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Financial Accounting Standards Board
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BY EMAIL: director@fasb.org

RE: File Ref. No. 2012-220
Disclosure Framework

Members of the Board:

On behalf of Sandler O'Neill + Partners, L.P., I am commenting on the Board's Discussion Paper ("DP"), *Disclosure Framework*, issued July 12, 2012 for comment by November 30, 2012. The DP poses twenty-two questions to stakeholders requesting feedback helpful to the Board in developing a framework for identifying information that should be disclosed in notes to the financial statements as a means of improving their relevance and organization.

Sandler O'Neill is a market-leading, full-service investment banking firm and broker-dealer focused on the financial services sector.¹ We address the Board as a firm of financial professionals who work closely with a wide variety of financial companies nationwide and, increasingly, around the globe. Our clients include some one thousand such companies, including banks and thrifts, insurers, and their holding companies, as well as investors in them.

Overview of the DP

The scope of the DP includes only the notes to financial statements rather than information contained elsewhere in financial reports, most notably management's discussion and analysis ("MD&A"). The matters considered are equally applicable to public and non-public entities, including private companies and not-for-profit entities.

The content of financial statements and notes to them derives from the objective of general purpose financial reporting, which is

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to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.²

The Board posits that investment and credit decisions are based on implicit or explicit assessments of prospects for cash flows – including probabilities, timing, and amounts – to the holder of those investments, loans, or other forms of credit. In turn, the prospects for cash flows to the holder depend on the holder's assessment of prospects for net cash inflows to the entity and the rights to cash flows from the entity that a specific investment or credit instrument conveys to its holder.

Whereas definitions and principles of recognition applicable to assets, liabilities, and equity govern the financial information provided on the face of financial statements, no such gatekeepers exist for information provided in the notes. Rather, accounting standards and practices have established a de facto boundary for the notes that is comparatively imprecise and permissive, hence expansive.

Because excessive disclosure is burdensome to reporting entities and can overwhelm users or lead them to overlook important information, the DP discusses decision questions developed by the Board that are intended to limit note disclosure to information that:

- is unique to an entity or its industry
- is not already apparent from the financial statements or readily available from public sources, or
- could materially affect assessments of cash flow prospects.

Such a decision framework for the content of notes to financial statements implies that users would be expected to be knowledgeable about matters such as general business risks and economic conditions, U.S. GAAP, commonly used pricing models, and SEC reporting requirements.³

The DP suggests two means of incorporating the disclosure framework into U.S. GAAP. The first would be the addition of a chapter to Concepts Statement No. 8 in the form of decision questions or a comparable set of principles to guide the Board in its development and review of disclosure requirements. The alternative would be to provide such questions or principles in the Accounting Standards Codification and eliminate existing specific disclosure requirements, leaving it to reporting entities to apply the

² FASB, Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting* (Sept. 2010), ¶ OB2.

³ See footnote 5 below and related text for discussion of the *informed user*.

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guidance in reaching their own conclusions about what to disclose in the notes to financial statements.⁴

Discussion of Key Topics

Our purpose is to provide the Board conceptual commentary on framing topics in the DP rather than discrete responses to the specific questions posed to respondents. We believe, however, that our broader commentary implies answers to many of the specific questions the DP poses even though we may not explicitly address them.

The Board's discussion of key topics has a yin-yang quality about it arising from the need to balance opposing impulses and modalities of thought inherent in the preparation of financial disclosures. For example, whereas the concept of the *informed user* would tend to limit needed disclosure, the very inclusive concept of *cash flow prospects* could greatly expand information subject to disclosure by reason of relevance or materiality.⁵ Concerning interim disclosure, the Board attempts to balance the desire for more disclosure against the practical constraint of tight deadlines for its production.

More generally, the conscious reasoning underlying the Board's decision process is counterbalanced by the more intuitive approach to disclosure decisions that managements characteristically take by virtue of their intimate knowledge of their businesses and what really matters.

Scope; Boundaries of Financial Statements vs. Notes

Confining the scope of the DP to the notes to financial statements rather than other information contained in financial reports is appropriate. In particular, while the financial statements take a snapshot of condition and performance as of a date certain, and the notes supply framing context as needed, MD&A provides the screenplay that places all else within the larger story line. Financial statements, notes, and MD&A compose a spectrum of presentation from data to integration that is increasingly within the directorial purview of management and, as a result, less susceptible of prescription and audit, but

⁴ The decision questions are organized into three categories of information about (1) the reporting entity in general, (2) line items in the financial statements, and (3) other events and conditions not yet reflected in the financial statements that could affect prospects for future cash flows. DP ¶ 2.10.

⁵ See DP ¶¶ 4.14 to 4.16 for the Board's discussion of what we call the *informed user*, who would be expected to be knowledgeable about matters such as general business risks and economic conditions, U.S. GAAP, commonly used pricing models, and SEC reporting requirements (¶ 1.16). The informed user is related to but different from the *reasonable user*, a concept the DP also employs. See ¶¶ 2.16, 4.18, 4.19, & 6.17. The reasonable user is similar to but broader than the concept of the *reasonable investor* in federal securities law in representing normative conclusions regarding the importance and implications of information (see footnote 9 below). By contrast, the informed user (or investor) represents normative knowledge rather than judgment.

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not beyond severe adverse consequences for abuse. This state of affairs is as it should be, and should be left alone.

We find the Board's brief discussion of the boundaries of information in financial statements and notes interesting but not wholly persuasive, as well as incomplete, perhaps revealingly so. Whereas the "definitions of and recognition requirements for assets, liabilities, and equity establish a boundary around the information to be provided on the face of the financial statements," the Board believes that U.S. accounting standards and practices have established only a de facto boundary for notes "that is not as sharp as it might be and has been extended over time" (DP ¶ 1.13).

We generally agree with the Board's observations about boundaries, but with two important reservations:

1. The omission of any reference to core components of the income statement, in particular revenues and expenses, as establishing boundaries for information provided on the face of the financial statements is intriguing – not only because it is so striking but also because it may reflect the disconnect between investors' and creditors' normative focus on net income as opposed to the Board's fair-value focus on the balance sheet.
2. Not only the boundaries for notes but also the boundaries for information provided on the face of the financial statements have been extended over time. Indeed, the Board itself has vastly expanded the information provided on the face of financial statements through its introduction of the concept of other comprehensive income ("OCI") and Level 3 fair-value measurement and recognition. Such mission creep has impressed into service in the financial statements matters that would be more appropriately disclosed in the notes for reasons of relevance to the reporting entity's business strategy and uncertainty of measurement.

Finally, we believe the expansion of disclosures in the notes arises in no small part from the litigious environment within which U.S. companies must prepare financial reports.⁶ Like the multiplication of procedures and tests in the practice of defensive medicine, the growth of much disclosure in financial reporting is a response to the plaintiffs' bar, and

⁶ See DP ¶ 4.31, where the Board itself acknowledges this state of affairs. See generally Jordan Milev, Robert Patton, and Svetlana Starykh, *Recent Trends in Securities Class Action Litigation: 2011 Mid-Year Review* (NERA Economic Consulting: July 26, 2011), available at [http://www.nera.com/nera-files/PUB_Mid-Year_Trends_0711\(3\).pdf](http://www.nera.com/nera-files/PUB_Mid-Year_Trends_0711(3).pdf); Kathryn Mary Schumann, "Cross-Listed Firms and Shareholder-Initiated Lawsuits: The Market Penalties of Securities Class Action Lawsuits against Foreign Firms." PhD diss., University of Tennessee, 2012, available at http://trace.tennessee.edu/utk_graddis/1345.

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we doubt that, regardless of good intentions, the Board will be able to counteract defensively motivated disclosure.

Prospects for Cash Flows

Unless limited, the very expansive operation of the concept *prospects for cash flows* could be tantamount to requiring reporting entities to include investment opinions on themselves in the notes to their financial statements. This result occurs in three steps:

1. “Investment and credit decisions are based on implicit or explicit assessments of prospects for cash flows – including probabilities, timing, and amounts – to the holder of those investments, loans, or other forms of credit” (DP ¶ 1.10).
2. The term *cash flows* is defined to include “flows of economic value other than cash and . . . refers to *net* inflows or outflows” (DP ¶ 2.9) [emphasis in original]. We interpret this definition to include existing or potential gains or losses on instruments issued by the reporting entity and held or to be held by existing or potential investors and creditors, which is consistent with the third point immediately below.
3. Cash flows that are important to existing and potential investors or creditors are those to themselves either “directly from the entity or from sale of its investment or credit instruments.” Such cash flows are distinct from but dependent on cash flows to the issuer because the latter “are the sources of outflows to investors or creditors or market price changes in the investment and credit instruments” (DP ¶ 2.9).

Taken as a whole, the discussion of prospects for cash flows could be read to contemplate imposing on a reporting entity the requirement of projecting future earnings – and perhaps even market interest rates – in the notes, implying if not assigning price targets for its own equity and debt instruments based upon those projections.⁷

In short, such a view of the role of notes to financial statements could transform financial reports from documents descriptive of historical results into documents predictive of the future value of an issuer’s capital instruments. If this is not the Board’s intent, the Board should clarify the same in any future discussion.

⁷ See Decision Questions L5 & O7, which focus on disclosing the possible effects on future cash flows of general economic and market factors, including interest rates, stock prices or volumes, and foreign exchange rates (DP ¶¶ 2.17 & 2.19).

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Relevance and Materiality

The Board seems to imply that materiality is a concept typically – perhaps exclusively – associated with items on the face of the financial statements and reasons that materiality can therefore serve as the gatekeeper of relevance in the notes:

In general, the notion is to consider how a user might use the information on the face of the financial statements to develop a *baseline* assessment of an entity's prospects for future cash flows and then to consider how information (either quantitative or qualitative) that might be disclosed in notes affects that assessment. If a particular disclosure would be expected to change users' assessments by a material amount, that disclosure would be considered relevant to that entity.⁸

It strikes us that the DP puts the cart before the horse. More specifically, in common usage materiality does not determine relevance or the lack thereof but, rather, a degree of relevance that renders information significant enough to reasonable investors or creditors for legal liability to arise from misleading disclosure or nondisclosure.⁹ Put another way, all material information is relevant, but not all relevant information is material. Materiality presupposes rather than determines relevance.

Taken to its logical conclusion, the operational relationship between materiality and relevance described in the DP would limit note disclosure to material information because all else would be irrelevant. We assume the Board does not intend this result.

The Board is much closer to the common understanding of relevance and materiality in its Concepts Statement No. 8:

Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.¹⁰

⁸ DP ¶ 1.28; see ¶ 1.27. "The baseline assessment would be based on assumptions that a reasonable user probably would make in the absence of information to the contrary." DP ¶ 4.19.

⁹ See generally Cadwalader, Wickersham & Taft, *SEC Release on Materiality in Financial Disclosure* (1999), available at <http://corporate.findlaw.com/finance/sec-release-on-materiality-in-financial-disclosure.html>.

¹⁰ FASB, Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting* (Sept. 2010), ¶ QC11.

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This formulation of relevance, materiality, and their relationship is also much closer to that of the U.S. Supreme Court and the Securities and Exchange Commission. Although we are not lawyers, we commend the Board to its Concepts 8 formulation as much more serviceable than its DP iteration.¹¹

Decision Process

Of the two means suggested for incorporating the disclosure framework into U.S. GAAP, we believe the better choice to be adding a chapter to Concepts Statement No. 8 in the form of decision questions or a comparable set of principles to guide the Board in its development and review of specific disclosure requirements, which should dovetail with guidance from other sources, particularly the Securities and Exchange Commission.

This is not to say that we would object to a principles-based disclosure framework for reporting entities, but merely that the decision questions or comparable principles should not be imposed on reporting entities. As we note above, by virtue of their intimate knowledge of their businesses and what really matters, managements rely heavily upon intuitive rather than conscious reasoning in making disclosure decisions.

Conscious and intuitive reasoning are very different modalities of thought reflecting the equally different perspectives of the Board and managements on disclosure decisions, and they should not be conflated. We are particularly troubled by the Board's assumption regarding required documentation and audit of disclosure decisions.¹² Had Shakespeare been subject to such a regimen, he would have written few sonnets and no plays.

Conclusion: The Perils of Unified Field Theory

The Board's disclosure framework DP is a thoughtful document, but one that betrays the perils of attempting to impose a unifying theoretical framework upon resistant phenomena rather than permitting a more pragmatic framework to arise from close empirical observation of data in its brute diversity.

The oddities and errors of the DP – only the most salient of which are discussed above – arise in no small part from the Board's reductive bias in approaching standard setting. Evident throughout the DP is the hegemonic influence of fair value orthodoxy, seen especially in its emphasis on the cash flow characteristics of capital instruments rather

¹¹ See footnote 5 above. The Board mentions the possible need to change the Concepts 8 description of materiality, apparently because of a perceived inconsistency with U.S. Supreme Court decisions. DP ¶ 4.2, note 6.

¹² See Question 11 for Respondents: "Reporting entities would need to document the reasons for their decisions about which disclosures to provide. How would reporting entities document the reasons for their disclosure decisions and how would auditors audit those decisions?" DP ¶ 4.37.

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than the business models of issuers, as well as the regnant touchstone of the balance sheet rather than the income statement – net income in particular.¹³

Reductive fair value bias is at work in the DP not only via the Board's financial instruments project but also other major projects. The central conceit of the insurance contracts project is that because some insurance contracts clearly are financial instruments, all insurance contracts should be accounted for as such. Similarly, the central conceit of the leasing project is that because some leases clearly are financed purchases, all leases should be accounted for as such. Such thinking pays homage to reductive theory at the expense of reality and accounting conventions that helpfully reflect its complexity.

What is urgently needed is an empirical rather than an a priori perspective that values pragmatism over theoretical purity and understands that accounting conventions and disclosures that do not respect business models will coerce them, to the detriment of companies, investors and creditors, and society alike. Good theory reflects reality rather than distorting it. This is the goal to which the Board's standard setting and disclosure framework should aspire.

Sincerely,



Joseph Longino
Principal

cc: The Honorable Jeffrey J. Diermeier, Chairman
Financial Accounting Foundation

The Honorable Paul A. Beswick, Acting Chief Accountant
U.S. Securities and Exchange Commission

The Honorable Hans Hoogervorst, Chairman
International Accounting Standards Board

¹³ We document and discuss the errors of fair value orthodoxy in our September 6, 2012 Basel III comment letter to the federal banking agencies opposing their proposed inclusion of unrealized gains and losses on available-for-sale securities in the regulatory capital of U.S. banks.