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Full Disclosure vs. Effective Disclosure

As a guiding principle for financial reporting, "full disclosure" is being overtaken by "effective disclosure."

ILLUSTRATION: CLAIRE FRASER/IMAGEZOO

"Full disclosure" has long been a guiding principle for financial reporting. Yet there are clear signs that this principle isn't as useful as it once was in ensuring that the information needs of report users are met. In this month's column, I'll explain why full disclosure is no longer a useful goal. I'll also briefly describe how standards setters and regulators have begun to shift their focus from *full* disclosure toward *effective* disclosure.

"Full" Is Subjective

The word "full" conveys completeness. As such, it implies the existence of a quantitative and/or qualitative benchmark against which completeness can be assessed. Then what's the appropriate benchmark to use in assessing whether disclosures that are included in financial reports are "full"? The answer depends on the reporting entity and report users.

Financial-reporting standards, such as U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), require each reporting entity to make specific disclosures in notes that accompany the entity's financial statements. But financial-reporting standards vary among countries and types of entities. As a result, full disclosure for one entity could be a subset of, a superset of, or simply different from full disclosure for another entity. Thus, from the entity's perspective, financial-reporting standards provide only a subjective benchmark for assessing the fullness of disclosures in financial reports.

Additionally, stakeholders of an entity may expect more, less, and/or different disclosures than those that are prescribed by a particular set of financial-reporting standards. For example, in early 2012, Chesapeake Energy Corporation's shareholders were dismayed to learn that the company's chief executive officer (CEO) had engaged in certain personal financial deals with third parties—previously undisclosed transactions that were perceived as having the potential to compromise the CEO's fiduciary duty to the company's shareholders. The revelation of those transactions caused Chesapeake's stock to lose $500 million in market value. But my research into this matter led me to conclude that Chesapeake had *not* failed to adhere to the disclosure rules of U.S. GAAP or the regulations of the U.S. Securities & Exchange Commission (SEC). Does that mean that Chesapeake's investors shouldn't have been upset? No. In this case,

investors' subjective benchmarks for full disclosure hadn't been met even though standards-based benchmarks were met.

As illustrated, the "full" in "full disclosure" is very subjective. Because we lack widespread agreement on what "full" means, "full disclosure" isn't really a useful principle for guiding financial reporting.

"More" Isn't Necessarily "Better"

Given that a universally accepted, objective standard for "full" disclosure doesn't exist, can we simply assume that more disclosure is always better than less disclosure? No. For three specific reasons, more disclosure isn't necessarily better.

First, as I summarized in my September 2011 column, recent reports from various organizations throughout the world have emphasized that expanding disclosure requirements in financial-reporting standards is actually undermining the usefulness of the disclosures that entities provide. Ideally, disclosures would always be relevant, material, and novel, but many of the disclosures that must be included in financial reports today exhibit none of those characteristics. The "clutter" and overall lack of organization of note disclosures are increasingly causing the disclosures to fail to serve the interests of financial-report users.

Second, some reporting entities try to use additional disclosures to compensate for improper financial reporting practices. For example, as I described in my October 2011 column, Groupon reported a certain non-GAAP financial measure in its initial public offering (IPO) registration statement—a measure that's impermissible under the SEC's financial-reporting rules. Even though the measure was accompanied by extensive explanatory disclosure, the disclosure had no chance of convincing the SEC to ignore Groupon's reporting violation. As this example illustrates, fundamental wrongs can't be made right by additional disclosure.

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Third, extensive disclosure can be risky. Certain disclosures can reveal information that benefits the reporting entity's marketplace competitors or legal adversaries. Taken into consideration with the other two reasons, you can see that a more-demanding benchmark of disclosure fullness isn't necessarily more desirable than a less-demanding benchmark.

Recent Developments

On July 12, 2012, the U.S. Financial Accounting Standards Board (FASB) issued a discussion paper (DP) on the Board's Disclosure Framework project. The DP was accompanied by an invitation to comment "to ask for stakeholder input on ways to improve effectiveness of disclosures in notes to financial statements of public, private, and not-for-profit organizations." On the same day, the European Financial Reporting Advisory Group (EFRAG) issued a similar consultative document, *Towards a Disclosure Framework for the Notes*. And just a few days earlier, the FASB decided to remove from its agenda the Disclosure of Certain Loss Contingencies project, which had been strongly opposed for many years by preparers and the legal community.

Collectively, these developments acknowledge that:

- "Fullness" of disclosure in financial reporting is subjective with regard to both the reporting entity and users of the entity's reports.
- More disclosure may actually be less beneficial to a reporting entity and its stakeholders.

Given the lack of an objective benchmark for disclosure fullness, as well as the dubiousness of a "more is better" approach, the shift toward defining principles for maximizing the effectiveness of an entity's disclosures, individually and holistically, is most welcome. **SF**

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