SEC Historical Society

Deloitte Fireside Chat XI: Disclosure Effectiveness

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Dr. James McKinney: Good afternoon and welcome to today's Deloitte's Fireside Chat, broadcast on www.sechistorical.org. I am Dr. James McKinney, Clinical Professor in the Accounting and Information Assurance at the Robert H. Smith School of Business, University of Maryland, and moderator for today's program.

The Deloitte's Fireside Chat series is made possible through a partnership between Deloitte, LLP and the SEC Historical Society. Deloitte is a brand name under which tens of thousands of dedicated professionals and independent firms throughout the world collaborate to provide audit, consulting, financial advisory, risk management, and tax services to selected clients.

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Today's broadcast is the 11th in a series that began in 2009 to address current issues in financial regulation of interest to the accounting and auditing professions. All past broadcasts ranging from financial reporting to the role of professional judgment are available in the Deloitte Fireside Chats section under Programs in the virtual museum and archive. I had the privilege of moderating a chat in 2012 on international convergence. I am happy to share that more than 32,000 visitors to the virtual museum and archive have accessed one or more of these chats during or since broadcast. I encourage those joining with us today to check out the Deloitte Fireside Chats section at the conclusion of the broadcast. This series will be well worth your time.

Today's program will be looking at disclosure effectiveness. I am joined today by James Kroeker, Daniel Murdock, and Thomas Omberg.

Jim Kroeker was appointed a member and vice-chairman of the Financial Accounting Standards Board on September 1, 2013. He previously served with Deloitte LLP as deputy managing partner for professional practice. Jim also served as SEC Chief Accountant from 2009 to 2012.

Dan Murdock serves as Vice-President, Corporate Controller for Comcast Corporation. Prior to joining Comcast earlier this year Dan served as Deputy SEC Chief Accountant. He previously was Deloitte & Touche, LLP's audit/industry professional practice director for media and entertainment.

Tom Omberg is Deloitte's national manager partner – quality and professional practice network. During the early 2000s he was deputy controller for Bear, Stearns & Co.

Gentlemen, welcome. Let's go ahead and begin. Since we're starting, why don't we discuss why are we talking about this subject to begin with. Why are we discussing disclosure effectiveness today?

James Kroeker: I am happy to lead off. I think we're talking about it for a number of reasons. One, disclosure effectiveness potentially means different things to different people, and while I think there's some shared goals when people talk about disclosure effectiveness, at the highest level, it is that investors want the information they need in order to make informed capital allocation decisions. I think there's a mutual interest between investors and preparers—they want reduced cost of capital. I think at that level the system works well and has shared goals. When you get below that, I think there are differing perspectives about the amount of information that can be consumed by different types and different classes of investors, a different perspective on cost and benefits—at least at some level—and different perspectives of whether or not we have too much information provided today—and whether all of that information is material—or, in some cases, do we have too little information. Hopefully, we'll be able to explore that throughout the course of this discussion.

Daniel Murdock: From a more practical standpoint, the Jobs Act was passed a while back and it required the SEC to do a study of the costs of compliance with regard to registrants and disclosure. I think it's important to note this is not a new subject for us as a profession. I think it's one that we take off the shelf and talk about every once in a while, certainly something that the FASB has talked about in the past. I think the last time that it was discussed in earnest it ended up with more disclosure that was required around pension accounts. It's very timely today because if you look at the size of documents from years ago to where they are today, they just keep getting bigger and bigger. When you think about the cost of compliance, it's a good time to be having that discussion today.

Thomas Omberg: I think, as Dan mentioned, this is not a new topic; we've been talking about it off and on for 20-plus years. If you go back to the '90s, there was the Summary Annual Report that was supposed to help somewhat with disclosure effectiveness; unfortunately, it didn't. But as Dan mentioned, I think we've seen 10-K's, 10-Q's and other financial reports that are just getting longer and longer, and during that time we've also seen the reporting deadlines get shorter and shorter, and so I think the importance of talking about disclosure effectiveness is that as you shorten reporting deadlines and as you lengthen the disclosure requirements in the financial statements, it just creates more risk around how can you get a quality financial statement in the time allotted. I think it's really important we have this conversation now, not so much about whether we can reduce the number of disclosures, but how do we make sure the right things are being disclosed. I know we'll talk about that today and then hopefully at the end of this we'll say is something going to be different this time around than has come out of all the dialogues we've had over the last 20 or so years.

Dan Murdock: I think even the title is important to note that it's disclosure effectiveness. If you went back a couple years it started as disclosure overload and that sort of terminology fell away relatively quickly because I think, while the impetus of the conversation this time around has been cost of compliance and too much disclosure, not just from an inefficiency standpoint, from an effectiveness standpoint, if there's too much information you could get lost in the trees, so to speak. Part of this discussion, this conversation of the profession could very well lead to more disclosures, so if you think of something that the FASB has done recently with respect to revenue, that's an area that if you look historically was lacking in disclosures because there weren't many requirements, and so now there will be a lot of disclosures coming around in an area that you would expect a lot of good robust disclosure considering how important revenue is. Even in the title I think it's telling in terms of what we're trying to accomplish.

Dr. James McKinney: Why don't we talk about who actually uses this information. Who are the users of the disclosure that's being put out and what is the operable balance of information for each of those?

James Kroeker: From the standard-setting perspective, we need to think about users relatively broadly. I'll start with what's directly in our remand—that is, anyone using financial statements to make capital allocation decisions. That's a pretty broad group of people when you think about it. It could range all the way from individual equity investors who might be savvy and sophisticated, but with differing levels of sophistication and differing abilities to process information as compared to, say, a hedge fund manager or an institutional investor. You have equity capital on one side, debt investors, all the way to suppliers or even employees who might be making effective capital allocation decisions by going to work at a company, taking stock or taking a pension plan that might not be paid for, for years. You have a broad group of users just at that level, which is, I think, part of what makes this discussion so challenging.

Daniel Murdock: You can talk about it at two levels if you would. There's a way to talk about it at a very high level and I think about it with respect to the FASB that they have to serve all users. If you think about the institutional investors and the rise and the amount of money that's managed by institutional investors vis-à-vis the retail investors over the last several decades, we're seeing less and less direct holdings by the individual or the retail investor, sort of past investing or institutional investors. When you think about it from a preparer standpoint and how we prepare the document we're probably not so linear to say we are preparing this document for institutional investor or for a retail investor, but in terms of how we talk about it and think about it, it's more, I'll say maybe the Supreme Court definition of a reasonable investor. What I mean by that is there will be many of us involved in producing the document whether it's the 10-K, 10-Q or other information that we post on our website.

We asked ourselves the question, does this make sense to us? Intuitively to me that arrives at us essentially building the disclosure for a reasonable retail investor and individual investor. If it doesn't pass that test that's what causes us to go back and think, is that something that we really need or do we need more? I think from our standpoint in terms of how we prepare our documents or our disclosure it is focused around that individual investor, and I can also say that I think, coming in from the outside, it is the right approach because if you think about an institutional investor and the rise of technology over the last decades, there's no such thing as too much information. You can go from 50 pages to 500 pages and if you have the software you can just check the changes from one document to another, so there's never really too much information for an institutional investor.

Now a retail investor, somebody that we might know that tries to pick up the document and gets 500 pages, that's really pretty difficult. There's even a conflict of interest one might say between those two, because the institutional investor wants to manage the money of the individual investor. I think organically that's how it developed or from an outsider coming into the organization, being there a relatively short period of time, that to me is the right perspective is to build it for the individual investor, but I think that's fundamental in terms of how you approach the issue and how you hear about users' perspective with respect to can there be too much information. You have to decide which investor is speaking, is it the individual or the institution.

Thomas Omberg: I think Dan really hit on something. If you look at the scale and the depth of users and you look at how that's grown over the last 10 to 20 years, it's really grown significantly so then when you think about the disclosures that those investors are looking for and that those users of the financial statement are looking for, because they may not just be investors, they may be regulators, they may be agencies, they may be other parties, and so if you think about the depth of what they're looking for and the scope of really what they're looking for it's really quite significant. I think if anyone goes and just clicks to an investor's relations page on a big public company's website, you see just the dearth of information that's there. The 300 page 10-K is there, the 150 page 10-Q is there, but you've got earnings releases and you've got presentations that have been made to investor groups. There is really just a significant amount of information because the users of financial statements and of information, they just have an insatiable appetite. I think that gets us back to this challenge that we have of how do we look at financial statements and how do we look at regulatory filings and make sure that we've got the right information there without getting to the point that we've got overload. It really comes down to trying to understand what the users want and how can you provide that information in a way that they can actually use it to make the decisions they want to make or to draw the conclusions that they want to draw.

James Kroeker: The other point that Dan made is that, certainly from the perspective of a standard setter, we're thinking about the reasonable investor. The point is not any consumer of information, but sort of the middle: what is the reasonable person looking for? I think the point about information consumption has probably changed, even the expectation of what a reasonable person can consume if you compare the ability to consume information today as opposed to, say, 20 to 30 years ago. Even the reasonable person can probably consume more information given technology than they could, say, 20 to 30 years ago.

Daniel Murdock: There's overlap between the two investors, too, and that's part of what makes this all the more intriguing. At least in my discussions with institutional investors, they would similarly agree that if there's information that's really not going to change the outcome or move the needle they don't really want that information either, it's just that they don't necessarily have to sort of trudge through the 500-page document to get to it. You have what I would argue is both groups, if you look at them on a scale or a spectrum if you will, you have them both agreeing with respect to what they want and that's part of what makes this all the more challenging. It's a little bit like the Supreme Court Justice, he knows it when he sees it. We can all agree in terms of what should be there and what doesn't have to be there, but it's just so hard trying to articulate that and getting through the details whether it's cultural shifts or how things are written that gets us to the right answer. Again, that's what makes it all the more frustrating, all these groups, everyone, whether it's the standards setters, regulators, users, preparers, we all tend to agree as to what should be there and it makes it all the more frustrating in terms of trying to get to that answer.

Dr. James McKinney: Why don't we talk about where we should be going. What are some of the goals of disclosure, or effective disclosures for the preparers and issuers, whether the preparers are issuers or non-issuers for users, standard setters, regulators, and finally from the viewpoint of the auditors, what are their goals?

Daniel Murdock: Broadly I think we would all agree that the goal of disclosures is to provide timely, accurate, clear, and complete information to investors in just the way that Jim articulated with respect to making the best capital allocations as they can come to. I would argue that timely and accurate aren't really, if you think about what our goals are today, what I would consider in the main focus of disclosure effectiveness, and are probably not even complete. If anything we've got, depending on how you approach disclosure you approach it with more of a checklist mentality, then you've got completeness and cost that is associated. It's really the clearness issue, and so that's a lot of what drives us with respect to how we approach disclosure.

By way of example at our company, share base compensation is not a big number. There's probably two paths you can go down with respect to how we disclose share base compensation. The number is bigger than a breadbox but it's not something I would argue is that significant the way other companies may use share base compensation. You could provide every single disclosure that's numerated within the codification and I think really once you saw the number you would realize that those assumptions aren't really going to affect things too much if you're preparing a model. Or you could go a reduced route, and that's to the end of clarity. With respect to share based compensation, because it's not a material number to us, we disclose the amount of share based compensation so the user can understand how much there is, but then we provide abbreviated disclosures because we don't want to put all of that information in the document, because frankly it's just not necessary.

I would tell you that from a preparer standpoint, I think the discussion we're having today is really about that clarity point, both with using non-jargon language, more plain English where we can reorder things, try to putting accounting policies next to the footnote that has the numbers, trying to reduce redundancies between the forepart of the document and the back part of the document. I don't think it's as much if you look at our goals today around disclosure effectiveness, as much around timely, accurate or complete but more about clarity.

Thomas Omberg: I think when you look and you say what are the goals, Dan summarized quite well what everybody wants from disclosure effectiveness: how do we get timely, how do we get efficient, how do we get accurate, how do we get the relevant information that the users of financial statements and consumers of financial information want? I do think this topic has become a little controversial and that people automatically believe that disclosure effectiveness means that, all of a sudden, preparers are going to start taking things out and they're going to try to take a 300-page 10-K down to 150 pages. This really isn't about how do you minimize the financial disclosures that you're making; it's more about trying to figure out with the time that you have to get financial statements out, with the information that users of financial statements want, how can you drive a better more efficient set of financial statements that is more useful to investors.

Dan, you have a great example around stock; pensions are another one. The disclosures around pensions are extremely voluminous and many companies today no longer offer the old-style defined benefit pension plans. Is it okay for a company who perhaps has a pension plan that's in runoff mode to minimize those disclosures to a certain extent so that they can focus on what's really important to investors and to users of the financial statements? It's not about trying to say let's pare this disclosure down or that disclosure down, it's about trying to figure out what are the things that investors really want to understand and users of financial statements really want to understand at a deeper level so they can make the decisions that they want to make. Some of that is a little backward looking and some of that is forward looking. It's trying to find the right balance in the disclosures that makes those financial statements more credible and more relevant to the users.

Daniel Murdock: I've heard people describe it as going from compliance to communication. I think that's certainly a good way of describing it, but as Tom was talking what I wouldn't want people to lose on is that interaction with our investor relations department that any public company might have. If you think about it, and I'm totally agreeing with Tom, one reaction might be it's to reduce cost and take out these things that maybe aren't as significant, but what is significant are things that come in our investor relations departments, so as we finished an earnings release you may get calls about how does this work or how does that work. That's the input we take on a quarter by quarter basis and say okay investor relations, what kind of information can we provide in the document so you don't have to answer these kinds of questions, because you would rather not be having to answer questions about accounting or what assumptions did you use, etc. That's a dynamic process and to me once you can take out the details and focus on the things that are most important then that makes it a much more effective process where we're all focused on those things that are most important.

James Kroeker: That's just a little bit from what we're doing—or what we're focusing on—as we think about disclosure effectiveness. Just peeling that down a layer—and I think Dan said it well, and I think Tom effectively made the same point—are the goals of "timely" and "accurate." Those two factors actually compete against each other. I could give you an exceedingly accurate and long document if you gave me a year to produce it. If you gave me ten minutes, the accuracy is going to go down but the timeliness increases. I think part of that is balance, and we've had a longer list of just absolute requirements in shorter time frames, as Tom has said. I think investors are not going to accept less timely information than we have today, so that's off the table, at least from my perspective. So with those time constraints, how do we get to a system that allows you to focus on the important information? Dan describes stock compensation or share based payments, and in our newer standards, we have tended to have—just from a FASB perspective—a longer list of absolute requirements.

That standard happens to have an objective that seems fairly simple, and goes on to say in meeting that objective that, “at a minimum, you shall do the following.” I don’t think this is a significant overstatement that goes on for a page plus, in terms of the original pronouncement of “here are the things that, at a minimum, you shall do.” That’s been the trend, and I think that’s helpful in terms of making sure people comply with the objective. But then, when that standard doesn’t apply at a particularly significant level, if we’re going to do that in an increasing pace at the FASB, providing some flexibility if those disclosures aren’t material to you, you don’t need to spend a lot of time providing that information.

We recently issued an exposure draft that would say just that: that if a disclosure is immaterial, you need not provide the disclosure. I will be very interested in the feedback, but that’s really the objective: how do we focus on the material? We have some standards where there are very few disclosure requirements and the topic could be exceedingly important. Revenue was one, prior to the new revenue recognition standard. Go look at GAAP, and try and find the mandated disclosures for revenue—they were pretty short. I suspect that, of all things investors are interested in, it’s going to be revenue, and companies that tell you they have immaterial revenue have bigger issues than their accounting books and records—they probably have fundamental issues. How do we have that balance of providing a greater level of detail where it’s important, but also the flexibility to move forward and not threaten anything material?

Daniel Murdock: I don’t know that we could have a discussion today, and I’ll say this as a former regulator, that technology is an aspect of this. If you think about what is available electronically today from the SEC is essentially a paper format, it’s an electronic format of a paper 10-K. How much opportunity do we have by enabling technology. I am sort of speaking from the way a regulator might look at this, but that’s a part of the equation. If you look again to where we were 10 or 20 years ago and where we’ll be in 10 or 20 years, I think there’s a lot of value that can be unlocked from there. If you think about timely, we’re moving to a faster and faster consumption of information. So that’s I think certainly part of the discussion, the other part of the discussion is not just the base financial statements, but the forepart of the document and the discussion around the business or results, also the information that’s required of entities other than the registrant. Right now the SEC would have a requirement about which financial statements that you would have for a company that you acquire. One perspective on that might say well if the FASB has addressed that in the last 10 or 15 years with respect of business combinations, then do you defer to them and say they thought about it and they didn’t think private companies needed to have those financial statements, maybe albeit a standard or requirement that’s been in place a long time, maybe you look at it today and you don’t need it as much because of the disclosures that are required by the standards. It’s so big and the goals can be so varied even amongst the people here or if you had a regulator, whether it be of the registrant or the auditing profession. That’s part of the challenge in and of itself is trying to define and define a clear goal that we all coalesce around.

Thomas Omberg: Dan, one of the things, when you say, it’s so big. We can actually make it a little bit bigger because when we talk about disclosure effectiveness, we really talk about it in the construct of the existing framework that we have, regulatory and standards in the framework that we have. I do think that users of financial statements, consumers of financial data need to start to think about what information is really important to them, because a lot of what they see in a 10-K is historical and sometimes dated and so do they want to see real time sales data, do they want to see real time trade statistics for a financial institution for a broker? It's really thinking about it, if we're going to have a conversation about disclosure effectiveness then maybe we should have a broader conversation just around what is the information that the users and consumers of financial data want to see, and is what they're getting relevant. Non-GAAP disclosures have become the norm and in part they've become the norm because the GAAP disclosures aren't good enough for the users of the financial data. I think we ought to broaden it out and have a conversation beyond just the existing framework of what is the relevant information that the people want. If we get to the end and we solve for disclosure effectiveness but there's still this insatiable appetite for non-GAAP disclosures and further information, then we really haven't solved the core issue.

Daniel Murdock: And even this discussion is focused, you could say arguably there's maybe three broad buckets of disclosure and we're talking about essentially financial disclosure. Another one that is part of the SECs mandate is corporate governance type disclosures and then the third are sort of these public policy type disclosures that maybe don't necessarily fit neatly within the financial disclosures or corporate governance type disclosures, but nevertheless make their way into requirements. It would be helpful as a preparer to understand what is the document intending to do. If you look at it essentially as the 10-K's of financial document, other documents more corporate governance related, even the third sort of bucket of items interesting to get aligned sort of what the goals are.

James Kroeker: We have a work stream that is looking at least at part of that issue—again, at the FASB, our mandate being the financial statements—but even there you get into questions about boundaries and scope and damage, and whether information in the forepart is repeated somewhere else in the documents, or do you have something, a requirement in MD&A or risk factors and you have a similar but not identical requirement in the financial statements. The FASB historically has set disclosures at the very end of a project, so you spend years thinking about the debits and the credits and the double entry set of books, and you get to the end of the project and you say well what disclosures should we have. On the one hand you've got to start with the debits and the credits if you're going to do the accounting, but sometimes it's as simple as "this would be nice, so let's add this" and "is it really needed or what is the framework?"

We've established a framework to think about the boundaries of what would go in a GAAP set of financial statements. Some of the things you talked about are more forward looking. And absolutely important to investors from our perspective, we have proposed a disclosure framework that would say forward looking information really ought to be in MD&A or other spots in a document, not the least of which is because of the legal and regulatory environment in which we operate. It doesn't mean that there wouldn't be things forward looking in measures of financial statements, a fair value measure. Those disclosures might be in bounds, but really to try and be more structured of how we think about disclosures so you get consistency across topic, consistency across time and then, hopefully, a greater consistency of the boundaries of financial reporting.

Daniel Murdock: I would argue another goal of the regulator is probably to encourage us, and I'll say us broadly as the preparer community, but to avail ourselves of the tools that are already available to us. You've probably seen or heard people say that many of the forepart disclosure requirements are intended to be complementary, they are not intended to be duplicative so you don't have to lift literally the same footnote and put it into a different part. I think that's a lot of what the SEC has been trying to get the message out around is think about those things that you can already do as a preparer group. It is easy to look across the table at an auditor and say someone speculated, well is it the preparer that's not pushing it and really trying to get it done. You say look, be careful down that path because you might get the comment that says where's this disclosure, where's that disclosure, even though again we would argue that's the right thing to do on behalf of investors and certainly happy to get into a dialogue about it. There's some behavioral issues on a preparer's side, but behavioral issues on an auditor side that might be easy for me as a preparer to say, I wanted to do it but I wasn't sure if my auditor would let me. Easy to point to behavioral issues that an audit regulator might similarly say, it's very difficult to piece it apart, and the attorneys have their spot in that discussion as well, that might say it's the securities attorney that's encouraging you to put more and more because of the legal remedies that may afford you. I think from the SEC standpoint, that is a dialogue that they want us to continue to talk about and it's part of why I offer a perspective on share based compensation. Our auditors have been fantastic to work with and totally understand the perspectives that we're coming from. To that end we haven't had the same issues but I will tell you from discussions of other preparers that it's a very real concern. Why would you want to do this to yourself, why would you take this on, and that's where our perspective is, it's a responsibility. We can't approach this with a checklist mentality because that's doing a disservice to our investors. We have to do the best to make our document as much as of a communication tool as we can, it's not something that's really elective for us.

Dr. James McKinney: Now that we've established some goals and we have discussed this already but when we talk about disclosure challenges, what are some of the challenges from the different perspectives of the preparers, users, standard setters, auditors, what are some of the success stories that have been achieved by these different parties?

Thomas Omberg: I think Dan just hit on some of the challenges but frankly what I think are some of the checks and balances that are there, which is the tension that exists, the positive tension that exists in just a process where you have a preparer and you have an auditor and you have a regulator. Everybody is looking to make sure that there's the right level of tension that you get the right disclosure in the financial statements, and if you have a preparer who perhaps wants to minimize or who wants to use materiality thresholds, the auditor is there to make sure that we put the appropriate independent eye on that. The regulator is there to make sure that you've got the right tone in the system around that, and the preparers and auditors have responsibilities. I think there is that healthy tension that is in the system, but if you look and you say what are some of the challenges, that healthy tension also creates some of the challenges. Dan talked about a preparer who perhaps wants to go and take a fresh look at a disclosure and really ask the appropriate questions, is the disclosure meaningful, is the disclosure material, is the disclosure relevant. Sometimes that's a conversation that needs to happen between the preparer and the auditor and there may, in the course of that conversation, the preparer may say well it's easier for me just to make the disclosure. I don't think it means anything but it's easier just to make the disclosure or sometimes there's the fear of is this something I'll get a comment on later on if the SEC reviews my 10-K or my 10-Q, are they going to write a comment letter.

There's the I'll-over-disclose to potentially avoid having to deal with a comment down the road from a regulator without really taking a step back and thinking if a comment does come in and it's a well-thought-out process of we're not going to make the disclosure because it's not meaningful to users of the financial statements, it's not material and we have a strong basis for doing it. There is still a little bit of a hesitation in the system, and again this isn't about reducing relevant useful disclosure in financial statements, it's all about trying to make the financial statements more relevant, more readable, more understandable, more useful, but there are a lot of different parties that get involved. Sometimes it's easier to take last year's 10-K and roll it forward to this year's 10-K and update it for whatever happened this year than it is to take a fresh look and to say is this really needed.

We've seen some of the success stories, a lot of companies are beginning to look and say let's take a real good strong fresh look, not with the goal of cutting, but asking why are we disclosing the information we're disclosing. Are we disclosing because our pensions were relevant 15 years ago and they're not today, so let's go look and let's make sure we understand the regulations and the standards that require the disclosure, are those still current today, are they still relevant today and if not then let's make a change.

I think people having the ability to step back, look at something through a fresh perspective, with the right lens and then making sure that you've got the right culture in the organization that again this is about making the document a better document and this is about giving something to users of the financial statements that allow them to better understand the company and what's going on with the company.

James Kroeker: I think the discussion today has been one, and I think you described it right as, by and large, the healthy tension that exists. I think on occasion you actually get into a level of mistrust. There is a healthy tension, but when something goes wrong—let's say even in the best of circumstances—somebody had to disclose any contingency that was reasonably possible of being material, and somebody with hindsight got that judgment wrong, that could breed distrust. Or maybe it's not so healthy when somebody actually has the assessment but is hesitant to disclose. I think that's a minority of situations, but when that happens, I think that breeds mistrust between an investor community who wished they had that information when they made their investment decision, and at the other end I think we're talking about a very reasonable auditor and preparer today. There are a small number of preparers who say I just want to scale back the document to scale it back, and so when you get those two ends of the spectrum in the debate…that does make it more challenging. Again, I would describe it, by and large, as a healthy tension. But that's an aspect or another challenge from a standard setter standpoint and I will get into what I think is one of the successes: really, how do we get behind the costs and benefits of disclosure.

It's very easy at one level to understand why something could potentially be useful but how would an investor actually use that in an analysis and would it move—or would any individual piece of information that you're thinking about requiring a disclosure on average—move the dial? We can think about that intellectually, but getting actual investors around the table to say how they would use this, and then getting preparers to really help us understand what the costs are. If we do something this way—what is the absolute cost of this?—it's very challenging. One of the success stories I think we've had in doing that was in our revenue recognition standard where we had articulated a much longer set of disclosures. Investors, by and large, were satisfied. They're not going to say it was too much, but preparers did have some concern about the cost of particular disclosures. We actually got a group of preparers and investors in the same room and around the table. Investors said "I absolutely need this," and companies would articulate the cost and ask "what is it you're actually looking for?" We're not trying to hide anything here, but let us tell you the cost that's involved in doing that—is there something else that might be done more effectively or efficiently to get you what you're looking for? I think getting the affected groups around the table—and that includes auditors as well, because what is potentially achievable by a preparer—you then have to think about the audit and the regulatory environment around that as well. Can the audit actually be done at an effective level at the same time?

Daniel Murdock: I will come back and maybe amplify a point that I made, but both Jim and Tom talk about healthy tension. I think this is a message frankly that we hear from the SEC but that needs to start with the preparer. If the preparer starts with a let me just roll the document forward, it's compliant and it's got the full set and it's got everything it could possibly have, I would argue that there's one piece of tension missing because it's our document to prepare. So if that's what we think, it's not really the auditor's place or the regulator's place to say you have too much information, you're not going to get a comment letter from the SEC that says please take out these disclosures. While I would agree with Tom and Jim in terms of the ideal that healthy tension is built into this system, and that's a good way to design the process. It has to start with the preparer taking up the charge to try and turn that document into something that's more meaningful arguably, and that without that that healthy tension won't exist. I am agreeing with you, we might differ with respect to how much that healthy tension exists around disclosure. I think it would be for it to exist more with preparers initiating that conversation about removing some things.

Thomas Omberg: Jim you talked about bringing in users and having a conversation around how they're using the information and I do think as we go down a path of disclosure effectiveness that forms like that are really going to be crucial and not just users, but users and preparers. I frequently hear from preparers when we talk about disclosures I frequently hear from them, yes I understand it's required and the numbers themselves may be material but no one has ever asked me about that information. Now I don't take the no one has ever asked me about the information in footnote 10 to mean if you took it out nobody would notice, because maybe it's crystal clear to the people who are reading it and they rely on it and they really use it in the analysis that they do. It's also possible that no one is using that information at all, and again, if we just look at relevance over time, and information that was probably relevant 10 or 15 years ago may still be relevant today but it might not be. I do think that as hard as it might be trying to find the forum to get users and preparers together to really go through and make sure that we're disclosing. At the end of the day, these are all choices that have to be made. There isn't an infinite amount of resources or an infinite amount of time to put together a set of financial statements or to put together a 10-K and so we've got to be mindful about making sure with the time constraints that are there and with reasonable resource constraints how do we make sure that we're getting the right and best information, recognizing that there are some users of financial statements that want every piece of data they can possibly put their hands on. I don't know that we can build a disclosure model that would fully satisfy that group but making sure, to Dan's earlier point, of figuring out who the right users of the financial statements are and really on almost a continuous basis looking at those disclosures, again not to make them shorter but to make sure that things are no longer relevant or coming out and the reality is when that happens there are probably things that are relevant that we need to think about getting at.

Daniel Murdock: We touched on that point but I think it's worth saying again, it is not just a cost play to do this, in fact what our experience was is that there is a cost any year that you give it a fresh look and we did that a few years back, share based compensation was one of them, derivatives was one of them and pensions disclosures, as Tom pointed out, was another one. But it takes time and it takes effort and work in that year to document your conclusions which is typically in our example pretty static items so it won't bear much updating in the future years. But in that year that you give it a fresh look it does take time, we make sure we document our conclusions and build processes around them so we can keep track of them over time. In that year certainly wouldn't have been less expensive to do what we did it would have been less expensive to just roll the dice, commit, and put everything in, but again we do it for the purposes of clarity and certainly there will be benefits going forward because the less things you have obviously there will be less cost. Just to sort of state that point again, it's certainly not cost beneficial in the year that you give it that fresh look.

James Kroeker: Just to go back to a point you made, Tom. As a standard setter, I think we have every incentive to bring preparers and investors together. I think you get a better end result. We just talked recently about improving tax disclosure, and there's been a lot of interest currently in the disclosures around tax and having a forum with preparers, auditors, and—most importantly—getting users at the table as part of that discussion. As I said, it improves the package but selfishly, as a standard setter, it also helps acceptance if the parties are taking to each other. That's because we're not in the middle saying "users told us this"—we can do that, but it's much more effective when other people are hearing that discussion and somebody then pushes back on "why didn't a preparer want to provide this?" or of drilling down on what is the real cost. I think the acceptance between all parties has also helped when you can get people talking directly to each other.

Dr. James McKinney: I was speaking of FASB and the initiatives of FASB. FASB recently proposed some changes to the materiality definition of the cost of statements. Around the same time the SEC put out some request for comments on disclosure within the Regulation S-X. What are the impacts of disclosure of these two different initiatives?

James Kroeker: I can start with the document that we recently issued, an exposure draft on materiality. We really issued two exposure drafts—one was on our concept statements. We have a conceptual framework going back to the very beginning days of the FASB in the early '70s. Concept Statement 2 had a definition of materiality—it was very closely aligned with the

Supreme Court definition. Loosely, it said something would be material if it were probable that it would change effectively the total mix of information to investors. It's a loose paraphrase, but it was very aligned with the Supreme Court definition.

Around 2010, we updated our concept statements to align our definition with that of the IASB. We issued Concept Statement 8, which actually changed the language in materiality. We had a definition that talked about material being something that could impact an investor. Our conceptual framework is non-authoritative— it's really how the board thinks about materiality in setting standards. It was never intended to be a tool for preparers, per se, to think about materiality. The SEC since then has provided guidance in a staff accounting bulletin that really aligns with Concept Statement 2. The FASB's current proposal on the concept statement is really to move back, to eliminate the FASB definition and to say that the Supreme Court definition that was aligned with the old definition is really how the board should be thinking about materiality as it sets standards. Of course we're not making assessments of errors, we're thinking about what types of information ought to be, as a starting point, broadly relevant to people.

The second piece is our second exposure draft, which is more operational, and indicates that materiality is a concept that's long been in GAAP. If you have historically followed the FASB, you may recall that the end of every pronouncement, pre-Codification, was a little box that said "the provisions in this standard need not apply to immaterial items." That got brought in as a single statement into the Codification that says "this is really clarifying as it relates to disclosure, if you don't apply the standard to an immaterial item, it is not an accounting error." A piece of that as well is to think about how prescriptive we want to be—or do we want to provide for flexibility and scalability? Do we want take out where we've said in standards like share based payments "you shall disclose at a minimum…", or to continue to provide lists of disclosures but not have statements that would limit flexibility such as at a minimum which caused people to think "I can't omit any of these even if they're not material." That was never the intended effect, but we see that behavioral effect. That's an exposure draft that just recently went out, so obviously this interview will be around for history, but if you're listening now, please provide your comments.

Thomas Omberg: I think on the FASB proposal there's been a little bit of controversy over is this, giving corporate America the ability to not disclose things that they previously would have been required to disclose. As Jim said I think it's clarifying with some of the intent around disclosure, certainly if a disclosure is material under any reasonable viewpoint that the disclosure is required. I think there is some other knock on impacts such as do you need to tell audit committees about disclosures that might have been in FASB standards but weren't made because a company made a determination they weren't material. I think this helps to clarify that under the proposal if it's not material you don't have to make it. To the extent that you don't make it's not considered to be an omitted disclosure, it's not considered to be any sort of an error in disclosure. I do think there's been controversy that perhaps this is going to allow companies to not disclose things. I don't think that was the intent, I don't think that will be the outcome, I think it just clarifies what most people believe to be practice. I think it's good, I think from FASB's perspective it will help in this clarification and that's positive.

As it relates to the SEC, I think the SEC is also, they are embarking on a look at disclosure effectiveness broadly, this is the first request for comment that they've come out with on an item that could be viewed as narrow. Do you have provide financial information on an entity other than the parent companies, so if you're acquiring a company do you need to provide information on the company you're about to acquire, if you have an equity method investment do you have to provide financial information about the investee. It's really asking for comment about how is this information used, because again getting back to the conversation we were just having are users of the financial statements really using this information and let's understand how they're using it so we can make sure that the disclosures that are being provided are relevant and useful because many of these disclosures are quite time-consuming for preparers to put together and for auditors to audit so let's make sure that those who are using it are really using it, are there tweaks that can be made to it or significant changes that can be made to it to make it more useful. If by in large in some instances they're not looking at it then we ought to think about whether we're providing it.

I don't think this is a view of trying to take information away from investors. My sense is that if investors report to the SEC that this information is very useful and here's how they use it and here's why they need to continue to get it that that voice will be heard. I would encourage everybody to comment on the proposal from the SEC. Again I think it's all about trying to understand how do we make sure we've got the right information out there for the public and the users and consumers of financial data to use in the analysis that they do and not in an attempt to keep information from investors or users of financial information or just arbitrarily shorten the financial reports.

Daniel Murdock: What's interesting to me about the materiality discussion in particular, what Jim went through with what the FASB has recently discussed, is where we sit today and different from where I would hope we would sit in the future is we use the term materiality, we use it so frequently and yet I think there is such different views on what that term means, and maybe it's derivatives. While we can all probably look at the Supreme Court definition of materiality and understand it when you look at the inverse of that which is material, it's a little bit like talking about contingencies and what's probable at one end and remote at the other. You wouldn't just say that there's probable and improbable because there's lots of layers underneath improbable.

It might be more likely, not, possible, remote, and so there is material and then there's immaterial and I can't say I remember it but Chairman Williams spoke to the AICPA in 1981 just after the Foreign Corrupt Practices Act was enacted and there was a little bit of the same chronic concern, because now there's books and records requirement. If you look at it you could say gosh, what do I have to pay attention to? Do I have to pay attention to literally every penny that I spend as a company? That would be so costly it would be inoperable, and in that speech he described there is essentially three levels.

There's a deminimis and then there's a reasonable level where you keep your books and records, and it explains in that speech that it certainly wasn't meant to be at the material level because if you kept your books and records for payments to foreign officials at the material level there would be so much that wouldn't be effective. It also wasn't meant to be at the deminimis level that you're sitting around worried about pennies if you will. To me that's a little bit of the disclosure discussion that in practice, I think we all know that we're not talking about the close calls. If something might be material that gets in the document, everyone errs on the side of conservatism.

We are literally talking about things that are so obvious that you're embarrassed to bring them to the audit committee. These are items, and you can say it stems from having a single view of materiality as if it could be reduced to a number, which no matter how many times we talk about it cannot be, but if you did reduce it to an individual number the income statement and the balance sheet are two fundamentally different statements. The balance sheet is large and it's a big brother, and so if you base it off the income statement and reduce it to a numerical threshold then you could be bringing things to an audit committee on the balance sheet that's billions and billions of dollars that are clearly deminimis.

I applaud the FASB for taking the step that they did and it starts the conversation which can always be a touchy conversation, but I think a good one and an important one, because I wouldn't want people to get the feeling that all of a sudden there are all these close calls that will not be disclosed. That's not at all what it is like in practice, it is these things that are clearly immaterial where institutional investor, retail investor, regulator, auditor, preparer, standard setter all looks at that and says really is that sincerely what we're talking about. It's much easier than it sounds from this sort of high level discussion.

James Kroeker: Dan, that is a perfect point. This was not intended to take important information, the close call, and take that away. There are safeguards in the system that exist and will continue to exist, and it's a little bit like the bad story that gets told a hundred times and the great story gets told to two or three people. You hear stories of the corporate boardroom of having to go to the audit committee with things that just don't matter and it gets replicated into people spending time on the unimportant, and they could be reallocating that time to the important. As a standard setter, I don't want people spending time on unimportant things. Let's move on and go to the important—and that's really the objective here. One of the safeguards is if you were concerned that this was about the borderline significant, and the auditor has an obligation to take close calls to the audit committee in any respect, meaning sort of the significant judgment. If you had a close call, if you had a company that says "I don't want to do this close call in that rare circumstance," the auditor has already got a governance response to involve folks.

Daniel Murdock: While that is said in the spirit of the FASB, if you look at the SEC's invitation to comment about financial information of people other than the registrant, one of the rules in there is Rule 3-10 that provides relief to companies that might have an issue or debt that's a subsidiary, but if it's 100% and meets certain conditions then you can avail yourself of this rule and not have to provide standalone financial information of this 100% owned entity that you issued a guarantee to, and you can instead put that information in a condensed consolidating format in a footnote. I think is a very good rule with respect to trying to provide some common sense and some cost of compliance relief with respect to that particular topic.

As they look at that rule, I think it's a good one, I wish more people could get into it because the 100% owned is a particularly high test and a bright line and one in particular that we think as a result of the way that we have organized our subsidiaries we ought to be able to avail ourselves of, but that to me is another example of one that's not even a close call. Although the text would not allow us to avail ourselves of that particular rule, when you look at it and you can explain it you say this isn't even a close one, you are indifferent to the financial statements of that subsidiary. While albeit too technical for this discussion it's not the close calls, it's the ones that everybody can look around the table and say we clearly don't need those disclosures.

Dr. James McKinney: We are coming to the end of our discussion. If we were to look at disclosure effectiveness a year from now, what might we be discussing then?

Thomas Omberg: I think if we look out a year from now we can say that we've been successful if we've advanced the dialogue, and I think as Jim mentioned if we bring more people to the table, if we get users, preparers, auditors, standard setters and regulators to have a full conversation around what really is relevant, what really is important, what really is needed. Again I have said it repeatedly, we're not focused on how to bring down the number of pages, we're focused on how to make sure what's there is high quality, recognizing the time constraints that exist in getting financial statements out and the deadlines for getting them filed. My hope is over the next year we can start that. The SEC and the FASB have both put forth some modest proposals that should allow us to start that dialogue in good faith together to move forward with the goal of continuing to have the highest quality financially reporting in the world and let's go execute disclosure effectiveness as that as a backdrop.

James Kroeker: I would agree with that—and if you look at not just the proposals we've talked about, but also how we have finalized significant increases to disclosures around insurance companies. Short duration insurance is an area where investors said they really would like a greater understanding of historical loss patterns. We got that done. We also have proposals that we're close to on income tax disclosures and on fair value disclosures—an area where people have called for a look at whether or not the volume serves everyone, not necessarily the largest financial institutions. We've got those, and I hope we make real progress there, and I think thinking about materiality is going to be critical to the success of being more prescriptive in some areas to get to the material but providing that flexibility. I hope we can move that in a year.

Daniel Murdock: I'll be a bit of a wet blanket. It took decades to get here, it will take a long time to get out of where we are, if we're still talking about disclosure effectiveness in a year, I think that's success.

Dr. James McKinney: Great. I guess we are coming to the end of this discussion now. First of all I would like to thank Jim, Dan, and Tom for their insights and for sharing them. I should note that their views are their own views and not of their organizations, their current organizations or their past organizations.

I hope that as an audience you have found this to be an informative discussion on disclosure effectiveness. This program will also add to the valuable body of knowledge in the program series. The audio of the broadcast will be available soon in the virtual museum and archive and an edited transcript will be available later.

On behalf of the SEC Historical Society, I would like to thank Deloitte LLP again for their generosity and assistance in making today's program possible. Remember you can go to www.sechistorical.org to find the previous Fireside Chats. Thank you for joining us today and have a good afternoon.