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# Adequat Disclosure

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ADEQUATE DISCLOSURE

IN FINANCIAL STATEMENTS

by

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## CHAPTER I

## DISCLOSURE AND ITS IMPORTANCE IN FINANCIAL STATEMENTS

Adequate disclosure in financial statements is of great concern to today's accountant. Lack of it is an invitation to liability on an accountant's part. While disclosure is of great concern, there are few set rules or regulations as to what it is or how it is achieved. While the American Institute of Certified Public Accountants and the American Accounting Association are both trying to discover or create rules, regulations and generalities, the final decision rests with the local practitioner himself. He must determine what is material, consistent and/or adequate where disclosure is concerned.

While the main emphasis of this paper is on adequate disclosure in financial statements, there is disclosure given in reports to stockholders, president's letters, prospectuses, and management letters, to name a few areas. Every area or development which needs disclosure will not be listed, but a few specific instances will be explained. The objective is to point the way toward adequate disclosure giving some ideas and generalizations on what to look for and do in this area.

Financial statements are, so to speak, a picture of a business as of a given date and for a period ended at that date. They tell of the growth of the business during that period and are the history of the business.

Mr. Peloubet and Mr. Heaton agree that accounting at the stage of statement preparation places the emphasis on conformity with generally accepted accounting principles, consistency, adequate disclosure, materality, and appraisal of accounting policies.[1] They mention disclosure along with generally accepted accounting principles because it is a generally accepted accounting principle.

"The standard of disclosure is concerned with the fairness of presentation in the financial statements."[2] Fairness is a part of financial disclosure, so the accountant must skillfully disclose enough to be fair with the readers of the statements. The United States government is also concerned with disclosure and has issued the Securities Act of 1933 and the Securities Exchange Act of 1934 dealing with the problem.

There is no definition that can be given but perhaps this will serve as a guide. "Adequate disclosure is perhaps best viewed as imperative to accountants to stress the aspects which should be stressed."[3] That is the clearest, all inclusive definition available.

The criteria for standards of disclosure are indefinite and vague because they are often based on value judgements rather than objective fact. Disclosure should be thought of in the broadest terms, and can be discussed in terms of what should be disclosed, to whom, and how it should be made.

Disclosure has been referred to as, "that intangible measure of the adequacy of the descriptive and supplemental information in financial statements..."[4] and that it "requires the revelation of information which if withheld, might influence a prospective creditor's decision to loan funds or a prospective investor's decision to buy securities".[5] However helpful these may or may not be is of little concern, because definitions are not too helpful in deciding what constitutes adequate disclosure. Since definitions are of little value, this list tells some of the information which should be disclosed.

1) Legal data (number of authorized shares of stock, preferred dividends in areas).

2) Descriptive data (pledged assets).

3) Commitments (large commitments or purchase commitments above market).

4) Events subsequent to the balance sheet date.

5) Contingencies and other uncertainties (usually found in footnotes).

6) Values other than those used in the accounts (market value of temporary investments, if carried at cost).

7) Explanations of special transactions or changes in the nature of the business.

8) Accounting basis of valuation (for inventories-lower of cost or market).

9) Changes in procedures and their effect (also changes in classification).[6]

This list will help the accountant determine what he should disclose, but there is also another important list of items to be considered when determining adequate disclosure in financial statements.

1) Public interest is of principle concern.

2) When a conflict of interest is involved, supression of useful information is justified only when the extent of injury to the enterprise exceeds the benefit accruing to the public.

3) Materiality remains an important consideration.

4) Financial statements cast in traditionally acceptable form may be deficient in the disclosure of important conditions, qualifications, or anticipations necessary for the making of informed decisions.

5) Informative disclosure to prudent investors presumes statement content which is explicit, complete, and unequivocal.[7]

The two lists give the accountant something to go by when he speaks of adequate disclosure. Disclosure is a personal judgement on the part of the independent accountant and rules cannot be set down for every situation.

The auditor, when determining the adequacy of disclosure, "must consider the terminology used, the details given, the sufficiency of explanatory or descriptive matter, and the classification of items in the statement".[8]

Financial disclosure has been explained by a list of what should be disclosed and a list of considerations to be used to determine adequate disclosure, but a real definition cannot be given nor can all of the circumstances in which disclosure should be used be explained.

Adequate financial disclosure is needed because accounting reports should disclose matters which are necessary to avoid misleading the readers. Readers of financial statements have been dissatisfied with disclosure but

> as these basic dissatifactions are very general in nature and reflect a vague feeling that financial statements could be more useful, specific suggestions or proposals for further improvements are unlikely to come from the users themselves. This follows naturally from the fact that the increasing complexity of accounting problems has reduced the number of users who can understand the difficulties involved well enough to suggest specific, practical solutions.[9]

The independent accountant's summaries must disclose all material facts which would affect an analyst's interpretation. Incomplete information or half truths would be misleading to any user of accounting statements. A registration statement and a prospectus are used to provide disclosure under the Securities Act of 1933, and the Securities Exchange Act of 1934 imposes a duty on the accountant to provide information which is necessary or appropriate in the public interest or for the protection of investors.

But even without the law imposed by government, the accounting profession has its own rule. It is the third standard of reporting which states "informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report".[10] By this standard, we mean that the financial statements must be as informative as possible. Even non-accounting matters if significant must be disclosed. Statement classifications must be clean cut in title and content, unusual items should be shown seperately if large enough to make the usual classifications misleading.

The most important reason the accountant needs adequate disclosure is for the readers of the statements.

> John L. Fox states that, disclosure means many different things, depending on the needs of the user of financial information. To some investors, financial disclosures beyond dividends and earnings per share is probably not too relevant. To the CPA, disclosure means the inclusion in annual financial statements of all information necessary for fair presentation.[11]

These are but two of the persons interested in financial statements, and here is a list of some other users of accounting information and the questions that they have.

1) Top level management questions generally deal with:

a) the role of products, people, departments, and functions in ensuring the continuance and well-being of the whole organization and,

b) the position of the firm with respect to its social, legal, political and economic environment.

2) Lower level management questions are concerned with adequacy of their past performance compared with expectations and indications of expected future performance.

3) Creditors questions relate to solvency and the risk factors associated with a given firm.

4) Owner-investors and potential investors desire information about:

a) profitability and,

b) ability of the firm to continue or increase profitability, thereby presumably maximizing the present value of their funds over other possible investment alternatives on a current basis.

5) Closely related to the owner-investor above is the investment analyst, a broker. He desires to question a business as to its goals, plans, forecasts and profitability by each sub-unit, or product or function in order to form more valid analysis of short and long term profitability and longevity consideration.

6) The government and other regulatory agencies have questions dealing with tax related aspects of business operations and to socio-political aspects of the economic behavior of the firm in its outside relationships.

7) Persons and agencies external to the firm and its economic success voice questions related to its functioning as a cultural and social phenomenon. Its relationship with, and effect

upon employees, consumers, and others from a variety of standpoints, are subject to study and analysis.[12]

This list shows the importance of financial disclosure and also the broad interests of the persons for whom the statements are prepared.

It should be easy to see that financial statements cannot be made universally acceptable to all and will, therefore, be lacking in disclosure to some interested persons. Some of the additional facts desired by readers are.

1) More details are wanted, for example, sales by categories, information as to the amount of specific expenses, such as advertising or research.

2) More information is desired as to the accounting principles followed and to what the reader may consider to be changes therein from year to year.

3) More information is requested as to changes in operating conditions and policies, such as revisions in credit terms, methods of doing business and so on.

4) Desired changes are suggested in our fundamental approach to accounting, for example, abandonment or modification of our usual assumption that the monetary unit remains constant.[13]

More disclosure is desired, as can be seen, but the accountant must be careful not to overdisclose. However, "if matters which the independent auditor believes require disclosure are omitted from the financial statements, the matters should be included in his report and he should appropriately qualify his opinion".[14]

# CHAPTER II

## PROBLEM AREAS IN FINANCIAL DISCLOSURE

Earlier it was stated that all areas of difficulty cannot be mentioned, but the main problem area must be discussed. This is disclosure of events subsequent to the balance sheet dates.

"The primary responsibility for the financial statement, and accordingly for any adjustment or annotation because of post-balance sheet events, is that of the entity or person whose financial statement are under consideration..."[15] The auditor's responsibility for reporting with regard to post-balance sheet events or transaction, is found in the third standard of reporting, which was mentioned earlier.

Disclosure of events subsequent to the date of financial statements is "one of the most troublesome aspects of a public accountant's practice..."[16] These events may have a material effect on the financial statements or may be important in connection with consideration of the statements.

"In view of the fact that an auditor has to keep in touch with the client he should not hesitate to update his certificate."[17] When he changes his report or adjusts this statement, this adjustment becomes part of the statements themselves.

When the accountant speaks of post-balance sheet, or post-statement events, he means the period from the balance date to the date of completion of all important audit procedures. This date will be about the same date as the completion of work in the client's office, and should be used as the date of the auditor's report.

"As far as the independent accountant is concerned, it appears that the law imposes a duty which does not end with the signing of his certificate (report)..."[18] Therefore, the accountant has a duty to try and determine if anything has happened which affects the statements. The problem is that a considerable portion of the auditor's examination must necessarily take place after the balance sheet date.

There are three types of subsequent events which are found in the period into which audit procedures extend. They are, as taken from Statements of Auditing Procedures #25:

> a) Events of the first type directly affect the financial statements and should be recognized therein. Thus, if subsequent information is acquired in time to permit its use, if the information provides a basis for more accurate estimates or provisions, and if the information would have been used had it been available at the balance sheet date, appropriate adjustments should be made in the statements.
> b) Events of the second type have no direct affect on the statements and therefore, do not require adjustments of the financial statements of prior periods, but their affects may be such that disclosure is advisable. For example, serious damage from fire or flood or large capital issues.
> c) Events of the third type include non-accounting events such as war, management change, loss of important customers, product changes and strikes. Disclosure of such events frequently creates doubt as to the reason therefore, and inferences drawn could be misleading as often as they are informative.[19]

The committee believes that disclosure should be confined to events which aid in the interpretation of the financial statements.

Post-balance sheet disclosure usually consists of the following:

1) Reorganization, mergers, sale or retirement of substantial amounts of capital stock.

2) Suspension of operations by a strike, fire or other casualty, or an uninsured loss.

3) Commitments for plant expansion.

4) New long term financing, refinancing under different terms or the payment of long term debt.

5) Legal action-judgements rendered or new litigation began.

6) Purchase or sale of substantial amounts of investments; extreme market fluctuations of investments.

7) Purchase, liquidation or sale of a subsidiary.

8) Changes in accounting methods.

9) New long term leases.

10) Contracts entered into which restrict retained income or working capital.

11) Stock or other options given, received or exercised.

12) Pension plans adopted or modified.[20]

This list should serve to show some of the many different situations which need to be disclosed.

The problem now is to find the information. One of the most valuable procedures is a conference with the company's officials and a review of the statements. This will help the auditor to decide if the over-all picture has changed materially as a result of recent developments. In a large company or corporation "usually a conference at the company's main office should suffice for this purpose, and it should not be necessary to send staff accountants to every location visited in the audit".[21] Other procedures recommended by the Committee on Auditing Procedure are:

1) The reading of available minutes of stockholders' meetings, meetings of directors, and financial or executive committee.

2) Readings of such available interim financial statments as regularly prepared by the client.

3) The reading of the prospectus and review of pertinent portions of the rest of the registration statement.

4) Questioning of officers, employees and legal counsel.

5) Any other steps which the auditor deems necessary for a "reasonable investigation" under the particular circumstances.[22]

The auditor, if he has knowledge of post-balance sheet events or transactions which may be significant in relation to specific financial statements, has a duty to either, (a) see that they are put in statements, or (b) if they are not in the statements, to qualify his report or give appropriate information in it.

Here are some other areas of disclosure with which the accountant must be concerned. When an income statement is being prepared for an interim period and the income and expenses of the business are not evenly distributed throughout the fiscal year, then a footnote must be attached to disclose that this statement may not be indicative of the yearly earnings rate.[23] If a company has discontinued an important division of its branches, this fact should be disclosed.[24] The Securities and Exchange Commission has said the purpose of the income statement is to show the result of operations for the period. New higher costs for the next period do not necessarily need disclosure, but in some cases disclosure should be made.[25] If a company has few customers, say for example only two or three, this fact should be disclosed. The value behind this can be easily seen, because if one of the customers should change suppliers, sales would be cut by one third. When a company's profits are declining, this should also be disclosed in the statements.

Other areas needing disclosure are long term leases and purchase lease agreements. The committee on accounting procedure stated that if the amounts involved are material:

> a) Disclosure should be made in financial statements or in footnotes thereto of:
>
> 1) Important obligations assumed.
>
> 2) The amount of annual rentals and periods for which they are payable.
>
> b) The above information should be given, in the year it originates and also for as long as the amounts are material.
>
> c) In addition, in the originating year, there should be disclosure of the principle details of any important sale-and-lease transaction.[26]

In differentiating between long term and short-term leases three years is the period used to distinguish the two. When the lease is in substance a purchase, the property should be included among the assets of the lease. In accounting for this type of lease, it should be treated simply as a payment of an obligation and interest thereon.[27]

With conglomerates and diversified companies have come new problems for readers of financial statements. Completely different products, sales and expenses are lumped into these statements, making the statements unsatisfactory to the reader. Various suggestions have been made including sales broken down by the different division,[28] sales quantity figures,[29] and a figure for sales at last year's prices.[30]

The Accounting Principles Board is studying the problem and, until they make a definite pronouncement, have given these interim recommendations.

> For the present the board urges diversified companies to disclose voluntary supplemental financial information as to industry segments of the business. Some disclosures which are now being made are:
> a) Revenue by industry activity or type of customer.
> b) Revenues and profits by seperatable industry segments.
> c) Seperate financial statements of segments of the business which employ distinctly different types of capital structures.
> d) Revenue by industry activity, together with a general indication of the profitability of each category.
> e) Information that the operations of a segment of the enterprises are resulting in a loss, with or without disclosure of the amount of such loss.[31]
>
> The board believes that the experience derived from voluntary disclosure efforts, together with the conclusions to be derived from research activities and further study, should provide it with a sound basis for making a definitive pronouncement in the future on the need for, and extent of, disclosure of supplemental financial information by diversified companies.[32]

Until the board comes out with its pronouncement, the companies will have to determine their own disclosure policy.

With all this talk of disclosure, can there be too much disclosure? Yes, there can be. "What constitutes a matter requiring disclosure is for the independent auditor to decide in the exercise of his judgement in the light of the circumstances and facts of which he is aware at that time."[33] Adequate disclosure calls for disclosing material facts, not just more detail.

"Evidence is plentiful that, as more notes, explanations, supporting schedules, and break downs are given, the more likely it is that the average investor or stockholder will be dissuaded or discouraged from even reading the statements and supporting data, let alone studying them carefully enough to understand them."[34] When the accountant does over-disclose, matters of importance tend to be overlooked among matters of relatively little importance.

Over-disclosure is not a recent problem, as seen in Associated Gas and Electric Company, 11 SEC 1026 (1942), where the court said too much detail may become a source of confusion.

There are instances where disclosure should not be made, for example, the accountant does not have to disclose a contract if it would impair its value, and is not necessary for the protection of investors. "The social interest may be served by permitting the withholding of relevant information in those cases where it would not be in the public interest to make full disclosure, even though such withholding might make the report biased or lacking in relevant data."[35] An example might be if the company is involved in a suit, making a reserve for the possible loss might give bad publicity and be harmful to the company. Rule 0-6 of the Securities Exchange Act states that no document may contain information that has been classified or determined by an appropriate department or agency of the United States government to require protection in the interest of national defense.[36]

# CHAPTER III

## ACHIEVING ADEQUATE DISCLOSURE

To achieve adequate disclosure the accountant must evaluate information against two tests.

1) Its relative materiality in the particular circumstances and,

2) The extent to which it makes the statements less useful because of complexity.[37]

As much of the information as possible should be put in the statements themselves, not in notes to them. Wordiness should be avoided, clarity can best be obtained by being as brief as possible while still giving full disclosure.

Four examples of disclosures that should be made are:

1) In depreciation:

   a) Expense for the period.

   b) Balances of the major categories of assets at balance sheet date.

   c) Accumulated depreciation.

   d) Method or methods used to figure depreciation.

2) Pension plans:

   a) Statement plan exists, describe groups covered.

   b) Statement of the accounting and funding policy.

   c) The provision for pension cost for the period.

   d) Excess, if any, of the actually computed value of vested benefits over the total of the pension fund and any balance sheet pension accruals, less any pension accruals, less any pension prepayments or deferred changes.

e) Nature and effect of significant matters affecting comparability.[38]

3) Restrictions on retained earnings, working capital, or financial operations in the bonded indentures or preferred stock should be disclosed.[39]

4) Items not in the regular or normal activities of the business, for example loans to officers, tax refunds.[40]

How should disclosure be made? In the statements themselves if possible, or disclosure can be and frequently is, made in notes attached to the financial statements.

The following are some examples of disclosure made in the statements themselves. In the income statement, disclosure is made of material nonrecurring or unusual gains or losses. Changes in costs or price changes can be made in the statement also. Long term leases, accumulated depreciation, and contingencies can be shown on the balance sheet. Differentiating between current and long term assets and liabilities is disclosure.

Adequate disclosure can also be made by use of footnotes. Footnotes should not be considered improper, they are essential and often actually the only way of presenting the facts. Footnotes can be categorized into three broad areas.

1) Financial data which is not included in the statements.

2) Accounting information which may be required to interpret the statements properly.

3) Extraneous matters which may be essential to the readers attempting to use the statements.[41]

There are four principle types of notes of explanation.

1) Notes made to provide additional factual details beyond those which may be feasibly incorporated in the statement describing a company's depreciation policy.

2) Notes made to provide interpretation as an aid in appraising the significance of items in the statement proper as for example, a note stating the basis used in determining cost of inventories.

3) Notes to provide facts which by convention are not included in the statement proper as for example, a note giving the amount of cumulative unpaid dividends.

4) Notes made to explain the degree of uncertainty attaching to an asset or liability of material amount as for example, the state of a tax controversy with the United States Treasury Department.[42]

The balance sheet is usually the source of most of the references to notes,[43] but whatever the source, it must be remembered that footnotes are regarded as part of the statement itself.

"If disclosure cannot be made in the financial statements (including the notes) other methods may be used, e.g., the president's letter to the stockholders special communications to investors, and the like."[44]

## CHAPTER IV

## RESPONSIBILITIES CONCERNING DISCLOSURE

In regard to the auditor's responsibility for disclosure in financial statements, the third standard of reporting, mentioned earlier must be taken into consideration. His responsibility is directly related to this standard. Other rules and regulations which place responsibility on him are, rule number 5 of the Rules of Professional Conduct of the American Institute of Certified Public Accountants which states that when a member expresses an opinion he may be held guilty of an act discreditable to the profession if,

> a) He fails to disclose a material fact known to him, which is not disclosed in the financial statements, but which is necessary to make the statements not misleading, or
>
> b) He fails to report any material misstatement known to him to appear in the financial statements, or
>
> c) He fails to direct attention to any material departure from generally accepted accounting principle...[45]

The Securities and Exchange Commission, states concerning financial statements filed in connection with registration of securities, that the accountant is responsible for disclosure of material events occurring after financial statements are filed and up to the effective date of the registration.

This last rule again points out the importance of post-balance sheet disclosure and the responsibility the auditor has in this area. If the auditor finds events which would have affected his report and if he feels that there are persons who will rely on the statements, he should advise his client to disclose the new facts and their impact on the financial statements. If the client agrees with him, but declines to disclose data considered essential to a fair presentation or to incorporate it by reference in the notes, the independent auditor should provide the necessary supplemental information in his report, usually in a middle paragraph, and appropriately qualify his opinion.[46]

The following is an example of the afore mentioned paragraph.

(middle paragraph)

> On January 15, 1962, the company issued debentures in the amount of $___ for the purpose of financing plant expansion. The debentures agreement restricts the payment of future cash dividends to earnings after December 31, 1961.

(opinion paragraph)

> In our opinion, the accompanying financial statements, except for the omission of the information in the preceeding paragraph present fairly...[47]

If the report has been made and an event occurs, and your client refuses to make disclosure, the auditor should take the following steps.

1) Notification to client that auditor's report must no longer be associated with the financial statements.

2) Notify regulatory agencies that the auditor's report should no longer be relied upon.

3) Notify each person known to you to be relying on the report.[48]

If the accountant is unable to notify persons he thinks might rely on the report, notification of the regulatory agency is considered sufficient.

"The public accountant's examination should enable him to form an opinion not only whether the individual items in the financial statements as a whole are true and not misleading."[49] It must be remembered that the statements may be true, but also at the same time misleading for lack of information.

The Accounting Principles Board has issued specific rules for disclosure, for example, on disclosure of leases, events subsequent to the date of financial statements, and more rules are being developed to fit particular problems. The extent and method of disclosure will be spelled out by the board.

# CHAPTER V

## CONCLUSION AND RECOMMENDATIONS

In conclusion, the growth in the use of notes to financial statements can be easily seen.

In the 1956 Accounting Trends and Techniques, it was stated that in 1955, 541 companies out of 600 included notes. The 1961 edition reported that in 1960, 580 companies out of 600 included notes, and in the 1969 edition, all 600 companies included notes in their 1968 statements. This shows the growth of disclosure, and also points out its importance at least to the companies surveyed.

As was stated earlier, responsibility for disclosure is a matter which, in the final analysis, rests on the accountant. He must decide what is material and should be included. In coming to his decision, the accountant should consider the two main groups using financial reports, the sophisticated present or potential investor (individual, company or pension fund) and the security analyst representing a bank or brokerage firm (the public's investment advisor).[50]

There will be more rules in this area in the future, and the accounting profession should welcome these rules because they will lead to increased comparability of financial statements.

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