

# ACCOUNTING STANDARDS CODIFICATION AND THE CLARITY OF FINANCIAL DISCLOSURES

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## ABSTRACT

The Financial Accounting Standards Board required all companies to refer to the new Accounting Standards Codification (ASC) for authoritative guidance for all financial statements filed after September 15, 2009. The Securities and Exchange Commission encouraged companies to take this opportunity to improve the readability of financial statements by using “plain English” to describe reporting methods rather than to reference Codification section numbers. We examined the financial statements of the Forbes 100 largest firms before and after the change and found that approximately 60 percent chose to eliminate references to specific ASC sections. However, further analysis of the readability of disclosure notes using the Flesch Reading Score and Flesch Grade Level indicated that financial disclosures remain unreadable to large percentages of the population and that there is little correlation between readability and whether or not the company references ASC numbers.

## Introduction

Making financial statements understandable to investors has been an underlying goal of the Securities and Exchange Commission (SEC) since it was formed in 1934. Accomplishing this goal involves consideration of several issues, such as: (1) How much financial knowledge should the investor be assumed to have? Investors range from those with little knowledge of even the most common business terminology to analysts with expert knowledge of specific industries. At what expertise point on this continuum should financial statement understandability be targeted? (2) How can difficult concepts be described in readable, understandable language? Regardless of the knowledge level of the user, the task of describing complex transactions may be impossible to accomplish without resorting to complicated descriptions. Consider the difficulties of describing the valuation of derivative securities or the composition of pension expense without resorting to complex language; and (3) how can the competing goals of users and providers be reconciled? Investors want to know the true implications on income and assets of financial transactions; while managers may be more interested in presenting their results in the best light possible. In 1998, the SEC issued The Plain English Rule (Rule 421(d)) requiring companies to use “plain English” in the forefront of prospectuses and encouraged these guidelines be incorporated in other financial disclosures.

The concern of the SEC for readable financial disclosures has become a factor in the implementation of the recent Financial Accounting Standards Board (FASB) Codification of financial accounting standards. Between 2004 and 2009, the FASB undertook a massive reorganization of the various rules and regulations that comprise generally accepted accounting principles (GAAP). Companies

were required to use the Codification (known as the Accounting Standards Codification or ASC) as the authoritative guidance for financial reporting for fiscal periods ending after September 15, 2009.

Companies are required in their financial statements to either use Codification references for accounting standards or delete references and include only descriptions of the content of the standards. For example, in the past research and development costs were primarily governed by Statement of Financial Accounting Standards (SFAS) No. 2. A company that referenced SFAS No. 2 previously might now reference ASC 730-10-35, the location in the Codification. However, an alternative would be to state that the entity expenses research and development expenditures as incurred. While the FASB is the dominant source of GAAP, the SEC has the ultimate authority to set financial reporting standards and serves as the governmental watchdog over financial disclosures. The SEC stated that their preference would be for descriptions rather than numerical references.

We researched the disclosure techniques used by the Fortune 100 largest firms in their first and second financial statements filings after September 15, 2009. We found that approximately 60 percent have actually taken the SEC's wishes to heart and changed from referencing the old standards to including only descriptions. Further analysis indicates that these firms tend to have slightly higher profit margins and return on assets ratios than the firms using numerical references; however price-earnings ratios had no statistical differences. One major auditing firm, PricewaterhouseCoopers, had significantly more Fortune 100 companies making the switch than the other three Big-4 firms. We also examined sample disclosures as to their readability using the Flesch Reading Score and Grade Level, finding that there is little correlation between using references and readability on these measures.

## **Background**

The central theme of both the 1933 Securities Act and the 1934 Securities Exchange Act was disclosure. However, it was not until 1998 that the Securities and Exchange Commission formally addressed the understandability and readability of disclosures in order to make them more accessible to the "average" investor by implementing Rule 421(d). This rule requires firms to use "plain English" in the forefront of their prospectus filings, with explicit encouragement to incorporate this presentation style in all disclosure documents. Arthur Levitt, then SEC Chairman, noted in the foreword of *A Plain English Handbook*,

"Investors need to read and understand disclosure documents to benefit fully from the protections offered by our federal securities laws. Because many investors are neither lawyers, accountants, nor investment bankers, we need to start writing disclosure documents in a language investors can understand." (p. 3)

Rule 421(d) specifically requires that issuers use short sentences, everyday language, active voice, tables for complex information, no legal jargon, and no multiple negatives.

While it may initially seem obvious that plain English is inherently better than complex technical or legalistic rhetoric, there are different objectives at play among regulators, corporate management and investors. In a speech in 2005, then SEC Commissioner Cynthia Glassman noted, "it is my perception that disclosing parties and their lawyers - be they mutual funds,

broker-dealers, investment advisers, or operating companies - view their disclosure obligations with an eye toward limiting their potential liability.” Another potential explanation is the opportunistic theory that managers may have incentives to conceal information when earnings performance is bad. Indeed, several studies have found positive relationships between readability of annual reports and earnings performance, suggesting that managers may be opportunistically choosing to reduce the readability of annual reports to hide adverse information from investors (Li, 2008, Loughran and McDonald, 2010).

Former SEC Chairman Christopher Cox (2008) reiterated how seriously the agency takes its “plain English” goal in a speech to the US House of Representatives. He cited empirical evidence collected by the SEC that “most retail investors are throwing away the disclosure documents that the SEC requires, instead of reading them.” Chairman Cox noted that various tools exist to measure the readability of documents, including the Flesch Reading Ease score and the Flesch Grade Level, both of which are features of Microsoft Word spell and grammar checking functions. Scores range from 0 to 100 on the Flesch Reading Ease score, with standard writing scoring about 60 to 70 on this scale. Many states with readability standards for insurance forms require between 40 and 50 on this test. Chairman Cox noted that an independent review of the description of executive compensation in proxy statements from 2007 yielded an average score of just 34.86, accessible to only about one third of American adults.

Prior to the FASB Codification, authoritative US GAAP was a proliferation of thousands of standards established by a variety of standard-setting bodies over a more than 60-year time period. These standards lacked a consistent and logical structure, and resulted in numerous complaints to the FASB. These complaints centered on the time required to research issues, and the possibility of missing vital information because of the dispersed nature of the standards. In 2004, the FASB launched the codification project to address these issues and to ease future issues such as the convergence of US and international accounting standards.

The FASB issued its final Statement of Financial Accounting Standards in June 2009: SFAS No. 168, “The *FASB Accounting Standards Codification*<sup>TM</sup> and the Hierarchy of Generally Accepted Accounting Principles -- a replacement of FASB Statement No. 162.” This standard established the FASB Accounting Standards Codification<sup>TM</sup> as the source of authoritative accounting principles for nongovernmental entities in the preparation of financial statements in conformity with generally accepted accounting principles. The standard was effective for financial statements issued for interim and annual periods ending after September 15, 2009.

While the Codification did not change GAAP, it did affect financial statement disclosures. In financial statements issued for periods ending after September 15, 2009, companies had to change disclosures related to specific standards, as these standards were no longer authoritative. Companies could choose from several methods for disclosure: delete references to specific pre-Codification GAAP, change references to Codification references, or include pre-Codification GAAP references along with Codification references.

The transition apparently caused confusion for many companies as to whether they must go back and change references in SEC filings already submitted. In a panel discussion with the American Institute of Certified Public Accountants (AICPA), Wayne Carnall, the SEC Chief Accountant

expressed frustration with the number of inquiries being received, saying “You should not be making references to specific standards that very few understand,” indicating that disclosures would be improved by describing the principle rather than listing a citation. He also noted that rules and regulations from the SEC can only do so much, and that the burden of improving disclosures lies with management and the outside auditors. “Don’t write documents just to protect yourself from litigation or to satisfy a regulator. Think about the user.” (McCann, 2009)

### Methodology

Did companies take to heart the admonishment by the SEC to use this change period to make their financial disclosures more understandable? Many of the largest firms actually did delete references to specific GAAP and included only descriptions of standards in either their first or second filings, as we found in our study of the Fortune 100 firms. We chose to look at the largest firms because they generally set the example that trickles down to smaller firms over time, and they tend to be audited by the largest firms who also set the standard for the auditing industry. The sample of companies included those in Fortune Magazine’s 2009 list of the largest companies as defined by gross revenues. We reviewed three sets of financial statements: (1) the last statements filed before September 15, 2009; (2) the first statements filed after September 15, 2009; and (3) the second statements filed after September 15, 2009. These statements consisted of either 10-Q (quarterly) or 10-K (annual) reports, as appropriate to their fiscal reporting year. With few exceptions, these companies have either December year-ends (or January or February year-ends in the case of retail firms) leading us to examine two quarterly reports followed by an annual report. Five of the companies did not have SEC filings as they were not currently publicly traded, leaving a sample of 95 companies.

The review of the last SEC filing prior to the Codification indicated that 92 of the 95 companies included references to the old FASB (legacy) standards. To determine whether the other three companies had changed their disclosures in response to the impending Codification, we looked at the last SEC filing preceding these filings. In all three cases, the company had included legacy standard references. In essence, all 95 companies had used legacy standard references prior to the Codification. (Three companies included both legacy standards and Codification references in the last filing prior to September 15, 2009, in anticipation of the change.)

We then reviewed the first two filings subsequent to the Codification to determine whether the company used Codification references or used no references. Table 1 reports the increases in the use of descriptions without references over the three filing periods.

Auditor	No. of Companies	No References in Last Filing Prior to September 15		No References in First Post September 15 Filing		No References in Second Post September 15 Filing	
Deloitte	24	2	8%	10	42%	13	54%
E&Y	25	1	4%	12	48%	14	56%
KPMG	18	0	0%	8	44%	10	56%
PWC	28	0	0%	20	71%	20	71%
Total	95	3	3%	50	53%	57	60%

Most companies chose to delete specific references and use only descriptions in the very first filing after the Codification deadline, with 53 percent using descriptions by the first filing.

Another 7 percent made the change for their annual reporting in the second filing.

PricewaterhouseCoopers stands out with 71 percent of its Fortune 100 clients using only descriptions. However, Deloitte, Ernst & Young, and KPMG also had more than 50 percent of their clients making the change to descriptions. Our findings are similar to a small sample study (50 companies) done recently by the AICPA. They also found 50 percent of large accelerated filers switching to descriptions, but found that small firms were less likely to change references to descriptions, at only 33 percent. (AICPA, 2010)

We were interested as to whether there were characteristics of firms which might be associated with their decision to change to descriptions, so we did further analysis as to their profitability and stock performance. We divided the sample into two groups: the 57 firms with no references and the 38 firms still using references. We analyzed the operating margins (net income as a percentage of revenues) and return on assets (net income as a percentage of assets) as measures of profitability for the 2009 fiscal year. We used price to earnings ratios as a surrogate to see if the market valued the earnings of the two groups differently. Table 2 reports these results.

It appears that companies using descriptions without accompanying references may have slightly higher operating margins and returns on assets, however these groups are too small and have such high variances that the means are not statistically significantly different. We used the price to earnings ratio as a surrogate for the value assigned to earnings by the stock market. There were no statistically significant differences between the two groups.

Ratio	Companies without References to ASC		Companies with References to ASC	
	Mean	Median	Mean	Median
Operating Margin	8.02	6.93	6.08	4.28
Return on Assets	6.12	5.31	5.33	4.90
Price-Earnings	13.71	11.89	13.43	13.50

We also looked at the nature of the industries in both groups. Both groups contained significant numbers of financial, high technology electronics, retail, and energy companies, spread fairly evenly among the four auditing firms. We contacted a senior manager at PWC for his impressions as to the disparity between his firm and the others in terms of percentage changing to descriptions. He was unaware of any specific company policy or auditing guidance that would be different among the four firms; however, he did indicate that many engagement teams have been questioning the benefits of providing descriptions versus the costs required.

### **Discussion**

For years, the SEC pushed firms for descriptions rather than references to standard numbers, with few results. The Codification seems to have spurred 50 to 60 percent to finally make this change. But an underlying question remains as to whether the descriptions used satisfy the

desire to make financial statements more understandable. Descriptions themselves can be as legalistic and jargon-filled as references to standards and may not meet the SECs “plain English” guidelines. Consider the disclosures in Table 3, all of which come from the 2009 10-K of each of the respective companies.

The examples are from firms in the petroleum refining industry and cover their descriptions of how they account for suspended oil well costs, a special industry practice. Exxon-Mobil and Occidental Petroleum make no reference to Codification numbers, whereas Chevron makes passing reference. However, there is little connection between these references and the readability of the standards. Exxon merely cites the basic structure of the authoritative structure, without any elaboration, earning it a zero in readability and an incredibly high grade level. Chevron, even though citing the codification, slightly improves its scores by adding detail to the basics; however the extra detail is too dense to add much to the Flesch scores. Occidental Petroleum goes further by shortening its sentences and using common, shorter words, actually bringing its readability into the range of much of the population.

Company	Flesch		Disclosure
	Read Score	Grade Level	
Exxon-Mobil	0.0	28.3	The Corporation continues capitalization of exploratory well costs beyond one year after the well is completed if (a) the well found a sufficient quantity of reserves to justify its completion as a producing well and (b) the entity is making sufficient progress assessing the reserves and the economic and operating viability of the project.
Chevron	4.7	24.1	Accounting standards for the costs of exploratory wells (ASC 932) provide that exploratory well costs continue to be capitalized after the completion of drilling when (a) the well has found a sufficient quantity of reserves to justify completion as a producing well and (b) the enterprise is making sufficient progress assessing the reserves and the economic and operating viability of the project. If either condition is not met or if an enterprise obtains information that raises substantial doubt about the economic or operational viability of the project, the exploratory well would be assumed to be impaired, and its costs, net of any salvage value, would be charged to expense. The accounting standards provide a number of indicators that can assist an entity in demonstrating that sufficient progress is being made in assessing the reserves and economic viability of the project.
Occidental	36.7	13.7	The costs of exploratory wells are initially capitalized pending a determination of Petroleum whether proved reserves have been found. At the completion of drilling activities, the costs of exploratory wells remain capitalized if a determination is made that proved reserves have been found. If no proved reserves have been found, the costs of the related exploratory wells are charged to expense. In some cases, a determination of proved reserves cannot be made at the completion of drilling, requiring additional testing and evaluation of the wells. Occidental's practice is to expense the costs of such exploratory wells if a determination of proved reserves has not been made within a 12-month period after drilling is complete.

The first two examples in Table 4 illustrate how two companies disclosed the new requirements of a change in accounting principle for non-controlling interests in consolidated statements. We chose to look at a “change” because adoption of a change was the most common location of extensive references to legacy references or Codification references in the firms in our sample that used references. Berkshire Hathaway continues to refer to pronouncement numbers, and received poor Flesch scores in readability and grade level. (We believe their explanation is quite good in terms of quality of explanation, illustrating that the Flesch scores do have their limitations in terms of measuring content.) Microsoft’s disclosure note receives much higher scores, primarily due to its use of shorter words. The third example is our attempt to improve upon the Microsoft disclosure by primarily changing the passive sentences to active sentences. This exercise reinforced to us the extensive time that would be required to edit all disclosures in this manner.

**Table 4**  
**Examples of Disclosures under the Codification:**  
**Accounting for a Change in the Reporting of Noncontrolling Interests**

Company	Flesch		Disclosure
	Read Score	Grade Level	
Berkshire-Hathaway	0.0	23.6	As of January 1, 2009, we adopted certain provisions of ASC 810 Consolidation which require that noncontrolling interests (formerly known as “minority interests”) be displayed in the balance sheet as a separate component of shareholders’ equity and that net earnings attributable to the noncontrolling interests be identified and presented in the statement of earnings. In addition, changes in ownership interests where the parent retains a controlling interest are to be reported as transactions affecting shareholders’ equity. Previously such transactions were reportable as additional investment purchases (potentially resulting in recognition of additional other assets, including goodwill, or liabilities) or sales (potentially resulting in gains or losses).
Microsoft	24.3	18.7	On July 1, 2009, we adopted guidance issued by the FASB that changes the accounting and reporting for non-controlling interests. Non-controlling interests are to be reported as a component of equity separate from the parent’s equity, and purchases or sales of equity interests that do not result in a change in control are to be accounted for as equity transactions. In addition, net income attributable to a non-controlling interest is to be included in net income and, upon a loss of control, the interest sold, as well as any interest retained, is to be recorded at fair value with any gain or loss recognized in net income.
Reworded Microsoft	49.3	10.9	On July 1, 2009, we adopted guidance issued by the FASB that changes the accounting and reporting for noncontrolling interests. We now report non-controlling interests as a component of equity separate from the parent’s equity. In addition, we include net income attributable to a noncontrolling interest in our net income. When we have purchases or sales of additional stock that do not result in a change in control, we account for them as equity transactions. If we sell stock that results in a loss of control, the remaining stock will be valued at fair value at that date. We will recognize any gain or loss on the transaction in net income.

The difficulty with the objective of making financial disclosures more understandable is the presumed expertise of the user of the information. What is easily understandable varies with accounting expertise, knowledge of the nature of the transactions disclosed and financial statement analysis skills. A financial report that is understandable and easily readable to an accounting expert with substantial business experience and knowledge might be completely dense to a user who lacks that specialized knowledge. The FASB and the International Accounting Standards Board (IASB) attempted to define the appropriate knowledge level in a recent joint conceptual framework project. “Users of financial reports are assumed to have a reasonable knowledge of business and economic activities and to be able to read a financial report.” It further cautions that relevant information should not be excluded simply because it may be too difficult for some users to understand. (IASB, 2006) The vague nature of “reasonable knowledge” and “reasonable diligence” continue to perplex companies as to how to improve the understandability of their reports.

The FASB Codification has at least spurred a significant percentage of Fortune 100 companies to eliminate references to specific GAAP; which should lead to more detailed descriptions of their accounting policies. Whether these changes will result in more transparency as to the economic significance of operating activities remains to be seen. Difficulties remain that are functions of the knowledge level of the user, the vast complexity of modern-day transactions, the costs involved in preparing financial reports, and the natural tendency of entities to want to present themselves in the best light possible.

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