Parliamentary Joint Committee on Corporations and Financial Services: Briefing paper on Corporate Disclosure Regulation

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> *Great companies exist only because they are created and safeguarded by our institutions; and it is our right and our duty to see that they work in harmony with these institutions. The first requisite is knowledge, full and complete; knowledge which may be made public to the world.*[40]

The audience that public companies interact with today is extensive, including shareholders, analysts, creditors, employees, trade unions, industry associations, rating agencies, environmental groups, academics, researchers, public bodies, regulators and so forth. Hence company disclosure is no longer about merely sending an occasional report to shareholders. Companies must communicate with their many stakeholders in a clear, concise and effective manner. Comprehensive and timely disclosure is vital for the health of corporations and financial markets, and to maintain sustainable and competitive national and global economies. Most jurisdictions, including Australia, have established disclosure regimes applicable to listed companies, including periodic reporting obligations, and rules requiring timely disclosure of material information between reporting periods. The International Organization of Securities Commissions (IOSCO) indicates that the primary rationales for company disclosure regimes are protecting investors, ensuring that markets are fair, efficient and transparent, and reducing systemic risk.[41]

The quantity and quality of listed company disclosure in Australia is highly variable. The required regularity and mandated content of the periodic reports (beyond the financial statements) is significantly less than in other jurisdictions such as Canada and the United States (US). The mandated management discussion and analysis (MD&A) in the half year and preliminary final reports is general in nature, leaving companies with broad discretion around their content and tone. The MD&A is often poorly framed and disconnected from the financial statements and reported result. Substantive or adequate content is often lacking, particularly tailored risk disclosures and performance analysis and commentary on long-term trends. Yet as IOSCO notes, financial information in periodic reports is the core information around which related information, such as MD&A of the historical results and prospects, should be framed.[42] The form in which information is provided in periodic reports is discretionary and the timeliness of these reports is problematic. There is no quarterly reporting obligation and the final year reporting processes are not as efficient and equitable as they should be. At present, most listed companies report their fully year results on a preliminary basis with minimal financial notes and

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[40] Theodore Roosevelt, State of the Union Message to Congress (3 December 1901).

41 International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation* (June 2010) 3.

[42] Technical Committee of the International Organization of Securities Commission, *Principles For Periodic Disclosure By Listed Entitles* Final Report (February 2010) 4.

MD&A. The annual reports contain more comprehensive notes and some MD&A, but these reports are typically released a month later, by which time the report content is generally no longer materially price sensitive.

All modern governments should ensure there are efficient and fair mechanisms to enable individuals to manage their own savings and retirement plans when they elect to do so and can satisfy legal requirements. Many governments, including Australia, will not have sufficient capacity to provide pensions to all constituencies, and an increasing number of people will have to independently fund their retirement. Hence financial market structures and policies that facilitate and encourage individuals to engage and assume at least partial control over their personal savings and retirement plans are become increasingly important. However, investors and savers can only achieve a degree of control over their financial futures when meaningful information is provided at all levels of the savings chain. Notably, listed companies sit at the centre of financial markets and provide the richest and most important primary source of information, which is used by both financial intermediaries and direct investors.

The primary purposes of the Australian corporate disclosure regimes should be revisited, with a particular focus on the integrated framework, and the nature and scope of information publicly available. Company information needs to be released through non-discriminatory public channels in order to sustain broad market participation and vigorous competition. The most relevant and reliable information on publicly listed companies is provided in periodic reports and information released continuously between reporting periods, and these regimes are intended to be complementary. The integrated company disclosure framework only achieves its intended purpose when publicly available information is sufficiently regular and detailed to enable all persons with a warrantable interest to make well-informed decisions throughout a financial year.

Accordingly, I propose the following:

- A reconsideration of the role and purposes of the periodic reporting and continuous disclosure regimes in Australia;
- A reconsideration of how to effectively integrate the periodic and continuous disclosure regimes;
- An examination of the efficacy of the integrated disclosure framework from a user's perspective;
- The introduction of unaudited quarterly reporting;
- The introduction of standard form periodic reporting;
- Enhanced MD&A reporting rules, which require mandatory tailored risk disclosures and long-term performance reviews within periodic reports;
- Clarity around the purpose and content of annual reports;
- A merger of the final year reporting processes (i.e. the preliminary final and annual reports), so that all participants are provided with complete information on a broadly equal basis.

BACKGROUND TO THE PROPOSALS

Comparative Research

My research has reviewed the national disclosure structures that apply to companies listed on major global exchanges in the United States (US), Canada, Germany, the United Kingdom (UK), Japan, Hong Kong, Australia, and Singapore. It has considered interdisciplinary empirical studies by finance, accounting, economics and legal scholars, disclosure review programs, and a sample of listed company reports, disclosures and websites across the selected countries. It uses the empirical studies to provide evidence on disclosure practices. It draws on disclosure reviews by regulators to identify common disclosure issues that arise and provide useful feedback and insight on processes and measures to improve company disclosure standards. It examines listed company reports, disclosures and websites to identify and discuss commendable reporting and communication practices for consideration when establishing a best practice company disclosure framework.

Why Are Mandatory Company Disclosure Frameworks Necessary?

Louis Brandeis famously stated more than a century ago that the potent force of publicity should be used as a continuous remedial measure in the impending struggle for real and useful disclosure within financial markets.[43] While it is easy to espouse the benefits of public transparency and accountability in financial markets, these goals have to be sought by every nation and community. Effective company disclosure frameworks are difficult to develop and maintain. Disclosure regimes are highly political, and power imbalances mean the strength and efficacy of disclosure regimes tend to be diluted over time.[44] Company disclosure policies and practices are generally determined as a result of political compromise.[45] Each constituency uses democratic processes to lobby for a regulatory environment that puts it in the best position.

Incentives are also a critical element of corporate disclosure frameworks. Disclosure issues generally arise when company managers and directors are reluctant to explain a company's position in plain terms to the world at large. Public company directors and managers naturally want to present company developments with which they are associated in the best possible light. Compelling monetary and personal incentives cause them to try to restrict or delay public dissemination of information when the content is negative, when public disclosures may reflect poorly on management, or when there are conflicts of interests. The largest institutions are clearly incentivised to obtain information privately in order to gain knowledge advantages vis-à-vis other participants. The groups in the most vulnerable position are small institutional or retail investors, and those in the community who are, or may be, adversely affected by corporate developments. These participants must generally rely on public disclosures and are the least likely to get timely access to all material information. It is difficult to overstate the importance of a continued presence of direct investors in financial markets. These participants assist to keep financial markets competitive, responsive and dispersed. They also form a critical segment of the

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[43] Louis Brandeis, *Other People's Money* (1914) Ch V.

[44] See Archon Fung, Mary Graham and David Weil, *Full Disclosure: The Perils & Promise of Transparency* (Cambridge University Press, New York, 2007) 125-126.

[45] Ibid 7.

market that competes with asset managers and other financial intermediaries, thereby ensuring that intermediaries provide options for end savers that are cost effective and valued.

What Do Effective Company Disclosure Frameworks Matter?

The primary purpose of financial exchanges and markets is to enable intermediation between listed entities seeking capital and savers with excess capital. Holistic analysis of disclosure regimes includes the costs and benefits of these regimes, and the comparative outcomes and costs that result from, or are associated with, disclosure omissions or deficiencies. It is important to understand the difference between who benefits from poor transparency and a lack of public scrutiny mechanisms in financial markets, and who bears the cost. The economic and social costs that arise in financial markets with ineffective disclosure regulation are too often forgotten.

Interdisciplinary scholarly research consistently suggests that superior corporate and economic outcomes are associated with enhanced company disclosure standards, high levels of transparency, broad and diverse market participation, effective legal protection for minority shareholders, investor confidence, and public trust.[46] As a whole, the empirical research points to compelling commercial, economic and social imperatives for effective corporate disclosure frameworks.

Tensions between Public and Private Disclosure Models

Company disclosure regimes in modern financial markets can essentially be characterised as emphasising, or giving preference to, either a public or private model. These models reflect the tensions between (a) financial market structures dominated by large financial institutions and intermediaries and (b) long-established aspirations for markets that are fair, efficient and transparent for all participants. Rapid increases in the absolute and relative levels of equity trading and ownership by large global institutions (with corresponding increases in institutional influence and power) feed into continued demands for a weakening of public communication models. However, when countries permit senior executives and asset managers to engage with selected participants behind closed doors on a regular basis, this promotes distinctly tiered disclosure channels and can result in weak public disclosure frameworks. Empirical research suggests that countries that allow listed companies to publicly disclose only limited and filtered information are unlikely to produce optimal long-term corporate or national outcomes.

Digital advances have radically changed modern communication models and the way that companies, investors, and stakeholders should interact and compete. Global communities and modern financial markets have embraced technological change, and entire populations are increasingly dependent on digital interfaces. To remain relevant and credible, corporate disclosure and the associated regulatory frameworks must reflect these momentous societal changes. The primary tests of effective company reporting and communication in contemporary markets include the ease with which information can be sourced and downloaded electronically, the quality and timeliness of publicly accessible company reports and disclosures, and the

[46] See e.g., Gill North, *Corporate Communication in the 21st Century* (Kluwer Law International, The Hague, 2015) forthcoming. The book provides summary outlines of the many bodies of empirical research that examine company disclosure.

adequacy of online facilities and forums that allow interactive dialogue between companies, shareholders and other stakeholders.

What are the Elements of an Effective Disclosure Framework?

Company disclosure structures only achieve their intended purposes when publicly available information is sufficiently comprehensive and timely to enable well-informed decision making. As a spokesman for the Association for Investment Management and Research suggests, the 'voice of the investor has for too long been marginalized in the debates on financial reporting ... [Investors] need … regular, comprehensive reporting of financial information … They need it in accepted formats … based on generally accepted accounting standards …'[47] Listed companies have made large cost savings during recent decades from regulatory changes that permit electronic dissemination of reports. Some of these savings should be redirected to enhance the quality of publicly available company information, including the provision of information on a layered basis[48] to enable all interested persons to access the type and level of information they require.

My comparative research and analysis found that there are substantive differences between the periodic reporting rules and practices in the US and the rest of the world. The US was the first country to establish comprehensive company disclosure rules and standards in the 1930s. While its disclosure structure is not perfect, it has an admirable clarity of purpose. Section 2 of *Securities Exchange Act* of 1934 indicates that 'transactions in securities as commonly conducted upon securities exchanges … are effected with a national public interest, which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including … to require appropriate reports …'. In addition, s 2 of the New York Stock Exchange (NYSE) Listing Manual states that the disclosure rules are intended to '[e]nsure timely disclosure of information that may affect security values or influence investment decisions, and in which shareholders, the public and the Exchange have a warrantable interest.' Thus the explicit goal of securities regulation in the US is to enhance the national public interest. Further, the public sphere is the intended audience of disclosures made by NYSE listed companies. This is a sound framework for considering the effectiveness of existing disclosure law and practice.

Publicly available company information should be in a form that allows comparative analysis. The US has used periodic reporting templates for many decades; Form 10-K is used for preliminary full year reporting, and Form 10-Q is used for quarterly reporting. The financial statements in the 10-Ks and 10-Qs are supported by comprehensive MD&A and financial notes and all of the financial content must be reported in compliance with accounting standards. The MD&A includes a tailored outline of the company's strategies, performance, risks, and opportunities. These periodic reports are completed as standard forms that allow comparative company, sectoral and market analysis. Companies must complete all of the form sections

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[47] Chartered Financial Analysts Institute, *European Investment Professionals Back Quarterly Reporting* (20 November 2003).

[48] Layered disclosure is disclosure in segments, with information presented in varying forms and detail to suit a broad audience with differing interests, time constraints, knowledge and ability.

(including commentary on the recurring and non-recurring elements of the reported result), thereby ensuring comprehensive information is presented on a consistent basis each reporting period. The content of these reports is well focused and uncluttered because the Securities and Exchange Commission (SEC) does not permit companies to include pictures, disconnected commentary, or marketing material. Relevant information is easily located because the reports contain an electronic table of contents and use standardised headings, and they are formatted in single online pages. All of these mandated reports can be readily accessed and downloaded from the SEC maintained Electronic Data Gathering, Analysis, and Retrieval System (commonly referred to as EDGAR).[49] This standardised reporting framework enables all participants and stakeholders to engage in comparative analysis of individual companies, sectors, and financial markets. Supervision of the company disclosure framework by the SEC is also consistent and comprehensive. The SEC seeks to promote public disclosure as the primary means of corporate communication in the US, and it unashamedly directs companies to provide comprehensive and timely information to enable all interested persons to assess a company's performance and value its securities. To summarise, periodic disclosure regulation in the US encompasses the following features:

- Preliminary full year reporting on Form 10-K and quarterly reporting on Form 10-Q;
- 10-Ks and 10-Qs that include a full set of financial statements, comprehensive MD&A, and detailed financial notes (all of which comply with accounting standards);
- Content in the 10-Ks and annual reports that is broadly consistent;
- Form 10-Ks that include five year financial performance tables; and
- Regular reviews of company reports and disclosures by the SEC.

While disclosure structures outside of the US reflect some of these features, no other national company disclosure framework is as integrated, comprehensive or transparent. Other jurisdictions have elected to take a "lighter touch" approach with respect to corporate disclosure regulation and practice. Moreover, the gap between disclosure standards and practices in the US and those in other jurisdictions, including Australia, continues to widen. While claims are made that transparency in financial markets has become a regulatory mantra and that investors are being overwhelmed by information,[50] reviews of periodic reports and continuous disclosures reveal that, in practice, available listed company information is often relatively sparse, sanitised and dated.[51] All jurisdictions are encouraged to follow the US disclosure model as global best practice.

Conclusion

In order to work effectively, company disclosure frameworks need to be driven by clear objectives and principles that are consistently applied. These frameworks work best when listed

[49] See SEC, *SEC Filings And Forms (EDGAR)* at http://www.sec.gov/edgar.shtml (last visited 14 June 2013).

[50] See, e.g., The Kay Review of UK Equity Markets and Long-Term Decision Making: *Final Report* (July 2012)(Final Report) 70 <http://lawcommission.justice.gov.uk/docs/kay-review-of-equity-markets-final-report.pdf> (last visited 14 June 2013).

[51] The author has reviewed company disclosure regimes in each of the jurisdictions discussed. She has also read and analysed company reports and disclosures from around the world for more than thirty years as a scholar, institutional analyst and retail investor.

companies adopt a normative culture of continuous public disclosure. Such cultures are only possible when directors and senior executives acknowledge the substantial benefits derived from timely and frank communication about company developments and performance. Long-term benefits are only derived from corporate disclosure regimes if there is broad participation, investor confidence and continued public trust in the integrity of financial markets. Such confidence is generated by giving legal weight to principles and rules that provide all participants with a right to comprehensive information on a timely basis, and that ensure minority shareholders rights are protected and market misconduct is enforced.

All nations should recommit to strong public disclosure frameworks as the primary means of listed company communication and engagement. Individual countries and the global community need to acknowledge that public scrutiny and accountability of large corporations is critical, and that disclosure structures serve long-term national interests. The Global Financial Crisis, and continuing economic and financial challenges in some parts of the world, serve as a stark reminder that the health of modern financial markets, real economies and people’s lives are closely interconnected. Strong and concerted commitment to established disclosure frameworks is required so that aspirations and statements about financial market transparency and informed decision-making do not become mere platitudes.