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Dear EFRAG Members

Invitation to comment – Discussion Paper: *Towards a Disclosure Framework for the Notes*

The global organisation of Ernst & Young is pleased to respond to the discussion paper, *Towards a Disclosure Framework for the Notes* ("the DP" or "the Document") developed by the European Financial Reporting Advisory Group ("EFRAG") as part of its Pro-Active Work.

We believe that the long-standing issue of disclosure overload poses a significant challenge. We agree with EFRAG that there are no simple solutions. The debate on disclosure overload has gained significant momentum due to its complexity and EFRAG's proposals in the DP make a significant contribution to this much needed debate. We appreciate the breadth and depth of the discussion in the DP.

We believe disclosure overload is mainly an application issue. It is debatable as to what extent the current situation is the result of disclosure requirement overload, but we agree that there is significant room for improving the presentation of disclosures. As set out in the DP, the issue has two dimensions:

- Disclosure requirements, mainly directed to standard-setters
- Application, mainly directed at preparers (and their auditors)

Therefore, a disclosure framework that serves two purposes is needed to guide the International Accounting Standards Board ("IASB") as the standard-setter and to help preparers (and their auditors) make their judgements. EFRAG's DP is silent on the ultimate form of any such a framework, e.g. as part of the Conceptual Framework or as a separate standard. We note also that concept of a disclosure framework means different things to different people.

We believe that certain aspects of the issue can be dealt with in the shorter term, while other aspects need to be addressed as a long-term project. While the short-term project may yield results within the current International Financial Reporting Standards ("IFRS") requirements and the existing boundaries of the financial statements, ultimately these two phases are intertwined.

As the current disclosure regime has developed in response to the needs of capital markets and legal and regulatory requirements are often built around this, we believe that the involvement of regulators in both the short-term and the long-term phase of this project is crucial. Furthermore, any change to current requirements would need to consider the auditability and enforceability of the revised disclosure requirements.

EFRAG sets out to achieve a change in behaviour. This would have to take into account that some of the behaviour in applying global IFRS requirements is driven by local accounting traditions. Europe is no exception to that rule.

Hereunder, we summarise the issues we suggest could be dealt in the two phases of the disclosure project:

- Short-term phase:

  - *Development of guidance on the application of the materiality concept to disclosures.*
    Materiality is defined as an entity-specific aspect of relevance in the Conceptual Framework. While IAS 1 and IAS 8 specifically address materiality, in principle, there is little guidance on how the materiality concept is to be applied to disclosures. Applying materiality to disclosures goes beyond just applying quantitative criteria; it also requires qualitative judgement. We believe that application guidance should be developed to assist preparers when making such judgements. We believe that such guidance is more educational in nature, and should reinforce the overall principle.

  - *Reconsider the existing disclosure requirements in a comprehensive review of the current disclosure requirements.*
    Generally we do not believe current IFRS includes many disclosure requirements that do not contribute to the usefulness of the financial statements of some or all entities. However, we believe that a review should be undertaken to determine whether existing requirements could/should be eliminated or clarified. Clarifications, for example, may help to avoid boilerplate disclosures, where current requirements are vague or overlap with other requirements. Further, this process could clarify which disclosure items are not subject to materiality considerations. This would lead to certain disclosure items being required for all entities to which it applies, whereas other disclosure items are required subject to an entity-specific materiality consideration ("scalable approach").

  - *Providing guidance on effective communication of disclosures.*
    This step is intended to improve the quality of disclosures once the need to disclose the information is determined. There are several issues to be considered. First, users tend to prefer summarised information before considering more detailed information. We believe presenting the disclosures in the financial statements in a hierarchical manner will enhance the usefulness of financial statements. Additional guidance could emphasise the importance of customising disclosures to the circumstances of the entity to further avoid boilerplate information. Furthermore, certain information required in disclosures usually remains unchanged over several periods, e.g. the summary of accounting policies. Presenting such information outside the financial statement may be worth considering (i.e. including them in the financial statements by reference only).

- Long-term phase:

  - Conducting further research on the needs of the users, and an assessment of the cost-benefit considerations. This should include consideration of whether principle-based or rule-based disclosure requirements, or a combination of both, will be better at improving the overall usefulness of the disclosures.

  - Reconsideration of the boundaries of the financial statements, and how financial statements can and should interact with other forms of financial reporting (management reporting, corporate governance reporting, etc).

  - Consideration of how financial statement disclosures tie in with the broader development of integrated reporting.

  - Consideration of the format of financial statements in the context of modern technology (e.g. XBRL).

  - Consideration of the role of auditors, regulators, and other parties influencing the practices of reporting entities.

Our assessment of the disclosure overload problem does not differ significantly from the description in the DP. As indicated above, we believe that there is a need to find appropriate solutions in a short-term project. Those solutions should be found within the current boundaries to the notes of a set of financial statements. Therefore, we provide our input only to some of the specific questions raised in the DP (see appendix).

We acknowledge and support the exchange of views between EFRAG and the Financial Accounting Standards Board ("FASB") in developing the respective disclosure framework papers. Further, we also appreciate the role of the International Auditing and Assurance Standards Board ("IAASB") on this topic. We believe the exchange of views across jurisdictions and across disciplines (accounting vs. auditing) facilitates a more robust process and an enhanced output. Any further debate should therefore consider solutions developed in the US and from an audit perspective by the IAASB (or others). However, the ultimate responsibility for developing a disclosure framework and adapting individual standards lies with the IASB as the standard-setter for IFRS.

Should you wish to discuss the contents of this letter with us, please contact Leo van der Tas at the above address or on +31 88 4075035.

Yours faithfully

Ernst & Young

Appendix – Responses to the questions in the discussion paper – disclosure framework

Question 1.1 – Key principles

The DP 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?

As indicated in our cover letter, we believe that EFRAG's proposals make a significant contribution to addressing disclosure overload and agree that there is a need for a disclosure framework.

We believe that the current disclosure overload issue is mainly due to 'application overload'. It is debatable as to what extent the current situation is the result of disclosure requirement overload. In addition, we agree that there is significant room for improving the presentation of disclosures (ie language, formatting, organisation).

As set out in the DP we agree this has two dimensions:

- Disclosure requirements, mainly directed to standard-setters
- Application, mainly directed at preparers

Therefore, we also agree with EFRAG that principles should be developed in relation to:

- The form of disclosures requirements
- Materiality
- Application guidance on disclosures.

We believe that appropriate solutions to resolve the abovementioned issues should be found in a short-term project within the current boundaries of the financial statements.

Beyond those broader issues, we would like to note that the building blocks or elements of the Disclosure Framework are referred to in different ways. The DP mainly refers to "key principles"[1] but also to "essential qualities"[2] of a Disclosure

[1] Page 2, page 8, para 7.

Framework. To us, the difference between key principles and essential qualities is unclear.

Question 1.2 – Understanding the problem

This DP suggests there are two main areas for consideration to improve the quality of disclosures:

a. avoiding disclosure overload, which may be caused both by excessive requirements in the standards, and by ineffective application of materiality in the financial statements.
b. enhancing how disclosures are organized and communicated in the financial statements.

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

As indicated in our cover letter, we believe there is disclosure overload. In our view, this is mainly an application issue. It is debatable to what extent the current situation is the result of disclosure requirement overload. However, we agree that there is significant room for improving how disclosures are presented.

Question 2.1

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.

We agree that the proposed definition is a helpful starting point for further discussion.

EFRAG proposes that the notes should be limited to items (or their description) that arise from past transactions. Paragraph 2b of the DP (page 2) indicates that information about the future would only be provided in the notes to the extent that it

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[2] Page 8, para 7.

relates to past transactions. Some users of financial statements call for more "forward-looking information" to be included in the notes. This should be carefully considered in any further debate as to what are the boundaries of the notes. We note that it may sometimes be difficult to define such boundaries. For example, the hedged volume of future sales that relate to a cash flow hedge of anticipated transactions.

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?

We refer to our answer to question 2.1.

Question 3.1

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?**

We agree that it is appropriate to derive the objective and the content from the overall objective of financial reporting as set out in the Conceptual Framework. This currently does not specifically address information contained in notes. However, since the notes form part of a set of financial statements, which as a whole, should fairly present the reporting entity, they should support the objective of financial reporting.

As outlined in our cover letter, we believe that the issue facing all parties is application overload, and that better communication of information is required. Resolving of these issues should be achieved within the current Conceptual Framework and in reference to the objective of financial reporting stated therein.

EFRAG notes that for many jurisdictions, this boundary is one between audited and unaudited information, but does not consider this aspect further in its analysis.[3] We believe this aspect has great importance for any discussion about notes, since users appreciate the quality provided by an auditor's assurance. Most likely, this issue may come become more relevant once the boundaries of financial statements as a whole or the location of specific disclosures are re-considered.

Question 3.2

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?

We believe that the indicators proposed in chapter 3 are relevant to both the short-term and the long-term process to be undertaken as part of the disclosure project suggested in our cover letter.

Question 3.3

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[4] that should be provided in the notes?

The importance of stewardship to financial reporting was considered extensively as part of Phase A of the Conceptual Framework. The notes in financial statements form an integral part of financial reporting and any discussion on stewardship should be considered in that broader context.

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[3] Chapter 1, p18, paragraph 16.
[4] This is addressed in Chapter 3, p32, paragraphs 21-24

Considering the discussion on risk, we believe that EFRAG is blurring the line that currently distinguishes between uncertainties in applying accounting requirements (e.g. measurement uncertainty) and operating or economic risks. This is caused by including the former under risk disclosures[5]. Operating risks should not be presented in the notes.

Question 3.4

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 most effective in improving the quality of information in the notes?

As indicated in our cover letter, we believe that disclosure requirements should include a required minimum. Additional disclosures would only apply if it is applicable to the reporting entity and after an entity-specific materiality assessment. This would balance the need to have a certain amount of common information that is required from all entities and the required flexibility in disclosing decision-relevant information.

[5] Chapter 3, p29, paragraph 16a.

Question 3.5

Some standard setters have established, or have proposed establishing, differential reporting regimes[6] 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 entity size, or whether they relate to interim or annual financial statements.

Do you think that establishing alternative disclosure requirements is appropriate?

IFRS already includes some element of differential reporting, for example:

- IFRS 8 *Operating Segments* and IAS 33 *Earnings per Share* only apply to entities whose shares are traded in a public market or that files, or is in the process of filing its financial statements with a securities commission or other regulatory organisation for the purpose of issuing ordinary shares in a public market

- IFRS for SME can be applied to smaller and medium-sized entities

We believe that the IASB should not introduce any other elements of differential reporting. The introduction of such regimes should be decided at the level of each jurisdiction which has the best knowledge of its economic and legal environment. We note that, for example, Australia and the UK have opted to undergo such a process.

Scalable IFRS, as suggested in our cover letter, may contribute towards some form of differential reporting. Scalable IFRS disclosure requirements would contain the required minimum disclosures for all entities and an entity-specific materiality assessment for other disclosure items.

[6] Chapter 3, p44, paragraph 62-69

Question 4.1

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?

As indicated in our cover letter, we believe the disclosure framework should reinforce the materiality principle. Guidance should be developed to support this principle. The proposed statement in itself would be insufficient.

For a more detailed discussion of applying materiality to disclosures, we refer to our comment letters to the European Securities and Markets Authority ("ESMA")[7] and the IAASB's[8] initiatives.

Question 4.3

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?

We believe that the proposals provide a good starting point and that these should be considered in the development of any materiality guidance.

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[7]Consultation paper 'Considerations of materiality in financial reporting', November 2011, refer to ESMA's website: www.esma.org

[8]Discussion paper 'The evolving nature of financial reporting: Disclosure and its audit implications', January 2011, refer to: http://www.ifac.org/publications-resources/evolving-nature-financial-reporting-disclosure-and-its-audit-implications

Question 5.1

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

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

As indicated in our cover letter, improving the presentation of note disclosures is one of three goals in the proposed short-term project.

We agree with EFRAG that this project would provide an opportunity to consider a more useful organisation of the notes.[9] A hierarchy of information should be considered. The goal would be to find ways of appropriately presenting key themes that today tend to get lost in detailed disclosures. This idea is also addressed by EFRAG under the heading of 'prioritising disclosures' in paragraph 34 of Chapter 5. We believe that rather than performing such a prioritisation every annual period (i.e. the order of the notes change from period to period bringing forward those disclosures that are more relevant), EFRAG should consider an approach similar to the one suggested above. That is, to define a required minimum and any further entity specific disclosures. These entity specific disclosures could be in the form of a summary that highlights key themes in the current financial statements, and should be presented as a note at the beginning of the disclosures. The content of this summary would necessarily change from period to period.

Paragraph 37 of Chapter 5 suggests that IAS 34 may be a blueprint to prioritise information. We question whether IAS 34 in its current form provides a sufficiently comprehensive approach to the problem. In particular, since IAS 34 is dependent on full year financial statements. Further, we note that companies tend to present the information required by IAS 34 in a consistent notes structure from one interim period to the next, in the same way as for annual financial statements.

[9] Chapter 5, p61, paragraph 26

Question 5.2

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

We refer to our answer to question 5.1.

Question 6.1

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?

We refer to our cover letter. EFRAG's proposals are currently based on the existing delineation of the notes as part of today's financial reporting. As other initiatives, such as integrated reporting and XBRL exist, as well as the related assurance engagements, continue to develop, it will be necessary to consider how the financial information will link with other information provided in the future.