How to “cut the clutter” in your financial statements

In recent years, there has been a widespread acknowledgement that financial statements have become too lengthy and complex. This view has been shared by standard-setters, preparers and readers of financial statements around the world. Financial statements have grown in size every year, with a typical ASX listed company often preparing over 100 pages of information.

As a result, the G100 group noted that *“it is not surprising that many companies have reverted to preparing two sets of financial reports; those required in compliance with IFRS, which are increasingly being regarded as a compliance exercise, and those where the company produces additional, specifically tailored reports to its shareholders.”*

Similarly, the UK Financial Reporting Council found that *“Clutter undermines the usefulness of annual reports and accounts by obscuring important information and inhibiting a clear understanding of the business and the issues that it faces .”*

In response, the International Accounting Standards Board (IASB) launched an initiative to determine how ‘disclosure overload’ could be reduced by all financial statement preparers.

A key outcome of this process was a revised version of AASB 101 *Presentation of Financial Statements*. The revised standard clarifies several key concepts around the preparation of financial statements, including:

- That materiality applies to all four primary statements and the notes to the financial statements, and to all accounting standards.
- Although each Australian Accounting Standard contains specific minimum disclosure requirements, an entity need not provide a disclosure if the information resulting from that disclosure is not material. Therefore, it is necessary to consider whether each disclosure required by an accounting standard is material, and whether presentation or disclosure of that information is warranted.
- Material information should not be obscured by ‘hiding’ it in a large volume of immaterial information. Similarly, material information should not be aggregated with immaterial information of a different nature or function.
- Preparers need to consider whether further disclosures should be provided, in addition to specific minimum requirements, to enable the reader to understand the information contained within the financial statements.
- Entities can exercise flexibility when it comes to the structure of the financial statements in order to give more prominence to relevant areas.

These principles are designed to reassure preparers of financial statements that they have the freedom to apply materiality and exercise judgment in deciding what should be included in financial statements. This article considers a number of ways in which this can be applied in practice.

1. Focus on Materiality

The revised AASB 101 confirms that the concept of materiality applies to disclosures just as much as to the numbers themselves. This presents several opportunities for reducing the volume of disclosure in the notes to the financial statements:

- Some balances are frequently immaterial or 'small' in the context of the financial statements, but have extensive disclosure requirements. These disclosures can be rolled back. Areas to focus on could include:
  - Share based payments – is it necessary to include a detailed description of every tranche of option issued?
  - Financial instruments – are all the risk and liquidity disclosures relevant to the users of the financial statements?
  - Property plant and equipment – is it necessary to make extensive use of tables showing detailed movements of relatively small amounts.
- Likewise, a material balance in the Statement of Financial Position does not mean that all disclosures relating to it are material. For example, preparers might ask themselves whether a note on prepayments provides any further useful information to the reader.

Preparers should remember that materiality is determined by understanding what information would be relevant and useful to the readers of financial statements, rather than only considering an arbitrary size threshold.

2. Change the order

A typical set of financial statements consists of the primary statements, followed by multiple pages of accounting policies (usually in Note 1), with numerical disclosures further back. These notes often appear in the same order that the related items appear in the balance sheet and income statement.

Why are they presented this way when Australian Accounting Standards do not mandate any order for notes? The reason is no more than "that's the way we've always done it."

The contents of Note 1 are rarely important enough to justify such a prominent position. They usually consist of densely written and technically worded descriptions of accounting policies, augmented by detailed descriptions of standards which have not yet been adopted and may not be for several years.

In order to simplify the structure of the financial statements, preparers should consider the following:

- Notes in financial statements should be re-ordered so as to group similar items together. For example, notes on receivables, loans, capital management and financial instruments are often widely separated, even though the information within them can overlap and is more relevant when considered together.
- Those disclosures of greatest interest to investors and other users should be presented first.
- A description of only the significant accounting policies should be included, while others might be removed altogether. This information may be better presented as part of the related note, rather than in Note 1.
- Disclosures included for compliance purposes, rather than for information, should be towards the end of the report (or removed entirely).

3. Use plain English

The use of technical language and accounting jargon is a common complaint by readers of financial statements, particularly when describing accounting policies. Preparers can take action to reduce this problem:

- Reconsider whether all accounting policies are necessary, particularly if they relate to transactions that did not occur in the current or prior year.
- If a policy is simply a copy of the wording from the accounting standard, then it adds no value to the user and could be removed or updated to be entity-specific.
- Are you asking yourself if all Board members understand the accounts without further explanation? If not, then the readers will also likely struggle.

4. Change approach

Preparers should start to incrementally move towards 'de-cluttering' by changing their approach to drafting the financial statements. As an initial approach, this may include:

- Limiting the reliance placed on 'model' financial statements for accounts preparation. Using model financial statements that are not entity-specific will often result in the preparation of disclosures that use 'boiler-plate' language, without giving a genuine insight into the business.
- Moving away from using a checklist-based approach, to assessing disclosure completeness. Rather than asking whether all the boxes have been ticked, preparers should be focussing on the messages they are trying to convey, and whether there is anything else that they think investors or other users would like to know.

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Case Study: Bega Cheese

A comparison of the Bega Cheese Ltd financial statements between 2013 and 2015 shows a successful application of the de-cluttering principles above. In particular:

- The notes to the financial statements have been re-ordered with the accounting policies section moved from first to last,
- Notes were grouped together around common themes based on plain English descriptions (e.g.. "How numbers are calculated"), and
- The total volume of note disclosures has been reduced from 40 to 26 pages by removing immaterial and unnecessary disclosures.
- A comparison of the index from the 2013 and 2015 financial statements shows the effect of the changes made.

Source: Bega Cheese Limited Annual Reports 2015 and 2013

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Please contact your local Crowe Horwath advisor to find out how we can assist you.

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How can Crowe Horwath assist you?

Crowe Horwath can help you to improve the presentation of your financial statements and build efficiency into your year-end reporting process by:

- Reviewing your current financial statements and identifying areas where opportunities exist for de-cluttering,
- Benchmarking your current financial statements against current best practice,
- Providing guidance to finance teams or to Audit Committees, and
- Assisting with drafting and preparation of financial statements.

Please contact your local Crowe Horwath representative for further details.

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[i] *Group of 100 – Less is More*

[ii] *UK FRC – Cutting Clutter – Combating clutter in annual reports*

About Crowe Horwath

Crowe Horwath Australasia is the largest provider of practical accounting, audit, tax, business and financial advice to individuals and businesses from a comprehensive network of over 100 offices.

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