Have You Ever Seen "Footnotes" to the Financial Statements?

An Ode to a True Resource, the Notes to the Financial Statements

By Vincent J. Love, CPA/CFF, CFE

Use the right word, not its second cousin.

—Mark Twain's satirical essay, "Fenimore Cooper's Literary Offenses"

CPAs know that the financial statements include the balance sheet, statement of operations, cash flow statement, and statement of changes in capital accounts (usually called the basic financial statements), and the *notes* to the financial statements. The first four statements represent a concise summary of all of an entity's recorded economic events at and for the period designated on the statements. To understand the numbers and brief descriptions displayed on the face of those statements, it is essential to read the notes to those statements. There are usually no *footnotes* to those statements. Reading the AICPA's "Trends and Techniques" guides or conducting a short research project on financial statements, it is not surprising that there is no section on, or references to disclosure in, "Footnotes," but there is a section on, and a part of issued financial statements titled, "Notes to Financial Statements."

Webster's New Collegiate Dictionary defines a "footnote" as "1: a note of reference, explanation, or comment usu. placed below the text of a printed page. 2: something that is subordinately related to a larger event or work." The Notes to the Financial Statements on the other hand are an inseparable part of the financial statements and are not bibliographic references or ancillary comments—in other words, they are not footnotes or endnotes.

So there are no footnotes to the financial statements or disclosures in a footnote. Simple? No. Read the literature and you will see even FASB—the organization entrusted to set U.S. GAAP—cannot always get it right! The AICPA does much better but is not completely prefect either.

FASB Cannot Get It Right, but Plays Both Sides

The recent FASB Proposed Statement on Financial Accounting Concepts, *Conceptual Framework for Financial Reporting, Chapter 8: Notes to Financial Statements,* is crystal clear. There are only "Notes to Financial Statements" and every reference in the proposal is correctly made to "disclosure in the Notes." Nowhere are footnotes mentioned because they do not exist in published financial statements.

But: concurrent with and finalizing the proposal on including guidance on the notes to the financial statements in the concepts statement, FASB issued ASU 2014-15, *Presentation of Financial Statements-Going Concern (Subtopic 205-40), Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern.* In this ASU, the only reference is to the non-existent "footnotes" to the financial statement. Thirty-eight times (38—count them!) the update mentions disclosure in "footnotes." There is even a quote by the FASB Technical Director in *Accounting Today* referencing disclosures in "footnotes." Does the staff on different projects talk to each other? Does their research include determining the composition of issued financial statements? Did they ever search for "Footnotes to the Financial Statements?"

The reference to "footnote disclosure" spills over into other non-FASB publications reporting on the activities of FASB and its new pronouncements. Have the writers of all of these articles ever read a set of financial statements that includes the caption: "Footnotes to the Financial Statements?"

The AICPA Almost Gets It, but …

The AICPA does better, but it has not completely purged all of its literature of references to footnote disclosure. It still sparingly exists in some Accounting and Auditing Guides, answers to technical questions, and other literature, including a website report on ASU 2014-15. However, all of its most authoritative literature does not contain references to footnote disclosures to financial statements. The AICPA generally addresses disclosure in the notes to the financial statements.

The Disclosures Are Important—Not Ancillary

Reading the notes to the financial statements is an indispensable part of the process of understanding and analyzing an entity's financial position, operations, and cash flow. No user of financial statements can claim that he or she has read the financial statements without thoroughly reading the notes in conjunction with the related amounts and captions displayed on the statements. They should be treated as important as the basic financial statements. Indeed, they contain much more analytical information. The notes do not contain mere bibliographic, or ancillary and secondary information. They are not "subordinately related to a larger event or work." In many financial statements, they overwhelm the basic financial statements in terms of the number of pages and the amount of significant data relevant to understanding and analyzing the financial condition and operations of the entity being reported on.

CPAs also know it is impossible to accurately compare two different entities without reading the notes to each entity's financial statements. Different entities can use different (but equally acceptable) accounting methods, different estimates for depreciable asset lives, different terms related to their debt, or different circumstances in many other ways. An entity's significant accounting policies are disclosed in the notes to its financial statements. In addition, the notes will disclose other information needed to analyze an entity's financial strength, such as major events that occurred after the date of the statements, material estimates used in compiling the financial statements, transactions with related parties, and contingent liabilities.

Accounting standards require that the notes contain all of the material information not on the face of the financial statements that is necessary to understand a company's financial position and the results of its operations. There are, however, varying opinions on how much should be disclosed about an asset, liability, or transaction. Too much disclosure can at times be just as misleading as too little disclosure.

Note disclosures, given the acceptability of differing GAAP and amount of disclosure, can offer an insight into the character of an entity's management. Managements can differ greatly in the amount of detail they disclose in the notes and the choices they make in the timing of when to record income and expenses. The presence or lack of detail and the way a transaction is recorded can be a clue to the management style of the company and the quality of its financial reporting. The notes are important; so call them what they are—*notes*.

Call Them What They Are

There are no "Footnotes to the Financial Statements." You will not find any such section in published financial statements that are reported on by PCAOB registered CPAs, or members of the AICPA; you will only find "Notes to the Financial Statements." Search as you may, but if you do find one, it will be to this author's dismay. Users must read the "Notes to Financial Statements," for they contain important and relevant information for understanding and analyzing an enterprise's management and the accompanying financial statements.

I would like to finish this short tirade against the misuse of "footnotes" as a poor substitute for "notes" in financial reporting on the following note:

So the writer who breeds more words than he needs, is making a chore for the reader who reads.

—Dr. Seuss ❑

Vincent J. Love, CPA/CFF, CFE, *is the chair of VJL Consulting LLC, New York, N.Y., and a member of* The CPA Journal *Editorial Board.*