Disclosures in financial statements to better reflect investor needs

Nick Anderson

Nick Anderson, a member of the International Accounting Standards Board (Board), discusses a pilot approach to developing disclosure requirements in IFRS Standards. The pilot approach responds to investor demand for better quality information in the notes to financial statements.

More information is not necessarily better, just as less information is not necessarily better; instead better quality information is needed. We have consistently heard this message from users of financial statements (investors) over the years. However, delivering better quality information has been a challenge for companies.

To help companies, the Board is proposing a new approach to developing and drafting disclosure requirements in IFRS Standards. The proposed approach is intended to help companies:

• understand why information is useful to investors; and
• apply better judgement about what information is material and should be disclosed.

In this Investor Perspectives article, we discuss some changes to the financial statements that investors will see if the proposed approach is finalised, including illustrative examples. We provide context for the proposed approach by discussing the issues investors face with information provided in financial statements today and why those issues arise.

Why is there a need for change?

Financial statements do not always communicate the company-specific information that investors need for making decisions.

Disclosures fail to be useful when they contain:

1. **not enough relevant information**
   - Relevance is fundamental to good financial reporting. When there is insufficient relevant information, investors may be unable to make the right decisions about the company.

2. **too much irrelevant information**
   - Irrelevant information clutters the financial statements. Clutter can cause investors to overlook relevant information, or create additional work for investors to identify relevant information.

3. **information communicated ineffectively**
   - Relevant information is useful to investors only if it can be easily understood. If relevant information is buried in a small font on page 215 of a 250-page report, there is a high chance that investors would miss it. Information that lacks understandability and clarity makes financial statements time-consuming to analyse.

The Board’s research has shown that the main reason disclosures are not as useful as they could be is ineffective judgements about which information is material and should be disclosed.
Materiality judgements and the checklist approach

Information is material when omitting, misstating or obscuring it could reasonably be expected to influence decisions that investors make.

The Board develops disclosure requirements that are expected to result in relevant information for companies generally. However, information that is material to one company may not be material to another. Individual companies should apply materiality judgements to provide information that reflects their particular facts and circumstances. In essence, materiality works like a filter—enabling companies to focus on disclosing the right information for investors.

However, in practice, disclosure requirements in IFRS Standards are often used like checklists. The problem with this checklist approach is that it results in a ‘better safe than sorry’ attitude. Companies and auditors err on the side of caution by including immaterial information rather than risking any legal and regulatory implications of excluding information identified in the Standards. Companies also face practical challenges in determining whether information is material because they do not always understand why that information is useful to investors.

Addressing the problem will undoubtedly require a long-term group effort between all those involved in financial reporting and the Board. Effective materiality judgements are at the centre of that effort.

The proposed approach

The Board’s proposed approach to developing disclosure requirements is intended to enable companies to make better materiality judgements. Under the approach, the Board would develop specific disclosure objectives that clearly describe investors’ information needs. Companies would be required to apply judgement and provide information to meet those needs.

The focus is on enabling companies to enhance their use of judgement to provide more useful disclosures in financial statements. Although a change in the volume of a company’s disclosures may be a consequence of the proposed approach, changes in volume are not its objective.

The proposed approach also provides more tools within the Standards to help companies apply judgement about which information is material to meet the objective. The tools include explanations of what investors may do with the information provided, application guidance, illustrative examples and items of information that could satisfy those objectives.

Each specific disclosure objective would be explicitly linked to items of information that could satisfy the objective. However, compliance under the proposed approach could only be achieved by using judgement to decide what information should be disclosed to satisfy the specific investor needs described in the disclosure objectives. As such, in most cases, companies would not be required to disclose those items of information but instead be required to ensure that information disclosed meets the described investor need. From a practical perspective, this requirement to use judgement removes any perception that applying requirements like a checklist achieves compliance.

To test whether the proposed approach would achieve its intended purpose, the Board has selected two IFRS Standards for which investors have often found the resulting disclosures in financial statements to be unsatisfactory—IFRS 13 Fair Value Measurement and IAS 19 Employee Benefits. The Board has applied the proposed approach to these Standards and proposed amendments to their disclosure requirements.

What does this mean for investors?

The proposed approach should result in information in the notes to financial statements that is more company-specific and better responds to investor information needs.
More relevant information

The proposed approach relies on early dialogue with a broad and representative group of investors to develop the specific disclosure objectives. The Board therefore expects disclosure requirements it develops under the proposed approach to identify information that is important to investors, enabling companies to effectively communicate more relevant information.

For example, investors have told us that the most important information about defined benefit plans is their cash flow effects. However, investors often do not get this information today.

The proposals include a specific disclosure objective requiring a company to enable investors to understand the expected effects of the defined benefit obligation on its future cash flows. To meet this objective, a company with a material defined benefit obligation would need to explain how any related deficit would be funded. The most relevant information would vary depending on the company’s circumstances—for example, depending on whether the plans are closed or open to new members and whether the company has any specific arrangements for addressing the deficit.

Examples—more relevant information

Expected future contributions to meet the defined benefit obligation at the end of the period

At 31 December 20X3, the net defined benefit liability was CU663 million. The plans are closed to new employees but continue to accrue benefits for current employees. The Group has specific arrangements with the plan trustees to address the deficit and expects to reduce that deficit over six years as follows:

<table>
<thead>
<tr>
<th>CU in millions</th>
<th>20X4</th>
<th>20X5–20X8</th>
<th>20X9</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected contributions</td>
<td>103</td>
<td>133</td>
<td>85</td>
</tr>
</tbody>
</table>

The expected contributions to reduce the deficit have been calculated using actuarial assumptions agreed with plan trustees based on an assessment performed on 31 March 20X3. The plan trustees will perform the next funding assessment no later than 30 June 20X7.

Removal of less relevant information

The specificity of the disclosure objectives and explanations of what investors would do with information provided would enable companies to avoid boilerplate disclosures and focus only on disclosing relevant information.

For instance, a lengthy narrative that lacks company-specific information about the risks to which defined benefit plans expose a company is unlikely to be useful to investors. Under the proposed approach, such narrative information would be immaterial and would not help a company to comply with the disclosure objectives. Consequently, companies would have no incentive to include such information in financial statements.

It is understood that some investors worry about removing requirements to disclose specific items of information. However, it is important to remember that the proper application of materiality judgements and required disclosure objectives should ensure that useful information is disclosed whenever it is material. On the other hand, the inclusion of immaterial information can obscure useful information.

1 The purpose of the examples and disclosures in this article is to illustrate the implications of the proposals. The examples and disclosures are simplified. Assumptions have been applied that may not be relevant in all facts and circumstances.
The proposed approach requires companies to consider not only the content of their disclosures, but also how effectively the information is disclosed.

For example, with respect to defined benefit plans, the first question investors want to answer is how much the plan is in surplus or deficit by—is this a plan they need to worry about? However, investors often find it difficult to obtain a clear understanding of the effects of defined benefit plans on the primary financial statements (including the profit or loss statement, balance sheet and cash flows statement).

The proposals include a specific disclosure objective requiring a company to provide an upfront quantitative executive summary in the notes about defined benefit plans. This summary would allow investors to quickly determine whether a defined benefit plan is material to their analysis, and if so, navigate to the subsequent detailed disclosures and reconcile them to the primary financial statements. Indeed, a table can be worth a thousand words!

Example—information communicated effectively

<table>
<thead>
<tr>
<th>Amounts in the primary financial statements relating to defined benefit plans</th>
<th>Group statement of financial performance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Group statement of financial performance</strong></td>
<td><strong>20X3</strong></td>
</tr>
<tr>
<td></td>
<td>Fair value of plan assets</td>
</tr>
<tr>
<td>UK plan</td>
<td>3,479</td>
</tr>
<tr>
<td>US plan</td>
<td>1,088</td>
</tr>
<tr>
<td>Other plans</td>
<td>46</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>4,613</strong></td>
</tr>
</tbody>
</table>

The Group held a deferred tax asset relating to the defined benefit obligation of CU112 million in 20X3 and CU109 million in 20X2. More information about the Group’s deferred tax balances can be found in Note Y.

**Group statement of cash flows**

Included in the group statement of cash flows are CU215 million of regular contributions and CU208 million of contributions to reduce the deficit as at 20X3.

What about comparability?

Relevant, company-specific information is important to investors but so is comparable information. The proposed approach aims to strike the right balance between these two factors.

To comply with the specific disclosure objectives, companies would focus their disclosures on information that is material in their circumstances. By identifying items of information that may enable a company to meet the objective in the Standards, the Board will help to achieve comparability between companies for which similar information is material.
It is important to note that uniform information is not the same as comparable information. When the same information is material to two companies, disclosing identical information is useful. However, if different information is material to the two companies, uniform disclosures could be a bit misleading.

Forcing companies to make identical disclosures if different things are material to them is not the goal. Meaningful comparability – which allows investors to compare material information for company A with material information for company B – is what matters and what the proposed approach facilitates.

### Practical implications of the proposed approach

- Effective communication with investors is the only way to achieve compliance with the new objective-based requirements.
- Comparability would be achieved between companies when the information is both material and useful to investors.
- A significant shift in stakeholders’ behaviour towards disclosures would be required.

### We need your views

Disclosure requirements developed using the proposed approach would require companies to comply with disclosure objectives rather than with prescriptive requirements to disclose particular items of information. Do you agree with the proposed approach? Would it result in information in financial statements that is more useful for your decision-making? Would the proposals introduce any new costs to the way you analyse or extract information, in particular through digital means?

The Board has also proposed amendments to the disclosure requirements in IFRS 13 and IAS 19 applying the proposed approach. Do you think the specific disclosure objectives accurately reflect investor needs? Do the proposals clearly communicate those needs to companies?

We would like to hear your views and comments on these issues. The proposals are open for comment until 12 January 2022. Please let us know what you think.

### Get in touch

The Board seeks to meet one-on-one with investors to explore feedback on both the proposed approach and its application to the two test Standards.

If you would be interested in participating in this way, please feel free to contact me at nanderson@ifrs.org or Sid Kumar from the Investor Engagement team at skumar@ifrs.org.

We are also available if you have any questions about the feedback process or if we can assist you in submitting feedback in any form.

The views expressed in this article are those of the author as an individual and do not necessarily reflect the views of the International Accounting Standards Board (Board) or the IFRS Foundation (Foundation). The Board and the Foundation encourage members and staff to express their individual views. This article has not undergone the Foundation’s due process. The Board takes official positions only after extensive review, in accordance with the Foundation’s due process.