How Meaningful Is the Latest Addition to the FASB *Conceptual Framework*?

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From 1978 to 2018, the Financial Accounting Standards Board (FASB) issued Statements of Financial Accounting Concepts to guide the Board in its creation of generally accepted accounting principles. This paper reviews the purpose of the FASB's Conceptual Framework project and briefly describes the Concepts Statements in place prior to 2018. It explains the impetus for the latest addition to the Framework, Concepts Statement No. 8, Chapter 8. Drawing from the Statement itself, the paper highlights some of its interesting and controversial components. Finally, an evaluation of its significance is made using stakeholders' comment letters to the FASB.

Keywords: Conceptual Framework, FASB, financial statement disclosures, notes to the financial statements, standard-setting

INTRODUCTION

Notes to the financial statements, whether mandated or recommended by the U. S. Securities and Exchange Commission or Financial Accounting Standards Board, serve users of annual financial reports in a variety of ways. Notes are intended to provide useful background information on accounting policies and choices, break down highly aggregated transaction data contained on the financial statements, and offer management's perspectives on the entity's operating performance and financial condition. Users – outsiders – are welcomed into the entity; through quantitative and qualitative disclosures they take a tour inside and learn about routine and non-routine transactions and events and their impacts.

For publicly traded companies, from the late 1960s on the Securities and Exchange Commission promoted an expectation that annual reports would include disclosures and notes to explain details behind financial statement data. Over the years, however, financial statement users have expressed concerns about note disclosures. They claim these follow boilerplate content from year to year, are vague, are complex and difficult to understand, and do not provide information needed to make investing and lending decisions. Preparers feel the disclosures take too much time to prepare and do not justify the costs of doing so. From a regulatory perspective, the Securities and Exchange Commission reported on a JOBS Act project and announced new initiatives in December 2013 designed to solicit ideas about ways to reduce information overload in financial statement note disclosures and other information required by the SEC (SEC, 2013). This report noted 17 years had elapsed since a similar disclosure simplification effort had taken place, and that the topic of disclosures was worth revisiting in light of significant business events of the first decade of the new millennium: the dot-com bubble, financial reporting scandals, and the global recession. As well, the SEC observed, a review of disclosure practices and regulation was timely because "technological advances have continued to significantly change the ways that businesses operate and communicate with investors, as well as the ways that capital markets function and market

participants receive and use information" (SEC, 2013). In 2016, the SEC issued its own 300+ page proposed rule on updating and simplifying disclosures for registrants (SEC, 2016).

Another "expectation gap" appears to be emerging between the preparers of financial reports and their users, particularly analysts and large investors. While some financial statement users feel there is not enough detail in the notes, others feel there is too much and redundant disclosure and have raised calls to reduce the information overload. Complicating things even further are demands by financial statement users for expanded narratives that include information about social responsibility, environmental topics, and corporate governance. Hence, private sector bodies such as the Global Reporting Initiative and Sustainability Accounting Standards Board have entered the fray with reporting guidelines of their own.

Elkins and Entwistle (2018) write

> The area of disclosure is broad, complex, and multidimensional. In addition, it involves stakeholders (preparers, users, auditors) who may hold contrasting views on disclosure problems and disclosure solutions. The boundaries of disclosure also extend beyond the financial statements to include information found, for example, in the management discussion and analysis or in sustainability reports.

It is not a question of whether users will expect corporate annual reports to include such comprehensive collections of information (*i.e.,* disclosure), but rather, when.

Members of the FASB have not been inured to the concerns expressed by people on all sides of the argument. As early as July 2009, the topic of financial statement disclosure appeared on the technical agenda of the FASB (Deloitte, 2018). In July 2012, the Board chose to issue an Invitation to Comment on the proposed new content for SFAC No. 8 (to be included as Chapter 8), financial statement note disclosure. Using feedback from respondents, the Board continued to modify the content for the proposed Chapter 8 and on March 4, 2014 released the Exposure Draft of Chapter 8 (FASB, 2014). Based on comment letters sent to the FASB and reactions obtained through stakeholder interactions, the final version of the chapter was piloted in parallel with the FASB's normal process of updating four Accounting Standards Codification Topics and Subtopics (covering defined benefit plans, fair value measurements, income taxes, and inventory. SFAC No. 8, Chapter 8, was officially released in August 2018.

The primary purpose of Chapter 8 is to offer "a decision-making framework for the FASB to follow when determining required disclosures in standards-level projects" (KPMG, 2018). As the Board creates new standards – or updates existing ones – this chapter describes how the Board should go about its process of "determining the information to be included in the notes to the financial statements" (KPMG, 2018).

Yet what is the value of this newly added chapter to the FASB's *Conceptual Framework*? How significant and substantive is the guidance of Statement of Financial Accounting Concepts No. 8, Chapter 8? This paper briefly reviews the purpose of the FASB's *Conceptual Framework* project and describes the SFACs in place prior to 2018. Next, it explains why the FASB believed guidance on financial statement note disclosure was required. Drawing from the statement itself, the paper highlights some interesting and controversial components of SFAC 8, Chapter 8. Finally, an evaluation of its significance is expressed, based in part on stakeholders' comment letters.

OVERVIEW OF THE *CONCEPTUAL FRAMEWORK* PROJECT

Five years after the Financial Accounting Standards Board came into existence it released the first Statement of Financial Accounting Concepts, called *Objectives of Financial Reporting by Business Enterprises*, in November 1978. Neither of the profession's independent standard setting bodies, the Committee on Accounting Procedure (1939-1959) and the Accounting Principles Board (1959-1973), had much success in developing a set of fundamental concepts on which financial reporting principles would be based. Perhaps it was this legacy that pushed members of the FASB to pursue framework construction

in tandem with standard-setting activities in the mid-1970s. While critics might fault the CAP and APB failures, this author concurs with Baker (2017) that many of the ideas and concepts that ended up in the *Conceptual Framework* were outgrowths of theories, concepts, and postulates discussed by accounting theoreticians –academics and practitioners both – in the first half of the 20th century.

The *Conceptual Framework* was envisioned as a foundation and scaffolding on which actual accounting standards would be constructed. Miller (1985) identifies three reasons why the FASB created the *Framework*: a) existing practice is expressed; b) future practices can be developed; and c) vocabulary and "fundamental issues" and be explained. Several years after the first six Concepts Statements were published, Koeppen (1988) writes that the *Framework* "offers the accounting profession an opportunity to develop greater consistency in accounting standards and practices". Similar sentiments are expressed by Gore and Zimmerman (2007) as they explain that a framework improves the efficiency of setting accounting standards by having a "common set of terms and premises for analyzing accounting issues". Gornik-Tomaszewski and Choi stress the importance of a conceptual framework, warning that "different conclusions might be reached on similar or even identical issues addressed on different dates, making the standard setting very ineffective". Shifting notions of these foundational ideas could translate into "less useful financial reports" for users (2018).

Today, the website introducing the *Conceptual Framework* states:

> The FASB Concepts Statements are intended to serve the public interest by setting the objectives, qualitative characteristics, and other concepts that guide selection of economic phenomena to be recognized and measured for financial reporting and their display in financial statements or related means of communicating information to those who are interested. Concepts Statements guide the Board in developing sound accounting principles and provide the Board and its constituents with an understanding of the appropriate content and inherent limitations of financial reporting.

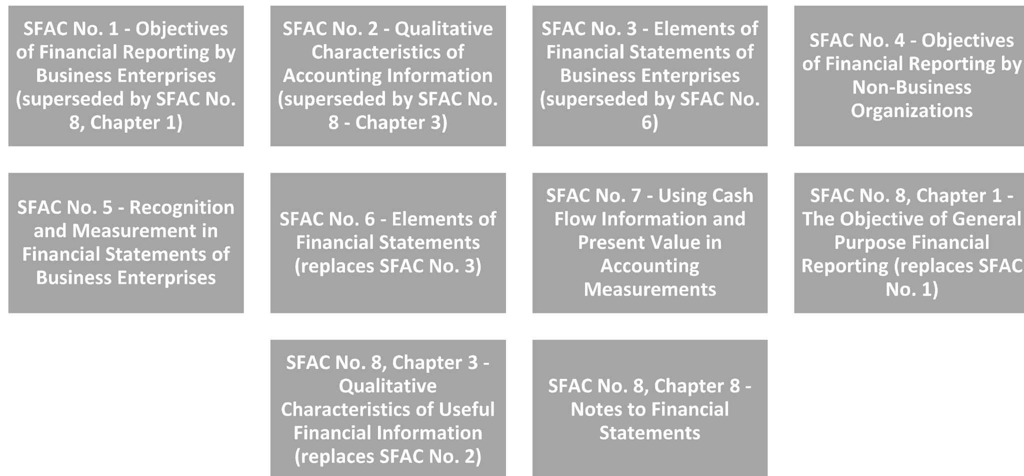
In a seemingly contradictory fashion, the Concepts Statements do not serve as generally accepted accounting principles and are not considered authoritative. These statements present starting points of reference for the FASB. Only in the odd case when the authoritative literature does not explain proper accounting for a transaction will the statements of the *Conceptual Framework* be treated as GAAP.

Gornik-Tomaszewski and Choi (2018) suggest a conceptual framework needs to be consistent and logical if it is to serve as the underpinning for accounting standards. Otherwise, standard-setting would be chaotic at worst or cave in to individual FASB members' biases at best. As the seven members of the Board rotate on and off, concepts could be subject to the whims of Board members and potentially result in standards developed according to what is most expedient (Gore and Zimmerman, 2007).

Although due diligence practices have been incorporated into the process of creating the content of the *Conceptual Framework* statements, Ohlson et al. – writing in *Accounting Horizons* in 2010 – claim the Concepts Statements are "quite limited in their influence" and do not "distill into a coherent whole". Even FASB members themselves have acknowledged that some parts of the *Framework* suffer from a lack of completeness, consistency, and clarity (Gore and Zimmerman, 2007). Such sentiments prompted the FASB to initiate a thorough review of the Concepts Statements.

For readers not fluent with these statements, Figure 1 depicts the historic and current content of the *Conceptual Framework* project.

FIGURE 1
THE FASB'S CONCEPTUAL FRAMEWORK



Beginning with Statement of Financial Accounting Concepts No. 8, the FASB breaks down the Statement's content into separate chapters. This is a radical departure from past practice. Also observe that SFAC No. 8 is titled "Conceptual Framework for Financial Reporting", an odd title that implies the other extant Statements (*i.e.*, SFAC Nos. 4, 5, 6, and 7) are not part of this *Framework*.

THE VALUE OF NOTE DISCLOSURES – AND A FEW CAVEATS

Members of the Financial Accounting Standards Board recognize that notes play an essential role in assisting financial statement users understand data reported on financial statements. Paragraph 7 of Statement of Financial Accounting Concepts No. 5 makes this clear: "Although financial statements have essentially the same objectives as financial reporting, some useful information is better provided by financial statements and some is better provided, or can only be provided, by notes to financial statements or by supplementary information or other means of financial reporting." (FASB, 2014b). The FASB acknowledges that the highly aggregated and summarized line items shown on most financial statements is "inherently limited" (FASB, 2018) and needs further explanation; notes fill this need.

Elkins and Entwistle (2018) remark "high quality disclosure is important to well-functioning capital markets." They remind us that to be useful, notes need to be "potentially material" and "clearly written". This is reiterated by Singh and Peters (2013), who state "financial statements cannot be fully understood, however, without extensive, clear, and complete supporting disclosures." In providing such detailed narratives about their account balances and transactions, preparers must write their notes using "rigor equal to that applied to basic financial statements" say Singh and Peters. Note disclosures ought not be crafted in a hasty or careless fashion nor viewed as an afterthought.

But on occasion, note disclosures have been constructed in a fashion that avoids – rather than promotes – information transparency (O'Brien, 2009). Perhaps this stems from a desire on the part of preparers to redirect user focus to other aspects of the financial statements. Miller (1985) suggests that frameworks are subject to criticism of a political and technical nature. In extending this idea to portions of the FASB *Conceptual Framework* dealing with note disclosure, might we at least entertain the suggestion that at times note disclosure requirements could have been the result of satisficing behavior of FASB members? Countering this viewpoint is Kirk's (1981) adamant statement that standard setting won't involve "purposeful compromising of conflicting constituent viewpoints". Horngren (1981) commenting in the same publication as Kirk, admits "no matter what conceptual framework is developed, its success will be heavily affected by individual interpretations". He acknowledges the survival of the FASB

depends on the acceptability of its work by the Securities and Exchange Commission. Is it not plausible that rules and guidance related to note disclosures may well be crafted to satisfy one of the most significant external stakeholders of financial reporting?

HIGHLIGHTS OF SFAC NO. 8, CHAPTER 8

In the introduction to SFAC No. 8, Chapter 8, the FASB suggests the relationship between note disclosures and financial statements is affected by the changing "economic, legal, political, technological, and social environment" of financial reporting (FASB, 2018). As such, now seems to be the time to add specific guidance to the *Conceptual Framework* to guide members of the FASB in the amount and type of note disclosures that should be included in the creation of future GAAP.

A note's *raison d'être*, according to Chapter 8, is "to supplement or further explain the information on the face of the financial statements" for users. Amplification and clarification of financial statement data, as well as explanation of events and circumstances connected with the data is best delivered – and in some cases can only be delivered – through the narrative we know as the Notes to the Financial Statements (FASB, 1985).

What types of information are included in the notes? SFAC No. 8, Chapter 8 defines three clusters of narratives: "(a) financial statement line items, (b) the reporting entity, and (c) past events and current conditions and circumstances that have not been recognized that can affect an entity's cash flows". Chapter 8 also articulates two categories of information that do not need to be reflected in the notes:

- "assumptions and expectations about uncertain future events that are not reflected in financial statements", and
- "information about matters that are not specific to the entity and are common knowledge or attainable at little cost from other sources and readily available from other sources as long as a knowledgeable user should be aware of the need for the information and its availability"

As well, the FASB recognizes that requiring too much note disclosure can be disadvantageous. To compensate for this, the Board describes what it will keep in mind as it establishes guidance for notes (Paragraph D22):

- notes should be relevant for financial statement users across a "broad range of entities",
- the cost-benefit consideration should be kept in mind when asking preparers to provide note disclosures,
- possible "unintended adverse consequences" of note disclosure must be kept in mind, and
- there is a possible negative impact of requiring "future-oriented information"

It is impractical to discuss the full content of SFAC 8, Chapter 8 in this paper. Thus, the following subsections identify and critique several items this author deems of greater significance to the FASB's standard setting process and for financial statement preparers.

Relevance (Paragraph D23)

A well-known and longtime qualitative characteristic of accounting information, relevance again makes an appearance in SFAC No. 8, Chapter 8. This time, the FASB explains that the note disclosures it will require "are based on broad general considerations of relevance rather than on entity-specific judgments about materiality". Materiality and relevance, though related, are treated separately in this Concepts Statement. FASB guidance does not identify those matters that are material and therefore require note disclosure. The determination of material subjects rests with the reporting entity. Disclosure rules should not be "so prescriptive that they preclude reporting entities from making materiality judgments".

Potential Adverse Consequences (Paragraphs D28-D32)

Preparers, users, and standard-setters are deeply cognizant that requirements to disclose can have unintended negative outcomes. Maintaining the right balance between disclosing information about

situations and providing too much detail involves careful discretion and sometimes the use of legalistic language on the part of note preparers. Another attribute of accounting information, neutrality, is mentioned as a desirable qualitative aspect of financial reporting. Standard-setters, however, in their desire to enhance the usefulness of disclosures, may at times overprescribe the amount of detail and discussion preparers need to include. When these disclosures have the capacity to inflict legal, competitive, reputational, or economic harm (other than resource allocation decisions by investors and creditors) on preparers, these "potential adverse consequences" ought to be considered by the FASB before it obliges prepares to disclose the information.

Future-Oriented Information (Paragraphs D33-D40)

Financial statements' predictive value can be enhanced when certain "forward-looking" information is provided to users. But the drawback of providing this type of information is "some of that information may turn out to be materially different from the actual future events or conditions when they occur. Some potential consequences are litigation or threat of litigation and loss of credibility." While protections are offered by the Securities and Exchange Commission for some types of "forward-looking" disclosures that are not part of audited financial statements, there is no protection over future-oriented details considered part of the financial statements. The FASB feels it can ask for note disclosure about the "estimates and assumptions" that factor into GAAP calculations of financial statement line items since these judgments form the basis for measuring current transactions. But it does not anticipate asking for disclosures about business strategies and future plans because these narratives "may render them less effective and, therefore, adversely affect the reporting entity". Additionally, revealing management's strategies and plans "seldom explains information on the face of the financial statements".

Events That Can Affect Cash Flows (Paragraphs D62-D67)

Contingencies, commitments, and subsequent events share a common characteristic: they lack financial statement impact but represent past or future business occurrences. Nonetheless, investors and creditors "are likely to want as much information as possible about the potential effects of those events on the entity" because of their future effect on assets and liabilities. The FASB acknowledges these events might "require an entity to make difficult estimates or judgments or may subject the entity to a potential disadvantage (or a loss of advantage) to competitors, litigants, or others". Identifying and describing such an event is the minimum standard for disclosure. Whether an event is disclosed also depends on the entity's assessment of the event as "unique, infrequent, unusual, or routine and whether it could have a continuing effect on routine and frequent business activities".

Appendix A: Decision Questions

SFAC No. 8, Chapter 8 creates a "question and response" appendix intended to guide FASB members' effective use of the Concepts Statement. It is reminiscent of the format chosen by the Securities and Exchange Commission's Staff Accounting Bulletin 101 (issued on December 3, 1999 – available at https://www.sec.gov/interps/account/sab101.htm) to steer accountants' questions on matters of revenue recognition. If FASB members respond in the affirmative to one of these questions they "should consider requiring disclosure" for the topic (Holzmann and Munter, 2014).

PARTING THOUGHTS: SIGNIFICANCE OF SFAC NO. 8, CHAPTER 8

Why was the time right for a Concepts Statement on the subject of note disclosure? Sentiments expressed in comment letters received by the FASB to its *Invitation to Comment* (July 2012) point to disclosure overload associated with increased business complexities and the promulgation of more detailed and intricate financial accounting standards. Excerpts from a sample of these comment letters is shown in Table 1.

As the FASB has been working on an overhaul of its *Conceptual Framework* Project since 2010, perhaps the development of a chapter to proffer this collection of principles, paths, and a do-it-yourself Q&A guide for the Board should not come as a surprise. The value of SFAC No. 8, Chapter 8 will be in

its ability to deliver on the rhetoric of “reducing disclosure overload”. Only when future FASB ASC Updates and new Topics are promulgated can we examine the required and suggested disclosures to see if Chapter 8 has made a meaningful contribution to note disclosures.

TABLE 1
COMMENT LETTER EXCERPTS

Comment Letter Source	Comment Letter Excerpts
No. 8, defense manufacturing	However, the current approach often results in entities defaulting to disclosing “everything” without the use of judgment, given the tendency for entities and their auditors to be risk averse in our regulatory and litigious environment. This results in disclosure “overload.” We suggest that the framework focus on empowering entities to exercise greater judgment in evaluating disclosures for relevancy and materiality prior to inclusion in their financial statements, as this will generate the most impactful improvements for both entities and users.
No. 13, public accounting firm	We echo the Board’s statement that is it more vital to financial reporting to increase the effectiveness of disclosure versus a simple reduction in the volume of financial statement disclsoures.
No. 21, financial services	The complexity of the underlying accounting standards, the volume of associated disclosures, and the general apprehension with removing disclosures once they have been provided as well as a lack of integration in practice of accounting topics across notes, have all contributed to disclosure overload. As a result, companies have been conflicted with balancing the effective communication of information that they deem most relevant and important to investors and other stakeholders with the volume of disclosure required.
No. 31, information technology products and services	The current state of disclosure requirements plus what is projected from the key convergence projects is unsustainable, yet users continue to say they require even more information. We specifically support the concept of limiting the volume of disclosures required when: a) those disclosures overlap with what is required in the Management Discussion and Analysis (MD&A), and b) disclosures are not meaningful or significant to an entity’s reported results and financial position (i. e. a checklist based approach to disclosure). We believe that the most effective disclosures are those that provide insight into an entity’s particular circumstances. As a result, we believe that a disclosure framework that allows for judgment in the selection of disclosure elements based on general principles, including materiality, applicable to the entity is the most appropriate approach.
No. 52, state CPA society	In general, we support the efforts of the FASB staff in establishing a draft disclosure framework, with a goal 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.
No. 68, healthcare provider	Over time, the complexity of accounting issues faced by financial statement preparers combined with highly prescriptive disclosure requirements in promulgated accounting standards have led to a greater volume of disclosures in the notes to financial statements, without necessarily improving the quality of information available to the users of those financial statements. We do not believe that management's discussion and analysis (MD&A) that is currently required by the SEC for quarterly and annual filings should be included in the disclosure framework. Since much of MD&A is forward-looking and business focused, including it in the framework for financial statement disclosures could result in difficulties auditing such information.

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