Preparing annual reports in the 1990s

Elizabeth Howard

Compliance and disclosure are the basis of annual reporting. When the Securities and Exchange Commission (SEC) was formed in 1934, the accompanying securities laws required public companies to file certain financial data and other information about their operations with the SEC so it would be available to investors. What they didn't require was embellished prose, slick four-color photographs and fluorescent pie charts and graphs. There are no legal requirements for a company to publish this type of annual report.

With today's electronic communication, the facsimile machine, video and advanced computer networks, is the traditional annual report becoming an anachronism?

Annual reports will exist, in one form or another, as long as public companies offer shares of stock to the public and to their institutional fiduciaries. Corporate identity is the motivating factor. The annual report is a company's primary calling card; the lasting visual impression of an organization. Yet, market psychology and economic factors are fluid. The following points must be kept in mind when planning an annual report in the 1990s.

1) Identify target audiences and how they perceive the corporation.
2) Make decisions about how to resolve conflicts among the external perceptions.
3) Understand how changes passed by the SEC will affect the annual report.
4) Develop a concept and create a visual impression that reflects the company's culture.
5) Plan the report with an international audience in mind.

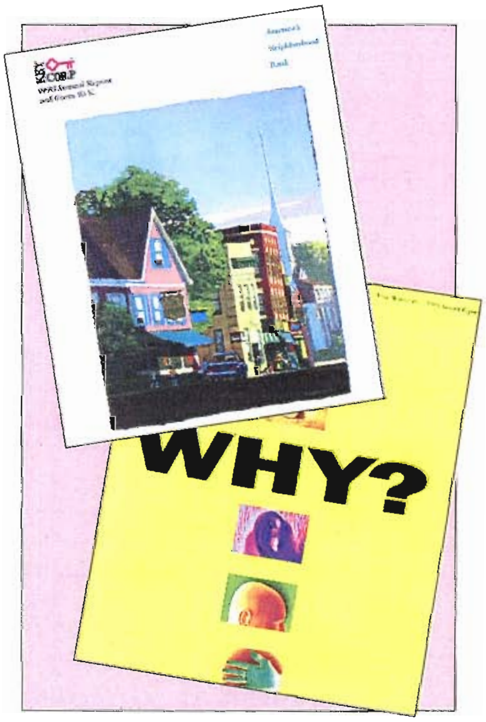
Identify the audience

For public relations executives, an important issue in the 1990s will be corporate governance. Who is controlling the corporation and what issues are they concerned with? Identifying the shareholder audience for the annual report is essential in order to understand how it should be written and designed. Investment bankers are another key audience. At times, members of the media and other interested parties might look at the report.

During the 1960s and 1970s, annual reports were directed to individual shareholders, as well as institutions. Today, almost 70% of all stock is managed by institutions and professional money managers. The shift in U.S. investor type is a result of the stock market crash of October 1987. At that time, many individual investors were forced out of the market.

"The lack of realization on the part of senior management of who constitutes the audience accounts for the lack of balance in the presentation," said James McClure, a vice president in the Senior Management Equity Assets Group at Goldman Sachs & Company, New York City.

Institutional investors are sophisticated. Most look at the financial statements in the annual report first. While the average individual investor does not understand the financial statements, institutional investors know what to look for. Therefore, the chairman's letter can't gloss over figures buried in the back of the report.



Key Corporation's annual reports can be understood by both institutional and individual investors. Time Warner's 1989 annual report, while visually exciting, did not fully answer the question its cover raised.

Resolve conflicts in perception

Conflicts often occur between internal and external perceptions of the company because of what happens *inside* the company before such new developments reach the investing public. The role of the communications department is to suggest methods of defining and then resolving these conflicts in how the company is perceived. It might require something as formal as an audit conducted by an outside consulting firm or as informal as conversations with analysts covering the industry, important customers and even representative shareholders.

One annual report that dealt with this issue effectively was published by the Lotus Corporation in 1988. Lotus was a high-flying technology company in 1982 with sales of $53 million, when its business plan had called for $5 million. The company stumbled in 1988. Analysts and others were asking, "Where is the company today, where is it going and how is it perceived in the marketplace?" To answer these questions, Tom Hughes, vice president of creative services, designed the 1988 annual report around an event. A forum was planned that included a customer, an editor, a financial analyst, an industry analyst, a shareholder and the chairman of Lotus. The 1988 annual report was an edited transcript of the forum.

SEC mandates changes

It is not a requirement that the annual report be filed with the SEC. However, it *is* a requirement that the financial data in the report be consistent with SEC filings (forms 10K and 10Q). The most significant change that can be found in 1990 annual reports is in the Management's Discussion and Analysis (MD&A) section. These changes put a new emphasis on the quality of disclosure.

The SEC's Division of Corporate Finance conducted two studies into disclosure in the MD&A section and found that it was lacking. In the first study, the division's staff reviewed the periodic reports of 218 companies. This review led the staff to require 72 of those companies to amend their reports. This is very significant, because the documents had already been filed. An amendment leads to the conclusion that the original filing was deficient. A second study was done that was smaller in scope.

"The SEC's goal for the MD&A section is to have it written in such a fashion that it provides what I call 'soft information,'" commented Monte Wetzler, an expert in U.S. securities law and a partner in the New York City law firm of Breed, Abbott & Morgan. "Management is asked to write a description, in layman's terms, for the shareholders describing what they believe is going to happen to the company. Management is asked to consider existing trends and events that might have a material effect on the company. If management is unable to make a determination of whether or not a result is reasonably likely to occur, then the assumption must be that it will.

"The SEC does not define what it means by reasonably likely to occur or what is meant by a material effect upon the company," Wetzler continued. "Although the SEC's explanations are vague, I encourage everyone involved with the annual report to review this section carefully.

"The SEC is currently reviewing a proposal that will require a company to include a statement in the annual report that acknowledges the company's financial statements are management's responsibility and to describe the system of internal controls that are in place," Wetzler noted. "This rule will probably be adopted in the future. In fact, a number of companies are already doing this on a voluntary basis."

Reflect corporate reality

Although written by corporate counsel and outside attorneys, the MD&A section should be understood by individuals writing material in the front of the book. Ask for a meeting with the legal counsel to review this material.

The financial data in the back of the book should speak clearly to a professional audience. It is the front of the book and the overall visual presentation that allow for creativity and imaginative solutions that speak to everyone.

One solution that was noted in most business pages was the cover of the 1989 Time Warner annual report. The report was the first issued after the merger of Time and Warner Communications. With large bold letters, on a fluorescent background, the book asked "WHY"? Was it effective? "I believe the cover of the report asks the right question," said McClure of Goldman Sachs. "The problem is that the inside only gives one dimension of the picture. It's designed like a stylish urban magazine, and $8.3 billion in debt had been heaped on the shareholders. There are only 11 pages of financial statements."

Similar confusion is evoked by reviewing the 1989 Exxon Annual Report following the Valdez oil spill in Prince William Sound in March 1989. The chairman's letter opens with the comment that the company continues to run smoothly in spite of this catastrophe. The accompanying essays on Exxon and the environment, while attempting to describe their cleanup efforts, carried a tone of wanting the entire incident to disappear.

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One of the problems in writing annual reports is that lawyers and accountants are involved. This is because of rule 10B-5, which essentially imposes a liability on a company that issues a false or misleading statement in connection with the purchase of a security. Again, although the annual report is not an SEC filing, "management is cautioned not to 'free write,' " according to Wetzler.

Once the copy is prepared, lawyers and accountants will debate the use of specific words. They will often try to change the language to "legalese." Public relations practitioners will have to make sure the report does not resemble a patchwork quilt of language type and style.

The individuals who run a company are the only ones who understand its historical cycles and the nuances of what distinguishes the company from its competition, according to McClure of Goldman Sachs. He noted that Warren Buffet, the chairman of Berkshire Hathaway, writes the company's annual report, and makes a great deal of effort to outline what has occurred and gives projections of what is expected to happen. *(See "The Buffet Method," by Robert K. Otterbourg, July 1990, page 22.)*

Another good example, McClure suggested, is the report of Key Corporation, a bank holding company in Albany, NY. "Their annual report was a revelation to me," McClure said. "I had not seen an annual report this good for a long time. When I met with the chairman there were few questions to ask. The preamble to the MD&A section was clear, concise and thorough. The mythical 'little old lady in Peoria' could have understood it as much as the institutional investor. Management made a head-on attempt to tackle loan loss analysis and to look at the future and where the company was headed. This is something that I had not seen in 19 years of reviewing annual reports."

In corporations where the public relations department has total responsibility for the annual report, including writing the chairman's letter, it is important that extensive interviews are arranged with the chairman and other executives managing the company. Reflect their vision, articulate their thoughts and write, if possible, in their style. The goal is to have the report convey the culture of the organization and not mimic trends in annual reporting.

Consider international aspects

The most important trend in corporate merger and acquisition activity is expanding foreign involvement. Therefore, in preparing an annual report it is important to note that it will probably be reviewed by an international audience.

The United States has the most stringent financial reporting rules of any country in the world. However, as international investment grows, some executives are calling for harmonization of reporting standards. The SEC has been asked to relax some rules of reporting so that American companies can become more competitive internationally. Wetzler of Breed, Abbott & Morgan believes that the SEC has already proposed the deregulation of certain disclosure requirements for consideration with multijurisdictional offerings. Yet, he added, those proposals have not affected annual reports to shareholders.

Like hemlines, there are trends in annual reporting. This season's crop of 1990 annual reports will be to the point, and probably printed on recycled paper with biodegradable ink. Chairmen and other senior managers are beginning to pay more attention—to the message, to the image annual reports convey and to the cost of publishing the book. An analogy one report designer suggested is that American business can currently be described as an ocean liner going through a storm. CEOs are recognizing that it is important to give their investors the perception that they are equipped to withstand the rough seas. This bodes well for public relations executives who will be asked to advise management about communicating during the turbulent business climate.

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