A RE-EXAMINATION OF UNSPECIFIED OPERATING EXPENSE DISCLOSURE REQUIREMENTS IN NEW ZEALAND: HAS FRS 9 MADE A DIFFERENCE?

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The helpful comments of Professor Alan MacGregor, Mr Markus Milne, and participants at the Department of Accountancy and Business Law seminar series of the University of Otago, and at the Financial Reporting and Business Communication Research Conference, Cardiff (July 2000) are gratefully acknowledged. However any errors are the property of the author.

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Abstract

In 1995, a new general disclosure standard (FRS 9) was issued by the Institute of Chartered Accountants of New Zealand (ICANZ) and subsequently obtained approved from the Accounting Standards Review Board (ASRB). The Financial Reporting Act (1993) requires compliance with such approved standards. Lont (1997) showed that prior to FRS 9, most companies did not disclose expense components such as administration, cost of sales, selling, salaries and wages.

FRS 9 and other relevant pronouncements by the ICANZ state that components of expenses should be disclosed if separate disclosure is necessary in order to achieve the objectives of general purpose financial reporting.

This paper examined if an increase in the level of disclosure for several common expense categories has occurred since the introduction of FRS 9. Financial report data from 1970 to 1999 was used to determine whether the level of disclosure of the gross margin, salary and wages, selling expenses, and administration expenses increased after FRS 9 came into force.

The results generally found no improvement in the disclosure of the expense component monitored after the introduction of FRS 9. If anything, the disclosure levels of the non-mandated components monitored have marginally declined. Several mandated expenses were also monitored and the results showed most companies disclosed those components (depreciation, audit and directors fees were monitored).

The paper has implication for ICANZ, the New Zealand Stock Exchange, and the Companies Office to reflect on the lack of expense disclosure shown in the annual reports of New Zealand companies when compared to the requirements in the USA and the UK. Prior to June 2001, New Zealand could argue that Australia was as equally vague on this issue. New Zealand stands isolated from other G4 countries on this issue If the intention of FRS 9 was in part to improve expense disclosure to be consistent with these countries, then FRS 9 appears to have failed.

BACKGROUND

This paper seeks to examine whether the introduction of FRS 9[1] is associated with an increase in the amount of unspecified expense disclosure by NZSE listed companies.

This section briefly outlines a case for the desirability of increased expense disclosure. Section 2 considers the legal requirement to disclosure components of expenses in the Statement of Financial Performance. Section 3 outlines the sample and method while Section 4 reports the empirical results. Section 5 provides concluding comments.

The Statement of Financial Performance is one of cornerstones reports for assessing the performance of a company. Most would agree that to assess and evaluate the company's financial performance, shareholders and other users would need to understand something of the relationship between operating revenues and expenses. In the absence of such information, it would not seem possible to determine a true and fair view of the performance of the company and it is more likely inefficient investments decisions would be made. A large body of survey research of users[2] and the AICPA (1994)[3] has indicated a demand for the breakdown of expenses.

The United Kingdom (UK) requires the disclosure of the turnover, gross profit, cost of sales, staff costs, distribution costs and administrative expenses under the Companies Act (UK) (1985)[4]. The USA's Security and Exchange Commission (SEC) requires "cost of sales", "selling distribution, and general expenses" to be disclosed under regulation S-X 210.5-03.

In Australia, AASB 1018: Statement of Financial Performance has addressed the issue. From June 2001, Australian companies will be required to disclose component expenses by their nature or function. The disclosure test is based on whether "its disclosure is relevant in explaining the financial performance of the entity for the reporting period" (Sec 5.4). Furthermore, Sec 5.7states "Entities disclosing revenue from the sale of *goods* must disclose cost of sales relating to the sale of those goods."

In New Zealand, directors and auditors fees, interest expenses, bad and doubtful debts, donations, amortisation of goodwill and intangible assets, cost of capital leases, (Section 6.13, FRS 9), research cost (Section 5.1, FRS 13) and developments costs (Section 5.2, FRS 13[5]) are required to be disclosed as expenses. However the disclosure of operating

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[1] Information to be Disclosed in Financial Statements.

[2] Courtis (1992) used meta analysis to cumulate the findings of 11 studies of preparers and users. A weighted score of 3.86 was found for the importance of the breakdown of operating expenses. COGS rated 3.92 while a breakdown of revenue rated 3.84, where 5 was most important.

[3] American Institute of Certified Public Accountants (AICPA), Improving Business Reporting - A Customer Focus. *Special Committee on Financial Reporting.*

[4]Under the UK Companies Act (1985), companies can choice any 1 of 4 prescribed formats. It is not necessary to disclose staff costs if format 1 and 3 is chosen. If format 2 or 4 is chosen it is not necessary to disclose administration or distribution costs. The UK Companies Act (1985) provided prescribed formats for companies to follow for large, median, and small companies. Public companies cannot be granted any exemption however no exemption is made under the Act for the disclosure of turnover, gross profit, cost of sales, staff costs, distribution costs and administrative, except as already mentioned for median or small companies. Some may argue that New Zealand firms are much smaller than their UK equivalent, however the UK Act defines a company as small if it meets 2 or more of the conditions of the following conditions.

(1) aggregate turnover not more than £2.8m net (£3.36m gross),
(2) aggregate balance sheet total (not more than £1.4m pounds net (£1.68m gross), aggregate number of employees of not more than 50.

Note that companies can choose and 1 or 4 prescribed formats and it is not necessary to disclose staff costs if format 1 and 3 is chosen. If format 2 or 4 is chosen it is not necessary to disclose.

[5] Development costs that meet the requirements of paragraph 5.3 can be capitalised.

expenses such as cost of sales, selling, marketing, distribution or administration cost have not been specified in New Zealand accounting standards.

Lont (1997) showed that between 1970 and 1994 (prior to FRS 9) few companies disclosed expense information such as selling expenses (5% disclosed), administration expenses (13% disclosed), salaries and wages (14% disclosed), or sufficient information to calculate the gross margin (10% disclosed). This evidence suggested the level of operating expense disclosure in annual reports was less than that found in the United Kingdom (UK) and the USA. The AICPA (1994) argues that USA disclosure is inadequate and a top priority for them to address. Given such concerns in the USA, it follows that a greater degree of concern would exist in New Zealand if the amount of disclosure was below the current minimum standards in the UK or USA.

The calls for increased disclosure are not new nor are the reasons for why it is considered desirable. For example, Horngren (1957) argued that if analysts were kept well informed then they would show more interest in the company, have a more favourable attitude to the company (higher P/E ratio), be better informed and therefore the company would be less prone to wild share price fluctuations, and over the long term this would result in a higher share price.

Some may argue that the market is the best mechanism to determine the appropriate level of disclosure, however Tweedie (p. 3, 1988) argued that even with self regulation, "bad accounting may drive out good!". The level of disclosure (including expense disclosure) has been identified as being inadequate in the USA [AICPA's Jenkin committee's report (1994)]. The Jenkin report (1994) suggested increased disclosure was related to efficient capital allocations and both the company and the economy benefit from improved disclosure. For example companies benefit by a lower cost of capital (on average), access to more liquid markets, and opportunities to obtain greater efficiency. The economy benefits by better allocation of capital, lower cost of capital, more liquid markets, improved economic performance, and enhanced consumer protection[6]. This report supported the need to increase expense disclosure to ensure major categories are shown separately, with a break down between fixed and variable, cash and non cash components.

One stream of research argues that increased disclosure would result in a lower cost of capital because revealing public information would reduce information asymmetry that can reduce the cost of capital through increased demand or reduced transaction cost[7]. Another stream of theoretical research argues that the increased disclosure can reduce the cost of capital by reducing undiversifiable estimation risk[8].

It is difficult to empirically measure the benefit of increased disclosure on the cost of capital because of the difficulty in establishing causality. For example, it could be the size is the main determinate of the cost of capital, and that size is associated with the level of disclosure.

Healy, Palepu, and Sweeney (1995) and Healy and Palepu (1995), and Botosan (1997) tend to support at least an association between the level of disclosure and the cost of capital. Botosan (1997) found greater disclosure was associated with a lower cost of capital for those firms that had a low analyst following however no difference was found for firms

[6] See the Jenkin committee's [Chapter 4, 1994]) for a detailed discussion on these points.

[7] For example see Glosten and Milgrom (1985) Diamond and Verrecchia (1991). Welker (1995) found results that were consistent with the notion that a well regarded disclosure policy reduced information asymmetry and therefore increased market liquidity.

[8] For example see Klein and Bawa (1976) and Clarkson, Guedes, and Thompson (1996).

with a high analyst following. Nevertheless, cost saving could be made if access to information was made easily to analysts.

THE REQUIREMENT TO DISCLOSE COMPONENTS OF EXPENSES

This section discusses and provides an interpretation of expense disclosure requirements. In 1993 the New Zealand parliament passed a new *Companies Act* together with the *Financial Reporting Act* (1993) designed to address the shortcomings under the previous Companies Act (1955). The passage of new legislation was in line with recommendations from 2 reports that examined the legislative and regulatory problems that arose after the 1997 share market crash[9]. The *Financial Reporting Act* (1993) required "reporting entities" [10] to comply with generally accepted accounting practices and established the Accounting Standards Review Board to approve financial reporting standards.

Under the Financial Reporting Act (1993) Part I, Section 3, *applicable financial reporting standards* must be complied with. Under Part I, Section 2 (Interpretation), an applicable financial reporting standard means an approved financial standard approved by the Accounting Standards Review Boards under Section 27 of the Act.

Under Part IV, Section 36 (2) directors who fail to comply with an approved financial reporting standard face a fine not exceeding $100000 on conviction. Harris (1995) stated non-compliance with GAAP (or a true and fair view) which was not an approved financial reporting standard could not be prosecuted under this section of the Act.

The need to report components of operating expense centres on FRS 9 Section 6.10 that states, "components of operating expense shall be disclosed separately if separate disclosure is necessary to achieve the objectives of general purpose financial reporting". Such wording means the level of disclosure is stated in a general way and the level of disclosure required is open to interpretation. According to FRS 2,[11] "the detail necessary, subject to benefit: cost considerations to understand the relationship between revenue and expenses". Such wording could be used to limit disclosure, but if we presume the intention of the standard was for only relevant disclosure to be released then, we would at least expect some additional expense disclosure to be made.

Prior to Financial Reporting Act (1993), companies were not legally required to follow accounting standards however regulations such as New Zealand Stock Exchange (NZSE) listing requirements and the Institute of Chartered Accountants of New Zealand (ICANZ)[12] rules that compelled members to comply with issued accounting standards provided some regulatory rigor.

Under the *Financial Reporting Act (1993),* companies must comply with GAAP (firstly approved financial standard, or if there was no standard then those standards that have

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[9] See the Russell Committee 1989 report of the Ministerial Committee of Inquiry into the share market, Wellington: Government Printing Office and the Securities Commission 1990 report "Capital structure and financial reporting in New Zealand", Wellington: Government Printing Office.

[10] An issuer of allotted securities as deemed under Section 5 of the Securities Act or a company other than an exempt company

[11] FRS 9, 6.1 states Section B, 6.1-6.14 of FRS 2: Presentation of Financial Reports (1994) should be required to be read in conjunction with FRS 9.

[12] Prior to 1996 the Institute of Chartered Accountants of New Zealand (ICANZ) was known as the New Zealand Society of Accountants (NZSA).

authoritative support in New Zealand[13]). If after such compliance a true and fair was still not presented, then additional information was required to ensure a true and fair view was presented [Section 11, (2) of the Act].

Lont (1997) argued that the concept of presenting a true and fair view in itself would require sufficient information to at least confirm a user's expectations[14]. However the lack of legal enforcement (Harris, 1995) suggests such an over-ride is meaningless.

In March 1995, FRS 9 was approved by the ASRB and became effective for companies with balance dates after 30th June 1995. Few items or component were specifically included in FRS 9, however a general statement that required components to be disclosed was made in both FRS 2 (Section 6.4) and FRS 9 (Section 6.10).

Other standards require additional expense disclose (for example SSAP 3 on depreciation or FRS 13 on research and development costs), however no New Zealand accounting standard specifically requires items such as administration, selling, salaries and wages and cost of sales to be disclosed therefore the discussion is mainly limited to FRS 2 and FRS 9.

Section 6.10 of FRS 9 states:

> Components of operating expense shall be disclosed separately if separate disclosure is necessary to achieve the objectives of general purpose financial reporting

Lont (1997) argued that FRS 9 was still clear in its intent to require disclosure of relevant expenses categories, despite little new specific disclosure being specified. In part such an argument relies on the need to disclosure sufficient information to make an informed decision. Lont (1997) also pointed out that the appendix of FRS 2 states "separate disclosure of the components of expenses on the face of the statement or by way of note will often be appropriate. Expenses may include cost of sales, administrative expenditure,

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[13] (ASRB Release 1, 1994) on accounting policies that have authoritative support in New Zealand provided some guidance on this point. The ASRB was addressing the need for transition requirements given many accounting standards issued by the ICANZ (then the NZSA) had yet to gain approval by the ASRB. While it was clear from the Financial Reporting Act (1993) that approved standards must be followed, it was less clear what constituted New Zealand GAAP in the absence of an approved standard. In the ASRB view, SSAP's yet to be approved by the ASRB would almost certainly constitute GAAP under section 3(b) of the Act, however the Board was empowered to issue a directive on the matter and provided a list of accounting standards that were deemed to have authoritative support as from 1 July 1994. SSAP 9, the general disclosure standard prior to FRS 9 was amongst that list. No other guidance has been provided on GAAP by the ASRB.

[14] Two legal opinions on presenting a true and fair view support such an interpretation. See Hoffman, L. and Arden, M.H. 1983, September. Supplementary joint opinion. Accounting Standards Committee. [London] and Hoffman, L. and Arden, M.H. 1984, March. Supplementary joint opinion. Accounting Standards Committee. [London] for details. The necessary requirements that a company must complete to meet a true and fair view have been the subject of debate, with one view that a technical interpretation (compliance with GAAP) is sufficient while others argue true and fair is a higher order concept that should be able to over-ride inappropriate accounting standards. The Financial Reporting Act (1993) requires GAAP to be followed with additional information provided to present a true and fair view disclosed if necessary. Therefore under the Financial Reporting Act (1993) GAAP is a necessary but not sufficient requirement. Australia has a similar environment (mandated standards which have the force of law but with the condition a true and fair view must be provided). Gearin and Khandelwal (1995) argue that both mandatory accounting standards (to ensure directors do not opt out of minimum requirements) and a true and fair over-ride (to ensure a proactive approach is taken) should be considered necessary. Brotherston (1992) reported that a survey by McBride consultancy that showed fewer than 20% of analysts and 40% of private shareholders thought companies provided a true and fair view in their annual reports. In contrast 80% of financial directors thought the accounts showed a true and fair view of the company. Interesting the financial directors surveyed thought the main purpose of an annual report was to give information on the company's financial performance. It is therefore ironic that in New Zealand so little detail is provided on the components of expenses to allow such an assessment to take place.

benefits and grants paid, finance costs, and other expenses". In other words an expectation that such expenses would become commonly reported has been created. The need for trust in financial reporting was recently highlighted by Whittington (1999/2000) if those shaping the future of financial reporting wish to meet users needs to ensure the spirit of the standards are followed.

Lont (1997) did suggest that a murkier situation had been created by the approval of FRS 9 compared to the exposure draft for FRS 9 (ED-67) when he wrote,

> Section 6.7 of ED-67 required the cost of sales, distribution costs and administration expenses to be disclosed. No specific mention of these items are made in FRS 9…

Lont (1997) analysed submission on the issue and noted a mixed response was received by the ICANZ with user groups calling for greater expense disclosure, as did one of the two academic groups while four companies (issuers) and some accountants were concerned about commercial sensitivity of some items being disclosed. Several concerns related to materiality issues, for example, some questioning the need for specified disclosure of non material components. Some argued that all material operating functions should be disclosed.

Furthermore, Section 6.10 is a conditional statement in that only the information "necessary to achieve the objectives of general purpose financial reporting" is required to be disclosed. How should the word "necessary" be interpreted? Lont (1997) argued that expense disclosure was necessary to be able to make an informed decision as to the relationship between revenue and expenses.

Some may argue while such disclosure may be of interest, it was not necessary, but this would be against the spirit of general purpose financial statement and sections of FRS 2 and the Statement of Concepts (1993)[15]. For example, if most (all) operating expenses are aggregated, how can an assessment of past financial performance occur? The evidence before the introduction of FRS 9 appears to support a low expense disclosure culture in New Zealand with Lont (1997) able to show that the majority of the expenses were aggregated.

Section 4.2 of the New Zealand Statement of Concepts requires information to "confirm or correct prior expectations about past events (feedback value)" to be provided. It is not a requirement for the information to change a person's view with the confirmation of expectation (feedback value) considered an important attribute in its own right.

With regard to materiality, Section 2.3 of FRS 9 states a statement, fact, or item is material it is "likely to influence the users of the financial report in making decisions or assessments". The ability to compare expense components over time (especially the gross margin) is likely to be a key consideration for investors when assessing the financial performance of the company. Aggregated figures make it more difficult to understand the drivers of profitability and the permanence and quality of earnings.

While cost: benefit arguments may need to be considered, the cost of producing the information is low if it is already captured in the accounting system, and the UK (even for small companies) and USA require greater expense disclosure to be made, discounting commercial sensitivity costs as a possible reason not to disclose.

[15] The Statement of Concepts is not an approved financial standard but it has been acknowledged by the ASRB as an important guideline for standards to follow (see ARSB Release 3, Section 6.2, 1994).

In summary, FRS 9 is consistent with the intent of FRS 2 and under Sec 5.1, Sec 6.10 of FRS 9, all expense items of such incidence and size and those components that would help assess the performance of the business were required to be disclosed subject to benefit/cost and materiality considerations. However the approach by ICANZ of not specifying key expense components to be disclosed in FRS 9 means the specific components to be disclosed was left to professional judgement.

The implication of non-compliance of the relevant sections of FRS 9 is an interesting point to consider. If such disclosure is required but not provided, such a breaches the exposes directors to fines of up to $100,000 under the Financial Reporting Act. Furthermore, the New Zealand Companies Office has the power to require companies to rectify such a breach. The failure of auditors to qualify the report would presumably breach the rules of the Institute of the Chartered Accountants of New Zealand and also expose them to a potential claim from shareholders. For example shareholders may take a class action if the delay or total nondisclosure of inefficient expenditure by a company resulted in poorer performance than would have been the case if sufficient disclosure as required under FRS 9 had been made and allowed shareholders to mitigate their position by lobbying the company to improve its performance or sell their shares in the company.

This paper will allow users of financial reports and regulators to reflect on the desirable level of expense disclosure and examine whether FRS 9 is associated with improved levels of disclosure compared to those found under the previous standard (SSAP 9).

SAMPLE AND METHOD

The section provides evidence of the level of expense disclosure for companies listed on the New Zealand Stock Exchange that were available in the University of Otago's Financial Report Database from 1970 to 1999. Since the enacting of the Financial Reporting Act (1993), such companies must comply with approved financial statements.

Table 1 shows the sample size by year in relation to the population.

Insert Table 1 Here

Method

A disclosure index from 1970 to 1999 for those NZSE companies on the database was created for total income and several expense categories as follows.

(1) Total Income (mandated since 1979)
(2) Selling (unspecified)
(3) Administration (unspecified)
(4) Salaries and Wages (unspecified)
(5) Gross margin (either Sales and COGS or Sales and Gross Profit) (unspecified)
(6) Auditor Fees (mandated)
(7) Depreciation (mandated)
(8) Directors Fees (mandated)

Categories 2 to category 5 were included because similar categories are required to be disclosed in the UK but recall the conditional aspect of such disclosure as outlined in footnote 4. Audit fees, depreciation and directors' fees were included to show the level of disclosure achieved when an item was mandated. The disclosure level of Sales/Total

Income (required since 1979) also provided another benchmark to assess if compliance with mandated categories was being followed.

If the company disclosed the component in the profit and loss account or notes to account, it was coded 1, otherwise it was coded zero. Only the profit and loss account (statement of financial performance) and the related notes to accounts of the annual report were examined.

Results for all years and for each individual year were then calculated. While the companies over time change, it is the percentage as a total of the number of reports that is of importance. A limitation of the study is that the entire population was not available, however New Zealand's major companies are included in the sample.

Coding Conventions

Total Income

The coding conventions used in the database mainly in the 1970's meant sales may or may not have been captured in the "other income" fields. A set of conventions were employed to help ensure the figures for the 1970's were as accurate as possible. There were 3825 sales observations, however there were 5363 "total income" observations in the database. Total income was a calculated field that included the other income components plus sales and therefore would only be valid if all these components were coded. To determine if total income had been sufficiently disclosed, the following rules were applied.

For those observations that (1) Gross profit was disclosed, (2) the Sales field was blank, but (3) data for other income fields was present.

If Gross Profit was less than total income, then the Sales figure was coded as being disclosed. There were 506 observations where Gross Profit was higher than total income. There were 70 observations where Gross Profit was the same as total income. In those cases, total income was coded zero.

For those observation where (1) Gross Profit was not disclosed, (2) the sales field was blank, but (3) data for other income fields was present.

If the ratio of NPBT/ Total Income was less than 3 then it was deemed total income was disclosed. If the ratio of NPBT/ Total Income was 3 or greater then total income was coded as 0 (not disclosed). This rule was somewhat arbitrary but its effect is to improve disclosure levels of total income.

There were 327 observations with a ratio of NPBT/ Total Income greater than 3, mostly in data from the 1970's (only 26 were in the 1980's and none in the 1990's.

These rules were not necessarily mutually exclusive, however the application of these rules lead to 4461 observations being classed as having total income disclosed or 636 more observations if only the Sales category was used.

Selling and Marketing Expenses

If distribution expenses were shown separately to selling expenses, these were combined with selling and marketing expenses.

If selling and distribution expenses were reported as a combined figure, these were coded as selling Marketing expenses[16].

Administration Expenses

Some companies report "Administration and other expenses". These were all coded to administration expenses.

No other coding conventions were employed.

RESULTS

All Years Combined

The combined results are presented to provide an overview of the level of disclosure and also allow a comparison with the results found in Lont (1997).

Table 2 shows the percentage disclosing both sales and GP for all years combined and was similar to that reported by Lont (1997) [13.2% verses 15% in Lont (1997)]. Therefore it appears that most companies do not disclose sufficient information to determine the gross margin. Compared to Lont (1997), Sales/Total Income disclosed, Gross profit not disclosed was higher because of the presence of other income sources that was deemed to have sufficiently captured the revenue sources of the firm (66.0% compared to 49.4%).

Insert Table 2 Here

Table 3 shows the overall percent disclosure level for the other 6 expense categories monitored, administration, salaries and wages, selling expenses, audit fees, directors' fees and depreciation. Depreciation was traditionally mandated under both Schedule 8 of the Companies Act (1955), SSAP 3 and SSAP 9 (the disclosure standard prior to FRS 9). Audit fees and directors' fees have been traditionally been specified as items requiring disclosure. Note however that the neither the Companies Act (1993) or FRS 9 mandates the specific disclosure of depreciation, however SSAP 3 does require such disclosure (but this is not an approved financial reporting standard).

Lont (1997) showed almost identical results for administration, salaries and wages, selling expenses for the period from 1970-1994. It is also clear that items specified in SSAP 9, Schedule 8 of the Companies Act (audit fees, directors fees, and depreciation) and FRS 9 result in a high level of compliance by companies.

Insert Table 3 Here

For administration expenses, 13.0% entries were recorded in the database. It was noted in the section of database coding conventions, that some companies reported "administration expenses and other expenses" and these were coded to administration expenses in the database. To assess if this category was acting as a catch all field rather than a separate item, administration expenses were compared to total expenses. This check was only possible for companies listed from 1984. This was because total expenses as a field was only available from 1984 onwards and a lack of disclosure of total revenue items meant total expenses could not be reliably calculated prior to 1984. There were only 376

[16] These scenarios were relatively rare occurrence.

observations for both administration and total expense records in the database for that period.

Table 4 shows the distribution for administration expenses as a per cent of total expenses, and shows administration expenses were generally not a "catch all" field. Some expenses are mandated, therefore it would not be reasonable to expect the ratio to be 100%. While it is left to the reader to determine an appropriate cut off point, note for 30 observations (10.9% of the sample) the ratio of administration expenses as a per cent of total expenses was 90% or greater and around a quarter of the sample had an administration expenses/total expense ratio of 50% or greater.

Insert Table 4 Here

Table 5 examines the number of companies that disclosed none, 1, 2, 3 or all 4 unspecified expense components that were monitored (cost of sales, salaries and wages, selling expenses, and administration). The combined results showed 57.5% of the reports disclosed none of the 4 expense components monitored, 32.3% disclosed only 1 component, 8.3% disclosed 2 components, 1.8% disclosed 3 components, while only 0.1 (7 reports) disclosed all 4.

Insert Table 5 Here

Level of Disclosure by Year

This subsection provides empirical evidence of the level of disclosure for total income and the expense components monitored for each year from 1970 to 1999. This allows a comparison of the disclosure level prior to and after the introduction of FRS 9.

Table 6 shows the Per Cent disclosure details for various combination of revenue and cost of sales possibilities. Since the introduction of SSAP 9 (1978), total income (sales) has been a mandated figure. Note the relatively high level of nondisclosure of total income prior to 1979 and the general compliance with the requirement to disclose total income once SSAP 9 (1978) mandated the item.

Insert Table 6 Here

A cross tabulation of total revenue and gross profit/cost of sales was calculated by year to allow an assessment of whether the calculation of a gross margin was possible. Table 6 shows it has been the typical practice in New Zealand to disclose either Gross Profit or Revenue but not both therefore it has not been possible to calculate the gross margin for most companies.

Since the introduction of FRS 9, there has been a slight decline in the number of companies reporting sufficient information to calculate the gross margin, with the disclosure level ranging from 4.5% in 1999 to 8.1% in 1997. Since 1987, the disclosure level has been less than 10%. The highest level of disclosure was 30.6% of companies in 1979[17], but this rate was only sustained for that year and had fallen to 16.7% by the following year. It appears more disclosure of the gross margin occurred in the 1970's compared to the late 1980's and 1990's. Some caution is needed when interpreting the figures for the 1970's as the figures

[17]The general disclosure standard SSAP 9 was introduced in 1978.

have not been entirely validated, however this does not negate the conclusion that the disclosure of the gross margin appears to have declined during the 1990's.

In 1998, only 8 companies of the 121 companies whose annual reports were included in the database disclosed their gross margin were Independent Newspapers, Tasman Agriculture Limited, Roller Mills Fashion, Designer Textiles, Hallenstein Glasson Holdings, Natural Gas Corporation, Carter Holt Harvey, Telecom Corporation

Of the 110 companies surveyed in 1999, only 5 companies disclosed their gross margin, namely Carter Holt Harvey, Hallenstein Glasson, Independent Newspapers, Telecom Corporation, and Natural Gas Corporation[18].

Table 7 provides the actual per cent for administration expenses, salary and wages, selling expenses, depreciation, audit fees and directors' fees. For administration expenses, the disclosure level ranged from a low of 7.2% in 1995 to a high of 26.3% in 1984. Disclosure levels from 1996 to 1999 ranged from 8.4 to 9.6%. All disclosure levels from 1983 to 1994 were higher than was found for the 1996-1999 period.

The disclosure of salary and wages was slightly lower reporting tendency relative to administration expenses. There appears to have been a decline in the level of disclosure since FRS 9 was introduced. For example, for the entire period the disclosure levels ranged from 4.8% (1980) to 16.5% (1983) while disclosure levels from 1996 to 1999 ranged from 8.9 to 11%.

Most annual reports did not disclose selling expenses. There appears to have been a slight improvement in the level of disclosure since FRS 9 was introduced compared to the late 1980's and early 1990's. For the entire period the disclosure levels ranged from 2% (1982) to 12.1% (1983). Disclosure levels from 1996 to 1999 ranged from 5% to 5.8%.

The level of disclosure for mandated items was much higher. For example the majority of companies disclosed depreciation over time. The disclosure levels for the entire period ranged from 85.2% (1981) to 97.2% (1972). Note however, the disclosure levels from 1996 to 1999 ranged from 88.4% to 91.6% and this is slightly lower than earlier years.

A higher level of disclosure was evident for audit fees, with a slightly lower level of disclosure for directors' fees when compared to audit fees. It is clear that a high level of compliance has occurred for these mandated categories.

Insert Table 7 Here

Table 8 provides a frequency table of the number of expense components a company disclosed of the 4 that were monitored for each year (Cost of Sales, Salaries and Wages, Selling Expenses, Administration were examined). The table shows the number of reports that disclosed none, 1, 2, 3, or all 4 items as a percentage of the total number of reports surveyed for that year. For example, 41.1 of the reports did not disclose any of the 4 items in 1970, while 0.7% (1 report) disclosed all 4. There were only 7 announcements (6 before 1982 and 1 in 1988) spread over 6 years where all 4 components were disclosed.

[18] Roller Mills Fashion report was yet to be included in the University of Otago's database.

The level of **non-disclosure** has increased since the introduction of the general disclosure standard (SSAP 9 was issued in 1978). Prior to 1979, no more than 43.5% of reports did not disclose any of the 4 expense components monitored. In the 1980's, the level of non disclosure ranged from 49.1 to 71.2% of reports, while in the 1990's, the range of nondisclosure was between 70.5% and 80.7%. Since 1996, the average level of non-disclosure of any of the 4 components monitored was 79% of the annual reports surveyed.

It is apparent from an examination of the evidence that increased disclosure of the component of expenses that were not mandated has not increased since the introduction of FRS 9 (1995).

While some problems exist in using Chi Squared statistic (the independent observation assumption is breached), Chi Squared tests were calculated (but not presented) which supported the conclusion that a higher level of disclosure has not occurred for unspecified expense components after the introduction of FRS 9. Furthermore, there was some evidence the level of disclosure has declined over time.

Insert Table 8 Here

It is possible that a company disclosed other items not captured in the database used for this study. To overcome this problem (to some extent), the annual reports for 98 companies in 1999 were further examined for additional expense component disclosure which was unspecified but which was considered to be of an ordinary nature (asset write downs and abnormal gains or losses were not considered). Two types of disclosures were monitored, ones which could be considered common to all companies and those who used labels to describe their expenses that were considered more unique to the disclosing company but which was still classed as an operating expense.

For the components considered common to all companies, 6 components were identified. These were the 4 components previously monitored in this study (administration, cost of sales, salary and wages, selling expenses) and repairs and maintenance and insurance. The results of this additional analysis are shown in Table 9. Not unexpectedly (given the relationship between the 2 samples), the results were consistent with the evidence presented in Table 8. Table 9 results show that almost 80% of the companies monitored did not disclose any of the 6 expense components in their Statement of Financial Performance or related notes to account.

Insert Table 9 Here

Table 10 provides a more comprehensive survey, in that all expenses classified as operating expenses were counted. This analysis showed that around 64% of reports examined did not disclose any components of unspecified operating expense while only 10.2% of the reports disclosed 3 or more items.

Insert Table 10 Here

Table 11 provides a profile of the companies that disclosed 3 or more items. A tendency for larger companies to disclose information is apparent. As shown in Table 10 there were 14 companies that disclosed 3 or more components. Based on market capital, 6 of the 14 companies were Top 10 companies (Telecom, Carter Holt Harvey, Fletcher Challenge, Air NZ (A & B shares combined), Sky Network Television, and Independent Newspapers).

Those 6 companies also had either overseas listings or major overseas shareholders.

Insert Table 11 Here

CONCLUDING COMMENTS

The evidence shows a low level of disclosure of unspecified components of operating expenses such as cost of sales, selling expenses, administration expenses, salary and wages. In contrast, specified expense categories examined such as revenue, directors fees, auditors fees, and depreciation were usually disclosed.

The evidence showed the level of non disclosure of 4 unspecified expense components appears to have declined since the introduction of the first general disclosure standard (SSAP 9) compared to earlier time periods. More importantly, the introduction of FRS 9 does not appear to have improved the situation.

FRS 9 is not a standard that allows the company to take a laissez faire approach to their reporting standards. The lack of specific components in FRS 9 does create an arguable position that the previous status quo was acceptable however evidence was presented that the level of disclosure for those components monitored is declining when compared to the past. While it may have been the intention of the standard setters to allow flexibility in the type of expense disclosure, companies and their auditors appear to have interpreted the standard to mean unspecified expense disclosure is not generally required.

The issue from a shareholder's (or investor's) point of view is that directors can not be held to account for their actions if sufficient details are not released to make an informed decision on the stewardship of the company. Is it acceptable or desirable for investors to be denied access to a key profit figures (for example the gross profit margin), how efficiently managers had consumed the resources, for example how much had been consumed by employees (salary and wages), in administrating the company (administrative expenses), in promoting the companies products (selling and marketing expenses) and maintaining the companies assets (maintenance and repairs)? The situation for many shareholders and potential investors in New Zealand is the denial of such basic information.

Investors do have a choice as to where they invest their money and it is possible for investors to avoid such companies or New Zealand shares altogether. However many investors have a bias for their local market and the aftermath of the share-market crash showed the failing of the previous disclosure regime.

There are reasons to explain a reluctance to increase disclosure in the annual report, for example;

(1) the perceived relevance of information[19],
(2) the existence of other sources of information[20].
(3) increased litigation costs if certain types of information were released, and
(4) the financial costs of complying with the production of additional information.

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[19] Concerns about the lack of incremental information value and the oversupply of information have also been expressed. See Brownlee and Young (1986) (1987) for arguments against mandated disclosure by the SEC. However the lack of disclosure of any operating expenses means information overload cannot be considered an issue.

[20] The best source for providing the information should be considered. See Birnberg (1980) for a discussion of the role of accounting information in financial disclosure.

Given FRS 9 has the force of law, the only defence companies have against disclosure was if the component was immaterial or not necessary to meet the purposes of general-purpose financial reports.

Additional analysis (for 1999 only) showed larger firms or those with overseas listings tended to disclosure more expense components. This finding is consistent with studies of voluntary disclosure in annual reports[21]. Hossain, Perera and Rahman (1995) New Zealand study of 55 annual reports for the year 1991 found size[22], foreign listing status highly significant in explaining the disclosure levels of up to 95 discretionary items. Ahmed and Courtis[23] (1999) provided a meta analysis of 29 disclosure studies and concluded that the strongest explanation of disclosure level was corporate size.

Conflicting evidence regarding the importance of the auditor on disclosure levels has been reported. For example, Craswell and Taylor found a significant result while Firth (1979) and Hossain, Perera and Rahman (1995) did not find the type of auditor to be a significant explanatory variable. Hossain et al argued the lack of association between the type of auditor and the level of disclosure levels supported Bradbury's (1990) contention that a lack of incentives existed for New Zealand auditors to influence clients to improve disclosure practice.

Healy and Palepu (1993) argued managers can improve their communication with investors by developing an appropriate disclosure plan while Dyckman and Zeff (1999/2000) declared that "cognisance must be taken that the most enduring conclusion from three decades of empirical research in financial reporting: that disclosure is the substantive issue" (p90).

The globalisation of financial markets and the move to harmonisation or even standardisation will impact on disclosure practices. New Zealand will be forced into line eventually or face the costs of inaction.

Brown (1999/2000) argued globalisation would result a reliance on general rather than specific disclosure requirements to keep markets informed because of the need to ensure flexibility. He suggested the need for regulations might eventually diminish, as information intermediaries who can take care of themselves become more commonplace.

Sir David Tweedie, the chairman of the International Accounting Standards Committee (IASC), argues a move to international accounting standards is what the market wants to happen[24]. He argues that one set of high quality accounts are demanded because of (1) cost savings for multinationals, (2) concern by investors that some countries accounting standards were not up to standard and (3) the lack of transparency evident after the Asian financial crisis.

There are costs associated with the non-disclosure of information, for example it has been suggested a higher cost of capital, less consumer protection, less market liquidity, lower efficiency and greater information asymmetry can result from inadequate disclosure.

[21] Buzby (1975), Firth (1979), McNally, Eng, Hasseldine (1982) and Hossain, Perera and Rahman (1995) found size to be positively related to disclosure levels.

[22] Size was argued to proxy for higher agency costs (more outside shareholders), competitive advantage (higher for large firms), information production costs (lower for large firms), and demand for information (more analysts following larger firms).

[23] Dhaliwal (1980) offered a methodological improvement for the creation of disclosure indices while Marston and Shrives (1991) reviewed the results of studies that used of disclosure indices.

24 UK's Tweedie takes helm at new IASC, *Financial Executive*, Mar/Apr 2001.

New Zealand now stands isolated from Australia, the UK, and the USA on expense disclosure. Therefore the ICANZ, the ASRB, the NZSE, and the Companies Office needs to consider whether clearer guidelines and enforcement is required to ensure we are consistent with the standards adopted by these other G4 countries. An amendment to FRS 9 to ensure relevant expense disclosure by subcategories, together with examples for different types of business should provide the necessary clarity for prepares and auditors alike.

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Table 1: Sample Size by Year[25]

Year	Number of New Zealand (local) Issuers on the NZSE	Number of NZSE Company's annual reports in Database
1970	266	146
1971	266	171
1972	256	212
1973	257	230
1974	264	231
1975	257	246
1976	254	252
1977	247	248
1978	242	249
1979	227	235
1980	275	227
1981	278	223
1982	268	198
1983	281	206
1984	300	167
1985	316	257
1986	339	246
1987	361	282
1988	295	219
1989	247	172
1990	171	135
1991	139	112
1992	122	114
1993	138	116
1994	150	130
1995	145	138
1996	138	119
1997	145	123
1998	126	121
1999	137	110
Total		5598

[25] It has not been determined why the number of listed companies on the NZSE was sometimes less than the companies in the database as such occurrences will have little impact on the general conclusions. Not all listed companies were available on the database and the composition of the companies listed on the NZSE has changed dramatically over the time of the study.

Table 2:
Disclosure of Revenue and Gross Profit in New Zealand Financial Reports, (1970-1999, n=5635)

		Gross profit		
		Disclosed	**Not disclosed**	**Total**
Sales/Total Income disclosed	% of total	13.2%	66.0%	79.2%
Sales/Total Income not disclosed	% of total	12.6%	8.2%	20.8%
Total	No. of reports	1455	4180	5635

Table 3:
Per Cent Disclosure of Selected Expenses in New Zealand Financial Reports, (1970-1999, n=5635)

	Administration Expenses	Salaries and Wages	Selling Expenses	Audit Fees	Directors' Fees	Depreciation
Disclosed	13.0%	11.6%	4.3%	96.2%	93.4%	93.1%
Not Disclosed	87.0%	88.4%	95.7%	3.8%	6.6%	6.9%

Table 4:
Administration Expense as a Per Cent of Total Expense (1984-1999)

(Administration Expense/Total Expense)*100 Bin Range	Frequency	Per cent of Total	Cumulative Per cent
1%	6	1.60%	1.60%
5%	52	13.83%	15.43%
10%	61	16.22%	31.65%
20%	66	17.55%	49.20%
30%	53	14.10%	63.30%
40%	34	9.04%	72.34%
50%	22	5.85%	78.19%
60%	15	3.99%	82.18%
70%	13	3.46%	85.64%
80%	13	3.46%	89.10%
90%	22	5.85%	94.95%
Up to 100%	19	5.05%	100.00%
Total	376		

Table 5:
Frequency Table of the Number of Unspecified Expense Components Disclosed by a Company

Number of expense components disclosed	Frequency	Percent	Cumulative Percent
0	3238	57.5%	57.5%
1	1821	32.3%	89.8%
2	470	8.3%	98.1%
3	99	1.8%	99.9%
4	7	.1%	100.0%
Total	5635	100%	

Table 6:
Per Cent of Reports that Disclosed Total Income, Gross Profit or COGS, and Gross Profit Margin (item as a per cent of total number of reports)

1970	36.30%	52.1%	13.70%	38.4%	25.3%	146
1971	39.2%	52%	15.2%	36.8%	24.0%	171
1972	42.50%	49.1%	15.10%	34.0%	23.6%	212
1973	45.2%	46.5%	13.0%	33.5%	21.3%	230
1974	48.10%	45.9%	13.40%	32.5%	19.5%	231
1975	52.4%	45.1%	16.3%	28.9%	18.7%	246
1976	52.00%	44.8%	17.50%	27.4%	20.6%	252
1977	56.90%	46.4%	19.80%	26.6%	16.5%	248
1978	63.90%	47.4%	24.90%	22.5%	13.7%	249
1979	80.40%	42.6%	30.60%	11.9%	7.7%	235
1980	85.90%	25.1%	16.70%	8.4%	5.7%	227
1981	88.30%	27.8%	20.60%	7.2%	4.5%	223
1982	92.40%	10.1%	7.10%	3.0%	4.5%	198
1983	93.70%	6.8%	3.40%	3.4%	2.9%	193
1984	91.00%	19.8%	12.00%	7.8%	1.2%	167
1985	98.10%	17.9%	16.00%	1.9%	0.0%	257
1986	96.30%	13.4%	11.80%	1.6%	2.0%	237
1987	97.90%	10.6%	9.20%	1.4%	0.7%	282
1988	98.20%	9.1%	7.80%	1.4%	0.5%	219
1989	98.80%	5.8%	5.20%	0.6%	0.6%	172
1990	100.00%	5.9%	5.90%	0.0%	0.0%	135
1991	100.00%	8%	8.00%	0.0%	0.0%	112
1992	100.00%	7.9%	7.90%	0.0%	0.0%	114
1993	100.00%	9.5%	9.50%	0.0%	0.0%	116
1994	100.00%	7.7%	7.70%	0.0%	0.0%	130
1995	100.00%	8.7%	8.70%	0.0%	0.0%	138
1996	100.00%	7.6%	7.60%	0.0%	0.0%	119
1997	100.00%	8.1%	8.10%	0.0%	0.0%	123
1998	100.00%	6.6%	6.60%	0.0%	0.0%	121
1999	99.10%	4.5%	4.50%	0.0%	0.9%	110

Table 7:
Per cent of reports that disclosed Selected Expense Categories

	Administration Expenses	Salary and Wages	Selling	Depreciation	Audit Fees	Directors' Fees	Total Number of Reports
1970	8.9%	6.2%	4.8%	94.5%	80.8%	95.2%	146
1971	9.4%	7.0%	4.1%	96.5%	88.3%	95.3%	171
1972	9.4%	8.5%	2.8%	97.2%	88.7%	97.2%	212
1973	13.0%	8.7%	3.9%	96.1%	89.6%	94.8%	230
1974	10.4%	11.3%	3.9%	96.5%	92.6%	96.5%	231
1975	11.0%	13.4%	6.5%	95.9%	92.7%	96.3%	246
1976	11.5%	11.1%	3.6%	96.0%	93.3%	94.8%	252
1977	12.1%	12.9%	4.8%	96.4%	96.0%	94.4%	248
1978	12.4%	14.9%	4.4%	96.8%	97.2%	95.6%	249
1979	10.2%	13.6%	3.0%	93.2%	97.4%	94.0%	235
1980	8.4%	4.8%	2.2%	93.4%	97.4%	93.8%	227
1981	19.7%	14.3%	8.1%	85.2%	97.3%	92.4%	223
1982	9.1%	16.2%	2.0%	94.4%	98.5%	96.0%	198
1983	16.0%	16.5%	12.1%	94.2%	98.1%	93.2%	193
1984	26.3%	13.8%	5.4%	92.8%	98.2%	92.2%	167
1985	20.2%	16.0%	4.7%	92.6%	99.2%	94.9%	257
1986	16.3%	13.4%	3.7%	89.0%	97.6%	89.8%	237
1987	16.3%	8.5%	2.8%	90.8%	97.5%	85.5%	282
1988	16.9%	8.2%	2.3%	93.2%	99.1%	89.0%	219
1989	15.1%	11.0%	3.5%	91.3%	98.8%	84.9%	172
1990	11.9%	14.1%	2.2%	90.4%	100.0%	88.1%	135
1991	14.3%	14.3%	3.6%	91.1%	100.0%	87.5%	112
1992	13.2%	12.3%	2.6%	92.1%	100.0%	90.4%	114
1993	12.9%	14.7%	3.4%	92.2%	100.0%	94.0%	116
1994	10.8%	11.5%	3.8%	92.3%	98.5%	93.8%	130
1995	7.2%	10.9%	2.9%	89.9%	98.6%	92.0%	138
1996	8.4%	9.2%	5.0%	91.6%	100.0%	96.6%	119
1997	8.9%	8.9%	5.7%	90.2%	98.4%	95.9%	123
1998	10.7%	9.9%	5.8%	88.4%	99.2%	95.9%	121
1999	10.0%	10.0%	4.5%	89.1%	99.1%	98.2%	110

Table 8:
Frequency Table of the Number of Expense components Disclosed by a Company by Year (As a Percent of the sample for that year)

	No Disclosure	1	2	3	4 items	Sample Size
1970	41.1%	48.6%	8.20%	1.4%	0.7%	146
1971	40.4%	49.7%	7.60%	1.8%	0.6%	171
1972	43.4%	45.8%	8.50%	2.4%		212
1973	43.5%	43.0%	11.30%	2.2%		230
1974	43.3%	44.6%	9.50%	2.6%		231
1975	42.7%	42.3%	11.40%	3.7%		246
1976	42.9%	46.0%	8.30%	2.8%		252
1977	40.7%	46.8%	8.90%	2.8%	0.8%	248
1978	39.0%	47.0%	10.00%	4.0%		249
1979	43.8%	46.8%	6.00%	3.0%	0.4%	235
1980	65.2%	30.0%	4.00%	0.9%		227
1981	47.1%	39.0%	11.20%	2.2%	0.4%	223
1982	68.2%	26.8%	4.50%	0.5%		198
1983	59.7%	30.1%	9.20%	1.0%		206
1984	49.1%	37.1%	13.20%	0.6%		167
1985	56.4%	29.6%	12.80%	1.2%		257
1986	65.9%	22.0%	11.80%	0.4%		246
1987	69.1%	23.8%	6.70%	0.4%		282
1988	71.2%	21.9%	6.40%		0.5%	219
1989	70.9%	22.7%	6.40%			172
1990	72.6%	20.7%	6.70%			135
1991	70.5%	20.5%	7.10%	1.8%		112
1992	75.4%	14.0%	9.60%	0.9%		114
1993	73.3%	15.5%	8.60%	2.6%		116
1994	76.9%	13.8%	7.70%	1.5%		130
1995	78.3%	15.2%	5.10%	1.4%		138
1996	80.7%	10.9%	5.90%	2.5%		119
1997	78.9%	13.0%	5.70%	2.4%		123
1998	76.9%	15.7%	5.00%	2.5%		121
1999	80.0%	13.6%	3.60%	2.7%		110

Table 9:
Disclosure of 6 Unspecified Expenses Components for 1999, n=98

Number of Components Disclosed of the 6 Components Monitored	Frequency	Per Cent	Cumulative %
0	78	79.6%	79.59%
1	12	12.2%	91.84%
2	2	2.0%	93.88%
3	5	5.1%	98.98%
4	1	1.0%	100.00%

Table 10:
Disclosure of Any Unspecified Expenses Components for 1999, n=98

Number of Unspecified Operating Expenses Components Disclosed	Frequency	Per Cent	Cumulative %
0	63	64.29%	64.29%
1	18	18.37%	82.65%
2	3	3.06%	85.71%
3	4	4.08%	89.80%
4	3	3.06%	92.86%
5	5	5.10%	97.96%
6	1	1.02%	98.98%
7	1	1.02%	100.00%

Table 11:
Profile of Companies Disclosing more than 3 operating expense components

% of Total Market Capital	Market Capital as at 31/12/99 ($000's)	Company Name	Components Disclosed of the 6 components monitored	Total Components Disclosed
0.8%	428,812	Tranz Rail	1	7
1.3% 1.4%	683,013 (A shares) 778,575 (B Shares)	Air New Zealand	3	6
0.8%	417,235	Fernz Corporation	4	5
2.0%	1,084,159	Independent Newspapers	3	5
0.5%	272,550 39,020 67,709 convertible	Kiwi Income Property Trust[26]	0	5
0.05%	26,595	Nuhaka Farm Forestry Fund	2	5
1.14%	617,841	Transalta New Zealand	3	5
0.07%	36,704	National Property Trust[20]	0	4
0.01%	7,632	Opio Forestry Fund	2	4
2.12%	1,151,705	Sky Network Television	1	4
0.41%	222,500 217,500 convertible	AMP NZ Office Trust	0	3
8.0%	4,341,428	Carter Holt Harvey	3	3
7.7%	4,179,664 (combined)	Fletcher Challenge	1	3
29.0%	15,779,652	Telecom Corporation	3	3

Total Market Capital was NZ$54,364m as at 31/12/99.

[26] SSAP 17: Accounting for Investment Properties and Properties intended for Sale did not require the type of disclosure reported by Kiwi or National Property Trust.