

7 February 2013

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By post and email: disclosure@frc.org.uk

Dear Deepa

Reporting disclosure framework

Ernst & Young LLP welcomes the opportunity to comment on the FRC's consultation paper ("the Consultation"), issued in October 2012, called *Thinking about disclosures in a broader context, a roadmap for a disclosure framework*.

We have outlined below a number of general comments on the Consultation, before responding to the questions in the appendix to this letter.

Overall comments

We share the FRC's concerns about the complexity and relevance of today's annual financial reports. Disclosure overlap and overload contribute to lengthy annual financial reports which may be costly to produce, with an increased risk that key messages become obscured. The challenge is to find a way to coordinate and consolidate disclosure requirements from different standard setters, regulators and governments, so these requirements are relevant to a wide range of users.

Therefore the starting point should be the user, and accordingly any disclosure framework should be built upon a clear understanding of what users of the annual financial report actually want and need. Once a framework is developed, the promotion of best practice and the publication of application guidance on materiality would help preparers implement the framework and apply materiality appropriately to disclosures.

Setting disclosures – standard-setters

Different standard setters and regulators should focus on coordinating and consolidating their respective disclosure requirements. This will help reduce disclosure overload and duplication.

Individual standards should be introduced with clear objectives reflecting the information needs of users. This is an approach that the IASB has adopted in more recent standards, such as the update to IAS 19 (effective 1.1.2013). This approach will assist preparers in understanding the



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purpose of the disclosures, and assessing whether specific disclosure requirements are material to the financial statements (and/or whether additional information should be disclosed).

Standard setters should also ensure that specified disclosure requirements do indeed meet the information needs of users. Certain disclosure requirements may be of interest to some but not other users. We believe that standard setters, in determining disclosure requirements, should not seek to anticipate the needs of every user. Some users currently improvise to get the information they need, which perhaps indicates that their requirements are not always adequately captured in the standard setting process. For example, investors/analysts have been known to make their own adjustments to information on operating lease rentals in the profit and loss account, to get a better understanding of these commitments. In light of this, there would be merit in the IASB conducting a comprehensive review of the current disclosure requirements to determine whether existing requirements could/should be eliminated or clarified (and to carefully consider the information needs of users in setting future disclosure requirements).

Fewer specified disclosure requirements could mean information that is relevant to some users is deleted. This would be mitigated if there are clear disclosure objectives, so that preparers can determine what information is material (decision-useful) in the entity's specific circumstances. A move away from lengthy detailed disclosure requirements will inevitably increase the need for the application of judgement by preparers and auditors (and regulators). However, sensible and consistent application of judgement (and promotion of best practice) could be supported by industry initiatives (such as the Financial Stability Board's *Improvements in Financial Statements Disclosures*), the work of the Financial Reporting Lab and annual reviews such as the FRRP annual reports. Over time, reference to the disclosure objectives of an accounting standard might also help to drive a stronger consensus amongst different standard setters and regulators, on what constitutes materially significant and insignificant disclosures.

Implementing disclosures – application of materiality

Preparers may sometimes be cautious and take the view that if a particular line item is material, then all of the related disclosure requirements should be included as well, regardless of whether users of their financial statements actually need this information. While preparers are familiar with applying materiality concepts to the primary financial statements, applying materiality concepts to disclosures is less well understood. Preparers would, therefore, benefit from greater guidance on the application of materiality to disclosures (as well as access to best practice examples). However, preparers need confidence that there is a consensus on the application of materiality shared by regulators.

Disclosure placement

The placement of disclosures can also affect the complexity and understandability of financial reports. We consider that the Consultation provides a useful framework for assessing disclosure placement (in both a hard copy and online reporting framework) but that its ideas should not be applied rigidly. Indeed, the work of the Financial Reporting Lab provides an opportunity for companies to experiment with different positioning of information in the annual

financial report, to test these ideas with users (such as investors/analysts) and to promote best practice. We believe that placement should ultimately be driven by what users find most helpful. We welcome and support the work of the Financial Reporting Lab in providing insights from companies, investors and analysts.

There is also scope for placing narrative type disclosures required by accounting standards elsewhere in the annual report, potentially co-locating with similar disclosures required by regulatory or statutory requirements – e.g., disclosures on operational policies for managing the risk of financial instruments could be located in the management commentary or statement on corporate governance (alongside risk management and internal control disclosures). This should be distinguished from, say, information on measurement estimations and uncertainties in relation to items in the financial statements, which belongs in the financial statements.

Disclosure presentation

More generally, it is important that a disclosure framework also covers the presentation of information and the conciseness of information (i.e., the level of detail needed, and ensuring that key messages are clearly explained rather than being obscured by detail). This should help the annual financial report more clearly 'tell the story'.

Experimentation and different approaches to disclosure placement could lead to diversity in the structure of annual financial reports – so it is important that both hard copy and online formats are carefully indexed so that users can easily navigate to the information they need. In addition, references to financial information required by accounting standards which is positioned outside of the audited financial statements should be clearly labelled as audited (and distinguished from information which is not audited), to avoid misleading the user.

Conclusion

This Consultation raises important issues which the FRC and others have sought to address before. When considering the next steps we encourage the FRC to consider the conclusions drawn from this earlier work, as well as upcoming changes to the UK's narrative reporting framework (the proposed Strategic Report), the integrated reporting framework currently under development by the IIRC and others, and developments in technology (such as XBRL and other electronic formats).

If you would like to discuss any of our views please do not hesitate to call me. In the meantime we wish you well as you progress this initiative. For the avoidance of any doubt, this is not a confidential reply.

Yours sincerely



Tony Clifford
Partner
Financial Reporting Group

Appendix

Q1. Would a disclosure framework that addresses the four questions identified below help address the problems (i.e. information overload) with disclosures?

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

Yes, but it depends on the range and commonality of responses as to whether a successful framework can be developed. A successful framework needs to be kept relatively simple, with contents that the majority of preparers agree to follow.

Q2. Do the following disclosure themes capture the common types of disclosures that users need?

We agree with the disclosure themes listed on pages 16 and 17 of the Consultation for the management commentary, corporate governance statement and financial statements. However, the challenge is establishing the level of detail that should be disclosed under each one, and where in the report and accounts those disclosures should be placed.

There is some overlap with integrated reporting, i.e. corporate reporting that communicates in a concise way how the entity's strategy, governance, performance and practice (operating within the social, environmental and economic context) leads to value creation of the business over the short, medium and long term. We encourage the FRC to engage on a proposed framework on integrated reporting to be issued by the International Integrated Reporting Council in April 2013 (with a final framework to be issued by December 2013).

Q3. Do you agree with the components of the financial report (listed below)? Are there any other components that should be identified?

- Management commentary
- Corporate governance
- Financial statements

We agree with these components.

We note that within each component, there may be key information of interest to the 'ten minute reader' (see, however, our response to Q6) supplemented by detailed information.

For example, such key information could include:

- Management commentary - a concise business review;
- Corporate governance - the statement of compliance with the UK Corporate Governance Code (and the audit committee report) and parts of the Remuneration Report; and
- Financial statements - the primary statements and certain notes in the financial statements (e.g. key accounting policies, estimations and judgements, notes on key items).

Q4. Do you believe that the placement criteria identified in this paper (listed below) are appropriate?

- Information should be included in the management commentary, if it provides an investor with information that puts the financial statements into the context of the entity and its operating environment.
- Information should go in the notes if it is essential to an understanding of the primary financial statements and its elements.
- Information should be covered in the governance statement, if it provides information about the responsibilities of the board in setting the company's strategic aims, supervising the management of the business and reporting to shareholders on their stewardship.

Overall comments

We believe the above placement criteria are broadly appropriate. We also agree with the criteria for placing information on risks and uncertainties (set out on page 25 of the Consultation) in different components of the annual report. While not specifically included as an example in the table on page 25, we also consider that information on measurement estimations and uncertainties in relation to items in the financial statements also belongs in the financial statements.

However, on occasion, particular issues will cut across components of the report, and therefore, it may not always be appropriate to apply the placement criteria rigidly. In addition, companies may be able to better present information (e.g., accounting policies – see below) within a single component. Indeed, the work of the Financial Reporting Lab provides an opportunity for companies to experiment with different positioning of information in the annual financial report, to test these ideas with users (such as investors/analysts) and to publicise best practice. We welcome and support the work of

the Financial Reporting Lab in providing insights from companies, investors and analysts.

Experimentation over placement

To illustrate, there is the opportunity for preparers, even within the current regulatory framework, to experiment with different approaches (e.g., co-locating relevant accounting policies with the related notes; presenting critical accounting policies, estimations and judgements at the front of the financial statements, while including others in an appendix note to the financial statements). The forthcoming project by the Financial Reporting Lab on accounting policies may provide insight on what investors/analysts do find useful, and practical approaches that companies can take in presentation of accounting policies.

We believe that placement should ultimately be driven by what users find most helpful. Having said this, experimentation and different approaches could lead to diversity in the structure of annual financial reports – so it is important that both hard copy and online formats are well indexed so that users can easily find information.

Disclosure requirements cutting across components

The preparation of annual reports and accounts, and positioning of material, also needs to comply with accounting standards, statutory and other regulatory requirements. Such requirements can affect the positioning of material, or require careful cross referencing to other areas of the annual report.

For example, in regard to financial instruments, narrative and quantitative information is required by accounting standards and there are statutory disclosure requirements to disclose financial risk management objectives and policies, and risk exposures in the directors' report.

The placement criteria included on pages 21 and 22 of the consultation would suggest that:

- disclosure about objectives, policies and strategies over these risks should be included in the management commentary, together with information on unrecognised amounts (e.g. commitments, off balance sheet amounts);
- details on risk management and control environment should be included in the corporate governance statement); and
- quantitative information and narrative information over risk exposures and estimation uncertainties in relation to financial instruments held by the entity would be included in the financial statements.

However, there is a degree of overlap and to assist a better understanding of how this information interrelates, it may be useful to co-locate certain of these disclosures in the same place, as well as including clear references to related content included elsewhere

in the annual report (in order to meet the requirements of accounting standards and company law).

Regardless of the extent to which particular items of information might cross different areas of the same report, references to financial information required by accounting standards which is positioned outside of the audited financial statements should be clearly labelled as audited (and distinguished from information which is not audited), to avoid misleading the user.

On-line presentation of annual financial reports

The FRC should also consider the format of the financial statements in the context of modern technology (e.g., XBRL) and liaise with government and regulators (such as BIS or the FSA) as to whether certain information, which is 'standing data' which does not usually change from year to year, could be positioned on a website.

We note that recent FRC and BIS consultations on 'Effective Company Stewardship' and 'Narrative Reporting' did discuss inclusion of more information on company websites. These proposals were not taken forward and while there was some (but not universal) support, the consultation responses highlighted implementation issues (including for dual listed companies). Therefore, it is likely that any extension of website publication is a longer term initiative.

We consider there would be benefits from extension of website publication, provided there is sufficient support from both companies and users. In addition, it would be necessary to consider how significant changes could be highlighted in the annual report.

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

Regulatory coordination

Different standard setters and regulators should focus on coordinating and consolidating their respective disclosure requirements. This will help reduce disclosure overload and duplication. An example is similar but differently expressed disclosure requirements on executive remuneration in company law and in the Listing Rules.

Disclosure objectives

Individual standards should be introduced with clear objectives reflecting the information needs of users. This is an approach that the IASB has adopted in more recent standards, such as the update to IAS 19 (effective 1.1.2013). This approach will assist preparers in understanding the purpose of the disclosures, and assessing whether specific disclosure requirements are material to the financial statements. The disclosure objectives would also provide preparers with a framework to use to apply judgement over what additional information, if any, they should report. Consequently, preparers may become more inclined to stand back and consider whether all material (and only

material) information is disclosed. This should help to make disclosures by individual companies more proportionate.

Over time, reference to the disclosure objectives of an accounting standard might also help to drive a stronger consensus amongst different standard setters and regulators, on what constitutes materially significant and insignificant disclosures.

Specific key disclosures meeting information needs of users

Standard setters should also ensure that specified disclosure requirements do indeed meet the information needs of users. Certain disclosure requirements may be of interest to some but not other users. We believe that standard setters, in determining disclosure requirements, should not seek to anticipate the needs of every user. Some users currently improvise to get the information they need, which perhaps indicates that their requirements are not always adequately captured in the standard setting process. For example, investors/analysts have been known to make their own adjustments to information on operating lease rentals in the profit and loss account, to get a better understanding of these commitments. In light of this, there would be merit in the IASB conducting a comprehensive review of the current disclosure requirements to determine whether existing requirements could/should be eliminated or clarified (and to carefully consider the information needs of users in setting future disclosure requirements).

Fewer specified disclosure requirements could mean information that is relevant to some users is deleted. This would be mitigated if there are clear disclosure objectives, so that preparers can determine what information is material (decision-useful) in the entity's specific circumstances. A move away from lengthy detailed disclosure requirements will inevitably increase the need for the application of judgement by preparers and auditors (and regulators). However, sensible and consistent application of judgement (and promotion of best practice) could be supported by industry initiatives (such as the Financial Stability Board's *Improvements in Financial Statements Disclosures*), the work of the Financial Reporting Lab and annual reviews such as the FRRP annual reports.

Q6. Do you agree with the framework for materiality in the paper? How could it be improved?

The FRC proposes that within the financial report as a whole, three different levels of materiality from a disclosure perspective may apply.

- Top level – these are disclosures that would be of interest to the 10-minute reader. In 'Cutting clutter', we noted that a number of descriptors are used in IFRS and Company law in the context of disclosures and could be interpreted as an attempt to define this top level of materiality.
- Middle level – the concept of materiality as described in accounting standards.
- Bottom level – this refers to items that are considered to be insignificant or trivial, which is a term that is often used in auditing standards.

Overall comments

We are not convinced that the three levels of materiality set out in the paper provide a robust framework for assessing materiality of disclosures. The bottom level is not relevant as insignificant or trivial items would not be material to the financial statements. The key focus should be on the middle level, although the top level may be useful in terms of assessing the presentation of the key messages in the annual financial report. We discuss these concepts further below.

Application guidance on materiality needed

In our view, the concept of materiality (which has qualitative as well as quantitative aspects) is reasonably well understood in relation to the primary financial statements, but is less well understood in relation to disclosures, where narrative as well as quantitative information is important. Materiality concepts are relevant to the level of disaggregation of line items or related information to include in the notes, as well as to whether to give specific disclosures (and if so, in how much detail).

This is a complex area where we consider that preparers would benefit from application guidance as assessing materiality of disclosures can be particularly judgemental. For example, a lower level of quantitative materiality is generally applied to related party disclosures compared to some other notes to the financial statements because of their qualitative significance. Other areas of the financial statements, e.g. impairment, may be subject to measurement uncertainty so it can be important to clearly understand the valuation methodologies and assumptions used, and more detail is likely to be material to a user where an impairment becomes sensitive to reasonably possible but different assumptions. A contingent liability may be considered highly unlikely to be required to be settled, however, disclosures need to be adequate for users to appreciate its potential financial significance and the uncertainties over the amount or timing of any outflow. A business may, at any time, be subject to a large number of legal cases, but judgement is required in determining which of these are material for disclosure, and in what detail or level of aggregation.

This becomes particularly important should standards move to more use of disclosure objectives, supported by shorter lists of key disclosure requirements. However, sensible and consistent application of judgement (and promotion of best practice) could be supported by industry initiatives (such as the Financial Stability Board's Improvements in Financial Statements Disclosures'), the work of the Financial Reporting Lab and annual reviews such as the FRRP annual reports.

'Top level materiality'

We consider that the 'top-level' materiality concept identified in the Consultation has merit in helping preparers determine what is included in the Strategic Report (once implemented) and the arrangement of the information to ensure that key messages are not obscured ('cutting clutter'). We support the clear-signposting of high level messages in the annual report and financial statements. One approach is to pull together key

information in one place – as in BIS's original proposals for a Strategic Report and in integrated reporting initiatives.

However, while that approach is certainly helpful, we do not believe it is necessary to have a single section of the annual financial report so long as users can easily find the key information they need, such as a concise business review (including commentary on the financial performance and position), the remuneration report, the audit committee report (which, under the 2012 UK Corporate Governance Report should discuss, inter alia, the significant issues that the committee considered in relation to the financial statements, and how addressed) and key information in the financial statements (e.g. critical accounting policies, estimates and judgements, and key notes). Therefore, attention should be paid to clear indexing in both hard copy and online formats.

Having said this, we consider that it is unhelpful to place an over-emphasis on concepts such as the 'ten-minute reader'. It is important for users to be able to identify easily the key messages and the right context for interpreting the development, performance, and position of the business. However, such high level content is not sufficient on its own, and it is important that users read the annual report and financial statements to get a full understanding.

'Middle level of materiality'

The middle level of materiality is relevant to determining whether the financial statements give a true and fair view. As noted above, we believe preparers would benefit from further application guidance on applying materiality to disclosures.

Preparers need confidence that regulators would apply the concept of materiality in the same way. If this is not the case, preparers and their auditors are more likely to take a cautious approach and take the view that if a particular line item is material, then all of the related disclosure requirements should be included as well, regardless of whether users of their financial statements actually need this information.

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

Encouraging high quality and concise reports

When new disclosure requirements (especially narrative ones) are introduced, it can take time and guidance before preparers include good quality disclosures that clearly 'tell the story'. For example, the FRRP has noted an improvement in quality of disclosure over principal risks and uncertainties disclosure, following its publication of a generic press notice setting out expectations (and commentary in its annual reports). Conciseness is important though, and the FRRP has emphasised the need to focus disclosure on the principal uncertainties.

Many listed companies provide high quality detail in the management commentary and corporate governance components of the annual financial report but it is not always concise. We believe it would be helpful if the FRC developed guidance which would

encourage preparers to make the new strategic report to be concise and contain key details of strategy, business model, principal risks and uncertainties and review of the business.

Sign-posting the key messages

Users need to be able to quickly identify the key information (and changes) in other components of the annual financial report, such as the financial statements, and key changes in corporate governance or executive remuneration (see our responses to Q3 and Q6).

Personal statements from committee chairs or the Chairman could assist this process - if these highlighted the key developments and changes in corporate governance or risk management processes. The new-style audit committee reports required by the 2012 UK Corporate Governance Code have the potential to provide more insight on the key issues considered in relation to financial statements. We note that the Financial Reporting Lab has a project on these new audit committee disclosures, which will assist in promoting best practice, on implementation of the 2012 UK Corporate Governance Code.

Cutting the clutter – the challenges

To cut clutter, companies may need to evolve new processes for putting together an annual financial report. Such exercises will also require significant board level support and can take time. We encourage the FRC to continue to support efforts to cut clutter over a wide range of fronts to ensure these happen in a comparable way across companies, are coherent with other initiatives by different organisations. The FRC should recognise that it could take time to get this right.

Possible initiatives include developing a disclosure framework and related application guidance, and the work of the Financial Reporting Lab - such as the prospective projects on audit committee reports, accounting policies, risk disclosures. It is also important that such initiatives are supported by a consistent approach to assessing materiality of disclosure by enforcement regulators such as the FRRP and AIU.

Preparers may find it difficult to craft a concise and meaningful annual financial report, which clearly 'tells the story' and complies with all disclosure and other reporting requirements within the short reporting cycles within which listed companies, in particular, operate. These short reporting cycles mean that companies have to put in place formal processes for preparing the annual financial report to ensure that this complies with the regulatory requirements. While a 'cut the clutter' exercise can assist in streamlining the annual financial report, the process for preparing the annual financial report needs to be able to validate whether certain disclosure requirements are immaterial and whether transactions and events in the period necessitate new disclosures. The narrative management commentary (or strategic or business review) cannot be finalised until late in this process. Users and regulators may need to be mindful that it can take more time to 'tell the story' well, in a clear and concise way –

and that there is a potential trade-off between receiving the annual financial report quickly and high quality and concise information.