

COMPLIANCE WEEK

Cleaning Up Financial Reporting Language

By Louis M. Thompson, Jr., *Compliance Week Columnist* — September 18, 2007

When the Securities and Exchange Commission created its Advisory Committee on Improvements to Financial Reporting earlier this summer, one of its challenges was for corporations to make information more “investor friendly”—that is, more useful and understandable.

But we’ve been here before. In the mid-1990s, the SEC embarked on a “plain English” campaign that resulted in the creation of an executive summary in mutual fund prospectuses to discuss investment risks in terms that the average individual investor could understand. This came about when the SEC challenged some linguistic experts and lawyers to read some existing fund prospectuses and explain what they meant. When they had difficulty doing so, it was clear that the average individual investor would have great difficulty making an informed investment decision based on the same information.

A decade later, the Commission issued guidance in December 2003 calling on companies to create their Management’s Discussion and Analysis of Financial Condition and Results of Operations in plain English and presented “as seen through the eyes of management.” Clearly, this was an effort to get companies to ditch the boilerplate and begin “communicating with investors in a clear and straightforward manner,” as the SEC release described.

Now, this new call for clarity was only a guidance document rather than a new set of rules, so many companies did not take the SEC seriously. In 2005, the Commission’s Office of Economic Analysis completed a comparative study of a sample of S&P 500 companies’ MD&As filed in 2004 and 2005. Using a word analysis approach comparing individual company’s MD&As over the two-year period, SEC analysts found 90 percent consistency in the language between the two filings. In other words, they were almost pure boilerplate.

Moreover, the guidance urged companies to create an overview of the MD&A that would provide investors who didn’t want to drill down into the detailed information with a way to get the essence of management’s view of the company’s financial condition and operations. Some corporate lawyers balked at using an executive summary, fearing the legal liability of potential errors of omission should material information be left out of the summary that some investors used to make investment decisions. Alan Beller, then director of the Division of Corporation Finance, considered this an overreaction from the lawyers. Nevertheless, numerous senior managers listened to their legal counsel and refused to incorporate an executive summary in spite of the SEC guidance—which clearly stated: “An introduction or overview, by its very nature, cannot disclose everything and should not be considered by itself in determining whether a company has made full disclosure.”

In a discussion paper published in August by Robert Pozen, chairman of the SEC’s new advisory committee, he noted that preparers of financial information want clear instructions on what they should cover in financial reports. They do *not* want to be second-guessed by regulators and litigants in situations where they have made reasonable, good-faith judgments on what to include in their disclosures.

On the other hand, Pozen’s paper stated that investors want to understand financial reports at the level of detail desired by each type of user. He suggested that a “tiering of information” would address the needs of different investor groups that exist in our capital markets. For example, “the individual investor may be interested mainly in a journalistic outline of the key points about the progress of the business. By contrast, a sophisticated investor may be interested in a full discussion of management’s choice of assumptions underlying the financial reports, as well as a comparative analysis of particular financial indicators versus a peer universe.”

Pozen’s idea is that by using the Internet, a company could create a summary page in journalistic style with hyperlinks to the more detailed information in the body of the document. This approach also tacitly recognizes increased investor reliance on news releases and company Web sites that report interim and annual results in advance of formally filed documents. (One possible implication from all this: Perhaps the required formats of filed documents may not be the best means of communicating to investors, and should be revised.)

The committee should also consider a concept articulated in a November 2001 speech by then-SEC Chairman (and now Compliance Week columnist) Harvey Pitt when he called for “creating a dynamic model of current disclosure of unquestionably material information and to clarify and sharpen financial disclosure, so that every investor can readily understand a company’s true financial picture. We need to come up with an approach that is less burdensome, but more meaningful, than our current system.”

We should not assume that only the individual investors would be interested in the top tier of information and the more sophisticated investors want all of the detail; an overview is not automatically a means to “dumb down” the information. As I noted in my Compliance Week column last month, regarding the changes in the investment and trading environments, some of the “PhD quants” who are plugging information into their algorithmic models may be looking for three or four nuggets that may even be non-financial in nature: for example, what the CEO sees as key value drivers of the company’s stock and how these measure up to his or her expectations.

It appears that the advisory committee will be following up on the SEC staff’s 2003 report to Congress on principles-based standards versus rules-based ones. The belief is that the former will lead to fewer complex standards, but will rely more heavily on the judgment factor in the implementation process.

ABOUT THE AUTHOR



Louis Thompson Jr. is an internationally recognized expert on corporate governance and disclosure, having served for more than two decades as president and chief executive officer of the National Investor Relations Institute until his retirement earlier this year. An adviser to the Securities and Exchange Commission and the New York Stock Exchange, Thompson is currently serving a second term on the NYSE Individual Investor Advisory Committee.

Prior to joining NIRI, Thompson was assistant White House press secretary to President Gerald Ford.

A veteran of the U.S. Command in Vietnam and the Office of the Secretary of Defense, Thompson has held executive communications positions for a number of organizations, including the American Enterprise Institute for Public Policy Research, and the National Council for Economic Education.

A former journalist and news anchor, Thompson remains chairman of the advisory council for the Greenlee School of Journalism and Communication at Iowa State University, where he was the 2001 recipient of the James W. Schwartz Award for Distinguished Service in Journalism and Communication conferred by the Greenlee School.

A former member of the Harvard University New Foundations Working Group on corporate governance, Thompson is a partner with business consultancy Genesis, based in Denver. He is also a managing director of Washington, D.C.-based Kalaroma Partners, the advisory firm founded by former SEC Chairman and Compliance Week Columnist Harvey Pitt.

More From Lou Thompson

[Click Here for Other CW Columns by Louis Thompson Jr.](#)

Related Coverage

[SEC Calls for Input on FR Advisory Committee Issues \(Aug. 28, 2007\)](#)

[FR Advisory Committee on Where to Begin \(Aug. 7, 2007\)](#)

[SEC Committee To Study Complexity \(July 3, 2007\)](#)

[SEC Looks to Fill Holes in MD&A \(Jan. 17, 2007\)](#)

[SEC’s Glassman Speaks Out On MD&A \(March 21, 2006\)](#)

Investors, individual and institutional alike, would benefit if management communicated information in the following hierarchy :

1. Management's summary discussion of key factors that drive value in the company's business. These can be financial and non-financial in nature.
2. Description of the key strategies to create and enhance shareholder value and the key performance measures used to evaluate whether the strategies are working.
3. Discussion of industry trends and other external factors, such as economic matters that affect the company's performance. Additionally, there should be a brief discussion of the uncertainties that could influence company performance. This may necessitate disclosure of forward-looking information that would promote better investor understanding. The safe-harbor should be used when discussing prospective information.
4. A high-level discussion and analysis, as seen through the eyes of senior management, of the company's financial condition and material changes in financial condition and operations since the last report. This requires the involvement by senior managers in crafting this discussion, since it is supposed to be coming from them.
5. Disclosure of liquidity and capital resources necessary to run the business. This would involve an analysis and explanation of the sources and uses of cash.

This list of disclosures needed to create better investor understanding of a company and its prospects for performance is by no means complete, but it does suggest a hierarchical approach that begins with the most important information before getting into the more detailed financial information.

The advisory committee's challenge is to develop a report that begins to change corporate behavior, where companies voluntarily adopt communications that clearly say what investors need to know from management's perspective to make informed investment decisions.

The apparent lack of initiative by many companies over the past four years to adopt the SEC's guidance on improving the MD&A would lead one to be a bit skeptical about voluntary compliance, although I personally favor that approach. Principles-based guidelines or rules give latitude for exercising good judgment. They also give companies the opportunity to do the right thing by informing investors using plain English as opposed to clouding meaning through complex, legalized language even though it may be complete and truthful.

Compliance Week provides general information only and does not constitute legal or financial guidance or advice.

[Back](#)