Dear Sir,

Summary

The proposed disclosure principles for notes to the financial statements in the Exposure Draft, “Conceptual Framework for Financial Reporting – Chapter 8: Notes to the Financial Statements”, should be reconsidered. They are unlikely to enhance the existing disclosure and presentation framework for financial statement footnotes. The Exposure Draft:

- Does not address a view, held by many within the accounting community, that the current volume of required footnote disclosures needs to be reduced.

- Presumes that footnotes should be referenced to individual line items in the financial statements. It neither discusses nor considers alternative presentation structures, such as grouping footnotes by the nature of the transactions or categorizing them by the significance they might have to the entity. More flexibility within the disclosure framework might provide better approaches in bringing clarity and usefulness to the information being presented.

- Does not take under consideration the concerns expressed by the accounting community that preparers are presenting information in the footnotes without regard to the materiality that it might have to the entity. The Exposure Draft does not offer a methodology that advises preparers in arranging and ranking the information in accordance with its importance and relevance to an entity’s operating results and financial condition. Preparers have not been given a set of principles to distinguish significant events from outcomes that are immaterial. Without such guidance, they may be inclined to give equal weight to each potential disclosure.

Under the proposed framework, disclosure principles will go beyond the traditional view in which footnotes are expected to augment and clarify details of recognized transactions that cannot be explained fully on the face of the financial statements. They will include information regarding past events and current conditions and circumstances that do not affect individual line items in the financial statements, but may affect an entity’s cash flow prospects. Nevertheless, many of the examples in the Exposure Draft for this category of financial information are unlikely to happen often. They presume a gap between the time an event occurs and when it affects the operating results and financial condition of an entity. However, under normal circumstances, there is likely to be no time gap at all. These examples will have an immediate impact on the entity’s transactions. An entity will be unable to defer them for any length of time.

Of greater concern is the notion that a sensitivity analysis is based on past events and current conditions and circumstances. Such a classification seems inappropriate because hypothetical changes to past events and current conditions and circumstances represent predictions of the future. In a sensitivity analysis, recognized transactions are transformed from events that are based on objective evidence provided by arm’s length transactions to outcomes that represent the possible effects of future economic and market conditions on the entity. These outcomes are future events that are speculative in nature and not grounded in tangible evidence. Incorporating sensitivity analyses
within the disclosure framework contravenes assertions in the Exposure Draft that assessments of the future by management should be excluded from any disclosure requirement.

Only existing litigation, known violations of laws and regulations, and events that occur after the reporting date of the financial statements seem to meet the definition of past events and current conditions and circumstances that can affect the cash flow prospects of an entity even though they have not been recognized in the financial statements. They are extant events that may affect future cash flows if they are resolved and can create either resources for or obligations against an entity at some future date. If it can be established that resolution of these types of events at some future date could potentially create resources for or obligations against an entity, then they might be considered as candidates for disclosure if the expected resources or obligations could possibly be material to the operating results and financial condition of the entity.

Potential litigation, suspected violation of laws and regulations, and presumed events that do not create recognizable transactions due to significant ambiguities in the basis for recognition do not meet these requirements. There is no tangible evidence to support their existence. A supposed condition or circumstance whose presence is uncertain and indeterminable cannot give rise to a recognizable event. It is essentially a nonevent. The disclosure of such an item in notes to the financial statements is beyond the scope of an evidentiary-based accounting model and, therefore, should not be permitted.

To the extent that there are past events and current conditions and circumstances that do not affect individual line items in the financial statements even though they may have the potential to affect cash flows at some future date, then at least four conditions should be met before such events can be considered for disclosure:

- There is tangible evidence that an event has occurred.
- The extant event is specific to the entity.
- If the event were to be resolved, it could potentially create either resources for or obligations against an entity. If the possible resolution of an event is not expected to create resources for or obligations against an entity, then it should not be considered for disclosure in notes to the financial statements.
- If resolution of the event can potentially create either resources for or obligations against an entity, those expected resources or obligations should be significant to the operating results and financial condition of the entity.

Past Events and Current Conditions and Circumstances That Do Not Meet The Recognition Criteria

The concept that past events and current conditions and circumstances can affect the cash flow prospects of an entity even though they do not affect the line items in the financial statements seems to all appearances to be implausible. This supposition is contrary to the putative belief that only transactions that meet the criteria for recognition in the financial statements can affect cash flows. As such, recognized transactions appear to be the only suitable candidates for disclosure in notes to the financial statements.

Nor do examples a, b, c, d and f in paragraph D57 necessarily support this proposition, as they are neither absolute nor definitive. They are open to interpretation. Contrary to the expectations in the Exposure Draft, these events appear to create or to be based on recognized transactions that have an immediate and decisive effect on line items in the financial statements during the normal course of business. An entity cannot defer or impede the impact these conditions and circumstances will have on its operating results and financial condition. The examples in paragraph e, on the other hand, do not fall within the context of past events and current conditions and circumstances. They are more closely related to future events:

- Examples b, c and d, in particular, seem to portray past events and current conditions and circumstances that will likely meet the criteria for recognition in the financial statements. It is inconceivable that an entity is capable of insulating itself from current and existing uncertainties in the volumes and prices of its inputs and outputs, market access to its inputs and outputs, retention of a qualified workforce, and maintenance of suitable physical facilities. Any uncertainties or volatilities in these operating factors will probably have an
instantaneous and tangible effect on an entity's transactions and financial statements taken as a whole. Such events are unlikely to leave an entity's operating results and financial condition untouched for any period of time.

- Along the same lines, the ability of an entity to continue to operate as a going-concern in example f is based primarily on the evaluation of the current financial statements. The recognized transactions within those statements are likely to provide the preponderance of evidence in assessing the adequacy of current cash flows. Past events and current conditions and circumstances that do not affect individual line items are superfluous in comparison.

- Disclosure of an entity's dependence on a few major customers or suppliers is important in comprehending the significant drivers of a business. It provides supplementary information on the sources of profitability that cannot be explained fully on the face of the financial statements. The relationships with customers and suppliers are grounded on past and current transactions that are recognized in the individual line items. They are not based on events that do not affect the operating results and financial condition of an entity. As in examples b and c, any uncertainties and volatilities in the volumes and prices of the inputs and outputs and market access to the inputs and outputs will be reflected immediately in the financial statements. A delay in the recognition of these events is unlikely. Under these circumstances, classification of this type of disclosure as additional information regarding individual line items appears to be more appropriate.

- Classification of the sensitivity analysis examples in paragraph e as past events and current conditions and circumstances seems inappropriate because these analyses do not evaluate the impact of current economic and market conditions on the entity. They represent predictions of the future inasmuch as they measure the sensitivity of an entity's operating results and financial condition to future changes in economic and market circumstances. Accordingly, they should be excluded from the disclosure framework as discussed below.

The justification for disclosure of potential litigation, suspected violations of laws and regulations, and presumed events that do not create recognizable transactions due to significant ambiguities in the basis for recognition (see paragraph D52 and questions L-3, L-4 and L-5) seems even less certain. Not only do these supposed events have no effect on line items in the financial statements, but their very existence is in doubt. These uncertain conditions and circumstances to the existence of a supposed event are beyond the evidentiary-based framework of accounting. They lack the tangible and factual manifestation of actual events that have occurred. Such nonevents do not warrant disclosure. Only those events whose presence is certain and determinable should be considered.

Nor does the Exposure Draft provide any guidance that limits disclosure to those potential and suspected events that might be realized over time. There appear to be no practicable rules within the proposal to identify and distinguish them from those potential and suspected events that will never occur. If no such methodology can be developed, then all potential and suspected events may have to be considered for disclosure. The possibilities may be limitless. Some constraints will be needed to keep preparers from being overwhelmed by all the potential outcomes.

Existing commitments that have not been recognized, but are expected to be recognized in the future, in paragraph D52 (c) do not appear to fall within the context of past events and current conditions and circumstances that do not affect individual line items. Given that the commitments in this example emanate from contracts and other types of arrangements to deliver goods, provide services, permit asset use and extend credit, they represent ongoing transactions with suppliers, lessors and lenders that are incurred in the normal course of business. The disclosures of these arrangements should be classified as additional information about line items because they represent transactions of an ongoing business that have an immediate and continuing impact on the financial statements. The fact that additional transactions will be incurred under these contracts and commitments after the date of the financial statements is not a sufficient reason to classify this information as past events and current conditions and circumstances that affect cash flows but not the financial statements. The information regarding possible contractual and commitment transactions after the financial statement date should be incorporated in the notes as part of the overall discussion of the terms and conditions of current contracts and other types of arrangements.

Within the examples provided in the Exposure Draft, only existing litigation, known violations of laws and regulations, and events that occur after the reporting date seem to exemplify the concept of past events and current
circumstances that affect cash flow prospects of an entity even though they do not affect the line items of the financial statements. They are extant events that do not qualify as recognized transactions as of the reporting date because not all the issues that will determine whether they will create resources for or obligations against an entity have been resolved. They may have the potential to affect the cash flows of an entity at some future date when and if the issues are resolved, but these circumstances do not necessarily require a disclosure. At least four conditions should be met before disclosure can be considered:

- There is tangible evidence that an event has occurred.
- The extant event is specific to the entity.
- If the event were to be resolved, it could potentially create either resources for or obligations against an entity. If the possible resolution of an event is not expected to create resources for or obligations against an entity, then it should not be considered for disclosure in notes to the financial statements.
- If resolution of the event can potentially create either resources for or obligations against an entity, those expected resources or obligations should be significant to the operating results and financial condition of the entity.

Requirements such as the ones listed above can assist in reducing the number of possible disclosure requirements to a more manageable level.

Future-Oriented Information

The disclosure of future events in notes to the financial statements is beyond the scope of an evidentiary-based accounting model because the existence of a future event is uncertain and indeterminable as of the reporting date. Future events can neither give rise to transactions that meet the criteria for recognition in the financial statements nor have a tangible effect on the cash flows of an entity until the equivocal conditions and circumstances that underlie them are resolved. No standard methodology exists that can ascertain with certainty the eventual outcomes of future events and the eventual impact they might have on an entity before they occur. They can only affect the operating results and financial condition of an entity when they are realized, which may or may never happen, at some future date.

Although the Exposure Draft supports neither disclosure nor management assessment of future events, the delineation between (i) past events and current conditions and circumstances and (ii) future events is ill defined. The distinction between these two concepts begins to dissipate in the discussion of the third type of future-oriented information in paragraph D29, as this subject moves from the treatment of estimates and judgments used in measuring recognized transactions to disclosures of future changes to existing conditions on specific line items and the entity taken as a whole. These proposed disclosures are based on neither past events nor current economic and market conditions. They go beyond these bounds. They are future events, as they represent possible future changes to the existing economic and market conditions in which the entity operates.

To eliminate possible management predictions and assessments of the future from disclosure in notes to the financial statements, the Exposure Draft suggests that a standardized mathematical model might be applied such as the commonly used method to calculate the possible effects of a 100-basis point change in the interest rates on interest income and expense. This is a straightforward model in which there are no predictions of the future by management, there is only one unknown input variable and only one outcome, and the possible outcomes of all other variables that can be affected by an interest rate change are held constant.

However, the application of a one input and one outcome model may be of limited use in the other economic and market factors listed in paragraph D57 (e) and question L-5. Isolating the effects of hypothetical changes to currency exchange rates, commodity prices, stock market prices, housing starts, inflation and unemployment to one or two lines will be more challenging and burdensome for preparers, as the impact from the potential changes to these factors on the entity are more pervasive. Future changes to any of these economic factors will probably affect revenues, expenses, receivables, payables, inventories, etc. Users of financial statements will not accept an analysis
that is limited to a single line item under these circumstances. They will want to understand the effects of such changes on the entire entity.

The complexity of such sensitivity analyses will increase if an entity uses multiple currencies or commodities to conduct its business or holds a number of stocks in its investment portfolio. It is unlikely users will allow an entity to limit the analyses to one particular foreign currency, commodity or stock. They will want the analyses to include all currencies and commodities used in the business and each stock held in the investment portfolio.

In developing the scenarios, the expected magnitude and direction in the change of each currency exchange rate, commodity price and share price will not be the same. An anticipated percentage change in the rate of exchange between two currencies will not equal the expected change in exchange rates between a different pair of currencies. Nor will a projected price change in a commodity or equity security correspond, respectively, to an expected price change in a different commodity or equity security. There are few direct relationships in the market values among the items in each of these categories to permit a one-to-one percentage change analysis. The forecasts of supply and demand, monetary and fiscal policies, balance of trade, relative economic growth rates of countries, industries and entities, etc. will affect each projected commodity price, stock price and currency exchange rate differently.

The relationships of inflation, housing starts and unemployment to individual line items are less obvious and more complex. These factors are economic indicators that do not directly influence individual line items because they do not drive the economy. They measure economic conditions. A change in one of these indicators signifies a change in the underlying economic circumstances, and therefore, the indicators can only be indirectly connected to the effects of a change in the general economy on the entity. Any analysis will have to contemplate the relationships between the indicators and the underlying economic forces they measure and the effects these economic forces have on the entity. The impact from a change to the general economy on the entity will be more diffused than the effects of currency exchange rates and commodity prices because changes in the general economy cannot be identified precisely with specific transactions. It will probably flow through most of the accounts of an entity. Isolating it to one or two items seems impracticable.

These sensitivity analysis examples are in conflict with the view in the Exposure Draft that management assessment of the future should be excluded from a disclosure requirement. Judgment seems necessary to determine how changes in supply and demand, monetary and fiscal policies, balance of trade, relative economic growth rates of countries, industries and entities, etc. might affect future currency exchange rates, commodity prices, stock prices, housing starts, inflation and unemployment. The possible variables are too numerous to reflect them all in the construction of each economic and market factor model. Such models are too onerous and unwieldy to use. To simplify them, judgment is required to identify those elements that will have a significant influence on the projected economic and market outcomes. The effectiveness of a model will depend on the estimates and assessments used to select those variables that best represent the economic phenomenon being forecasted. The process, under these circumstances, does not seem possible without some sort of evaluation of the underlying economic and market factors by management. Their understanding of the entity and the economic and market conditions in which it operates is paramount, and they will use this knowledge to choose the appropriate variables.

Nor does this issue seem to be limited to modeling. The questions listed in paragraph L-5 outline a framework for a management discussion of the effects of possible future economic conditions on an entity. They require management to analyze the future factors that will affect an entity’s cash flow prospects through sensitivity analyses and a description of the policies, practices and strategies that could be used to mitigate the possible future outcomes (However, one should note that not all future events will have adverse effects on an entity requiring mitigation. Certainly, some outcomes will prove beneficial.). Such discussions are outside the evidentiary-based framework of the current accounting model, as they are not based on past events and current conditions and circumstances. Paragraph L-5 should be eliminated from the proposed disclosure framework because it will require a management discussion of the future.

More troubling is that the Exposure Draft places no limits on the types and numbers of scenarios that should be considered and presented. There is no methodology to identify which outcomes are more likely to occur, and of those items that are likely to occur, which of them might possibly be significant to the operating results and financial condition of the entity. Without a systematic approach to narrow the scope of possibilities, each outcome must be given equal weight. There is no process to highlight the more likely and significant outcomes and eliminate those
potential events that are immaterial to the entity. Everything and anything, therefore, must be taken into account. The possibilities will become endless. There is no indication from the Exposure Draft as to how the scope can be narrowed to a manageable level so that preparers can cope with numerous outcomes that these analyses can generate.

Changing inputs to recognized transactions to predict possible future outcomes should not be considered part of the disclosure framework. They are matters of conjecture and opinion. There is no underlying tangible evidence to substantiate them. In changing the inputs, recognized transactions are transformed from events that are based on objective evidence provided by arm’s length transactions to predictions of future outcomes. The results do not represent the effects of past events and current conditions and circumstances on the financial statements. They represent possible outcomes of future events, which are beyond the basic recognition standards for financial statements.

Yours very truly,

Andrew Prytherch