



# Grant Thornton

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Our Ref: MC/PL

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31 January 2013

Dear Ms Raval

## **Thinking about disclosures in a broader context**

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to comment on the Financial Reporting Council's (FRC) consultation 'Thinking about disclosures in a broader context' (the Paper).

We agree that there is a clear need for a disclosure framework to assist the IASB and other bodies that promulgate corporate reporting regulations to allow them to make better-informed and more co-ordinated decisions when prescribing requirements.

The paper is a very valuable contribution to the process and debate. We believe that the final outcome of this debate should be an annual report which more clearly and concisely explains the position, performance and development of the business. We therefore agree with the FRC that the issue is not just about the quantity but also about the quality of disclosures. We believe that two central issues that a disclosure framework needs to address are the difficulty in applying materiality to disclosures and the lack of clarity of communication in the annual financial report.

## **Materiality**

We believe that the debate has to reinforce the requirement in paragraph 31 of IAS 1 'Presentation of Financial Statements' that disclosures are required only for material items. We believe that a combination of factors has led to the importance of materiality regarding disclosures being lost by preparers and management becoming less confident about making judgements in this area. We accept that the concept of materiality is difficult to apply when considering disclosures but hope that this paper and the surrounding debate can provide a fertile ground for discussion and aid the development of useful guidance.

## **Lack of clarity**

We believe that the debate also has to centre on the lack of clarity in the annual financial report, as this contributes to poor quality disclosures. A disclosure framework must encourage the provision of a report that will remove duplication and encourage cohesiveness. We therefore welcome the FRC's approach of not limiting the discussion to the primary financial statements and notes.

### **Chartered Accountants**

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However, the FRC's paper splits the annual financial report into three distinct sections with placement criteria for each section and we believe that this approach itself may not address the lack of clarity by thinking about disclosure overload in this way. We have commented on this in more detail in questions three and four.

In our view, the annual financial report must contain only information for the identified user and we have considered the identity of the user in question one. As a result of this view, some of our responses discuss whether information currently located in the annual financial report could be located elsewhere. We believe this would allow the key messages to be reported clearly and improve the clarity of the annual financial report.

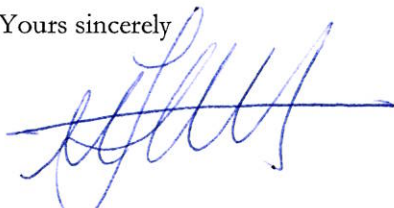
As part of our commitment to this wider debate Grant Thornton is taking part in the work being done by the International Integrated Reporting Council (IIRC) as a member of the Pilot Programme Business Network. We believe that there are a number of areas in which the ideas being considered by the IIRC can help further the disclosure framework debate and have commented on these in our detailed responses.

We note that there have been a number of recent consultations that have considered, to some extent, the areas of narrative reporting and disclosure requirements and we encourage the FRC to ensure that the responses to these consultations are considered and action taken in tandem with this paper. We encourage the FRC to take the lead in the debate by convening meetings of all interested parties and regulators in the UK.

Finally, we believe that the role and input of investors is essential for driving change. There appears to be little incentive for management to be innovative in this area and so it is essential that investors are engaged in order to facilitate developments. We suggested in previous consultation responses that more safe harbours for directors may encourage better communication. We also believe that the role of the Financial Reporting Lab is important, as it may provide a safe environment for innovative approaches to be tested. An example of this was the project, at the request of The Department of Business, Innovation and Skills (BIS), on a single remuneration figure in July 2012.

If you have any questions on our response, or wish us to amplify our comments, please contact Jake Green (tel: 020 7728 2793, email: [jake.green@uk.gt.com](mailto:jake.green@uk.gt.com)) or Peter Leadbetter (tel: 020 7728 2977, email: [peter.leadbetter@uk.gt.com](mailto:peter.leadbetter@uk.gt.com)).

Yours sincerely



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## Appendix A

### **Grant Thornton responses to specific questions raised in the Paper**

#### **Question one: 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?

We agree that a disclosure framework that addresses the four questions listed above will help address the problems with disclosures.

#### **What information do users need?**

##### **Lack of clarity**

We believe that one reason for a lack of clarity in the annual financial report is that the report often tries to meet the needs of too many users. In our view, the user must be explicitly identified before the four questions can be answered. The paper takes as read that the users are investors per the IASB guidance in the Conceptual Framework OB2 and we agree that investors are the primary users of financial statements. However we also note the IASB guidance is slightly wider and also includes creditors and lenders. The information that creditors and lenders need may be of a slightly different nature to that of investors and this should be taken into account when developing a disclosure framework.

The IASB Conceptual Framework OB10 notes that in general financial reports are not primarily aimed at other groups such as regulators and members of the general public but rather are aimed at the investors and creditors. We believe that identifying the user and not including regulators or prudential regulators in this definition will help identify the boundary of the annual financial report. By ensuring the information included in the annual financial report is for the benefit of the identified user rather than other parties, we believe this will improve the clarity of the annual financial report.

We further note that even after identification, users are not a homogenous group and have varying needs. This adds complexity to trying to find a balanced solution that meets all the needs of a class of user. The Financial Reporting Lab may be able to co-ordinate a review of the key information required by the majority of investors in order to establish their information needs.

We accept however that information currently included in the annual financial report may be included due to different legislative and regulatory requirements. As the debate around disclosures develops, the input of bodies such as BIS and the FSA will be required in order to establish how best to ensure their needs are met and to consider whether the annual financial report is the most appropriate place to record the information they require. We envisage the FRC having a key role to play. The FRC should continue to reinforce the purpose of the annual financial report and who the users of it are and therefore discourage other parties from misusing the annual financial report for their own purposes.

We also believe that the definition of disclosure on page 47 of the Paper is important. By defining disclosure as being the provision of additional information that is not generally available to users, this will remove the risk of information being duplicated in the financial

statements where it is readily available elsewhere and therefore help to reduce the size of the annual financial report. We believe this will improve the clarity of the annual financial report by not repeating information that is already available to a user and focusing on new, relevant information.

#### **Materiality**

Once the users are identified, care must be taken in asking what information users need and it is imperative that this question is allied with the question of what is material. The annual financial report should not attempt to provide users with all the information that they need without considering materiality. In an attempt to reinforce the importance of materiality and change behaviour, we believe that the concept of materiality must be emphasised at every step in the development of a disclosure framework and so the question could be amended to "what material information do users need?"

#### **Where should disclosures be located?**

##### **Lack of clarity**

We believe that the question of where disclosures should be located should be considered in the context of whether information is included inside or outside the annual financial report, rather than where exactly in the annual financial report the information is placed and we have commented on this further in question three and four. By including or excluding information in line with the objective of the annual financial report, only relevant information for the user will be included and thus the clarity of the annual financial report will improve.

#### **When should a disclosure be provided?**

##### **Materiality**

We believe that difficulty in applying materiality to disclosures is at the heart of the disclosure issue and so it is imperative that a disclosure framework addresses this point. Also we would welcome further consideration of the non-disclosure of information that is considered to be commercially sensitive by an entity despite it being material. We would note that a disclosure framework should emphasise that non-disclosure of material information due to it being commercially sensitive is not permitted. In particular, in some instances this information has already been made available to investors and so should also be included in the annual financial report. However, we do note that the seriously prejudicial exemption currently in IAS 37 and FRS 12 would need to be maintained for certain situations. An example would be where the disclosure of information would be seriously prejudicial to the outcome of a court case.

#### **How should disclosures be communicated?**

The question of how disclosures should be communicated is one that we envisage becoming more and more important with the advent of new technologies such as XBRL, the rise of the internet and changes in the ways users work. We have considered this further in our response to question seven.

#### **Question two: Do the disclosure themes set out on pages 16 of this paper capture the common types of disclosures that users need?**

This question is mainly a question for users but we agree that the themes appear to capture the types of disclosures that users need.



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

We agree with the components of the financial report as identified on page 20 but disagree with them being viewed as discrete components. We see the issue of components as contributing to the lack of clarity in the annual financial report.

**Lack of clarity**

**The issue**

We believe that a lack of cohesiveness in the annual financial report is one factor that leads to a lack of understandability. The existence of discrete components often leads to information being duplicated in different components of the financial statements or even inconsistent information being presented, which may be confusing to users.

**The cause**

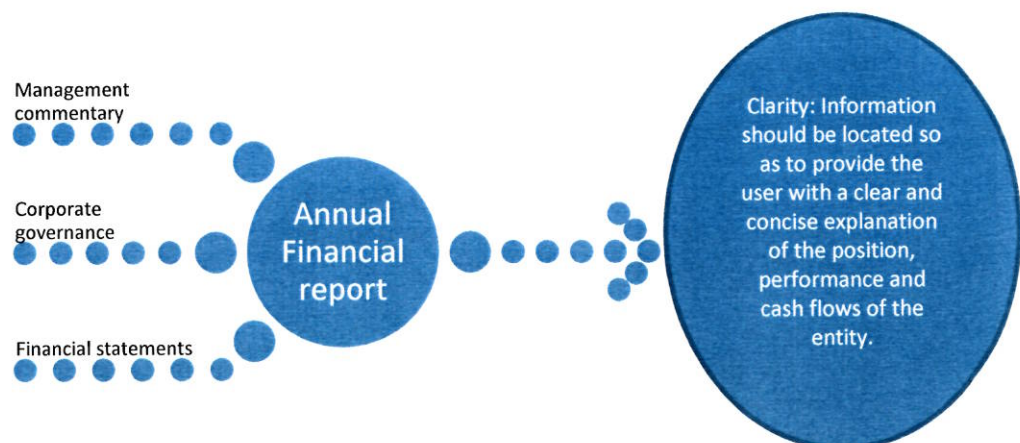
A number of competing regulatory requirements have commonly led to information being presented in separate parts of the financial report. For instance, the annual financial report may contain a CEO's report, operating and financial review, corporate governance statement, directors' report, primary statements and the notes.

**Solution**

The Paper proposes that there are three distinct components being: management commentary, corporate governance and financial statements.

Rather than there being three separate components of the annual financial report, we believe the three components should be viewed as running throughout the annual financial report concurrently and when taken together, they form the annual financial report. Our view on this question influences our position regarding the placement criteria and we have considered this in more detail in our response to question four.

We have used the following diagram to express our view of how the components of the annual financial report could be viewed as running side by side:



We believe that when considering the components of the annual financial report, a key issue is whether information is included within the annual financial report or elsewhere. We believe

that currently the annual financial report may contain information that does not meet the objective of the annual financial report and so may reduce its clarity. In our view, the work of the FRC in Appendix B provides a useful platform for discussing this issue.

If we assume that the preliminary announcement provides investors, which the FRC has identified as the user, with the material information that they need, then we need to consider the reason for the inclusion of any additional information in the annual financial report. If the information included in the annual financial report does not fit with the objective of the annual financial report then this information should be included elsewhere. We believe that an exercise, perhaps supported by the Financial Reporting Lab should be undertaken in this area. The exercise would review the information that investors use in the annual report and consider the reason for the inclusion of information that they do not use. This may provide further discussion of whether the additional information is actually required in the annual financial report or can be relocated elsewhere.

**Question four: Do you believe that the placement criteria identified in this paper are appropriate?**

We note that the IASB's views on placement criteria was developed in the context of its project on management commentary but the practice statement is non-mandatory. We therefore believe that a disclosure framework that considers placement criteria and is incorporated in the Conceptual Framework would provide useful guidance to preparers.

**Lack of clarity**

**The issue**

In our view, a key problem of current financial reporting is that different areas of the report are often prepared by different departments or individuals within an entity. As a result, the annual financial report often does not tell a consistent story which, impairs the value of information in the report. Another result of this approach is that often information is duplicated.

Additionally, different preparers within a company often have different ideas of materiality which can impair the value of information and cloud a user's judgement as to whether information is material.

**The cause**

Currently there is a lack of guidance regarding the placement of information in the annual financial report and we therefore welcome the Paper's consideration of this issue. However, we believe that a financial reporting framework that includes the Paper's placement criteria will not improve the clarity of the annual financial report.

We believe that the annual financial report should be viewed as a cohesive document and that the location of information within the annual financial report should not be determined by 'bright lines' as suggested in the Paper.

**Solution**

We do not believe that placement criteria are required but rather a principle should be established, as detailed above. The placement principle would be supported by our proposal regarding the components of the annual financial report in question three where the components are viewed as running through the annual financial report and not being distinct silos of information. The principle should emphasise the importance of materiality, avoidance of duplication and require that the annual financial report when taken as a whole, provides a single story. We suggest the principle could be as follows: "Information should be located in



the annual financial report so as to provide the user with a clear and concise explanation of the position, performance and cash flows of the entity."

We accept that the problem of duplication is often a result of overlapping regulations. This problem could be overcome in some instances by way of cross reference. For example, we often see directors' reports containing a cross reference to the disclosures required by IFRS 7 'Financial Instruments: Disclosures' in order to comply with the risk disclosure requirements of the Companies Act. We see this as a valid approach that improves the understandability of the report while also complying with current regulatory requirements that require various components of the annual financial report to contain certain information.

We note that the work of the IIRC in integrated reporting may provide further areas to explore. The integrated report may be applied by all companies, regardless of size and accounting regime.

We recognise that the changes suggested above would need to result in a reconsideration of the auditor's role in reviewing/auditing information and the scope of the audit.

#### **Question five: How should standard setters address the issue of proportionate disclosures?**

We believe that disclosures will be proportionate when only those disclosures that are material are made and therefore the issue of proportionality is essentially a question of materiality.

#### **Materiality**

##### **The issue**

Where a standard currently contains a long list of disclosure requirements, both preparers and auditors often see these requirements as a checklist and all of the prescribed disclosures are included, without considering whether they are material. However, we believe that even if a long list of disclosure requirements is included in a standard, the disclosures made by an entity would be proportionate if only the material disclosures from this list were made.

The role of regulators is important in this area as well, as it can help set the tone for preparers and auditors. The Financial Reporting Review Panel's (the Panel) 2012 report was helpful in this regard, where it encouraged preparers not to see points raised in panel letters as a checklist of disclosures that should be included. Instead, the Panel noted that preparers should have confidence in deciding whether disclosures are material when considering whether or not to include them.

##### **The cause**

In our view, the issue surrounding proportionality is a result of difficulty in applying materiality to disclosures. We therefore believe that a disclosure framework must include guidance on proportionality in order to inform the development of new standards and also provide guidance to preparers. We have explored materiality in more detail in our response to question six.

##### **Solution**

In order to encourage a change in behaviour, we believe that a different approach is needed. The Paper suggests three approaches as a resolution to the issue of proportionate disclosure.

We do not support a disclosure framework that is based solely on principles, as we do not believe that this approach would meet the comparability requirement in the Conceptual

Framework. In particular, the Conceptual Framework QC20 notes that financial statements are more useful if they can be compared with similar entities and the results of the entity in other periods. We therefore believe that the flexibility created where disclosures are purely principle based could lead to a reduction in the comparability of annual financial reports, which may not meet investors' needs.

Neither do we support an approach that would prescribe different disclosure requirements for different industries. We believe that defining the industries would be an onerous task that would either be too general to have value or too detailed and therefore costly to maintain. There would also need to be constant revision as new industries emerge requiring new disclosure frameworks to be developed. Finally, there would inevitably be companies that appear to fit into two industries or that change their business models and so the disclosure requirements for these companies would not be clear. We therefore do not support the creation and maintenance of different disclosure regimes. However, we note that the current practice of SORPs in the UK is known and understood and allows industries with particular requirements or nuances to interpret these on a reasonable and consistent basis.

We believe that the proposal to simplify the disclosure requirements for all entities would be appropriate and have provided some further ideas, detailed below.

Each standard should contain an underlying principle regarding disclosures that requires material information to be provided so as to allow a user to understand the transactions an entity has entered into. These should include consideration of any material changes from the prior year and/or transactions that may lead to a material change in cash flows in the future. The standard could then specify disclosures that are required as a minimum to meet this principle.

In our view, these proposals would aid the application of materiality to disclosure requirements. At the same time, the proposals would reduce the list of disclosure requirements and therefore the risk of disclosure overload. We also believe the proposals would encourage clear presentation of the key issues.

The current disclosure requirements in IFRS 3 'Business Combinations' are a good example of the above proposal in practice. There is the general requirement in IFRS 3.59 to explain to a user the nature and effect of business combinations that occurred during the period or after the period and before the accounts are authorised. This principle effectively requires that sufficient information is presented to enable users to understand the material transactions that have occurred in the year. In an appendix the standard then has some detailed minimum requirements to aid the application of this principle.

If disclosures were to be focused on material changes from the prior year or material changes in cash flows for future years then this may have some profound impacts and may lead to information currently included in the accounts being located in a different place. In our response to the 'Cutting Clutter' consultation, we suggested that long-standing information such as director biographies could be located outside the annual financial report, perhaps on the internet. We also now suggest that where there have been no changes since the prior year, corporate governance information could also be located outside the annual financial report, although we accept there are current legislative requirements that would prohibit this. However in considering a disclosure framework, we believe that current legislation should not create boundaries at the outset and so should encourage the pursuit of innovative solutions in this area.



When considering the proportionality of disclosures, we agree with the Paper that the identification of the cost: benefit driver is appropriate. The key area that cost: benefit analysis will influence is where information is not produced at all by management, except for the annual financial report. The key challenge here will be to judge what value this information has to users against the cost to produce it. The Financial Reporting Lab might consider how it could obtain information about the benefit to investors of the additional disclosures included in the annual financial report where that information is not used by management for running the business. In our response to question six we discuss the concept of materiality under the IIRC prototype and believe that this will be relevant in considering the cost: benefit of disclosures.

**Question six: Do you agree the framework for materiality set out in this paper? How could it be improved?**

**Materiality**

**The issue**

We believe that a key problem with disclosures is a difficulty in applying materiality. This can lead to disclosure overload. We therefore welcome the Paper's consideration of materiality.

**The cause**

In our view, a key cause of the issue is that materiality is more easily applied when considering quantitative amounts and is by nature difficult to apply qualitatively. This can lead to additional information being included that may not actually be material.

**Solution**

We are not entirely clear on the basis for the three-level approach applied on page 34 of the Paper and believe that introducing varying degrees of materiality may only confuse preparers and users. We do agree however that the variety in language as noted on page 34 in current standards and legislation may prove confusing when trying to consider what is material and the disclosure that is required. We believe the standards should simply require disclosure when an item is material and use the term material on a consistent basis throughout the standards.

In the IIRC prototype, the definition of materiality is considered slightly more broadly than that outlined currently in the Conceptual Framework. In order for an item to be material under the IIRC prototype, the item must be of a nature to substantively influence the assessments and decisions of both the organisation's highest governing body and the intended user. The inclusion of those charged with governance in the prototype may provide more of a focus in helping entities determine what is material from a disclosure point of view. We would welcome further consideration of this idea in reviewing the concept of materiality for a disclosure framework.

The Paper includes a proposed framework for applying materiality in Appendix C and we encourage attempts by the FRC to provide further guidance regarding the application of materiality to disclosures. However, we believe there are items requiring disclosure that may be missed by this framework. Under the framework for instance, no disclosure would be required for share-based payments where the charge in the year is immaterial. However, information regarding the impact of share-based payments on future cash flows and the dilution of capital may be material to a user. The judgements in determining that share-based payments are immaterial may also be material to a user, ie if different judgements were made when valuing the share-based payment, the charge might have been material.

To address this point, we propose the inclusion of additional questions where an item is immaterial on the face of the primary statements or in the notes. We would include the following questions based on those for disaggregated items:

- "Is further information required for a user to assess the timing of material cash flows or liquidity?" and
- "Is the line item subject to material measurement uncertainty?"

We also note the following in relation to Appendix C. In considering whether a disclosure is required, this appendix contains two sections, one each for 'recognised' and 'unrecognised' items. Each section asks an initial question as follows:

- Recognised: Is the line item shown on the face of the primary financial statements or notes material?
- Unrecognised: Are the items not currently recognised on the balance sheet (but that will affect future cash flows) likely to be very important to users?

The first question in relation to recognised items therefore asks if the items are "material". However when reviewing unrecognised items, the first question asks whether items are "likely to be very important to a user". This appears to create a different threshold for disclosure of recognised and unrecognised items and it is not clear if this was intended. We believe the framework could be made simpler by both questions using the term "material".

**Question seven: Are there other ways in which disclosures in financial reports could be improved?**

We believe that financial reports could be improved by giving further consideration to technology and the way in which information is reported. We would support companies' and regulators' initiatives in this area and believe the Financial Reporting Lab has the potential to play a key role in this.

We also believe that a co-ordinated approach is required and the FRC could consider setting up a joint regulatory working party to help correlate regulator demands and ensure a consistent approach is reached between BIS, the Financial Services Authority (and its successor) and the FRC.