FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

June 2018

Improving financial statements

This monitoring report summarises the findings from our thematic review to determine the extent of improvements in the presentation of financial statements in a clear, concise and effective way, and sets out some suggestions for additional improvement.

This monitoring report is intended for all financial statement stakeholders. In this report we refer to organisations preparing financial statements as 'entities' or 'preparers', and the primary consumers of financial statements (existing and potential investors, lenders and other creditors) collectively as 'users'.

Introduction

Investor decision-making is a strategic priority for the FMA. While investor decision-making is influenced by many factors, providing investors with quality financial information in the financial statements is integral to achieving our objective of capable, confident and well-informed investors.

In December 2014 we released a report Quality Financial Reporting – How to Improve Financial Statements ('the 2014 Report'). In this we encouraged entities to reassess their approach to the preparation and presentation of their financial statements with a focus on them being an effective communication tool. To achieve this, the proposed approach was to:

Step 1: Focus on providing material information ('Material information') and

Step 2: Communicate this in a clear, concise and effective way ('Effective communication')

The 2014 report remains a useful reference for entities to consider when preparing their financial statements.

2018 review

In early 2018 we reviewed the most recently issued financial statements[1] of the NZX 50 as at 30 November 2017 to determine the extent of improvements since the release of the 2014 Report. The focus of our review was limited to the Effective communication (step 2 above), in particular the approach to the content, layout or structure of the financial statements.

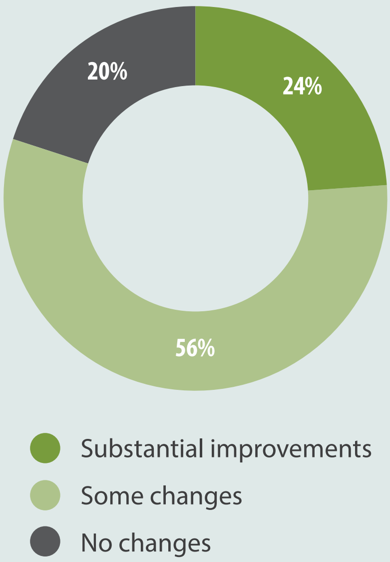
Overall we found that 80% of entities made some change to the content, layout or structure. The level of changes, however, varied significantly between entities, with only 12 of the 50 making substantial observable improvements. The observations made in this report mainly reflect the substantial improvements to content, layout or structure identified in the financial statements of these entities.

In general, entities thought about:

- How to focus content on what is most important to users.
- Changing the layout to improve clarity and understandability.
- Removing irrelevant information.

While the extent of substantial improvements varied, we consider that the observed efforts improved the clarity and conciseness of the financial statements, and worked towards better and more effective communication to users.

Extent of improvements to content, layout or structure: NZX50 financial statements



1. Our review captured financial statements issued in the 2017 calendar year and where necessary prior periods.

Two steps to effective financial statements

The objective of financial statements is to provide financial information about the entity that is useful for its users when making decisions about providing resources to the entity. To achieve this, financial statements serve as an important communication tool where entities tell their story and users can understand and use that story to make informed investment decisions.

1 Material information[2]

Consideration of materiality is fundamental for the preparation of financial statements[3]. Information should be disclosed only when it is assessed to be material[4] to users' decision-making processes; and only material information can be considered relevant[5] to users. Consequently, if information or an item or transaction is determined to be immaterial, it is not relevant and as such obstructs the useful information contained in the financial statements.

Effective application of materiality requires ongoing application of professional judgment. This involves continuous consideration of both quantitative and qualitative factors. For example, for disclosures presented in the notes to the financial statements, preparers should determine what information needs to be provided and in how much detail, to support users' decision-making. Entities should document their materiality assessment and rationale to support decisions made, taking into account all relevant facts and circumstances.

In September 2017, the International Accounting Standards Board (IASB) issued a practice statement Making Materiality Judgements. This provides guidance and examples to help preparers of financial statements make materiality judgments. We encourage entities to consider this statement when deciding what information is material.

To enhance understandability[6] and transparency, entities should disclose what they consider to be material and relevant in their financial statements.

2. Our review did not include assessment of materiality including any other compliance with applicable accounting standards
3. Paragraph 7, NZ IAS 1 Presentation of Financial Statements
4. Materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an entity's financial statements (Paragraph QC11 NZ Framework)
5. Relevant financial information is capable of making a difference in the decisions made by users (Paragraph QC6, NZ Framework)
6. To make information understandable it needs to be classified, characterised and presented clearly and concisely (Paragraph QC30, NZ Framework)

2 Effective communication

Disclosing material and relevant information in a clear, concise and effective way makes the financial statements easier to understand. This can be achieved by focusing on the following principles:

- Relevance of information disclosed
- Order and format of the financial statements
- Clear and concise disclosures written in plain English.

The focus of our recent review was on the approach to and application of the above principles to the extent observable. We set out our observations on the improvements to content, layout or structure below, together with some additional suggestions for entities to consider to facilitate the application of these principles[7].

The principles, observations and additional considerations are not exhaustive and there are numerous additional ways to improve disclosures in the financial statements and deliver a clear reporting and communication tool.

Relevance of information

Focus on the relevance of information disclosed so that useful information is prioritised in the financial statements. Present 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.

What we've seen

- Setting the scene by disclosing up front what the entity considered to be material and relevant information for financial reporting purposes.
- Giving greater prominence to the most important events and transactions by highlighting and/or summarising up front 'significant' or 'material' events and transactions, and cross-referencing to relevant notes.
- Re-ordering notes to the financial statements and/or presenting information in the individual notes by importance.
- When notes were categorised into sections (see 'Order and format' below), providing a summary of the main transactions or performance highlights within each section.
- Explaining structural changes made to the financial statements and the rationale for them.
- Visually signalling items of most importance within a note by using features such as:
  - call-out boxes, to highlight the most relevant information in the notes
  - symbols or images, to draw attention to specific information disclosed throughout the notes (for example accounting policies, assumptions, key estimates and judgements).

Other things to consider

- Annually reassess the adequacy of the information provided, to assess relevance of new transactions and information, and eliminate or re-prioritise the information that is less relevant for the current period.
- Consider the levels of prominence given to information in both the annual report and financial statements by aligning highlights in the management commentary with the presentation of the relevant notes and information in the financial statements.

7. Where a particular observation relates to multiple principles, we have categorised it in the principle of most relevance to that observation.

Order and format

Consider whether the presentation structure of the financial statements supports the communication of relevant information to users. Ensure that important notes are not buried at the end of the financial statements and not seen by users.

What we've seen

- Categorising notes into sections or groups of commonality (for example, 'Performance', 'Operating assets and liabilities', 'Funding', 'Financial risk management').
- Combining information of a similar nature into one note (for example, information about 'Revenue' and 'Trade receivables').
- Merging separate disclosure requirements into one combined note (for example, disclosing the information about the fair value hierarchy together with the information about the items measured at fair value).
- Presenting information of less relevance at the end of the financial statements and signalling relevance with appropriate labelling (for example 'Appendix' or 'Other notes').
- Adding a contents page for the notes to the financial statements to aid navigation.

Other things to consider

- Consider the design and presentation structure of the notes for each reporting period to ensure it supports the communication of relevant information and facilitates users' understanding.

Clear and concise disclosures written in plain English

Consider the style of writing, length of sentences and the use of large amounts of text. Use precise language and explain complex accounting and reporting issues clearly. Try to avoid technical jargon.

What we've seen

Across the sample, we observed an overall improvement in the style of writing, length of sentences and use of plain English. Examples included:

- Using shorter sentences.
- Removing repetition and using cross-references to connect different parts of the financial statements.
- Using overviews and/or summaries to highlight key information.
- Using diagrams and graphs to summarise information clearly and more effectively than long sections of text.
- Using tables to simplify overly lengthy disclosures.

Other things to consider

- Presenting a brief paragraph (keep it simple) to explain the accounting complexity relevant to the notes in plain English with limited technical language. Explain the economic substance of a material transaction if it would facilitate better understanding of the transaction.
- Breaking complex and lengthy notes (such as financial risk management and valuations) by using headings and sub-categories.
- When providing financial statements electronically, using hyperlinks as well as cross-references to connect different parts.
- Including a glossary of terms used in the financial statements, in particular to explain complex terminology and any technical jargon.
- Having someone outside the finance team read the financial statements to determine whether they are easy to understand.

What's next?

The FMA will continue to monitor efforts made in this area, engage with the financial statements stakeholders, and promote improvements in the quality and value of financial statements.

We encourage entities to be bold, commit to reassessing their approach to financial reporting, and strive towards producing financial statements that are useful and serve their purpose. This includes considering the key areas in our 2014 Report, focusing on material information and communicating this in a clear, concise and effective way, and building momentum to continuously improve the financial statements. We encourage entities to consider the observations and additional suggestions noted in this report when considering how to improve the content, layout or structure of the financial statements.

Management, directors[8], auditors, standard setters and regulators[9] have an important role to play in improving the effectiveness of financial statements as a communication tool, and helping investors make confident and well-informed decisions. These efforts will ultimately contribute to the promotion of fair, efficient and transparent financial markets.

8. In February 2018 the FMA published its refreshed Corporate Governance handbook for directors, executives and advisors. In May 2017 the NZX released its updated Corporate Governance Code.
9. See 'What is the role of stakeholders?' in the 2014 Report.

AUCKLAND

Level 5, Ernst & Young Building
2 Takutai Square, Britomart
PO Box 106 672, Auckland 1143

Phone: +64 9 300 0400

WELLINGTON

Level 2, 1 Grey Street
PO Box 1179, Wellington 6140

Phone: +64 4 472 9830

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND