Ms Jenny Carter
Financial Reporting Council
5th Floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

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Dear Ms Carter

Request for comments on 'Cutting clutter'

We have pleasure in responding to the FRC's discussion paper entitled *'Cutting clutter'*.

Overview

We strongly support the FRC's efforts to improve the quality of companies' reporting and to reduce clutter in annual reports as part of that broader objective.

We agree with the main observations of the discussion paper:

- There is substantial scope for segregating standing data, either to a separate section of the annual report or to the company's web site (subject to the latter being permissible in law).
- Immaterial disclosures are unhelpful and should not be provided.
- The barriers to reducing clutter are mainly behavioural.
- There should be continued debate about what materiality means from a disclosure perspective.

It is important for the efficient operation of our capital markets that corporate reports do not contain unnecessary information. But it is just as important that useful information is presented in a coherent way so that users can find what they are looking for and gain an understanding of the company's business and the opportunities, risks and constraints that it faces.

Corporate reporting should be driven by users' information requirements; any information not required by users yet provided in the annual report is clutter. Identifying the target audience for the annual report as a whole, or for its constituent elements, is crucial in determining the appropriate content. As stated in our response to the FRC's discussion paper, *'Louder than words'*, we view the primary purpose of the annual report to be to provide shareholders and investors with information that is useful in making their investment decisions and in assessing management's stewardship. Other avenues of communication should be used to provide information required by other stakeholders outside of this purpose. We therefore support the FRC's efforts to encourage regulators and standard setters to consider how they ensure that future changes to reporting requirements do not increase clutter and that there is a clear understanding of what is necessary to be reported rather than just nice to have.

Encouraging an environment of innovation in corporate reporting is important and can yield improvements in the way companies communicate with their shareholders and investors. However, such innovation should have at its core clearer, more transparent and more cohesive reporting that improves the understanding of a company's business and financial performance and facilitates more efficient and effective analysis of the business as an investment proposition. As noted in our response to the FRC's consultation on '*Effective company stewardship*', we support the establishment of a 'financial reporting lab' where innovations in corporate reporting can be developed and tested. We believe that the lab will provide important evidence that the FRC and other stakeholders, including those on the global stage such as the IASB, can use to improve the form and content of annual reports. We are pleased to see the FRC driving this initiative forward with a view to using the evidence it gathers to continue to play a leading role in shaping corporate reporting.

Navigating the annual report

The length of the annual report is not, in our view, the main problem: it is not the volume of disclosure that matters but its quality and the way it is organised. In the main, users complain not about the length of the annual report but about finding it hard to access the information they need. The inclusion of immaterial disclosures will usually make this problem worse but, in a well organised, integrated annual report, users will often be able to bypass much of the information they consider unimportant. The ability to bypass unimportant information is particularly feasible for those using online reports - where users can 'click' from one web page to another to look at only those matters of interest to them – but even in this context it is preferable to eliminate immaterial information altogether.

In our response to '*Effective company stewardship*', we expressed our support for companies taking advantage of technological developments to increase the accessibility of the annual report and its components. Corporate reporting should keep pace with developments in communications and technology. We particularly welcome the broad encouragement to companies to make their annual reports searchable on the web. Ensuring that companies publish an easily searchable report in PDF or similar format might be the simplest and most effective step that the FRC could promote in this area. We also support the FRC in encouraging an environment of innovation, promoting the development of other tools to make corporate reporting information available to users in different media formats. However, technology cannot be used in isolation and we encourage the FRC to foster an environment in which companies are empowered in good faith to explore new ways of organising their data so as to make it easier to navigate without fear of regulatory challenge.

Clutter in the 'front half'

The growth in the length of annual reports has been driven as much by increasing volumes of narrative information in the 'front half' and the organisation thereof as it has by additional IFRS disclosure requirements for the financial statements. In addition, the length of annual reports is sometimes increased by information being provided in both the financial statements and in the 'front half' with inadequate cross-referencing between the two. We agree therefore that the focus of clutter reduction should not overlook the 'front half'.

All users need a transparent integrated annual report which sets out management's view of the business and the information it uses to plan and monitor progress against objectives. An effective annual report connects the 'front half' to the financial statements and joins together the reporting on the various aspects of the company, including the business model, objectives, strategy and the quality and sustainability of earnings. But various stakeholders have different information needs and, as stated above, the annual report should not necessarily be the vehicle for all those information requirements; the growing trend in recent years has been for annual reports to become 'all things to all men'. This has tended to spread the messages considered key by each group too thinly across the annual report such that no group is fully satisfied. We consider this to be an unfortunate and increasingly common example of clutter.

We agree that information about corporate social responsibility (CSR) should be included in the annual report only where it is relevant to the performance of the business. Frequently, as noted in the discussion paper, CSR reporting is not integrated into the annual report as a whole and it is unclear how the activities outlined in these statements are relevant to the company's business model, objectives, strategy and performance. Isolated CSR reporting will not make the connection between CSR matters and the development, performance and position of the company's business and, arguably, will not satisfy the requirements of section 417 of the Companies Act 2006. If that is the case, it is arguable that such disclosures would be clutter.

The CSR is not the only element of the 'front half' which could benefit from the elimination of clutter. We are pleased to see that that Governance reporting is one of the areas identified for attention by the FRC. Remuneration reporting is another area where removal of clutter would be beneficial. We encourage the FRC to work with BIS in re-examining the disclosure requirements as part of the current consultation on the future of narrative reporting. With this in mind, we draw your attention to the recommendations in our joint Report Leadership publication with CIMA and Radley Yeldar, *'Executive remuneration: Simple, practical proposals for better practice in reporting executive reward'.*

Barriers to reducing clutter

Materiality

We agree that preparers, auditors, regulators and users should continue to debate what materiality means in the context of disclosure.

As previously noted, in our response to *'Louder than words'* we agree with making it clear that non-material disclosures are not required. However, the assessment of what is material can be highly judgemental and can vary from user to user. In view of the behavioural barriers described in the discussion paper, we believe the FRC can continue to provide valuable leadership, for example if the Financial Reporting Review Panel (FRRP) were to include in its specific and generic communications examples of disclosure that it considers excessive. The disclosure aids in the discussion paper are a helpful start.

We note the discussion paper's contention that accounting manuals and illustrative financial statements address all disclosure eventualities and therefore tend to promote disclosure of immaterial amounts. We believe it is inherent in these tools that they include all possible disclosures that could be material. Most users of these tools will be aware that the disclosure requirements apply only to material items, but we accept that they should, where appropriate, state that fact explicitly. We will include such a statement in future versions of our own illustrative financial statements, but we doubt whether this will have much impact on the volume of disclosure in absence of actions to tackle the behavioural barriers discussed below.

Behavioural barriers

We agree that there are behavioural barriers to reducing clutter. Companies have a tendency to repeat disclosures because they were there last year. A new disclosure requirement in an accounting standard will usually create an additional disclosure in a company's financial statements unless the amounts involved are clearly trivial.

Generally, change is welcomed, or at least not resisted, when it bears no risk and there is little or no cost involved. Removing disclosures is perceived as creating a risk of adverse comment and, more importantly, regulatory challenge. Disclosure is the safest option and is therefore often the default position. Preparers and auditors may be reluctant to change from the current position unless the risk of regulatory challenge is reduced.

Breaking down this barrier will require all affected parties to have a common mindset. The FRC's 'financial reporting lab' has the potential to help in achieving this objective by bringing stakeholders together in a safe environment to seek consensus on what is and what is not important.

We would expect that, with leadership from the FRC, companies can be persuaded to look at their disclosures and identify those that are potentially immaterial. The difficulty will come when directors have to make the decision as to whether to omit those disclosures from their financial statements altogether. Unless regulators and standard setters are of the same mindset as regards excluding immaterial disclosures, and communicate their thinking to the business community, we suspect that directors and auditors will continue to take the safe option and continue to disclose.

Legal barriers

We note that the disclosure of certain standing data on a company's web site (as opposed to in the financial statements or in an appendix) would require changes in UK company law and, in some cases, EU company law. We welcome this month's BIS consultation on the future of narrative reporting and the proposal to present online the detailed content of the annual directors' statement. We urge the FRC to liaise with BIS to deliver any necessary change to UK law and to determine what is feasible and sensible in relation to seeking change in EU law.

Disclosure aids

Corporate governance

We support the proposal in the disclosure aid to put only company-specific messages in the governance statement with generic and longstanding process information being provided in an appendix and, once permitted, on the company's web site. These proposals are consistent with our upcoming joint publication with CIMA and Radley Yeldar, *'Report Leadership – simple, practical proposals for better reporting of corporate governance'*. This publication also contains illustrative examples of how companies could report on the key areas suggested in the disclosure aid.

The disclosure aid refers to the UK Corporate Governance Code having a number of disclosure requirements which could be satisfied in an appendix; however it does not state that the FSA's Listing Rules also require that the corporate governance statement describes how the main principles of the Code have been applied. We suggest that this is also included in the appendix (or on the company's web site, if permitted) and the above mentioned publication gives an example of how this might be achieved.

Accounting policies

We agree that it is desirable that accounting policy disclosure should focus on those policies that are significant in terms of the company's operations and are:

- different from those adopted previously; or
- selected from various options permitted by accounting standards.

It is not the length of the accounting policies disclosure that is itself problematic, but the fact that new or amended policies can be obscured in a long note running over several pages. A further problem is that accounting policy disclosure is often 'boilerplate', providing little specific detail of how companies apply their general policies to particular transactions.

We agree that specific identification of those policies that are new or changed would be an improvement on current practice. We also agree that it might be helpful to describe those accounting policies that have not changed elsewhere in the annual report (whilst remaining within the scope of the audited financial statements) or, with regulatory change, on the company's web site. We note that the New Zealand Institute of Chartered Accountants and the Institute of Chartered Accountants of Scotland made a similar recommendation in their recent report, *'Losing the excess baggage – reducing disclosures in financial statements to what's important'*.

Even in the absence of regulatory change, it could be argued that accounting standards only require disclosure of changed or selected accounting policies. IFRS requires disclosure of 'significant accounting policies' (IAS 1 para 117) while UK GAAP requires disclosure of *"…each of the accounting policies that is material…"* (FRS 18 para 55(a)). In other words, neither IFRS nor UK GAAP require disclosure of insignificant or immaterial accounting policies. Omissions in financial statements are material only if they could, individually or collectively, influence the economic decisions that users make. So the question is: would the omission of an accounting policy that is, for example, prescribed by an accounting standard affect the economic decisions of users? In many cases, it would not. Of far greater importance is the disclosure of the judgements made in selecting the accounting policies, especially where a choice is available.

However, we believe that the fear of regulatory challenge will continue to lead companies towards disclosing long descriptions of accounting policies within the financial statements. The cautious approach of UK companies is not surprising given that the FRRP has, in the past, objected to non-disclosure of accounting policies that merely repeat requirements of accounting standards (PN03 28/1/92). If companies are to be encouraged to re-think their disclosure of accounting policies, the FRC might helpfully provide comment on that press release and on where the boundaries lie for those companies that may wish to experiment with their reporting.

Share-based payment

We agree with the central theme of the disclosure aid; that disclosure of non-material schemes should be omitted from the financial statements. But share-based payment can be a sensitive issue, particularly when connected to key management personnel, and companies may wish to disclose additional information for other reasons.

Scope of the project

Although not explicitly stated, the discussion paper is aimed at publicly accountable entities. Consideration should also be given to the information needs of shareholders and investors in non-quoted companies. Many of these will be UK GAAP reporters and their ability to reduce clutter may be constrained by legislation that does not apply to IFRS reporters. As the ASB is currently considering the future of UK GAAP, the FRC should contribute to this debate in a broader sense regarding the overall form and content of annual reports produced by entities that are not publicly accountable.

Audit implications

In our response to *'Effective company stewardship'* we recommended that efforts should continue to comprehensively re-examine the whole corporate reporting model and consider how that model, assembled piecemeal over time, can be made more effective and streamlined. This re-examination should be demand-driven and guided by what investors need. It might involve re-calibrating the audit model, to respond to new demands and to recognise the growing importance of narrative reporting.

We recently published a survey of the views of leading investment professionals in the UK, '*Audit today and tomorrow*', which includes some suggestions about how the assurance model might evolve to underpin a broader data set in the future (for example, more assurance over non-GAAP quantitative performance measures and industry metrics).

A reassessment of the whole model will take time and may necessitate changes to law and other requirements. In the meantime, any changes to the method of delivery of information currently included in annual reports or its presentation will have an impact on the audit. For example, if standing information is taken out of the annual report and included on the company's web site, consideration should be given as to whether and if so how this information is to be audited. There is also the related question of how companies and their auditors should identify the information that has been audited and distinguish it from that which has not.

What happens next?

We support the FRC's intention to work with the Government on its proposals to simplify narrative reporting to make it clearer and more focused. We also welcome the FRC's plan to hold a meeting with interested parties in the autumn so that views can be shared, progress discussed and good practice showcased. We would very much like to be involved in that debate.

The objective of improving the quality of reporting is not unique to the UK. The IASB has recently issued a request for views regarding its forward agenda in which it acknowledges that stakeholders have said that disclosure requirements are too voluminous and not always focused in the right areas.

Through its establishment of a 'financial reporting lab', the FRC will be in an excellent position to provide evidence to influence the IASB and have an important voice in this global debate.

If you would like to discuss any of these points in more detail, please contact Peter Holgate (020 7213 5675) or Peter Hogarth (020 7213 1654).

Yours sincerely

PricewaterhouseCoopers LLP