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Disclosure effectiveness: is it on your board's agenda?

The role of financial disclosures has never been so important. Investors, creditors, analysts and other stakeholders are requiring more insight about a company's performance, strategic direction and exposure to risk. In the absence of clearly communicated financial information from the company, these stakeholders may draw potentially incorrect conclusions about a company's performance and strategic objectives.

At the same time, the disclosure process has become more complex. Accounting requirements and government regulations are frequently changing, and web-based and social media channels are altering the methods and means of making disclosures.

As a result, many companies are taking a fresh look at how effectively they tell their story. While regulatory bodies such as the U.S. Securities and Exchange Commission (SEC) are examining ways to modernize the disclosure framework, companies are differentiating themselves in advance of any formal standard-setting and rulemaking by successfully adapting to the shifting investor demands and expectations. According to recent research conducted by EY and the Financial Executives Research Foundation (FERF)[1], nearly three quarters of companies are taking action to improve their disclosures and financial reporting.

Companies that have successfully improved and streamlined their disclosures cite many benefits, including the following:

- Enhanced investor confidence due to communication of more meaningful information
- Increased efficiencies in preparing investor communications and continual evaluation of the relevancy of disclosures
- Improved coordination throughout the organization, including with the board of directors, regulators and external advisors
- Strengthened market reputation and leadership

The disclosure landscape and calls for improvement

Disclosures encompass the traditional required communications, such as annual and quarterly financial reports, proxy statements and earnings release filings, but also include information that may be provided via company websites and social media platforms. Enhancing the effectiveness of corporate disclosures is of paramount importance to companies, investors, creditors, regulators and capital markets at large for a variety of reasons, including helping to ensure that an organization's message is accurate and clear.

Done right, effective disclosures can boost an organization's reputation, inspire investor confidence and enhance shareholder value. These same disclosures can help lessen the impact of negative news. Done wrong, they can make a bad situation worse. Weak financial communications cause uncertainty for investors; if not properly managed, such communications can significantly damage financial reputation, adversely impacting an organization's market value and cost of capital.

The volume and complexity of financial reporting requirements have grown significantly. Financial-statement users often say that disclosure documents contain too much boilerplate language and are repetitive, making it difficult to find the more important information. Some investors and other users have called for new disclosures or improvements to existing ones. Regulators and accounting standard setters have embarked on initiatives to improve the effectiveness of disclosures over the past several years.

The Financial Accounting Standards Board (FASB) is developing new disclosure guidance for inventories, fair value measurement, income taxes and defined benefit plans as part of its broader disclosure framework initiative. Additionally, the FASB is currently evaluating proposed guidance on applying materiality to disclosures as part of its broader disclosure framework project to improve the effectiveness of disclosures in financial statements. For International Financial Reporting Standards filers, the International Accounting Standards Board is also making progress on improving the effectiveness of financial statement disclosure.

The SEC is in the process of reviewing disclosure requirements in Regulations S-X[2] and S-K and continues to reach out to companies, investors and other market participants for recommendations on how to improve and modernize the disclosure regime.

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What is the role of the board and the audit committee?

SEC Chief Accountant Jim Schnurr recently noted that "the audit committee plays a critical role in overseeing management's preparation of reliable financial statement disclosure."[3] In addition to putting the disclosure effectiveness initiative on their agendas, audit committees can take the following steps to enhance disclosure effectiveness:

Set the tone for disclosure innovation and effectiveness

Boards and audit committees should empower management and proactively support efforts to focus on disclosure effectiveness and disclosure innovation. The audit committee's opinion carries a lot of weight. If management and the financial reporting team know they have the support of the audit committee, they may be more willing to make changes.

Audit committees should work with management to instill a disclosure mindset, bearing in mind that repetition and immaterial disclosures are areas for improvement in company communications. When reviewing documents, audit committees should focus on the general manner of presentation and wording of financial communications for clarity, transparency and the use of plain English. Audit committees should challenge management to be innovative and enhance understandability by streamlining the financial reports whenever they can to communicate more succinctly.

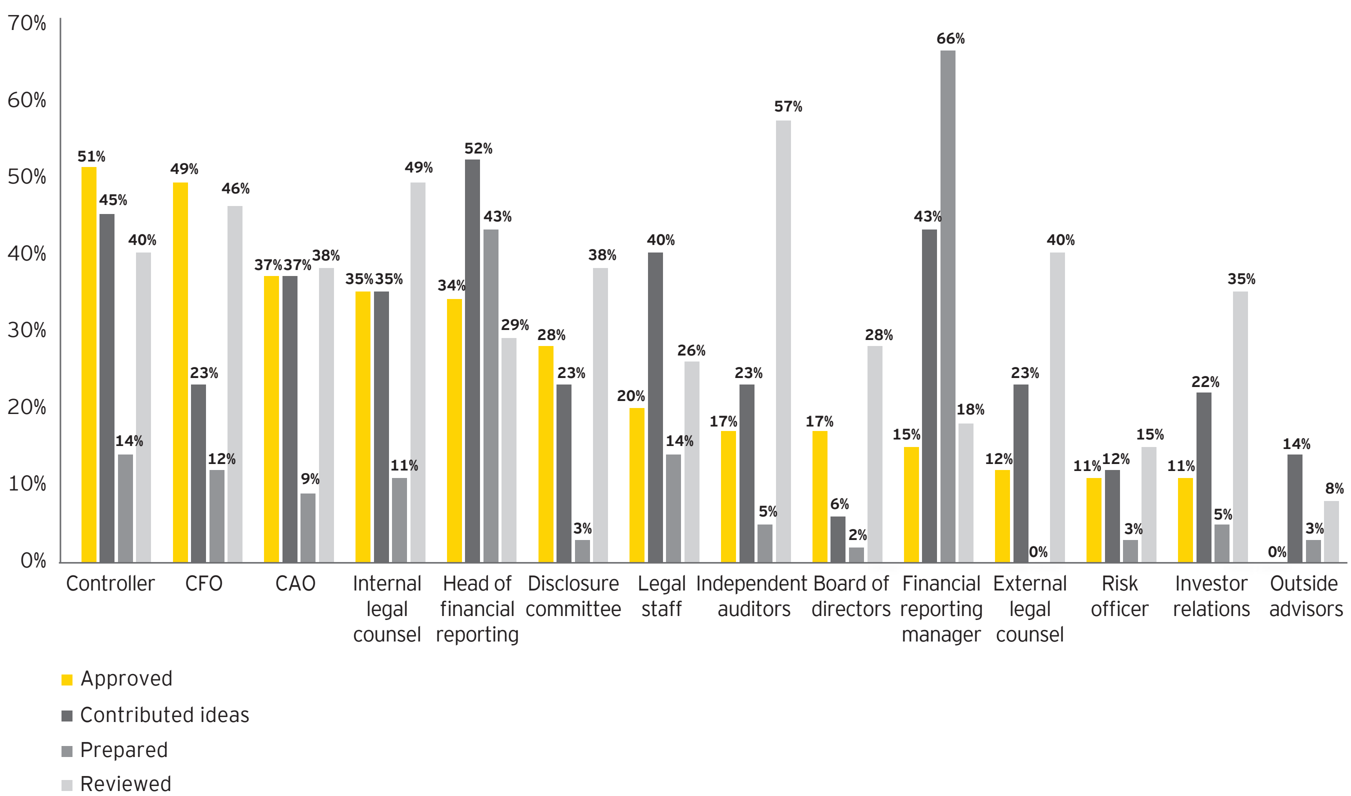
Be an engaged stakeholder from the start

Disclosure effectiveness is a cross-functional journey that involves engaging senior executives, controllers, heads of SEC reporting and investor relations, in-house and external counsel, and board members — from the start. Top-down commitment throughout the organization is necessary to sustain the focus on improving the quality of information provided to investors.

The audit committee should confirm and monitor that there is appropriate coordination with key internal stakeholders and timelines for implementing disclosure changes. Involving a company's external auditor is also essential.

Disclosure effectiveness is a collaborative effort that involves numerous internal stakeholders, including the board. Our survey results indicate that numerous individuals and internal groups within an organization are involved in enhancing disclosures, whether it be preparing the documents, contributing ideas to improve disclosures, reviewing or approving documents.

Participation in the disclosure improvement initiative



Challenge and continuously consider how the organization's disclosures can be more effective for investors

Investors are not just focused on headline performance numbers. Instead, they want information that will help them best assess performance, evaluate strategy and identify risks.

Companies are responding to investor demands differently and are focusing on making their financial communications more streamlined, connected and understandable. According to the FERF/EY report, the three key focus areas in companies' improvement efforts are:

1. Disclosing material information and eliminating immaterial information (80%)
2. Reducing redundancies and using more cross-referencing (77%)
3. Eliminating outdated information (70%)

Removing immaterial information, redundant disclosures and outdated information may be a good start for disclosure improvement. However, companies should consider plans for more robust efforts, including holistic changes across all financial communication channels. Companies should also consider ways to improve the presentation of information through greater use of bullet points, tables, charts, graphics and infographics to communicate the information rather than simply disclosing it narratively.[4] Benchmarking disclosures and communications against peers and disclosure leaders can identify gaps and areas of improvement.

Encourage a holistic, efficient and effective disclosure program that enhances communication with key stakeholders

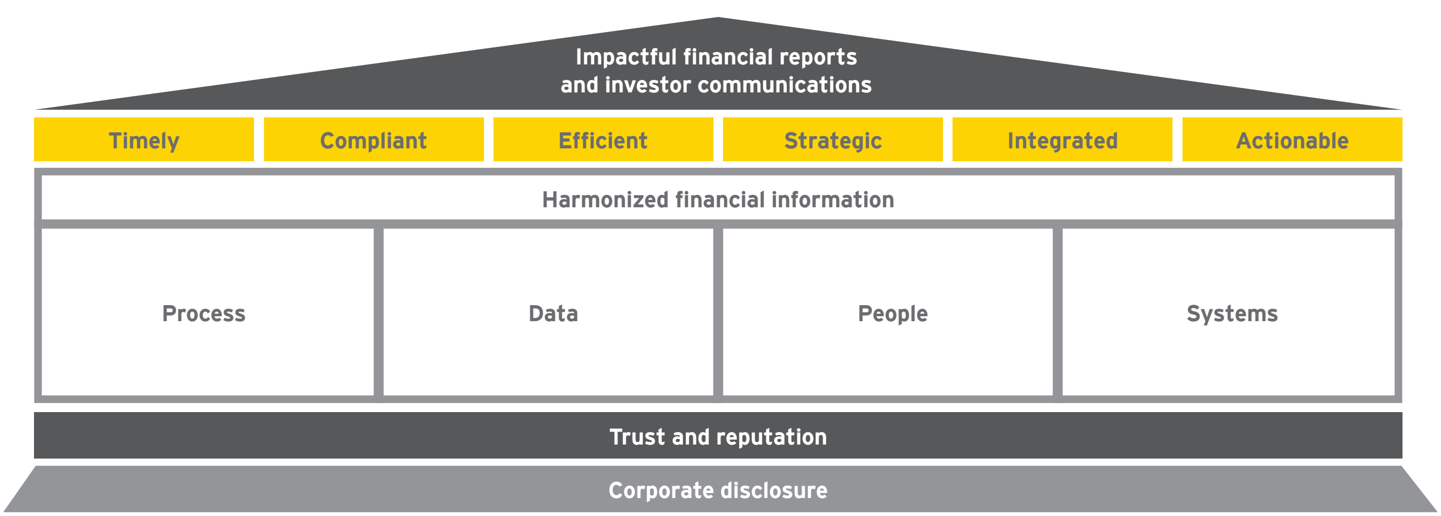
An effective plan to improve disclosures may require additional documentation about significant judgments (e.g., materiality assessments), as well as better integration of people, data and technology that can benefit from audit committee support and oversight. Audit committees can provide helpful input about the scope and extent of disclosure effectiveness efforts.

Considerations

Companies must consider time, cost and resource constraints, as well as regulatory disclosure requirements. Focusing on improving specific disclosures that are cumbersome or overly complex may be more efficient than trying to rewrite the financial statements and SEC reports from scratch. In order for disclosure effectiveness efforts to be successful and sustainable, they should be treated as a journey and not as a one-time initiative. The objectives of disclosure effectiveness should be embedded into the company's financial-reporting DNA.

As companies embark upon ways to improve disclosures and deliver impactful financial reports and other related communications to stakeholders, it's essential to address the impact on some of the foundational drivers, such as process, data, people and system requirements, which will enable better financial reporting. Audit committees can encourage management to make meaningful change in its disclosures by creating a framework and process that, at a minimum, achieves the following:

- Evaluates current disclosures, both financial and non-financial, and related investor communications
- Identifies and recommends process, content and system improvements, allowing for greater synergies between strategic, operational, financial and sustainability messaging
- Enables the systematic implementation of leading-practice disclosure programs based on the distinct information needs of different stakeholders



Putting it into practice: a spotlight on General Electric

Many consider General Electric (GE) one of the largest high-profile companies to embrace the call to action. In its most recent 10-K and annual report, GE used graphics and a layered style to create a more engaging and streamlined way to communicate with its shareholders. Christoph Pereira, GE's chief corporate, securities and finance counsel, explains that "Disclosure documents have dramatically increased in length over the last 15 years as a result of the Sarbanes-Oxley Act and other legislation … Yet in today's age, everyone's attention span seems to be getting shorter by the day."[5]

GE's 10-K includes 15 introductory pages of charts and graphics covering revenues, earnings-per-share growth, employees and key performance areas in a format that is easily digested. Putting the 10-K summary and introduction sections up front provides investors with a snapshot of salient information that is covered in greater detail elsewhere, such as broad-level strategy and capital allocation choices. The executive summary sets the stage and answers two critical questions that are often on the minds of investors: where have they been? and where are they going?

The summary is informative, providing an outlook into GE's key businesses as well as trends and significant developments in a variety of visually compelling formats, such as the use of bullet points. Pereira notes that GE approached its 10-K document with the mindset that "quality of disclosure is not about the amount of information, but rather about meaningful, well-presented information that is tailored to fit the needs of the audience … The new 10-K, especially the 10-K Introduction and Summary section, gives readers a more bite-sized view of GE, while still allowing the reader to delve into all the details by referring to the full 10-K. This layered disclosure approach has been very successful for us … "[6]

Conclusion

With so much at stake and so much changing, it is imperative that boards take a fresh look at their companies' financial reporting and disclosures. Audit committees play a pivotal role in helping to shift the disclosure effectiveness mindset within the company. Boards and audit committees must set the tone at the top for this management-driven initiative, and they should encourage management to make disclosures more clear and informative.

More and more companies are recognizing that in the absence of clearly communicated financial information, stakeholders, including activist investors, may draw potentially flawed conclusions about the company's performance and strategic objectives. An effective disclosure process is the key to addressing such issues.

Questions for the board and audit committee to consider

- Does the company have a plan and process to improve disclosure effectiveness? If so, what are the planned improvements, and how were the targeted disclosure areas identified?
- If the company is planning to enhance its disclosures, is there a clear timeline and project-management support to meet the deadlines? Which people within and outside the company are involved in the process?
- Does the audit committee interact with the disclosure committee? Do both committees understand the plans to improve disclosure effectiveness?
- What disclosures are most important to the company's analysts and investors, and has the company recently considered how to enhance those disclosures? Have analysts or investors requested additional disclosures?
- Has the company reached out to analysts and investors to obtain feedback about the quality and transparency of its disclosures?
- If the company has eliminated immaterial disclosures, how did management evaluate and document its materiality considerations?
- How is technology being leveraged to improve the effectiveness, timeliness, readability and reach of the company's disclosures? Is layering being used to allow stakeholders to focus on the information most pertinent to them?
- Has the board or management considered engaging outside consultants or advisors to evaluate the company's disclosures and benchmark them against peers and analysts' expectations?

Endnotes

1. "Disclosure effectiveness: Companies embrace the call to action," Financial Executives Research Foundation in collaboration with EY, November 2015.
2. "To the point: Our recommendations for changing Regulation S-X disclosures about entities other than the registrant," Ernst & Young LLP, 20 November 2015.
3. Remarks Before the UCI Audit Committee Summit, 23 October 2015.
4. "Disclosure effectiveness: what companies can do now," Ernst & Young LLP, October 2014.
5. "Reimagining the 10-K – Disclosure as a Tool for Good Governance," GE Reports website, accessed 26 January 2016.
6. Ibid.

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