21 December 2012

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Ms Françoise Flores
Chairman
EFRAG
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By email: commentletters@efrag.org

Dear Françoise

Towards a Disclosure Framework for the Notes

ICAEW is pleased to respond to your request for comments on the discussion paper *Towards a Disclosure Framework for the Notes*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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cc: Deepa Raval, Financial Reporting Council

ICAEW REPRESENTATION

TOWARDS A DISCLOSURE FRAMEWORK FOR THE NOTES

Memorandum of comment submitted in December 2012 by ICAEW, in response to the EFRAG, ANC and FRC discussion paper *Towards a Disclosure Framework for the Notes* published in July 2012

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the discussion paper *Towards a Disclosure Framework for the Notes* published by EFRAG (European Financial Reporting Advisory Group), ANC (Autorité des Normes Comptables) and FRC (Financial Reporting Council) in July 2012, a copy of which is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

MAJOR POINTS

Support for the initiative

5. We believe that the question of the effectiveness of disclosure in annual reports is an important one that needs to be addressed by all parties with an interest in financial reporting. We therefore welcome the publication of this discussion paper, which provides a useful review of some of the major issues involved. Our comments are framed in the context that we believe disclosures in financial statements, combined with the rest of the annual report, should provide the information necessary for a shareholder to assess the performance and financial position of the company and the financial and operational stewardship of management – providing a 'true and fair' view in one place.

Scope

6. The discussion paper would be still more useful if it were not confined to the notes to the financial statements. The problem of the effectiveness of disclosure is not confined to the notes, and some of its causes – such as poor organisation and repetition of disclosures – can only be addressed adequately by looking at the annual report as a whole. In this respect, we believe the FRC discussion paper, *Thinking about Disclosures in a Broader Context: A Road Map for a Disclosure Framework*, makes an important contribution to the debate. We will be commenting separately on the FRC document shortly, and will send a copy of our comments to EFRAG. We hope that in deciding how to proceed in the light of responses to its own discussion paper, EFRAG will also take into account the FRC paper and comments on that.

7. As an aside, it is unfortunate that it has been considered necessary to publish two parallel consultative documents on disclosure at the same time. Whilst the issues discussed in both papers make a valuable contribution to the debate, they could unhelpfully be seen by some as an example of the lack of coordination among financial reporting authorities that can lead to overlapping and disorganised disclosure requirements.

A disclosure framework

8. The discussion paper seems to envisage the development of a freestanding disclosure framework for the notes. The International Accounting Standards Board (IASB) has announced that it intends to deal with disclosure in its revived conceptual framework project. We believe that this is the right place for any 'framework' statement on disclosure. We would expect this approach to mean that framework material on disclosure would not refer to the notes alone, and it should also ensure that unnecessary duplication would be avoided where there are questions that apply to disclosure as well as to recognition, measurement or presentation. In deciding how to proceed, we believe that EFRAG should support the IASB's initiative to deal with disclosure as part of its overall conceptual framework for financial reporting, and should consider how its future work can best fit with this project.

9. The material on disclosure in the conceptual framework should help to ensure that disclosure requirements are introduced only when they are justified and are removed when they have ceased to be worthwhile. Once the IASB has finalised this aspect of its conceptual framework, it would be helpful for it to set up a review of existing disclosure requirements to ensure that they meet the criteria in the revised framework.

Multiple regulators

10. It also needs to be recognised that part of the problem of disclosure effectiveness arises from the existence of multiple bodies in different countries that are able to impose disclosure requirements. Sometimes these are intended for the benefit of shareholders – as with, for example, disclosures relating to directors' remuneration. But annual reports also include disclosures that are not primarily of interest to shareholders, but are instead what may be regarded as public policy disclosures for the benefit of third parties (eg, civil society groups). Again, these are imposed by bodies other than the IASB.

11. For these reasons, the problem of disclosure overload will not be solved unless it is tackled by all the bodies that are able to impose disclosure requirements. This would have to be done on an international basis. Ideally, legislators and regulators internationally would accept the IASB's disclosure requirements as sufficient, and not cause duplication and unnecessary complexity by adding their own disclosure requirements. It would also be helpful to have agreement on the objective of annual reports and on who they are intended for, which in our view is the company's investors and other providers of capital.

12. Where information is not required primarily for shareholders' benefit, we believe that it should not form part of the annual report, except to the extent that it is relevant to them. If political pressures mean that such disclosures have to be made somewhere, it would be helpful to have some suitably high profile way of making them without burdening shareholders with disclosures that are not primarily for their benefit. This is particularly the case for listed companies which are (in the UK at least) required to have a website, which offers an efficient alternative disclosure channel. The EU's current proposals on country-by-country reporting of payments to governments by extractive and other industries provide an example of how things might be done. The proposed requirements as currently drafted would mandate disclosure of the relevant information, but would *not* require it to be in the annual report. With this objective in mind, we believe there needs to be greater focus on how technological advances over the past decade or so may be better utilised to enable companies to report more effectively (see also paragraph 15 below).

Materiality

13. While the paper's discussion of the principles that should be followed by standard setters in order to avoid disclosure overload is useful, we are not sure what practical effect they would have. We suspect that more progress would be made if materiality (also discussed in the paper) could be effectively applied by preparers so as to avoid the disclosure of immaterial information. But there seem to be formidable obstacles to changing attitudes in applying materiality in this way. Companies are concerned at how regulators might react; in some jurisdictions non-disclosure – even of items that they consider to be immaterial – could expose preparers to litigation. The tendency to far more disclosure requirements also has a behavioural impact: thus, from management's and auditors' point of view, a checklist approach to disclosure appears to be the simplest and most cost-effective way to deal with the need to deliver a large amount of information within what is often a very pressured timescale. There may also be users who prefer companies to disclose even immaterial amounts rather than exercise discretion as to what should be disclosed; such users are presumably happy to ignore what they consider to be immaterial. So while materiality seems to be the key to the problem, it does not offer an easy solution.

Meeting different users' needs

14. There are significant differences between the needs of different users of financial reporting information. Most users probably have relatively little time to devote to any single company's disclosures and are interested in a relatively small number of companies. Some users have the necessary resources of time and skills to be able to make good use of very extensive disclosures and may wish to compare data from a large number of companies. And even these users differ in what information they regard as useful; equity investors and fixed income investors, for example, may have different priorities.

15. It is unrealistic to expect the needs of these diverse types of users to be met by a single set of disclosures. It is therefore important that disclosures should be structured in a way that makes the key information easily accessible to ordinary users, while also allowing those users who want much more extensive information to access what they need. It is for further consideration what exactly should be provided as core information circulated automatically to all shareholders in the annual report. At a minimum it should contain the primary accounting statements and material supporting disclosures, but there is an important debate to be had on where the boundaries should be drawn and how far they should be a matter of management discretion. Put another way, the financial statements must provide a 'true and fair view' and there needs to be a clear view of how much disclosure is enough to achieve that. The more extensive information set could ultimately be available only on the internet.

16. We understand that there are obstacles to structuring and layering information in this way – both because some users object to the idea and because of legal obstacles relating to voting on annual reports and the audit of financial statements (and auditors' responsibilities for reading accompanying information). However, these objections should not be insurmountable and in the internet age current arrangements are likely to be unsustainable. At some point it will have to be recognised that disclosures should be restructured more radically to meet the very diverse needs of different types of users.

17. One objection may be that the annual report should be the only repository for information about a company's performance and management's stewardship, and that everything should therefore be sent automatically to all shareholders. As the volume of disclosures grows, we believe that it becomes increasingly unconvincing to argue that all of them – perhaps 50 or 100 pages – are essential in order to give a true and fair view. But we do not think that any shareholders should be denied access to a full set of disclosures. On the contrary, they should be easily accessible to all investors if they wish to see them. But we doubt very much whether most shareholders do want to work their way through a full set of disclosures. And if this view is correct, sending them all a full set of disclosures automatically is unlikely to be helpful even if, ideally, all shareholders should have the time and skills to read and learn from all relevant disclosures made by all the companies in which they invest. Again, we believe there needs to be a more active debate concerning the use of technology in reporting, thus enabling users to 'click through' to the level of detail they need.

18. As noted, the type of restructuring that we have suggested would have implications for the scope and form of the audit report. These questions need to be addressed as a separate exercise, but we do not see that audit considerations should impose insuperable obstacles to the sort of changes that we suggest.

19. It should also be recognised that, given the extent and diversity of some users' needs for information about companies, it is unrealistic to expect that there will be any significant reduction in the disclosures that companies will be required to make. Actual disclosures may be significantly reduced if cuts can be made in immaterial disclosures, and we have already noted the obstacles to achieving this (paragraph 13 above), but if structural issues are dealt with properly, it should be possible to have both clear and succinct communication **and** an underpinning detailed data set that between them will meet the needs of most users.

RESPONSES TO SPECIFIC QUESTIONS

Q1.1 – Key principles

The Discussion Paper sets out a number of key principles that should underpin a Disclosure Framework. Do you agree with these key principles? If not, what alternative principles would you propose?

20. Except as noted below, we agree with the key principles set out at pages 2-3 of the discussion paper.

21. We do not think that it is sensible to define the purpose and content of the notes separately from that of the primary financial statements (Key Principles, paragraphs 1-4). The purpose of the financial statements as a whole is to give a true and fair view of a company's state of affairs and profit or loss. As the primary statements on their own cannot do this, the purpose of the notes is to provide whatever additional information is necessary for the financial statements as a whole to give a true and fair view.

22. We agree that information in the notes should be specific to the company. The notes should not provide information to the shareholders that is immaterial to the company, even where the company is a significant operator in a particular market. Where regulators require information that is additional to the requirements of IFRS, it should be provided in separate filings, publicly available where appropriate.

23. It is unclear what is intended by the proposition (Key Principles, paragraph 7) that a consistent level of granularity is important in disclosure requirements. While we support a consistent approach to setting disclosure requirements in accounting standards, different degrees of detail in disclosures will be appropriate on specific issues. The important point is that actual disclosures should avoid what is immaterial; this is picked up at paragraph 12 of the key principles.

24. While we agree that 'disclosure requirements should be set so as to avoid any possible overlap within notes' (Key Principles, paragraph 11), this principle would presumably become redundant if disclosure requirements were determined in accordance with a framework.

Q1.2 – Understanding the problem

The Discussion Paper suggests that there are two main areas for consideration to improve the quality of disclosures:

a) **avoiding disclosure overload, which may be caused both by excessive requirements in the standards, and by ineffective application of materiality in the financial statements;**

b) **enhancing how disclosures are organised and communicated in the financial statements, to make them easier to understand and compare.**

Do you agree that these are the two main areas for improvements?

25. We agree that these are two of the main areas for consideration, but would add a third: ensuring that disclosures meet users' needs. We have not attempted to prepare a comprehensive list of additional disclosures that would meet shareholders' needs, but we understand that they see significant room for improvement in areas such as segmental and product disclosures, disclosures on financing arrangements and liquidity, and providing gross amounts where assets and liabilities are netted off against each other. Sometimes, as in the net surplus or deficit on a defined benefit pension scheme, there are relevant requirements for the disclosure of gross amounts, but in general disclosure of net amounts only can give a misleading impression and may well result in an item be treated as immaterial when the variability in the underlying gross amounts is in fact material information.

26. Chapter 5 of the discussion paper makes a number of suggestions for improving communication in financial reporting (eg, disclosures should be clear, balanced and concise; information should be cross referenced), and we support these.

27. As regards the organisation of the notes, we believe that it is helpful to many users to have a fairly standardised order in which information is disclosed. The approach in IAS 1, *Presentation of Financial Statements*, under which the notes reflect the order of information in the primary statements, will usually be most helpful (Chapter 5, paragraph 31). We do not suggest, however, that there should be specific requirements to standardise the order of disclosures, as there is a need for flexibility, which IAS 1 recognises (Chapter 5, paragraph 32). A standardised order for disclosures can also discourage preparers from thinking about how best to communicate their disclosures for the benefit of the generality of readers. Should companies wish to volunteer information in standardised formats for the benefit of specific groups of users, this can of course be provided publicly online, without cluttering the annual report.

Q2.1

In chapter 2 a definition of the purpose of the notes is proposed to assist in deciding what financial information should be required in the notes. Do you think that there is a need to define the purpose of the notes? If not, please provide your reasoning.

28. We have discussed this point at paragraph 21 above. We do not think that the purpose of the notes can be sensibly defined separately from that of the annual report as a whole. In that context, we would agree that clear principles for determining what information should be presented in the notes, what information should be provided elsewhere in the annual report and what information may be published through other means would be helpful.

Q2.2

Is the proposed definition of the purpose of the notes helpful in identifying relevant information that should be included in the notes? If not, how would you suggest it should be amended?

29. As stated above, we are concerned that the proposed definition considers the notes in isolation. The purpose of the notes is to provide whatever additional information is necessary for the financial statements as a whole to give a true and fair view. Leaving that aside, the points made in the definition are not unreasonable, but are probably too high-level to be particularly helpful in answering specific disclosure questions.

Q3.1

In chapter 3, it is proposed to identify specific users' needs that the notes should fulfil. Those users' needs are drawn from the Conceptual Framework. It is also suggested that a Disclosure Framework should also include indicators to assist the standard setters to decide when additional information is required to fulfil those users' needs.

a) Is the description of the approach clear enough to be understandable? If not, what points are unclear?

b) If you do not support this approach, what alternative would you support and why?

c) Do you think that a category on 'information about the reporting entity as a whole' should be included? If so, why?

30. We do not think that it is entirely clear at the moment how the proposed identification of users' needs would fit in with the key principles at pages 2-3 of the discussion paper.

31. We are not sure whether there should be a separate category of information about the entity as a whole. Provided the information is genuinely financial reporting it may be appropriate. But a lot of information about the reporting entity as a whole either belongs in the front half of the annual report (eg, on the structure of the group) or may be regarded as public policy disclosures for the benefit of third parties (as noted at paragraph 10 above), which may not belong in the annual report to shareholders at all.

Q3.2

Are the proposed users' needs and indicators in chapter 3 helpful to identify relevant information? If not, how would you suggest amending them, or what other basis would you suggest to identify relevant information to be included in the notes?

32. Although the approach adopted in the discussion paper is described as being for the purposes of 'setting the requirements', it often reads as though it is more relevant to decisions by a company on what it should disclose – or perhaps by a regulator assessing whether a company has made appropriate disclosures. However, we have no specific suggestions on the listed needs and indicators.

Q3.3

Do you agree with the way how risk and stewardship are addressed in the Discussion Paper? If not, what are your views about how risk and stewardship information should be provided in the notes?

33. We believe that it would be more useful to consider risk reporting and stewardship reporting in a discussion that looks at the annual report as a whole. In relation to stewardship specifically, we do not agree that information solely for stewardship purposes should be excluded from the notes. In our view, an important role of financial reporting is to provide information on management's operating and financial stewardship of the business. Such information may also be useful for other purposes – eg, for helping to forecast future cash flows – but in our view it should be part of companies' financial reporting in any case.

Q3.4

Standard setters frequently mandate detailed disclosure requirements in each standard. In chapter 3, it is suggested that the way in which disclosures are established influences behaviours, and alternative approaches are discussed.

Do you think that standard setters should change their practice of mandating detailed disclosure requirements in each standard? If so, which of the alternative approaches discussed do you think will be the most effective in improving the quality of information in the notes?

34. In principle, we support the idea of disclosure objectives in standards that leave it to companies to decide exactly what disclosures are necessary to meet the objectives. We therefore support the IASB's move in this direction, but would encourage the Board to go further and to consider deleting detailed mandatory disclosure requirements. We are not sure that to date disclosure objectives have achieved the intended effect as companies tend to provide the same detailed disclosures, in accordance with whatever guidance may be available, rather than develop their own entity-specific disclosures. This uniformity may be considered helpful by some users, but if the intention is to achieve more entity-specific disclosures, it seems that a change in attitude will be needed – among preparers, auditors and regulators (see paragraph 13 above) – as well as changes in the detailed requirements of standards. The deletion of detailed disclosure requirements should perhaps be done on a limited trial basis initially, as there may be concerns among users that it could lead to a significant deterioration in the quality of disclosures.

35. In an increasingly international accounting environment, such a change needs to be adopted internationally if it is to be effective. It would create problems for companies with multiple listings, for example, if regulators in different countries took different attitudes to the use of materiality to cut down on disclosures. There would also be a problem if regulators in different countries were to interpret disclosure objectives differently from one another, leading to what would in effect be detailed disclosure requirements that differ from country to country.

Q3.5

Some standard setters have established, or have proposed establishing, differential reporting regimes on the basis that a 'one size fits all' approach to disclosures is not appropriate. They consider that reporting requirements should be more proportionate, based on various characteristics such as entity size, or whether they relate to interim or annual financial statements.

Do you think that establishing alternative disclosure requirements is appropriate?

36. Alternative disclosure requirements already exist in various circumstances – based on size, ownership and industry. We believe that this is appropriate, and that the important consideration for companies generally is who uses their financial reporting information. Reflecting this, the primary distinction in disclosure requirements for companies generally should be whether they are privately or publicly owned (ie, with shares publicly traded). We therefore support the reduced disclosure requirements for private subsidiaries of public companies in the current reform of UK GAAP. However, within the category of private companies, it will sometimes be appropriate to make a secondary distinction between different categories of company on grounds of size.

37. In our view, industry-specific disclosure requirements in financial reporting standards should be kept to a minimum, as it is easy for the process of developing special standards for specific industries to get out of hand. With this in mind, we believe it is important that standard setters are not unduly influenced by concerns for a particular sector (such as banking) when establishing disclosure requirements for general purpose financial statements. In some industries, specific additional disclosures may well be appropriate and agreed with users, but this should take place outside the standard-setting process. We would encourage such private sector initiatives, which can often deal with issues in a more timely way than is possible for mandatory standards.

Q4.1

Chapter 4 discusses the application of materiality to disclosures. Currently IFRS state that an entity does not need to disclose information that is not material.

Do you think that a Disclosure Framework should reinforce the application of materiality, for instance with a statement that states that immaterial information could reduce the understandability and relevance of disclosures?

38. We are not convinced that reinforcing the application of materiality in this way would have much of an effect in practice. Once again, the key change required is probably a change of attitudes – among preparers, auditors and regulators.

Q4.2

Chapter 4 also includes proposed guidance to assist in the application of materiality.

Do you think that a Disclosure Framework should include guidance for applying materiality? If you disagree, please provide your reasoning.

39. It would be helpful for the IASB's conceptual framework to expand on the single paragraph on materiality that it currently contains, but we do not expect this to make a significant difference to practice for the reasons given above. It will be important, though, that any IASB guidance on materiality should take account of regulators' views, as it will be ineffective if enforcement agencies take a different view from the IASB guidance.

Q4.3

Is the description of the approach clear enough to be useful to improving the application of materiality? If not, what points are unclear or what alternatives would you suggest?

40. We have no further comments on this point.

Q5.1

Chapter 5 includes proposals for improving the way disclosures are communicated and organised.

Would the proposed communication principles improve the effectiveness of disclosures in the notes? What other possibilities should be considered?

41. We welcome the discussion paper's proposals for improving the way disclosures are communicated and organised, but for such improvements to be fully effective they need to be applied to the annual report as a whole, not just to the notes to the financial statements. The discussion paper refers to the use of technology to improve communication (Chapter 5, paragraphs 43-47), and we believe that this should be explored further, both in terms of putting online some of the information that is currently in printed reports, and using technology to make what is online more accessible (see paragraph 15 above).

Q5.2

Do any of the suggested methods of organising the notes improve the effectiveness of disclosures? Are there different ways to organise the disclosures that you would support?

42. As stated above (paragraph 27), we believe that it is helpful to many users for notes to follow a predictable order, as proposed in IAS 1, though there is a need for flexibility in the application of any approach of this sort. We would not, therefore, agree with any requirement that the notes should be set out in order of priority (Chapter 5, paragraph 34-37), which would mean that their order would change significantly from year to year and from one company to another.

43. Accounting policies notes were introduced at a time when mandatory accounting requirements were relatively slight, and companies were able to make extensive choices as to how to account for items and transactions. Accounting choices have now been narrowed down by accounting standards, and as a result a good deal of the information in accounting policies notes is effectively boilerplate. We suggest that, while statements of accounting policies should still be available in full on companies' websites, in printed reports there should be a statement that the company has complied with applicable IFRS (or whatever standards are applicable), and that accounting policies on particular items or transactions should only be disclosed to the extent that they provide information on management judgements and choices. It would also be helpful if they appeared with the items to which they related or were at least cross referenced to these items. As accounting policies change, safeguards would be needed to ensure that users can easily and accurately access the accounting policies that apply to the particular financial statements that they are interested in. But we believe that this can be more effectively achieved when they are not presented with many pages of what often amounts to boilerplate policy disclosure.

44. We believe that in the UK it is the insistence of the Financial Reporting Review Panel on the inclusion of a full set of accounting policies notes in the financial statements that prevents adoption of the approach we have suggested. It would be helpful if the Panel could reconsider this policy, which may be based on old legal advice that is not necessarily applicable to accounts prepared in accordance with IFRS.

Q6.1

Are there any other issues that you think need to be addressed to improve the quality of information reported in the notes to the financial statements? Please explain how you think these issues should be addressed and by whom.

45. We have no further comments.

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