Ernst & Young LLP
1 More London Place
London
SE1 2AF

Tel: +44 20 7951 2000
Fax: +44 20 7951 1345
ey.com

Sir Jon Thompson
Chief Executive Officer
Financial Reporting Council
8th Floor, 125 London Wall
London EC2Y 5AS

5 February 2021

Direct line: 020 7951 2474

Email: hball@uk.ey.com

Dear Sir John

EY response to the FRC Future of Corporate Reporting discussion paper

EY welcomes the opportunity to contribute our views to the Financial Reporting Council (FRC) on its Future of Corporate Reporting discussion paper.

The appendix to this letter provides our initial comments in support of the FRC's objective, to help facilitate a change to the UK corporate reporting framework. We see value in starting the conversation on these important themes and, in time, developing material changes that will benefit everyone.

Overall summary

Corporate reports allow users to comprehend the purpose and prospects of a company and its business, providing insights on the culture, risk profile and long-term outlook. However, the type and level of information disclosed, and medium used to communicate it, varies between organisations. This undermines the comparability of data and, in some cases, proves burdensome and overwhelming for companies and users respectively.

EY supports the need for a comprehensive framework for corporate reporting, which could not be achieved without fundamental statutory and regulatory change. The proliferation of multiple sources of requirements has led to a disjointed disclosure regime that is inefficient and inhibits transparency and clarity.

We encourage the introduction of a robust set of reporting standards on non-financial information (NFI) and believe more work in this area should be done in conjunction with a focus on long term value [1] (LTV) and a more sustainable economy and society. Standardisation will result in more comparable, relevant and reliable NFI disclosures from companies, and make assurance possible where appropriate, thus addressing the information needs and concerns of investors and other stakeholders.

[1] The Embankment Project for Inclusive Capitalism (EPIC) incorporates a corporate reporting framework developed by EY. Its purpose reflects the points raised in this letter and appendix. More information can be found on the EPIC website.

As part of our ongoing engagement with corporates, we hosted two roundtables in December 2020 and January 2021 to exchange views on the discussion paper. The comments we provide in this paper incorporate the feedback received.

Current context

The Government has, for several months, been expected to deliver a comprehensive white paper, taking forward recommendations from the three audit reviews commissioned by the Department for Business, Energy and Industrial Strategy (BEIS) and we hope the publication will not be delayed any further. Reforming the ecosystem of reporting, director accountability and audit must be tackled cohesively and at speed, or the change society expects will not come to fruition.

The genesis of these reforms preceded COVID-19 and we must now ensure that any changes, rather than proposing to remedy past failures, will incorporate lessons learnt from the pandemic and look to the future, by shaping UK business frameworks for the longer term, contributing to a sustainable economy that works for planet, people and prosperity.

The way forward

The UK is an important economy. It has long been regarded as a world leader in corporate governance and reporting, audit and accounting and regulatory oversight. The balance of high standards, proportionate legislative requirements and appropriate levels of flexibility have made it an attractive place to invest and do business.

It is imperative that any reforms will address the complexities and inconsistencies that have, to some extent undermined the value of reporting. They should instead enhance, rather than hinder, investors' confidence in the quality of the UK business environment, allowing us to retain a leading position in capital markets.

Your discussion paper provides interesting reflections and we agree with broadening the scope of mandatory 'stakeholder reporting' to enshrine in law what leading companies are already doing.

We would encourage the FRC to further develop its thinking in order to introduce significant change and simplification to essential mandatory disclosures and related materiality interactions.

The Government's consultation and resultant legislation will have implications for the outcome of this discussion paper and will allow you to articulate concrete proposals in order for a proper debate to take place. Further work in this space, should be done once the breadth of upcoming changes, as well as the political and regulatory appetite for significant reform in company law, will be clearer.

For this reason, our views in this letter and appendix are preliminary and do not provide exhaustive answers to all the questions posed by the discussion paper. As time moves on, we would welcome the opportunity to engage further and, together with other interested parties, contribute to shaping proposals and bringing a new reporting framework closer to realisation.

Your sincerely

[redacted]

Hywel Ball
UK Chairman

Annex

Comments on the discussion paper

1. Rationale for intervention

Over the years the UK reporting framework has evolved, as a result of international initiatives as well as through domestic measures which have introduced disparate legal and regulatory requirements. The annual report is still the corner stone of this system, it allows shareholders and other stakeholders to better understand a company because of the wealth of valuable financial and non-financial information about its business model, strategy and objectives, risk, performance and rewards.

Stakeholders, and particularly investors, rely on this information and trust its level of assurance. There is however consensus that the length and complexity of the information in the annual report has a detrimental impact on its main purpose as a communication tool.

There is a significant level of inconsistency in the way the same type of information is provided by different companies, many of whom publish additional, voluntary non-financial information outside of the annual report. Additionally, the method used to determine a number of non-financial disclosures is not precisely defined, leading to a lack of reliability in what companies produce.

- We agree with the rationale of tackling corporate reporting's complexities; there are many different existing reporting requirements from many different bodies. Simplifying, streamlining and harmonising them with any new requirements would lead to a more easily digestible set of reports for stakeholders to interpret.

- For this reason, we believe that an effectively transformative reform of corporate reporting in the UK cannot take place in the absence of adequate reform of the legislative and regulatory frameworks.

- A transformed approach to corporate reporting which enables improved understanding and reliance for stakeholders could differentiate UK reporting on the world stage, leading to improved investment and commercial opportunities.

2. Towards a definition of 'corporate reporting'

In addition to compliance with strict financial reporting requirements, companies are nowadays expected to 'communicate' with a wider audience than its direct shareholders and provide additional information in order to better tell their story, whether or not as a result of specific legal requirements.

The definition of 'corporate reporting' proposed by the FRC acknowledges this trend and moves away from the assumption that the primary user of the information in the annual report is the investor, giving effective recognition to wider stakeholders.

However, granting businesses total discretion to identify and satisfy the interests of all stakeholders is likely to be perceived as unhelpful, leading to a lack of clarity by companies, nor be welcome by investors.

The inclusion of the 'purpose' for the disclosure introduces a helpful materiality lens. There is a risk though that, as defined, the types of information companies put in the public domain could extend beyond relevant boundaries - for example it could include any form of advertising.

- We encourage adopting an approach along the lines of the EY Long-Term Value methodology, which envisages that directors should identify those stakeholders who are key to the company achieving its purpose and strategy.

- Companies should be open about who their stakeholders are and explain how their interests are met through the corporate disclosures.

- Consideration should be given to narrowing down the proposed definition to mandatory disclosures as a priority. Companies may be additionally encouraged to apply the communication principles to other elements of external reporting – but voluntary reporting should not be explicitly in scope.

3. Objective-driven reports

The proposal of moving away from focusing on the user of the information and, instead, adopting an objective-driven approach, is radical and, in our view worth exploring, however would require legislative changes in order to be implemented.

The existing UK requirements for listed companies, to produce annual reporting and accounts, intrinsically link objective and user of the information. Focusing on the objective of the report is a clear evolution from the perceived needs of a single set of users to a framework that recognises different categories of recipients. This approach may also have the potential of adding value and effectiveness to the flow of information between companies and the outside world, the opportunity for better defining supporting reports, increasing the level of granularity, improving consistency and facilitating comparability between companies.

- We recommend for these dynamics to be considered carefully, both in terms of the duties imposed on boards, but also in terms of establishing new stakeholders' expectations. As currently defined in the discussion paper, the delineation of objectives between different reports appears to have been defined for some, but set at such a high, theoretical level, that would unlikely provide helpful steer to the preparer. For other reports, companies would have the autonomy to define the objective, although it is not clear to what extent. In our view this could create challenges, including a wide variety of purposes across companies, and related inconsistencies.

- In the absence of a materiality lens defined according to the ‘stakeholder’s need’, we recommend clearly defining the objective of the reports according to a different materiality test.

4. Unbundling the annual report

One of the key proposals in the discussion paper is to overcome the length and complexity of the annual reports by dividing it into separate reports. The implicit assumption is that creating a reporting network should facilitate easier access to information considered by stakeholders as relevant to them.

To a certain extent, companies already do this, for example by separating sustainability disclosures or instead, through the use of technology, allowing users to select sections to be downloaded or read. Therefore, in principle we believe the suggested approach has merit.

At the same time, while potentially facilitating readers’ access to the information, we are concerned that simply unbundling the report may risk it losing coherence and would not reduce the burden on preparers.

One of the key strengths of the Annual Report and Accounts (ARA), which also makes them more easily digestible, is the Strategic Report. It requires boards to tell the story of the company ‘through their eyes’. The story needs to be trustworthy, it must have integrity, and investors find it very powerful if it is understandable and they have confidence it is fair and balanced.

Additionally, although the proposed approach focuses on the objective rather than the recipient of the report, when considering digitally enabled opportunities it will be important to take into account the variety of ways different categories of recipients would select and make use of the information in companies’ reports. Some will focus on the integration of data about the same company, to understand its story; others will instead isolate certain information about a company, for the purpose of comparability against others.

- We recommend that any disaggregation of the annual report will need to strike the right balance between effectively splitting information according to its differing purposes in separate reports, while still ensuring the business report retains the key aspect of narrative storytelling.

- In order to reduce the complexities, we suggest reconsidering the scope of what constitutes standing data. Doing so would create a great opportunity to ring-fence information that does not help tell a company’s story in any given year, create an indexed style report and move the information out into a compliance style report. Such standing data could perhaps be provided at two time points – in line with the year-end date, then updated within e.g. 1 month of a change to the standing data (for example list of subsidiaries following an acquisition or disposal).

- Importantly, a flexible network of reports should make full use of technology. The discussion paper acknowledges that further work is needed to develop concrete proposals, but we believe the suggestions are a helpful start.

- Careful consideration will need to be given to the publication timescales of separate reports, whether aligned to year-end or otherwise, in a way that would allow users to link data sets at a given time, but mindful of unnecessary burdens placed on preparers.

5. Materiality

EY is of the view that different materiality definitions are necessary, particularly when distinguishing between financial and non-financial information (NFI), but clarity is of the essence.

The concept and definition of materiality is directly linked to the specific purposes and variety of recipients' use of the information.

- A specific materiality test should apply for company data used for comparability purposes which supports that comparability. Conversely, in the absence of comprehensive standards, the information the company publishes with the purpose of telling its story to stakeholders, should rely on a materiality definition that will need to be determined and transparently explained by that company.

- In a model of objective-driven reports, the materiality test will need to be set according to that objective, so it becomes critical that the purpose is also clearly defined. Furthermore, information that might be material to the objective but is immaterial to all stakeholders may obscure the more relevant data.

6. Public interest reporting and non-financial information

The discussion paper proposes the introduction of a Public Interest Report (PIR) and clarifies that thinking in this area is still at an early stage, we therefore suggest some considerations to support the development of more concrete proposals.

Investors and other stakeholders are increasingly aware of the importance of non-financial information, as it underpins enterprise value in both the current and longer term. NFI is therefore critical to the objective of the Business Report, as defined in the discussion paper, of demonstrating how the company creates long-term value in accordance with the stated purpose.

Our own work on long-term value has in fact demonstrated that the linkage between how a company drives and protects value by meeting the needs of its key stakeholders requires disclosure of a breadth of non-financial information, directly linked to these outcomes.

We therefore believe it is of critical importance to capture Environmental, Social and Governance (ESG) disclosures and are supportive of making reporting content along these lines mandatory for all, as it will force companies that are weaker in this space, and shied away from sustainability reporting in the past, to increase disclosure and transparency, hopefully leading to better behaviours and allowing for better comparison across companies.

In order for the proposed separate PIR to be relevant to both companies and stakeholders, its rationale, objective and scope will need to be carefully considered. The distinction between the Business Report, focused on internal outcomes, and the PIR on the external outcomes, is a bold and interesting idea.

In the stakeholder engagement session that the FRC hosted and EY attended, it was clear that the thinking behind this distinction was based on the Impact Management Project's[2] definition of dynamic materiality: that the PIR should be focused on external impacts, and the outcomes that these have, on the economy, environment and people. The example that was given on monetising the impact of training in Figure 4 of the discussion paper suggests that the FRC is supportive of introducing a social impact valuation framework. This is an idea which deserves greater exploration and we would welcome the opportunity to share with you how we are seeing this area evolving amongst corporates at the moment.

Should the content of the PIR ultimately be similar in content to what companies currently include in sustainability reports (and many in their annual reports), beyond existing regulatory requirements, there is a risk that it may not prove popular amongst investors (FRC's own research suggests the sustainability reports are the least read) or become an opportunity for companies less committed to doing the right thing, of 'hiding' their related performance in a less prominent report.

We also believe that the concept of public interest would benefit from further clarification, as companies should be required to articulate what it means to them, how it extends beyond those identified as their stakeholders and how the PIR disclosures align to the corporate purpose and meet the "reasonable person" test.

Additionally, we note how, while the overarching theme of the FRC proposal is on "unbundling", the approach suggested for the PIR instead suggests bringing together reports that are currently separate and potentially have a different cut-off date than the annual report and this may increase reporting burdens.

- Avoiding unhelpful repetition of information will also be critical. Some of the information currently proposed to feature as minimum content of the business report, is likely to significantly overlap with the PIR (*Explanation of how value is distributed to other stakeholders to sustain value creation, such as employees, local communities, and the natural environment, and how this contributes to sustaining value creation; Impact of a company's activities on stakeholders and the environment)* nor it is clear in which report s.172 disclosures should feature.

[2] Home | Impact Management Project

- It will be important to strictly define the boundaries of this report – as there is a risk of proliferation that corporates are concerned about, namely that fringe activist information requests will result in the need to disclose ever more detail - this risk is increased by the concept of an objective driven report – without the overlay of a stakeholder materiality lens.

- Defining materiality and the metrics on which judgements have been made is crucial, otherwise we are likely to see a proliferation of boiler plate statements.

7. Further considerations

Governance is one of the key elements of ESG and a crucial aspect of sustainable value creation, however the discussion paper does not appear to reference related disclosures in any of the proposed reports. EY's work on the EPIC framework for long-term value demonstrates how governance reporting helps assure shareholders and other stakeholders that a business's strategy execution is directed, controlled and monitored effectively.

Going forward, companies will need to strengthen their ability to identify and manage risks, beyond compliance. Companies will need new and strengthened control frameworks to support boards and allow audit committees in overseeing the robustness and reliability of the information they communicate to stakeholders. Enhancements around internal controls on financial reporting currently being debated should incorporate and anticipate the changes needed to support the shift in non-financial information reporting envisaged in this paper.

We believe an effective reform of the corporate reporting framework must be made in conjunction with technology. Introducing sustainable reforms in corporate reporting will need to be made through effective applications of Fourth Industrial Revolution technologies, if we are to thrive in a post-pandemic world and build the resilience of our business environment.