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Back to the Basics: Financial Statement Disclosures & Reporting Requirements

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Abstract

To protect stakeholders relying on published financial statements, accounting practices, measurement techniques, disclosures and footnote requirements have been developed over the years by the Financial Accounting Standards Board (FASB) and generally accepted accounting principles (GAAP). As indicated by Saidu and Dauda (2014), the move towards adopting high quality standards was spurred by the numerous financial scandals experienced worldwide in the late 1990s. The United States government has and continues to regulate the standard-setting process and financial reporting environment of publicly traded companies to ensure investors have all relevant information to evaluate a company's financial position and make informed decisions. This paper provides a description of the disclosure techniques available in published financial statements, and analyzes the types of financial reporting requirements promulgated by the AICPA Code of Professional Ethics and the federal securities laws of the U.S. Securities and Exchange Commission (SEC), including the Securities Act of 1933, the Securities Exchange Act of 1934, the Foreign Corrupt Practices Act of 1977, and the Sarbanes-Oxley Act of 2002.

Keywords: corporate governance, financial reporting, disclosure techniques

1. Introduction

To protect stakeholders relying on published financial statements, accounting practices, measurement techniques, footnote and disclosure requirements have been developed over the years by the Financial Accounting Standards Board (FASB) and generally accepted accounting principles (GAAP). As indicated by Saidu and Dauda (2014), the move towards adopting high quality standards was spurred by the numerous financial scandals experienced worldwide in the late 1990s. The United States government has and continues to regulate the standard-setting process and financial reporting environment of publicly traded companies to ensure investors are protected. To that end, stakeholders must have all relevant information relating to a company's financial position to make sound, informed business decisions. In addition to the four most common financial statements (balance sheet, statement of retained earnings, and cash flow statement), footnotes, supplementary schedules, and parenthetical disclosures are needed to improve the intelligibility of the statements (Schroeder, Clark & Cathey, 2011). This paper provides a description of the disclosure techniques available in published financial statements and analyzes the types of financial reporting requirements promulgated by the AICPA Code of Professional Ethics and the federal securities laws of the U.S. Securities and Exchange Commission (SEC), including the Securities Acts of 1933 and 1934, the 1977 Foreign Corrupt Practices Act, and the 2002 Sarbanes-Oxley Act.

2. Discussion

2.1 Disclosure Techniques

The most basic way management reports to external users of financial information is through its financial statements. As mentioned earlier, the four most common statements include the balance sheet, statement of retained earnings, and cash flow statement. The statements quantitatively present financial information according to the principles established by the FASB and the SEC. As indicated by Schroeder et al. (2011), footnotes, supplementary schedules, and parenthetical disclosures provide significant amounts of additional information to stakeholders by explaining, clarifying, and developing information that cannot be easily incorporated into the financial statements themselves. Footnotes can include general information about a company, descriptions of accounting policies, and explanations of intricate or ambiguous financial statement items. In addition, supplementary schedules or exhibits may be used to highlight company trends or comply with specific FASB pronouncements; and parenthetical disclosures can be used to describe information within the financial statements, usually on the balance sheet (Schroeder et al., 2011).

2.2 The Auditor's Report

The audit report is one form of disclosure accompanying corporate financial statements that informs users on the reliability of the statements and indicates whether they are fairly presented in accordance with GAAP. The report is provided after auditors obtain sufficient evidence and conduct an independent examination of the statements and the propositions therein. According to Messier, Glover and Prawitt (2012), "the audit report is the most important "deliverable" on an audit engagement" (p. 613). The original audit report has been revised many times over the years to accurately describe the audit engagement, strengthen its transparency, and clarify management and auditor responsibilities (Goldman & Ratcliffe, 2013). In 2011, the Auditing Standards Board began its Clarity Project, which was a framework aimed at modifying the auditing standards to accomplish several objectives (Hepp & Reinstein, 2021). The first revision was made in 2014 with SAS 128. The revision did not significantly change any of the standards but made them easier to read and understand. The second part of the Clarity Project modified the auditor's report to align with International Auditing and Assurance Standards Board (IAASB) standards. The most recent revisions were made in 2019 (effective for periods ending on or after December 15, 2020) and occurred as a result of SAS 134 (Auditors Reporting and Amendments) and SAS 135 (Omnibus Statement on Auditing Standards). These standards, issued by the AICPA's Auditing Standards Board (ASB), provide for major revisions in the form and content of the standard audit report and are intended to increase the transparency of the process. Some of the highlights include:

- moving the "Opinion" to the front of the report, following it with a section "Basis for Opinion", and adding sections as necessary based on audit findings
- expanding titles to the standard report and adding information (including an additional paragraph dealing with the entities ability to continue as a going concern)
- clarifying responsibilities of company management and auditors for any going concern issues
- introduction of section communicating key audit matters (KAM)
- expanding the disclosures regarding auditor responsibilities (Hepp & Reinstein, 2021).

Audit opinions accompanying annual financial reports give market information on corporations and lower "information risk" for stakeholders. Information risk in this context can be construed as a risk that disclosed market information is "substantially different from the true underlying financial, and some would say economic, reality experienced by the company" (Houghton & Jubb, 2003, p. 300). Auditors have several options when completing an audit and reporting on the financial statements in the annual reports of their clients. Types of reports vary and include unqualified/unmodified, unqualified with explanation, qualified, disclaimer or adverse opinions. The circumstances of each individual engagement dictate which type of report is appropriate.

2.2.1 Management's Discussion and Analysis

A Management Discussion and Analysis (MD&A) section must be included in audit reports for publicly held companies. The MD&A section of the report provides an additional layer of transparency by highlighting company performance and trends during the preceding period and disclosing any matter that could influence future financial success. Information about liquidity, capital resources and results of operations is disclosed, and an evaluation of market risk is provided. The information is intended to enable financial statement users to evaluate past performance and assess its impact on future performance (Schroeder et al., 2011).

2.3 The AICPA Code of Professional Ethics

It is crucial that market stakeholders maintain confidence in the integrity and objectivity of the accounting profession and their work. One way to provide assurances that quality services are being provided and protect the profession's integrity is to establish an ethical framework from which to operate. The AICPA Code of Professional Conduct provides the necessary ethical framework for accountants auditing corporate financial statements and includes four core components: Principles, Rules, Interpretations and Ethics Rulings. The six general principles provide the foundation of the Code and describe the behavior expected of independent auditors. According to Love (2010), the general principles necessitate the highest level of ethical behavior. They call for more than just minimal adherence to the personal characteristics and behavioral traits which sustain ethical behavior. Table 1 summarizes the six principles and provides a brief description of each one.

Table 1. The AICPA code of professional conduct's foundational principles

Article 1—Responsibilities	Activities should be carried out by exercising "sensitive professional and moral judgments".
Article II—The Public Interest	Members should serve with a commitment to professionalism. They should also maintain public trust and serve the interest of the public in their professional responsibilities.
Article III—Integrity	Professional duties should be performed with the highest degree of integrity to "maintain and broaden public confidence".
Article IV—Objectivity and Independence	Members should be free of conflicts of interest and maintain independence in fact and appearance when providing attest engagements.
Article V—Due Care	The technical and ethical standards of the profession should be observed while striving for continuous improvement in the quality and competence of member services.
Article VI—Scope and Nature of Services	When deciding on the nature and scope of provided services, members should adhere to the Code of Professional Conduct and its principles.

Note. (Love, 2010, p. 64).

The principles mentioned above are not enforceable but provide the foundation for the rules CPAs must abide by in conducting attest engagements. Most of the disclosure issues addressed within the Code involve the scope of services CPAs provide to their clients. Independence issues and potential conflicts of interest that exist throughout the business environment among constituents such as auditors, analysts, and company executives are addressed. In addition, the Code of Ethics provides rules on contingent fees, commissions, and compliance with standards of practice (Schroeder et al., 2011).

2.4 The SEC's Federal Securities Laws

2.4.1 U.S. Securities and Exchange Commission

The United States government has played an important role in setting standards and disclosure requirements for publicly held companies. A public company falls under the jurisdiction of the SEC and is subject to extensive disclosure and reporting requirements as a result. The SEC is the regulatory agency established by Congress to enforce the securities laws, promote stability in the markets, and most importantly, to protect investors. The mission of the SEC is to maintain order and efficient markets while protecting investors and facilitating fair trade and capital formation. All public investors should be provided with basic facts about investments before they are purchased to make informed decisions. To that end, public companies are required by the SEC to disclose meaningful financial information to market stakeholders (The Investor's Advocate, 2014). Among the laws under the SEC's jurisdiction are the Securities Acts of 1933 and 1934, the Foreign Corrupt Practices Act of 1977, and the Sarbanes-Oxley Act of 2002. These laws stress the obligation companies have to provide prospective investors in public securities with honest and complete disclosures of their activities (Schroeder et al., 2011). Further details follow concerning each law and their impact on required corporate disclosures.

2.4.2 The Securities Act of 1933

The 1933 Act regulates companies offering their initial sale and distribution of securities investments to the public. Under the Act's provisions, companies preparing for an initial public offering (IPO) must file a registration statement and prospectus with the SEC detailing relevant information about the public offering and cannot issue any stock for a 20-day waiting period. In addition, the prospectus must include audited financial statements for the past three years preceding the IPO filing (Houser, 2011). The goal of the Act is to protect investors from fraud by requiring companies to provide adequate disclosure of material facts relating to the offering so that they can adequately assess the risk before investing (Schroeder et al., 2011).

2.4.3 The Securities Exchange Act of 1934

After the initial sale of securities is made to the public, the government also regulates the trading of securities and the conduct and reporting requirements of corporate insiders. The rules of the 1934 Securities Act mandate periodic quarterly and yearly reporting as well as significant disclosure requirements with respect to certain specified events such as stockholder's meetings, executive compensation, investor relations, and material contracts (Houser, 2011). The Act also grants legal authority to the SEC for establishing and regulating accounting and reporting standards for companies under its jurisdiction, but it has typically relied on the FASB to establish those standards (Schroeder et al., 2011).

2.4.4 The Foreign Corrupt Practices Act of 1977

There are two main elements of the 1977 Foreign Corrupt Practices Act. The first makes it illegal to bribe a foreign political or government official for the purpose of obtaining or retaining business. The second element requires publicly held companies to keep accurate financial records and maintain systems of internal control which are sufficient to enable the preparation of financial statements in accordance with GAAP. Failure to adhere to any of the provisions of the Act can result in both civil and criminal penalties (Schroeder et al., 2011).

2.4.5 The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act (SOX) was passed by Congress in 2002 as a reaction to the financial scandals plaguing corporate America. The intent of the law was to provide greater transparency and reliability in reporting and to increase investor confidence in the financial statements and annual reports of publicly held companies (Jennings, 2012). The provisions of SOX generally apply to any public company under the jurisdiction of the SEC, and the rules created under the Act have the force of law (Hopwood, Leiner, & Young, 2012). Section 409 of SOX requires companies to disclose any material changes in their operations or financial condition to the public timely basis. Changes which are likely to impact financial performance should be communicated to stakeholders immediately, even if the projected impact on their performance might not transpire for some time. In addition, according to the requirements of Section 409, disclosures should be presented in easy to understand terms and should include trend and qualitative information as well as graphical representations when necessary to communicate circumstances that are likely to impact a company's financial position (Barrett, 2004).

Sarbanes-Oxley contains a number of other provisions mandating certain reporting and disclosure requirements. Section 302 requires the certification of company financial statements by top executives. The officer certification section covered in Section 302 of SOX requires a company's top administrators to attest that the financial statements they file are accurate "in all material respects" (Wade, 2008). Section 401 dictates that companies disclose all significant off-balance sheet transactions, and to reconcile pro forma financial statements to statements issued under GAAP (Small, Ionici, & Zhu, 2007). Section 404 of the Act, Management Assessment of Internal Controls, requires that financial reporting risks be identified by publicly held firms. Further, companies are required to establish related internal controls, perform an assessment of their effectiveness, and fix any significant deficiencies. Identified risks must also be re-tested with established controls and the results re-documented (Small et al., 2007). Section 404 of SOX provides not only for the creation and maintenance of internal control processes, but the testing and monitoring of those processes as well (Wade, 2008), thereby reducing the risk of financial statement misstatements, errors, or omissions. SOX also mandates that related party transactions be disclosed, as well as whether or not ethics codes have been adopted for upper management (Hopwood et al., 2012). In addition, Sarbanes-Oxley places greater responsibilities on audit committees in publicly held companies and requires independence from all members of the committee.

As a result of SOX, audit committees became responsible for the hiring, compensation, and oversight of the public accounting firms conducting financial statement audits and their role in overseeing the accounting and internal control systems of public companies has been greatly expanded. Sarbanes-Oxley also requires that audit committees be comprised of at least one member who is a financial expert. Public companies are required to be compliant with each provision of the legislation or face severe penalties and in some cases, criminal prosecution.

3. Conclusion

The rationale behind the regulation of corporate disclosure is essential to stakeholders because it adds value to the financial reporting mechanisms investors rely on and strengthens their decision making processes. Over the last several decades, the sweeping legislative reforms of the SEC's federal securities laws have had profound effects on corporate governance and financial reporting requirements. A number of footnote and disclosure requirements have evolved to promote understandable and fairly stated information to investors, analysts, and other stakeholders relying on published financial statements. The laws have resulted in more transparency and reliability in financial reporting, improved internal control systems, greater executive accountability, and have strengthened the reporting standards of publicly held companies.

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