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DISCUSSION PAPER

Invitation to Comment

Issued: July 12, 2012
Comments Due: November 16, 2012

Disclosure Framework

This Invitation to Comment is issued by the Financial Accounting Standards Board for public comment as a step preceding the development of an Exposure Draft.

Written comments should be addressed to:

Technical Director
File Reference No. 2012-220

Financial Accounting Standards Board
of the Financial Accounting Foundation

Notice to Recipients of This Invitation to Comment

The Board invites individuals and organizations to send written comments on all matters in this Invitation to Comment. Responses from those wishing to comment on the Invitation to Comment must be received in writing by November 16, 2012. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 2012-220. Those without email should send their comments to "Technical Director, File Reference No. 2012-220, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116." Do not send responses by fax.

All comments received constitute part of the FASB's public file. The FASB will make all comments publicly available by posting them to the online public reference room portion of its website.

An electronic copy of this Invitation to Comment is available on the FASB's website.

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Disclosure Framework

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, PO BOX 5116, NORWALK, CONNECTICUT 06856-5116

Invitation to Comment

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INVITATION TO COMMENT

The objective and primary focus of this project is to improve the effectiveness of disclosures in notes to financial statements by clearly communicating the information that is most important to users of each entity's financial statements. Although reducing the volume of notes to financial statements is not the primary focus, the Board hopes that a sharper focus on important information will result in reduced volume in most cases.

Achieving the objective of improving effectiveness will require development of a framework that promotes consistent decisions about disclosure requirements by the Board and the appropriate exercise of discretion by reporting entities. The Board also is considering whether and, if so, how to provide guidance to improve the organization, formatting, and style of notes to financial statements.

This Invitation to Comment does not include preliminary views or proposals of the FASB. The following are reasons for issuing this Invitation to Comment:

1. It describes ways in which notes to financial statements need to be improved.
2. It describes at least one possible way to address each need.
3. It solicits information about other areas that need improvement and other possible ways to achieve improvements.

For some of the issues, only one method of resolution is discussed. That one method should not be construed as a proposal or preliminary view but as an indication that the Board and staff have not yet identified other reasonable possibilities. Before forming preliminary views or developing proposals, the Board will consider additional issues and alternative ways of resolving issues that respondents identify and describe.

Specific questions for respondents are set out in each section of this Invitation to Comment. For the convenience of respondents, a complete list appears below.

QUESTIONS FOR RESPONDENTS

The Board invites comments on all matters in this Invitation to Comment, particularly on the issues and questions below, but respondents need not comment on all issues. Comments are requested from those who agree with the ideas expressed as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the ideas expressed included herein are asked to describe their suggested alternatives, supported by specific reasoning.

Chapter 1—Scope and Introduction

Question 1: The details of this Invitation to Comment do not focus on the informational needs of donors to not-for-profit organizations. How, if at all, should the Board's decision process (see Chapter 2) be supplemented to consider the needs of donors? How, if at all, should not-for-profit reporting entities modify their decision-making process (see Chapter 4) for the needs of donors when deciding which disclosures to include in notes to financial statements?

Chapter 2—The Board's Decision Process

Question 2: Do the decision questions in this chapter and the related indicated disclosures encompass all of the information appropriate for notes to financial statements that is necessary to assess entities' prospects for future cash flows?

Question 3: Do any of the decision questions or the related indicated disclosures identify information that is not appropriate for notes to financial statements or not necessary to assess entities' prospects for future cash flows?

Question 4: Would these decision questions be better applied by reporting entities instead of the Board? In other words, should the Board change its practice of establishing detailed requirements in each project and, instead, establish a single overall requirement similar to the questions in this chapter?

Question 5: Do you think that this decision process would be successful in helping the Board to set more effective disclosure requirements? If not, what would be a better approach?

The Board would appreciate it if respondents would apply this decision process to the *FASB Accounting Standards Codification*® Topics of their own choosing and identify any changes to existing disclosure requirements that would seem to result.

Chapter 3—Making Disclosure Requirements Flexible

Question 6: Would any of the possibilities in this chapter (see paragraphs 3.8 and 3.11) be a practical and effective way to establish flexible disclosure requirements?

Question 7: If more than one approach would be practical and effective, which would work best?

Question 8: Are there other possibilities that would work better than any of the ones discussed in this chapter?

Chapter 4—Reporting Entities' Decisions about Disclosure Relevance

Question 9: This chapter attempts to provide a benchmark for judgments about disclosure relevance by clarifying the objective for the judgments. Is the description of the approach clear enough to be understandable? If not, what points are unclear?

Question 10: Can this approach (or any approach that involves describing the objective for the judgments) help identify relevant disclosures? If so, what can be done to improve it? If not, is there a better alternative? What obstacles do you see, if any, to the approach described?

Question 11: Reporting entities would need to document the reasons for their decisions about which disclosures to provide. How would reporting entities document the reasons for their disclosure decisions and how would auditors audit those decisions?

The Board asks that respondents help assess the practicality of the possible guidance in this chapter and its potential for improving disclosure effectiveness by applying it to some or all of the notes in their prior period financial statements. Please provide information about the results of that test that is as specific as possible.

Chapter 5—Format and Organization

Question 12: Would any of the suggestions for format improve the effectiveness of disclosures in notes? If so, which ones? If not, why not?

Question 13: What other possibilities should be considered?

Question 14: Do any of the suggested methods of organizing notes to financial statements improve the effectiveness of disclosure?

Question 15: Are there different ways in which information should be organized in notes to financial statements?

Chapter 6—Disclosures for Interim Financial Statements

Question 16: Do you think that any of the possibilities in this chapter would improve the effectiveness of disclosures for interim financial statements?

Question 17: If you think that a framework for the **Board's** use in deciding on disclosure requirements for interim financial statements would improve the effectiveness of interim reporting, what factors should the Board consider when setting disclosure requirements for interim financial statements?

Question 18: If you think that a framework for **reporting entities'** use in deciding on disclosures for interim financial statements would improve the effectiveness of interim reporting, what factors should reporting entities consider when providing disclosures for interim financial statements?

Question 19: What impediments do you see regarding the development of a framework for the Board, reporting entities, or both that addresses disclosures for interim financial statements?

Chapter 7—Other Matters for Discussion

Question 20: Would the change to the requirements described in paragraph 7.8 for disclosure of the summary of accounting policies improve the effectiveness of disclosure?

Question 21: Should the summary of accounting policies include information about industry-specific accounting policies?

Question 22: Are there other required disclosures that could be modified or eliminated in the short term that would result in a significant reduction in the volume of notes to financial statements?

CHAPTER 1—SCOPE AND INTRODUCTION

Scope

1.1 The discussion in this Invitation to Comment applies only to notes to financial statements. It does not address parts of a financial report outside of financial statements, such as management's discussion and analysis (MD&A).

1.2 The Invitation to Comment also applies to financial statements of public and nonpublic entities. There is a separate effort under way to develop a framework for evaluating financial reporting issues for private companies that may have some effect on the matters discussed in this Invitation to Comment. Because that framework is not available at this time, there is no further discussion of it in this document.

1.3 Not-for-profit entities face issues similar to some of those discussed in this Invitation to Comment. The discussion of the Board's decisions and disclosure relevance is focused on the needs of investors, lenders, and other creditors but does not necessarily address the needs of donors or others that provide resources to not-for-profit entities. Responses to this Invitation to Comment that focus on the needs of donors will help in the development of supplemental parts of the disclosure framework specific to not-for-profit entities.

1.4 The Board undertook this project to enhance the information provided in notes to financial statements.[1] Improving disclosure effectiveness will require considering the information content of the notes and the understandability and ease of accessing that information (organization and formatting). Both are important. Providing relevant information is a necessary beginning, but that information will not be useful if potential users misunderstand it or cannot find it.

1.5 Consequently, although limiting or reducing volume is not the primary objective of the effort to improve notes to financial statements, it is a highly desirable outcome to the extent that it enhances users' ability to find and understand relevant information.

1.6 The Board acknowledges that concerns about disclosure effectiveness and volume extend beyond notes to financial statements, especially for reporting entities subject to Securities and Exchange Commission (SEC) requirements. For example, some have suggested merging notes to financial statements with MD&A. That way, information about an item will be more closely associated with management's comments about that item. This Invitation to Comment does not address those issues, but the Board is committed to working with all parties

[1] Appendix A further describes the reasons why the Board undertook this project as well as discusses previous attempts at improving disclosure effectiveness.

concerned to improve effectiveness, reduce overlap, and otherwise streamline the entire reporting package.

1.7 The staff of the FASB has cooperated with the staffs of the European Financial Reporting Advisory Group (EFRAG),[2] the Financial Reporting Council of the United Kingdom (FRC), and the Autorité Des Normes Comptables of France (ANC) in developing this Invitation to Comment and a similar discussion paper on disclosure framework to be issued jointly by the EFRAG, the FRC, and the ANC. The objectives of the two documents are the same. That is, both aim to improve the effectiveness of disclosure. Neither document is aimed specifically at reducing disclosure volume, but both acknowledge that eliminating unnecessary disclosure improves disclosure effectiveness. The scope of both papers is limited to notes to financial statements.

1.8 The way each paper addresses the issue of disclosure effectiveness is somewhat different. Both documents address the standard setter's decision-making process, reporting entities' selections of disclosures, and how to organize and format those disclosures. However, the approaches described in these three sections are different.

Fundamental Principles Underlying the Discussion in This Invitation to Comment

1.9 Consideration of the appropriate content of notes to financial statements starts with consideration of their intended purpose, which is derived from the purpose of financial reporting in general. The objective of financial reporting is to provide financial information that is useful for making investment and credit decisions.[3]

1.10 Investment and credit decisions are based on implicit or explicit assessments of prospects for (probabilities, timing, and amounts of) cash flows

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[2]EFRAG was set up in 2001 to assist the European Commission in the endorsement of International Financial Reporting Standards (IFRS), as issued by the International Accounting Standards Board (IASB), by providing advice on the technical quality of IFRS. EFRAG is a private sector body set up by European organizations that are prominent in European capital markets, known collectively as the Member Organisations.

[3]The following is the full description of the objective of financial reporting from paragraph OB2 of FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*, *Chapter 1,* The Objective of General Purpose Financial Reporting, *and Chapter 3,* Qualitative Characteristics of Useful Financial Information:

> . . . to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit.

to the holder of those investments, loans, or other forms of credit. Different investors, lenders, and other creditors have different ways of making those assessments. Some include direct valuations of the business, analysis of financial ratios and other key metrics of performance or financial position, and various other technical methods.

1.11 The value of an equity or credit instrument can be realized by selling it to another market participant or by receiving cash or other items of value directly from the issuing entity. Even if the instrument is sold, the amount the investor or creditor will realize depends on cash flows from the issuing entity because in setting a price other market participants will consider prospects for cash flows from the issuing entity.

1.12 Ultimately, assessments of prospects for cash flows from an entity and, therefore, the related investment and credit decisions depend directly or indirectly on two factors. The first is an assessment of prospects for net cash inflows to the entity. The second is the nature of the specific investment or credit instrument—the rights to cash flows that the entity conveys to its holder and its relationship to other claims against the entity. That includes the level of subordination or seniority, collateral, if any, the interest rate, and any other relevant terms of the right to distributions from the entity. Some fundamental and important information is provided on the face of the financial statements, but the information that can be provided in that form is inherently limited. Therefore, notes to financial statements must provide additional relevant information that cannot be or is not provided on the face of the financial statements.

1.13 There are, of course, limits to the information that can and should be provided in a set of general purpose financial statements. The definitions of and recognition requirements for assets, liabilities, and equity establish a boundary around the information to be provided on the face of the financial statements. No equivalent boundary exists for information in notes to financial statements. U.S. accounting standards and practices have established a de facto boundary, but that boundary is not as sharp as it might be and has been extended over time.

1.14 This Invitation to Comment does not attempt to define in a single sentence a boundary for notes to financial statements. However, the decision questions discussed in Chapter 2 (and SEC requirements) would limit the information required for notes to financial statements. One important purpose of including those questions in this Invitation to Comment is to allow respondents to comment on the appropriateness of that limit. In other words, are all the questions necessary, and have any necessary questions been omitted?

1.15 The disclosure framework described in this Invitation to Comment is based on the idea that excessive disclosure is burdensome to reporting entities and can overwhelm users or lead them to overlook important information. With that in mind, the decision questions in Chapter 2 are intended to limit note disclosure to information with the following characteristics:

a. It is unique to an entity or its industry.
b. It is not already apparent from financial statements or readily available from public sources to which users could be expected to have access.
c. It could make a material difference in assessments of future cash flow prospects.

1.16 Some of the general implications of that limitation include the following:

a. Users would be expected to have information about general business risks, general economic conditions (such as which industries are growing and which are declining, interest rate curves, rates of inflation), and similar items.
b. Users would be expected to be aware of such things as U.S. generally accepted accounting principles (GAAP), commonly used pricing models, and SEC reporting requirements. Accounting methods would be disclosed only in situations in which alternatives are permitted, the method is not otherwise apparent, or the method has changed. The mechanics of widely used pricing models would not require explanation, although entity-specific inputs and assumptions may require explanation.

Summary of Matters Discussed in This Invitation to Comment

1.17 This Invitation to Comment explains some ideas that, if successfully developed and implemented, could significantly change the way that disclosure requirements are set and the way that reporting entities determine the content, format, and organization of notes to financial statements. The key matters include the following:

a. How to establish disclosure requirements that consistently address relevant financial information and avoid irrelevant information
b. How to tailor disclosures to fit the circumstances of individual reporting entities
c. How a reporting entity might determine whether each potential disclosure is relevant in its circumstance
d. How the organization and format of notes might be improved
e. How disclosures in financial statements for interim periods should differ from those in annual financial statements
f. Other matters including costs and consequences of disclosure requirements.

1.18. This Invitation to Comment includes only very limited discussions of the specific criticisms and concerns that led the Board to undertake this effort. Paragraph 1.38 provides a listing of some of the many papers prepared by others on that subject.

Addressing Relevant Information and Avoiding Irrelevant Information

1.19 Chapter 2 includes a set of yes/no questions for the Board to consider. If those questions are answered with a *yes*, the Board would need to indicate specific types of disclosures that would be relevant.

1.20 The list of questions does not represent a proposal by the Board, but a first step in developing a proposal. The list is intended to make it easier for the Board and readers of this Invitation to Comment to consider the full range of existing disclosure requirements in an organized and summarized way. The list was developed by analyzing existing disclosures and considering academic research on disclosures. The staff analyzed selected *FASB Accounting Standards Codification*® Topics using the decision questions in Chapter 2 and found that, in general, the indicated disclosures were consistent with existing requirements.

1.21 The Board expects that the development of the decision questions (or an alternative method of achieving the same objective) will lead to an additional chapter in FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*, *Chapter 1,* The Objective of General Purpose Financial Reporting, *and Chapter 3,* Qualitative Characteristics of Useful Financial Information, to explain how to address relevant information and avoid irrelevant information. That chapter might include decision questions or the same ideas expressed as a set of principles. The Board would consider those questions or principles as it sets future disclosure standards. When the decision questions and the rest of the framework in this Invitation to Comment are more fully developed, the Board also plans to reconsider existing disclosure requirements in light of the framework.

1.22 An alternative to an additional chapter in Concepts Statement 8 would be to provide a similar set of decision questions or principles in the Codification and eliminate existing specific disclosure requirements. That would require reporting entities to make their own decisions about disclosures with much less detailed guidance. However, that could result in significant increases or decreases in existing disclosures, depending on each reporting entity's judgments, and will almost certainly result in less comparable disclosures from entity to entity or from period to period.

1.23 The three categories of information to which the decision questions relate include the following:

a. General information about the reporting entity (for example, what the reporting entity does and what subsidiaries and variable interest entities are included in consolidated financial statements)
b. Information about line items in financial statements (for example, descriptions and explanations, disaggregations, measurement methods, and measurement uncertainty)
c. Information about events and conditions that have not yet been represented in financial statements but that are likely to affect

assessment of prospects for future cash flows from the entity to its resource providers (for example, contingent gains and losses from various sources).

How to Tailor Disclosures to Fit the Circumstances of Individual Reporting Entities

1.24 Chapter 3 discusses changing the way that disclosure requirements are established. Currently, disclosure requirements are not described as variable or flexible and usually are not applied selectively. Many entities provide all of the information listed in a disclosure requirement if their financial statements include transactions or accounts related to that particular Codification Topic unless those transactions or accounts are clearly immaterial. For example, an entity with a defined benefit pension plan is likely to disclose every single item of information required by the related Topic even if some of those items have essentially no potential to affect future cash flow prospects.

1.25 Permitting some judgment about which disclosures are relevant in a particular entity's circumstance could be an effective way to reduce disclosure volume without reducing effectiveness. Currently, there is some variability in disclosure requirements. Some disclosures apply only to reporting entities in specified businesses or entities in the development stage, and others apply only to reporting entities over a specified size. However, that variability is the exception instead of the rule.

1.26 There are a number of possibilities for improving disclosure selectivity. The Board might set different requirements for different entities without requiring reporting entities to make their own judgments. For example, differences might be based on the size of the reporting entity or the business in which the entity engages. The Board also might set different requirements for entities with particular types of asset mixes, leverage ratios, or other characteristics. Alternatively, the Board might set no specific disclosure requirements but, instead, require reporting entities to apply the decision questions in Chapter 2 (instead of the Board applying them to set disclosure requirements). That would put essentially all of the responsibility for making judgments about differences on reporting entities. A possibility between those two extremes would be for the Board to specify a list of potential disclosures for each Topic and establish principles or provide other guidance on how each reporting entity should assess the relevance of each disclosure in its own particular circumstances.

Determining Whether a Disclosure Is Relevant

1.27 Chapter 4 discusses how reporting entities could identify which of the full list of disclosures (discussed in the preceding paragraph) they should include in notes to financial statements. The method described could allow reporting entities and auditors to consider disclosure relevance in a manner similar to the way that they apply materiality to items on the face of the financial statements.

1.28 In general, the notion is to consider how a user might use the information on the face of the financial statements to develop a *baseline* assessment of an entity's prospects for future cash flows and then to consider how information (either quantitative or qualitative) that might be disclosed in notes affects that assessment. If a particular disclosure would be expected to change users' assessments by a material amount, that disclosure would be considered relevant to that entity.

1.29 That portion of the overall framework might result in new guidance issued in an Accounting Standards Update. If so, it would be implementation guidance similar to the guidance on how to determine fair values that was originally issued as FASB Statement No. 157, *Fair Value Measurements*. It would not require any additional disclosures.

Improving Organization and Formatting

1.30 Chapter 5 discusses different ways of ordering and formatting notes to financial statements. Some ordering possibilities are flexible and based on relationships of particular disclosures of importance. Other possibilities for organization of notes to financial statements are more fixed and uniform. Formatting issues include best practices that assist the reader with navigating and understanding the information contained within the disclosures.

1.31 If the Board were to establish requirements for ordering or formatting notes, the discussion in Chapter 5 would lead to new guidance issued in an Accounting Standards Update. If not, ordering and formatting guidance may be issued in some other (possibly nonauthoritative) form.

Disclosures in Interim Financial Reports

1.32 The Board would like to establish some principles to use in establishing disclosure requirements for financial statements for interim periods to avoid making ad hoc decisions in each project. Chapter 6 discusses ways to provide a decision process (a) for the Board to use when establishing disclosure requirements, (b) for reporting entities to use in applying disclosure requirements, or (c) both. That process might be a modification of the process for annual financial statements or it might be a separate and different process.

1.33 The Board does not plan to reconsider as a part of this project the use of condensed statements or the basic premise that interim periods are an integral part of an annual period. The context for the discussion of disclosures for interim periods is the existing requirements.

Other Matters

1.34 Chapter 7 requests comments and suggestions on specific changes to existing standards relating to the summary of accounting policies that may improve financial reporting relatively easily and inexpensively.

1.35 Chapter 7 also discusses the Board's existing policies and practices for considering costs and other consequences of disclosure requirements. That discussion is for information only, and it does not identify or suggest changes to those existing policies and practices. But there are other efforts under way by the Board and others that may eventually result in changes.

Cooperation with the EFRAG, the FRC, and the ANC and Similarities to Their Discussion Paper

1.36 The staffs of the FASB and the staffs of the EFRAG, the FRC, and the ANC have cooperated in the preparation of this Invitation to Comment and a similar discussion paper to be issued jointly by the EFRAG, the FRC, and the ANC. The Board and the EFRAG's Technical Expert Group (TEG) as well as the FRC and the ANC have the same objectives and similar, if not identical, visions of the desired outcomes.

1.37 The following are the primary similarities between the two projects on a disclosure framework:

a. Both acknowledge that eliminating unnecessary disclosure would improve effectiveness.
b. Both scopes limit the discussion to notes to financial statements.
c. Both discuss potential improvements in three areas—standard setters' decisions about establishing disclosure requirements, reporting entities' selections of disclosures that are appropriate in their circumstances, and communication improvements (organization and formatting).
d. The two papers discuss different approaches to improvements in those three areas that are not inconsistent with one another.

Reports and Comments by Other Groups

1.38 This Invitation to Comment includes only limited background information about the criticisms of financial statement disclosures that led the Board to undertake a project to improve disclosures. The concerns have been publicized by several groups including the following (presented in chronological order with references to web postings):

a. Steering Committee Report Series, Business Reporting Research Project, *GAAP-SEC Disclosure Requirements* (2001): http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1175801856648
b. Investors Technical Advisory Committee (ITAC) Agenda Request (2007): http://www.fasb.org/cs/ContentServer?c=Document_C&pagen

ame=FASB%2FDocument_C%2FDocumentPage&cid=1175801635556

c. *Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission* (2008): http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf
d. United Kingdom Financial Reporting Council, *Combating Clutter* (2011): http://www.frc.org.uk/getattachment/8eabd1e6-d892-4be5-b261-b30cece894cc/Cutting-Clutter-Combating-clutter-in-annual-reports.aspx
e. The Institute of Chartered Accountants of Scotland/New Zealand Institute of Chartered Accountants Joint Working Group, *Losing the Excess Baggage—Reducing Disclosures in Financial Statements to What's Important* (2011): http://nzica.com/sitecore/shell/Controls/Rich%20Text%20Editor/~/media/NZICA/Docs/Tech%20and%20Bus/Financial%20reporting/Losing%20the%20excess%20baggage%20-%20reducing%20disclosures%20in%20financial%20statements%20to%20whats%20important%20-%202011.ashx
f. Financial Executives Research Foundation/KPMG, *Disclosure Overload and Complexity: Hidden in Plain Sight* (2011): http://www.kpmginstitutes.com/financial-reporting-network/insights/2011/pdf/kpmg-fei-dis-rep-disclose-overload-complexity.pdf
g. Autorité Des Normes Comptables Proposal, *Simplify Accounting Obligations for Small Listed Companies' in Europe* (2011): http://www.anc.gouv.fr/sections/nos_publications/nos_publications_fic/small_listed_compani/view

Question for Respondents

Question 1: The details of the Invitation to Comment do not focus on the informational needs of donors to not-for-profit organizations. How, if at all, should the Board's decision process (see Chapter 2) be supplemented to consider the needs of donors? How, if at all, should not-for-profit reporting entities modify their decision-making process (see Chapter 4) for the needs of donors when deciding which disclosures to include in notes to financial statements?

CHAPTER 2—THE BOARD'S DECISION PROCESS

Objectives of This Chapter

2.1 This chapter discusses how to identify information that should be disclosed in notes to financial statements. The discussion is structured around a decision process similar to what the Board might eventually add to its Conceptual Framework and use in each future standard-setting project.

2.2 The decision process in this chapter is not a final product; at this stage, it is not even a proposal. The process has been included to make it easier for interested parties to consider disclosure requirements broadly and to understand what objective each is intended to achieve.

2.3 The Codification includes many individual disclosure requirements that were established project by project. Requirements with similar objectives are worded differently in different Topics. In addition, bases for conclusions in original pronouncements have not always explained why the Board decided to require specific disclosures. To consider each disclosure requirement in the Codification individually and to assess consistently the relevance of each would be an overwhelming task.

2.4 For that reason, the Board found it necessary to categorize existing disclosures in a logical way so that they can be considered in groups instead of individually. The decision questions were created by the staff after studying existing disclosures and considering various ways of categorizing them. Published academic research on disclosures in notes to financial statements included categorizations that also assisted in the effort. A few additional questions were added to address ongoing concerns that have repeatedly been raised by constituents, for example, Question L11.

2.5 The categorization described in this chapter is not the only way to organize disclosures. A separate discussion paper on disclosure framework to be issued jointly by the EFRAG, the FRC, and the ANC includes a different method of organization (based on indicators), the objectives of which are consistent with the Board's objectives.

2.6 A fully developed set of decision questions similar to the ones in this chapter could be a useful addition to the Conceptual Framework. Another possibility would be to replace the existing detailed disclosure requirements with a single set of overall disclosure requirements based on decision questions. That single set of requirements would apply to all Topics (and to anything not addressed by a Topic).

2.7 Although the decision questions are in many cases written in the context of individual assets, liabilities, events, conditions, or transactions, the assessment

of cash flow prospects referred to in the questions is always made by evaluating the effect that the disclosure could have on the cash flow prospects of the entity.

Structure of the Decision Process

2.8 As discussed in paragraphs 1.9–1.12 of this Invitation to Comment, investment and credit decisions depend directly or indirectly on prospects for cash flows from the equity or credit instruments. Therefore, the Board's decisions about which information should be disclosed in notes is based on whether the information contributes to assessment of those prospects. The decision questions in this chapter are designed to identify that type of information.

2.9 To avoid frequent repetitions of the discussion in paragraphs 1.9–1.12, the phrases *prospects for cash flows* and *cash flow prospects* are used throughout this chapter. The term *cash flows* is intended to include flows of economic value other than cash and, unless specifically indicated otherwise in the context, refers to *net* inflows or outflows. In addition, the inflows that are important to existing and potential investors and creditors are inflows to themselves (directly from the entity or from sale of its investment or credit instruments). However, the phrase *prospects for cash flows* generally refers to the net inflows to reporting entities because they are the sources of outflows to investors and creditors or market price changes in the investment and credit instruments. If there is reason to expect a difference, the Board must consider both. For example, collateral requirements or participation rights may prevent some investors and creditors from receiving benefits from some of an entity's inflows, and it would be important for the entity to disclose that information.

2.10 The decision questions are organized into three categories: information about the reporting entity in general (Questions G1–G4), additional information about line items in financial statements (Questions L1–L16), and information about events and conditions that are not yet recognized in financial statements but that affect the entity's potential cash inflows and outflows (Questions O1–O7). The matters addressed by each category of questions are as follows:

- a. Information about the reporting entity in general:
  - (1) Operations, restrictions, and other similar matters
  - (2) Segments
  - (3) Consolidated subsidiaries and variable interest entities
  - (4) Related party transactions
  - (5) Accounting for matters not addressed in an accounting standard
- b. Information about line items in financial statements:
  - (1) Descriptions of line items, their natures, their terms, if any, and their sensitivities to change
  - (2) How the line items affect prospects for future cash flows (whether they will be sold, rented, collected, used to produce goods for sale, etc.) and how they relate to other items in

financial statements (hedging relationships, liens, contractual restrictions on use, sale, and settlement)

(3) How the items are accounted for—for example, policies, measurement methods and measurement uncertainties, and amortization

(4) Breakdowns of line items that combine items with different descriptions, effects on cash flow prospects, or accounting methods

(5) Explanations of period-to-period changes in line items if the reasons are not otherwise apparent

c. Information about other events and conditions (the effects of which have not yet been reflected in financial statements) that can affect prospects for future cash flows:

  (1) Descriptions of other events or conditions, their natures, effects on cash flows, probabilities of occurrence, and sensitivities to changes in conditions

  (2) Measurement methods and measurement uncertainties, if applicable.

2.11 Many of the decision questions have broad applicability. That is, if the Board were to use them to establish disclosure requirements, they would apply differently to different Topics. However, some of the questions could be used to establish a single broad standard instead of a series of detailed requirements in individual standards. In particular, the questions about other events and conditions are worded more like standards than concepts and could be applied more easily by reporting entities instead of by the Board.

General Information about the Decision Process

2.12 A very important assumption underlying this decision process is that in each future project that results in new guidance issued in an Accounting Standards Update, the Board would establish flexible disclosure requirements. Chapter 3 explains how the Board might do that. The practice of establishing a single one-size-fits-all package of information often leads to default decisions to provide the entire package even if some of it is unnecessary. The objective would be to permit or require reporting entities to make an explicit decision about each disclosure. Chapter 4 describes the basis for the reporting entity's decision, which in many cases is not simply the materiality of the related line item.

2.13 The decision questions in this chapter describe the information that the Board would consider requiring in general terms or as principles. More specificity is neither possible nor desirable at this level. For example, the detailed information that users might need to understand the effects on cash flow prospects of a complex and varied portfolio of derivative instruments might be very different from the detailed information needed for trade accounts receivable.

2.14 The Board has not attempted to explicitly define the boundaries of notes to financial statements, but the decision questions are intended to limit note disclosure to information with any of the following characteristics:

a. It is unique to an entity or its industry.
b. It is not already apparent from financial statements or readily available from public sources to which users could be expected to have access.
c. It could make a material difference in future cash flow prospects.

2.15 Some of the general implications of that limitation include the following:

a. Users would be expected to have information about general business risks, general economic conditions (such as which industries are growing and which are declining, interest rate curves, rates of inflation), and similar items.
b. Users would be expected to be aware of such things as U.S. GAAP, commonly used pricing models, and SEC reporting requirements. Accounting methods would be disclosed only in situations in which alternatives are permitted, the method is not otherwise apparent, or the method has changed. The mechanics of widely used pricing models would not require explanation, although entity-specific inputs and assumptions may require explanation.

General Information about the Reporting Entity As a Whole

2.16 The following group of questions relates to information about a reporting entity in general that can affect prospects for future cash flows.

Question G1. Do the financial statements reflect transactions, balances, or other contractual relationships with related parties on terms that could be different from arm's-length transactions and contracts with third parties?

Information to Be Considered for Disclosure

The information to be considered would include the following:

a. Nature of the transaction(s), balance(s), or contract(s)
b. If possible, a general indication of the magnitude of the effect on the financial statements of the difference between the actual transactions, balances, and contracts, and the amounts that would have been reported for arm's-length transactions, balances, and contracts in the aggregate
c. Any unique or highly unusual aspects of the transaction(s), balance(s), or contract(s) that would affect an assessment of the entity's prospects for future cash flows.

Why the Information Could Be Important

Without disclosure of related party transactions, reasonable users would be entitled to assume all transactions to be at arm's length and would assess prospects for future cash flows on that basis. Transactions with related parties may not be at arm's length and, even if they are, similar future transactions may not be. The prices may be different, the payment requirements or other terms may be different, or the transactions may not have occurred at all with unrelated parties. Any of that information has the potential to influence users' assessments of prospects for future cash flows.

Question G2. Does the reporting entity issue consolidated financial statements?

Information to Be Considered for Disclosure

The information to be considered would include the following:

a. General or specific information about the entities included in the consolidated financial statements
b. Comparison to the group of entities in the previous years' consolidated financial statements, if there are any changes in the consolidated members in the current reporting period
c. Consolidation policies and procedures, including the reasons for consolidating entities, and elimination of intercompany transactions and balances, if any.

Why the Information Could Be Important

The nature and composition of a reporting entity can make a difference in its ability to generate cash flows and move cash from one part of the business or the other, which can affect cash flow prospects. More important, however, is the fact that changes in the composition of the entity could significantly affect year-to-year comparisons.

Question G3. Are there restrictions on the entity's use of assets and potential concerns about the entity's cash flows that are not otherwise apparent from the financial statements?

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of the following:

a. Description of restrictions on the uses of assets
b. The amount of cash and other liquid assets available to meet anticipated cash requirements
c. Description of plans or strategies to deal with any concerns about shortfalls

d. Descriptions of commitments made or planned uses for a cash balance.

Why the Information Could Be Important

Restrictions affect the ability to realize a return on assets, to meet liquidity needs, and to pay dividends, among other things. All of those can affect an assessment of prospects for future cash flows.

Question G4. Does the entity operate different types of businesses in different geographic areas or in other segments that are managed separately?

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of the following:

a. Description of the entity's segments
b. The markets or geographic locations in which the entity operates.

Why the Information Could Be Important

Different businesses and different geographic areas contribute to different rates of growth and return as well as different levels of risks and uncertainties. Any of those can significantly affect users' assessments of prospects for future cash flows.

Information about Line Items

2.17 The following group of questions relate to information about line items in financial statements that can affect prospects for future cash flows.

Question L1. Is there information about the nature or quality of the phenomenon or phenomena represented by the line item (for example, the underlying rights, obligations, or transactions) that can affect assessments of future cash flow prospects[4] and that is not adequately conveyed by the line item's description?

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of the following:

a. Enough information (normally narrative instead of quantitative) about the phenomenon or phenomena so a user may access reference materials or other sources of information to understand the phenomenon or phenomena

[4]See paragraphs 2.8–2.9 for important information about this term.

b. If a user could not reasonably be expected to find adequate information from other sources, an explanation of the nature of the phenomenon in enough detail to provide an understanding of how the item might affect prospects for future cash flows.

Why the Information Could Be Important

Without an understanding of what a line item represents (its nature and quality), a user would not be able to understand its effect on future cash flow prospects.

Question L2. Does the line item represent any of the following:

a. Financial instruments
b. Other contracts or legally binding documents
c. Other binding arrangements?

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of the following:

a. Terms (obligations and rights) needed for assessment of prospects for future cash flows. Some examples are amounts and timing of payments and receipts, interest rates, and the nature and timing of other required performance, call or put options, and penalty or bonus clauses.
b. If the item is an asset, the likelihood of the risk of counterparty nonperformance (credit risk or failure to deliver other assets or services) at the date of the financial statements.
c. The potential effect on the financial statements of the reporting entity of counterparty nonperformance.
d. The potential effect on the financial statements of the reporting entity of the entity's nonperformance.
e. The estimated amounts and timing of future cash flows that are contractually required, but whose amounts and timing are not contractually specified.
f. The estimated amounts and timing of future cash flows that are not contractually specified but that are anticipated or otherwise probable (for example, based on past history or economic incentives).

Why the Information Could Be Important

Without an understanding of obligations and rights under legal agreements, a user would not be able to determine the effect on prospects for future cash flows.

Question L3. Is the existence or ownership of the rights and obligations underlying the line item uncertain?

This question is different from the uncertainty question related to measurement (see Question L9) in that it does not relate to uncertainty about outcomes but to

uncertainty about whether an asset or liability exists or is owned or owed by the entity.

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of a description of the uncertainty or uncertainties about the existence and ownership of the item. In addition, the Boards should consider requiring disclosure of how future cash flows would change if the uncertainty is resolved in a manner that is different than the entity expected.

Why the Information Could Be Important

This disclosure would avoid potentially misleading a user into underweighting risks in a circumstance in which a recognized asset or liability is questionable.

Question L4. Does the line item include components of different natures that could affect prospects for future net cash flows differently?

There are many examples of line items that contain different components, and not all would necessarily affect prospects for future cash flows differently. Some include the following:

a. A portfolio of financial instruments of different types
b. Inventories of different types of products or of raw materials, work in process, or finished goods
c. Revenues from different products or services whose sales are not correlated
d. Pension expense on the income statement, which includes service cost, interest expense, return on assets, and amortizations of prior service costs and actuarial gains and losses
e. Real estate that includes apartment buildings, malls, and office buildings.

The following are examples of indications that components affect prospects for future cash flows differently:

a. Different frequency or timing of occurrence
b. Different probabilities of repeating
c. Responses to different variables or different responses to the same variables
d. Different rates of return expected.

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of the amounts and natures of the different components of the line item.

Why the Information Could Be Important

If cash flows attributable to different components would be expected to change in the opposite direction or by much different percentages as economic conditions or the entity's circumstances change, a user would have to know the different components to assess prospects for future cash flows.

Note: The Board could consider a general requirement for the disclosure instead of establishing separate requirements in each area of the Codification.

Question L5. Are the cash flow prospects related to the line item affected by changes in general economic conditions or market factors, *and* are the conditions, factors, or likely effects on the line item not apparent from the nature of the line item?

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of the following:

a. A description of the types of changes in future economic conditions or market factors that could be expected to cause frequent or significant changes (for example, interest rates, stock prices, and foreign currency rates; housing starts, unemployment, and inflation)
b. An indication of how changes in those factors would affect the prospects for cash flows arising from the line item
c. A general description of the policies, practices, and strategies that could mitigate the effects of the changes in conditions or factors
d. An indication of the past effectiveness of the policies, practices, and strategies.

Why the Information Could Be Important

Changes in cash flow prospects are essential to users' decisions. The prospects for future cash flows generated by some line items may change in ways that a user could not be expected to determine without additional information in financial statements. The entity's mitigation policies, practices, or strategies would be important if they could eliminate effects on prospects for future cash flows that a user might otherwise anticipate.

Question L6. Are the prospects for future cash flows related to the line item affected by changes in entity-specific factors or sector-specific factors, particularly those that can be expected to change frequently or significantly, *and* would a user not be expected to be aware of the factors or their potential effects?

Examples include volatile demand for the entity's products or services, social factors affecting the sector or entity, imminent obsolescence, supply chain

concerns, new laws and regulations, availability of trained workers, management turnover, or environmental hazards.

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of the following:

a. A description of the entity-specific factors or sector-specific factors that could be expected to cause frequent or significant changes
b. An indication of the effects on the line item of changes in those factors
c. A general description of the policies, practices, and strategies that could mitigate the effects of the changes in conditions or factors
d. An indication of the past effectiveness of the policies, practices, and strategies.

Why the Information Could Be Important

The prospects for future cash flows generated by some line items may change in ways that a user could not be expected to determine without additional information in financial statements. Revenues, costs, and many other line items that would be affected by those factors would be things that a user would be expected to understand if that user understood the industry in which the entity operates. However, some entities may have unique or unusual businesses that may require explanation. The entity's mitigation policies, practices, or strategies would be important if they could eliminate effects on prospects for future cash flows that a user might otherwise anticipate.

Question L7. If the line item is an asset, liability, or equity instrument, could the causes of changes from the prior period be generally understood?

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of the causes of changes from the prior period (such as major inflows and outflows summarized by type or a detailed roll forward). It would be important to separate routine changes from nonroutine changes and changes in reported amounts caused by changes in accounting, changes in economic conditions, and changes in contractual obligations or rights.

Why the Information Could Be Important

This information would allow a user to assess the likelihood of future similar changes. Disaggregation would be important because different types of changes have different implications for the assessment of an entity's future cash flow prospects.

Note: The Board could consider a general requirement for the disclosure instead of establishing separate requirements in each area of the Codification.

Question L8. If the item is a productive asset or intellectual property, has the quality or utility of the item changed?

This disclosure is related to measurement but is not strictly a measurement issue. Some productive assets are carried at amounts that are not closely related to their current values and do not change in relation to those values. For example, a building with a carrying amount that is being depreciated may actually be appreciating in value and its cash flow generating potential may be increasing.

Information to Be Considered for Disclosure

The Board should consider requiring a description of the nature of the change and how that change could affect prospects for future cash flows. The objective of this disclosure would be to provide information not signaled or indicated by accounting and reporting. For example, the carrying amounts of depreciable assets may systematically decline in a way that masks a change in utility or value. The asset may have been depreciated at a rate that exceeds the rate at which its economic value has declined. Therefore, a technological change that causes it to become significantly less valuable in a single year may not require an impairment write-down. That change in economic value is the kind of thing contemplated by this disclosure.

Why the Information Could Be Important

As described above, information about the quality or utility of a particular asset may not be apparent from the financial statements and may have a significant effect on cash flow prospects. However, information of this type may not be unique to the entity or may be apparent from sources outside the financial statements or in other portions of the financial statements. For example, a change in demand for rental property held by the entity or for the entity's major products may be general knowledge and may be demonstrated by changes in rental income or revenues. That information would be most important if the entity's experience is counter to expectations or otherwise outside expectations.

Question L9. Does the line item include individual items (or groups) that are measured differently?

This information is not the same as the information addressed by Question L7 because differences in measurement may exist for very similar or identical items. Two items measured the same way may have different responses to changes in market conditions.

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of descriptions, carrying amounts, and measurement methods of the items or groups measured differently.

Why the Information Could Be Important

The effect on cash flow prospects of a single amount that is a total of items measured differently may be impossible to assess without knowing the components. If a user could assess prospects for future cash flows based primarily on revenues, expenses, and other items in income, measurement differences in balance sheet amounts may not be particularly important and additional discussion or elaboration would provide little incremental benefit. However, if users would assess prospects for future cash flows based on return from an asset or the market price of an asset, measurement differences would be much more important and providing details would be worthwhile.

Note: The Board could consider a general requirement for the disclosure instead of establishing separate requirements in each area of the Codification.

Question L10. Are there acceptable[5] alternative accounting policies or methods that might have been applied to this line item?

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of the following:

a. The accounting policy or method applied
b. The magnitude of the effect if the accounting method is unusual, if results produced are counter to what a reader might otherwise expect (for example, last-in, first-out inventory costing), or if the method otherwise dramatically affects the financial statements (full cost versus successful efforts).

Why the Information Could Be Important

If more than one accounting method could be applied to an item, a user would not be able to judge the effects of the line item on future cash flows without an explanation of what the item represents. For example, if a line item could be measured at transaction price or fair value, a user needs to know which is applied.

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[5] In this context, the term *acceptable* refers not only to alternatives that are the entity's choice, but also to practicability exceptions and alternatives that are prescribed in different circumstances if a reader cannot discern which method is being used by reading financial statements.

Question L11. Does the line item include balances or the effects of transactions or events that either:

a. **Are not addressed by directly applicable reporting requirements**
b. **Are not clearly analogous to other transactions or events for which there is applicable guidance?**

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of the following:

a. Nature of the transactions or events and the method of accounting applied to them
b. If applicable, uncertainties related to recognition or measurement or both
c. Any unique or highly unusual aspect of the transaction or event that would affect an assessment of the entity's prospects for future cash flows.

Why the Information Could Be Important

Without this information, users would have no way of knowing how the results of important transactions have been reported and, therefore, could easily misunderstand what has been reported.

Question L12. Has the accounting policy or method used for this line item changed because of adoption of or transition to newly issued guidance or because the previous method was determined to be improper?

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of the following:

a. The fact that a change has occurred
b. The reason(s) for the change
c. How the change would have affected previous years (preferably) or, if that is not feasible, how the previous method would have produced different information this year.

Why the Information Could Be Important

Without an explanation of a change in accounting, a user could easily be misled. To properly assess the effect of past trends on future cash flow prospects, a user would need to know how much of the increase or decrease in the carrying amount of an asset or liability or the year-to-year change in revenue or expense is due to the accounting change and how much is due to an economic change.

Question L13. Will this line item be affected in future years by transition to an accounting standard that has been issued but that is not yet effective or not fully effective?

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of the following:

a. When the transition will occur
b. A description of the anticipated effect on future financial statements
c. The pro forma effect on current-year financial statements.

Why the Information Could Be Important

Information about the future accounting treatment could be helpful in assessing how perceptions about cash flow prospects might be affected by a new accounting treatment.

Furthermore, such disclosures can be useful in making disclosures comparable from entity to entity and from period to period for the same entity.

Question L14. Is the method for determining the amount of the line item uncommon, not apparent from the description, or otherwise hard to discern?

Information to Be Considered for Disclosure

The Board should consider requiring an explanation of how the amount of the line item was determined (for example, an option pricing model, a matrix pricing technique, or an internally developed technique). However, if the computation is unique or unusual but prescribed in an accounting standard (such as the way of determining deferred taxes or uncertain tax positions), disclosure might be unnecessary if the line-item description is adequate to indicate the accounting requirement that is applied.

Why the Information Could Be Important

Not understanding what a carrying amount means makes it difficult or impossible to determine what it implies for assessments of future cash flow prospects.

Note: The Board could consider a general requirement for the disclosure instead of establishing separate requirements in each area of the Codification.

Question L15. Is the carrying amount of the line item an estimate that required assumptions, judgments, or other internal inputs that could reasonably have been different?

This question is not limited to fair value or other estimates of current value. At times, accumulations of costs involve uncertainties (about which costs to include,

for example), and impairment allowances not based on quoted market prices are nearly always subject to significant uncertainties.

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of enough detail about the significant estimates, assumptions, judgments, or other internal inputs to provide a general understanding of how the carrying amount was determined, the level of uncertainty inherent in the amount, and how significantly the number might have changed if the inputs had been different.

Why the Information Could Be Important

The relevant information would not necessarily be sufficient to allow the user to recalculate the numbers using different assumptions. Nor is that its purpose. Management's judgments about uncertainties and unknowns significantly influence the amounts reported, which influence users' assessments of prospects for future cash flows. Users need to understand the level of uncertainty inherent in an amount, the factors to which the price or carrying amount is sensitive, and how an estimate is put together. The need for the information is based on the potential variability in prospects for future cash flows as a result of different but reasonable assumptions, judgments, or methods of estimating. Generally, the harder an amount is to estimate, the more explanation is required (assuming the magnitude is similar). Three factors go into estimates of prices or values: amounts of cash flows, timing of cash flows, and probability of variation in cash flows. The disclosure should focus on the ones that are relevant in a particular situation.

Question L16. Is there an alternative measure or way of applying a measurement that clearly would be useful in assessing prospects for future cash flows?

An alternative measure might be considered for an asset or a liability. One example is the fair value of a financial instrument reported at a cost-based amount. Another example is an impairment allowance for inventory assessed in the aggregate that might be different from an item-by-item assessment.

Information to Be Considered for Disclosure

The Board should consider requiring disclosure of the following:

a. Identification of the alternative measurement or method of application
b. An indication of the magnitude of the difference between the reported measurement and the alternative measurement (or the amount of the alternative measurement).

Why the Information Could Be Important

Two types of measurement could be important for different reasons. The fair value of an asset could be useful as a benchmark for comparing one entity with another or to evaluate management's decisions about selling or holding assets. A user's method for assessing gross profit on sales could produce better results if that user knew the impairment on an item-by-item basis instead of in the aggregate or vice versa.

How users incorporate a portfolio of securities into assessment of future cash flow prospects could differ depending on whether the total value is based on the sale of the portfolio as a whole or the sale of a smaller block, especially for large blocks of a single security. For example, a user might want an idea of the magnitude of the control premium.

Alternative measures generally would be much less important for an item that generates cash flows by being used to produce, transport, or market a product or service than for an item that is settled in cash or can be exchanged for cash.

Information about Other Events and Conditions That Can Affect an Entity's Prospects for Future Cash Flows

2.18 The following group of questions relate to information about other events and conditions (the effects of which have not yet been reflected in financial statements) that can affect prospects for future cash flows.

2.19 The heading titled "Why the Information Could Be Important" has been omitted for the questions in this section because the explanation is the same in each case. All of the questions in this section relate to matters for which there is no information on the face of the financial statements, and all relate to matters that can affect prospects for future cash flows.

Question O1. Have any of the following events or conditions created a possibility that net cash flows that the entity would otherwise have experienced will be significantly different (lower or higher):

- **a. Potential litigation against the entity or by the entity against another entity or entities (because of specific matters instead of general business risk)**
- **b. Existing litigation against the entity or by the entity against another entity or entities, the outcome of which is still uncertain**
- **c. Possible or known violations by the entity of laws, regulations, or contractual terms or violations of the entity's rights under statutes, regulations, or contracts**
- **d. Other uncertain conditions?**

Information to Be Considered for Disclosure

The information to be considered would be the following:

a. The existence and description of the event or condition
b. Whether the effect of the event or condition would involve the entity's routine and frequent business activities or would have an infrequent or one-time effect on cash flows
c. Whether the event or condition itself is unique or infrequent or is routine or frequent
d. The entity's judgment about the magnitude of the possible effect on future cash flows as a point estimate of the most likely outcome, as a probability-weighted outcome, or as a range of possible outcomes
e. The entity's judgment about the probability that the event or condition will affect future cash flow prospects.

If the entity has plans that it believes may minimize decreases or maximize increases in net cash inflows, it may describe those actions and should explain whether the amounts disclosed as possible effects on future cash flows assume that the planned actions will be effective. In other words, if the disclosure assumes that the entity will be able to minimize a probable loss or maximize a probable gain, disclose that fact. Unless the entity has prior experience in successfully minimizing that type of loss or maximizing that type of gain, the more pessimistic amount also should be disclosed (assuming the minimizing or maximizing plans fail).

Question O2. Are there other events or conditions that are not represented by an asset or liability and a gain or loss (or income or expense) in the entity's financial statements but about which there was uncertainty in the decision not to recognize? (That would include items other than the contingencies discussed in Questions O1(a) and O1(b).)

Information to Be Considered for Disclosure

The information to be considered would be the following:

a. The existence and description of the event or condition
b. Uncertainties that were assessed in deciding not to recognize an asset or liability and gain or loss (income or expense) and the reason for that decision
c. Whether events or conditions of the same type are routine and frequent or would have an infrequent or one-time effect on cash flows
d. Whether the event or condition itself is unique or infrequent or is routine or frequent
e. The entity's judgment about the magnitude of the possible effect on future cash flows as a point estimate of the most likely outcome, as a probability-weighted outcome, or as a range of possible outcomes

f. The entity's judgment of the probability that the event or condition will affect future cash flow prospects.

Question O3. Could future loss of or deterioration in the relationship with one or a few customers or suppliers significantly affect an entity's future cash flows?

Information to Be Considered for Disclosure

The information to be considered would be the following:

a. The fact that the entity is dependent on one or a few customers or suppliers and an indication of the degree of dependence
b. A judgment of the prospects for losing the customers or suppliers
c. An explanation of actions the entity has taken to mitigate potential effects from the deterioration of a relationship with a supplier.

Question O4. Could the entity's future cash flows be subject to significant positive or negative changes because of volatility or other uncertainty in volumes or prices in the markets for the entity's inputs or outputs?

Information to Be Considered for Disclosure

The information to be considered would be the following:

a. Possible cause of the volatility or other uncertainty in inputs or outputs markets
b. The worst-case effect on the financial statements of volatility in inputs and outputs markets.

Question O5. Is there uncertainty in an entity's access to the markets for its inputs or outputs (whether resolution of the uncertainty would result in increased or decreased access)?

Information to Be Considered for Disclosure

The information to be considered would be the following:

a. The existence and possible causes and effects of the uncertainty about restrictions in access to inputs and outputs markets
b. The potential effects on the financial statements of significant access restrictions to inputs and outputs markets
c. How the entity plans to mitigate adverse financial statement effects arising from restrictions to its access to inputs and outputs markets.

Question O6. Is there significant uncertainty about an entity's ability to maintain a qualified work force and suitable physical facilities (whether resolution of the uncertainty would result in increased or decreased ability)?

Information to Be Considered for Disclosure

The information to be considered would be the following:

a. The existence and causes of the significant uncertainty to maintain a qualified work force and suitable physical facilities
b. The potential effects of that uncertainty on financial statements
c. How the entity plans to mitigate adverse financial statement effects arising from the significant uncertainty about maintaining a qualified work force or suitable physical facilities.

Question O7. Could an entity's possible future cash flows be subject to significant changes because of the effects of possible future changes in the following:

a. Interest rates
b. The entity's ability to obtain financing
c. Foreign currency exchange rates
d. Commodity prices (whether exchange-traded or not) or volumes
e. Stock market prices or volumes
f. Other financial market prices or market conditions?

Information to Be Considered for Disclosure

The information to be considered would be the following:

a. An explanation of the macroeconomic factor(s) that affect particular assets, liabilities, or equity instruments
b. The potential effects of changes in the macroeconomic factors on the assets, liabilities, and equity instruments and on net income and other comprehensive income.

Testing of the Decision Process

2.20 The staff informally tested the decision questions by applying them to various accounting topics and comparing the results to the current disclosure requirements. That testing identified a few existing disclosure requirements that would not be indicated by the decision questions. Testing also indentified some information not currently required to be disclosed that would be indicated by the decision process. Overall, the testing was not sufficiently complete or rigorous to draw firm conclusions about the results the Board would get in a standard-setting process or the disclosures that an entity would make. It simply served to indicate the completeness of the decision process.

2.21 The decision questions were applied to the following areas and the results were compared to existing disclosure requirements:

a. Defined benefit plans (Subtopic 715-20, Compensation—Retirement Benefits—Defined Benefit Plans—General)
b. Receivables, and loans and debt securities acquired with deteriorated credit quality (Subtopics 310-10, Receivables—Overall, and 310-30, Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality)
c. Property, plant, and equipment (Subtopic 360-10, Property, Plant, and Equipment—Overall).

2.22 The decision questions also were tested against current agenda projects. However, because neither this framework nor those projects were completed at the time that this Invitation to Comment was issued, the outcome of that testing is unclear.

Questions for Respondents

Question 2: Do the decision questions in this chapter and the related indicated disclosures encompass all of the information appropriate for notes to financial statements that is necessary to assess entities' prospects for future cash flows?

Question 3: Do any of the decision questions or the related indicated disclosures identify information that is not appropriate for notes to financial statements or not necessary to assess entities' prospects for future cash flows?

Question 4: Would these decision questions be better applied by reporting entities instead of the Board? In other words, should the Board change its practice of establishing detailed requirements in each project and, instead, establish a single overall requirement similar to the questions in this chapter?

Question 5: Do you think that this decision process would be successful in helping the Board to set more effective disclosure requirements? If not, what would be a better approach?

Request of Respondents

The Board would appreciate it if respondents would apply this decision process to the Codification Topics of their own choosing and identify any changes to existing disclosure requirements that would seem to result.

CHAPTER 3—MAKING DISCLOSURE REQUIREMENTS FLEXIBLE

3.1 To some, reducing the volume of disclosures in financial reports is an end in itself, but to the Board, reducing volume is a means of increasing effectiveness. Volume is not necessarily bad if the information is relevant to an assessment of the prospects for cash flows from a particular entity. However, unnecessary volume increases the workload of issuers of financial statements (to gather the data and prepare the disclosure). It also increases the workload of users of financial statements (to study the data to determine what is relevant and what is not) and increases the probability that they will overlook information that could affect their investment and credit decisions.

3.2 Board members and the staff have been told on several occasions that one factor creating unnecessary volume is that disclosure requirements for a given Topic are generally viewed as inseparable packages. That is, all are viewed as required if any one of them is required.

3.3 Some have suggested that the Board should address that problem by simply eliminating disclosure requirements. However, with few exceptions, the existing disclosure requirements address information that is relevant for assessing cash flow prospects for at least some entities. Unfortunately, information that might be irrelevant to one entity might be highly relevant to another entity, and the Board cannot set disclosure requirements entity by entity.

3.4 As an example, a reporting entity may have material liabilities from two different defined benefit pension plans. One plan is active, and the liability is growing. The other plan has been curtailed, and the amounts and timing of expected future payments have much less potential variability. Although the amount of the liability for each plan may be about the same at present, the relevance of the required disclosures is not the same. Assessment of the future cash outflows related to the curtailed plan could be done with little or no information other than the amount of the liability and some information about expected payments. In contrast, future cash outflows related to the active plan are unknowable at present, and more information would be necessary to help users assess effects on prospects for cash flows.

3.5 As mentioned in paragraph 3.2, reporting entities normally provide all of the information listed in a disclosure requirement if their financial statements include material transactions or balances related to that Topic. Otherwise, they provide no information if there are no such transactions or balances or the existing transactions and balances are clearly immaterial. That practice can result in reporting information that is not relevant. In the previous example of the curtailed defined benefit plan, the reporting entity probably would provide every single disclosure required for defined benefit plans even if some have no potential to affect future cash flow prospects.

3.6 The only way to avoid unnecessary disclosure volume without eliminating requirements that are applicable to some entities may be to apply selectivity to disclosure requirements. Selectivity in disclosure requirements is not without precedent. Not all existing disclosure requirements apply to every entity. Some apply only to reporting entities in specified businesses or entities in the development stage, and others apply only to reporting entities over a specified size. However, that variability is the exception instead of the rule and results from the Board's decisions instead of reporting entities' decisions.

3.7 Permitting or requiring selectivity in applying disclosure requirements offers significant potential for reducing the volume that results from reporting information with very little or no relevance to decisions of investors, lenders, and other creditors. In fact, it may be the single best way to reduce volume enough to enable users of financial statements to more easily find the information they need.

3.8 There are a number of possibilities for achieving disclosure selectivity. The following are two extremes of the range of possibilities:

a. The Board could take most of the responsibility for judgments by setting different requirements for different entities. For example, differences might be based on the size of the reporting entity or the business in which the entity engages. The Board also might set different requirements for entities with particular types of asset mixes, leverage ratios, or other characteristics.
b. The Board could put most of the responsibility for judgments on the reporting entities. The Board would set no specific disclosure requirements but would require reporting entities to apply the decision questions in Chapter 2.

3.9 Although the Board has not deliberated the issue of how to encourage appropriate selectivity, each of those extremes has obvious problems. It might be impossible for the Board to incorporate effective selectivity into disclosure requirements. At best, it would require the Board to specify a large number of different categories based on the size of the entity, industries, asset mixes, leverage ratios, or other characteristics. Some of the boundaries almost certainly would be arbitrary, and arbitrary boundaries tend to raise questions and create implementation difficulties. For example, which disclosures would reporting entities provide if they move from one category to another?

3.10 In the U.S. legal and regulatory environment, broad general requirements like the decision questions in Chapter 2 have the potential to create significant problems, not the least of which is inconsistency. Some reporting entities probably would feel obligated to disclose every possible bit of information to avoid being second-guessed. Others might not disclose enough information. Regulators and auditors would not necessarily reach the same conclusions as reporting entities about which information is relevant.

3.11 Luckily, there are possibilities between the two extremes:

a. The Board could change the way in which it words disclosures to be less prescriptive and thus allow flexibility in the way in which the entity complies with a particular requirement (in other words, there only would be judgment about how to provide a disclosure and not whether to provide a disclosure).
b. The Board could identify one set of potential disclosures for each Topic and require reporting entities to make their own decisions about the relevance of each item.
c. In each Topic, the Board could set a minimum disclosure or set of disclosures and an expanded set of disclosures. Reporting entities would make their own judgments about whether to provide the minimum disclosures or whether some or all of the expanded disclosures are relevant to their financial statements.
d. The Board could establish three or more tiers of information items (instead of just a minimum and maximum) or otherwise provide a graduated scale of information requirements in each Topic. Reporting entities would make their own decisions about which level applies to them.

3.12 Examples using stock-based compensation and retirement benefits from defined benefit plan disclosure requirements are provided at the end of this chapter to illustrate the possibilities. Those examples, which were prepared without Board deliberations, will undoubtedly raise questions, concerns, and points of disagreement. In fact, they may serve to illustrate reasons why some of the possibilities are not realistic.

3.13 Unless the Board chooses to take all responsibility for disclosure selectivity (see paragraph 3.8(a)), reporting entities would need principles or other guidance to help them assess relevance. Chapter 4 discusses one possible type of that guidance, which would apply readily to alternatives (b) and (c) in paragraph 3.11. It could probably be modified to apply to alternatives (a) or (d) in paragraph 3.11 as well.

3.14 It should be apparent from this discussion that although permitting or requiring selectivity in the application of disclosure requirements can reduce the number of pages in financial statements, it will not necessarily reduce the time and effort in preparing notes to financial statements. In fact, for many entities, more time and effort may be required, especially in the first year of application and in any year in which the entity's circumstances have changed significantly.

Less Prescriptive Requirements

3.15 One way to add flexibility to the requirements would be for the Board to word the requirements to prescribe the objective of the disclosure or the general

type of information that is required, and not to prescribe the form of the disclosure. For example, paragraph 715-20-50-1(b) requires the following:

> A reconciliation of beginning and ending balances of the fair value of plan assets showing separately, if applicable, the effects during the period attributable to each of the following:
>
> 1. Actual return on plan assets
> 2. Foreign currency exchange rate changes . . .
> 3. Contributions by the employer
> 4. Contributions by plan participants
> 5. Benefits paid
> 6. Business combinations
> 7. Divestitures
> 8. Settlements.

3.16 That requirement could be worded in the following way to allow for flexibility in the way an entity complies with the requirement:

> Information that explains significant changes to the fair value of plan assets during the period.

3.17 In some cases, an entity would provide a reconciliation containing all of the data that are detailed in paragraph 3.15 to comply with the requirement in paragraph 3.16. In other cases, the only significant changes may be due to returns on plan assets during the period, and the entity could comply with the requirement in paragraph 3.16 by providing a statement to that effect. This approach could be applied on its own to add flexibility to disclosure requirements. It also could be combined with any of the other approaches discussed in this chapter.

Example of Applying the Minimum and Expanded Disclosure Approach to Stock-Based Compensation

3.18 The following is an example of how the minimum and expanded disclosure approach could be applied to stock-based compensation. Existing disclosures not identified as minimum requirements (the expanded requirements) would be necessary only if that additional information is relevant.

3.19 The staff arrived at the *minimum* list by considering disclosures that seem basic to understanding the overall effect of stock-based compensation on an entity's financial statements. The staff also looked to identify requirements that seemed useful only in select circumstances and excluded those requirements from the minimum list (but retained them as part of the expanded list to be

considered by the entity). None of the requirements were viewed as wholly irrelevant.

3.20 The example in paragraph 3.21 is not intended to signify a proposed change to stock-based compensation disclosures. The Board has not deliberated any categorization of existing disclosures.

3.21 Below are the disclosure requirements from paragraphs 718-10-50-1 through 50-4 that might be identified as minimum disclosure requirements (for ease of use, existing Codification references have been maintained):

> 718-10-50-2(b) The method it uses for measuring compensation cost from share-based payment arrangements with **employees**.
>
> 718-10-50-2(h) For each year for which an income statement is presented . . . the following:
>
> 1. Total compensation cost for share-based payment arrangements
>   i. Recognized in income as well as the total recognized tax benefit related thereto
>   ii. Capitalized as part of the cost of an asset.
>
> 718-10-50-2(j) If not separately disclosed elsewhere, the amount of cash received from exercise of share options and similar instruments granted under share-based payment arrangements and the tax benefit realized from stock options exercised during the annual period

3-Tier Pension Example

3.22 The following example of prioritizing existing current disclosure requirements is based on an idea suggested to the Board by a user of financial statements. The following tiers are based on the level of activity and complexity of an entity's defined benefit pension plans.

a. Tier 1—Applicable to all defined benefit pension plans
b. Tier 2—Applicable to all defined benefit pension plans with moderate activity and complexity
d. Tier 3—Applicable to all defined benefit pension plans with extensive activity and complexity.

3.23 This Invitation to Comment does not define *moderate* or *extensive* activity or complexity. That might be done as part of the work needed to move toward an Exposure Draft, if the idea of three tiers of disclosure is deemed worthy of further consideration. Furthermore, the Board has not deliberated any changes to the

disclosure requirements for retirement benefits from defined benefit plans as part of this project.

Tier 1—Defined Benefit Pension Plan

3.24 Tier 1 might include the following requirements from paragraph 715-20-50-1:

> An employer that sponsors one or more defined benefit pension plans or one or more defined benefit other postretirement plans shall provide the following information, separately for pension plans and other postretirement benefit plans. Amounts related to the employer's results of operations shall be disclosed for each period for which a statement of income is presented. Amounts related to the employer's statement of financial position shall be disclosed as of the date of each statement of financial position presented. All of the following shall be disclosed:
>
> a. A reconciliation of beginning and ending balances of the benefit obligation showing separately, if applicable, the effects during the period attributable to each of the following:
>   1. Service cost
>   2. Interest cost
>   3. Contributions by plan participants
>   4. Actuarial gains and losses
>   5. Foreign currency exchange rate changes (The effects of foreign currency exchange rate changes that are to be disclosed are those applicable to plans of a foreign operation whose functional currency is not the reporting currency pursuant to Section 830-10-45.)
>   6. Benefits paid
>   7. Plan amendments
>   8. Business combinations
>   9. Divestitures
>   10. Curtailments, settlements, and special and contractual termination benefits.
>
>   For defined benefit pension plans, the benefit obligation is the projected benefit obligation. For defined benefit other postretirement plans, the benefit obligation is the accumulated postretirement benefit obligation.
>
> b. A reconciliation of beginning and ending balances of the fair value of plan assets showing separately, if applicable, the effects during the period attributable to each of the following:

1. Actual return on plan assets
2. Foreign currency exchange rate changes (see (a)(5))
3. Contributions by the employer
4. Contributions by plan participants
5. Benefits paid
6. Business combinations
7. Divestitures
8. Settlements.

c. The funded status of the plans and the amounts recognized in the statement of financial position, showing separately the assets and current and noncurrent liabilities recognized. . . .

e. For defined benefit pension plans, the accumulated benefit obligation.

f. The benefits (as of the date of the latest statement of financial position presented) expected to be paid in each of the next five fiscal years, and in the aggregate for the five fiscal years thereafter. The expected benefits shall be estimated based on the same assumptions used to measure the entity's benefit obligation at the end of the year and shall include benefits attributable to estimated future employee service.

g. The employer’s best estimate, as soon as it can reasonably be determined, of contributions expected to be paid to the plan during the next fiscal year beginning after the date of the latest statement of financial position presented. Estimated contributions may be presented in the aggregate combining all of the following:
   1. Contributions required by funding regulations or laws
   2. Discretionary contributions
   3. Noncash contributions.

h. The amount of net benefit cost recognized, showing separately all of the following:
   1. The service cost component
   2. The interest cost component
   3. The expected return on plan assets for the period
   4. The gain or loss component
   5. The prior service cost or credit component
   6. The transition asset or obligation component
   7. The gain or loss recognized due to settlements or curtailments.

i. Separately the net gain or loss and net prior service cost or credit recognized in other comprehensive income for the period . . . and reclassification adjustments of other comprehensive income for the period, as those amounts, including amortization of the net transition asset or

obligation, are recognized as components of net periodic benefit cost.

j. The amounts in accumulated other comprehensive income that have not yet been recognized as components of net periodic benefit cost, showing separately the net gain or loss, net prior service cost or credit, and net transition asset or obligation. . . .

n. If applicable, the amounts and types of securities of the employer and **related parties** included in plan assets, the approximate amount of future annual benefits of plan participants covered by insurance contracts, including annuity contracts issued by the employer or related parties, and any significant transactions between the employer or related parties and the plan during the period.

o. If applicable, any alternative method used to amortize prior service amounts or net gains and losses. . . .

p. If applicable, any substantive commitment, such as past practice or a history of regular benefit increases, used as the basis for accounting for the benefit obligation.

q. If applicable, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event.

r. An explanation of any significant change in the benefit obligation or plan assets not otherwise apparent in the other disclosures required by this Subtopic.

Tier 2—Defined Benefit Pension Plan

3.25 Tier 2 might include the following requirements from paragraph 715-20-50-1:

> 715-20-50-1 . . . the following information, separately for pension plans and other postretirement benefit plans. . . .
>
> d. The objectives of the disclosures about postretirement benefit plan assets are to provide users of financial statements with an understanding of:
>   5. Significant concentrations of risk within plan assets.
>
>   An employer shall consider those overall objectives in providing the following information about plan assets:
>
>   ii. The fair value of each class of plan assets as of each date for which a statement of financial position is presented. . . .
>
>   iv. Information that enables users of financial statements to assess the inputs and valuation techniques used to develop fair value

measurements of plan assets at the reporting date . . . :

01. The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3). . . .
02. For fair value measurements of plan assets using significant unobservable inputs (Level 3), a reconciliation from the opening balances to the closing balances, disclosing separately changes during the period attributable to the following:
    A. Actual Return on Plan Assets (Component of **Net Periodic Postretirement Benefit Cost**) or Actual Return on Plan Assets (Component of **Net Periodic Pension Cost**), separately identifying the amount related to assets still held at the reporting date and the amount related to assets sold during the period
    B. Purchases, sales, and **settlements**, net
    C. The amounts of any transfers into or out of Level 3 (for example, transfers due to changes in the observability of significant inputs)
03. Information about the valuation technique(s) and inputs used to measure fair value and a discussion of changes in valuation techniques and inputs, if any, during the period. . . .

k. On a weighted-average basis, all of the following assumptions used in the accounting for the plans, specifying in a tabular format, the assumptions used to determine the benefit obligation and the assumptions used to determine net benefit cost:
    1. Assumed discount rates . . .
    2. Rates of compensation increase (for pay-related plans)
    3. Expected long-term rates of return on plan assets.

l. The assumed health care cost trend rate(s) for the next year used to measure the expected cost of benefits

covered by the plan (gross eligible charges), and a general description of the direction and pattern of change in the assumed trend rates thereafter, together with the ultimate trend rate(s) and when that rate is expected to be achieved.

Tier 3—Defined Benefit Pension Plan

3.26 Tier 3 would include all other disclosure requirements from paragraph 715-20-50-1 that are not included in Tiers 1 and 2. The remainder of those requirements has been omitted but are summarized as follows:

a. Narratives to provide understanding on goals, objectives, investment risk, policies, assumptions, expected rate of return, etc.
b. Sensitivity analysis of health care costs and obligations
c. Net gains/losses flowing through other comprehensive income
d. Expected/anticipated future return of plan assets within the next operating cycle.

Questions for Respondents

Question 6: Would any of the possibilities in this chapter (see paragraphs 3.8 and 3.11) be a practical and effective way to establish flexible disclosure requirements?

Question 7: If more than one approach would be practical and effective, which would work best?

Question 8: Are there other possibilities that would work better than any of the ones discussed in this chapter?

CHAPTER 4—REPORTING ENTITIES' DECISIONS ABOUT DISCLOSURE RELEVANCE

Introduction

4.1 Chapter 3 of this Invitation to Comment suggests ways that the Board could establish flexible disclosure requirements that could be applied differently (essentially customized) by different entities. For example, the Board might require that reporting entities apply decision questions like the ones in Chapter 2, or it might establish lists of specific disclosures for each Topic and require that reporting entities provide the disclosures that are relevant in their own particular circumstances. Flexible disclosure requirements in any form might be supplemented with required minimum disclosures.

4.2 If the Board decides to establish flexible disclosure requirements, reporting entities will need to know how to determine what is relevant in their particular circumstances. This chapter describes one way for reporting entities to think about that determination that could be adapted to apply to flexible disclosure requirements in any form. Although this discussion refers to materiality, it does not add anything new to existing literature or practice for deciding whether an amount is material. That decision is already required for reasons other than disclosure.[6]

4.3 There are two important cautions to remember when reading this chapter. First, the fact that only one possibility is discussed does not mean that the Board has concluded that there are no other possibilities. There almost certainly are other possibilities, some of which may prove to be superior to the one discussed in this chapter, but the Board has not yet identified or developed others.

4.4 Second, this chapter suggests a way to help reporting entities make judgments about disclosure relevance. It describes a relevant disclosure as information that can change users' assessments of prospects for cash flows[7] by a material amount. Although the notion of effects on cash flows is described in arithmetic terms, the Board is not considering requiring a computation. The magnitude of an effect on users' assessments of cash flow prospects is not quantifiable. In addition, the thought process is described in terms of the way cash flow prospects could be assessed, but it is not intended to replicate what users do.

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[6]The U.S. Supreme Court has interpreted materiality in at least two decisions, and reporting entities must comply with that interpretation. Because the description in Concepts Statement 8 is different, the Board may need to change it. However, that is beyond the scope of this Invitation to Comment.

[7]As discussed in paragraph 2.9, the phrases *prospects for cash flows* and *cash flow prospects* are used as a convenience to avoid longer and more complicated sentence structures.

The Basic Criterion behind Reporting Entity Decisions

4.5 Information should be disclosed if it has the potential to make a difference in users' decisions about providing resources to the reporting entity. 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. Users' decisions are subject to change if their assessments of cash flow prospects change materially. Consequently, a reporting entity should provide a disclosure if it would change users' assessments of cash flow prospects by a material amount.

4.6 Those statements, which explain how the definition of relevance in paragraph QC6 of Concepts Statement 8 applies to information in notes, have practical implications.

4.7 First, if a Topic includes a list of disclosures, a reporting entity should assess the relevance of each disclosure instead of automatically including the whole list if the related line item (or other event or condition) is material. Reporting entities should provide only the disclosures that are relevant in their own circumstances. Some, all, or none of the disclosures listed in a Topic could be judged to be relevant.

4.8 Second, materiality is generally acknowledged to relate to the nature *and* magnitude of an error or omission, and the same is true of disclosure relevance. However, it is much easier to think quantitatively (in terms of magnitude) than qualitatively (in terms of nature). That means it is inherently difficult to assess relevance of information in notes because much of it is qualitative instead of quantitative. Even when information in notes is quantitative, it may not have a dollar-for-dollar effect on net income, net assets, or any other metric to which an error or omission might be compared in judging materiality.

4.9 Fortunately, materiality is not defined in terms of net income or other metrics. Effects on metrics are rough proxies for effects on assessments of future cash flow prospects. Therefore, in assessing relevance of disclosures, reporting entities need to consider how information affects users' assessments of prospects for future cash flows. This chapter provides some general ideas about how that can be done.

4.10 In many cases, whether an item of information considered for disclosure in notes is relevant or not will be clear. Only in borderline cases would it be necessary to make potentially difficult judgments, and there would be no prohibition against taking a conservative approach to those judgments by providing disclosures that may or may not be relevant.

Using Magnitude to Consider Disclosures in Notes to Financial Statements

4.11 Some decisions about relevance of particular disclosures relate only to materiality of an item in the financial statements. For example, a description of what an item represented in the financial statements[8] should be provided if the item is material and the information is not otherwise apparent. Similarly, the accounting policy for a material item should be disclosed if there are alternatives or there has been a change.[9]

4.12 However, relevance of many disclosures is not directly related to the magnitude of an item on the face of the financial statements. For example, the relevance of information about measurement uncertainties and sensitivities to future changes in value[10] depends on the magnitude of the uncertainty or possible future change and not the size of the item as reported currently. All disclosures related to other events and conditions[11] indicate potential future effects on cash flows.

4.13 The approach described in this chapter focuses on the potential effects of an item of information on users' assessments of cash flow prospects. The fundamental premise is that users' decisions will change if their assessments of cash flow prospects change materially.

4.14 A user that is well informed about routine business matters and transactions and about existing economic conditions could use that knowledge and the information on the face of a reporting entity's financial statements to form an initial expectation about prospects for future cash flows from an investment[12] in that entity. For purposes of this discussion, that initial expectation will be called a *baseline assessment* of cash flow prospects.

4.15 The baseline assessment would be based on what a reasonably well informed user would assume the normal and routine characteristics of a particular item to be. For example, well-informed users could be expected to know the normal and routine contractual terms of sales and accounts receivable in a particular industry. Normal and routine terms would be the input for the baseline assessment.

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[8]See Chapter 2, Questions L1–L4.
[9]See Chapter 2, Questions L10–L13.
[10]See Chapter 2, Questions L11 and L14–L16.
[11]See Chapter 2, Questions O1–O7.
[12]The term *investment* refers to resources provided to the entity in the form of equity or debt instruments, loans, or other forms of credit. The term *future cash flow prospects* refers to the likelihood of a return of and return on an investment whether the cash flows come from the entity or from other market participants to whom the investor may sell its investment.

4.16 The baseline assessment probably would be different from (and maybe very different from) a more in-depth assessment that would include consideration of information in notes to financial statements. For example, if the terms of the sales or accounts receivable reported in an entity's financial statements are not the normal and routine terms that a well-informed user would expect, information on the actual terms would be considered for disclosure relevance. If knowledge of those terms would materially change users' assessments of cash flow prospects, the terms would be relevant and should be disclosed.

4.17 Judgments about disclosure relevance start with the requirements established by the Board in each applicable Topic. A disclosure is applicable if the required information is relevant. Information is relevant if, individually or in combination with other related information, it would affect users' assessments of prospects for cash flows by a material amount.

4.18 For example, a contract with rights that results in a recognized asset may have a nonroutine term that, if triggered, could produce a cash flow outcome that is different by a material amount from a similar contract without that term. The ways that reasonable users would assess cash flow prospects with and without knowledge of that nonroutine term *could*[13] be different. Therefore, if the existence of that term could not be discerned from information on the face of the financial statements, it could be relevant for disclosure purposes.

4.19 To summarize, the following are the three main points that form the basis for this discussion:

a. Information in notes is viewed as incremental to a baseline assessment of cash flow prospects that users might make if they had only the information on the face of the financial statements.
b. The baseline assessment would be based on assumptions that a reasonable user probably would make in the absence of information to the contrary. For example:
    (1) Sales probably would be assumed to be arm's length and final unless different terms are disclosed. A reasonable person might not be able to make any assumption about customers' rights of return or concentrations of sales to one or a few customers.
    (2) Financial instruments probably would be assumed not to have embedded derivatives or other unusual terms unless their existence is disclosed.
    (3) The use of assets probably would be assumed to be unrestricted unless the existence of restrictions is disclosed.
c. A disclosure would be considered relevant if it would be expected to change users' assessments of prospects for future cash flows by a material amount.

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[13]See paragraph 4.22 for an explanation of the use of the word *could* instead of *would*.

4.20 One possible practical expedient might be to think about prospects for future cash flows as reflected in ratios and other metrics that provide quick ways of comparing performance between entities and periods. The ratios and other metrics that are most relevant to a particular entity vary depending on (a) the industry or business in which an entity operates, (b) an entity's own financial condition and performance, and (c) other factors. Many reporting entities have a reasonable understanding of the key ratios and other metrics that users of their financial information consider to be most relevant. If that is the case, those metrics may be a good tool for thinking about relevance of disclosures to users.

4.21 In other words, the way a particular disclosure would affect users' interpretation of key metrics may in some cases be an appropriate surrogate for the effect on assessments of cash flow prospects. However, information that the reporting entity judges to be relevant should be disclosed even if it does not affect any of the key metrics.

Probability (Uncertainty) and Timing (Discounting)

4.22 The term *could* is used in paragraph 4.18 instead of *would* because there are two factors other than magnitude to consider—probability and timing. For some decisions about whether to provide specific disclosures, reporting entities will need to consider probability and timing of future events or changes in conditions. (Paragraph 4.11 describes the types of disclosures that are not affected by the probability and timing of effects on future cash flows.)

4.23 If the probability of a future event or a change in condition that can materially affect future cash flows is low enough, users may not change their baseline assessments enough to make a difference in a decision. Similarly, a potential event or change in condition that can materially affect future cash flows may be so far in the future that it would not change users' decisions.

4.24 This discussion of probability and timing suggests that reporting entities' decisions about disclosure relevance can be guided by a loose approximation of probability-weighted value—a hypothetical sum of the possible magnitudes times the probabilities of each magnitude. If that sum were a material amount, a disclosure would be considered relevant. However, as a practical matter, an entity could rarely, if ever, be able to make precise arithmetic computations. The probability-weighted value notion is suggested only as a way to structure thinking.

4.25 Some obvious relevance decisions that might help illustrate the way of thinking are as follows:

a. An assessment of very low probability of an effect on future cash flows would generally mean no disclosure is required unless the possible magnitude were extremely high.

b. An assessment that the magnitude of any possible effect would be less than a material amount also would mean no disclosure is required (regardless of the probability).
c. An assessment of an extremely high magnitude effect would require disclosure unless the probability is almost negligible.
d. An assessment of a very high probability of a greater than material effect would require disclosure.

4.26 Discounting, while technically applicable, generally would not be considered because of the inherent imprecision; but in borderline cases, discounting might be marginally helpful. For example, consideration of discounting might help eliminate a disclosure if the effect in question cannot occur for many years and the magnitude times probability is judged to be near the lowest threshold of materiality.

4.27 If it seems likely that discounting could make a difference to a reporting entity's decision, a reasonable approach would be to use, for example, the rate for low-risk government borrowings. Neither of the suggested rates would be likely to contribute to omitting relevant information because investors probably would not use lower discount rates in their assessments.[14] Surely, there would be no need to include a profit margin or an uncertainty discount or premium since the notional result is not fair value and is not intended to be.

4.28 To reiterate, consideration of discounting probably would not be important very often because the effects being considered are notional and the estimate would not be precise. However, in extreme cases, timing could make a significant difference.

Other Influences on Decisions about Disclosure Relevance

4.29 The following are matters other than how to determine relevance that must be addressed if unnecessary disclosure is to be eliminated:

a. The role of auditors, regulators, and legal advisors in reporting entities' disclosure decisions
b. The practice of carrying forward disclosures from previous years without reconsideration
c. The possibility that individual disclosures that would not significantly affect users' decisions if viewed in isolation might be more significant if viewed together
d. Whether reporting entities should be required to disclose information about a Topic that they judge to be relevant but that is not included in the list of disclosures for that Topic.

[14]The choice of rate to use would not change the content of the disclosure if the entity decides that the disclosure is required; it would only help determine whether to make the disclosure.

4.30 Paragraphs 4.31–4.37 pose questions and raise issues that the Board, reporting entities, and other participants in the financial reporting process must consider to improve disclosure effectiveness. In most cases, the range of possible answers or solutions is not yet clear.

Auditors, Regulators, and Legal Advisors

4.31 It is obvious that audit firms, regulatory agencies, and legal advisors can significantly influence reporting entities' decisions about individual disclosures. It has been suggested that the mechanical use of disclosure checklists by auditors and regulators has been a significant factor in causing unnecessary disclosure volume. A reporting entity's most expedient (and potentially least risky) response to questions or comments often seems to be to add disclosures. Legal advisors understandably advise entities to add disclosures to eliminate the risk of omitting material facts even if management thinks the information is irrelevant.

4.32 Probably few, if any, auditors and regulators criticize disclosures as being unnecessary. If the Board decides to require that reporting entities make decisions about the relevance of individual disclosures, the question becomes whether auditors or regulators would or should object to the inclusion of disclosures that they judge not to be relevant.

Disclosures from Prior Periods

4.33 Disclosures from previous years' financial statements often are carried forward without reevaluation. If the disclosures relate to uncertainties or contingencies that have been resolved or to transactions or balances that are not in the financial statements for the most recent period presented, those disclosures probably are no longer necessary.

4.34 Questions with less obvious answers also should be considered by the Board and reporting entities. For example, is it necessary to describe measurement uncertainties related to amounts in prior period financial statements? If so, what is the purpose of that disclosure? Similarly, is there a need for disclosure about sensitivities to change of amounts in periods other than the most recent reporting period? There may not be general agreement on the answers to those questions.

Disclosures That Are Relevant Only in Combination with Other Disclosures

4.35 The possibility exists that a group of individual disclosures might not be relevant when considered individually but might become relevant when considered as a group. Informally stated, the relevance of the whole picture may be greater than the sum of the relevance of the parts. So far, no examples of those situations have been provided, but if that can happen, how would a reporting entity search for disclosures with that characteristic?

Relevant Information Not Specified in a Disclosure Requirement

4.36 Another possibility is that a reporting entity may be aware of information that would be relevant to users of its financial statements but that is not specified in a disclosure requirement. Ideally, the Board would establish requirements that are sufficiently comprehensive so that the problem would not arise. Is it necessary to add a requirement in each Topic to disclose other information necessary to prevent financial statements from being misleading?[15]

4.37 Would such a requirement be too difficult for reporting entities to comply with? Would it expose them to liability for failing to disclose information that with hindsight is judged to be relevant?

Questions for Respondents

Question 9: This chapter attempts to provide a benchmark for judgments about disclosure relevance by clarifying the objective for the judgment. Is the description of the approach clear enough to be understandable? If not, what points are unclear?

Question 10: Can this approach (or any approach that involves describing the objective for the judgments) help identify relevant disclosures? If so, what can be done to improve it? If not, is there a better alternative? What obstacles do you see, if any, to the approach described?

Question 11: Reporting entities would need to document the reasons for their decisions about which disclosures to provide. How would reporting entities document the reasons for their disclosure decisions and how would auditors audit those decisions?

Request of Respondents

The Board asks that respondents help assess the practicality of the possible guidance in this chapter and its potential for improving disclosure effectiveness by applying it to some or all of the notes in their prior period financial statements. Please provide information about the results of that test that is as specific as possible.

[15]Currently, SEC registrants are subject to a general requirement (SEC Rule 12b-20) to include "such further material information, if any, as may be necessary to make the required statements . . . not misleading."

CHAPTER 5—FORMAT AND ORGANIZATION

Introduction

5.1 The most frequent criticisms about format and organization of notes include the following:

a. Disclosures are boilerplate and do not provide relevant information.
b. Information about particular events or transactions is hard to piece together.
c. The relationships between disclosures and financial statements are difficult to understand.
d. The most relevant information is difficult to identify.

5.2 Clear, concise, and well-organized notes could significantly improve users' ability to locate and understand the information they need. This chapter provides some suggestions.

Format

Disclosures Should Be Entity Specific

5.3 Notes to financial statements often contain language drawn directly from the requirements in accounting standards or are written in so generic a fashion that they can be carried forward for years without change. Notes of that type may comply with a strict reading of a disclosure requirement, but they often are not particularly useful.

5.4 For example, a statement such as "the Company made certain judgments and assumptions when arriving at this amount" could be applied to many line items in a set of financial statements and is not particularly helpful. If the information is relevant, reporting entities should explain the judgments and assumptions made, how much of the reported amount was subject to those judgments and assumptions, and the uncertainties in measurement from using those judgments and assumptions.

Disclosures Should Have Common Points of Reference

5.5 When disclosures are provided using common points of reference (that is, common time intervals, common levels of disaggregation, and common methods for describing the effects of uncertainties), the effects on cash flow prospects are easier to bring together and understand.

5.6 For example, if maturity schedules are disclosed and the time intervals for those disclosures are not prescribed, providing those maturities using common

time intervals would allow the user to bring those disclosures together more easily.

5.7 Another example would be when an entity discloses the effect of a particular economic condition on part of its business. If one disclosure describes a particular condition's effect on a line of business while another describes the effect on a geographic region, those pieces of information would be hard to bring together. However, if the condition that affects a particular geographic region could be linked to the particular segment or segments that operate in that region, that link would provide the users with a common point of reference to understand many of the conditions that could affect future cash flows.

5.8 Part of the reason that common points of reference are not always used by reporting entities is because disclosure requirements are set by the Board one project at a time. For example, different disclosures of sensitivities are required for different assets and liabilities in the Codification. The Board's approach to setting requirements would play a role in whether this suggested improvement could be properly implemented.

Enhancing the Understandability of Notes

5.9 Using the following tools when preparing notes to financial statements would add to the understandability and relationships of the information provided:

a. Tables
b. Headings
c. Cross references
d. Highlighting.

Tables

5.10 Reporting entities should consider using tables instead of narratives to present large amounts of numerical information or other uniform information, such as the following:

a. Roll forwards
b. Schedules of maturities
c. Disaggregations of amounts from financial statements
d. Inputs to formulas
e. Details of the terms of several similar agreements or details of several similar transactions.

Headings

5.11 Notes usually have headings that explain their content. Subheadings also may be useful within notes that contain distinctly different kinds of information. For example, because notes describing loss contingencies often address more than one matter, subheadings would make it easier to find a specific matter.

Similarly, a user probably could locate specific information more easily if a note on insurance-related items had subheadings for claims, acquisition costs, reinsurance, and other matters.

Cross References

5.12 Users have stated that references from financial statement line items to notes are very useful because they act as a partial table of contents for notes.

5.13 References from notes to line items also can be useful, especially when it is not apparent which line item includes the transactions or balances discussed in a note. For example, if there is no separate line item for contingent losses in an income statement, a user might not be able to tell which line item included a loss discussed in a note. Because a loss of that nature would probably affect users' decisions differently from recurring expenses, the reference may be useful in forming expectations about net income in future periods.

5.14 References from one note to another also can be useful. For example, if a detailed list of investments is in one note and a discussion of the fair value measurements is in another note, a cross reference could save time.

Highlighting of Information

5.15 Highlighting more relevant information in a note or information that is different from past years could help users focus on points that they might otherwise overlook or at least not find easily. There are a number of ways in which entities could highlight items. One way would be to start each note with a discussion of the most *newsworthy* item in that note. Using different text styles or sizes is another possibility.

5.16 Another way to highlight information could be for an entity to begin notes to financial statements with a summary that identifies some of the most noteworthy events or transactions that occurred during the year and points to notes that contain the detailed information about those events or transactions.

Questions for Respondents

Question 12: Would any of the suggestions for format improve the effectiveness of disclosures in notes? If so, which ones? If not, why not?

Question 13: What other possibilities should be considered?

Organization

5.17 The following are criticisms about the organization (structure and order) of notes to financial statements:

a. Information about closely related matters is not always included in the same note or consecutive notes.
b. Disclosures about a particular asset, liability, revenue, or expense are sometimes in different notes.
c. Unrelated items are included in the same note merely because they are covered within the same accounting topic.
d. The order of notes is not always logical.
e. The order of notes does not give any indication about the relevance of the information.

5.18 The following general possibilities for improving the organization of notes to financial statements have been suggested:

a. Specify a particular order for all entities so that users will always know where to look for information.
b. Allow flexibility and provide implementation guidance (or advice) to help reporting entities determine the order.

5.19 Standardization would create consistency, whereas a flexible approach has the benefit of enabling a company to effectively communicate how events and transactions have affected and may affect the company.

Specifying a Standard Order

5.20 U.S. GAAP does not require that notes be presented in a specific order, but there is an encouragement that accounting policies should be described in the first note. Accounting policies often are followed by notes about assets and liabilities in balance sheet order. Notes required by more recent guidance and other notes like contingencies and segment information often appear last. However, those are generalizations only and not consistent practices.

5.21 International Financial Reporting Standards (IFRSs) also do not have a strict requirement, but paragraph 114 of IAS 1, *Presentation of Financial Statements*, states that entities *normally* present notes in the following order:

a. Statement of compliance with IFRSs
b. Summary of significant accounting policies applied
c. Supporting information for items presented in the statements of financial position and of comprehensive income, in the separate income statement (if presented), and in the statements of changes in equity and cash flows, in the order in which each statement and each line item is presented

d. Other disclosures, including:
   (1) Contingent liabilities and unrecognized contractual commitments
   (2) Nonfinancial disclosures, for example, the entity's financial risk management objectives and policies.

5.22 The following is another logical possibility of order:

a. Disclosures about the entity as a whole
b. Disclosures about transactions or events that have had or will have a broad impact on the financial statements
c. Disclosures about the line items in the financial statements ordered by appearance in the statement of financial position followed by disclosures about the income statement
d. Disclosures about items not recognized in the basic financial statements
e. Accounting policies.

5.23 The order in the preceding paragraph would be consistent with comments from users about the information they said is most relevant.

Flexibility with Implementation Guidance

5.24 Users have told the Board that related information in notes needs to be linked in some way. At present, different notes contain related information that must be considered together in assessing cash flow prospects.

5.25 One potential improvement would be to group related information. The following are three examples of how an entity might group some of its disclosures:

a. An entity makes an acquisition that creates goodwill and intangibles and increases debt. That entity could put disclosures about the acquisition, goodwill and intangibles, and debt in the same note or present the individual notes consecutively.
b. A manufacturing entity hedges future purchases of raw materials. The entity has experienced minor difficulties in acquiring the materials it needs and may experience greater difficulty in the future. That entity could put disclosures about its inventory, its derivatives designated as inventory hedges, and its risk of potential supply problems in the same note.
c. An entity obtains the use of plant and equipment in three different ways. It issues long-term debt to buy some items, it leases some items under capital leases (which result in recognizing both assets and long-term debt), and it leases some items under operating leases. That entity could disclose a single note with information about its plant and equipment, its operating and capital leases, and its long-term debt or group the individual notes together.

5.26 Not all entities will have the same set of related information, and a single item of information may relate to two or more other items of information that do not relate to each other. An illustration is the inventory hedge mentioned in paragraph 5.25(b). Some users may prefer to see the derivative designated as an inventory hedge discussed with other derivative instruments that are unrelated to inventory. Each entity would have to decide the best way to group things in its own financial statements.

Order of Grouped Information

5.27 Once related information is grouped, one way to further organize notes to financial statements would be to order the groupings by what is most relevant. That would be responsive to those users who think that the most relevant information should come first. However, users do not necessarily agree on what is most relevant.

5.28 Some would say that notes to financial statements should be ordered according to their relevance to users. However, the question then becomes, "which user?" One option would be to have management identify the most prevalent type of user and order notes to financial statements accordingly.

5.29 Another way would be to have the entity's management order the groups by what it views as most relevant. Although that order may not be in exactly the same order as what every user views as most relevant, it likely would be reasonably consistent with what users view as most relevant.

5.30 Some may be uncomfortable with relying on management's view. However, that is a decision about order of information and not whether to include information. A user would not lose information because of management's view. Hopefully, that would facilitate better communication. Also, understanding which information management thinks is most relevant may be informative.

5.31 Grouping related information and presenting it in order of decreasing relevance would result in a different order of notes by each entity, which may make specific information harder to find. It also would change the appearance of notes to financial statements. Some possible changes include the following:

a. Information about derivatives that used to be in a single note may be separated into a number of notes according to why the entity owns the derivative (for example, inventory hedges in the inventory note, interest rate hedges in the debt note, and speculative derivatives in a separate note).
b. Disclosures about fair value could be in the notes about items measured at fair value instead of in a single note.
c. Groupings and order could change from period to period as relationships and level of relevance change.
d. Accounting policies that meet the criteria for disclosure would be explained in the same notes as the items to which the policies apply.

Other Approaches

5.32 Some have suggested that notes to financial statements should be organized based on operating, investing, and financing classifications. That would appear to be logical and useful in some circumstances. However, it raises the following issues:

a. Those categories have not been defined for the statement of financial position and the statement of comprehensive income.
b. Some disclosures would cut across categories (for example, purchased property, plant, and equipment is an investing item, operating leases are operating items, and capital leases are financing items).
c. For some entities, the most relevant disclosures could be part of the investing or financing categories. There would be no ability to move the most relevant information earlier in the notes.

Questions for Respondents

Question 14: Do any of the suggested methods of organizing notes to financial statements improve the effectiveness of disclosure?

Question 15: Are there different ways in which information should be organized in notes to financial statements?

CHAPTER 6—DISCLOSURES FOR INTERIM FINANCIAL STATEMENTS

Introduction

6.1 The discussion in this chapter applies to SEC registrants that are required to file Form 10-Q, which includes a set of condensed financial statements with abbreviated notes. The discussion also would apply to private companies if they issue interim financial statements in accordance with the requirements for Form 10-Q.

Background

6.2 The SEC requirements and the requirements in the Codification are based on the premise that an interim period is not a discrete reporting period but an integral part of the next annual reporting period. Appendix B provides a summary of those and other interim requirements. SEC requirements pertaining to notes are very high level and are based on the general principle that the purpose of interim financial statements is to update information from the previous annual financial statements.

6.3 The objective of the disclosure framework project is to increase the effectiveness of disclosure, and the project's scope does not extend beyond notes to financial statements. Interim reporting comprises not only disclosure but also presentation, recognition, and measurement. Although it is possible that changes to interim reporting as a whole could improve the effectiveness of the disclosures, the discussion in this chapter only focuses on disclosures in notes to interim financial statements.

6.4 The Board is searching for ways to deal with two basic criticisms of existing requirements and practices related to notes to interim financial statements. Addressing both criticisms will be particularly difficult because they are in direct opposition to one another.

Criticisms of Interim Reporting

6.5 On one hand, users of interim financial statements, especially equity investors and investment advisors, have said that there is not enough information in interim financial statements to meet their needs. Investors make decisions all year long that are the same as the ones they make using information from annual reports, related press releases, and other information provided by management.

6.6 On the other hand, issuers of interim financial statements have said that tighter deadlines for interim financial reports than for annual financial reports make it impossible to provide interim financial statements that are as complete as annual financial statements. In fact, many say that gathering and preparing the information to comply with existing requirements stretch their capabilities to such an extent that the risk of errors and omissions is unacceptably high.

6.7 The following assumptions underlie the remainder of the discussion in this chapter:

a. Investors make decisions about buying, selling, or holding all year long.
b. An interim period is an integral portion of an annual period.
c. Interim financial statements are updates of the previous annual financial statements.
d. Deadlines for filing interim reports are tighter than deadlines for filing annual reports, and reporting entities' capabilities for providing disclosures are limited.

Addressing Criticisms

6.8 The total volume of disclosures in interim financial statements has grown so much that some reporting entities consider it nearly unmanageable. Existing interim-period disclosure requirements associated with different Topics are of uneven quality and volume. Recently issued guidance in Accounting Standard Updates generally requires a greater volume of disclosure for interim reporting. Topics that have not been considered recently may omit disclosures that would be considered very important. There are several possibilities for addressing the issues.

Disclosures for Interim Reporting That Mirror Annual Disclosures

6.9 One possibility would be to require all of the same disclosures in interim financial statements that are provided in annual financial statements. That, however, would not be appropriate for a number of reasons.

6.10 Preparing the same set of notes for an interim period as for an annual period is not feasible because of the tighter reporting deadlines. At least some investors have told the Board that they value timeliness over additional disclosures.

6.11 Differences between disclosure in annual and interim financial statements are not just all due to the tight deadlines for interim reporting. Different disclosures are needed at interim dates because interim periods are considered

integral parts of annual periods. That means that many amounts reported are allocations of estimated annual amounts. It also is understood that estimates are used at interim periods, and so amounts reported have been determined differently from their annual counterparts. Users need disclosures in interim financial statements about how reporting entities measure certain items differently at interim dates and at year-ends.

6.12 One also would expect that because accounting is different at interim periods[16] there would be some quantitative disclosures that could not be made at interim periods. If an item is not necessarily measured the same way at interim reporting dates as it is at year-end, the disclosures about measurement would not be the same. For example, actuarial valuations of pensions are not required at interim dates. Some of the required disclosures about pension plans cannot be provided if a valuation is not performed.

6.13 Finally, interim reports provide a condensed update that highlights changes since the last annual report. If the disclosures in the interim report were as extensive as disclosures in annual reports, the significant changes might be harder to identify.

The Board's Framework for Setting Disclosure Requirements for Interim Financial Reporting

6.14 Because of the current nature of interim reporting in U.S. GAAP, some say that a reduced set of minimum disclosure requirements for interim reporting is appropriate. However, the way that the Board currently establishes those requirements is unsatisfactory. Because there is no decision framework, disclosure requirements for interim financial reporting are established on an ad hoc basis.

6.15 The following methods could be used to establish requirements for interim periods:

a. Modify the annual disclosure requirements to fit interim reports.
b. Develop a set of decision questions for setting disclosure requirements for interim reports.

6.16 Either alternative would need to allow for the following:

a. Consistency from Topic to Topic
b. Consistency with the condensed nature of interim reports (for example, disaggregation of every line item that is aggregated in condensed financial statements would defeat the purpose of permitting condensed financial statements)

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[16]See Appendix B for a discussion of interim reporting guidance.

c. Consideration of the difference in recognition and measurement requirements for interim reports (see paragraph 6.12).

Modifying the Annual Disclosure Requirements

6.17 If the Board based disclosure requirements for interim periods on annual disclosure requirements, it would need to develop principles for determining when those annual disclosures are useful in interim reports. Some of the principles would be similar to the following:

a. Do not require an annual disclosure in interim reports if the following is the case:
   (1) Users can easily estimate the relevant data point based on changes in the amounts in interim financial statements as compared with amounts reported in annual financial statements (including notes) or based on what reasonable users would expect from reading the annual disclosures.
   (2) The information that would be disclosed has changed very little from the same disclosure in the last annual report.
   (3) The disclosure relates to recognition and measurement requirements for annual financial statements that are different in interim reports.
   (4) The disclosure is not consistent with the condensed nature of interim financial statements. For example, annual disclosure requirements that serve to disaggregate or give more detail seem to contradict the fact that the interim report is meant to be condensed.

b. Require in interim reports a disclosure not made in annual reports if the following exists:
   (1) There are alternative recognition, measurement, allocation, or accrual requirements for interim reports that are different from those in annual reports.
   (2) There are other unique circumstances in interim reports.

6.18 Other principles may be needed to address other unique aspects of interim reporting.

Separate Decision Questions for Setting Disclosure Requirements for Interim Reporting

6.19 If the Board developed a set of decision questions for establishing disclosure requirements for interim reports, some of those questions could include the following:

a. Are there aspects of the business or the transaction that would be reflected differently during interim periods because of the nature of the business?

b. Are there likely to be changes from the prior year-end to the current interim reporting date that would have to be disclosed to be apparent?
c. Would additional explanation be needed about amounts in financial statements because those financial statements are condensed?
d. Is it likely that there would be events or conditions that would arise during interim periods that were not reported in the prior annual period?
e. Is it likely that an event or condition reported in the last annual statement would change significantly?
f. Is the accounting required for interim periods different from that required in annual reports?

6.20 Disclosure requirements for interim reports probably would need to be flexible. The decision about how to allow flexibility in interim disclosures would probably depend on the Board's ultimate decision about flexibility in annual reports.

The Reporting Entity's Decision Process for Determining Interim Period Disclosures

6.21 The decision process described in Chapter 4 would not work for interim reports without modification. Using condensed interim financial statements as the baseline (see the baseline assessment described in Chapter 4) likely would result in even more disclosures than would be required in annual reports because there is less information in interim financial statements.

6.22 A decision process for disclosures in interim reports could have two different starting points. The Board could require reporting entities to start with the list of disclosures required in annual financial statements or it could establish a list of disclosures to be provided for interim periods. In either case, the decision process would be similar.

6.23 If the starting point is the annual disclosures, a disclosure could be ruled out for interim reports if it does the following:

a. Duplicates the previous annual disclosures or information
b. Changes during the period but in a way that investors would have expected based on the annual disclosures and condensed interim financial statements.

6.24 Annual disclosure requirements not automatically ruled out would be provided in interim financial statements if users would be misled by extrapolations or projections from the last set of annual financial statements and notes and interim financial statements.

6.25 The process for assessing relevance would be similar to the one described in Chapter 4 except that the baseline would be different. In Chapter 4, the baseline assessment is based on annual financial statements without notes. For interim disclosure decisions, the baseline assessment would be based on previous annual financial statements and notes, adjusted for consideration of condensed interim financial statements.

6.26 Regulation S-X Rule 10-01, *Interim Financial Statements*, already requires reporting entities to decide which disclosures are needed to prevent the interim statements from being misleading or to highlight material events. That notion also could be incorporated as part of a framework for disclosures that are part of interim reports.

6.27 That decision process also should result in the inclusion of the most newsworthy changes that the entity has experienced since the prior annual period by leaving out disclosures that tell the user what they would have expected to see based on the trend.

6.28 To implement a decision process like the one described in paragraphs 6.21–6.27, reporting entities would have to establish and maintain procedures for disclosure controls, which would impose a cost. However, a similar type of system would be needed for annual disclosure decisions if entities decide when to provide annual disclosures. Therefore, the incremental cost to extend the system to cover interim reporting might not be excessive.

Questions for Respondents

Question 16: Do you think that any of the possibilities in this chapter would improve the effectiveness of disclosures for interim financial statements?

Question 17: If you think that a framework for the **Board's** use in deciding on disclosure requirements for interim financial statements would improve the effectiveness of interim reporting, what factors should the Board consider when setting disclosure requirements for interim financial statements?

Question 18: If you think that a framework for **reporting entities'** use in deciding on disclosures for interim financial statements would improve the effectiveness of interim reporting, what factors should reporting entities consider when providing disclosure requirements for interim financial statements?

Question 19: What impediments do you see regarding the development of a framework for the Board, reporting entities, or both that addresses disclosures for interim financial statements?

CHAPTER 7—OTHER MATTERS FOR DISCUSSION

7.1 This chapter discusses other matters pertaining to disclosures, including the following:

a. Summary of accounting policies
b. Costs and consequences.

Summary of Accounting Policies

7.2 Both users and reporting entities have identified the summary of accounting policies as a likely candidate for short-term improvement.

7.3 The note that includes the summary of accounting policies sometimes describes policies that users understand or can easily find otherwise. Also, much of the summary stays the same from period to period, and some of it is irrelevant because it addresses immaterial items. As a result, the requirement for a summary of accounting policies may increase the volume of notes without adding useful information.

7.4 Paragraph 235-10-50-3 requires the following:

> Disclosure of accounting policies shall identify and describe the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. In general, the disclosure shall encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it shall encompass those accounting principles and methods that involve any of the following:
>
> a. A selection from existing acceptable alternatives
> b. Principles and methods peculiar to the industry in which the entity operates, even if such principles and methods are predominantly followed in that industry
> c. Unusual or innovative applications of GAAP.

7.5 It is helpful to consider that the policy note was required as part of APB Opinion No. 22, *Disclosure of Accounting Policies*, which was issued in 1972. At that time, information about reporting requirements was less accessible. Annual financial statements were a primary source of information to many users because information was, in general, neither readily accessible nor available in the quantity that it is today. Therefore, a robust disclosure about accounting policies provided in each year’s notes would have been helpful to users.

Possible Changes to the Summary of Accounting Policies

7.6 Moving accounting policies outside financial statements (for example, to a company's website) may reduce the volume of the report, but the effectiveness of that could not be evaluated in the short term.

7.7 "Yes" answers to decision Questions L10 and L11[17] in Chapter 2 indicate disclosure of an accounting policy only if users otherwise would not be able to determine the policy. The indicated disclosures include the following:

a. If there are acceptable[18] alternatives:
   (1) The accounting policy or method applied
   (2) The magnitude of the effect if the accounting method is unusual, produces results counter to what a reader might otherwise expect (for example, last-in, first-out inventory costing), or otherwise dramatically affects financial statements.
b. If the reporting entity engaged in transactions or has been affected by events not addressed directly by reporting requirements and for which there are no clearly analogous transactions or events, the nature of the transactions or events and the method of accounting applied to them.

7.8 Replacing the existing requirement with a narrower requirement similar to the information indicated by Questions L10 and L11 could reduce the volume of notes to financial statements without diminishing their relevant content.

7.9 Although there is no decision question that indicates that industry-specific accounting policies would be useful, those policies are identified as an example in the current requirement as something that the summary should provide.

7.10 The staff was unable to identify any other existing disclosure requirements that could be addressed in the short term that would result in a significant reduction in volume in notes to financial statements. However, the staff thinks that with a fully developed disclosure framework, disclosure requirements could be reevaluated and possibly reduced.

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[17]Question L11 includes other disclosures about transactions or events, but they are not about accounting policies and, therefore, are not reproduced here.

[18]In this context, the term *acceptable* refers not only to alternatives that are the entity's choice, but also to practicability exceptions and alternatives that are prescribed in different circumstances if a reader cannot discern which method is being used by reading the financial statements.

Questions for Respondents

Question 20: Would the change to the requirements described in paragraph 7.8 for disclosure of the summary of accounting policies improve the effectiveness of disclosure?

Question 21: Should the summary of accounting policies include information about industry-specific accounting policies?

Question 22: Are there other required disclosures that could be modified or eliminated in the short term that would result in a significant reduction in the volume of notes to financial statements?

Costs and Consequences of Disclosures

7.11 Most of this Invitation to Comment discusses how to improve disclosure effectiveness, that is, to maximize the benefits of disclosures in notes to financial statements. In all standards projects, whether the subject is recognition, measurement, or disclosure, the Board considers costs as well as benefits. Therefore, this paper would not be complete without a discussion of costs.

7.12 The purpose of that discussion is to facilitate clearer communication when the Board is gathering information to use in considering costs and benefits of new requirements. There is no discussion in this Invitation to Comment of how to compare the benefits of a reporting requirement to its cost. That is inherently a matter of judgment by the Board and is under consideration by the Board and others in efforts separate from this project.[19]

7.13 Possible consequences to reporting entities of disclosing information also are discussed. General statements about costs of reporting requirements (in comment letters and at meetings) often seem to be based on an assumption that consequences are included in costs. Although the Board considers both costs and consequences in establishing reporting requirements, the considerations may not be exactly the same and distinguishing between the two can avoid misunderstandings.

7.14 Paragraph QC35 of Concepts Statement 8 identifies cost as a constraint on the information that can be provided by financial reporting and states that it is important that costs be justified by benefits.

7.15 Paragraph QC36 identifies the costs to providers of financial information:

[19]This Invitation to Comment is based on the Board's existing concepts and practices.

> Providers of financial information expend most of the effort involved in *collecting, processing, verifying, and disseminating financial information,* but users ultimately bear those costs in the form of reduced returns. [Emphasis added.]

7.16 Paragraph QC36 refers to the *effort involved in collecting, processing, verifying and disseminating financial information*. That explains what the Board means when it refers to the cost to reporting entities of a reporting requirement. Collecting and processing may involve training costs, additional payroll costs, and development and maintenance of systems and controls.

7.17 Paragraph QC36 also identifies the costs to users of financial information:

> Users of financial information also incur costs of analyzing and interpreting the information provided. If needed information is not provided, users incur additional costs to obtain that information elsewhere or to estimate it.

7.18 Costs to both providers and users of financial information must be considered in establishing reporting requirements. If a requirement results in reporting information that users are expending time and effort (or money) to obtain from other sources or to estimate, the costs to providers are at least partially offset by reduced costs to users. The Board considers the costs to users of analyzing and interpreting information when deciding on the format in which the information is to be provided. For example, disclosures that are not organized or formatted in a way that is easily understood cost users time and effort to analyze and interpret.

7.19 The cost of providing a disclosure is a part of the cost of the standard as a whole. It is possible that providing additional disclosure can compensate for not requiring a relatively expensive measurement method that might be viewed as more informative than the method required (although that may be a difficult conclusion to justify, it is not impossible).

Consequences

7.20 There are many types of consequences of disclosing financial information. They can be positive or negative or both. The Board works to understand the consequences and to avoid unintended consequences. Different types of consequences require different responses.

7.21 Net positive consequences to the capital market as a whole are benefits of reporting standards even if the results are negative to some entities. More appropriate allocation or pricing of capital is a benefit to the market as a whole even though it is a negative consequence for entities that lose capital or for which the cost of capital increases. Of course, the Board cannot judge directly where

capital should be allocated or how it should be priced. The Board’s charge is to establish requirements for information that helps investors, lenders, and other creditors to assess prospects for cash flows from entities to which they are considering providing resources. Those users make the capital allocation decisions.

7.22 Changes in reporting standards sometimes affect contracts with covenants or other provisions that refer to amounts reporting under U.S. GAAP. The effects can be the time and money expended to modify the contracts or higher interest rates or other costs under the terms of the contracts. Those effects are more likely to come from changes in recognition and measurement requirements than from changes in disclosure requirements, but disclosure requirements might have an effect. The Board strives to minimize such effects by allowing delayed effective dates.

7.23 At times, users of financial statements insist that the Board should require disclosures that reporting entities say will result in harming them competitively or in litigation. The Board assesses those statements and works to balance the needs of different parties and prevent disclosure requirements from harming entities (which also can harm existing investors, lenders, and other creditors). The Board has made exceptions and modifications in the past and, on occasion, has refrained from issuing a standard when the case against harm was strong enough.

APPENDIX A

Project Background and Previous Attempts at Improving Disclosure Effectiveness

A1. On July 8, 2009, the FASB chairman announced the addition of the disclosure framework project to the Board's agenda. Its objectives are as follows:

a. To establish an overarching framework intended to make financial statement disclosures more effective, coordinated, and less redundant
b. To seek ways to better integrate information provided in financial statements, MD&A, and other parts of a company's public reporting package.[20]

A2. The project was added in response to requests and recommendations received from several stakeholders. Among them were a December 2007 agenda request from the FASB's Investors Technical Advisory Committee (ITAC) and the August 2008 recommendation of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission.

A3. ITAC had suggested that the FASB add a project to its agenda to consider and establish a new *principles-based* disclosure framework to be used for disclosures in FASB standards. Within that agenda request, ITAC provided ideas for a proposed disclosure standard for the Board's consideration. The *Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission* recommended that the SEC and the FASB work together to develop a disclosure framework to, among other things, "integrate existing SEC and FASB disclosure requirements into a cohesive whole to ensure meaningful communication and logical presentation of disclosures, based on consistent objectives and principles."[21]

A4. Similarly, in its 2005 *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*, the SEC staff observed that notes to financial statements are (a) critically important, (b) necessary to achieve transparency, and (c) could be

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[20]The second objective envisioned that, following the establishment of the disclosure framework, the Board and its staff would work with the staffs of the SEC and other regulators that have a role in a company's public reporting package.
[21]*Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission* (Pozen Committee) (August 1, 2008) Recommendation 1.2: 8, http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf.

improved. The staff suggested that improvements could be achieved if standard setters develop a disclosure framework and "if issuers were to seek to achieve the goal of communicating with investors, rather than focusing principally on technical compliance with rules and regulations."[22]

A5. Improving communications between issuers of corporate reports and equity investors, lenders, and other users of financial reports is a long-standing goal shared by both users and issuers of those reports, as well as auditors, regulators, and others interested in financial reporting. In his 1949 article, "Weaknesses in Present Accounting Which Inhibit Understanding of Free Enterprise," Maurice H. Stans noted the importance of the corporate annual report in telling the story of a company's part in society, the accounting and reporting problems that existed at that time, and the dangers ahead for free enterprise that could result if the weaknesses persisted. Among those problems he observed were "that there are still no fixed standards of minimum disclosure for financial statements."[23]

A6. Certainly, since then, many improvements have been made in financial accounting and reporting. Following the FASB's formation in 1972, numerous initiatives and projects were undertaken to address specific concerns about ineffective disclosure standards. Nonetheless, former Board member Katherine Schipper noted the following in 2007:

> The amount of financial reporting information that is communicated by means of required disclosures is significant, and has been increasing over time, with no sign of abatement. Despite their abundance, required disclosures are not well understood: we lack a comprehensive theory of *mandatory* disclosures; many questions remain as to how preparers, auditors, and users of financial reports view disclosures, particularly as compared to recognized items; and the Financial Accounting Standards Board (FASB)'s conceptual framework does not provide either a conceptual purpose for disclosures or criteria to support a sharp distinction between recognized and disclosed items. This last omission is particularly puzzling since standard setters make recognition versus disclosure distinctions in nearly every standard.[24]

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[22] *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*, issued by the SEC staff (June 15, 2005): 113, http://www.sec.gov/news/studies/soxoffbalancerpt.pdf.
[23] *Journal of Accountancy* 84, no. 6 (December 1947): 468–469.
[24] Schipper, Katherine, "Required Disclosures in Financial Reports," *The Accounting Review* 82, no. 2 (2007): 301–326.

A7. Despite the Board's past efforts, there remains no generally accepted theory of required disclosures, and concerns persist about redundant, excessive, or ineffective disclosures.

A8. Beginning in 2011, the FASB staff has cooperated with the staffs of the EFRAG, the FRC, and the ANC in developing this Invitation to Comment and a similar discussion paper on disclosure framework to be issued jointly by the EFRAG, the FRC, and the ANC. The Board and EFRAG's TEG and the FRC and the ANC have the same objectives and similar, if not identical, visions of the desired outcomes.

APPENDIX B

Summary of Current Requirements for Interim Financial Statements

Condensed Primary Statements

B1. SEC Rules state that interim financial statements may be abbreviated. Practically speaking, some of the resulting differences in interim reporting as compared with annual reports include the following:

a. Balance sheets including only major captions
b. Income statements including only major captions
c. Statements of cash flows with a single line for operating cash flows.

B2. IFRSs also permit condensed financial statements.

B3. Those requirements matter for two reasons, each of which seems to contradict the other when thinking about the role of disclosure in interim reporting. Because the statements are condensed, investors likely could use more information to understand the summarized information. However, the statements are condensed because the interim statement is understood to be an update of annual financial statements and is provided on a timelier basis. Therefore, it may be illogical to then require disclosures that are more detailed when the statements themselves are condensed.

Integral Nature

B4. Paragraph 270-10-45-1 notes that "each interim period should be viewed primarily as an integral part of an annual period." As a result, for example, paragraph 270-10-45-9 explains that an entity may allocate expenses across interim periods in a systematic fashion and paragraph 270-10-50-1(c) requires an entity to disclose when revenues in the period are affected by seasonality. The intention is to help investors avoid making bad assumptions about how the annual results will look based on potentially unrepresentative results in interim periods.

B5. Therefore, some disclosures about how annualized amounts are allocated to interim periods are not relevant in annual financial statements but may be necessary for investors to understand interim financial statements. Furthermore, some disclosures required for annual periods may be less meaningful at interim periods.

Interim Disclosure Guidance

B6. U.S. GAAP, SEC Regulations, and IFRSs specify various individual disclosure requirements for interim reports that are similar but not identical.

B7. SEC Rules include qualitative guidance for reporting entities in the selection of information for disclosure in interim reports. The following are excerpts from Regulation S-X Rule 10-01:

> The interim financial information shall include disclosures either on the face of the financial statements or in accompanying footnotes sufficient so as to make the interim information presented not misleading.
>
> . . . disclosure shall be provided where events subsequent to the end of the most recent fiscal year have occurred which have a material impact on the registrant.
>
> . . . footnote disclosure which would substantially duplicate the disclosure contained in the most recent annual report . . . may be omitted.

B8. Paragraph 15 of IAS 34, *Interim Financial Reporting*, provides the following guidance for when an entity should make interim disclosures:

> An entity shall include in its interim financial report an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. Information disclosed in relation to those events and transactions shall update the relevant information presented in the most recent annual financial report.

B9. The authoritative literature clearly states that interim statements and disclosures do not stand on their own. Regulation S-X Rule 10-01 notes that registrants may presume that users have “read or have access to” the previous year’s financial statements. Paragraph 270-10-45-1 states that interim financial information is “essential to provide investors and others with timely information as to the progress of the entity. The usefulness of such information rests on the relationship that it has to the annual results of operations.” As noted in the previous paragraph, IAS 34 states that an interim statement is “an explanation of events and transactions . . . since the end of the last annual reporting period.”

Use of Estimates

B10. Determining the results of operations on a meaningful basis for intervals of less than a year is inherently difficult and requires estimates not required for annual financial statements. Paragraph 270-10-05-2 states the following:

> In view of the limited time available to develop complete information, many costs and expenses are estimated in interim periods. For example, it may not be practical to perform extensive reviews of individual inventory items, costs on individual long-term contracts and precise income tax calculations for each interim period. Subsequent refinement or correction of these estimates may distort the results of operations of later interim periods.

B11. Similarly, paragraph 41 of IAS 34 states that "the preparation of interim financial reports generally will require a greater use of estimation methods than annual financial reports."

B12. Additional estimates, many of which are not generated by automated processes in entities' financial reporting systems, are an important consideration in understanding the time pressures that reporting entities face in preparing financial statements for interim periods.