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What is the future role of financial reporting?

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INTRODUCTION

Put simply, are traditional financial reports still relevant?

Are traditional financial reports still a valid part of organisational communication and accountability? Or has the financial report become an impenetrable collection of numbers and words, prepared only for compliance purposes, and only understood by a few technical elite? Is the financial report keeping up with the increasingly complex demands of businesses in a timely manner? What effect is digital disruption having on financial reporting? Put simply, are traditional financial reports still relevant? These are simple questions with complex answers.

Discussion on the effectiveness of financial reporting as a communication tool (often referred to as 'disclosure overload') has received considerable international attention recently. Through a contemporary lens, this paper responds by examining the experiences of two leading companies and their assault against disclosure overload.

It is clear that established views on the role of financial reporting are being challenged. Such challenges simultaneously provide an opportunity to listen to the debate, imagine and action. *future*[inc] acts as a catalyst to this debate by providing insights from real-world experiences in the trans-Tasman market. Action calls for decisions to be made within the debate – decisions as to how we are positioned as individuals, organisations and as a profession. Chartered Accountants have the opportunity to be leaders in improving and shaping the future of financial reporting – let's do it.

UNDERSTANDING THE CHALLENGE

Digital technologies are changing at such a pace and magnitude.

Traditionally, financial statements have been viewed as an essential tool for informing investors (and other interested parties) about a business's performance. Increasingly, however, businesses are finding other ways to communicate both historical performance and future prospects.

Examples include the increasing use of alternative performance measures (APMs) in financial reports (such as Earnings Before Interest, Tax, Depreciation and Amortisation – EBITDA), analyst presentations and other forms of direct communication with investors. A mounting body of literature suggests that financial reports are becoming too complex and losing relevance. Left unchecked, is financial reporting in danger of becoming a compliance exercise? Some might argue that this point has already been reached.

To make financial reports relevant again will require dialogue and action on the part of reporting entities, regulators, auditors, standard setters and other user groups.

How did financial reporting get to this state?
The following factors are often regarded as having contributed to the problem:

- Increasingly complex businesses: Commentator Roger Trapp observed on Forbes.com that increasingly businesses are more global and are using more complex metrics to assess performance.[1] Fallout from the 2008 Global Financial Crisis (GFC) means they are also using increasingly sophisticated techniques (such as complex derivative instruments) to manage risk. This makes it harder for businesses to tell their performance story in a succinct, informative and compelling way.
- Increasingly complex rules: In response to more sophisticated transactions and risk management techniques, accounting standards have become more complex. For example, the International Accounting Standards Board (IASB) response to the GFC was to rewrite their entire accounting standard for financial instruments. Inevitably, businesses are required to provide more detailed disclosure in their financial reports about exposure to and management of financial risks. There has also been an increase in the level of regulation for many industries. Australasian businesses need only compare the amount of security market legislation that existed before the GFC with that which exists today.
- Digital disruption: Digital technologies are changing at such a pace and magnitude that they have the potential to disrupt the established methods of financial reporting. Entities are using these technologies more often to present financial information, allowing users to define their own reporting needs. Delivery of financial information need no longer be constrained by the traditional formats.
- A boilerplate mentality[†]: It is tempting for a business to adopt a boilerplate mentality in an effort to manage audit and regulatory risks. This manifests itself through extensive quoting of accounting standards in financial reports, rather than tailoring those reports to reflect the uniqueness of the entity. It also results in the reporting of immaterial information. The consequence is that key performance messages are at risk of being lost in a sea of irrelevant information.
- Timeliness of reporting: Most businesses prepare financial reports on an annual basis, months after the fact. They find other ways to communicate more regularly with interested parties. Examples include continuous disclosure to regulated exchanges, press releases and monthly newsletters to shareholders.

[†] Boilerplate mentality for the purposes of this paper is defined as the inclusion of transactions not relevant to the entity and the disclosure of immaterial items.

A CLOSER LOOK

The Chartered Accountant of the future is someone who is agile and keeps moving with a changing world.

A number of pioneering entities are taking a broader perspective than simply reordering or reducing existing information – they are rewriting existing disclosures to remove boilerplate text, presenting additional information where relevant, and thinking of original ways to report existing information.

Flight Centre and Chorus are two such entities. Below we individually explore each of their recent innovative reporting redesign experiences and ask ourselves – where to from here?

LEARN BY EXAMPLE: MAKE A START

So what can others learn from the experiences of Flight Centre and Chorus? Of course, any transformation project of this nature is going to need to be tailored to the specific reporting entity. However, Flight Centre and Chorus offer the following tips to inspire those contemplating their own review of financial reporting:

- Get engagement from key stakeholders and project sponsors from the outset.
- Start early. Give yourself and the organisation enough space and time to do it right the first time.
- If offered the choice of a big bang or progressive approach, go for the big bang.
- Look at other comparable organisations for ideas but determine what information is going to be decision useful for your own stakeholders.
- Be bold and give it a go.

CASE STUDY: FLIGHT CENTRE

Flight Centre, which has its headquarters in Brisbane, Australia, is one of the world's largest travel agency groups. It has company-owned operations in 11 countries and a corporate travel management network that spans more than 75 countries. It employs more than 15,000 people globally and has a total of 2,500 stores.

Rather than making incremental changes over a series of reporting periods, Flight Centre carried out a complete redesign of their financial reports between the production of the 2013 and 2014 annual reports. The redesign was driven by a desire to improve the quality of their financial reporting while reducing the level of duplication. The project robustly challenged the information that had previously been included. It considered what information was likely to be most material to users, the best groupings for that information and the story needed to frame those groupings.

Flight Centre provides two stand-out examples of what can be achieved by taking a fresh approach to financial reporting. The first is the way they have grouped information around key themes including financial overview, cash management, risk management and reward and recognition. These themes are replicated in Flight Centre's other communications to the market, such as analyst presentations.

> Flight Centre chose a big-bang approach to improving disclosure effectiveness.

This consistency provides two obvious advantages: a clear and compelling story for users; and internal efficiencies for the company in not having to present the same financial information in different formats.

The second stand-out example is a one-page summary of the significant matters in the current reporting period. This summary immediately follows the primary financial statements and highlights the key factors impacting performance. Such summaries acknowledge that not all users will have the time or inclination to read through all of the detail in the financial statement notes. However the summary cross references this detail should a user require additional information. The matters considered to be significant were those the company had identified as priorities. For example, the company has previously given a commitment to only incur capital expenditure up to the amount of depreciation in a given period. Accordingly, information on cash management appears early in the financial report.

Flight Centre chose a big-bang approach to improving disclosure effectiveness. While this required planning and engagement with key stakeholders many months before the end of their reporting period, it allowed the company to look at disclosures as a whole and tell a consistent story. This might not have been possible if the improvements were made piecemeal over a series of reporting periods.

Flight Centre management views accounting standards as the most significant constraint to further improvement. They say users of their financial reports, mainly investment analysts and retail investors, focus on segment and lease commitment information.

It might be argued that much of the other information in the notes, while it is material as defined by accounting standards, is of little relevance to those users. This issue challenges the core principles of financial reporting: who are the financial reports being prepared for and what level of disclosure is most relevant to those users? Sophisticated retail investors – who are increasingly prominent – might need key performance metrics they are able to model ("slice and dice") to inform their investment decisions. They may be less interested in much of the remaining detailed disclosure required by current accounting standards.

CASE STUDY: CHORUS

Chorus became New Zealand's largest telecommunications infrastructure company when it de-merged from telecommunications service provider Telecom (now Spark) in 2011. The de-merger provided a unique opportunity for Chorus to define its own financial reporting landscape.

This landscape now depicts a complete financial story that links financial reporting with analyst briefings, other market communications and reporting to the stock exchange. Management commentary is combined with the financial reports to tell a consistent story about the past and future performance of the company. While financial reports may be losing relevance for many entities, they are central to the financial reporting communication package at Chorus.

The project to improve disclosure effectiveness at Chorus was driven by management, knowing they had the full support of the board. Free of any pre-defined boundaries, the Chorus management team was liberated to explore a broad range of options. Obtaining project sponsorship early on was critical. This meant engaging the board and the company's auditor from the beginning.

So what did Chorus do differently? There were no "sacred cows". Nothing was ruled out before the project began. Many entities would place limits on the project from the outset, for example by scoping out certain disclosure notes from inclusion in the project. External constraints are often cited as the reason for imposing such limits. Chorus let external constraints have only a minimal impact on what they wanted to achieve, and on what they were ultimately able to achieve. Their main concern was how a non-traditional set of financial statements would be received by the market.

Obtaining project sponsorship early on was critical. This meant engaging the board and the company's auditor from the beginning.

Their efforts were somewhat restricted by the presentation requirements in accounting standards. They continue to disclose a significant amount of information on debt hedging, for example, which was considered to be material, but they question how useful the information is in its current format.

Chorus eliminated much of the immaterial disclosure from its financial reports, but chose to disclose additional financial information, such as normalised results, in an effort to enhance their communication value. They were more concerned with improving the quality of information than they were with reducing the volume.

Flight Centre and Chorus received wide spread praise from the investment community for what they achieved.

Adding information does bring its own challenges. In recent years, securities regulators have been at pains to limit the amount of non-GAAP[†] financial information in financial statements and other stakeholder communications. This can create a tension between preparers and regulators. Non-GAAP information is often included on the basis that preparers find it more decision useful than GAAP information alone. Common examples include APMs such as EBITDA and key performance indicators prepared on a non-GAAP basis. Regulators are concerned that such information inhibits comparison across reporting entities and that the lack of a recognised basis of preparation allows entities to manipulate the presentation from year to year.

Chorus notes that many of the legislative disclosure requirements haven't kept pace with a changing world. One example of this is the New Zealand legislative requirement to disclose the 20 largest shareholders. The number of retail investors is on the decline. With the majority of investments now held through custodial services, one might question the relevance of such a disclosure in today's world.

As a newly demerged business, Chorus had the luxury of starting their financial reporting transformation project with a clean sheet of paper. Most organisations are not so fortunate. However, we hope that other businesses will be inspired by Chorus's achievements. The market responded very positively to the performance story they told, demonstrating an appetite for change and setting a challenge to other businesses to improve the quality of their reporting also.

WHERE TO FROM HERE? - CONTINUOUS IMPROVEMENT

Flight Centre and Chorus received wide spread praise from the investment community for what they achieved. So where to from here? Both companies view their journey as one of continuous improvement. They continue to respond to changing user demands and market conditions. This means they continue to refocus and sharpen the key messages each reporting season to respond to these changing needs. Chartered Accountants will continue to play a pivotal role as financial reporting evolves. For Chorus, the Chartered Accountant of the future is someone who is agile and keeps moving with a changing world. They will continue to provide relevant information in a more sophisticated world so that users understand your business. After all, if people don't understand your business, they won't give you their money. Where the supply of capital is finite, responding to these needs will be critical. The call for change has been made.

[†] Non-GAAP is a term used to define financial information that is not prepared on the basis of generally accepted accounting standards (GAAP).

A SURVEY OF THE TRANS-TASMAN RESPONSE

Of the entities surveyed, the most notable changes are being made to accounting policies and the notes.

Are businesses responding to the call for change? One might reasonably expect that if a small group of influential entities were to tackle the disclosure effectiveness problem, change within the wider financial reporting community would soon gather pace.

How many are opting for change?

We carried out a survey of over 800 ASX and 25 NZX50 listed entities. The results provide useful insight into the level of effort being made by Australian and New Zealand entities to improve their disclosure effectiveness.

> The usefulness of financial reporting is further improved by the removal of irrelevant information.

Entities were included in the survey based on a review of their publicly available financial statements for the year ended 30 June 2014. The financial statements of entities within the sample were scanned for the following signs of efforts to improve disclosure effectiveness.

1. Presentation of accounting policies in a manner other than immediately following the primary financial statements.
2. Evidence of attempts to group like notes in the financial statements.
3. Any noticeable reduction in the volume of reported financial information from prior reporting periods.
4. Other indicators that suggest the financial statements had been prepared using a non-traditional structure.

These criteria will have captured commonly acknowledged methods for improving disclosure effectiveness, but may have overlooked qualitative improvements, such as replacing boilerplate text with entity-specific information. No detailed analysis of individual financial statements was performed.

Survey results highlighted a noticeable difference between the level of effort being made in the two countries. There was an encouraging level of engagement from New Zealand's largest entities: 28%, or 7 of the 25 entities surveyed, had taken steps to improve the quality of their financial reporting. A much smaller percentage of Australian entities had made obvious changes to the form and content of their financial statements (6% or 47 of the 800 entities surveyed).[†]

WHAT CHANGES ARE BEING MADE?

There is still a significant majority of listed entities in both countries that choose to retain a more traditional style of financial reporting: primary financial statements first, then accounting policies, detailed notes in broad order of profit or loss, and balance sheet line items. Items not directly linked to a line item in the primary financial statements (such as commitments, contingencies and financial risk management notes) are usually presented at the end. However, of the entities surveyed, the most notable changes are being made to accounting policies and the notes, both of which appear to have minimal impact on the length of the redesigned financial statements.

We discuss these changes in more detail below.

Accounting policies

The most obvious method to improve disclosures is to relocate accounting policies to appear either with the relevant notes or to a more logical location elsewhere in the financial statements. This is an easy win for preparers. It should be a relatively simple exercise to take the accounting policies and align them with the relevant note disclosure. The Australian entities in our survey reordered their accounting policies in a range of ways. Results were fairly evenly split between moving them to the end of the financial statements, placing them

[†] In addition to researching NZX50 entities, we surveyed 20 entities on the NZX SMALLCAP index (that is, entities listed on the NZX main board but outside the NXZ50 index) for the same reporting period. Only one entity within this sample had made any obvious attempt to improve disclosure effectiveness when assessed against same criteria.

with the relevant note disclosure and reorganising them in some other way. By contrast, virtually all New Zealand entities that presented their accounting policies in a non-traditional way chose to locate them with the relevant note disclosure.

Notes

While it requires slightly more effort, grouping like notes is also a reordering of existing information and as such should be reasonably simple for most businesses. Grouping the accounting policy and notes for property, plant and equipment is a good start. Linking these with the asset impairment policy and note, however, tells a more comprehensive story about the entity's use and management of productive assets.

Approximately one third of the Australian entities surveyed that had presented their financial statements in a non-traditional way had made an obvious attempt to group like notes. Meanwhile, four of the seven New Zealand entities had made an obvious effort to group like notes. The remaining entities largely followed a traditional ordering, by first presenting profit or loss information and then following the order in which line items appear on the balance sheet.

An alternative approach is to order the notes based on their significance to the reporting entity, from most important to least important. Again, subjectivity comes into play, both in the entities' ordering of the notes and in our survey of them. However, it was interesting to observe the number of both Australian and New Zealand entities burying, in the middle of the notes, what might be considered by many financial statements users to be the most decision useful information. A notable example was the number of asset intense entities that chose to report routine lines of mandated profit or loss disclosure, such as audit fees, ahead of information about the use, valuation and impairment of the entity's productive assets.

Report length

The usefulness of financial reporting is further improved by the removal of irrelevant information. As we have discussed, decisions about what to include are often determined by the concept of materiality. Clarifying the concept of materiality is a key focus for the IASB.

Overall, the average length of the New Zealand financial reports we surveyed actually increased by an average of 5.9% between 30 June 2013 and 30 June 2014 (from an average of 84 pages to 87 pages). Only five entities (20%) reduced the length of their financial reports between 2013 and 2014.

Of those New Zealand entities that had made obvious efforts to present their financial statements in a non-traditional way, the average length of the financial statements was only reduced by 2% between 2013 and 2014. This might surprise some readers. The discussion on disclosure effectiveness often focuses on reducing the volume of information presented. In 2013, the IASB itself announced, 'We managed to reduce the size of our 2012 Annual Report and the accompanying disclosures by 25 per cent compared to the previous year. At the same time, we actually increased the amount of useful information in the report and made it easier to read.'[2] Such statements are good for the press but are unlikely to reflect the reality for most reporting entities. The relatively small decline in the length of financial statements observed in New Zealand will only tell part of the story.

WHERE TO FROM HERE?

We hope more entities will look to improve the effectiveness of their disclosure as we enter the 2015 reporting season. Anecdotal evidence obtained from a small sample of entities and their boards suggests that they will, perhaps driven by the achievements of the entities that made improvements in 2014, peer pressure within industries, and cross pollination of boards. Clusters of entities are likely to make improvements based on the geographical location of their head office.

Grouping the accounting policy and notes for property, plant and equipment is a good start. Linking these with the asset impairment policy and note, however, tells a more comprehensive story about the entity's use and management of productive assets.

CUT-THROUGH PRACTITIONERS

Chartered Accountants will take a leading role in this revolution.

The role of Chartered Accountants

The challenge has been set. There is a clear call for reporting entities to improve the effectiveness of their disclosure.

Our research highlights that the challenge has been accepted by a small but trendsetting group of reporting entities that are striving to improve the effectiveness of their financial reports. Boards are seeing the efforts made by other entities and challenging their own management teams to do the same.

Our research highlights a wide spectrum in the level of effort entities are going to in improving disclosure effectiveness. At the one end, a range of entities appear to be making smaller initial steps to facilitate better understanding by reviewing the location of their accounting policies. The case studies allow us to take a deeper dive into two entities that have taken a more holistic approach to disclosure effectiveness. While these entities too continue to make incremental improvements in their financial reporting, their initial approach was more akin to a big bang. Making substantive improvements at a single point in time, at least for these two entities, offered an opportunity to review their financial reporting as a whole. There is an opportunity for future research to confirm whether those entities making incremental steps are able to achieve the same level of final outcome as those who have adopted the big bang approach. This will surely depend on whether there is sustained support for improving disclosure effectiveness or a shift in corporate priorities over time.

This publication focuses on what reporting entities are able to achieve within existing reporting constraints. The ability to take financial reporting to the next level will rely on the continued goodwill of standard setters, regulators and other interested parties. It will also depend on how agile each of these parties is in responding to the increasing impact of digital technologies in defining the financial reporting landscape.

Chartered Accountants will take a leading role in this revolution. Of course, improving financial reporting is not an accounting exercise alone. It requires input from boards, investor relations teams and a host of other parties within an organisation. But it is the Chartered Accountants who will understand how the disclosure effectiveness issue has arisen and therefore how best to address it.

So often accountants are, perhaps unfairly, blamed for the ever-increasing disclosure burden. Now, there is a genuine enthusiasm for change within the financial reporting community. This can perhaps be attributed to a shift in perception: businesses are seeing disclosure effectiveness as a value add rather than a compliance cost.

This is not a time for the profession to rest on its laurels. It should continue to question what more it can do to remain relevant to business and the wider community.

Assurance insights

It is often said that assurance professionals contribute to the disclosure overload problem. Efforts to manage legal risk can lead auditors to use checklists, for example, which encourage an approach of disclosing all of the items set out as possible requirements in accounting standards. But assurance professionals are also part of the solution. Applying professional scepticism while working with reporting entities can help to identify and reduce boilerplate disclosure. Is it really needed? What value is this providing to the user?

Chartered Accountants providing assurance services are at the forefront of change. They have an opportunity to challenge reporting entities on the way financial information is being presented, questioning whether it is communicating the right messages in the most effective way.

Businesses are seeing disclosure effectiveness as a value add rather than a compliance cost.

> The biggest impact is in a user's ability to define their own information needs, take that information and digest it in a way tailored to the specific needs of that user. Contrast this against the role of an accounting standard setter in developing generic accounting standards trying to be all things to all users and the ability of digital technologies to disrupt traditional views of financial reporting becomes obvious.

But there are other challenges facing assurance professionals.

Changes in financial reporting are interfering with assurance norms. Already, we are seeing more financial information being presented outside the boundaries of a traditional set of financial statements. Examples include summarised financial information that appears in shareholder newsletters or on the reporting entity's website. Current accounting standards, in part, acknowledge this change. IFRS 7, for example, anticipates that certain information about the existence and management of financial risks may be described outside the financial report.

The basis for preparing financial information is also changing. The increasing use of non-GAAP information (such as EBITDA) has required Australasian securities regulators to issue guidance on the subject. The introduction of reports and information, such as sustainability, or matters being explored through initiatives such as integrated reporting in annual reports, blurs the boundary around the financial information that is subject to audit. Whereas all of the information within a traditional set of financial statements was subject to a level of audit assurance, this is often now no longer the case. Certain non-GAAP measures and forward-looking statements included within the notes are now being flagged as unaudited. Conversely, certain information outside the traditional set of financial statements is being subject to a level of assurance. An example is the requirement in Australia for an external audit review of director remuneration information. These requirements are often driven by changes in legislation.

Digital disruption is a mega-trend impacting most aspects of daily life. It is also increasingly impacting financial reporting as it is changing the way people receive and interact with information. Traditional financial reporting has developed against a backdrop of accounting standards, regulation and levels of assurance where the information is contained in a prescribed financial report format. Digital technologies are placing more control in the hands of users, potentially bypassing the constraints established by regulators, standard setters and assurance professionals. The biggest impact is in a user's ability to define their own information needs, take that information and digest it in a way tailored to the specific needs of that user. Contrast this against the role of an accounting standard setter in developing generic accounting standards trying to be all things to all users and the ability of digital technologies to disrupt traditional views of financial reporting becomes obvious.

As the debate on financial statement noise develops, so too will debate over the appropriate role for assurance practitioners. Assurance contributes to trust in the financial reporting process, which is essential for effective markets. Maintaining that trust is essential. Can assurance practitioners effectively balance the need to retain trust and manage legal risk, with the increasing need to ensure financial statements are a relevant and decision useful tool for users.

UNPACKING THE CASE FOR CHANGE

Discussion on disclosure effectiveness has been gaining momentum in recent years.

Against a building momentum for change, what are financial statement preparers to do: sit back and wait or act now? If they act now, what can they achieve?

The international debate on the current state of financial reporting has been a wake-up call for business. Simply rolling out the same financial reporting format year-in, year-out puts them at risk of alienating the users of those reports. Capital is a scare resource. Alienating existing and prospective debt and equity investors is a high-risk business strategy.

Many businesses aren't sitting around waiting for change to occur in accounting standards, regulation or auditor behaviour. They are improving the quality of their own financial reporting within the existing constraints in response to changing user needs.

Table 1 provides examples of what might be achieved now based on the requirements of existing accounting standards. These examples have been modified from EY's 2014 report, *Improving Disclosure Effectiveness*.[3]

Some of these suggestions should be relatively easy for reporting entities to implement Relocating the accounting policies alongside the relevant note, for example, simply requires the reordering of existing information. Reordering existing notes will require a greater degree of judgement. The order may require continual review each reporting season; particularly for businesses that are more likely to be subject to a change in business focus, business risk profile or the macroeconomic environment. For example, the GFC will have caused most financial institutions to place more focus on financial asset impairment in their 2008 reporting season than they might have in 2007.

Taking a fresh approach to financial reporting, rather than rolling out last year's template, requires commitment from those charged with governance.

Other avenues for improvement will be more resource intensive. Taking a fresh approach to financial reporting, rather than rolling out last year's template, requires commitment from those charged with governance. Managers needs to challenge all aspects of their current reporting and develop better ways to present high quality information to users.

Framing the international discussion

Discussion on disclosure effectiveness has been gaining momentum in recent years. Many national and regional accounting standard setters have published their own reports on the subject, including the European Financial Reporting Advisory Group (EFRAG) in 2012 and the European Securities and Markets Authority (ESMA) in 2011.

The EFRAG paper highlighted the lack of a consistent thought process in developing disclosures as part of the accounting standard setting process. The paper argued for the establishment of a disclosure framework with a primary focus on developing disclosures based on their relevance to users of financial reports. It emphasised that immaterial information is, by definition, unlikely to have an impact on decisions about investment or resource allocation, or improve regulatory risk management. EFRAG argued that the IASB needs to lead the debate on developing a disclosure framework, but acknowledges that 'all constituents are involved and contribute to the debate about improving the quality of disclosures'.[4]

The ESMA paper also focused on materiality. In its role as the oversight regulator for European security markets, ESMA sought feedback from constituents on materiality and how well the concept was understood when applied to financial reporting. In its feedback statement, published in 2013, ESMA noted that while the concept of materiality appears to be well understood, there is wide diversity in the ways it is applied. In particular, respondents sought additional guidance in the use of judgement when applying materiality. ESMA, like EFRAG, encouraged the IASB to provide additional guidance to financial report preparers on applying the concept of materiality.

Table 1: Improving Disclosure Effectiveness

Suggested improvements	Considerations	Concerns/challenges
Improving navigation of financial statements through the use of a table of contents, colour coding or similar means	• Easier for the reader to identify information they are searching for and navigate through the notes to the financial statements • Permitted under current IFRS	
Disclosure of accounting policies, judgements, estimates and assumptions together with specific and quantitative disclosures	• Easier for the reader to connect the accounting policy with specific quantitative information • The preparer will need to reconsider irrelevant accounting policies • Permitted under current IFRS	Entities will need to maintain internal processes for recording all previously applied accounting policies to ensure consistent application in future periods
Ordering the notes according to importance	• Adds another dimension to the financial statements as it communicates to users the information that the entity considers important • Encourages the preparer to re-think the relevance of information and therefore to remove clutter • Permitted under current IFRS	• High level of judgement required. What one sees as less important, another might find more relevant • May reduce comparability between entities • The selected order normally needs to be applied consistently from one period to another, unless the level of importance changes
Grouping disclosures by nature	• Structuring notes into sections by nature to assist user navigation, e.g. grouping entity disclosures, such as corporate and group information, estimation of uncertainty disclosures, risk-based disclosures, etc. • Permitted under current IFRS	• High level of judgement required • May reduce comparability between entities • The selected order would normally be applied consistently from one period to another
Combining ordering based on importance and grouping by nature	Combination of the two above	Combination of the two above
Presentation of 'Executive summary' or 'Key developments' note	• Communicates the most significant events of the period to users • Permitted under current IFRS	Would be viewed by some as adding to the clutter rather than reducing the overload problem
Presentation of certain disclosures outside of financial statements	• IFRS 7 permits certain information (such as the nature and extents of risks arising from the use of financial instruments) to be disclosed outside the financial statements, provided that it is appropriately cross-referenced in the financial statements • In interim condensed financial statements, certain information may be disclosed outside the financial statements as long as the financial statements include relevant cross-references • Would allow a reduction in the volume of financial statements	
Inclusion of alternative performance measures (APMs) in the financial statements	• May be helpful for the users since it makes it easier to reconcile management-reported information with actual figures in IFRS financial statements • Goes beyond the issue of disclosure overload, but is an approach some believe will be helpful in achieving more effective communication	• May in effect increase the clutter. APMs combined with IFRS information can confuse users, rather than provide clarity • Use of APMs also needs to be weighed against local regulator guidance in this area

REDUCING THE EXCESS BAGGAGE

The idea that financial reporting is becoming increasingly complex is not new to the IASB. At the time EFRAG and ESMA were producing their papers, the IASB had commissioned its own research. *Losing the Excess Baggage*[5] – a joint project between the New Zealand and Scottish accounting institutes – proposed a significant reduction in the level of mandatory disclosure required in financial reports, including the removal of immaterial disclosures.

The joint project team established assessment criteria against which all existing disclosures could be measured. The criteria focused on material information and emphasised the removal of duplicate disclosures, disclosures that were considered overly complex and disclosures that were not useful in decision making. All IFRS disclosure requirements were assessed against these criteria and specific recommendations made to the IASB. The project team found that reductions in the level of disclosure could be made in almost all existing accounting standards.

While the specific recommendations outlined in *Losing the Excess Baggage* have not been taken up by the IASB to date, it has helped to spearhead the call for change. The report's recommendations provide a glimpse of what might be achieved following a comprehensive review of all existing disclosure requirements.

THE STANDARD SETTER'S RESPONSE

IASB Disclosure Initiative

In response to a growing call to action, the IASB hosted a public discussion forum on disclosure effectiveness in May 2013. Following the forum, it committed to a long-term disclosure initiative aimed at improving the effectiveness of financial reporting. The project is broad in scope and may take several years to complete. However, a series of short-term initiatives are addressing some of the concerns raised by the EFRAG, ESMA and *Losing the Excess Baggage* reports.

A closer look at materiality

As part of the research phase of its disclosure initiative, the IASB aims to improve guidance on applying the concept of materiality to financial reporting.

KEY COMPONENTS OF THE IASB DISCLOSURE INITIATIVE INCLUDE:

- Short term or 'implementation' projects: including amendments to IAS 1 *Presentation of Financial Statements* (completed) and a proposed amendment to IAS 7 Cash Flow Statements. If approved, the amendment to IAS 7 would require reconciliation between the opening and closing value of liabilities arising from financing activities.
- Research projects: reviewing existing guidance on materiality, developing a series of principles of disclosure and reviewing the disclosure requirements in existing standards. In developing the principles of disclosure, the IASB intends to review the objectives of financial reporting as defined by their *Conceptual Framework for Financial Reporting*.
  This includes reviewing the nature and role of the primary financial statements together with the nature and role of the notes that accompany them.
- A series of ongoing activities looking at the use of digital reporting (such as XBRL), filing and access requirements around the world.[6]

IAS 1 states that information should only be presented in financial reports if it is considered material by virtue of either its size or the nature of the information. For example, related party transactions are often of a small dollar value, but because of their nature are generally considered to be material and worthy of inclusion.

The existing materiality guidance in accounting standards is brief and often overlooked in favour of long lists of what might appear to be mandatory disclosure requirements. To some extent the problem is semantic. For example, the standard setting out the disclosure requirements for financial instruments states that certain very specific information 'shall' be provided. To many, the word 'shall' indicates a requirement to provide all of the disclosure in the list, whether it is material or not. By providing greater clarity on the concept of materiality, the IASB hopes to emphasise that information is only material if it is decision useful to readers of financial reports.

The IASB is expected to publish further guidance on materiality in 2015. This is expected to clarify that an entity need not provide a specific disclosure required by an IFRS in the financial statements, including the notes to the financial statements, if the information is not material.

Short term amendments to IAS 1

The IASB's shorter term amendments to IAS 1 are as follows:

- Materiality—include a paragraph to highlight that disclosing immaterial information can obscure the material information provided.
- Line items—clarify that the line items listed for inclusion in the primary financial statements can be disaggregated and should be disaggregated if that provides more relevant information.
- Line items—include additional guidance to consider when an entity should provide additional totals and subtotals in the statement of financial position and statement of comprehensive income.
- Notes: presentation order—amendments that give entities greater flexibility to vary the order in which they present the notes to the financial statement.[7]

These short-term improvements are not the ultimate solution to the disclosure effectiveness issue. However, they do present preparers with a range of options they might consider when improving the messaging of their financial reports: most should be possible with only minimal modifications to existing practice, on the basis that they involve the reshaping of existing information, rather than the creation of new information.

While the concept of materiality appears to be well understood, there is wide diversity in the ways it is applied.

THE TRANS-TASMAN DISCUSSION

Australia and New Zealand have been, and continue to be, part of the global disclosure effectiveness discussion.

In Australia, the paper *Rethinking the Path from an Objective of Economic Decision Making to a Disclosure and Presentation Framework* was published by the Australian Accounting Standards Board in 2013. It discussed 'the failure [of current disclosure requirements] to identify the generic types of information about an entity that should be relevant to users in order for them to make decisions about the allocation of scarce resources'.[8]

The paper proposes that purpose-driven disclosures could result from a better understanding of the 'stocks and flows' impacting an entity's performance. The paper calls for boilerplate disclosures to be replaced with information that is specific and relevant to the entity.

New Zealand's securities market regulator, the Financial Markets Authority (FMA), hosted an event in 2014 that brought together those with a vested interest in improving disclosure effectiveness. The forum report highlighted the challenges facing financial reporting in New Zealand and looked at how financial reports can once again become a clear and effective communication tool. It outlined the contribution each interested party can make in improving disclosure effectiveness.[9]

The FMA noted as part of its contribution that reporting entities can and should remove immaterial disclosure and would not be penalised for doing so. This is a welcome step forward and echoes similar sentiments made by the Australian regulator at the same 2014 FMA-hosted event. With less risk of regulatory intervention, entities are more likely to remove boilerplate discourse.

Is less always more?

Hans Hoogervorst, Chairman of the IASB, recently cautioned that "the complexity and length of financial reporting is a reflection of an increasingly complex economic reality." He went on to say, "complexity is a reality we have to live with".[10] While it is easy to point the finger at regulators and standard setters for creating disclosure overload, we should not overlook the fact that businesses themselves have become more complex. New information demands constrain the extent to which financial reporting can be reduced. So far, much of the focus has been on reducing the volume of information reported. However, improving the usefulness and therefore the quality of financial reports might not always involve a reduction in volume: for example, if boilerplate text were replaced with disclosures tailored to the reporting entity. This is a more complex challenge for businesses. It takes time, energy and commitment by the reporting entity to review the way financial reports are presented holistically and start to rebuild those reports in a more useful and informative way.

Questions for Organisations Considering Making a Change:

- Can you afford not to?
- Which approach suits your organisation - Big bang or incremental?
- How do you maximise stakeholder engagement?
- Where will you position your organisation in the market:
  As a trendsetter....Or a follower?

STAKEHOLDER CALL TO ACTION

While some level of complexity in financial reports is necessary given the increasing complexity of businesses and the environment in which they operate, important information can be lost in unnecessary clutter.[11]

John Price, Commissioner, Australian Securities and Investments Commission

Stakeholders must adopt effective disclosure behaviours. Chartered Accountants must think critically and move beyond noise and numbers, and make the cut-through.

Professional Body

- Reframe the issues and facilitate debate – locally and internationally.
- Walk the talk - consider ways to role model good financial reporting.
- Advocate effective disclosure in submissions to standard setters and regulators.
- Socialise innovative examples of streamlined effective disclosure such as Flight Centre and Chorus.
- Socialise digitally disruptive solutions .

Preparer

- Reflect on the story your organisation wants to convey via their financial statements.
- Stand back and question the content of financial statements as a communication tool – what is necessary, and what is irrelevant detail? Keep the former, eliminate the latter.
- Question everything - have an open mind.
- Be clear on objectives and how these can be achieved (learn from leading lights).
- Get Board and auditor buy in from the get-go.
- Consider assisting those Board members with a non-financial background by presenting a mocked up set of streamlined financial statements to the Board.
- Consider building a multi-stakeholder team.
- Consider using visual information such as graphs – a picture says a thousand words.
- Encourage a culture of change: Collectively challenge regulator focus on trivial disclosure infringements.
- Be open to digitally disruptive solutions.
- Be brave – have courage.
- Consider the cost of delaying further – get started now.

Board

- Be open minded about cutting the clutter.
- Be a leader amongst your peers.
- Be proactive – challenge your management team as to what they are doing in this space.
- Appoint an "effective disclosure" champion to work with management.
- Plan ahead – give it sufficient time.
- Do it in one go with a "big bang".

Auditor

- Be proactive – raise effective disclosure as part of ongoing reporting to the Board and Management.
- Ensure involvement in the process from the outset.
- Support the Board and Management from the start.
  – be a sounding board for Management as they go through the streamlining process – review early drafts of the mock up, review the Board paper and flag any issues early on (minimise risk for the Board and the Organisation).
- Help initiate discussion then support management as they go through the process with the ultimate aim of risk minimisation.
- Bring peer experience from other clients (both local and global) provide shared knowledge.

Standard Setter – Setting the framework

- Be flexible, dynamic and open-minded.
- Look long term–prioritise a principles based disclosure framework. Without this we may be wasting resource tinkering with existing standards.
- Maintain and facilitate open dialogue between and with all stakeholders.
- Times have changed - consider a more widespread view than financial statements alone.

Regulator – Monitoring the output

- Give preparers permission to be brave.
- Demonstrate commitment to effective disclosure through action – e.g. reconsider the message conveyed by issuing letters for minor disclosure infringements.
- Openly applaud examples of innovative and effective disclosure.
- Lead by example.
- Clearly outline expectations at a principles level
  – provide examples.
- Publicly make disclosure overload a work programme priority.

The Investor

- Preparer, Board, auditor – challenge them to faithfully and succinctly reflect the organisation's financial story.
- Challenge the standard setter to develop an entirely new principle based disclosure framework.
- Keep standard setter informed of current investor needs. Engage them in continuous dialogue.
- Support the regulator by acknowledging the tension between investor protection, and the desire for financial statements to become an effective communication tool.
- Give the regulator permission to support prepares, auditors and the Board in financial statement decluttering.

IS THE BIGGER QUESTION WHAT IS THE FUTURE ROLE OF FINANCIAL REPORTING?

This paper draws upon two leading light case studies to illustrate the progress so far towards improved financial statement disclosure effectiveness. The goal being enhanced relevance of financial statements as a communication tool.

It is evident through this examination that the investor landscape is increasingly dominated by sophisticated institutional investors with access to bespoke financial reporting via corporate investor relations. Arguably these investors place very little reliance on audited financial reports beyond their independent attestation. Investor disengagement occurs against backdrop of the inexpensive mass collection of data available digitally.

This prompts us to ask the bigger question - what is the future role of financial reporting in this digital landscape? Chartered Accountants have the opportunity to be leaders in improving and shaping the future of financial reporting–let's think critically and move beyond noise and numbers and make the cut-through. **That is what Chartered Accountants Australia and New Zealand is about.**

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