22 September 2011

Our ref: ICAEW Rep 90/11

Your ref:

Mr Roger Marshall
Chairman
Accounting Standards Board
5th Floor, Aldwych House
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By email: clutter@frc.org.uk

Dear Roger

**CUTTING CLUTTER: COMBATING CLUTTER IN ANNUAL REPORTS**

ICAEW is pleased to respond to your request for comments on the report *Cutting Clutter: Combating Clutter in Annual Reports*, and we look forward to contributing to the future work of the Financial Reporting Council and the Accounting Standards Board on improving the structure and accessibility of corporate reporting.

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

Yours sincerely

Nigel Sleigh-Johnson

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ICAEW REP 90/11

# CUTTING CLUTTER: COMBATING CLUTTER IN ANNUAL REPORTS

**Memorandum of comment submitted in September 2011 by ICAEW, in response to the Accounting Standards Board report *Cutting Clutter: Combating Clutter in Annual Reports* published in April 2011.**

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## INTRODUCTION

**1.** ICAEW welcomes the opportunity to comment on the Accounting Standards Board (ASB) report *Cutting Clutter: Combating Clutter in Annual Reports*.

## WHO WE ARE

**2.** 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 Financial Reporting Council (FRC). 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.

**3.** Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure that these skills are constantly developed, recognised and valued.

## COMMENTS ON THE REPORT

### The role of regulators and standard setters

**4.** We welcome the FRC's efforts to cut clutter in annual reports and believe that *Cutting Clutter* makes a useful contribution to this objective. A number of the ideas identified in the report seem to us to be well worth pursuing, and we look forward to contributing to the further development of these initiatives. Two ideas that we consider especially promising are the FRC's proposal for a Financial Reporting Lab and the identification of companies that have successfully cut significant amounts of clutter from their annual reports, and so could set an example for others.

**5.** The annual report is an important communication tool for companies, but clutter makes it less useful than it should be. Dealing with the 'front end' of the annual report first, a leading cause of clutter in annual reports is the wide range of requirements imposed on companies by laws, regulations and financial reporting standards. The report acknowledges that regulators contribute to the problem of clutter, but then seems to envisage that the people who will actually tackle it are preparers. We believe that regulators and standard setters have the key role to play in cutting clutter – both by cutting the requirements that they themselves already impose and by guarding against the imposition of unnecessary new disclosures.

**6.** No single regulatory authority 'owns' the annual report: a range of authorities acting independently of one another are able to add to its required content. A premium listed company will be following, among other things, the Disclosure and Transparency Rules (DTRs) and Listing Rules, company law, financial reporting standards, and the Corporate Governance Code. If it has an overseas listing, it will also have to follow any local requirements, such as those of the SEC in the US.

**7.** A related problem is that different regulators have different audiences in mind for the requirements they impose on annual reports. Ideally, any report should be focused on a particular user group and its interests, and arguably the annual report should be focused on shareholders and investors. The attempt to reach ever-wider ranges of actual or potential users inevitably leads to a loss of focus and makes it more difficult to structure reports effectively.

**8.** Another important regulatory cause of clutter is the corporate reporting enforcement system. There is a bias towards disclosure in legal and regulatory enforcement; action is more likely to be taken where information is not disclosed than when it is disclosed. As the question of what exactly to disclose is often (and inevitably) a grey area, it is understandable that preparers and auditors should incline towards disclosure in doubtful cases rather than towards non-disclosure. We do not think that this bias in the enforcement system is necessarily wrong (that is perhaps a debate for another day), but there is a need to be realistic about how much can be achieved in cutting clutter against this background.

**9.** Streamlining requirements and avoiding regulatory overlap would free up the time of those involved in the corporate reporting process, meaning that they can spend less time thinking about compliance and more time thinking about effective presentation. Companies are perfectly capable of presenting information effectively when they are allowed to – in presentations to analysts, for example. But if such presentations were regulated in the same way as annual reports, they would no doubt become just as ineffective.

**10.** The FRC could usefully take an active role in discouraging the annual report from being used as a regulatory dumping ground for information required for public policy reasons that are not aligned with the needs of capital providers. There needs to be a single authority that is given power to act as a gatekeeper for the annual report, and the FRC seems to us to be the most appropriate body for this. In taking forward the work of *Cutting Clutter* it is in any case important that the FRC should identify how it can cut regulatory requirements, commit itself to specific targets, and report publicly on progress in reaching these targets. These commitments should encompass the work of the Financial Reporting Review Panel and the Audit Inspection Unit.

**11.** Looking to the 'back end' of the annual report, the audited financial statements, a great deal may depend on the attitude of the IASB to dealing with disclosure in a holistic manner. We note that the recent joint report by the Institute of Chartered Accountants of Scotland and the New Zealand Institute of Chartered Accountants, *Losing the Excess Baggage – Reducing Disclosures in Financial Statements to What's Important*, makes proposals that could reduce the length of financial statements by an estimated 30%. We do not know how users will view these proposals, but they at least show what could be done. The IASB's agenda consultation includes a proposal to look at presentation and disclosure issues and, if persuaded to take this on, the IASB should be encouraged to take the opportunity to look at how disclosure requirements can be rationalised and made more effective.

### Obstacles

**12.** In pursuing the objective of cutting clutter, the FRC is likely to encounter a number of obstacles. We discuss below the most important ones that we have identified:

- users' information needs, including the issue of comparability;
- the diverse audiences of corporate reporting; and
- conflicts between different objectives and principles for annual reports.

**13.** The Foreword to *Cutting Clutter* states that 'Clutter undermines the usefulness of annual reports and accounts by obscuring important information and inhibiting a clear understanding of the business and the issues that it faces.' This must be true in principle, but it would be useful to know how big the problem is, in terms of how far users' understanding would be improved once the clutter has been removed.

**14.** The answer to this question may well vary among different classes of users, and we suggest that one of the ways in which the FRC could help further progress in cutting clutter would be to clarify how different types of users are affected by it. Professional investment analysts, for example, are likely to have different information needs from the typical private investor. The report states that 'We are convinced that users suffer from the provision of immaterial disclosures'. The FRC's earlier report, *Louder than Words: Principles and Actions for Making Corporate Reports Less Complex and More Relevant*, noted that the users whom the FRC spoke to in preparing the report 'do not consider [annual reports] too complex overall'. While complexity and clutter are not the same thing, it is conceivable that some users are not in fact too concerned by clutter in annual reports. The FRC would be able to strengthen its case if it could refer to evidence showing how far users do in fact suffer from clutter.

**15.** Professional investors have an insatiable appetite for information. There is a risk that in cutting what is thought to be clutter, regulators or standard setters will remove information that some users find useful. As the size and complexity of businesses grow, as more and more capital is invested in them, as the costs of producing, transmitting and analysing information fall, and as standards of transparency rise, it is only to be expected that the volume of disclosures by companies will also rise. We would expect that most of this increase in information will be useful to investors, and care needs to be taken that 'decluttering' is restricted to removing genuinely useless disclosures. Not all useful information, of course, needs to be in the annual report.

**16.** Comparability is also an issue. Some users, who electronically process financial reporting disclosures by a large number of companies (perhaps using XBRL), expect a high degree of comparability, even where the relevant items are individually immaterial. That is, they expect certain information to be disclosed by all companies and have a problem if they cannot find disclosures that match these expectations. They would therefore have problems if the disclosures that they expect to find have been cut out of the accounts on grounds of immateriality. This emphasises the importance of understanding the needs of different types of users.

**17.** In practice, corporate reporting has diverse audiences – a point that *Cutting Clutter* does not always seem to recognise. The report criticises the inclusion of some information in annual reports on the grounds that it is irrelevant to resource allocation decisions. It suggests that much CSR reporting may come into this category – a point that supporters of CSR disclosures would probably dispute. More importantly, *Cutting Clutter*'s argument on this point overlooks the fact that annual reports are designed to address diverse audiences, including employees, potential employees, politicians (in some cases), and groups that have a specific interest in CSR issues. While it could be argued that the diverse groups that are interested in companies' activities would be better served by focused reports that address their specific needs (our point at paragraph 7 above), this is a question that each company has to decide for itself. There may be good reasons of cost, convenience or credibility why companies decide to put everything into a single report. The proposals on 'integrated reporting' recently published by the International Integrated Reporting Committee are likely to cause further debate in this area.

**18.** There is also a tension between the desire to ensure that users have all the information they need and the objective that annual reports should be an effective way of communicating key points. The more the annual report becomes a data repository, the less effective it is likely to be as a medium for conveying a digestible number of clear messages.

**19.** It is often set out as a principle that readers of an annual report should be able to find all the information that they need about a particular subject in one place. It is also a commonly accepted principle of reporting that it should avoid repetition. Both principles may be regarded as serving the objective of making reports as helpful and uncluttered as possible. Unfortunately the two principles conflict and can only be satisfied simultaneously where the subject matter of annual reports is a series of discrete issues, which do not overlap. This is far from being the case in practice, as annual reports now cover such a wide range of issues – plans for the future, past performance, risks – that overlaps are unavoidable. This exacerbates the problem of clutter.

### Challenges for preparers

**20.** The report appears to take existing reporting requirements as given, and therefore focuses on advising preparers what they can do to cut clutter. We have drawn attention above to what we see as the more important role of regulators and standard setters. No doubt in many cases preparers can also help, at least potentially, but cutting clutter is not necessarily easy or straightforward. The process will have costs and risks, which need to be compared with its expected benefits. So preparers too will face a number of challenges:

- understanding what the benefits will be from cutting clutter;
- comparing them with the costs; and
- considering any risks that the process creates.

**21.** A question companies may want to ask is whether the likely benefits to users of whatever it can achieve by way of decluttering would feed through into a lower cost of capital or other improvement in relationships with users. If not, what other benefits would decluttering bring?

**22.** The helpful behavioural aids in the report indicate that cutting clutter will involve an extra effort by preparers in terms of planning, reviewing and considering potential cuts. There may also be additional costs in terms of discussion with the auditors and taking legal advice. It is possible that the additional costs incurred by preparers in cutting clutter would be one-off, while the benefits – both in terms of improved relationships with users and the reduced time that it would take to prepare and check annual reports – would endure for a number of years. This would have to be taken into account in any assessment of costs and benefits.

**23.** There will also be some risks for preparers. As the report correctly notes, information may currently be included in the report and accounts because preparers err on the side of caution. Not erring on the side of caution clearly involves increased risks. Ideally preparers would be able to identify what should or should not be included in their disclosures with unerring precision and total confidence. As this is not the case, and it is difficult to see how it ever could be, they have a choice between, on the one hand, erring on the side of caution and, on the other, risking criticism or regulatory or legal action. However, cutting clutter could also reduce reporting risks – eg, by avoiding unnecessary duplication, which might inadvertently involve slight but significant differences in wording.

### Red herrings

**24.** In our view, *Cutting Clutter* introduces a few red herrings into the debate. These include:

- the question of materiality;
- accounting firms' manuals;
- the use of checklists; and
- risk reporting.

**25.** The report identifies 'the lack of clarity around materiality' as a cause of clutter. And ICAEW's *Guidance on Materiality in Financial Reporting by UK Entities* (TECH 03/08) is identified as an obstacle to clearing clutter because it focuses on what to include in financial reporting rather than on what to exclude. As this issue was also raised in the FRC's 2009 report, *Louder than Words*, we reviewed the guidance at that time to see whether it was likely to encourage clutter. We concluded, and we continue to believe, that the approach adopted in the guidance is the right one. The context of the original guidance was a risk that companies might fail to disclose relevant information on the grounds that it was allegedly immaterial. We suspect that this would continue to be a problem in the absence of appropriate guidance.

**26.** The existing guidance on materiality does in fact discourage inclusion of genuinely immaterial items. It quotes the warning against immaterial information and clutter in the ASB's *Statement of Principles for Financial Reporting*. It quotes the explicit statement in IAS 1, *Presentation of Financial Statements*, that immaterial information need not be disclosed. And it points out that items that are large in absolute terms may none the less be immaterial. Overall, we believe that the guidance is balanced and appropriate, but we would of course be grateful for any suggestions from the FRC, or the proposed Financial Reporting Lab, as to how it could be improved.

**27.** Disclosure of quantitatively immaterial items can in any case be useful if it includes relevant information. For example, a company may wish to emphasise that it has only a small amount of derivatives (or none at all) or of specific classes of sovereign debt. Disclosing the amount draws attention to it and answers any questions that users might have if it were not disclosed. And we referred earlier to the importance that some users attach to having full sets of comparable information, even if some of the items in the data sets are individually immaterial. If, as noted above, the IASB were to look at a presentation and disclosure framework in its future agenda, materiality in the context of disclosure is something that the standard setter would need to deal with and that is perhaps the most appropriate place for it to be addressed.

**28.** The report identifies accounting firms' manuals as culprits in encouraging clutter, because – it is claimed – 'the words can tend to result in a checklist for inclusion'. We do not agree that accounting manuals are at fault in this respect. They rightly focus on what might have to be included in financial reporting as this is what their readers need to know.

**29.** As for a checklist approach, no doubt the unthinking use of checklists can encourage the inclusion of unnecessary disclosures. But it should be recognised that checklists are useful tools for various professions where complex rules or procedures have to be followed. On this, see Atul Gawande's book, *The Checklist Manifesto: How to Get Things Right* (2009). Few professional tasks can be more complex than ensuring compliance with financial reporting requirements; it would not be sensible to leave compliance to preparers' and auditors' unaided memories. However, checklists only remind their users what they need to consider for inclusion. We do not believe that in themselves they push people towards unnecessary disclosures.

**30.** The report suggests improved risk reporting as a possible way of reducing clutter. We agree that long lists of principal risks can be unhelpful to users, and that preparers should consider whether they can be made any shorter or more informative through ranking them by importance. But we do not think that it would be useful to encourage any artificial reduction in disclosure of risks that companies consider significant. The fact that a company discloses 20 risks does not mean that it is wrong to describe them as 'principal' ones. In producing the list of 20 it may have excluded many more that did not qualify as principal, and perhaps any of the 20 could sink the company or seriously damage it.

**31.** Nor do we think that it is necessarily correct to criticise companies for disclosing generic risks as principal ones. For many companies their principal risks are the same as those that face other companies with similar business models or operating in the same location. Generic risks may well be principal ones for such firms, and users need to understand them. Arguably, the global financial crisis showed that many people were unaware of the generic risks inherent in the banking business model.

**32.** We will consider the question of risk reporting further in our forthcoming Information for Better Markets report, *Reporting Business Risks: Meeting Expectations*.

### The way forward

**33.** We believe that the most important issues to address in removing clutter from annual reports are regulatory ones: the variety of authorities responsible for the annual report and the diversity of questions that they require the annual report to address; the sheer volume of disclosure requirements; the legal and regulatory enforcement systems' bias towards disclosure. However, preparers can also make a contribution, and we highlight a number of ways in which they can be assisted to do so:

- the Financial Reporting Lab;
- more guidance and examples;
- identifying successful clutter cutters;

- improving the structure and searchability of reporting;
- addressing incentives; and
- making it possible to remove some material to websites.

**34.** We strongly support the FRC's Financial Reporting Lab initiative, and believe that decluttering is one of the issues that the Lab could usefully address. We are happy to continue to assist with the Lab's work in any way we can.

**35.** Although the 'disclosure aids' in *Cutting Clutter* are useful, we believe that further guidance and examples would be extremely helpful for those preparers who wish to cut clutter. The ASB's Reporting Statement, *Operating and Financial Review*, shows how this approach can be used effectively. We look forward to seeing how the Financial Reporting Lab can contribute to this.

**36.** The disclosure examples in the report should not of course be taken literally or they would give a misleading impression of how easy it will be to improve the clarity of reporting. They are essentially models of page design, which give an appearance of clarity because the textual elements are remarkably brief given what they purport to describe and are in fact gobbledygook – 'lorem ipsum' text used by printers to showcase design where meaningful words would be a distraction – and because there are very few words on each page (fewer than 300). Any annual report that actually had this number of words per page would probably need three or four times the number of pages that it currently requires.

**37.** In reporting, the real challenge is to draft the text with brevity and clarity, while conveying the full meaning of what will often be a complex message. Reporting that does this is unlikely to be as brief or therefore to appear as visually compelling as the examples in *Cutting Clutter*. As we noted in our response to *Louder than Words*, 'Drafting is a skill. Those who prepare corporate reports will not necessarily have it or even recognise that it is needed. It can be bought in, but preparers may not consider the gains to be worth the additional costs, which include the time-costs of briefing the external drafters and checking and revising their work.' As we mentioned earlier, if preparers had to spend less time focusing on compliance, they could spend more time thinking about communication. In the meantime, examples of well drafted text for complex disclosures would be helpful.

**38.** Indeed, as companies gain experience of cutting clutter, it would be helpful for the FRC to review how well different companies are performing in this respect and to draw attention to those who are doing it most successfully. These exemplary clutter cutters could provide a model for others. Again, we understand that the Financial Reporting Lab may adopt this approach, which we think would be very helpful.

**39.** In our response to *Louder than Words*, we pointed out that it should not be assumed that users want to read an annual report from beginning to end. They are more likely to dip into it for specific pieces of information, so structure and searchability are important. We suspect that improving the structure of annual reports would often be more useful than cutting content in increasing their understandability, at least in the case of printed reports. For reports made available on the internet, searchability is often the key to helping users navigate their way through a long document. Provided a report is fully searchable, inadequacies in its structure are less important. Again, we look forward to the contribution the financial reporting lab will make in facilitating experiments in restructuring.

**40.** We welcome the FRC's recognition that, if corporate reporting is to be changed, the forces shaping the 'behaviours' of those involved need to be understood and addressed. *Cutting Clutter* takes some useful first steps in this direction, but no doubt the FRC also recognises that much more needs to be done to understand the incentives that shape the actions of all those involved in the corporate reporting process – especially regulators and standard setters.

**41.** In our response to *Louder than Words* we recommended that some of the information currently in annual reports could be transferred to companies' websites, and we are pleased to see that this idea has been taken up in *Cutting Clutter*. This suggests removing from the annual report much explanatory material on financial reporting that does not change from year to year. It would be sensible to consult a range of different types of users on whether the removal of specific items would be helpful or unhelpful. Users may prefer to have all the relevant information in one place. We continue to believe that putting information on websites, rather than in the annual report, is a potentially useful approach and that it should be explored further. But the idea is a radical one, and specific proposals for exclusion from the annual report will need to be tested with users to see whether they would in practice be helpful or unhelpful. There will be also be legal and auditing issues to be dealt with, although these should not be insuperable problems. We note the publication of the BIS consultation on narrative reporting, which will be a useful catalyst for debate on this issue.

**42.** We in any case consider that it is wrong in principle to remove from the financial statements, and so from the annual report, disclosures that are essential to a true and fair view. It is possible that some information currently in the financial statements – or information that might be included in them in future – should be regarded as useful data that passes a cost-benefit test, rather than as information that is essential to a true and fair view. We hope that standard setters will focus on this issue, particularly as they take up the challenge of developing a disclosure framework. The US Financial Accounting Standards Board is already working on this, and we hope that its work will lead to proposals that can in due course be considered and, where appropriate, be either adopted or further developed by the International Accounting Standards Board – as noted above, this is a potential agenda item that the IASB has highlighted in its recent agenda consultation.

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