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Dear Jeroen

DISCLOSURE OF NON-FINANCIAL INFORMATION BY COMPANIES

ICAEW is pleased to respond to your request for comments on the consultation *Disclosure of Non-Financial Information by Companies*.

ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 136,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance, which has over 775,000 members worldwide. ICAEW is listed in the European Commission's Register of Interest Representatives (identification number: 7719382720-34).

We have attached as an appendix to this letter our answers to your questionnaire *Disclosure of Non-Financial Information by Companies*. We have also submitted a response to the questionnaire electronically.

Please contact me should you wish to discuss any of the points raised in the appendix to this letter.

Yours sincerely

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Question 1

How would you consider the current regime of disclosure of non-financial information applicable in your country? Please explain. In replying to this question, please provide information on what way current reporting provides useful information, and to what extent it is sufficiently tailored to the circumstances of the company. Please also comment on whether you find non-financial information useful for the decision-making of a company.

We are broadly content with the current UK regulatory regime for non-financial reporting. We believe that the provisions of the Fourth and Seventh Directives, as enacted in UK company law, provide an appropriate legal framework, which focuses on the success of the company for the benefit of the shareholders, while taking account of wider stakeholder interests when these are relevant to that long term success. The framework differentiates between companies according to size and capital structure, and importantly, is therefore a proportionate approach. The regulatory requirements for listed companies in this area is an overlay of the legal regime, which is broadly similar. This legal and regulatory framework is helpfully supplemented in the UK by non-mandatory guidance in the form of the UK Accounting Standards Board's Reporting Statement *Operating and Financial Review*. The work of the UK Financial Reporting Review Panel (FRRP) is also proving important in providing an external incentive for companies to make an effort to improve their reports whilst not acting as a deterrent against those companies seeking to present information in more innovative ways. The main improvement that could be made to legal and regulatory requirements would be to simplify and, where it occurs, remove excessive or overlapping requirements, as noted in our answer to question 3 below.

This framework combines statutory, regulatory and non-mandatory guidance in a well-balanced and effective manner and overall, while some improvements may be possible, is fit for purpose. In the UK, the Department for Business, Innovation and Skills (BIS) has recently concluded a consultation *The Future of Narrative Reporting* to examine whether any improvements can be made to this framework. Similarly, the UK Financial Reporting Council is currently conducting a consultation, *Effective Company Stewardship*, which also includes an examination of corporate reporting. We hope the Commission will take note of the responses to those consultations.

It is important that the requirements for narrative and non-financial reporting allow commentary to be tailored to the circumstances of the reporting company, as is generally the case under the current framework in the UK. It should be recognised that management commentary differs from most other information in the annual report in that its form and content is much more varied, based upon the circumstances of the company and how it is run by management. Indeed the value of commentary is directly derived from its bespoke nature. Whereas users may benefit from financial information communicated in a standardised format, such standardisation in management commentary would be likely to result in 'boiler-plate' narrative disclosures of little value.

A valuable component of article 46 of the Fourth company law directive is that the information described need only be disclosed to 'the extent necessary for an understanding of the development, performance or position of the company's business'. This is a proportionate approach, and it is one that we strongly support. Of itself this guards against 'boiler plate' responses by limiting disclosures to those items where the company has something meaningful to say, as well as helping to focus management efforts on what is important.

This is important. We do not believe that the Annual Report or the Financial Statements should be permitted to become a repository for disparate information with a variety of purposes and audiences, which would lead to the opposite of what, in our answer to question 3, we set out as the qualities of good corporate reporting – a coherent, consistent document free of clutter. We do believe that non-financial risk factors are often relevant to an understanding of a company's performance, position or development and we support the provisions of the Fourth company law directive that, while proportionate, require their disclosure where relevant.

Furthermore, companies are often exposed to systemic risk factors that can have a material effect upon operations. An understanding of these factors is certainly relevant to investors. For example an oil company has a risk of being exposed to environmental clean-up costs due to the nature of its operations. However, these risks are often generic across an industry, could require extensive

documentation to be properly understood, and may not develop in accordance with the annual cycle of corporate reporting. We therefore question whether, were their disclosure to be required, it would be appropriate to include such information within the annual report or financial statements.

Question one asks respondents to comment on whether they find non-financial information useful for the decision-making of a company. We suggest that this part of the question has been slightly mis-phrased. We do not believe that the annual report or the financial statements are the best source of information for the purpose of a company's internal decision making, as management has access to much more extensive, timely and tailored unpublished data. If the question is re-phrased to 'whether you find non-financial information useful for the purposes of making investment decisions concerning a particular company', it becomes much easier to answer. Both the annual report and the financial statements are prepared with a view to the information needs of capital providers, and have an important confirmatory value. To the extent that investors take decisions based upon this information, the provision of clear, uncluttered and consistent management commentary can assist in that process.

Question 2

Have you evaluated the effects, and costs and benefits, of any current corporate disclosure of environmental and social information?

No. ICAEW has not conducted an exercise of this type.

Question 3

If you think that the current regime of disclosure of non-financial information should be improved, how do you suggest that this should be done?

We believe that the current regime for the disclosure of non-financial information is an effective framework for satisfying the information needs of users. The business review required of UK companies does, we believe, represent a best practice example of what may be achieved in this area. Furthermore, in the UK we feel that management commentary has seen continuous improvement in recent years and that there is much to be celebrated in the achievements of many companies in this area. The Financial Reporting Review Panel (FRRP) has only recently assumed responsibility for reviewing these disclosures and is making good progress in further driving up standards. Therefore we believe that the best way to elicit continuous improvement is through peer pressure as a result of the championing of best practice, backed up by proportionate and targeted regulatory intervention.

The FRRP set out in their 2010 annual report a number of features that they believe make for good reporting. We strongly agree with these features and have drawn on them to illustrate how companies can improve the quality of their management commentary without change to the existing regulatory framework:

A single story

The FRRP stresses the need for consistent messages within the annual report and the financial statements, i.e. the same story should be told throughout. To achieve this objective, there needs to be clarity about what belongs in the notes to the financial statements (information that is essential to an understanding of the elements of the financial statements, as well as the fair presentation of the entity's financial position, performance and cash flows) and what represents management commentary (information that places the results and financial position in context). Without resolving this question, there is a risk that the volume of disclosures may continue to grow with no improvement, or perhaps even deterioration, in the clarity and coherence of corporate reporting.

Overlap currently exists between the type of information that is disclosed in the notes to financial statements and that which is included in management commentary. For example, certain information on financial risk is required to be disclosed by IFRS 7 *Financial Instruments: Disclosures*, but is also included in management commentary due to legal requirements. In our view, limiting this overlap is strongly desirable and will greatly assist in the representation of a coherent story throughout the annual report and the financial statements.

Coherence

Coherence between management commentary and the financial statements is also important.

One example of where inconsistency has the potential to arise is the segmental disclosures of IFRS 8 *Operating Segments*. IFRS 8 requires the measures of segment profit or loss to be those amounts that are reported to the chief operating decision maker and used to manage the business; we would expect those same measures to form the basis for management commentary.

However, it is important to note that a valuable attribute of management commentary is its ability to communicate financial metrics that complement the information presented in the financial statements, so different measures can be shown, as long as these link up or are reconciled to the GAAP numbers. The Committee of European Securities Regulators (CESR) has published guidance on the use of these non-GAAP financial measures (*Recommendations on Alternative Performance Measures*), which can provide useful information to users, provided they are appropriately recognised, measured and presented.

Cut the clutter

Good management commentary tells the story of the business. It is relevant. As such its volume and format should be expected to vary with the circumstances of the individual business. Industry or economy-wide risk conditions are frequently of relevance to a company's performance and are likely to be of significant interest to investors. But such risk conditions are many and their adequate explanation may require lengthy description, they also are unlikely to develop in accordance with the annual cycle of corporate reporting. The annual report is therefore not the best place to locate information of this type. Reports that are padded with generic text, included with a view chiefly to satisfy regulatory requirements, are unattractive and uninformative. Aside from being unwanted, such generic information detracts from the real story. In addition, companies should be encouraged to focus on what they perceive to be the most significant information; a list of principal risks should include the few truly important factors of specific relevance to the company and not extensive lists of generic risks applicable to any company.

To facilitate the necessary focus it is imperative that management is allowed sufficient discretion; guidance should be built around core principles (already provided in the existing legislation), which gives a high-level framework to allow management to determine the most useful information to include in their management commentary.

Finally, we would like to reiterate that we do not believe that these improvements can be achieved through incremental regulation. More prescriptive rules specifying the contents of management commentary are highly likely to be met by generic 'boiler plate' disclosures that add little value. Furthermore, while incremental regulation is undesirable, intervention by alternative regulatory bodies is even more pugnacious. If improvement to regulation is decided upon then this must be within the framework of the existing requirements, not external to them.

Question 4

In your opinion, should companies be required to disclose the following:

- I. Whether or not they have a CSR policy, and if they do, how they implement that policy and what the results have been.
- II. The principal business risks and opportunities arising from social and environmental issues, and how they are taken into account in company strategy.
- III. Key information regarding issues such as employee engagement (eg. Employee training policy, equality and diversity, etc); customer satisfaction (eg. Customer loyalty); public perception of the company (eg. Stakeholder dialogue); environmental policies (eg. Energy efficiency, waste reduction); and innovation (eg. R&D expenditure);
- IV. Other, please specify.

In general, mandating management commentary on specific topics does not in our experience lead to good corporate reporting. We applaud those companies that have taken significant efforts in the establishment of CSR policies and we do believe that the improved governance that can result from such policies can add real value to a business. However, we question the value of merely

disclosing generic data relating to that policy as a part of management commentary. These disclosures are unlikely to make any difference at all to the effectiveness of such a policy, and therefore we wonder whether the focus of this question is right. If the objective is to improve the effectiveness of CSR policies we question its inclusion in a consultation on management commentary.

We support the requirements currently contained in the Fourth and Seventh Directives for companies to disclose principal business risks and uncertainties in their annual report. We believe that this information is useful to capital providers. We also believe that it is important that emphasis be placed on 'principal' risks – those factors that have both the potential and the likelihood to have a material effect on the financial statements, and not to have these obscured by other factors of lesser importance (particularly if there is no explicit ranking to allow the reader to distinguish the most important items). Where environmental or social factors form part of these principal risks we strongly believe that these should be disclosed and that there is value for users in doing so. However, the factors that are relevant to understanding a company's risk environment vary from organisation to organisation. Requiring the disclosure of particular metrics that may be irrelevant or ancillary to the disclosing business does not result in information that is useful to investors, and may indeed obscure other, more relevant information. This is particularly the case as this type of requirement is likely to be met by generic boiler-plate narrative disclosures that add little value.

Question 5

In your opinion, for a EU measure on reporting of non-financial information to achieve materiality and comparability it should be based upon:

- I. Principles**
- II. Key Performance Indicators**
- III. Other**

- a) In case you consider that Key Performance Indicators (KPIs) would be useful, would you think that they should be general for all economic sectors or sector specific**
- b) Please indicate which indicators you would consider to be the most relevant for all economic sectors**

We agree that KPIs are an important element of good management commentary and note that the Fourth and Seventh Directives already require the disclosure of KPIs by large companies and of financial KPIs by medium-sized companies. We support this disclosure. However, we believe that the choice of KPIs must be determined by companies themselves.

Specific KPIs should not be mandated. KPIs are as distinct as an organisation's business model and as such are bespoke to that organisation's policies and circumstances. What is 'key' to one organisation may not be key to another, and mandating a pre-determined set of KPIs that may be irrelevant or misleading as indicators of an organisation's success is highly inappropriate. The important term here is 'key'; only the individual business can decide what is in fact 'key' to its own specific circumstances. KPIs should not be invented for corporate reporting purposes. The metrics to use for KPIs should be self-evident, as they should be derived from the factors that management refer to in their monitoring of the business; if a factor is not relevant to this then it probably isn't 'key' at all. Furthermore, although KPIs may be expected to be self-evident to management, this may not be the case to the external user of the accounts. By publishing a medley of key and largely irrelevant performance indicators, the reader's ability to use those indicators to appraise the business is impaired, possibly materially. A genuine KPI should be expected to reflect a factor that has had, or can be expected to have, a significant effect on performance, and as such these metrics can be utilised by investors in their decision making process. Displaying such decision useful information alongside metrics that have little relevance to the decision process has the potential to be misleading, to obscure useful messages, and ultimately to risk the KPIs as a whole being disregarded by readers. This would be a shame.

Question 6

In your opinion, what should be the process to identify relevant principles and/or indicators (whether general or sector-specific)? Please explain. In replying to this question, please comment on whether the Commission should endorse or make reference to any existing international frameworks (or a part of them), such as Global Reporting Initiative (GRI), UN Global Compact, the OECD Guidelines, ISO 26000, or other frameworks; or whether companies should be required to select relevant indicators together with their investors and other stakeholders and to disclose information according to such indicators, depending on the use that different stakeholders would make of such information.

We believe that good management commentary involves the identification by a company of those specific factors that it believes have a material effect on its performance, position and development. We object to the phrase 'select relevant indicators' in the question above, as this appears to imply the choosing of KPIs from a generic list. As we set out in our answer to question 5 above, KPIs are bespoke to each business, furthermore, being 'key' they are likely to be factors that management is aware of in its running of the business. They are not factors external to the business and nor can they be created, as suggested in the question, to meet a perceived need of a stakeholder group.

As set out in our answer to question 3, we agree with the features of good reporting that the FRRP set out in their 2010 report. We would suggest that were the EC to seek a set of principles that could be used as a framework for good management commentary, these may offer a valuable starting point. In particular we value the principles that the annual report and financial statements should tell a single story, and that they should be coherent and uncluttered.

Question 7

In your opinion, should companies be required to disclose the steps they take to fulfil the corporate responsibility to respect human rights?

We are highly supportive of efforts to improve corporate social responsibility and believe that all entities have a duty to respect human rights. We welcome initiatives to embed these ways of thinking within corporate culture.

However, this is not the right question. We believe that companies should respect human rights; and if the intention of the EC is to ensure that they do so, it would seem rather naive to imagine that this may be achieved through the imposition of a disclosure requirement that is likely to be responded to merely by generic, boiler-plate narrative. We believe the question the EC is attempting to pose here is 'how can we ensure that companies respect human rights'; and we would suggest that a questionnaire addressing management commentary is not the place to attempt to find a solution to this important issue.

Question 8

In your opinion, should companies be required to disclose the risks they face and the policies they have in the field of corruption and bribery?

Corruption and bribery can represent real business risks for business organisations, particularly those operating in many different countries, with different value systems and culture. We believe that it is essential that for organisations where this is a risk, robust policies and procedures are in place for countering it, and that these are rigorously enforced. The UK is about to bring into force rigorous anti-bribery laws. We support these rules and furthermore note that these requirements go somewhat beyond the provisions in place in many other EU countries. Were the EC to feel that some action should be taken to counter corporate involvement in bribery, we suggest that they investigate the extension of anti-bribery provisions to other EU countries such that there is a level playing-field for all.

Again, however, we do not believe that disclosures should be required on this subject as such a move is likely to be met by generic, boiler-plate text. Of course for those companies with material

operations in countries with high corruption levels, this could represent a significant business risk, and as such we would expect it to be disclosed under the present requirements.

Question 9

In your opinion, what companies should be required to disclose non-financial information?

- I. Large listed companies
- II. Large companies (listed and non-listed)
- III. Medium—sized and large listed companies
- IV. Medium-sized and large companies (listed and non-listed)
- V. All listed companies (small, medium and large)
- VI. All listed and non-listed companies (small, medium and large)
- VII. None
- VIII. Other, please specify

All of the above, but to different extents.

We do not believe that the non-financial disclosure requirements, currently contained with the Fourth and Seventh Directives and enacted in UK company law, should be extended. We support these requirements in their current form. We agree that all large and medium-sized businesses should provide a fair review of their business and a description of the principal risks and uncertainties they face, together with information about the performance of the business during the year and of its position at the year-end. We feel that the current disclosure regime is effective in promoting the disclosure of information that is useful to capital providers as the primary users of the financial statements, while not providing a level of prescription that is met merely by generic, boiler-plate narrative disclosures. Therefore we do not believe its extension is necessary or desirable.

Question 10

In your opinion, should institutional investors be subject to specific or additional disclosure requirements, for example to disclose whether and how they take into account environmental and social issues in their investment decisions? Please explain in replying to this question, please provide information on which issues seem to be the most relevant and why; and which institutional investors should be subject to such an obligation.

No. We believe that where there is an appetite for disclosures of this type the market will impel institutional investors to make them. The provision of investment services is an extremely competitive market, and therefore where there is a demand among investors for this information then its provision would clearly represent a source of competitive advantage. Conversely if that demand is not there then such disclosures are unlikely to receive much attention.

Question 11

In your opinion, should European policy promote the concept of "integrated reporting"? Integrated reporting refers to a report that integrates the company's key financial and non-financial information to show the relationship between financial and non-financial performance (environmental, social, and governance). Please explain. In replying to this question, please indicate the advantages and disadvantages of an integrated report, as well as possible specific costs of integrated reporting.

As this important issue is currently being considered by the International Integrated Reporting Committee, we suggest that its report is awaited before further consideration is given to the question. There is much more work that needs to be done in this area before it can be regarded as operational, and much research is required as to whether capital providers believe such an approach gives them useful information that justifies the cost (and potential delay in producing the relevant information, where additional work, systems changes and assurance are required).

Question 12

In your opinion, should disclosed non-financial information be audited by external auditors? Please explain in replying to this question please provide any evidence you may have regarding costs of auditing non-financial information, as well as your views on other possible forms of independent reviews besides external auditing.

There is a requirement that auditors read the annual report to ensure its consistency with the information published in the financial statements. Beyond this, we do not believe that information outside the financial statements should in general be included in the remit for statutory audit.

In principle some external auditors are suitably qualified to examine management commentary. However, in practice we believe that management commentary is best considered outside the scope of the statutory audit of the financial statements, which is a specific report addressed to capital providers. A separate assurance engagement – rather than an ‘audit’ engagement – would be more transparent and allow a more tailored approach. Were any management commentary to be included in a separate document, outside of the annual report or financial statements, it may perhaps be easier to devise an assurance report, tailored to that specific information, without the risk of deadening the information by making it more cautious or generic.

In setting up a regime for assurance reporting, we suggest a voluntary rather than a statutory approach. This is because the preparedness of businesses and the level of interest in non-financial information among stakeholders is likely to be different according to jurisdiction, industry or entity. In particular, we note that many entities are currently at the stage of implementing CSR and other non-financial policies rather than reporting on them. We fear that a premature legal requirement for non-financial information assurance may force some entities to divert resources from investing in improving their CSR and other non-financial performance to reporting and assurance that lack substance. A voluntary approach should give these businesses some time while allowing others to demonstrate their leadership in non-financial information reporting.

There are many examples of non-audit assurance reporting on non-financial information. Assurance reports on sustainability information are regularly issued by larger businesses, and smaller businesses are increasingly interested in the subject. To help them understand what assurance reporting means and the benefit it brings, ICAEW has produced a short practical guide for management *Sustainability Assurance: Your Choice* (icaew.com/index.cfm/route/172346). There are other assurance engagements such as those that focus on internal controls of service organisations. Examples of these; all based on the international framework published by the International Audit and Assurance Standards Board (IAASB), may be found on ICAEW's website (icaew.com/assurance). ICAEW has also compiled existing examples in a 2008 publication *Assurance on non-financial information: Existing practices and issues*.

The time spent on these engagements would vary, depending on the scope of information covered, the complexities, and how users were intending to use the information. The cost of engagement would be proportionate to the time spent.