Effective Financial Reporting

Are you willing to hit the button?

March 2021

Introduction

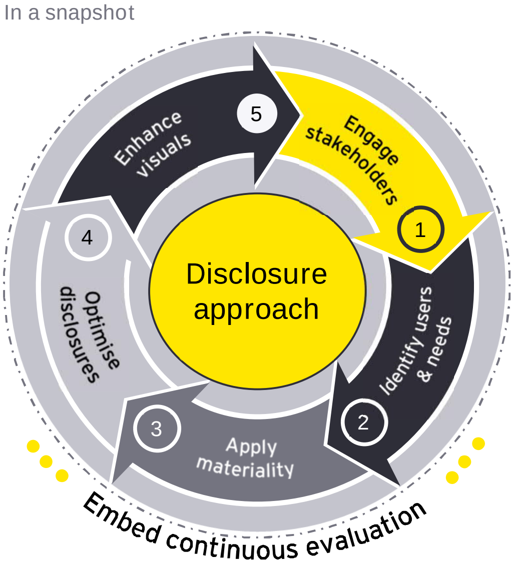
The Covid-19 pandemic has unleashed changes in the way companies *do* business such as the greater use of online distribution channels, virtual work arrangements, restructuring of supply chains and the realignment of strategies. Ultimately, these changes will reshape an organisation's narrative for how they *talk* about their business in the near term.

Apart from current disruptions, there are other good reasons for preparers of financial statements to hit the button for improving their communications. Companies are facing a "period of quiet" for new accounting standards, and the recent implementation of complex accounting standards (AASB 9, 15 and 16) might have allowed detailed clutter to creep into financial reports.

When we say effective financial reporting, we think of enhanced quality of relevant disclosures required by accounting standards, whereby important and sufficient information is concisely and clearly conveyed. The goal is to support decision-making by those providing resources to the company. Such decisions include buying, selling or holding equity and debt securities of the company, providing or settling loans or other credit, exercising voting rights, or otherwise influencing management's actions.[1]

We provide our insights and practical steps within, which can be summarised by this framework.

In a snapshot



Establishing your "disclosure approach"

Before hitting the button, it is important that senior management, along with the Board of Directors (BOD), establishes your company's "disclosure approach". This provides clarity on the attitude towards financial reporting. While approaches could sit in a continuum from being "compliance driven" to "communication driven", the latter style is the perspective we encourage since it fosters better understanding.

In moving towards effective financial reporting, some key questions to ask are:

- How can we enhance dialogue with investors by focusing the information about performance and risks?
- What encourages finance teams to improve the financial statements? What hinders them?
- How can we empower good decision-making when weighing disclosure choices, and minimise the risk of obscuring important information with clutter?
- Do we progress with changes incrementally in phases (e.g. reducing clutter, focusing on certain notes), or all at once?
- Do we begin with a clean slate or the "current state" of our disclosures? A clean slate will force re-think of what is important, whereas current state might misplace the focus onto the *minutiae*.

[1] *Conceptual Framework for Financial Reporting*, paragraph 1.2.

What steps do I take?

1. Engage stakeholders

Significant changes to the financial statements require sponsorship by the senior leadership in the organisation (CFO/CEO). Buy-in from, and regular milestone progress updates with, the BOD is critical as it ultimately approves the financial report.

In addition:

- Other key stakeholders to engage throughout include investor-relations, analysts, and auditors.
- A dedicated project team should be formed with the appropriate knowledge and relationships to contribute perspectives ("getting the right people in the room").
- Appraise external parties (e.g. auditors and analysts) early in the process and at milestones, so late surprises are avoided.

2. Identify users and their information needs

Who are the target readers of your report and what are they interested in?

- Existing and potential investors, lenders and other creditors that rely on general-purpose reports are usually the primary users of financial reports.[2]
- Disclosures should attempt to meet the needs of the maximum number of primary users, not individual users.[3] This will help identify and prioritise user needs, and shape your considerations of materiality, areas of importance, and presentation styles.

You may also want to consider other parties that may potentially have an interest in the report, such as regulators and tax authorities, as well as customers or members of the public. Community expectations and social licenses can have an influence on some management decisions (i.e. "the headline in the morning news test").

For a grasp of the users' needs, preparers will need to put themselves into the shoes of a reasonably informed investor seeking *unbiased* meaningful information that is sufficient to meet their needs. This perspective cannot be understated in light of the stewardship responsibility being fulfilled by management. Hence, the involvement of independent directors on key matters can provide better governance to the process.

Questions to ask:

- What do analysts see as the primary drivers of the company's performance and value?
- What questions have been recently asked by shareholders and analysts?
- Are there recurring requests for information that are better presented in the financial report?
- Are peers providing other information that might be useful for sector comparability?

3. Apply materiality

Materiality is aligned with effective financial reporting. It recognises that focusing the financial report on material information makes the report more concise and understandable for better decision-making.

"Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general-purpose financial statements make on the basis of those financial statements".[4]

- Materiality considers both the size and nature of items and events.
- Materiality is assessed individually and/or collectively.
- There is no "bright line" test and management judgment is required.[5]

Disclosures may have built up over several years without critical re-assessment about whether they are still material to the financial statements. They are only relevant to the period covered by the financial report, so there should be a regular review of previous judgments – what was once material might no longer be so, and what was previously not material might be now.

"ASIC's surveillance continues to *focus on material disclosures* of information useful to investors and others using financial reports, such as assumptions supporting accounting estimates and significant accounting policy choices."

"ASIC *will not pursue immaterial disclosures that may add unnecessary clutter* to financial reports; efforts should be made to *communicate* information more *clearly* in financial reports."
(Emphasis supplied)

ASIC. *MR 18-159 Major changes affecting reported net assets and profit, and other focuses for 30 June 2018 reporting.* 31 May 2018

[2] *Conceptual Framework for Financial Reporting*, paragraph 1.5.
[3] *Conceptual Framework for Financial Reporting*, paragraph 1.8.
[4] AASB 101 *Presentation of Financial Statements*, paragraph 7.
[5] AASB Practice Statement 2 *Making Materiality Judgements* provides further considerations.

What sources of information should I be including in my considerations?

- Metrics monitored by senior management can indicate areas of focus and risks for the business. It is reasonable to consider the related IFRS information may be useful
- Information publicly announced by the company during the reporting period (e.g. media releases and stock exchange notices)
- Regulator focus areas that are relevant to you
- Significant accounting policy choices (particularly when IFRS permits alternatives) and specific judgements made by management in preparing the financial statements
- Major sources of estimation uncertainty affecting amounts recognised in the financial statements at the end of a reporting period
- Scoping questions within disclosure checklists that identify key topics applicable to your activities. What are the sensitive disclosures not being made by management that a director ought to consider?, and
- Key audit matters discussed in the audit report.

4. Optimise disclosures

Improving readability of the financial report will require a review of existing disclosures for clarity, importance and writing style - in plain English, not technical jargon.

Broadly, suboptimal disclosures can be grouped as:

- Not providing enough relevant information (e.g. excluding key growth assumptions in impairment data), including only disclosing the minimum required
- Excessive inconsequential information, and
- Ineffective communication of information provided.[6]

The following should be considered:

- Tailoring information to your company's circumstances and business. Generic narratives and descriptions provide arguably low (or no) value
- Determining whether the emphasis of information is appropriate. Is important information crowded out by excessive detail? Is a key detail inappropriately aggregated with other data?
- Deciding whether more information is needed beyond those required on important areas, including those that might be misunderstood
- Rearranging information to reside within related notes (e.g. presenting information on interest rate and liquidity risks with components of borrowings)
- Grouping related disclosures (e.g. working capital related balances, or sources of long-term financing/capital)
- Adopting a more systematic presentation (e.g. presenting accounting policies within the relevant supporting note, and/or presenting notes in order of importance such as a real estate business disclosing its investment property earlier) and
- Linking notes by cross-references (including hyperlinks for digital information) to highlight relationships and avoid duplication.

5. Enhance visuals

Design and layout can creatively deliver a clear and easy to read report – and are all too often neglected due to the focus on the accuracy and completeness of quantitative data. A professional designer could provide valuable assistance in creating an effective presentation of information. Some options to consider are using:

- Colour or shading to emphasise sections or types of disclosures (e.g. accounting policies)
- Diagrams, tables and/or charts for presenting data-intensive information
- Break-out boxes for highlighting or distinguishing information, and
- Symbols and footnotes to reduce clutter or repetition.[7]

Embed continuous evaluation

Moving towards effective financial reporting is not a "set and forget exercise." Rather there should be continuous evaluation that includes:

- Reassessing items of significance and relevance to the business and current reporting period
- Drawing links within the report, and consistency with other communications provided to the market
- A gatekeeper to assess whether the overall presentation of the financial report is effective. A member of the investor relations team, who has an appreciation of financial reporting, may take a broad view of the disclosures, and
- Exploring opportunities to connect the financial report with the Directors' Report (operating and financial review) as appropriate.

To discuss further, please contact your local EY adviser.

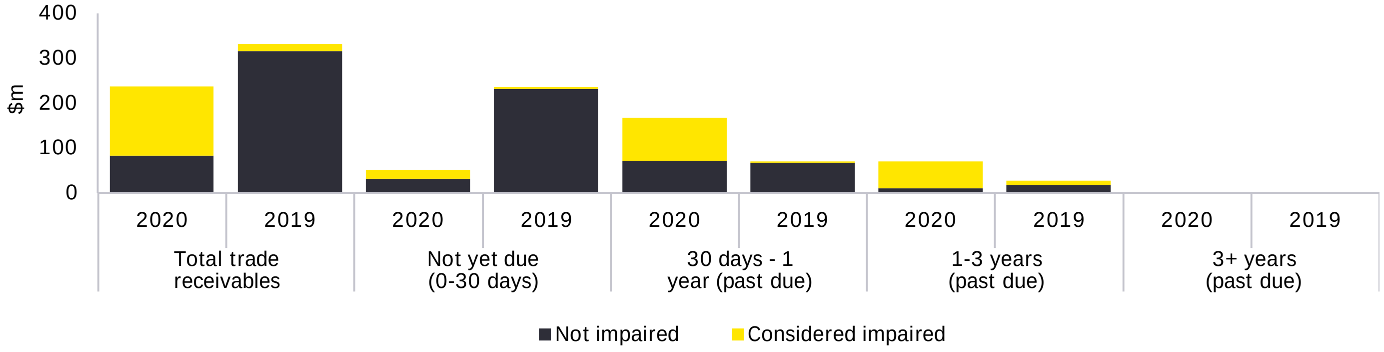
[6] *Better Communication in Financial Reporting*, IFRS Foundation, page 4. 2017

[7] Examples of effective disclosure techniques we have seen in the market are illustrated in the Appendix.

Appendix: Examples of disclosure techniques

The following are examples of disclosure techniques as applied by a sample of companies in their published financial statements. These anonymised examples are provided for illustration purposes and should not be viewed as the only way to present information. Use of these techniques should consider your entity's specific facts and circumstances, your assessment of user needs as well as the requirements of relevant accounting standards and other legislation.

Example 1A: Use of a bar chart to depict ageing and credit quality profile of trade receivables*



**In addition to above chart, a separate table was presented showing actual amounts for each time period.*

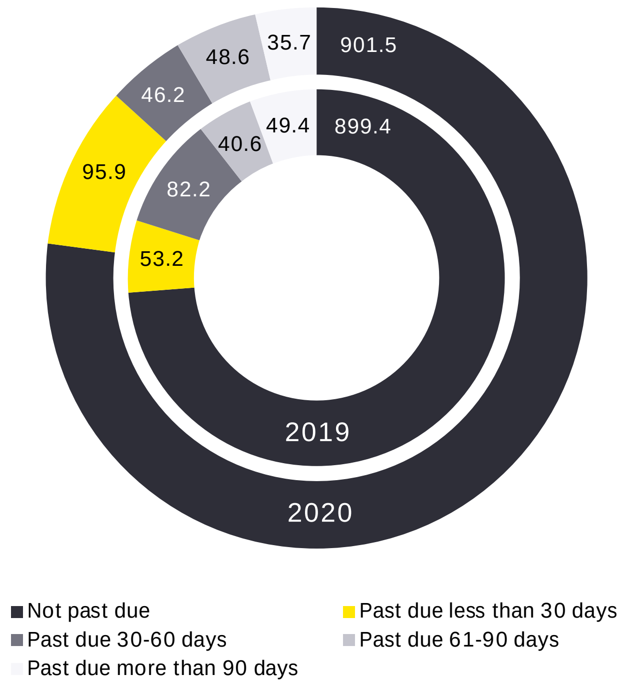
Example 1B: Use of a pie-chart to depict ageing profile of trade receivables

Receivables

Trade and other receivables as at 30 June comprise:

Consolidated ($m)	2020	2019
Trade receivables	930.8	852.4
Allowance for expected credit losses	(8.3)	(9.5)
	922.5	842.9
Receivables from related parties	197.1	272.4
Accrued revenue	52.7	5.6
Total current trade and other receivables	1,172.3	1,120.9

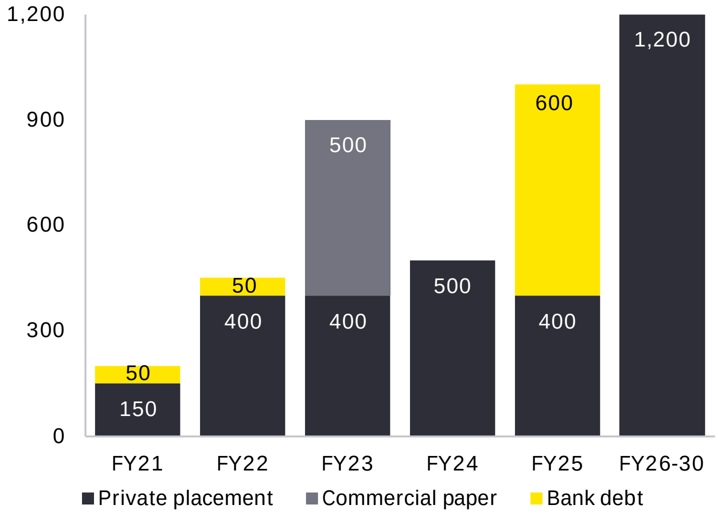
Total ageing profile of current trade and other receivables are as follows ($ million):



Example 2: Use of bar chart to depict the maturity profile by funding source

Maturity profile of debt by facility (2020)

($ millions)



Interest-bearing liabilities and borrowings

	2020 $m	2019 $m
Current		
Bank overdrafts – unsecured	50	-
Senior Notes - unsecured	150	225
	200	225
Non-current		
Bank loans – unsecured	650	700
Commercial paper	500	-
Senior Notes - unsecured	2,900	3,800
	4,050	4,500

Example 3: Tabular presentation with the use of concise and plain English

Business combinations and acquisitions

Significant acquisitions during the year ended 30 June 2020:

Business acquired	Date of acquisition	Description of acquisition
ABC123	1 Sep 2019	Traffic management software provider in Canada
XYZ456	1 Nov 2019	Leading Euro-based depot and terminal logistics solutions provider
DEF678	1 Dec 2019	Leading cargo management company in Japan
ZZZ123	1 Jan 2020	Leading cargo transfer solutions in New Zealand
JSD245*	31 Mar 2020	Tariff solutions provider in Australia

**Asset acquisitions.*

Example 4: Inclusion of quantitative or qualitative materiality thresholds as applied to disclosures

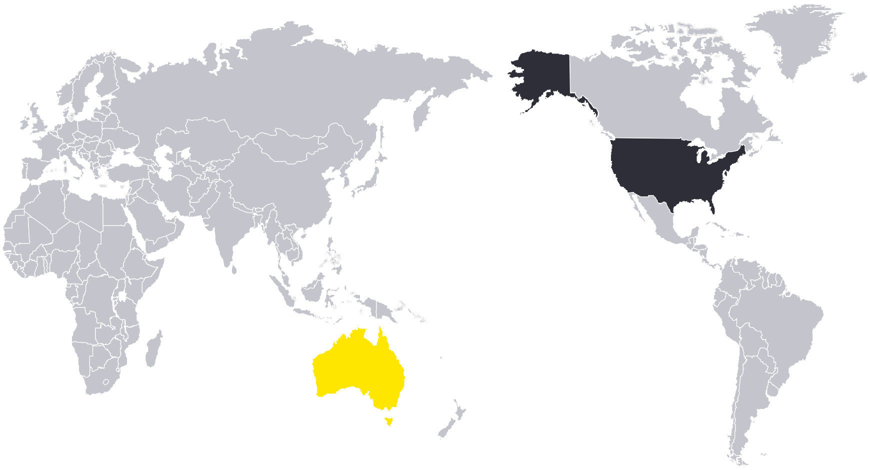
Company 1: Business combination note

During 2020, the Group completed 24 acquisitions. The table below discloses information on assets and liabilities acquired on an aggregate basis if the individual acquisition price is below US100m.

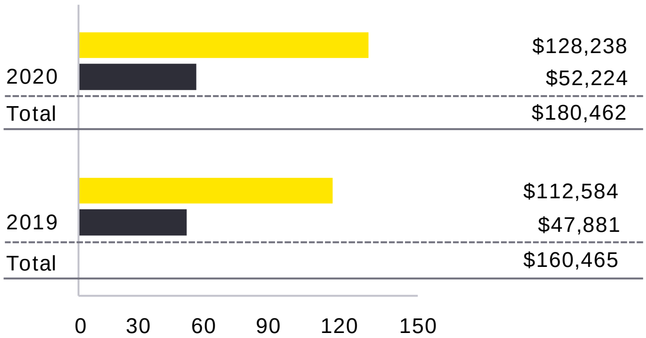
Company 2: Investment in subsidiaries note

The subsidiaries presented in the table below include those with total assets over Euro 100 million, or net income attributable to shareholders over Euro 5 million. Also included are entities which are deemed strategic from an operational perspective or regionally significant.

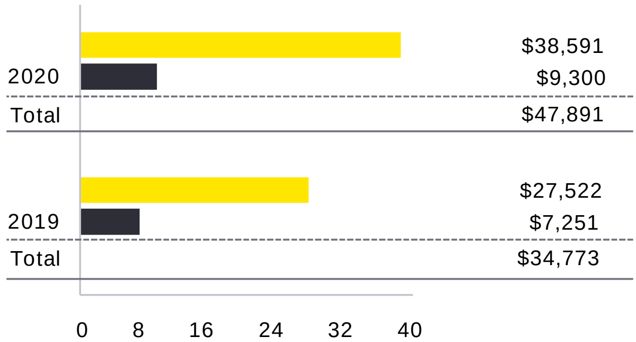
Example 5A: Use of a pictograph for segment information



Revenue from external customers

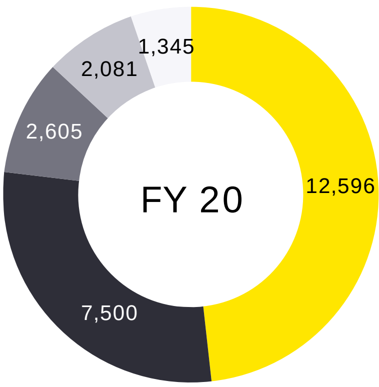


Non-current operating assets



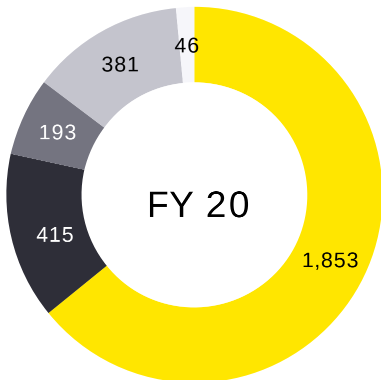
Example 5B: Use of pie charts for presenting segment metrics

Revenues from contracts with customers by segment



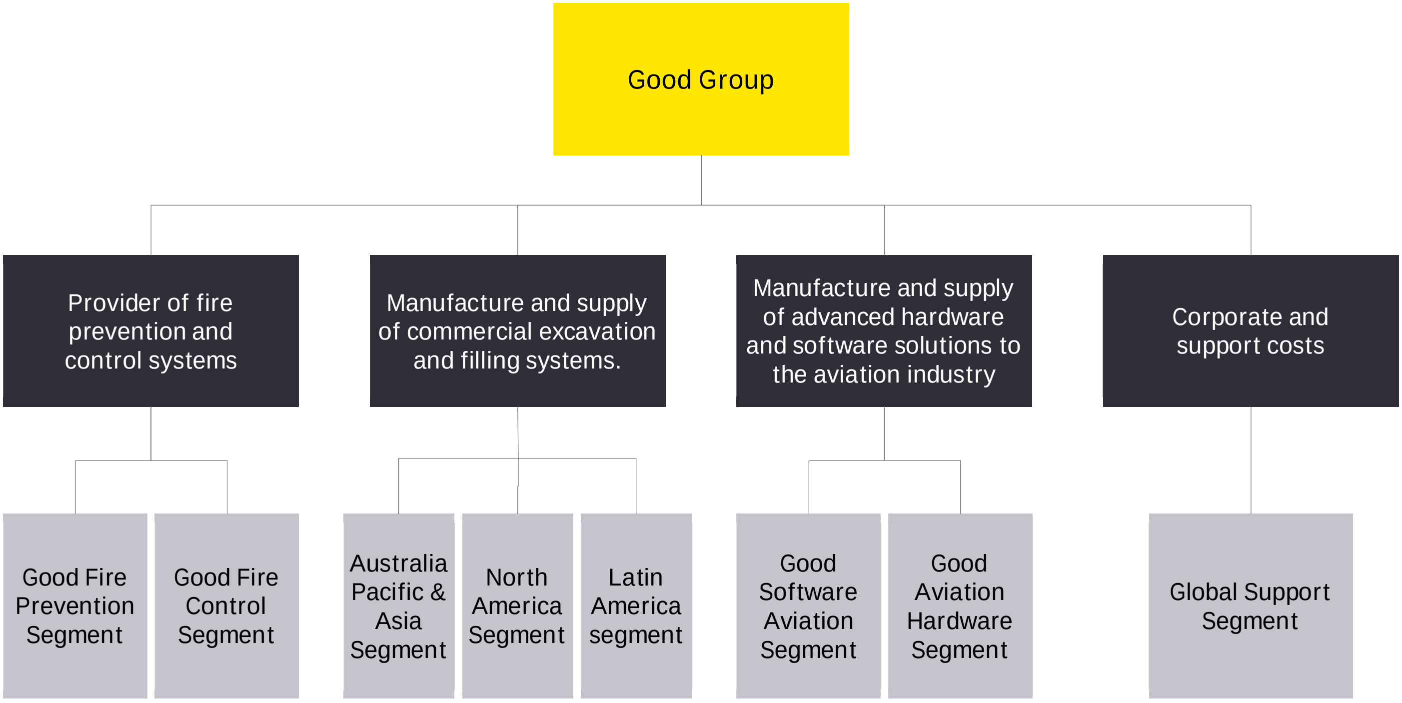
	$m	%
Jupiter	12,596	48
Neptune	7,500	29
Mars	2,605	10
Venus	2,081	8
Mercury	1,345	5

Segment result



	$m	%
Jupiter	1,853	64
Neptune	415	14
Mars	193	7
Venus	381	13
Mercury	46	2

Example 6: Use of an organisational chart to depict 8 operating segments



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