28 October 2013

Our ref: ICAEW Rep 154/13

Your ref:

Mark Jackson
Business Environment
Department of Business, Innovation and Skills
1 Victoria Street
London
SW1A 0ET

Dear Mr Jackson,

EU Commission proposals to reform non-financial reporting – Calls for Evidence

ICAEW is pleased to respond to your request for comments on *EU Commission proposals to reform non-financial reporting.* The attached submission deals with the issues raised other than those relating to country by country reporting.

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

Yours sincerely

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ICAEW REP 154/13

ICAEW REPRESENTATION

EU Commission proposals to reform non-financial reporting

Memorandum of comment submitted in October 2013 by ICAEW, in response to the Department for Business, Innovation & Skills Call for Evidence on EU Commission proposals to reform non-financial reporting, published in October 2013.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the Call for Evidence on *EU Commission proposals to reform non-financial reporting* published by the Department for Business, Innovation and Skills on 4 October 2013. This second of two submissions covers the EU proposals other than those relating to country by country reporting.

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 140,000 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. ICAEW has been a persistent champion of efforts to improve the reporting of narrative and non-financial reporting by major companies, including proportionate regulatory intervention. We believe that in the UK, such efforts have led in recent years to a significant enhancement in the relevance and quality of the published information available to users. We welcome the review of requirements at EU level, which if successful could act as a catalyst for positive and cost-effective change across the Union.

6. In our view an annual report should form a coherent stand-alone document, free of clutter, which clearly articulates a consistent narrative demonstrating how the business achieves success, principally on behalf of its shareholders. Such a narrative should combine both financial and non-financial information in the most effective way to convey its message. It is in this context that we have assessed both the European Commission's proposals to reform non-financial reporting and subsequent suggestions for amending those proposals.

7. In our September 2013 briefing paper, *Reform of the Accounting Directive: Disclosure of Non-financial information*, we expressed broad support for the legislative proposals along with several - very important – reservations. Where appropriate we have reiterated below the comments in that briefing.

RESPONSES TO SPECIFIC QUESTIONS

Do you agree that the EU proposal should be consistent with the UK's traditional approach and therefore limit the scope to (large)-listed companies only? What should the threshold for inclusion be, and why?

8. We agree that the EU proposal should be consistent with the UK's traditional approach, which would limit the scope of the non-financial reporting proposals to all companies with securities admitted to trading on an EU-regulated market. The proposed size-based criteria would draw in some private companies but exclude some listed companies. On the one hand there are sound reasons underpinning the principle of requiring far more extensive disclosures from all companies that raise funds from the public, and on the other we are unaware of any compelling evidence of demand from users for the disclosure of significantly enhanced non-financial information by private companies, however large. In our experience the current requirements for private companies contained with the Fourth and Seventh Directives provide an effective and proportionate reporting framework.

Do you agree with the EU Council Presidency that companies should be allowed to decide whether or not to have one of the related policies according to the relevance/materiality to their specific business?

9. Management commentary differs from most other information in the annual report in that its form and content is much more varied, based on the circumstances of the company and how it is run by management. Indeed the value of commentary is directly derived from its bespoke nature, and the success of the Business Review requirements in the UK owed much to the proportionate nature of the regime, on the requirements for disclosure 'to the extent necessary', 'where appropriate' or 'consistent with the size and complexity of the business'. 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. The alternative is for the annual report to become a repository for disparate information with a variety of purposes and audiences, which would militate against the qualities of good corporate reporting outlined above.

10. We therefore strongly agree with the Presidency proposal to amend the wording of paragraph 1b to Article 46 to include 'to the extent necessary for an understanding of the undertaking's development, performance or position.'

11. We would also recommend that the penultimate sentence to paragraph 1b of Article 46, which introduces a variation on the 'comply or explain' theme, is abandoned. If no disclosures are made on a specific topic in relation to a reporting period, this should not be taken as meaning that the company considers that anything it might say on the subject is entirely unimportant; it may be important but is not sufficiently material for inclusion within the annual report for that period.

Should companies report in all policy areas on their risks and risk management activities?

12. 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 shareholders and other users.

13. 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. Reports that are padded with generic text, included to satisfy regulatory requirements, are unattractive and uninformative. 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.

14. New paragraph 1(b) (iii) of Article 46 does not talk about principal risks, disclosure of which is already required by paragraph 1(a) of Article 46. It is therefore likely in effect to mean companies disclose a list of risks relating to environmental, social, employee, human rights, corruption and bribery (where most will inevitably have 'a policy'), which will be unhelpful for users. Whilst we strongly support the improvement of risk reporting, and believe that non-financial risk factors are often relevant to an understanding of a company's performance,

position or development, this seems counter-productive. It also will tend to mean less cohesive reporting, contrary to the principles of the current move towards more integrated reporting.

Do you agree with the need to include a "safe harbour provision" in this proposal?

15. We agree that directors should not be required to disclose information in the annual report that would be prejudicial to the interests of the company (and hence its shareholders), and that this should be reflected in the EU proposal. Prejudicial disclosure exemptions are important for matters in the course of negotiation and events yet to unfold entirely, where early disclosure of the details might lead to unnecessary loss for the company - and its shareholders. This is often consistent with the rules on disclosure of price sensitive information to the market, where matters under development do not need to be disclosed immediately. UK experience does not support the view that such a provision "allows companies too much latitude to avoid making otherwise necessary disclosures".

16. We support the use of appropriate 'safe harbours' in financial reporting legislation too (i.e. legal protection for directors unless they are fraudulent or reckless as to what they say) but think that the use of that term in this context is misleading.

Do you agree that the information about gender diversity at various levels of the organisation should always be provided, as a priority above any other diversity disclosure?

17. We are keen advocates of efforts to embrace diversity across organisations and in principle support additional reporting on diversity issues by large organisations. We welcome the focus in the EU proposals on diversity in its widest sense: while gender diversity is high on the policy agenda at present, it may be that other forms of diversity are considered equally or more important depending on the circumstances of the company, for example ethnic diversity.

18. We also suggest therefore that the long but incomplete list of different aspects of diversity - age, gender, geographical, educational, professional background - be excluded from the legislation and replaced by a more general requirement to disclose information on diversity policies and achievements, drafted in terms of principles so that companies can provide disclosures that emphasise issues of particular relevance to them.

Do you agree that the degree of flexibility provided will allow sufficient comparability and effectiveness of the information? Do you instead think that the list of internationally recognised frameworks should be limited to those that would allow a sufficient degree of detailed comparable disclosure? If so, which would you recommend?

19. We welcome the flexibility afforded by the proposed use of internationally recognised frameworks, and national frameworks based on them. However, we agree that the framework applied should provide a sufficient degree of comparable disclosure. As reporting frameworks, and assessments of their adequacy, will tend to evolve over time, we would caution against embedding the list of recommended international frameworks in EU law; it would be better to frame some other form of recommendation outside legislation instead, if even that were considered necessary. We would also recommend that the effectiveness of this innovative approach is reviewed say three years after the legislation comes into effect.

Do you think that the EU Proposal should include a requirement for companies to consider their supply chain?

20. We understand concerns about impacts and risks to communities and the environment associated with company supply chains and strongly agree that this matter merits international attention. However, financial statements prepared under IFRS and other

reporting regimes are produced primarily to meet the information needs of existing and potential investors, lenders and other creditors in making economic decisions. Reporting to shareholders on company performance is also the basis in EU law for the preparation of financial statements. Tempting though it is to use financial statements as a vehicle for disclosures driven by other public policy imperatives, we do not believe that mandating supply chain disclosure, particularly in the form laid out in the proposal, is consistent with the fundamental objective of financial reporting. Appropriate disclosure to investors and lenders of supply chain risk is already required, in effect, by the requirement in existing law to discuss principal risks and uncertainties in the annual report.

21. If, notwithstanding our concerns, legislative proposals are developed in this area, they should be subject to an appropriate cost: benefit analysis and be sufficiently flexible to permit companies to provide the required information through delivery mechanisms other than the annual report and accounts.

Are there any other issues that you would wish to make us aware of?

22. If private companies, despite our concerns, remain within the scope of these requirements, it would be important to retain the exemptions for qualifying subsidiaries, to retain the proportionality that this affords.

Are there any particular costs and benefits you would wish to make us aware of? Are there any risks or unintended consequences?

23. We have no further comments at this stage.

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