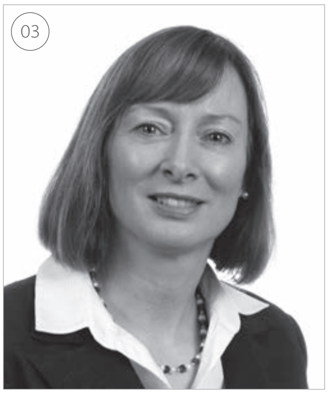
QUALITY FINANCIAL REPORTING

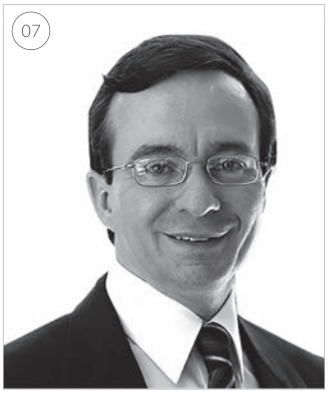
HOW TO IMPROVE FINANCIAL STATEMENTS

The FMA's response to themes raised at its September 2014 quality financial reporting event

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

Beyond IFRS: Quality Financial Reporting Event Summary





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Chairman of the FMA Audit Committee

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Brian Gaynor (Milford Asset Management)
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Recordings of the individual presentations are available on FMA's YouTube channel.

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November 2014

FMA
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Introduction

In September 2014, the FMA hosted a half-day discussion forum in Auckland titled 'Beyond International Financial Reporting Standards (IFRS): Quality Financial Reporting'. This forum aimed to facilitate a clearer understanding of disclosure challenges within the New Zealand environment, and identify ways to improve financial statements so they are a clear and effective reporting and communication tool.

The forum comprised keynote presentations from invited speakers and a panel discussion. Attendees came from a range of backgrounds, including financial reporting preparers, users, standard setters, auditors, law firms and FMA representatives.

From the discussion at the forum it is clear to us that disclosure challenges exist. But there is no single step or solution to overcome it.

It was also evident that all stakeholders contribute to one or more of the perceived problems about the extent and complexity of disclosures in financial statements.

These challenges provide an opportunity for stakeholders to reassess their approach and focus on moving forward, and improving financial reporting disclosure.

This report outlines the FMA's response to the main questions raised at the forum.

It also outlines some ideas that may help address disclosure in financial statements, and ultimately make financial statements a more effective communication tool.

Existing and potential investors, lenders and other creditors are the primary consumers of financial statements. In this document we refer to these groups collectively as 'users', and the organisations preparing financial statements as 'entities'.

What information do users need?

Over the years, it has become evident that annual financial statements are not meeting users' needs as a tool to support their investment and other business decisions.

Financial statements that are not clear, concise and effective have an adverse impact on the effective communication channel between entities and their users.

Many commentators agree that disclosure overload in financial statements can obstruct the more useful information contained in financial statements. There is a clear need for disclosures contained within the financial statements to be refocused on their primary purpose. That is, to provide investors with useful information that will help them make decisions about providing resources to the business, and assess management's stewardship of the resources entrusted to it.

Disclosures in financial statements need to provide sufficient information that helps users to assess the prospects for providing future net cash inflows to an entity.[1] This requires a shift away from the current prevailing approach to disclosure, which satisfies the requirements of all accounting standards without considering material relevance of that disclosure to the entity.

The desired approach is to focus on identifying material information and communicating this in a clear, concise and effective manner. To be of real help to users, financial statements should tell the entity's story.

In our view, this material information should include:

- information for understanding the entity's financial position, performance, cash flows and prospects
- a disaggregation of the individual balances at a level of detail that enables the key components of primary financial statements to be understood
- information about significant business developments
- matters of importance to the business
- the specific financial risks to which the business is exposed, together with their context and management's approach to those risks
- an explanation of the basis for recognition and measurement of line items in the primary financial statements, in particular when management exercised its judgement
- information relating to items not recognised in the statement of financial position that, if or when recognised, will have a significant effect on future cash flows.

Financial statements are one of many sources of financial information

When thinking about the information financial statements can provide, users should keep in mind that they are just one of many sources of financial information. Financial statements are only part of the story, and users should not expect that they include everything they need to know.

[1] Paragraph OB3, NZ Framework

The *New Zealand Equivalent to the IASB Conceptual Framework for Financial Reporting 2010* (NZ Framework) highlights that financial statements do not and cannot provide all of the information that primary users need[2]. If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. Relevant information is capable of making a difference in decisions made by users[3].

For example, financial statements form part of the annual report, which contains a wider range of useful information such as management commentary, corporate governance statements (for NZX listed entities) and information required by the *Companies Act 1993*. In addition to the annual report, users should also consider relevant information from other sources, for example the general economic conditions and expectations, industry and company outlooks[4].

We also strongly encourage entities to improve the transparency and consistency of information disclosed in the annual report. We believe entities should focus on disclosing only relevant, quality information in all their documents and avoid including information that is not material, or not useful to the end user.

Non-GAAP financial information can be useful for investors

We understand that results presented in accordance with New Zealand generally accepted accounting principles (NZ GAAP) may not adequately portray the performance of an entity in certain circumstances. No single income line can capture everything about a company's performance that a user will need, due to, for example, the multi-faceted nature of company performance.

For this reason, we accept that non-GAAP financial information may be useful for investors if it is built on the cornerstones of NZ GAAP. Non-GAAP financial information is normally presented outside of the financial statements, for example within the management commentary, market announcements, and entity's market presentations.

The FMA issued guidance on non-GAAP financial information in September 2012, which includes detailed guidance to help reduce the risk of non-GAAP financial information being misleading. We continue to encourage all entities to use this guidance when presenting non-GAAP financial information.

Key points

- Financial statements should tell a story about the entity in the most clear and effective manner.
- Financial statements' primary purpose is to provide investors with useful information that will help them make decisions about providing resources to the entity and assessing management's stewardship of the resources entrusted to it.
- Financial statements do not and cannot provide all of the information that primary users need.
- Financial statements are one of many sources of financial information.
- Non-GAAP financial information can be useful for investors in specific circumstances, and we encourage the use of the FMA guidance note when presenting this information.

[2] Paragraph OB6, NZ Framework
[3] Paragraph QC6, NZ Framework
[4] Paragraph OB6, NZ Framework

How should materiality be considered?

Not all disclosures provide useful information to investors. As discussed earlier, some financial statements contain content that is not relevant or material, potentially obscuring the information that is important.

NZ IAS 1 *Presentation of Financial Statements*[5] notes that an entity need not provide a specific disclosure required by a New Zealand accounting standard if the information is not material. Applying that fundamental principle, information should be disclosed only when it is determined to be material to the users of the financial statements.

The NZ Framework also states that: *"Information is material if omitting it or misstating it could influence decisions that users make on the basis of 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 the individual entity's financial report."*[6]

Materiality depends on the size and nature of the omission or misstatement judged in the context of the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

The concept of materiality seems to be clearly described in the NZ Framework. However, as acknowledged by the International Accounting Standards Board (IASB), its application in practice is seen by many as a major cause of disclosure overload. This may be due to a failure to use management's professional judgement when considering materiality, and therefore applying a 'tick box' approach to the financial statements. This results in financial statements that include a significant portion of immaterial and irrelevant disclosures.

Many commentators agree that materiality is well-established as a concept in relation to recognition and measurement, but consider that this is less clear when it comes to disclosures. This leads us to conclude that entities are generally applying a compliance based model for disclosures, rather than a materiality and principle based model.

We believe that disclosure in financial statements should include information assessed as material to the primary users' decision making process. That assessment needs to be made by management applying professional judgement, and determined based on the surrounding circumstances.

Effective application of materiality requires an ongoing application of professional judgement. Therefore, we encourage entities in New Zealand to consider materiality throughout the financial year, not just at the end of the reporting period when financial statements are prepared and not just focusing on quantitative disclosures.

We note that in May 2014, the New Zealand Accounting Standards Board (NZASB) issued an explanatory guide on materiality for public benefit entities. This guide helps with the application of materiality to presentation and disclosure, when preparing general purpose financial reporting in accordance with Public Benefit Entity Standards. Although directed at public benefit entities, we believe it contains guidance helpful to all sectors and we encourage all entities to consider this guide.

[5] Paragraph 31 of NZ IAS 1 *Presentation of Financial Statements*

[6] Paragraph QC 11 of NZ Framework

We believe the following points can help preparers apply the concept of materiality during the financial reporting process.

- Use professional judgement in making disclosure decisions, to ensure that only material disclosures are presented. Practical steps towards making this change could be to refocus on entity specific information and avoid:
  - a 'tick the box' approach
  - use of numerous disclosure checklists
  - overuse of boilerplate disclosures.
- Ask yourself – is it relevant? Communicate what is relevant and understand the users' needs. For example:
  - focus on the needs of existing shareholders when assessing whether the information is relevant and whether the disclosures matter to them
  - for listed entities, this may involve more frequent dialogue between the board and the key institutional investors and other shareholder representatives.
- Establish financial reporting processes and allocate enough time to the financial reporting process throughout the financial year.
- Engage with the auditors throughout the financial period to discuss material disclosures, transactions and implications on the financial statements.
- Keep updated with the disclosure initiative projects the IASB is undertaking, in particular the research projects on materiality and principles of disclosure. Have your say during the relevant submission process – your view counts!

Key points

- Information should be disclosed only when it is determined to be material to users of the financial statements.
- Effective application of materiality requires an ongoing application of professional judgement.
- Consider materiality throughout the financial year by establishing adequate financial reporting processes including:
  - ongoing engagement with the auditors
  - frequent dialogue with shareholders
  - avoiding a 'tick the box' approach and overuse of boilerplate disclosures
  - focusing on disclosing relevant information.

When should disclosure be provided?

Financial statements are often prepared from a template, which creates generic boilerplate disclosures that do not necessarily provide entity specific information. This often results in financial statements being a compliance tool rather than a communication tool that tells a specific story to users.

Below are some principles an entity could consider when preparing its financial statements that will help ensure they are an effective communication tool. Please note that this list is not exhaustive.

Assess disclosure so that disclosures are entity-specific

Each disclosure should be assessed so that disclosures are entity-specific and material. Clearly communicate how effectively management and boards have put the assets entrusted to them to use.

Shift from compliance to communication approach

Financial statements are an important communication tool where preparers tell their story and users hear and use that story to make relevant investment decisions.

Consider order and format

Consider whether the current presentation structure of the financial statements supports the communication of relevant information to users. Use of the same template, year after year, may mean important notes are buried at the end of the financial statements and not seen by users. In determining the structure of the financial statements, you may also wish, as a starting point, to consider what other entities have done with their financial statements to better communicate their story, and whether that may apply to your entity.

Focus on the relevance of information disclosed

Focus on the relevance of information disclosed so that useful information is prioritised in the financial statements. Think about presenting relevant notes and information about main transactions and events affecting the entity with more prominence, and earlier in the financial statements. Avoid boilerplate disclosure and avoid duplication within the financial statements.

Clear and concise disclosures written in plain English

Consider the style of writing, length of sentences and the use of large amounts of text. The language used should be precise and explain complex accounting and reporting issues clearly. Try to avoid technical jargon. The "clear, concise and effective" theme of the *FMA's Guidance Note: Effective Disclosures*, issued in June 2012[7], even though directed at the disclosures in the offer documents, is equally applicable to the financial statements and any other financial report. Have the financial statements read by someone in your organisation outside the finance team. If they don't understand them, they might not be clear, concise and effective.

Reflect the current reporting period

Information in the financial statements should reflect the current reporting period, for example specific transactions and changes relevant to it. Any information that is no longer useful should be omitted from the financial statements. For example, the entity does not need to disclose comparative information if it is not considered to be relevant in the current period[8].

[7] *Consultation Paper: Update of Guidance Note: Effective Disclosures* was issued on 24 October 2014 and aims to revise the existing guidance note.

[8] Paragraph 38 of *NZ IAS 1* requires comparative information in respect of the preceding periods for all amounts reported in the current period's financial statements, expect when NZ IFRS permit or require otherwise.

Explain the substance of the transactions

While the accounting standards dictate note disclosures, an entity should ensure the notes adequately explain the economic substance of the transaction. The entity may disclose additional information where it is important for an understanding of the performance of the company.

Consider the level of information for material transactions

Entities need to consider the amount of information disclosed for material items, as additional information may not necessarily be material. An assessment as to whether the omission of a required note (or specific disclosure requirement within the note) constitutes a misstatement is encouraged. This requires case-by-case judgement. The decision to include or exclude such information should be based on whether the omission would change users' economic decisions.

Consider which accounting policies are significant

Management should consider which accounting policies are significant to the user in understanding specific transactions and therefore should be disclosed. Management should also consider including significant accounting policies as part of the relevant notes, to increase the connectivity. Management could also consider linking within the financial statements (or as a separate section of the financial statements), for example as an appendix to the financial statements.

Key points

- There is a strong need for entities to provide clear, concise and effective disclosures, but with all relevant information included in the financial statements.
- Preparers can apply numerous principles when preparing their financial statements, to improve disclosure and deliver a clear reporting and communication tool. For example, preparers can:
  - disclose entity-specific information
  - apply the communication approach to the financial statements
  - consider order and format
  - disclose only relevant information
  - ensure clear and concise disclosures written in plain English
  - focus on disclosing information that reflects the current reporting period
  - focus on the substance of the transactions
  - consider level of information for material transactions
  - consider which accounting policies are significant.

What is the role of stakeholders?

Most of the identified reasons for disclosure overload have been linked to the behavioural patterns of financial statement stakeholders.

Preparers

In New Zealand, finance teams generally operate on a lean basis with few available additional resources. While this may be effective on a day to day basis, it puts significant pressure on the year-end financial reporting process. For this reason, there is often reliance on the external auditor to drive the financial reporting process rather than the preparer, which leads to a 'tell us what to do' approach.

There is a tendency for preparers to adopt the following mind set when it comes to the financial statements:

- it was there last year
- we've got the information, so why not disclose it?
- the regulators are focusing on this
- everyone else discloses it
- you can't take anything out
- IFRS says disclose it
- better too much than too little
- auditors tell us what to do.

This mind set is often combined with an approach that sees financial statements' disclosures being considered at the last stage in the financial reporting process. The result is that auditors and preparers have no opportunity to step back and assess what story needs to be told, and the best way to present that story in the financial statements.

We believe that sound project governance, embedded around the financial reporting process, would create a positive step in the right direction. For example, preparers should consider the following points.

- Create a financial reporting process throughout the financial year. In particular, a detailed planning phase that includes implementation of controls around the preparation of disclosures.
- Clearly identify the primary users of your financial statements, identify their needs and how those needs can be most effectively met.
- Set clear objectives up front to disclose only material items and disclosures relevant to those primary users. Financial statements should not and cannot include all the information its primary users want, so focus on relevant and material information when making disclosure decisions.
- Maintain ongoing communication between preparers and auditors, including discussion and agreement up front with the auditors around materiality.

- Have a process for evaluation and applying key learnings from previous years.
- Ensure early reassessment of new transactions, changes in accounting policies, and how financial statements will be presented each year.

Directors[9]

Directors are accountable for the preparation and authorisation of financial statements and responsible for ensuring the quality and integrity of financial reporting. This includes their relevance, faithful representation, comparability and timeliness, and how understandable they are for users.

We strongly encourage boards to produce financial statements that are clear, concise and effective. Directors can achieve this by creating and supporting strong governance around the financial reporting process. This includes ensuring clear leadership and the ongoing involvement of directors in the financial reporting process. Ongoing involvement requires exercising professional judgement in determining material information, and documenting decisions the board has made regarding the inclusion or exclusion of information in financial statements.

Auditors

Auditors play an important role in improving the quality of financial reporting disclosure. For example, they can be involved in up front discussions with management, directors and the audit committee around accounting policy changes, new transactions and the implications on disclosures.

When reviewing their clients' financial statements, auditors should apply materiality and professional judgement to their review, avoiding a "checklist" approach to disclosure that is contributing to the volume of information in financial statements. Also, instead of asking the entity to put more disclosures in, auditors should seek to understand why they left it out.

We expect auditors to encourage entities to consider a new approach to their financial statements disclosure.

Standard setters

New Zealand standard setters are, without a doubt, playing a vital part in this initiative. The External Reporting Board (XRB) has already identified disclosure ineffectiveness as a key issue. Globally, the IASB is focusing on disclosure overload and issuing guidance on the application of materiality, in particular from a disclosure perspective. The IASB is also running a project to develop disclosure principles within the Conceptual Framework. However, even within the existing framework, there are significant improvements that can be made. We await these further developments with interest.

[9] In November 2014, FMA released updated corporate governance handbook for feedback. The handbook is intended as a reference to directors to help them decide how best to apply key corporate governance principles including financial reporting.

The FMA

The FMA's main objective is to promote and facilitate the development of fair, efficient and transparent financial markets. The disclosure of clear, concise and effective financial information provides investors with access to information that will help them make informed financial decisions.

We are therefore very supportive of entities who want to provide users with more relevant financial information.

We appreciate that entities may be concerned about regulatory intervention when they omit disclosures from their financial statements. Our view is that an entity can and should make decisions, based on professional judgement, to remove disclosure that is not material. In doing so, it should document its rationale. This ensures that, should we make any enquiries, the entity has documented support for its decision.

We encourage entities to not be overly concerned by enquiries from the FMA. In most cases we are simply seeking further information to understand the approach that has been taken. Our approach to financial statement monitoring is risk based and therefore immaterial items are unlikely to be questioned.

Key points

- There are a number of different parties who have a role to play in improving financial statement disclosure.
- For entities, a sound governance process for financial reporting should create a positive step in the right direction. This highlights the need to consider the financial statement content during the year and maintain an ongoing discussion with the auditors.
- Auditors can assist by considering materiality when reviewing financial statement disclosures and encouraging their clients to consider the need for financial statements that better meet the needs of investors.
- The FMA supports the exercise of professional judgement to remove immaterial disclosures from financial statements.

Clear, concise and effective financial information helps investors make better-informed investment decisions.

Conclusion

The aim of our discussion forum in September was to facilitate a clearer understanding of the challenges with disclosure in the New Zealand environment, and identify ways to ensure financial statements are a clear and effective reporting and communications tool.

In this report we have aimed to take the discussion a step further by providing practical information for preparers and their auditors to use when considering how an entity can make changes to its financial statements.

We acknowledge that a thorough review of the content and disclosures within the financial statements involves a great deal of work during the reporting period. However in our view the benefits of streamlining financial information far outweigh the costs.

Streamlining financial information ensures users get information that is focused on their needs and improves communication between an entity and its users.

All those involved in the preparation, audit and review of financial statements need to participate in the improvement of disclosure practice in New Zealand. This means that directors, management, auditors, users and regulators all need to invest time and effort to effect positive change.

We have highlighted key areas in which these efforts can be directed, but our primary message is that financial statement information should focus on the specific needs of its primary users. This will ensure that businesses provide users with the information they want, uncluttered by immaterial content and delivering clear, effective messages about performance.

Making such a change to financial statements is bold. We encourage entities to be bold and reduce the clutter by removing boilerplate and immaterial disclosures and focussing on the areas we have covered in this report.

- What information do users need?
- How should materiality be considered?
- When should disclosure be provided?

If all preparers and auditors focus on being bold and committed to change, and step back from the rules-based approach to disclosure requirements, we will see an improvement in the quality and value of financial statements for those that use them the most. This would be a great success for New Zealand investors and other consumers of financial information, and contribute to the promotion of fair, efficient and transparent financial markets.

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