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European Financial Reporting Advisory Group
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Comment on Discussion Paper *Towards a Disclosure Framework for the Notes*

We welcome the opportunity to provide our comments on the Discussion Paper (DP) *Towards a Disclosure Framework for the Notes*.

We appreciate the efforts of the European Financial Reporting Advisory Group (EFRAG) to improve the effectiveness of disclosures in the notes to financial statements. We support the development of a Disclosure Framework, sharing the EFRAG's view that the increasing volume of the note disclosures may have decreased the quality of information. We believe standard-setting based on an appropriate Disclosure Framework would enhance the users' ability to find and understand relevant information.

Our key comments are summarized below.

Scope of the notes to financial statements

The DP proposes to determine the scope of the notes to financial statements based on specific users' needs. However, we suggest determining it based on the timing of underlying transactions and events and the descriptions of a complete depiction in paragraph QC13 of the IASB's Conceptual Framework. The details of our suggestion will be described in the response to Question 3.2 and in Appendix B.

Materiality

We support the DP in that it gives considerable attention to the application of materiality relating to the notes to financial statements.

Although paragraph 31 of IAS1 states that an entity need not provide a specific disclosure required by an IFRS if the information is not material, such judgments are not always made appropriately in practice. We believe that developing guidance for applying materiality would help improve the current practice.

However, in our view, the proposed guidance would not be sufficient to address the issues that we

are currently faced with and therefore we look forward to further consideration to develop more practical guidance, including qualitative and quantitative examples.

Cost and benefit consideration

We believe cost and benefit consideration should be addressed in a separate category as a key principle related to all other key principles.

Auditability

Although the DP does not address the auditability issues, we believe a final Disclosure Framework should include consideration about auditability of the notes to financial statements. In developing disclosure requirements, consideration of their auditability is necessary because users regard audited information in the financial statements as highly reliable.

Appendix A contains our responses to the Questions to constituents and Appendix B illustrates our view regarding the scope of the notes to financial statements.

We hope our comments will contribute to the forthcoming deliberations of EFRAG.

Sincerely yours,



Ikuo Nishikawa

Chairman of the Accounting Standards Board of Japan

Appendix A
Responses to Questions to constituents

Question 1.1

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

We consider some of the proposed key principles should be amended. We also suggest adding some principles to the key principles.

● **Purpose and content of the notes**

Information on risks and alternative measurements, as described in paragraph 3 of the key principles, should be combined with the principle described in paragraph 2.

Information about the future, information on risks and alternative measurements are equally important because they are at the boundary of the scope of notes to financial statements. Paragraph 2 of the proposed key principles state explicitly that information about the future that is unrelated to past transactions and other events is not provided in the notes. However, information on risks and alternative measurements are treated as a complement in paragraph 3. We recommend EFRAG reconsider the structure of the key principles by combining paragraph 2 and 3.

● **Setting disclosure requirements**

We suggest replacing the key principle in paragraph 8 with a description such as “Disclosure requirements should be described at a lower level of granularity to allow the entity to disclose information suitable to the entity-specific circumstances”.

As mentioned in our response to Question 3.4, our preferred approach is to develop detailed requirements at a lower level of granularity. According to this view, the wording “principle-based” would be inappropriate.

● **Cost and benefit considerations**

The proposed key principles include the description about a cost-benefit trade-off in paragraph 9. We believe this issue should be addressed in a separate category as a principle related to all other key principles, rather than being included in this place.

In addition, we consider it better to replace the phrase “meet a cost-benefit trade-off” with “ensure that benefits outweigh costs”.

● **Auditability**

Although the DP does not address the auditability issues, we believe a final Disclosure Framework should include consideration about auditability of the notes to financial statements. In developing

disclosure requirements, consideration of their auditability is necessary because users regard audited information in financial statements as highly reliable.

Question 1.2

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

In our view, the primary problem is inclusion of irrelevant information which results in inappropriate volume of disclosures, rather than disclosure overload.

We expect disclosures based on an appropriate Disclosure Framework would achieve an appropriate volume of disclosures as a whole because all and only relevant information is disclosed.

Question 2.1

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

We agree that there is a need to define the purpose of the notes, because the definition of the purpose of the notes would provide a benchmark in determining the scope of the notes to financial statements.

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?

The proposed definition appears to contain both the purpose and the scope of the notes. We consider they should be separately defined.

Paragraph OB3 in the Conceptual Framework states that existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to the entity. In this regard, the primary financial statements by themselves may not be able to provide sufficient information and therefore the notes to financial statements are needed to amplify and explain the primary financial statements.

Thus, we suggest defining the purpose of the notes as “to provide information to help the assessment of the prospects for future net cash inflows to the entity by amplifying and explaining the primary financial statements”.

The definition of the scope of the notes should include not only descriptions 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, but also information on risks and alternative measurements

that are discussed in Chapter 3 of the DP. In addition, we consider that non-adjusting events after the reporting period should be included in the notes to financial statements. The definition of the scope of the notes should be developed by combining these elements.

Question 3.1

- (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?

The DP proposes to determine the scope of the notes to financial statements based on specific users’ needs which are drawn from the Conceptual Framework. However, in our view, the rationale for how the specific users’ needs are drawn from the Conceptual Framework is not sufficient.

We suggest that the scope of the notes to financial statements related to line items should be determined based on the timing of underlying transactions and events and the descriptions of a complete depiction in paragraph QC13 of the Conceptual Framework. Details of our suggestion are described in the response to Question 3.2.

In addition, a category of “information about the reporting entity as a whole” should be included. This is because information such as general information about the consolidated group and significant business combination is a different tier of information from that relating to specific line items and should be treated separately.

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?

As mentioned above, we suggest that the scope of the notes to financial statements related to line items should be determined based on the timing of underlying transactions and events and the descriptions of a complete depiction in paragraph QC13 of the Conceptual Framework, instead of users’ needs.

We focus on the nature of the items which are to be included in the notes to financial statements. When developing disclosure requirements, consideration is needed about whether the benefits outweigh the costs and whether such disclosures can be audited. Therefore, we do not intend that all items that we analyze below should eventually be disclosed as the notes to financial statements.

Our idea of the scope of the notes to financial statements is based on the categorization as described in Appendix B. Our views for those categories are summarized below.

- Category A

- Category A represents disclosures about the items related to the transactions, events or conditions that occurred before the year end and are recognised on the face of financial statements and are measured without using estimates¹.
- For items in Category A, quantitative and qualitative information should be included in the notes to financial statements. Examples of quantitative information would be disaggregated information such as the breakdown of the item, maturity analysis, a reconciliation of the carrying amount from the beginning to the end of the period, and segment information. Qualitative information would include descriptions of the nature of the item, descriptions of what the numerical depiction represents, explanations of significant facts about the quality and nature of the item, the process used to determine the numerical depiction and factors and circumstances that might affect the quality and nature of the items.
- In principle, the descriptions of plans or strategies for risk exposures would be inappropriate for inclusion in the notes to financial statements. This is because such information may contain descriptions reflecting management's biases and thus its faithful representation or verification might be impossible. For example, some may describe an overly optimistic plan whereas others may describe an overly pessimistic plan. Such information would be reported outside of the financial statements, such as in the MD&A.
- Information prepared using alternative methods that are different from those used in recognition on the face of financial statements, such as sensitivity analysis and pro forma information, generally should not be included in the notes to financial statements. This is because, in many cases, narrative descriptions of the facts would provide sufficient information.

- Category B

- Category B represents disclosures about the items related to the transactions, events or conditions that occurred before the year end and are recognised on the face of financial statements and are measured using estimates.
- For items in Category B, which involve a high degree of uncertainty in the estimates,

¹ In this comment letter, the term 'estimates' includes fair value estimates.

information prepared using alternative methods that are different from those used in recognition on the face of financial statements, such as sensitivity analysis and pro forma information, generally would be included in the notes to financial statements. This is because there are concerns that narrative descriptions of the facts alone might fail to provide sufficient information to assess the entities' prospects for future cash flows when there is a high degree of uncertainty in the estimates.

- The scope of the notes to financial statements would be the same as category A except for the information described above.

- Category C

- Category C represents disclosures about the items related to the transactions, events or conditions that occurred before the year end but are not recognised on the face of financial statements. An example in this category is contingencies which exist at the year end but are not recognised on the face of the financial statements.
- For items in Category C, the scope of the notes to financial statements would be the same as Category A. However, the volume and depth of the disclosures required are usually less than those required in Category A. For example, quantitative information may only contain the breakdown of the items and further disclosures may not be required.

- Category D

- Category D represents disclosures about non-adjusting events after the reporting period which are related to the transactions, events or conditions which have not occurred before the year end and are not recognised on the face of financial statements.
- For items in Category D, quantitative and qualitative information would be included in the notes to financial statements. However, qualitative information would be limited to a description of the nature of the item.
- We consider that only the information related to the financial position at the year end and the financial performance for the years presented generally would be included in the financial statements. However, non-adjusting events after the reporting period are included in the notes to financial statements as an exception. This is because disclosing non-adjusting events after the reporting period in advance to the next fiscal year's financial statements would contribute to assessing the entities' prospects for future cash flows. To achieve this purpose, disclosing only quantitative information and descriptions of the nature of the item would be sufficient.

- **Category E**

- Category E represents disclosures about the items other than non-adjusting events after the reporting period which are related to the transactions, events or conditions which have not occurred before the year end and are not recognised on the face of financial statements.
- Items in this category include information on risks which do not exist at the year end but may exist in the future.
- Items in this category generally should not be included in the notes to financial statements but should be reported outside of the financial statements, such as in the MD&A. This is because such information is unrelated to the financial position at the year end and the financial performance for the years presented and its faithful representation and verification might be impossible.

Question 3.3

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

We consider the proposed scope of the risk information is appropriate for inclusion in the notes to financial statements.

We believe the information related only to stewardship would not be included in the notes to financial statements. The stewardship information is closely related to the information on governance, such as that regarding directors and the audit committee, which is reported outside of financial statements. In our view, the information related only to stewardship should also be reported outside of financial statements.

Question 3.4

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?

(General comments)

One view is that standard-setters do not need to set disclosure requirements because management has the incentive to voluntarily disclose internal information in order to minimize its capital costs. Users are likely to evaluate the company conservatively when management has information but does not disclose them. In order to avoid such situation, it is expected that management would

voluntarily disclose such information without any disclosure requirement and thus capital markets would function efficiently.

However, in reality, management has the tendency not to disclose negative information sufficiently and it would be necessary to set mandatory disclosure requirements.

Considering these factors, the extent of disclosure would depend on the view on how much information should be disclosed mandatorily, and that view is likely to change over time. Furthermore, this view may depend on how stringent capital markets are regulated in each jurisdiction. In some jurisdictions, discussions with regulators may be necessary in addition to the discussions among preparers, users and standard-setters.

(Commentary on the proposed approaches)

In our view, among the five approaches discussed in the DP, the most appropriate one would be the approach at the right end of the spectrum, under which detailed requirements are developed for each accounting standard. In this approach, it is critical to set granularity at a lower level.

Currently, some accounting standards require too much disaggregated information that is not needed for management purposes. In addressing this issue, an approach that makes the wording of disclosure requirements less prescriptive would be workable and achieve efficient and effective disclosures.

In addition, we suggest that this approach should be taken together with establishing alternative disclosure requirements as described in our response to Question 3.5

Question 3.5

Do you think that establishing alternative disclosure requirements is appropriate?
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We consider that establishing alternative disclosure requirements is appropriate.

In our view, ‘one size fits all’ approach is not always appropriate, because the necessary disclosures may vary depending on a number of factors such as size of the entities, complexity of the related transactions and events and public accountability of the entities. A practical and acceptable approach would be that standard setters establish three or more tiers of information items depending on the complexities of the related transactions and events, enabling reporting entities to make their own judgments of the tier they should fall within.

Regarding interim financial statements, the frequency of the interim reporting varies by country and the objectives may be different. We think that an approach that is different from the approach for the annual financial reporting should be developed to meet the objectives of interim financial

reporting because we believe the extent of disclosures in interim financial statements should be determined in the light of the objectives of interim financial reporting.

Question 4.1

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

We agree that a Disclosure Framework should reinforce the application of materiality.

We believe that emphasizing the application of materiality in a Disclosure Framework would be meaningful, even though the Conceptual Framework contains the description of materiality.

However, we consider just having a description about the application of materiality in a Disclosure Framework would not be sufficient. Stakeholders often fail to adequately apply materiality in practice although conceptually understanding it. We consider it critical to take actions to enhance common understanding regarding the application of materiality among auditors and regulators.

Question 4.2

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

We agree that a Disclosure Framework should include guidance for applying materiality.

We acknowledge that developing guidance for applying materiality would be difficult because judgments of materiality may vary depending on the nature or magnitude of the related items, and the relevant circumstances. However, having guidance for applying materiality would help enhance common understanding among auditors and regulators.

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?

We consider that the proposed guidance would be insufficient to address the issues that we are currently faced with.

Although the table in Chapter 4 illustrates relationships between indicators for relevant information and materiality, it just states whether the related items are material or not. In addition, it seems that most of the examples described in paragraph 25 through 41 in Chapter 4 are already considered in practice.

We look forward to further consideration to develop more practical guidance, including qualitative and quantitative examples.

Question 5.1

Would the proposed communication principles improve the effectiveness of disclosures in the notes? What other possibilities should be considered?
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We agree that the proposed communication principles generally improve the effectiveness of disclosures in the notes.

In particular, we emphasize the importance of tables and cross references. Historically, disclosures using uniform tables have been frequently used under Japanese GAAP and users find such disclosures to be highly useful. Although cross references are currently used, the extent of cross references should be expanded, because there is a concern that users might miss the related information when it is disclosed in other notes.

Question 5.2

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

We disagree with presenting notes to financial statements in order of priority with the most significant information included first.

Ordering of items relying on the managements' view of relevance could result in focusing too heavily on the items which management wants to emphasize and therefore might mislead users. In addition, disclosures in such orders may make it difficult for users to find the relevant information when users compare companies because the information would be disclosed in different orders for each entity.

Appendix B Scope of the notes to financial statements

				Transactions, events and conditions that occurred before the year end (including related estimates)		Transactions, events and conditions that have not occurred before the year end				
				Recognised on the face of financial statements		Not recognised on the face of financial statements				
				Items measured without using estimates *1	Items measured using estimates *1	Unrecognised items	Non-adjusting events after the reporting period	Other than non-adjusting events after the reporting period		
Category				A	B	C	D	E		
Factual information	Quantitative information	Numerical depiction	Disaggregated information such as the breakdown of the item, maturity analysis, a reconciliation of the carrying amount from the beginning to the end of the period, segment information	○	○	○	○	×		
	Qualitative information	Descriptions of the nature of the item	Explanations of the nature of the transactions	○	○	○	○	×		
		Descriptions of what the numerical description represents	Significant accounting policies	○	○	○	×	×		
		Explanations of significant facts about the quality and nature of the item	Restrictions on the use of the assets	○	○	○	×	×		
		Explanations of the process used to determine the numerical depiction	Explanations of the methods of the measurements, models, assumptions and input	○	○	○	×	×		
		Explanations of factors and circumstances that might affect the items' quality and nature	Descriptions of risk exposure, measurement uncertainty	○	○	○	×	×		
		Descriptions of the plans or strategies regarding the risk exposure of the item	Plans to deal with any concerns about cash shortfalls	×	×	×	×	×		
Information prepared using alternative methods that are different from those used in recognition on the face of financial statements	Quantitative information	Numerical depiction	Amounts calculated using pro forma calculation, sensitivity analysis	×	○	×	×	×		
	Qualitative information	Related explanatory descriptions	Explanations of input and models used in the pro forma calculation/the sensitivity analysis	×	○	×	×	×		

○ Generally included in the notes to financial statements

× Generally not included in the notes to financial statements

*1 The term 'estimates' includes fair value estimates.