



Response to the FRC Discussion Paper Thinking about disclosures in a broader context

31 January 2013

INTRODUCTION

ICAS welcomes the opportunity to comment on the FRC's Discussion Paper, 'Thinking about disclosures in a broader context'.

The ICAS Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

The ICAS Corporate Reporting Task Force and Accounting Standards Committee have considered the Discussion Paper and I am pleased to forward their comments.

Any enquiries should be addressed to Ann Buttery, Assistant Director, Technical Policy and Secretary to the Corporate Reporting Task Force and Accounting Standards Committee.

RESPONSE TO THE DISCUSSION PAPER

GENERAL COMMENTS

The FRC's concerns about the complexity and lack of relevance of today's annual financial reports are very valid. Extensive disclosure requirements lead to annual financial reports which are incredibly complex and often difficult to read, with a risk that key messages become lost. The task at hand is to align the disclosure requirements from different standard setters, regulators and governments. This will reduce complexity, aid clarity of message and improve the general quality of communication to users.

Any disclosure framework should be built upon a clear understanding of what users of the annual financial report actually want and need. Guidance on materiality is important to help preparers apply the disclosure framework once it is developed.

A reduction in the level of detailed disclosure requirements would lead to the exercise of greater judgement by preparers and auditors as to what is important for each entity at the relevant point in time.

The ICAS vision of corporate reporting, as outlined in its publication 'Making Corporate Reports Relevant', is a short form integrated report replacing the current annual report as the key communication document for the majority of users. This readable and concise document would tell the story of the business. It would summarise the key aspects of performance and prospects with the necessary detailed disclosures, such as the full financial statements, governance statements and sustainability reports, remaining available to the user and easily searchable on the company's website. We therefore support the work of the International Integrated Reporting Council (IIRC) in its development of a more holistic summary report which would describe the strategy, business model and performance of a business.

KEY COMMENTS

- We believe the first question should be "who are the users?"
- We believe that materiality is key. As such, 'all and only material information' should be presented in the notes. For a material line item in the financial statements, each relevant piece of information should be considered, but only information which is material should be disclosed. Unnecessary or immaterial information should be excluded, thereby enhancing the usefulness and accessibility of the financial statements, and enabling users to focus on what is important. However, materiality should be assessed in both quantitative and qualitative terms in order to give a 'true and fair view'.

- We disagree with the placement criteria in that we consider that information regarding unrecognised amounts, such as material non-adjusting post balance sheet events, should be disclosed in the notes to the financial statements, rather than within the management commentary. These are events which can fundamentally influence the economic decisions of users, and therefore should be disclosed within the notes in order that the financial statements are 'complete' in giving a 'true and fair view' or 'fair presentation'.
- We agree that disclosures within the financial report should help 'tell the story' about the performance, position and prospects of the entity.
- We believe that the organisation of the annual report should be constructed in such a way that users should be able to follow its logic.

RESPONSE TO DISCUSSION PAPER 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?

In our view the most important question, and the question that should come before all others, is "who are the users?"

For example, the ICAS/NZICA publication 'Losing the Excess Baggage' considered the IASB 'Conceptual Framework for Financial Reporting' which states that "the objective of general purpose financial statements is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity."

The publication noted that those are the 'primary users', however it also recognised that they are principally private sector entities, and with IFRS being used by the public sector in a number of jurisdictions, the primary users of an entity's financial statements could be a wider grouping than investors, lenders and other creditors.

However, it also specifically notes the Conceptual Framework statement that general purpose financial reports are not primarily directed to other groups, such as regulators and members of the general public.

Once the users have been identified, the other questions can then be addressed.

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

The second question might be, "is it possible to meet all the needs of all users?"

We agree that different groups including, for example, investors, preparers, and auditors, have different views on what information needs to be provided; however, disclosures cannot provide all the information that the primary users need. 'Losing the Excess Baggage' noted that disclosures in financial reporting need to be considered in the context of meeting the needs of the maximum number of primary users.

In our view, information should be provided to help the primary users to assess the performance and position of the entity and its prospects for future cash inflows. To do so, they need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management, and board, have discharged their responsibilities in the use of the entity's resources.

Standard setters will need to consider if the standards they issue genuinely meet the needs of the primary users.

We note that the discussion paper has adopted a 'user needs' approach, however it could also be debated whether financial reporting needs to provide a database of raw information that allows users' models to best predict, for example, future earnings, or information which facilitates the users' personal judgements.

People have bounded rationality, and cognitive biases, whereas models are more objective. Consideration should therefore be given as to whether the information that is provided is that which users say they want, versus that which standard setters believe users *should* have, in order to make the best decisions.

However, we would like to clarify that financial statements should still be considered to be useful in their own right, and not simply a vehicle which provides a database of information for users.

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?*

We note that the 'financial report' is normally considered to be simply the financial statements and notes. However, the definition of 'financial report' in this context is broader covering the whole of the annual report, including Management Commentary and Corporate Governance.

It should also be considered how this definition would fit with 'Integrated Reporting' which seeks to develop a report integrating the business model, strategy and performance of a business with its economic, social and environmental context.

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

We believe that placement and presentation should be strongly influenced by what users find most useful and by ease of communication and understanding. The framework should try to avoid rigid application of placement and presentation as this can add to complexity.

As such, the organisation of the financial report should be constructed in such a way that users should be able to follow the logic.

However, whilst we broadly agree with the placement criteria suggested, we believe that unrecognised amounts including, for example, non-adjusting post balance sheet events should be explained in the relevant notes in the financial statements, rather than in the management commentary, in order to give a 'true and fair view' or 'fair presentation'.

We also note the following:

- The information disclosed in the financial statements on risk should be based upon what would give a true and fair view, or 'fair presentation,' and that reliance should be placed on management judgement. We accept that most disclosures on risk will continue to be made outside the financial statement section of the annual report.
- We support the inclusion of a summary, immediately after the accounting policies, giving details of the significant judgements applied. Such disclosures are critical to the effective operation of a principles based financial reporting framework. These could be cross-referenced to specific notes to the financial statements.
- We believe the order of the notes should be logical, linking to the order of the items contained in the primary statements themselves, with disclosures of a fundamental or pervasive nature appearing near the front.
- We support standard accounting policies being included in an appendix, or on the entity's website, with only policies which have changed, and the effects of those changes, being disclosed within the financial statements.

We also believe that, as far as possible, disclosures should not be duplicated within a single set of financial statements and, whilst placement criteria might go some way to reducing the level of disclosures, we consider that our approach in 'Losing the Excess Baggage', of removing the disclosures considered unnecessary, would be more effective.

We also believe that improvements in this area will develop in line with the continuing advances in technology.

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

We believe that standard setters should amend their practice of mandating detailed disclosures and refer to the recommendations made in 'Losing the Excess Baggage', which considered materiality to be key.

In particular, we would encourage standard setters to write disclosure requirements in a less granular and more principles based way, which allows management more discretion in deciding which information is material and should therefore be disclosed. Our 'Losing the Excess Baggage' report demonstrates this in its suggested changes to disclosure requirements in specific standards.

We do not believe that establishing alternative disclosure requirements in full IFRS is appropriate. A listed company has certain reporting requirements that should not be subject to size thresholds. If the information disclosed is based on the breadth and complexity of the activities of the company and a proper assessment of users' needs and materiality is applied, then proportionate disclosure should follow.

We specifically support the '*IFRS for SMEs*' as a separate accounting regime for non-public entities.

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

'Losing the Excess Baggage', considered materiality to be key. In accordance with the IASB's Conceptual Framework, each disclosure should pass the test of being 'capable of making a difference' to users' decisions.

As such, we believe that 'all and only material information' should be presented in the notes. For a material line item in the financial statements, each relevant piece of information should be considered, but only information which is material should be disclosed. Unnecessary or immaterial information should be excluded, thereby enhancing the usefulness and accessibility of the financial statements.

However, materiality is not just a matter of amount, it also relates to the nature of the item. For example, a line item may be quantitatively very small however it might be material because of the risks associated with it – an example being derivative contracts. The information disclosed in the financial statements should be based upon what would give a true and fair view, or 'fair presentation', of the financial position, performance and cashflows of an entity. Materiality has quantitative and qualitative aspects which both need to be considered in order to ensure that the overarching principle of 'true and fair' is achieved.

We agree that the IASB should draft appropriate supporting guidance for application of its definition of materiality in the Conceptual Framework, and also that the IASB should liaise with the IAASB on this to secure a consistent approach in auditing standards.

We also agree that a clearer definition, and more consistent usage, of the different terms in relation to materiality is required. However, any descriptor term which is used should be defined – as “materiality” itself is defined. In our ‘Losing the Excess Baggage’ work we considered this matter and, given the pervasive nature of the “materiality” definition, found it very difficult to devise a workable definition for any other descriptor. We anticipate that this may also be an issue in developing criteria for determining the content of the management commentary in annual reports and in integrated reports.

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

The ICAS research publication ‘Business Reporting; The Inevitable Change’ (published 1999) noted that there are four categories of disclosure choices available to preparers:

- Mandatory public disclosures (boundary defined by regulation)
- Voluntary public disclosures (boundary defined by the company)
- Selected private disclosures from company meetings with analysts and major investors, one-to-one meetings and site visits
- Undisclosed private information

‘Losing the excess baggage’ sought to delete ‘encouraged’ disclosures –noting that if disclosure is always thought to be needed it should be specifically required, and that, beyond this, management should decide what further information is disclosed based on considerations of materiality. We believe that there should be some discussion in the framework of mandatory and voluntary disclosures.