The Value of Good Corporate Disclosure

By Kenneth F. Fick

Annual and quarterly SEC filings are a key source of information from which analysts and investors make investment choices. For firms with little or no analyst coverage, SEC filings may be the only source investors use to decide whether to buy or sell. Improving the quality and level of disclosure in a company's 10-K, 10-Q, and 8-K periodic reports is one of the most overlooked strategies a company can use to decrease its cost of capital and increase its market value. A company's ability to effectively communicate the activities of the business will increase an investor's understanding of the firm and consequently lower the investor's perceived risk.

Various academic studies demonstrate that firms with higher disclosure quality will experience smaller bid-ask spreads, greater analyst coverage, more accurate earnings forecasts, and lower cost of debt and equity capital. The precise financial impacts of improved corporate disclosure are difficult to quantify and vary by industry and firm. Recent studies have shown that the difference in the cost of equity between the most forthcoming firms in an industry and the least range anywhere between less than 1% to almost 10%. There is a similar effect when it comes to the cost of public debt where, all other things constant, companies with more informative disclosure enjoy approximately 1% lower interest costs compared to peers. This advantage applies even to private debt, such as bank loans; again, with all other things remaining constant, a company will enjoy an approximately 1.6 basis point lower loan spread for every unit increase in disclosure. Empirical evidence clearly shows that poor corporate disclosure can be costly and that by improving corporate disclosures, a company can gain a competitive financing advantage in the marketplace.

There are two primary schools of thought on why better corporate disclosure is associated with a lower cost of capital. The first suggests that greater disclosure enhances stock market liquidity, therefore decreasing transaction costs and increasing the demand for a company's securities. The second suggests that better corporate disclosure reduces estimation risk through improved stock price informativeness and reduced reliance on informal technical market signals. Both schools contend that the effect of better disclosure is more pronounced in companies with low market capitalization when compared to their market peers.

Traditionally, investor relations activities have not focused on improving periodic reports when launching an investor outreach campaign, under the belief that companies generally already produce a very high level of disclosure. In addition, information abounds in the public domain from lawyers, accountants, and other experts as to specific language and templates to use in the creation of periodic reports. This article will describe certain objectives to help improve both the quality and level of disclosure. When adhered to, these objectives will result in improvements to corporate disclosure and have a lasting effect on a company's cost of capital.

Common Excuses

Even with the vast amount of information provided by the SEC and available in the public domain as to what qualifies as good corporate disclosure, preparers still provide myriad excuses why achieving better results is so elusive. Some common excuses include—

- reluctance to disclose what a company sees as competitively sensitive information;
- desire to avoid the invasion of personal privacy of employees (typically this is in regard to executive compensation disclosures);

- the belief that the current disclosure is too voluminous and that no one reads the reports anyway, therefore the additional time and energy that it would take to improve them is not going to yield any additional benefits; and
- concern that providing more than what the existing disclosure rules require exposes the firm to potential litigation.

Excuses are primarily based on either fear or lack of resources. When preparers are pressed as to what information may be too competitively sensitive or an invasion of an employee's privacy, they will most commonly concede that the information they think would be too sensitive is already widely known to their competitors and industry peers. A lack of resources is a very common excuse for many different corporate initiatives and although a typically valid excuse, especially in smaller companies, there is a common misconception that quality corporate disclosure is synonymous with profuse corporate disclosure, which is certainly not the case. Finally, there is the threat-of-litigation excuse. This is based on the assumption that that if a company provides too much information in its corporate disclosures, it is at greater risk of lawsuits filed by aggressive attorneys. Yet the U.S. legal and regulatory structure predominantly only allows legitimate lawsuits with sufficient merit against companies to go to trial. Although this may not always be the case, by focusing on the quality of corporate discourse and the level of disclosure when compared to market peers, a company can actively work to mitigate any potential litigation risk and increase its chances of prevailing in court if a trial is unavoidable.

Quality of Corporate Disclosure

By simply following effective report writing guidelines, anyone can produce more useful periodic reports. They should be prepared with the overarching objective of providing information to aid investors in making investment, credit, and similar resource allocation decisions while incorporating the fundamental qualitative characteristics of comprehensiveness, relevance, timeliness, reliability, comparability (across institutions and over time), and materiality. This objective is fundamental to U.S. GAAP (and to International Financial Reporting Standards [IFRS]) and to securities laws. Beyond this overarching objective, every company is different and, therefore, the guiding principles used to develop a company's periodic reports should be customized to meet the needs of the organization and its key stakeholders. All periodic reports should be written in order to be meaningful to all users, minimally complex, and to provide transparent and meaningful information to the investor.

Meaningful to all users. Many companies have a very narrow interpretation of the identity of the users of its periodic reports and, when asked, refer to the well-known "reasonable investor" standard from Staff Accounting Bulletin (SAB) 99 as it applies to materiality. A much broader user group is supported by the accounting literature, however. FASB Concepts Statement 1 indicates that potential users of financial statements should include individuals with both direct and indirect interests in a reporting entity. This can include vendors, customers, rating agencies, counterparties, and creditors. In addition, with the recent investments in the private sector by public entities, it may also be reasonable to include users within the federal government, including Congress, government agencies, and maybe even U.S. taxpayers. A report user can include any person who has an interest in understanding the operations, performance, and financial condition of a company.

Minimally complex. Complexity in financial reporting can be loosely defined as the difficulty a report user has in fully understanding the economic results and position of a company. This complexity can be greatly reduced by following the SEC's guidance on the use of "plain English" in all periodic reports. Writing in plain English can in some ways be the most important guiding principle, because disclosures are ineffective if users do not understand the information provided. This article does not attempt to summarize or repeat all the SEC's specific instructions here, but urges careful and periodic consideration of the SEC's guidance on this goal.

Fundamentally, reports in plain English should provide concise, comprehensive, and meaningful descriptions of the operations, cash flows, liquidity, and financial position of a company. This does not mean excluding complex information to make the report easier to understand. Corporate disclosure inevitably entails discussion of complex transactions and issues, and determining the appropriate assumed level of reader sophistication is critical. Paragraph 34 of FASB Concepts Statement 1 states that the information included in financial reports "should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence."

Transparent and meaningful information. Numerical presentations, accompanied only by factual descriptions of those numbers, are insufficient to adequately explain material information to report users. Management's analysis and interpretation of the current information, including explanations of how it differs from past periods and how matters may change in the future, is critical. Additional disclosure must be provided "through the eyes of management" for an investor to judge the quality of earnings, the likelihood that past performance is indicative of future performance, and how the issuer's financial condition has changed and could change in the future. In short, corporate disclosure should explain what keeps management up at night. The use of this type of qualitative disclosure is most commonly presented within the management discussion and analysis section of a periodic report, but careful attention should be given to provide qualitative explanation wherever quantitative information is provided.

All too often, periodic reports do not provide sufficient contextual information to completely convey management's perspective, the analysis of the financial condition of the company, and its future prospects. Instead, the focus is based on reporting financial information that is quantitatively accurate but not enlightening to external report users.

Level of Corporate Disclosure

Disclosure levels tend to be positively correlated with company size. For example, smaller companies with limited resources may choose to disclose less information than larger competitors. This has the unintended consequence of increasing information asymmetry, therefore shifting more firm-specific risk to insiders while shifting market risk to outsiders. This is magnified by the fact that investors interested in small publicly traded companies are typically left to their own resources

with limited other available sources of information.

Different industries display different patterns of disclosure, making it almost impossible to create a uniform outline for companies to follow. For example, the banking industry remains highly regulated in the United States and requires specific disclosures related to types of loans, securities held, and amount and type of leverage used, not all of which may be applicable to other industries. Previous academic studies had relied on the disclosure ratings provided in the Annual Review of Corporate Reporting Practices compiled by the Association of Investment Management and Research (now the CFA Institute), which was last published in 1997.

How does a company know if it is providing a sufficiently high level of disclosure to investors, without adversely impacting its cost of capital? Ideally, a company must disclose enough information in an effective enough manner that information-gathering costs and agency costs are minimized. The good news is that a company's level of disclosure is based on what is appropriate for its industry peer group. Therefore, by analyzing the periodic reports of larger companies, which a smaller company may aspire to become, one can determine what additional information would be useful to include in future corporate disclosures. Unfortunately, there is no hard-and-fast rule when it comes to an appropriate level of disclosure. Investors will always demand more, and management must strive to achieve an appropriate balance among what is competitively appropriate, is legally compliant, and meets capital providers' informational needs.

Adding to financial reporting complexity is the need to convey information on an entity that is constantly changing and evolving. The nature of any business is not static but requires adaptation to new economic scenarios, business methods, customer preferences, and government interactions. This means periodic reports must evolve along with the business itself in order to meet investors' informational needs. The effective communication of the economic drivers of these businesses is critical in minimizing the natural information asymmetry that exists between business managers and investors.

Further Tips for Clear Disclosure

In order to produce better periodic reports, preparers should consider starting with a blank slate and not use the prior periodic report as a starting point. This will allow preparers to create an outline based on the most recent economic conditions and global, regional, and industry forces as well as other factors affecting the company, without the constraint of what happened in previous periods. In addition, they should avoid using boilerplate language as much as possible, they should have one senior-level executive be solely responsible for the final report in order to create a single voice and writing style, and they should cross-check all qualitative and quantitative information within the report to other public disclosures such as press releases and investor presentations to ensure there is a consistent level and quality of information provided throughout all channels.

No matter how substantial periodic reports are, they will never speak for themselves. They require interpretation by users and remain only one element in a broader repertory of channels for communication and accountability between a company and its stakeholders. Written effectively, periodic reports will go a long way in easing market uncertainties regarding a company's future prospects and therefore lower its overall cost of capital, minimize litigation, and increase the overall value of the firm. ❑

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