Federal Accounting Standards Advisory Board

October 10, 2018

MEMBER ACTIONS REQUESTED:

- Please provide responses to the questions on page 10 before October 22.

Memorandum

To: Members of the Board

From: Grace Wu, Assistant Director

Wendy M. Payne /s/

Through: Wendy M. Payne, Executive Director

Subject: Note Disclosure Principle Framework Proposed Outline and Discussion – **Tab B**

MEMO OBJECTIVE

The objective of this memorandum is to seek the Board's input on the proposed note disclosure (NODI) principle outline and some potential principles.

BRIEFING MATERIAL

This memorandum includes some initial thoughts on the NODI principle outline and some potential principles. Questions for the Board are included in the discussion section and at the end to solicit feedback from members.

BACKGROUND

During the April 2018 Board meeting, the Board discussed and approved the NODI project's scope and some potential principles, including setting up disclosure objectives for each statement; to continue the current disclosure method by focusing on the different types of information disclosed about an entity's assets, liabilities, net position, revenue, and expenses; and to clarify the role of disclosures and develop content principles. Members also discussed how some voluntary information included in the disclosures would be helpful.

This memo expands on the April meeting. Based on the research on other note disclosure guidance and the working group results, a preliminary note disclosure outline proposed below. This outline is an initial thought on the principles, it likely will change as more research is conducted and more inputs received. In addition, some topics related to the outline will be discussed below as well.

Outline

On August 28, 2018, the Financial Accounting Standards Board (FASB) issued conceptual framework Chapter 8, *Notes to Financial Statements.* It explains "what information the FASB Board should consider including in notes to financial statements by describing the purpose of notes, the nature of appropriate content, and general limitations." After considering current note disclosure approaches including FASB's, as well as what has been approved by the Board in the past meetings, staff suggests a preliminary outline covering topics for the note disclosure principle framework. This outline is a high level thought on the topic, further research will be performed on each topic after Board's inputs. In the outline below, the bold words stand for the section titles, unbold words indicate what may be covered in that section:

Section I Disclosure Purposes

- Disclosure is "reporting information in notes or narrative regarded as an integral part of the basic financial statement."
  - An item of information is a candidate for required information[1] if it is consistent with the objectives of federal financial reporting and meets certain qualitative characteristics and cost-benefit considerations. Basic information is information which is essential for the financial statements and notes to be presented in conformity with GAAP. (SFFAC 2, par. 73A-B)
  - Disclosures: are an integral part of the financial statements and make the financial statements more informative and not misleading. Disclosure is not a substitute for recognition. However, unrecognized elements are candidates for disclosure. (SFFAC 2, par. 68)

Section II Disclosure Content

Topic 1: What information identified as required information should be disclosed?

- Information not conveyed by the line item but relevant, such as:
  a. Supporting information for items presented on the face of the statements
  b. Relevant information about the reporting entity
  c. Information about other past events and current conditions and circumstances that can affect an entity's resources.

Topic 2: How to judge relevance

- Disclosures should include information not conveyed by the line item but relevant to an understanding of the line item and otherwise not available to users in a cost effective manner
- Relevance is a broader concept than materiality (materiality is entity specific while relevance is assessed broadly)
- A list of questions will be developed to aid the Board in assessing relevance as it considers new disclosure requirements
- Providing disclosure objectives in each Statement would help the preparer judge what information to include in disclosures

[1] Required information comprises basic information (statements and notes) and required supplemental information (RSI). SFFAC 2 provides guidance on distinguishing between basic information and RSI.

Topic 3: What should not be disclosed?

- General information if it can be obtained easily somewhere else
- Expectations and assumptions about the future that are not inputs to current measures in financial statements or notes (note that some federal financial statements are projections)
- Differentiate the MD&A vs. note disclosure
- Consideration of sensitive disclosure including adverse consequences
- Information for which the cost of disclosure exceeds the benefits

Topic 4: Disclosure style

- Note shall be presented in a systematic manner as far as practicable by presenting disclosures associated with an entity's assets, liabilities, net position, revenue and expenses.
- Disclosures should not provide definitions for commonly used terms or terms already defined in the standards. Ideally GFFR should provide definitions in a glossary or on line.
- Board would encourage some basic communication principles

Section III Appendix

- Question list for the Board including detail examples of how to apply the list
- Others

Discussion Topics

1. Future Oriented Information

Sometimes, information about future events, conditions and circumstances can significantly affect an entity's resources. Generally, there are three types of future information.

The first type is projections or similar assertions about unknown future events that are largely beyond management's control. This type includes comprehensive long-term projections for the U.S. government or social insurance programs. SFFAS 36 *Comprehensive Long-Term Projections for the U.S. Government* specifically requires:

> *3. Disclosures that explain and illustrate:*
> *a. the assumptions underlying the projections,*
> *b. factors influencing trends, and*
> *c. significant changes in the projections from period to period.*

> *36. The basic financial statement, Long-Term Fiscal Projections for the U.S. Government, should state the projection period and display the following projected amounts as both present value dollars and as a percentage of the present value of GDP for the projection period indicated:*
> *a. receipts, disaggregated by major programs such as Medicare, Social Security, and all other receipts, and total receipts;*
> *b. non-interest spending, disaggregated by major programs such as Medicare, Medicaid, Social Security, and all other non-interest spending, total non-interest spending; and*
> *c. the difference between projected receipts and projected non-interest spending.*

This type of information is required to meet federal financial reporting objectives. However, such information is rarely required in relation to elements of the accrual basis federal financial statements. For example, grant liabilities are reported based on activities through the end of the reporting period despite expectations that grants will be fully expended.

This first type of future oriented information is appropriate in the federal financial statements but is not considered appropriate in non-governmental financial statements and is generally not required by other standard boards. For example, the SEC requires the preparer to provide “forward-looking” information outside the audited financial statements.

The second type is information about estimates and assumptions used as inputs to measurements that affects the presentation, recognition, or measurement of an item, such as recoverable amount of certain classes of property, outcome of litigation in process. Those represent a faithful estimate/representation of the line item. This type of future oriented information is appropriate for disclosure.

FASB conceptual framework Chapter 8, *Notes to Financial Statements* describes a third type of future oriented information (labeled below as the second because FASB dispenses with the first type described above early in its discussion) states:

> *D39. The second [third] is information about management’s existing plans and strategies related to matters under management’s control. This type of future-oriented information may be appropriate if management’s existing plans and strategies affect the presentation, recognition, or measurement of line items. However, disclosures of management’s existing plans and strategies <u>are rarely required</u> for the following reasons:*
>
> > *a. Disclosing some types of plans and strategies may render them less effective and, therefore, adversely affect the reporting entity.*
> >
> > *b. Disclosing plans and strategies seldom explains information on the face of the financial statements.*
>
> *D40. In summary, the Board <u>generally does not require disclosures of expectations and assumptions about the future that are not inputs to current measures in financial statements or notes</u>. [Emphasis added.]*

FASB does not preclude disclosure of future oriented information in the third type. However, such disclosures would be unusual. For federal reporting entities, plans and strategies are likely to be publicly discussed. For example, plans to reform operations such as the Postal Service are widely reported. While staff is inclined to agree that “information about management’s existing plans and strategies related to matters under management’s control” is less likely to qualify as required information (that is, necessary to meet reporting objectives) than the second type, staff suggests that the Board not rule out disclosures of the third type of future oriented information.

There is no guidance in current FASAB standard to differentiate the treatment of different types of future oriented information, except some discussions in SFFAC 5 *Definition of Elements and Basic Recognition Criteria for Accrual Basis Financial Statements* about uncertainty:

> *9. An item that meets the appropriate definition of an element is an asset, liability, revenue, or expense, even if it is not recognized in the accrual-basis financial statements because, for example, it is not measurable or its amount is not material. Unrecognized elements are candidates for disclosure in the notes to financial statements or as supplementary information.*

58. In addition to the basic recognition criteria, decisions whether to recognize or disclose an item take into account considerations that also include uncertainties. These considerations are measurement of an appropriate attribute, which may include an assessment of the probability of future flows of economic benefits or services, and assessments of the materiality of the item and the benefit versus the cost of recognizing it.

59. Uncertainty increases the costs of financial reporting, particularly the costs of recognition and measurement. Also, reassessments and restatements may be required if items previously reported as expenses or revenues, or not reported, are later found with benefit of hindsight to have the essential characteristics of assets or liabilities.11 It may be possible to reduce uncertainty by exerting greater effort or spending more money, but it also may not be worth the added cost. As discussed in paragraph 6, the exercise of judgment may be necessary, but this Statement does not require certainty.

Question: Staff agreed with other standard boards' views on the second and third types of future oriented information. The future oriented information that is an input to a faithful measurement of a line item in accrual basis financial statements should be disclosed so that users are informed of the assumptions, methods, and risk underlying these measurements.

The third type of "forward-looking" information – plans and strategies under management's control - would be a good prediction for future risk or resource needs. However, generally should not be included in the audited financial statements. Such information may be placed in MD&A section given its uncertain nature due to many assumptions and estimates involved. Staff agrees with FASB's conclusion that this information generally would not qualify for disclosure in the note, and believes the federal factors to consider in the sector will be different.

In addition, some federal financial statements present projections such as comprehensive long-term projections and project social insurance. In those cases, disclosures must provide the first type of forward-looking information to support the projections. Guidance has been set up specifically to address those situations. The concepts should discuss the scope of disclosures needed when projections are presented as basic financial statements.

Does the Board agree that future oriented information should be described as three major types? If so, does the Board generally agree with staff's views regarding each type and wish to include a section in the concepts statement describing the factors to consider in requiring disclosure of each type of future oriented information?

2. Role/Content of Note Disclosure vs. MD&A

During April's meeting, the Board agreed that clarifying the role/content of the NODI would assist the Board and preparers to determine what type of information should be included in the NODI. What was discussed in that meeting is reflected in above outline section 2 topic 1 *what should be disclosed*. In that topic item 2 is about relevant information of the reporting entity.

SFFAC 2 *Entity and Display* discusses how the Board identifies required information and sorts required information between basic information (financial statements and disclosures) and required supplementary information (RSI). SFFAC 2 states:

Determining Required Information

73A.Selecting a category for communicating information may involve a process that begins with determining what information should be required. Required information is *information that consists of basic information and RSI. An item of information is a candidate for required information if it is consistent with the objectives of federal financial reporting and meets certain qualitative characteristics and cost-benefit considerations. The Board developed these factors earlier in the conceptual framework. SFFAC 1 identifies the reporting objectives (paragraphs 112 to 150) and the qualitative characteristics (paragraphs 157 to 164). It also discusses cost versus benefit considerations (paragraphs 151 to 155).*

Determining Basic Information versus RSI

73B.Information that meets the criteria for required information is a candidate for basic information or RSI. Basic information is information which is essential for the financial statements and notes to be presented in conformity with GAAP. The FASAB standards are the core12.1 of GAAP and auditors may be engaged to express an opinion as to whether basic financial statements and notes are presented in conformity with those criteria.

73C.RSI is information that a body that establishes GAAP requires to accompany basic information. It may be experimental in nature to permit the communication of information that is relevant and important to the reporting objectives while more experience is gained through resolution of accounting issues. Also, the information may be expressed in other than financial measures or may not be subject to reliable estimation. As issues are resolved, the information may be considered basic at some point in the future.

73D.The Board specifies what information should be presented as basic information and what information should be presented as RSI. Assessing whether required information is a candidate for basic information or RSI may involve the Board's consideration of a range of factors which are listed in Table 1: Factors to Consider in Distinguishing Basic Information from RSI on page 107. The factors are not listed in a particular order and some may convey similar ideas. In addition, different Board members may assign different weight to each factor. Thus, the factors provide a general framework for each Board member's judgment and are not considered to present a decision tree, hierarchy, or precise algorithm for classifying items.

73E. For example, members may consider the relevance of the information to fair presentation. If the information has a high relevance to fair presentation, it may be a candidate for basic information communicated by financial statements and notes to the financial statements. The financial statements and notes could not be considered fairly presented if the information is missing or materially misstated. The rationales for some of the other factors that members may consider are:

a. Use of various types of financial data or financial transaction data. Members may deliberate the nature of the data used or the type of system used to process the information. Financial data used or data derived from a system for processing financial transactions, may be more likely to be considered basic information.

b. Level of importance the Board wishes to be communicated in the financial report or the auditor's report. In addition to the nature of the information, the Board may take into account the effect of categorizing an item as basic information or RSI in the financial report and what the auditor's report would communicate if the item is missing or materially misstated. By designating an item as basic information rather than RSI, the Board can have some bearing on the level of importance conveyed in the financial report and auditor's report. In other words, users may pay less attention to items categorized as "supplementary" in the financial report. Conversely, they may be more concerned with *the auditor's conclusions regarding the fair presentation of the financial statements. Hence, the more important the item, the more likely it would be a part of the financial statements and notes prepared in conformity with GAAP, such that if the item is missing or materially misstated, the matter would be conveyed in the auditor's report on the fair presentation of the financial statements.*

c. The extent to which the information interests a wide audience (rather than specialists). If an item of information is of great interest to users, the information may be a candidate for basic information. Conversely, if the item is primarily of interest to subject matter specialists, the information may accompany the basic information as RSI.

d. Extent to which there are not alternative sources of reliable information. If organizations routinely publish an item of information that is scrutinized by independent advisors, it may be more likely to be considered RSI than basic information.

e. Agreement on criteria that permit comparable and consistent reporting. If there is a lack of specific criteria for measuring an item, preparers may have great discretion in developing their calculations and auditors may lack criteria necessary for the expression of an opinion. The item of information may be a candidate for RSI.

f. Experience among users, preparers, and auditors with the information. The Board may consider the views of expert users, preparers, and auditors in developing measurement criteria for basic information. If the level of experience regarding an item is low, input on specific criteria may not be available. Also, when there is not sufficient experience to develop measurement criteria, auditors may have concerns about expressing an opinion on the information. They may express qualifications or include explanations in their report. Categorizing the information as RSI may encourage reporting while more experience is gained and criteria developed.

g. Benefit/cost ratio of using resources to compile the information as well as ensure accuracy. The Board may consider the benefit and cost associated with producing and auditing the item of information.

SFFAC 3 *Management's Discussion and Analysis* states:

Summary

MD&A is an important vehicle for (1) communicating managers' insights about the reporting entity, (2) increasing the understandability and usefulness of the GPFFR, and (3) providing accessible information about the entity and its operations, service levels, successes, challenges, and future. Some federal agencies also refer to MD&A as the "overview."

The basic concept that underlies the standards for MD&A is:
Each general purpose federal financial report (GPFFR) should include a section devoted to management's discussion and analysis (MD&A). It should address the reporting entity's performance measures, financial statements, systems and controls, compliance with laws and regulations, and actions taken or planned to address problems. The discussion and analysis of these subjects may be based partly on information contained in reports other than the GPFFR. MD&A also should address significant events, conditions, trends and contingencies that may affect future operations.

A separate document titled Standards for Management's Discussion and Analysis presents the standards for MD&A. The standards for MD&A say that MD&A should address:
• the entity's mission and organizational structure;
• the entity's performance goals and results;
• the entity's financial statements;
• the entity's systems, controls, and legal compliance; and
• the possible future effects on the entity of existing, currently-known demands, risks, uncertainties, events, conditions and trends.
The discussion and analysis of these subjects may be based on information in other discrete sections of the GPFFR or it may be based on reports separate from the GPFFR. The standards require MD&A to be included in each GPFFR as required supplementary information (RSI).

Based on the SFFAC 2 and SFFAC 3 requirements, it appears that there could be duplicated disclosure information in MD&A and NODI sections, especially on the relevant information to the entity related to the financial statements. Both sections discuss the nature, activities and any special restrictions or privileges that apply to an entity. The difference is that the note disclosure information is audited information and MD&A is not.

Question: There are views that basic information (financial statements and notes) and MD&A each should be stand-alone documents, as such a bit of duplication is acceptable. There are other views that there should not be duplication between MD&A and basic information. Instead, information that may be duplicated should instead be referred to in one section.

Despite the different views on the duplication issue, the fundamental difference between the basic information and MD&A is that the basic information is audited. In staff's view, to differentiate the MD&A and NODI, the Board could expand upon the principles in SFFAC 2, par 73B-E to identify the type of entity relevant information to be considered basic information that is audited. Explicitly considering this in the context of MD&A requirements may potentially resolve the duplication issue since what is presented in the NODI would be audited information and MD&A would be non-audited information. As such, MD&A section may potentially reference to the basic information (since those are audited) but not the other way around.

Does the Board agree that there is a need to clarify the role/content of the MD&A and NODI? If so, which approach is the Board inclined to adopt – duplication or referencing from MD&A to notes?

3. Sensitive Disclosure

In the federal environment, besides the information requiring protection from unauthorized disclosure referred to as "classified national security information", there may be some disclosures that have potential adverse consequences. For the non-governmental sector, this concept is explained in the FASB conceptual framework Chapter 8, Notes to Financial Statements:

D32. The Board should consider the following potential adverse consequences when determining whether to require a particular disclosure:
a. Legal harm. Some information, if disclosed, may subject the reporting entity to certain legal consequences. For example, disclosing certain information about the reporting

entity's contract with a counterparty may cause the reporting entity to breach a confidentiality clause of the contract.
b. Competitive harm. Various factors could cause competitive harm. For example, requiring an entity to disclose product pricing information may cause competitive harm to the reporting entity.
c. Reputational harm. Some activities of an entity, if made known, could cause harm to the entity's reputation. For example, information about an entity's waste-disposal practice may cause users to reallocate resources away from the entity and not on the basis of the returns they expect.
d. Other economic consequences that are not relevant to resource allocation decisions. While general purpose financial statements are intended for users to make resource allocation decisions, others may use certain information in notes for purposes other than making those decisions. In some cases, the unintended use of that information may negatively affect the entity's ability to operate in its economic, legal, political, and social environments.

Question: Staff's view is that besides the national security related requirements, the Board should consider the sensitive/adverse disclosure for potential harms to the federal government.

Does the Board agree that there are potential adverse disclosures similar to FASB's list in the federal environment? Should a principle be developed on this topic?

NEXT STEPS

Members are requested to provide inputs to the principle outline and identify the next steps staff should consider taking.

MEMBER FEEDBACK

If you require additional information or wish to suggest another alternative not considered in the staff proposal, please contact staff as soon as possible. In most cases, staff would be able to respond to your request for information and prepare to discuss your suggestions with the Board, as needed, in advance of the meeting. If you have any questions or comments prior to the meeting, please contact me by telephone at (202) 512-7377 or by e-mail at wug@fasab.gov with a cc to paynew@fasab.gov.

QUESTIONS FOR THE BOARD

1) Does the Board agree the proposed outline? If not, do you have any suggestions?

2) Does the Board agree that future oriented information should be described as three major types? If so, does the Board generally agree with staff's views regarding each type and wish to include a section in the concepts statement describing the factors to consider in requiring disclosure of each type of future oriented information?

3) Does the Board agree that there is a need to clarify the role/content of the MD&A and NODI? If so, which approach is the Board inclined to adopt – duplication or referencing from MD&A to notes?

4) Does the Board agree that there are potential adverse disclosures similar to FASB's list in the federal environment? Should a principle be developed on this topic?

5) Does the Board wish to discuss any other matters not identified by staff?