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Herculean Task
The Road to Effective Disclosures

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Introduction

The call for modernizing and improving the public-company disclosure regime — whether in the name of combatting complexity and "overload," improving efficiency or effectiveness, or adapting to new technology — is hardly new. Indeed, in the past decade alone, several regulatory and standard-setting initiatives have included such broad goals. But none of those efforts resulted in fundamental changes to the disclosure system, in part because of competing agenda priorities and difficulties achieving consensus on the specific nature of comprehensive changes.

Lately, however, regulators and standard setters have been renewing their focus on disclosure effectiveness. SEC Commissioner Kara Stein remarked in a May 2014 speech that "[i]mproving disclosures is an important and herculean task," and certain projects at the SEC and at the FASB and IASB have been gaining momentum. Although those projects are in the early stages, their common goal of making comprehensive improvements to the U.S. public-company disclosure regime may increase their likelihood of success. While views on how to achieve improvements may differ, most seem to agree that the entire disclosure system is due — if not overdue — for modernization.

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SEC Disclosure Effectiveness Project

A motivating factor in the SEC's recent efforts to improve disclosure effectiveness (known as its "disclosure effectiveness project") has been its concern that investors often struggle to find salient information in registrants' filings. In an October 2013 speech, SEC Chair Mary Jo White questioned "whether investors need and [investors] are optimally served by the detailed and lengthy disclosures about all of the topics that companies currently provide in the reports they are required to prepare and file with [the SEC]." And in a May 2014 speech, Ms. White emphasized the importance of "full and fair disclosure [for the] capital markets to thrive" and asked whether "the information companies are currently required to disclose is the most useful information for investors and whether [it] is being provided at the right time and in the right way."

Further, in a January 2014 speech, Commissioner Daniel Gallagher noted his observations that registrants often disclose matters that are generic, outdated, redundant, and immaterial. He stated that "[t]oday's mandated disclosure documents are no longer efficient mechanisms for clearly conveying material information to investors."

The SEC's recent focus on disclosure effectiveness has also been prompted by Section 108 of the JOBS[1] Act, under which the SEC was instructed to review disclosure requirements in Regulation S-K (which contains many of the nonfinancial statement reporting requirements for SEC filings), identify ways to update and modernize them for emerging growth companies (EGCs), and submit a report to Congress. In its report

[1] Jumpstart Our Business Startups.

(issued in December 2013), the SEC recommended seeking disclosure improvements for all public companies, not just EGCs, even though a more comprehensive study would take additional time.

With the SEC's report serving as a springboard for further action, Ms. White asked the staff to undertake a comprehensive review of the disclosure requirements in Regulation S-K as well as those in Regulation S-X (which contains requirements on the form and content of financial statements included in SEC filings) and to make specific recommendations. To achieve this objective, the SEC noted that it would focus not only on eliminating outdated, redundant, and overlapping disclosures but also on identifying topics for which investors may need better or more information to make informed investment decisions. Remarking on the need to reduce immaterial disclosures, Keith Higgins, director of the SEC's Division of Corporation Finance, noted in a March 2014 speech that "[u]nfortunately, there is no easy answer or consensus on how to do so. What one person sees as overload, another might very well see as important information for making an investment or voting decision."

SEC Review of Disclosure Content

In an April 2014 speech, Mr. Higgins explained that the SEC staff will identify ways to improve the disclosure requirements in Regulations S-K and S-X. The staff will analyze Regulation S-K as part of the first phase of its disclosure effectiveness project, focusing "on the business and financial disclosures that flow into periodic and current reports, namely Forms 10-K, 10-Q, and 8-K, and, in one way or another, make their way into transactional filings." For example, the staff will consider eliminating disclosure requirements that were originally created to fill a void in U.S. GAAP but are no longer necessary. Further, the staff will:

The SEC staff plans to study whether the benefits associated with requirements in Regulation S-X outweigh their costs to preparers.

- Assess whether to update industry guides and form-specific disclosure requirements and incorporate them into Regulation S-K.
- Consider the merits of permitting scaled disclosures for certain issuers (e.g., smaller reporting companies or EGCs).

Editor's Note: In her May 2014 speech, Ms. White indicated that since investors have a significant interest in increased transparency into audit committee activities, she has asked the SEC staff to consider, separately from the disclosure effectiveness project, whether audit committee reporting requirements and reports can be improved. Commenting generally on how the SEC staff will prioritize its ongoing review, Mr. Higgins noted in his April 2014 speech that the staff's evaluation of proxy disclosures would take place in a "later phase of the project."

In addition, the staff plans to study whether the benefits associated with requirements in Regulation S-X outweigh their costs to preparers. For example, the staff will review:

- A registrant's obligation to provide other entities' separate financial statements in registration statements, periodic filings, or both.[2]
- The need for registrants to provide "recasted" financial statements after a retrospective change is adopted.[3]
- Overlap in the disclosures required by Regulation S-X and U.S. GAAP.

[2] In conjunction with, for example, SEC Regulation S-X, Rules 3-05 (significant business acquisitions), 3-09 (significant equity method investments), 3-10 (guarantors), or 3-16 (collateralizations).

[3] In certain circumstances, a registrant may be required to update or "recast" its previously filed financial statements to retrospectively reflect its adoption of accounting standards or other events (including, for example, the reporting of discontinued operations and changes in segments).

SEC Review of Disclosure Format

Mr. Higgins indicated that the staff would also study how information is currently disclosed and whether improvements can be made to the presentation of company filings. Similarly, Ms. Stein has stated that disclosures need to be more accessible, useful, and timely. In her May 2014 speech, she noted the following:

> In an era where nearly all data is electronic . . . a huge portion of public disclosures are presented in a format that isn't structured and easily accessible for analytics. [The SEC] should be making sure that as many disclosures as practicable are required to be submitted in useful, structured formats that investors, the public, and the Commission can use. In the same vein, I believe [the SEC] should require disclosures to be timelier. News and business move faster than ever before. Does it still make sense for investors to wait for quarterly or annual statements that are delivered weeks or months later?

In particular, the SEC has questioned the appropriateness of the format, structure, and timing of filings in light of improvements in technology and ways that investors search for information. In his March 2014 speech, Mr. Higgins discussed considerations related to the SEC's efforts to "harness the rapidly changing technology that has made the sharing of information so efficient in other areas of life [and] bring the same level of efficiency to how investors find information about a company." He also outlined the SEC's plans to enhance the "navigability" of disclosure documents by exploring:

- Improved structured data, hyperlinks, or topical indexes.
- A "company disclosure" or "core disclosure" system for certain information that changes less frequently or infrequently — such as the description of the business and certain other company information — which could be disclosed in a "core" document and then supplemented by periodic and current reports.

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Editor's Note: As part of examining potential improvements to disclosure format, the SEC solicited support in July 2014 for modernizing its EDGAR filing system. Contractors submitted proposals to provide "the groundwork for SEC decision-making to shape the modernization effort," including:

- Reducing the number of form types and acceptable data formats.
- Reducing the duplication of information collected.
- Functionally improving communications between filers and the SEC staff.
- Improving the functional "look and feel" for a better filer and investor experience.
- "Other innovative ideas that the contractor will bring to the table and that the contractor will identify in their interviews with stakeholders."

FASB Disclosure Improvement and Simplification Efforts

The FASB has also been looking into ways to reduce complexity and improve financial statement disclosures. In a June 2014 speech, FASB Vice Chairman Jim Kroeker noted that the "object of [the Board's disclosure framework] project is to remove the clutter, and focus on making disclosures more useful to investors."[4] In a key step toward meeting that objective, the FASB released an exposure draft for public comment in March 2014 on its decision process for determining disclosures to require in notes to financial statements (see Deloitte's March 6, 2014, *Heads Up* for additional information). The comment period ended in July 2014, and the FASB plans to start redeliberations in September 2014. In addition, the Board has been considering a similar decision-making framework for financial statement preparers and has been reviewing information gathered in a field study by its staff about how public, private, and not-for-profit organizations determine which disclosures to provide in the notes to their financial statements.

[4] The IASB is considering a similar disclosure framework project (see discussion below).

In June 2014, the FASB launched its simplification initiative, which consists of narrow-scope projects to simplify U.S. GAAP that would be conducted in a short time frame. As noted by FASB Chairman Russell Golden, "investors tell [the FASB] that overly complex financial reports often obscure important information they need to make sound capital allocation decisions. Preparers tell us that a complicated, unclear standard obscures its meaning. And even when an accounting treatment is clear, applying it is lengthy, difficult, and expensive. When accounting is complex, no one wins."

The FASB has received feedback on the initiative from more than 70 stakeholders. As a result, the Board has issued proposals to simplify:

- Inventory in ASC 330[5] by addressing the complexity of current guidance on measuring inventory, which requires entities to estimate net realizable value.
- Income statement presentation in ASC 225-20 by eliminating the requirement to separately report extraordinary items.[6]

In addition, the FASB plans to explore ways to address feedback that (1) there are too many disclosures related to fair value measurement and defined benefit plans and (2) more disclosure requirements are needed about income taxes. The FASB also intends to evaluate whether simplified accounting alternatives available to private companies could be extended to public companies.

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Editor's Note: In January 2014, to help reduce the complexity of financial statement preparation for private companies, the FASB issued ASU 2014-02[7] and ASU 2014-03,[8] which permit eligible private companies to use alternative approaches to account for goodwill and interest rate swaps, respectively (see Deloitte's January 27, 2014, *Heads Up* for additional information). In addition, this year the FASB issued:

- ASU 2014-08,[9] which seeks to reduce the complexity involved in evaluating when a disposal would be presented as a discontinued operation in an entity's income statement (see Deloitte's April 22, 2014, *Heads Up* for additional information).
- ASU 2014-10,[10] which eliminated the concept of development-stage entities (see Deloitte's June 11, 2014, journal entry for more information).

IASB Disclosure Initiative

In a May 2014 speech, IASB Chairman Hans Hoogervorst noted that he has received feedback from constituents outside the United States who "complain about complexity, about financial reports becoming ever lengthier, about the real message getting drowned in excessive disclosures." Pointing out that the disclosure problem is often related to behavioral factors, he stated:

> [M]any preparers will err on the side of caution and throw everything into the disclosures. They do not want to risk being asked by the regulator to restate their [financial statements]. Furthermore, sometimes it is just easier to follow a checklist . . . . Such risk aversion, although understandable, can lead to a ticking-the-box mentality. The communicative value of financial statements suffers as a result.

[5] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

[6] For a complete list of the FASB's projects, see the Board's technical agenda.

[7] FASB Accounting Standards Update No. 2014-02, *Accounting for Goodwill* — a consensus of the Private Company Council.

[8] FASB Accounting Standards Update No. 2014-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps— Simplified Hedge Accounting Approach* — a consensus of the Private Company Council.

[9] FASB Accounting Standards Update No. 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity.*

[10] FASB Accounting Standards Update No. 2014-10, *Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810,* Consolidation.

In light of this mindset, the IASB has launched a disclosure initiative, which consists of a number of implementation and research projects, including:

- Disclosure-framework and standard-level review projects that focus on (1) developing a set of principles for determining disclosures in IFRSs[11] and (2) reviewing existing IFRSs to evaluate whether they contain contradictory, duplicative, or overlapping disclosure requirements.[12]
- A project to amend IAS 1[13] to address certain existing presentation and disclosure requirements and entities' use of judgment when preparing financial statements.[14]
- A research project addressing materiality to determine (1) how materiality is applied in practice and (2) whether further guidance on materiality is needed.[15]

Next Steps

The twists and turns on the road to effective disclosures are likely to be substantial, and the journey could span months if not years. Since the magnitude of changes to current practice may be significant, investors, preparers, and other users of financial information are encouraged not only to closely monitor developments about disclosure effectiveness but also to actively provide their comments and input by posting them to the SEC's, FASB's, and IASB's respective Web sites.

Even though the SEC's disclosure effectiveness project has recently begun, registrants can improve their disclosures under current rules. In his April 2014 speech, Mr. Higgins proposed a "call to action" for registrants to reduce repetition, tailor disclosures, and eliminate outdated and immaterial information. For more information, watch for Deloitte's upcoming *Heads Up*.

[11] As a result of its research related to the disclosure framework project, the IASB may replace IAS 1, *Presentation of Financial Statements*; IAS 7, *Statement of Cash Flows*; and IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. The IASB is also separately considering whether to amend IAS 7 to include a reconciliation of liabilities arising from financing activities and disclosure requirements aimed at improving information about restrictions on cash balances.

[12] A discussion paper is expected in 2015.

[13] IAS 1, *Presentation of Financial Statements*.

[14] The comment period ended last month, and the IASB plans to start redeliberations in the third quarter of 2014.

[15] The IASB staff plans to discuss the results of the research with the IASB in the third quarter of 2014.

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