Financial Statement Disclosure Effectiveness: Forum Observations Summary
Introduction

On July 12, 2012, the Financial Accounting Standards Board (FASB) issued an Invitation to Comment (ITC), Disclosure Framework, which outlines possible approaches to improving the effectiveness of disclosures in notes to financial statements. The ITC begins with a discussion of approaches that the FASB might use when setting disclosure requirements in individual projects. It then explores how those disclosure requirements may be made flexible so as to enable a preparer to tailor the disclosures based on its particular circumstances. That tailoring would be based on the preparer’s assessment of relevance. The ITC suggests a way for preparers to think through that assessment and discusses how an entity could organize and format its notes to make the financial statements more effective.

To encourage the full range of financial reporting stakeholders to engage in a broad discussion, the FASB and the Center for Audit Quality (CAQ) sponsored forums on financial statement disclosure effectiveness at Columbia University’s Center for Excellence in Accounting and Security Analysis on October 4, 2012, and at Stanford University Graduate School of Business on October 8, 2012. Participants discussed what could be done to improve financial statement disclosure effectiveness (other than through changes to current disclosure requirements) and how stakeholders might support those efforts. Costs, benefits, and incentives for change also were discussed.

The forums began with a brief overview of the ITC followed by a panel discussion that involved the range of stakeholders in the financial reporting process. The panelists discussed the current environment surrounding financial statement disclosures, including existing obstacles to improving disclosure effectiveness and how they might be overcome. Focused discussions were then held in break-out sessions followed by reports to the whole group and further discussion.

Stakeholder groups represented by forum participants included financial statement preparers and users, board and audit committee members, external auditors, attorneys (corporate counsel, disclosure attorneys, and litigators), regulators, standard setters, and academics. The forums were attended by 54 individuals. Comments were not for individual attribution. Members representing regulators expressed their own views, not those of their agencies/organizations.

Observations on the FASB’s ITC

The ITC focuses on how to improve disclosure effectiveness of notes to financial statements. Participants discussed the intended role of the notes, questioning whether it was (1) to further explain the amounts presented in the financial statements (in other words, provide information to enable further analysis) or (2) to provide information about matters that may affect the entity’s future success but that are not reflected in the financial statements. Some participants said that it is the former and others made the argument that any information about items not in the financial statements ought to be provided somewhere other than in the notes. Some participants also said that disclosures contained in the notes should be consistent with other communications made by the issuer (such as press releases and investor conferences).

Many participants voiced general support for the FASB’s ITC as a good starting point for discussing disclosure effectiveness. Many also noted that it would be difficult to maximize financial statement disclosure effectiveness without also considering Securities and Exchange Commission (SEC) disclosure requirements and presentation of information in the primary financial statements. Though many aspects of the ITC were discussed during the forums, discussions focused mainly on disclosure flexibility and the concept of relevance as a means to achieve flexibility.
Flexibility

The ITC suggests that flexibility of disclosure requirements could be accomplished in a variety of ways. At one end of the spectrum, the FASB could establish a set of high-level principles and allow preparers to decide what to disclose; at the other end, the FASB could prescribe which disclosures would be required based on entity-specific factors, such as industry, size, or particular financial ratios. The ITC recognizes that there is a range of possible approaches between those two extremes. For example, some ways that disclosures could be made flexible would be for the standards to have:

- Less prescriptive language
- A full set of disclosures that all entities would consider for disclosure and remove those that are not relevant
- A minimum set of disclosures that all entities would provide with additional disclosures to be considered (minimum/maximum approach)
- Various levels of disclosure based on activity (tiered approach)

Many participants thought that providing flexibility in future disclosure requirements could significantly improve disclosures, although there was diversity in views on how to achieve such flexibility. When contemplating the minimum/maximum approach, one participant suggested that, in an ideal world, a preparer would provide the same disclosures whether flexible disclosure requirements are stated as a minimum set that preparers could add to, or as a maximum set that preparers could subtract from, as appropriate. Regardless of the manner in which the preparer would carry out its decision making, many participants gravitated toward the idea of always providing a minimum set of disclosures that would allow users to compare entities on some uniform basis.

Preparers also believed that it would be easier to support providing additional disclosures to those that represent a minimum, than it would be to justify omitting disclosures from a maximum set. Participants who supported starting with the maximum set of disclosures thought the approach would reduce the tendency for a preparer to provide only the minimum required disclosures.

Other participants thought establishing three or more tiers of disclosures would be preferable; for example, one break-out group suggested a “scaled approach” whereby the FASB would prescribe different sets of disclosure requirements based on industry or entity’s specific criteria, limiting the preparer’s flexibility in assessing relevance and possibly resulting in more consistent and comparable disclosures. One participant feared that preparers would simply provide a maximum set of disclosures due to the time and effort needed to justify any omissions of disclosures on items the entity deemed no longer relevant.

Some participants observed that finding the right balance between flexibility and structure is critical. Some preparers believed that having flexibility is important and debated differences in methods for achieving it, while investors expressed concerns around the impact of flexibility on comparability and desired a structure that promoted standardization and facilitated comparisons across entities.

Relevance

The ITC suggests that preparers should make decisions about which disclosures to provide based on the relevance of the information to investors and creditors. It defines relevance as the potential to make a difference in assessments by investors and creditors of prospects for future cash flows from an equity investment, loan, or other interest. In discussing relevance, some participants focused heavily on the perceived risk of litigation or regulatory action as a result of omitting information previously provided in notes.

Relevance versus materiality

Some participants generally supported relevance as an appropriate criterion for determining which disclosures to provide, but others indicated that, because relevance has not been used as a basis for reporting entities’ decisions, it might be more confusing to use relevance instead of the term materiality, which is already familiar to preparers. The language in the ITC that a disclosure would be relevant if it “could be useful to investors …” was considered too broad and too low a threshold. Participants generally favored using “would be useful” instead of “could be useful.” Moreover, while many participants did not favor using a new term in describing how to identify appropriate disclosures, some stated that a clear explanation of how relevance differs from materiality is necessary if that term is used.

Another point raised was the need for an “initial filter” of whether the item to which the disclosure relates is material. (In other words, if an entity’s only pension plan is not material, the entity would not need to consider disclosing any information about it.) Some participants suggested that disclosure items should not be omitted because of
insufficient relevance but should be given low priority within the notes (for example, by reordering notes).

The effect on the assessment of future cash flows

The ITC states: “A disclosure has the potential to make a difference in users’ decisions if it affects their assessments of the prospects for cash flows from their equity investments, loans, or other financial interests in the entity.” A number of participants stated that other metrics are just as relevant to investors and users of financial statements, if not more so. Those participants cited market share, book value, units sold, and margins as examples of metrics that are more important to users than “prospects for cash flows.” Several participants pointed out that the cash flows referred to in the ITC are those an investor, creditor, or potential investor can hope to collect as the result of providing resources to an entity, and that the other metrics are indicative of those cash flows. Others suggested different ways of thinking about relevance, such as consideration of the information that management uses to run its business and allocate resources internally. Some believed that whether information is used by management or reported to the CEO/CFO as risks to the business could be another way of assessing relevance.

In addition, some participants thought that the ITC blurred the line between the notes and Management’s Discussion and Analysis (MD&A) because it suggests using future cash flows as a tool to assess relevance. It seemed to them that the use of “assessing future cash flows” as described in the ITC would require preparers to develop and disclose cash flow forecasts, along with other forward-looking information, in the notes to financial statements. There was some discussion on the overlap of disclosures relating to future returns and other forward-looking information in the notes and in MD&A. Participants also discussed the differences between disclosures in MD&A and financial statements, noting that the former may be subject to forward-looking statement safe harbors and the latter are audited.

ADDITIONAL OBSERVATIONS

During the forums, participants discussed how issuers might make financial statement notes more effective in the current reporting environment, the costs, benefits, and incentives impacting disclosure practices and other issues. Key points made are summarized below.

Streamlining disclosures in the current environment

Participants discussed ways to streamline disclosures in the current environment and some recent examples of such streamlining by reporting entities. Preparers who had streamlined notes experienced resulting clearer communication, enhanced trust by investors and other stakeholders, greater efficiency preparing and auditing disclosures, and increased morale among finance staff. They believed that the benefits far outweighed the costs of streamlining disclosures.

“Prescriptive” nature of current accounting standards

Some participants suggested that the volume of disclosure was driven in part by the way the accounting standards are typically written (for example using words such as “shall” and “at a minimum” followed by a list of detailed requirements). Thus, preparers (and their lawyers) do not feel empowered to exercise judgment in determining relevancy and/or materiality in conforming to the standards. A number of participants encouraged the FASB to consider modifying standards in a way that allows for judgment (for example by re-styling current disclosure requirements as disclosure guidelines).

Overlap of notes and MD&A disclosures

Although the FASB’s Disclosure Framework project is not aimed at identifying current areas of overlap between disclosures in the notes to the financial statements and in MD&A, as noted in the discussion on relevance above, some participants identified the significant overlap of
“Any intelligent fool can make things bigger and more complex... It takes a touch of genius — and a lot of courage to move in the opposite direction.”

~ ALBERT EINSTEIN

information between the notes and MD&A as unnecessary and inefficient. There was confusion on how to address the overlap issue (whether a better use of cross-referencing from one to the other would be appropriate or useful to reduce duplicative disclosures) and if there would be legal consequences of cross-referencing. Some participants identified the notes on contingencies and accounting policies as examples of disclosures that typically overlap between MD&A and notes. The second forum was not in favor of cross-referencing as a tool to address overlap due to concerns related to audit responsibility (when referencing from the notes to MD&A) and loss of safe-harbor protections (when referencing from MD&A to the notes). Some participants at both forums encouraged the SEC and the FASB to agree on where a particular disclosure should be presented and only require it once. However, a minority of participants felt that MD&A and the notes should each stand on their own, and opposed cross-referencing.

“Stale” disclosures

Participants discussed the practice of retaining certain disclosures even when they are no longer considered to be relevant. Some thought discontinuing certain disclosure requirements at a standard setting level might help alleviate the volume of “stale” information. Others pointed out that eliminating specific disclosures may be difficult because an item could be relevant after a point in time for some preparers but not for others. Some users said they would not oppose a preparer removing information that is no longer relevant as long as the preparer explained why the information was being omitted in the year it is first omitted.

Evergreen1 information

Other participants discussed having an information trail of changes made to “evergreen” information so that they could track an entity’s disclosures over time. Participants identified possible approaches to retain recurring information while improving disclosure efficiency. One such approach might be to retain information (such as an accounting policy note) on a company’s website instead of in the financial statements. Some participants cited diminished utility of the accounting policy note due to fewer options in current GAAP than in historical GAAP. However, some suggested that the benefit of being able to access a historical set of accounting policies may be lost with an “evergreen” file concept; having a record of accounting policies that correspond to the accounting done during different time periods also was important to regulators.

Others supported requiring disclosure of accounting policy changes rather than presentation of a full set of policies. Some also stated that the separate disclosures of critical accounting policies and significant accounting policies (such as in MD&A and in the notes) should be combined into one disclosure. Others pointed out that if the accounting policy note included only policies for which there is variability in accounting (for example, inventory cost methods), that information could be in the note following the item to which it relates, thus eliminating the need for a separate accounting policy note.

Costs, benefits, and incentives

Participants weighed the costs, benefits, and incentives of establishing a process of determining and assessing relevance of disclosures. Several preparers summarized successful efforts to streamline disclosures, and a number of participants identified a number of immediate and longer-term benefits, including:

• A clearer communication of financial performance contributing to enhanced trust of management by users
• Less time expended in preparing and auditing disclosures
• Increased morale within the finance staff and improved goodwill with auditors and regulators
• Better allocation of capital by investors, according to academic research

1 Evergreen information as used in this document refers to disclosures that change infrequently, if ever.
The preparers who had streamlined their disclosures observed that the internal costs (staff, internal review, and audit committee approval time) were not significant. Moreover, they stated that the auditors and regulators (if filings were reviewed) had been persuaded by reasoned arguments and supporting documentation showing why omitted information was in fact not relevant. There was a great deal of interest in these efforts, although some participants noted that an issuer may not want to be the first in its sector to undertake such a project.

Participants generally observed, however, that there would be some costs incurred in selecting disclosures based on relevance and/or materiality, particularly during the initial implementation. Significant costs and impediments identified by the preparers were: (1) the need to document and explain why information is being omitted for regulators, auditors, analysts, investors, and other stakeholders, and (2) the legal and regulatory risks of being “second-guessed” by one or more of those stakeholders. One preparer noted that the appropriate amount of disclosure would likely be determined during the implementation of new accounting standards, meaning that most of the work of selecting appropriate disclosures would be done during the transition phase.

Despite comments by preparers who had successfully tailored disclosures, many participants observed that the path of least resistance is to continue to add disclosure, rather than to evaluate and remove disclosure. In short, it may be safer and easier to retain stale disclosures or use boilerplate language. Some participants believed that absent a holistic approach (that includes evaluation of SEC disclosure requirements and shifts the existing compliance-oriented paradigm), there will be insufficient incentive to change current reporting practices. Moreover, several users resisted the notion of the preparer assessing relevance of disclosures because information judged not to be relevant at that point in time may be relevant in the future. Furthermore, several users indicated an appetite for more information — not less.

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CONCLUSION

As demonstrated by the degree of engagement, the issue of greater financial statement disclosure effectiveness deserves careful consideration by the FASB and stakeholders. Participants generally thought that providing a benchmark for applying judgment on which financial statement disclosures to provide was desirable, but there were mixed views on whether to base the decision on relevance or to use the more familiar term, materiality, in order to achieve the desired objective.

Sophisticated analysts and users who are capable of analyzing high volumes of disclosure did not express a significant interest in reducing the volume of disclosure, although other users who do not have that capability did support efforts to streamline. Moreover, there was general support for considering the entire financial report in efforts to improve disclosure effectiveness, and not just the notes to financial statements. Finally, participants encouraged using the flexibility available within the current disclosure regime to improve disclosure effectiveness while consideration of the disclosure framework proceeds.
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About the FASB

Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities.

The mission of the FASB is to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports. That mission is accomplished through a comprehensive and independent process that encourages broad participation, objectively considers all stakeholder views, and is subject to oversight by the Financial Accounting Foundation’s Board of Trustees.

About the CAQ

The Center for Audit Quality is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets by:

- Fostering high quality performance by public company auditors;
- Convening and collaborating with other stakeholders to advance the discussion of critical issues requiring action and intervention;
- Advocating policies and standards that promote public company auditors’ objectivity, effectiveness and responsiveness to dynamic market conditions.

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