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Subject: Disclosure Framework for the Notes - comment letter

Dear Sir, Madam,

This letter responds to the invitation to comment in EFRAG's discussion paper "Towards a Disclosure Framework for the Notes". I commend EFRAG for undertaking this study. I appreciate the opportunity to comment. The comments below represent my personal views. As an academic, I have no interest to declare, other than that I am a keen user of notes to financial statements, in particular those prepared on the basis of International Financial Reporting Standards. I use such notes both for my own instruction and as an inexhaustible supply of teaching materials. As I recognize that this is not the primary function of financial statements, I have endeavoured to adopt a more general perspective in commenting on your discussion paper (DP).

General

My main comment refers to your principle 1 (as numbered on p. 2; by the way, it might be helpful to adopt a consistent numbering of the principles throughout the paper, independent of the paragraph numbers), which reads as follows: "*The purpose of the notes is to provide a relevant description of the items presented in the primary financial statements and of unrecognized arrangements, claims against and rights of the entity that exist at the reporting date.*"

The proposal to define the purpose of the notes in terms the items in the primary financial statements is a central element of the DP. I accept the validity of the reasons cited in 1.14, although I note that, for better or for worse, this is a conservative approach. While I certainly believe there is something worthwhile to conserve in the tradition of using financial statements based on accrual accounting as an important element of financial reporting, I can see the risk that, by making the boundary between the financial statements (including the notes) and the rest of financial reporting more pronounced, the financial statements may increasingly be seen as just a compliance document rather than an integral part of financial reporting.

This points to a more important concern, which is that the DP is not, in my view, based on a sufficiently clear articulation of the limitations of accounting-based financial statements. This is important because I suspect that, historically, the notes have developed largely as a more or less conscious attempt to mitigate these limitations. The limitations I have in mind have been discussed extensively in the accounting literature, so I will not attempt to state them fully. In brief, if financial statements (i.e. balance sheet and income statement) are viewed, as in the IASB's Conceptual Framework, in terms of information about financial position and performance, they are problematic in that:

- except in the simplest situations, the 'financial position' of an entity is not well defined, as it depends to a large extent on expectations (mainly of cash flows) and preferences (such as risk preferences); the same is necessarily true of performance envisaged as change in financial position;
- the measurement bases frequently used in financial statements, such as cost, do not incorporate all available information relevant to determining financial position; if they do, such information is frequently summarized into point estimates using procedures that allow a range of outcomes;
- many elements that can be thought of as part of financial position are not recognized in statements of financial position (e.g. internally generated intangibles);
- the totals in financial statements are based on the aggregation of individually recognized items that are not identified on the basis of a well-understood concept of unit of account, and which are measured using a variety of measurement bases; as a result, it is difficult to state positively how the main totals (equity, income) should be interpreted.

These limitations, which are at least in outline generally understood, have not prevented people from finding financial statements useful, so in that sense they are not problematic. They are, however, relevant for your DP, because I find the IASB's conceptual framework to be not very explicit in stating these limitations of financial statements. This means that if you tie the disclosure framework to the items in the (primary) financial statements as defined by the IASB, you have to decide yourself which deficiencies you want to address in the notes and how far you want to go in that respect.

To say that the notes should 'amplify and explain' the primary financial statements (principle 2a, page 2) simply begs the question of where that should stop before providing full cash flow estimates and all supporting information. To say that the notes should focus on past transactions and other events existing at the reporting date (principle 2b) does help somewhat, but reporting-date conditions still essentially includes the whole range of potentialities the entity is facing. It is therefore not surprising that future-oriented information continues to creep into your detailed recommendations, such as information about the consequence of a possible change in business model for the measurement of assets and liabilities (para. 3.17.b). Similarly, there could well be a fluid boundary between information about how an item fits into an entity's operations and financial structure (3.5.b.ii) and information about an entity's strategy, or its MD&A.

On a related note, to say that 'disclosure should not be used to compensate for inadequacies in recognition, measurement, and presentation requirements (principle 10, page 3) is fine if this is simply meant in the formal sense of non-compliance with existing accounting standards. However, many of your recommendations seem to deal rather with the substantive issue of inadequacies in existing standards. For instance, requiring that an offset be undone in the notes, or that alternative measures should be provided for assets measured at cost but that could easily be traded in the market

(examples, p. 52-53) comes close to questioning whether the offset or the measurement at cost should have been allowed in the first place.

In short, while I think that many of your recommendations make sense from a pragmatic point of view, I think that, as a framework, the paper would be strengthened in an important way by articulating (a) why primary financial statements by themselves are, for many users, an inadequate representation of financial position and performance and (b) what it takes in terms of notes to expand the financial statements (including notes) to a representation of financial position and performance that may still have significant limitations in terms of total user information needs but can nevertheless serve as an adequate independent package within the entire set of information about the enterprise.

I accept that this recommendation touches on fundamental issues that standard setters have been discussing for decades, and will not be resolved any time soon. An alternative approach would therefore be to reduce the extent to which the DP uses deductive reasoning based on the Framework, and to present it more clearly as an inductive approach aimed at rationalizing and streamlining existing practices.

Responses to selected questions

Question 1.1.

I agree with the general tenor of the principles. As indicated above, I believe that their effectiveness as a coherent starting point for determining proper practices requires that they are based more explicitly on a view of the limitations of accrual-accounting based primary financial statements.

Question 1.2

Personally, I do not find organization and communication to be a major problem. As an academic, I am inclined to discount complaints of information overload, given the quite extensive theoretical and empirical literature suggesting that users of financial statements prefer to have rather than not to have information that they know is available to management. In my view, the more important question is how to ensure that disclosures are cost-effective and a proper use of society's resources. In that respect, the DP might address more extensively that disclosure requirements can be part of the problem in that they may distort or prevent the cost-benefit trade-off that reporting entities would have to make themselves in the absence of requirements. The DP might also address more explicitly what the role of the standard setter is with respect to disclosure relative to the own responsibility of the reporting enterprise, the auditor, and the users of financial statements. A case might perhaps be made that some of the perceived problems with disclosures result from the standard setter assuming too much of the responsibilities that might better be left with companies and their auditors.

Question 2.1

Yes, I think it is helpful to define the purpose of the notes. Again, I would bring in the limitations of accrual-based financial statements in any discussion of the purpose of the notes.

Question 2.2.

It is not clear to me why the definition focuses on 'relevant description' rather than 'faithful representation', given that the Framework (QC13) seems to ascribe an important role to the notes with respect to the completeness aspect of faithful representation. I accept that 'relevant description' could be a useful selection criterion for inclusion of information in the notes, but I would expect in that case that the DP elaborates that point in terms of predictive or confirmatory value (as in QC7-9) rather than in terms of the vague "should fulfil some specific users' needs" (para. 2.9.a).

In addition, it is not clear to me why the definition uses 'unrecognised ... claims against and rights of the entity' rather than 'unrecognised assets and liabilities'. I am aware that the Framework uses similar language (e.g. OB 13, except that there 'resources' is used rather than 'rights'), but that is before the focus is narrowed down to assets and liabilities as the main elements of the primary financial statements. For the DP, it seems to me there are two possibilities: either the notes are tied to the primary financial statements in the sense that the notes provide information on items that meet the definition of elements of financial statements (i.e. assets and liabilities and changes therein) but failed to satisfy the recognition criteria (as suggested in 2.9.e) or the notes can or must include information on some or all resources that do not meet the definition of assets and some or all claims that do not meet the definition of liabilities. If the latter, some more discussion is obviously required where to draw the line.

With respect to principle 2b (as numbered on p. 2), I suggest that 'past transactions and events existing at the reporting date' is not a very happy choice of words. Perhaps 'past transactions and events, and conditions existing at the reporting date' is better.

Question 3.1 (a) and (b) and 3.2.

It seems to me that if the DP builds on user needs as drawn from the Framework, the notion of cash flow predictability should occupy a much more central place in describing relevant information. That point is mentioned, but it could be used more rigorously to distinguish between information which should and should not be included in the notes.

This notion of cash flow predictability could perhaps be used to derive a more rigorous set of indicators. For instance, offsetting assets and liabilities is not necessarily something that has to be undone in the notes, I would say. That should depend on whether the gross amounts have some predictive or confirmatory value. Similarly, the importance of specific contractual terms must be judged in terms of cash flow predictability. Insufficient captions have to be dealt with by choosing better captions, not by more extensive notes.

Question 3.1 (c)

Yes, I think a category of 'information about the entity as a whole' is justified. The fundamental reason is that the lack of a proper concept of unit of account is one of the key deficiencies of accrual-based financial statements. Providing information in the notes about groups of items or even the entity as a whole seems easily justifiable from that point of view. More specifically, when the items in the primary financial statements are prepared on a consolidated basis, I would not find it illogical to provide some information on group structure.

Question 3.2

Again, I would attempt to address risk from the point of view of achieving a mitigation (within understood limits) of the deficiencies of accrual-based financial statements. The most important issues there are measurement and recognition uncertainty, and disclosures that enhance understanding of the predictive or confirmatory value of outcomes. Some of the other suggested disclosures (risk appetite, possible change in operating objectives) seem to move well beyond the objective of describing financial statement items as of the balance sheet date.

Question 3.3.

I have no particular comment on stewardship, other than that I would not try to revisit the debate over stewardship by means of the notes.

Question 3.4

Your discussion could benefit by a more explicit consideration of the role of the standard setter in disclosure, in particular whether it is the responsibility of the standard setter to innovate, to describe best practices, or rather to set the minimum levels of disclosure.

For what it is worth, my impression is that companies and their auditors would not welcome a situation in which they have to report just on the basis of general principles and objectives. In other words, disclosure checklists can be cost-effective because their application does not require extensive deliberation or consultation. If some specific requirements are desirable, it seems to me that the current practice of listing specific disclosure requirements in each standard is sensible, given that the standards tend to deal with items, events, or transactions that are quite different in nature. It also allows the standard setter to explain how it intends these requirements to be read for these items with a view to discouraging unnecessary disclosure. I can definitely see a risk that a general disclosure standard would give rise to a maximum interpretation across all items.

Maybe a mixture of the approaches in Table 1 (p. 39) can work:

- specify an item-specific disclosure objective in each standard
- specify the item-specific disclosures that the standard setter considers as the minimum requirement to meet the objective in each standard
- develop general criteria (say in IAS 1) for roll-forward schedules and item breakdowns

Question 3.5

I have no problem with standard setters establishing alternative disclosure requirements, provided that it is done in the context of national GAAP. For IFRS (whether as issued by the IASB or as adopted for use in a particular jurisdiction), this should be left to the IASB. If a jurisdiction believes that IFRS is inappropriate for certain types of companies, it should require these companies to follow national GAAP.

Question 4.1

I do not quite see how disclosure of immaterial information could impair the relevance of any disclosure. I can see that it could impair the representational faithfulness in the sense that the information could become (intentionally or unintentionally) 'slanted, weighted, emphasized, de-

emphasized' to affect the probability that information will be received favourably or unfavourably by users (QC14, wording adjusted).

Other questions

I have no particular observations to offer on the remaining questions.

Kind regards,

Kees Camfferman
Professor of Financial Accounting