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REPORTING ON THE ANNUAL REPORT

Working Paper 82-402*

by

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REPORTING ON THE ANNUAL REPORT

by Gail E. Farrelly and Gail B. Wright*

Introduction

The annual report has been a subject of examination from a variety of perspectives; managers, investors, and regulators all have shown concern about the content of the annual report. This study emphasizes the managerial viewpoint and provides some practical suggestions for improving the annual report, so that managers can maximize the value of this important document to the investment community.

For investors, when the allocation of resources means choosing among competing alternatives, a rational choice implies reliance on the annual report to provide information in such a way as to facilitate comparisons among firms. Easily accessible, comparable information is the essential ingredient of such a data base. While a variety of information sources exists -- sources which may be more forward looking, less biased, or more quantitatively specific -- researchers continue to find support for the premise that the annual report is a significant, if not the most important, source of investor information. Chang and Most recently completed questionnaire research attempting to identify the usefulness of the traditional corporate annual report to three user groups (individual investors, institutional investors, and financial analysts). They report that: "... all three groups in the U.S.A., ... rated the annual report as their most important source of investment information."[1]

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Their work is representative of continuing emphasis by researchers on the usefulness of the annual report.

Among others who place importance on the annual report are:

-- The Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC), which are involved in a continuous attempt to improve the quality and quantity of information contained in annual reports to investors.

-- Firms which spend large amounts of time, energy, and money in the preparation of annual reports to shareholders. Ross reports that, according to Dun's Review:

> Annual reporting has become a $120-million-a-year business, ... The magazine estimates that 15,000 publicly held companies distribute a minimum of 50 million copies a year at an average cost of $2.40 a copy.[2]

Not only must the financial statements and prescribed information fulfill the requirements of the SEC and of FASB standards but also, taken as a whole, the annual report provides perhaps the best opportunity for communication by management.

From both management's and society's points of view, it is crucial that the expensive, time-consuming process of preparing, disseminating and digesting annual reports be worthwhile -- that is, that the reports reap benefits which more than compensate for their costs. It may be impossible to quantify a cost/benefit analysis for every disclosure in the report. However, it is possible, as well as necessary, to perform a qualitative analysis of the attributes of the report.

We have chosen to examine here the general presentation of information within the annual report as well as some specific items (table of contents, management report, management's discussion and analysis). The results and recommendations are presented in four sections. Following a discussion of the

current trend toward general guidelines, there is an analysis of the importance of certain items to the usefulness of the report. SEC staff comments and related examples are presented here. Our recommendations for improving the annual report are followed by concluding remarks.

Use of General Guidelines to Structure Annual Reports

The importance placed on annual reports by the SEC is evidenced by rules adopted by the Commission in August of 1980 which were "... intended to make the report to holders the basic disclosure document and to avoid duplicating that information in filings with the agency."[3] According to Harold Williams, who was then chairman of the SEC, this group of rules is "by far the single most important advance" in simplifying the SEC's disclosure system.[4] An eventual merger of the corporate annual report with the 10-K report is looked upon favorably by some and regarded with misgivings by others. Such a merger would lessen redundancy and provide a single standard for publishing financial information; as a result, disclosure might be improved. On the other hand, a combined report might be too technical to be truly "readable" for the average investor.

Whether there will be a complete merger of the annual report with the 10-K report remains to be seen. However, what is evident at present is that the recent trend in guidance provided to the writers of annual reports has been toward broad guidelines, rather than specific rules. The requirements of Item 11 of Regulation S-K exemplify this trend toward generalization. It is effective for management's discussion and analysis of financial condition and results of operations for annual reports issued after December 15, 1980. Here the SEC indicated that the requirements were "... intentionally general and nonspecific in order to encourage registrants' initiative in discussing those

matters most significant to individual circumstances."[5] "General and nonspecific" requirements can lead to a fuller disclosure of financial conditions and circumstances than might have occurred with a single rigid set of requirements. The user might be treated to a broader disclosure and fuller understanding of the economic and business environment of the firm. Management, however, must be conscientious in assuring that the manner of fulfilling broad requirements produces meaningful disclosure and is consistent with the specific information tendered by the statements themselves. Since broad guidelines leave disclosure largely to the discretion of management, some problems can result. Two of these problems are:

1. Possible loss of comparability

Type and amount of disclosures made are frequently the result of management's "personality" or corporate characteristics. (Anthony Sampson emphasized the impact of "corporate character" on operational differences among major oil companies in his book, *The Seven Sisters*.)[6] Such characteristics -- by either amplifying disclosures or by adding little to that presented by the statements themselves -- could have the effect of negating comparability of the information presented across the broad spectrum of annual reports. As suggested in its 1981 releases, the SEC attempts to deal with this problem by continually monitoring disclosures made by specific firms.[7] The Commission urges corporations toward fuller disclosure by providing examples of discussions it considers meaningful.

2. Users as victims of "information entropy"[8]

Whereas we usually consider information entropy to occur as the direct result of lack of information, this is only one facet of information loss in the communication process. Information can be "lost" in other ways. For example, the reader may be inundated with excessive data (much of which is

fairly insignificant), so that the objective of the communication is lost or at least unclear. Or, the failure to organize and cross-refer information may cause users to lose sight of the "whole" and draw erroneous conclusions.

We have examined a sample of 1980 annual reports to analyze the nature and extent of these two problem areas. This examination leads us to believe that the two problems are serious but can be handled. We have developed recommendations for dealing with these problems in order that annual reports may become even more useful than they are now. The objective is to create comparable design of data flows -- that is, an organizational design which would serve users' interests as communication of the business environment becomes ever more complex.

Analysis of Current Annual Reports

Accessibility of Information

It is critical that the user be able to access, within the total annual report, the financial information that he needs for decision making. In the present study three items were selected -- table of contents, management report, and management's discussion and analysis -- which bear on the usefulness of the annual report. The analysis considered 1) existence, 2) location and identification, and 3) content of the three items mentioned above within the annual report. The objectives of the examination were to determine comparability of overall design and to assess the degree and type of information entropy encountered. The basis of the study was a random sample of 25 annual reports from Fortune 500 companies with fiscal years ending December 31, 1980.

The Table of Contents is an invaluable tool to users of annual reports. It shows the placement and existence of desired information. Perhaps more importantly it outlines the overall design or data flow of information in the

report. Clearly the table of contents is a useful tool for examination of one report or for the comparison of information in several annual reports. It is, surprising, then, to find such a commonplace device missing in three (12%) of the 25 reports examined. In two other reports the table of contents referred only to the financial section. It was placed at the beginning of that section in the middle of the annual report.

Management's Responsibility for Reporting

The American Institute of Certified Public Accountants (AICPA) places a great deal of importance on the Management Report. The Commission on Auditors' Responsibilities (Cohen Commission) recommended that communication about management responsibilities for financial statements be improved. It took the position that some users have the erroneous opinion that financial statements are representations of the auditors, not management. The Commission concluded that:

> At present, management is not required to report on financial statements, although it is responsible for the representations in them. It is incongruous that the party responsible for the representations does not have to acknowledge its responsibility and that the only report on the statements may be the auditor's.[9]

While a report by management is not included in all of the 25 reports analyzed, a large majority of those surveys (21 or 84%) did contain such a report. The management report is not easy to find in all annual reports, as it is not consistently a separate item; nor does it have a unique title. Some annual reports label the report by management "Responsibility for Financial Statements," while others simply call it "Management's Report." One management report, originally thought to have been omitted from the annual report, was later located without any title as the first section of the Financial Review. Identification of the management report would be improved by referencing it in the table of contents.

The AICPA Special Advisory Committee on Reports by Management shares our concern about placement of the management report. It specifically recommends that the report should be close to the financial statements "... but should not be included in the notes to the financial statements."[10] Although the Committee does not recommend that a management representation of responsibility be required, it does recommend that such a report be published and that it include "...information and representations on (1) the financial statements, (2) internal accounting control, (3) the audit committee, and (4) the independent auditor."[11] It also encourages discussion of related topics when appropriate, if such discussion is concise and without duplication.[12] The Committee's suggestions are both logical and important; if firms were to act on suggestions such as these, fewer users of annual reports would be victims of the information entropy previously discussed -- in this case, lack of information as to reporting responsibilities.

A Change of Direction

The SEC has required management to include a Discussion and Analysis of significant events for some time. However, the emphasis of the discussion changed for annual reports of years ending after December 15, 1980. Rather than direct the analysis toward percentage comparisons by year for income or other financial items, the SEC now requires:

> ... information on financial conditions as well as operations, with an emphasis on liquidity, capital resources and the impact of inflation, and, within each of those areas, a focus on trends and material changes, events and uncertainties.[13]

Since the SEC requires the Management Discussion and Analysis, we were aware that all the reports we examined would contain this item. We were interested, however, in the usefulness of this required item in terms of its (1) accessibility and/or identification and (2) content. We concentrated our attention

on the former characteristic; the SEC staff evaluated the latter characteristic on a broad basis, and a synthesis of the Commission's findings is presented in the next sections.

In the reports examined, we found that the SEC title, "Management's Discussion and Analysis of Financial Condition and Results of Operations," or even a shortened version of that title, has not been uniformly adopted. Subsection titles for "Liquidity" and "Capital Resources" are omitted frequently. No specific place within the report exists for this section of financial information considered by the SEC to be critical for a thorough understanding of corporate financial position. In our study, the management discussion could be found anywhere in the financial section from the first item of the Financial Review to the last item after the notes. In one report, the discussion was mixed with other financial information and not identified as a distinct item. In our opinion, lack of organization and identification mars the usefulness of the management discussion within the annual report.

The SEC, after reviewing a number of 1980 disclosures, issued releases to discuss its assessment of the initial responses to the new requirements of the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations."[14] The Staff concluded that the quality of discussion was a major improvement. In the area of results of operations, many registrants focused their analysis on segment data and information about significant events and trends. This analysis resulted in presentations which were generally more readable and informative than previous mechanical discussions of percentage line item changes. In dealing with financial conditions and changes in financial condition, registrants provided considerably more information than in the past, in a variety of formats. The SEC also remarked on the discussion provided by firms of other economic, industry and specific

company factors and uncertainties relevant to an accurate understanding of operations and financial condition. Overall, the Commission Staff was pleased with the results of the new requirements and did not see the need for more specific requirements at this time.

A Trend Toward Forward-Looking Information

The SEC staff was pleased with the number of registrants who elected to include forward-looking information which is encouraged, but not required. According to the SEC:

> Forward-looking disclosures were most frequent in the area of expenditures which are by nature future oriented. However, certain registrants also provided forward-looking information with respect to operations and liquidity. The disclosures, which varied from brief comments to broader discussions, including in some cases a five-year forecast of revenues and cash flow, demonstrated that the discussions need not be quantitative to be meaningful.[15]

The safe harbor rule, enacted by the SEC in 1979, provides some protection for firms which include forward-looking information in their reports.

The trend toward providing some forward-looking information in annual reports is important. In principle, the annual report is an appropriate vehicle for management/investor communication It provides an opportunity for management to communicate directly and to provide data which perhaps no other source can duplicate. But, in practice, the annual report may not function effectively as such a vehicle, if it provides only historical (rather than projected) information. Copeland and Weston conclude that:

> Investors gain little benefit from historic accounting data because they contain no new information. Therefore, although the annual report may serve as a useful device for monitoring the performance of management, it has little value to the investment community. Relevant data are forward-looking.[16]

The annual report may not even be useful in monitoring the performance of management if it contains no forward-looking data. It seems reasonable to assume that planning and control are facets of decision making for both management

and investors and that decision making on the part of investors should build upon:

1. Knowledge of management's plans for the future progress of the firm; and

2. Monitoring the progress of management as plans evolve in action.

Monitoring builds on knowledge of future plans. It is important to develop and assess effective presentations of forward-looking information. Hopefully, in time, investors will be able to find in all annual reports easily accessible, comparable, forward-looking information to use in decision-making.

Disclosure Examples Provided in the SEC Evaluation

In its evaluation of the the 1980 disclosures, the SEC provides some discussion and "real-life" examples of different approaches to the the various disclosure requirements. It is the opinion of the Staff that "... registrants may benefit from seeing a sample of different approaches to the various disclosure requirements, especially in the more novel disclosure areas."[17] Study of the SEC comments is important, especially in view of the fact that companies have been provided with guidelines, rather than strict requirements. Comparisons of a variety of presentations may eventually indicate one mode of presentation to be superior to the others, so that a required format might seem appropriate. On the other hand, although the guidelines may remain, some firms may find new formats for presenting their information more effectively. The SEC provides examples in three disclosure areas: results of operations, liquidity and capital resources, and inflation.

1. Regarding results of operations, the SEC emphasizes the need to identify and discuss significant events, whether they be internal or external to the company. Registrants provided meaningful discussion of the implications of a variety of significant events or uncertainties which were expected

to materially impact future operations -- for example, the decontrol of U.S. oil prices, the proposed Canadian oil production taxes and price restrictions, or, for railroads, the Staggers Act. One company discussed the impact on pre-tax income of closing certain unprofitable facilities:

> Second, as part of our efforts to improve future profitability, we permanently closed, during the first three quarters of 1980, a small West Coast ship repair yard, a manufacturing facility of our ... Tank operation, and two coal mines, each of which had become unprofitable to operate. In addition, during the fourth quarter, we permanently closed another unprofitable coal mine and sold our 14% interest in ... a Canadian company. These actions, combined with a loss on the sale of ..., a crude oil carrier, reduced 1980 pre-tax income by $15 million.[18]

This disclosure calls the attention of the reader to a significant event, and reminds the reader to take this event into account in using financial results of the past to predict the future.

In keeping with the trend toward future-oriented information mentioned earlier, the SEC provides the following examples of one firm's five-year sales forecast by segment:[19]

SALES GROWTH BY PRODUCTS

(In Thousands)

	Forecast		Actual		
	5-Year Growth Rate 1981-1985	1985	5-Year Growth-Rate 1976-1980	1980	1975
Building Products	15%	$ 610,000	23%	$304,000	$107,000
Energy-Related and Other	17%	635,000	23%	290,000	102,000
Industrial Components	18%	395,000	11%	172,000	102,000
Total	16%	$1,640,000	20%	$766,000	$311,000

This forecast was accompanied by disclosure of ten underlying assumptions as well as management's explicit expression of confidence in the forecast. Comparisons of projections with past results make it particularly useful for judging future profitability.

2. Regarding inflation disclosures, the Commission points out that SFAS 33 ("Financial Reporting and Changing Prices," the ruling of the FASB regarding financial reporting disclosure on inflation) applies only to public companies of a fairly large size (total assets exceeding $1 billion or inventory and property, plant and equipment exceeding $125 million). Nevertheless, the Commission believes that "... management for all registered companies should focus on translating the potentially confusing situation concerning inflation into a meaningful discussion of the effects of changing prices on the registrant's business."[20] The SEC provides numerous examples of the manner in which various companies have responded to the requirement of inflation disclosure. Following are two examples discussing the impact of inflation on monetary assets and liabilities:

Example 1.

> Inflation also affects our assets and liabilities when the amounts are fixed without reference to specific future prices. However, since our monetary assets (cash and receivables) are less than our monetary liabilities the Company will achieve some benefits by paying its fixed debts with dollars that have decreased in purchasing power.[21]

Example 2.

> To the extent that the general rate of inflation exceeds the interest rate yield of the Trust's mortgage loan portfolio ($5.8 million at an average interest rate of 9.5% at November 30, 1980), the economic value of the receivables, stated in dollars of constant purchasing power, may be less than their carrying value.[22]

Both of these examples deal with the effects of inflation, but the anticipated effects are different. The first firm anticipates a purchasing power gain, while the second warns of the possibility of a purchasing power loss. Disclosures such as these should assist investors in understanding the far-reaching and complicated effects of inflation on a variety of firms. Hopefully, SFAS 33 goes a long way in requiring the larger firms to provide supplementary data

on inflation. However, the SEC also plays an important role in requiring that smaller firms, as well as larger ones, provide some disclosure to help investors understand and anticipate the effects of inflation on profitability.

3. Regarding liquidity and capital resources, the SEC reminds companies that "... liquidity has both short-term and long-term aspects. It involves internal as well as external sources and is often closely associated with an enterprise's capital resources."[23] The discussions of liquidity and capital resources may be combined when the two topics are interrelated.

According to the SEC, cash flow from operations, as well as related working capital considerations, should be included in assessments of liquidity. One report cited in this area provides a discussion of cash flow from operations as a three-year trend (1978-1980). In this example, management incorporates a discussion of internal and external sources of funds (capital resources) for capital expenditures and specifically addresses the shortfall between operating cash flow and cash requirements for plant additions. In another example, a firm provides a five-year (1981-1985) cash flow forecast, which shows that management anticipates a substantial increase in the actual cash balance by 1985. Such forecasting exemplifies the trend toward forward-looking information discussed earlier.

The SEC reminds registrants that, in addition to cash flow from operations and related working capital considerations, assessments of liquidity should include matters such as the following:

A) Available unused sources of financing. These would include existing lines of credit, ease of access to markets, and convertibility of noncurrent assets to cash.

B) Trends in liquidity and known commitments. One of the disclosures cited included elements such as: trend data including a chart of changes in

cash balances for the past five years, identification of factors considered to be key indicators, and forward-looking information on planned expenditures.

C) Known or likely deficiencies and remedies. One of the examples cited discusses a liquidity deficiency and the efforts to remedy it. The discussion concludes with a comment on the related uncertainty as to the enterprise's future operations:

> The ability of the corporation and its subsidiaries to continue as a going concern and to meet their obligations as they come due will, in the short term, be dependent upon a restructuring of their outstanding debt, the ability to successfully complete the cash sale of surplus [equipment] and ultimately upon a return to successful operations.[24]

D) Significant events and uncertainties, including flexibility to adapt to change. One of the reports cited considers how a general economic recession might affect the firm's capital appropriation budget. In another report, the firm links a decline in its bond rating to internal cash generations problems and discusses the associated uncertainties for its short- and long-term capital spending plans.

SEC releases such as the ones discussed here have important roles to play in the evolution of the annual report as a document ever more responsive to the needs of investors. It is not enough simply to require that annual reports include more information or specific data. Information must be accessible and appropriately organized to convey its full meaning.

Improving the Annual Report

Our major recommendation is for the development of an organizational scheme for presenting the data in the financial section of the annual report. Figure 1 depicts this organizational scheme. For better presentation, the information should be structured in such a way that the data flows from a broad verbal interpretation of significant items and events through the statements

themselves to more specific information contained in notes or supplemental information. In such an approach to data organization, the user is first informed of the elements considered to be significant by management. He can then examine the statements, already aware of important elements. Detailed information or calculations following the statements can serve as explanation for the reader to follow up as desired. A system of cross-referencing throughout the financial section would aid in the coordination of data flow. Hopefully, this would provide a consistent framework for the data base presently a part of annual reports; and as new information is required, it could be inserted so as not to disrupt previously developed data flows. The framework we suggest may help by presenting a coordinated information system which can more easily assimilate and adapt future requirements.

On a more specific note, in reference to the table of contents, management report and management discussion, we recommend the following:

1. A table of contents should be provided at the beginning of each annual report. Along the lines of organization presented by Figure 1, page number locations should be referenced, as a minimum, for the following: Financial Review, Financial Statements, Management's Discussion and Analysis, Management and Auditor Reports, Notes, Unaudited and Supplemental Data. Other significant items outside of the financial section (for example, Description of Operations, Letter to Stockholders, Price Range of Stock) should be referenced in the table of contents as well.

2. The Management Letter, clearly labeled as such and referenced in the table of contents, should appear consistently in one particular place in the annual report. The most logical place would appear to be alongside the auditor's report. This report should be specific about management's corporate

responsibilities. Following the recommendations of the AICPA Special Advisory Committee on Reports by Management, we agree that:

A) Reference to types of internal controls employed under a cost/benefit basis is useful.

B) Recognition of the use of judgment and estimates as opposed to numerical precision of statement data is a significant communication which could improve user understanding.

C) Composition of the audit board and frequency of meetings hold implications for disclosing the significance of its duties and its independence from the managerial function.

Also, we believe that management (like the auditors) should sign its report as a more personalized display of involvement in the reporting process.

3. Management's Discussion and Analysis is an extremely significant section of the report. This section should be acknowledged in the table of contents for easy accessibility. And, in addition to the general title of Management's Discussion and Analysis, subtitles for the required subjects of "Results of Operations," "Liquidity" and "Capital Resources" should be used. Hopefully the content of this section will improve as firms gain experience with the new requirements and as the SEC continues to monitor and to report on the efforts of firms to disclose information in this area.

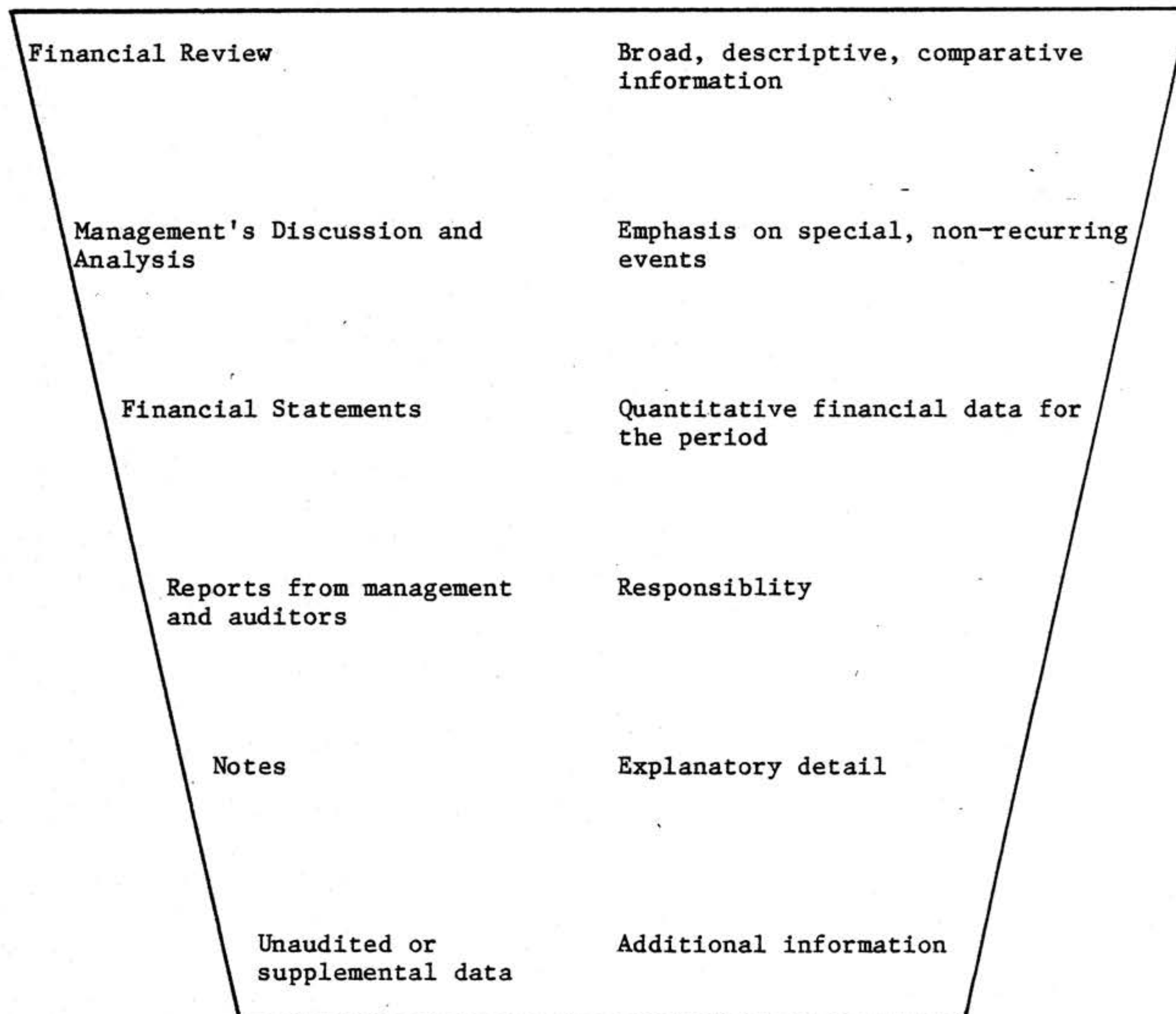
Conclusion

Resource allocation decisions are dependent, at least partially, on the data bases provided in annual reports. It is important that these data bases provide comparable and easily accessible information. This article points out some suggestions for improvements along these lines.

Recent SEC requirements permit more latitude to firms in "telling their own story" in the annual report. Continued study of how firms interpret these requirements is necessary, so that the sum of "stories" told is meaningful to investors. Improving communication between the corporate community and the public is an important goal. The annual report holds tremendous potential for helping us achieve this goal, and thus it is worthwhile to devote study and attention to the form and substance of this vital document.

Figure 1

STRUCTURE OF DATA FLOWS



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6. Anthony Sampson, The Seven Sisters (New York: Viking Press, 1975).

7. See SEC Releases No. 6349 and No. 18120, entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations," dated September 28, 1981. These releases are in SEC Docket, Vol. 23, No. 13, Oct. 13, 1981, pp. 962-85.

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11. Ibid, p. 3.

12. Ibid.

13. See SEC releases referred to in Reference No. 7 above. SEC Docket, Vol. 23, No. 13, Oct. 13, 1981, p. 963.

14. See SEC releases referred to in Reference No. 7 above.

15. See SEC releases referred to in Reference No. 7 above. SEC Docket, Vol. 23, No. 13, Oct. 13, 1981, p. 963.

16. Thomas E. Copeland and J. Fred Weston, Financial Theory and Corporate Policy (Reading: Addison-Wesley Publishing Company, 1979), p. 369.

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18. Ibid, p. 965.

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20. Ibid., p. 981.

21. Ibid., p. 983.

22. Ibid., p. 983.

23. Ibid., p. 972.

24. Ibid., p. 980.

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