**IMPROVING TRANSPARENCY IN NOTE DISCLOSURES:**

**CAN FASB MAKE THE “HARD” DECISIONS?**

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***Grumpy Old Accountants, August 2012***

The Financial Accounting Standards Board (FASB) is getting around to addressing the disclosure catastrophe that has befallen our beloved financial statements. Yes, in case you haven’t noticed, the financial statement notes (the report content that really matters) have disintegrated into a series of disorganized, generic, boilerplate text references that can at best be called tedious, and at worst uninformative and misleading. Since the financial report implosion of 2002, today’s financial reports have doubled in size but supply only half the information. So, FASB’s recent invitation to comment on its [Disclosure Framework](http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175824166287&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs) is a Christmas gift in July.

But what took so long? Maybe, the FASB schedule has opened up a bit now that IFRS adoption is dead, and financial reporting transparency can get the attention it really deserves. Still, we aren’t going to get too excited as the FASB likely won’t pass anything for years and years.

We also wonder if the FASB is really qualified for rehabilitating financial statement note disclosures. Why you ask? Just read the invitation to comment. The FASB takes an introduction and four chapters (50 pages total) to actually get to the substantive issues in Chapter 5 – Format and Organization. Wow! Who really cares enough about note disclosure reform and transparency to wade through this verbose narrative that describes topics such as the board’s decision process and some general comments about flexibility and relevance? The Grumpy Old Accountants of course…and we definitely have some ideas to share!

Our very simple (and easy to implement) recommendations address issues raised in two sections of Chapter 5 in FASB’s invitation to comment: *Organization* (page 55) and *Enhancing the Understandability of Notes* (page 53).

**Organization**

We tend to generally favor the ordering suggestions outlined in paragraph 5.22, except that we see no need for “disclosures about transactions or events that have had or will have a broad impact on the financial statements.” These are much too judgmental and subjective, and hence not worthy of the printed space.

First and foremost, each financial statement line item in both the balance sheet and income statement should be supported by its own individual note disclosure. The numbering sequence of the notes would be driven by the ordering of assets, liabilities, and stockholders’ equity in a company’s balance sheet, followed by the sequencing of specific income statement line items. The accounting policy note would not be numbered but would precede the numbered notes under a caption titled “General Reporting Considerations”. More details to follow below.

Additionally, each balance sheet and income statement amount reported should exactly match the related note disclosure and any supporting schedule provided. For example, impairment losses and restructuring costs reported in the income statement should be supported by a schedule in the related note disclosure.

Finally, we propose elimination of the accounting policy note that we currently see “abused” in today’s financial statements. We propose including any accounting policies for specific balance sheet and income statement components together with the specific note disclosures outlined above. For example, as one analyzes the accounts receivable reported by an entity, the accounting policy for the item would be read first, then any detailed asset disclosures. Why do companies make readers flip back and forth between balance sheet, policy note, and a detailed note? Worse, why do companies make readers peruse a variety of notes on the same account? Are companies trying to confuse or mislead?

As to the issues raised by the FASB in paragraphs 5.27 through 5.30, our organization proposals are logical, easy to implement, meet the needs of most users, and are less subject to management manipulation.

**Enhancing the Understandability of Notes**

Not surprisingly we have some very strong opinions on how to improve the content of financial statement notes, thus their understandability and transparency. First, as noted above, we recommend scrapping the accounting policy note as discussed above. It would be replaced by a general (and unnumbered) section immediately following the last financial statement presented. It would be labeled “General Reporting Considerations” and would ***include* *only*** the following items:

* General business description including the reporting entity’s fiscal year end and reporting period.
* Basis of presentation (i.e., US GAAP, IFRS, liquidation, etc.)
* Principles of consolidation and a detailed schedule of consolidated entities (ownership percentage, reason for consolidation, total assets and revenues of consolidated entity, etc.)
* Reclassifications and restatements both of which would be supported by detailed schedules and related discussions (reasons, impact, etc.)

More specifically, this new note would ***exclude*** the following items which would either be eliminated in entirety, or relocated to a specific financial statement note:

* The general “use of estimates” paragraph should be eliminated and replaced by a specific discussion of management estimates used for each financial statement line item in their own unique note disclosure.
* Revenue recognition policy disclosures would be included in a separate revenue note tied directly to the income statement line item. These would be greatly expanded to include not only a description of each revenue recognition method used by the company, but an actual example of how the method is applied to sample company transactions. Additionally, the reporting entity would detail what percent of total revenues is accounted for by each revenue recognition method. Additionally, boilerplate verbatim references to and extracts from specific accounting standards would be eliminated.
* Accounting principles used for cash and cash equivalents, inventories, investments (including equity method investments), derivatives, goodwill and intangibles; property, plant, and equipment; maintenance activities, debt, pensions, credit concentrations and business risks, foreign currency translation, stock based compensation, income taxes, and the like, should be relocated to their respective financial statement line item notes, and either matched or reconciled to the balance sheet and/or income statement.
* The generic “New Accounting Standards” section in which companies cite new standards *ad nauseam,* and contend that little or no effect on current or future reporting will occur, should be eliminated in entirety. Instead, if a new standard will have an impact, then it should be discussed in the specific financial statement line item note affected together with a pro-forma schedule showing the potential impact.

Any frequent reader of today’s corporate financial statements recognizes the unbalanced coverage present in most all reports. One specific example is the level of discussion and detail presented for revenue recognition vis-à-vis pension plan or stock compensation plans. The later generally consume at least three to four pages each of note disclosures, while revenue recognition may get a page of disclosure at most. And which number do you think investors value more highly? Yes, clearly we need expanded note disclosures for revenue, cost of goods sold, and other P&L line items.

The FASB while pursuing their Disclosure Framework project might also wish to consider investigating the “linkages” between existing note reporting requirements. For example:

* An entity’s acquisition note should include not only transaction specifics but also tie to the statement of cash flows as well as financial statement note disclosures for goodwill and intangibles, acquisition costs incurred, etc. Also, the note should specifically discuss how intangibles are allocated to reporting segments.
* Any note disclosures describing “unusual” asset write-downs (e.g., impairments, etc.) or liability accruals (e.g., asset retirement obligations, etc.) that rely on discounted cash flow techniques should provide detailed schedules to support amounts reported including cash flow estimates, discount rates used, terms assumed, etc.
* To support the statement of cash flows, a separate cash flow note should be added that reconciles the indirect method (operating section) items listed to the balance sheet and income statement reported amounts. Increasingly, the reported items in the indirect method operating sections do not tie out to balance sheet changes (and the differences are not necessarily due to acquisitions and foreign currency effects only). For example, a schedule for Accounts Receivable might look something like this:

|  |  |  |  |
| --- | --- | --- | --- |
| **Item** | **Income  Statement** | **Cash Flow Statement** | **Reconcile to  Balance Sheet** |
|  |  |  |  |
| Sales | 60,500 | 8,100 | 52,400 |
| Bad debts (net) | (800) |  | (800) |
| Securitization | (200) | 50,000 | (50,200) |
| Foreign currency effect | 300 |  | 300 |
| Business combination effect | 0 | (800) | 800 |
|  | 59,800 | 57,300 | 2,500 |
| Beginning balance |  |  | 1,000 |
| Ending balance |  |  | 3,500 |

Well, that’s it for now from the land of accounting geezerdom. If you agree, please spam the FASB with your concurrence, and own insightful comments. After all, the FASB definitely needs our help when it comes to promoting transparency and encouraging confidence in the quality of reported amounts. Without us, it will likely just be more of the same…unreadable blah, ba blah, ba blah!

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*