



Disclosure effectiveness

What companies can do now

October 2014

The EY logo consists of the letters 'EY' in a bold, black, sans-serif font. The 'E' and 'Y' are connected at the top. The background of the cover features a yellow diagonal stripe and a series of vertical lines on the left side.

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Introduction

Overview

With regulators and standard setters now looking at how to make corporate disclosures more effective, companies can take steps now to make their own disclosures more meaningful.

The problems with disclosures are well known. As the volume of disclosures has grown,¹ regulators and financial statement users have repeatedly said that disclosure documents contain too much boilerplate and are so repetitive that it is difficult for investors to find the most important information. Meanwhile, some investors and other users have called for new disclosures or improvements in existing ones.

Companies that have successfully streamlined their disclosures by focusing on relevant and material information cite many benefits, including:²

- ▶ Increased investor confidence due to communication of more meaningful information
- ▶ Greater efficiency in preparing investor communications and auditing disclosures
- ▶ Improved coordination throughout the organization, including the board of directors, and with regulators and external advisers
- ▶ Strengthened market reputation and leadership

Companies that want to make their disclosures more effective will need to consider time, cost and resource constraints, as well as regulatory disclosure requirements. Developing appropriate processes to enhance disclosures often requires planning and support from executive management and the Audit Committee; outreach to investors; and coordination with lawyers, auditors and other advisers.

It may be more productive for a company to target specific disclosure areas that are particularly complex or lengthy rather than start with a blank sheet to rewrite the financial statements and SEC reports. We believe both preparers and users are best served when there is sustained focus on improving the quality of information provided to investors.

This publication discusses how companies might consider making their disclosures more effective. It highlights our recommendations, along with illustrations that may help companies take steps to improve their disclosures.

“When disclosure gets to be ‘too much’ or strays from its core purpose, it could lead to what some have called ‘information overload’ – a phenomenon in which ever-increasing amounts of disclosure make it difficult for an investor to wade through the volume of information she receives to ferret out the information that is most relevant.”

– SEC Chair Mary Jo White³

¹ In an EY study, we found that the average number of pages devoted to footnotes and management’s discussion and analysis in the annual reports of 20 well-known companies quadrupled from 1992 to 2011. See our [To the Point](#) publication, [Now is the time to address disclosure overload](#)

² Center for Audit Quality, [Financial Statement Disclosure Effectiveness: Forum Observations Summary](#)

³ [The Path Forward on Disclosure](#), National Association of Corporate Directors – Leadership Conference, 15 October 2013

Disclosure effectiveness initiatives

The Securities and Exchange Commission (SEC) staff is reviewing the requirements of both Regulations S-K and S-X to identify ways to reduce the costs and burdens on companies while still providing material information to investors.

The initiative grew out of a December 2013 study of disclosure requirements in Regulation S-K, which was required by the Jumpstart Our Business Startups Act. In this study, the staff of the SEC's Division of Corporation Finance recommended that the SEC undertake a comprehensive review of the existing disclosure requirements. SEC Chair Mary Jo White has called the disclosure effectiveness initiative a priority and has directed the SEC staff to make specific recommendations this year.

Reducing the volume of disclosures is not the SEC staff's sole objective. If the staff identifies potential gaps in disclosure or opportunities to increase transparency, it may recommend new or enhanced disclosure requirements. It also will consider how technology and cross-referencing can promote these objectives.

The SEC is encouraging companies, investors and other market participants to submit their views on how to make disclosures more effective. Suggestions can be submitted through the spotlight page on the SEC's website.⁴ The SEC is expected to issue one or more concept releases later this year to seek public input.

The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) also are seeking ways to improve disclosures in the financial statement notes.⁵

The FASB has proposed adding a new chapter to its conceptual framework in an effort to improve the process for establishing new disclosure requirements and evaluating existing ones. In addition, the FASB will be revisiting certain disclosure requirements (e.g., for pensions, fair value measurements, interim reporting) in narrow, short-term projects. The FASB also is working on a project to provide guidance on the decision process companies should employ for evaluating what disclosures to make.

The IASB also is taking steps to improve disclosures, including:

- ▶ Identifying a set of principles that would inform the organization, format and linkage of information in financial statement disclosures

⁴ <http://www.sec.gov/spotlight/disclosure-effectiveness.shtml>

⁵ The primary advisory committees of the Boards, [Financial Accounting Standards Advisory Council \(FASAC\)](#) and [IFRS Advisory Council](#), also have highlighted disclosure initiatives as top priorities.

- ▶ Reviewing existing disclosure requirements to identify duplication and overlap
- ▶ Researching how materiality is applied in practice and considering whether further guidance is necessary

The following EY publications provide more information on these initiatives:

EY resources

- ▶ [SEC in Focus, Issue 4](#) (SCORE No. CC0402), October 2014
- ▶ [Financial reporting briefs](#) (SCORE No. BB2827), September 2014
- ▶ [SEC in Focus, Issue 3](#) (SCORE No. CC0396), July 2014
- ▶ [Applying IFRS – Improving disclosure effectiveness](#) (EYG No. AU2513), July 2014
- ▶ [To the Point – A framework to help the FASB establish effective disclosures](#) (SCORE No. BB2707), March 2014
- ▶ [To the Point – SEC staff recommends a comprehensive review of SEC disclosure requirements](#) (SCORE No. CC0386), January 2014
- ▶ [To the Point – The SEC's opportunity to consider disclosure overload](#) (SCORE No. CC0359), October 2012

In addition, several other regulators, standard setters and organizations around the world are undertaking similar disclosure effectiveness projects. These projects are summarized in the appendix to this publication.

“[O]ur goal is to both improve disclosure content – make it more useful to investors – and at the same time, where we can, reduce the amount of disclosure content ... The framework is designed to lead to disclosures that clearly communicate the information that is most important to the users of the financial statements.”

– Russell G. Golden, FASB Chairman⁶

⁶ [Remarks of Russell G. Golden, AICPA Conference on Current SEC and PCAOB Developments](#), December 2013

The SEC call to action

While the SEC staff is reviewing the SEC's disclosure requirements, staff members also are asking companies to proactively enhance their disclosures by:

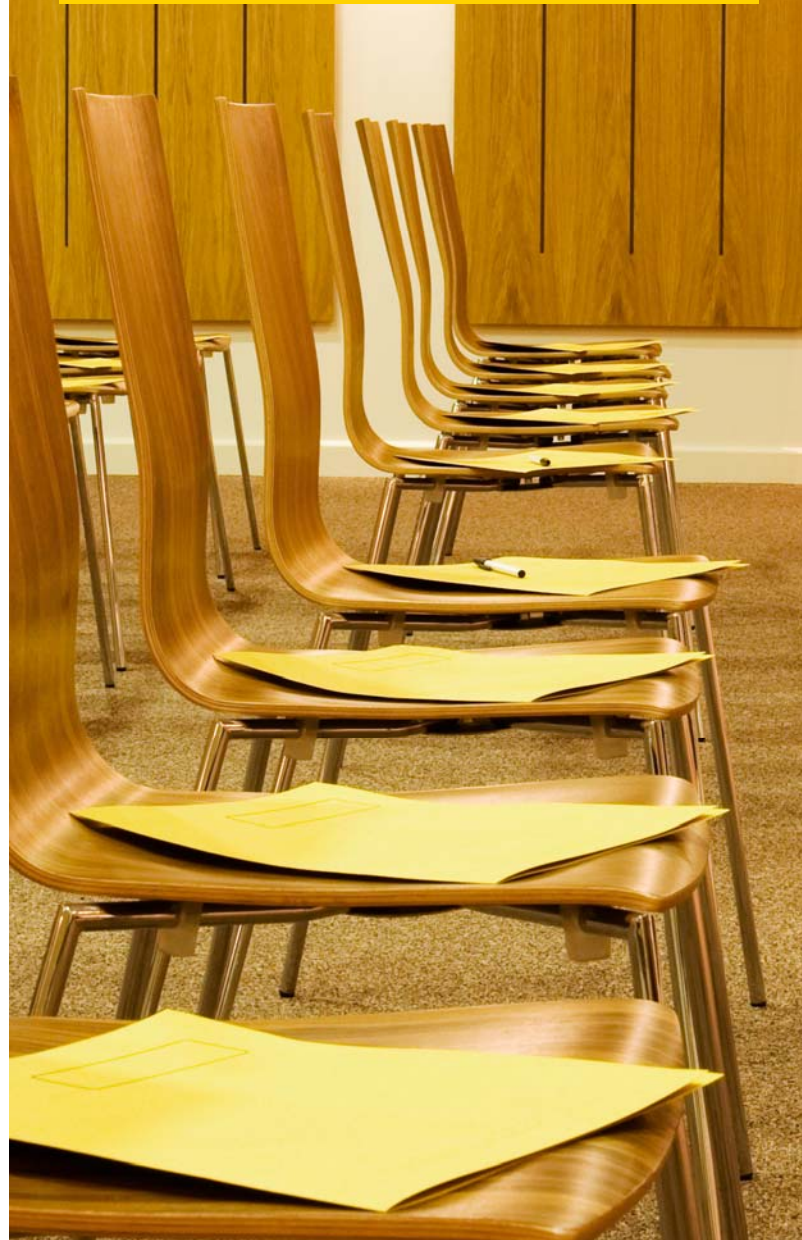
- ▶ Reducing repetition
- ▶ Tailoring the disclosure to focus on material information
- ▶ Eliminating outdated and immaterial information

In a recent speech at the US Chamber of Commerce, SEC Division of Corporation Finance Director Keith Higgins also invited companies that would like to discuss changes to their disclosures before including them in a filing to contact the SEC staff.

In this publication, we explore the staff's suggestions in greater detail and highlight areas where companies may apply them.

"Our effort will truly succeed only if all of the stakeholders in our current disclosure system – companies, investors, legal and accounting professionals and other market participants – contribute to the dialogue about the improvements that could be made to the quality and effectiveness of disclosure so that it is less burdensome both for companies to prepare and for investors to read."

– SEC Division of Corporation Finance
Director Keith Higgins⁷



⁷ *Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting*, 11 April 2014

Materiality considerations

Materiality is one of the key principles of financial reporting. Efforts to make disclosures more effective typically focus on evaluating whether existing or proposed disclosures provide material information to financial statement users or merely add clutter.

The US Supreme Court ruled that a fact is material if there is “a substantial likelihood that the disclosure of the omitted fact **would** have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” (Emphasis added.) The Court rejected the view that a fact is material if an investor **might** find it important, concluding that “management’s fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information – a result that is hardly conducive to informed decision making.”⁸

Several SEC staff members and commissioners have questioned whether the Supreme Court’s fear has become a reality. In a recent speech,⁹ SEC Commissioner Daniel Gallagher stated, “Companies’ disclosure documents are being cluttered with non-material information that can drown out or obscure the information that is at the core of a reasonable investor’s investment decision.”

We agree with the view that investors are not well-served if disclosure documents are filled with immaterial disclosures. Materiality should determine whether information is included in or excluded from a disclosure document. Materiality also should influence how prominently the information is presented.

Evaluating materiality, however, requires significant judgment. SEC Staff Accounting Bulletin (SAB) Topic 1.M, *Assessing Materiality*, provides further guidance about materiality and states that materiality judgments involve the consideration of both quantitative and qualitative factors. The SAB provides a list of quantitative and qualitative factors for evaluating the materiality of a misstatement. While this list is neither easily applied to disclosure considerations nor all-inclusive, companies must eventually evaluate whether omitted or misstated disclosures, individually or in the aggregate, would affect a reasonable investor. When evaluating materiality, companies may consider whether their disclosures:

- ▶ Affect the fair presentation of the financial statements
- ▶ Indicate potential areas of management bias

- ▶ Relate to sensitive matters (e.g., executive compensation disclosures, fraud, noncompliance with laws)
- ▶ Affect significant accounting policies in areas for which there is a lack of authoritative guidance or consensus
- ▶ Relates to accounts or disclosures for which significant judgment is used in the application of accounting principles, including critical accounting policies

Making and documenting materiality judgments will never be an easy task, but companies that take a fresh look at their disclosures often identify areas that could be eliminated or substantially reduced without significantly altering the total mix of information.

“After nearly a century in the making, our disclosure regime is not based entirely on line item requirements; rather, it is fundamentally grounded on the standard of ‘materiality.’ ”

– SEC Chair Mary Jo White¹⁰

The FASB defines materiality differently than the US Supreme Court did. In defining materiality, the FASB says, “information is material if omitting it or misstating it **could** influence decisions that users make on the basis of the financial information of a specific reporting entity.”¹¹ (Emphasis added.) We believe that the FASB’s use of the word **could**, may contribute to excessive footnote disclosures.¹²

⁸ *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449-450 (1976)

⁹ *Remarks at the 2nd Annual Institute for Corporate Counsel*, 6 December 2013

¹⁰ *The Path Forward on Disclosure*, National Association of Corporate Directors – Leadership Conference, 15 October 2013

¹¹ FASB Concepts Statement 8, *Qualitative Characteristics of Useful Financial Information*

¹² In our [comment letter](#) to the FASB on its Discussion Paper, *Disclosure Framework*, we recommended that the FASB amend its definition to be consistent with the Supreme Court’s opinion.

Materiality of an item

FASB Accounting Standards Codification (ASC) 105-10-05-6 states that “the provisions of the Codification need not be applied to immaterial items.” However, neither the FASB nor the SEC provides specific guidance clarifying how to consider the materiality of individual disclosure requirements. As a result, companies often provide every specified GAAP disclosure that relates to each area (e.g., stock compensation expense) that they determine is material to their financial statements.

We believe that companies should consider how individual disclosures affect the total mix of information available. That is, companies don’t need to include all specified disclosures if they conclude that an individual disclosure is immaterial. We believe this view is consistent with the Supreme Court’s definition of materiality.

Materiality considerations as part of SEC review process

Companies tend to retain disclosures that were material in a previous period but may no longer be material. This phenomenon is especially true when the disclosure was added in response to an SEC staff comment. The SEC staff has said publicly that companies should remove disclosures made in response to earlier SEC staff comment letters if those matters are no longer material.

The SEC staff also has said that just because it raises questions, companies should not assume that they need to add more disclosures to their filings, particularly immaterial information. The SEC staff often issues comments seeking clarification rather than additional disclosure. In some cases, registrants should respond by revising their disclosure to make it more effective rather than adding new disclosures.

The SEC staff is assessing whether its comment letter practices have contributed to the disclosure of immaterial information and will consider whether any changes to its filing review and comment practices are necessary.



Leading practices on structure and content

The SEC has said that companies can improve the relevancy of disclosures and reduce clutter by presenting information in a logical, easy-to-read manner.

In 2003, the SEC issued FR-72, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, which provides interpretive guidance concerning the preparation, format and content of management's discussion and analysis (MD&A). FR-72 states that MD&A should provide an explanation of the company's financial statements that enables investors to see the company through the eyes of management.

In addition, FR-72 says the primary purpose of MD&A is for management to communicate with investors in a straightforward manner. It states that companies should:

- ▶ Focus on material information, eliminate immaterial information and avoid unnecessary duplicative disclosure
- ▶ Use a "layered" approach to present their disclosure so that the most important material information is most prominent
- ▶ Present MD&A in a clear and understandable way by using tables and headings to help readers follow the flow of pertinent information
- ▶ Provide not only required disclosure but also an analysis that explains management's view of the implications and significance of that information

We encourage companies to revisit these principles when enhancing the effectiveness of their MD&A disclosures. We also believe companies should consider whether similar principles can be applied to the presentation of financial statement notes or other disclosures outside their financial statements. For example, these principles may guide how a company presents and discusses both financial and nonfinancial information, including operational and strategic goals, key performance indicators, and corporate and social responsibility information considered material to its investors.

In the following sections, we discuss these concepts and best practices based on our review of filings by companies that have already applied them.

Use of layering

Layering refers to emphasizing the most important information and providing additional details elsewhere. Layering can be accomplished in several ways.

FR-72 encourages companies to use an executive-level overview to provide context for their MD&A. The summary should present the important factors in evaluating the company's financial condition and operating performance without merely repeating the detailed discussion and analysis that follows.

The SEC staff expects an informative executive-level overview to provide insight into material opportunities, challenges and risks on which the company's executives are most focused for both the short and long term, as well as the actions they are taking to address them.

In our view, companies can apply this concept to other disclosures. They can use summaries, activity rollforwards or hyperlinks that emphasize or allow navigation to the most important information, provide additional context and details, or minimize redundancies.

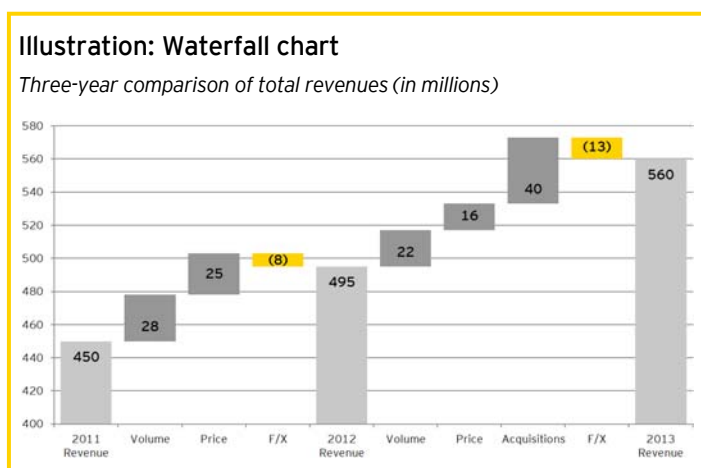
See below for recommendations and illustrations of how layering can be used to make MD&A and footnote disclosures more effective.

Longer term, we expect technology to play an important role in disclosure reform. For several years, the SEC has contemplated using technology to structure disclosure and make it easier for investors to find material information.¹³

¹³ For example, in 2008, the SEC formed the 21st Century Disclosure Initiative and released a report, *Toward Greater Transparency: Modernizing the Securities and Exchange Commission's Disclosure System*, with recommendations for comprehensive changes to the disclosure system.

Use of graphs, charts and tables

Information often can be presented more clearly and concisely in graphs, charts and tables than in text. In recent standards and rule releases, the FASB and SEC have encouraged and, in some cases, required tabular presentations of disclosure. For example, the rules related to executive compensation disclosures require tabular disclosures along with narrative discussion that supplements the tables.¹⁴ Furthermore, FR-72 encourages the use of tables to compare and explain changes in results between different periods. The following is an example of a “waterfall” chart that some companies have used to depict changes in balances from one period to the next:



As companies make greater use of charts and graphs in their disclosures, the presentation in annual reports is becoming more like that of investor-day presentations and internal managerial and board reporting.

As a leading practice, companies should avoid simply repeating in text information that is evident in the charts or tables. For example, some companies have stopped describing a change between periods that is reflected in a table and focused instead on discussing the reason(s) for the change. See our illustration under “MD&A – results of operations.”

Use of cross-references

Regulators often point to duplicative disclosures as a factor contributing to information overload and investor confusion. When a company provides substantially similar disclosure in different areas of a filing, the document is longer than it needs to be and users aren't likely to understand why disclosure is repeated. Disclosures about significant accounting policies, loss and legal contingencies, and business descriptions are often repeated in different places in the disclosure documents (e.g., risk factors, MD&A, footnote disclosure).

Cross-referencing is an effective way to reduce repetition and direct the reader to a section that contains additional relevant information on a topic. There are valid concerns that cross-referencing from the financial statement notes to MD&A may result in confusion with respect to audit responsibility. Conversely, there are valid concerns that referencing from MD&A to the notes results in the loss of safe-harbor protections for forward-looking disclosures. Despite these concerns, we believe there are several areas where companies can use properly worded cross-references (e.g., from MD&A to the notes) to enhance their disclosure.

In addition, if information is complementary but not required content and could provide additional context, insight or detail, a company may point to such information outside the disclosure document (e.g., on the company's website) without making the information part of the SEC filing. A company also may consider, as appropriate, incorporating by reference disclosure from previous filings, thereby avoiding repetition.

¹⁴ [Executive Compensation and Related Person Disclosure](#), Release Nos. 33-8732A; 34-54302A; IC-27444A, 6 September 2006

“Whatever is disclosed should be presented, when practicable, in a more accessible, straightforward manner – such as charts, graphs, tables, and summaries – so that the information is more digestible and understandable. A simpler presentation can make it easier for investors to focus on and process the information that matters most.”

– Former SEC Commissioner Troy A. Paredes¹⁵

Eliminating immaterial disclosures

We have seen companies effectively reduce the size of their filings by removing immaterial disclosures that have accumulated over time. For example, disclosures that were included for business conditions or events that are no longer material to understanding the company’s operating results or financial condition may linger in filings for several periods.

As part of their financial reporting processes, companies should identify immaterial disclosures that can be omitted or substantially reduced. In conjunction with that, they should document their rationale. Contemporaneous documentation of the rationale for omitting immaterial disclosure items can be valuable if those omissions are later challenged by regulators or litigants.

In many cases, because the FASB does not list all specified disclosures in a single place,¹⁶ companies use disclosure checklists that accumulate all individual SEC and FASB disclosure requirements to evaluate which disclosures are applicable and material. Companies should also use these checklists to document the relevant quantitative and qualitative factors they evaluated when deciding to exclude disclosures they deemed not material.

¹⁵ [Remarks at The SEC Speaks in 2013](#), 22 February 2013

¹⁶ If the FASB accumulated all specified disclosures in one location, that list would represent approximately 400 pages of the Accounting Standards Codification.



Recommendations to improve disclosures

In this section, we explore how companies are making their disclosures more meaningful. The illustrations below reflect effective practices that we have seen in company filings. However, because every company's facts and circumstances are different, companies must tailor the structure and content of disclosure based on their needs.

Financial statement footnotes

Several companies have focused on making certain lengthy footnote disclosures more meaningful while still providing the required information.¹⁷ Most commonly, we have seen companies change how disclosures about pensions and other postretirement benefits, stock-based compensation, loss contingencies, derivatives and hedging, and fair value measurements are presented such that required information is conveyed in a meaningful manner.

Order of financial statement notes

Most companies disclose their significant accounting policies in the first note to their financial statements. ASC 235, *Notes to Financial Statements*, encourages this format: "Disclosure is preferred in a separate summary of significant accounting policies preceding the notes to financial statements, or as the initial note, under the same or a similar title."

However, ASC 235 states that entities have the flexibility to disclose information about accounting policies differently. The FASB's Discussion Paper, *Disclosure Framework*, also considers other ways to organize these disclosures that may be more appropriate. For example, notes could be grouped (e.g., by related transaction or by operating, financing or investing activities) and organized from most to least relevant. The Discussion Paper acknowledges that grouping information may make it harder to compare a company's disclosures with those of other companies but could make the disclosures more relevant to users.

Some companies have grouped the disclosure of certain accounting policies with the more expanded disclosures for that particular area presented elsewhere in the footnotes to avoid discussion of financial statement line items in multiple footnotes. In most of these cases, the company includes an initial note with a discussion of some significant accounting policies and uses a table to link to the relevant footnote where there is a more complete discussion of other policies, along with the related estimates and other required disclosures:

Illustration: Summary of significant accounting policies

The following table includes other significant accounting policies that are described in other notes to the financial statements, including the number and page of the note:

Significant Accounting Policy	Note #	Page #
Accounts Receivable	4	34
Fair Value Measurements	5	35
Investments	6	40
Derivatives and Hedging Activities	7	43
Goodwill	8	50
Pension and Other Postretirement Benefit Plans	9	52
Income Taxes	14	60
Stock-Based Compensation	15	65
Legal Contingencies	16	70
Reportable Segments	17	73

¹⁷ In our [comment letter](#) on the FASB's Proposed Statement of Financial Accounting Concepts, Chapter 8: Notes to Financial Statements, we support the FASB's decision to address disclosure effectiveness. While reducing the volume of disclosure is not the FASB's primary objective in its project, we believe the FASB should use the project as an opportunity to develop a roadmap to address disclosure overload.

In addition, we also have seen companies make other changes to the financial statement presentation, such as:

- ▶ Organizing the notes based on importance
- ▶ Listing the applicable note about certain financial statement captions on the face of the balance sheet or income statement for ease of reference
- ▶ Using a chart immediately before the notes that provides a brief description of each financial statement caption and related accounting policy as well as a link to the related footnote¹⁸

Quarterly disclosures

Registrants may presume that users of quarterly financial information have read previously filed annual reports.¹⁹ Therefore, they are not required to repeat annual disclosures from the latest annual report unless necessary for a fair presentation or to comply with ASC 270, *Interim Reporting*, and other accounting standards that specify interim disclosure requirements. Some companies have eliminated or streamlined quarterly disclosures of items that are required only in annual financial statements such as when no material changes have occurred in significant accounting policies since the last annual report. However, some quarterly filings include disclosures beyond those specified in US GAAP.

In recent years, new FASB standards have required essentially the same disclosures in both interim and annual financial statements. As part of its disclosure framework project, the FASB is considering amendments to ASC 270 to clarify that updated disclosures are not required if they don't significantly alter the total mix of information available to investors.²⁰

Disclosure of significant accounting policies

The significant accounting policies note should identify and describe the material accounting principles followed by the company, the methods of applying those principles and the important judgments made in applying them. In particular, ASC 235 requires disclosure of material accounting principles and methods that involve any of the following:

- ▶ A selection from existing acceptable alternatives
- ▶ Principles and methods peculiar to the industry in which the entity operates, even if such principles and methods are predominantly followed in that industry
- ▶ Unusual or innovative applications of US GAAP

We often see companies go well beyond this requirement and describe policies for every line item. For example, a company may disclose its accounting policy for prepaid expenses even when it has made no material judgments or policy elections in the periods presented. Companies should consider removing disclosures of accounting policies that are not currently applicable or material to the financial statements or that require little to no discretion to apply.

Furthermore, companies frequently cite the requirements in the FASB Codification when they describe their policies. In our view, disclosure should not repeat what a standard says about policy requirements if the standard does not permit alternative methods. Instead, companies should describe policy elections they have made and the related judgments and estimates required to apply the authoritative literature to their transactions, if relevant.

¹⁸ This presentation can be useful for a web-enabled version of the annual report that can be placed on a company's website and can replace the outdated pdf version of the Word file.

¹⁹ Regulation S-X, Rule 10-01 *Interim financial statements*

²⁰ Our [To the Point, A framework to help the FASB establish effective disclosures](#), provides an overview of the FASB's exposure draft. In our [comment letter](#), we supported the FASB's objective of improving disclosure effectiveness by developing a framework the Board would apply when instituting new disclosure requirements and evaluating existing ones. However, we are concerned that the proposed framework would actually perpetuate the significant expansion in disclosure that has occurred over the past few decades. We suggested changes to the framework and recommended that the Board provide guidance on materiality and clearly distinguish between annual and interim requirements.



SAB 11-M disclosures

SAB Topic 11-M, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period*, requires a company to disclose the effect of new standards that are not yet adopted “unless the impact on its financial position and results of operations is not expected to be material.”

However, companies commonly include in their disclosures a description of each new standard, the alternative methods of adoption permitted by the standard and the method that the company expects to use, if determined, followed by this or a similar statement:

“The Company does not expect the adoption of this standard to have a material effect on its financial position or results of operations.”

Because companies are not required to summarize or disclose when effects of new standards are immaterial, companies should consider condensing these disclosures into one paragraph or eliminating these disclosures entirely.²¹ A company should consider including a discussion of only new standards that are reasonably likely to have a material effect on its financial statements. A table also could be used to provide SAB 11-M disclosure in a concise manner as shown in the following before and after illustration:

²¹ SAB Topic 11-M encourages, but does not require, the registrant to disclose that a standard has been issued and that its adoption will not have a material effect on its financial position or results of operations.

Recent accounting pronouncements

Existing disclosure:

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This ASU will replace existing revenue recognition standards and significantly expand the disclosure requirements for revenue arrangements. The provisions of ASU 2014-09 are effective for annual periods beginning after December 15, 2016, including interim periods within that reporting period, and early application is not permitted. The new standard may be adopted retrospectively for all periods presented, or adopted using a modified retrospective approach. Under the retrospective approach, the fiscal 2016 and 2015 financial statements would be adjusted to reflect the effects of applying the new standard on those periods. Under the modified retrospective approach, the new standard would only be applied for the period beginning January 1, 2017 to new contracts and those contracts that are not yet complete at January 1, 2017, with a cumulative catch-up adjustment recorded to beginning retained earnings for existing contracts that still require performance. Management is currently evaluating the methods of adoption allowed by the new standard and the effect the standard is expected to have on our financial statements and related disclosures.

In April 2014, the FASB issued ASU 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*. ASU 2014-08 changes the criteria for determining which disposals can be presented as discontinued operations and modifies the related disclosure requirements. Under the new guidance, a disposal of a component of an entity or a group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has

(or will have) a major effect on an entity's operations and financial results and is disposed of or classified as held for sale. The standard also introduces several new disclosures. The guidance applies prospectively to new disposals and new classifications of disposal groups as held for sale after the effective date. ASU 2014-08 is effective for annual and interim periods beginning after December 15, 2014, with early adoption permitted. We do not expect that the adoption of this standard will have a material effect on our financial statements.

In July 2013, the FASB issued ASU 2013-11, *Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Exists*. This update requires unrecognized tax benefits to be offset against a deferred tax asset for a net operating loss carryforward, similar tax loss or tax credit carryforward in certain situations. This update was issued due to the diversity in practice in presentation of unrecognized tax benefits in those instances. Some entities present unrecognized tax benefits as a liability unless the unrecognized tax benefit is directly associated with a tax position taken in a tax year that results in, or resulted in, the recognition of a net operating loss or tax credit carryforward for that year and the net operating loss or tax credit carryforward for that year has not been utilized. Other entities present unrecognized tax benefits as a reduction of a deferred tax asset for a net operating loss or tax credit carryforward in certain circumstances. The objective of this update is to eliminate this diversity in practice. The amendments in this update must be applied prospectively for reporting periods beginning after December 15, 2013. We adopted the standard on January 1, 2014. As a result of the adoption we decreased noncurrent deferred income tax assets by \$95 million with a corresponding decrease in other noncurrent liabilities.

Alternative enhanced disclosure:

The following table provides a brief description of recent accounting pronouncements that could have a material effect on our financial statements:

Standard	Description	Date of adoption	Effect on the financial statements or other significant matters
<i>Standards that are not yet adopted</i>			
ASU 2014-09, <i>Revenue from Contracts with Customers (Topic 606)</i>	The standard will replace existing revenue recognition standards and significantly expand the disclosure requirements for revenue arrangements. It may be adopted either retrospectively or on a modified retrospective basis to new contracts and existing contracts with remaining performance obligations as of the effective date.	January 1, 2017	We are currently evaluating the alternative methods of adoption and the effect on our financial statements and related disclosures. ²²
<i>Standards that were adopted</i>			
ASU 2013-11, <i>Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Exists</i>	The standard requires unrecognized tax benefits to be offset against a deferred tax asset for a net operating loss carryforward, similar tax loss or tax credit carryforward in certain situations.	January 1, 2014	The adoption of this standard resulted in a reduction in noncurrent deferred income tax assets of \$95 million and a corresponding decrease in other noncurrent liabilities.

²² The SEC staff expects that an entity's SAB 11-M disclosures will evolve in each reporting period as more information about the effects of the new standard becomes available.

MD&A disclosures

As discussed, FR-72 encourages companies to focus their MD&A on material information from management's perspective. However, MD&A continues to be the top area of focus in SEC staff comment letters.

EY resources

- ▶ [SEC Comments and Trends: An analysis of current reporting issues](#) (SCORE No. CC0398), September 2014

Executive overviews

While many companies include an MD&A overview in their filings, the SEC staff has emphasized that the overview should continue to evolve over time and avoid generic or boilerplate language. The overview should summarize the most important aspects of the company, including its performance and financial condition, and complement the more detailed discussions in the rest of the document. It should not repeat discussion about the company's business provided earlier in the filing or language from management's detailed analysis in the sections that follow.

We believe the executive overview is one area that could be improved if companies started with a clean sheet of paper each period and outlined the significant and new information affecting their operations and financial performance.

Results of operations

The SEC staff often requests that registrants explain the results of their operations with greater specificity, including identifying underlying drivers of each material factor that has affected their earnings or that is reasonably likely to have a material effect on future earnings. MD&A also should disclose key performance indicators, financial or nonfinancial, used to manage the business.

Companies should provide insightful analyses of items that are material to understanding their results and trends. They should focus on an effective presentation and ensure their analysis highlights the most important information while omitting discussions of items that are not material. Many companies have moved away from MD&A presentations that list every financial line item and include separate discussions of each period-over-period analysis (i.e., separate sections to discuss 2014 vs. 2013 and 2013 vs. 2012 changes in financial statement line items).

Instead, we have seen effective MD&A disclosures that incorporate some or all of the following:

- ▶ Combine the discussion and analysis of material financial statement line items over three years
- ▶ Provide tables or charts to compare the periods, including the components of changes (e.g., table showing the components of sales growth), as well as trends in key performance indicators
- ▶ Include narrative discussion that does not repeat information that is evident in the tables or charts
- ▶ Use bullet points to quantify and explain reasons for changes, including the offsetting factors
- ▶ Disclose activity rollforwards followed by a description of material known trends, events or uncertainties
- ▶ Analyze trends in financial and nonfinancial information in a separate MD&A section about key performance indicators

The example on the next page shows how to apply several of these best practices to MD&A disclosures to reduce repetition and structure the discussion to enhance the analysis of key drivers and trends.

MD&A – Results of operations

Existing disclosure:

	2013	2012	2011
Revenue	\$ 415,000	\$ 350,000	\$ 335,000
	<i>[other line items excluded for illustration purposes]</i>		

Year ended December 31, 2013, compared to year ended December 31, 2012

Revenues

Total revenues increased by approximately \$65 million, or 19%, to \$415 million during the year ended December 31, 2013 as compared to \$350 million for the year ended December 31, 2012. The revenue growth results from the acquisition of ABC, Inc. in the US which contributed \$35 million during the year, and increased sales of customers primarily as a result of significant focus on selling new products. Excluding the ABC, Inc. acquisition, North America revenue increased \$29 million to \$285 million in 2013 from \$256 million in 2012 due to the increased sales of our new routing and switch products. Revenue in Europe increased from \$94 million in 2012 to \$95 million in 2013 due to a slight increase in data center equipment sales offset by the unfavorable effects of foreign currency.

Year ended December 31, 2012, compared to year ended December 31, 2011

Revenues

Total revenues increased by approximately \$15 million, or 4%, to \$350 million during the year ended December 31, 2012, as compared to \$335 million for the year ended December 31, 2011. The revenue growth is primarily attributed to increased sales volume from our routing and switch products. North America revenue increased \$21 million to \$256 million in 2012 from \$235 million in 2011 due to stronger demand for our networking, router and switch products. Revenue in Europe declined from \$100 million in 2011 to \$94 million in 2012 due to lower sales of data center equipment as a result of intense competition and the unfavorable effects of foreign currency.

Alternative enhanced disclosure:

Revenues

	2013	2012	2011
North America	\$ 320,000	\$ 256,000	\$ 235,000
Europe	95,000	94,000	100,000
Total revenue	415,000	350,000	335,000
\$ Change	65,000	15,000	
% Change	19%	4%	

The following are components of revenue growth compared to the prior year:

	2013 vs. 2012	2012 vs. 2011
Volume	7%	4%
Price	3%	1%
Acquisitions	10%	-
Foreign currency effects	(1)%	(1)%
	<u>19%</u>	<u>4%</u>

Total revenue changes are due to:

- ▶ North America revenues in 2013 rose by \$35 million, or 14%, due to the ABC, Inc. acquisition and by \$29 million, or 11%, due to organic growth related primarily to sales of our new routing and switch products. Increases in 2012 were due to stronger demand for our networking, router and switch products.
- ▶ Europe revenues were relatively flat in 2013 as the slight increase in data center product sales was offset by unfavorable foreign currency effects. Decreases in 2012 resulted from lower volumes of 3%, primarily in data center products, resulting from increased competition. The remaining change was due to unfavorable foreign currency effects.

Critical accounting estimates

Critical accounting estimates are those that are most important to the financial statement presentation and that require the most difficult, subjective and complex judgments. FR-72 reminds SEC registrants that MD&A rules require disclosure of a critical accounting estimate in either of the following cases:

- ▶ The nature of the estimates or assumptions is material because of the levels of subjectivity and judgment needed to account for matters that are highly uncertain and susceptible to change
- ▶ The effect of the estimates and assumptions is material to the financial statements

Disclosures about critical accounting estimates should provide a robust analysis that supplements the description of accounting policies in the notes to the financial statements and (1) addresses why the accounting estimate or assumption may be susceptible to change and (2) analyzes the following:

- ▶ How the company arrived at the estimate/assumption
- ▶ How accurate the estimate/assumption has been in the past
- ▶ How much the estimate/assumption has changed in the past
- ▶ Whether the estimate/assumption is reasonably likely to change in the future

The SEC staff has commented that some registrants repeat verbatim in MD&A portions of the significant accounting policies footnote. While accounting policies in the notes to the financial statements generally describe the method used to apply significant accounting principles, the discussion in MD&A should be limited to only those areas that use assumptions and judgments that most materially affect the financial statements. That section of MD&A should provide insight into the uncertainties involved in applying the principle at a given time and the variability that is reasonably likely to result from its application.

SEC registrants should consider a cross-reference to footnote disclosure about significant accounting policies if necessary, but should limit the MD&A disclosure to an analysis of the specific underlying assumptions and judgments.

The following illustration uses cross-references and tailors the discussion of critical accounting estimates. While the enhanced disclosure in the illustration is roughly the same length, it uses cross-references, bullets and tables to make the disclosures more effective.



Critical accounting estimates

The following excerpt from the critical accounting estimates section about pensions illustrates improvements that tailor the discussion to provide appropriate insight into management's judgments and uncertainties and use cross-references, bullet points and tables for more effective presentation:

Existing disclosure:

The Company sponsors multiple defined benefit pension plans that cover certain US employees. The Company accounts for its pension plans in accordance with Accounting Standards Codification (ASC) 715, *Compensation – Retirement Benefits*. The funded status of the plans is measured as the difference between the fair value of the plan assets and the projected benefit obligation. Liabilities and expense for pension plans are actuarially determined using significant assumptions, including the rate used to discount the projected benefit obligation, the long-term rate of return on plan assets and several assumptions related to the employee workforce (salary increases, mortality rates and other factors). There are inherent uncertainties related to these assumptions and management's judgment in applying them. Consistent with the accounting guidance, the Company has policies that generally defer the effect of changes in actuarial assumptions and differences between the expected and actual return of plan assets over future periods. Unrealized gains or losses are recorded in other comprehensive income (OCI), a component of shareholders' equity.

A significant estimate in determining pension cost in accordance with accounting guidance is the expected return on plan assets. The Company estimated the expected long-term rate of return on plan assets was 7.25% and 7.50% as of December 31, 2013 and 2012, respectively. The expected return assumptions were developed by considering various factors, such as the plans' investment guidelines, mix of asset classes, historical returns of equities and bonds, and expected future returns. Management believes these assumptions are reasonable. If the plan assets earn an average return less than 7.25% over time, future pension cost likely would increase.

In addition, the Company estimates the discount rate by performing an analysis of the rates of return on high-quality, fixed-income investments. The Company estimated discount rates of 4.50% and 3.75% at December 31, 2013 and 2012, respectively. Management believes these assumptions are reasonable. However, an increase in the discount rate would decrease the plan obligations and the net periodic benefit cost, while a decrease in the discount rate would increase the plan obligations and the net periodic benefit cost.

Alternative enhanced disclosure:

We sponsor multiple defined benefit pension plans that cover certain US employees. For a description of our related accounting policies, refer to Note 2 in the consolidated financial statements. Changes in significant assumptions could materially affect the amounts, particularly the long-term rate of return on plan assets and the rate used to discount the projected benefit obligation:

- ▶ Return on plan assets – We determine the expected long-term rate of return on plan assets based on the building block method, which consists of aggregating the expected rates of return for each component of the plan's asset mix. Our assumed expected rate of return considers past returns on plan assets as well as various other factors, such as the plans' investment guidelines, the expected mix of asset classes and current market conditions. The expected long-term rate of return on plan assets was 7.25% and 7.50% as of December 31, 2013 and 2012, respectively. The decline in the expected long-term rate of return is primarily attributed to a shift in the plan asset mix to fixed income securities from equities, which comprised 42% and 37% of plan assets as of December 31, 2013 and 2012, respectively.
- ▶ Discount rate – In estimating this rate, we analyze the rates of return on high-quality, fixed-income investments that receive one of the two highest ratings from a recognized rating agency and the schedule of expected cash needs of the plans. We estimated discount rates of 4.50% and 3.75% at December 31, 2013 and 2012, respectively.

The following illustrates the sensitivity of the net periodic benefit cost and projected benefit obligation to a 1% change in the discount rate or return on plan assets (in millions):

Assumption	Change	2014 net periodic benefit cost	2013 projected benefit obligation
Discount rate	1% increase	\$ (8)	\$ (85)
	1% decrease	9	90
Return on plan assets	1% increase	(15)	N/A
	1% decrease	15	N/A

For 2015, we expect net periodic pension cost to decline by approximately \$2 million due to the 75 basis point increase in the discount rate partially offset by the 25 basis point decline in the expected long-term rate of return due to the shift in plan asset mix.

Other disclosure areas

Business disclosures

Item 101 of Regulation S-K, *Description of Business*, specifies disclosure about the registrant's business, including its operating segments and geographic areas.

Many companies have identified the business section in Item 1 of Form 10-K as one of the first areas where disclosures can be improved. Although the business disclosures may be fairly static from period to period, the discussion becomes lengthy when disclosures are added over time. In addition, certain portions of the business discussion often are repeated in other sections of the filing, including MD&A and risk factors. The company's website also may provide significant information about the company's business.

Although the company's Form 10-K should comply with the requirements of Item 101 of Regulation S-K, we believe companies can reduce repetition throughout their filings by using cross-references to other areas of the document or to other publicly available information.

Risk factors

Item 503(c) of Regulation S-K requires a registrant to disclose its significant risks and how it is affected by each of them. Risk factors should be specific to the company's facts and circumstances and not merely general risks that could apply to any company.

Because of the safe harbor in the Private Securities Litigation Reform Act of 1995, many companies are hesitant to limit the number or length of risk factor disclosures. However, investors frequently have said that risk factors are generic and confusing. The most important risk factors often are not presented first, and readers have a hard time determining whether a risk is likely to become a reality. The SEC staff also has questioned risk factor disclosures that could apply to any public company, saying they are not sufficiently specific or detailed to address the facts and circumstances of a particular company.

At a minimum, we believe risk factor disclosures can benefit from better organization and tailoring the discussion of the risk to the business.

For example, Item 503(c) requires the discussion of risk factors to be "concise and organized logically." Some companies have used headers to group risks by the type of factors, such as the following:

- ▶ Risks related to operational factors
- ▶ Risks related to technology factors
- ▶ Risks related to economic or market factors
- ▶ Risks related to legal and regulatory factors

Companies then use sub-captions to describe the risk factor specific to them.

Companies also may want to emphasize recent trends or changes during the period in the likelihood that certain risk factors may occur as well as their approach to manage and mitigate these risks.

Legal proceedings

Companies may include loss contingency disclosures in several sections of the filing, including the legal proceedings section, risk factors, MD&A and loss contingencies footnote to the financial statements.

There is significant overlap between the disclosure requirements for loss contingencies under US GAAP and Regulation S-K. Accordingly, many filings duplicate disclosure of litigation matters.

However, the SEC staff has emphasized that the disclosure requirements are different. For example, Item 103 of Regulation S-K requires registrants to briefly describe any material pending legal proceedings to which the registrant or any of its subsidiaries is a party. US GAAP²³ requires disclosures based on the likelihood of loss, including an estimate of reasonably possible losses or a statement that such an estimate cannot be made.

To improve disclosures in this area, companies should consider using a bullet-point list of material legal proceedings with the descriptions required by Regulation S-K and appropriate cross-references to MD&A and the financial statements footnotes where each matter might be discussed.

EY resources

- ▶ [SEC Comments and Trends: An analysis of current reporting issues](#) (SCORE No. CC0398), September 2014

²³ ASC 450, *Contingencies*

Process to improve disclosures

It is important for companies to have a process in place to regularly review the effectiveness of their disclosures and a plan to make ongoing improvements to their financial reporting.

Key stakeholders

First, companies need to identify key stakeholders and confirm their commitment to improving the company's financial reporting process and SEC filings. The following individuals (and/or senior members of their functions) typically are the key participants and influencers:

- ▶ Chief executive officer and chief financial officer (CFO)
- ▶ Controller, chief accounting officer, director of external reporting or equivalent roles
- ▶ Chair of the audit committee
- ▶ Head of the disclosure committee, if applicable
- ▶ General counsel
- ▶ Head of investor relations
- ▶ Chief risk officer and head of strategy
- ▶ Managers and CFOs of key operating business units or divisions

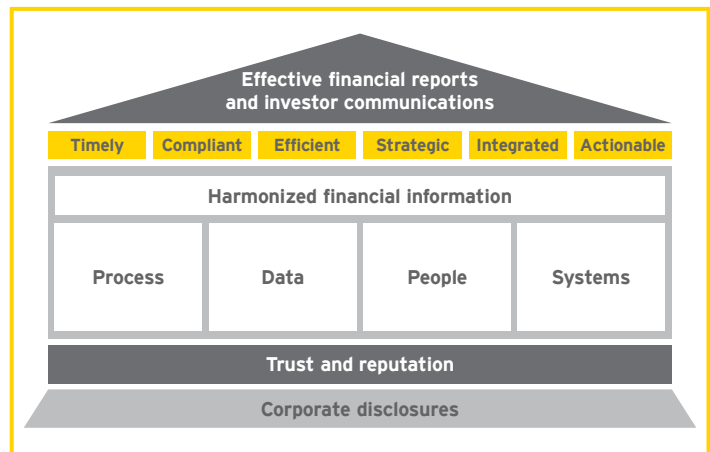
Depending on the nature of the business, input may be needed from other members of the management team (i.e., head of research of a pharmaceutical company, chief credit officer of a banking institution). Communication with the external auditor also is essential. In addition, companies can contact the SEC staff to discuss potential changes to their disclosures.

Process and plan

Companies should develop an overall plan with a clear timeline and project management support. Ideally, the focus should be the reporting process as a whole, not just the financial statement disclosures or MD&A in isolation. An effective plan integrates the company's processes, people, data and systems to:

- ▶ Address investor communications more holistically
- ▶ Identify and implement any necessary process, content and system changes

- ▶ Establish greater synergies between strategic, operational, financial, regulatory, and sustainability reporting and messaging
- ▶ Produce compliant SEC filings in a timely and efficient manner



Companies should consider benchmarking their disclosures against those of their peers. Benchmarking can identify best practices within the industry. Such an approach also can identify potential gaps that can be addressed with additional information or performance metrics to meet the needs and expectations of investors and/or analysts who follow the company or industry.

In addition, many companies are making meaningful improvements to their investor communications by developing web-enabled versions of financial reports that look better and are easier to navigate than traditional reports. These reports help readers focus more quickly on areas of interest, move from section to section, or find additional information using hyperlinks.

A journey, not an initiative

Companies may decide to make significant disclosure improvements all at once or incrementally by targeting one particular disclosure area at a time.

Some companies may start by focusing on making specific disclosures more effective as an initiative, but it is important to embed the objective of disclosure effectiveness into the company's financial reporting DNA to ensure that the changes are successful and sustainable.

Conclusion

As the SEC staff and the FASB work on their disclosure effectiveness initiatives, companies can take immediate action to make their disclosures more meaningful. These actions can go a long way toward enhancing disclosure and providing investors with information that is easier to understand.

We believe that companies that take the steps we describe in this publication will see a variety of benefits, including more efficient reviews by executives and directors and greater investor confidence.

While meaningful and lasting change to the disclosure regime will take time, we hope this publication has provided you with a road map of improvements you can follow in drafting your upcoming filings and financial statements.

Appendix

Current initiatives on disclosure effectiveness by standard setters, regulators and organizations include:

Standard setter/regulator/organization	Project/report/study
SEC	<ul style="list-style-type: none"> ▶ Disclosure Effectiveness
FASB	<ul style="list-style-type: none"> ▶ Disclosure Framework ▶ Conceptual Framework ▶ Simplification initiative
IASB	<ul style="list-style-type: none"> ▶ Disclosure Initiative
Center for Audit Quality (CAQ)	<ul style="list-style-type: none"> ▶ Financial Statement Disclosure Effectiveness: Forum Observations Summary
US Chamber of Commerce	<ul style="list-style-type: none"> ▶ Corporate Disclosure Effectiveness: Ensuring a Balanced System that Informs and Protects Investors and Facilitates Capital Formation
UK Financial Reporting Council (FRC)	<ul style="list-style-type: none"> ▶ Louder than Words ▶ Cutting clutter ▶ Financial Reporting Lab insight report: Towards Clear & Concise Reporting
UK Department for Business, Innovation & Skills (BIS)	<ul style="list-style-type: none"> ▶ The future of narrative reporting
International Integrated Reporting Committee (IIRC)	<ul style="list-style-type: none"> ▶ The International Integrated Reporting Framework
Joint oversight group of the Institute of Chartered Accountants of Scotland (ICAS) and the New Zealand Institute of Chartered Accountants (NZICA)	<ul style="list-style-type: none"> ▶ Losing the excess baggage
European Securities and Markets Authority (ESMA)	<ul style="list-style-type: none"> ▶ Consultation Paper – Considerations of materiality in financial reporting ▶ Feedback Statement – Considerations of materiality in financial reporting
European Financial Reporting Advisory Group (EFRAG)	<ul style="list-style-type: none"> ▶ Discussion Paper – Towards a Disclosure Framework for the Notes
Australian Accounting Standards Board (AASB)	<ul style="list-style-type: none"> ▶ Rethinking the Path from an Objective of Economic Decision Making to a Disclosure and Presentation Framework
Chartered Financial Analyst (CFA) Institute	<ul style="list-style-type: none"> ▶ Financial Reporting Disclosures – Investor Perspectives on Transparency, Trust, and Volume ▶ Forward-Looking Information – A Necessary Consideration in the SEC’s Review on Disclosure Effectiveness: Investor Perspectives
Enhanced Disclosure Task Force (EDTF)	<ul style="list-style-type: none"> ▶ Enhancing the risk disclosures of banks
International Accounting and Assurance Standards Board (IAASB)	<ul style="list-style-type: none"> ▶ The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications
Institute Of Chartered Accountants In England And Wales (ICAEW)	<ul style="list-style-type: none"> ▶ Financial Reporting Disclosures: Market and Regulatory Failures

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