

Applying IFRS

Improving disclosure effectiveness

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working world

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1. Background

The terms 'disclosure overload' and 'cutting the clutter' are used to describe a problem in financial reporting that has become a priority issue for the International Accounting Standards Board (IASB or Board), local standard setters, and regulatory bodies. The growth and complexity of financial disclosure is also drawing significant attention from financial statement preparers, and most importantly, the users of financial statements.

In an attempt to seek ways to improve disclosure in IFRS financial reporting, the IASB has begun a broad-based initiative to explore the options, starting with a discussion forum on disclosure¹ in January 2013. In conjunction with this, the IASB staff also conducted a survey, for which a feedback statement was published in May 2013².

The IASB's broad-based disclosure initiative comprises a number of short and longer-term projects, including the following:

- ▶ *Narrow-scope amendments* - The IASB has recently proposed narrow-scope amendments to IAS 1 *Presentation of Financial Statements* to address some of the concerns about the existing presentation and disclosure requirements and to help entities in applying judgement when preparing their financial statements. These amendments are intended to clarify, rather than significantly change, the existing requirements of IFRS.
- ▶ *Materiality* - This is a short-term initiative that addresses materiality. The objective is to help preparers, auditors and regulators to use judgement when applying materiality in order to make financial reports more meaningful. The project will consider the full scope of financial statements, but the focus will be on applying materiality to the notes.
- ▶ *Single standard on presentation and disclosure* - In the longer term, the Board will explore whether IAS 1, IAS 7 *Statement of Cash Flows* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* should be replaced with a single standard on presentation and disclosure.
- ▶ *A more general review of disclosure requirements* - The IASB will also begin a research project to review disclosure in existing standards to identify and assess conflicts, duplication and overlap.

The problem of disclosure overload is not unique to IFRS. In the USA, the Financial Accounting Standards Board (FASB) is also exploring ways to improve financial reporting disclosures and has recently issued an Exposure Draft - *Proposed Statement of Financial Accounting Concepts*³, proposing a new chapter for its conceptual framework that is intended to improve its process for establishing disclosure requirements.

A number of other standard setters and regulators are currently undertaking projects on disclosure overload. These projects are summarised in Appendix A of this publication.

¹ <http://www.ifrs.org/Current-Projects/IASB-Projects/Disclosure-Initiative/Discussion-Forum-Financial-Reporting-Disclosure/Pages/Discussion-Forum-Financial-Reporting-Disclosure.aspx>

² <http://www.ifrs.org/Alerts/PressRelease/Documents/2013/Feedback-Statement-Discussion-Forum-Financial-Reporting-Disclosure-May-2013.pdf>

³ http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176163868268

1.1 'Disclosure overload' - what is it?

Although there is no formal definition of the disclosure overload issue, from the different discussions and debates among stakeholders, three common themes have emerged:

- a) Format/structure
- b) Tailoring
- c) Materiality

When deciding on the format for the financial statements, it is common practice to follow the structure suggested in paragraph 114 of IAS 1. However, as financial statement disclosures have increased in volume as transactions and the requirements of accounting standards become more complex, alternative formats may better communicate the links between different pieces of information and more transparently reflect the financial position, performance and risks of the entity.

Investors, analysts and other users of financial statements often observe that disclosures in the financial statements are boilerplate and generic, and therefore do not provide decision-useful information. Tailoring disclosures to the entity-specific facts and circumstances may not reduce the length of the financial statements, but it should reduce the clutter and, in turn, enhance the usefulness of the financial statements.

Applying the concept of materiality requires judgment, yet there is little guidance available, which may attribute to perceived disclosure overload. IFRS sets out the minimum disclosure requirements, which, in practice, tend to be complied with without consideration of the relevance of the information for the specific entity. If a particular transaction or item is immaterial to the reporting entity, then it is not relevant, in which case, IFRS allows for non-disclosure. If immaterial information is included in the financial statements, the sheer volume of information can potentially reduce the transparency and usefulness of the financial statements as the material, and thus relevant, information, loses prominence.

To improve the relevance of disclosure, additional guidance on how to apply the materiality threshold in practice would be helpful. Nevertheless, in spite of the current absence of such guidance, there is significant room for improvement by preparers, auditors and regulators. By shifting the focus from a mere 'compliance mode' to also consider decision usefulness, preparers, auditors and regulators will be further encouraged to consider the relevance and thus materiality of the minimum disclosure requirements.

1.2 Exploring ways to improve disclosure effectiveness

The inclusion of immaterial information is not explicitly prohibited under IFRS: while paragraph 31 of IAS 1 permits the exclusion of immaterial information, it does not prohibit its disclosure. This is clarified in the proposed narrow-scope amendments to IAS 1, "The IASB does not propose to prohibit entities from disclosing immaterial information, because it thinks that such a requirement would not be operational (...)"⁴.

Furthermore, even though alternative formats may allow the users easier access to, and a better understanding of, the financial information contained within the financial statements, a shift in format cannot be enforced by reference to explicit requirements within IFRS. Therefore, reducing disclosure overload can only be achieved by reference to the primary purpose of the financial statements,

⁴ Paragraph BC6 of Exposure Draft ED/2014/1 *Disclosure Initiative (Proposed amendments to IAS 1)*

namely, to communicate in a transparent manner the financial position and performance of the entity. If an entity is able to improve the effectiveness of communication through the financial statements, the entity is reducing the users' uncertainty about its financial position and performance and, ultimately, the cost of capital.

This publication explores ways of making financial statements more effective in communicating financial information under current IFRS. The focus is on financial statements, rather than the broader context of financial reporting. That is not to disregard the interaction between the financial statements and other types of financial reporting, such as, for instance, management reports accompanying the financial statements, but rather a result of the fact that accounting standards only apply to the financial statements, and not to other types of financial reports.

Financial reporting goes beyond financial statements, and includes different management reports, press releases, presentations, etc. Today's technology allows for integrated solutions that provide ways to improve the effectiveness of financial information communication that are not available in the conventional formats. However, standard setters and regulators continue to focus their regulatory efforts on financial statements reporting in the conventional printed format. Therefore, the discussions in this publication are generally confined to financial statements reporting in the conventional formats.

2. Alternative ways to structure financial statements disclosures

The commonly applied financial statements format may be a possible cause of the perceived disclosure overload problem, as explained above. In this section, we consider alternative format restructuring options, including some that have already been adopted by certain entities. We believe that these alternatives offer ways to enhance an entity's effectiveness in communicating financial information. However, we acknowledge that current IFRS might not allow for full implementation of all of the alternatives discussed under all circumstances.

It is clear that determining the most appropriate format is not a 'one size fits all' exercise. Therefore, each entity needs to consider the specific facts and circumstances, including the specific needs of its primary users, as well as jurisdictional limitations or restrictions.

In accordance with the IASB's *Conceptual Framework for Financial Reporting* (Conceptual Framework), comparability across entities is one of the "qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented" (Conceptual Framework, paragraph QC19). Therefore, when developing the notes format, preparers should consider the formats adopted by industry peers which may enable users to more readily make useful comparisons.

Consistency over periods is another important quality of decision-useful financial information. Entities must therefore strive to present and disclose information in financial statements using the same format from period to period. In our view, a change in format should only be made if it improves the financial statements by highlighting the more relevant information more effectively than the currently applied format.

In Appendix B, we provide a high-level summary of considerations, concerns and challenges of the alternatives explored in this section.

2.1 Improving navigation of financial statements

Generally, financial statements users use the financial statements as a book of reference - the place to look for information to answer questions about an entity on an *ad hoc* basis. Therefore, users value summary pages or content listings that allow them to easily identify information they are searching for and navigate through the notes to the financial statements. It is common, under current practice, to include a content listing before the notes. However, many entities still do not provide the reader of the financial statements with such a summary. In section 2.4 below, we have included an example of such a content listing that may serve as an illustration of how to provide the users with a good basis for the book of reference type of use.

There are other means of improving navigation of the financial statements, such as traditional headers and cross-references, as well as less commonly used content banners, section signs, callout boxes, highlighters, indices, etc. Illustrative examples of some of these means can be found in the 2013 financial statements of PANDORA A/S⁵, a Danish jewellery producer, and ITV plc⁶, a UK media and television company.

⁵ http://files.shareholder.com/downloads/ABEA-4ZFRFB/2958171579x0x726400/D98BDCF4-7469-45A1-BB88-AEAE531ADBBA/PANDORA_ANNUAL_REPORT_2013_UK.PDF, p. 42-98

⁶ http://www.itvplc.com/sites/itvplc/files/ITV%20Annual%20Report%202013_0.pdf, p. 104-173

2.2 Disclosure of significant accounting policies, judgements, estimates and assumptions

Currently the predominant practice is to disclose all significant accounting policies summarised in a single note at the beginning of the notes section in the financial statements, in line with the proposed structure in paragraph 114 of IAS 1:

1. Statement of compliance with IFRS
2. Summary of significant accounting policies applied
3. Supporting information for items presented in the required financial statements
4. Other disclosures

However, paragraphs 115 and 116 of IAS 1 allow an entity to vary the order of specific items within the notes, as well as to present notes providing information about the basis of preparation of the financial statements and specific accounting policies as a separate component of the financial statements. Furthermore, the recently issued Exposure Draft ED/2014/1 *Disclosure Initiative (Proposed amendments to IAS 1)* proposes to further clarify that alternative ways to order the notes may be appropriate.

Disclosure of accounting policies, judgements, estimates and assumptions together with specific and quantitative disclosures

Many of the companies attempting to improve their financial statements have chosen to present each of the significant accounting policies, judgements, estimates and assumptions within the relevant note. Some of the accounting policies relate to the financial statements as a whole and, therefore, will not fit into a single note disclosing a particular line item in the financial statements. These accounting policies may be disclosed together.

Cairn Energy plc, a UK oil and gas company, is one among a number of entities that have introduced this approach in its financial statements. In the notes to its 2013 financial statements, the entity first explains the structuring of the notes, as follows:

Section 1 – Basis of Preparation

This section contains the Group's significant accounting policies that relate to the financial statements as a whole. Significant accounting policies specific to one note are included with that note. Accounting policies relating to non-material items are not included in these financial statements.

This section also includes new EU endorsed accounting standards, amendments and interpretations and their expected impact, if any, on the performance of the group.

In Note 1.1 of its financial statements, Cairn Energy goes on to outline significant accounting policies that relate to the financial statements as a whole, including the basis of preparation, the basis of consolidation, and foreign currency accounting policies. The accounting policies applied for transactions, assets, and liabilities are included in the specific notes to which they relate. For instance, accounting policies for intangible exploration/appraisal assets are disclosed in Note 2.1, which provides other quantitative and qualitative disclosures about such assets⁷.

⁷ http://www.cairnenergy.com/files/reports/annual/ar2013/2013_annual_report.pdf, p. 99-146

By including the policy disclosures along with the specific and quantitative information in the relevant notes, the reader can more easily connect the two, which, in many cases, allows for a more efficient appreciation of both the policy disclosures and the specific and quantitative information. By adopting this approach, the preparer is encouraged to revisit the need for disclosure of policies on transactions and items that currently do not impact the financial statements. For instance, many entities disclose a policy for loss of control in subsidiaries, in spite of such transactions not having occurred in the current or comparative periods. The disclosure of policies for hypothetical transactions is not required, in our view. In many cases, we find that removing such disclosures allows the reader to focus more easily on the more relevant information affecting the entity's financial position and performance.

Although we encourage preparers to remove disclosures of accounting policies not relevant for the current period from its financial statements, an entity will still need to maintain internal processes for recording all previously applied accounting policies to ensure their consistent application in the future periods.

Disclosing only non-mandatory policies or only new policies

Another approach that has been debated by some is one in which only policies that do not follow directly from the standards are disclosed. For instance, as a non-common control business combination has to be accounted for under the acquisition method in IFRS 3 *Business Combinations*, presenting a policy repeating the standard's requirement is considered redundant by some as it potentially adds clutter to the financial statements. It is argued that policy disclosures are only required in cases in which the standards allow for policy choices. For instance, IAS 16 *Property, Plant and Equipment* permits a policy choice between the cost and revaluation model; as such, entities should disclose the policy they have applied. In cases in which the standards and interpretations do not specifically address a transaction and, thus, the entity has developed its accounting policy under the guidance of paragraphs 10-12 of IAS 8, the policy disclosure must be made. It is argued that since the specific disclosure requirements of the standards do not require an entity to repeat the policy requirements of the standards, as for instance, in the case of IFRS 3, it is acceptable to leave out such disclosures. Furthermore, paragraph 119 of IAS 1 recognises that the identification of relevant policies for disclosure purposes involves judgement, and also emphasises that policy disclosures are particularly relevant when a standard allows for policy choices, which seems to suggest that disclosure of mandatory policies, for which no choice is involved, is not required.

We believe the approach may have some merit for users that have sufficient experience with IFRS and knowledge of the mandatory policy requirements of the standards. However, an entity should consider the needs of the primary users even if they have less experience with IFRS. IAS 1 currently requires the disclosure of a summary of significant accounting policies applied. Therefore, we believe that disclosing only non-mandatory policies is not appropriate under current IFRS.

For the same reason, adopting an approach in which only policies that have not been disclosed in previous periods' financial statements are disclosed in the current period, is generally not appropriate in complete interim and annual financial statements. This is the approach adopted in IAS 34 *Interim Financial Reporting* for condensed interim financial statements, because these financial statements are intended to provide an update on the latest complete set of annual financial statements. However, as discussed above, entities may improve the efficiency of the disclosures by reducing the volume and length of the notes as a result of removing the disclosure of irrelevant accounting policies. Entities

may also find that the summary of accounting policies may be placed towards the end of the financial statements, e.g., in an appendix. Orange SA, a French telecommunications operator, provided a summary of accounting policies disclosure closer towards the end of its 2013 financial statements (in Note 18)⁸.

2.3 Ordering the notes in reference to importance

Presentation of the more important information upfront is another way to make the communication of financial information more efficient:

- ▶ Information that is, by nature, more important is disclosed more prominently, for instance directly after the primary financial statements (examples may include segment disclosures, source of uncertainty disclosures, risk disclosures, etc.).
- ▶ Information that is, by nature, less important is provided closer to the end of financial statements, e.g., as an appendix (for instance, not-yet-effective standards, IFRS policies with no alternatives, PPE and intangible assets roll-forward disclosures, etc.)

Based on the following proposed amendment to IAS 1, this approach appears to be supported by the IASB: “When determining a systematic order for the notes, an entity may order notes in a way that gives prominence to disclosures that it views as more relevant to an understanding of its financial position or financial performance or makes the relationship between some disclosures more understandable”⁹.

Determining the relative importance of specific disclosures, as suggested above, is not an easy task, as it involves judgement similar to that required when applying the materiality threshold.

It may be that other qualitative criteria can also be developed as a basis for making decisions on the location of information in the financial statements - for example recurring vs. non-recurring information, new vs. previously disclosed information, etc.

We believe that organising the notes by reference to some kind of measure of importance is a potentially more effective way of communicating the financial position and performance of an entity. Also this approach encourages the preparer to re-think the relevance of the financial statements information, which will often result in some previously disclosed, but immaterial, information no longer being included in the financial statements. It also adds another dimension to the financial statements as it communicates to the users what the entity itself considers the most important aspects of its financial statements.

However, if an entity chooses to reorganise its notes, the selected approach will need to be applied consistently from one accounting period to another, unless the level of importance changes. Consistency across periods enhances the users' ability to navigate within the financial statements, as also discussed in the introduction to this section.

In practice, ordering the notes according to their importance is often combined with grouping the notes by nature, which is further discussed below.

2.4 Grouping disclosures by nature

Grouping the notes by nature involves splitting them into sections to assist the users' navigation within the financial statements. For instance, an entity may

⁸ <http://www.orange.com/en/finance/nbsp7/regulated-information>, 2013 registration document, p. 99-204

⁹ Paragraph 113A of Exposure Draft ED/2014/1 *Disclosure Initiative (Proposed amendments to IAS 1)*.

group entity disclosures, such as corporate and group information, estimation of uncertainty disclosures, risk-based disclosures, etc.

For example, PANDORA A/S in its 2013 financial statements has chosen to group notes into five major sections, as follows:

- ▶ Basis of preparation
- ▶ Results for the year
- ▶ Invested capital including working capital
- ▶ Capital structure and financing items
- ▶ Other disclosures¹⁰

<h2>NOTES</h2>	
<p>PANDORA is continuously developing the Group's financial reporting. As part of this development, PANDORA has restructured the consolidated financial statement in order to increase focus on what drives the Group's performance. The notes have therefore been grouped in 5 sections related to key figures. The notes contain the relevant financial information as well as a description of accounting policies applied for the topic of the individual notes.</p>	
Section 1: Basis of reporting, p.47	Section 4: Capital structure and financing items, p.70
1.1 Basis of reporting p.47	4.1 Share capital, p.70
Section 2: Results for the year, p.50	4.2 Earnings per share and dividend, p.71
2.1 Revenue, p.50	4.3 Net interest-bearing debt, p.71
2.2 Segment information, p.51	4.4 Financial risks, p.72
2.3 Employee benefit expenses, p.53	4.5 Financial instruments, p.75
2.4 Share-based payments and employee shares, p.54	4.6 Net finance income, p.76
2.5 Taxation, p.57	Section 5: Other disclosures, p.77
Section 3: Invested capital including working capital, p.59	5.1 Business combinations, p.77
3.1 Intangible assets, p.60	5.2 Contingent liabilities, p.78
3.2 Property, plant and equipment, p.64	5.3 Related parties, p.79
3.3 Inventories, p.66	5.4 Fees to statutory auditor, p.79
3.4 Trade receivables, p.67	5.5 Approval of the Annual Report, p.80
3.5 Provisions, p.68	5.6 Companies in the PANDORA Group, p.80
	5.7 Financial definitions, p.81
	5.8 Post balance sheet events, p.81

¹⁰ http://files.shareholder.com/downloads/ABEA-4ZFRFB/2958171579x0x726400/D98BDCF4-7469-45A1-BB88-AEAE531ADBBA/PANDORA_ANNUAL_REPORT_2013_UK.PDF, p. 42-98

2.5 Combining ordering based on importance and grouping by nature

The combination of the two previously discussed approaches is another alternative that entities may consider in order to increase the effectiveness of their financial statements; i.e. grouping disclosures by nature and ordering them by reference to their importance. An example of such an approach would be to organise the notes to the financial statements into the following sections:

- ▶ *Key numbers*: provides a breakdown of individual line items in the financial statements that the directors consider most relevant and summarises the accounting policies, judgements and estimates relevant to understanding these line items
- ▶ *Capital*: provides information about the capital management practices of the Group and shareholders' returns for the year
- ▶ *Risk*: discusses the Group's exposure to various financial risks, explains how these affect the Group's financial position and performance and what the Group does to manage these risks
- ▶ *Group structure*: explains aspects of the Group structure and how changes have affected the financial position and performance of the Group
- ▶ *Unrecognised items*: provides information about items that are not recognised in the financial statements but could potentially have a significant impact on the Group's financial position and performance
- ▶ *Other*: e.g., provides information on items which require disclosure to comply with local regulatory pronouncements, but are not considered critical in understanding the financial performance of the Group

An example of the combined approach applied in practice can be found in the 2013 financial statements of Cairn Energy plc, where it gives prominence to disclosures about its core business and presents notes grouped into sections in the following order:

- ▶ Section 1 - Basis of preparation
- ▶ Section 2 - Oil and gas assets and related goodwill
- ▶ Section 3 - Financial assets, working capital and provisions
- ▶ Section 4 - Results for the year
- ▶ Section 5 - Capital structure and other disclosures
- ▶ Section 6 - Post balance sheet events¹¹

2.6 Presentation of 'Executive summary' or 'Key developments' note

It is debatable whether including an executive summary of the main disclosures before presenting the more detailed disclosures in accordance with IFRS would help to reduce the overload problem. Some may find that including such a summary only adds clutter to the financial statements. For instance, in Australia, a so-called 'concise financial report' can be prepared and sent to shareholders instead of the full financial report with complete financial statements. In practice, very few companies prepare concise financial reports.

¹¹ http://www.cairnenergy.com/files/reports/annual/ar2013/2013_annual_report.pdf, p. 99-146

Presenting the key developments, for instance goodwill impairments in the current period, business combinations in the current period, etc., up-front in a key developments note may be an alternative to the executive summary approach above.

A key developments note may be particularly useful if the financial statements are assessed on a stand-alone basis. However, the prevailing practice in most jurisdictions is to accompany the financial statements with a management report in which key developments are summarised and discussed. Therefore, in determining whether a key developments note is helpful in enhancing the effectiveness of the financial statements, it is important to consider the context in which the financial statements are used.

Such an approach can be found in 2013 financial statements of Lafarge S.A., a French producer of building materials (refer to Note 3 “Significant events of the period” in the financial statements)¹².

2.7 Presentation of certain disclosures outside of financial statements

IAS 1, IAS 34 and IFRS 7 *Financial Instruments: Disclosures* appear to suggest that it is inappropriate to present any IFRS-required disclosures outside the financial statements, even if incorporated by cross-reference, unless specifically allowed by the relevant standard. IFRS 7 allows certain information to be presented outside the financial statements as long as it is incorporated by cross-reference from the financial statements to another statement, such as a management commentary or risk report that is available to users of the financial statements on the same terms and at the same time as the financial statements. IAS 34 also allows entities to present disclosures required in paragraph 16A in the interim financial report if the interim financial statements are condensed. The cross-referencing requirement in paragraph 16A in IAS 34 is currently being redeliberated by the IASB (in the Annual Improvements 2012-2014 cycle).

To ensure that users are able to locate the required disclosure, a cross-reference must be sufficiently specific. A cross-reference that lacks specificity would effectively extend the perimeter of the financial statements, potentially causing confusion about the consistency and completeness of the financial statements. Furthermore, as the assurance provided by external parties (typically the external auditor) is normally restricted to the financial statements, and this assurance serves to enhance the usefulness of the financial statements, a lack of clarity created by unclear cross-referencing will reduce the usefulness of the financial statements. An illustrative example of a cross-reference technique ensuring the required specificity can be found in the 2013 financial statements of HSBC Bank Canada¹³:

b Presentation of Information

- i) Disclosures required under IFRS 7 ‘Financial Instruments Disclosures’ (‘IFRS 7’) concerning the nature and extent of risks relating to financial instruments have been included in the audited sections of ‘Risk Management and Capital’ within Management’s Discussion and Analysis.

¹² http://www.lafarge.com/04022014-press_publication-2013_annual_report-uk.pdf, p. F1-F98

¹³ <http://www.hsbc.com/investor-relations/financial-and-regulatory-reports>, p. 63

Presentation of certain disclosures outside the financial statements would not necessarily reduce the volume or increase the effectiveness of disclosures. However, in the case where the required information is already provided elsewhere in a report that also contains the financial statements, cross-referencing might be an efficient tool to reduce duplication and improve the transparency of the overall document. It may be particularly helpful in jurisdictions where other reporting requirements overlap with the financial reporting requirements. For example, many jurisdictions have extensive management remuneration disclosure requirements, which may overlap with the requirements of IAS 24 *Related Party Disclosures*. The financial statements must include the disclosures required by IAS 24, but do not have to include the additional local jurisdictional disclosures, unless the local disclosure requirements specify that such disclosures must be included in the financial statements. When the additional remuneration disclosures are provided outside the financial statements, entities should consider whether the separate remuneration report should cross-reference to the financial statements for the IAS 24 disclosures, or if these disclosures should also be included in the remuneration report.

As reporting requirements continue to increase globally, permitting greater use of cross-referencing to avoid duplication, and thus potentially avoid cluttering the financial statements, may be something the IASB should consider exploring further as a part of its disclosure initiative efforts.

Some entities that are restructuring their financial statements have considered whether the accounting policy disclosures can be moved to the company's website. For instance, in one case an entity considered an alternative financial statements approach which included so-called "Q-codes" in place of the accounting policies. To access the company's accounting policies, the reader would hold their smartphone over the code which would link them to the relevant location in the entity's website. However, it was concluded that the relevant local regulations did not allow for such an interactive reporting format. Furthermore, we do not believe the approach is acceptable under current IFRS for the reasons explained above.

2.8 Inclusion of alternative performance measures in the financial statements

Another practice adopted by some entities to improve their annual reports is the incorporation of analytical non-IFRS information from the management report within the IFRS financial statements. This may be helpful for the users of financial statements as it makes it easier to reconcile management report information with actual figures in the IFRS financial statements.

The overall usefulness of alternative performance measures (APMs) for users' decision-making is widely acknowledged. The European Securities and Markets Authority (ESMA) has recently issued a Consultation Paper - *ESMA Guidelines on Alternative Performance Measures*, which states, "the aim of these [draft] guidelines is promoting transparency on APMs used by issuers by ensuring their adherence to general qualitative characteristics that enhance usefulness of financial information to users"¹⁴.

¹⁴ http://www.esma.europa.eu/system/files/esma-2014-175_cp_on_the_draft_guidelines_on_apms.pdf, paragraph 13, p.10

However, rather than having the intended effect, the inclusion of APMs within IFRS financial statements may increase the clutter. This is because the IFRS standardised information is mixed with APMs, which could potentially confuse users as to what the baseline measures are and may reduce comparability across entities. The ESMA consultation paper does not appear to rule out the inclusion of APMs within the IFRS financial statements, but requires that the APMs must be given less prominence than the IFRS information, and that a reconciliation between the two must be presented. Similarly, paragraphs 55 and 85 of IAS 1 require an entity to present additional line items, headings and subtotals in the statement of financial position and the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial position and performance¹⁵.

IAS 1 acknowledges the fact that many entities present reports and statements such as financial reviews by management, environmental reports and value added statements outside the financial statements but, at the same time, makes clear that such reports and statements presented outside financial statements are outside the scope of IFRS (IAS 1.13-14).

¹⁵ In the recently issued Exposure Draft ED/2014/1 *Disclosure Initiative (Proposed amendments to IAS 1)*, the IASB proposed to add requirements for how an entity should present subtotals in the statement(s) of profit or loss and other comprehensive income and the statement of financial position.

3. Tailoring of disclosures

Often information provided in financial statements is of a generic boilerplate nature and provides little or no added value to the users. Boilerplate disclosures may not only fail to add incremental value to the financial statements, but may reduce the overall transparency of the financial statements as they may draw attention away from the entity-specific information.

Based on observations of current practice, the significant accounting policies disclosure and the disclosure of sources of estimation uncertainty are two particularly relevant areas to consider when exploring the potential for tailoring of information.

3.1 Significant accounting policies

Significant accounting policies disclosure is intended to provide the users with an understanding of the measurement bases and other policies applied in preparing the financial statements. Without this information, a user cannot make an informed decision based on the financial statements, as the financial position and performance reflected by the financial statements depends on the policies applied. For instance, the financial position, as reflected by the financial statements of an entity applying the revaluation model in IAS 16, conveys different information compared to the financial position of an entity applying the cost model.

Paragraph 119 of IAS 1 explains that “management considers whether disclosure would assist users in understanding how transactions, other events and conditions are reflected in reported financial performance and financial position” and, in making that assessment, entities should generally not include information about policies not applied in the financial statements. Non-applicable policies are not relevant to the users’ understanding of the financial statements. More importantly, the inclusion of such non-applicable policies could confuse the users, either as their disclosure suggests that transactions (or other events or conditions to which the non-applicable policy is relevant) have occurred, when they have not, or they will merely serve to act as irrelevant clutter, or a combination of the two.

Tailoring the disclosures implies that non-applicable policies should not be disclosed. Furthermore, the disclosure of applied policies should be entity-specific in the sense that it should go beyond only repeating the relevant requirement. For instance, disclosing that revenue on sale of goods is recognised when the criteria in paragraph 14 in IAS 18 *Revenue* are met, represents a generic boilerplate-type disclosure if it stands alone. However, this information combined with information on how, for example, the entity determines whether the significant risks and rewards of ownership have been transferred to the buyer, provides useful and tailored information to the user.

3.2 Sources of estimation uncertainty

Users often report concerns about estimation uncertainties being reflected in IFRS financial statements. This is because IFRS requires an entity to rely on its best judgement in determining assumptions about the future in preparing the financial statements. Unless users are provided with sufficient information about the uncertainties, they may not be able to make informed and qualified decisions based on the financial statements.

According to paragraph 125 of IAS 1, an entity must disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty, that have a significant risk of resulting in material adjustments to the carrying amounts of assets and liabilities in the next annual financial statements.

While disclosure of sources of estimation uncertainty represent decision-useful information to the users, if it is not sufficiently entity-specific, and/or if entities list any kind of source of estimation uncertainty without giving prominence to any that have a significant risk of resulting in material adjustments within a predictable future period (the next financial year under paragraph 125 of IAS 1), the usefulness of the disclosure is drastically reduced. In practice, many entities are complying with the form of the disclosure requirement, but not the substance of it and, in effect, are cluttering the financial statements instead of providing the users with relevant entity-specific information. For instance, it is not uncommon for entities to list 10 to 15 sources of estimation uncertainty, without providing insight into which of them are more significant, and therefore, users need to be particularly aware of them.

4. Materiality

The concept of materiality is key to preparing financial statements under IFRS. It is of particular importance to investors and other users of financial statements, as it impacts which information is considered relevant and is therefore presented in the financial statements. The application of the concept of materiality requires significant judgement, which is inherently subjective. The IASB currently provides limited guidance on the application of the concept of materiality.

4.1 IFRS definitions and requirements

IFRS provides the following definitions of materiality:

“Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about 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.” (Conceptual Framework, paragraph QC11)

“Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.” (IAS 1.7)

IFRS also makes the following references to the application of the concept of materiality with respect to presentation and disclosure requirements:

“An entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial.” (IAS 1.29)

“... If a line item is not individually material, it is aggregated with other items either in those statements or in the notes. An item that is not sufficiently material to warrant separate presentation in those statements may warrant separate presentation in the notes.” (IAS 1.30)

“An entity need not provide a specific disclosure required by an IFRS if the information is not material.” (IAS 1.31)

Traditionally, in the preparation of financial statements, entities are focused on ensuring that material information is not omitted. Current IFRS does not explicitly prohibit the provision of immaterial information in financial statements. As such, this together with the disclosure checklist approach encouraged by some auditors, regulators and legal advisors, may have contributed to the problem of disclosure overload.

Within its project on narrow-scope amendments to IAS 1, the IASB proposes to highlight that providing too much irrelevant or immaterial information can obscure useful information in financial statements.¹⁶ However, the IASB does not propose prohibiting the disclosure of immaterial information.¹⁷

¹⁶ Paragraph 30A of Exposure Draft ED/2014/1 *Disclosure Initiative (Proposed amendments to IAS 1)*

¹⁷ Paragraph BC6 of Exposure Draft ED/2014/1 *Disclosure Initiative (Proposed amendments to IAS 1)*

We agree with the Board that the inclusion of irrelevant or immaterial information can obscure useful information in the financial statements. We also believe that the inclusion of 'clutter' in financial statements contradicts the objective of general purpose financial reporting outlined in the IASB Framework. However, the materiality assessment is not a bright-line rule exercise. Therefore, preparers must apply their best judgement when determining which information to include, and equally what information to exclude on the basis that it is immaterial.

4.2 Attributes of information considered for materiality assessment¹⁸

It is important to bear in mind that materiality should not be assessed merely by comparison with the absolute or relative size of an amount. According to paragraph QC11 of the Conceptual Framework, "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."

Paragraph 7 of IAS 1 also states:

"Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."

Therefore, both quantitative and qualitative factors are relevant to all materiality decisions. This is especially relevant for disclosures that mainly include verbal description, rather than numerical information, and may even be entirely qualitative. Basing the assessment of materiality only on the amounts involved is generally not appropriate for disclosures.

The quantitative analysis of the materiality of an item should not be determined solely by a simple quantitative comparison with primary statement totals, such as profit for the period, or with statement of financial position totals. The individual line item in the primary statement in which the item is included should also be assessed when determining its materiality. In addition, other relevant facts and circumstances may need to be considered. For example, in an examination of whether subsequent expenditure on property, plant and equipment is correctly capitalised, the amounts in question may be small relative to the total property, plant and equipment balance on the balance sheet, but may significantly impact profit or loss for the period. Additionally, that comparison is relevant in determining whether the balance of the individual line item should be further disaggregated for disclosure purposes.

The nature of, and circumstances surrounding, an item will vary and each entity must make an assessment according to its own particular circumstances and financial statements. Examples of common transactions and outcomes where materiality judgements are usually particularly sensitive, and thus, where the adjudged materiality threshold may be lower, include:

- ▶ Transactions with related parties
- ▶ Sensitive matters, such as fraud and non-compliance with law
- ▶ Unusual or non-recurring transactions/balances
- ▶ Accounting errors

¹⁸ This topic as well as other considerations on materiality were discussed in the ESMA's Consultation Paper - *Consideration of materiality in financial reporting*, issued in November 2011, and in the European Financial Reporting Advisory Group's (EFRAG) Discussion Paper - *Towards a Disclosure Framework for the Notes* (Chapter Four: Applying the requirements - materiality), issued in July 2012.

4.3 Materiality of information versus materiality of the item

Paragraph 31 of IAS 1 states that, “an entity need not provide a specific disclosure required by an IFRS if the *information* (emphasis added) is not material.” The definitions of materiality in IAS 1 and IAS 8 require that the omission of required notes is evaluated individually to determine whether the omission is material. That means that the omission of a disclosure that relates to a material line item in the financial statements is in itself not necessarily material.

If all omissions of required notes were considered material misstatements merely because they relate to material financial statement line items, this would, in our view, reduce the ability to apply judgement provided by paragraph 31 of IAS 1, which explicitly refers to ‘specific disclosures’ required by an IFRS.

In assessing the materiality of disclosures, consideration should be given to the individual element of a disclosure requirement, rather than all the disclosures required by one standard, and the relevance of the information provided by that specific element. Consequently, a specific piece of information required by an IFRS is not disclosed if it is immaterial, even if the disclosure requirement relates to a material line item presented.

A similar view was taken in a report issued in June 2011 by the Institute of Chartered Accountants of Scotland (ICAS) and the New Zealand Institute of Chartered Accountants (NZCAS) entitled, “*Losing the excess baggage - reducing disclosures in financial statements to what’s important*”, in connection with a project commissioned by the IASB¹⁹.

4.4 Measures to improve the application of the concept of materiality

Below, we discuss certain measures that may be considered in order to remove irrelevant/immaterial information from the financial statements.

Immaterial disclosures

Typically, materiality considerations are more easily addressed with respect to primary statement line items. As soon as the entity has identified material line items, a common mistake, as explained above, is to immediately conclude that all the related disclosure requirements are material. For example, if an entity has a material pension liability, it does not automatically imply that all the related disclosure requirements about that liability are material; rather the entity would need to make a materiality assessment with respect to each individual disclosure requirement. Other examples of disclosures, which tend to be mechanically included in financial statements as relating to material line items, include information on share-based payment transactions, roll-forwards of property, plant and equipment and intangible assets.

A number of disclosures required under IFRS do not relate directly to financial statement items, but are, nonetheless, of significance for the overall assessment of the financial statements of a reporting entity. Examples include the disclosure of operating segments required by IFRS 8 *Operating Segments*, related party disclosures required by IAS 24 and the risk disclosures required by IFRS 7.²⁰ We believe that, when determining the materiality applying to such notes, one would need to consider the same factors, i.e., the omission or misstatement of notes providing supplementary information is evaluated by considering the amounts involved as well as the surrounding facts and circumstances.

¹⁹ <http://icas.org.uk/excessbaggage/>

²⁰ The ESMA Consultation Paper - *Consideration of materiality in financial reporting*, p.13

Irrelevant accounting policies

Accounting policies that are not significant or relevant for an understanding of the financial statements are not required to be disclosed, as discussed in sections 2.2 and 3.1 above (IAS 1.117). Paragraph 119 of IAS 1 states that, in deciding whether a particular accounting policy should be disclosed, management considers whether disclosure would assist users in understanding how transactions, other events and conditions are reflected in the reported financial performance and financial position. Examples of accounting policies that would not warrant a disclosure would be:

- ▶ Accounting policies on financial instruments that the entity does not have
- ▶ Accounting policy on discontinued operations when the entity did not have any discontinued operations in either the current or the comparative period

Factors to consider when deciding whether an accounting policy is significant include:

- ▶ The magnitude of the sums involved
- ▶ The nature of the entity's operations
- ▶ If there is a policy choice in accordance with IFRS
- ▶ Whether some standards specifically require disclosure of particular accounting policies (e.g., IAS 16 requires disclosure of the measurement bases used for classes of property, plant and equipment)
- ▶ Whether there are significant accounting policies that are not specifically required by IFRS, but are selected and applied in accordance with IAS 8
- ▶ Whether the policy has changed since the prior year

Use of illustrative or other entity's financial statements

A common error preparers make is to include every disclosure that is illustrated in a set of model accounts without considering their materiality or relevance to the reporting entity. Illustrative financial statements are commonly designed to include all possible scenarios and should be used critically to make sure immaterial or irrelevant information is not disclosed just because it is included in the model accounts.

For instance, our publication, *Good Group (International) Limited (Good Group) illustrative financial statements*, is designed to capture a wide set of circumstances and transactions, and in enhancing the relevance of Good Group, all minimum disclosure requirements of IFRS are complied with, generally without considering the materiality threshold established in IAS 1. Also, since Good Group is a fictitious entity, assessing materiality is not possible in some circumstances. Good Group is a helpful enabler for entities preparing financial statements under IFRS, but its illustrative nature must be appreciated.

Furthermore, disclosures illustrated in a set of model accounts are often boilerplate and therefore need to be thoroughly tailored to an entity's specific circumstances.

Similarly, if an entity is referring to another entity's financial statements to apply best industry practise, it should not do so uncritically. Although the financial statements of other entities in the same industry may provide some insights to assist decision-making about what information to disclose, materiality assessment is entity-specific and, therefore, management must apply its own judgement.

Auditors and regulators

Auditors and regulators are often blamed for exacerbating the problem of disclosure overload by encouraging a disclosure checklist approach.

Indeed, when conducting an audit, the auditor's primary focus is to ensure that the entity does not omit disclosure of material information in its financial statements. However, an entity should not assume their auditor will require every disclosure mentioned in IFRS in order for the financial statements to be unqualified. A preparer must be able to explain the judgement behind its disclosures in order to conclude that certain information is considered immaterial or irrelevant.

Similarly, regulators are not expected to pursue immaterial disclosures. Often, regulators will require additional information from entities if minimum disclosure requirements do not appear to be complied with. In such cases, the entity must be able to justify the non-disclosure by reference to immateriality, or another basis, if applicable. Regulators are concerned about financial statements providing useful and meaningful information to users and will generally discourage disclosure of information that does not contribute to such usefulness. However, it is important to note that there may be additional local requirements that cannot be assessed under the IFRS materiality threshold.

Continuing assessment of materiality

Entities should bear in mind that an item or disclosure that may be material in one financial reporting period may become immaterial in another, and vice versa. After a new disclosure is introduced in the notes, there is a tendency for it to be carried forward in the following periods. Elimination of information previously disclosed may attract scrutiny and the entity may conclude that it is easier to continue the disclosure rather than to explain why it has been discontinued. On one hand, users need continuity of information between reporting periods. On the other hand, as emphasised in this section, immaterial information in the notes reduces their quality and usefulness.

Materiality should not be assessed only by reference to the conditions at the reporting date. Consideration should be given to the full reporting period. Information could be material because it enables users to understand how the entity generated its performance for the period.²¹

²¹ The EFRAG Discussion Paper - *Towards a Disclosure Framework for the Notes*, p.51

5. Challenges in adopting alternative formats, tailoring disclosures, and making materiality assessments

While we strongly encourage preparers to identify ways to improve the transparency and efficiency of their financial statements, as discussed in the exploration of different approaches to reduce disclosure overload in sections 2 -4 above, entities must be aware of potential challenges arising from adopting alternative formats and applying the materiality concept more widely, as follows:

- ▶ Adopting alternative formats to financial statements may involve a high level of judgement. What one sees as less important, another might find more relevant.
- ▶ Adopting alternative formats may result in financial statements becoming less comparable from one entity to another.
- ▶ Completion of disclosure checklists might become more complicated with adoption of alternative formats as the structure of the financial statements may not comply with the checklist structure.
- ▶ Materiality is a matter of judgment and must be carefully considered on an item-by-item basis, and over time.

The objective of financial reporting is to provide decision-useful information to the stakeholders of the entity. Measures that can enhance decision usefulness include: adopting a notes structure that allows users easier access to the key factors determining the entity's financial position and performance; tailoring the information to the specific circumstances of the entity; and reducing the clutter of financial statements through improved application of the materiality concept in IFRS. The ultimate goal is to decrease the cost of capital; as such, continually assessing how to improve disclosure effectiveness is, despite the challenges outlined above, worthwhile.

6. Concluding remarks

There is a perception that current disclosure practices are ineffective in drawing the attention of the users to the most decision-useful information. This publication has explored some of the ways to make financial statements more effective in communicating financial information under current IFRS, by discussing alternative ways to structure and tailor the financial information, and by considering the application of the materiality concept, particularly in the context of disclosures.

It is important to emphasise that the disclosure overload problem is one of perception in the sense that little research has been done to support its existence. Further research is needed in order to allow standard setters and preparers to better understand the nature of the problem. Nevertheless, we hope the discussions in this publication may assist preparers in their efforts to make the financial statements more useful and transparent.

Appendix A – Current initiatives on disclosure overload

A number of standard setters and regulators are currently undertaking projects on disclosure overload, including the following:

Standard setter / Regulator	Project
The IASB	Disclosure Initiative
The FASB	Disclosure Framework
The UK Financial Reporting Council (FRC)	Louder than Words Cutting Clutter Financial Reporting Lab
The UK Department for Business, Innovation and Skills (BIS)	The future of narrative reporting
The International Integrated Reporting Committee (IIRC)	The International Integrated Reporting Framework
A 'joint oversight group' of the Institute of Chartered Accountants of Scotland (ICAS) and the New Zealand Institute of Chartered Accountants (NZICA)	Losing the Excess Baggage
The European Securities and Markets Authority (ESMA)	Consultation Paper - Consideration of materiality in financial reporting Feedback Statement - Considerations of materiality in financial reporting
The European Financial Reporting Advisory Group (EFRAG)	Discussion-Paper - Towards a Disclosure Framework for the Notes
The Australian Accounting Standards Board (AASB)	Rethinking the Path from an Objective of Economic Decision Making to a Disclosure and Presentation Framework
Chartered Financial Analyst (CFA) Institute	Financial Reporting Disclosures: Investor Perspectives on Transparency, Trust, and Volume
The Enhanced Disclosure Task Force (EDTF)	Enhancing the risk disclosures of banks
The International Accounting and Assurance Standards Board (IAASB)	The Evolving Nature of Financial Reporting: Disclosure and its Audit Implications
The Institute Of Chartered Accountants In England And Wales (ICAEW)	Financial Reporting Disclosures: Market and Regulatory Failures

Appendix B - Alternative ways to structure financial statements: a summary of considerations, concerns and challenges

Suggested solution	Considerations	Concerns/challenges
Improving navigation of the financial statements	<ul style="list-style-type: none"> ▶ Easier for the reader to identify information they are searching for and navigate through the notes to the financial statements ▶ Permitted under current IFRS 	
Disclosure of accounting policies, judgements, estimates and assumptions together with specific and quantitative disclosures	<ul style="list-style-type: none"> ▶ Easier for the reader to connect the accounting policy with specific quantitative information ▶ The preparer will need to reconsider irrelevant accounting policies ▶ Permitted under current IFRS 	<ul style="list-style-type: none"> ▶ An entity will need to maintain internal processes for recording all previously applied accounting policies to ensure consistent application in future periods
Disclosing only non-mandatory policies or only new policies	<ul style="list-style-type: none"> ▶ The volume of financial statements is reduced ▶ The users are expected to have sufficient experience with IFRS and therefore know the mandatory policy requirements of the standards 	<ul style="list-style-type: none"> ▶ IAS 1 currently requires the disclosure of a summary of significant accounting policies applied. Therefore, we believe that disclosing only non-mandatory policies is not appropriate under current IFRS.
Ordering the notes by reference to importance	<ul style="list-style-type: none"> ▶ Adds another dimension to the financial statements as it communicates to users the information that the entity considers important ▶ Encourages the preparer to re-think the relevance of information and therefore to remove the clutter ▶ Permitted under current IFRS 	<ul style="list-style-type: none"> ▶ High level of judgement required. What one sees as less important, another might find more relevant ▶ May reduce comparability between entities ▶ The selected order normally needs to be applied consistently from one period to another, unless the level of importance changes

Suggested solution	Considerations	Concerns/challenges
Grouping disclosures by nature	<ul style="list-style-type: none"> ▶ Structuring notes into sections by nature to assist user navigation, e.g., grouping entity disclosures, such as corporate and group information, estimation of uncertainty disclosures, risk-based disclosures, etc. ▶ Permitted under current IFRS 	<ul style="list-style-type: none"> ▶ High level of judgement required ▶ May reduce comparability between entities ▶ The selected order needs to be applied consistently from one period to another
Combining ordering based on importance and grouping by nature	<ul style="list-style-type: none"> ▶ Combination of the two above 	<ul style="list-style-type: none"> ▶ Combination of the two above
Presentation of 'Executive summary' or 'Key developments' note	<ul style="list-style-type: none"> ▶ 'Executive summary' or 'Key developments' note communicates the most significant events of the period to the users ▶ Permitted under current IFRS 	<ul style="list-style-type: none"> ▶ Such a summary would be viewed as adding to the clutter by some, rather than reducing the overload problem
Presentation of certain disclosures outside of financial statements	<ul style="list-style-type: none"> ▶ IFRS 7 permits certain information to be presented outside the financial statements ▶ Some entities have been considering whether the disclosure of accounting policies can be moved to the company's website ▶ The approach would allow a reduction in the volume of financial statements and may be helpful in achieving more effective communication 	<ul style="list-style-type: none"> ▶ IFRS requires an entity to clearly identify the financial statements and distinguish them from other information in the same published document ▶ However, IFRS 7 permits certain information to be disclosed outside the financial statements, provided that this information is appropriately cross-referenced in the financial statements ▶ In interim condensed financial statements, certain information may be disclosed outside the financial statements as long as the financial statements include relevant cross-references

Suggested solution	Considerations	Concerns/challenges
Inclusion of alternative performance measures (APMs) in the financial statements	<ul style="list-style-type: none"> ▶ May be helpful for the users since it makes it easier to reconcile management reported information with actual figures in IFRS financial statements ▶ Goes beyond the issue of disclosure overload, but is an approach some believe will be helpful in achieving more effective communication 	<ul style="list-style-type: none"> ▶ The approach may in effect increase the clutter, as IFRS information is mixed with APMs, which potentially can confuse users, rather than provide clarity

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