TRIGGERED DISCLOSURES: ESCAPING THE DISCLOSURE DILEMMA!

Backing up company stories…

Recapping the Disclosure Dilemma

- In a post a few weeks ago, I argued that the disclosure process had lost its moorings, as corporate disclosures (annual filings, prospectuses for IPOs) have become more bulky, while also become less informative at the same time.
- I argued that some of this disclosure opacity could be attributed to the law of unintended consequences, with good intentions driving disclosure rules, and that some of it is deliberate, as companies use disclosure rules to create more complexity.
- In this post, I propose one way out of the disclosure dilemma, albeit one with little chance of being adopted by the SEC or any other regulatory group, to the disclosure problem.

The Disease

- Company disclosures have become more bulky over time, whether it be in the form on annual filings (like annual reports or 10K/10Q filings in the US) or prospectuses for initial public offerings.
- These disclosures have become less readable and more difficult to make sense of, partly because they are so bulky and partly because disclosures with big consequences are mingled with disclosure with small or even no consequences, often leaving it up to investors to determine which ones matter.
- The net effect is that investors feel more in the dark now, when investing in companies, than ever before, even though the push towards more disclosures has ostensibly been for their benefit.

The Diagnosis

- The first is that technology has made it possible to collect more data, and on more dimensions of business, than ever before in history, and report that data. The second is that interest groups have become much more savvy about lobbying regulatory groups and accounting rule writers to get their required data items on the required list. The third is that companies have learned that converting disclosures into data dumps has the perverse effect of making it less likely that they will held accountable, rather than more.
- That said, there are three other reasons for the disclosure bloat:
  - The first is the prevailing orthodoxy in disclosure is tilted towards "***one size fits all***", where all companies are covered by disclosure requirements, even if they are only tangentially exposed.
  - The second is the notion of ***materiality***, where ‘*Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity*’.
  - The third is that the ***disclosure rule writers happen to be in the disclosure business***, and since more disclosure is good for business, the conflict of interest will always tilt toward more rather than less disclosure.

Escaping the Disclosure Trap

- There is a way out of this disclosure trap, but it will require a rethink of the status quo in disclosures.
  - It starts first by moving away from "one size fits all" disclosure rules to disclosures tailored to companies, a "triggered" disclosure process,
  - where a company's contentions about its business model and value trigger disclosures on the parameters of that model.
  - It extends into materiality, by reframing that concept in terms of value, rather than profits, and connecting it to disclosure, with disclosure requirements increasing proportionately with the value effect. the disclosure business.

1. One Size does not fit all!

- At the time, the notion that it disclosure requirements should be general, and apply to all companies, was rooted in the idea of fairness.
- In the decades since, there have been carve outs to this general rule, but they have been narrowly carved out for segments of firms. For instance, oil companies have been required to disclose their ownership of "proven undeveloped reserves", in addition to details about quantity, new investments and progress made during the year in converting those reserves. These exceptions notwithstanding, disclosure laws written to cover concerns in one section (such as the issue and prevalence of management options with technology firm or lease commitments at retail and restaurant companies) have been applied broadly to all companies.
- It is time to rethink this principle and allow for a more variegated disclosure policy, with some disclosures required only of subsets of companies. Since the next big bout of disclosures that are coming down the pike will be related to ESG, this discussion will play out in a wide range of ESG data items.

2. From earnings-based to value-based materiality

- While we may agree with the premise that any information that has a material effect should be disclosed, but there is disagreement on what comprises materiality.
- I believe that the "materiality principle" is diluted by measuring it in terms of impact on net income and the fact that accountants tend to be naturally conservative in measuring that impact. Simply put, it is safer for an accounting or audit firm to assume that a disclosure is material, and include it in reports, even if it turns out to be immaterial, than it is to assume that it is immaterial, and be found wrong subsequently.
- One solution to this problem is to redefine materiality in terms of effects on value, rather than earnings, thus accomplishing two objectives.
  - First, it will reduce the number of noise disclosures, i.e., those that pass the materiality threshold for earnings, but don't have a significant impact on value.
  - Second, since value is driven by expected cash flows in the future and not in the past, it will shift the focus on disclosures to items that will have a recurring or continuous impact on the company.

3. Triggered Disclosures

- Triggered disclosures, where disclosures are tailored to a company's make-up and valuation stories, are one solution.
  - For instance, a company that claims that brand name is its supreme competitive advantage would then have to provide information to not only back up that claim, but also to allow others to value that brand name. In contrast, a company that does not have any pretentions about brand name driving its value (Exxon Mobil, even Walmart) should not be covered by those disclosure requirements.

Application: Initial Public Offerings

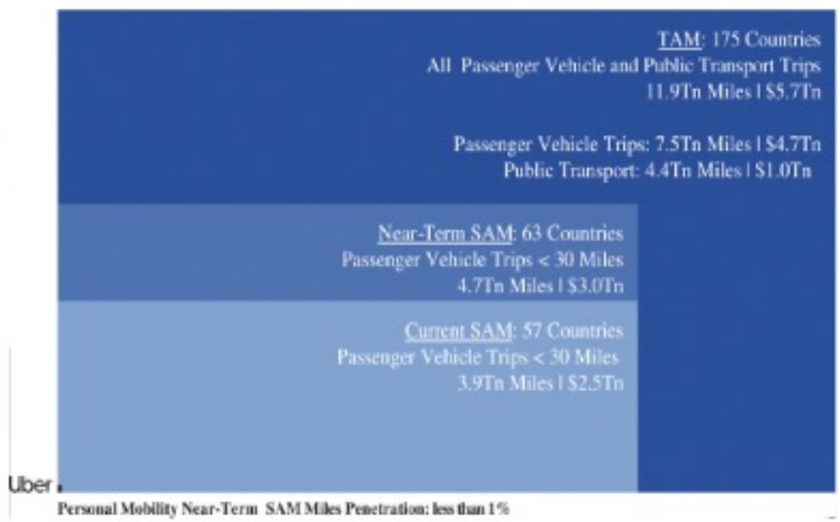
- I will focus on initial public offerings, where there is a sense that the disclosure rules are not having their desired effect.
- In my last post, I noted that prospectuses, the primary disclosure documents for a companies going public, have bulked up, contrasting the Microsoft and Apple prospectuses that came in at less than a 100 pages in the 1980s to the 400+ page prospectuses that we have seen with Airbnb and Doordash in more recent years.
- At the same time, applying a disclosure template largely designed for mature public companies to young companies, often with big losses and unformed business models, has resulted in prospectuses that are focused in large parts on details that are of little consequence to value, while ignoring the details that matter.

Triggered Disclosures in Prospectuses

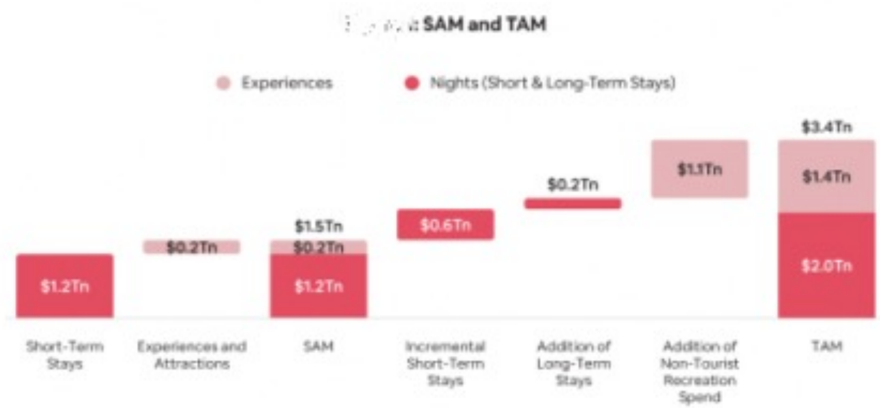
- Since companies going public often do so on the basis of stories that they tell about their futures, and these stories vary widely across companies, this segment of the market lends itself well to the triggered disclosure approach.
- To do so, I will draw on a paper that I co-wrote with Dan McCarthy and Maxime Cohen, to provide details. In that paper, we argue that a going-public company that wants to build its story around certain dimensions (a large total addressable market or a large user base) will trigger disclosure of a more systematic, business type-specific, collection of "base disclosures" that are required to understand the economics of businesses of that type, whatever type that might be.

a. Total Addressable Market (TAM)

Uber (2019)



Airbnb (2020)

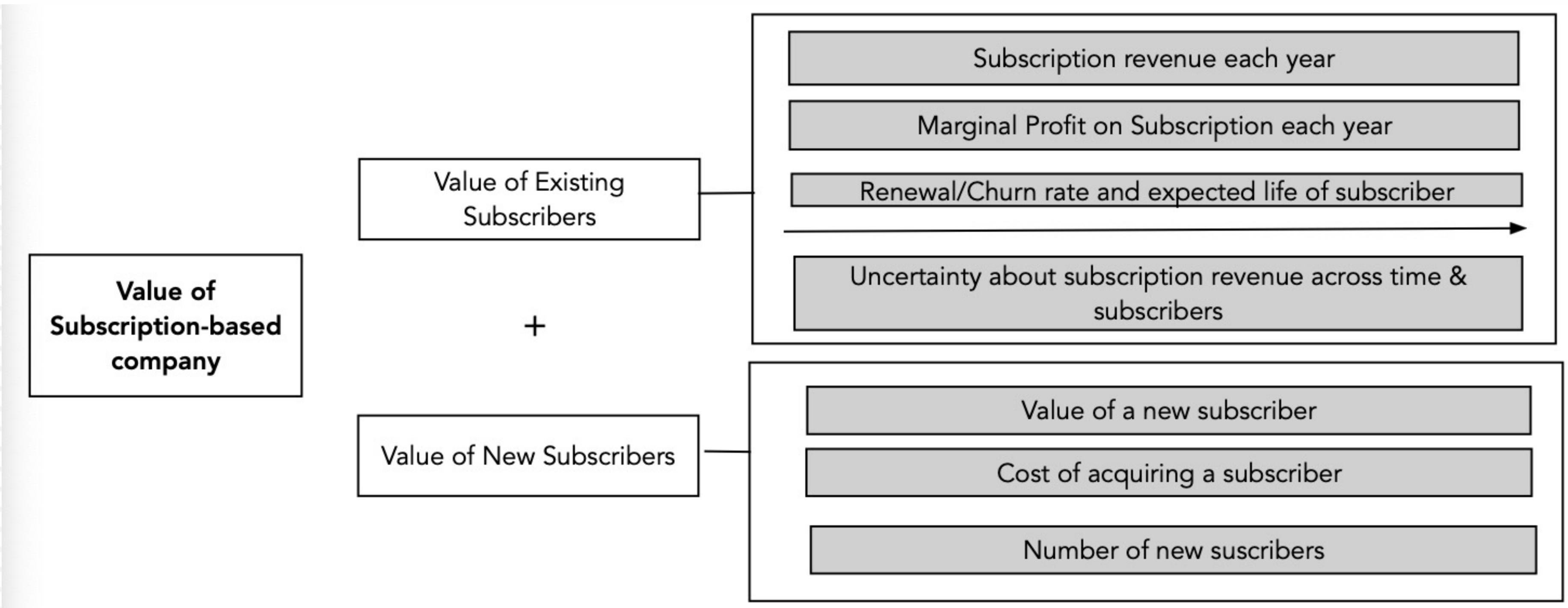


Companies going public have increasingly supported high valuations by pointing to market potential, using large TAMs as one of the justifications. These TAMs are often not only aspirational, but also come with very little justification and no timeline for how long it will take for the existing market sizes to grow into those TAMs.

TAM Constraints

- a. Basis for TAM and its antecedents: Companies that specify a TAM should also specify the existing market size (i.e., the serviceable addressable market or SAM), as well as additional "bridges" so that investors can understand the evolution from SAM to TAM. Investors who may be skeptical of a lofty TAM could still look to SAM as a more achievable intermediate metric.
- b. Market share estimates: As long as companies do not have to twin TAM with expectations of market share, there is little incentive for them to restrain themselves when estimating TAM. We would recommend requiring that companies that disclose TAM figures couple them with forecasts of their market share of those TAM figures.
- c. Ongoing metrics or measures: Companies usually provide TAM, SAM, and variants thereof on a one-shot basis, disclosing these figures in their pre-IPO prospectuses and then never again. We believe that investors should be given these measures on an ongoing basis.

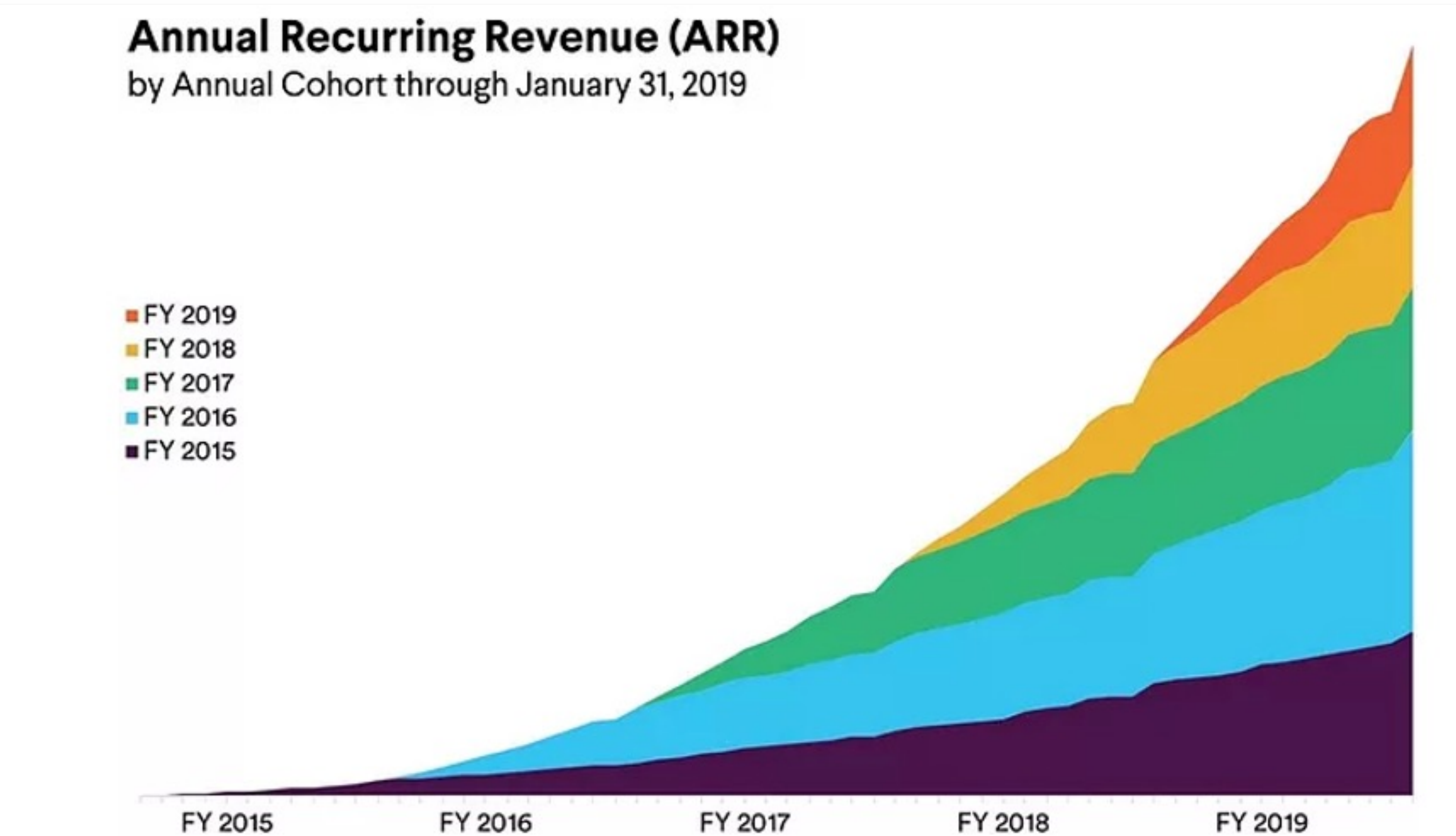
b. Subscription based companies



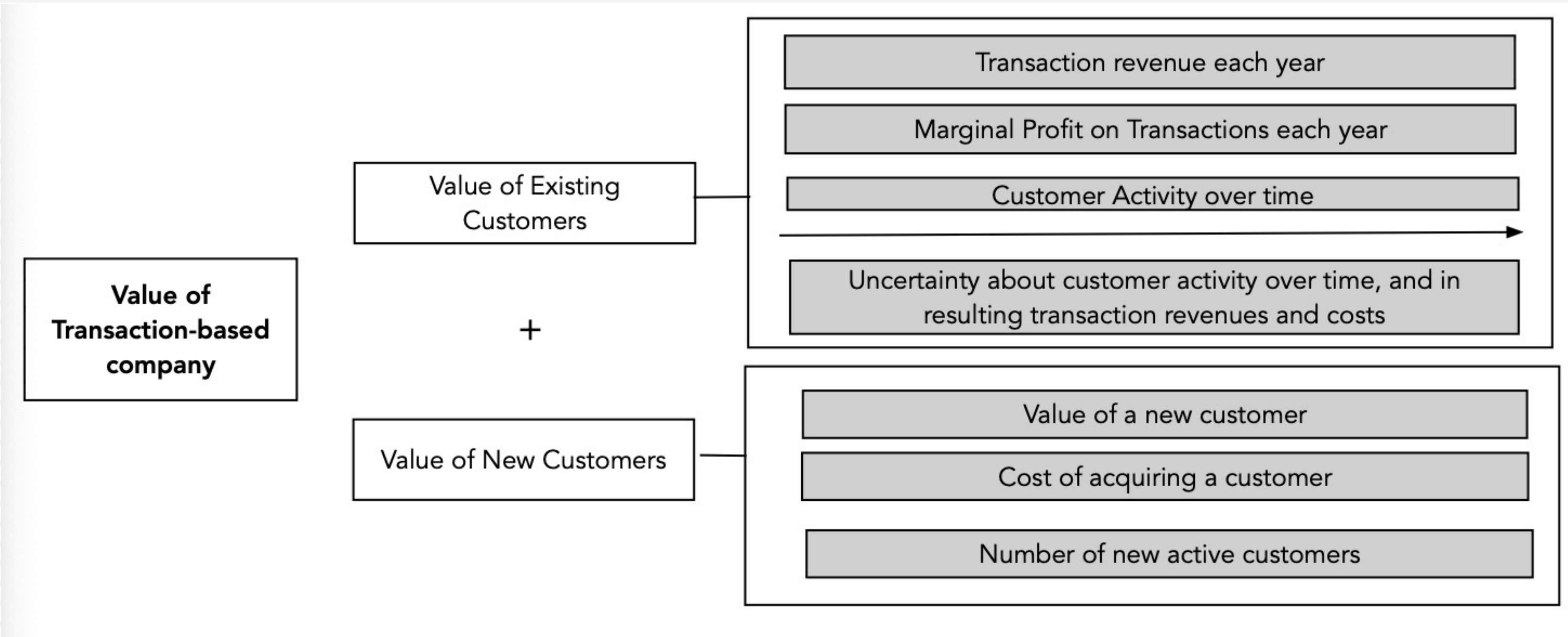
Subscription Information

- Total subscriber count: The most basic prerequisite is that we observe the total number of subscribers in each period, to track overall growth trends in the number of subscribers and to understand how revenue per subscriber evolves over time.
- Subscriber churn: To value a subscriber, a key input is the renewal rate or its converse, the churn rate. Holding all else constant, a subscription business with a higher renewal rate should have more valuable subscribers than one with a lower renewal rate.
- Contribution profitability: It is not enough to retain customers – for customers to be valuable, they need to generate incremental profits while they are alive. It is important to know, then, how customers monetize over time and how this translates into variable profitability (more commonly referred to as “contribution profitability”).
- Subscriber acquisitions & drop offs: To move from the value of a single subscriber to the value of the entire subscriber base, we must also know how many subscribers are acquired over time, not just the net subscriber count.
- Cost of acquiring subscribers (CAC): Subscription-based companies attract new subscribers by offering special deals or discounts, or through paid advertising. While the cost of acquiring subscribers can sometimes be backed out of other disclosures at subscription-based companies (such as subscribers numbers, churn and marketing costs), it would make sense to require that it be explicitly estimated and reported by the company.
- Cohort data: While many subscriber companies are quick to report total numbers, only a provide a breakdown of subscribers, based upon subscription age. This breakdown, called a cohort table, can be informative to observe retention and/or monetization patterns across cohorts.

A Cohort Table



c. Transaction based companies



Transactional Information

- Active customer count: We replace the notion of an “alive” customer, which is relevant for subscription-based companies, with that of an “active” customer, which is more suitable for transaction-based businesses. An active customer is one who has placed at least one order over some preceding time window.
- Total orders: In transaction-based companies, the average purchase frequency of active customers can change, often significantly, over time. We need to know the total orders because this further allows us to decompose changes in revenue per active customer into changes in order frequency per active customer and changes in average order value.
- Promotional activity: It can be easy to significantly increase purchase activity through enticing targeted promotions, creating the illusion of rapid growth that may not be sustainable over the long run, due to their substantial cost. Since these promotions are often reported as revenue reductions, rather than expenses, the cost of these campaigns are often opaque, to investors.

d. Fintech Companies

- <u>Quality/Risk metrics on operating activity</u>: In the aftermath of the 2008 crisis, banks, insurance companies and investment banks have all seen their disclosure requirements increase, but ironically, the young, technology-based companies that have entered this space seem to have escaped this scrutiny. In fact, the absence of a regulatory overlay at these companies makes this oversight even more dangerous, since an online lender that uses a growing loan base as its basis for a higher valuation, but does not report on the default risk in that loan base, is a problem waiting to blow up.
- <u>Capital Buffer</u>: In the last century, regulators have replaced these voluntary capital set asides, at banks and insurance companies, with regulatory capital needs, tied (sometimes imperfectly) to the risk in their business portfolios. Many fintech companies have been able to avoid that regulatory burden, largely because they are too small for regulatory concern, but since they are not immune from shocks, they too should be building capital buffers and reporting on the magnitude of these buffers to investors.

Conclusion

- As data becomes easier to collect and access, the demands for data disclosure from different interest groups will only increase over time, as investors, regulators, environmentalists and others continue to add to the list of items that they want disclosed.
- That will make already bulky disclosures even bulkier, and in our view, less informative.
- There are three ways to have your cake and eat it too:
  - Allow for increasing customization of disclosure requirements to the firms in question, since requiring all firms to report everything not only results in disclosures becoming data dumps, but also in the obscuring of the disclosures that truly matter.
  - Shift the materiality definition from impact on earnings to impact on value, thus moving the focus from the past to the future.
  - Tying disclosures to a company's characteristics and value stories will limit those stories and create more accountability.