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25 January 2013

Ref.: FRP/AKI/TSI/IDS

Dear Ms Flores,

Re: EFRAG Discussion Paper *Towards a Disclosure Framework for the Notes*

- (1) FEE (the Federation of European Accountants) is pleased to provide you below with its comments in relation to the Discussion Paper *Towards a Disclosure Framework for the Notes* (the "Discussion Paper" or "DP") published by European Financial Reporting Advisory Group (EFRAG), Autorité des Normes Comptables (ANC) and the Financial Reporting Council ("FRC").
- (2) We support the work that EFRAG has performed to date in trying to develop a disclosure framework aimed at setting a number of principles to increase the relevance of the notes to the financial statements. Disclosures in the financial statements are an integral part of the corporate financial reporting made by entities. We believe that it would be difficult to find remedies to the shortcomings of financial reporting as we know it today (such as overload and complexity) by addressing disclosures in financial statements in isolation. Therefore, we recommend that EFRAG takes a broader perspective and considers the development of a coherent disclosure framework that is applicable to all the different elements of the annual financial report including management commentary, corporate governance and financial statements (not solely financial performance but also of the challenges faced by the entity more broadly).

Increasing length and complexity of the Financial Statements and usefulness for users

- (3) Developments over the years have significantly increased the level and complexity of the disclosure requirements. This evolution has intended and unintended consequences on the readability and understandability, as well as the auditability of the financial statements as a whole.
- (4) The increasing volume of information has not always enhanced the accessibility and usefulness of the information presented in the financial statements as the length and complexity of the annual reports may obscure important and key disclosures relating to the performance of a company.
- (5) There is increasing criticism that financial statements may not appropriately respond to users' needs. Those who mandate the disclosures of the annual reports need to think of financial reporting not as a compliance exercise but rather as a critical component of the financial reporting. Having a clear understanding of the users' needs before proceeding to mandate disclosures is more likely to result in effective, practical financial communication.

- (6) There is a tendency for preparers to include all disclosures required in the financial statements to ensure compliance with the relevant standards because they fear the negative consequences of non compliance if scrutinised by regulators and/or auditors for omissions. Therefore, in the application of standards, it would be appropriate to move away from an approach based on compliance checklist to an approach based more on judgement.
- (7) At the same time, users are expressing frustration that financial statements include boilerplate information instead of the relevant information they need. Hence there appears to be a real need to refocus the purpose of financial reporting by establishing what information is essential as part of general purpose financial statements.

Holistic approach to improve financial reporting

- (8) Against the trend of ever more disclosures, there have been several attempts to reduce the length and the complexity of the disclosures whilst increasing the quality and focus of the information they provide.
- (9) Despite all the achievements of these many projects, we believe that changes are not only needed in the area of financial statements disclosures, but also to corporate reporting as a whole to further increase its relevance and usefulness. To achieve these goals, the debate should take a broader perspective focusing on both the financial statements and the narrative section of the annual report.
- (10) The scope of information currently included in financial statements may not be sufficient any longer to enable users to make informed decisions. A growing number of investors increasingly seek to understand the overall performance of the company and the link between corporate financial information and the company's strategy, business risks and governance. They are gradually extending their focus beyond financial information to key non-financial information included in the narrative section of the annual report. Therefore, we believe a holistic approach needs to be taken to effectively tackle current issues in financial reporting and improve corporate reporting as a whole.
- (11) Improving financial reporting is a shared responsibility and, while we believe that the role of the standard setters and supporting organisations is paramount, we would encourage them to engage more broadly in this area.

Placement criteria for disclosures

- (12) As part of this holistic approach to improving financial reporting, we support the development of a disclosure framework and the efforts of EFRAG in this respect. However, in our view, EFRAG should take a broader perspective when thinking about disclosures.
- (13) For instance, the FRC *Thinking about disclosures in a broader context* paper provides some ideas about how to draw the boundaries between different elements of the annual financial report and how to develop placement criteria for disclosures. Therefore, we would recommend EFRAG to consider these ideas while further developing the disclosure framework.

- (14) Before a final conclusion can be drawn on where the disclosures need to be placed in different elements of the annual financial report, it would be necessary to identify some placement criteria. The development of such criteria would provide a structure for a financial report. It may even be a significant way forward to eliminate the existing inconsistencies and duplications within the financial reports. A coherent disclosure framework for this purpose would ultimately improve the quality of the information provided to users.
- (15) It is also important for EFRAG to continue with its efforts to undertake proper field testing such that the future development of the disclosure framework can be based upon an assessment of what information users are looking for in the notes and which information can be justified for presentation from a cost-benefit point of view.

Auditor's involvement

- (16) Although it is not addressed in the Discussion Paper, there are aspects related to the auditability of financial statement disclosures which should also be taken into account while developing a disclosure framework.
- (17) To respond to stakeholders' demands for assurance and to audit requirements imposed by regulators, it is important that management, who remains responsible for preparing information, ensures that disclosed information is supported by sufficient and appropriate evidence.
- (18) This may not be possible where the information in disclosures is derived from systems which are separate from the main accounting systems and thus might not be subject to the same internal controls. This might mean that they are more challenging to audit.
- (19) It should also be noted that the increasing amount of qualitative and forward-looking information in financial reporting, which require management's judgement and estimation, also increases the level of judgement that auditors need to exercise. Therefore, the "auditability" of such disclosures is also an element that should be considered when developing a disclosure framework, as is also the case for financial reporting standards.

Further FEE responses to the detailed questions of the Discussion Paper are included in the Appendix to this letter.

For further information on this letter, please contact Tibor Siska, Project Manager, at the FEE Secretariat on +32 2 285 40 74 or via email at tibor.siska@fee.be.

Yours sincerely,



André Killesse
President



Olivier Boutellis-Taft
Chief Executive

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?

- (20) We generally agree with most of the key principles set out in the DP. These would provide a useful high-level foundation on which to build the disclosure framework. However, at this stage, the development of the key principles into the proposals is not always clear. It is therefore difficult to establish how some of the principles fit within the framework proposed.
- (21) Regarding the principle that disclosure requirements should *achieve proportionality to the entity's users' needs*, we have some reservations about the practicability of the differential disclosure regime as described on page 44 and 45 of the DP. We also question the relevance and sufficiency of the information that may result from such a regime.
- (22) The DP explains that the differential disclosure regime would set different levels of requirements for each standard. There would be a minimum set of requirements 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. This could potentially imply that the preparer would need to assess different levels of materiality when preparing financial statements.
- (23) While we agree that a materiality principle, if properly applied, could help in defining what constitutes relevant information about the reporting entity and therefore should be included in the notes, we are concerned that the approach proposed in the DP is overly complex with categories and indicators that would likely be difficult to implement. Materiality is necessarily a matter of professional judgement that cannot be reduced to a mechanical exercise.
- (24) Instead of proportionality of disclosure based purely on materiality of the item, we could envisage that disclosures could be supplemented by further information depending on the extent and the complexity of the transactions.
- (25) To this end, a disclosure framework could establish minimum disclosure that would need to be supplemented by further information when the nature and extent of transactions cannot be explained concisely. As an example, entities that enter into derivative contracts would be required to provide basic information about these instruments (fair value, maturity, etc.). An entity that makes extensive use of derivatives would be required to provide more detailed information for example with respect to the methods and processes used to determine fair value, etc. This more detailed information would not be required for entities that have a limited number of derivatives in place (reflecting the fact that entities making limited use of such contracts are not expected to have complex processes in place).

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?

- (26) We agree with the suggested two main areas for improvements.
- (27) However, we believe that the overload problem does not stem solely from an ineffective application of materiality. Current company reporting appears to focus on quantitative compliance stemming from extensive regulatory requirements, rather than on an informed management displaying their own insight in the context of their own financial statements. To address this, there is a need for a behavioural change by all parties in the financial reporting chain including standard setters, preparers, auditors and regulators. Establishing clearly the principles underlying the disclosures requirements may contribute to this change.
- (28) In fact, the emphasis on compliance also has a negative impact on the effectiveness of communication in that entities are apprehensive in trying new ways to communicate information even though they may be more effective.

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?

- (29) The DP defines the purpose and definition of the notes with the aim of assisting in deciding what information should be included in the notes and what information should be provided elsewhere. It also explains a number of implications of applying this definition.
- (30) One of the implications is that forward looking information can only be included in the notes if it is closely linked to the measurement of items recognised in the primary financial statements. We think this is too restrictive and that this definition would not allow for information to be included in the notes that is still of relevance to the users that is not necessarily linked to the primary financial statements.
- (31) For instance, we are not sure whether information about an entity's ability to continue as a going concern and the related underlying assumptions are entirely captured by the proposed definition. These types of disclosures provide relevant information but they could be considered as not being directly linked to the primary financial statements.

- (32) In its response to the International Auditing and Assurance Standards Board's (IAASB) Invitation to Comment on Improving the Auditor's Report, in respect of going concern, FEE called for "...more disclosures by management. With the growing demand from investors for additional information on going concern assessments, entities should be required to provide more information on the assumptions and other information used to support management's assertion that the entity would be able to continue its activities in the foreseeable future, currently considered as a period of at least one year. This is especially important in situations where there may be concerns about the impact of future events..." We maintain this position and would be concerned if the definition of the purpose of the notes resulted in reducing disclosures on going concern.
- (33) In addition, there is a contradiction between the proposed definition and the requirement to include information about alternative measurements in the notes since these are not about recognised amounts in the primary financial statements.
- (34) In order to demonstrate the operability of the proposals, it would be useful if the DP showed some examples of the implication of applying the proposed definition of the notes, particularly for disclosures that are eliminated from the notes. That would help to better understand the boundaries between the notes and other information disclosed outside the financial statements.
- (35) More importantly, before a final conclusion can be drawn, it would be necessary to identify some placement criteria for disclosures to set the boundaries of annual financial reports as a whole. The development of such placement criteria would provide a clear structure for an annual financial report. It may even be a significant step forward to eliminate the currently existing inconsistencies and duplications in annual financial reports.
- (36) This would also help standard setters and regulators to determine where the disclosures should be placed and for preparers and auditors how to apply disclosure requirements. A coherent disclosure framework for annual financial reports as a whole would ultimately improve the quality of the information provided to the users.
- (37) Nevertheless, we are aware that there are currently barriers to place disclosures into different parts of the annual financial report due to requirements in the accounting standards or other constraints exposed by legal requirements. However, in our view, there would be a need for a holistic approach to overcome the problem of disclosure overload and to improve corporate reporting as whole.
- (38) For instance, the FRC *Thinking about disclosures in a broader context* paper provides some ideas on how to draw the boundaries between different elements of the annual financial report and how to develop placement criteria for disclosures. We would recommend EFRAG to consider these ideas while further considering the development of the disclosure framework.

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?

- (39) Disclosure requirements have built up, standard by standard, over many years, following a "bottom up" approach. To provide an appropriate context in which to understand the financial performance and position of an entity, it would be useful to also introduce a "top-down" approach starting with a (business) "summary" including information addressing the entity as a whole, its business model, the risks to which it is exposed and how it manages them, as well as whether management is running the company in good faith and fulfilling its stewardship obligation. This summary, that would not necessarily be part of the financial statements, would be followed by relevant complementary detailed disclosures.
- (40) Even though we generally agree with the underlying principles, we do not concur with all aspects of the proposed implementation of these principles. These are the examples that we have identified:
- In respect of the "risks" category, on page 29 of the DP, it is suggested that there should be information included in the notes about the consequences of a change in the operating objectives of the reporting entity even if such circumstances are deemed remote. In the example provided, this provision will result in disclosing the fair value of loans that are reported at amortised cost on the basis that this information would be relevant to users in order for them to understand the consequence of a change in the business model. However, such a requirement to disclose alternative measurement appears to contradict the definition of the notes (set out in Chapter 2) since this type of information is not about recognised amounts in the primary financial statements.

- In respect of the “stewardship” category, the DP proposes to eliminate the related party disclosures on the basis that they are only concerned with stewardship. We are not convinced that this assumption is right because in our opinion disclosures about related party transactions also provide relevant information about the financial position of the company. Therefore, providing information about such transactions (e.g. transfer of resources, services and obligations between the reporting entity and the related party) is important to support the understandability of the underlying transactions and to meet the needs of users.
 - With respect to “when to require disclosure”, we also note that the illustration in Appendix 1 indicates that under the DP proposal non-adjusting post balance sheet events would not be disclosed in the notes since they relate to a future period and, therefore, do not fall within the proposed definition of the notes. We do not agree with this proposal. For instance, information about material litigations arising after the reporting date and not necessarily resulting in an adjusting event is likely to be useful to users and, therefore, it should be disclosed in the notes.
- (41) We believe that establishing indicators of useful information is worthwhile. However, they should remain guidance and not be transformed into rules that have to be followed in establishing disclosure requirements.
- (42) In order to make the use of these indicators more understandable, we would recommend including some illustrative examples indicating where a reduction to the number of disclosures is expected in comparison to the disclosure requirements that are currently included in the standards. As a result of these examples, it would also be expected to see where the application of the indicators results in more disclosures compared to what we have today.

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?

- (43) It appears logical to develop disclosures on a standard by standard basis. Disclosures are a natural extension of the recognition and measurement principles applicable to a specific matter. However, care should be taken not to repeat the errors of the past by establishing piecemeal disclosure requirements outside an overall framework that sets objectives and ensures proportionality of the information required by the various standards.
- (44) Accordingly, we would envisage standards that define minimum disclosure requirements to fulfil the objectives set in the overall framework, with additional proposed disclosures (for example, to be shared with industry specialists) to apply when the matter is material.

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?

- (45) Instead of the standard setters handing over to users the entire responsibility for judging what is relevant information or in the contrary, providing detailed disclosure requirements, we would prefer a solution in the middle of these two extremes.
- (46) For example, we could see that standard setters would establish only minimum disclosure requirements which should be supplemented by further information when the nature and the extent of the transaction cannot be explained concisely. To achieve that objective, preparers would assess the necessity for additional information based on their own circumstances surrounding the relevant business case. Please refer to our answer to question 1.1 for further details.

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?

- (47) We agree that the Disclosure Framework could reinforce the application of materiality reminding preparers of circumstances which can lead to unnecessary disclosure of immaterial items. However, we think the application of materiality should be addressed in IAS 1, particularly in relation to general information.
- (48) However, more importantly, the overload problem does not stem solely from an ineffective application of materiality but there is also a need for behavioural changes by all parties in the financial reporting chain including standard setters, preparers, auditors and regulators. We refer to our comments in our response to question 1.2 for further details.

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?

- (49) As mentioned above, we are concerned that the approach proposed in the DP is overly complex with categories and indicators that would likely be difficult to implement. Materiality is necessarily a matter of professional judgement applied to the financial statements as a whole that cannot be reduced to a mechanical exercise. Therefore, it is difficult to provide a very detailed description of materiality that can be applied at individual transaction level.

- (50) We acknowledge that the understanding and application of this concept may differ in practice among preparers, auditors, users of financial statements as well as enforcement authorities.
- (51) Significant diversity in practice in the application of materiality in IFRSs among preparers, auditors, enforcers and among different entities is undesirable.
- (52) Materiality is currently defined within IFRSs. It is regarded as an entity-specific aspect of relevance based on the nature or function, or both, of items to which the information relates. Hence, materiality is by definition subject to judgement (i.e. all facts and circumstances have to be taken into account). Both qualitative and quantitative considerations are required. Therefore, it would be unrealistic to expect that uniformity in the application of the concept of materiality could be achieved.
- (53) We would support development of further guidance, in relation to materiality, in particular on qualitative factors, but only at a global level. In addition, we would like to note that auditing standard setters, such as the IAASB, provide additional guidance on this issue to auditors. In our view, it is important that any further guidance developed by the IASB is consistent with the guidance of the IAASB.
- (54) In addition, while the application of materiality requires judgement in any case, the main problem is its application to general (narrative) information. In our view, IAS 1, and not necessarily the disclosure framework, should provide guidance for applying materiality, in particular to general information.

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?

- (55) Generally we agree with the proposed communication principles. Further we concur with EFRAG that the communication principles must be developed from the premise that disclosure requirements should be applied with a view to communicating information to users rather than being a mere compliance exercise. The proposals could contribute to improving the effectiveness of the disclosures.
- (56) Regarding the methods of organising the notes, we tend to agree with the flexible approach proposed in the DP. It proposes that the disclosures in the notes should be included in order of priority with the most significant information included first.

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.

- (57) We have no additional issue to note.