Scope and quality of disclosures

Audit and Reporting Quality

October 2014

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Disclaimer
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The Netherlands Authority for the Financial Markets

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. We promote the fair and conscientious provision of financial services to consumers and private investors, as well as professional and semi-professional parties. We supervise the fair and efficient operation of the capital markets. Our aim is to improve consumers' and companies' confidence in the financial markets, both in the Netherlands and abroad. In performing this task, the AFM contributes to the stability of the financial system, the economy and the reputation and prosperity of the Netherlands.

1 Management summary

Information in the financial statements must be company-specific and relevant
Internationally, there is much attention to the readability and accessibility of financial reporting. In recent years, the AFM has called on companies to make their disclosures in the financial statements company-specific and relevant and avoid the use of 'boilerplate' texts as far as possible. This appeal was made because the AFM has noted in recent years that boilerplate texts are still being widely used and that relevant information is either lacking or obscured. In order to make good decisions, it is important that investors can base their decisions on relevant disclosures and that usage of boilerplate texts is reduced. For this reason, the AFM carried out a thematic review of the quality and scope of the disclosures in the financial statements in 2014.

The key findings of the review were:

- All those involved should focus on telling the company's own story, instead of preparing or testing a compliance document.
- Information in the financial statements must be relevant.
- Good practices which provide company-specific and relevant information.

All those involved should focus on telling the company's own story, instead of preparing or testing a compliance document
The review shows that the financial statements are too frequently and too strongly seen as a compliance document. The company and the auditor appear to be fixated on meeting the requirements of legislation and regulation and use a standard sample set of financial statements or type of checklist, in order to ensure they do not run into problems with internal and external supervisors. The company and the auditor therefore are forgetting that they need to consider and assess what the financial statements actually say. Reporting companies' own stories seem to be getting lost as a result of simply following a checklist or a financial statements format.

The review also reveals that there is no single definition to describe 'the users'. This makes it difficult to define the information that the users of financial reporting require.

According to the respondents, in the past the AFM mainly focused on compliance with legislation and regulation and not so much on company-specific information. The AFM has taken this comment on board, and adjusted its supervision in an attempt to focus more on company-specific information. However, it is also aware that this process is not yet complete. The AFM will therefore take further steps as described in the concluding paragraph of this section.

The conclusion of this review is that all the main parties involved in the financial statements process, that is, the preparers, the auditors, the users, the internal supervisor and the AFM, need to devote more attention to the company's own story and not treat the financial statements as a compliance document.

Information in the financial statements must be relevant

The financial statements must contain all the information that is relevant for the users. Relevant information is information that is specific to the company and that could influence an investor's decision. Those involved in the financial statements process need to assess whether the information provided on the company is relevant. For instance, a disclosure relating to a material item does not have to include all the required disclosures included in a reporting standard if some of the latter disclosures are not relevant. On the other hand, a disclosure may provide relevant information even though the related item does not appear material in terms of size.

Good practices are those that provide company-specific and relevant information.

The AFM gives a number of examples of disclosures in financial statements in this report. These quotations are qualified by the AFM as good practices and can serve as inspiration to include company-specific and relevant information in the disclosures. These good practices can also be used as a guide for other parties concerned in the discussion of how the relevance of the financial statements can be improved. For the AFM, providing a good disclosure is not a one-off exercise, but a continuous process that must be repeated each year to further increase relevance. The good practices are listed in paragraph 3.3.

The AFM welcomes proposals for improving the relevance of disclosures

The AFM is aware that it also has a role to play in improving the scope and quality of the disclosures in the financial statements. The AFM fulfils this role through, among others, its participation in international joint ventures such as ESMA and IOSCO. The AFM wishes to inform the public as to what it considers to be good practice. Companies subject to supervision and their auditors are welcome to put suggestions to the AFM regarding the inclusion of company-specific and relevant disclosures in the financial statements and making progress with respect to reducing the usage of boilerplate texts. The AFM moreover welcomes the submission of good practices from those involved. The ways in which you can assist the AFM are described in section 3.4.

2 Rationale, objectives and population

2.1 Rationale

The worldwide attention to the quality and scope of the disclosures in financial statements was the rationale for this review. Internationally, several reports1 have been published on reviews and initiatives in this field. The AFM has also received signals from the market that the disclosures in financial statements are too lengthy, that companies use many boilerplate texts and that disclosures frequently contain information that is not relevant. This can affect decision-making by users of financial statements. The AFM has therefore in the past called on companies to make the disclosures in their financial statements more company-specific and more relevant.

The AFM announced that it would carry out an exploratory review of this issue in its annual 'In Balance' report in 2013. We used the above-mentioned publications for this purpose, and we distributed a questionnaire among companies, auditors and users. We also held a number of interviews with respondents in order to obtain further information.

2.2 Objectives

The AFM wants financial statements to include relevant and company-specific disclosures. Reducing the use of boilerplate texts and disclosures that are irrelevant contribute to forming a better impression of the company that prepared the financial statements. Through its review, the AFM gained an understanding of the views of companies, auditors and users. By listing a number of good practices in this report, the AFM wishes to contribute to the debate on the importance of relevant and company-specific disclosures.

2.3 Population

For the purpose of this review we distributed a questionnaire among companies, auditors and users of financial statements. 33 respondents completed the questionnaire. The largest single group among the respondents were the auditors (15). An equal number of users and companies responded (both 9). The relatively limited number of respondents means it is not possible to draw conclusions regarding the experiences and opinions of the companies, auditors and users per group. The results of the survey, however, do show the same picture as the results of the international reviews. We feel that these findings provide a sufficient basis to report on items of improvement in the quality and scope of the disclosures in the financial statements.

[1] See for example the FRC report 'Cutting Clutter', the FRC Lab report 'Towards Clear & Concise Reporting', the report of the Joint Working Group of the ICAS and the NZICA 'Losing the Excess Baggage', the IASB Exposure Draft 'Disclosure Initiative' amendments to IAS 1.

3 Key findings of the review

The AFM has included the results of the survey, the conclusions of discussions with a number of respondents and important findings from international reviews in the results of its review. This section also lists certain ‘good practices’[2]. These are intended to serve as examples of companies that have moved towards reduced usage of boilerplate texts and sought to meet their disclosure requirements by including company-specific and relevant information.

3.1 All those involved should focus on telling the company’s own story, instead of preparing or testing a compliance document

The AFM’s review into the views in the market on the scope and quality of the disclosures in financial statements has shown that the respondents fall into four groups that have significant influence in this area. These are the companies, the auditors, the users and the external supervisor. The fifth party involved, the internal supervisor, was not seen as an important element by the respondents. We have listed the findings per group from the point of view of the respondents below.

Companies

The review showed that the primary focus of the preparers of the financial statements, the companies, is that the process of producing the financial statements should run smoothly. Respondents thought that many companies use all or parts of model financial statements provided by their auditors. Companies apparently do not focus adequately on providing company-specific or relevant information, and do not take the trouble to make the boilerplate texts from model financial statements company-specific. Adopting this attitude means that companies need discuss the financial statements with their auditors only to a minor extent, and provides a certain degree of certainty about the completeness of the information to be included.

Auditors

The review showed that the role of the auditor in the financial statements process could be improved. The survey revealed that respondents consider a checklist mentality and fear of the AFM on the auditor’s part to be the reason that auditors do not readily agree with innovations in the financial statements, even if such an innovation would increase the relevance of the information included.

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[2] The good practices cited in this report are examples of specific disclosures from existing financial statements and annual reports. The AFM hopes that other companies will be inspired by these good practices to increase the quality and relevance of their own disclosures. The good practices quoted should not be seen as a standard or as the only correct substance of existing or future disclosures. Other formulations to comply with legislation and regulation are possible. The inclusion of good practices in this report does not imply any judgement by the AFM regarding the financial statements in question as a whole.

The AFM takes the view that there is a duty here for the auditor. The auditor can point out to the company at an early stage that the financial statements do not have to be solely focused on compliance. The auditor should support the company in the process of including company-specific and relevant information in the financial statements.

Users

There is no standard user. The review reveals that there is no single definition to describe the users. This makes it difficult to define the information that the users of financial reporting require.

Some of the respondents indicated that the users would prefer more information rather than less. They also stressed the importance of company-specific and relevant information. Boilerplate texts in financial statements provide little information of value to the users. In addition, it emerged that some users only read parts of the financial statements. They see the financial statements as a reliable reference to be able to use the information provided in press releases and other press publications.

The external supervisor - the AFM

According to the respondents, in the past the AFM mainly focused on compliance with legislation and regulation and not so much on company-specific information. The AFM has taken this comment on board, and adjusted its supervision in an attempt to focus more on company-specific information. However, it is also aware that this process is not yet complete. The AFM will therefore take further steps as described in the concluding paragraph of this section, see section 3.4.

Internal supervisors

Most of the survey respondents said that they had no information regarding the activities of the internal supervisors in the financial statements process. At the same time, the respondents said that they thought that the internal supervisors were not primarily concerned with the content of the financial statements. In this review, the AFM considers the internal supervisors to include the company's supervisory board or audit committee. The AFM is currently carrying out a project to obtain information on the role of audit committees in the preparation of the financial reporting and the conduct of the audit. Further information on this project can be found in section 2 of 'In Balance 2014'.

3.2 Information in the financial statements must be relevant

The financial statements must contain all the information that is relevant for the users. Relevant information is information that is specific to the company and that could influence an investor's decision. Those involved in the financial statements process need to assess whether the information provided on the company is relevant. For instance, a disclosure relating to a material item does not have to include all the required disclosures included in a reporting standard if some of the latter disclosures are not relevant. On the other hand, a disclosure may provide relevant information even though the related item does not appear material in terms of size.

IFRS is principle-based, but is applied as if rules-based

The majority of the consolidated financial statements of listed companies subject to supervision by the AFM are prepared on the basis of International Financial Reporting Standards (IFRS). IFRS is principle-based, contrary to reporting standards that are based on the strict application of rules, known as rules-based standards. The review shows that those concerned tend to apply IFRS as if it were rules-based. All disclosures are included, and the question of relevance to the users appears to be a secondary consideration. This leads for example to the inclusion of accounting policies for items that do not appear in the financial statements or are not material.

Another very common application of a rules-based approach is continuing to include disclosures that are no longer relevant due to the passage of time or changes to the size and composition of balance sheet items. The AFM calls on companies to remove disclosures if they are no longer relevant. This will make the relevant information more accessible to the users.

Boilerplate texts are not informative

Another problem revealed by the review, and also from international reviews, is the extensive usage of boilerplate texts. The texts in financial statements appear to be copied from a reporting manual. Whether this is IFRS or another set of reporting standards makes no difference in this respect. The inclusion of a boilerplate text that could be included in any financial statements without amendment offers less information value to the users.

The AFM calls on companies to limit their use of boilerplate texts as far as possible. A good example of where this appears to be possible concerns the accounting policies. Several studies show that accounting policies that are not specific to the company concerned have been copied from a reporting manual. This information is usually not relevant.

A few companies have developed initiatives to make the content and composition of their accounting policies relevant to the users. They do this for instance by stating which accounting policies are relevant to the company or describing the reasons for choices they have made. The AFM welcomes such initiatives.

Consistency between annual report and financial statements

The review focused on the financial statements. The financial reporting is broader and includes the annual report, the risk paragraph, the corporate governance report and the report of the supervisory board. The information in this part of the financial reporting is also relevant for the information in the financial statements. The review shows that users look to see whether the information included in the annual report is consistent with the information included in the financial statements. For instance, it is strange if the report of the management board gives a detailed account of various product groups while the segment reporting in the financial statements is provided at a higher business level, meaning there is no connection between the annual report and the financial statements. The AFM calls on companies and auditors to ensure that a better standard of consistency is applied so that the relevant information is disclosed in both the annual report and the financial statements.

3.3 Good practices that provide company-specific and relevant information

The AFM gives a number of examples of disclosures in financial statements in this report. These quotations are qualified by the AFM as good practices and can serve as inspiration to include company-specific and relevant information in the disclosures. These good practices can also be used as a guide by the other parties concerned in order to get the discussion of how the relevance of the financial statements can be improved off to a timely start. For the AFM, providing a good disclosure is not a one-off exercise, but a continuous process that must be repeated each year to further increase relevance.

The AFM explains the reason why each example represents good practice. Obviously, quotation of part of a disclosure from a set of financial statements does not imply that the AFM considers the entire disclosure or financial statements to represent good practice.

Separate presentation of accounting policies

Source: Financial statements of Sligro Food Group N.V. (Sligro) 2013, page 95
Subject: Presentation of accounting policies

Sligro has chosen to separate its presentation of its accounting policies in its financial statements on the basis of relevance. Instances where Sligro has had to make choices itself regarding the specific implementation of an accounting policy are presented under ‘G’. Policies of a more critical nature are presented separately under ‘H’. The accounting policies that are standard under IFRS regardless of the company or its business sector are presented under ‘I’. Sligro thus achieves a situation in which the relevant accounting policies, that is, those with respect to which Sligro has made an individual choice and those with a material impact are made more accessible for the users. The contents of the relevant section of the financial statements is included below to illustrate the above.

Overview of accounting policies	
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Accessibility and structure of the disclosures

Source: Financial statements of ITV plc (ITV) 2013, page 120

Subject: Design of the disclosure, accessibility of the disclosure

ITV has chosen to disclose its accounting policies separately, whereby policies that apply only to one item are presented with that specific item rather than a separate statement of accounting policies at the beginning of the disclosures.

ITV also inserts brief text balloons (‘In this section’) in its disclosures explaining the contents of the section for each element. For more complicated matters, a text balloon ‘Keeping it simple’ is inserted that explains the main features of the section concerned. This makes the financial statements more readable and accessible.

In this section . . .

This section focuses on the results and performance of the Group. On the following pages you will find disclosures explaining the Group's results for the year, segmental information, exceptional items, taxation and earnings per share.

Keeping it simple . . .

This section analyses the Group's profit before tax by reference to the activities performed by the Group and an analysis of key operating costs.

Earnings before interest, tax, amortisation (EBITA) and before exceptional items remains the Group's key profit indicator. This reflects the way the business is managed and how the Directors assess the performance of the Group. This section therefore also shows each division's contribution to total revenue and EBITA.

Following revisions to IAS 19, we have restated our prior period results and the details of those restatements are included in note 3.7.

Disclosure on the basis of principle
Source: Financial statements: NSI N.V. (NSI) 2012, page 140
Subject: disclosure of bank covenants if there is a risk these will be breached.

NSI gives an example of when the principles in the reporting standards are more important than the specific requirements. By disclosing its bank covenants, NSI provides information on its financial position. This disclosure is not obligatory under IFRS 7, because the covenant has not been breached. By including this information nonetheless, NSI presents a picture of its financial situation. Without this information, the disclosure is not complete.

The inclusion of relevant information in the disclosures does not therefore automatically mean that there will be fewer disclosures.

The example below is a brief quotation from the whole disclosure relating to the covenants in the 2012 financial statements. The AFM considers that this section explains why this disclosure is relevant.

> (…)*Solvency ratio*
> Based on the covenants, the adjusted equity at group level must amount to at least 40%. In 2012 this amounted to 40.3% (2011: 41.2%) and therefore meets the standard.
>
> There were no changes to NSI's capital management policy during the past year.
>
> Apart from the requirements that apply due to the company's status as a fiscal investment institution, neither the company nor its subsidiary companies are subject to externally imposed capital requirements.
> (…)

3.4 The AFM welcomes proposals for improving the relevance of disclosures
The AFM is aware that it also has a role to play in improving the scope and quality of the disclosures in the financial statements of listed companies falling under its supervision. The AFM fulfils this role through, among others, its participation in international joint ventures such as ESMA and IOSCO. The AFM also wishes to inform the public regarding what it considers to be good practice. The AFM wishes to encourage the companies under its supervision and their auditors to include company-specific and relevant disclosures in their financial statements, and to help them make progress regarding reducing the use of boilerplate texts. The AFM cannot do this alone, and accordingly appeals to those involved for their support. The AFM proposes the following actions.

Companies subject to supervision and their auditors can submit proposals to the AFM

Companies subject to supervision which together with their auditors consider possible steps to provide more company-specific and relevant disclosures in their financial statements are welcome to contact the AFM.

The AFM will be pleased to work together with the company and its auditor regarding their proposed changes. This contact should ideally take place at an early stage in the formulation of the financial statements so that the company will be able to publish its financial statements in good time.

The AFM welcomes suggestions for good practices from those involved

The AFM calls on all parties involved, companies, auditors, users and internal supervisors, to let it know when a good practice is identified. The AFM has given some examples of good practices in this report. This is of course a selection and not an exhaustive list. The AFM wishes to have a better understanding of what other parties consider to be good practice. The AFM therefore requests that you send examples of such good practice. Please send us an e-mail stating the good practice and the source, such as 20XX financial statements of company Y. Please also state why you consider this to be a good practice. The AFM hopes to receive numerous examples of good practices in the course of 2014 and 2015 and to publish them at a later date.

If you would like to participate in one or both the AFM's initiatives, you can contact us as shown below:

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