Investors, creditors, analysts and other stakeholders require more insight than ever about your company’s performance, strategic direction and exposure to risk. The financial report is the single most trusted source of information on financial performance and plays a critical role in building trust between management and stakeholders. At EY, we see reporting effectiveness as an important element in maintaining the relevance and quality of financial reporting as a whole.

Boards and senior management are increasingly aware of the importance of ensuring the company’s messages are succinct, accurate, consistent and clear. As of June 2015, over one third of the ASX100 had substantially improved the clarity and readability of their financial report and many more had taken the first steps on the journey. Standard setters and regulators in Australia and globally have expressed clear support for these efforts. Projects are underway at the International Accounting Standards Board (IASB), UK Financial Reporting Council (FRC), US Securities and Exchange Commission (SEC) and the US Financial Accounting Standards Board (FASB) to look for ways to enhance the regulatory framework and provide more flexibility to reporters.

This guide will give you some insights about what options might be available. It provides an overview of the practical steps that you can take to improve the effectiveness of your financial reports using worked examples based on EY Australia’s illustrative financial statements, Endeavour (International) Limited (Endeavour). These examples are not intended to be templates: instead, we trust this guide will empower boards and their finance teams to produce a financial report that reflects the drivers of value and addresses stakeholder concerns for their own, specific entity.

Tracey Waring
Partner and EY Oceania IFRS Leader
Ernst & Young Australia
What makes an effective financial report?

The key to effective reporting is to focus on the user. An effective report:

- Adopts a user perspective to the disclosures required: what is important for them to understand about your company? What information do they look for?
- Considers language - it adapts boilerplate disclosures to make them relevant to the particular company, avoids jargon, and doesn’t assume in-depth knowledge of the business or of accounting requirements
- Doesn’t take a ‘tick box’ approach to disclosure but considers materiality in the context of the company and its stakeholders
- Appreciates that good design and layout make for a much easier read

In practice, this requires a focus on broad concepts as well as detailed information; language as well as numbers; and form of presentation as well as content. This can be challenging as it demands a different skillset to that traditionally held by the financial reporting team. At the same time, those outside the reporting team can struggle to understand the complexities and risks inherent in financial reporting. And let’s be honest, it takes more time than rolling forward last year’s accounts and churning out boilerplate disclosures.

Finance teams in leading organisations, however, are taking the opportunity to: demonstrate that they have a strategic perspective; and to strengthen connections with the broader business. And when they do, the results can be remarkable. Effective reports can be up to 40% shorter, with fewer, more relevant notes which actually tell a clear story, making for easier preparation, review and most importantly, understanding.

38% of June reporters in the ASX100 substantially updated their financial report in 2015*

*Source: EY survey of 30 June 2015 reporting
1. Develop your strategy and structure

The first step in improving the effectiveness of your financial report is to understand your audience: who is reading your report and what they are interested in?

Understanding your users
Investors would usually be the primary users of financial reports. However, you may also want to consider other potential users, such as regulators, capital providers, tax authorities, special interest groups – even creditors, employees and customers. Depending on which of these audiences you see as your priority, the decisions you make about materiality, disclosure and presentation may differ.

You then need to understand the perspective of your users, and how your organisation presents itself to the world in communications other than the financial report. Sources for gaining those perspectives might include the following:

<table>
<thead>
<tr>
<th>External sources</th>
<th>Internal sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Analyst reports</td>
<td>• Investor briefings</td>
</tr>
<tr>
<td>• Proxy advisor reports and feedback</td>
<td>• Media releases</td>
</tr>
<tr>
<td>• Media coverage</td>
<td>• Previous year reports</td>
</tr>
<tr>
<td>• Shareholder questions or feedback</td>
<td>• Brand guidance</td>
</tr>
<tr>
<td>• Analysis of shareholder registry</td>
<td>• Your website</td>
</tr>
<tr>
<td>• ASIC areas of focus</td>
<td>• Your PR and marketing</td>
</tr>
<tr>
<td></td>
<td>communications</td>
</tr>
</tbody>
</table>

Taking a user’s view of your financial report
Challenge yourself to consider how the information in the financial report might be most usefully presented for your users. Ask yourself:

- What do your users see as the primary drivers of performance value?
- What indicators of financial performance do users consider?
- What areas of external risk do users see as important?
- What does management believe is important for users to understand to be able to assess your organisation’s value and performance?

Once we have a clear picture of the user perspective, it’s then possible to develop a strategy and plan for addressing their needs.

Building your project team
One of the biggest benefits our clients tell us they have seen from a reporting effectiveness project is improved connections between the finance function and the rest of the business – including operations and functional teams, such as corporate affairs. Having representatives from those groups on your project team helps to achieve that outcome. It also assists in bringing an outside perspective to your report: a challenge to the familiar perspective.

Structuring your report
The next step is then to restructure your financial report to reflect the priorities of your stakeholders. An example of one potential way to restructure your table of contents is shown at right, with some observations for how this might change for companies in different circumstances.

As Endeavour is a relatively traditional manufacturing business, the focus of investors would tend to be on:

- **Sales** – is there continuing and growing demand for their products, at a good price?
- **Cost** – can they make and sell products for less than they are able to charge: are they maximising margins?
- **Innovation** – is the business investing in the future, and how?
- **Capital management** – is the business carrying too much debt, or paying too much interest? What resources can it draw on to fund its operations?
- **Risk** – what risks is the business subject to and how are those risks being managed?
Example revised contents to Endeavour financial report

Section A: Current performance
A1. Segment information
In this example, we have taken the view that users will primarily be concerned with the tax expense, and have moved detailed information reconciling tax accounting to the financial statements, to the ‘Other’ section.

A2. Revenue

A3. Expenses

A4. Income tax

Section B: Building for the future
Enabling innovation
B1. Research and development costs

B2. Intangible assets

Investing and growing our business
B3. Investment properties

B4. Business combinations

B5. Subsidiaries

B6. Joint ventures

B7. Associates

Endeavour’s long-term growth levers are acquisitions, alliances and its investment portfolio. An oil and gas downstream producer might focus on capital expenditure on new projects as their investment in future growth.

Section C: Working capital management
C1. Inventories

C2. Trade and other receivables

C3. Cash and short-term deposits

C4. Trade and other payables

Working capital management is key for many businesses. For Endeavour, the main levers are inventories, cash flow management and receivables/payables management.

Section D: Investing in our people
D1. Employee benefits

D2. Share-based payments

Section E: Funding and risk management
E1. Long-term borrowings

E2. Capital management

E3. Issued share capital

E4. Hedging activities

Risk management information can be presented in a single note (the traditional presentation) or can be split up so that the information sits with related information in other notes. This example reflects the latter approach: we would include information on interest rate risk and liquidity risk in this section, and trade receivables risk in Note C2 above. General information about risk policies is contained in Note G5.

Section F: Shareholder wealth and investor returns
F1. Earnings per share (EPS)

F2. Issued capital and reserves

F3. Dividends paid and proposed

Section G: Other compliance and regulatory information
G1. Basis of preparation

G2. Income tax – detailed disclosures

G3. Information about subsidiaries

G4. Discontinued operations

G5. Financial risk management objectives and policies

G7. Related party disclosures

G8. Commitments and contingencies

G9. Events after the reporting period

G10. Auditors’ remuneration

G11. Information relating to Endeavour (International) Limited (the Parent)

Complex entities or those who have recently restructured might choose to include a section that brings together all the disclosures relating to group structure and entities.

Endeavour has a strong R&D program and relies on building intellectual property for future income streams. An online retail company, for example, might include information on marketing expenses, software development or franchising agreements under a similar heading.

The segment note is generally the most read note in the financial report and should therefore be reviewed carefully to ensure it is clear and reflects management’s perspective on the business.
2. Move and review

Moving disclosures

The next step is to move the notes to their new location based on the updated table of contents. This can be done by simply cutting and pasting existing notes, but to get the maximum value we recommend that consideration be given to the content of each note and how it can be most effectively grouped. For example, many companies have chosen to:

- Present accounting policies together with the disclosures most relevant to them.
- Provide a summary table of significant judgments and estimates up front, and present the detail in the most appropriate section of the notes – often highlighted to make it easier for users to find them.
- Move detailed, less relevant disclosures towards the back – for example, they present the overall balances of defined benefit superannuation funds in the main section of the notes but the detailed information about fund assets, liabilities and sensitivities in an appendix at the back.

Others have also rearranged the information within related notes: for example, by presenting the information on interest rate and liquidity risk together with the information on borrowings.

Reviewing disclosures

Increasingly, companies are also challenging themselves to review their existing disclosures to ensure they are clear, relevant and in plain English rather than technical jargon. This approach tends to provide the greatest benefits in terms of reducing the volume and improving the readability of the report. To achieve this, you should:

- Review disclosures to understand how best to link the sections together so that the user understands the connection and can find the information they need.
- Ensure information is tailored to your company and not generic – for example, not “we follow a risk policy as set out by the board” but “our risk policy is...”
- Determine whether the emphasis of information is appropriate. Is important information hidden in footnotes to tables, or unimportant information taking up too much space and provided in too much detail?
- Decide whether you need additional information on important areas or areas that are regularly misunderstood.

A worked example – the Endeavour business combination note

The Endeavour illustrative accounts include the acquisition of Extinguishers Limited, with disclosures relating to that acquisition spread out across several notes. In this worked example, we have brought together those disclosures into one note and reviewed the language to ensure it is clear and relevant to the specific transaction and entity’s circumstances. As a result, the volume of the disclosures has been reduced by over 40%.

### Note XX Business Combinations

#### Acquisition of Extinguishers Limited

The Group acquired Extinguishers Limited, an unlisted Australian company specialising in the manufacture of fire retardant fabrics, on 1 May 2015. The acquisition significantly enlarges the range of fire prevention products that Endeavour is able to offer its clients.

The entity was acquired with shares of the Group, with further consideration payable in cash after 12 months contingent on the performance of the entity. The acquisition has resulted in the Group holding 80% of the voting shares in Extinguishers Limited. The acquisition is reflected in this financial report at the full value of Extinguishers Limited, based on the fair value of the shares transferred plus the value of the remaining 20% still held by non-controlling interests.

<table>
<thead>
<tr>
<th>Purchase consideration transferred</th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares issued, at fair value</td>
<td>7,203</td>
</tr>
<tr>
<td>Contingent consideration</td>
<td>714</td>
</tr>
<tr>
<td><strong>Total consideration</strong></td>
<td><strong>7,917</strong></td>
</tr>
</tbody>
</table>

**Transaction costs:** $600,000 of transaction costs were expensed and included in administrative expenses.

**Shares:** The Group issued 2,500,000 ordinary shares as consideration for the 80% interest in Extinguishers Limited. The fair value of the shares is the quoted price of the shares of the Company at the date of acquisition, which was $2.88 per share.

**Share issuance costs:** $32,000 of share issuance costs have been charged directly to equity as a reduction in issued capital.

**Contingent consideration:** Contingent consideration will be paid to the previous owner as follows:

a) $675,000, if the entity generates up to $1,000,000 of profit before tax in a 12-month period after the acquisition date or
b) $1,125,000, if the entity generates $1,500,000 or more of profit before tax in a 12-month period after the acquisition date.
Recognised through profit or loss.

Recovery of the contingent consideration liability of $358,000 has been recognised through profit or loss. The liability has increased to $1,072,000, and a fair value of the contingent consideration has been recognised for the difference between the market rate and the contracted rate.

Change in fair value of contingent consideration: Any significant increase (decrease) in the profit after tax of Extinguishers Limited would result in a higher (lower) value of the liability, while a significant increase (decrease) in the discount rate and own non-performance risk would result in lower (higher) fair value of the liability. Since acquisition the business has performed better than expected and, as at 31 December 2015, the key performance indicators of Extinguishers Limited show that it is highly probable that the target will be achieved due to a significant expansion of the business and the synergies realised. As a result, the fair value of the contingent consideration liability has increased to $1,072,000, and a remeasurement charge of $358,000 has been recognised through profit or loss.

As at the acquisition date, the fair value of the contingent consideration was estimated to be $714,000. The fair value was determined using discounted cash flows. The significant unobservable valuation inputs were:

| Assumed probability-adjusted profit before tax of Extinguishers Limited | $1,000,000 to $1,500,000 |
| Discount rate | 14% |
| Discount for own performance risk | 0.05% |

All cash flows have been recognised in the current period.

Impact on operations: From the date of acquisition, Extinguishers Limited contributed $17,857,000 of revenue and $750,000 to profit before tax. If the acquisition had taken place at the beginning of the year, revenue from continuing operations would have been $222,582,000 and profit before tax would have been $12,285,000.

Provision for onerous operating lease costs: The terms of the operating lease were significantly higher than the market rate at acquisition date. A provision has been recognised for the difference between the market rate and the contracted rate.

Contingent liability: A contingent liability was recognised at the acquisition date for a claim by a supplier whose shipment was rejected and payment was refused due to quality concerns. The claim is subject to legal arbitration and is expected to be finalised in late 2016. The liability was originally assessed at $380,000 but has now been reassessed at $400,000, based on the expected probable outcome (see Note X). The difference has been recognised as a charge to profit or loss.

Provision for restructuring: Prior to the acquisition, Extinguishers Limited decided to eliminate certain product lines (see Note X). The restructuring provision recognised was a present obligation of Extinguishers Limited immediately before the acquisition and the restructuring plan was not conditional upon the company being acquired by the Group.

Deferred tax liability (DTL): The DTL arises mainly from the accelerated depreciation for tax purposes of tangible and intangible assets.

Non-controlling interest (NCI): The NCI in Extinguishers Limited is recognised at fair value, based on significant inputs that are not observable in the market. Fair value was estimated using a discounted earnings technique based on:

- An assumed discount rate of 14%
- A terminal value, calculated based on long-term sustainable growth rates for the industry ranging from 2% to 4%, which has been used to determine income for the future years
- A reinvestment ratio of 60% of earnings

Goodwill on acquisition: Goodwill is initially measured at cost. This is calculated by taking the fair value of the identifiable net assets acquired and subtracting the amount recognised for non-controlling interests, and then deducting this amount from the consideration. The excess is recognised as goodwill. Goodwill is then tested for impairment in subsequent periods.

Goodwill comprises a customer list (which is not separately recognised as it is not separable and cannot be recognised as an intangible asset) and expected synergies arising from the acquisition. It has been allocated entirely to the fire prevention segment. None of the goodwill recognised is expected to be deductible for income tax purposes.
3. Consider materiality

AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors states that ‘omissions or misstatements are material if they could, individually or collectively, influence economic decisions that users make on the basis of financial statements’ (AASB 108.5). The concept of materiality is strongly aligned with effective reporting. It recognises that focusing the financial report on information that is material to stakeholders makes the report clearer and easier to read. In practice, however, many entities have felt constrained by various requirements in other accounting standards that appear to be written in such a way that does not appear to allow for the application of materiality (for example, through the use of wording such as ‘as a minimum’). This can result in entities presenting information in their financial statements that they do not feel is relevant or material for their report users.

In order to reduce the level of boilerplate disclosures, standard-setters are focusing on encouraging preparers to effectively apply materiality to the presentation and disclosure of financial information as well as measurement. The IASB’s recent draft practice statement on materiality, and the AASB’s amendments to AASB 101 Presentation of Financial Statements, both clarify that disclosure requirements only apply to material information.

Materiality considers both the size and nature of the disclosure. There is no ‘bright line’ test and management judgment is required. Therefore, it is important that materiality calls, and the rationale for deleting information, be clearly documented (see point 5 below for more information).

Applying materiality

Companies may have built up disclosures over a number of years without having critically re-assessed whether or not they were still material to the business. A detailed review of the notes will also usually uncover immaterial detail within the notes. Entities looking to more effectively apply materiality could consider:

› Reducing the level of detail, for example by rewriting lengthy boilerplate disclosures

› Moving away from blindly copying illustrative financial statements or statements from a competitor and instead considering the application of the standard to your entity’s circumstances

› Regularly reviewing materiality judgements - what was once material might no longer be

› ASIC’s annual focus areas

As Endeavour is intended to provide examples of disclosures, the materiality test has not necessarily been applied, and therefore there could be a number of potentially immaterial notes within this financial report. For example, in our example of a reworked table of contents for Endeavour above, we have actually removed the disclosures relating to government grants. This assessment was based on both its small size as a percentage of revenue and assets, and its nature: a business such as Endeavour would generally source its funding predominantly from equity or debt, not government grants.
4. Design and layout

Design and layout are critical to creating a clear and easy to read report – and are all too often neglected. Design elements such as colour, graphics and headings can make your report easier to navigate and help you to connect related information. We recommend getting advice and assistance from a professional designer. While account preparation tools may impose constraints on design and layout, a designer may be able to identify some simple changes to improve readability.

Some options to consider include:

- Using colour to identify different sections of the report or different types of disclosures (for example, accounting policies).
- Break out boxes are a good way of highlighting or distinguishing information – but remember they also make information more prominent, so be careful not to over-emphasise less important information.
- Graphs and charts make it easy for users to see and understand information. Again, it is important to not over-emphasise information by presenting it in graphical format.
- Considering whether the page orientation, font size and type, highlighting and the use of headings enhances or detracts from readability.

A worked example – Endeavour’s geographic segment information

<table>
<thead>
<tr>
<th>Segment information</th>
<th>Revenue from external customers</th>
<th>Non-current operating assets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2015</td>
<td>$128,238</td>
</tr>
<tr>
<td></td>
<td>2014</td>
<td>$112,584</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>$240,822</td>
</tr>
</tbody>
</table>

Tables

Tables are obviously an important element of the design of financial reports. There is no one ‘right’ way of presenting tables, as they form part of the overall design and presentation will depend on factors such as font size, whether columns are used, page orientation, whether it is specifically required by the accounting standards, and so on.

In general, it is preferable to keep comparatives side by side, but this needs to be balanced with the need to keep the number of columns to a reasonable level so that it is not too difficult to read across the row.
Note XX Operating leases

The Group has entered into operating leases on its investment property portfolio consisting of certain office and manufacturing buildings. These leases have terms of between 5 and 20 years. All leases include a clause for an annual rental increase according to prevailing market conditions.

The total contingent rent recognised as income during the year is $13,900 (2014: $12,007).

Future minimum rent receivable under non-cancellable operating leases as at 31 December is as follows:

<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Within one year</td>
<td>1,418</td>
<td>1,390</td>
</tr>
<tr>
<td>After one year but not more than five years</td>
<td>5,630</td>
<td>5,520</td>
</tr>
<tr>
<td>More than five years</td>
<td>5,901</td>
<td>5,864</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>12,949</strong></td>
<td><strong>12,774</strong></td>
</tr>
</tbody>
</table>

Accounting policies

Recognition of leases

The determination of whether an arrangement is (or contains) a lease is based on the substance of the arrangement at the inception of the lease. The arrangement is, or contains, a lease if the arrangement conveys a right to use the asset or assets, even if that right is not explicitly specified.

Critical judgment or estimate – operating leases

The Group has entered into commercial property leases on its investment property portfolio. Based on an evaluation of the terms and conditions of these arrangements, the Group has determined that it retains all the significant risks and rewards of ownership of these properties and therefore accounts for the contracts as operating leases. The lease terms do not constitute a major part of the economic life of the property and the minimum lease payments do not amount to substantially all of the fair value of the property.
5. Practicalities – stakeholder engagement and documentation

**Stakeholder engagement**

Stakeholders of the reporting process should be engaged from the beginning, and kept informed throughout the process. As well as the Audit Committee and auditors, other stakeholders are likely to include the CEO, company secretary, investor relations, corporate affairs and other senior operational leaders.

**Timeframes**

Modifying financial statements often raises questions around the appropriateness of disclosures – and can even trigger a review of the substance of accounting policies themselves. For this reason it is important to allow sufficient time to complete the project, to allow for stakeholders to be properly engaged, for consultations to occur, and for reviews to be completed. In general, you should allow a minimum of three months prior to year end; more if your financial report is lengthy or your team or Audit Committee are also occupied with other projects.

**Review and documentation**

Auditors should be engaged throughout the process to ensure they are comfortable with the decisions being made. It is also important that a thorough technical review be performed when all drafting has been finalised, preferably by someone who has a fresh set of eyes. Any 'missing' disclosures identified may still be excluded on the basis of materiality, but this review provides a final check and helps to ensure that a strong rationale has been documented for all excluded disclosures.

Thorough mapping of changes to the report, and documentation of the rationale for those changes, is critical. Documentation:

- Helps to make the review process smoother
- Provides an easily auditable trail of the changes
- Provides comfort to the Audit Committee and auditors that changes have been made for good reason
- Provides a process whereby previously immaterial disclosures can be reviewed and reinstated in later years if changing circumstances means they become material
Contacts

To discuss further please contact your EY adviser or one of the Assurance Leaders below:

**National**
Michael Wright
Oceania Managing Partner
Assurance
Tel: +61 2 8295 6450

Tracey Waring
Oceania IFRS Leader
Tel: +61 3 9288 8638

**Adelaide**
Mark Phelps
Tel: +61 8 8417 1660

**Brisbane**
Alison de Groot
Tel: +61 7 3011 3437

**Canberra**
Ben Tansley
Tel: +61 2 6267 3933

**Melbourne**
Rodney Piltz
Tel: +61 3 9288 8618

**Perth**
Darren Lewsen
Tel: +61 8 9217 1218

**Sydney**
John Robinson
Tel: +61 2 8295 6536

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