21 December 2012

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Ms Deepa Raval
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By email: disclosure@frc.org

Dear Deepa

Thinking about Disclosures in a Broader Context: A Road Map for a Disclosure Framework

ICAEW is pleased to respond to your request for comments on the discussion paper *Thinking about Disclosures in a Broader Context: A Road Map for a Disclosure Framework*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

THINKING ABOUT DISCLOSURES IN A BROADER CONTEXT: A ROAD MAP FOR A DISCLOSURE FRAMEWORK

Memorandum of comment submitted in December 2012 by ICAEW, in response to the Financial Reporting Council discussion paper *Thinking about Disclosures in a Broader Context: A Road Map for a Disclosure Framework* published in October 2012

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the discussion paper *Thinking about Disclosures in a Broader Context: A Road Map for a Disclosure Framework* published by the Financial Reporting Council (FRC) in October 2012, a copy of which is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

MAJOR POINTS

Support for the initiative

5. We believe that the question of the effectiveness of disclosure in annual reports is an important one that needs to be addressed by all parties with an interest in financial reporting. We therefore welcome the publication of this discussion paper, which provides a useful review of some of the major issues involved. Our comments are framed in the context that we believe disclosures in financial statements, combined with the rest of the annual report, should provide the information necessary for a shareholder to assess the performance and financial position of the company and the financial and operational stewardship of management – providing a 'true and fair' view in one place.

Scope

6. We agree that disclosure needs to be considered beyond the confines of the audited financial statements and so prefer the scope of this discussion paper to that of the EFRAG, ANC and FRC discussion paper, *Towards a Disclosure Framework for the Notes*. The problem of the effectiveness of disclosure is not confined to the notes, and some of its causes – such as poor organisation and repetition of disclosures – can only be addressed adequately by looking at the annual report as a whole.

7. However, it is unfortunate to have two parallel discussion papers on essentially the same subject in issue at the same time. While we support a great deal of what the FRC proposes, and in many respects prefer the overall approach to that taken in *Towards a Disclosure Framework for the Notes*, the existence of two similar papers could unhelpfully be seen by some as an example of the lack of coordination among financial reporting authorities that can lead to overlapping and disorganised disclosure requirements.

A disclosure framework

8. The discussion paper seems to envisage the development of a freestanding disclosure framework for the notes. The International Accounting Standards Board (IASB) has announced that it intends to deal with disclosure in its revived conceptual framework project. We believe that this is the right place for any 'framework' statement on disclosure. This approach should also ensure that unnecessary duplication would be avoided where there are questions that apply to disclosure as well as to recognition, measurement or presentation. In deciding how to proceed, we believe that the FRC should support the IASB's initiative to deal with disclosure as part of its overall conceptual framework for financial reporting, and should consider how its future work can best fit with this project.

9. The material on disclosure in the conceptual framework should help to ensure that disclosure requirements are introduced only when they are justified and are removed when they have ceased to be worthwhile. Once the IASB has finalised this aspect of its conceptual framework, it would be helpful for it to set up a review of existing disclosure requirements to ensure that they meet the criteria in the revised framework.

Multiple regulators

10. It also needs to be recognised that part of the problem of disclosure effectiveness arises from the existence of multiple bodies in different countries that are able to impose disclosure requirements. Sometimes these are intended for the benefit of shareholders – as with, for example, disclosures relating to directors' remuneration. But, as the discussion paper recognises (page 7), annual reports also include disclosures that are not primarily of interest to shareholders, but are instead what may be regarded as public policy disclosures for the benefit of third parties (eg, civil society groups). Again, these are imposed by bodies other than the IASB.

11. For these reasons, the problem of disclosure effectiveness will not be solved unless it is tackled by all the bodies that are able to impose disclosure requirements. This would have to be done on an international basis. Ideally, legislators and regulators internationally would accept the IASB's disclosure requirements as sufficient, and not cause duplication and unnecessary complexity by adding their own disclosure requirements. It would also be helpful to have agreement on the objective of annual reports and on who they are intended for, which in our view is the company's investors and other providers of capital.

12. Where information is not required primarily for shareholders' benefit, we believe that it should not form part of the annual report, except to the extent that it is relevant to them. If political pressures mean that such disclosures have to be made somewhere, it would be helpful to have some suitably high profile way of making them without burdening shareholders with disclosures that are not primarily for their benefit. This is particularly the case for listed companies which are (in the UK at least) required to have a website, which offers an efficient alternative disclosure channel. The EU's current proposals on country-by-country reporting of payments to governments by extractive and other industries provide an example of how things might be done. The proposed requirements as currently drafted would mandate disclosure of the relevant information, but would not require it to be in the annual report. The UK government's recent proposals for an annual directors' statement, designed for online publication, were also an encouraging step, and it is unfortunate that these proposals were not pursued – at least for public companies – in the draft regulations, *The Future of Narrative Reporting: A New Structure for Narrative Reporting in the UK*, published in October. We return below (paragraphs 15-17 and 30) to the question of publishing information online.

Materiality

13. While the paper's discussion of how standard setters should avoid disclosure overload through a proportional approach is useful, we are not sure what practical effect this approach would have. We suspect that more progress would be made if materiality (also discussed in the paper) could be effectively applied by preparers so as to avoid the disclosure of immaterial information. But there seem to be formidable obstacles to changing attitudes in applying materiality in this way. Companies are concerned at how regulators might react; in some jurisdictions non-disclosure – even of items that they consider to be immaterial – could expose preparers to litigation. The tendency to far more disclosure requirements also has a behavioural impact; thus, from management's and auditors' point of view a checklist approach to disclosure appears to be the simplest and most cost-effective way to deal with the need to deliver a large amount of information within what is often a very pressured timescale. There may also be users who prefer companies to disclose even immaterial amounts rather than exercise discretion as to what should be disclosed; such users are presumably happy to ignore what they consider to be immaterial. So while materiality seems to be the key to the problem, it does not offer an easy solution.

Meeting different users' needs

14. There are significant differences between the needs of different users of financial reporting information. Most users probably have relatively little time to devote to any single company's disclosures and are interested in a relatively small number of companies. Some users have the necessary resources of time and skills to be able to make use of very extensive disclosures and may wish to compare data from a large number of companies. And even these users differ in what information they regard as useful; equity investors and fixed income investors, for example, may have different priorities.

15. It is unrealistic to expect the needs of these diverse types of users to be met by a single set of disclosures. It is therefore important that disclosures should be structured in a way that makes the key information easily accessible to ordinary users, while also allowing those users who want much more extensive information to access what they need. It is for further consideration what exactly should be provided as core information circulated automatically to all shareholders in the annual report. At a minimum it should contain the primary accounting statements and material supporting disclosures, but there is an important debate to be had on where the boundaries should be drawn and how far they should be a matter of management discretion. Put another way, the financial statements must provide a 'true and fair view' and there needs to be a clear view of how much disclosure is enough to achieve that. The more extensive information set could ultimately be available only on the internet.

16. We understand that there are obstacles to structuring and layering information in this way – both because some users object to the idea and because of legal obstacles relating to voting on annual reports and the audit of financial statements (and auditors' responsibilities for reading accompanying information). However, these objections should not be insurmountable and in the internet age current arrangements are likely to be unsustainable. At some point it will have to be recognised that disclosures should be restructured more radically to meet the very diverse needs of different types of users.

17. One objection may be that the annual report should be the only repository for information about a company's performance and management's stewardship, and that everything should therefore be sent automatically to all shareholders. As the volume of disclosures grows, we believe that it becomes increasingly unconvincing to argue that all of them – perhaps 50 or 100 pages – are essential in order to give a true and fair view. But we do not think that any shareholders should be denied access to a full set of disclosures. On the contrary, they should be easily accessible to all investors if they wish to see them. But we doubt very much whether most shareholders do want to work their way through a full set of disclosures. And if this view is correct, sending them all a full set of disclosures automatically is unlikely to be helpful even if, ideally, all shareholders should have the time and skills to read and learn from all relevant disclosures made by all the companies in which they invest. Again, we believe there needs to be a more active debate concerning the use of technology in reporting, thus enabling users to 'click through' to the level of detail they need.

18. As noted, the type of restructuring that we have suggested would have implications for the scope and form of the audit report. These questions need to be addressed as a separate exercise, but we do not see that audit considerations should impose insuperable obstacles to the sort of changes that we suggest.

19. It should also be recognised that, given the extent and diversity of some users' needs for information about companies, it is unrealistic to expect that there will be any significant reduction in the disclosures that companies will be required to make. Actual disclosures may be significantly reduced if cuts can be made in immaterial disclosures, and we have already noted the obstacles to achieving this (paragraph 13 above), but if structural issues are dealt with properly, it should be possible to have both clear and succinct communication and an underpinning detailed data set that between them will meet the needs of most users.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Would a disclosure framework that addresses the four questions identified below help address the problems with disclosures?

- **What information do users need?**
- **Where should disclosures be located?**
- **When should a disclosure be provided?**
- **How should disclosures be communicated?**

20. We agree that a framework that addresses these four questions would be helpful, but we believe – as indicated above – that it should be part of the IASB's conceptual framework rather than a freestanding document.

Q2: Do the disclosure themes set out on page 16 of this paper capture the common types of disclosures that users need?

21. We agree that the disclosure themes identified capture the common types of financial reporting disclosures that users need. We would reiterate the point (paragraphs 10-11 above) that the relevant users are the providers of capital.

Q3: Do you agree with the components of the financial report as identified on page 20? Are there any other components that should be identified?

22. We agree with the components of the financial report as outlined on page 20.

Q4: Do you believe that the placement criteria identified in this paper are appropriate?

23. We agree that the placement criteria identified are appropriate.

Q5: How should standard setters address the issue of proportionate disclosures?

24. We support the idea of differential disclosure regimes as a way for standard setters to address the issue of proportionate disclosures. Alternative disclosure requirements already exist in various circumstances – based on size, ownership and industry. We believe that this is appropriate, but that the important consideration for companies generally is who uses their financial reporting information. Reflecting this, the primary distinction in disclosure requirements for companies generally should be whether they are privately or publicly owned (ie, with shares publicly traded). We therefore support the reduced disclosure requirements for private subsidiaries of public companies in the current reform of UK GAAP. However, within the category of private companies, it will sometimes be appropriate to make a secondary distinction between different categories of company on grounds of size.

25. In our view, industry-specific disclosure requirements in financial reporting standards should be kept to a minimum, as it is easy for the process of developing special standards for specific industries to get out of hand. With this in mind, we believe it is important that standard setters are not unduly influenced by concerns for a particular sector (such as banking) when establishing disclosure requirements for general purpose financial statements. In some industries, specific additional disclosures may well be appropriate and agreed with users, but this should take place outside the standard-setting process. We would encourage such private sector initiatives, which can often deal with issues in a more timely way than is possible for mandatory standards.

26. The principle (page 31) 'Cost of providing the information justified by the benefits to users' is in our view an important one. The costs of disclosure can be particularly high if information is prepared especially for external reporting purposes – ie, it is not used by management. These costs can only be justified if the information is indeed valuable to users, which may be the case where users need the information to be comparable with that provided by other companies. However, a company should not be required to disclose information to shareholders in respect of operations that are immaterial to it, even when it is a significant operator in that market. We also suspect that there may be too much effort (and cost) incurred in trying to arrive at precise numbers for accounting purposes, when users are probably content with estimates that are at least roughly right.

Q6: Do you agree with the framework for materiality set out in this paper? How could it be improved?

27. The starting point for the disclosure framework (on pages 54-55) needs to be amended as it does not cover situations where a disclosed item is immaterial, but is the result of netting material assets and liabilities – eg, as in the net surplus or deficit for a defined benefit pension scheme. Also, the framework seems to focus only on users' interest in information relevant to assessing future cash flows, and to overlook stewardship.

28. The purpose of the ranking of different levels of materiality at pages 34 and 52-53 is not entirely clear, and nor is the ranking of different terms of significance and materiality at page 35. However, the point made in the table on page 34 – that there are a number of different terms in IFRS and company law that seem to have meanings similar to but not quite the same as materiality – is a valid one that may need to be addressed.

29. We do not agree with the suggestion on page 33 that there should be a higher level of materiality for disclosures in the notes.

Q7: Are there other ways in which disclosures in financial reports could be improved?

30. As indicated above (paragraphs 15-17), we believe that it would be useful to explore further the use of technology to improve communication, both in terms of putting online some of the information that is currently in printed annual reports, and using technology to make what is online more accessible. Information might usefully be put online where it provides background information that changes little from year to year and/or is not needed to give a true and fair view of a company's state of affairs and profit or loss. Much corporate governance information may come into this category, as would any accounting policies notes that merely repeat the requirements – eg, IFRS – governing the company's financial statements, confirmatory disclosure that an item is immaterial, and analyses specified by regulators for public disclosure, but which are neither required by IFRS nor of interest to shareholders.

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