Regulating Corporate Annual Reports in Australia

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The purpose of the corporate annual report is to communicate information to the corporate shareholder and other stockholders (or potential stockholders). The information should communicate the financial condition of the enterprise, and provide other information that would likely be of interest to the user. It is the shareholder who is the owner of the company, and it is the existing shareholder who must be the primary audience. As owners, the shareholders have the primary right to determine what information they would like disclosed, whether preparers or other users believe that to be so. The corporate annual report is also the main communication vehicle that managers have to communicate the effectiveness of their accomplishments in meeting their fiduciary duties and carrying out their stewardship functions in the organization. So, it is the shareholders, both institutional and individual, that ultimately must determine the form and content of the annual report, rather than the accountants, auditors, or corporate management.

The process of communication requires that the receiver be informed. If there is no understanding by the receiver of the material being communicated, no informational value is contained therein, and the communication has no value. If corporate managers want to communicate effectively with the owners, they must attempt to communicate in a language that the shareholders understand.

In this paper I examine perceived changes in the usefulness of corporate annual reports to individual investors in Australia over time, using a comparison of 1996 survey results [Anderson and Epstein, 1996] with the earlier Anderson study conducted in 1978 [Anderson, 1979]. The 1978 to 1996 time period is of particular interest, given that corporate legislation has become more demanding in terms of disclosure, the accounting standard-setting process has been overhauled, stock exchange listing requirements increased, and government intervention occurred. Further, over this period the Australian financial system was deregulated, a number of major corporate crashes took place, and global events such as the share market crash and recession occurred.

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Regulatory Environment

The regulation of financial reporting is designed to improve the quality and uniformity of corporate financial reporting. Within Australia the three main regulatory sources have been corporate legislation, the accounting profession, and the stock exchange, and each has had as its goal the protection of the public interest through the regulations prescribed.

Corporate Law

Prior to Federation in 1901, the Australian colonies (later states) inherited existing English law but not their company legislation [Gibson, 1971, p. 24]. Nevertheless, the Australian colonies formulated corporate legislation in the decade following the United Kingdom's Joint Stock Companies Legislation and Regulation Act 1844. This legislation was modeled on the enacted English Acts. Western Australia, constituted as a colony, enacted its first legislation on companies in 1858. Subsequently, the other colonies passed their own legislation, usually based on the existing English Act.

Early legislation, while similar in purpose, was colony-based, and calls for the creation of a federal power to coordinate such legislation only arose following the corporate collapses of the 1890s [McQueen, 1991, p. 22]. These corporate collapses, with resulting losses to investors, created public concern about the failure of colonies to protect them against corporate abuse. One colony which responded to these events was Victoria, which in their 1896 Act made it compulsory for public companies to present an annual audited financial statement. However, it was not until the 1928 Act in Victoria was passed that disclosure of the contents of the balance sheet became mandatory. This development reflected the view held for many years [Littleton, 1953; Chatfield, 1978] that the balance sheet was the primary financial statement of regulated financial disclosure. This was also reflected by the fact that the Act contained no provisions as to the contents of the profit and loss statement except for requiring disclosure of directors' remuneration. While some uniformity of disclosure across the States had been achieved by the late 1920s, it was observed [CIA, 1931, p. 232] that "...when the business history of Australia is written, future generations will marvel at the unique and somewhat ridiculous spectacle of a comparatively small business community allowing itself to be shackled and confused with some thirty-odd Companies Acts..." The Great Depression and the Royal Mail case of 1931 were responsible for further changes in the Companies Act in 1938, with the profit and loss statement being required to clearly separate current and non-recurring items, and to specify separate identification of the net balance of profit or loss on trading, income from investments in subsidiary companies, profit or loss arising from a sale or revaluation of fixed or intangible assets, and amounts transferred from reserves or provisions.

In the same Act, consolidated statements were first legislated, requiring a profit and loss statement and balance sheet for each subsidiary, or the inclusion of the consolidated statements of the parent and its subsidiaries with

the parent company accounts [Whittred, 1988, p. 104]. Seventeen years later, the Companies Act was amended to require disclosure of abnormal items which had affected the determination of profit, together with disclosure of any change in accounting principles. This reinforced the increasing importance of the profit and loss statement over the balance sheet.

At the time of the first survey the statutory provisions governing financial statements were contained in the Uniform Companies Act (1961). This Act had to be passed by each state Parliament as an Act of that state, but it did end the isolated approach to corporate law. Under section 161 of this Act, accounts meant profit and loss accounts and balance sheets including notes attached or intended to be read with these items. Under the Act no particular form of presentation was required, but the content of the accounts were governed by the Ninth Schedule of the Companies Act. The annual accounts had to be accompanied by a statement by the principal accounting officer that the accounts gave a true and fair view (s.162) and by a directors' report under section 162A. The contents of the directors' report provided the names of the directors in office, the principal activities of the company and whether there had been any significant change in the nature of these activities during the year, the net profit or loss for the financial year after tax, whether circumstances not dealt with in the report would render any amount stated in the accounts misleading, whether the results of the company's operations were affected by an event, item, or transaction of a material and unusual nature or such had occurred between the end of the financial year and the date of the report. The Ninth Schedule, while not limiting the contents of the profit and loss account and balance sheet, prescribed information that must be included.

In 1974 the Interstate Corporate Affairs Commission was established to improve reciprocal arrangements and procedures for companies. Companies incorporated in one state were no longer treated as a foreign company by other states and instead were given recognized company status. It was clear by then that a national uniform company law and administration was needed, and in 1977 the ministers responsible for corporate affairs agreed to a general framework for a cooperative commonwealth and states scheme to regulate companies and securities matters. In December 1978 a formal agreement detailed the elements of the regime, which included uniform and complementary Commonwealth and State companies and securities legislation and uniform administration by State and Australian Capital Territory corporate affairs authorities by delegation from a new body, the National Companies and Securities Commission (NCSC). The main legislation for the new regime was the Companies Act 1981 (Cth) which essentially was a consolidation of earlier companies legislation with some reforms included from the National Companies Bill. Each State enacted application statutes applying the contents of the Act as part of the laws of that State. The NCSC had administrative powers conferred on it by the legislation, but each State retained its own administration. The NCSC also made uniform policy but delegated to the States the routine matters involved, although maintaining a regulatory role in takeovers.

In 1981 the National Cooperative Scheme was introduced, which developed national legislation applicable to all the states. Subsequently, under the 1981 Companies Act, further changes were introduced with the requirement that a balance sheet and profit and loss statement be prepared and presented to shareholders at an annual general meeting, accounts should show a "true and fair view," accounts be in accordance with approved accounting standards, and also comply with the disclosure requirements of the 7th Schedule. The new 7th Schedule, to be adopted for the 1986 financial year, imposed a prescribed format for profit and loss statements and balance sheets, differential disclosure for different companies, disclosure of directors and executives remuneration, disclosure of trading activities involving economic dependency upon another party, superannuation commitments, audit fees, material interests in businesses, profit or loss on material revaluation or devaluations of non-current assets and abnormal items, extraordinary items, and profit or loss arising from the use of equity accounting.

In 1987 a Senate Standing Committee on Constitutional and Legal Affairs reported that the co-operative regime had outlived its usefulness and that there should be a single commonwealth regime. In 1989 the Commonwealth Parliament enacted the Corporations Act 1989 as a national law governing companies and securities without the need for State cooperation. It was accompanied by the Australian Securities Commission Act. The Acts, when drafted, relied on s.51 of the Australian Constitution as the authoritative basis for such legislation. However, the Acts were not proclaimed in anticipation of a constitutional challenge on whether s.51 gave the Commonwealth power to make corporate legislation operative in Australia. In a High Court case, NSW v. Commonwealth (1990) 169 CLR 482, three states challenged the legislation and it was held that s.51 (xx) of the Commonwealth Constitution did not allow the Commonwealth to make a law for the incorporation of trading or financial corporations as distinct from regulating their activities once they were created.

In 1990, a Heads of Agreement of the Commonwealth, State and Northern Territory Law Officers agreed on the preparation of uniform legislation based on the Corporations Act 1989 and the Australian Securities Commission Act 1989 with necessary amendments. This Heads of Agreement obviated the need to rely on the corporations power in s.51(xx). The Commonwealth could now base its constitutional validity of the 1989 provisions of the Corporations Act 1989 (Cth) and the Australian Securities Commission Act 1989 (Cth) with the 1990 amendments, on the Commonwealth's legislative powers under s.122 of the Commonwealth Constitution, and enable the legislation to govern companies and securities in the Australian Capital Territory.

On 1 January 1991, national legislation came into operation and is cited as Corporations Law and governs corporations, securities, and the futures industry. Under Corporations Law annual accounts are still required and its regulations prescribe the format for the profit and loss statement and balance sheet together with other required disclosures. The content of the directors'

report is specified and in addition to previous disclosures it also must include details of any dividend paid or proposed, date on which any share options granted in the company and any directors' benefits arising as a result of a contract made by the company with an outside entity. For public companies additional details included in the report are qualifications, experience and special responsibilities of directors, shareholdings in the company, and specific details of interests in contracts with the company.

The administering authority for the Corporations Law become the Australian Securities Commission. Its functions include regulation of the securities industry by licensing professional participants, monitoring securities exchanges, and by policing provisions of the Corporations Law [Baxt et. al, 1988, p. 7]. Section 298 of the Corporations Law requires the directors of a company to ensure that the accounts are made out in accordance with applicable Accounting Standards.

Accounting Standards

A feature of Australian financial reporting was the reliance on legislative regulation to govern the form and content of disclosure in annual reports. Professional accounting bodies, while formed as early as 1885, were not active in the prescription of accounting methods and disclosure by Australian companies. Of the professional bodies, the Institute of Chartered Accountants was the first to issue any statement which could be viewed as a forerunner to the accounting standards. In 1946, the Institute issued a series of five Recommendations of Accounting Principles which covered the treatment and disclosure of various items. However, such recommendations were not prescribed, reflecting the view within the profession that setting accounting standards was not the profession's role.

Changing attitudes within the profession were driven by both financial and political factors. The 1960s saw a significant number of companies fail even after the auditor had certified accounts as "true and fair" [Peirson and Ramsay, 1983, p. 289]. These failures brought public criticism, and with it threatened government intervention, which led the two main accountancy bodies in Australia to form, in 1966, a joint research body, the Australian Accounting Research Foundation (AARF). However, by the time of the first study in 1978, only thirteen standards had been issued and this lack of progress could be attributed to poor funding support for research, and the profession's concern with trying to solve the accounting problems caused by inflation.

At the same time, the profession was unable to legally enforce its standards and as well could not require compliance by non-members of the accountancy profession [Zeff, 1973, p. 6]. In 1978 the two professional accounting bodies reorganised this arrangement and created under AARF an Accounting Standards Board (AcSB).

A year earlier, Frank Ryan [1977], the Commissioner for Corporate Affairs for New South Wales, argued that the objective of standards was to

introduce a definitive concept of what gives a true and fair view and this could not be achieved without legislative support to ensure compliance. At the time the National Companies and Securities Commission (NCSC) had responsibility for policy and administration with respect to company law and the regulation of the securities industry. The professional accountancy bodies submitted to the NCSC that the standards review function stay in their hands, but this view was not accepted. In 1984 the Accounting Standards Review Board (ASRB) was established with legislative power to approve standards, from the profession or any other source. The ASRB [Peirson and Ramsay, 1983, p. 289] was to:

- determine priorities for reviewing and approving accounting standards;
- sponsor the development of accounting standards;
- review accounting standards referred to it;
- seek expert advice;
- conduct public hearings into whether a proposed accounting standard should be approved;
- invite public submissions; and
- approve accounting standards.

By 1987 it was clear that having two standard-setting boards was not efficient and conducive to the standard-setting process and in the following year it was agreed that the ASRB would be the sole standard-setting body for the private sector. The AcSB was dissolved.

With the Corporations Law introduced in 1990 the standard-setting process again changed. Under section 224 of the Australian Securities Commission Act 1989 an Australian Accounting Standards Board (AASB) was created to replace the ASRB. The functions of the AASB, which commenced operations from the beginning of 1991, were expanded beyond those of the ASRB to reflect its explicit role as a standard-setting body.

The major functions of the AASB were specified in section 226 as follows:

- to develop a conceptual framework, not having the force of an accounting standard, for the purpose of evaluating proposed accounting standards;
- to review proposed accounting standards;
- to sponsor or undertake the development of possible accounting standards;
- to engage in such public consultation as may be necessary to decide whether or not it should develop a proposed accounting standard; and
- to make such changes to the form and content of a proposed accounting standard as it considers necessary and has the power to make accounting standards under section 32 of the Corporations Law.

By the time the 1996 study was undertaken, the AASB had issued over twenty accounting standards.

Stock Exchanges

Another regulatory force in the financial reporting process has been the Stock Exchange. Stock Exchanges in Australia are privately constituted, autonomous bodies developed primarily to provide markets for shares and other securities of companies. Its regulatory role is derived through its listing rules which seek to ensure adequate disclosure by companies as a means of protecting the interests of the investing public. Companies with their shares listed on the Stock Exchange must comply with these rules and failure to do so may lead to the removal of securities from the market. Rudimentary listing requirements were introduced by the Stock Exchange before 1900, although printed rules did not appear until 1925 [Gibson, 1971, p. 75].

In 1970 the State stock exchanges were private regulators, but this changed with the introduction by the various states of a Securities Industry Act. This legislation was a response to the stockbroking profession's inability to properly regulate itself as documented by the Rae Report. The recognition of public interest and the need to maintain an efficient competitive and informed stock market led to subsequent regulations in 1975, which widened the enforcement of the rules beyond the parties to the contract.

Just prior to these amendments to the Security Industries Act, a formal relationship between the official list requirements and accounting standards was established, with the listing rules being modified to include the preparation of published accounts in accordance with accounting standards issued at the time.

In 1987 the State stock exchanges merged as one national body titled "The Australian Stock Exchange Ltd" (ASX). The ASX is an incorporated company and operates under s.9 of the Corporations Law as a stock exchange. Under Corporations Law there are two types of rules, Listing Rules and Business Rules. The Listing Rules, defined in section 761 of the Corporations Law, controlling companies listed on the exchange, are required under Corporations Law section 769(2)(d) and (e) to make satisfactory provision for trading of securities and for the protection of the interests of the public including the provision of a fidelity fund. They aim at full corporate disclosure by setting out "rules for the listing of companies, rules designed to ensure an adequately informed market, rules to govern the orderly conduct of trading and settlement, and a limited number of additional rules to regulate companies' activities" [ASX Discussion Paper 4, 1990].

The ASX aims are based on four principles: 1) the listing and quotation principle, under which an entity must satisfy minimum standards of quality, size, operations, and disclosure so as to trade in the market; 2) the need to keep the market informed under the market information principle; 3) ensuring that every listed entity operates to the highest standards of integrity, accountability, and responsibility under the regulatory principle, and 4) commercial certainty as to the fulfilment of contractual obligations under the trading and settlement principle [ASX Exposure Draft, April 1995].

The listing rules specify the minimum level of disclosure, and in 1992, continuous reporting was introduced, under which listed companies are to report immediately any change in principal activities, in expectations, and in accounting policies that is likely to have a material effect on reported profit.

An examination of the three regulatory sources reveals that the period between the two surveys was one of considerable development. Historically, corporate law was aimed at protection of members and creditors of a company by periodic disclosure through financial statements, and this basic objective is still unchanged. Similarly, accounting standards which impose accounting rules and financial disclosure are also another way of protecting the interests of shareholders. By prescribing reporting requirements, accounting standards can ensure comparability of accounting information disclosed to investors by companies and better measure performance. To the extent that accounting standards reflect social values, the standard setting process becomes a political issue [Watts and Zimmerman 1986, pp. 229-238], since their application impacts on a wide range of different user groups. Further, if accounting standards reflect social values then they must have community support and it has been argued that the accounting profession in Australia has not achieved the ability to enforce its pronouncements [Godfrey, 1994, p. 303]. Government intervention, through the creation in 1984 of the Accounting Standards Review Board, reflected the government's view that regulation of the profession was necessary given the history of corporate collapses over previous decades even though auditors had certified the accounts.

Research Methodology

The major objective of the research reported below was to analyse the usefulness of the annual report using a survey questionnaire. The content of the questionnaire was based, in part, on an earlier survey conducted in 1978 in Australia [Anderson, 1979], with minor amendments incorporated from earlier studies [Epstein, 1975; Epstein and Pava, 1993]. The questionnaire replicated parts of the questionnaire used by each author and also was expanded to consider other additional items not included in the original study. A pilot study was conducted and, based on responses, the preliminary questionnaire was modified prior to the conduct of the study.

The names and addresses of the shareholders surveyed were selected at random from the share registers of Australian companies. Only shareholders who held a minimum of 100 shares in a publicly traded major company were included in the study.

All shareholders not responding to the first mailing were sent a second letter and another copy of the questionnaire. Total responses received were 436 from Australia shareholders (first mailing 291, second mailing 145). To examine non-response bias, the results between respondents to the first mailing and respondents to the follow-up mailing were compared. The follow up procedure is a way of weakening the resistance of potential non-respondents [Wallace and

Cooke, 1990, p. 285]. If there are no significant differences between the two samples, our confidence is enhanced that no important biases have been introduced and that the sample results can be generalized to the population of interest. No significant difference in respect to investor characteristics or to questions concerning readership and usefulness of annual report items existed. Consequently, the results of both mailings were combined for the purposes of analysis and the findings are detailed in the remainder of this article.

Results

Table 1 reports the results related to the demographic characteristics of respondents. From this table it can be seen that a majority of shareholders are over 59 years of age and are predominantly male. There is a wide distribution in terms of the percentage of wealth invested in shares although in dollar terms 55 percent had over $100,000 of their wealth invested in shares. Around one-third of respondents had either formal educational training or had been employed in a job in which they became familiar with financial accounting information.

Table 1: *Demographics of Respondents*

	1979	1996
Age		
Under 40	5	9
40-59	38	36
Over 59	57	55
Percentage of Invested Dollars in Shares		
Under 10%	22	12
10%-24%	22	16
25%-49%	25	27
50%-75%	16	28
Over 75%	15	17
Amount in Dollars Invested in Shares		
Under $10,000	23	10
$10,000-$24,999	16	9
$25,000-$49,999	18	10
$50,000-$99,999	19	16
Over $100,000	24	55
Formal Training or Job Experience		
Yes	30	36
No	70	64
Gender		
Male	76	63
Female	24	37

At the time of the 1979 study no demographic characteristics of shareholders had been identified by the stock exchanges in Australia. The first

such study took place in 1986 and subsequently in 1988, 1990, and 1994. The findings of the latest survey reveal that the demographic characteristics of respondents are not dissimilar to those of our study, the only major difference being that ASX investors tended to be younger [ASX Survey, Sydney 1994].

Table 2: *Shareholders Investment Goals**

	1979	1996
Safety of Capital	48.9%	50.3%
Steady Income	43.3	39.7
Speculative Gains	7.8	7.6
Other	4.3	2.6

* Percentage of respondents who ranked item as the most important goal.

Table 2 reports the survey results on investors' goals. From this table it can be seen that safety of capital has become more important relative to the 1978 results. The movement from steady income and speculative gains to safety of income is a movement from a short-term focus and indicates a more conservative approach to investing.

An important result of our survey is related to the question of how shareholders approach investment decision making. Investors need both to evaluate managerial effectiveness, and to formulate forecasts about future performance. The current reporting environment offers numerous potential sources of information to interested investors. For example, investors can access investment services and stockbrokers, or rely on their own analysis of the annual reports.

The survey results both in absolute terms and relative to the 1978 results, show little has changed. The advice of stockbrokers is still the most important information source for decision making as shown in Table 3. These findings confirm the stockbroker as the primary source, followed by financial newspapers and magazines with the annual report ranked third most important. Annual reports have not improved in ranking between the two surveys and this would suggest that regulatory changes have not improved the annual report's importance as a source of information.

Table 3: *Source of Shareholder Investment Decisions**

Q: On what basis do you normally make your investment decisions?

	1979	1996
Your analysis of annual reports	21.2%	14.4%
Technical analysis	4.9	4.3
Financial newspapers and magazines	22.3	23.0
Advice of investment services	5.0	9.1
Advice of stockbroker	42.5	45.5
Advice of friends	4.0	3.7

* Percentage of respondents who ranked source first in importance.

Table 4: *Readership of Corporate Annual Report Items**

	1979	1996
Balance sheet	36.0%	41.0%
Profit and loss statement	48.8	48.5
Cash flow statement	24.6	24.0
Directors' report	40.1	59.0
Chairman's address	52.8	67.8
Footnotes to the financial statements	21.6	14.5
Auditor's report	17.0	22.9
Essay and pictorial	33.0	46.5

* Percentage of respondents who found item somewhat useful.

An interesting question is to what extent investors read and find useful the items contained in the annual report. Investors were asked how thoroughly they usually read the items contained in the annual report. From Table 4 it can be seen that the most thoroughly read items are the chairman's address (68 percent) and directors' report (59 percent). Their ranking ahead of the financial statements indicates that less sophisticated investors have less difficulty in understanding their contents than they do with the profit and loss statement and balance sheet.

Usefulness of Annual Report Items

Table 5 presents the results of a question on the usefulness of annual report items. A slight majority of investors reported the profit and loss statement, balance sheet, and chairman's address as the most useful items contained in the annual report. The ranking of these three items is unchanged from 1978, although reported usefulness has increased for each one over the intervening years. The findings confirm the usefulness in the investment process of the traditional financial statements which are well-known and have a long history in financial reporting. The most dramatic percentage increase is with the chairman's address, reflecting the desire of investors for indications of the future profitability of the company in which they have invested. One significant finding was that the cash flow statement which replaced the funds statement in 1992 was found only slightly more useful. The explanation for this was that it had only been recently introduced and investors found it difficult to understand.

Table 5: *Usefulness of Corporate Annual Report Items**

	1979	1996
Balance sheet	45.4%	54.3%
Profit and loss statement	54.5	57.6
Cash flow statement	28.3	31.5
Directors' report	31.0	47.3
Chairman's address	36.5	53.7
Footnotes to the financial statements	20.4	9.0
Auditor's report	20.6	23.6
Essay and pictorial	31.0	33.1

* Percentage of respondents who found item somewhat useful.

Summary and Conclusion

Corporate annual reports are the primary form of communication between a company and its owners. This paper examines the usefulness of annual reports over time under a changing regulatory environment. Between the years when the two surveys were conducted, there have been changes to the regulatory environment, designed to improve the quality of financial reporting and provide greater protection for investors. Yet, despite these changes the responses between the surveys reveal that little has changed. The corporate annual report has not improved in usefulness relative to other information sources for investor decision-making. Further, the relative usefulness and readership of the contents of various sections of the corporate annual report have not greatly changed. The usefulness of the director's report has increased as improved disclosure requirements enable shareholders to better gauge accountability of directors. The evidence in respect of the financial statements is less encouraging. The profit and loss statement and balance sheet have retained their importance while the shift from a funds statement to a cash flow statement by the accounting profession has had little significant influence.

Our evidence would suggest that the increased resources devoted to the regulatory process have not led to an improvement in the usefulness of the corporate annual report. Regulators need to re-examine the objectives of the financial reporting process and ensure improved quality communications to the corporate shareholder.

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