

Towards a Disclosure Framework for the Notes DISCUSSION PAPER



JULY
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These key principles set out the features that are required for an effective Disclosure Framework.

General objective of a Disclosure Framework

To ensure that all and only relevant information is disclosed in an appropriate manner, so that detailed information does not obscure relevant information in the notes to the financial statements.

Purpose and content of the notes

- 1 The purpose of the notes is to provide a relevant description of the items presented in the primary financial statements and of unrecognised arrangements, claims against and rights of the entity that exist at the reporting date.
- 2 Consequently:
 - a. The disclosures in the notes should provide information which amplifies and explains the primary financial statements;
 - b. The notes should focus on past transactions and other events existing at the reporting date; information about the future that is unrelated to those past transactions and other events, is not provided in the notes; and
 - c. Information in the notes should be entity-specific.
- 3 As a complement to reported numbers showing the entity's financial situation and performance in the balance sheet and profit and loss, notes should provide information such as, but not limited to, (a) assumptions and judgments that are built into the reported numbers of items in the balance sheet and profit and loss; (b) information on risks that may affect these reported numbers; and (c) alternative measurements where this information would be relevant.
- 4 It is necessary to consider the implications of recognition and measurement attributes on the disclosure requirements so that, ultimately, the usefulness of information is assessed as a whole. In particular, the more uncertainty affects the amounts in the primary statements, the more disclosures are usually needed.



Setting the disclosure requirements

- 5 Disclosure needs to be an objective distinct from other objectives, specifically from recognition, measurement and presentation.
- 6 Disclosure requirements should be developed and justified with the same level of depth and scrutiny as recognition, measurement and presentation requirements.
- 7 Disclosure requirements should be set in a consistent manner across the whole set of accounting standards, including the level of granularity.
- 8 Disclosure requirements should be principle-based and detailed rules should be avoided.
- 9 Disclosure requirements should achieve proportionality to the entity's users' needs, and meet a reasonable cost-benefit trade-off in all circumstances. Alternative disclosure regimes may have to be put in place to achieve proportionality.
- 10 Disclosure requirements should not be used to compensate for inadequacies in recognition, measurement and presentation requirements.
- 11 Disclosure requirements should be set as to avoid any possible overlap within notes and reviewed over time to eliminate requirements that are no longer relevant.

Applying the requirements

- 12 Care should be taken in applying the materiality principle in practice, bearing in mind that disclosing immaterial information (and information on situations that do not apply in practice to the reporting entity) reduces the relevance and the understandability of disclosures.

Communicating information

- 13 Disclosure requirements should be applied with a view to communicating information to users rather than a compliance exercise.

Succeeding in practice

- 14 Preparers, auditors and regulators, each in their specific role, have a shared interest in fostering the improvement of disclosures, through the application of all principles above.

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This Discussion Paper is issued by the European Financial Reporting Advisory Group (EFRAG), the French Autorité des Normes Comptables (ANC) and the UK Financial Reporting Council Accounting Committee (FRC).

The following standard setters in Europe also support the issue of this Discussion Paper:

Austria, AFRAC - Austrian Financial Reporting and Auditing Committee

Belgium, CNC/CBN - Commission des Normes Comptables/Commissie voor Boekhoudkundige Normen

Cyprus, ICPAC - Institute of Certified Public Accountants of Cyprus

Denmark, FSR - danske revisorer

Estonia, EASB - Eesti Raamatupidamise Toimkond

Italy, OIC - Organismo Italiano di Contabilità

Lithuania, AAA - Audito ir Apskaitos Tarnyba

Malta, MIA - The Malta Institute of Accountants

Netherlands, RJ - Raad voor de Jaarverslaggeving

Norway, NRS - Norsk RegnskapsStiftelse

Poland, Polish Accounting Standards Committee

Portugal, CNC - Comissão de Normalização Contabilística

Slovenia, Slovenski Institut za Revizijo

Spain, ICAC – Instituto de Contabilidad y Auditoría de Cuentas

Sweden, Rådet för finansiell rapportering

DISCLAIMER

These bodies, while encouraging debate on the issues presented in the paper, do not express any opinion on those matters at this stage.

Copies of the Discussion Paper are available from the websites of those bodies issuing it. A limited number of copies of the Discussion Paper will also be made available in printed form, and can be obtained from either EFRAG, ANC or the FRC.

The paper invites comment on its proposals via the ‘Questions for Respondents’ at the end of each section (which are summarised in the Invitation to Comment). Such comments should be sent by email to:

commentletters@efrag.org or by post to:

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so as to arrive no later than 31 December 2012. All comments received will be placed on the public record unless confidentiality is requested.

Our Proactive Work in Europe

It is important to set the project within the broader context of our Proactive Work. EFRAG aims to influence future standard-setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB's work. This proactive work is carried out in partnership with National standard setters in Europe to ensure resources are used efficiently and to promote stronger coordination at the European level. Four strategic aims underpin proactive work:

- engaging with European constituents to ensure we understand their issues and how financial reporting affects them;
- influencing the development of global financial reporting standards;
- providing thought leadership in developing the principles and practices that underpin financial reporting; and
- promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our proactive work and current projects is available on the EFRAG's website (www.efrag.org).

WHAT IS THE PROBLEM?

- 1 Financial statements are an important means of conveying useful information to assess stewardship and predict future cash flows. Effective communication lies at the heart of good financial reporting. However, the relevance of the notes to the financial statements has become deteriorated for a number of reasons:
 - a. standard setters have attempted to increase the level of transparency by adding to disclosure requirements. They have come to see the notes as a repository of ‘useful’ information often responding to calls that more information may result in fewer financial disasters. To an extent, the notes have become regarded as a means of compensating for the shortcomings of recognition and measurement principles. As a result, the notes are no longer principally ‘footnotes’ to the primary financial statements;
 - b. transactions and financial reporting requirements have grown in their complexity;
 - c. the difficulty in practice of applying materiality judgements to disclosures;
 - d. preparers, as well as auditors and regulators, opting for ‘safety’ by using a ‘checklist’ requirements approach; and
 - e. the time pressure on entities to issue financial statements given the other forms of communication that are available in the marketplace at the end of the reporting period.

All these factors have come together to make the notes far too complex to be easily understood.

- 2 These reasons, have at their root, a complex set of behaviours that need to change. These behaviours need to be tackled comprehensively to ensure the problem is not just relocated between the parties involved.
- 3 There is a strong consensus in the financial community that disclosures in the notes to the financial statements have become unwieldy; the increasing length of the notes has done little to improve the quality of information, and may have even decreased it because of information overload. Accordingly, it has become increasingly difficult for capital providers to rely on the information contained in the notes to support their decisions about the allocation of resources. Recent reports by different parties (preparers, users and auditors of financial statements) have highlighted the need for the current disclosure regime to be overhauled as it is no longer sustainable. There have been calls for the International Accounting Standards Board (IASB) to commence work on the development of a Disclosure Framework to ensure that disclosure requirements under International Financial Reporting Standards (IFRS) are based on sound principles and yield relevant information for users of financial statements.



- 4 There have been several attempts to rationalise disclosure requirements but they have typically been met by debate about *why* such disclosures should be removed or changed. It is suggested in this Discussion Paper that there are no ‘quick fixes’ and taking a ‘red-pen’ to existing disclosures is not sufficient in charting a sustainable way forward. The debate needs to move beyond simply a discussion about more or less disclosure to how to improve the quality of what is disclosed to better serve the objective of financial reporting.

How should those issues be addressed?

- 5 It is suggested that what is needed is a comprehensive re-think about the role of the notes to the financial statements. That needs to be set in the broader context of information that users rely on to form their judgements and the notes should not deliberately replicate information that is otherwise publicly available that is not essential to understanding the financial statements.
- 6 Our analysis of the issues and consideration of the Conceptual Framework has suggested that in moving towards developing a Disclosure Framework it is important to:

(a) clarify the purpose of the notes

It is important that a Disclosure Framework includes a clear definition of the purpose of the notes. What role should they play? The answer to that question drives what information should be included in the notes and what belongs elsewhere. The purpose of the notes needs to flow from the objective of financial reporting in serving the needs of users and be derived from, and consistent with, the purpose of the financial statements as articulated in IAS 1 *Presentation of Financial Statements*. As a starting point, it is suggested that the purpose of the notes is to provide a relevant description of the items presented in the primary financial statements and of unrecognised arrangements, claims against and rights of the entity that exist at the reporting date. The purpose of the notes is discussed in chapter 2.

(b) develop principles to identify what information to include in the notes

A Disclosure Framework should guide the standard setter in determining what information is considered relevant and faithfully represents the underlying economic events, given what is already conveyed by recognition and measurement requirements. This issue is discussed in chapter 3, pages 24 to 34.

(c) consider the form of disclosure requirements

In responding to some of the key behavioural issues, the form in which the standard setter sets the requirements is important in driving the information that is ultimately reported. For example, detailed disclosure requirements that require specific items to be disclosed are more likely to produce ‘boilerplate’ information whereas requirements that are more objectives-based require greater judgement and consideration of an entity’s circumstances. Comparability is also an important factor to bear in mind in deciding the form of disclosures. This issue is discussed in chapter 3, pages 35 to 43.

(d) strengthen the application of materiality so that the only information disclosed is the what is necessary to understanding an entity's financial performance and position;

Decisions about how to relate requirements to the specific context of each entity are achieved through the application of the concept of materiality, which is an entity-specific aspect of relevance. There appears to be a diversity of views around the practical application of this concept; the Discussion Paper analyses both its quantitative and qualitative aspects and offers suggestions on how the application of materiality could be improved. Consideration is also given to the 'scalability' or dynamic nature of disclosures so that the question of what to disclose and the degree of detail is likely to be sensitive to an entity's specific circumstances including external factors such as economic conditions and exposure to risks. Again, it links back to responding to the fundamental question about what information is likely to be relevant to users of the financial statements to enable them to assess stewardship and predict future cash flows. Preparers, as well as auditors and regulators, have a key role to play in improving how materiality is applied. This is discussed in chapter 4.

(e) articulate the key features of effective communication that can be applied to the notes.

Decisions about how best to communicate information in the notes involve judgements about how to present them, how to link information to provide coherent explanations about transactions and events and the manner in which the notes are organised. These decisions around communication also concern how to convey the key messages and the way disclosures are organised and presented. This is discussed in chapter 5.

- 7 In designing a Disclosure Framework we propose a set of Key Principles. The Key Principles are proposed as the essential qualities of an effective Disclosure Framework. Some of these may appear self-evident but that does not detract from their importance.
- 8 This Discussion Paper does not attempt to offer a single solution but considers a series of decisions that need to be taken in deciding *what* and *how* information should be disclosed in the notes.
- 9 Inevitably, a discussion about the notes leads to consideration of the geography of information in the financial report and other forms of corporate reporting. Whilst it is acknowledged that there is a broader question to pose about the disclosure of information in corporate reporting more generally, it is not within the scope of this Discussion Paper. Our principal focus is on improving the quality of information disclosed in the notes.

Questions to constituents

EFRAG, ANC and FRC invite comments on all matters in this Discussion Paper, particularly in relation to the questions set out below. Comments are more helpful if they:

- a. address the question as stated;
- b. indicate the specific paragraph reference, to which the comments relate; and
- c. describe any alternative approaches EFRAG, the ANC and the FRC should consider.

EFRAG, ANC and FRC will consider all comments, which will be received by 31 December 2012.

Question 1.1 – Key principles

The Discussion Paper sets out a number of key principles that should underpin a Disclosure Framework.

Do you agree with these key principles? If not, what alternative principles would you propose?

Question 1.2 – Understanding the problem

This Discussion Paper suggests that there are two main areas for consideration to improve the quality of disclosures:

- a. avoiding disclosure overload, which may be caused both by excessive requirements in the standards, and by ineffective application of materiality in the financial statements;
- b. enhancing how disclosures are organised and communicated in the financial statements, to make them easier to understand and compare.

Do you agree that these are the two main areas for improvements?

Question 2.1

In chapter 2 a definition of the purpose of the notes is proposed to assist in deciding what financial information should be required in the notes.

Do you think that there is a need to define the purpose of the notes? If not, please provide your reasoning.

Question 2.2

Is the proposed definition of the purpose of the notes helpful in identifying relevant information that should be included in the notes? If not, how would you suggest it should be amended?

Question 3.1

In chapter 3, it is proposed to identify specific users' needs that the notes should fulfil. Those users' needs are drawn from the Conceptual Framework. It is also suggested that a Disclosure Framework should include indicators to assist the standard setters to decide when additional information is required to fulfil those users' needs.

- (a) Is the description of the approach clear enough to be understandable? If not, what points are unclear?
- (b) If you do not support this approach, what alternative would you support and why?
- (c) Do you think that a category on "information about the reporting entity as a whole" should be included? If so, why?

Question 3.2

Are the proposed users' needs and indicators in chapter 3 helpful to identify relevant information? If not, how would you suggest amending them, or what other basis would you suggest to identify relevant information to be included in the notes?

Question 3.3

Do you agree with the way how risk and stewardship are addressed in the Discussion Paper? If not, what are your views about how risk and stewardship information that should be provided in the notes?

Question 3.4

Standard setters frequently mandate detailed disclosure requirements in each standard. In chapter 3, it is suggested that the way in which disclosures are established influences behaviours, and alternative approaches are discussed.

Do you think that standard setters should change their practice of mandating detailed disclosure requirements in each standard? If so, which of the alternative approaches discussed do you think will be the most effective in improving the quality of information in the notes?

Question 3.5

Some standard setters have established, or have proposed establishing, differential reporting regimes on the basis that a 'one size fits all' approach to disclosures is not appropriate. They consider that reporting requirements should be more proportionate, based on various characteristics such as entity size, or whether they relate to interim or annual financial statements?

Do you think that establishing alternative disclosure requirements is appropriate?

Question 4.1

Chapter 4 discusses the application of materiality to disclosures. Currently, IFRS state that an entity does not need to disclose information that is not material.

Do you think that a Disclosure Framework should reinforce the application of materiality, for instance with a statement that states that immaterial information could reduce the understandability and relevance of disclosures ?

Question 4.2

Chapter 4 also includes proposed guidance to assist in the application of materiality.

Do you think that a Disclosure Framework should include guidance for applying materiality? If you disagree, please provide your reasoning.

Question 4.3

Is the description of the approach clear enough to be useful to improving the application of materiality? If not, what points are unclear or what alternatives would you suggest?

Question 5.1

Chapter 5 includes proposals for improving the way disclosures are communicated and organised.

Would the proposed communication principles improve the effectiveness of disclosures in the notes? What other possibilities should be considered?

Question 5.2

Do any of the suggested methods of organising the notes improve the effectiveness of disclosures? Are there different ways to organise the disclosures that you would support?

Question 6.1

Are there any other issues that you think need to be addressed to improve the quality of information reported in the notes to the financial statements? Please explain how you think these issues should be addressed and by whom.

Table of contents

KEY PRINCIPLES	2
OUR PROACTIVE WORK IN EUROPE	5
EXECUTIVE SUMMARY	6
WHAT IS THE PROBLEM?	6
HOW SHOULD THOSE ISSUES BE ADDRESSED?	7
QUESTIONS TO CONSTITUENTS	9
TABLE OF CONTENTS	13
CHAPTER ONE: SETTING THE SCENE	15
UNDERSTANDING THE PROBLEM	15
OBJECTIVE AND SCOPE OF THE DISCUSSION PAPER	17
STRUCTURE OF THE DISCUSSION PAPER	19
THE FASB DISCUSSION PAPER ON DISCLOSURE FRAMEWORK	20
CHAPTER TWO: DEFINING THE PURPOSE OF THE NOTES	21
IS THERE A NEED FOR A DEFINITION OF THE NOTES?	21
PROPOSED DEFINITION OF THE NOTES	22
FOCUS ON PAST TRANSACTIONS	23
CHAPTER THREE: SETTING THE REQUIREMENTS	25
PROPOSALS IN THE DISCUSSION PAPER – IDENTIFYING USERS’ NEEDS	26
<i>Aggregation/disaggregation of the line item</i>	27
<i>What the item is</i>	27
<i>How does the item fit into the entity’s operations and financial structure</i>	27
<i>How the item has been accounted for</i>	28
<i>Information about the reporting entity as a whole</i>	28
ARE THERE OTHER CATEGORIES?	28
<i>Risk</i>	29
<i>Stewardship</i>	32
IS DISCLOSURE IN ADDITION TO PRIMARY STATEMENTS ALWAYS REQUIRED TO FULFIL USERS’ NEEDS?	33
WHEN TO REQUIRE DISCLOSURE?	33
HOW STANDARD SETTERS COULD SET DISCLOSURES	37
<i>What approach could standard setters take?</i>	38
<i>Differential disclosure regimes</i>	41
<i>A comprehensive perspective</i>	45
<i>Setting the requirements – highlights on relevance</i>	46

CHAPTER FOUR: APPLYING THE REQUIREMENTS - MATERIALITY	47
INTRODUCTION	47
MATERIALITY OF INFORMATION AND MATERIALITY OF THE ITEM	49
GENERAL OBJECTIVE OF APPLYING MATERIALITY	49
SHOULD THE DISCLOSURE FRAMEWORK INCLUDE GUIDANCE ON MATERIALITY?	50
CONTINUAL ASSESSMENT OF MATERIALITY	51
GUIDANCE ON THE ASSESSMENT OF MATERIALITY	51
APPLYING THE REQUIREMENTS – HIGHLIGHTS ON MATERIALITY	57
CHAPTER FIVE: APPLYING THE REQUIREMENTS - COMMUNICATION	58
INTRODUCTION	58
COMMUNICATION PRINCIPLES	59
<i>Organisation of information</i>	61
<i>Display of information in the notes</i>	63
DEVELOPMENTS IN FINANCIAL REPORTING	64
CHAPTER SIX: CONCLUSIONS AND NEXT STEPS	65
APPENDIX 1 – APPLICATION EXAMPLES OF THE DEFINITION OF THE PURPOSE OF THE NOTES	67
<i>Applying the proposals – related party transactions</i>	70
<i>Applying the proposals - events after the reporting date</i>	71
APPENDIX 2 – DISCUSSION OF THE RATIONALE FOR THE INDICATORS	72
APPENDIX 3 – BIBLIOGRAPHY	75
APPENDIX 4 – ACKNOWLEDGMENTS	78

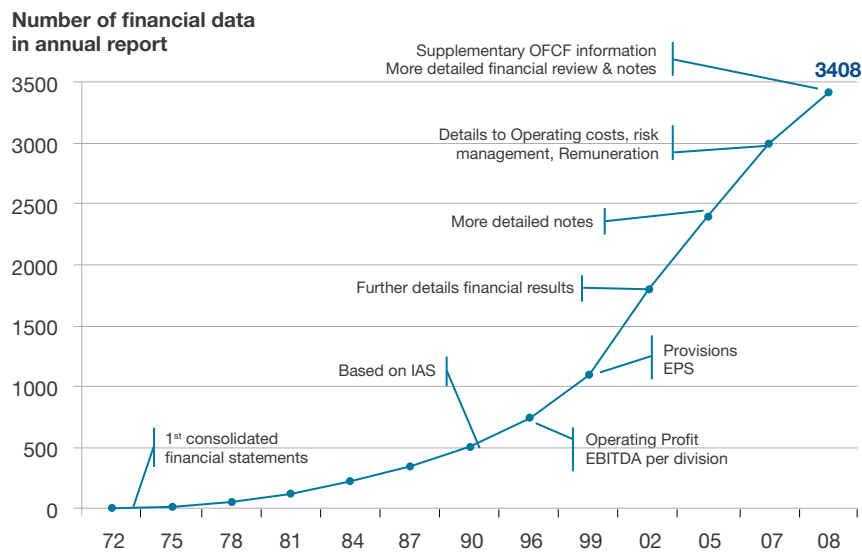
Chapter one: Setting the scene

This chapter discusses how to remedy the deficiencies identified in the current disclosure regime. It also explains the scope of the Discussion Paper in responding to those issues.

Understanding the problem

- 1 Users rely on information contained in financial statements to make economic decisions. As the primary financial statements only provide very aggregated information, the notes to those financial statements provide essential additional information needed to understand the financial performance, financial position and cash flows of an entity. It is perhaps because of their pivotal role that the notes have grown as a default location for required facts and figures about the entity, and their direct link with the primary financial statements has been eroded. In the last few years, partly because of the repercussions of the global financial crisis, there have been growing calls to address the ‘disclosure problem’ on a number of fronts. Some have suggested that the problem relates to corporate reporting in general and that there is a need to consider ways of integrating information. Others have focused on various components such as management commentary and risk reporting.
- 2 There are no concepts when it comes to decisions about what to disclose alongside the primary financial statements or how that information should be communicated. That is not to say that standard setters have ignored disclosures, but it is fair to say that they have not been subject to the same level of consideration and scrutiny as recognition and measurement requirements.
- 3 Current IFRS are stacked with disclosure requirements and new ones are added every time a new or amended standard is adopted. These disclosures are justified on the basis that they provide users of the financial statements with information that is relevant to economic decisions they make. However, that assertion remains largely untested because although much has been written about what is wrong with the existing disclosure regime, very little has been offered in terms of solutions or concepts to guide judgements about disclosures.
- 4 There are two main areas of improvement for the quality of disclosures:
 - a. avoiding disclosure overload, which may be caused both by excessive requirements in the standards, and by ineffective application of materiality in the financial statements;
 - b. enhancing how disclosures are organised and communicated in the financial statements, to make them easier to understand and compare.

- 5 Over the last decade the number of disclosures has been growing. This trend has led to an increase in the length of financial statements. For instance, the following graph shows the progression of purely quantitative data given in the Annual Report of a major pharmaceutical company that adopted IAS for its 1990 statements and from 1994 onwards has produced them ‘in accordance with IAS/IFRS’:



- 6 Whilst this trend can partially be explained by the greater complexity of the transactions that the entities undertake, and the economic environment they operate in, there are also other drivers of this increased volume. For example:
- the lack of a Disclosure Framework has meant that disclosures for each standard in the financial statements have been developed in isolation. This Discussion Paper aims to address the underlying principles and content of a Disclosure Framework to assist standard setters to develop disclosure requirements on a more consistent basis using a set of agreed principles to do so;
 - information is provided without sufficient consideration of its relevance, including disclosure of items that are often immaterial (an example would be often mentioned are disclosures under IFRS 2 *Share-based Payments* when the awards are immaterial). Similarly, there may be a disproportionate focus on complex specific transactions with insufficient consideration given to the “bigger picture”. This Discussion Paper aims to provide the basis for a more effective application of the concept of materiality in practice; and
 - the lack of clarity on the application of materiality to disclosures, especially qualitative ones. This typically leads to ‘black letter’ compliance by preparers (i.e. to full compliance with all disclosure requirements regardless of materiality or understandability) to avoid debates with auditors, users, regulators and others.

- 7 Some users prefer to have as much information as possible but a number of studies (FRC 2009, ICAS 2011 and KPMG 2011) have concluded that the volume of existing disclosures has added to the complexity of the financial statements and may confuse rather than inform users by obscuring relevant information. In addition, such volume may result in an undue cost for preparers in managing and reporting extensive disclosures.
- 8 In addition to the increased volume, insufficient attention is given to the organisation of disclosures, which make the notes difficult to navigate.
- 9 Finally, there are the qualitative aspects of disclosures including lack of clarity, with ‘boilerplate’ information that does not add value or communicate useful information.

Objective and scope of the Discussion Paper

- 10 There may be different perceptions of what needs to be fixed in the current disclosure regime, and how to do it, therefore it is important to clearly indicate the objectives of this Discussion Paper:
 - a. identify what disclosures are relevant for the notes to the financial statements;
 - b. discuss what materiality means from a disclosure perspective; and
 - c. develop a set of principles for good communication of disclosures.
- 11 This Discussion Paper intends to assist:
 - a. users, to obtain information that is relevant and faithfully represents the entity’s financial performance and position;
 - b. standard setters, to identify what information should be required in the notes, and how to set requirements in the standards; and
 - c. preparers of financial statements and others (such as auditors and regulators), to make disclosure decisions based on the requirements, thereby improving the quality of their disclosures.
- 12 It is suggested that a Disclosure Framework will play an important role in improving the quality of disclosures. The notion of quality is defined as improving relevance and logical organisation of information and simplifying the preparation and use of disclosures. Although reducing the length of the notes to financial statements is not the primary intent, a sharper focus on relevance will likely result in a reducing their volume, which is a legitimate expectation.

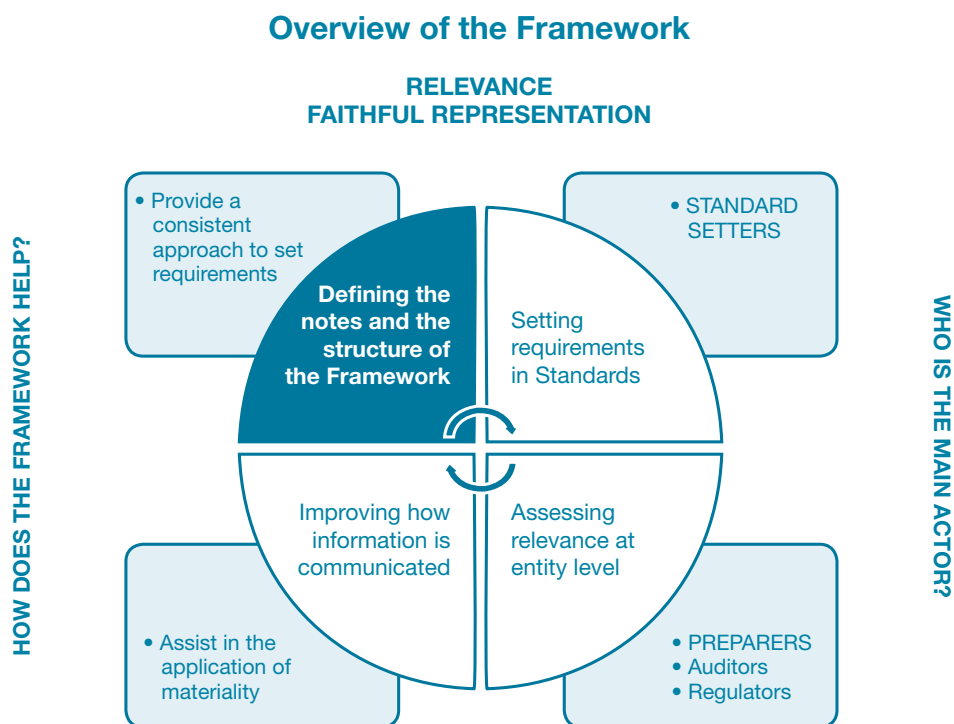
- 13 The proposed scope of application for this Discussion Paper is the notes to the financial statements.
- 14 Many believe that integrated reporting is the key to communicating how an entity creates value for its stakeholders, and therefore a Disclosure Framework should encapsulate all corporate information. However, the scope of the Discussion Paper was intentionally not extended to financial reporting as a whole, for the following reasons:
- a. in many jurisdictions, including the European Union, the IASB's remit is for financial statements only and information required in other parts of the financial reports is under the responsibility of other institutions or authorities (e.g. parliaments, governments, regulators, etc);
 - b. information required in the various parts of the financial reports differs greatly (e.g. governance, internal controls, etc). Setting a limited scope was therefore considered the best way to launch a debate that could achieve a concrete impact on practice in a reasonable timeframe;
 - c. other parts of the financial reports are still evolving and it seems too early to develop a framework that would attempt to embrace the whole breadth of reporting and also address the immediacy of concerns about the current disclosure regime; and
 - d. the concept of integrated reporting, which is gaining momentum, acknowledges that financial statements will continue to exist as one part of the integrated reporting framework. It is therefore all the more crucial to have a sound Disclosure Framework for the notes to the financial statements.

As a result, the Discussion Paper does not address other disclosures included in documents other than the financial statements and the potential use of cross-references between the financial statements and those documents.

- 15 The Discussion Paper does not address presentation of financial statements, which is subject to the requirements in IAS 1 *Presentation of financial statements*.
- 16 The Discussion Paper does not specifically consider whether the content of the notes should be audited or not, and how the various approaches affect the "auditability" of the information in the notes. We observe that notes are a part of the financial statements and as such are subject to audit in many jurisdictions. In the Feedback Statement to the IAASB's *The Evolving Nature of Financial Reporting: Disclosures and Its Audit Implications* it is noted that "Respondents were generally of the view that if information is not capable of being audited, it should not be within the financial statements. A few were, however, comfortable with such information being left in the financial statements but labelled as unaudited".

Structure of the Discussion Paper

- 17 The Discussion Paper addresses how a Disclosure Framework could be structured and applied to achieve improvements in setting, preparing and communicating information in the notes to the financial statements.



- 18 A considerable amount of research has been undertaken in developing this Discussion Paper. For readers that are interested in learning more about some of the background work that supports this Discussion Paper supporting materials can be found at www.efrag.org.

The FASB Discussion Paper on Disclosure Framework

- 19 The EFRAG, ANC and FRC project team has cooperated with the FASB staff in the preparation of this Invitation to Comment and a similar Discussion Paper to be issued by FASB. The FASB Discussion Paper is available on the FASB website www.fasb.org.
- 20 Both documents focus on improving disclosure effectiveness and have the following in common:
 - a. both acknowledge that eliminating unnecessary disclosure would improve effectiveness;
 - b. both limit the scope of the discussion to notes to financial statements; and
 - c. both discuss potential improvements in three areas — standard setters' decisions about establishing disclosure requirements, reporting entities' selections of disclosures that are appropriate in their circumstances, and communication improvements (organization and formatting).

The two papers discuss different approaches to improvements in those three areas that are not inconsistent with one another.

Chapter Two: Defining the purpose of the notes

This chapter considers the purpose of the notes to the financial statements. It is suggested that the purpose of the notes should be derived from the purpose of the financial statements (of which the notes are a part).

Is there a need for a definition of the notes?

- 1 In a project that attempts to decide what information should be included in the notes, a good starting point is to define the purpose of the notes, and what role they play in financial reporting.
- 2 Paragraph QC5 of the Conceptual Framework states that the fundamental qualitative characteristics that make financial information useful are *relevance* and *faithful representation*. Relevant financial information is information capable of making a difference to the decisions made by users. A faithful representation is a depiction of an item that is complete, neutral and free from error. A perfectly faithful representation is seldom possible, but the objective is to maximise these qualities. The Conceptual Framework describes the process of applying the fundamental qualitative characteristics as follows.
- 3 First, identify an economic phenomenon that has the potential to be useful to users of the reporting entity's financial information. Second, identify the type of information about that phenomenon that would be most relevant if it is available and can be faithfully represented. Third, determine whether that information is available and can be faithfully represented.
- 4 This implies that the an item is recognised in the primary financial statements because it provides relevant information. Nevertheless, to obtain faithful representation, it may be necessary to disclosed further information in the notes. Hence a fundamental part of the purpose of the notes is to provide a faithful representation of items that are recognised in the primary financial statements. The question therefore arises: to what extent the notes to the financial statements should include anything else? Information that is not about a recognised amount in the primary financial statements, for example alternative measures of recognised items or information about unrecognised items, may be relevant to (i.e. capable of making a difference to the decisions of) users. But how much of it belongs in the notes to the financial statements?
- 5 In answering this, it is important to consider the context of the notes. They form an integral part of the financial statements but the financial statements are one component of a broader financial reporting package, which in turn is only part of the total information set about an entity.

- 6 The purpose and components of financial statements are set out in paragraph 9 of IAS 1:

Financial statements are a structured representation of the financial position and financial performance of an entity. The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it.

- 7 The Conceptual Framework and IAS 1, acknowledge that notes are an integral part of the financial statements but IFRS does not provide a definition of the notes. Paragraph 112 of IAS 1 *Presentation of Financial Statements* states:

The notes shall (a) present information about the basis of preparation of the financial statements and the specific accounting policies used [...], (b) disclose the information required by the IFRSs that is not presented elsewhere in the financial statements and (c) provide information that is not presented elsewhere in the financial statements but is relevant to an understanding of any of them.

Proposed definition of the notes

- 8 In this Discussion Paper, it is proposed that the notes should be defined as follows:

The purpose of the notes is to provide a relevant description of the items presented in the primary financial statements and of unrecognised arrangements, claims against and rights of the entity that exist at the reporting date.

- 9 The following paragraphs a. to e. are essential to the understanding of the proposed definition:

- a. 'relevant' implies that disclosures should fulfil some specific users' needs¹, and should be provided only if they are material for the specific entity;
- b. 'description' means that notes are supposed to provide quantitative descriptions of the items (e.g. breakdowns, maturity analysis) as well as qualitative descriptions of these items (e.g. accounting policies, judgements) which amplify and explain the primary financial statements;
- c. 'items presented in the primary financial statements' are those items presented in one of the following statements: statement of financial position, statement of profit and loss and other comprehensive income, statement of change in equity, or statement of cash flows;
- d. 'unrecognised arrangements that exist at the reporting date' are transactions or firm agreements with a third party that occurred in the past and for which no asset or liability has been recognised at the reporting date (such as the set-up of a Special Purpose Entity, or the granting of a guarantee); and

¹ Specific users' needs to be fulfilled by the notes are discussed in detail in chapter 3.

- e. 'unrecognised claims against and rights of the entity that exist at the reporting date' are claims and rights from/ against third parties that arose from past events and that did not meet the recognition threshold (like an unrecognised deferred tax asset, a claim against a competitor for patent violation when the inflow of economic benefits is only probable, or a contingent liability).

Focus on past transactions

- 10 Historically, the notes to financial statements were 'footnotes' to items presented in the primary financial statements. Over time, information contained in the notes has expanded and the boundary between the primary financial statements and other information contained in annual reports has been blurred; one example commonly given is the risk management disclosures in IFRS 7 *Financial Instruments: Disclosures*.
- 11 One of the implications of applying the definition of the notes is that some disclosures which are currently included in the notes would be provided elsewhere. That information is still useful and this Discussion Paper does not suggest that those disclosures are eliminated but they may fit better elsewhere. This Discussion Paper effectively defines the boundary of the notes. There are a number of implications of this approach:
 - a. the notes focus on past transactions up to the reporting date;
 - b. the basis for the disclosure in the notes is that the disclosures are linked to the numbers in the primary financial statements; and
 - c. forward-looking information is excluded unless it is reflected in the measurement of items in the primary financial statements.
- 12 In arriving at the definition of the notes, there are certain types of disclosures where the boundary line is less clear. These are:
 - a. unrecognised items – this Discussion Paper draws the line at unrecognised arrangements, rights and claims;
 - b. risk disclosures (this is discussed further in chapter 3);
 - c. related party disclosures (see Appendix 1); and
 - d. non-adjusting post-balance sheet events (see Appendix 1).
- 13 In the 1989 Conceptual Framework it was acknowledged that financial statements (including notes) related to the past (financial statements "largely portray the financial effects of past events"), but this reference to "past events" disappeared following Phase A of the revision of the Conceptual Framework published in September 2010.

14 Based on the selected characteristics, it is suggested that:

- a. the disclosures in the notes should provide information which amplifies and explains the primary financial statements;
- b. the notes should focus on past transactions and other events existing at the reporting date; information about the future that is unrelated to those past transactions and other events, is not provided in the notes; and
- c. information in the notes should be entity-specific.

15 Illustrative examples of the application of the definition are available on the project page on the EFRAG's website <http://www.efrag.org/Front/p169-1-272/Proactive---A-Disclosure-Framework-for-the-notes-to-the-financial-statements.aspx>.

Chapter Three: Setting the requirements

This chapter considers how standard setters should identify what is the relevant information to be provided in the notes, and how to require entities to provide it. In most accounting regimes, each accounting standard includes disclosure requirements, and addresses classes of transactions (like business combinations) or types of items (like intangible assets or provisions). A Disclosure Framework could follow the same approach, although a number of alternatives are explored.

1 In chapter 2, it has been suggested that notes should provide relevant description of the items in the primary statements. The following step is to identify what is relevant information. The definition of the notes acts as a filter for the content, but it may be necessary to go beyond the definition to identify what is relevant information.

2 Paragraph OB2 of the Conceptual Framework provides the following definition of the objective of financial reporting:

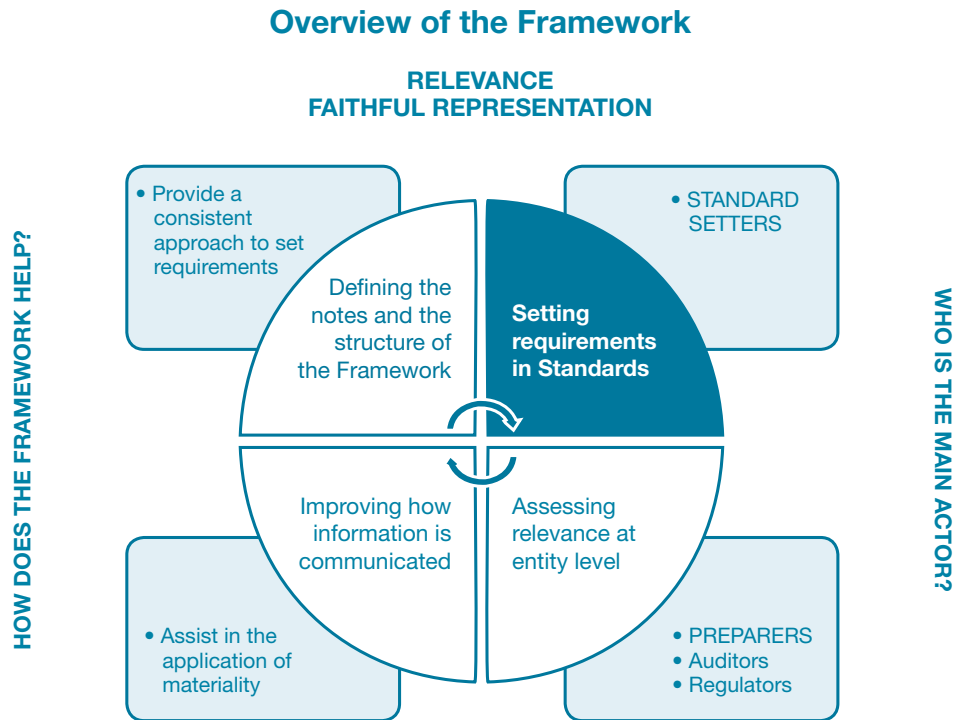
The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

3 It also indicates that the following information is useful:

- a. the nature and amounts of the entity's economic resources and claims; and
- b. the changes in the entity's economic resources and claims that result either from the entity's financial performance or other events (issuing debt or equity instruments).

4 If disclosures should be required only when they provide supplementary information to the amounts reported in the primary statements, it seems appropriate that a Disclosure Framework indicates what specific users' needs are to be fulfilled by the notes. One possible way to do that is to include categories of information in a Disclosure Framework.

Proposals in the Discussion Paper – identifying users' needs



- 5 It is suggested in this Discussion Paper that the notes should fulfil the following categories of users' needs:
- a. what the components of the line item are; and
 - b. for disaggregated amounts, information on:
 - i. what the item is;
 - ii. how the item fits into the entity's operations and financial structure; and
 - iii. how the item has been accounted for.

Aggregation/disaggregation of the line item

- 6 The amounts presented in the primary financial statements are often an aggregation of amounts arising from different events and transactions. It is useful to subdivide these into components to allow a better understanding of them and insight into the prospects for future cash flows.

What the item is

- 7 This category includes information about the nature of the item. This might include a description of its contractual terms, or its main characteristics. Depending on the item, this alone might help users assess the prospects for future net cash inflows to an entity.

How does the item fit into the entity's operations and financial structure

- 8 This category includes the following information:
- a. if the item is in the balance sheet, what does it imply about prospects for future cash flows, for example:
 - i. how the entity plans to recover or settle the item?
 - ii. how the item is related to other items in the entity's balance sheet, for example:
 1. is it linked to other items by the way it is used or by contract, statute, or regulation?
 2. is it hedging other items, or hedged?
 - b. if the item is in the income statement, what is the predictive value of the information?
 - c. links between items in the primary financial statements, for example roll forwards or reconciliation of the balance of a particular line item, (or a disaggregated amount from a line item). Such information helps users understand if and how items in the balance sheet have generated cash flows during the period; and
 - d. information about transactions that affect many line items, e.g. business combinations. Such information helps users understand the composition of line items and transactions, thereby helping them assess the prospects for future cash flows.

How the item has been accounted for

- 9 This category includes the following information:
- accounting policies that explain how the item has been recognised and measured;
 - measurement inputs that form the basis of a measurement calculation. Disclosure of key assumptions may provide users with information about the economic environment in which the measurement was made and how conservative or otherwise an entity's assumptions are compared with others, without providing all the information necessary to recalculate the measurement using different inputs; and
 - measurement uncertainties.

Information about the reporting entity as a whole

- 10 During the debate on this Discussion Paper, there has been a suggestion that financial statements should also include some information not related to individual items, or the relationship between them. Disclosure requirements included in standards typically deal with items and transactions, but some existing requirements go beyond that: for example, the description of the structure of a group or the uncertainties about the going concern assumption.
- 11 Some believe it is appropriate to identify an additional fifth category: namely of information about the reporting entity as a whole (or group). However, the inclusion of such a category would require defining its content in a prescriptive way. In the absence of a direct link to the items in the primary financial statements, or to other matters existing at the reporting date, this category could expand the information set beyond the proposed definition of the purpose of the notes.

Are there other categories?

Risk

- 12 Recent market volatility and significant changes in credit standing and investment returns have drawn particular attention to information on risk exposures and how entities manage them. It is generally accepted that information about risk is critical to understanding the financial performance and position of an entity. This is because information about risk is fundamental to users assessing and predicting about the future cash-flows of an entity. In particular:
- it assists a user to understand the potential for loss (and gain) in the entity's assets and liabilities;

- b. it provides insight into the performance of an entity in the current or prior periods by revealing the relationships between the level of returns obtained and the exposure to risks that has been taken; and
- c. it helps a user understanding the resilience of the entity and its ability both to withstand adverse changes in market and other conditions, and to take advantage of favourable changes in those conditions.
- 13 It is therefore generally accepted that a better understanding of risks by investors and other users would be beneficial. Hence the proposed definition of the purpose and content of the notes should be assessed from the perspective of the information on risks, to ensure that risk information relevant to the understanding of the entity's financial position and past performance is provided to users in the financial statements.
- 14 In chapter 2 some key principles are proposed that define the purpose and content of the notes. We discuss below the information on risks that should be provided as part of the financial statements and whether it falls within the scope of these principles.
- 15 As a complement to reported numbers showing the entity's financial situation and performance in the balance sheet and profit and loss, notes should provide information such as, but not limited to, (a) assumptions and judgments that are built into the reported numbers of items in the balance sheet and profit and loss; (b) information on risks that may affect these reported numbers; and (c) alternative measurements where this information would be relevant.
- 16 This Discussion Paper identifies the following broad group of risk disclosures:
- a. risks directly linked to assumptions and judgements included in the reported numbers – (measurement and recognition uncertainty);
- b. risks that an entity is exposed to due to the business it is in:
- i. risks linked to the impact of a change in operating objectives;
- ii. risks linked to the exposure to market conditions or other external factors; and
- c. information on an entity's risk's appetite.
- 17 Information that is useful to assess risk in the financial position and financial performance of an entity can be categorised as follows:
- a. Measurement (and recognition) uncertainty

Many of accounting estimates that are used in the valuation of assets and liabilities, and therefore, in the gains and losses of one period, or in the assessment of certain arrangements, claims and rights existing at the reporting date, whether they are recognised

or not, inevitably include uncertainties in the outcomes of certain transactions. Examples include the use of management's assumptions (measurement mark to model, impairment tests) and judgements made to assess uncertain economic conditions (provisions).

This uncertainty can be characterised as the accounting effect of the level of reliability of a measurement at a given date. A low level may affect recognition, and not only measurement, because an asset or liability can only be recognised when cash inflows or outflows are considered more likely than not (the so-called "probability recognition criterion").

Limitations of reliability are attributable to two causes: one is economic indeterminacy, which arises when some value-affecting quality or property of an asset or liability is unknown or unknowable. The second is estimation uncertainty, which occurs when the measurement of a known quantifiable phenomenon requires judgement about an uncertain existing condition incorporated in the measurement attributes.

To arrive at a sound assessment of the financial position and performance of an entity from its financial statements, users need to understand how uncertainties have affected measurement and recognition.

The principles set out in chapter 2 provides for information on recognition and measurement uncertainty. The definition of the notes provides for both recognised and unrecognised items. This chapter develops the relevant categories and indicators to implement this principle.

b. Impact of a potential change in operating objectives

Accounting standards may require that the measurement of assets and liabilities reflects the business model of the entity. For example loans managed in a banking book may be measured at amortised cost, provided that their terms provide for cash-flows that are solely payments of principal and interest.

While these circumstances may be remote, users should be able to assess the consequences of a change in the business model of the entity, e.g. what would be the outcome if loans reported as managed in the banking book at the closing date were to be sold. Therefore, providing the fair value of loans reported at amortised cost may therefore be relevant information for users.

The principles set out in chapter 2 allow for the disclosure of information relevant to the circumstances above in that they for 'alternative measurements where this information would be relevant'. Assessing the consequences of a change in operating objectives is one of the circumstances where this principle would apply.

c. Exposure to market conditions or other external factors

Reported items in primary financial statements and disclosures about unrecognised items, generally reflect how market conditions and other external factors affect the financial position and performance of the entity in the current and prior periods. To be able to forecast future cash flows, users need to understand the risks and exposures were such conditions to change, together with the amounts involved. Users need also to understand the extent of hedging activities, i.e. how the entity has changed its exposure to market conditions or other external factors, in implementing its risk management strategies.

Some risks may affect different transactions (e.g. interest rate volatility), so the analysis of how such risks affect the reported items should be made globally. Therefore, given the importance and pervasiveness of risks, users need information that is both concise and comprehensive.

The principles set out in chapter 2 and the explanations in this chapter, provide for the information that users need. Chapter 2 stipulates that the notes should provide 'information on risks that affect reported items'. This chapter calls for appropriate disaggregation of reported items to reflect 'sensitivity to different variables'. This indicator is necessary to arrive at useful level of disaggregation in the assessment of risk. Disclosure of information to understanding an item would lead to providing the appropriate narratives on risks. This chapter also calls for appropriate links to be made between items in the financial statements, in order to reveal the extent of hedging activities.

Based on this analysis we can conclude that the proposed content for the notes to financial statements together with the suggested disclosure strategy to be followed by standard setters or preparers, will provide relevant information on exposures to risk at the reporting date. No specific risk category is therefore necessary, risk being however a key consideration when considering each of the four (or five) categories discussed above.

d. Information on an entity's risk appetite

To respond to users' call for enhanced disclosures about risk management, risk exposures and remuneration, part of the regulatory regime in financial services has focused on information about risk appetite. Risk appetite is the amount of risk, on a broad level, that an entity is willing to accept in pursuit of profit. Information on risk appetite could be provided in conjunction with risk management information. Others consider that this information should instead be put in the context of the entity's business model to facilitate understanding of entities' risk-adjusted performances.

- 18 The search for more relevant and effective presentation of risk information raises placement issues. Not all are convinced that risk information can be meaningfully analysed into components and reported in various parts of the financial report. This group would suggest that risk information should be presented in one place to give a complete picture about the nature and extent of risks faced by an entity and how the potential impact of those risks on cash flows is being managed. For example, in Germany entities are required to prepare a risk report and note disclosures are cross-referenced to it in order to achieve compliance.
- 19 However, others question what is so special about risk that it requires a different approach from other financial information. For example, to forecast future cash flows of a business segment also requires other information distributed throughout the entire financial reporting, in addition to information on risk.
- 20 The development of the Disclosure Framework will therefore have to address this issue. This development should take into account the many initiatives currently being undertaken² to identify what comprehensive risk information capital markets need.

Stewardship

- 21 Paragraph 9 of IAS 1 states:

Financial statements also show the results of the management stewardship of the resources entrusted to it.

- 22 The definition of the notes includes stewardship as an integral part. Disclosures in the notes are provided to the users not just for making buy or sell decisions but also to evaluate the stewardship of management for the resources entrusted to it.
- 23 However, the definition of the purpose of the notes determines the content. While such information may help to assess stewardship, no information is included in the notes solely to achieve that purpose. For example, according to the definition, notes should not include management strategy, (it is neither an item recognised in the primary financial statement, nor an arrangement, claim against or right of the entity), whereas management strategy is needed as part of the stewardship objective.
- 24 Closely linked to the notion of stewardship are disclosures on related parties, which are considered in Appendix 1.

² For instance, the Eurofi working group and the Enhanced Disclosure Task Force are developing principles and case studies of risk disclosures by financial institutions. This study is to be included in a Financial Stability Board publication expected in October 2012.



Is disclosure in addition to primary statements always required to fulfil users' needs?

- 25 The standard setters need to assess when disclosures are necessary to fulfil the users' needs discussed above, assuming that users have a reasonable knowledge of business and familiarity with accounting standards. This assumption is consistent with paragraph QC32 of the Conceptual Framework.
- 26 In some cases, there is no need for disclosures to provide definitions of common terms. For instance, it should not be necessary to explain what 'amortised cost' is, to describe the nature of 'trade receivables' or to provide information on measurement uncertainty when an item is carried at cost.
- 27 It is therefore useful to include in the Disclosure Framework guidance for the standard setters about when disclosures are needed to fulfil the users' needs.
- 28 It may be argued that the fundamental qualitative characteristics of relevance and faithful representation are sufficient for this purpose. However, these qualitative characteristics may be too 'high level' to operate in practice as an appropriate filter.



When to require disclosure?

- 29 It is suggested that the Disclosure Framework should include indicators that assist the standard setters to assess when disclosures are needed. Triggering an indicator would suggest that users need more information about an item than that contained in the primary financial statements.
- 30 It is important to stress that this approach is not intended to be formulaic, and will require judgement by standard setters because:
 - a. the indicators are not intended to be prescriptive, but only to guide the standard setters in its assessment;
 - b. the indicators are meant to highlight if user needs are likely to need additional information about a line item. Even if an indicator suggests that is the case, standard setters will still have to decide the appropriate level of granularity (for instance, the indicators may suggest the need for information about measurement inputs, but standard setters will need to decide if entities should disclose some or all the relevant measurement inputs and the appropriate unit of account).

- 31 The following table illustrates possible indicators for each category of information introduced above. These indicators to assess relevance will be integrated in the next chapter by another set of indicators to assess materiality. Disclosures ultimately included in the financial statements will be the result of these two assessments:

Category of information representing users' needs	Proposed indicators	Content of the information
Aggregation / disaggregation of the line item.	The item includes components originated from different business activities.	Disaggregation and segment information.
	The item includes components with different characteristics, such as: <ul style="list-style-type: none"> • distinct measurement basis; • sensitivity to different variables; • different recovery/settlement; • different rights or obligations; • different seniority. 	
	A standard allows or requires offsetting assets and liabilities (or income and cost).	Information on gross amounts.
What the item is.	The caption is not sufficient to understand the nature of the underlying item.	Relevant terms and conditions for understanding the item.
	There are specific contractual terms and conditions important to understand the item.	
	There are financial enhancements and/or restrictions around the item.	

How the item fits into the entity's operation and financial structure.	The item arises from a transaction or group of transactions that impact items included in different captions.	Description.
	The information explains the entity's exposure to cash flows arising from unrecognised claims, rights and arrangements.	Nature of the exposure and possible amount, timing and uncertainty of potential cash flows.
	The item refers to the investing or financing activity of the entity.	Breakdown of the change of the balance over the period.
	The item is expected to be recovered (or settled) beyond the operating cycle of the activity.	
	Whether the measurement basis is at cost but the item can easily be traded on a market (1).	Alternative measures.
How the item has been accounted for.	A standard allows for alternative recognition or measurement.	Accounting policy and/or application guidance.
	A new standard has come into force.	
	A standard sets a high-level principle which needs articulation by the entity (2).	
	There is no specific guidance in the standards.	Accounting method.
	A standard does not indicate a specific measurement method.	
	The key measurement inputs are neither based on contract or Level-1 prices.	Key measurement input.
	A standard aggregates items usually measured or presented separately (3).	Information on aggregation objective and method.

NOTES

1 – The proposed indicators assume that the appropriate measurement attribute should always be based on the intended way to recover/settle. In those cases where this is not the case, the indicator could be amended as follows:

There is divergence between the measurement basis for the item and the entity's intended way to recover/settle.

These divergences are expected to occur rarely, for instance when the entity has decided changes in its operating objectives.

2- One typical example is revenue recognition where the application of the general principles (transfer of risks/rewards or measurement of stage of completion) often requires entities to develop their own detailed application guidance.

3- One aggregation for measurement purposes is the grouping of assets in a Cash Generating Unit for applying the requirements in IAS 36 *Impairment of Assets*. One aggregation for presentation purposes is the presentation of disposal groups in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.



How standard setters could set disclosures

- 32 This chapter has so far discussed improving and rationalising the process by which standard setters identify what information is to be provided in the notes. However, it could be argued that this is only part of the debate, and that real improvement may come only if the whole process of setting requirements is fundamentally re-assessed. The way in which standard setters set disclosures at the standards level may in fact influence the behaviours of preparers and other parties involved in the preparation and use of the information.
- 33 In many reporting regimes, disclosure requirements are included in each separate standard. Therefore, disclosure requirements are developed each time in relation to classes of items (for instance, financial instruments) or types of transactions (for instance, business combinations).
- 34 As a consequence, disclosure requirements in different standards have been developed on an *ad-hoc* basis, implying the lack of a unified and consistent approach. Disclosure requirements are also affected by the economic, business, and social conditions at the time when they were written.
- 35 There have been calls for new approaches to setting disclosure requirements, for instance it has been suggested that there should be a single, consistent disclosure set for all line items in the primary statements^{3,4}.
- 36 The tension around disclosures is due to different factors for instance, one tension is between providing entity-specific information and comparability. While information in notes is most useful the more it provides specific information about the entity, users also need to be able to compare entities. To have perfectly specific information, preparers should be allowed to choose freely which information they should provide; to have perfectly comparable information, all preparers should provide the same types of information.
- 37 Another tension exists between the cost of preparing information and the benefit of having it. For each new requirement, preparers are more likely to emphasise the incremental cost associated with it; while users are more likely to see it as potentially beneficial.
- 38 Different users may have different information requirements and trying to satisfy the needs of all these different users' groups may make the notes difficult to use. Some believe that there should be a focus on the needs of long term debt and equity holders.

³ Letter of the ITAC to the FASB, December 2007

⁴ Recommendation 1.2 of the report of the Advisory Committee on Improvements to Financial Reporting, August 2008.

What approach could standard setters take?

General principles

39 Regardless of the approach taken, there are some general principles in this Discussion Paper that standard setters should always apply:

- a. disclosure needs to be an objective distinct from other objectives within the Conceptual Framework, specifically from recognition, measurement and presentation;
- b. disclosure requirements should be developed and justified with the same level of depth and scrutiny as requirements for recognition and measurement;
- c. consistency in the way disclosure requirements are set is necessary, including in the level of granularity;
- d. disclosure requirements should be principle-based and detailed rules should be avoided;
- e. disclosure requirements must achieve the appropriate level of proportionality to the entity's users' needs and meet a reasonable cost-benefit trade-off in all circumstances. Alternative disclosure regimes may have to be put in place to achieve proportionality⁵;
- f. disclosure should not be used to compensate for inadequacies in recognition, measurement and presentation requirements; and
- g. it is necessary to consider the implications of recognition and measurement attributes on the disclosure requirements, so that, ultimately, the usefulness of information is assessed as a whole.

40 The following table and paragraphs illustrate different approaches that standard setters may take in relation to requiring information in the notes, and it is possible that different approaches could be combined. The spectrum runs from allowing considerable discretion to preparers, to allowing little, if any.

⁵ Differential regimes are discussed below in paragraph 63.

Table 1: Distribution of disclosure discretion between standard setters and preparers

What is disclosed depends upon preparer	General disclosure objectives	Industry level prescriptions	Single set of requirements	Detailed requirements
Preparers have complete discretion over the disclosure practices of their reporting entities.	Standard setters define general objectives but preparers decide what to disclose to meet objectives	Standard disclosure tailored to needs and characteristics of a specific industry.	A single set of requirements is provided for all items and transactions	Standards provide detailed requirements for each class of items and transactions.



Rely exclusively on preparers to provide relevant information

- 41 At the far left of the spectrum, standard setters would assign the responsibility for the judgement on what is relevant information entirely to preparers. This alternative is based on the premise that preparers are in the best position to assess what information is really relevant for their entity, and should be allowed to ‘tell the story’ as they see fit.
- 42 The lack of requirements would reduce the ‘checklist’ mentality. Preparers, but also auditors and regulators, would have to exercise their judgement and could not fall back on mechanical compliance with predetermined accounting rules.
- 43 In terms of cost, this approach may prove beneficial because preparers would be able to align their external reporting to the internal reporting, and streamline their reporting function.
- 44 However, it may prove to be more challenging for the parties involved. A list of requirements in a standard provides a commonly agreed starting point to develop the notes – if this is removed, preparers will have to stand ready to justify each inclusion and each omission to users, auditors and regulators. While the time to assemble the information may be shortened, the time needed to validate the appropriateness of the information may in the end increase.

- 45 Further, this approach could result in a significant reduction of comparability. However, it is reasonable to think that within each industry information would still be provided in a fairly consistent manner.
- 46 Finally, some may argue that there are incentives for management to omit or minimise ‘bad news’. This alternative could make it easier for management to omit unfavourable information.

Provide only disclosure objectives in each standard

- 47 An intermediate step between the above and the current regime of detailed requirements. is to include general disclosure objectives in each standard.
- 48 More recent IFRS (from IFRS 2 onward) include not only detailed requirements but also the general objective of disclosures at the beginning of the disclosure section. These disclosure objectives require for instance that disclosures explain the nature and extent of existing arrangements; or the financial effect of the transactions; or the nature and extent of risks associated with these assets and liabilities.
- 49 Being an intermediate solution, it has the advantage of granting flexibility to preparers (thus achieving the objective of providing entity-specific of information), while at the same time it sets a common frame for the type of information that preparers need to consider and provide.
- 50 Setting an objective instead of a list of requirements can be a way to give full responsibility to the preparer to satisfy the information needs of the users. Preparers that do not provide relevant information would not be able to excuse themselves by saying that they have formally complied with the requirements.
- 51 However, it may be argued that this approach works only if the objectives are sufficiently precise and useable in practice. If the disclosure objectives are generic and vague, this alternative would practically be the same as the first alternative (i.e., no requirements at all).
- 52 The IASB concluded that overall objectives are useful but need to be accompanied by specific requirements. For instance, paragraph 420 of the Basis of Conclusion of IFRS 3 Business Combinations states that:

...both Boards concluded, as the IASB did in developing IFRS 3, that it is not necessary (or possible) to identify all of the specific information that may be necessary to meet those objectives for all business combinations. Rather, the revised standards specify particular disclosures that are generally required to meet those objectives, and require acquirers to disclose any additional information about the circumstances surrounding a particular business combination that they consider necessary to meet those objectives.

In other words, the objectives seem to work as a “catch-all” provision rather than being specific.

Develop industry-based disclosure requirements

- 53 A third approach is to develop detailed requirements at the industry level, rather than by item/transaction. The same information can be of greater or lesser importance in different industries; this is confirmed by the fact that preparers and users have historically developed specific metrics or Key Performance Indicators for different industries. For instance, Research and Development expenses are crucial in the pharmaceutical industry because the main driver for future revenues and cash flows is the ability to develop new compounds.
- 54 However, this would only work effectively if there was a generally accepted taxonomy of industries. Also, it introduces a significant degree of complexity.

Develop a single, common set of requirements

- 55 A fourth approach involves developing a single set of requirements to be applied to every line item. A logical implication of this alternative would be to group all requirements in a single Disclosure Standard (although this is not essential; the core point is to have a common set for all classes of items and types of transactions). Making the same requirements applicable to every line item would:
- ensure the same degree of quality of information for all items and transactions;
 - simplify the requirements, and make them more stable over time;
 - facilitate the revision of disclosures when standard setters identify new information needs, because it would be sufficient to amend the Disclosure Standard instead of reviewing each standard separately; and
 - provide entities with guidance on disclosure even for those items and transactions for which no accounting standard currently exists.
- 56 However, this approach assumes that certain pieces of information are always relevant, irrespective of the characteristics of the underlying asset. In this approach, the only real filter operates at the entity level, and not at the standard level.
- 57 It could be argued that the same disclosures are not appropriate for all items or transactions. Is it true that users need the same information about monetary as well as about non-monetary items? Or about current and non-current items? Is information on measurement uncertainty as important for items carried at fair value as for those carried at amortised cost? If this is not the case, then it is not appropriate to mandate the same requirements for all items and transactions.

58 A variant to this approach could be to have the standard setter assess for each type of asset, and liability or transaction, whether the disclosure standard provides all and only the relevant, information. Furthermore, the standard setter could amend or specify, at standard level, the general disclosure requirements. The general disclosure standard could also identify disclosures which would be relevant in certain circumstances (revaluation for example) and not in others.

Develop distinct disclosure requirements in each standard

59 At the right end of the spectrum is the current regime, under which detailed requirements are developed for each accounting standard. A greater emphasis must be placed on the level of granularity when the standard setters write detailed requirements rather than general objectives.

60 The report from ICAS and NZICA *Losing the excess baggage*⁶, proposes that requirements could be written in a less granular way. For instance, the following table compares some of the disclosure requirements as they are in IFRS 2 and how they are re-formulated in the report:

Original wording	Proposed revised wording
<p>If the entity has measured the fair value of goods or services received as consideration for equity instruments of the entity indirectly, by reference to the fair value of the equity instruments granted, to give effect to the principle in paragraph 46, the entity shall disclose at least the following:</p> <p>(a) for share options granted during the period, the weighted average fair value of those options at the measurement date and information on how that fair value was measured, including:</p> <p>(i) the option pricing model used and the inputs to that model, including the weighted average share price, exercise price, expected volatility, option life, expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of expected early exercise;</p>	<p><i>If the entity has measured the fair value of goods or services received as consideration for equity instruments of the entity indirectly, by reference to the fair value of the equity instruments granted, to give effect to the principle in paragraph 46, the entity shall disclose at least the following:</i></p> <p><i>(a) for equity instruments granted during the period, the weighted average fair value of those options at the measurement date and information on how that fair value was measured, including the valuation techniques and inputs used.</i></p> <p><i>(b) for share-based payment arrangements that were modified during the period:</i></p> <p><i>(i) an explanation of those modifications;</i></p> <p><i>(ii) the incremental fair value granted (as a result of those modifications); and</i></p>

⁶ The report *Losing the excess baggage* is available at <http://icas.org.uk/excessbaggage/>

(ii) how expected volatility was determined, including an explanation of the extent to which expected volatility was based on historical volatility; and

(iii) whether and how any other features of the option grant were incorporated into the measurement of fair value, such as a market condition.

(b) for other equity instruments granted during the period (i.e. other than share options), the number and weighted average fair value of those equity instruments at the measurement date, and information on how that fair value was measured, including:

(i) if fair value was not measured on the basis of an observable market price, how it was determined;

(ii) whether and how expected dividends were incorporated into the measurement of fair value; and

(iii) whether and how any other features of the equity instruments granted were incorporated into the measurement of fair value.

(c) for share-based payment arrangements that were modified during the period:

(i) an explanation of those modifications;

(ii) the incremental fair value granted (as a result of those modifications); and

(iii) information on how the incremental fair value granted was measured, consistently with the requirements set out in (a) and (b) above, where applicable.

(iii) information on how the incremental fair value granted was measured, consistently with the requirements set out in (a) where applicable.

- 61 It could be argued that this change is more about the style of requirements than their substance, and that the articulation on the right side is a more concise way of expressing the same requirements. However, the style in which the requirements are written impacts behaviours.

Differential disclosure regimes

- 62 Some would argue that unless differential disclosure regimes are introduced, standard setters would fail to set disclosure requirements that would be proportional to the entity's users' needs and meet a reasonable cost-benefit balance in all circumstances. A different perspective in standard setting would therefore permit or require differential disclosure regimes.
- 63 One way to apply a differential disclosure regime is to set different levels of requirements for each standard. There would be a minimum set of requirements (assuming the item was material to the entity) and each preparer would add more layers of information based on the relative importance of the item in the context of its own financial statements. However, some believe that such an approach could lead to assessing different 'materialities' or at least different levels of materiality. Making the distinction between 'material' and 'immaterial' items can already be challenging; adding several levels of materiality increases complexity. Under this regime, the differentiation is based on the relative importance of the item for the entity.
- 64 It is also possible to express it differently. The differentiation could be based on the type of financial statements being prepared (individual versus consolidated financial statements or interim and year-end financial statements), the size of the reporting entity, the industry of the entity or the public accountability of the entity applying IFRS. This latter approach was adopted by the Australian AASB, which permits entities applying IFRS that are not publicly accountable to apply a reduced disclosure regime.
- 65 The UK FRC is also implementing a reduced disclosure framework which provides exemptions from certain disclosure requirements in IFRS for qualifying subsidiaries and parent entities as well as introducing a differential disclosure regime for financial institutions.
- 66 Similar concepts have been highlighted in recent projects. The ANC, after due consultation, has proposed a reduced disclosure regime for 'small listed companies'⁷, arguing that the application of IFRS requirements is often burdensome for 'small listed companies'. The ANC proposal suggests eliminating a series of disclosure requirements considered superfluous for 'small listed companies' and proposing a model of simplified notes to the financial statements, designed to provide the minimum expected information. The benefit of this proposal, in the ANC's view, is to alleviate current disclosure requirements assessed as having been developed principally with large listed companies in mind, resulting in a cost-benefit balance no longer being achieved. This approach is not without precedents in standard setting as, for example, some requirements apply only to entities in specific businesses or to the entities over a specific size⁸.

⁷ *Simplify accounting obligations for "small listed companies"* in Europe, October 2011.

⁸ For example, on September 15, 2010 the SEC issued a rule that permanently exempts registrants that are neither accelerated nor large accelerated filers from Section 404(b) internal control audit requirement.

- 67 The challenge of differential disclosure regimes, were they to be generally applied, is in identifying suitable differentiating criteria and fulfilling users' needs in different circumstances. Some believe that such an approach could only lead to arbitrariness and a lack of proper fulfilment of users' needs. They are hence led to believe that proper application of the materiality principle is the only possible route to meeting users' needs from a capital market perspective. For example, the IFRS Advisory Council in its meeting in February 2012 recommended that solutions to the disclosure overload should be sought that would apply to all reporting entities using IFRSs⁹. In other words, the application of 'materiality of information' criteria, illustrated later in this Discussion Paper, could result in a similar outcome.
- 68 However, the application of the materiality principle is not working as it should be. Therefore, some believe that standard setters could achieve proportionality by developing differential disclosure regimes. Such initiatives on differential disclosure regimes acknowledge that users' needs are different according to the type of entity or type of accounts being prepared under IFRS.
- 69 The advantage of differential disclosure regimes is that they allow flexibility, i.e. reflecting different users' needs and achieving a reasonable cost-benefit balance in different circumstances, without relying on a separate assessment of materiality for each item of information. In addition, determining whether entities meet defined criteria to apply one or another set of disclosures may be easier. Those who support this approach believe that a significant reduction in disclosure overload will not be achieved otherwise, and that reliance on the materiality principle alone will be insufficiently effective.

A comprehensive perspective

- 70 Regardless of the approach, standard setters should assess the need for each disclosure requirement in the context of the full set of accounting standards. It would be useful to develop a mapping mechanism of existing disclosures, so that in new projects, disclosure requirements that potentially duplicate information already available are eliminated from the start.
- 71 For the same reason, standard setters should apply the principles in the Disclosure Framework when developing new requirements but also when reviewing existing requirements at regular intervals.
- 72 So in relation to their evolution over time, disclosures requirements should be set as to avoid any possible overlap within notes and reviewed over time to eliminate disclosures that are no longer relevant.

⁹ IFRS Advisory Council June 2012 meeting - Agenda Paper 3- Summary of the disclosure discussions at the February 2012 Council meeting.

Setting the requirements – highlights on relevance

- 73** Disclosure requirements should be set as to provide a relevant description of items presented in the primary financial statements and unrecognised arrangements, rights and claims at the balance sheet date.
- 74** Relevant description includes:
- a. disaggregation at a level that enables the key components of the primary financial statements to be understood;
 - b. a description of the nature of the item;
 - c. an explanation about how the item fits into an entity's operation and financial structure; and
 - d. information that explains how an item has been accounted for.

Chapter Four: Applying the requirements - materiality

This chapter considers the application of requirements in preparing financial statements. It is a key element of a Disclosure Framework that preparers identify what is relevant information in their specific context, so that only material information is included in the notes. Although materiality is not a new concept, attention is usually given to its application to recognised amounts. Also, often in practice the focus is rather on including material information, than excluding immaterial information. Materiality is essentially a matter of judgement; however, this chapter develops suggestions on how to improve its application to disclosures.

Introduction

- 1 As explained in chapter 2, standard setters make generalisations about the information needed for decision-making, but it is preparers that ultimately decide what information is relevant in the context of their own specific financial statements.
- 2 More frequently, preparers will have to decide if disclosure requirements in the standards are material for the entity. Less frequently, preparers will also have to consider if they need to provide information beyond that required to meet the users' needs.
- 3 An effective application of materiality depends also from on audit firms, regulatory agencies, and legal advisors, all of which can significantly influence the decisions of preparers. It has been suggested that auditors and regulators using disclosure checklists in a mechanical manner has been a significant factor in causing unnecessary disclosure volume. Often, an entity will find it more expedient and less risky to comply with a requirement rather than trying to argue about its immateriality. Legal advisors may also advise entities to add disclosures as a way to minimise the risk of non-compliance, even when information could be deemed immaterial.
- 4 In paragraph QC11 of the Conceptual Framework, materiality is defined as follows:

Information is material if omitting it or misstating it could influence decisions that users make based on 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

- 5 Under the revised Conceptual Framework, 'materiality' is discussed as a entity-specific aspect of the relevance concept. This is important to bear in mind when shifting the focus away from assessing materiality based on various 'thresholds' to establishing what constitutes relevant information about the entity. It therefore calls forward the same discipline and considerations that standard setters need to apply in setting requirements.

- 6 Sometimes, the word ‘material’ is interpreted as only involving the absolute or relative size of an amount. However, materiality depends on both quantitative and qualitative factors; a line item or information may be material by nature or by size. This is especially true for disclosures that often include verbal description as well as numerical descriptions and may even be only qualitative. Basing the assessment of materiality only on the amounts involved is generally not appropriate for disclosures.
- 7 Traditionally, the focus on materiality is to ensure that entities do not omit material information. However, the same attention should also be given to ensure that immaterial information is excluded. Immaterial disclosures may obscure relevant information and therefore hinder understandability. When selecting suitable information to inform their decision making, users have to filter out information from the mass available in the financial report. If, therefore, preparers add more ‘noise’ to the environment, all they do is increase the users’ difficulty in filtering out what is important, which in turn results in reduced, not increased, effectiveness.
- 8 This concept was expressed in paragraph 3.29 of the 1999 ASB Statement of Principles for Financial Reporting:

Materiality is...a threshold quality....when immaterial information is disclosed in the notes, the resulting clutter can impair the understandability of the other information provided. In such circumstances, the immaterial information will need to be excluded.

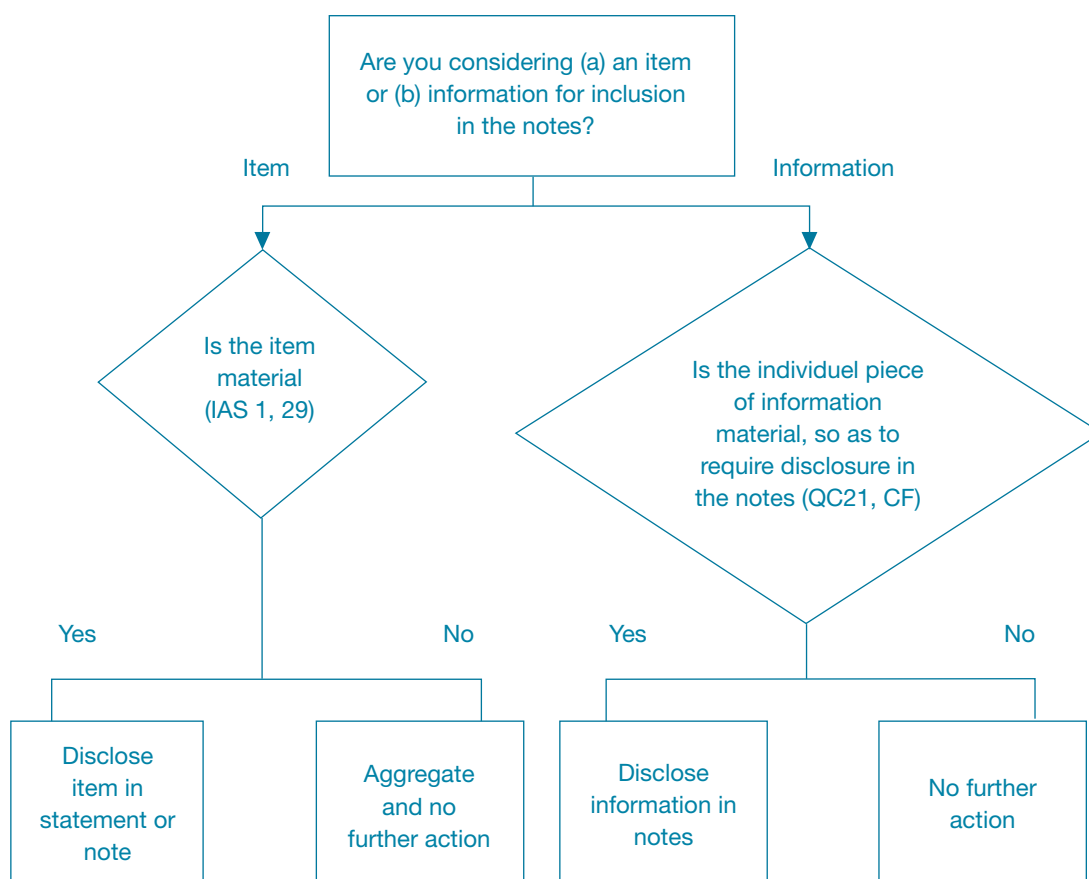
- 9 Some have suggested that the Disclosure Framework should contain an explicit prohibition against providing immaterial information. However, such a prohibition could be difficult to enforce.

Materiality in IFRS

- 10 The Conceptual Framework does not specify how to apply materiality to the notes. IAS 1 paragraph 31 states that an entity does not need to provide a specific disclosure required by an IFRS if the information is not material. So, an entity would be allowed to disclose immaterial information.
- 11 Paragraph 30 of IAS 1 also indicates that an item that is not sufficiently material to warrant separate presentation in the primary financial statements may warrant separate presentation in the notes. Therefore, a disclosure may be material, although related to an individually immaterial item.

Materiality of information and materiality of the item

- 12 One aspect concerning materiality for disclosures is whether there should be a separate assessment of (i) the materiality of an item and (ii) the materiality of each piece of information about a material item. For example: if an entity has a material pension liability, does it automatically imply that all the related disclosure requirements about that liability are material? Or should each of them be assessed separately? The *Losing the excess baggage report* replies in the negative and illustrates this debate with the following diagram:

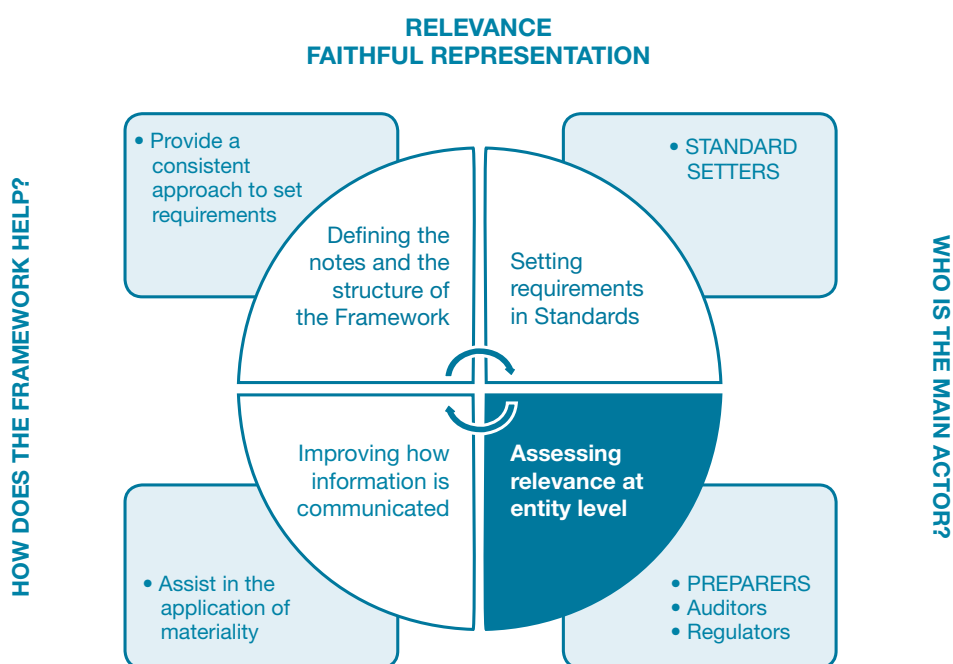


General objective of applying materiality

- 13 Care should be taken in applying the materiality principle in practice, bearing in mind that disclosing immaterial information (and information on situations that do not apply in practice to the reporting entity) reduces the relevance and the understandability of disclosures.

Should the Disclosure Framework include guidance on materiality?

Overview of the Framework



- 14 Materiality is an entity-specific concept, which means that its application may result in different outcomes. Assessing materiality inevitably requires the exercise of professional judgement. However, we believe that this does not rule out the possibility of developing some guidance to assist preparers and other parties make this assessment.
- 15 Some disagree, arguing that there are too many scenarios, facts and circumstances that can influence the assessment and no guidance can be comprehensive. There is also a danger that any guidance is interpreted as a checklist.
- 16 Others think that the lack of guidance in how to apply materiality makes it more difficult for entities to resist external pressure to comply with all requirements in the standards.
- 17 The accounting literature is thin on application of materiality. The ideas and proposals in this chapter aim at advancing the debate.



Continual assessment of materiality

- 18 After a new disclosure is introduced in the notes, there is a tendency for it to be carried forward in following years. 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. Further, users need some continuity of information between reporting periods. On the other hand, including immaterial information lowers the quality of the notes.
- 19 IAS 1 requires entities to provide one year of comparative information. For consistency, it is suggested in this Discussion Paper that the assessment of materiality should usually cover this same period.
- 20 Materiality should not be assessed only with 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.



Guidance on the assessment of materiality

- 21 The Discussion Paper suggests that a Disclosure Framework includes indicators to assist preparers and other parties to assessing when compliance with disclosure requirements set in standards would result in material information.
- 22 The following table illustrates possible indicators to assist preparers and other parties to assess the materiality of the disclosures at the entity level of the specific entity.
- 23 The indicators are consistent with those proposed in chapter 3 to assist in the assessment of relevance. This consistency is highlighted in the following table, that shows the association between the indicators for relevance proposed in chapter 3 and the indicators for materiality:

Relevant information indicators (discussed in chapter 3)	Materiality indicators	Content of the information
The item includes components originated from different business activities.	Does the item include individually material components? See paragraphs 25 to 28 below for a more detailed discussion on disaggregation by maturity.	Disaggregation and segment information.
The item includes components with different characteristics, such as: <ul style="list-style-type: none"> • distinct measurement basis; • sensitivity to different variables; • different recovery/settlement; • different rights or obligations; • different seniority. 		
A standard allows or requires offsetting assets and liabilities (or income and cost).	Is any of the gross amount offset material? and Is there any significant risk of impairment of the asset that has been offset, or significant credit risk of the counterparty?	Information on gross amounts.
The caption is not sufficient to understand the nature of the underlying item.	Is the related item material? and Are the characteristics of the item, its terms or conditions unusual?	Relevant terms and conditions for understanding the item.
There are specific contractual terms and conditions important to understand the item.		
The item has credit risk enhancements attached.		
There are restrictions around the use of the asset.		
The information relates to a transaction or group of transactions that impact items included in different captions.	Did the linkage affect the accounting treatment of the item? and Is any of the linked items material?	Description of the transaction and how it links different items.

The information explains the entity's exposure to cash flows arising from unrecognised claims, rights and arrangements.	See below paragraphs 29 to 38 below.	Nature of the exposure and possible amount, timing and uncertainty of potential cash flows.
The item refers to the investing or financing activity of the entity.	See paragraphs 39 to 41 below.	Breakdown of the change of the balance over the period.
The item is expected to be recovered(or settled) beyond the operating cycle of the entity.		
The measurement basis is at cost but the item can easily be traded on a market.	Is the related item material? and Are the alternative measures materially different?	Alternative measures.
A standard allows for alternative recognition or measurement.	Is the related item material?	Accounting policy and/or application guidance.
A new standard came into force.		
A standard sets high-level principles without providing details.		
There is no specific guidance in the standards.		
A standard does not indicate a specific measurement method.	Is the related item material? or Is the method uncommon or different from generally accepted methods?	Accounting method.
The key measurement inputs are neither based on contract nor Level-1 prices.	Would a reasonably possible change of the key input have a material impact?	Key measurement input.
A standard aggregates items usually measured or presented separately.		Information on aggregation objective and method.

- 24 With reference to some types of information (e.g. maturity analysis, information on unrecognised items and reconciliation) alternative indicators offered different advantages and disadvantages. Paragraphs 25 to 41 below discuss the rationale around each of the alternatives.

Assessing materiality – maturity analysis

- 25 It should be noted that IFRS 7 requires a maturity analysis in the context of liquidity risk, but not in the context of credit risk. To illustrate the discussion, the analysis focuses only on maturity analysis of liabilities.
- 26 The discussion on assessing the materiality of a maturity analysis for liabilities should address two questions:
- a. is that information material only in the presence of a risk condition? and if so
 - b. how to assess if a risk exists.
- 27 Two possible views have been considered. The first view is based on the assumption that users need a maturity analysis to understand the timing of future cash flows. In that case, the maturity analysis is needed even if the entity has no liquidity risk. Therefore, a liquidity analysis would be material in relation to material assets or liabilities.
- 28 The second view is based on the assumption that a maturity analysis is needed only when an entity has a material liquidity risk. Under this view, preparers would have to identify if liquidity risk was material, and if it was, provide the necessary disclosures.

Assessing materiality - exposure to cash flows arising from unrecognised items

- 29 When discussing the application of materiality of information on exposure to unrecognised items, it may be useful to discuss separately two types of items:
- a. Type 1 items - items arising out of arrangements, claims and rights that were not recognised because they did not meet the definition of an asset or liability; and
 - b. Type 2 items - firm commitments and executory contracts, that exist at the reporting date and have not been recognised.
- 30 Recognition uncertainty surrounds type 1 items, so information on them is useful not only for its predictive value but also to understand why the item was not recognised.
- 31 One approach is to consider the amount at which the entity would have measured the item if recognised. However, not all items have a binary nature (that is, an item with an outcome that is either nil or a fixed amount). These items may instead expose an entity to a range of outcomes that are not all material. The information to be disclosed should take into consideration the full range of possible outcomes.

- 32 Therefore, when preparers assess whether to comply with requirements to disclose information on type 1 unrecognised items, they would be expected to consider:
- a. if the entity did not recognise the item because the measurement was not reliable; or
 - b. if the item would have been recognised, had it been a material amount (for items with multiple outcomes, the preparers consider the range of all possible outcomes).
- 33 For type 2 items, the simplest approach is to consider the materiality of contractual amounts (in absolute terms). This would imply that any firm commitment that is quantitatively material would likely be disclosed. This approach would capture transactions currently not disclosed – such as, commitments for salaries of employees under contract.
- 34 The rationale behind this approach is that users need information on items that can materially affect future cash flows. However, requiring disclosure of all material commitments at the reporting date does still not provide a comprehensive picture of future cash flows.
- 35 Therefore, it seems appropriate to propose some other conditions to guide the preparers' assessment. To do that, there are two alternatives:
- a. the first is to consider if the unrecognised item is likely to affect significantly the trend of an item in the primary financial statements (in relation to current and past periods); or
 - b. the second is to consider if a transaction has a recurring or non-recurring nature which makes it less predictable.
- 36 Under the first alternative, the less a user can make predictions based on historical data, the more information on commitments is likely to be material. However, this is not easy to assess, because other events can amplify or offset the impact of a transaction on the trend. Assume that an entity that sold 100 airplanes in the prior year, has already signed at year-end an enforceable contract with a new client to deliver 10 planes in the subsequent period. At the same time, the entity expects that some clients from the current year will not buy planes in the following year. Although the transaction is individually material, the overall trend may not show a significant change.
- 37 Under the second alternative, an entity would look at both the size of the contractual amount and at whether the transaction is unpredictable by its nature. Commitments for sales of regular goods or services would often not qualify, while commitments for material capital investments and disposals more often would. This alternative seems more consistent with current IFRS requirements that mandate disclosure of capital commitments, but not for service or sales arrangements.

- 38 Based on the above, the assessment of materiality of information about exposure from type 2 unrecognised items could be based on the following:
- a. does the magnitude of the item makes it unpredictable and affect significantly predictions based on the past knowledge of the entity (first alternative)?; or
 - b. is the potential amount involved material to the entity and the underlying event infrequent (second alternative)?

Assessing materiality – changes in a balance over the period

- 39 An assessment of materiality of information about changes in a balance over the period could be based on the following:
- a. is the balance at the reporting date, or the change between opening and closing balances, material to the entity?; and
 - b. was the change in the balance affected by either
 - i. quantitatively material items that are non-recurring in nature (such as a curtailment or an impairment)?; or
 - ii. items that are recurring in nature (such as pension service cost or amortisation/ depreciation) and have unusual magnitude?

Following (b.ii) above would imply determining an additional threshold (‘unusual magnitude’) for items that are recurring in nature. This requirement adds complexity.

- 40 Following (a) above implies taking into consideration both the size of the balance and the change over the period.
- 41 The following is an illustration of the proposals:

SCENARIO	A	B	C
Opening balance	3,500.0	3,500.0	3,500.0
Acquisitions	400.0	3,000.0	400.0
Depreciation	(500.0)	(900.0)	(500.0)
Impairment	(800.0)	-	(200.0)
Forex differences	100.0	100.0	100.0
Closing balance	2,700.0	5,700.0	3,300.0

Assume that the entity has determined a quantitative materiality threshold of 400 for items of property, plant and equipment.

In scenario A, the entity likely concludes that the roll-forward is material, because the final balance is material and there was a material amount non-recurring in nature (impairment).

In scenario B, the entity likely concludes that the roll-forward is material because the final balance is material and there was a recurring event (acquisitions) of an unusual magnitude.

In scenario C, the entity may conclude that it does not disclose the roll-forward. There was a non-recurring event but for an amount below materiality; and although the acquisitions reach the materiality threshold, they were not unusual in magnitude.

Applying the requirements – highlights on materiality

- 42 Disclosures are not required if information is immaterial.
- 43 Disclosures are not required for every line item presented in the primary financial statements unless the information would be material.

Chapter Five: Applying the requirements - communication

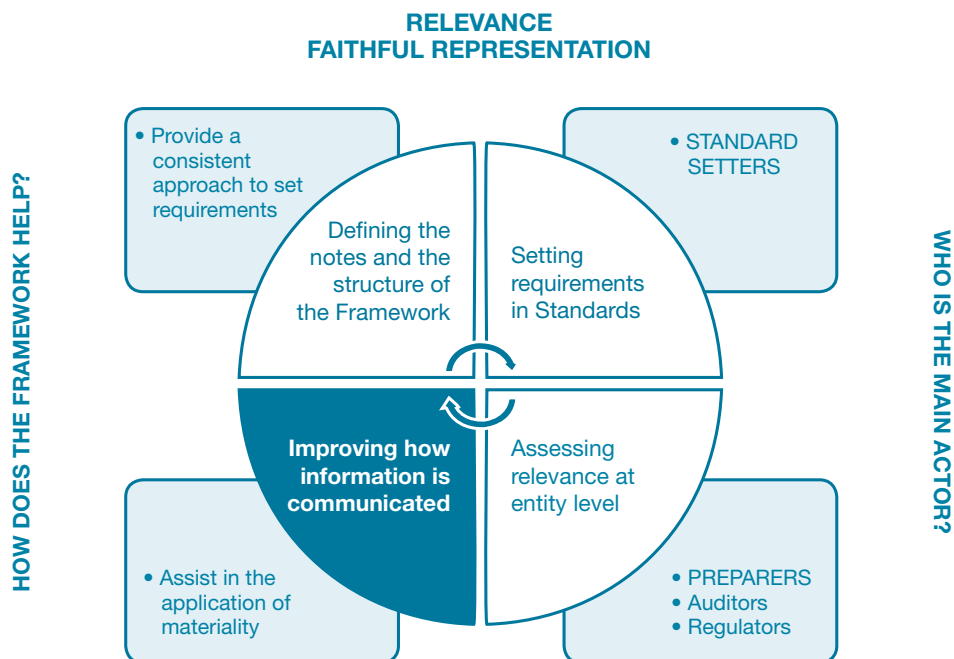
Financial statements are aimed at communicating financial information to users. While the content of the notes is of utmost importance to achieve relevance and faithful representation, poor communication hinders the quality of information, especially within lengthy reports. Chapter 5 includes a number of principles and suggestions to improve the way in which information in the notes is organised and communicated. New developments in technology may help users in navigating the information but preparers still need to ensure its clarity and understandability.

Introduction

- 1 Disclosures in the financial statements should be a tool for communicating information to users, but sometimes this is overlooked when greater emphasis is placed on compliance. Communication principles in the Disclosure Framework could improve the quality of disclosures.
- 2 The primary responsibility for communication falls to the preparer and it is important that the notes form part of telling the 'story' of an entity's financial performance and position. It is, therefore, difficult to establish anything other than high-level generic principles that can be used when presenting information in the notes.
- 3 Standard setters can assist by providing guidance to highlight areas or ways in which the presentation and form of disclosures can be enhanced to facilitate better communication.
- 4 Auditors and regulators can also facilitate good communication by placing less emphasis on black letter 'compliance' and more on the overall quality of information. Auditors often use checklists or produce templates for financial statements, which can move the focus away from communication. Some regulators support strict compliance at the lowest level of granularity which can obscure the key messages being conveyed in the financial statements.

Communication principles

Overview of the Framework



- 5 Some of the qualitative characteristics of financial information in the Conceptual Framework (relevance, faithful representation and understandability) are useful as a basis for developing the communication principles for the Disclosure Framework.
- 6 However, the qualitative characteristics alone are not sufficient in driving improvements in the quality of disclosures and more specific principles are required. Whilst in some respects some of these principles may appear to be ‘common sense’ recent studies have highlighted that there are some quite basic features that are lacking in how information is presented in the notes (and in other parts of the financial report).
- 7 The communication principles were developed from the premise that disclosure requirements should be applied with a view to communicating information to users rather than a compliance exercise.

Disclosures should be entity-specific

- 8 One of the issues is that the notes to the financial statements are often prepared from a template based on the requirements in the standards. The result is ‘boilerplate’ disclosures, which are not fully specific to the entity. Disclosures should be included only if they provide information that is relevant to the entity.
- 9 For example, if an entity is required to disclose judgements and assumptions made, the entity should not merely say that ‘the amount reported includes judgements and assumptions’. Rather, it should explain the nature of the judgements and assumptions, and how these originate from the way the entity operates.
- 10 Entities should assess each disclosure for its relevance to the entity and tailor it as appropriate to meet user’s needs.

Disclosures should be current

- 11 Entities often roll forward disclosures from the prior period into the current reporting period and future reporting periods, although they may no longer be useful.
- 12 Instead, entities should ensure that disclosures are relevant to the current reporting period. Descriptions of events and transactions from prior periods should be carried forward only if they are needed to understand the performance in the reporting period, or the position at the reporting date.

Disclosures should inform and explain the substance of the transaction, going beyond the requirements if necessary

- 13 Disclosures in the notes are often provided on a checklist basis so although a particular disclosure may formally meet the requirement of a particular standard, it may not adequately explain the substance of a transaction or series of transactions or other events and conditions.
- 14 Information provided should enable users to understand the economic substance of what has taken place to enable them to assess the likely cash flow implications and form a view on how well management have safeguarded the entity’s resources.

Disclosures should be organised

- 15 Notes generally do not present information in order of priority. This may make it more difficult for the reader to identify information on events or transactions that have most significantly affected the performance of the entity during the period or its financial position.
- 16 Disclosures should give prominence to key items that have affected the financial performance or position of the entity, or may do so in the future. Paragraphs 34 to 39 discuss further the prioritisation of information.

Disclosures should be clear, balanced, concise and written in plain language

- 17 Disclosures are often written or presented in a style that makes them difficult to read and understand. Therefore, they fail to provide an adequate explanation of the subject matter.
- 18 There are a number of ways to improve matters. For instance, the use of a glossary is encouraged where industry-specific or specialised accounting terms are used.
- 19 In certain circumstances, it may be appropriate to use tables or graphical presentations to communicate key points, rather than relying solely on text to convey information. Entities should make an effort to provide important content in an effective and concise manner.
- 20 Highlighting information in a note that is substantially different from past years, could help users focus on points that they might otherwise overlook or at least not find easily. There are a number of ways in which entities could highlight items. One way would be to use different text styles or font sizes.

Disclosures should be linked

- 21 The disclosures in the notes often seem disconnected and it is often difficult to see the relationships between items.
- 22 Entities should link disclosures to the nature of their activity.
- 23 There should be a clear link between amounts in the primary statements and the notes.
- 24 Cross-references from the primary financial statements line items to notes can be very useful because they act as a partial table of contents. Cross-references from one note to another can also improve readability and save time.
- 25 Grouping information could be helpful when different related information must be considered together to understand the impact of an event or transaction. Ways to group information are discussed below in paragraph 38.

Organisation of information

- 26 This project provides an opportunity to consider whether disclosures can be better organised. For this Discussion Paper, organisation deals with the structure and order of information in the notes.
- 27 There are two approaches to organising information in the notes – standardisation on one hand and a flexible approach on the other.
- 28 Standardisation has the benefit of consistency whereas a flexible approach may be better at telling a company's story.

Standardisation – current approach

29 The current approach is that note disclosures are typically presented with the accounting policies first, followed by notes that relate to the primary financial statements (usually in the order in which those statements are presented), with the other notes (such as those relating to items not recognised) shown at the end. Often, disclosures relating to standards that are more recent are in the back of the document.

30 The current approach seems to be driven by paragraph 113 of IAS 1 which states:

An entity shall, as far as practicable, present notes in a systematic manner...

31 Paragraph 114 of IAS 1 then sets out the order in which notes may be presented: “An entity normally presents notes in the following order, to assist users to understand the financial statements and to compare them with financial statements of other entities:

- a. statement of compliance with IFRSs;
- b. summary of significant accounting policies;
- c. supporting information for items presented in the statements of financial position and of comprehensive income, in the separate income statement (if presented), and in the statements of changes in equity and cash flows, in the order in which each statement and each line item is presented; and
- d. other disclosures, including:
 - i. contingent liabilities and unrecognised contractual commitments, and
 - ii. non-financial disclosures, e.g. the entity’s financial risk management objectives and policies.

32 However, paragraph 115 of IAS 1 then says that ‘In some circumstances, it may be necessary or desirable to vary the order of specific items within the notes’.

33 The current approach has the benefit that there is generally consistency in the order of presentation of notes between entities. On the other hand, notes about significant information, may be buried at the back of the notes section. Alternative approaches to organising information in the notes are considered below.

Flexible approach - prioritising disclosures

- 34 There are many alternative ways in which the notes can be presented. One way of arranging disclosures in the notes would be to include them in order of priority with the most significant information included first. Currently accounting policies (which often repeat parts of accounting standards) are included as note 1. Prioritising information has the benefit of signposting users to read the important information first, if they read the notes front to back.
- 35 Prioritisation requires the management to make an assessment of what will be of most importance to users. As part of the development of this Discussion Paper, disclosures contained in preliminary announcements were reviewed as a mechanism for identifying the most important needs of users. On this basis, the research revealed that the most important note disclosures for users were: segmental information, tax, dividends, EPS, business combinations, and pensions. Very few accounting policies were disclosed.
- 36 As a downside, prioritising information is time consuming: preparers would need to re-organise the order of the notes each year, including renumbering and changing cross references. Also, the priority chosen by the management could be challenged by auditors and regulators.
- 37 The extent of judgement could be reduced by the introduction of principles or rules for prioritising information; for example, IAS 34 Interim Financial Reporting includes a list of the minimum content in the notes which include unusual items, dividends, segments, post balance sheet information and changes in composition of the entity.

Grouping information

- 38 Another approach to arranging the notes is to group information with similar characteristics. For example, some investors believe that it would be better to group information relating to risks in one place.
- 39 There are different ways to achieve this: (i) by grouping similar notes together or (ii) by grouping of information within notes. Some entities for instance group information within the notes so each note contains the accounting policy relating to the line item, disaggregation of the line item and an explanation of the key movements during the year.

Display of information in the notes

- 40 The manner in which information is presented in the notes may impact the importance attributed to it by users. That is, it may be difficult to get a sense of the importance of a disclosure from how entities currently present it in the notes.
- 41 As an example, the share based payment note may extend to a number of pages, yet the share based payment charge may be relatively small by comparison. A user may be misled into thinking that share based payments may be more significant given the amount of information that is provided.

Developments in financial reporting

- 42 When considering the organisation of information in the notes, it was recognised that there are current developments in financial reporting which may affect the way in which information is organised and in some respects shifts the focus of the debate.

Technology

- 43 More people are using online annual reports (including the financial statements) and perhaps using printed annual reports less. The online platform allows users to navigate disclosures more easily using HTML formats or using the search function in PDF documents. In such an environment, the organisation of disclosures may be less important as users dip in and out of the annual report to find information that they need, rather than by reading it from front to back.
- 44 In particular, XBRL will influence communication of financial information, rather than changing the content of disclosures (as this will depend on the data input by preparers). Application of an XBRL taxonomy and creation of an XBRL file representing an entity's financial statements also is a mechanism whereby the preparers assess their disclosure choices relative to the IFRS taxonomy and checklists, the consistency and linkages between the disclosures it makes. XBRL could be a feedback mechanism (or even enforcement) to monitor the application and utilisation of disclosure requirements. standard setters could then use information gained from such feedback in conjunction with the Disclosure Framework to eliminate, amend or create new disclosures.
- 45 Financial statements tagged with XBRL are interactive. It creates a different way of viewing financial statements, moving away from a sequential series of financial and non-financial presentations to a pool of data that can be analysed across entities and periods whilst maintaining original context and meaning.
- 46 However, XBRL requires the user to know which data to extract; XBRL is powerful tool but is not the fix to the communication issue. So the communication principles previously spelled out in this chapter will remain relevant.
- 47 Another issue related to the use of technology is whether entities should have standing information (such as accounting policies) available on an entity's website rather than reported directly in the financial statements. This was one of the recommendations in the UK FRC's *Cutting clutter* report. Developments in technology may influence how much information is included in the printed financial statements. In electronic format, there may be less need for disclosures that disaggregate in the printed financial statements, if this could be achieved by a drilling down of the numbers in the primary financial statements. There may be less need for comparative data or movement tables if information is easily accessible on line. Currently many jurisdictions require the annual report to be a printed document but this may change in the future.

Chapter Six: Conclusions and next steps

This final chapter sets out some concluding remarks and outlines the next steps in the Disclosure Framework project.

- 1 The problems with the current disclosure regime are well known and there is now general consensus that something must be done. The IASB's recent agenda consultation flagged the development of a Disclosure Framework as a top priority that the Board needs to take forward within its next three-year agenda cycle. Whilst the problem is clear, finding a solution is more difficult.
- 2 This Discussion Paper has presented the case for how a Disclosure Framework may assist in improving the quality of information in the notes to the financial statements. It has been suggested that a Disclosure Framework should address not only the content and form of disclosure requirements set by standard setters but also how those requirements are applied by entities in drawing up their financial statements. It does not pretend to offer all the answers but is intended to serve as the basis for initiating a debate about how the current disclosure regime could be improved.
- 3 The analysis presented draws heavily on the concept of relevance (and its sub-element materiality) and in deriving the purpose of the notes from that of the financial statements. It is recognised that there could be other starting points though they would be difficult to justify under the existing IFRS regime. There have been some calls for more comprehensive and detailed reporting of risks. Whilst it is recognised that information about risks is fundamental to understanding the financial statements, the issue of risk reporting goes beyond the development of a Disclosure Framework.
- 4 Constituents are asked to give careful consideration to the design of a Disclosure Framework – what it should address and which of the various alternative approaches set out in this Discussion Paper should be developed further. In particular, a central issue for the IASB to consider is at what level it should set requirements to drive forward the necessary improvement in the quality of information disclosed.
- 5 At this stage it is important that the implications of the various proposals are considered and debated rather than trying to arrive at firm conclusions too quickly. As highlighted in this Discussion Paper, the behavioural issues are complex and interrelated so it is important that any proposed solution deals with these comprehensively.
- 6 For this reason, it is important that all constituents are involved and contribute to the debate around about improving the quality of disclosures. Users and preparers are certainly the key figures in the debate; but auditors, auditing standard setters and regulators have also a vested interest in an effective and useable Disclosure Framework,

- 7 The Discussion Paper has not suggested any placement criteria and does not deal with where information should be located that does not form part of the notes as defined. The IASB in their Practice Statement *Management Commentary: A framework for presentation* notes that the Conceptual Framework is currently silent on the placement of information in the financial report and that until principles are developed, there will continue to be overlap between information that is disclosed in the notes and management commentary. In a similar fashion, developments in initiatives such as the development of an Integrated Reporting Framework may have implications for the financial statements in the future; but at this stage it is too early to know how those initiatives will develop.
- 8 The next steps EFRAG, ANC and FRC take on this project will depend upon constituents feedback and how the IASB progresses its work on the development of a Disclosure Framework. Once the comment period on this Discussion Paper closes, EFRAG, ANC and FRC will consider the comments received and decide on what next steps are appropriate in the light of other developments.

Appendix 1 – Application examples of the definition of the purpose of the notes

- 1 The following paragraphs contain examples of how standard setters could apply the proposals. However, they only partially illustrate these suggestions, because many of the proposals in the Disclosure Framework apply at the entity level.

IAS 36 – Impairment of Assets

- 2 Paragraph 130 requires disclosure, among others, of the basis to determine the recoverable amount of the asset and the discount rates in the value in use calculation.

Is the requirement part of the purpose of the notes?	Yes. The information relates to recognised assets.
Does the requirement fall within one of the identified categories that serve users' needs?	Yes. The information relates to what the item is and how it is accounted.
Why does the requirement provide useful information?	The requirement provides information on the methods used and key measurement inputs. The WACC in the VIU calculation is presumably not a market-only based rate.

IFRS 12 – Disclosure of Interest in Other Entities*

- 3 Paragraph 17 requires disclosure of an entity's current intention to provide financial or other support to a consolidated structured entity, including intentions to assist the structured entity in obtaining financial support.

Is the requirement part of the purpose of the notes?	No. The intention to provide support is neither a recognised liability nor an arrangement, claim or right at the reporting date. However, if the intention to provide support has a material impact on the assessment of the existence of control, then it would be part of the significant judgements made to assess control.
Does the requirement fall within one of the identified categories that serve users' needs?	N/A
Why does the requirement provide useful information?	N/A

* The IASB issued IFRS 12 in May 2011. The Standard is not yet effective.

- 4 Paragraph 29(c) requires disclosure of the amount that best represents the entity's maximum exposure to loss from its interest in unconsolidated structured entities.

Is the requirement part of the purpose of the notes?	Yes. The information refers to arrangements existing at the reporting date.
Does the requirement meet one of the identified users' needs?	Yes. The information explains how the item fits in the entity's operations.
Why does the requirement provide useful information?	The requirement provides information about the entity's exposure to potential cash flows from arrangements existing at the reporting date.

- 5 Paragraph 12 requires disclosure, among other things, of the name, proportion of ownership rights and voting rights held by non-controlling interests (for each subsidiary with material non-controlling interest).

Is the requirement part of the purpose of the notes?	Yes. The information refers to assets and liabilities at the reporting date.
Does the requirement meet one of the identified users' needs?	No. The information is not specific to any line item in the primary statements. The conclusion would change if the Framework included a category for "general information on the reporting entity"
Why does the requirement provide useful information?	N/A

IFRS 7 Financial Instruments: disclosures

- 6 Paragraph 27B requires disclosure of information about the level of fair value hierarchy used by the entity in measuring fair value of its financial instruments; transfers between levels and a reconciliation of financial instruments measured on a Level 3 fair value.

Is the requirement part of the purpose of the notes?	Yes. The information refers to assets and liabilities at the reporting date.
Does the requirement fall within one of the identified categories that serve users' needs?	Yes. The information refers to how the item is accounted for.
Why does the requirement provide useful information?	The information is about key measurements inputs that are neither contractual nor market rates. The Framework does not mandate the granularity of the disclosures. The judgement is with the standard setter.

- 7 Paragraph 25 requires disclosure of the fair value for each class of financial assets and liabilities (with some exceptions).

Is the requirement part of the purpose of the notes?	Yes. The information refers to assets and liabilities at the reporting date.
Does the requirement fall within one of the identified categories that serve users' needs?	Yes. The requirement provides information on how the item fits in the entity's financial structure.
Why does the requirement provide useful information?	The information is useful but only if the item can be traded on an active market.

Applying the proposals – related party transactions

- 8 Without detailing the complexity of related parties, we can distinguish 3 main types of disclosures according to IAS 24 *Related Party Disclosures*:
- a. Type 1: Description and amount of transactions during the period and amount of outstanding balances, including commitments with entities over which the reporting entity has control, joint control or significant influence;
 - b. Type 2: Description and amount of transactions during the period and amount of outstanding balances, including commitments with persons (or close members) or entities that have control, joint control or significant influence over the reporting entity and with key management personnel (or close members). The same disclosures are required for operations with entities controlled/ jointly controlled by one of the persons above;
 - c. Type 3: Description and amount of key management compensation.
- 9 Such disclosures could be required as part of the ‘composition of the item’ category if considered relevant based on proposed criteria discussed in chapter 3.
- 10 Some may argue that this type of information must always be disclosed regardless of the size of the transaction because:
- a. Type 2 disclosures are generally also useful to assess management integrity and to ensure equal treatment of shareholders (such transactions are subject to shareholders’ approval in some jurisdictions);
 - b. Type 3 disclosures are also useful information to assess management integrity and competence (by comparison to the entity performance) and to understand the drivers that could influence the strategy.
- 11 However, if these disclosures are only directed at assessing the quality of corporate governance, because they only address stewardship issues, they do not seem to fall within the proposed definition of the notes.
- 12 By forming this tentative conclusion in the Discussion Paper, it is acknowledged that some jurisdictions require such information to be disclosed in the notes, or have other specific requirements regarding related parties, while other jurisdictions have no specific rules.

Applying the proposals - events after the reporting date

- 13 Non-adjusting post balance sheet events* relate to a future period and therefore do not directly meet the definition of the purpose of the notes. Such items arise solely because of the timing of the financial reporting process – they might not exist if entities were to issue financial statements at a different reporting date.
- 14 Considering the proposed definition of the purpose of the notes, non-adjusting post-balance sheet events would not be disclosed in the notes. To include them, there would be two alternatives:
 - a. treat non-adjusting post-balance sheet events as an exception to the definition of the purpose of the notes; or
 - b. amend the definition and refer to “arrangements, claims against and rights of the entity existing at the date the financial statements are authorised to be issued”. That would allow capturing non-adjusting post-balance sheet events when material.

* IAS 10 Events after the Reporting Period requires amending amounts recognised in the primary statements for the effect of adjusting post-balance sheet events.

Appendix 2 – Discussion of the rationale for the indicators

- 1 The following paragraphs aim to explain the rationale for selecting the indicators proposed in chapter 3 to assess when to require additional information.

Information on components originated from different business activities

- 2 Segment information is widely considered one of the most important disclosures, with users sometimes asking for enhanced information.
- 3 Information on segments is required to enable users to identify the performance of the components of a business. Different activities are likely to be exposed to different risks, and have different margins, therefore users need this information to forecast cash flows and facilitate sum-of-parts valuation of businesses.

Information on components with different characteristics – distinct measurement basis

- 4 IAS 39/IFRS 9 *Financial Instruments* allows different measurement bases according to the characteristic of the instrument or the way the entity manages it. Understanding how the entity manages the asset is useful to assess performance and make predictions on future changes.

Information on components with different characteristics – sensitivity to different variables

- 5 Users need to know if and how cash flows attributable to different components react in opposite direction, or in a quantitatively different percentage in response to changes in variables (such as interest rates, commodity price, financial instrument price, foreign exchange rates, index of prices or rates, credit rating or credit index) or market conditions.

Information on components with different characteristics – different timing of recovery/settlement

- 6 Information on the timing of cash flows is important to assess the entity's exposure to a refinancing risk and to assess the future impact of refinancing.

Information on components with different characteristics – different rights or obligations

- 7 An entity may have legal ownership of an asset or control by some other means. For instance, an entity may obtain control of the right to use an asset by entering in a lease contract.
- 8 Owning an asset allows an entity to recover its value not only by use but also by sale. The user needs to know the nature of an entity's rights over the asset because this may influence the assessment of prospects for future cash flows.



Information on components with different characteristics – different seniority

- 9 Seniority refers to precedence in position over other lenders. In the event of bankruptcy of the issuer, senior debt must be repaid before subordinated debt. Information on seniority is important to understand the uncertainty of cash flows associated with the different instruments.

A standard allows or requires offsetting assets and liabilities

- 10 Some standards allow or require offsetting items in the primary statements, such as IAS 19 Employee Benefits. It is important to disclose assets and liabilities before the effect of the offset, because their measurement may be different and/or they may have a different sensitivity to pertinent variables.

Information on transaction or group of transactions that impact items in different captions

- 11 In some cases it is not possible to have a proper understanding of a transaction by looking at items in isolation. For example a business combination affects different assets and liabilities in the financial statements of the acquirer; or an entity in an emission trading scheme has received an award that it intends to use to settle its obligations under the scheme. Although the measurement attributes of the linked items may be different, it is important to be aware of their economic linkage.

Breakdowns of the changes in the a balance over the period

- 12 A breakdown of the change in the a balance is more likely to be useful for items concerned with investing or financing activity. This is because users have other sources of information to make predictions on the future level of operating activity of the entity. Often there are also correlations between operating items – users can predict the amount of trade receivable based on the expected sales. On the other side, investing (and financing) transactions tend to be more irregular and infrequent. In addition, they may have less of a direct correlation to the operating activity.
- 13 A breakdown of the change is also more likely to be useful when the item is expected to be recovered or settled beyond the operating cycle of the company, because major increases or decreases in long-term assets or liabilities typically have a lasting impact on the future cash flows of the entity.

The item is carried at cost but it can be easily traded on a market

- 14 When an asset (or liability) is easily marketable an entity may change the way to recover it at a short notice. Therefore, information on the fair value of these assets (such as most financial instruments) could be deemed to be always relevant.

Information on accounting policy and/or application guidance

- 15 Accounting standards often do not provide entities with choices. For instance, IAS 12 Income Taxes requires recognition of deferred tax liabilities for all existing taxable temporary differences (with a few exceptions); and recognition of deferred tax assets for all existing deductible temporary differences, to the extent that the entity considers recovery to be probable. In these cases, a detailed description of the accounting policy often does not provide any added value to the readers of the financial statements.
- 16 Therefore, an entity may not provide information on the accounting policy in other cases, although the amounts may be material. Some say this is harmful to users that are not fully familiar with accounting standards. While it is reasonable to expect a basic knowledge from users, not all of them may have sufficient training.
- 17 Those who share this concern suggest that entities should provide all other accounting policies outside the notes, for instance as permanent data on the entity's website, with a reference in the notes. However, others think it is the users' responsibility to search for this information.

Information on accounting methods and key measurement inputs

- 18 Standards sometimes allow multiple measurement methods. For instance IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires using a "best estimate" without explicitly requiring a weighted average or a most likely approach. The objective of the information is to enable users to understand the extent of uncertainty inherent in the measurement.

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