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Consistency in financial reporting

Objective

1 The EFRAG Board decided to consider issues associated with consistency in financial reporting. This paper identifies some of the issues that could be considered in that discussion.

Consistency in context

2 Consistency is described in the 2015 *Conceptual Framework* Exposure Draft as "the use of the same methods for the same items". Consistency is related to, but not the same as, comparability. The Conceptual Framework does not include *consistency* among the qualitative characteristics of financial reporting, but instead as one of the factors that contributes to *comparability*.

3 It is interesting to note that consistency is described in terms of the same methods, not the same outcomes. Perhaps this is because this is because the same method can result in different outcomes due to the use of different assumptions and estimates. Estimation uncertainty can be considered as an inherent and, at least to some extent, unavoidable feature of financial reporting.

4 Comparability is "the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items". Comparability is one of the enhancing qualitative characteristics of financial reporting in the *Conceptual Framework* and is also one of the technical endorsement criteria in the IAS Regulation. It is widely accepted that comparability does not require absolute uniformity of accounting for the same transactions and events: such an outcome is clearly impossible to achieve (e.g. due to unavoidable factors such as estimation uncertainty). Also, pursuing absolute uniformity is likely to undermine the principle-based nature of IFRS Standards.

5 It follows from the above that efforts to achieve consistency should be pursued as far as necessary and/or practical in order to reach a desired level of comparability, but not as a goal in itself.

Potential sources of inconsistency

6 Putting aside any issues with misrepresentation or other misuse of IFRS Standards, what factors might lead to inconsistent financial reporting? The preliminary list that EFRAG Secretariat considers might lead to inconsistency in financial reporting arising from IFRS Standards is (the list is in no particular order and includes issues that overlap):

(a) *Different interpretations of IFRS Standards.* This root cause – which might be termed 'interpretive inconsistency' – is the main focus of the IFRS IC and also a major focus of Transition Resource Groups for recent major standards. Constituents might arrive at different interpretations for several reasons, ranging from ambiguities or inconsistencies in the Standards, which might require interpretive guidance or standard-setting response, to education needs (see (b) – (d) below).

(b) *Culture, education and experience*. With standards that require the application of judgement, it is very difficult to apply standards to specific transactions without being affected by past experience, including the requirements of any former GAAPs applied, and education.

(c) *Rules are easier than principles*. It is easier to look for rules and procedures to avoid dealing with uncertainty. It may be that participants in the preparation of financial statements (preparers, auditors, regulators) prefer to apply a rule that seems to be near the issue than to apply judgement to the economics of the transaction or event.

(d) *Top-down or bottom up*. That is, in applying IFRS Standards, some preparers may take a holistic view – analyse the substance of a transaction in the light of the principles in IFRS Standards before moving to the Standards that are relevant to the transaction. Alternatively, the transaction could be approached from the bottom up and each element of the transaction accounted for under the relevant standard without consideration of the overall result.

(e) *Format of IFRS Standards*. Complex transactions often require complex standards but, in some cases, it is difficult to find the requirements for relatively simple transactions. If accounting for simple transactions is unnecessarily difficult, people will not be encouraged to look for the way to approach complex transactions.

(f) *Explicit flexibility in IFRS Standards.* IFRS Standards provide many explicit accounting policy choices, practical expedients, transition options and other areas of explicit flexibility. A topical example is the flexibility in IAS 1 *Presentation of Financial Statements* in presenting the primary financial statements. Some argue that fixed formats for the primary financial statements may reduce inconsistency. Fixed formats clearly have a role to play in making information in the financial statements more accessible. It is not clear whether fixed formats would make the information more consistent.

(g) *Implicit flexibility in IFRS Standards.* As well as explicit or stated flexibility in IFRS Standards, some degree of flexibility is implied by broader 'gaps' in the Standards (e.g. business combinations under common control) or narrower topics on which the IASB has, deliberately or otherwise, provided limited or no guidance (e.g. how to account for a change in an interest in an associate in accordance with IAS 28 *investments in Associates and Joint Ventures*).

And the solution is?

7 *Issue (a)* relates in part to the IFRS IC's process and the IASB's wider initiatives aimed at implementation. While some constituents have questioned whether the IFRS IC is sufficiently active to drive the degree of consistency they consider to be necessary or desirable, EFRAG has expressed caution over suggestions to increase the output of interpretive material. For example, EFRAG's response to the 2015 IFRS Foundation Review of Strategy and Effectiveness stated: *"EFRAG is of the opinion that standards should articulate clear principles and be written in a way that makes them capable of being applied in practice, without the need for extensive further interpretations or guidance, or excessive additional work by those using them ….. EFRAG would caution the Trustees to set up any initiatives that would limit the exercise of professional judgement, aiming at uniformity of financial information, rather than consistency in application of the standards*".

8 *Time and education* will assist in addressing issues (b) – (d). EFRAG could contribute by sponsoring academic research into the process of applying IFRS Standards, and then consider how education and training could address any identified problems.

9 *Issue (e)* relates to the processes of the IASB. EFRAG is calling for a standards-level review of disclosures in its draft response to the Principles of Disclosure Discussion Paper. This could be an opportune time for EFRAG to recommend a review of standards to ensure that the accounting for simple transactions is easily accessible.

10 *Issue (f)* will be considered in the IASB's Primary Financial Statements project. EFRAG could review all aspects of this project to assess the extent to which inconsistencies in financial reporting are addressed.

11 *Issue (g)* is likely to be addressed over the longer term through the IASB's research program. Some issues might be able to be addressed in the shorter term through the standards-level review of disclosures.

Questions for the EFRAG Board

12 Do you consider that inconsistency in financial reporting in Europe is insufficiently addressed by existing mechanisms and, if so, to what extent?

13 What further action, if any, does the EFRAG Board consider could be taken by EFRAG to enhance consistency in financial reporting?