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Financial Services Commission Symposium
November 17, 2004

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THE EDUCATION AND EMPOWERMENT OF INVESTORS

I THE UNDERTAKING

This paper undertakes a consideration of the education and empowerment of investors. It inquires into the unstated assumption that the education and empowerment of investors is urgent and important, and ponders the question of what are some of the ways in which such education and empowerment might be accomplished, given all the opportunities and hurdles.

It seeks to inquire, further, into whether the inputs necessary to educate and empower retail investors are different from those necessary for institutional investors; whether any help to average retail investors is likely to be wholly or largely indirect; whether there is a role for, and, if so, how significant are, more demanding accounting rules and more stringent requirements for financial statement disclosures; and whether it is likely that greater emphasis needs to be placed on qualitative, narrative financial and non-financial information in order to help investors better understand the issues they face in making investment decisions.

II BACKGROUND

Recent times have witnessed a surge of interest in the education and empowerment of investors and in the consequential investment of time, effort and political capital in the pursuit of that objective.

The passage of the Sarbanes-Oxley Act in the USA and corresponding (though not always comparable) pieces of legislation in the United Kingdom, Japan, Singapore – to pick a few examples

– testifies to the passion that educating and empowering (and otherwise protecting) investors has become. Perhaps that motivation, the resultant regulatory structures and powers, and the “let’s get it- right” vision that have been thereby birthed, are why we are here today.

What are some of the recent experiences that have given rise to this growing interest in the education and empowerment of investors?

The list in Appendix I exemplifies the range of frauds that occurred in certain publicly listed companies in the United States over the past decade.

In the cases referred to, non-disclosure persisted, not only because there were not the sufficiently detailed mandatory requirements that insisted on disclosure, and not only because there were not sufficiently strong elements of the business culture at the time that inspired voluntary disclosure of details necessary to understand the company's true financial position where laws, regulations and standards did not mandate such disclosure (ie, based on principles and not rules), but also because the management teams employed non-disclosure as a tool of deceit, with the aim of keeping their questionable practices veiled from investors and others. The discovery of these frauds, the ensuing scandals, and information on how widespread the practices were, set in motion a chain of events which resulted in an overhaul of the regulatory framework and a public education drive to protect the unsuspecting investor from a repeat of this type of abuse.

The recent business failures and related scandals may, or may not, have significantly dampened the confidence of some potential investors in publicly traded securities; what it has certainly done is fuelled the fire of investors' quest, and that of those who represent or protect them, for more and better quality information – information that will aid them in making sound decisions as to which companies' securities they should buy, hold or sell. The increasing demand for information by, and supply of it to, the average citizen, particularly where the citizen has an interest or stake in the relevant enterprise, appears more and more to be modern day reality. All this is facilitated by technological improvements and the consequential ease of transmission of information. The financial statements and other reports contained in companies' annual and other periodic reports are, therefore, going to be subject to greater scrutiny in the quest for critical information.

Informed risk assessment is critical to successful investing. However, the investor's capacity to assess risk depends, to a large extent, on technical financial and accounting knowledge, including his ability to properly interpret the financial statements using amounts and disclosures in corporate reports (e.g. the financial statements, directors report, chairman's report). This expectation assumes that investors are technically trained and, therefore, possess the required level of proficiency in analyzing accounting data. However, this is not so in the majority of instances, and it is probable that local shareholders do not attend annual and other shareholders' meetings because:

- they are not able to analyse the statements;
- they are sufficiently satisfied once a dividend is paid;
- they do not understand the power they can wield as owners of the enterprise.

There is, it should be observed, a cynical response to this last suggestion: The notion that shareholders/investors hold, let alone wield, power is viewed disparagingly by those who recognize that investors were virtually defenseless in the collapse of significantly large conglomerates such as Enron, WorldCom and Adelphia to name a few. These debacles resulted in the bankruptcy of tens of thousands of investors - a fate which did not seem to be shared by the CEOs and other top executives of the failed enterprises. In fact, it was the persons to whom the investors had entrusted their resources who colluded to utilize questionable business practices to further enrich themselves at the investors' expense. This begs the question whether the investor has a prayer of hope in an environment where those entrusted with the management of his resources are bent on deception through the engineering of non-existent earnings and a picture of perfect financial health to lure him to spend more.

III THE TARGET AND NATURE OF EDUCATION AND EMPOWERMENT

It has been said above that we will inquire into various matters having to do with the education and empowerment of investors. In the pursuit of this objective, one of the questions which we must ask is this: Who is the investor? Who is it that it is being suggested wants, or needs, to be educated and empowered?

Broadly, the investor is anyone providing assets to be employed in one or more of the chain of activities from production of goods and services through to their sale and delivery to and consumption by others, all for a reward that exceeds the cost of the assets employed, thereby earning a profit and increasing wealth. The owner of the assets may deploy them himself or he may entrust them to someone else to manage, for a reward, with a view to the same objective - earning a profit and increasing wealth. For the purposes of this paper, we will concentrate on the latter group, those who entrust their resources to others (including co-investors, partners) to manage. That group needs to be narrowed even further, however, so we will focus not on those who entrust their resources to others in private arrangements; rather, we focus on the public interest, for-profit enterprises –eg, companies whose equity or debt stock is publicly offered and/or traded on an exchange, financial institutions, unit trusts, and broker/dealers.

It is important to pause to observe that, in this context, considering income and wealth focuses our attention on economic activities, and therefore economic decisions. Further, income and wealth accumulation are of necessity outcomes in the future. Investors make economic decisions now with a view to enjoying increases in wealth in the future. So investors have, or contemplate having, a direct economic interest in some particular business enterprise. That interest is seen in terms of an increase in wealth. Such increase in wealth, in turn, is measured in terms of the business enterprise's ability to generate favourable cash flows. Investors evaluate such expected future cash flows from the perspectives of amount, timing and certainty.

The needs of investors, therefore, include, very importantly, information that helps them make judgements about the amount, timing and likely variability of cash flows; from there they move on to estimate a value for the company, if they are shareholders, or the protection needed in a credit contract, if they are creditors.

We mention in passing that present and potential investors are only some of those who have a direct or indirect interest in particular business enterprises. Others who have, or contemplate having, a direct interest in particular business enterprises include lenders, trade creditors and employees.

Managers and directors, who are charged with the responsibility of managing the enterprise in the interest of owners, also have a direct interest. Members of other groups, such as financial analysts and advisors, regulatory authorities, and labour unions, have derived or indirect interests because they advise or represent those who have, or contemplate having, direct financial interests.

The Notions of Education and Empowerment: What we understand to be behind these notions is a belief that investors in publicly issued and/or publicly traded investment securities are doing rather more badly, or less well, than they, as a matter of right, should be doing. These sub-optimal results are, it seems to be assumed, a consequence of two things: (1) mis-information - whether by error or calculated deception and/or inadequate good quality information; and (2) inadequate access to, or right to make demands from, those who are required to, or ought to be required to, provide investors with information that they need to make the economic decisions that they wish to make, and to demand an accounting from the stewards to whom economic resources are entrusted.

To empower someone is to give power to that person. Most of the different shades of meaning of the word power in any major dictionary have to do with the ability of a thing or a person to have its or his way, to accomplish its or his purpose by overcoming contrary or opposing forces. Consider our usage of the word in reference to a powerful government or politician or country or hurricane or regulatory agency.

And it is worth noting, too, that those who hold power change. The person able to have his way today may be more easily limited or stopped tomorrow. The process of education and empowerment is a continuing and adaptive process, given that we are operating in a rapidly changing world.

For the purposes of this paper, I suggest that investors are educated and empowered when:

- 1 they have access to information to which they have a legitimate right;
- 2 they understand the information;
- 3 they (as current, as distinct from potential, investors) can demand and obtain information and explanations necessary for them to make economic decisions relating to their investment; and
- 4 they (as current, as distinct from potential, investors) can demand and obtain information and explanations necessary for them to better understand and evaluate management's stewardship of resources with which they have been entrusted.

IV INFORMATION NEEDS OF INVESTORS

So investors need information to assist them in making sound decisions that will lead to increases in income and wealth. One key question that arises, therefore, is this: What does meeting this objective require?

Because of the above-described economic interests, the various groups have a need for information about particular business enterprises. Common to all of them is the interest in the ability of the enterprise to generate cash and cash equivalents. Information that is needed is that which facilitates estimates of future generation of cash and cash equivalents. Using the same logic as those who set International Financial Reporting Standards, we proceed on the basis that because investors are the providers of risk capital to the enterprise, financial (and other) information that meet their needs will also meet most of the general information needs of other users.

Put another way, it has been strenuously argued that the governing objective of all publicly traded companies should be to maximize the value of the company for shareholders. Achieving this corporate objective not only serves the interests of the company's owners but also serves the economic interests of all stakeholders over time. *"The shareholders always get paid last"*. It is, therefore, essential that management of companies provides quality information to the shareholders through adequate and useful disclosure in the annual and other reports to facilitate them in making economic decisions to safeguard and maximize their interests.

In the particular context of this paper, we will therefore focus on investors – those reliant on hired managers to provide them with the required information. This, as noted above, will principally be the holders and potential holders of publicly traded securities, with some attention to other investors whose capital, entrusted to the management of others, is at risk.

V THE SOURCES OF INFORMATION TO INVESTORS

As noted above, investors are looking for information to help them predict cash generating ability as a surrogate for predicting increases in their own income and wealth. It would not be too narrow to suggest that other activities engaged in by the investor are part of this overall process. For example, investors may well use information to evaluate the stewardship of the management of the enterprise – i.e., to make judgements about the adequacy and appropriateness of the compensation to

management; but ultimately, it is to make predictions about the likely success of the management in managing the invested resources so as to maximize increase in investor wealth.

All enterprises, including the private ones, have reporting (and sometimes accounting) requirements imposed on them by the laws under which they are incorporated; consider the Companies Act, Building Societies Act, Co-operative Societies Act. In addition, however, those we consider today are also subject to the accounting and/or reporting requirements of additional laws and regulations, examples being the Banking Act, Financial Institutions Act and Securities Act, together with relevant regulations thereunder, as well as the provisions of the rules of the Jamaica Stock Exchange – in the case of those whose stocks are public ly listed.

It is acknowledged that some investors and others may have a combination of objectives in relation to which they desire and expect information on, and from, the business enterprise. Governments and their agencies –eg, taxing authorities and regulators – customers, and the general public may have other than economic interests that inform their desire for information on other aspects of the enterprise. This would include information on its philosophy and operation in key areas: its recognition of itself as a corporate citizen that should adopt and abide by certain core values, including enlightened labour practices, trade practices, and respect for the natural and social environment, among others.

For our purposes today, however, we focus on the information needs of current and potential investors. That information may be financial and non-financial, quantitative and narrative. There are several ways of providing such information to investors. These include the following:

- Annual reports, often containing audited financial statements, financial highlights, Chairman's statement, Directors' report, Management Discussion and Analysis/Operations report, Segment reports, and Pictorial highlights;
- Quarterly reports;
- Dividend announcements;
- Special announcements, issued to and carried in the mass media, dealing with some major transaction or event;
- Conference calls and/or meetings with analysts and business journalists.

The list of what other reports there should be and the matter of their content and format has been the subject of much debate and, increasingly, legislative and regulatory interventions. One critical item in the list is the annual audited financial statements. We now turn to their role in the education and empowerment of investors.

V.1 Financial Statements as a Source of Information to Meet Investors' Needs

The Objective of Financial Statements

The objective of financial statements is to provide information about the

- financial position,
- performance, and
- changes in financial position

of an enterprise that is useful to investors and others in making economic decisions. The investor is

interested in wealth creation and income generation. His fundamental decision is whether to buy, hold or sell a stock.

Three statements, together with notes and supplementary information, are presented to provide this information:

1 The Statement of Financial Position or balance sheet presents the enterprise's financial position: what it owns, what it owes to outsiders (ie, non-owners) and the residual equity of the owners.

The financial position of an enterprise is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates.

2 The Statement of Revenue and Expenses and, to a lesser extent, the Statement of Changes in Equity provide information on the performance of the enterprise. Performance is the ability of an enterprise to earn a profit on the resources that have been invested in it. Information about the amounts and variability of profits helps in forecasting future cash flows from the enterprise's existing resources and in forecasting potential additional cash flows from additional resources that might be invested in the enterprise.

3 The Statement of Changes in Financial Position (typically presented as a Statement of Cash Flows) provides users of financial statements with information they seek about the investing, financing and operating activities that an enterprise has undertaken during the reporting period.

This information helps in assessing how well the enterprise is able to generate cash and cash equivalents and how it uses those cash flows.

4 Notes and Supplementary Schedules and other information are also included in the financial statements intended to

(a) explain items in the balance sheet and income statement, (b) disclose the risks and uncertainties affecting the enterprise, and (c) explain any resources and obligations that are not recognised in the balance sheet.

It has long been recognized that financial statements have to satisfy certain criteria in order for them to meet their objective. The result of the efforts to ensure this is a significant body of accounting standards. In the case of major standard setters (FASB, IASB) a framework has been developed and is being enhanced to guide the standard-setting process. Among the results of some considerable effort in this regard is the identification of a set of characteristics which financial statements should possess. Accordingly, these inform the standards governing accounting, presentation and disclosure requirements. In Appendix I to this paper we list some of the characteristics that are currently part of the framework used by the IASB.

V.1.1 Limitations of Financial Statements

The education and empowerment of investors require recognition of some practical limitations of financial statements. There are some limitations on the producer side, and others on the user side.

On the producer side, it is important to recognize that there may be deficiencies because of difficulties that are inherent in the preparation and presentation of the financial statements.

Perhaps the most obvious is the human factor with the propensity to make errors, whether due to carelessness or genuine misunderstanding. We mention this even though the quality control processes are not expected to fail to prevent, or detect and correct, material errors in the published financials. Then there are the judgement issues, the “fuzzy” issues – those which lend themselves to varying interpretations so that the output of the process is dependent on the judgement of the preparer. In short, the accountancy profession struggles with the continuing challenge of effectively transforming ideas and concepts into a coherent set of statements that users will understand. Added to these inherent limitations is the cunning of those company officials who inflate company earnings by the use of a variety of financial gymnastics such as the aggressive (ie, early) recognition of revenues, the failure to make provisions for obsolete inventories or to effect write downs in investments, and other such tactics. These practices have even driven both the regulators and, as witness International Standard on Auditing ISA 240, *The Auditor’s Responsibility to Consider*

Fraud and Error in an Audit of Financial Statements, the practitioners in the accountancy profession to take stronger steps to improve the accuracy and, therefore, the usefulness of financial information that is presented to the investing public. The urgency of addressing the limitations on the producer side may have been spurred, in part, by the threat of suits, but, equally importantly, in part by the recognition that the conduct of some companies, the Enrons and the Worldcoms of our time, left much to be desired; and those who were part of the network of guardians did not bat well in their innings. These companies had moved from just playing with numbers to manufacturing numbers, while the press failed to see the unreality of the numbers reported, and the financial analysts, some of whom had gladly accepted the label of gurus, were completely duped.

The time taken for the production and eventual presentation of a set of audited financial statements is another inherent limitation of historical financial statements. This may beg the question of the timeliness and thus of the relevance of the reported information to an investor seeking to make smart, future-oriented decisions in a sometimes fast-paced, ever-changing environment. Can a user make a rational investment or credit decision on the basis of historical numbers presented in a set of financial statements published three months after the year end? The preparers do their best to try and capture any material events that may have occurred between the date of the company's financial year end and the date of the signing of the accounts, but is this sufficient? The loss of a major deal, the perpetuation of a fraudulent activity of great magnitude or the taking of a major investment decision are all events which may occur shortly after the signing of the audited accounts and be so fundamental as to change the positive outlook presented by the published accounts. Yet this is not disclosed to the investor; but could it be? Isn't this just another of the inherent limitations of historical financial statements with which we must live?

The producer-side limitations presented are not an invitation to dispose of your next set of audited accounts – they are certainly not useless! Historical information not only provides a background perspective on a management’s stewardship but can also identify useful trends (eg. revenue/cost relationships) to assist in the prediction of the entity’s future growth and profitability.

The users of financial statements are not only challenged by the producer-side limitations, but also some on the user side. Among them are the complexity of financial and accounting concepts and the plethora of additional disclosures that create difficulties for the average investor in extracting truly valuable information from financial reports in order to make informed decisions about the company.

A couple of examples related to IASs will highlight the challenges for the average investor:

- IAS 12, *Income Taxes*, requires companies to make deferred taxation provisions for “temporary differences” which arise between the carrying amount of an asset or liability and the amount attributed to them for taxation purposes. This practice has sometimes resulted in wide swings in a financial institution’s after- tax profits – a number commonly referred to by the average investor.
- IAS 39, *Financial Instruments - Recognition and Measurement*, requires companies to account for investments on the basis of how they classify them, those classifications being based on specified criteria. Such accounting can result in two companies owning the same investment at year-end marking it to market but including the resulting unrealized losses/gains in different sections of the financial statements (one in equity, the other in the statement of income and expenses), resulting in different assessments of each company’s performance by an investor (who is usually focused only on the profit statement).

Another limitation that users need to be aware of is that the financial statements will not disclose readily or at all, matters that maybe important determinants in investment-decision-making. Among such matters are such issues as competitive company/industry changes, the immediate impact of a bad acquisition decision, aggressive accounting or even financial position deterioration concealed by strong income numbers. While such trends can normally

be discerned from an analysis of the financial statements (eg. competitive issues from the gross margin ratio; management's efficiency in cost and tax management from the net margin ratio; quality of earnings from a review of the adequacy of provisions and write-offs, reasonableness of depreciation rates, etc; and cash flow quality from distinguishing between cash generated from normal activities as distinct from extraordinary/discontinued activities), they are best ascertained from review of additional disclosures.

Cisco's demise due to a downturn in the technology industry and competitive pressures caught investors by surprise but it should have been evident if proper assessments were done over a period.

Enron, a symptom of aggressive accounting and fraud, should have been predicted, given the deteriorating cash flows, decline in core earnings, etc., but investors failed to see the "writing on the wall" and even financiers were duped; and it is worth noting that some of these investors and financiers were among the most educated and empowered.

All is not lost, however, for there are things that can be done to ameliorate the worst consequences of some of the limitations.

V.1.2 Overcoming the Limitations of Financial Statements: The roles of the Analyst, the Financial Writer and the Regulator

It is here suggested that there are things that can be done in the face of the acknowledged limitations.

Here are some suggestions:

- Strengthening the education of users as it relates to the use of financial and non-financial information that is available currently.

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- Continuing the improvements in financial statements and other financial and non-financial disclosures.

- Placing greater reliance on analysts, financial writers in the media, and other similar

professionals in providing assistance to the unsophisticated retail investor.

Because the retail investor is always going to need help for the foreseeable future, even if the other desirable improvements proceed apace, the last point is of particular importance and we therefore make the following further comments:

As in any other sophisticated market, so in the market for stocks and other financial instruments, the financial analyst has a critical role to play in educating and empowering the investor. The financial analyst can add value to the investor's decision-making process by disseminating information based on his/her superior understanding of a firm's financial performance and future prospects, obtained through thorough analysis of financial statements and other available information – financial and non-financial.

Considerations such as differences in the required technical expertise, the circumstances under which legal liability could arise, and the incentive-based nature of the compensation of many analysts causes the analysts' role to differ markedly from that of the independent auditors. The auditors' role is to, based on the conduct of an audit in accordance with auditing standards, eg, ISA, express an opinion on the truth and fairness of financial statements, prepared in accordance with accounting standards - which preparation, in turn, accounts for transactions, events and circumstances, embodying easily verifiable exchanges and less verifiable judgements and estimates.

On the other hand, the analyst's role is to see beyond the historical data presented; through effective financial statement analysis, he attempts to get at managers' *inside information* from *public* financial statements and other disclosures.

Financial analysts are expected to specialize - to develop company and industry specific knowledge, thereby enabling them to assess the quality of a company's reported numbers and make any adjustments necessary to arrive at estimates of or judgements about sustainable cash-generating ability – which is primarily what wise investing is about. Analysts are also expected to evaluate the appropriateness of management's forecasts implicit in accounting method choices and reported accruals. These tasks require a thorough understanding of the company's business and the relevant International Financial Reporting Standards used in the

preparation of the financial statements and other reports. A skilled analyst will do a series of analyses before coming to a conclusion about a company's current financial position and its future prospects. Such analyses include:

- Business Strategy Analysis (identifying key profit drivers and business risks, and assessing the industry's and company's strategies)
- Accounting Analysis (analyzing the degree to which the company's accounting captures the underlying business reality)
- Financial Analysis (using financial data to evaluate the performance of a company and to assess its sustainability)
- Prospective Analysis (forecasting)

The analyst is expected to gain critical insights into a company and its prospects through various communications (meetings and conference calls) with its management during the year.

The analyst must seek to assume the role of a "bridge" between the management, the accountancy profession and the average investor. Another critical ally to the investors in their education and empowerment is the media. The media is considered the financial markets' watchdog, bringing light to company plans, distinguishing realism from idealism and searching out the truths from the half-truths – a role that must be taken seriously.

Yet another ally, and the focus of increasingly greater scrutiny, is the regulator. The regulator's role is even more critical than the analyst and media's, as it is often seen as one of the crucial drivers of investor confidence. The regulator is expected to establish frameworks which will require regulated enterprises to act in a safe, sound and judicious manner, even if this is not their natural inclination. They are also expected to have the inside scoop on any attempts at scurrilous practices of management and to "nip them in the bud" before their more serious consequences are realized. In the final analysis, the regulator does have a critical responsibility to the investing public.

We are unlikely to get very far in the debate about who has the greatest responsibility – company management, the auditor, the regulator, the analyst, the media. They all form part of the mix of skills and powers required for educating and empowering the investor.

V.2 INFORMATION OTHER THAN FINANCIAL STATEMENTS IN ANNUAL REPORTS

We have noted above that annual reports, often containing audited financial statements, financial highlights, Chairman's statement, Directors' report, Management Discussion and Analysis/Operations report, Segment reports, and Pictorial highlights, are one of the chief means of communicating with current and prospective investors. We have looked at the objective and some of the limitations of the financial statements contained in the annual reports. What of the other items in the Annual Report?

In the current Jamaican environment, the requirements for what should be contained in annual reports arise from the following:

The Jamaica Stock Exchange Rules

The current requirements of the JSE Rules regarding the disclosure in annual reports of listed issuers are in rules 408, Audited Financial Statements, and 409, Annual Report. They essentially require financial statements, prepared in accordance with International Financial

Reporting Standards, to be filed with the JSE within 90 and 120 days, respectively, of the financial year-end. The shareholdings of directors and senior management and their connected persons are required to be included in the annual report.

The Companies Act

The Companies Act has no specific requirements for items to be included in the annual report in addition to financial statements, other than the directors' report.

International Financial Reporting Standards

The International Financial Reporting Standards ("IFRS") (formerly International Accounting Standards ("IAS")) issued by the International Accounting Standards Board deal mainly with the accounting treatments and disclosures in financial statements of particular transactions or items of the financial statements. Since the focus of this paper is to explore adequate and useful disclosures in annual reports rather than the accounting treatments and disclosures for a particular transaction or item, issuers may refer to the appropriate IFRS/IAS for the relevant requirements.

As a general rule, financial statements of enterprises covered by the above-listed requirements comply, or substantially comply, with such requirements.

It should be noted, however, that some of the requirements are really quite a 'bare-bones' presentation of a few facts and figures: this is particularly true of the directors' report. Some of the voluntarily included items – the Chairman's Statement, the management review and the financial highlights do provide additional information but, anecdotally, is sometimes regarded as not being sufficiently detailed, analytical and incisive, with some persons, for those reasons, regarding them as public relations pieces.

There is need for more detailed research; however, the most significant lack appears to be of forward-looking/strategic non-financial information. Except for a few notable exceptions that provide reasonably detailed Management Discussion & Analysis ("MD&A") and quantitative as well as narrative financial and non-financial information, management needs to commit itself to the voluntary provision of such information – incremental to the financial statements. In the absence of the voluntary provision of such information, the interests of empowering investors may require that additional disclosures be mandated.

V.3 Limited comparison of annual report requirements in Jamaica and a developed market

The Appendix to this paper contains a list of some of the disclosures required by some international (USA) regulators and exchanges. It is evident from the list presented there that the requirements are quite detailed and voluminous. They cover financial and non-financial, quantitative and narrative disclosures far in excess of the requirements in the local environment. They include much more forward-looking/strategic non-financial information. This may be partly explained by the scale and complexity of environments like that in the USA. Nevertheless, they provide examples of the direction in which we may look to enhance the local requirements.

V.4 Disclosures and communications other than in annual reports

The JSE rules have requirements for the filing of quarterly reports by companies whose stocks are listed and traded on the exchange. This is provided for in Rule 407, which does not provide detailed requirements, but simply states that the quarterly financials should comply with the provisions of IFRS. The other requirement is for shareholdings of Directors and Senior Management and their connected persons, and the shareholdings of those persons holding the ten (10) largest blocks of shares to be included in the report.

These requirements are basic compared to the voluminous submissions that are required in, say, the USA.

In relation to the communication of **other information** to the public, the JSE's Rule 410 outlines the *modus operandi* for such announcements, stating:

“Prior to or concurrently with any public announcement every listed company shall forward to the Exchange notification of all dividends, profits, issues, expansion programmes and any other changes including any information necessary to enable share/stockholders to appraise the position of the company and to avoid the establishment of a false market in the company's securities.

It is appreciated that it is impossible to ensure that all shareholders and everyone interested in the securities of a company obtain the information simultaneously but a company can ensure that as large a proportion as possible have the information so that no transaction takes place in which one party or his agent is in possession of information of which another is not.”

VI DETERMINING THE NATURE AND ADEQUACY OF DISCLOSURE

Most persons would likely agree that additional disclosure would contribute to the education and empowerment of investors. What is not clear, however, is this: when is disclosure adequate? Are there objective criteria against which adequacy may be measured?

The existing legislated reporting requirements are based on a model of reporting tied to financial statements. With increasing frequency and vigour it is being argued that this is not adequate. This point was made tellingly by Robert K Elliott, then Immediate Past Chairman, AICPA, on June 7, 2001, in oral testimony to the US House Sub-committee on Capital Markets, Insurance and Government-Sponsored Enterprises. An extract from his testimony is included at Appendix III.

The process of determining adequacy usually starts with determining what investors needs are and, therefore, what it takes to meet those needs. The American Institute of Certified Public Accountants (“AICPA”) sought an answer to that question. It appointed the Jenkins Committee and in 1991 commissioned it to recommend techniques by which business reporting could be improved. The Committee emphasized that business-reporting (as distinct from financial reporting) information should be aligned to the needs of the users of the reports. In summary, it proposed a model which, included the following key concepts, among others (as reported in CA Magazine April 1995):

THE 10 ELEMENTS OF THE JENKINS COMMITTEE’S MODEL OF BUSINESS REPORTING

Financial and non financial data

- Financial statements and related disclosures
- High-level operating data and performance measurements that management uses to manage the business

Management’s analysis of the financial and non financial data

- Reasons for changes in the financial, operating and performance-related data, and the identity and past effect of key trends

Forward-looking information

Opportunities and risks, including those resulting from key trends

- Management’s plans, including critical success factors
- Comparison of actual business performance to previously disclosed opportunities, risks, and management’s plans

Information about management and shareholders

- Directors, management, compensation, major shareholders, and transactions and relationships among related parties

Background about the company

- Broad objectives and strategies
- Scope and description of business and properties
- Impact of industry structure on the company

Included in the above headings would also be material addressing the following objectives:

1. Report on each business segment of a company's business having diverse opportunities and risks
2. Explain the nature of a company's businesses, including the linkage between events and activities and the financial impact on a company of those events and activities
3. Indicate the relative reliability of the different types of information in business reporting
4. Focus on measurements that help users understand a company's performance relative to that of competitors and other companies It has been proposed that, using criteria such as these, a disclosure index could be established against which published annual reports could be measured. Some thinkers have attempted this. One such attempt restricted the criteria to non-financial disclosures. The authors, Robb, et al, (2001) came up with a disclosure index based on a scoring system that attributes ratings to the annual reports, in turn, based on two key sets of indicators, each of which had a subset of three categories of items, with each group having several items, the numbers of which are shown in parentheses below.

1. Forward Looking Non-Financial Information (31)

- Environment around the company (12)
- Strategy and management (14)
- Company trends (5)

2. Historical Non-Financial Information (34)

- Environment of the company (7)
- Production (18)
- Customers (9)

Weights were assigned to each of the items according to the extent of disclosure, viz: 1 (no disclosure), 2 (some disclosure) or 3 (extensive disclosure).

Someone may wish to design a similar model for evaluating disclosure by companies whose stocks are listed on the JSE. The emphasis would, as in the case above, need to be on non-financial disclosure since an incredible amount of work has gone into financial disclosures, as witness IFRSmandated disclosures in financial statements.

VII CHALLENGES AND DETERRENTS TO EXPANDED DISCLOSURE

If the desire for strategic, forward-looking, soft, qualitative and other types of non-financial information is so strong and the support from researchers for its delivery is so great, why is there so little progress providing it? There are, no doubt, many reasons for the slow pace of change.

One of them is cost. Even when one filters out what investors and those who advise them *want*, and gives them only what they *need*, there would still very likely be some significant costs in moving to the type of disclosure being proposed by some. Cost, though, is not just cost in cash terms. One must add the cost measured in terms of losses of competitive advantage, particularly in those markets where one reporting enterprise is issuing business reports containing information that other enterprises are not required to disclose. An example of such information is segment information. A significant challenge that remains is how to ensure that costs do not exceed benefits. In considering this, however, one should be encouraged by the lessons learned in overcoming earlier cost-inspired resistance. One such lesson is the significant progress made in the use of fair values in financial statements.

Though it is still not a perfect science and fair value amounts have to be read in the context of disclosures about how they are determined, it is reasonable to suggest that progress has been made and benefits exceed costs.

Another important reason is the litigation threat. Hear how Jenkins puts it in an interview with CA Magazine in April 1995:

We were trying to make two points, at least, in this area. One is that it's absolutely clear that investors and creditors, and the capital markets, would benefit significantly if they had better information of a forward-looking nature. Today, in most countries, providing that information is restricted because of the litigation threat.

The CEO of an established high-tech public company, which had just settled a class-action claim concerning forward-looking information, was upset that we were encouraging such information in business reporting. "I have information that I know would be useful to my shareholders and potential shareholders," he told me, "but I dare not provide it [for fear of litigation]."

So who are the losers with this litigation problem? Well, the companies are victims, the auditors, as well. But the biggest losers are probably the investors, because they're not getting information on which to make the best decision.

The second point is the need for deterrents to this unwarranted litigation, through legislation, or safe harbours, or other means. I find it very encouraging that the SEC is now asking for input on how to develop safe harbours. Our committee really didn't feel qualified to come up with what these deterrents might be. Our recommendation was designed to (1) make the point about the value of forward-looking information and (2) encourage those that have the responsibility and the means, perhaps, of developing those deterrents to get at it.

VIII SUMMARY AND CONCLUSIONS

From what we have stated or implied herein, it will be evident to all from the cumulative experiences of both the developed and emerging markets that, try as we might, the small investor would be hard-pressed to approach anything like the level of education and empowerment suggested in the working definition of education and empowerment set out earlier. We would suggest that a significant part of their empowerment is the empowerment of those who act on their behalf – the regulators, analysts, media, independent auditors and other professionals.

The significant efforts being made to improve accounting and financial disclosure must continue – and we see this happening with improved accounting standards, such as IFRS. It is evident that there is a significant role for demanding accounting rules and more stringent requirements for financial statement disclosure. However, voluntary disclosure of non-financial information, both historical and future-oriented, must be strongly encouraged. Yet it is very likely that, in relation to non-financial information, management will need to be nudged. Some have argued that it is the market that should be allowed to do the nudging by rewarding companies that provide information relevant to users' needs. Others have argued that there is a need to move beyond voluntary disclosure – to legislation and regulation – as we see happening in some developed markets now.

Caution is urged, however, as it is important to consider and deal effectively with the issues that attach to requiring softer, more qualitative information in addition to financial statements and other financial information. These include issues such as costs, protection of competitive advantage, and deterring unwarranted litigation.

Appendix I

EXAMPLES OF NON-DISCLOSURE IN RECENT BUSINESS FAILURES IN THE USA ENRON

Top executives in this company used ‘creative accounting’ methods by:

- 1) recording 1.4 billion dollars as revenue when it was in fact money from a series of loans;
- 2) employing off balance sheet financing vehicles as a mechanism for nondisclosure of loans. These vehicles, dubbed ‘special purpose entities’, were given immunity from losses. Participants in these schemes were shielded while investors bore all the risks. These vehicles were facilitated through the Board of Directors waiving the conflict of interest restriction thereby permitting executives of Enron to manage partnerships which would engage in business with Enron;
- 3) non-disclosure of the companies business model; and
- 4) non-disclosure of any information which would portray the company’s failing financial strength/health

GEN. ELEC GE Capital, a unit of General Electric, was identified as its chief profit earner.

However, very little about the unit was disclosed, thereby preventing knowledge of what resources were being used to generate revenue. When the CEO retired from office, the share value of the company fell appreciably. The new CEO adopted a policy of providing much more financial information about the unit. These disclosures revealed that the company had been absorbing expensive living costs for the previous CEO not only while he was employed but during his retirement.

MICROSOFT The company employed the strategy of understating and overstating its revenue at times in an endeavour to portray a quarter by quarter smooth progression of increases in the mid 1990s. This smooth progression would be regarded favourably on Wall Street. Although this activity did not serve to lower the Microsoft share price, this

manipulation of the records was a clear case of fraud.

WORLDCOM In a bid to maintain the company's high share price, the chief financial officer and controller manipulated data to hide the company's costs and to increase profits. This was facilitated by a highly centralised financial reporting policy in the company whereby only a chosen few individuals had access to the company's profit and loss statement. Consequently this type of fraud went undetected for years.

Appendix II

QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

The usefulness of financial statements is, *inter alia*, a function of their ability to convey information of the type and in the manner that facilitates economic decisions by investors, creditors and other users –ie, to be useful they must possess certain qualitative characteristics.

There are four principal qualitative characteristics:

- Understandability
- Relevance
- Reliability
- Comparability

Understandability: Information should be presented in a way that is readily understandable by users who have a reasonable knowledge of business and economic activities and accounting and who are willing to study the information diligently.

Relevance: Information in financial statements is relevant when it influences the economic decisions of users. It can do that both by (a) helping them evaluate past, present, or future events relating to an enterprise and by (b) confirming or correcting past evaluations they have made. Materiality is a component of relevance. Information is material if its omission or misstatement could influence the economic decisions of users.

Timeliness is another component of relevance. To be useful, information must be provided to users within the time period in which it is most likely to bear on their decisions.

Reliability: Information in financial statements is reliable if it is free from material error and bias and can be depended upon by users to represent events and transactions faithfully.

Information is not reliable when it is purposely designed to influence users' decisions in a particular direction. There is sometimes a tradeoff between relevance and reliability, and judgement is required to provide the appropriate balance.

Reliability is affected by the use of estimates and by uncertainties associated with items recognized and measured in financial statements. These uncertainties are dealt with, in part, by disclosure and, in part, by exercising prudence in preparing financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, prudence can only be exercised within the context of the other qualitative characteristics in the Framework, particularly relevance and the faithful representation of transactions in financial statements. Prudence does not justify deliberate overstatement of liabilities or expenses or deliberate understatement of assets or income, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

Comparability: Users must be able to compare the financial statements of an enterprise over time so that they can identify trends in its financial position and performance. Users must also be able to compare the financial statements of different enterprises. Disclosure of accounting policies is essential for comparability.

There is no doubt, therefore, that a properly prepared set of financial statements will provide much valuable information for decision makers.

Appendix III

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SOME OF THE DISCLOSURES REQUIRED ON SOME INTERNATIONAL EXCHANGES

1 Corporate Overview

2 Business Description

Summary, Business overview, Regulatory framework, Property, Legal proceedings.

3 Management Discussions and Analysis/Operating and Financial Review

Overview, Group operating performance, Review by division/segments, Liquidity and capital resources, Cash flow, Disclosures about market risk, Five year summary, Critical Accounting policies and estimates, GAAP reconciliations, Risk factors.

The Securities and Exchange Commission (SEC) in the US, on regular basis, provides its views regarding disclosure and improved ‘quality of information’ that should be considered by companies in the Management’s Discussion and Analysis (“MD&A”) section of Form 10-K (Annual Report), Form 10-Q, and registration statements filed with the SEC.

The companies are **required** to disclose a whole range of matters in the ‘MD&A’ section of the Annual Report. These include the following:

Earnings

Dividends

Business activities

Results of operations – Revenue; expenses; other business activities; effects of inflation; future earnings potential; restructuring; environmental matters; regulatory matters; income tax matters; other matters Accounting policies; new accounting standards

Financial condition and liquidity – Overview; sources of capital; financial activities; offbalance- sheet financial arrangements; credit risk; market price risk; capital

requests; contractual obligations

Cautionary statement regarding forward-looking information

Strategic goals

Estimated capital expenditure

Projections - dividend payout

EPS

In addition, they are also required to disclose in this section, their critical accounting policies, accounting estimates made in applying these policies, related qualitative and quantitative disclosures and the likelihood of a material change in the company's financial statements under different conditions or using different assumptions to arrive at these accounting estimates. The MD&A must discuss all known trends, demands, commitments, events and uncertainties that are reasonably likely to have a material effect on the company's financial condition, results of operations, liquidity and capital resources. This has improved disclosure in three specific areas - liquidity and capital resources, including off-balance sheet arrangements; certain trading activities involving non-exchange traded contracts accounted for at fair value; and relationships and transactions with persons or entities who derive benefits from their non-independent relationship with the registrant or the registrant's related parties.

4 Corporate governance

Social, environmental and ethical report, Directors and senior management, Directors' report, Directors' remuneration report.

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5 Shareholder information

Trading market, Dividends, Exchange rate information, Exchange controls and other limitations affecting security holders, Taxation, Memorandum and Articles of Association, Material contracts.

6 Additional recent reporting and disclosure obligations

The annual report reporting and disclosure obligations for public companies in the USA have significantly changed in recent years as a result of the Sarbanes-Oxley Act of 2002 (the SOX Act) and SEC rules promulgated under the Act. The annual report reporting and disclosure obligations also have been impacted by anew corporate governance standards and disclosure rules recently adopted by the national securities exchanges and national securities associations, new SEC rules relating to nominating committee functions and security holder communications with directors and new SEC MD&A interpretive guidance

In view of the heightened sensitivity of regulators and shareholders, it is essential that all public companies fully understand and comply with the new disclosure obligations and MD&A guidance. It is clear that the SEC, shareholders and watchdog agencies will be carefully reviewing upcoming annual reports and proxy statements to ensure compliance with the new standards. In addition, experience during 2003 revealed that the staff of the SEC has become aggressive in requiring prompt amendments to annual and other periodic reports if a company's disclosures did not comply with applicable requirements. It can be expected that this trend will continue in 2004.

- **Majority of Independent Directors.** Subject to certain limited exceptions, all listed companies are required to have a majority of independent directors on their boards. Boards of directors must now make affirmative determinations regarding each director's

independence.

- ***Additional Audit Committee Disclosures.*** All companies whose securities trade in the U.S. should comply with certain minimum standards regarding the composition and functions of their audit committees, including the independence of all audit committee members.
- ***Audit Committee Financial Expert.*** Domestic reporting issuers must now disclose in their annual reports whether their board of directors has determined that the issuer's audit committee has at least one member who is an "audit committee financial expert" as defined by the SEC.
- ***Security Holder Communications with Directors.*** Under new SEC rules, a company must disclose in its proxy statement whether or not the board of directors has a process for security holders to send communications to directors and, if not, the basis for the view of the board of directors that such a process is inappropriate.
- ***Codes of Ethics and Codes of Business Conduct.*** Domestic reporting issuers must now disclose in their annual reports, either directly or through incorporation from their proxy statements, whether they have adopted a written code of ethics. The code of ethics must meet specified standards and must apply to the issuer's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. An issuer must make its code of ethics publicly available either by filing a copy of its code as an exhibit to its annual report, posting the text of its code (or the relevant portions) on its Web site, or undertaking in its annual report to provide a copy of its code to any person without charge upon request.

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- ***Other NYSE and Nasdaq Requirements.*** The NYSE requires companies to disclose in their proxy statements (i) the name of the director, if any, chosen to preside at required executive sessions of non-management directors or, alternatively, the procedures by which a presiding director is selected; and (ii) the method by which interested persons can communicate directly with the presiding director or the non-management directors as a group.

- ***MD&A Aggregate Contractual Obligations.*** In its MD&A, a company is now required to disclose in tabular format the amounts of payments due under specified contractual obligations, aggregated by category of contractual obligation, for specified time periods. The required categories are: long-term debt obligations; capital lease obligations; operating lease obligations; purchase obligations; and other long-term liabilities reflected on the company's balance sheet under GAAP. The table should include footnote disclosures to describe provisions that create, increase or accelerate obligations, and other pertinent data.

In addition to the foregoing, the SEC issued two important MD&A releases in 2003 that are required reading for all persons involved in the MD&A drafting process. Issued in early 2003, the first release summarized staff disclosure comments from its review of annual reports for 2001 filed by Fortune 500 companies in the following 10 categories: MD&A generally; critical accounting policies; non-GAAP financial information; revenue recognition; restructuring charges; impairment charges; pension plans; segment reporting; securitized financial assets; and environmental and product liability. The second, a general interpretive release issued in December 2003, encourages senior-level management participation in the MD&A drafting process and provides specific guidance regarding:

- the overall presentation and focus of MD&A (including, through executive-level

overviews, a focus on the most important information and a reduction of duplicative information);

- emphasis on analysis of financial information;
- known material trends and uncertainties;
- key performance indicators, including non-financial indicators;
- liquidity and capital resources; and
- critical accounting estimates

Appendix IV

Extract from oral testimony Robert K Elliott, then Immediate Past Chairman, AICPA, on June 7, 2001, the US House Sub-committee on Capital Markets, Insurance and Government-Sponsored Enterprises “The current financial reporting model — in the U.S. and overseas — is very much based on the assumption that profitability depends on physical assets, like plant and machinery; on raw materials, like coal, iron ore, sheet metal, electrical wire, and plastic; in other words, on the tangible assets needed to produce tangible products. This is the financial reporting model of the industrial age.

But, as we all know, we are no longer in an industrial age. We still have elements of it, of course, and we always will, but we have moved deeply into the information age. Today’s economy is different from anything we have dealt with before. It is founded upon new technologies, globalization, and the increasing importance of intangibles, such as brands, relationships, people, systems, and knowledge. Companies are creating value in different ways, using new combinations of tangible and intangible assets. In fact, it is the combination and interaction of various types of assets that will determine a business’s economic success.

Those looking to deploy their capital do not restrict the kind of information they use to only financial information. They also use non-financial information, such as information about top executives, product developments, and capacity for innovation. There should be no surprise here that non-financial information has been considered useful. [This Committee’s predecessor in 1991 required insured depository institutions to begin to report on internal controls and auditors to express an opinion about management’s assertions.

There is good reason to believe that the accounting model should not be limited to financial information. [The]...Jenkins Committee described investor information needs that go far beyond what is required by the current financial reporting model and included non-financial information.

In fact, to capture the idea of reporting non-financial information, the Jenkins report adopted the broader term “business reporting.”

Consider the effect of the amount and quality of information on economic growth. Capital must be deployed where it can be most productive, or it will not contribute maximally to economic growth. At the root of productive investment is information. Those with capital cannot select the most productive companies unless they have information that lets them pick winners — information that reflects how value is created by companies today. Yet most of this information is not recognized by the current accounting model.

The timeliness of business information is as critical to its usefulness as its relevance. This is another area where progress can be made. Many companies already make investment information available on their Web sites. Cisco Systems, for example, can “close its books” — traditionally a process measured in weeks — in mere hours.

The capabilities I have been describing will allow a frequency and richness of disclosure that is more helpful to investors, because it is more closely aligned with the pace of change in corporate prospects.”

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