Finding the Forest Among the Trees

Overcoming Overload and Achieving Greater Disclosure Effectiveness

By Howard B. Levy

The fundamental objective of any disclosure document is the clear communication of relevant and material information in a summarized and understandable form. “Disclosure effectiveness” refers to the extent to which that objective is met. It is notable that the SEC has been said to prefer disclosure effectiveness to “disclosure overload,” which is, essentially, its opposite. Perhaps this is because it focuses responsibility on issuers rather than regulators, which are inherently slow in taking action (absent an immediate crisis like Enron that results in Congressional pressure). Nevertheless, there are certain steps that regulators, rule makers, and standards setters can take in the short term to improve disclosures.

The term “transparency” has been used extensively in recent years to describe a highly valued characteristic of corporate disclosure; in a broader sense, the term has also been used almost interchangeably with disclosure effectiveness. One can reasonably conclude that disclosure overload is a severe impediment to transparency, and that the principle of “less is more” is consistent with both transparency and overall effectiveness.


The Wall Street Journal recently reported that the average annual report on form 10K increased from about 30,000 words in 2000 to 42,000 words in 2013 (V. Monga, E. Chasan, “The 109,894-Word Annual Report,” Wall Street Journal, June 1, 2015).

Despite all the speeches, studies, and publications to the contrary, the regulatory environment (as it is manifest in both the SEC comment letter and PCAOB inspection processes) continues to discourage the application of materiality or relevance judgments as well as other efforts that might be directed at improving disclosure effectiveness, but could seem risky to issuers.

What Is the Root of the Problem?

“Meaningful, effective disclosure does not simply mean more disclosure,” said no less than former SEC Commissioner Troy A. Paredes. “Because of information overload, in some cases, more disclosure can mean less effective disclosure” (remarks at “The SEC Speaks in 2013,” February 2013). The problem of disclosure effectiveness and its causes can be summarized as follows:

- Too many prescriptive requirements, such as for disaggregated detail and boilerplate
- Transactions that are too complex
- Descriptions that rely excessively on technical jargon
- No option to omit required disclosures that may actually be stale or redundant based upon materiality or relevance judgments
- Little discretion or judgment applied by issuers or regulators to distinguish the important from the unimportant
- Writing that is badly organized, redundant, overly dense or unfocused, and generally poor
- Issuers’ fear of litigation risk or regulatory sanction
- Tight reporting deadlines that leave no time to streamline disclosures
- Slow and arduous process to change regulations.

The problem of disclosure can be found both within the financial statements and outside of the financial statements (e.g., in annual reports or proxy statements). Ineffective disclosure leads to information overload.

When disclosure gets to be ‘too much’ or strays from its core purpose, it could lead to what some have called ‘information overload’Da phenomenon in which ever-increasing amounts of disclosure make it
difficult for an investor to wade through the volume of information she receives to ferret out the information that is most relevant. (SEC Chair Mary Jo White, remarks at the National Association of Corporate Directors Leadership Conference, October 15, 2013)

Which Steps Have Been Taken?
The SEC launched its “Plain English” initiative in 1998 (which did not establish any rules for registration statements or periodic 1934 Act reports) and subsequently, along with FASB and the CAQ, it has conducted frequent surveys and forums, issued reports, and given speeches, many of which have been addressed to lawyers, not CFOs (see the sidebar, For Further Reading). In 2008, the SEC issued a “Report of the Advisory Committee on Improvements to Financial Reporting,” and in 2009 it began what it called the “21st Century Disclosure Initiative.” A congressional mandate was issued in 2013 under section 108 of the Jumpstart Our Business Startups Act.

In 1995, FASB issued a “prospectus” asking readers “to consider possible changes to current disclosure requirements consistent with one or both of the following objectives: (1) to reduce the cost of preparing and disseminating disclosures while providing users with the information they need and (2) to eliminate disclosures that are not useful for decision making.” It began its Disclosure Framework Project in 2009, “with the goal of establishing an overarching framework intended to make financial statement disclosures more effective and coordinated and less redundant” and ultimately to provide guidance to issuers on how to decide what disclosures to make.

FASB followed in 2012 with an invitation to comment on its “Disclosure Framework” outlining possible approaches to improving disclosure effectiveness. In March 2014, FASB proposed an addition to its Conceptual Framework (Chapter 8: Notes to the Financial Statements) in order to improve the process for establishing disclosure requirements in new standards and evaluating existing ones.

[FASB’s] goal is to both improve disclosure content—make it more useful to investors—and at the same time, where we can, reduce the amount of disclosure content … The framework is designed to lead to disclosures that clearly communicate the information that is most important to the users. (FASB Chair Russell G. Golden, remarks at AICPA Conference on Current SEC and PCAOB Developments, December 2013)

Every Big Four firm has written about this subject and provided guidance to its issuer clients. But in my opinion, the many initiatives undertaken over the years have had little or no impact on disclosure effectiveness, as evidenced by current SEC filings.

What Can Regulators Do to Fix the Problem?
As recently as March 24, 2015, the SEC chair told Congress that the staff is “coordinating with FASB to identify ways to improve the effectiveness of disclosures in corporate financial statements and to minimize duplication with existing disclosure requirements” (Mary Jo White, testimony before the House of Representatives).

FASB could raise its priority for finalizing the proposed chapter 8 to its Conceptual Framework, providing conceptual guidance for establishing new disclosure requirements in future standards, but it could accelerate actions to evaluate and revise its existing standards to ensure more flexibility and greater issuer judgment as to appropriate disclosures and their placement. For example, ASC 235-10-50-6 states that accounting policy disclosure “is preferred in a separate summary of significant accounting policies preceding the notes to financial statements, or as the initial note, under the same or a similar title.” In the author’s opinion, FASB should remove that sentence and revise any direct or indirect references thereto to allow for greater flexibility as to the placement of this disclosure. Prescriptive words such as “shall” and “at a minimum” preceding a list of detailed “requirements” could also be eliminated from the standards.

In addition, FASB should introduce the concept of relevance into its standards as a disclosure criterion and consider revising its definition of materiality by substituting “would” (or “would likely”) influence decisions of an investor for the less-open-to-judgment “could” and therefore conform more closely to the U.S. Supreme Court’s definition [TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449-450 (1976)].

FASB could insert language directly into its standards to suggest issuers use a line-by-line materiality or relevance assessment of disclosure items—rather than the current inference that all disclosure items are equally required, without regard to their significance to the users of a particular issuer’s financial statements.

The PCAOB could instruct its inspectors to give credence to such materiality or relevance judgments as made by issuers and evaluated (and documented) by auditors. It also could recognize that both authoritative accounting standards and SEC disclosure regulations generally allow the omission of a “required” disclosure item, if it is not material or relevant to the needs of users in relation to the financial statements taken as a whole.

As for the SEC, it could change the tone and direction of its periodic commend letters to issuers, to signal that the staff is not merely interested in adding disclosures. It could also encourage issuers to improve disclosure effectiveness in future filings by suggesting specific opportunities for eliminating redundancies, stale or immaterial items, and other excessive disclosures—asking for commitments from issuers in that regard and making them accountable for improvements. The SEC could instruct its review staff to be clearer in comment letters when asking for additional information; this would avoid any implication that expanded disclosures are being requested if they are not. The staff should also recognize rationales set forth by issuers stating that additional disclosures would likely not be significant to users.

According to Deloitte, SEC staff members have said that an SEC comment letter should not be viewed as an indication that the staff has “concluded the requested information is material” and therefore must be disclosed, and that issuers should “consider relevance, applicability, and materiality before adding (or agreeing to add) disclosures to their filings” (Kolber and DiLeo, “SEC Staff Suggests Ingredients for Effective Disclosures,” Heads Up, Deloitte & Touche LLP, October 16, 2014). Most issuers did not understand this, but according to the SEC:
Just because we issue a comment, it does not mean that we have concluded the requested information is material. It is the beginning of what we hope is a dialogue. A response of “we don't believe the information is material, but we'll include it to clear the comment and move on” is not a desirable result—for the company, investors or us. (Keith F. Higgins, director, SEC Division of Corporation Finance, remarks before the American Bar Association’s business law section, April 11, 2014.)

Higgins said: “While it may be called ‘disclosure overload,’ ‘cutting the clutter,’ or ‘losing the excess baggage,’ we can all probably agree on the need to reduce immaterial disclosures that make more important information harder to identify” (remarks at PLI’s 13th Annual Institute on Securities Regulation in Europe, March 20, 2014).

What Can Issuers Do?

Despite whatever regulators and standards setters do in the short (or long) term, real change will come only when issuers make a sincere effort to improve their filings. To do so, they will have to venture outside their comfort zones, break away from what they have always done, get more aggressive, and overcome their fear of litigation or adverse regulatory consequences.

Former FASB Chair Leslie Seidman suggested last year that companies can take steps to present information in a more user-friendly way, without any rulemaking by the SEC or FASB, and “without any significant concern about second-guessing” by regulators (remarks at the 40th Annual Meonske Professional Development Conference, Ohio Regional Council of the Institute of Management Accountants, Kent State University, April 25, 2014). Keith F. Higgins, director, SEC Division of Corporation Finance, has said that issuers can improve effectiveness outside of regulatory changes:

Updating our rules is only one step—albeit an important one—in improving company disclosures. For their part, companies should examine how they can improve the quality and effectiveness of their disclosures. (SEC Press Release 2013-269, “SEC Issues Staff Report on Public Company Disclosure,” Dec. 20, 2013)

Among the more specific steps listed below that can be taken, issuers are well advised, in general, to reevaluate facts and circumstances at least annually, and consider whether information presented in an old disclosure remains material and relevant, and to avoid continuous repetition of outdated information that has lost its significance, even if the disclosure was added in response to an earlier SEC comment letter. Attention should also be devoted to avoiding redundancies within disclosure documents in favor of cross-references to the financial statement notes from other sources. Cross-referencing should be used judicially when it is deemed to benefit readers:

Think twice before repeating something [for example, regarding critical accounting estimates] … if there were ever a place in a report that cried out for a cross-reference — and there are likely plenty of them—this is near the top of the list. … Before you repeat anything in a filing, please step back and ask yourself—do I need to say it again? (Keith F. Higgins, remarks before the American Bar Association Business Law Section, spring meeting, Apr. 11, 2014).

Management’s Discussion and Analysis

Management’s discussion and analysis (MD&A), introduced into Regulation S-K (item 303) in 1968, is probably second only to the financial statements in terms of the amount of attention it gets from the SEC staff and users of public disclosure documents. Many investors do appreciate the forward-looking information that may be included in the MD&A. But the MD&A has expanded and become the principal repository of redundant, irrelevant, stale and otherwise excessive disclosures. Consequently, the MD&A presents many opportunities for improving disclosure effectiveness.

The following discussion is divided into the principal categories of the MD&A. An expanded matrix of this guidance presented in a checklist form is also available from http://www.cpajournal.com.

Overview. The overview in the MD&A is often presented as a lengthy, chronological history of the issuer’s activities from inception that continually gets longer as new material is added and nothing is removed. Very often, it contains redundant language taken verbatim from a business description presented in the financial statement notes or elsewhere in the filing. This is not an overview. Although the overview may make judicious cross-references (discussed below) to more detailed information elsewhere, it should consist only of highly summarized information that focuses primarily on the present and the future—but not the past.

Critical accounting policies and estimates. The SEC’s definitions of these terms overlap considerably, making it difficult (and unnecessary) to distinguish between the two. (The former is generally considered to be broader, encompassing everything in the latter along with nonquantitative but nevertheless critical judgments made with regard to the selection of accounting policies from among available alternatives, rather than judgments made solely in their application.) Accordingly, the terms are commonly combined in MD&A captions as critical accounting policies and estimates. The terms are interpreted by the SEC as follows:

n Critical accounting policies. Accounting policies that management believes are most “critical”—that is, they are both most important to the portrayal of the company’s financial condition and results, and they require management’s most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. (FR-60, Release 33-8040)

n Critical accounting estimates. Accounting estimates and assumptions that may be material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on financial condition or operating performance … [and] that supplements, but does not duplicate, the description of accounting policies in the notes to the financial statements and provides greater insight into the quality and variability of information regarding financial condition and operating performance. (FR-72, Release 33-8350)

The important consideration is that critical threshold is on a higher plane than significant threshold. Accordingly, merely copying
or cross-referencing the significant accounting policies in the financial statement notes fails to meet the objectives of this requirement, in that it neither identifies nor provides any greater insight into the critical items.

**Recently issued accounting standards.** SEC Staff Accounting Bulletin (SAB) 74 effectively requires the disclosure of new pronouncements issued but not yet adopted that are reasonably likely to have a material effect on future financial statements. Unless made pursuant to PCAOB Interim Auditing Standards AU section 9410.15–.18, which effectively requires disclosure of matters likely to result in retroactive financial adjustments, these disclosures need not be in the financial statements, but may be in the MD&A. Nevertheless, undesirable practices have led many issuers to go beyond the requirements and intent of SAB 74 by: discussing new accounting standards that will not have any significant effect on their future financial statements, reciting the entire summary published by FASB with the standard, including these disclosures in the financial statement notes, or including standards that are merely proposed but have not yet been issued or that have already been adopted as accounting changes. Issuers should review the language in SAB 74 and reduce their disclosures to conform to this language, relocating them to the MD&A if appropriate.

**Comparative variance analysis**—operations and cash flows. The primary excess seen in this area is the line-by-line comparison of immaterial items or items with immaterial period-to-period changes. Other common deficiencies include explaining the detailed composition of the changes experienced without explaining the reasons for the changes.

**Liquidity and capital resources.** This section of the MD&A should provide insight into the issuer’s cash management and capital resources needs. It should emphasize primarily forward-looking information about its short- and long-term plans for meeting those needs. Although it should also contain some summarized information about historical sources of liquid capital, it should not (though it often does) focus heavily on the past nor should it repeat information from the statement of cash flows.

**The Financial Statements and Notes**

To achieve greater disclosure effectiveness,
ment notes and in the legal matters section of the filing. Although the disclosure requirements applicable to legal matters provided by Regulation S-K (item 103) may often be met merely by cross-referencing the financial statement note, those requirements are clearly different from U.S. GAAP (ASC 450-20-50). In no event, however, is a detailed, motion-by-motion chronology of the legal proceedings (as is often encouraged or even drafted by legal counsel) either necessary or recommended.

Disclosure of risk factors is important for any entity, and particularly those issuers with high-volume trading, a large public float, or whose share value is otherwise more likely to be affected. But the SEC staff has observed that these disclosures have tended to become an area of overkill—too extensive, full of boilerplate, and redundant. Such excess is often viewed as a risk management device and based upon the advice of legal counsel. But the staff (and most likely readers) would like to see these disclosures more focused and tailored, and limited to those items that have the most probable and significant future effect on the issuer’s business and its share value. Perhaps risk factors would best be presented in a descending order of significance. This is the one area where this author has ever seen an SEC comment letter request a reduced disclosure—albeit not until 2015.

What Else Can Issuers Do?

Issuers would be well advised to avail themselves of the opportunities presented to provide authorities with their views about disclosure overload versus effectiveness in thoughtful and well-articulated comments regarding proposed changes in rules and standards—perhaps prepared in consultation with their professional advisors.

Effecting meaningful change will require a substantial investment in time and effort on the part of issuers. Everything need not be done all at once, but it can be done effectively over time; also, it can be addressed in between reporting periods so as not to be hindered by deadline pressure. But issuers have to start somewhere. Clearing out some of those extra trees in financial disclosures so that readers can begin to focus on the forest will be well worth the time and effort.

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