Group of 100

Less is more

October 2009

Executive summary

Background

- The G100 has prepared this document in response to an invitation from Sir David Tweedie to develop a principles-based approach to determining disclosures.

- Entities and users are questioning the value many of the current disclosures bring to a financial report.

- The principles based approach that is currently being used in standard setting is contradicted by the rules-based approach to disclosure requirements.

- Disclosure requirements in individual standards do not allow the requisite degree of flexibility to consider an entity's operations as a whole or the prevailing market conditions at any given point in time.

- As a result of perceived deficiencies with the current disclosure regime, many companies are preparing more focused and user friendly information for investors in addition to their financial report.

- The G100 believes the time is appropriate to consider a principles-based framework for assessing current disclosures and developing new disclosure requirements.

Relevance

- Relevance of information to users, particularly shareholders and other capital providers should be the first and most important consideration when setting disclosure requirements.

- Disclosures should be equally understandable to the reasonably knowledgeable user and the sophisticated expert.

- Comparability and consistency across both peer groups and reporting periods will allow for meaningful analysis by users.

Materiality

- The determination of what is deemed to be material to the financial report is a matter of judgement.

- The G100 recommends the adoption of:

  a) a more consultative approach with greater engagement of users in determining the required level of disclosures in standards; and

  b) greater emphasis on economic substance rather than form on the part of both auditors and regulators.

Executive Summary (continued)

Transparency

- Users are entitled to a balanced and complete view of the entity's performance and position where disclosures faithfully represent the economic substance of transactions and reflect the underlying business operations.
- The benefits of any particular disclosures should be balanced against any potential commercial risks to the entity from the disclosure of potentially commercially sensitive information.
- Both auditors and regulators will need to acknowledge that the judgment applied by management could result in differing levels of disclosure between entities when expressing an opinion on the financial report and in reviewing it for compliance with legislative requirements
- Over time, the market will reward those entities with appropriate disclosures relative to those entities with inadequate levels of disclosure.

Contents

Introduction

Background

This project was initiated in response to an invitation by Sir David Tweedie, IASB Chairman, to develop a set of principles for the purpose of guiding decisions when determining disclosures required by accounting standards.

The request followed a G100/FRC workshop at which the outcome of a survey of the experiences of G100 members' implementation of Australian equivalents to IFRSs ("AIFRS") was discussed.

In undertaking the project the G100 was not driven by concerns about the quality of financial reporting in Australia. Rather, the project was initiated because although the existing financial reporting and regulatory framework is of high quality, concerns were being expressed about the volume, complexity and usefulness of a number of the requirements in the existing disclosure regime.

The current situation

Many entities and users are currently questioning the value the disclosures bring to a financial report

Many entities and users are currently questioning the value that the disclosure requirements of current International Financial Reporting Standards ("IFRS") bring to users of financial reports. In particular, there is concern that the volume and complexity of disclosure has a potentially negative impact by distracting users from the information that is relevant to their decision making. In essence, there is a risk that quantity is outweighing quality.

Whilst the G100 acknowledges the need for adequate disclosure, and in particular, agrees that a minimum level of disclosure is necessary for those entities that access the market to raise capital, the G100 also believes that the current level of IFRS disclosure requirements should be reviewed for the following reasons:

79% of G100 members surveyed felt that IFRS added unwarranted and complex disclosures to their financial report

- A recent survey conducted by the G100 of its members identified that 79% of preparers indicated that IFRS resulted in areas of unwarranted and complex disclosures that were not useful to users of financial statements or in the management of the entity.
- The requirement to make additional disclosures is a seen as a common "fall back" strategy, designed to compensate for inadequacies in the accounting methods prescribed, or because of compromises made by the standard setter, rather than to provide financial statement users with insightful information.

The areas where respondents felt that the most unwarranted complexity exists are:

- Defined benefit plans *IAS19 Employee Benefits*
- Financial instruments (*IFRS 7 and IAS 39)*

For example: The *IAS 19* “corridor approach” to accounting for pension liabilities allows entities to “smooth” the impact of actuarial gains and losses and market value movements in fund assets over the working lives of employees. A very detailed note is therefore required about the gains and losses, the amounts that have been recognised, and the impact of smoothing.

For example: The recent amendments to *IAS 39 Financial Instruments; Recognition and Measurement* regarding re-classification of financial assets and the accompanying detailed disclosures that are required where the amendment is applied include disclosures that are not used by management in running the business.

- The majority of IFRS have adopted a prescriptive approach in specifying disclosure requirements, in contrast to a principles-based approach for recognition and measurement requirements.
- In addition users are revealing that the financial statements do not meet these information needs.
- With the focus of the International Accounting Standards Board (“IASB”) on resolving accounting methods, it would appear that less effort has been applied to examining the merit of disclosures.

For example: The accounting standards on income taxes (*IAS 12 Income Taxes*) and provisions (*IAS 37 Provisions, Contingent Liabilities and Contingent Assets*) require detailed reconciliations in relation to each type of temporary difference included in deferred tax assets/liabilities and provision. It is questionable whether these disclosures are relevant to users or help them make investment decisions.

As a result of perceived deficiencies with the current disclosure regime, many companies are preparing additional information for investors outside of their financial report

- The increasing complexity of transactions has caused the IASB to require more rather than less disclosure, without providing evidence of any testing or investigation whether the increased disclosures actually enhance reader comprehension.
- Disclosures have been dealt with on a topic-by-topic basis with little consideration for the entire body of disclosure and its impact on the overall financial report.

Given the significance of the above issues, it is not surprising that many companies have reverted to preparing two sets of financial reports; those required in compliance with IFRS, which are increasingly being regarded as a compliance exercise, and those where the company produces additional, specifically tailored reports to its shareholders.

In the opinion of many directors, such shareholder reviews, information packs and shareholder-friendly reports better communicate the performance and position of the company as seen through the eyes of management.

Proposed way forward

The G100 believes the time is appropriate to consider a principles based framework in order to apply current disclosures and develop new disclosure requirements

Whilst there has been broad consensus support for the move towards developing more principle-based standards; the G100 believes that the time is appropriate to consider a similar approach for both developing disclosure requirements in new standards and assessing existing disclosure requirements. Such principles would need to be considered at both an individual standard and at an overall level.

The remainder of this paper documents disclosure principles that the G100 believe should be applied by standard setters in determining disclosures to be required and by directors in assessing the applicability of those disclosures for company financial reports.

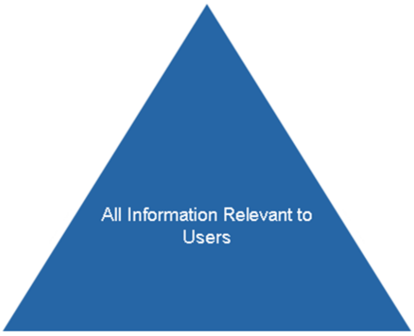
The G100 believes that appropriate consideration of the following principles by the standard setter, preparers and regulators alike, would result in more tailored disclosures and an overall enhanced quality of financial reports provided to users:

1. Relevance: Determine what information is relevant for users to make decisions

2. Materiality: Apply materiality

3. Transparency: Ensure a balanced and objective view is provided acknowledging constraints relating to potentially commercially prejudicial information

1 Determine Relevant Information



Relevance of information to users should be the first, and most important, consideration when setting disclosure requirements.

Whilst there may be a range of potential users of financial reports, the G100 considers that the primary users of financial reports are the company's current shareholders and capital providers; and accordingly, the information needs of this user group should be given precedence to facilitate their decision making including assessment of the stewardship/accountability of management.

The G100 believes that the information needs of other secondary users (such as credit providers and potential shareholders) will be comparable with those of current shareholders and capital providers.

In assessing what information is useful for current shareholders and capital providers, consideration should be given to the following principles:

Relevance

Relevance of information to users should be the first, and most important, consideration when setting disclosure requirements

- Financial statements should be prepared with the end user in mind.
- Shareholders are interested in information about the amount, timing and uncertainty of an entity's cash flows, its ability to pay dividends and to provide a return on their investment.
- Information is also sought about how well the directors and management have discharged their responsibility to make efficient and profitable use of the assets entrusted to them.
- Providing sufficient information about past, present or future events to enable users to assess business activity and management performance, and to help forecast future growth potential is critical.

Understandability

Disclosures should be equally understandable to the reasonably knowledgeable user and the sophisticated expert

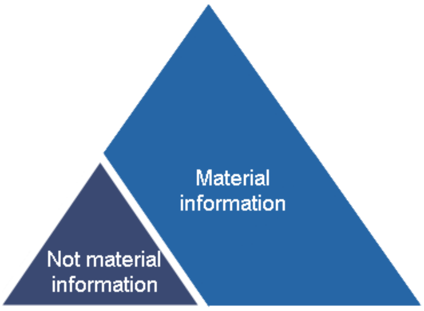
- Disclosures need to be understandable to both the reasonably knowledgeable user and the highly sophisticated expert.
- The financial report disclosures should be clear, concise and written in Plain English.
- The full set of disclosures should "tell the story" of an entity's performance and financial position.

Comparability and Consistency

Comparability and consistency across both peer groups and reporting periods allows for meaningful analysis by users

- Usefulness of information is enhanced when it is both consistent and comparable.
- Users should be able to identify and analyse trends in an entity's financial position and performance over time. This includes ensuring that similar transactions are dealt with in the same way over time, enabling users to identify differences in treatment year-on-year.
- Comparability also needs to be maintained, to a degree, between peers and competitors. The G100 believes this can be addressed through having a threshold level of minimum disclosures for those companies raising capital in public markets.

2 Apply Materiality



The G100 acknowledges that the concept of materiality is embedded in the existing financial reporting framework but believe it is not always well applied in practice by preparers.

This is particularly the case in relation to disclosures as preparers for a variety of reasons (including perceptions about the reactions of regulators and auditors) tend to take a lower risk or conservative approach by providing more information rather than less; irrespective of its materiality.

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial report. An item may be material by virtue of its size or nature; that is materiality has both quantitative and qualitative aspects.

So whilst all of the information identified in the first level of the proposed threshold may be considered 'useful' to investors, there is a need to determine that information which is 'need to know' versus that which is 'nice to know'.

This is an area that requires preparers to exercise a degree of professional judgment to identify information that is relevant to the business.

Consultative approach

The determination of what is deemed to be material to the financial report is a matter of judgement. The G100 recommends a more consultative approach to assist in setting the required level of disclosures within standards

It is often difficult for preparers (or standard setters) alone to identify what is deemed to be material and useful for users. The G100 therefore proposes that standard setters adopt a more consultative approach to applying and setting disclosure requirements and to determine the types of disclosures that users find most useful.

It is recommended that industry working groups, the investor community and relevant regulators have increased involvement and input on disclosures at an early stage of the standard setting process.

The role of auditors

In order for preparers to be able to apply their professional judgement, it is important that auditors acknowledge and consider variations in the level and extent of disclosures in forming their opinion on the financial report. The G100 believes that increased focus should be given to the importance of addressing issues in the context of how the business is managed by adopting a "through the eyes of management" perspective and having a greater emphasis on economic substance rather than form.

The current practice of preparers utilising the template accounts of audit firms, whilst providing some efficiencies, does not always encourage the preparer to form their own opinion on what is material and therefore what should, or should not be, included in the financial report. These template accounts typically include illustrative examples for a wide range of transactions by diverse entities and it is important that preparers and auditors carefully examine whether these illustrative disclosures are relevant and material to the specific facts and circumstances of the company.

The role of regulators

The adaption of a principles-based disclosure regime also has implications for the role of the regulators. Under such a regime it will be necessary to acknowledge that differences in disclosure will occur as a result of the judgements made by management and directors about the economic substance and significance of transactions and events and usefulness of disclosures to shareholders and capital providers in making economic decisions.

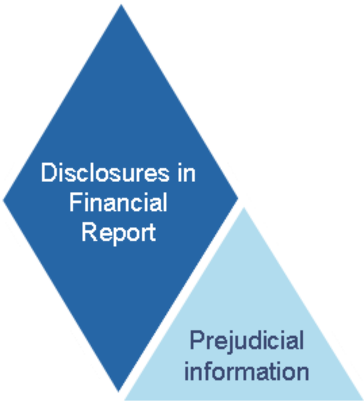
The role of the market

Over time, the market will reward those entities with appropriate disclosures and penalise those with inadequate levels

It is inevitable that where judgment is used in determining the level of disclosure required, differences will exist that could adversely affect comparability between entities within a peer group. However, this would be ameliorated by the enhanced quality of disclosures relating to the company's performance and position.

It is the view of the G100 that the market will reward those entities with the appropriate level, types and extent of disclosure, relative to those entities whose disclosure is deficient. Over time it is the market and the company's response to market expectations, not the regulator or auditor, that will effectively determine the required level (type, nature and extent) of disclosures provided by companies.

3 Transparency



As noted previously, the G100 considers that an entity's current shareholders and capital providers are the primary users of financial reports.

Transparent and unbiased disclosures within the financial report allow users to make informed decisions. Users are entitled to a balanced and complete view of the performance and financial position of the entity. To achieve the desired level of transparency, disclosures should faithfully represent the economic substance of transactions.

However, the application of the transparency principle is constrained to the extent that it is not in the best interests of shareholders to disclose information which is commercially prejudicial to the company.

As indicated in the G100's *Guide to Review of Operations and Financial Conditions* "the benefits of any particular disclosures should be balanced against any potential commercial risks to the entity from the disclosure of commercially sensitive information."

The benefits of any particular disclosures should be balanced against any potential commercial risks to the entity from the disclosure of commercially sensitive information

Therefore, as the company's directors are charged with enhancing shareholder value, they need to be able to make the judgement not to provide sensitive information if doing so is likely to unreasonably prejudice the company and its shareholders. Conversely, in these cases the directors would need to make an assessment of the risks to the company of not providing the information to the market.

The G100 acknowledges that that the application of such a principle, does increase the likelihood of preparers not providing potentially useful information to shareholders on the basis that it is commercially sensitive and may result in prejudice against the entity. Hence we believe that for preparers to be able to appropriately apply the above principle, both auditors and regulators will need to take a pragmatic approach when reviewing the financial report and acknowledge that the judgement exercised by management could result in differing levels of disclosure when expressing an opinion on the financial report and in reviewing it for compliance with legislative requirements.

Finally, similarly to the concept of materiality, we believe that in the fullness of time, the market will determine the allowable level of omissions due to commercial sensitivity.

4 A practical application

We are seeking to find the appropriate balance between rules and principles

Notwithstanding our desire to see more principles-based disclosures, the G100 accepts that there needs to be a threshold level of disclosure for all entities that access the financial markets to raise capital. To achieve this we accept that there does need to be some prescription around minimum levels of disclosure. These minimum disclosures should then be considered in conjunction with the disclosure principles to determine what additional disclosures should be made in a financial report. In effect, we are seeking to find the appropriate balance between rules and principles.

The G100 believes that *IAS 34 Interim Financial Reporting* provides an appropriate starting point for determining a threshold level of disclosure.

On this basis, at a minimum the financial report should comprise:

- a Balance Sheet
- a Statement of Comprehensive Income
- a Statement of Changes in Equity
- a Cash Flow Statement; and
- selected explanatory notes.

In determining those explanatory notes, the guidance in IAS 34 provides that an entity shall disclose any events and transactions that are material or significant to an understanding of the changes in financial position and performance of the entity for the period.

By combining the principles in IAS 34 and the principles of relevance, transparency and materiality, the following information may be considered for disclosure for each significant class of transaction or balance:

- the accounting policies adopted
- the critical accounting estimates and assumptions used in determining amounts and information about the sensitivity of those estimates and assumptions; and
- sufficient detail to enable a user to understand the composition of line items.

Conclusion

The G100 believes that now is the appropriate time to consider a change in how disclosure requirements are determined and applied.

The "principles-based" approach that is currently being used in standard setting (and is receiving broad support) is contradicted by the rules-based approach to disclosure requirements.

Disclosure requirements as set out in individual standards do not allow the requisite degree of flexibility to consider an entity's operations as a whole and the overall disclosure load.

In order to address these issues, (and eventually remove the need for entities to prepare additional information for their shareholders outside of the financial report, the G100 proposes that the disclosure principles outlined in this submission be applied by the standard setter when setting disclosures.

The G100 believes that the application of the "disclosure principles" in conjunction with a concerted effort for cultural change by all key stakeholders, will assist in driving enhanced quality and usefulness of financial reports to the end users.

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