EFRAG
European Financial Reporting Advisory Group

Purpose of the notes to the financial statements

A note prepared by EFRAG Secretariat

Objective

1 In 2012, EFRAG and its partners ANC and the FRC published a Discussion Paper ('DP') *Towards a Disclosure Framework for the Notes.* The aim of the paper was to improve the effectiveness and relevance of the information reported in the notes to the financial statements. The DP argued that to achieve this objective, improvements would be needed both in *setting* and *applying* the requirements.

2 Although the partners did not aim explicitly at reducing the volume of disclosures, it was acknowledged that there is a perception of disclosure overload, and that it is not only important to ensure that entities disclose *all the information that is relevant*, but also that they *do <u>not</u> disclose information that is <u>not</u> relevant* for the entity.

Why EFRAG and its partners think that delineating financial statements as a well-defined component of financial reporting is important

3 When discussing the scope of the project, EFRAG and its partners heard many saying that integrated reporting was the key to communicating how an entity creates value for its stakeholders, and therefore a Disclosure Framework should encapsulate all corporate information. A few others noted that the distinction between financial statements and other documents and the placement discussion was hardly relevant once information is available in a digital format.

4 However, the scope of the Discussion Paper was intentionally not extended to financial reporting as a whole for the following reasons:

(a) in many jurisdictions, including the European Union, the IASB's remit is for financial statements only and information required in other parts of the financial reports is under the responsibility of other institutions or authorities (e.g. parliaments, governments, regulators, etc);

(b) information required in the various parts of the financial reports differs greatly (e.g. governance, internal controls, etc). Setting a limited scope was therefore considered the best way to launch a debate that could achieve a concrete impact on practice in a reasonable timeframe;

(c) other parts of the financial reports are still evolving and it seems too early to develop a framework that would attempt to embrace the whole breadth of reporting and also address the immediacy of concerns about the current disclosure regime; and

(d) the concept of integrated reporting, which is gaining momentum, acknowledges that financial statements will continue to exist as one part of the integrated reporting framework. It is therefore all the more crucial to have a sound Disclosure Framework for the notes to the financial statements.

5 As a result, the Discussion Paper did not address disclosures outside the financial statements and the potential use of cross-references between the financial statements and other documents.

Purpose of the notes to the financial statements

6 The Conceptual Framework and IAS 1 *Presentation of Financial Statements* acknowledge that notes are an integral part of the financial statements but IFRS do not provide a definition of the notes. IAS 1 states:

(a) The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions […] This information […] assists users of financial statements in predicting the entity's future cash flows and, in particular their timing and certainty[1];

(b) The notes shall (a) present information about the basis of preparation if the financial statements and the specific accounting policies used […], (b) disclose the information required by IFRSs that is not presented elsewhere in the financial statements and (c) provide information that is not presented elsewhere in the financial statements but is relevant to an understanding of any of them[2].

7 Historically, the notes to financial statements were 'footnotes' to items presented in the primary financial statements. Over time, information contained in the notes has expanded and the boundary between the primary financial statements and other information contained in annual reports has been blurred; one example commonly given is the risk management disclosures in IFRS 7 *Financial Instruments: Disclosures*.

The proposals in the DP

8 The analysis of the issues and consideration of the Conceptual Framework suggested that in moving towards developing a Disclosure Framework it was important to clarify the purpose of the notes. The answer to that question drives what information should be included in the notes and what belongs elsewhere. The purpose of the notes needs to flow from the objective of financial reporting in serving the needs of users and be derived from, and consistent with, the purpose of the financial statements as articulated in IAS 1.

9 The DP proposed the following definition that should guide the standard setter in setting disclosure requirements that would make financial statements a well-defined component of financial reporting:

The purpose of the notes is to provide a relevant description of the items presented in the primary financial statements and of unrecognised arrangements, claims against and rights of the entity that exist at the reporting date.

10 The following paragraphs further clarified the proposed definition:

(a) 'relevant' implied that disclosures should fulfil some specific users' needs , and should be provided only if they are material for the specific entity;

(b) 'description' meant that notes are supposed to provide quantitative descriptions of the items (e.g. breakdowns, maturity analysis) as well as qualitative descriptions of these items (e.g. accounting policies, judgements) which amplify and explain the primary financial statements;

---

[1] IAS 1 paragraph 9.

[2] IAS 1 paragraph 112.

(c) 'items presented in the primary financial statements' are those items presented in one of the following statements: statement of financial position, statement of profit and loss and other comprehensive income, statement of change in equity, or statement of cash flows;

(d) 'unrecognised arrangements that exist at the reporting date' are transactions or firm agreements with a third party that occurred in the past and for which no asset or liability has been recognised at the reporting date (such as the set-up of a Special Purpose Entity, or the granting of a guarantee); and

(e) 'unrecognised claims against and rights of the entity that exist at the reporting date' are claims and rights from/ against third parties that arose from past events and that did not meet the recognition threshold (like an unrecognised deferred tax asset, a claim against a competitor for patent violation when the inflow of economic benefits is only probable, or a contingent liability).

11 One of the implications of applying the definition of the notes is that some disclosures which are currently included in the notes would be provided elsewhere. That information is still useful and the DP did not suggest that those disclosures are eliminated but they may fit better elsewhere. There are a number of implications of this approach:

(a) the notes focus on past transactions up to the reporting date;

(b) the basis for the disclosure in the notes is that the disclosures are linked to the numbers in the primary financial statements; and

(c) forward-looking information is excluded unless it is reflected in the measurement of items in the primary financial statements.

12 In arriving at the definition of the notes, there are certain types of disclosures where the boundary line is less clear. These are:

(a) unrecognised items – the DP drew the line at unrecognised arrangements, rights and claims;

(b) related party disclosures; and

(c) non-adjusting post-balance sheet events.

13 The DP also suggested to complement the definition with categories of information and indicators that would assist to assess when each type of information was relevant. Please refer to the Appendix to this paper.

The FASB project on Disclosure Framework

14 In the same period when EFRAG and its partners were developing the DP, FASB staff was also working on a Disclosure Framework Discussion Paper. The two teams exchanged views during the project and the documents had much in common in terms of the analysis of the issues and proposals.

15 The FASB Discussion Paper was also published in July 2012 and resulted in the recent publication of a proposed Statement of Financial Accounting Concepts *Conceptual Framework for Financial Reporting Chapter 8: Notes to Financial Statements.*

Purpose of the notes to the financial statements

16 The FASB ED *Conceptual Framework for Financial Reporting Chapter 8: Notes to Financial Statements* issued in July 2014 explains what information should be considered for inclusion in notes. It notes that '*one of the purposes of notes to financial statements is to amplify or explain information depicted in words and numbers on the face of, and included in totals of, financial statements*' and suggests that there are three general types of information to be included in notes to financial statements:

(a) Additional information about line items;

(b) Information about the reporting entity; and

(c) Information about other past events and current conditions and circumstances that can affect an entity's cash flows.

17 Rather than proposing an explicit definition of the purpose of the notes, the FASB ED contains a list of questions as a tool to assist the Board to decide when to consider whether a disclosure should be required and to identify the nature of the disclosure. A comparison between the content and list of questions in the FASB ED and the categories and indicators in the DP indicates many similarities.

18 However, some candidates for disclosure in paragraph D57 of the FASB ED would likely fall outside the proposed definition of the purpose of the notes in the DP:

(a) Dependency of the entity for its continued profitability (or existence) on one or a few customers or suppliers;

(b) Volatility or other uncertainty in volumes or prices in the markets for the entity's inputs or outputs that would have a significant effect on the entity's future cash flows;

(c) Uncertainty in an entity's access to the markets for its inputs or outputs (whether resolution of the uncertainty would result in increased or decreased access);

(d) Uncertainty about an entity's ability to maintain a qualified work force and suitable physical facilities.

What we heard from constituents

19 The DP asked constituents if they thought that a definition of the purpose of the notes was needed; and if so, their feedback on the proposed definition. Views were mixed. A majority agreed that a definition of the purpose is an appropriate first step in the development of a Disclosure Framework. In developing a principle-based Framework, it is important that the role and purpose of the notes is made explicit.

20 Most respondents did not object to the proposed definition, and in particular agreed with the role of 'relevance'. A number of amendments were however suggested:

(a) Replace 'relevant description' with 'faithful representation';

(b) Include a reference to materiality;

(c) Refer to 'reporting period' rather than 'reporting date'; and

(d) Include a reference to 'major sources of estimation uncertainty'.

Purpose of the notes to the financial statements

21 Some respondents appreciated the categories and indicators, but others were concerned that an excessive articulation introduced complexity.

APPENDIX – Articulation of the content of the notes

Category of information representing users' needs	**Proposed indicators**	**Content of the information**
Aggregation / disaggregation of the line item.	The item includes components originated from different business activities.	Disaggregation and segment information.
	The item includes components with different characteristics, such as: • distinct measurement basis; • sensitivity to different variables; • different recovery/settlement; • different rights or obligations; • different seniority.	
	A standard allows or requires offsetting assets and liabilities (or income and cost).	Information on gross amounts.
What the item is.	The caption is not sufficient to understand the nature of the underlying item.	Relevant terms and conditions for understanding the item.
	There are specific contractual terms and conditions important to understand the item.	
	There are financial enhancements and/or restrictions around the item.	
How the item fits into the entity's operation and financial structure.	The item arises from a transaction or group of transactions that impact items included in different captions.	Description.
	The information explains the entity's exposure to cash flows arising from unrecognised claims, rights and arrangements.	Nature of the exposure and possible amount, timing and uncertainty of potential cash flows.
	The item refers to the investing or financing activity of the entity.	Breakdown of the change of the balance over the period.
	The item is expected to be recovered(or settled) beyond the operating cycle of the activity.	

	Whether the measurement basis is at cost but the item can easily be traded on a market.	Alternative measures.
How the item has been accounted for.	A standard allows for alternative recognition or measurement.	Accounting policy and/or application guidance.
	A new standard has come into force.	
	A standard sets a high-level principle which needs articulation by the entity.	
	There is no specific guidance in the standards.	
	A standard does not indicate a specific measurement method.	Accounting method.
	The key measurement inputs are neither based on contract or Level-1 prices.	Key measurement input.
	A standard aggregates items usually measured or presented separately.	Information on aggregation objective and method.