Decluttering financial statements

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Aims

- develop a more cohesive understanding of decluttered financial information
- enhance capacity to supervise/regulate judgements in decluttering general purpose financial information

Regulatory evidence

IASB initiatives
Takeaways from the public discussion forum on financial reporting disclosure (January 2013)

The financial statements ‘disclosure problem’:

1. not enough relevant information;
2. too much irrelevant information; and
3. ineffective communication of information.

IASB active projects that support the Better Communication theme

- Disclosure Initiative;
- Primary Financial Statements; and
- IFRS Taxonomy.

IASB disclosure initiative examples of topics completed

- Removing language that:
  - implies a prescribed order of notes; and
  - prevents flexibility about the location of accounting policies in the notes.
- Materiality
  - clarified the definition of materiality and mandatory application guidance
  - IFRS Practice Statement 2: Making Materiality Judgments
- Specify requirement for net-debt reconciliation.

IASB active projects
topics remaining in the disclosure initiative

- Accounting policy disclosures: whether the IASB should develop guidance or requirements to help entities decide which accounting policies to disclose; and
- Location of information: whether the IASB should develop guidance or requirements about:
  - IFRS information outside the financial statements; and
  - non-IFRS information inside the financial statements.

Regulatory action by selected regulators
FRC (UK)

» Various 'cutting clutter' initiatives running for many years, for example:

- Combating clutter in annual reports (see https://www.frc.org.uk/getattachment/8250571d-4c6d-4d0a-9aa6-ef6a19c1fab2/Cutting-clutter-report-April-20112.pdf)
- "Cut the Clutter. Important messages, policies and transactions are highlighted and supported with relevant context and are not obscured by immaterial detail. Cross-referencing and signposting is used effectively; repetition is avoided" (see https://www.frc.org.uk/getattachment/311af48c-bdfa-4484-8e7d-6de689fd8f4b/Annual-Review-of-Corporate-Reporting-2016-17.PDF).

Regulatory action by selected regulators
JSE proactive monitoring in 2017 (emphasis added)

» the most frequent non-compliance identified is superfluous accounting policies (21 of 26 in 2016 and 5 of 6 in 2017):

Issuers are reminded that whilst the individual IFRS standards contain more than 2 000 potential disclosure items, paragraph 31 of IAS 1 *Presentation of Financial Statements* also states that: "...an entity need not provide a specific disclosure required by an IFRS if the information resulting from that disclosure is not material".

Underlying concepts

Primary users
test your understanding

Who are specified as the primary users of IFRS financial information?
Choose one of:

1) existing and potential service recipients and their representatives, and resource providers;
2) existing and potential investors (including the controlling shareholder), lenders and other creditors in making resource allocation decisions (buy, sell, hold, provide loan/settle);
3) existing and potential investors, lenders and other creditors who cannot require reporting entities to provide information directly to them in making resource allocation decisions; or
4) a broad range of users who are not in a position to demand reports tailored to meet their particular information needs.

Fundamental qualitative characteristics test your understanding

Which of the following characteristics must financial information possess for it to be useful? Choose any one or more of:

1) relevance
2) faithful representation
3) comparability
4) verifiability
5) timeliness
6) understandability

Fundamental qualitative characteristics the Conceptual Framework

- Relevance: capable of making a difference in users’ decisions
  - predictive value (useful input to process to predict future cash flows)
  - confirmatory value (confirm/disconfirm prior cash flow expectations)
  - materiality
- Faithful representation:
  - complete
  - neutral
  - free from error

Materiality
concept => principles => rule

- Concept: information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide 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.

Materiality
concept => principles => rule

» Consequently, an entity (materiality principles):

  » need not apply its accounting policies to immaterial items (paragraph 8 of IAS 8);

  » need not disclose immaterial information (paragraph 31 of IAS 1) and must not obscure material information with immaterial information (paragraph 30A of IAS 1); and

  » must provide additional disclosures when compliance with the explicitly specified disclosures is insufficient to enable users to understand the impact of particular economic phenomenon (paragraph 17(c) of IAS 1).

» However (materiality rule), otherwise immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows are inappropriate and must be corrected (paragraph 8 of IAS 8).

Roots of the cluttering problem

Root causes of the disclosure problem

- Behavioural issues:
  - making all specified disclosures avoids justifying ‘omitting’ disclosures to auditors and historically has not attracted regulatory challenge;
  - presenting boilerplate disclosures rather than meaningfully entity specific information;
  - aversion to making materiality judgements; and
  - failure to consider whether the disclosure of immaterial information obscures material information.
- Exacerbated by inappropriate use of:
  - comprehensive ‘Big4’ disclosure checklists; and
  - all encompassing ‘Big4’ illustrative financial statements.

example: preparing/auditing/regulating/reviewing accounting for depreciation using a disclosure checklist approach

Disclosure checklist approach: specified disclosures	Reference	Test
Depreciation methods used (cut and paste from 'Big4' illustrative financial statements)	IAS 16.73(b)	✓
Useful lives or the depreciation rates used (cut and paste from 'Big4' illustrative financial statements)	IAS 16.73(c)	✓
Gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period (as per 'Big4' illustration)	IAS 16.73(d)	✓
Depreciation for the period (cut and paste from 'Big4' illustrative financial statements)	IAS 16.73(e)(vii)	✓
Nature and effect of a change in an accounting estimate including (a) residual values; (b) costs of dismantling etc; (c) useful lives; and (d) depreciation methods	IAS 16.76 read with IAS 8	✓ procedure in accounting policy note (but no material change in the period evident from disclosures)

example: preparing/auditing/regulating/reviewing accounting for depreciation using a disclosure checklist approach (continued)

Disclosure checklist approach: specified and encouraged disclosure (ie about PPE that is likely no longer being depreciated)	**Reference**	**Test**
Carrying amount of temporarily idle PPE and carrying amount of PPE retired from active use and not classified as held for sale in accordance with IFRS 5	IAS 16.79(a) and (c)	assume N/A and see no evidence to the contrary
Gross carrying amount of any fully depreciated in-use PPE	IAS 16.79(b)	✓

Conclusion: ✓ compliant (very good)–entity provides all mandatory disclosures + provides some additional voluntary disclosures.

Concern: non-compliance with the depreciation principle might exist because the judgements made by management when applying the depreciation principle might not faithfully reflect the consumption of the items' service potential in the reporting period.

Evidence of likely compliance failure – cluttered financial statement disclosures potentially concealing depreciation judgements that appear to be inconsistent with the depreciation principle.

- Despite the extensive disclosures about depreciation estimates, significant fully depreciated items that are still in use provides strong evidence of non-compliance with the depreciation principle.
  - Rationale: if making appropriate judgements about how the entity consumes the service potential of the asset (ie depreciation judgements) that are updated periodically, it is difficult to envisage how an in-use asset would become fully depreciated.
- Contributory evidence of non-compliance with the depreciation principle includes:
  - no reference to residual values but entity presents gains/losses on disposal of PPE
  - no reference to components of significant items that likely should have component depreciation (for example, aircraft etc)
  - straight-line depreciation of items whose service potential likely evolves over time (for example, customer lists, bearer plants etc)
  - no disclosures about changes in accounting estimates (when consumption patterns likely changed in the period)

example: preparing/auditing/regulating/reviewing accounting for depreciation using a risk-based financial statements compliance review methodology (examples of searching questions)

Regarding material fully depreciated in-use items regulators could ask:

» When most recently did management reconsider the depreciation method, useful life, residual value etc of the item?

» What depreciation method was used? And what was management's logic in determining that the method best reflected how the asset's service potential is consumed?

» For how much longer does management expect to continue using the item?

» How much could the asset be sold for today (assuming proper marketing etc)?

Regarding components: has management replaced (or does management expect to have to replace) any high-value part of an item before it sells/scraps the item?

Risk-based financial statements compliance review methodology
example: depreciation (conclusion)

» Carefully consider management's responses to the searching questions.

Likely conclusion: compliance failure – financial statements cluttered with boilerplate depreciation disclosures potentially concealing material errors in the application of the depreciation principle.

Cluttering/decluttering mini-case studies

Cluttering/decluttering: mini-case study 1 jurisdiction specified materiality threshold source: derived from World Bank ROSC A&A compliance review

» A regulatory authority specifies the financial statement separate line-item presentation threshold in Jurisdiction A as:

  » for assets: 5% of the total assets.
  » for liabilities: 5% of the total liabilities.
  » for equity: 5% of the total equity.
  » for income and expenses: 10% of income.

Can an entity that files its IFRS financial statements with the regulatory authority claim compliance with IFRS?

Choose one of: 1) Yes; 2) No; or 3) it depends.

Cluttering/decluttering: mini-case study 2 source: UK FRC Corporate Reporting Review Annual Report 2015, pages 16 & 17

- With a view to making its annual report and accounts more clear and concise in its December 2013 accounts a company:
  - removed its share-based payment note and did not present the detailed disclosures required by IFRS 2.
  - disclosed the charge for the year and the dilutive effect of share-based payments.
- The share-based payment charge for the year was less than 1% of profit before tax and approximately 70% of the group materiality disclosed in the auditor’s report.

Is the omission of the share-based payment note material?

Choose one of: 1)Yes; or 2) No.

Cluttering/decluttering: mini-case study 2 (continued) source: UK FRC Corporate Reporting Review Annual Report 2015, pages 16 & 17

- The regulator
  - considered the information provided by the company together with the three principles of disclosure in IFRS 2
  - concluded that the company had addressed two of the principles
    - the only missing information identified related to the company’s approach to valuation.
  - asked the company whether high-level disclosure of the approach to the valuation of share-based payments would benefit users of the accounts
  - emphasised that their question did not mean that they wanted all the company’s previous share-based payment disclosures to be reinstated.

Cluttering/decluttering: mini-case study 2 (continued) source: UK FRC Corporate Reporting Review Annual Report 2015, pages 16 & 17

- The company’s amended view
  - including a brief description of its methodology for estimating the fair value of share-based payments would be helpful to users of the accounts and a proportionate disclosure.
- The regulator:
  - accept that detailed disclosures are not necessary when the amounts involved are immaterial.
  - will not ask companies to reinstate such disclosures following a ‘cutting clutter’ exercise.
  - believes it is important to consider the overall disclosure principles of a standard and assess whether including certain disclosures would be appropriate.

Cluttering/decluttering: mini-case study 3
source: World Bank ROSC A&A compliance review

- Bank's profit or loss for 2016 is $26 billion and it presents $13 billion income from revaluing its landrights in OCI for 2016 (its comparative figures are not restated).
- Nowhere in its accounting policies note does Bank mention that it has changed its accounting policy for landrights (classified as PPE) from the cost model to the revaluation model, ie not mentioned in:
  - its two page 'Changes in accounting policies' section of its accounting policy notes (Which provides only information about new requirements that are unlikely to have a material effect on the Bank's financial statements.)
  - its accounting policy note for PPE.
- In 'Note 17 Premises and Equipment' this change in policy mentioned for the first time: "Bank changed its accounting policy of landrights from cost model to revaluation model."

For each question below, Choose one of: 1) Yes; 2) No; or 3) It depends (specify…)

Are the financial statements cluttered?

Is material information obscured with immaterial information?

Are the financial statements IFRS compliant?

Regulatory action
cluttering most significant judgements in applying accounting policies

UK (FRC) ANNUAL REVIEW OF CORPORATE REPORTING 2016/2017

» Of the 20 reports included in our sample, we wrote follow-up letters to 5 companies where there was a substantive question relating to their disclosure of significant accounting judgements... Correspondence with these companies is ongoing.

» Most companies in the sample improved the granularity and level of detail of their disclosures. A far greater proportion clearly distinguished judgements from estimates... The better quality reports identified a smaller number of judgements but provided much richer information... Users of these reports would have a clearer picture… It was particularly helpful when companies explained the reasons for changes in the list of judgements and estimates considered to be key from those disclosed in the previous year.

» However, it was disappointing that a significant minority still used elements of boiler-plate text, which could apply to any company and gave no additional useful information to users of the accounts.

Regulatory action
cluttering most significant judgements in applying accounting policies

JSE proactive monitoring in 2017:

» disclosures must be entity specific and in sufficient detail to help the user of the financials understand how the accounting policies have been applied.

» generic wording that does not provide useful information should be avoided. Disclosures are not required for all items, and should only be provided in the circumstances detailed in IAS 1.

» Furthermore, it is important that judgements and estimates are clearly differentiated, failing which the incorrect paragraphs of IFRS may be applied and insufficient information provided.

Cluttering/decluttering: mini-case study 4
source: World Bank ROSC A&A compliance review

In its accounting policies note Bank's disclosures under the heading 'key sources of estimation uncertainty' includes:

Consolidation of Structured Entities

In determining the degree of control exercised, the Group considers whether these entities meet the definition of Structured Entities as set out in Note 2d and whether the Bank, in substance, controls such entities.

When the Group, in substance, controls the entity to which the financial assets have been transferred, the entity is consolidated by the Bank.

Are the financial statements cluttered? In particular, is material information potentially obscured with immaterial information?

Choose one of: 1) Yes; 2) No; or 3) It depends (specify…)

Cluttering/decluttering: mini-case study 5
source: World Bank ROSC A&A compliance review

In the accounting policies section of its financial statements Bank's disclosures under 'judgments made by management in the process of applying accounting policies that have the most significant effects on the amounts recognised in the financial statements' (ie paragraph 122 of IAS 1) includes:

Going concern
Management has assessed Bank's ability to continue its business and determined that Bank has the resources to continue its business in the future. In addition, management is not aware of any material uncertainties that may cause significant doubt on the ability of Bank to maintain its viability. Therefore, the consolidated financial statements have been prepared on the basis of a going concern.

Are the financial statements cluttered? In particular, is material information potentially obscured with immaterial information?

Choose one of: 1) Yes; 2) No; or 3) It depends (specify…)

Cluttering/decluttering: mini-case study 6 source: World Bank ROSC A&A compliance review

In the accounting policies section of its financial statements Entity A provides the following disclosure as one of the 'judgments made by management in the process of applying accounting policies that have the most significant effects on the amounts recognised in the financial statements' (ie paragraph 122 of IAS 1):

Determination of functional currency
The functional currency of each entity within the Group is the currency from the primary economic environment where such entity operates. Those currencies are the currencies that mainly influence the revenues, costs and financing of each of the respective entities.

Entity A does NOT identify investment classification as a most significant judgment even though Entity A's management appears to have experienced difficulty in classifying some major investments. For example (see next page):

Cluttering/decluttering: mini-case study 6 (continued) source: World Bank ROSC A&A compliance review

In particular significant judgement appears to be necessary to determine whether Entity A controls or has significant influence over Entity B and Entity C. Entity C is a big-loss-making company.

Rather than providing justifying evidence in support of its accounting for Entity C as an associate, Entity A states only that "ownership in Entity C established is not followed by control and therefore, Entity C's financial statements are not consolidated."

Page Annual Report Page Annual Financial Statements	p182 Group chart (indicates subsidiary)	p696 P11 under heading 'Associates'	p758 p73 Note 'Investment in Associates'
Entity B	Yes 50.9%	48.9% Associate	48.9% Associate
Entity C (51%)			Associate
Entity D (45%)			Associate
Entity E (25%)	Yes	Associate	Associate

Cluttering/decluttering: mini-case study 6 (continued) source: World Bank ROSC A&A compliance review

Is Entity A's disclosure about the determination of functional currency boilerplate?

Choose one of: 1) Yes; 2) No; or 3) It depends (specify…)

Are Entity A's disclosure about the determination of the degree of influence it exerts over its investees cluttered?

Choose one of: 1) Yes; 2) No; or 3) It depends (specify…)

In Entity A's financial statements, is material information potentially obscured with immaterial information?

Choose one of: 1) Yes; 2) No; or 3) It depends (specify…)

Regulatory action cluttered disclosures about new requirements that are yet to be applied

- JSE proactive monitoring in 2017 regarding disclosures about the adoption of new Standards:
- Our findings generally pointed to disclosure that was neither entity specific, nor did it provide sufficient detail that would enable a user to make an adequate assessment of the possible impact thereof to the issuer’s financial statements.

Cluttering/decluttering: mini-case study 7
new requirements that are yet to be applied
source: World Bank ROSC A&A compliance review

- Many of the entities reviewed made generic disclosures about new and amended Standards that the entity is yet to apply because they are not yet effective. While many identified the date from which the new requirement would apply to it, most appear:
  - not to have considered the materiality of the new requirements; and
  - even when the date of initial application is after the date on which the financial statements were authorised for issue, have not disclosed:
    - (i) the nature of the impending change; and
    - (ii) discussion of the impact that the initial application is expected to have on the entity’s financial statements.

Cluttering/decluttering: mini-case study 7 (continued) new requirements that are yet to be applied

Are these entities' financial statements cluttered? In particular, is material information potentially obscured with immaterial information?

Choose one of: 1) Yes; 2) No; or 3) It depends (specify…)

Cluttering/decluttering: mini-case study 8 new requirements that are yet to be applied

Extract from HSBC 31 December 2015 Annual Financial Statements (emphasis added)

"**Future accounting developments**

In addition to completing its projects on financial instrument accounting, revenue recognition and leasing, discussed below, the IASB is working on a project on insurance accounting which could represent significant changes to accounting requirements in the future.

Minor amendments to IFRSs

The IASB has published a number of minor amendments to IFRSs through the Annual Improvements to IFRSs 2012–2014 cycle and in a series of stand-alone amendments, one of which has not yet been endorsed for use in the EU. HSBC has not early applied any of the amendments effective after 31 December 2015 and it expects they will have an insignificant effect, when applied, on the consolidated financial statements of HSBC and the separate financial statements of HSBC Holdings.

Major new IFRSs

The IASB has published IFRS 9 'Financial Instruments', IFRS 15 'Revenue from Contracts with Customers' and IFRS 16 'Leases'. None of these IFRSs have yet been endorsed for use in the EU."

[Because of the significance of **IFRS 9** for financial institutions HSBC then set out over **6 pages** its preparations for the adoption of IFRS 9 including its initial qualitative assessment of the impacts that its initial application is expected to have on its financial statements.]

For each of the other major new IFRSs HSBC discloses a short paragraph concluding:

"HSBC has assessed the impact of IFRS 15 and it expects that the standard will have no significant effect, when applied, on the consolidated financial statements of HSBC and the separate financial statements of HSBC Holdings"

HSBC is currently assessing the impact of IFRS 16 and it is not practicable to quantify the effect as at the date of the publication of these financial statements. " (note: IFRS 16 was issued in early 2016 after HSBC's 2015 reporting date)

Cluttering/decluttering: mini-case study 8 (continued) new requirements that are yet to be applied

Are HSBC 2015 financial statements cluttered? In particular, is material information potentially obscured with immaterial information?

Choose one of: 1) Yes; 2) No; or 3) It depends (specify…)

Cluttering/decluttering: mini-case study 9
POLICY for identifying fair value LEVEL 2

» In its 2016 financial statements HSBC identifies as a critical judgement the classification of Level 2 fair value measurements. It

> "classifies an instrument in its entirety as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's inception profit or greater than 5% of the instrument's valuation is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur. It generally does not mean that there is no data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used)."

Cluttering/decluttering: mini-case study 10
key sources of estimation uncertainty and related issues
source: World Bank ROSC A&A compliance review

» Despite identifying determining the fair value of its fixed assets as a key source of estimation uncertainty (see extract below) Bank asserts that the measurement is at Level 2 of the fair value measurement hierarchy (see extract next slide).

> "Fixed Asset Revaluation. The Bank's fixed assets revaluation depends on its selection of certain assumptions used by the independent appraisal in calculating such amounts. Those assumptions include among others, discount rate, exchange rate, inflation rate and revenue and cost increase rate. The Bank believes that its assumptions are reasonable and appropriate and significant differences in the Bank's assumptions may materially affect the valuation of its fixed assets."

» Moreover, Bank does not specify its policy for differentiating Level 2 from Level 3 fair value measurements

» Another country's shared regulatory experience: JSE proactive monitoring in 2016 observes "It is highly unlikely that property in the South African market will meet the criteria for a level 2 fair value classification.

Cluttering/decluttering: mini-case study 10 key sources of estimation uncertainty and related issues (continued) source: World Bank ROSC A&A compliance review

- Bank makes only the following disclosures about the valuation techniques used:

  "The valuations of land and building are performed by the following external independent appraiser: [X, Y and Z property appraisal service].

  Valuations are performed based on Country A Valuation Standards, determined based on reference to recent market transactions done on arm's length terms and appropriate requirements. The valuation methods used are market value approach, cost approach and income approach. Elements used in data comparison to determine fair value of assets, among others are as follow: a) Type and right on property; b) Market condition; c) Location; d) Physical characteristic; e) Income producing characteristic; and f) Land characteristic."

- Perhaps because it asserts Level 2 FVM, Bank does not provided quantitative information about the significant unobservable inputs used to develop those Level 3 fair value measurements (paragraphs 91 and 93(d) of IFRS 13).

Cluttering/decluttering: mini-case study 10 key sources of estimation uncertainty and related issues (continued) source: World Bank ROSC A&A compliance review

» Bank has classified nearly all of its Loans receivables at Level 2 in 2016 (in 2015 all loan receivables are classified at Level 2).

» Given the description of the methods and assumptions made (including methods that likely involve significant unobservable inputs, like discounting expected future loan cash inflows using estimated current market rates.) it seems highly likely that significantly more (if not all) of Bank's Level 2 fair value measurements of its loan receivables would more appropriately be classified at Level 3.

» Contributory evidence: some peer banks in the jurisdiction classify their loans receivable at Level 3

> "Loans, consumer financing receivables, and financing lease receivables are recorded at carrying amount net of charges for impairment. The estimated fair value represents the discounted amount of estimated future cash flows expected to be received. Expected cash flows are discounted at current market rates to determine fair value (level 3 - fair value hierarchy)."

Cluttering/decluttering: mini-case study 10 key sources of estimation uncertainty and related issues (continued)

Is Entity A's disclosure about the determination of functional currency boilerplate?

Choose one of: 1) Yes; 2) No; or 3) It depends (specify…)

Are Entity A's disclosure about the determination of the degree of influence it exerts over its investees cluttered?

Choose one of: 1) Yes; 2) No; or 3) It depends (specify…)

In Entity A's financial statements, is material information potentially obscured with immaterial information?

Choose one of: 1) Yes; 2) No; or 3) It depends (specify…)

Regulatory action
level of the fair value hierarchy

JSE proactive monitoring in 2016 (emphasis added):

- Issuer owned investment property was incorrectly classified this as Level 2 because it is highly unlikely that property in the South African market will meet the criteria for a level 2 fair value classification.
- In nearly all instances, debt Issuers, inappropriately classified their own debt instruments as being within the Level 1 hierarchy because the market in which the quoted price is observed is not an 'active market' given the inactivity of trade in listed notes on the South African interest rate market. Even when trade does occur, it is not usually of sufficient frequency and volume to meet a Level 1 classification. At best, corporate debt in South Africa is likely to be a Level 2 classification, and perhaps even a Level 3. Similarly, a special purposes vehicle that issued mortgage bond securities had incorrectly classified their debt instruments as a Level 1 fair value. Where debt instruments are measured on a basis other than fair value, fair value must be disclosed regulators observe instances in which such disclosure is lacking.
- Incorrectly classified their operational financial instruments such as trade receivables and trade payables, finance leases, loans receivable and loans payable at Level 2 fair values. As a result of this incorrect classification the Level 3 disclosures were also omitted.

THANK YOU