

point of view

Financial statement disclosures

Enhancing their clarity and understandability

Highlights

- Disclosure requirements have accumulated over many years. This information overload has led to questions about relevancy and usefulness of certain information.
- Preparers can take actions today to make sure they are preparing clear and understandable disclosures. Other capital market participants also have a role to play by encouraging disclosure of only important, relevant information.
- Within established rules and legal requirements, exercising well-reasoned judgment to determine relevant disclosures should streamline financial statement presentation and provide users with the information that is most important for decision-making.
- Organization and formatting can also enhance navigation within the financial statements.

Preparers and others have a role in making sure footnote disclosures are clear and understandable

- Investors and other stakeholders benefit from clear and understandable financial statement footnote disclosures when evaluating a company's performance and prospects for future cash flows.
- The FASB is developing a framework to increase the effectiveness of footnote disclosures. The framework will address both the FASB's process for establishing disclosure requirements and preparers' processes for determining which disclosures to make. The success of the Board's project to develop the framework will ultimately depend on the extent to which capital market participants support the project's objectives. In the meantime, there are steps that preparers and other capital market participants can take today to enhance the clarity and understandability of disclosures.
- Preparers can work to ensure that footnote disclosures clearly communicate relevant policies, provide clarity about significant transactions, give prominence to significant items, eliminate duplication, and provide meaningful, company-specific information. Use of proper organization and formatting, cross-referencing, plain-English, and tabular presentations also can enhance navigation within the financial statements.
- Other capital market participants have a role as well. When reviewing preparers' financial statements, auditors and securities' lawyers should maintain an ongoing awareness that employing a checklist or risk-based mentality may lead to inclusion of immaterial, or otherwise not-useful, disclosures. Standard setters and regulators can emphasize preparers' ability, within established rules, to use flexibility and well-reasoned judgment to determine their disclosures and encourage disclosure of information that is relevant and important for users to understand.

Financial statement disclosures can become cumbersome

“When disclosure gets to be too much or strays from its core purpose, it could lead to what some have called information overload.”

**-Mary Jo White
Chair of the SEC
(October 15, 2013)**

Improving communications between preparers and users of financial statements is a long-standing goal shared by all stakeholders.

Background

The idea of promoting clear and understandable communications between preparers and users is not new. For many years, stakeholders have said that information in the footnotes could benefit from a framework that would produce more decision-useful, less redundant, and better organized information. Many, including the FASB’s Investor Advisory Committee, recommended that the Board address note disclosure overload and relevancy concerns. The Board recently published an exposure draft of concepts to be used to develop future, and evaluate existing, disclosure requirements. Comments are due on July 14, 2014.

The disclosure framework project includes a separate component that addresses the decisions preparers make when evaluating which disclosures to include in their financial statements. The Board is conducting a field study to assess preparers’ abilities to exercise discretion over which disclosures they provide in footnotes to financial statements. The results of the field study and other feedback will be used to develop an exposure draft addressing the preparer’s decision process.

In December 2013, the SEC published a review of Regulation S-K requirements. Chair White has called for the Staff to begin an active review of existing disclosure rules focusing on not only the type of information that should be disclosed, but how it is presented, where it is disclosed, and how technology can be used to facilitate investors’ access to the information.

Objective of financial reporting

A primary objective of financial reporting is to provide information to investors, lenders, creditors, and others for use in making decisions about whether to commit resources to the company. These decisions could be based, in part, on the user’s assessment of the company’s performance and prospects for future cash flows. Footnote disclosures are one valuable source of information for that purpose.

Current concerns

Financial statement footnote disclosure requirements have accumulated, standard by standard, over many years. This has led to an increase in the volume of disclosures, which can cause cumbersome and unwieldy presentations and result in questions about the continued relevancy and usefulness of certain of the information provided.

“All or nothing” checklist approach

Some view existing requirements as calling for an all or nothing level of footnote disclosure. Given this view, some preparers do not believe they can exercise discretion when drafting footnotes on a particular topic. That is, if a company applies an accounting standard, all of the disclosures called for by the standard must be made regardless of whether it is important to a user’s understanding of the financial statements (e.g., whether it is material). Thus, some companies view footnote disclosure requirements as complete inseparable sets, whereby disclosures are included in their entirety rather than viewed as scalable based on facts and circumstances, as the rules permit.

Strict adherence to a list of required footnote disclosures may reduce the likelihood of preparers getting questions from auditors, regulators, and users. Therefore, it is understandable that some preparers gain comfort by using an all or nothing checklist approach rather than applying appropriate judgment to determine what information to disclose.

Cost of compliance

Extensive footnote disclosure requirements impose costs on both companies and investors. The costs to the company include preparing and analyzing information, maintaining internal controls, and audit costs. In addition to indirectly bearing such costs, an investor’s costs include the time needed to assess the large amount of data presented in the footnotes to determine whether it is relevant for their decision making.

Considerations for preparing disclosures

Disclosures should amplify the financial statements and provide users with relevant information to assess performance and prospects.

Preparers, auditors, and regulators should embrace the use of well-reasoned judgment to determine relevant footnote disclosures.

The purpose of footnote disclosures

In preparing footnote disclosures, consideration should be given to their intended purpose. We believe their purpose is to provide information to assist users in assessing both a company's historical performance and cash flow prospects. Disclosures should amplify information reported on the face of the financial statements, and focus users' attention on matters that are most relevant to understanding those financial statement areas.

Which type of information is appropriate for footnote disclosure is an important question. Consistent with applicable rules, we believe footnote disclosures should be limited to information about a company's historical transactions, financial position, and estimates and assumptions that underlie the financial statements. That type of information is subject to accounting standards and can be audited under applicable auditing standards.

In contrast, forward-looking information is best suited for management's discussion and analysis (MD&A), for which public companies are provided certain safe harbor protections. Outside of certain limited areas (e.g., contingency disclosures) predictions about future events are not appropriate for footnote disclosures.

Exercising judgment

Both US generally accepted accounting principles and SEC disclosure regulations generally allow omission of a required disclosure if it is not considered material to the financial statements taken as a whole. Companies may exercise discretion to fully omit or abbreviate certain aspects of an otherwise required disclosure if judged to be immaterial.

Using well-reasoned judgment, preparers should assess the disclosures required by accounting standards and, guided by materiality considerations, select those that are relevant to their users. In some situations, companies may need to supplement required disclosures with additional information to provide context or further clarification that they believe would be meaningful to users. Likewise, disclosures need not be included if they are

not relevant, and accordingly, disclosures made in prior periods should be removed if they are no longer relevant. In making this determination, preparers should assess the materiality of the information based on their facts and circumstances, considering court and SEC interpretations and advice from their legal counsel, when needed.

Other factors to consider that may make a transaction or event relevant for disclosure include: the magnitude of the transaction or account balance on the company's results of operations, financial position, and other performance indicators; the importance of the item relative to the company's industry; whether the event is a change in business strategy; the uniqueness of the transaction; and the use of related parties.

When applying judgment to decide which disclosures to include, preparers should focus on matters that are important to the user's understanding of the company's performance and prospects. While some preparers may find identifying such matters to be a challenge, the active engagement of users, auditors, and regulators in this model should facilitate this process.

Format and organization

Enhancing the format and organization of the footnotes should also be a focus. Hallmarks of appropriate footnote disclosures include clarity about relevant policies and significant transactions as well as organization that eases navigation. Preparers should consider employing best practices such as using plain-English to describe industry and company-specific policies, eliminating overly technical references, grouping related data together, using tabular formats, and cross referencing information from the face of the primary statements to the related footnote or between footnotes.

In conclusion

While the Board and SEC have disclosure reform on their agendas, clear and understandable footnote disclosure should be a focus of preparers today. We encourage preparers to work with their auditors to take a fresh look, and we encourage regulators, and securities' lawyers to do their part as well.

Questions and answers

Q: What are some examples of how preparer judgment could be applied in determining disclosures?

A: One example involves determining pension disclosures. Often disclosures related to immaterial or frozen pension plans still include extensive information that generally may not have a significant impact on a user's decision making. Another example involves stock-based compensation. For companies where the number and value of stock options outstanding is not significant to dilution or results of operations, the disclosure might benefit from greater consideration as to what information would be meaningful to investors.

Q: How are the digitization of information and its consumption affecting disclosure?

A: Electronic consumption of information is becoming widespread through the use of devices such as tablets and smart phones. In certain instances, analysts use digital interfaces to upload information into their valuation models. Investors also have the ability to access certain types of data, such as a company's historical stock price, reliably and instantaneously. We believe existing tools will continue to evolve and

new tools will be developed as digital delivery and consumption of information continue to advance. Standard-setters and regulators may decide to eliminate certain disclosure requirements if the data is reliably and easily accessible from other sources. Accordingly, we believe that digitization and use of new technology will continue to provide avenues to more quickly access the information available.

Q: Is the FASB project being conducted jointly with the International Accounting Standards Board (IASB)?

A: No. However, while this is not a joint project between the Boards, the IASB does have a broad-based disclosure initiative on its agenda to explore how disclosure in IFRS financial reporting can be improved. The initiative was informed by a Discussion Forum on Disclosure in Financial Reporting held in January 2013 and a related survey conducted by the IASB Staff. The initiative comprises a number of projects, including an exploration of how materiality is applied in practice, research to evaluate the possibility of a project addressing debt disclosures, and a review of existing IFRS disclosures to identify and assess conflicts, duplication, and overlaps.

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