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Dear Ms Raval

Discussion paper: Thinking about disclosures in a broader context

We welcome the opportunity to comment on this discussion paper and commend the FRC for expanding the scope of their deliberations beyond those set out in the joint Discussion Paper "Towards a disclosure framework for the notes".

We agree that the problems with disclosures, be they the inclusion of immaterial or boiler plate disclosures or the omission of relevant information, exist throughout the annual reports of companies and that the solutions to these problems can only be found by all relevant regulators, preparers, auditors and users working together. Whilst we consider the disclosure problems associated with the notes to the financial statements should be addressed first, optimal solutions will only be achieved by putting those financial statements within the context of the annual report as a whole.

In particular, consideration of placement criteria may aid the IASB and other standard setters in defining what information should be mandated within the notes to the financial statement; i.e. they will help to focus on the objectives of the financial statements and thereby aid the development of principles for inclusion of information in the notes.

Furthermore, the importance of avoiding duplication within the annual report may also encourage flexibility in the drafting of standard disclosure requirements. IFRS 7 explicitly permits the presentation of certain disclosures by cross-reference to another report that is available to users on the same terms and at the same time as the financial statements. Such solutions could be extended to other disclosure requirements that could legitimately be included in the notes or elsewhere in the annual report or even outside of the annual report, exploiting the immense development in communication media of recent years.

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Considering further developments in communication media, we do note that the discussion paper is predicated on the idea that the annual report is a single document and, it might be inferred, a predominantly hardcopy document. Given any solution to the disclosure problems is likely to be a medium term project, consideration, and even encouragement, should be given to developing innovative ways other media might be exploited to communicate financial information.

However, solutions on financial reporting issues must be developed in conjunction with developments in models of assurance. The scope and level of assurance provided by auditors differs between components of the annual report. If information that should be subject to audit is moved outside of the primary financial statements and related notes, or outside of the annual report entirely, new forms of assurance reporting will need to be developed.

We set out our responses to the detailed questions in the appendix to this letter. If you wish to discuss any of the matters raised please feel free to contact me.

Yours sincerely

PKF (UK) LLP

Anthony Appleton
Technical Director

Appendix – responses to detailed questions

1. ***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?

A disclosure framework that addressed these four questions would clearly help address the problems with disclosures.

We welcome the concentration on users' "needs". We agree with the assertion on pages 14/15 that disclosures should only be those sufficient to provide information that is common to most investors. However, it is clear that identifying these needs is likely to form a research project in its own right. It is easy to develop a "phone book" of all disclosures that might possibly be of interest but much harder to identify which disclosures are actually used in economic decision making.

The questions to users at the back of the discussion paper would be a start, but in particular we would urge research into how, if at all, current disclosures are actually used in practice. By asking which disclosures are used and how they are used, it may be possible to identify more detailed themes from which principles for the identification of sufficiently useful disclosures could be derived.

In our view, understanding what disclosures are used, and how, is fundamental to solving the disclosure problems. Financial reporting is not an abstract discipline; it is fundamentally a form of communication to meet the information needs of users and should therefore be based on a detailed analysis of these needs. These needs cannot be deduced from abstract reasoning but only by research into how information is used and information that is missing that would be used if provided.

We consider issues surrounding these questions in our responses below.

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

As noted above, we believe only detailed research will identify what users need (i.e. which disclosures are used in analysis and economic decision making) so we consider the themes to be only a starting point in the identification of types of disclosures. All current disclosure requirements could be allocated to one of these themes, without gaining any further insight into whether specific disclosures are needed.

We note that the separation into themes will be useful in allocating types of disclosure to the three main components of the annual report identified in the discussion paper (Management commentary, Corporate Governance and Financial statements), but also their possible placement within each component or their placement outside of the annual report (for example, on a website).

For example, we agree with the separation of explanatory information, disaggregation information and information on assumptions and uncertainties as this may encourage new perspectives and innovations. Some users of the financial statements may rely on the judgement of management and the assurance provided by auditors and will not challenge the assumptions used or wish to contextualise the information by understanding the sensitivity analyses. Other users (or indeed the same users but at different times) may wish to understand how the reporting of performance or position would change as assumptions are flexed. By including explanatory information separately from information on assumptions and uncertainties it may be easier to see the "wood for the trees".

The types of disclosure might be further segregated into information that is not subject to regular changes (e.g. risk management policies, accounting policies, estimation techniques) and those which are. It might be argued that the inclusion of the former makes the identification of information relevant to decision making more difficult. Solutions might include removing this entirely from the financial statements and placing on, for example, the company website or relegating such information to an appendix to the financial statements.

Further consideration of the types of disclosures and the extent and regularity of their use may lead to new innovations in financial reporting. However, such innovations will only be possible with the support and co-operation of regulators and standard setters.

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?

The three components of an annual report as identified in the discussion paper, accurately reflect the components in the current model of financial reporting. However, as discussed above a more radical approach would be to consider whether the placement of disclosures should be restricted to the annual report and not, for example, provided through other media and whether or not the components could be further segregated by type of disclosures (e.g. the separation of explanatory information from assumptions and sensitivity analysis).

In particular, the use of company websites as a source of information that is not subject to regular change should be considered – it is not at all clear why the repetition year-on-year of identical descriptions of accounting policies is a useful exercise. Clearly where such information changes in a year this should be highlighted in the financial statements and, without surrounding information on policies that remain unchanged, such changes will be given the prominence they deserve.

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

The placement criteria provide a useful starting point in determining the contents of the three main components of the annual report identified in the discussion paper.

We welcome the focus on the objectives of each component, though further debate is needed on the precise objective of the primary financial statements and accompanying notes. Deeper consideration of this may provide a framework for not only the placement of disclosures but also determining the scope of information included. There is likely to be information that users desire and use but the financial statements, in particular, and the annual report in general may not be the appropriate medium of communication.

As discussed above, consideration could be given to segregating these components further and to the provision of some of the information currently in the annual report by some other means. Further placement criteria would then be needed in response to such an expanded model of financial reporting.

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

We do not consider the three ways of addressing proportionality identified on page 30 (simplifying disclosure requirements, setting principle based disclosure requirements and the use of differential disclosure regimes) to be mutually exclusive. In fact, we suggest the best solution will incorporate elements of each of them.

A differential reporting regime has worked successfully in the UK for a number of years comprising IFRS, UK FRSs and the FRSSE. We support the FRC's development of FRS 102 and the IASB's IFRS for SMEs in providing different levels of disclosure for different entities. This ensures the level of disclosure adequately reflects the needs of users for entities with very different investor profiles, capital structures and degrees of complexity.

Even within a single financial reporting framework differential regimes apply quite appropriately. For example, the application of IFRS 8 and IAS 33 to publicly traded entities only. We believe this could be extended further by providing additional disclosure exemptions for parent and subsidiary companies applying IFRS in a manner similar to that developed by the FRC in FRS 101.

Whilst not a popular concept (note the IASB's decision to transfer disclosures from IAS 30 to IFRS 7), we do not discount the idea of applying different disclosure requirements to different industries. We welcome the FRC's proposals for FRS 102 that would require additional disclosures by financial institutions. Comparative research of the use of certain disclosures by industries may prove evidence to support such differentiation.

Within individual standards we believe part of the solution to the disclosure problems would be the inclusion of minimum simplified disclosure requirements along with a requirement to meet principle based disclosure objectives. These should reflect principles developed as part of the conceptual framework project that in turn reflect the research into users' needs and reformulation of the objective of the financial statements and other components of the annual report. The disclosure objectives in each standard should be sufficiently clear to provide a benchmark against which actual disclosures can be judged.

In summary, we believe a hierarchical structure similar to that set out below would provide a pragmatic balance between flexibility, comparability and verifiability:

- An overall disclosure objective (possibly within the Conceptual Framework) to identify the characteristics of disclosable financial information for each component of the annual report
- A specific disclosure objective in each standard or other regulation to identify the main information needs of users that should be addressed
- A list of minimum disclosure requirements in each standard or other regulation that are required in respect of material line items to adequately explain and amplify the primary financial statements
- A list of indicative disclosures that may meet the disclosure objective of the specific standard or regulation

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

We agree that a debate is needed on the meaning of materiality in the context of disclosures to ensure consistency of understanding and application. This debate needs to include standard setters and other regulators, enforcement agencies, preparers, auditors and, most importantly, users. We would not be the first to note that one of the causes of disclosure overload is the tension between these groups, with each blaming another for the need to include immaterial items.

When disclosure requirements are presented as a checklist in financial reporting standards and legislation it is not surprising that a compliance mind-set takes hold. It is often easier for preparers to include a disclosure than to present an argument as to why it is not material, when this argument may be subject to repeated review by auditors, enforcement bodies and regulators.

These behavioural issues should be taken into account in the drafting of standards and legislation. It is not enough to include a paragraph in the heart of IAS 1 that immaterial disclosures need not be given when prescriptive language requiring the inclusion of a list of disclosures, with each of apparently equal importance, is then given within each standard. A simple first step would be to redraft the disclosure sections of each standard, so as to present the disclosures as a list of possible disclosures to consider when aiming to "amplify and explain" the financial statements.

Whilst agreeing with the FRC that a debate on materiality is needed, we do not consider the framework set out in the discussion paper is sufficiently well developed to drive this debate. In our view, a fully developed framework for applying materiality to disclosures would:

- Highlight that a specific disclosure requirement may not be material even if the line item to which it refers is material
- Stress the entity specific characteristics of materiality in the context of disclosures. In particular, it would link the materiality of disclosures to the entity's business model, strategy and industry. For example, the materiality of information on the use of forward currency derivatives is very different when comparing a company that uses them only for the purchase of goods with a company that uses them for speculative purposes.
- Link materiality to the disclosure objective and principles. As discussed above we advocate a model of standard setting that sets out a clear objective of disclosures supported by indicative specific requirements. A particular disclosure would only be material if it helped preparers meet the disclosure objective.

Any framework for materiality in the context of disclosures will have to consider developments in audit reporting. It has been suggested in recent debates that auditors should include in their audit report an indication of the materiality level applied in the course of their work. In particular, we note that the FRC has prepared draft reports to further debate on the IAASB's discussion paper on auditor reporting. Given the difficulties in applying materiality to disclosures it will be particularly difficult to represent the materiality considerations in a single quantitative indicator.

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

The IASB's survey on disclosures in financial reporting highlights there are two problems with disclosures:

- The inclusion of irrelevant and/or immaterial information; and
- The omission of information relevant to decision making.

Any solution to these problems can only be sought by bringing together all parties in the financial reporting supply chain to seek agreement on:

- What the objectives of financial reporting are; and
- What disclosures users need for their economic decision making processes in practice.

We welcome the work being done by the FRC, EFRAG, the IASB and others to bring together interested parties but see this as only the first step towards developing a roadmap to a disclosure framework then ensures the annual report communicates clearly and succinctly the story of the reporting entity.