FORWARD-LOOKING INFORMATION

A Necessary Consideration in the SEC's Review on Disclosure Effectiveness

Investor Perspectives

CFA Institute

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CFA Institute is the global association of investment professionals that sets the standards for professional excellence. We are a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community.

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Executive Summary

The US SEC (Securities and Exchange Commission) is currently undertaking a review of the effectiveness of disclosures[1] under Regulation S-K,[2] which provides requirements for public company disclosures, and Regulation S-X,[3] concerning disclosures within the financial statements. Investors believe it is important for the SEC, as part of its disclosure effectiveness review, to complete its consideration (begun in late 2012) of the degree to which forward-looking information belongs within or outside the financial statements. In a speech at the December 2012 AICPA Conference on Current SEC and PCAOB Developments,[4] Paul Beswick, the SEC's chief accountant, made the following remarks with respect to the placement of information within or outside the financial statements:[5]

> So, where do I think that this brief, and I really mean brief, history lesson leaves me? Well, I believe that one could begin to draw some conclusions about the type of the information that should be included in other parts of the financial reporting package as compared to the financial statements. However, I believe that a healthy and robust dialogue could greatly contribute to this debate. Therefore, it is my intent for OCA [Office of the Chief Accountant], along with staff in other offices and divisions, to hold a roundtable in the upcoming months as the first step in considering this issue. We plan initially to focus on whether this issue should be further explored (including, for example, whether there [are] any perceived disclosure gaps today), and what are the critical decision points regarding this issue of the dividing line between what should appear in financial statements versus the broader financial reporting package.

[1]SEC Disclosure Effectiveness Review (www.sec.gov/spotlight/disclosure-effectiveness.shtml).

[2]Regulation S-K is the regulation under the Securities Act of 1933 and the Securities Exchange Act of 1934 that establishes the initial and periodic reporting requirements of US public companies (www.ecfr.gov/cgi-bin/text-idx?tpl=/ecfrbrowse/Title17/17cfr229_main_02.tpl).

[3]Regulation S-X is the regulation under the Securities Act of 1933 and the Securities Exchange Act of 1934 that establishes the form and content of financial statements included with the reports of public companies (www.sec.gov/about/forms/forms-x.pdf).

[4]AICPA refers to the American Institute of Certified Public Accountants, and PCAOB refers to the Public Company Accounting Oversight Board.

[5]Paul A. Beswick, "Remarks before the 2012 AICPA Conference on Current SEC and PCAOB Developments" (3 December 2012): www.sec.gov/News/Speech/Detail/Speech/1365171491922#.U5Bjq3adTls.

As we discuss in this report, and as touched on in Beswick's speech, the conversation regarding the characteristics of disclosures that belong within or outside the financial statements has—in our view—arisen, at least in part, because of the efforts of the Financial Accounting Standards Board (FASB, or the Board) to improve the measurements and disclosures related to financial instruments, impairments, liquidity and interest rate risk, going-concern status, and other note disclosures more broadly. In our view, much of the debate regarding whether such information belongs in the financial statements relates to the fact that the FASB's proposals incorporate greater degrees of forward-looking information.

In late 2013, CFA Institute published *Financial Reporting Disclosures: Investor Perspectives on Transparency, Trust, and Volume*, a report that describes investor perspectives on needed improvements in financial reporting disclosures.[6] This report is an extension of that report and provides investor perspectives on forward-looking information and whether a dividing line can be drawn between the forward-looking information that belongs outside the financial statements and the forward-looking information that can be included in the financial statements. In this report, we consider the following:

1. **Why forward-looking information is useful to investors**: The usefulness of forward-looking information to investors and the effect the financial crisis had on highlighting the need for further improvements in risk and liquidity disclosures, a type of forward-looking information.

2. **The definition and history of forward-looking information**: The definition and history of forward-looking information[7] under the Private Securities Litigation Reform Act (PSLRA, or Reform Act), the lack of a definition under US generally accepted accounting principles (GAAP), and the implications this has on perspectives regarding the location of forward-looking information.

3. **The misconception that US GAAP does not include forward-looking information**: The existence of forward-looking information in US GAAP and the evolution (i.e., the increasing inclusion of forward-looking information in financial statements) of US GAAP since the passage of the PSLRA in 1995. We show that US GAAP includes substantial degrees of forward-looking information and that there is a misconception that disclosures or measurements that are forward-looking belong, or should exist, outside the financial statements.

[6]A copy of the full report is available at www.cfainstitute.org/learning/products/publications/ccb/Pages/ccb.v2013.n12.1.aspx. A summarized version is available at www.cfainstitute.org/ethics/Documents/investor-perspectives-on-disclosures.pdf.
[7]Section 102 of the Private Securities Litigation Reform Act of 1995 (www.gpo.gov/fdsys/pkg/PLAW-104publ67/html/PLAW-104publ67.htm).

4. **Inconsistencies in the debate on forward-looking information**: The inconsistencies that investors see in the debate regarding the inclusion of forward-looking information in financial statements as the FASB develops new standards (e.g., impairments).

5. **The impact of the lack of a conceptual framework for measurement**: The impact of the lack of a conceptual framework for measurement, under US GAAP, on the inclusion of forward-looking information in financial statements. We also consider the FASB's recent efforts to introduce a new term (i.e., future-oriented information) in its proposal to introduce a conceptual framework for note disclosures.

We conclude by considering whether the SEC can, in fact, draw a dividing line between the forward-looking information that belongs within the financial statements and the forward-looking information that belongs outside the financial statements. We also consider whether, at this stage of financial standards development, creating a conceptual demarcation of whether such information is appropriate within financial statements may overlook the fact that the "conceptual Rubicon" has already been crossed; forward-looking information is already embedded in a significant number of existing accounting standards. Investors seek clarity on the SEC's perceived dividing line, as part of the disclosure effectiveness review, because the debate regarding its existence delays progress on improving disclosures that would be decision-useful for investors. The nature of the improvements, rather than their location in the financial filings, should be of principal concern to policymakers. The pursuit of artificial boundaries regarding where to provide additional forward-looking information simply ends up significantly constraining needed improvements to financial reporting information.

Forward-Looking Information: Essential Element of Decision-Useful Information for Investors

Telling the future by looking at the past assumes that conditions will remain constant. This is like driving a car by looking in the rearview mirror.

— *Herb Brody*

A primary objective of financial reporting is to provide information that will be useful to financial statement users in making economic decisions. Accordingly, it seems self-evident that financial statements that incorporate forward-looking information—such as liquidity and interest rate risk disclosures and fair value measurements—would be most useful to investors in making investment decisions.

CFA Institute has long advocated for more forward-looking measurements to enhance the decision-usefulness of financial statements for investors. Simultaneously, CFA Institute has sought better disclosures regarding management's assumptions, judgments, and estimates included in forward-looking measurements as well as better cash flow information to assess both the reasonableness of such assumptions, judgments, and estimates and the organization's ultimate realization of cash flows. Put differently, CFA Institute has sought both forward-looking measurements *and* disclosures that make such measurements meaningful.

In the United States, the common refrain used to exclude decision-useful forward-looking information from financial statements is that such information should, or must, be disclosed outside the financial statements under the Private Securities Litigation Reform Act of 1995 (PSLRA, or Reform Act)[8] and the protections it provides for such forward-looking statements. This position assumes that such disclosures will be made outside the financial statements on a mostly voluntary basis and made as effectively as those required by accounting standards to be included in financial statements.

[8]Section 102 of the Private Securities Litigation Reform Act of 1995 (www.gpo.gov/fdsys/pkg/PLAW-104publ67/html/PLAW-104publ67.htm).

This belief that forward-looking disclosures on such matters as risk and fair value will be sufficiently made outside the financial statements—with suggested or highly qualitative but not required quantitative disclosures—is met with a high degree of skepticism by investors, who did not see this occur before, during, or after the global financial crisis. Investors had to request additional quantitative and qualitative disclosures of risks, exposures, and liquidity issues as the 2008 financial crisis unfolded. Each quarter, additional disclosures emerged in response to investor requests. Further, the qualitative liquidity disclosure requirements proved insufficient in conveying the liquidity risks of entities during and after the financial crisis—for example, in the case of MF Global. In the view of most investors, the financial crisis highlighted the increased need for forward-looking information—not only because of the benefit such information would provide investors in understanding measurements, risks, and uncertainties, but also because improved disclosure requirements have the effect of increasing management's own assessment, understanding, and monitoring of risks (e.g., pension obligations).

Responding to a call for better risk disclosures (a type of forward-looking information), the Enhanced Disclosure Task Force (EDTF) of the Financial Stability Board (FSB) has made recommendations regarding a variety of voluntary risk disclosures. Other than a disclosure with respect to conflict minerals required under the Dodd–Frank Wall Street Reform and Consumer Protection Act, few significant changes in disclosures outside financial statements have been implemented to address issues that arose during the financial crisis.[9] Moreover, within the financial statements, investors have seen only minimal progress in improving the recognition, measurement, and disclosure issues that were most troublesome during the crisis. Disclosures have been added with respect to credit losses and the offsetting of derivatives, and certain additional fair value disclosures have been introduced. With respect to recognition, an amendment has been made to address two of the repurchase agreement misuses noted during the crisis, and a project—commenced prior to the financial crisis—now consolidates certain previously off-balance-sheet vehicles. Other than these items, investors have little to point to as improvements in financial reporting since the crisis. Further evidence of this is that the financial instruments project remains incomplete.

[9]In 2010, the US SEC issued a document on providing interpretive guidance on existing liquidity and capital resource disclosures ("Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis") and a proposed—but never finalized—rule on short-term borrowings ("Short-Term Borrowings Disclosure").

In an exchange at the 2013 World Economic Forum between Jamie Dimon, CEO of J.P. Morgan Chase, and Paul Singer, an investor and hedge fund manager at the investment fund Elliott Associates, the latter expressed his views regarding the opacity of financial institution reporting and the need for greater and improved disclosures about risks. An extract of the exchange follows.

Singer: One doesn't know from disclosures, or one can't find out from disclosures, whether global financial institutions are actually risky or sound, and I think that is something which needs to be fixed by global cooperation.

Dimon: You've made this comment publicly before. I called you up and asked you what you'd like to know. You probably have not read our Form 10-K. It is 400 pages long, where we break out assets by . . .

Singer: What 2008 showed was that many financial institutions didn't actually have a handle on—nor did their regulators on—the nature of their risks, and risk models which were being used were not adequate to describe transmission mechanisms. . . . What I am saying is that the path to normalization and a crystal-clear ability of global financial institutions to exist outside of an implicit governmental guarantee partially is dependent upon more deleveraging and more disclosures.

World Economic Forum (23 January 2013); the complete exchange can be viewed at http://www.weforum.org/sessions/summary/global-financial-context-0.

In our view, the complexity of financial institutions has surpassed the evolution of the disclosure requirements meant to explain that complexity. The comments of investor Paul Singer highlight this point, and the outreach of the Financial Accounting Standards Board (FASB) to investors demonstrates that investors seek better information on the cash flow characteristics—and risks—of financial instruments. The analysis and valuation of financial institutions is about assessing their risk-taking and risk management practices, and forward-looking measurements and disclosures are the most effective transmission mechanism in communicating such information.

The refrain that forward-looking information belongs outside the financial statements, however, has been used to object to and forestall improvements in financial statement disclosures regarding liquidity and interest rate risks proposed by the FASB in late 2012 and early 2013, which might provide investors in financial institutions with more decision-useful forward-looking information. As described more fully later in this report,[10] the SEC, during the same time as the FASB's exposure draft, indicated that it was developing a staff paper that would seek to clarify the dividing line between information (i.e., referring principally to forward-looking information) that belongs in the financial statements and information that belongs outside the financial statements—for example, in management discussion and analysis (MD&A). The staff paper was in response to an ongoing debate emanating from stakeholder responses to several of the FASB's recent proposals, most notably the aforementioned initiative to improve the disclosures of cash flow characteristics of financial instruments and liquidity of the entity (discussed more fully later in this report). The SEC announced later in 2013 that the staff paper would be deferred as part of the SEC's review of Regulation S-K[11] (also discussed more fully in the section "Can the SEC Draw a Dividing Line?").

We agree with the remarks made recently (May 2014) by SEC Commissioner Kara Stein to the Council of Institutional Investors, in which she articulated the need for improved disclosures that are in line with what has been deferred or delayed (e.g., funding and liquidity gap disclosures) because of the debate about where forward-looking information should be disclosed:

> That said, let me share some ideas about areas that may be ripe for improvement. Many of us continue to think about the lessons learned from the financial crisis. I am concerned that investors may not have sufficient information about some issuers' reliance on short-term funding for their long-term obligations. Companies' funding-liability mismatches played a key role in the crisis, and we need to make sure that we do what we can to prevent that from happening again. One way to do that is to enhance disclosures about issuers' funding arrangements. With additional transparency, shareholders can help rein in companies that become too reliant on short-term funding. Investment company disclosures regarding securities lending activities are also something that we should explore. Shouldn't a fund disclose both the percentage of its assets out on loan, and how it splits revenue from securities lending with its sponsor?[12]

[10]In the section "Can the SEC Draw a Dividing Line?," we describe in greater detail the SEC's actions related to forward-looking information and disclosure effectiveness.
[11]Regulation S-K is the regulation under the Securities Act of 1933 and the Securities Exchange Act of 1934 that establishes the initial and periodic reporting requirements of US public companies (Title 17, Part 229, on www.ecfr.gov).
[12]Kara M. Stein, "Remarks to the Council of Institutional Investors" (8 May 2014): www.sec.gov/News/Speech/Detail/Speech/1370541764008.

Deferring enhancements to financial reporting because of a debate regarding where forward-looking information belongs—particularly in such areas as risk and liquidity disclosures, which clearly proved problematic during the financial crisis—is not beneficial to investors who seek this decision-useful information. The nature of the improvements, rather than their location in the financial filings, should be of principal concern to policymakers. The pursuit of artificial boundaries regarding where to provide additional forward-looking information, such as risk disclosures, simply ends up significantly constraining needed improvements to financial reporting information.

In this report, we explore the elements of the debate regarding whether forward-looking information belongs within financial statements because the position that forward-looking information does not belong in financial statements appears inconsistent with current practice, recent developments, and attempts to develop more appropriate forward-looking measurements for the benefit of investors in the standard-setting arena. We consider the definition of forward-looking information, the evolution of US GAAP, the debate over standards under development, the impact of the lack of a conceptual framework for measurement and the FASB's attempt to provide a conceptual framework for disclosures, and whether the SEC can draw the dividing line discussed in 2012.

What Exactly Is Forward-Looking Information?

To understand the debate on forward-looking information, it is important to understand how it is defined as well as its origin and history.

Definition

US GAAP does not include a definition of "forward-looking information" or "forward-looking statement."[13]

In the Private Securities Litigation Reform Act of 1995,[14] the term "forward-looking statement," which can be oral or written statements, is broadly defined as

a. a statement containing a *projection* of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items;

b. a statement of the *plans and objectives of management for future operations*, including plans or objectives relating to the products or services of the issuer;

c. a statement of *future economic performance*, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission;

d. any statement of the *assumptions underlying* or relating to any statement described in subparagraph (a), (b), or (c);

e. any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer; or

[13]In the section "Lack of Conceptual Framework for Measurement: Complicates the Issue of Forward-Looking Information," we discuss the March 2014 FASB Exposure Draft, *Proposed Statement of Financial Accounting Concepts: Conceptual Framework for Financial Reporting—Chapter 8: Notes to Financial Statements*, which explores the concept of "future-oriented information."
[14]Section 102 of the Private Securities Litigation Reform Act of 1995 (www.gpo.gov/fdsys/pkg/PLAW-104publ67/html/PLAW-104publ67.htm).

f. a statement containing a *projection or estimate* of such other items as may be specified by rule or regulation of the Commission.

In addition, from our perspective, the inclusion of projections of "other financial items" (subparagraph [a]) and the assumptions underlying or relating to other financial items (subparagraph [d]) results in a very broad definition of forward-looking statements or information.

When used colloquially, the term "forward-looking information" is, in our view, generally meant to be in line with the definition of forward-looking statement in the PSLRA. As a result, accountants in the United States have a nearly automatic association with the term forward-looking information—an association that tells them that any such information must be included outside the financial statements—given that the PSLRA defines the term and US GAAP does not. However, this term—and its automatic association with information to be included outside the financial statements—requires further analysis and critical thinking to evaluate the precise characteristics that constitute forward-looking information and why it might belong outside the financial statements relative to the characteristics of similar information included in the financial statements.

History of Forward-Looking Information

The history of forward-looking information and the safe harbors provided to such information in the context of US securities law is important to an understanding of the current debate in the United States regarding the placement—inside or outside the financial statements—of forward-looking information. The following is a brief summary of the history of this very complex topic:[15]

Although the Securities and Exchange Commission (the "SEC") had at one time excluded forward-looking information from SEC filings, beginning in the early 1970s, the SEC adopted policies encouraging issuers to disclose voluntarily forward-looking information both in their public filings and in public statements generally. In so doing, the SEC recognized that management projections concerning future economic performance were "of significant importance" to informed investor decision-making. As time has gone by, the SEC has gradually required the disclosure of forward-looking

[15]Cadwalader, Wickersham & Taft LLP, "Application of the Safe Harbor for Forward-Looking Statements" (26 March 2008): http://corporate.findlaw.com/finance/application-of-the-safe-harbor-for-forward-looking-statements.html.

information in certain circumstances, most notably in Management's Discussion and Analysis of Financial Condition and Results of Operations as required by Item 303 of Regulation S-K ("MD&A").

By 1979, the SEC had adopted safe harbor rules in the form of Rule 175, with respect to the Securities Act of 1933 (the "Securities Act"), and its twin, Rule 3b-6, with respect to the Securities Exchange Act of 1934 (the "Exchange Act"). Under these rules, forward-looking information included statements concerning projections of certain financial information, management's plans for future operations, and statements of future economic performance contained in the issuer's MD&A. These safe harbors provided that statements of forward-looking information would not be considered fraudulent unless it was shown that the statements lacked a reasonable basis or were not made in good faith; however, these rules applied only to statements made in reports filed with the SEC or to related statements reaffirmed in subsequent filings.

Notwithstanding the view that forward-looking disclosure is useful to investor decisions and market efficiency, issuers remained reluctant to make such disclosures beyond those necessary to comply with SEC reporting requirements. The primary basis for this reluctance had been attributed to the significant litigation risks imposed on the company, and possibly its directors and officers, as a result of predictive disclosures that later turned out to be incorrect. This perception was heightened by the concern that the company would have difficulty in successfully exiting litigation at an early enough stage to avoid expensive discovery and the possibility of a large settlement.

Moreover, numerous commentators observed that the 1979 safe harbor rules were ineffective largely because they failed to protect companies from being sued over projections and did not protect oral statements. Indeed, both courts (with the notable exception of the U.S. Court of Appeals for the Seventh Circuit) and defendants rarely relied on the 1979 safe harbor rules. Instead, litigation concerning forward-looking statements focused on the requirement of F.R.C.P. 9(b), that a complaint set forth allegations of fraud with particularity or common law doctrines. The most significant common law doctrine providing protection for defendants seeking to avoid liability based on forward-looking statements became known as the "bespeaks caution" doctrine. The bespeaks caution doctrine generally protects an issuer or affiliate from liability based on forward-looking statements if the statements are tempered by the inclusion of cautionary language.

Based on the perception of significant abuse in private securities lawsuits, largely in the form of unmeritorious class action litigation, Congress enacted amendments to the Securities and the Exchange Acts with the passage of the PSLRA in 1995. Included in the PSLRA amendments was the adoption of a safe harbor for forward-looking statements designed to have broader application than the existing SEC safe harbor rules. Significantly, the PSLRA's legislative history expressly states that the "bespeaks caution" doctrine is not to be replaced by the Reform Act's safe harbor, nor is the judicial development of that doctrine to be halted.

For purposes of the statute, a forward-looking statement includes statements containing projections of financial matters, plans, and objectives for future operations or future economic performance (such as statements contained in the issuer's MD&A), as well as the assumptions underlying or relating to such statements. Forward-looking statements made in connection with tender offers, going private transactions, initial public offerings, and financial statements made in accordance with Generally Accepted Accounting Principles, however, are not covered by the PSLRA's safe harbor.

Bringing Together the Definition and History

The lack of a definition of forward-looking information in US GAAP and the term's history as one used with public securities law is the genesis of the debate over the location of forward-looking information.

Given the encouraged, rather than required, nature of certain forward-looking information, as well as the safe harbors afforded to it outside the financial statements, most companies would prefer to include such information in the forepart to the financial statements at their discretion rather than be required to include forward-looking measurements or disclosures in financial statements. For investors, this approach has the effect of making many such disclosures discretionary in nature when the information may in fact be essential to the investment-decision-making process. Further, the forward-looking information provided can sometimes be skewed toward the delivery of positive information. Moreover, much information may be provided in a qualitative fashion rather than in a more useful quantitative manner (e.g., liquidity disclosures). Thus, investors would prefer the inclusion of more explicit, required, and quantitative disclosures in financial statements. That being said, US GAAP does not include the term and thus, for some, the ability to incorporate forward-looking information. In the next section, we consider the evolution of US GAAP and, although not labeled as such, the incorporation of forward-looking information.

The Evolution of US GAAP: Increased Inclusion of Forward-Looking Information in Financial Statements

The Evolution

A shift toward greater inclusion of forward-looking measurements and disclosures in financial statements began to occur, and has only increased, following the passage of the PSLRA in 1995. Consider, for example, the development and adoption of these US GAAP standards since 1994.

Year Adopted	Standard Number	Description
1994	SFAS 115	*Accounting for Certain Investments in Debt and Equity Securities*—Expanded the use of fair value for certain debt and equity instruments.
1995	SFAS 119	*Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*—Expanded the fair value disclosures for various financial instruments.
1996	SFAS 123	*Share-Based Payment*—Costs associated with stock awards are required to be expensed, with the expense estimated using option-pricing models.
2001	SFAS 133	*Accounting for Derivative Instruments and Hedging Activities*—All derivatives are required to be measured at fair value through the income statement or other comprehensive income.
2007	SFAS 157	*Fair Value Measurements*—Formally articulated the methods by which fair values would be measured and the disclosures necessary to communicate the measurements. In subsequent amendments, the disclosure requirements associated with fair value have been further expanded.
2007/2008	SFAS 158	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*—Required that the funded status of employee benefit plans (the difference between the fair value of the plan assets and the projected benefit obligation) be recognized in other comprehensive income. With it came additional disclosures regarding the nature of the underlying assets and obligations. The projected benefit obligation and the plan assets are measurements and disclosures with high degrees of uncertainty and forward-looking estimates/information.
2007/2008	SFAS 159	*The Fair Value Option for Financial Assets and Financial Liabilities*—Allowed the option to account for certain financial assets and liabilities at fair value.

The increased use of fair value measurements for financial instruments, the expansion of fair value disclosures, the measurement of stock-based compensation amounts based on fair value models, and the recognition of net pension obligations all illustrate the increased inclusion of forward-looking information in financial statements over the past 20 years.

The Misconception

This evolution of accounting standards under US GAAP illustrates how forward-looking information has increasingly been included in the financial statements. However, many overlook that the broad definition of forward-looking information means that financial statements already include many measurements and disclosures that meet the definition of forward-looking information. In some instances, the use of such estimates is obvious (e.g., amounts that are carried at fair value, as described in the preceding section), particularly where fair value is based on management's own estimates of the future. In other instances, the estimates are buried more deeply in the valuation process—embedded in the valuation of reserves or other types of provisions and included in impairment assessments and write-downs or even in depreciation methods.

To address this misconception, we briefly examine in Appendix A some of the more significant areas of financial reporting in which estimates about the future form either an integral or a significant component of the amounts reported. Our analysis considers three categories:

- **Financial instruments:** Securities at fair value, loan impairments, securities impairments
- **Other assets and liabilities:** Property, plant, and equipment; intangible assets and goodwill; litigation and environmental reserves; pension and other postretirement benefit obligations; employee stock awards; deferred taxes and uncertain tax positions
- **Revenue recognition:** Allowance for doubtful accounts, warranties, sales incentive programs, long-term construction contracts, and multi-element/bundled projects and services

The summary in Appendix A is not meant to be exhaustive. Rather, it is meant to illustrate what a broad definition of forward-looking information encompasses and that financial statements already incorporate a substantial amount of forward-looking information.

The Question: What Forward-Looking Information Belongs in the Financial Statements?

The misconception regarding the degree to which forward-looking information is, and has increasingly become, included in financial statements has put pressure on the frequently asserted objection that forward-looking information does not belong in the financial statements. The nearly automatic association of the term forward-looking information with information that should be included outside the financial statements requires further evaluation. Despite forward-looking information not being defined within US GAAP, the evolution of accounting standards and the substantive inclusion of forward-looking elements within US GAAP measurements have created a need to consider a basic question: What forward-looking information belongs in the financial statements?

The Recent Debate on Forward-Looking Information: Investors Observe Inconsistencies

Recent proposals by the FASB have sparked a debate regarding what forward-looking information belongs in the financial statements. Here, we consider the evolution of the recent debate and provide investor observations.

Financial Instruments: Distinctions between Forward-Looking Disclosures and Measurements Are Artificial

Measurement of Financial Instruments (2010)

In 2010, the FASB exposed for comment a proposal[16] related to accounting for financial instruments that would have required nearly all financial instruments to be measured at fair value (i.e., a forward-looking measurement). In 2011, under substantial political pressure, the FASB backed away from this proposal. Partial justification for this reversal was the FASB's feedback from users/investors. The FASB's summary regarding its outreach efforts indicated that users/investors not only prefer a mixed-measurement model, with such financial instruments as loans carried at amortized cost, but also want *disclosures*, rather than *measurements*, of the fair value of financial instruments, along with disclosures regarding the underlying cash flow characteristics of financial instruments.[17]

[16]*Proposed Accounting Standards Update:Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (May 2010): www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175823559151&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs.

[17]This outreach was inconsistent with CFA Institute members' views and with the empirical research on the application of fair value to financial instruments. CFA Institute's comment letter on the proposed updates provides the results of member surveys on this topic (www.cfainstitute.org/Comment%20Letters/20100930.pdf).

Disclosures about Liquidity and Interest Rate Risk (2012)

Subsequently, in 2012, the FASB issued an exposure draft[18] that proposed not only disclosure of the expected cash flow characteristics of certain financial instruments and their related interest rate risk but also, through the use of tables, better illustrations of the liquidity, or liquidity gap, of the overall entity. This proposal, as with the original financial instruments proposal, was met with significant opposition by companies and preparers. Investors, however, did not object to the inclusion of such information in the financial statements. Much of the opposition was based on the belief that such information is forward-looking and does not belong in the financial statements. Consider, for example, the following excerpt from one large financial institution's comment letter on the proposal:

> Forward-looking disclosures are not appropriate for the financial statements. Interest rate and liquidity risk management information is inherently forward looking and by extension, meaningful disclosures of these risks should also be forward looking. Information and analysis that is forward looking is typically disclosed in the MD&A. Consistent with this view, the Board has acknowledged that there is a difference between disclosure information included within and outside of the financial statements and has recently embarked on a new project, the Disclosure Framework Project (DFP), to develop appropriate principles to determine the nature, amount and location of financial disclosures. . . . Accordingly, we encourage the Board to reevaluate the nature and location of the proposed disclosures and more closely coordinate with the SEC and prudential regulators that are developing similar disclosures to determine if improvements in MD&A disclosure requirements are necessary.[19]

Thus, in relation to disclosures associated with interest rate and liquidity risk, this financial institution argues that such forward-looking information does not belong in the financial statements.

[18]FASB, *Proposed Accounting Standards Update:Disclosures about Liquidity Risk and Interest Rate Risk* (June 2012): www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175824112049&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs.

[19]FASB, "Disclosures about Liquidity Risk and Interest Rate Risk," Comment Letter 39 (25 September 2012): www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175824541889&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=309024&blobheadervalue1=filename%3DAFIDIS.ED.0039.WELLS_FARGO_%26_COMPANY_RICHARD_D._LEVY.pdf&blobcol=urldata&blobtable=MungoBlobs.

The FASB tabled[20] the exposure document on liquidity and interest rate risk disclosures, despite the feedback from the investor/user community that supported disclosures over measurements of certain financial instruments at fair value. The FASB noted several reasons for tabling the proposal, including (1) the feedback that such forward-looking information belongs outside the financial statements, (2) concerns regarding the ability to portray the entire liquidity position of the entity, and (3) the SEC's planned consideration of the nature of forward-looking information and its placement inside or outside the financial statements.

Measurement of Financial Instruments (2013)

In 2013, the FASB issued a revised exposure draft on the classification and measurement of financial instruments[21] that called for the use of fair value in the measurement of certain financial instruments but amortized cost in the measurement of others. In very simple terms, the proposed classification was to be based on the business model (i.e., intent) of the entity holding the financial instrument and the cash flow characteristics of the financial instrument. In the exposure draft, the FASB proposed to require disclosure of the fair value of all financial instruments on the face of the balance sheet.

Investors find the assertion that forward-looking information—such as the cash flow characteristics of certain financial instruments, along with the impact of their interest rate and overall liquidity risk—should not be disclosed in the financial statements because of its forward-looking tendency to be contradictory. That contradiction stems from the following issues.

1. **Fair value (a forward-looking measure) disclosure required for all financial instruments:** The fair value of these financial instruments will be disclosed in the financial statements, and this fair value measurement is as forward-looking in nature as the disclosure of cash flow characteristics and liquidity risks. Additionally interesting to investors is the FASB's 2010 exposure draft that proposed to measure these same financial instruments at fair value in the basic financial statements.

[20]The FASB has indicated on its website that the project's objective is being revised. The last update was in November 2012.

[21]FASB, *Proposed Accounting Standards Update:Recognition and Measurement of Financial Assets and Financial Liabilities* (February 2013): www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175825999175&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=1363169&blobheadervalue1=filename%3DProposed_ASU_Financial_Instruments%25E2%2580%2594Overall_%2528Subtopic_825-10%2529_Recognition_and_Measurement.pdf&blobcol=urldata&blobtable=MungoBlobs.

2. **Same financial instrument, different measurement:** Depending on an entity's business model (i.e., intent), the same financial instrument may be measured at fair value (a forward-looking measure) in one entity's financial statements while measured at amortized cost (a historical measure) within the same entity or by another entity. Consider the following:

    - Fair value: For the entity whose financial instrument is measured at fair value, forward-looking risks are effectively incorporated into the financial instrument's measurement.

    - Amortized cost: For the entity whose financial instrument is measured at amortized cost, critics of forward-looking disclosures would assert that it would be inappropriate to disclose the expected cash flow characteristics and interest rate risk of the financial instrument in the financial statements owing to the information being too forward-looking. But the fair value of the instrument itself, based on such cash flows and current interest rate expectations, would be required to be disclosed.

Following this line of argument to its conclusion, the decision whether to include meaningful forward-looking information in the financial statements would ultimately depend on management's choice of measurement—and would thus create inconsistency in financial reporting when comparing entities.

In other words, investors see a conceptual inconsistency and contradictions in the requirement to measure, or disclose, certain financial instruments in the financial statements, using such forward-looking measurements as fair value while excluding from the financial statements the disclosure of the underlying cash flows, assumptions, and risks of such financial instruments. Moreover, management's discretion in choosing the measurement would determine whether forward-looking information is appropriate to disclose.

Impairment: The Expected Loss Impairment Model Is Inherently Forward-Looking

Forward-Looking Impairment Model Highlights Inconsistencies

Contradictions with respect to the nature of forward-looking information that belongs in the financial statements are further highlighted by the FASB's most recently proposed impairment model.[22] This model, referred to as the current expected credit loss (CECL) model, requires companies to make an assessment of expected credit losses—incorporating expectations regarding current and future economic conditions as they see them today—and to recognize such losses at the inception or acquisition of the financial instrument.

Investors find it inconsistent that although disclosures of the expected cash flows and liquidity and interest rate risk of financial assets, such as loans, measured at amortized cost and subject to impairments should not, as argued by some, be included in the financial statements (as discussed in the preceding section), impairments on such loans can be measured and recognized in the financial statements using these forward-looking estimates of credit losses. The message communicated to investors seems to be that credit risk on individual loans is less forward-looking than the associated interest rate risk and overall expected cash flows (which include credit risk).

The aforementioned cash flow and liquidity disclosures are necessary because they articulate the assumptions underlying the measurements (whether amortized cost less impairment or fair value) and thereby make them meaningful and decision-useful. They facilitate an understanding of the difference between the financial statement measurement (amortized cost less impairment) and the fair value disclosure. They also allow investors to evaluate the development of management's estimate and provide a basis for determining whether changes in economic circumstances, rather than simply management discretion, lead to changes in such estimates and judgments.

Furthermore, in the eyes of many investors, the lack of a market reference for forward-looking credit impairment measurements, as proposed by the FASB, raises more questions regarding their reliability than does the use of fair value. With fair value, there is an obligation to use, to the maximum extent possible, observable market inputs. Without improved forward-looking disclosures that support the cash flow characteristics of financial

[22]FASB, *Proposed Accounting Standards Update:Financial Instruments: Credit Losses* (December 2012): www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175825477164&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs.

instruments, as requested by investors in the FASB's outreach, investors will be left with little substantive insight into the impairments recognized in the financial statements—and with little information to reconcile the fair value disclosure of the financial instrument with its amortized cost less impairment.

Investors are concerned about the increased use of measurements that will lead to a greater degree of forward-looking subjective judgments and management discretion, without accompanying disclosures that provide transparency as to those assumptions, estimates, judgments, and forecasts (along with their development over time). Both fair value and amortized cost less impairment require disclosures of the underlying assumptions. Regardless of whether the FASB chooses the appropriate measurement (i.e., fair value) to include in the financial statements, disclosures supporting both amortized cost with impairment (the measurement basis) and fair value (the disclosure) are necessary.

Inconsistent Perspectives on Impairment and Risk Disclosures: An Example

Commenting on the FASB's proposals, there are some inconsistent views with respect to whether and when forward-looking information belongs in the financial statements. Compare, for example, the comments of the same financial institution cited previously—in which it opposed liquidity and interest rate risk disclosures on the basis of their being forward-looking—with its comments on an earlier version of the FASB's impairment model (i.e., a version that was less forward-looking than the new CECL model).

> Future conditions or events must be considered in the determination of expected credit losses: [this financial institution] is a proponent of a credit impairment model with a longer emergence period that allows for earlier recognition of expected credit losses. However, we do not agree with the Board's decision to diverge from the proposed IASB [International Accounting Standards Board] model by only allowing the consideration of past events and existing conditions when determining the amount of expected credit losses. Typically, future expectations are based on historical and current economic trends, published statistical data, borrower specific data, and reasonable forward-looking expectations, all of which are fundamental to our current quarterly processes for determining our financial condition. Precluding the consideration of this information from the determination of expected credit losses is not consistent with sound credit management or a market participant's view of credit risk inherent in fair value. Accordingly, credit loss reserves will lag changes in the market's credit assumptions, resulting in reported results that will be misleading to investors.

> The credit market disruption highlighted the need for more transparency related to an enterprise's exposure to credit risk. The notion of expected credit losses, whether based on expected cash flows, statistical data or implicit in a quoted price, inherently considers how expectations of future economic conditions affect current and historical conditions. The determination and disclosure of credit losses based on a static or historical view of credit exposure will not be reflective of actual credit losses inherent in financial assets, but rather a "rules driven" determination of exposure to credit risk, which in turn, may mislead financial statement users. In addition, this proposal will be operationally burdensome because it will require preparers to maintain multiple sets of books and records to monitor cash flows based on a static view (impairment), a market participant view (fair value), and the reporting entity's view (internal risk management).[23]

With respect to the impairment model, this financial institution asserts that future, not just current, conditions *must* be allowed to be incorporated into the estimation of expected credit losses because such information is the most useful to investors. Its comment letter on liquidity and interest rate risk (related to such loans), however, asserts that such cash flow disclosures, which support these measurements, should be excluded because they are forward-looking.[24]

Going-Concern Assessments: The Ultimate Forward-Looking Call

In 2013, the FASB exposed for comment a document that would require management—not simply auditors—to make going-concern assessments and include disclosures regarding material uncertainties that might signal a potential going-concern problem (i.e., early-warning disclosures). Many objected to this proposal, suggesting that such disclosures would become a self-fulfilling prophecy, even though the disclosures did not change the going-concern assessment criteria per se.

[23]FASB, *Proposed Accounting Standards Update: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, Comment Letter 193 (19 August 2010): www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175821154217&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs.

[24]In its comment letter of 31 May 2013 on the 2013 FASB and IASB impairment proposals, this same financial institution supported a model that provides it with the discretion to decide over what period the estimate of losses will be made (i.e., a forward-looking assumption).

As a substitute for the proposed going-concern uncertainty disclosures, some suggested that liquidity disclosures highlighting the liquidity status of the organization on a more routine basis should be added. The thinking was that such routine liquidity disclosures would facilitate an understanding and assessment of the cash flow prospects of the entity and thereby allow investors to make their own going-concern assessments on a routine, rather than an exception, basis. Ironically, these would be the types of disclosures similar to those proposed in the previously mentioned exposure draft on liquidity and interest rate risk, which the FASB tabled earlier in 2013 because of criticism over their forward-looking nature.

In early 2014, the FASB decided not to require the early-warning disclosures included in its original proposal and instead to require such disclosures only when there is substantial doubt as to an entity's going-concern status. Such disclosures are similar to those required, but rarely made, under existing auditing standards. This change would require management to make such going-concern assessments, rather than the auditor alone.

The FASB proposed but then withdrew its forward-looking early-warning disclosures in the going-concern proposal, just as it had done with the forward-looking disclosures on liquidity risk and with the financial instruments measurement proposal in 2010 (and the insurance proposal discussed later in the report). The FASB has a pattern of acknowledging the decision-usefulness of forward-looking measures and disclosures to investors but then rescinds the proposals because of opponents' concerns that they are forward-looking in nature. For that reason, investors consider it important for the FASB and the SEC to ascertain the characteristics of forward-looking information that belongs in the financial statements so the SEC can then determine the appropriate disclosures outside the financial statements; currently, the disclosures are not occurring sufficiently in either location. The importance of these needed improvements is highlighted by going-concern assessments in which sophisticated investors—who have the ability to formulate a more comprehensive picture of the entity from all available market information—generally abandon stocks before the auditor or management articulates a going-concern issue that is understandable to average investors.

The Proposed Insurance Model: Built on Forward-Looking Information

When investors consider the decisions made under the insurance contracts project of the FASB and IASB—until the FASB's recent decision to make only "targeted changes to US GAAP"—the assertion that forward-looking information cannot be included in the financial statements is seen as highly inconsistent with the underlying measurements being proposed under the project. The insurance proposal being carried forward by the IASB would require companies to use a building block approach to estimate future cash outflows related to liabilities and to discount such cash flows using a discount rate that, like the cash flows, would be updated each accounting period to arrive at the measurement of such liabilities. These measurements are highly forward-looking.

Even if the FASB does not fully adopt a current value approach as proposed under the IASB's model, US GAAP for insurance contracts currently requires the use of forward-looking assumptions in the establishment of insurance liabilities and the recognition and measurement of policy acquisition costs. Depending on the type of product, some of the assumptions are updated regularly and others are "locked in" until they deteriorate to a point at which they need to be unlocked to recognize the impairment of policy acquisition costs of the recognition of additional insurance liabilities. At that time, the forward-looking assumptions are updated. Under both models, forward-looking assumptions are incorporated into the financial statement measurements.

To ensure that the measurements are meaningfully understood and decision-useful, investors require disclosures on the underlying estimated cash flows and their assumptions at a point in time and over time—as well as the sensitivities of such measurements. Without disclosures that explain these measurements, the insurance project (i.e., in whatever form—current value or locked-in assumptions) will not result in a model that is decision-useful to investors. Further, given that the nature of the measurements may not reflect the most decision-useful information to investors (i.e., locked-in assumptions under a FASB-targeted improvement approach), it may be important to include forward-looking disclosures that supplement or complement the measurements incorporated into the financial statements. An approach that supports the inclusion of forward-looking disclosures—both within and outside the financial statements—that supplement measurement decisions may be necessary. Improved interest rate risk disclosures, for example, would be especially important for investors in this prolonged low-rate environment. The standard-setters should not be constrained in making such disclosure decisions by a debate regarding the location of such disclosures.

Revenue Recognition Includes Forward-Looking Information

Appendix A describes the ways in which current revenue recognition guidance includes forward-looking information. The newly issued revenue recognition guidance will also require a high degree of forward-looking information to develop such assumptions as the estimated selling price used in the allocation of revenue between elements of a multi-element contract. In a less obvious way, all the convergence projects incorporate the use of forward-looking information.

How Do Investors Reconcile These Inconsistencies?

All these examples highlight the inconsistencies and contradictions that investors observe with respect to the forward-looking information that can or cannot be included in the financial statements. Investors observe many instances in which forward-looking information is included in the financial statements when it calls for a high degree of management discretion in choosing the measurement and other instances in which less-forward-looking disclosures that will supplement or provide transparency to the measure are not included in the financial statements because they are forward-looking. Such inconsistencies make the refrain that disclosures cannot be included in the financial statements because they are forward-looking difficult for investors to accept at face value. As we discuss in the next section, this may stem from the lack of a conceptual framework for measurement. It may also result from a lack of clarity regarding whether the responsibility for forward-looking information and disclosures belongs with the SEC or the FASB.

Lack of Conceptual Framework for Measurement: Complicates the Issue of Forward-Looking Information

In the view of CFA Institute, the lack of a conceptual framework for measurement under US GAAP is one of the underlying contributors to the contradictions in the debate regarding the nature of forward-looking information to be included in the financial statements.

How the Lack of a Conceptual Framework for Measurement Affects Disclosure of Forward-Looking Information

The conceptually inconsistent measurement of assets and liabilities currently used in US GAAP financial statements—both at and after inception—creates confusion for all stakeholders regarding the characteristics of an asset or liability that define how it should be measured as well as the degree to which forward-looking information should be incorporated into the measurements. Forward-looking assumptions are also used in determining when items are recognized, or not recognized, in financial statements and can create inconsistencies in recognition as well as measurement.

Accounting measurements are generally neither of the measurements—cash or fair value—that investors find most decision-useful. Accordingly, most investors adjust the accounting measurements to the economic measurement of their choosing. The existing inconsistency and noneconomic nature of many measurements in the financial statements makes them difficult for investors to use without significant adjustment, which places additional importance on disclosures.

The lack of a conceptual basis for measurement leads to a debate regarding the nature of the disclosures necessary to make such measurements decision-useful to investors. Investors seek forward-looking assessments of value and an understanding of how they were derived, which requires disclosure of the underlying forward-looking assumptions, estimates, and judgments. Yet, as illustrated previously, many stakeholders fail to recognize the connection of the forward-looking disclosures to the related forward-looking measurements. In failing to recognize this connection, many stakeholders argue that the disclosures are too forward-looking to include in the financial statements because they believe that US securities law requires all such forward-looking information to be presented outside the financial statements.

Complicating the issue still further, disclosures are often seen by standard-setters as a *substitute* for appropriate presentation, recognition, or measurement, rather than as a *complement* to the basic financial statements. The degree of disclosure necessary to remediate these suboptimal decisions is then seen as either too much information or information that is too forward-looking to be included as disclosures in the financial statements. The challenge for investors is that the necessary forward-looking information is then neither measured nor disclosed in the financial statements and notes.

Establishing a measurement framework that uses economically relevant measurements and defines how and why assets and liabilities are measured would better guide investors regarding the measurements that are most useful for their analysis and investment decision making. Moreover, establishing a measurement framework would provide a basis for forming a disclosure framework to make such measurements even more meaningful.

The FASB's Proposed Conceptual Framework for Disclosures in Notes: Can Future-Oriented Information Meet Investor Needs?

Recently, the FASB exposed for comment a proposal[25] to update the conceptual framework for financial reporting related to the notes to the financial statements. In this proposal, the FASB introduces a new term, "future-oriented information."[26] The FASB appears to be attempting to differentiate "future-oriented information" from "forward-looking

[25]FASB, *Proposed Statement of Financial Accounting Concepts: Conceptual Framework for Financial Reporting—Chapter 8: Notes to Financial Statements* (March 2014).
[26]FASB, *Conceptual Framework for Financial Reporting—Chapter 8: Notes to Financial Statements*, pp. 14–17, Paragraphs D22–D31; paragraphs have been excerpted and included in Appendix B for reference.

information" as defined under securities laws. However, there appears to be no clear demarcation of the informational characteristics that make something "future-oriented" as opposed to "forward-looking." But there is an indication that disclosures of future-oriented information may be appropriate where such disclosures relate to items for which the Board—without the benefit of a conceptual framework for measurement—has made the decision to include in the financial statements or notes a measurement that may involve assumptions, estimates, plans, or strategies about the future. The final paragraph of the section on future-oriented information notes: "In summary, the Board generally does not require disclosures of expectations and assumptions about the future that are not inputs to current measures in financial statements or notes."[27]

The Board appears to recognize the need to include disclosures about items measured by using future-oriented information in the financial statements or notes but excludes from disclosure consideration information about measurements outside the financial statements or notes. This may reflect progress—given past instances, noted earlier, in which disclosures have been objected to as being forward-looking in nature when in fact they relate to items measured by using assumptions, projections, or estimates of the future in the financial statements. In the proposal, the FASB attempts to identify three types[28] of future-oriented information that it believes may be appropriate for disclosure consideration:

1. Estimates and assumptions used as inputs to measurements, many of which are future-oriented and internally developed
2. Existing plans and strategies related to matters under management's control
3. The effect of specified future changes in existing conditions on specific line items or on the entity as a whole

A careful read of the detailed descriptions of these three types of future-oriented information suggests there may be an emphasis on the fact that the assumptions, estimates, plans, and strategies that are being considered for disclosure

1. relate to line items measured in the financial statements,
2. are generally internally developed,

[27]FASB, *Conceptual Framework for Financial Reporting—Chapter 8: Notes to Financial Statements*, p. 17, Paragraph D31.
[28]FASB, *Conceptual Framework for Financial Reporting—Chapter 8: Notes to Financial Statements*, pp. 16–17, Paragraphs D26–D30.

3. are under management's control,

4. are not projections or predictions, and

5. will not result in adverse or negative consequences to the entity.

Clarification may be needed on several paragraphs[29] within the proposed standard because we understand the Board's intent may be different from the interpretation one might make from a review of these paragraphs. Specifically, we think that clarification, or more explicit articulation, regarding the following points may be necessary:

1. **Financial statements vs. notes to financial statements:** Much of the Board's discussion regarding disclosures of future-oriented assumptions, estimates, plans, and strategies refers to measurements of line items within the financial statements, despite the Board's assertion that disclosures for consideration relate to measurements—whether such measurements are included in a financial statement line item or are disclosed in the notes.

   Paragraph D31 of the proposal states: "In summary, the Board generally does not require disclosures of expectations and assumptions about the future that are not inputs to current measures in the financial statements *or notes*" (emphasis added).

   However, the discussion in Paragraph D27 of the proposal refers principally to inputs to "line items in financial statements" or the "measurement of assets and liabilities," leaving the impression that disclosures are only appropriate for consideration if they relate to measurements within the financial statements. For example, Paragraph D27 says:

   > Information about those inputs often is an important part of a *faithful representation of a line item* and does not create the same degree of risk of negative consequences as do projections or predictions about future events that are *not within a line item* in the financial statements. (emphasis added)

   It goes on to say:

   > However, some entity-specific measurements also include projections or predictions about future events (for example, salvage value, useful lives, and bad-debt percentages) that are important to *faithful representation of the line*

[29]FASB, *Conceptual Framework for Financial Reporting—Chapter 8: Notes to Financial Statements*, p. 16, Paragraphs D27–D28.

> *item*. Because that information *explains amounts included in financial statement line items*, it would be appropriate for the Board to consider requiring disclosure of these inputs. (emphasis added)

And is followed by:

> In contrast, estimates of future revenues related to future sales transactions or the timing of those revenues would not be related to past events or current conditions or circumstances. *Therefore, that information would be inappropriate for the notes unless it was an input to a current measure of an asset or a liability*. (emphasis added)

These references to line items in the financial statements—rather than to line items in the financial statements and/or measurements disclosed in the notes—leave readers with the impression that the Board will consider future-oriented disclosures related to measurements within the financial statements but not necessarily in the notes. We understand that the Board's intent is to consider disclosures of future-oriented information about measurements that are included in the notes as well as in the financial statements; however, this is not as explicit as may be necessary to mitigate any confusion on this point. Because this has been a major point of discussion in the conversation regarding what forward-looking information belongs in the financial statements and notes and what forward-looking information should be included in the MD&A, we believe the Board needs to be more explicit on this point.

Historically, the Board has used disclosures to take progressive steps toward improved measurement (e.g., pensions and stock-based compensation) by allowing investors and preparers a "first look" at the measurement through disclosures. Without the aforementioned clarification, adding forward-looking disclosures in the notes as a substitute for appropriate measurements and as a first step toward forward-looking measurements in the financial statements may be constrained.

2. **Internally developed vs. market-based inputs:** Paragraph D27 of the proposal states that the following is information that should be considered for disclosure:

> The first is information about estimates and assumptions used as inputs to measurements, many of which are future-oriented and internally developed. Information about those inputs often is an important part of a faithful representation of a line item and does not create the same degree of risk of negative consequences as do projections or predictions about future events that are not within a line item in the financial statements.

The latter part of the first sentence, and the sentence that follows it referring to these types of inputs, may leave readers with the impression that the Board believes internally developed future-oriented inputs may be more appropriate for disclosure than market-based, external inputs.

Paragraph D27 goes on to discuss market-based inputs as follows:

> Many such inputs relate to fair value measurements (which are estimates of current market prices). Those inputs reflect a market perspective instead of the entity's own perspective and are required specifically to be based on existing conditions and currently available information. In addition, they are either probability weighted or discounted at a rate that allows for risk and uncertainty. Even the results of entity-specific measurement inputs are purported to represent the way the entity views an item at the reporting date on the basis of existing conditions, and are not purported to be predictions.

The nuanced point the Board appears to be attempting to make is that internally developed assumptions may not have the same risk of negative consequences as external, market-based assumptions and that market-based assumptions are a reflection of current conditions and are not necessarily predictions—which, as we describe more fully, the Board perceives may have the potential for greater adverse or negative consequences. That being said, both internally developed and market-based assumptions included in fair value measurements, for example, that reflect current conditions also incorporate expectations of the future. Interest rate and credit spread assumptions may reflect current conditions, but they also reflect predictions and—when not observable—may reflect internally developed assumptions and inputs. Current market prices or assumptions always incorporate expectations (i.e., predictions) of the future; that is why investors find them so useful. Risk weighted or not, they also incorporate the potential for adverse consequences.

Accordingly, it is challenging to discern the distinction the Board is making between internally developed assumptions and market-based assumptions. Some investors believe that internally developed inputs—because management may be unduly optimistic—may represent greater risk of adverse consequences than inputs that are required to use market-based assumptions or inputs to the maximum extent possible. We more fully consider the distinction the Board is attempting to make with respect to negative consequences and projections and their inclusion in financial statement line items.

In our view, the Board needs to be more explicit on both how it perceives and how it will consider the differences in disclosure between internally developed and market-based inputs.

3. **Negative consequences:** The Board's proposal references negative consequences that may emanate from the disclosure of future-oriented information. Specifically, Paragraph D23 notes:

> However, there sometimes are potentially significant *negative consequences* to issuers of financial statements (and ultimately to their investors and creditors) of providing some future-oriented information. Predictions, projections, forecasts, or similar assertions about uncertain or unknown future events that are beyond management's control cause the most concern because some of that information may turn out to be materially different from the actual future events or conditions when they occur. Some potential consequences are litigation or threat of litigation and loss of credibility. (emphasis added)

Paragraph D25 goes on to say:

> The objective of financial reporting does not require a reporting entity's management to assess the entity's prospects for future cash flows, but to provide information to assist investors and creditors in making their own assessments. Therefore, it is not necessary for the Board to require that entities disclose in notes to financial statements the types of future-oriented information with the greatest potential for *negative consequences* to a reporting entity. (emphasis added)

The Board then articulates in Paragraph D26 (see Appendix B) that the disclosures of the three types of future-oriented information it is proposing to consider for disclosure would not be expected to have the same type of negative consequences as those in Paragraph D23 (excerpted in the preceding paragraph and in Appendix B). Further, as described, Paragraph D27 alludes to the fact that disclosures about inputs used in measurements of financial statement line items do not create the same degree of risk of *negative consequences* as do projections or predictions about future events that are not in a financial statement line item. Finally, in Paragraph D28, the Board indicates that disclosures about management plans and strategies that are under management's control are less likely to have negative consequences and should thus be considered by the Board for disclosure.

In our view, the Board needs to more clearly articulate the following:

> *Evaluations of negative consequence assertions:* How the Board will assess negative consequences when considering possible disclosures. Currently, assertions of negative consequences are made with respect to many of the changes in

> measurements or disclosures that the Board considers, many of which do not come to pass—for example, assertions made about the negative economic consequences that would result from the expensing of stock-based compensation.
>
> *Characteristics of disclosures with negative consequences:* The distinguishing characteristics of a projection, prediction, forecast, input, or plan that make it more at risk of creating a negative consequence. Presently, it would appear the Board believes that internally developed assumptions under management's control are less at risk of producing negative consequences—which may not be consistent with investors' perceptions. Further, as described more fully in the following text, there are inconsistencies in the decisions the Board has made with respect to the inclusion of projections and predictions in financial statement measurements and those that it deems too likely to produce negative consequences to be disclosed—specifically, how their inclusion in financial statement line items reduces their risk of negative consequences.

Overall, we think the notion of negative consequences needs to be more fully explored and articulated before being incorporated into a decision-making framework for disclosure. Without such an articulation, assertions of negative consequences, which may be difficult to validate, may prevail in the Board's decision-making process.

4. **Projections and their inclusion in future-oriented measurements:** The Board, through its discussion in Paragraphs D23 and D27 (see the preceding text and Appendix B), suggests that projections, predictions, and forecasts result in greater negative consequences and are less appropriate for disclosure than are plans and strategies under management's control because the former may turn out to be materially different from the actual future events or conditions when they occur.

   The Board acknowledges in Paragraph D27, however, that financial statement line items may include projections, predictions, and forecasts:

   > However, some entity-specific measurements also include projections or predictions about future events (for example, salvage value, useful lives, and bad-debt percentages) that are important to faithful representation of the line item. Because that information explains amounts included in financial statement line items, it would be appropriate for the Board to consider requiring disclosure of these inputs. In contrast, estimates of future revenues related to future sales transactions or the timing of those revenues would not be

related to past events or current conditions or circumstances. Therefore, that information would be inappropriate for the notes unless it was an input to a current measure of an asset or a liability.

Unexplained is why the Board believes it is appropriate to incorporate these same projections, predictions, or forecasts (e.g., future sales transactions or the timing of revenues) when used in financial statement measurements (e.g., goodwill impairments), but it is inappropriate to disclose them when they are used to ascertain that such a change in measurement is unnecessary. In other words, how is the quality, uncertainty, or potential negative consequence of such a projection, prediction, forecast, estimate, or assumption changed by its inclusion in the measurement (impairment) but not when it is used to make a decision *not* to alter the measurement (no impairment charge)?

The Board does not provide the distinguishing characteristics of a projection, prediction, or forecast that differentiate this risk of negative consequence or explain how its inclusion in a measurement makes it more appropriate for disclosure.

5. **Plans and strategies under management's control:** In our view, the information about existing plans and strategies that the Board believes should be considered for disclosure in Paragraph D28 of its proposal (see Appendix B) needs further clarification. The Board's assumption underlying that paragraph seems to be that such plans and strategies are under management's control and that their disclosure might result in adverse or negative consequences but that such adverse or negative consequences to the company would be different from those related to projections, predictions, and forecasts. This differentiation of adverse consequences is not clear from the articulation in the proposed standard, though there seems to be an implication that rendering the plans less effective is not the sort of adverse consequence the Board would consider in its thought process.

   Also unclear is whether the plans and strategies to be considered for disclosure relate to amounts recognized or disclosed in the financial statements. We understand that the Board may intend for this disclosure consideration to encompass plans and strategies related to something other than amounts recognized or disclosed in the financial statements. That said, we find this inconsistent with the overall guidance in Paragraph D31 as previously explained (i.e., concerning amounts in financial statements or notes).

   Overall, although it is clear that the Board is referring to plans and strategies solely under management's control, it is unclear how the Board is defining and differentiating, for disclosure consideration purposes, the adverse or negative consequences that may result and the relationship between such plans and strategies and amounts reflected in the financial statements and notes.

Finally, even if clarified, we question whether this section of the Board's proposal will produce any useful disclosures for investors because highly certain plans under management's control with little risk of adverse consequences are not those that management may want to disclose or, if it does want to disclose, will have much value relevance to investors.

Conceptual Framework: Summary

The FASB's proposal regarding the notes to the financial statements appears to reflect a recognition that measurements (whether in the financial statements or in the notes) incorporating forward-looking information need to be complemented by disclosures that help explain them.

We laud the FASB's efforts to define and differentiate future-oriented information and to provide guidance for disclosures of future-oriented information. The attempt to differentiate forward-looking information from future-oriented information may result in better critical thinking on the topic. With respect to the Board's definition of future-oriented information that should be considered for disclosure, we believe that further clarifications (e.g., the five items listed previously) are needed to explain the Board's objectives and intent.

The FASB's proposal, however, does not explain why certain measurements that contain forward-looking assumptions, estimates, plans, or strategies are included in the financial statements and notes and some are not. Put differently, what are the defining characteristics of an asset or liability that determine when and the degree to which forward-looking information is appropriate for incorporation into measurements and, by extension, disclosures included in the financial statements? The key distinguishing characteristic between forward-looking information and future-oriented information is that in the case of future-oriented information, the Board has decided to include such measurements within the financial statements or notes and disclosures may therefore be appropriate to assist in explaining the measurements. The FASB's proposal does not explain to investors when it is appropriate to include measurements that contain forward-looking information within the financial statements or notes. In our view, a conceptual framework for measurement may be needed before a conceptual framework for disclosure when it comes to forward-looking information. Without clarity on the inclusion of forward-looking information as a foundational element of measurement, discerning the characteristics of forward-looking information appropriate for disclosure will, in our view, remain challenging.

Can the SEC Draw a Dividing Line?

Review of Regulation S-K: An Opportunity for the SEC to Communicate Its Views on Forward-Looking Information

In a speech at the December 2012 AICPA Conference on Current SEC and PCAOB Developments, Paul Beswick, the SEC's chief accountant, made the following remarks with respect to the placement of information within or outside the financial statements:[30]

> So, where do I think that this brief, and I really mean brief, history lesson leaves me? Well, I believe that one could begin to draw some conclusions about the type of the information that should be included in other parts of the financial reporting package as compared to the financial statements. However, I believe that a healthy and robust dialogue could greatly contribute to this debate. Therefore, it is my intent for OCA [Office of the Chief Accountant], along with staff in other offices and divisions, to hold a roundtable in the upcoming months as the first step in considering this issue. We plan initially to focus on whether this issue should be further explored (including, for example, whether there [are] any perceived disclosure gaps today), and what are the critical decision points regarding this issue of the dividing line between what should appear in financial statements versus the broader financial reporting package.

As we have discussed in this report, the conversation regarding the characteristics of disclosures that belong within or outside the financial statements mentioned in Beswick's speech have—in our view—arisen, at least in part, because of the efforts of the FASB to improve, through the inclusion of forward-looking information, the measurements and disclosures related to financial instruments, impairments, liquidity and interest rate risk, going-concern status, and other note disclosures more broadly.

Subsequent to the speech, the SEC staff indicated that they would be developing a staff paper that would seek to clarify the dividing line between forward-looking information that belongs in the financial statements and forward-looking information that belongs

[30]Paul A. Beswick, "Remarks before the 2012 AICPA Conference on Current SEC and PCAOB Developments" (3 December 2012): www.sec.gov/News/Speech/Detail/Speech/1365171491922#.U5Bjq3adTls.

outside the financial statements—for example, in MD&A. Later in 2013, however, the SEC announced that the staff paper would be deferred, given the SEC's required review of Regulation S-K[31] under the Jumpstart Our Business Startups Act (JOBS Act). This review was completed and the report issued in December 2013.[32] The report did not, however, include a discussion of forward-looking information, though the SEC's work on forward-looking information was deferred in light of this report. The report indicated—and the SEC has articulated—a desire to review the effectiveness of disclosures under Regulation S-K more broadly than the effectiveness of disclosures required for the emerging-growth companies covered by the JOBS Act. To that end, the SEC has undertaken a project to review the effectiveness[33]—not simply the volume—of disclosures. As part of this initiative, the SEC has stated that it would like to review the effectiveness of disclosures under both Regulation S-X[34] (i.e., disclosures within the financial statements) and Regulation S-K (i.e., disclosures outside the financial statements). We believe that one element of this review—particularly because it is meant to look at the effectiveness of disclosures both within and outside the financial statements—should be to complete the work that the SEC staff began in late 2012 and suggested was necessary to inform preparers, auditors, and users/investors about the dividing line between forward-looking information that belongs in the financial statements and forward-looking information that is more appropriately disclosed outside the financial statements.

Distinguishing the Line May Be Challenging

As we have demonstrated, accounting standards are replete with requirements to incorporate forward-looking information in the financial statements; and in the nearly 20 years since the passage of the PSLRA, the financial statements have come to include more, rather than less, forward-looking information. Further, the standards currently under development extend the inclusion of such forward-looking information in the financial statements (e.g., the impairment model). Thus, the notion that a disclosure containing any forward-looking components does not belong in the financial statements is inconsistent with the inclusion of forward-looking elements in the measurements that are included in the financial statements.

[31]Regulation S-K is the regulation under the Securities Act of 1933 and the Securities Exchange Act of 1934 that establishes the initial and periodic reporting requirements of US public companies (www.ecfr.gov/cgi-bin/text-idx?tpl=/ecfrbrowse/Title17/17cfr229_main_02.tpl).
[32]SEC, *Report on Review of Disclosure Requirements in Regulation S-K* (December 2013): www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf.
[33]SEC Disclosure Effectiveness Review (www.sec.gov/spotlight/disclosure-effectiveness.shtml).
[34]Regulation S-X is the regulation under the Securities Act of 1933 and the Securities Exchange Act of 1934 that establishes the form and content of financial statements included with the reports of public companies (www.sec.gov/about/forms/forms-x.pdf).

Moreover, the FASB's proposal regarding the notes to the financial statements seeks to provide further clarification on what forward-looking information should be disclosed within the financial statements.

In our view, the SEC faces a significant challenge in drawing a dividing line between forward-looking disclosures appropriate for the financial statements and those that belong exclusively outside the financial statements. As we have discussed, the definition of forward-looking statements in the PSLRA of 1995 is very broad. A prohibition on including anything in the financial statements that meets the definition of forward-looking information under the PSLRA—as is commonly suggested—would be inconsistent with certain measurements and disclosures currently required to be included in the financial statements. For that reason, the SEC's challenge may be bigger than it first appears.

The question that the SEC may need to ask itself is not where the dividing line is but whether a dividing line exists at all. A critical examination of the body of accounting standards shows that the call for a review—as has been requested by some stakeholders—of whether, when, and where to include forward-looking information in financial statements may amount to the pursuit of false choices. At this stage of financial standards development, crafting a conceptual demarcation of whether such information is appropriate in financial statements seems to overlook the fact that the "conceptual Rubicon" has already been crossed. Forward-looking information is already embedded in a significant number of existing accounting standards.

Clarification Will Facilitate Action by Standard-Setters

If standard-setters are to decide what are the most meaningful measurements that belong *within* the financial statements, they need to have the capacity to include disclosures that make the measurements meaningful, even if such disclosures overlap with SEC disclosure requirements outside the basic financial statements. In its recent proposal on the notes to financial statements, the FASB has attempted to define that it is appropriate to include forward-looking disclosures only when they relate to forward-looking measurements in the financial statements and notes (i.e., what the Board has labeled future-oriented information). It is essential, however, that standard-setters develop a measurement framework that defines what they believe are the characteristics of forward-looking information that make it suitable for inclusion in the financial statements.

Standard-setters should have the ability and the compulsion to require disclosures—such as liquidity disclosures—within the financial statements when such disclosures are deemed a necessary improvement to financial reporting, even though they may not relate to measurements contained in the financial statements. The existence of a similar disclosure requirement for public companies under SEC rules should not preclude the inclusion of such information in the financial statements when economic events (e.g., the 2008 financial crisis) or secular trends suggest that disclosures of this nature are necessary to provide a complete picture of an entity's financial condition, results of operations, and cash flows or future cash flows. Guidelines can certainly be developed that would eliminate any duplicate presentation, with a bias toward the inclusion of such information in the financial statements where it is required/prescribed and, as a result, audited and likely more reliable for investors.

Presently, the perception that forward-looking information is under the purview of the SEC because of the PSLRA complicates and constrains—as we have illustrated—the FASB's efforts to establish improvements in measurements and disclosures that incorporate forward-looking information measurements.

Evolution Is Necessary

Just as the SEC prohibited the inclusion of forward-looking information in registration statements and filing documents prior to the 1970s (as noted in the brief history presented earlier), and the passage of the PSLRA in 1995 subsequently allowed the inclusion of forward-looking information in such registration statements and filing documents, the SEC's thinking on forward-looking information needs to evolve with the evolution of accounting standards.

The inclusion of forward-looking information within and outside the financial statements may not need to be considered mutually exclusive—just not redundant.

Final Observations: Investors See Action on Forward-Looking Information as Necessary Element of SEC's Disclosure Effectiveness Review

When information comes with the moniker of being forward-looking, accountants attach to it, because of the PSLRA, a bias that suggests it belongs outside the financial statements. As we have shown, the financial statements are replete with information that would be considered forward-looking under the definition in the PSLRA. Accordingly, the notion that forward-looking information cannot be included in the financial statements—as a means of objecting to the development or enhancement of financial statement measurements or disclosures—seems an inconsistent position to investors who use those financial statements.

As we stated earlier, deferring enhancements to financial reporting because of a debate regarding where forward-looking information belongs—particularly in such areas as risk and liquidity disclosures, which clearly proved problematic during the financial crisis—is not beneficial to investors. Commissioner Stein, as noted previously, provides an illustration of a funding/liquidity disclosure that, though proposed by the FASB, has not been added to the disclosure requirements for public companies within or outside the financials. The nature of the improvements, rather than their location in the financial filings, should be of principal concern to policymakers. The pursuit of artificial boundaries regarding where to provide additional forward-looking information, such as risk disclosures, simply ends up significantly constraining needed improvements to financial reporting information.

From an investor perspective, clarity on the nature and location of forward-looking information is a necessary element of the SEC's review of disclosure effectiveness to ensure that decision-useful disclosures, such as those mentioned by Commissioner Stein, are not omitted or overlooked because of the debate about where the dividing line lies regarding the placement of such information.

Appendix A. Hidden in Plain Sight: The Existence of Forward-Looking Information in Financial Statements

Given the very broad definition of forward-looking information, we considered the current accounting literature and the degree to which forward-looking information is already included in the financial statements. As noted in our commentary, these examples are not meant to be all-inclusive. Rather, they are meant to illustrate the extensive amount of forward-looking information currently included in US GAAP financial statements.

Financial Instruments

Financial Instruments Measured at Fair Value

The most obvious instance of forward-looking information in the financial statements is the case of financial instruments measured or reported at fair value. Reporting financial instruments at fair value requires an entity to project future cash flows, often far out into the future, discounted at a rate market participants would use to discount them. This is most evident in the valuation of exotic derivative instruments that do not trade on an exchange but instead are valued using an internal model. These so-called mark-to-model instruments are disclosed in Level 3 of the fair value hierarchy in order to indicate the significant subjectivity used to derive their value. But even the valuation of Level 2 financial instruments involves a fair degree of estimation. This is because financial institutions apply "valuation adjustments" and other reserves to quoted market prices to reflect the lack of liquidity of an instrument, the overall credit risk of a portfolio, and other reserves in order to reflect their best estimate of fair value. These estimates tend to be highly idiosyncratic and therefore give investors important insight into management's views regarding the risks of its portfolio as well as the marketplace. Though not estimates developed by management, Level 1 financial instruments incorporate the market's future expectations of cash flows and discount rates.

The disclosures of fair value for those items measured using a valuation basis other than fair value also result in the inclusion of forward-looking information in the financial statements.

Loans: Allowance for Loan Losses

Even financial institutions that carry the majority of their loan portfolios at so-called historical cost incorporate a fair degree of estimation about the future into these portfolios via the allowance for loan losses (ALL). Essentially, the ALL consists of management's assessment of the borrowers' ability to repay the loans. This applies even to loans that have not exhibited any evidence of impairment because the bank must nonetheless estimate whether, somewhere in the portfolio, it is "probable" that a loss has been incurred, even though the loss event might not yet be known.

Furthermore, although it is widely perceived that the provision for the ALL is based on historical information, historical loss experience typically represents only the starting point for determining the allowance. To produce an accurate estimate, management must also take into account recent trends both in its own lending behavior and in the economic environment to determine how historical loss ratios should be adjusted. Management must make estimates of not just the probability of default but also how much it expects to lose in the event of a default. Thus, management must make forward-looking predictions of how borrowers will behave and what the recoverable value is of any collateral that the financial institution holds against the loans.

Securities Impairment Charges

Securities categorized as "available for sale" (marked to market through other comprehensive income [OCI]) or held at amortized cost in the held-to-maturity portfolio are assessed for impairment if the current market value is less than its carrying value. The assessment of whether an impairment is temporary (no charge to earnings) or "other than temporary" (potential charge to earnings) requires management to make a number of predictions, including an assessment of the near-term prospects of the issuer of the security. In addition, management must assess how long it intends to hold the security. If it intends to hold the security long enough to recover any decline in market value below its cost basis, and it is unlikely to have to sell the security before it recovers in value, then only the amount of the impairment loss associated with the decline in the credit quality of the security is recorded as a charge to income. Thus, every impairment charge on these classes of securities carries with it some forward-looking information regarding not just the value of the security itself but also the expected holding period of the security.

Other Assets and Liabilities

Property, Plant, and Equipment

Such fixed assets as property, plant, and equipment are generally carried at historical cost—a basis of accounting that is typically considered to be of little predictive value. However, if we look deeper, we find that even this asset class includes and conveys forward-looking information/expectations. The selection of a depreciation period, although typically standard in nature, is nevertheless an indication of management's estimate of the future useful life of the asset.

Assets that are classified as "held for sale" convey the information that management is actively marketing these assets for sale and expects to sell them within one year. These assets are written down to their net realizable value, representing management's estimate of the future selling price of the asset less any selling costs. In addition, if there are indications that a long-lived asset carried at historical cost is impaired, management may be required to perform an impairment assessment, which involves identifying the cash flows that the asset is expected to generate in the future. For some assets, this can involve a projection of 30 to 40 years. If the sum of the undiscounted cash flows is less than the asset's carrying value, then the asset must be written down to its fair value. For property and equipment that is highly customized in nature, the fair value may be based entirely on management's internal assumptions regarding its market value.

Finally, for certain types of assets, an asset retirement obligation must be recorded. An asset retirement obligation represents the future cost to remove or retire a long-lived asset once the end of its useful life is reached. For capital-intensive entities—such as oil refineries, landfill operations, and mining companies—these obligations can be significant. The obligation must be recorded at its fair value and is usually calculated as the present value of the estimated future cash flows required to satisfy the obligation. The offset to this liability is recorded as an increase in the carrying amount of the related long-term asset. Because such assets as electric power plants, oil refineries, and mines usually have long lives—30 to 40 years or more—the timing and amounts of the cash flows to cover the actual costs of retiring an asset and settling the retirement obligation can be highly subjective. Nevertheless, management must make its best guess about inflation rates, labor costs, technological advances, and profit margins in a way that reflects how the market would view such items; prepare a range of estimated cash flows related to settlement of the obligation and weight them for their probabilities of occurrence; and discount the probability-weighted cash flow data using a risk-free interest rate adjusted for the company's credit standing. Thus, the asset retirement obligation represents management's predictions regarding the cost of removing or retiring the asset far out into the future.

Intangible Assets and Goodwill

Intangible assets acquired in a business combination, such as customer relationships and trademarks, are measured at fair value. These assets are typically valued on the basis of projections of future cash flows to be generated from the asset, such as revenue streams or royalty streams, discounted at rates consistent with rates used by market participants. These estimates are made by using various inputs, including historical data, current and anticipated market conditions, management plans, and market comparables. Although these inputs are generally not disclosed in the financial statements, the output—the fair value of the asset—incorporates these assumptions and thus indirectly conveys management's estimate of the future performance potential of these assets. The same is true of all assets and liabilities acquired in a business combination.

In addition, when a company has indications that either goodwill or intangible assets have been impaired, it must consider whether an impairment charge is necessary. Indicators of impairment consist of management's assessment of general economic, industry, and market conditions, as well as changes in company-specific factors, such as a change in the market for the company's products or services; increases in cost factors; changes in management, personnel, or customers; and a decline in overall financial performance. The last factor includes negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods.

The calculation of an impairment charge for goodwill requires a company to prepare cash flow projections similar to what would be done in a business valuation. The calculation of an impairment charge for intangible assets is similar, with the main difference being that cash flows are projected only as they are expected to be generated by the specific asset in question.

Thus, both the initial valuation of goodwill and intangible assets and any subsequent write-downs in value require management to predict the future cash flows associated with these assets. These measurements incorporate many of the forward-looking assumptions or disclosures that might be discussed in the MD&A section of the annual report.

Litigation and Environmental Reserves

Reserves that are established for litigation contingencies and environmental remediation liabilities are required to be provided for if a loss is considered probable and the amount of the loss can be reasonably estimated. Because the eventual costs associated with these types of contingencies are generally highly dependent on the facts and circumstances surrounding the specific event, historical experience is often not useful in estimating the amount of the reserve. For example, litigation reserves are generally determined on a case-by-case basis, and any reserve established involves an assessment of how management intends to respond to the particular lawsuit and its evaluation of the probability of an unfavorable outcome. Even if reserves are not recognized in the financial statements, the disclosures include a discussion of forward-looking information.

Similarly, environmental reserves are generally established on a site-by-site basis and require management to assess costs that will be incurred far out into the future because cleanup usually takes place over an extremely long time horizon.

Pension and Other Postretirement Benefit Obligations

The value of a company's pension obligation requires management to make a host of actuarial assumptions regarding the mortality and morbidity of its eligible population and predictions regarding the expected long-term rate of return on the assets held by the pension plan. Given the long time horizon of these obligations, these predictions represent forecasts that extend for 30 or 40 years into the future. The amount of the pension obligation is also highly dependent on the selection of the appropriate discount rate at which to discount the expected future cash inflows (return on plan assets) and outflows (payments to retirees).

Liabilities for other postretirement benefit obligations, such as medical and life insurance coverage, involve a number of additional actuarial assumptions over an exceedingly long-term horizon—for example, the estimated rate of compensation increases for employees and future increases in health care costs.

Employee Stock Awards

The value of employee stock awards, such as stock options and stock appreciation rights, is based on a valuation model that requires management to estimate the future volatility of the company's stock price, its expectations regarding future dividends, and the length of time that an employee is expected to hold an option before it is exercised or canceled. Any stock award, such as a grant of outright stock (i.e., not just stock options), also requires an annual estimate of how many awards the company expects will ultimately vest, or not be forfeited, by the employees. In other words, this estimate represents management's prediction of how long the current work force eligible for stock awards will continue to work at the company.

Deferred Taxes and Uncertain Tax Positions

Deferred tax assets are another item that unexpectedly conveys some forward-looking information. This is because a company must report a valuation allowance as a deduction against the deferred tax asset if it expects there is more than a 50% chance it will be unable to realize some of its deferred tax assets (because its future income will not be large enough to take full advantage of the benefits). For example, if a company loses $10 million, it would record a deferred tax asset representing its ability to carry this loss forward and offset it against taxes on future earnings. However, if the company does not expect to earn at least $10 million in profits in the future before the benefit expires, it must record a valuation allowance to offset the deferred tax asset. A valuation allowance thus depends a great deal on management assumptions regarding the expected future earnings potential of the company. Both the existence and the nonexistence of a valuation allowance convey management's forward-looking expectations.

In addition, a company may not take a tax benefit on its financial statements if it has taken a position on its tax return but does not believe that there is a greater than 50% probability that the position would be allowed by a taxing authority. If the company does not believe that the tax position will be accepted by the US IRS (Internal Revenue Service), it must establish a liability for the amount to be paid in the financial statements. Thus, this liability is dependent on management's estimate of its ability to convince the IRS in the future of the merits of its tax positions.

Revenue Recognition

Allowance for Doubtful Accounts

Similar to the allowance for loan losses discussed earlier, the allowance for doubtful accounts represents management's prediction of how much of its existing accounts receivable the company will be able to successfully collect in the future. It therefore includes forward-looking expectations.

Warranties

Reserves for product warranties are generally established on the basis of a company's historical experience. However, the reserve is essentially forward-looking in nature because management is attempting to quantify how many warranty claims will be made in the future against current sales. In fact, because the purpose of the reserve is to provide for future claims against current sales, warranty reserves have been shown to have predictive value regarding product quality and thus firm value and future firm performance.[35]

In addition, a company is required to disclose the maximum amount of future payments it could be required to make under the warranty, which is inherently forward-looking in nature.

Sales Incentive Programs

Similar to warranty reserves, a reserve must be established for sales incentive programs, such as volume discounts or rebates offered to customers. Again, although these reserves are generally based on a company's historical experience, the reserve is essentially a prediction of the number of customers the company expects will earn and claim rebates under the offer in the future.

Long-Term Construction Contracts

Revenue arising from certain types of long-term construction contracts is accounted for on the basis of the extent of the contractor's progress toward completion. Revenue recognition is thus highly dependent on the contractor's estimates (i.e., predictions) of total revenues to be earned on the contract, total costs to be incurred, and current progress toward completion. Progress toward completion can be based on a variety of metrics, such as labor hours, labor dollars, machine hours, material quantities, or total costs, and thus can provide the investor with insight into management's estimates regarding these inputs.

Bundled Products and Services (Multiple-Element Arrangements)

Companies often sell more than one product or service bundled together into a single contract or arrangement with a customer. The classic example is a smartphone that encompasses hardware (the phone), software (the computer inside), and a service arrangement, such as a monthly service fee. Another example is the sale of complex medical equipment with embedded software and ongoing maintenance and support services provided by the seller.

[35]See, for example, Daniel Cohen, Masako Darrough, Rong Huang, and Tzachi Zach, *Warranty Reserve: Contingent Liability, Informational Signal, or Earnings Management Tool?* (http://algomagic.s3.amazonaws.com/8168.pdf).

A key determinant in measuring revenue from these arrangements is how to separate the various elements and allocate the purchase price to each element in the arrangement. Where it is available, the price charged by the vendor for the separate elements must be used. When not available, management is permitted to use its best estimate of selling price for that element. The best estimate of selling price can be based on cost plus margin or on such market factors as overall economic conditions, customer demand, competition in the industry, or industry-wide profit margins. Thus, in many cases, revenue recognition for these bundled arrangements depends on management's prediction of how much revenue it could earn on a standalone basis for each of the components, based on its views of the current market environment.

Appendix B. FASB: Future-Oriented Information

The following information has been extracted from the FASB's *Proposed Statement of Financial Accounting Concepts: Conceptual Framework for Financial Reporting—Chapter 8: Notes to Financial Statements* (March 2014). Paragraphs D22 through D31 reflect the FASB's thoughts with respect to future-oriented information that is analyzed as part of the discussion of the conceptual framework in the body of this report.

Future-Oriented Information

D22. Making decisions about providing resources involves, in part, assessing prospects for the entity's future cash flows. Resource providers make estimates and assumptions about future events and conditions and might benefit from receiving such future-oriented information in notes to financial statements, at least for use in comparison with their own predictions or assessments. The cost constraint would not always preclude requiring entities to provide that kind of information. Some entities prepare forecasts or budgets or both, or set detailed numerical goals and objectives, and, in those cases, the incremental direct costs of preparing future-oriented information may not be particularly significant.[8]

D23. However, there sometimes are potentially significant negative consequences to issuers of financial statements (and ultimately to their investors and creditors) of providing some future-oriented information. Predictions, projections, forecasts, or similar assertions about uncertain or unknown future events that are beyond management's control cause the most concern because some of that information may turn out to be materially different from the actual future events or conditions when they occur. Some potential consequences are litigation or threat of litigation and loss of credibility.

[8]The cost and difficulty of auditing that information might, at least in some cases, change the judgment about whether costs are justified by benefits.

D24. SEC registrants are required to provide forward-looking[9] information with respect to certain disclosures in portions of certain registrants' regulatory filings that are outside of audited financial statements, and they are encouraged to provide forward-looking information where doing so would be useful to investors.[10] Federal securities laws and SEC rules provide a safe harbor for some forward-looking information.[11] The safe harbor does not extend to audited financial statements, whether or not the reporting entity is an SEC registrant.

D25. The objective of financial reporting does not require a reporting entity's management to assess the entity's prospects for future cash flows, but to provide information to assist investors and creditors in making their own assessments. Therefore, it is not necessary for the Board to require that entities disclose in notes to financial statements the types of future-oriented information with the greatest potential for negative consequences to a reporting entity.

D26. However, there are at least other types of future-oriented information that may be useful disclosures for the Board to consider in some cases and that would not be expected to have the same type of negative consequences as those discussed in paragraph D23.

D27. The first is information about estimates and assumptions used as inputs to measurements, many of which are future oriented and internally developed. Information about those inputs often is an important part of a faithful representation of a line item and does not create the same degree of risk of negative consequences as do projections or predictions about future events that are not within a line item in the financial statements. Many such inputs relate to fair value measurements (which are estimates of current market prices). Those inputs reflect a market perspective instead of the entity's own perspective and are required specifically to be based on existing conditions and currently available information.

[9]SEC rules provide a safe harbor for forward-looking information, as defined in those rules, which is provided outside of audited financial statements. To avoid any confusion over possible differences in definition or scope, the term *forward looking* is not used elsewhere in this chapter.
[10]See, for example, SEC Securities Act of 1933 Release No. 33-8350, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations* (effective date: December 29, 2003): "In addressing prospective financial condition and operating performance, there are circumstances, particularly regarding known material trends and uncertainties, where forward-looking information is required to be disclosed. We also encourage companies to discuss prospective matters and include forward-looking information in circumstances where that information may not be required, but will provide useful material information for investors that promotes understanding."
[11]See, for example, Section 27A(C) of the Securities Act of 1933, *Application of Safe Harbor for Forward-Looking Statements;* Section 21E of the Securities Exchange Act of 1934, *Application of Safe Harbor for Forward-Looking Statements,* on Safe Harbor; Securities Act Rule No. 175, *Liability for Certain Statements by Issuers;* and Exchange Act Rule 3b-6, *Liability for Certain Statements by Issuers.* Related to the plan, which are subject to external factors outside of the entity's control, would not be appropriate for requirement in the notes.

In addition, they are either probability weighted or discounted at a rate that allows for risk and uncertainty. Even the results of entity-specific measurement inputs are purported to represent the way the entity views an item at the reporting date on the basis of existing conditions, and are not purported to be predictions. However, some entity-specific measurements also include projections or predictions about future events (for example, salvage value, useful lives, and bad-debt percentages) that are important to faithful representation of the line item. Because that information explains amounts included in financial statement line items, it would be appropriate for the Board to consider requiring disclosure of these inputs. In contrast, estimates of future revenues related to future sales transactions or the timing of those revenues would not be related to past events or current conditions or circumstances. Therefore, that information would be inappropriate for the notes unless it was an input to a current measure of an asset or a liability.

D28. The second is information about existing plans and strategies related to matters under management's control. The disclosure of some types of plans may in some cases render those plans less effective and, therefore, adversely affect the reporting entity. That adverse consequence is different from those adverse consequences discussed in paragraph D23 and should be considered by the Board. Plans also are rarely required to be disclosed because a plan seldom supplements or explains amounts recognized in financial statements. For those reasons, it is likely that plans and strategies are not generally disclosed in notes to financial statements. However, there are exceptions, for example, plans as of the reporting date for the sale of a long-lived asset. That kind of future-oriented information does not involve an assertion about uncertain events beyond management's control nor does it represent promises by management, but it does represent management's current plans. That sort of disclosure is unlikely to result in a negative consequence to the entity as far as rendering the plan less effective, and it does help to further explain an amount that is currently recognized. However, an entity's plan and the entity's anticipated outcomes related to the plan, which are subject to external factors outside of the entity's control, would not be appropriate for requirement in the notes.

D29. The third is information about the effect of specified future changes in existing conditions on specific line items or on the entity as a whole. In some cases, it is difficult to discern the potential effects on cash flows of a particular line item (or of an entity) without some indication of the way that possible future changes in economic conditions would affect the line item (or an entity).

D30. One way to provide that information is by quantifying the effects of a specified change in economic conditions, for example, a 100-basis-point change in market interest rates. The Board might require that information in some circumstances if the information reflects the results of changing the inputs to a mathematical model and it is clearly explained that the effect (a) is specified in a standard and (b) does not represent a prediction by management. That sort of disclosure is different from a disclosure that requires an entity to predict changes in inputs, which are outside of its control and quantify those effects.

D31. In summary, the Board generally does not require disclosures of expectations and assumptions about the future that are not inputs to current measures in financial statements or notes.

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