

**SEC Advisory Committee on Improvements to Financial Reporting
Delivering Financial Information Subcommittee Update
May 2, 2008 Full Committee Meeting**

I. Introduction

The SEC's Advisory Committee on Improvements to Financial Reporting (Committee) issued a progress report (Progress Report) on February 14, 2008.¹ In chapter 4 of the Progress Report, the Committee discussed its work-to-date in the area of delivering financial information including its developed proposals relating to XBRL tagging of financial information and improved use of corporate websites and its future considerations relating to disclosure of key performance indicators, improved quarterly press release disclosures and timing, and the inclusion of executive summaries in public company periodic reports.

Since the issuance of the Progress Report, the delivering financial information subcommittee (Subcommittee IV) has deliberated further the areas of improved use of corporate websites, disclosure of key performance indicators, improved quarterly press release disclosures and timing and inclusion of executive summaries. This report represents Subcommittee IV's latest thinking, including its consideration of input received through comment letters and received orally at the March 14, 2008 Committee meeting in San Francisco and subsequent Subcommittee meeting with industry participants. Subject to further public comment, Subcommittee IV will recommend the following preliminary hypotheses to the full Committee for its consideration in developing the final report, which it expects to issue in July 2008.

II. XBRL

In the Progress Report, the Committee issued a developed proposal regarding XBRL (developed proposal 4.1). Refer to the Progress Report for additional discussion of this developed proposal. At the Committee meeting on March 14, 2008 held in San Francisco, the Committee received oral and written input from market participants regarding the XBRL developed proposal. The Subcommittee understands the SEC has scheduled an open meeting on May 14, 2008 to consider whether to propose amendments to provide for corporate financial statement information to be filed with the SEC in interactive data format, and a near- and long-term schedule therefore. Subcommittee IV proposes no revisions at this time to the developed proposal.

III. Use of Corporate Websites

In the Progress Report, the Committee issued a developed proposal regarding the use of corporate websites and the development of uniform best practices regarding corporate website use by industry participants (developed proposal 4.2). Refer to the Progress Report for additional discussion of this developed proposal. The Committee heard

¹ Refer to Progress Report at <http://www.sec.gov/rules/other/2008/33-8896.pdf>.

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additional input from industry participants, including newswire services, reporting companies, investors, and securities lawyers regarding the developed proposal as part of the comments received on the Progress Report. The Subcommittee heard from companies and investors about the value of corporate website disclosures as an additional, though not exclusive, means of providing information to the market in a timely manner available to all persons. Subcommittee IV proposes no significant revisions at this time to the developed proposals regarding corporate websites and industry developed best practice guidelines.

IV. Disclosures of KPIs and Other Metrics to Enhance Business Reporting

Preliminary Hypothesis 1:

The SEC should encourage private sector initiatives targeted at best practice development of company use of Key Performance Indicators (KPIs) in their business reports. The SEC should encourage private sector dialogue, involving preparers, investors, and other interested industry participants, such as consortia that have long supported KPI-like concepts, to generate understandable, consistent, relevant and comparable KPIs on an industry-specific and relevant activity basis. The SEC also should encourage companies to provide, explain, and consistently disclose period-to-period company-specific KPIs. The SEC should consider reiterating and expanding its interpretive guidance regarding disclosures of KPIs in MD&A and other company disclosures.

The Committee should further acknowledge the useful work of those consortia that endeavour to go beyond the limited scope of the Committee's recommendation to provide an overall structure which provide a linking of financial and KPI indicators into a seamless whole.

Background:

As the Committee noted in the Progress Report, enhanced business reporting and key performance indicators (KPIs) are disclosures about the aspects of a company's business that provide significant insight into the sources of its value. The Enhanced Business Reporting Consortium,² has stated that the value drivers for a business "can be measured numerically through KPIs or may be qualitative factors such as business opportunities, risks, strategies and plans—all of which permit assessment of the quality, sustainability

² The Enhanced Business Reporting Consortium was founded by the AICPA, Grant Thornton LLP, Microsoft Corporation, and PricewaterhouseCoopers in 2005 upon the recommendation of the AICPA Special Committee on Enhanced Business Reporting. The EBRC is an independent, market-driven non-profit collaboration focused on improving the quality, integrity and transparency of information used for decision-making in a cost-effective, time efficient manner.

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and variability of its cash flows and earnings.” KPIs include supplemental non-GAAP financial reporting disclosures that proponents have stated can improve disclosures by public companies. Such KPIs also may include non-financial measures. KPIs are leading indicators of financial results and intangible assets that are not necessarily encompassed on a company’s balance sheet and can provide more transparency and understanding about the company to investors. Proponents of the use of KPIs note that they are important because they inform judgments about a company’s future cash flows – and form the basis for a company’s stock price. Managers and boards of directors of companies use KPIs to monitor performance of companies and of management. Market participants and the SEC have identified KPIs as important supplements to GAAP-defined financial measures.

The Committee understands that investment professionals concur that investors are very interested in non-financial information as a way to better understand the businesses they invest in. They recognize that financial reports provide an accounting of past events and a current view of the financial condition of the company. The financials are viewed as an end of process result delivered as a combination of market conditions and company business strategies, processes and execution. The financials are, by their nature, not necessarily forward-looking indicators. Of interest to many investors from a business reporting standpoint is information regarding the fundamental drivers of the business and metrics used to give evidence as to how the business is being managed in the environment it finds itself in. Financial reporting captures some aspects of this but not all and, in fact, financial statements are not currently designed to provide a broader picture of the company and its operations.

From a corporate preparer standpoint, management uses KPIs as key metrics with which to direct the company as part of the strategic planning process both in terms of goal setting and as a way to provide analysis and feedback. In that regard the degree to which companies are comfortable sharing these metrics with shareholders, communication would be greatly enhanced. By its very nature such communication would increase the fundamental transparency of the business. Numerous prior studies have shown that greater transparency on the part of corporations reduces the company's cost of capital and no doubt improves market efficiency.

Recognizing this, the SEC encourages extensive discussion of the condition of the business in the MD&A. The SEC, in its 2003 MD&A Interpretive Release, stated the “[o]ne of the principal objectives of MD&A is to give readers a view of the company through the eyes of management by providing both a short and long-term analysis of the business. To do this, companies should ‘identify and address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the individual company’.” In this regard, the SEC noted the importance of disclosures of key performance measures - “when preparing MD&A,

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companies should consider whether disclosure of all key variables and other factors that management uses to manage the business would be material to investors, and therefore required. These key variables and other factors may be non-financial, and companies should consider whether that non-financial information should be disclosed.” The SEC went on to state that “[i]ndustry-specific measures can also be important for analysis, although common standards for the measures also are important. Some industries commonly use non-financial data, such as industry metrics and value drivers. Where a company discloses such information, and there is no commonly accepted method of calculating a particular non-financial metric, it should provide an explanation of its calculation to promote comparability across companies within the industry. Finally, companies may use non-financial performance measures that are company-specific.”³ This discussion is intended to give information about the business in a way that is consistent with the manner in which the business is run.

Discussion:

The Subcommittee’s hypothesis extends beyond a narrow definition of financial reporting to business reporting more generally. The Subcommittee has been evaluating whether public companies should increase their voluntary disclosure of financial and non-financial performance measures or indicators, such as KPIs. The Subcommittee has examined the current practices of public companies and notes that many companies are already disclosing some company-specific KPIs in their periodic reports filed with the SEC or in other public statements, but these company-specific measures may not necessarily be consistently reported by companies from period-to-period, are not necessarily well-defined, and may not be commonly used by other companies in the same industry so that they lend themselves to comparisons between and among companies. Therefore, as part of its review of KPI disclosure, the Subcommittee has evaluated the kinds of KPIs that should be made available, in what format, and whether they should be consistently defined over time. The Subcommittee has found that various groups, within and outside industries, are working on developing industry-specific and activity-specific KPIs in order to improve comparability of companies on an industry basis.

In developing its preliminary hypothesis on KPIs and other possible metrics to enhance business reporting, the Subcommittee consulted with industry members and others who have been working on this subject. As a result of these discussions and its evaluation of other materials, the Subcommittee preliminarily believes that further exploration of the use of KPIs and other metrics by public companies would be constructive.

³ SEC, *Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations*, Securities Act Release No. 33-8350 (December 19, 2003) (2003 MD&A Interpretive Release).

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Accordingly, for KPI reporting to be most effective and improve user understanding, the Subcommittee is considering that the full Committee recommend that companies should consider the following to improve KPI disclosures.⁴

- *Understandability* – The Subcommittee believes that a given KPI term, such as "same store sales," would be most useful in evaluating the relevant industry or activity if it had a standard agreed definition in the industry. For that reason, as part of its preliminary hypothesis, the Subcommittee notes that the SEC should explore ways to encourage private initiatives in various industries for the development of standard KPI definitions. It is presumed that there would be some terms that would be macro in nature that companies from all industries would make use of and thus would be activity-based, but it is assumed that many KPI terms would be industry-specific. Once a term has been defined by industry, the SEC and other global regulators should work with industry to support the use of such term in periodic and other company reports, with such modified or additional disclosures as the SEC and other global regulators deem necessary or appropriate. Companies should be encouraged to use such industry-defined terms and to disclose any differences in their use terms from any industry-defined and accepted definition. Companies would still have the freedom to use whatever terms they wished in describing their businesses but would be expected to make clear any differences between their definitions and those that have been industry-defined.
- *Consistency* – Whether or not a company uses an industry-defined term for its KPI disclosures, the KPI that is used should be reported consistently from period-to-period. Any changes in the definition of a KPI should be disclosed, along with the reasons for the change. KPIs should be reported not just for the current period but for prior periods as well so that investors can assess the company's development from period-to-period or year-to-year.
- *Relevancy* - KPI that are disclosed should be important to an understanding and tracking of the business or business segments for which they are used and should align with how reporting companies run their business.
- *Presentability* – When companies disclose KPIs in their reports and other releases, they should make clear to ordinary investors that the information is intended to provide information about the business of the company that is separate from and supplemental to the financial statements. This could either be done in a separate KPI section in MD&A or in subsections of parts of the MD&A, such as

⁴ The Subcommittee notes that the SEC has provided guidance as to some of these matters as well in its 2003 MD&A Interpretive Release as discussed above. The SEC noted that "[t]he focus on key performance indicators can be enhanced not only through the language and content of the discussion, but also through a format that will enhance the understanding of the discussion and analysis."

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the general business discussion or the discussion by business segment. Segment reporting of KPIs, given the logical connection to business line activities, could be very useful. The inclusion of tabular presentations showing current and prior periods should be seriously considered.

- *Comparability* – Encouraging companies to use industry-defined KPI's would enable investors to compare companies within and across industries and would also be quite useful at the industry segment level. Once industry-defined KPIs are available, the Subcommittee would hope that investor interest would encourage companies to use commonly defined KPI terms.

The Subcommittee has heard that some companies may be hesitant about increased disclosure of KPIs because of concern that disclosure of these metrics may compromise competitive information.⁵ Neither the Subcommittee nor investors want companies to give away the “crown jewels.” The Subcommittee has also heard questions about the validity of many of such competitive harm claims, particularly where information is widely known within a particular industry. The Subcommittee has heard that there is already so much information about companies that disclosure of unique competitive information would be rare. Nevertheless, the Subcommittee preliminarily believes that if a particular KPI could require the disclosure of competitively important information, the affected company could decline to disclose it.

In an ideal disclosure system, non-financial and financial indicators and elements would be presented within a cohesive framework that combines KPIs and other indicators with GAAP data and text discussion in order to create a complete a complete picture of a company. At this time, the Subcommittee believes that having the Committee propose to mandate or suggest such an organized structure is outside the scope of what the Subcommittee is evaluating, might be premature and inappropriate for a regulator or standard setter, possibly being too prescriptive.

Rather, the Subcommittee's preliminary hypothesis provides believes that the SEC should encourage an industry driven initiative with significant investor involvement to develop best practices that companies could follow in developing and disclosing KPIs. Just as financial reporting standards and the recently developed XBRL taxonomy may improve business reporting by creating standardized language, the Subcommittee believes the development of a KPI dictionary, developed on an industry basis but also allowing for company-specific definitions, also could provide valuable information to investors.

⁵ The Subcommittee also heard a question as to the liability treatment of KPIs.

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Thus, the Subcommittee has developed a preliminary hypothesis that is based on a number of industry-driven initiatives, with significant investor involvement, to develop best practices and common definitions for KPIs that companies could follow in disclosing KPIs. The hypothesis suggests that companies, investors, and business reporting consortiums should work together to develop industry-wide and activity-specific KPIs that conform to uniform or standard definitions, as well as company-specific KPIs. These KPIs should then be disclosed in a company's periodic reports, as well as other disclosure formats such as earnings releases. The hypothesis suggests that the KPIs:

- be clearly and consistently defined to allow investors understanding of the meanings of the KPIs;
- be disclosed, as relevant, on a company and/or segment basis; and
- permit cross-company and cross-industry comparisons.

The Subcommittee does not believe that the mandatory reporting of KPIs is desirable at this time. Instead, the Subcommittee believes that the Committee should consider encouraging the SEC to promote the development of commonly recognized and defined KPIs by industry groups.

Integration with Other Proposals:

The Subcommittee preliminarily believes that the formalization of KPI disclosures through commonly recognized definitions, will enhance the benefits that will come from other proposals from the Committee. For example, disclosing KPIs on company web sites would allow investors and other users of the reported information to gain an improved understanding of the prospects for a company and could lead to better capital market pricing.

V. Improved Quarterly Press Release Disclosures and Timing

Preliminary Hypothesis 2:

Industry groups, including the National Investor Relations Institute, FEI, and the CFA Institute should update their best practices for earnings releases. Such updated best practices guidance should cover, among other matters, the type of information that should be provided in earnings releases and the need for investors to receive information that is consistent from quarter to quarter, with an explanation of any changes in disclosures from quarter to quarter. Further, the best practices guidance should consider recommending that companies include in their earnings releases the income statement, balance sheet and cash flow tables, locate GAAP reconciliations in close proximity to any non-GAAP measures presented, and provide more industry and company specific key performance indicators.

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The SEC should consider reinforcing its view that disclosures in connection with earnings calls posted on company websites should be maintained and available on such sites for at least 12 months.

Background:

As noted in the Progress Report, the quarterly earnings release, often the first corporate communication about the result of the quarter just ended, is viewed as an important corporate communication. This communication often receives more attention than the formal Form 10-Q submission which often occurs a week or two later.

The quarterly earnings release is not currently required to contain mandated information other than that required by the application of Regulation G to the presentation of non-GAAP measures and the antifraud provisions of the federal securities laws. Industry groups have previously coordinated in developing best practices for reporting companies to follow in preparing their earnings releases. In addition, under SEC rules, companies must furnish earnings releases to the Commission on a Form 8-K. Investors and other market participants have expressed concern about the matters relating to earnings releases, including consistency of information provided in such releases, the timing of such releases in relation to the filing of the applicable periodic report, and the inclusion of earnings guidance in such earnings releases.

Discussion:

The Subcommittee has been examining a number of issues relating to the earnings release, including with regard to its consistency, understandability, timeliness, and the continued public availability of earnings conference calls. The Subcommittee had an opportunity to discuss the quarterly earnings release and these related matters with investor and company representatives. In addition, the Subcommittee considered the consistent provision of income statement, balance sheet and cash flow tables in the quarterly earnings release as well as the positioning and prominence of GAAP and non-GAAP figures, GAAP reconciliation, the consistent placement of topics, and clear communication of any changes to accounting methods or key assumptions. The Subcommittee viewed the goal for the earnings release to be a consistent, reliable communication form that all investors can easily navigate.

The Subcommittee also briefly discussed the advisability of requiring the issuance of the earnings releases on the same day that the periodic report (e.g., Form 10-Q) is filed, in contrast to the current practice in which the earnings release often is issued before the periodic report is filed. The Subcommittee heard from company and investor representatives in this regard and took note of the comments that the SEC received in

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connection with a prior request for comment to tie the filing of the quarterly report to the issuance of an earnings release. The Subcommittee understood that the practices of companies in this regard may differ depending on the size of the company and the company's own disclosure practices. For example, the Subcommittee understands that some large companies issue their earnings release at the same time as the filing of their quarterly reports. The Subcommittee also heard that smaller companies tended to wait to issue their earnings releases so that their news would not be eclipsed by news of larger and more well followed companies. While investors noted an interest in having the earnings release issued at the same time as the Form 10-Q is filed to avoid duplication of effort in analyzing the company's disclosures, representatives of companies and others expressed concern about the effect of delays in disclosing material non-public information about the quarter or year end. Investors also expressed concern regarding the trading of company stock by executives after the issuance of the earnings release but before the filing of the Form 10-Q and questioned whether executives could be prohibited from engaging in trading until after the Form 10-Q was filed.

The Subcommittee determined not to include a preliminary hypothesis that would change current market practice regarding the issuance of earnings releases but would suggest that, instead, the SEC monitor company practices in regard to the timing of the earnings release in relation to the filing of the relevant periodic report with the SEC.

The Subcommittee also heard concerns that companies were not keeping their earnings calls and related information posted on their websites for more than one quarter after the call, thus making quarterly comparisons difficult. The Subcommittee noted that the SEC had suggested that companies keep their website disclosures regarding GAAP reconciliations for non-GAAP measures presented on earnings calls available on their websites for at least a 12-month period and the Subcommittee's preliminary hypothesis would suggest that the SEC reiterate this guidance.⁶

The Subcommittee briefly discussed the practices of some companies in providing earnings guidance or public projections of next quarter's earnings by company officials, since some believe that this practice is an important underlying source of reporting complexity and other accounting problems. The Subcommittee also discussed the provision of annual guidance that may be updated quarterly. The Subcommittee does not intend to continue its evaluation of quarterly earnings guidance or to suggest any preliminary hypothesis regarding the provision of quarterly earnings guidance at this time because it notes that many others are evaluating the issues arising from the provision of quarterly earnings guidance.

VI. Use of Executive Summaries in Exchange Act Periodic Reports

⁶ See SEC *Conditions for Use of Non-GAAP Measures*, Exchange Act Release No. 34-47226 (Jan. 22, 2003).

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Preliminary Hypothesis 3:

The SEC should mandate the inclusion of an executive summary in the forepart of a reporting company's filed annual and quarterly reports. The executive summary should provide summary information, in plain English, in a narrative and perhaps tabular format of the most important information about a reporting company's business, financial condition, and operations. As with the MD&A, the executive summary should be required to use a layered approach that would present information in a manner that emphasizes the most important information about the reporting company and include cross-references to the location of the fuller discussion in the annual report. The requirement for the executive summary should build on the company's MD&A overview and essentially be principles-based, other than a limited number of required disclosure items such as:

- A summary of a company's current financial statements;*
- A digest of the company's GAAP and non-GAAP KPIs (to the extent disclosed in the company's 10-Q or 10-K);*
- A summary of key aspects of company performance;*
- A summary of business outlook;*
- A brief description of the company's business, sales and marketing; and*
- Page number references to more detailed information contained in the document (which, if the report is provided electronically, could be hyperlinks).*

Background:

Reporting companies are not currently required to include any type of summary in their periodic reports, although a summary of the company and the securities it is offering is a line-item disclosure in Securities Act registration statements. Companies, therefore, are familiar with the concept of summarizing the important aspects of their business and operations at the time they are raising capital. The Subcommittee has heard that retail investors find it difficult at times to navigate through a company's periodic reports, including its Form 10-K annual report. The Subcommittee has been evaluating the use of an executive summary in the forepart of a company's annual and quarterly Exchange Act reports to facilitate the ready delivery of important information to investors by providing them a roadmap of the disclosures contained in such reports.

Discussion:

The Subcommittee has been exploring a requirement to include an executive summary in reporting company annual and quarterly Exchange Act reports (Forms 10-K and 10-Q). The Subcommittee has met with investor and company representatives as well as securities counsel. The Subcommittee understands that a summary report prepared on a

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stand-alone basis would not necessarily provide investors with information they need in a desired format and that investors would not use such a summary. However, the Subcommittee understands that an executive summary included in the forepart of an Exchange Act periodic report may provide investors, particularly retail investors, with an important roadmap to the company's disclosures located in the body of such a report.⁷ The executive summary in the Exchange Act periodic report would provide summary information, in plain English, in a narrative and perhaps tabular format of the most important information about a reporting company's business, financial condition, and operations. As with the MD&A, the executive summary would use a layered approach that would present information in a manner that emphasizes the most important information about the reporting company and include cross-references to the location of the fuller discussion in the annual report.

As noted in the Progress Report and as contemplated in the Subcommittee's preliminary hypothesis, the goal of the executive summary would be to help investors fundamentally understand a company's businesses and activities through a relatively short, plain English presentation. An executive summary in a periodic report may be most useful if it included high-level summaries across a broad range of key components of the annual or quarterly report, rather than detailed discussion of a limited number of variables. The executive summary approach may be an efficient way to provide all investors, including retail investors, with a concise overview of a company, its business, and its financial condition. For the more sophisticated investor, an executive summary may be helpful in presenting the company's unique story which the sophisticated investor could consider as it engages in a more detailed analysis of the company, its business and financial condition.

The executive summary in a periodic report should be brief, and it might fruitfully build on the overview that the SEC has identified should be in the forepart of the MD&A disclosure. The MD&A overview is expected to "include the most important matters on which a company's executives focus in evaluating the financial condition and operating performance and provide context."⁸ The executive summary should build on the MD&A overview disclosure and include the following:

1. A summary of a company's current financial statements
2. A digest of the company's GAAP and non-GAAP KPIs (to the extent disclosed in the company's 10-Q or 10-K)
3. A summary of key aspects of company performance
4. A summary of business outlook
5. A brief description of the company's business, sales and marketing

⁷ Such reports generally are posted on company websites as well so that the executive summaries would be electronically available with hyperlinks to the more detailed information in the relevant report.

⁸ See 2003 MD&A Interpretive Release above.

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6. Page number references to more detailed information contained in the document (which, if the report is provided electronically, could be hyperlinks).

The Subcommittee's preliminary hypothesis provides that the executive summary should be required to be included in the forepart of a reporting company's annual or quarterly report filed with the SEC or, if a reporting company files its annual report on an integrated basis (the glossy annual report is provided as a wraparound to the filed annual report), the executive summary instead could be included in the forepart of the glossy annual report. If the executive summary was included in the glossy annual report, it would not be considered filed with the SEC. The Subcommittee understands that the inclusion of a summary in the body of the periodic report should not give rise to additional liability implications.

VII. Continued Need for Improvements in the MD&A and Other Public Company Financial Disclosures

The Committee noted in chapter 4 of the Progress Report that while investors and other market participants believe that while there has been some improvement in the MD&A disclosures since publication of the SEC's interpretive release in 2003, significant improvement is still needed. The Subcommittee evaluated the MD&A and other public company disclosures in the context of its preliminary hypotheses regarding disclosures of key performance indicators, earnings releases, and use of executive summaries in periodic reports.

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