European Securities and Markets Authority

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EFRAG discussion paper – *Towards a Disclosure Framework for the Notes*

The European Securities and Markets Authority (ESMA) is pleased to provide you with the following comments in response to EFRAG's discussion paper *Towards a Disclosure Framework for the Notes*, which are aimed at improving the decision-usefulness of financial statements and the transparency and enforceability of IFRSs.

ESMA is an independent EU Authority that contributes to enhancing the protection of investors and promoting stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. ESMA contributes to the regulation of financial services firms with a pan-European reach, either through direct supervision or through the active co-ordination of national supervisory activity.

ESMA agrees with EFRAG that the disclosures provided in the financial statements of issuers can be enhanced and that consideration needs to be given whether the current application of International Financial Reporting Standards (IFRS) could be improved and whether the International Accounting Standards Board (IASB) should take any initiatives enhancing disclosures.

ESMA, being supportive of the idea to develop a Disclosure Framework within the Conceptual Framework, welcomes EFRAG's discussion paper. However, we believe that the general objective of such a disclosure framework should be based on the objective of general purpose financial reporting as defined in the Conceptual Framework i.e. to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. As any investment is future-oriented, we would strongly encourage EFRAG to reconsider its approach and not to only focus on past transactions and to also include prospects for future cash flows.

ESMA believes that the IASB should set objective-based IFRSs (such as is currently the case with IFRS 7 – *Financial Instruments)* supplemented with principles and sufficient guidance allowing a company's management to align it as best as possible to its own situation whilst ensuring comparability between entities. Indeed, the purpose of a Disclosure Framework should be to develop standards that generate clear and entity-specific disclosures providing useful decision-making information re-assessed at the end of each reporting period. Disclosure requirements are no substitute for strong recognition and measurement principles.

However, while bearing this point in mind, it seems to us that the ongoing debate on the role of disclosures in IFRS financial statements is triggered by an apparent conclusion that such statements are becoming too voluminous. As enforcers of IFRS, often we see that issuers are not providing sufficient disclosures and financial statements providing boilerplate information directly mimicking the standards. Consequently, there might be a more urgent need to improve the accessibility of the information through better presentation (structure and format) of the financial statements.

Finally, we note that the discussion paper sets out different concerns and difficulties encountered in practice, but does not provide any suggestions on how to solve these. We would encourage EFRAG to explore alternative solutions in close liaison with the IASB.

Our detailed comments on the discussion paper are set out in the appendix to this letter and we are available to discuss all or any of these issues should you require further details.

Yours sincerely,

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Chair
European Securities and Markets Authority

Julie Galbo
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Corporate Reporting Standing Committee

APPENDIX 1 – ESMA's detailed answers to the questions in EFRAG's Discussion Paper *Towards a Disclosure Framework for the Notes*

Question 1.1 – Key principles

The Discussion Paper sets out a number of key principles that should underpin a Disclosure Framework.

Do you agree with these key principles? If not, what alternative principles would you propose?

1. Being supportive of the idea to develop a Disclosure Framework within the Conceptual Framework we welcome EFRAG's discussion paper. ESMA however believes that the general objective of such a disclosure framework should be based on the objective of general purpose financial reporting as defined in the Conceptual Framework (i.e. to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity).

2. In ESMA's opinion investors' needs should be the starting point for the development of such a Disclosure Framework and serve as a full principle instead of limiting it to the discussion now presented in chapter 3 of the discussion paper.

3. As any investment is future-oriented we would strongly encourage EFRAG to reconsider its approach and to not only focus on past transactions. The principle identified by EFRAG that "notes should focus on past transactions and other events existing at the reporting date" and exclude "information about the future that is unrelated to those past transactions" is difficult to understand. ESMA thinks that the primary financial statements should be supplemented by giving relevant information in the notes to the financial statements to assist users of financial statements in predicting the entity's future cash flows and, in particular their timing and certainty.

4. It is also clear that financial statements should contain a number of elements that relate to management's judgments about the future viability of the business and which therefore require disclosures about those future expectations. An example here might be goodwill disclosures, which require directors to make impairment decisions based on future estimates of the profitability of particular business segments but where those forecasts actually do not relate to the direct generation of the number concerned. It is not immediately clear to us how such disclosures would fall to be treated under EFRAG's definitions. As a result, we think that the key principles should also include some element of future expectation.

5. In general, ESMA believes that the IASB should set objective-based IFRSs (such as is currently the case with IFRS 7 – *Financial Instruments)* supplemented with principles and sufficient guidance allowing a company's management to align it as best as possible to its own situation whilst ensuring comparability between entities. Indeed, the purpose of a Disclosure Framework should be to develop standards that generate clear and entity-specific disclosures providing useful decision-making information re-assessed at the end of each reporting period. Disclosure requirements can in any case not substitute strong recognition and measurement principles.

Question 1.2 – Understanding the problem

The Discussion Paper suggests that there are two main areas for consideration to improve the quality of disclosures:

a. Avoiding disclosure overload, which may be caused by excessive requirements in the standards, and by ineffective application of materiality in the financial statements;

b. Enhancing how disclosures are organised and communicated in the financial statements, to make them easier to understand and compare;

Do you agree that these are the two main areas for improvements?

6. It seems to ESMA that the ongoing debate on the role of disclosures in IFRS financial statements is triggered by an apparent conclusion that financial statements are getting too voluminous. As enforcers of IFRS we see that issuers are not providing sufficient and entity-specific disclosures and that financial statements contain boilerplate information directly mimicking the standards. Consequently there might be a more urgent need to improve the accessibility of the information through better presentation (structure and format) of the financial statements.

7. EFRAG's question assumes incorrectly that current disclosure requirements are excessive and does not explore the alternative that issuers are not applying the concept of materiality effectively in practice. Linked to this is the use of checklists as a starting point to provide disclosures rather than a tool to verify all disclosures are provided at the end of the reporting process. Indeed, as IFRS enforcers we often see immaterial disclosures and believe that a better application of the materiality concept could result in higher quality financial statements which should include relevant disclosures such as assumptions used in the determination of the realizable value (level 2 and 3), sensitivity analyses and the effects of business combinations.

8. Issuers should first determine on a qualitative and quantitative materiality basis the message they want to convey in the financial statements and how to present that in the best manner possible (i.e. to present investors with relevant and material information and not just all information possible).

9. Having said that, ESMA believes that the IASB may want to review all disclosure requirements currently in place to identify possible out-dated, overlapping and perhaps irrelevant disclosure requirements in existing IFRSs.

Question 2.1 (p.21-24)

In chapter 2 a definition of the purpose of the notes is proposed to assist in deciding what financial information should be required in the notes.

Do you think that there is a need to define the purpose of the notes? If not, please provide your reasoning.

10. ESMA believes that defining the purpose of the notes might assist the standard-setter in developing its standards, prepares in defining what should be included in the disclosures and for investors to better understand what to expect to be disclosed in the financial statements. Such a definition should be in line with the Conceptual Framework.

Question 2.2

Is the proposed definition of the purpose of the notes helpful in identifying relevant information that should be included in the notes? If not, how would you suggest it should be amended?

11. As set out in our response to question 1, ESMA believes that the general objective of a disclosure framework should be based on the objective of general purpose financial reporting as defined in the Conceptual Framework (i.e. to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity).

12. In ESMA's opinion investors' needs should be the starting point for the development of such a Disclosure Framework and serve as a full principle instead of limiting it to the discussion now presented in chapter 3 of the discussion paper.

Question 3.1 (p.25-46)

In chapter 3, it is proposed to identify specific users' needs that the notes should fulfil. Those users' needs are drawn from the Conceptual Framework. It is also suggested that a

Disclosure Framework should include indicators to assist the standard setters to decide when additional information is required to fulfil those users' needs.

(a) Is the description of the approach clear enough to be understandable? If not, what points are unclear?

(b) If you do not support this approach, what alternative would you support and why?

(c) Do you think that a category on "information about the reporting entity as a whole" should be included? If so, why?

13. ESMA supports an indicator approach as EFRAG is exploring in its discussion paper. As we however disagree with the proposed purpose of the notes (see our response to question 1) we cannot agree on the proposed identified specific investor needs and the indicators. Consequently, ESMA believes EFRAG should further explore the indicator approach based on the correct specific investor needs.

14. ESMA feels it is important that any further work undertaken in this area indicates clearly how the interests of investors can be included in a methodology that creates clear, useful and investor friendly disclosures in the notes. Given that conflicts can arise between the two parties – preparers tend to less disclosure and investors tend to want more – it is important that any framework gives adequate consideration to how such conflicts can be resolved in order to promote high quality disclosures.

15. ESMA believes that the various approaches of distribution of disclosure discretion between standard-setters and preparers give a good indication of the level of discretion that exists within the disclosure setting process. However, ESMA is strongly opposed to any suggestion that disclosure requirements should fully depend on the decisions of preparers.

Question 3.2 (p.25-46)

Are the proposed users' needs and indicators in chapter 3 helpful to identify relevant information? If not, how would you suggest amending them, or what other basis would you suggest to identify relevant information to be included in the notes?

16. We have indicated before that we would put the needs of investors ahead of others because investors rely entirely on the financial statements (containing the notes) to make decisions about the usage or stewardship of the funds that they have invested in the entity concerned.

17. ESMA understands that the IASB already considers the effects of its standards during the standard-setting process. Though we would agree with EFRAG that the IASB should better communicate its initiatives in that area, ESMA believes that the IASB should first determine the best accounting policy, then identify the accompanying disclosure requirements and then apply an effects analysis.

In addition, investors should also accept changes in the disclosures based on changes in the entity. If users want entity specific and relevant information they should accept that they cannot expect disclosures to be included in a set of financial statements because they have been included in a previous set.

Question 3.3 (p.25-46)

Do you agree with the way how risk and stewardship are addressed in the Discussion Paper? If not, what are your views about how risk and stewardship information that should be provided in the notes?

18. ESMA agrees that risk and stewardship are key areas affecting investor decision making in the context of financial statements. However, it is not entirely clear to ESMA how these important issues are taken forward in the approaches discussed in the discussion paper particularly where their inclusion or otherwise in the notes is concerned. We strongly believe that the moving of current disclosures to other sections outside the financial statements should be discouraged as this might create a risk of reduction in overall value, quality and reliability of the disclosures.

19. The principles outlined at the beginning of the discussion paper, if strictly interpreted, would suggest that disclosures relating to risk and stewardship should not be included in the notes. Consideration of these elements will be important in most entities although, particularly where risk is concerned, it may be more crucial in some types of entities (e.g. financial institutions).

Question 3.4 (p.25-46)

Standard setters frequently mandate detailed disclosure requirements in each standard. In chapter 3, it is suggested that the way in which disclosures are established influences behaviours, and alternative approaches are discussed.

Do you think that standard setters should change their practice of mandating detailed disclosure requirements in each standard? If so, which of the alternative approaches discussed do you think will be the most effective in improving the quality of information on the notes?

20. ESMA believes that a review of disclosure requirements would be useful and might help the IASB in setting new requirements in future. However, we should not lose sight of the fact that the current disclosure requirements are also principle based and aim at providing relevant information to investors.

21. It is clear that in an environment where standards are set on the basis of principles in order that they can apply to the greatest range of issuers, any attempt to mandate disclosures will end up having to be on an "exhaustive" basis.

22. ESMA has some reservations on setting one disclosure standard. ESMA feels that granularity cannot be set across the whole set of standards because disclosures should be based on the transactions dealt with in a specific standard, its risk and rewards and the level of management judgement involved.

23. We would however not oppose to further explore the benefits of having all disclosure requirements in one single standard if that would help the IASB to ensure consistency of the disclosure requirements.

Question 3.5 (p.25-46)
Some standard setters have established, or have proposed establishing, differential reporting regimes on the basis that a 'one size fits all' approach to disclosures is not appropriate. They consider that reporting requirements should be more proportionate, based on various characteristics such as entity size, or whether they relate to interim or annual financial information?
Do you think that establishing alternative disclosure requirements is appropriate?

24. ESMA strongly opposes setting different disclosure regimes within one regulated market based entirely on the size of an entity or its operations because size is not a good proxy for the information needs of investors. If a small entity voluntarily enters into complex transactions – such as reversed take overs and/or enters into complex financial instruments – investors in the small company needs to be informed like an investor in any other company within that market. If the small company has simple operations and does not enter into complex transactions the amount of disclosures will be limited.

Question 4.1 (p.47-57)
Chapter 4 discusses the application of materiality to disclosures. Currently, IFRS state that an entity does not need to disclose information that is not material.
Do you think that a Disclosure Framework should reinforce the application of materiality, for instance with a statement that states that immaterial information could reduce the understandability and relevance of disclosures?

25. The concept of materiality relevant to decide what information needs to be contained in financial statements, is already described in the IASB's Conceptual Framework, which states that information is material if omitting it or misstating it could influence decisions that investors make on the basis of financial information about a specific reporting entity. The definition also indicates that materiality is an entity-specific aspect of relevance based on the nature or magnitude or both, of the items to which the information relates in the context of an individual entity's financial report. Furthermore, IAS 1 – *Presentation of Financial Statements* paragraph 31 includes a clear statement on materiality for disclosures which states that an entity need not provide a specific disclosure by an IFRS if the information is not material.

26. Consequently, what is being observed today is the difficulty issuers are faced with to apply the materiality concept when preparing their accounts, either because of legal liability issues or because of a reluctance to consider how they produce their financial statements year on year. Given the fact there is no requirement in IFRS to disclose immaterial information and that a disclosure does not need to be provided if the information is not material, ESMA believes that such a requirement does not need to be included in a Disclosure Framework. Such a requirement would also be difficult if not impossible to enforce and might end up being largely ignored.

27. ESMA believes that more research needs to be done on what investors really need in order to assess the performance of their investments and what leads them to make buy, sell and hold decisions and to work disclosure requirements around those triggers. We encourage EFRAG and the IASB to undertake such research as part of its outreach activities. This proposed research project also needs investors to participate and analyse the core elements of their investment decision process.

28. In order to stimulate the debate on the application of the materiality concept in IFRS financial statements, ESMA has issued a consultation paper during 2011 and also released a summary of responses in August of this year. ESMA is currently preparing a feedback statement and hopes that the conclusions of that project can feed into EFRAG's and the IASB's future works in this important area.

Question 4.2 (p.47-57)
Chapter 4 also includes proposed guidance to assist in the application of materiality.
Do you think that a Disclosure Framework should include guidance for applying materiality? If you disagree, please provide your reasoning.

29. ESMA believes that it is essential that useful and helpful guidance will be included to assist in the application of materiality. The proposed guidance is a good start in the debate around how the con-

cept of materiality should be applied in practice in the context of IFRS financial statements. The decision tree on page 49 of the discussion paper might help preparers in the application of materiality and seems conducive to encouraging issuers to take a principles based approach.

30. However, ESMA fears that the tables included in chapter 3 (pages 34 and 35) and chapter 4 (pages 52 and 53), if adopted as they stand, will just lead to a different type of checklist mentality.

31. ESMA also believes that the report points out an important element explaining why many irrelevant disclosures still end up being included in financial statements namely carry-forward of notes. ESMA feels that the discussion paper is right in stating that a continual assessment of materiality should be maintained and that notes that are no longer material should be left out of financial reporting when the information is not related to the two years, usually reported under IFRS. Preparers should be encouraged to make these assessments every year when preparing their accounts. Equally however, there needs to be some move on the part of investors to accept that where disclosures are omitted from accounts from one year to the next, this genuinely is because such disclosures are no longer relevant to their decision making processes.

Question 4.3 (p.47-57)

Is the description of the approach clear enough to be useful to improving the application of materiality? If not, what points are unclear or what alternatives would you suggest?

32. As indicated above, ESMA believes that evolution of an overall conceptual approach could be helpful for the application of materiality. However, we would not recommend using a table or checklist to assess materiality. Furthermore, we feel that if further guidance is required in respect of the application of materiality, it should be addressed by the IASB. As we understand that difference in practice is observed between accounting and auditing standards, it could be considered to involve the International Auditing and Assurance Standards Board (IAASB) also.

33. In general, ESMA agrees with the highlighted items referencing materiality and included on page 57.

Question 5.1 (p.58-64)

Chapter 5 includes proposals for improving the way disclosures are communicated and organised.

Would the proposed communication principles improve the effectiveness of disclosures in the notes? What other possibilities should be considered?

34. ESMA supports the communication principles identified in the discussion paper and in particular, that disclosures should be organized and linked. If applied properly these principles should enhance effective disclosures in the notes. If the objective of the principles is to enhance the usefulness of disclosures rather than merely to reduce them, a methodology of leading readers through notes so that they obtain all the information relevant to a particular balance even where such information may be spread through several notes is particularly powerful. So too is the idea of grouping disclosures of complementary relevance together so that readers encounter them together also has potential to increasing the investor-friendliness of disclosures.

35. The concept of prioritizing important disclosures on the basis of their relevance to the results, although interesting, should be viewed with more caution as it firstly assumes users read accounts front to back and also is somewhat arbitrary at its transition point between highly relevant and less relevant information.

36. ESMA feels that understandability of disclosures for investors should be key. A disclosure should explain the substance of a transaction rather than fulfil the IFRS requirements. This could lead to more disclosures than strictly required by IFRS. This could also mean that information on expected future cash flows will be provided.

Question 5.2 (p.58-64)

Do any of the suggested methods of organising the notes improve the effectiveness of disclosures? Are there different ways to organise the disclosures that you would support?

37. ESMA believes that the current online use of annual reports opens up more possibilities for investors to find the information they think is relevant. Technology giving individual investors the ability to decide what information they want to use does not alter the need for financial statements to (1) contain the right information for investors to manipulate and (2) to present that information in a investor-friendly and useful fashion.

38. ESMA is not in favour of splitting up the information that is now contained in the financial report and to publish it in different forms and/or on websites. For instance making accounting policies

available on a website and excluding them from the financial statements does not seem to be a great solution. It will be very difficult for users to determine whether all accounting policies still apply and whether the auditor has performed procedures on these policies. Uncertainty to the validity of the information published on the website will make the decision process for users of the information more difficult.

39. The paper also touches on the area of technology and how developments in this area, particularly XBRL, which might enhance users' ability to access the information contained in financial statements. The use of XBRL to later assist users to manipulate the information for their own purposes is therefore more a question of how the information should be filed than of how it should be compiled.

Question 6.1 (p.65-66)

Are there any other issues that you think need to be addressed to improve the quality of information reported in the notes to the financial statements? Please explain how you think these issues should be addressed and by whom.

40. ESMA does not have any further comments.