

Our ref: BT/FRC/CB
Your ref: Disclosures in a Broader Context
Via email : disclosure@frc.org.uk



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Deepa Raval
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Dear Ms Raval

Discussion Paper: Thinking About Disclosures in a Broader Context

We welcome the opportunity to comment on the FRC Discussion Paper (“the Discussion Paper”) and support the FRC in its efforts to influence the current international debate on disclosures in financial reporting with the ambition to move towards a globally accepted framework for disclosures.

Our responses to the questions raised in the Discussion Paper are set out in the Appendix to this letter. These take account of and include references to our survey of preparers and users which obtained 125 responses in early December 2012.

We have two main concerns arising from the Discussion Paper relating to placement criteria and materiality.

Firstly, we are concerned with the application of the placement criteria, specifically unrecognised amounts as shown on page 16 and 27. Unrecognised amounts, including, but not limited to, non-adjusting post balance sheet events such as those described on page 27 can be fundamental to an understanding of the financial position of the entity when results are released to investors and hence to the resource allocation decisions of investors or potential investors. We consider the location which would meet the objective of fair presentation is to include the explanation of unrecognised amounts to the relevant notes in the primary statements. We expand upon this in our response to question 4.

Whilst we accept that some duplication of information arising from different sources, such as standards and local legislation, could be reduced by carefully designed placement criteria we do not consider that there is sufficient duplication that will allow placement criteria to create the step change required to reduce the disclosure burden. Instead, the application of placement criteria may just relocate disclosures from one section of the financial report to another. However, if the FRC were to influence the IASB to remove the disclosures that were considered unnecessary by the ICAS/NZICA “Losing the Excess Baggage” paper, we believe that this would be a major step in reducing the volume of disclosures that can lead to clutter in financial statements.



Our second main concern surrounds materiality. We consider that the graphic in Appendix C could prove to be unhelpful in that the first question asks whether the line item is material. Disclosures relating to non material line items may themselves be material. We remain to be convinced that the complexities of the materiality concept can be faithfully distilled into a flowchart style graphic. There is a significant danger that this approach, albeit well intentioned, will result in materiality simply being looked at as a single threshold value, rather than considering the wider qualitative and quantitative aspects, and hence failing to acknowledge that materiality is incapable of monetary definition alone.

In conclusion, and as we noted in our response to the recent EFRAG Discussion Paper: Towards a Disclosure Framework for the Notes, we consider a significant reduction in clutter could be gained by two actions, namely:

- 1) Preparers, auditors and users having the confidence to apply IAS 1, paragraph 31, which states “An entity need not provide a specific disclosure required by an IFRS if the information is not material”, and
- 2) By the IASB implementing the recommendations from the ICAS/NZICA “Losing the Excess Baggage” paper.

If you wish to discuss anything further please do not hesitate to contact me.

Yours sincerely

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Question 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?*

Response 1

We consider that addressing the four questions identified above would help to resolve the problems being encountered with disclosures.

However, we have some concerns surrounding the answers to these questions, in particular on the application of placement criteria on unrecognised amounts and materiality considerations which we expand upon in later questions.

In our response to the recent EFRAG Discussion Paper “Towards a Disclosure Framework for the Notes” we considered that a framework for the notes, being a subset of the financial statements, should have a single objective set in the context of the overall objective of the financial statements which is to “present fairly the financial position, financial performance and cashflows of an entity” [IAS 1 paragraph 15]. Our suggestion was:

“To ensure that all and only relevant information is disclosed in an appropriate manner, so that detailed information does not obscure relevant information in the notes to the financial statements.”

We believe that this could reasonably be translated into a general disclosure objective for financial reporting, with an underlying subset of principles for applying that framework to the financial statements and other components of the financial report, each with reference to the overall aim of the financial report, using terminology which is already widely understood.

Question 2

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

Response 2

Yes, the disclosure themes capture the common types of disclosures. However, we have concerns on the placement of disclosures, especially surrounding unrecognised amounts, as we explain in our response to question 4.

Question 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?



Response 3

Yes, we agree with the components of the financial report.

Question 4

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

Response 4

Whilst we agree with the placement criteria on page 21, *“In the notes if it is essential to an understanding of the financial statements and its elements”*, we have some reservations, as highlighted in our covering letter, about the suggested application of the placement criteria to unrecognised amounts as shown on pages 16 and 27.

Unrecognised amounts, including, but not limited to, non-adjusting post balance sheet events such as those described on page 27 can be fundamental to an understanding of the financial position of the entity when results are released to investors and hence to the resource allocation decisions of investors or potential investors. We consider the location which would meet the objective of fair presentation is to include the explanation of unrecognised amounts in the relevant notes to the primary statements. We explore this issue in the next paragraphs.

As we noted in our response to the related EFRAG Discussion Paper we consider that the overall objective of the notes to the financial statements should be set as a subset of the overall objective of the financial statements. We suggested this would be *“To ensure that the notes to the primary financial statements only provide the necessary information to present fairly the financial position, financial performance and cash flows of an entity.”*

By introducing the concept of present fairly, we consider that information regarding unrecognised amounts should be disclosed in the notes to the financial statements where these are material in assessing the financial position, performance and cash flows of an entity when the users receive the financial statements. This is essential in providing useful information to the primary users, as that category of users are those making resource allocation decisions based on the financial statements when they are published.

For example, in order to provide useful information, disclosures relating to a post year end reduction in asset values should be presented in the note relating to that particular asset value at the reporting date. Other notes or locations may cross refer to this note, however the note that the item is described and located in should provide the additional relevant information regarding post balance sheet events.

If this disclosure is material, and it would only be disclosed if it was, then it may affect users decisions, and so to omit that information, or to locate it somewhere else in the annual report, would reduce the usefulness of financial statements.

We therefore consider that the analysis on page 27 should be amended as information related to the major destruction of a production plant is essential to an understanding of the financial statements and its elements when the user receives the financial statements upon approval by those charged with governance.



Finally, we consider that any principle or criteria that is developed uses terminology which is already linked to the true and fair view, and so descriptive words like ‘essential’ should not be introduced.

Question 5

How should standard setters address the issue of proportionate disclosures?

Response 5

We consider that proportionate disclosures would follow from setting clear disclosure principles and avoiding long lists of disclosure requirements which effectively become rules for preparers. We do not believe that the standard setters need to establish differential reporting within a particular standard, however we do support the introduction of a tiered system of reporting based on consistent underlying principles of recognition and measurement such as those being introduced in the United Kingdom and that have been introduced globally via IFRS for SMEs.

Were differential reporting to be introduced within a particular standard then this would add bright lines, and remove decisions from preparers about what is and what is not material for users of their financial statements. Instead, standards should be written in such a way that the more complex the transactions undertaken, the more disclosure is required to understand them, and the resulting position of the entity. If, for example, an entity has simple transactions, and non-complex financial instruments, principles based standards should only require the entity to disclose the information that is required to show a true and fair view. This, by definition, should be less than is required for complex transactions and financial instruments, and thus, proportionate disclosure will automatically follow.

Question 6

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

Response 6

Whilst we consider that preparers and regulators should have greater regard for what is and is not material we do not consider that additional guidance or a separate framework on this area in isolation would enable the step change in behaviour required. We believe a step change will arise from principles based standards which do not mandate lists of requirements, even if they are only meant to be applied to material items as per IAS 1, paragraph 31. As we noted in our response to the related EFRAG Discussion Paper, a disclosure framework should have the concept of materiality as a pervasive principle and not as a separate additional consideration.

We also note that the summary of responses document to the 2011 ESMA consultation “Considerations of materiality in financial reporting” highlighted a difference in understanding between preparers and users as it notes that “the majority of respondents considered the concept of materiality is generally well understood”, whilst a majority of user respondents were of the “view that the materiality concept was not clearly and consistently understood.” It therefore appears that preparers and hence the people that will be first



affected by a framework on materiality will not gain significant benefit. They would, however gain significant benefit from reduced lists of disclosure requirements as we note in our covering letter.

However, should a framework or application guidance be considered appropriate, however well intentioned, we strongly believe that it must be written as a framework and as application guidance, and not rules or requirements. In writing a framework or application guidance, we would urge the IASB to carry out this task in co-operation with the IAASB in order to secure a consistent approach for preparers and auditors.

We consider that materiality is incapable of monetary definition because it has both quantitative and qualitative elements so any framework or guidance will inevitably either be too vague to be of use, or too detailed so as to miss the point. Unfortunately, we consider that the Discussion Paper has fallen into this trap, and in fact, we are concerned that whilst the Discussion Paper covers a number of themes as regards materiality on pages 32 to 35 and provides some thoughts on how materiality may be applied to disclosures in Appendix C, we are not convinced a framework for materiality has been fully developed.

Whilst we tentatively agree that a framework for materiality may be helpful to some preparers and users, we are not convinced that the visual on page 54 and 55 really helps move the debate any further forward than IAS 1 paragraph 31 as it does not assist a preparer or user to decide if a disclosure is material or not, as it starts with the question of whether the line item is material.

As the Discussion Paper highlights, materiality has both qualitative and quantitative aspects but the suggested approach in Appendix C could, without great care, result in only quantitative aspects being considered. We have concerns that in attempting to distil the materiality framework in a visual manner, the suggested approach may instead hinder the professional judgement involved in assessing the complex area of materiality for preparers and auditors.

Continuing to consider the diagram in Appendix C for a moment, it starts by asking if the item is material, which could lead the preparer to consider a quantitative threshold assessment and thus fail to disclose qualitative information for a line item which is judged not material. As an example, both share based payments and derivative contracts can be recognised in the financial statements as quantitatively non-material line items, but the disclosures are likely to be material to investors to understand the hedging, reward structure or potentially dilutive aspects of these items. Considering the standards in the form they currently exist, it is better, we suggest, for the preparer to make an assessment of each disclosure that is advised by a standard (as they are currently written), and disclose what the users will require to make resource allocation decisions.

Finally, as regards Appendix C, the graphic does not, we suggest, provide a framework for narrative disclosures of overarching items which may warrant more or less disclosure due to the financial position or performance of an entity. As an example, the level of disclosures relating to the going concern assessment will vary from entity to entity and from year to year depending on a number of factors.



As we noted in our response to the FRC “Cutting Clutter” paper we consider the extant range of descriptors triggering disclosures to be unhelpful and support a move, as highlighted on pages 34 and 35 of the Discussion Paper, to a small number of defined and consistently used thresholds. We therefore disagree with the introduction of an additional descriptive term of “*very important*” for unrecognised amounts on page 55. We consider that these should be linked to the materiality descriptors already in use, rather than adding to the range of descriptive terms covered on pages 34 and 35.

In the short to medium term, we believe that a significant step change could be obtained by the IASB implementing the recommendations from the ICAS/NZICA “Losing the Excess Baggage” publication which recommended that unnecessary information should be removed thereby enhancing the usefulness of the financial statements. This will have the dual effect of ensuring that all, and only, the information required to achieve a fair presentation is presented in the notes to the financial statements, but also that such information should not be presented or duplicated elsewhere in the financial report.

Finally, in our survey, 86% of respondents agreed that the disclosure of information that is not material can obscure relevant information.

Question 7

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

Response 7

We support EFRAG and the FRC in calling for a change in the manner of setting standards. In our survey, only 15% of 125 respondents thought that the quality of financial reporting would be harmed by reducing disclosure requirements, whereas 76% thought that quality would not be harmed. We consider that standard setters should set principles of disclosure rather than lists of detailed requirements, although guidance is welcomed on how most entities can achieve the disclosure principle.

We believe that standard setters should amend their practice of mandating detailed disclosure and instead use clear disclosure principles. We also support and draw attention to page 16 of the ICAS document “A professional Judgement Framework for Financial Reporting – An international guide for preparers, auditors, regulators and standard setters”, in which 7 recommendations for standard setters are set out. Were these to be contained within the disclosure framework then higher quality, principles based standards should result.

We encourage the FRC to influence the IASB to remove the disclosures that were considered unnecessary by the ICAS/NZICA “Losing the Excess Baggage” paper as we believe that this would be a major step in reducing the volume of disclosures that can lead to clutter in financial statements.

In our view regulators play too great a role in influencing the level of disclosure. As noted in the Discussion Paper, the FRC “Cutting clutter”, and ICAS/NCIZA “Losing excess baggage” papers, materiality should play a key part in the amount of disclosure given and auditors and preparers need to have confidence in their ability to exercise judgement without the fear of unnecessary and costly challenge from the regulators.



We note that the UK regulatory arm of the FRC includes consideration of materiality on its website, reminding preparers that “Accounting standards do not apply to immaterial items and the Conduct Committee takes the same approach” and that “you need only consider additional disclosures if they are relevant and material to your next report and accounts.” We hope that other regulators take the same view and do not pressurise the IASB to include unnecessary disclosure requirements which preparers feel obliged to comply with.

Whichever framework regulators set, we consider that improving effectiveness of disclosures is not just about reducing the volume of disclosures. It is also about better signposting and organising, to enable the reader to find relevant information of substance and further related disclosures, and to determine what has changed since last year.

For example, disclosures about going concern can appear in various sections of the annual report. It is important that these disclosures are linked together to ensure a complete and balanced view is given, but also to avoid repetition within the annual report. We understand that duplication can arise from requirements being set out in accounting standards and from local legislation so any framework should encourage preparers to look at the annual report as a whole when considering disclosures. Local legislators can also assist by removing requirements that are already contained in accounting standards that are required to be applied in that jurisdiction.

We would also support accounting policies being included in an appendix or on the entity’s website with only policies which have changed in the current reporting period being disclosed.