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Our ref: VP / AS

Dear Ms Raval

Thinking about disclosures in a broader context: A road map for a disclosure framework

Deloitte LLP is pleased to respond to the Financial Reporting Council (FRC)'s invitation to comment *Thinking about disclosures in a broader context: A road map for a disclosure framework* (the FRC Paper). We agree that a disclosure framework should ensure that all and only relevant information is disclosed within the annual report in an appropriate manner, and in such a way that detailed information does not obscure relevant information. In particular:

- we agree that the purpose of the annual report taken as a whole is to provide context and explanation of the financial statements included therein. However, we acknowledge that there is a tension between this purpose and the requirement by some regulators to include additional information within the annual report;

- we agree that currently there is in place a principles-based model for measurement but a compliance-based model for disclosure and so concur there is a need for further guidance regarding the application of the concept of materiality that all stakeholders should follow; and

- we consider it important to avoid the "checklist mentality" for providing disclosures, and that this will only happen if standard-setters discontinue providing lists of detailed disclosure requirements. Overall, we consider that greater discretion over what is required to be disclosed should be given to preparers of financial statements.

The debate around the complexity of financial reporting and quality of disclosures in financial statements is clearly gaining momentum and stakeholders are becoming increasingly engaged in the issue. The International Accounting Standards Board (IASB) held a Discussion Forum: *Disclosures in Financial Reporting* on 28 January 2013 where many stakeholders agreed action was necessary. We urge the FRC to share with the IASB both the FRC Paper and feedback received from the constituents, as they will

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inform the IASB as it develops its Disclosure Framework. We do not support a unilateral action by any specific jurisdiction in this area and thus believe that a UK-specific disclosure framework should not be developed.

We note that publication of the FRC Paper coincides with the publication of others with a similar objective – to improve the quality of and simplify financial reporting disclosure. Deloitte Touche Tohmatsu Limited has responded to the European Financial Reporting Advisory Group (EFRAG), the Autorite des Normes Comptables (ANC) and the FRC's Accounting Council on their Discussion Paper *Towards a Disclosure Framework for the Notes*. Deloitte & Touche LLP in the US has responded to the US Financial Accounting Standards Board's discussion paper *Disclosure Framework* which sets out a possible disclosure framework for US GAAP. However, we recognise that the FRC is tackling a broader issue in its paper, adopting a holistic approach to a disclosure framework by considering disclosure in the annual report as a whole by looking at management commentary and governance, as well as financial statements. We support this holistic approach because we believe that the primary objective of financial statements is to communicate decision-useful financial information about the amount, timing and uncertainty of the reporting entity's future cash flows. Such an approach is also consistent with the findings in the IASB's survey on financial information disclosures, published on 24 January 2013. Half of the respondents that thought improvements could be made to the way financial information is disclosed felt improvements were required across all parts of the annual report. Despite the publication of separate consultation papers, we hope that the various regulatory bodies and standard-setters will collaborate in developing a consistent disclosure framework.

The argument for a disclosure framework

Our 2012 survey of UK listed company annual reports, 'Joined up writing', found that annual reports have more than doubled in length in the last 16 years to an average of 103 pages. This growing volume of disclosure runs the risk of obscuring the information that is of most value to users. With no shortage of new requirements from various regulators and standard-setters, this trend looks set to continue unless action is taken that will succeed in reducing the clutter.

Increasingly, the annual report is being used as a repository for information that various regulators want companies to make available. The annual report is used as a default medium for introducing regulation, rather than requiring disclosure, say on the company website, or in a separate regulatory document where it might be more easily identified by the appropriate regulator and specialist users. This adds to the volume of information and in many cases results in key information getting lost.

A disclosure framework should result in more targeted disclosures, elimination of duplication, a reduction in the burden of disclosures and better organisation, making reports easier to read.

The resulting disclosure framework should be respected by all those imposing requirements for companies to provide information in their annual report. They should be required to justify any mandatory additional disclosures. It is not only the regulators that need to take action. Preparers and auditors also have their part to play in assessing whether disclosure is material and considering the way information is communicated in the annual report.

The purpose of the annual report

The starting point when developing a disclosure framework should be a clear statement of the objective of the annual report. The answer to the question of who the annual report is for appears to be losing clarity when it comes to the narrative information in the annual report outside the audited financial statements.

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We believe it is appropriate to use a holistic approach and define the primary user group consistently with the IASB's Conceptual Framework, which identifies the primary user group as "existing and potential investors, lenders and other creditors". Specifically we believe that reasonably informed and knowledgeable investors taking a longer-term view of the entity should be identified as the primary user group. We agree therefore with the FRC's approach that disclosures that do not meet the objective of financial reporting should be excluded from the annual report.

We note that the proposed 'boundary' for financial reporting within the FRC Paper is not the same as the Department for Business, Innovation & Skills (BIS)' current proposals for narrative reporting and greenhouse gas reporting. The FRC Paper challenges whether certain currently required disclosures meet the objectives of financial reporting and therefore should be communicated through some medium other than the annual report. One example given in the FRC Paper is carbon reporting; another would be the proposal to disclose information about human rights. In our response to the 2011 BIS consultation, we disagreed with the BIS proposal. We continue to believe that application of the BIS proposals is likely to be met by the provision of bland, boilerplate disclosure. For some companies, human rights issues will be a significant business risk and would be covered by the need to discuss risks and uncertainties. For most it will not be a material issue but they will be required to make a 'negative statement' that they have nothing to disclose. As such, we agree with the boundaries proposed in the FRC Paper.

We encourage the FRC to work with BIS to ensure that both are agreed on the purpose of the annual report and user needs while also monitoring the work of the International Integrated Reporting Committee as it develops is integrated reporting model.

Materiality

The FRC Paper states that disclosures need to be proportionate to the nature of an entity taking into account the needs of the users of those financial reports. We agree that information needs to be relevant for users and pass a cost/benefit test. Even when there are differential disclosure regimes, the concept of materiality still applies. Applying the concept to disclosures is not as simple as it is when applying it to recognition and measurement. All users have different priorities and different ideas of what is material, and what is 'material' to a user (or preparer) in one year may not be so in a subsequent period. The result is, as the FRC point out, a principles-based model for measurement but a compliance-based model for disclosure.

The IASB's Conceptual Framework essentially defines whether information is material or not by whether its omission or misstatement could influence decisions users make on the basis of financial information. IAS 1 *Presentation of Financial Statements* makes it clear that an entity need not provide specific disclosures required by IFRSs if the information is not material. We note that respondents to the IASB's survey *Disclosures in Financial Reporting* who are preparers of financial statements have indicated that they consider that not enough is being done to exclude immaterial information in financial statements themselves. As such, we believe the concept of materiality needs to be developed further for audited information and disclosure, and better articulated to provide further clarity over assessing which disclosures are important to give preparers confidence in their judgements. This clarity should be provided by international standard-setters.

Until there is clarity over whether it is acceptable to 'leave out' disclosures that are considered not material, immaterial or insignificant, the risk of challenge by the FRC's Conduct Committee remains and companies may continue to err on the side of cautious clutter.

Detailed responses to your specific questions have been included in an Appendix to this letter.

If you have any questions or comments, please contact Veronica Poole (0207 007 0884) or Amanda Swaffield (0207 303 5330).

Yours faithfully

Veronica Poole
National Head of Financial Reporting
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Appendix – Response to specific questions

1. Would a disclosure framework that addresses the four questions identified below help address the problems with disclosure?

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

Yes, we agree that a framework addressing the above four questions would help to address the problems with disclosure overload.

All relevant standard setters and regulatory bodies would need to be committed to the project, agreeing upfront on the answer to these questions. As part of the process, all current standards, laws and regulations will also need to be reviewed to ensure that they will be able to be applied with the framework.

But before these questions can be addressed, we believe the Disclosure Framework should state clearly the objective of the annual report. We believe that the primary objective of financial statements is to communicate decision-useful financial information about the amount, timing and uncertainty of the reporting entity's future cash flows to the primary user group, and that the primary user group is as defined within the IASB's Conceptual Framework, being "existing and potential investors, lenders and other creditors". Specifically we believe that reasonably informed and knowledgeable investors taking a longer-term view of the entity should be identified as the primary user group.

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

Yes, the disclosure themes capture common types of disclosure that users need assuming that the purpose of the annual report as a whole is to understand the financial statements (see our point above questioning the objective of financial reporting).

If the purpose of the annual report is wider than this (i.e. it is to be used as a wider repository of information as requested by regulatory bodies, such as carbon emissions and human rights), the disclosure themes on page 16 would not be complete.

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

Yes, we agree with those identified. BIS, in their 2011 proposals for narrative reporting, introduced the idea of including certain information online in a separate Annual Directors' Statement. We see merit in excluding information that does not change from year to year (for example certain corporate governance disclosures) from the annual report and instead including a reference to where that information can be found. This is not being taken forward in BIS's most recent proposals which means that a significant amount of standing data will continue to be included in the annual report.

4. Do you believe that the placement criteria identified in this paper are appropriate?

Overall, yes we agree that the proposed placement criteria are appropriate. There is a heightened risk that, where a significant amount of financial information is placed in the management commentary rather

than the financial statements, it will not be clear to the users of the financial information which information has been audited (as opposed to reviewed by the auditors for consistency with the financial statements). An example of this would be those items with extensive disclosure requirements which would be disclosed within the management commentary under the placement criteria, such as non-adjusting post balance sheet events including business combinations, where users would expect the information to be audited as the disclosures are required by IFRSs.

Further, for all audited information that contributes to the true and fair view of the financial statements themselves but is disclosed in the management commentary, a cross-reference will need to be made from the financial statements to the relevant placement in the management commentary. If numerous, these extra cross-references could, in turn, create extra clutter.

We also consider that freedom around placement of information within the financial statements should be encouraged, and that this complements the application of the concept of materiality (see below). For example, supporting notes to the financial statements which an entity may consider to be most important to users and of most material significance could be placed straight after the primary financial statements, with less important (but still material) notes placed at the end of the financial statements, for example, as an appendix to the annual report. Such ordering of the notes may need to change in periods where material activity or judgements arise in an area previously considered to be less important.

5. How should standard setters address the issue of proportionate disclosures?

We note that in the UK, FRS 101 has already addressed the issue by reducing disclosures for subsidiary and individual parent entities within a group. Similarly, IFRS for SMEs and FRS 102 has reduced disclosure requirements around financial instruments.

We consider that principles-based disclosure requirements would be welcome for those entities which are unable to qualify for differential disclosure regimes but where the full suite of disclosure requirements is currently too long or simply not applicable. As an example, we note that in some jurisdictions IFRSs are mandatory for all entities but this is not necessarily appropriate for some sectors such as not-for-profit entities.

We do not agree with size being the sole criteria for qualifying for proportionate disclosure due to the risk that some companies may be on the cusp of the size criteria and so move from one size category to another year on year, resulting in inconsistent application of disclosure year on year.

Another approach to disclosure emanates from IFRS 8 *Operating Segments* which requires information provided to management to be reported, rather than standardised information. This has merit as it conveys how management view the business and it is also good from a cost-benefit perspective. Much time and expense can be diverted to pulling together information purely for statutory reporting purposes.

As such, we believe that criteria for proportionate disclosure are best based around type of entity (such as public accountability) to distinguish between the needs of an investor in a quoted company and those in an unquoted company. Where necessary, each industry sector should be responsible for forming its own industry-specific disclosure requirements.

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

Yes. We agree with the statement on page 32 that currently there seems to be in place a principles-based model for measurement but a compliance-based model for disclosure. As discussed in our cover letter, we agree there is a need for further guidance around the application of the concept of materiality to disclosure.

We strongly support the aim of a single set of high-quality financial reporting standards applied without regional variation. For this aim to be achieved, we believe that the fundamental qualitative characteristics applied in financial reporting, including the concept of materiality, must also be applied without regional variation. We believe that by addressing these issues through accounting and auditing standards applied across many jurisdictions could contribute to global consistency in a way that guidance issued at a national or regional level could not. For these reasons we believe that any additional interpretation of existing accounting and auditing standards regarding the concept of materiality should be provided at a global level by the IASB and International Auditing and Assurance Standards Board respectively under their established due process.

We consider the diagram in Appendix 3 to be appropriate and useful, particularly the idea of presenting a roll forward for material movements from comparative information. However, we consider that it may be too simplistic in places, such as an immaterial number shown on the face of the primary financial statements not having any further disclosure in the notes, yet the number itself could be the net of two or more material balances (for example, the net surplus or deficit for a pension scheme).

The ranking of terms from ‘significant’ to ‘insignificant’ provides a useful and summarised interpretation from the list of descriptors on page 34 that are currently used, but we do not consider having more than one level of materiality (“material” and “significant”) to be of further help. We consider that either an item is material and warrants disclosure, or it is not (and is not disclosed). However, as noted above in response to question 4, in order to aid management in ‘telling the story’ of an entity’s financial performance and position, placement criteria for the Notes to the financial statements could be applied by giving the most important or most material notes prominence within the document.

7. Are there other ways in which disclosures in financial reports could be improved?

We note that often the accounting policies disclosed are very lengthy and boiler-plate in nature, with little tailoring. As such, entities should be able to exclude, or at least significantly reduce, the disclosure of its accounting policies. One possible option could be to include one statement that accounting policies are in line with IFRSs and then detail any specific policies where a choice is available (such as revaluation vs. cost model under IAS 16 *Property, Plant and Equipment*) or company specific details are important (such as revenue recognition). We have noted through our 2012 annual survey of annual reports ‘Joined up writing’ that there are some companies already starting to experiment in this area, either through disclosing the accounting policies at the back of the financial statements, or else though the use of colour coding to highlight key policies.