrative organisation

Methods of quality control

<u>Confidential Business Information</u>

Share of market

Customer satisfaction

Productivity indexes

Volume of sales in physical units

Unit cost

Pricing policy and method

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[a] This list also incorporates examples cited in various articles on corporate disclosure.

Terms of sale

Marketing techniques or strategy

Financing plans and methods

Customer and source lists

Preliminary negotiations on mergers and acquisition

Research and development expenditures in disaggregative form

Expenditures by types of advertising

Detailed plans and expectations

Baram, in discussing trade secrets, explains why secrecy of proprietary information is desired by a firm (4):

> ...... The I7-year period (in the United States) of patent protection is often insufficient because inventions normally require a longer period of time, following reduction to practice and patentability, before commercial acceptance occurs. Thus early disclosure of the invention through the award of a patent only serves to inform the competition of one's state of the art. Industry has therefore continued to rely on secrecy to protect its intellectual property.

<u>A Classification Of Corporate Information</u>: It may thus be necessary to classify corporate information as proprietary and non-proprietary (see the following page). Where proprietary information is concerned, the position is clear. Disclosure would be damaging to the competitive posture of the disclosing enterprise, and would also have

Corporate Information

non-proprietary information — fully disclosed?

proprietary information — secrecy maintained

a significant dampening effect on innovation. An examination of the list of items of proprietary information would attest that this would be so. Hence, insofar as prorpietary information is concerned, it would be justified that there is a need for maintaining information secrecy.

It is in regard to non-proprietary information to which the question of full disclosure should be directed. At the present state of external reporting, the following types of information are generally regarded as inadequately disclosed[b]:

<u>Types Of Information Inadequately Disclosed</u>

Long-term leases

Comparative statements

Consolidated financial statements

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[b] This list incorporates examples cited in various articles on corporate disclosure.

Breakdown of sales and profit (by segments[c])

Capital asset breakdown

Hidden reserves

Business combinations

Turnover

Funds statement

Research and development[d]

Plans and expectations[e]

Statistics on employees and their renumeration

Recognizing that disclosure of proprietary secrets would <u>unquestionably</u> be damaging to the reporting enterprise, full disclosure is used in this study in a restricted sense meaning by this term the full disclosure of non-proprietary information. The following citations are thus pertinent:

> (a) Corporate secrets, the disclosure of which would ultimately be detrimental to the stockholders, would not be included, of course. Short of that, the scope of supplemental report would be defined only by the limits

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[c] Disclosure by "segments", as the term is used here, means disclosure on the basis of broad industry or product line groupings, and not in terms of specific products.

[d] It should be recognized that specific disclosure of this item would not be in a firm's interests.

[e] <u>Ibid</u>.

of what corporation officials would be willing to disclose privately to analysts and other representatives of institutional investors (5).

(b) In terms of industry lines, disclosure of earnings will not, according to sophisticated analysts, reveal any competitive secrets. Of course, proprietary information should so remain (i.e. as secret information) (6).

There is no assurance, however, that full disclosure of non-proprietary information would not also be prejudicial to the interests of an enterprise. Indeed, this would appear likely for an enterprise which operates in a keenly competitive environment. In other words, there might be circumstances where disclosure would be disadvantageous. But, on the other hand, such disclosures would be useful to investors and other interested parties. Where this is the case, it might be necessary to consider the disadvantages of disclosure vis-a-vis the benefits to interested outsiders. This will be discussed in the remaining part of this chapter.

AN EVALUATION BASED ON THE VALUE CONCEPT

Griffin and Williams, in a study of a large number of decisions and rulings by the United States Securities and Exchange Commission, observes that "when a conflict of interests is involved, suppression of useful information is justified only when the extent of injury to the enterprise exceeds the benefit accruing to the public." (7)

Similarly, Cramer, writing on conglomerate disclosure, suggests that "the crucial question is whether the nature of business organisations and their accounting is such that greater operating detail can be given in a manner that is advantageous to more people than those to whom it is prejudicial." (8)

Based on an empirical study, also regarding conglomerate reporting, Mautz concludes, inter alia, that "if presented in appropriate terms, disclosures useful to investors ordinarily need not be harmful to the disclosing enterprise. In recognition of the possibility of harm to shareholders in unusual cases, consideration needs to be given to recognition of hardship cases where the disadvantages of disclosure exceed the benefits to investors." (9)

The same point is also made by Backer and MacFarland in a separate survey study of external reporting for segments of a business. While concluding that it would be improbable that valuable information might be revealed in broadly based segment reports, nevertheless, they recognise that "there may, however, be individual circumstances in which disclosure would work hardship.

For this reason, any uniform rules which may be established to govern segment disclosures will need provision for exceptions where management can substantiate that material damage is likely to occur." (IO)

It is thus clear from the foregoing statements of the different writers regarding corporate reporting that, whether there should be or should not be extensive disclosure in the circumstances must be based on a consideration of the possible benefits of such disclosure to interested outsiders vis-a-vis the possible injury by such disclosure to the enterprise.

Beyond stating that the question of disclosure ought to be considered in terms of its possible benefits and its possible disadvantages, no suggestion, however, seems to be given by any of the writers to explain in explicit terms how such a consideration might be made. The following is, therefore, a suggested conceptual framework within which this might be achieved. This writer, however, does not pretend that there are no practical difficulties to be met but, as pointed out earlier, only the theorectical aspect will be discussed.

Value Concept: Value is, in fact, a broad term. It is used in a wide variety of ways so that its meaning may well be different to different people. Kohler's

A Dictionary for Accountants gives the meaning of value[f] as follows (II):

(a) Any preferred object or interest therein.

(b) Attributed worth, expressed in money and applied to a particular asset, as the value of an automobile; to services rendered, as the value of a man's labour.

(c) Hence, loosely, the amount at which an item appears in the books or on a financial statement; cost.

(d) The quantity of other goods or money required to be given in exchange for a particular good; an economic phenomenon based on the process of exchange in monetary terms in a market.

This corresponds with Clawson's classification of value (I2):

(a) Esteem value.

(b) Use value.

(c) Cost value.

(d) Exchange value.

Thus, because of differences in usage, the term value, if used without any qualification, has almost no significance. Therefore, a clarification of the meaning of value, as the term is used here, is appropriate. In

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[f] For an illustration of the many different meanings of value attached to any asset, see, for example, John Heath, "What Is Value?" Financial Executive, June, I97I, pp. I3-I5.

the context of this study, then, value is determined by two consideration: benefits and costs. As is clear from the previous chapters, the benefits of full disclosure are the sum of the "advantageous effects" it brings about, to whomsoever they accrue; the costs, on the other hand, are the sum of the "disadvantageous effects" if there is to be full disclosure.

It must be recognised that these benefits and costs do not all accrue immediately, but over time, more often in an uneven pattern. The streams of benefits and costs occurring through time thus may have different significant values. Clearly, then, in order to permit their comparison, they must be converted to a common point in time. Accordingly, the value of the benefits and costs which occur in the future may be discounted back to their present worth equivalent.

<u>Present Value</u>: The present value or present worth is the value of a sum discounted to the present at a given rate. For example, a sum of $IIO expected next year is equivalent to $IOO today at IO per cent per year. This is because a person expecting to receive that $IOO at the end of next year can instead borrow $IOO today, pay IO per cent interest for one year, and repay in full the capital and interest of $IIO. In the same way, a person expecting to make a payment of $IIO next year

could make the payment this year by depositing $IOO in a savings institution where interest at IO per cent is paid annually. Thus a benefit or cost, expected in the future, is only worth today what would have to be deposited in a savings institution (or paid into a bank) today in order to amount to the full expected value in the future (I3).

Using a symbolic notation, let

V_t = sum expected to be received in t periods

r = rate of discount

V_o = present value of sum expected to be received in t periods.

Then the relationship between them is given by

$$V_o = \frac{V_t}{(I + r)^t}$$

However, where the stream of future receipts or payments varies between one period and another, then it may be desirable to determine the present value of each receipt or payment for each period, and to find the sum of these present values. This may be shown as follows:

$$V_o = \frac{V_I}{(I + r)} + \frac{V_2}{(I + r)^2} + \ldots\ldots. + \frac{V_n}{(I + r)^n}$$

$$= \sum_{t=I}^{n} \frac{V_t}{(I + r)^t}$$

<u>Discounting Future Benefits And Future Costs Of Full Disclosure</u>: The same concept of discounting future effects to the present may be employed in the consideration of the benefits and costs of full disclosure. Considering first the benefits, let

B = total discounted benefits of full disclosure accruing to the public and to management.

The components of B represent the individual benefit items discussed previously which may be distinguished as follows:

B^I = efficient allocation of resources

B^2 = development of capital market

B^3 = lower cost of securing external capital

B^4 = savings on time and expense

B^5 = greater stability in securities markets

In each case, the future benefits may be estimated conceptually and then discounted back to the present worth as, for example,

$$B^{I} = \frac{B_t}{(I + r)^t}$$

where B^{I} = present value of estimated future benefits attributable to the efficient allocation of resources

B_t = benefits over a period t

r = discount rate

In this way, the present worth of the estimated future benefits may be obtained by finding their sum thus:

$$B = B^{I} + B^{2} + B^{3} + B^{4} + B^{5}$$

Similarly, let

C = extent of injury to the enterprise and to society

The components of C represent the individual items of possible cost effects as discussed previously; these are as follows:

C^{I} = injury to competitive position

C^{2} = disincentive effect on innovation

C^{3} = risk of misinterpretation

$C^4 \;=\;$ administrative costs

As before, the future costs may be estimated conceptually and then discounted back to the present worth, for example,

$$C^{I} = \frac{C_t}{(I + r)^t}$$

where C^{I} = present value of estimated damage as a result of injury to competitive positions

C_t = costs over a period t

r = discount rate

Summing up the present values of all the estimated future costs gives

$$C = C^{I} + C^2 + C^3 + C^4$$

The total discounted benefits are then compared with the total discounted costs. According to the notion that "suppression of useful information is justified only when the extent of injury to the enterprise exceeds the benefit accruing to the public" or that "the disadvantages of disclosure exceed the benefits to investors", as mentioned earlier[8], then this must imply that:

$$B < C$$

On the other hand, there should be more extensive disclosure wherever it "is advantageous to more people than those to whom it is prejudicial."[h] In other words, this means greater disclosure so long as

$$B > C$$

Thus, in considering the question of corporate disclosure which is the objective of this study, the technique of the value concept has been employed as a model. This conceptual model seeks to estimate the present value by the discounting of estimated future costs and future benefits of full disclosure, and then to compare the total discounted benefits with the total discounted costs.

This writer admits, however, that there may be difficulties in efforts to quantify the above consideration of costs and benefits. The following difficulties may be mentioned but no attempt will be made in this study to

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[g] See *supra*, pp. I23-I25.

[h] *Ibid*.

resolve them:

(a) Estimating the flows of future benefits and future costs;

(b) Determining the time horizon;

(c) Adjusting for price level changes;

(d) Selecting the discount rate.

Techniques may not now exist which will enable the above-mentioned factors to be determined within reasonable limits of objectivity. However, in time, these difficulties would probably be minimized though admittedly, complete objectivity might not be feasible. But these difficulties aside, the value concept model, in the opinion of this writer, appears to be conceptually valid.

SUMMARY

Operationally, full corporate disclosure should be bounded by the fact that information that would unquestionably be damaging to the reporting enterprise should not be disclosed. Accordingly, a distinction needs to be made between proprietary information and non-proprietary information; the meaning of full disclosure is applied to the latter.

Full disclosure of non-proprietary information may be considered in terms of costs and benefits or the value concept. Using this conceptual model, it is possible to conclude whether or not there should be greater disclosure in the given circumstances according as the discounted benefits exceed the discounted costs or vice versa.

Footnotes

I Robert K. Mautz, _Financial Reporting By Diversified Companies_, Financial Executives Research Foundation, New York, 1968, p. 67.

2 _Ibid._

3 Worth Wade, _Industrial Espionage And Mis-Use Of Trade Secrets_, (Ardmore, Pennsylvania: Advance House, 1964), p. 88.

4 Michael S. Baram, "Trade Secrets: What Price Loyalty?" _Harvard Business Review_, November-December, 1968, p. 69.

5 Herman W. Bevis, _Corporate Financial Reporting In A Competitive Economy_, (New York: MacMillan Company, 1965), p. 179.

6 Martin Mellman, "Profitability Disclosure By 'Conglomerate' Companies," _New York Certified Public Accountants_, August, 1967, p. 598.

7 C.H.Griffin and T.H.Williams, "Measuring Adequate Disclosure," _Journal of Accountancy, April_, 1960, p. 43.

8 Joe J. Cramer,"Income Reporting By Conglomerates --- Views Of American Businessmen," _Abacus_, August, 1968, p. 26.

9 Robert K. Mautz, _op. cit._, pp. 153-154.

IO Morton Backer and Walter B. MacFarland, _External Reporting For Segments Of A Business_, (New York: National Association of Accountants, 1968), p. 85.

II
Eric L. Kohler, A Dictionary For Accountants, (Englewood Cliffs, New Jersey: Prentice-Hall, Second Edition, I96I), pp. 504-505

I2
Robert H. Clawson, Value Engineering For Management, (Princeton: Auerbach Publishers Inc., I970), p. 27.

I3
W.R.D.Sewell, et. al., Guide To Benefit-Cost Analysis, Resources for Tomorrow Conference, Ottawa, Queen's Printer, I962, p. I6.

CHAPTER SIX

SUMMARY AND CONCLUSIONS

The subject of adequate corporate disclosure has, in recent years, commanded the considerable attention of a wide spectrum of interested parties, as may be evidenced by the large amount of business and accounting literature relating to the subject.[a] The need for more and better corporate disclosure is stressed by securities analysts, financial institutions, shareholder groups, professional organisations and, last but not least, Securities and Exchange Commissions. At the other end of this spectrum of interested parties is the management group who, while they are aware of the informational needs of outsiders, are, nevertheless, opposed to extensive disclosure; they consider these additional facts and figures "as important motivationally, legally, and competitively, as well as informationally" (I), unlike the outsiders who are only interested in the informational aspect.

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[a] See, for example, <u>bibliography</u>, pp. I44-I49.

This study therefore begins by examining the question of full corporate disclosure from the global viewpoint. More specifically, it seeks to identify the rationale of thinking by two opposing interests: first, that of outsiders for more extensive disclosure and, second, that of corporate management for their opposition to it.

Unfortunately, the lack of clarification of the concept of full corporate disclosure has led to its various interpretations and, consequently, the views expressed in favour of or in opposition to greater disclosure might not rest upon a common basis. In this study, the need for maintaining secrecy of proprietary information is recognised and the meaning of full disclosure is thus applied only to that category of non-proprietary information.

Perhaps one of the strongest arguments for more extensive disclosure is that it facilitates investment decision-making. With adequate information, investors are enabled to make a more intelligent selection of enterprises for investment, and capital resources are thereby channelled into uses that promise the highest productivity. The development of the capital market, so essential in the private-enterprise economy which is corporation-dominated, and the securing of external capital at a possible lower cost, are all dependent on greater corporate disclosure. Similarly, timely disclosure, by checking against rumours and speculative dealings, ensures more stability in the securities markets. Also, disclosure obviates the need for obtaining corporate information from other sources often at much cost in time and money. The legislative intent of requiring corporate disclosure to protect investors against any fraudulent practices by management is also discussed.

It is generally conceded that only a material item need be disclosed. But the concept of materiality, however, is not easily susceptible to precise definition as a review of the literature by authoritative accounting bodies and other writers has shown. Attempts have been made to establish quantitative yardsticks to measure materiality. One which this writer is in favour of is that of specifying an area in which disclosure is clearly necessary because of materiality, an area in which the size is clearly not material, and an intermediate "area of doubt," which must eventually be resolved into one of the other two. Such an explicit guideline would hopefully provide a common approach in the interpretation and application of the materiality concept by confining the exercise of judgement to the narrow border zone. In this way, a more consistent disclosure practice may be achieved. The qualitative aspect of materiality is also mentioned in connection with those items which, because of their very nature, would require disclosure regardless of the quantity.

As suggested earlier, management is not only concerned with the informational aspect of full corporate disclosure but also its motivational, legal, cost, and competitive aspects as well. Thus, from the point of view of corporate management, extensive disclosure would have a dampening effect on innovation and the propensity to take risks. It would also expose management to unwarranted legal risks as a result of losses suffered by outsiders due to misinterpretations of the information disclosed. There is also the argument that additional disclosure might involve considerable extra costs of preparation. But probably the strongest objection by management to extensive disclosure is its likely adverse impact on their enterprise's competitive position.

Thus the question of full corporate disclosure has been examined from the points of view of the different interests. In this connection, Mautz's conclusion of what should be the elements of an ideal solution is worth noting (2):

(a) The provision at minimum cost and risk to the reporting companies of information necessary for informed decisions by investors.

(b) The avoidance of any unnecessary disclosures which might be costly and/or troublesome to the reporting company. Here the burden of proof must be upon those who call for additional disclosures. The fact that reports of additional operating data will be both costly and possibly troublesome, seems well established. Those who contend that additional information should be provided, therefore, ought to support their contention by demonstrating that the benefits of such reports out-weigh the disadvantages and, further, that in such reports there is no inequitable favouring of one interest at the expense of others.

(c) Protection of all parties concerned against misunderstanding and misinterpretation of the reported data. The possibilities of misunderstanding and misinterpretation are evident. Also evident are the responsibilities which fall upon those who supply financial data to others. If required, precautionary measures should be taken both to protect those who might use such data erroneously and those who might be held responsible if regrettable misuse occurs.

Essentially, what this means is that, in the consideration of corporate disclosure, the "disadvantageous effects" indicating possible injury to the enterprise should be offset against the "advantageous effects" indicating possible benefits of full disclosure to the public. Conceptually, this involves estimating the present values by the discounting of estimated future costs and future benefits of full disclosure, and comparing the total discounted benefits with the total discounted costs. In other words, the model of the value concept is employed in this conceptual analysis. However, there has been no effort to consider the practical side of the model. While the practical problems may appear great, nevertheless, the value concept approach, at least conceptually, seems a sound and valid one.

Footnotes

[1] Robert K. Mautz, Financial Reporting By Diversified Companies, Financial Executives Research Foundation, New York, I968, p. 22.

[2] *Ibid*., p. I26.

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