Rethinking Disclosures

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Theoretically, Disclosure Based Regime should make everyone happy. All the three parties, the investor, the issuer and the regulator should think they have had a good deal. The investor should feel that she has an opportunity to use her better judgment since all the information is available. There is no reason why should she be left out of a good deal just because a stuffy bureaucrat in cubbyhole had a jaundiced eye or could not understand a great new business model. The issuer thinks that having laid down all cards on the table, it is a simple case of caveat emptor. Finally, the regulator can breathe easy as he does not have to take a call on behalf of the unwashed millions. Moreover if no new information surfaces, the investor is to blame for not having evaluation done properly and if new information about the issue surfaces, he can squarely blame the issuer or his agents for the lapse.

After about a quarter century of disclosure-based regime in India, all are dissatisfied. The Eldorado of informed decision-making is elusive for the investor. There are hundreds of shares to choose from. Each one trades at literally blinding speed of light. Each makes a disclosure on hundreds of regulatory requirements. The offer documents run into hundreds of pages packed with information in small fonts, most being trivial as the warning on a coffee-cup that the contents are hot and might scald. The surfeit of information hides a crucial piece or does not talk of really important things like strategy, competition, and pent up resentment of society against the company. The mandated disclosures do not tell how the company is using several resources like its own plant, its own employees, its own intellectual property, its social standing or the natural resources. The long-term survival of the company is dependent on several issues, which never find place in the present day disclosure regimes.

The issuers' lot isn't happy either. The regulators and standard setting bodies think of evermore-complicated schemes of disclosures. Instead of doing any real business, a vast majority of the head office staff is busy collecting data and filing statements. Worse is the fate of individual promoters who have to keep track of all their investments with reference to the disclosures required under various regulations. There is a story about an old lady who happened to be one of the promoters of a company being the mother of the main promoter. She or her accountants thought that their purchases were within the limits set by the regulator. Unfortunately they forgot about a lump sum they had entrusted with her portfolio manager. They did not get the details of the investments by the portfolio manager and add to her portfolio of shares. Life isn't fair! To add to their woes, there are disclosures to be made to a host of authorities in different formats at different dates. One employee prepares one statement and another makes the other statement; and there is a discrepancy between the two for which the company is held responsible.

Finally, the regulators too aren't in a happy position. Howsoever they might protest that in a disclosure-based regime, the investor has to take an informed decision, the investors and the public anyhow hold them responsible if anything goes seriously wrong. They are caught into allegations about not insisting on a certain detail. Even they are caught off guard when a company that was apparently doing well on the disclosed financial variables suddenly runs into a major trouble and they are accused of sleeping on the wheel.

System Based Disclosures

A recent initiative by SEBI is a unique. On a pilot basis, SEBI has tried to shift the burden of disclosure from the regulated entities to the regulatory system. SEBI had already mandated that the promoters should have all their holdings necessarily in dematerialized form. Promoters are also required under the takeover regulations and Insider Trading Regulations to report their holdings when they cross certain thresholds. If all the holdings are in dematerialized form, there is no reason why the information from their accounts cannot be picked up, consolidated and displayed on the web site of the Exchanges. That is what SEBI has actually done. The stabilization of the system may still take some more time so as to obviate the need of promoters filing their individual statements.

The concept introduced by SEBI has endless possibilities. With introduction of Electronic Issuance of Debt in private placement and progressive universal dematerialization, increasingly more disclosure responsibilities can be entrusted to the Financial Market Infrastructure institutions. With more general acceptance of XBRL (Extended Business Reporting Language), financial disclosures made at one place viz. MCA21, can be used to cull out various requisite statements needed by other regulators. The concept can be further generalized to 'One Place, One Time' disclosures. The idea is, if a transaction has been done in public space it is the responsibility of the public systems to take care of all related reporting. For example, if a person has traded on a Stock Exchange the information about the trade is available in the public domain and any reporting regarding the same should be the responsibility of public systems.

Information to the Investors – Going Beyond Financial Statements

There is another important element that needs to be fixed about disclosures. Disclosures are usually thought of as financial disclosures. There is no dearth of examples when seemingly strong companies can collapse almost overnight or suffer near fatal loss of reputation. The risks can come from failing to keep in pace with the changes in business environment or technology or an environmental disaster. Names like Kodak, Nokia and BP come to mind. Or it may be or disapproval from society like the buyers from factories that were gutted in Bangladesh fire. What tool can help companies to take an informed decision.

Integrated Reporting (IR) is one such model promoted by International Integrated Reporting Council (IIRC) that can help investors assess the companies much better. IIRC is a global coalition of, regulators, investors, companies, standard setter, accounting professionals and NGOs. More than 1000 companies including some Indian companies are already reporting in the IR format.

The objective of IR is to capture creation of value over time. The main premise of IR is that financial capital is not the only capital that is used by the companies. Reporting is one sided and incomplete if it is confined to recounting how the company utilizes equity and debt provided as financial capital. When the investors invest in the capital of a company, it is expected that the management will run the company in such a way that the invested capital will be enhanced and will also yield dividends. Regeneration of and accretion to capital is the hallmark of successful businesses. A business uses many capitals other than financial capital. For example, a company uses buildings and plants in carrying out its activities. A company that takes care of its buildings and plants and keeps on adding to their value and functionality will be more successful in the long run than one that does not. The neglect or the abuse might not immediately reflect in the financial statements. Bankers know this instinctively. That is why they always make it a point to visit the plants of a company before taking a final decision to lend. They know that financial statements are not enough. This kind of capital is called Manufactured Capital (MC) in the IR parlance. The Manufactured Capital might belong to the company or it might belong to society. For example, roads and ports are the publicly owned Manufactured Capital. A company may enhance the MC during a year or it might destroy it. A mining company might think that it is being smart in overloading its trucks and showing a little better financial profit. Yet in the long run it will damage the roads it uses and the costs will escalate exponentially in future. It must be now obvious why a company should take care of the Manufactured Capital even if it is public. It is perhaps also clear that the investor will do much better if she counted for MC as well.

Most of the companies now do account for their Intellectual Capital in the sense of patents. There is a little more to intellectual capital than patents. It is the sum total of processes and procedures that are embedded into the business model of a company that marks an outstanding company from its mediocre counterparts. Even this type of intellectual capital is to be recognized and attempt made that it is enhanced over a period of time rather than letting it deteriorate. Closely linked to intellectual capital is Human Capital. There was a time at the beginning of the Industrial Revolution when financial capital was most important for a company because other factors of production viz. land and labour were considered a commodity. Labour was plentiful and unskilled. One pair of hands was as good as another. If one labourer fell sick or died, another quickly replaced him seamlessly. Learning at the job took a couple of hours at the most. It is the other way round these days. It is the finance that has become a commodity. You can get it from anywhere in the world at the click of a mouse. At the very worst, you might have to pay a few basis points more. On the other hand, it is often impossible to fully replace a creative and knowledgeable employee. Companies like Google are entirely dependent on the skill and creativity of their employees. Human capital, therefore, needs to be recognized and accounted for. The processes and patents developed by this human capital gives rise to Intellectual Capital, which in a knowledge based society is important enough to command recognition as a distinct capital.

No company can exist in a vacuum. It is a part of the society and uses inputs put in by the society. For example, a software company does employ engineers trained by the local engineering colleges. If it neglects to help these colleges to upgrade themselves, it will lose out on the quality of future recruits. In a broader sense, a company can operate only till such time as the society gives it the license to operate. The day, the company loses that goodwill, its days are numbered. Therefore, it is necessary to also account for Social and Relationships, like we do for other types of capital.

Last, but absolutely not the least, is the natural capital that a company uses. Every business uses air and water though it might not always be obvious. It is not only the power plants that use enormous quantities of water. Integrated chip manufacturing involves unbelievably large quantities of water. There was a time it was considered kosher to abuse the environment thinking that only the future generations will pay for it. It is no longer true. The environmental balance has reached such a delicate stage that the environmental debts are to be paid here and now.

IIRC has provided a very detailed reporting framework for Integrated Reporting (IR). The most important element of IR is its strategic focus and future orientation. It requires the companies to tell about opportunities, risks and dependencies flowing from market position and business model. It requires them to tell about availability, quality and affordability of various capitals. The companies are warned to avoid boilerplate disclosures because unlike usual reporting, here we are reporting an uncertain future and not a definite past.

The information in the IR framework entails both quantitative and qualitative aspects. It is, therefore, so vast that without a focus on connectivity of information IR will become a jumble of unconneced facts. IIRC encourages the companies to tell the comprehensive value creation story with reference to external environment, governance, opportunities and risks, strategy and resource allocation, business model and performance, and future outlook. The idea is to tell how a user can understand the future of the company.

The Way Forward

In human history change has been accelerating. The pace of change has been telescoped in the last two centuries. The corporate form of business is under severe challenge from several quarters. One one hand, there are grumblings in the lower middle classes against corporate insensitivity while on the other, all corporate economic activity as unmitigated evil to certain environmental groups. There is a likely challenge both to the manufacturing process and business models. If corporate form of business is to survive, then it must offer a fair and transparent presentation of self to the public. I feel, that the above two initiatives point towards the way in which regulators might be able to offer a fair deal to the corporates while being helpful to the investors.