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Enhancing the quality of IFRS financial statements

There are significant qualitative aspects to the construction and presentation of financial statements under International Financial Reporting Standards ("IFRS"). This isn't surprising, considering that IFRS is designed as a principles-based set of standards. Some of these qualitative characteristics are identified in the Framework published with the IFRS standards and include such qualities as understandability, relevance, reliability, comparability and fair presentation.

We believe that enhanced quality doesn't require significant changes to the construction of financial statements: it's simply about enhancing the clarity or informativeness of the messages they convey.

With this sort of simplicity in mind, we've identified ten easy things you can do.

Other dimensions of quality

In addition to the ten ideas discussed, there are other ways to enhance the quality of IFRS-based financial statements. Some of these are simply matters of style and focus:

- use plain language rather than technical jargon; and
- identify and explain the cause of change, be it a change in a circumstance or a change in an accounting standard that causes a change in a balance.

More sophisticated approaches include enhancing the processes and procedures for selecting estimates, formulating judgments and choosing principles. While these aren't quite as simple, they are worth considering. For example:

- Are estimates neutral and unbiased or, better yet, "prudent", in their portrayal of the underlying phenomena the estimates are trying to capture? This would include avoidance of a pattern of bias in estimates, however minor, that all have the same directional effect on net income.
- Are judgments concerning financial reporting matters based on a balanced consideration of all the relevant factors that are identified in the accounting standards as being important to the determination? With principles-based standards it is expected that different parties may reach different judgments about circumstances. But all such judgments should be rooted in an analysis of relevant factors, appropriately considered. As a result, quality may not mean "identical answers" to issues but rather identical diligence in the consideration of factors.
- Are the choices of accounting principles, when available, made – and disclosed – in a manner that provides a meaningful picture of the underlying financial process? For example, how are the choices in applying IFRS 1 *First-time Adoption of International Financial Reporting Standards* made and are they fully explained? If such choices are made to simplify calculations on conversion, do they nonetheless potentially mask other messages that would otherwise be important for a financial statement user to know? Take, for example, previously unrecognized losses that on conversion to IFRS are charged directly to retained earnings. These losses will never be charged to earnings under either Canadian generally accepted accounting principles or IFRS. Are the issues such losses pose for the entity – e.g. higher than competitive expense levels, or significant funding needs to pay for those losses – apparent to the reader of the financial statements?
- Taken in total, does the picture provided by the financial statements prepared in accordance with IFRS clearly portray the financial and operational matters that are the significant concerns of management?

For further insight on any of the issues presented, please contact the Deloitte professionals listed on the back of this publication.

10 easy ways to improve the quality of IFRS financial statements

Just as you don't need a PhD in automotive engineering to distinguish a high-quality automobile from one that provides basic transportation, we believe you don't need to be a financial reporting expert to improve the quality of IFRS financial statements. In our view, the following ten ideas will improve the quality of IFRS financial statements, without requiring significant changes in their construction:

1 **Separately identify additional classes of assets and liabilities, revenues and expenses, beyond the minimum required. And use labels that provide more insight into the nature of the classes.**

For example, on its income statement, an entity might disaggregate its aggregate revenues by major lines of business. On its balance sheet, it might separate the elements of property, plant and equipment into more than the three elements in the category's label. If such information replicates the entity's segmented disclosures, consider a geographical disaggregation if that is not otherwise provided. This means readers would only have to look at the income statement or balance sheet to comprehend the distribution of sales volumes or productive asset investments.

2 **Treat the notes to the financial statements – the ones that provide details of specific balances – as more than a reconciliation prepared for accountants.** Add a narrative at the beginning of the note that identifies the most significant changes in that element of the financial statements.

While reconciliations may be a required element of IFRS financial statements, do not assume that readers will plow through endless details that have no context. Identify which items are most important, and what they represent. Are there significant specific additions to property, plant and equipment? If so, describe them. For instance, if it's a new plant, explain where it is and what it makes. Adding that information does not diminish the information in the reconciliation; instead, it may provide a better idea of the business activities that are reflected in the accounts.

3 **In the note disclosures discussing income statement items, include information about cash flows for the items in the same discussion.**

For example, if a defined benefit pension plan generates an expense but does not require immediate funding, or generates a gain but does require funding, (which is the more likely the case), then it would be useful to present the pension expense and the corresponding cash flows together. While there are requirements to disclose the amount of an entity's contributions to defined benefit pension plans, these amounts are often only disclosed as an element of a reconciliation of pension plan assets. It is unlikely that the average reader would be easily able to connect the two amounts, even though their significance is best established when the reader can determine the relative magnitudes of the expense recorded and the cash outflows for the same period.

4

When uncertainties are being addressed, consider disclosing the various options by which the uncertainty may be resolved.

Often, entities elect to disclose as little as possible about alternative possible outcomes for uncertainties in disclosures. While such a disclosure strategy doesn't raise any positive expectations in the minds of readers and prevents subsequent disappointment, it's also not informative and potentially can lead to the conclusion that little is being done – providing a surprise outcome in any event. If there are alternative ways to resolve a significant matter, for example, a liquidity challenge, then identify the realistic alternatives being considered.

5

Provide segment information on the elements of profit and loss on the face of the income statement, next to the consolidated totals.

This doesn't require the reader to wait until the segment disclosure note – which may appear near the end of the financial statements – to assess the significance of various operations to the whole.

6

In addition to explaining an entity's accounting policy choices, explain the nature of judgments made, and the reasons for them.

IFRS financial statements are judgment-intensive. These judgments extend from the degree that plant and equipment assets are componentized for depreciation purposes to the determination of an operation's functional currency. While IFRS does require an entity to disclose the significant judgments made in the preparation of the financial statements, the reasons supporting such judgments do not need to be disclosed for the statements to be in accordance with IFRS. If they were disclosed they may provide additional insight as to the underlying factors that support a numerical result. For example, if there is significant management judgment involved in the determination of a functional currency for an operation, explain the facts supporting the interpretation of those requirements. This provides the reader with an understanding of the complexity of the currency environment for that operation, which may otherwise not be apparent.

7

If an estimate is significant to a balance or an account, analyze changes in the estimate or its assumptions in the same detail as the changes in balances that they affect.

For example, an entity may change its estimate of the loss rates on accounts receivable. Disclosure of the bad debt rate and changes therein would likely provide additional insight to most investors. If the effects of such changes are significant or material to the determination of net income, the factors that drive that change in estimate, such as an extension of the average time to pay or an increased default rate, would certainly help the financial statement user to put the change into context.

8

Try, if possible, to put comparative information in the same line as the disclosure of the current amount.

The presentation of comparative information in financial statements is intended to permit the financial statement user to make comparisons and draw conclusions as to the period-to-period performance of the entity. Comparative information presented side-by-side with the current period's results facilitates such comparisons. But comparative information can also be presented in a separate table that simply details the results for the comparative period. This may help simplify the construction of the financial statements (delete one year's table, add another), but it makes the reader do more work to identify changes in the data. Side by side comparisons facilitate analysis.

9 **When an account is constructed of several components which in turn are estimates requiring detailed explanations, first identify the various components that appear on the financial statements, and show how they relate to each other, then provide details of assumptions.**

Many accounts, such as estimates of provisions, defined benefit pension plans and stock-based compensation, require disclosure of assumptions and estimates as well as reconciliations of balances. If the note is constructed as a compliance exercise, simply giving the required disclosure may result in the information about changes in balances being lost in the detail of assumptions. A clearer way of presenting such information is to draw the roadmap among interrelated financial statement amounts. That is, demonstrate where the various elements of a calculation appear on the financial statements. Then provide the data that support such balances and accounts – assumptions, rates, sources of information, etc. These should be presented for the interest of those readers who wish to analyze the changes in such factors.

10 **Provide information about important non-accounting attributes, as well as aggregated amounts when detailing balances.**

For example, when providing disclosure of property, plant and equipment, in addition to providing the required information about the remaining unamortized balance, identify the age of individually significant assets and, if objectively determinable, information about productive capacity alongside the financial balances. Descriptions of the nature of the assets or processes the entity uses may also be added to such disclosure, if the technological details are important to comprehending how the entity creates goods and services from various assets. Readers can then identify specific assets with the related financial statement numbers.

These are only some of the easy enhancements that may enhance quality of IFRS financial reporting at relatively little extra cost or effort.

Observations on quality

The compliance challenge with the adoption of IFRS has been a significant focus of many organizations' conversion efforts. However, if organizations seek to add value for their shareholders and other financial statement users, there are qualitative issues that should be considered as well as compliance matters.

The discussion above focuses on ten ideas that may be relevant to an organization's financial statements. There are also general qualitative issues that are more systematic than specific in nature. Given the expenditure already made on compliance issues, however, and the relatively low cost to implement many of these qualitative issues, we believe it is worthwhile for management and audit committees to investigate the benefits of their implementation.

For further insight on any of the issues presented in this publication, please contact the Deloitte professionals listed on the back of this publication.

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