Brewing Over

Decluttering financial statements

It is said that the length of financial statements has grown extensively in recent times and, in the process, financial statements have become cumbersome. This is often blamed on the increased complexity of financial reporting standards, as well as an increase in regulations. However, this may indicate that there has been a shift in focus during the preparation of financial statements. The focus may have shifted from meeting the needs of the primary users onto ensuring compliance with various reporting requirements, whether contained in IFRS or imposed by local regulators. Through this, management and preparers may have inadvertently lost sight of the objective of financial statements which is to provide financial information about a reporting entity that is useful to a wide range of users in making economic decisions.

Currently, preparers seem to be providing as much disclosure as possible in their financial statements to ensure that the entity will not be reprimanded by regulators or auditors for omitting information. This approach serves neither the users nor the regulators. Users could become overwhelmed with the irrelevant information disclosed and miss the crucial information which may be buried within the clutter. Meanwhile, the local regulator, the JSE, has repeatedly cautioned entities against the provision of unnecessary “boilerplate” disclosures through their proactive monitoring review process. Similarly, the IASB has published a number of documents, together with amendments to IAS 1, which encourage the use and application of materiality (judgements) in the preparation of financial statements to aid in reducing the disclosure of immaterial information.

So maybe less is more…

As a result of the above, the concept which has come to be known as “decluttering” of financial statements was born.

How does one go about decluttering their financial statements?

In short, the process of decluttering entails defining what is material – both quantitatively and qualitatively, identification and removal of immaterial information and, sometimes, the inclusion of information which was not previously provided in the financial statements but which has been assessed as being material. This will involve the application of judgement.

The need to apply materiality judgements is pervasive in the preparation of financial statements. These judgements are at the centre of providing relevant, useful information in financial

statements – and therefore, are at the centre of the decluttering process.

How do we determine which information is material?

In making this determination, qualitative and quantitative factors should be taken into account. Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions of the primary users. To quote the materiality practice statement, 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

When making materiality judgements, an entity needs to consider the type of information which could reasonably be expected to have an impact on the primary users of its financial statements. Therefore, involves the identification of the information needs of the primary users.

To do this, management should first identify who the primary users of the financial statements are.

Primary users is defined in the *Conceptual Framework*— investors (existing and potential), lenders (existing and potential) and other creditors (existing and potential) – although this is not an exhaustive list and will differ between entities. These are users who typically cannot demand specific information from entities and must largely rely on information presented in the general purpose financial statements.

With that being said, general purpose financial statements do not, and cannot, provide all the information that primary users require. Therefore, an entity's aim should be to meet the common information needs of its primary users, not to address the unique needs of single users.

Identification of the common information needs will aid the entity in determining information which could be qualitatively material.

Other factors which should be considered in determining qualitative materiality include the characteristics of the transactions which the entity entered into during the period. An entity should assess whether any of these were significant either in size or nature. Consideration of the industry in which the entity operates is also important. For instance fair value disclosures may take on greater relevance for property companies which hold large portfolios of investment properties measured at fair value as compared to manufacturing companies. The macroeconomic environment could also influence this assessment. During periods with increased uncertainty, such as the current period, disclosure of management judgements and sources of estimation uncertainty are likely to take on greater relevance.

Therefore by identifying the primary users, assessing their needs, together with consideration of other relevant factors (as referred to above), a preparer can define their "qualitative materiality".

Materiality also requires a quantitative assessment. Quantitative materiality is usually determined based on one or more of the measures presented on the face of the primary financial statements, e.g. a percentage of profit/loss, revenue, total assets, net assets, etc. The appropriate measure would be determined based on the

nature and circumstances of an individual entity. Further, different quantitative thresholds may be appropriate for different primary statements, or even, elements presented on the primary statements (i.e. an entity may determine a quantitative materiality for the Statement of Financial position, and a different quantitative materiality for the Statement of Profit or loss).

Once we have defined materiality, how do we declutter the financial statements?

Although no hierarchy exists among materiality factors, it may be efficient to assess an item of information from a quantitative perspective first. If an item of information is identified as being material on the basis of quantitative factors, it is not necessary to assess that item of information further against qualitative materiality factors, as given it is quantitatively material, it warrants disclosure. However, it is unlikely that a quantitative assessment alone would be sufficient to conclude that an item of information is *not* material. Therefore, an entity should assess the presence of qualitative factors prior to concluding that an item is immaterial, should it be assessed as being quantitatively immaterial.

Once an entity has identified the information which is material – applying the materiality and aggregation guidance contained in IFRS, this information should be disclosed in the financial statements. The remaining immaterial information can as a result be removed, unless such removal would make the financial statements misleading in some way.

Therefore the last step in a decluttering exercise is for management/preparers to have one final read over the decluttered financial statements as a whole to ensure that these statements continue to make sense and that the information which has been removed will not have an adverse effect on the user's understanding of the financial statements.

Considering the above, it is important to remember that separate disclosure of immaterial information is not required. Even if a specific standard requires that certain disclosures be provided, if the information resulting from that disclosure has not been identified as being material, it is not necessary to provide the disclosure. This is confirmed in paragraph 31 of IAS 1.

In closing, the preparation of financial statements should not be approached as a tickbox exercise, but rather as an opportunity for management to tell the primary users a story of what the company has been up to during the period(s) and showcase the results of these actions.

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