

City of London Law Society Company Law Committee response to the Financial Reporting Council's paper on "Cutting Clutter – Combating clutter in annual reports"

The City of London Law Society ("CLLS") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees and in this case the response has been prepared by a working party of the CLLS Company Law Committee comprising senior and specialist corporate lawyers.

We welcome the opportunity to comment on the FRC's consultation paper, *Cutting Clutter - combating clutter in annual reports*. Please note that in doing so we have not taken account of the proposals made in the BIS consultation, *The Future of Narrative Reporting*, issued on 19 September 2011.

We first make some general points on the paper and then comment on its three recommendations.

General Points

1. We think it important to start by considering the purpose of the annual report and the users for whom it is prepared. It fulfils a statutory requirement for a company to prepare such a report; it acts as a reference document for shareholders and potential investors, for analysts and the public; and it may also include, on a voluntary basis, additional material which a company wishes to communicate to other stakeholders (such as CSR reports). Each purpose will make different demands on the report and those who prepare it.
2. Much in an annual report that may be regarded as clutter is required to be there to comply with law, regulation or accounting standards. The preparers of reports do not have a discretion to exclude such material or to include it in a document or website which is not part of the annual report. Such changes can only be made by legislators, regulators and accounting standard setters and we note that large parts of the FRC paper is effectively addressed to them.

3. The annual report has for a number of years been used as a repository for an ever increasing number of disclosures which government or regulators deem necessary. Even in a period when it is generally recognised that annual reports are over-long and increasingly opaque, new disclosures are still being added – for example, the requirement in the FRC's 2010 UK Corporate Governance Code for discussion of a company's business model; the proposed disclosures on gender diversity from the Davies Report and the FRC; the proposed disclosures on the audit process in the FRC's 2010 *Effective Company Stewardship* consultation and its proposed expanded audit report commenting on the completeness of the audit committee report. Each such disclosure may have merit in itself, but collectively they do not lead to a clutter-free document.
4. The annual reports of some UK companies may need to comply with regulation in other jurisdictions and efforts to cut clutter may be constrained by those additional requirements.
5. We would also note that a company must treat all of its shareholders equally in the provision of information. All shareholders have the right to receive the same information about the company at the same time, and it is for each shareholder to decide whether they wish to make use of that information. It is not for a company to pre-empt a shareholder's rights in this regard by withholding the information.
6. We understand that some companies no longer produce summary reports or abridged annual reviews because of the increased use of electronic communications. The use of such communications does not, however, appear to have had any effect in reducing clutter or the length of reports.

Recommendation 1 – three calls for action

7. The paper recommends three calls for action (summarised on pages 10-11 and explored further in pages 20-29). These appear to be medium to long-term aims, in contrast to steps which might be taken now. We respond to these below.
8. **Encourage continuing debate on materiality**
 - 8.1 The paper identifies a lack of clarity as to what is meant by materiality. Because of that lack of clarity, it is said, disclosures are being made which are not material, and such immaterial disclosures are defined as clutter which obscures more relevant information. We agree that, as a general principle, it should not be necessary to disclose information which is not material.
 - 8.2 The paper rightly identifies a problem in the multiplicity of terms used in legislation and regulation to describe materiality, often with no guidance as to what each term means. More consistency in the terms used would be welcome, together with guidance as to what is intended by each term. It would also be of help if examples were provided as to how terms describing materiality might be interpreted in practice.
 - 8.3 It is important, however, that such guidance is not regarded as prescriptive and does not encourage a box-ticking approach or too slavish an adoption of its precepts. It should, instead, allow enough freedom for the preparers of

reports to come to their own subjective, reasoned conclusions on materiality, acting in good faith, and without fear of undue criticism or regulatory action.

- 8.4 We note that the FRC's call for action on this point seems to be largely targeted at continuing discussions with the IASB and the IAASB. Those involved in preparing reports should be included in that debate with regulators to ensure practical solutions are found to the problem of defining materiality for disclosures.
- 8.5 The paper recognises that this debate will take time to develop but says (on page 23) that "there are ways preparers can work with their auditors to agree significant reductions in disclosures, and with little or no risk of regulatory challenge". We nonetheless think it unlikely that auditors will in practice be able or willing to provide clear guidance on descriptive or non-financial disclosures.
- 8.6 There is also a limit as to what can be done without amending regulations and statute. The paper refers to "little or no risk of regulatory challenge". If there is "no risk", it will be an easy decision for the preparers of a report to exclude a disclosure; but where there is even a "little" risk of regulators or investors, often with the benefit of hindsight, challenging an omission, the obvious decision of the preparers of a report will be to include the disclosure and so avoid that risk. If regulators are serious about cutting clutter in annual reports, they need to provide much greater clarity and guidance as to the purpose of the report and of specific disclosure requirements, and as to how they judge materiality and what will be challenged and what will not.
- 8.7 The debate on materiality also needs to take account of the Listing Rules which require a company to take reasonable care to ensure that any information it notifies to a Regulated Information Service (including the Annual Report) is not misleading, false or deceptive and does not omit anything likely to affect the import of the information (Listing Rule 1.3.3R). (Note that there is no materiality test in that requirement.) The interplay with requirements of the Prospectus Rules can also be important. Guidance on how these various requirements can be satisfied without undue clutter would be helpful.

9. Investigate how to tackle longstanding explanatory material

- 9.1 The paper says the FRC believes that information in an annual report which does not change from year to year (or where the only changes are trivial) offers a significant opportunity to reduce clutter. It suggests that such material might instead appear on a company's website, although it recognises that this would require legislative change. In the meantime, the suggestion is that this information is presented separately in the report, perhaps in an appendix.
- 9.2 As a preliminary point, for such changes to be adopted by companies, it will be necessary to ensure that the current liability regime for information in an annual report is extended to cover the information wherever it appears. Section 463 of the Companies Act 2006 gives protection to directors in respect of information appearing in the Directors' Report and their Remuneration Report or which is deemed to form part of those reports. If information is to be hived off into an appendix or to a website, the same protections must apply.

- 9.3 With that qualification, we support the general intention behind these proposals, but have two additional reservations. First, explanatory information may not change from year to year but it nonetheless remains necessary to an understanding of aspects of the report and accounts. There is merit in a reader of an annual report being able to find all of this information in one place. If the reader of a hard copy report has to switch to look at a website to gain a full understanding of a point in the report, there is a risk that the report thereby becomes less accessible rather than more.
- 9.4 Second, even if the unchanging information is kept in the same document but relegated to an appendix, that may not be the best place to facilitate a quick understanding of a point. Readers of previous reports may be familiar with the issue and only need to be alerted to changes, but a new reader should not be disadvantaged by having to hunt in the small print for what remains key to a full understanding of the report. The preparers of reports will also be concerned that they present balanced and sufficiently informative disclosures and may therefore be unwilling to separate out relevant information in such an arbitrary manner.
- 9.5 We would urge legislators and regulators to move to a swift resolution of this issue so as to allow companies flexibility as to where they locate material in the best interests of all users of an annual report, and to allow them to respond to feedback from those users. If that is not possible, they should not expect the preparers of reports to find a stop gap solution which may cause as much confusion as it seeks to remedy.

10. Engage with other stakeholders around their information requests

- 10.1 This call for action appears to be addressed to the ASB itself rather than to other regulators or to companies and report preparers. We believe that the principal reason for content appearing in an annual report should be because shareholders and other stakeholders will find it of use. If that criterion is not satisfied, and there is no other compelling reason, it may be excluded. Pressure from activist stakeholders representing a minority interest to include material of concern to them, but not to others, should be resisted.
- 10.2 With different regulators, the EU and the UK government periodically requiring further content to be added to the annual report, it seems to us unlikely that a unified approach to cutting clutter can be achieved. It may be necessary for Government or a lead regulator to act as a "gatekeeper" with responsibility for coordinating, policing and ultimately deciding on new proposals for the content of annual reports.

Recommendation 2 – Address behaviours of teams preparing annual reports

11. We agree that the pressures on those preparing annual reports can lead to the inclusion of immaterial disclosures and overlong narratives. The volume of regulation governing the contents of an annual report means that its preparation is a time consuming and costly exercise. The largest listed companies may be able to devote the necessary resources to this task, but smaller companies can be constrained in what they are able to do. Pressures of time and cost understandably lead to defensive reporting and to easy options being chosen, such as repeating material from a previous year, cutting and pasting from the reports of other companies and including disclosures of marginal importance. Any easing of the regulatory burden

which allows companies to spend less time ensuring compliance with over-detailed regulations will allow them to think harder about making their annual reports more accessible, clear and relevant.

12. The behavioural aids on pages 18 to 19 may be of some use, but we note that there is little acknowledgement that the annual report is the responsibility of the whole board and that the directors remain liable for its contents. It is the board, led by its chairman, which ought to take important initial decisions as to the tone and objectives of the report.

Recommendation 3 – Disclosure aids for common areas of clutter to be tackled now

13. The paper provides three examples of disclosure aids which may assist in cutting clutter in particular areas of the annual report.

Governance

14. The discussion on pages 26-27 of the paper concerning governance disclosures says that only 18 of the 52 provisions in the UK Corporate Governance Code require disclosures, but comments that companies seem to say much more. This is because of Listing Rule 9.8.5R which requires a company with a premium listing to include in its annual report a statement of how it has applied the Main Principles in the Code "in a manner that would enable shareholders to evaluate how the principles have been applied". (This is in addition to any explanation of why certain Code provisions have not been complied with.) There may be little change in some of the content of this statement from year to year but companies have no discretion to exclude it or to transfer it to a website.
15. The disclosure aid on pages 34-35 of the paper does not seem to take account of this Listing Rule. We agree that this is information which may more usefully appear on a website and look forward to the FRC discussing necessary changes to the Listing Rules with the UKLA.
16. Note also that the FRC, in the preface to the UK Corporate Governance Code, encourages chairmen to report personally on the role and effectiveness of the board (sections A and B of the Code), thereby giving this information more prominence rather than less. Again, it is not clear that the "Governance overview" shown in disclosure aid 1 follows this guidance.
17. The paper also discusses corporate social responsibility disclosures. Section 417, Companies Act 2006, requires certain CSR disclosures and, as noted in the paper, others are likely to follow. Any reduction or halt to the increase in the number of such disclosures is dependent on government and regulators and we encourage the FRC to pursue this point. Other information in an annual report on CSR may be included voluntarily because of pressure from shareholders or other stakeholders. We suggest that the inclusion of such non-statutory information is left to companies and interested parties to work out between themselves. If the latter make clear they do not want the information, companies will soon stop including it. A website might, in any event, be a better place for CSR reports.

Accounting policies

18. See the comments made in paragraphs 9.1 to 9.5 above.

Share-based payments

19. We agree with the principle that only material disclosures concerning share-based payments should be included, but as no indication is given in disclosure aid 3 of the size of the company it is difficult to judge how materiality has been measured.
20. In many large companies constituent parts of the total profit and loss charge for share-based payments, and indeed for directors' remuneration, may not be material in terms of numbers. But materiality can also be judged in terms of the interest an item may attract from shareholders, and that may differ from company to company, thereby highlighting the difficulty in seeking to impose any third party view of what is material.
21. It is difficult to see how the example envisaged in this disclosure aid could be used without legislative change (as the paper seems to acknowledge). To take just one example, the directors' remuneration report of a quoted company "must include for each director, a detailed summary of any performance conditions to which any entitlement of the director to share options or under a long term incentive scheme is subject" (*para 3(2)(a), Schedule 8, Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008*). There is no discretion there to exclude information which may, on any assessment, be immaterial. Nor is there any guidance on what constitutes an appropriately detailed summary.

Further opportunities

22. We have the following comments on a number of the areas identified as offering good opportunities to reduce clutter:
- 22.1 **CSR reporting** – see paragraph 17 above.
- 22.2 **Directors' report – other statutory information** – we agree that pure factual information (for example, the names of directors and political and charitable donations) might be included in an annual return format, though we question whether it is necessary to be prescriptive with such a requirement. Other information, such as particulars of important events affecting the company since the year end and likely future developments in the business, require good narrative reporting and would not be suitable for an annual return format. While some companies might want to put information in an appendix, they should be free to locate it where they think it would be most useful to readers, given its nature and the context of the disclosure.
- 22.3 **Financial instruments and Principal risks** – as we commented in our response to the FRC's consultation on its paper *Effective Company Stewardship*, the drafting of risk factors is an area that would benefit from a proper review by a working party of regulators, companies, their advisers and shareholders which might cover:
- best practice in risk reporting;
 - the interaction of periodic reporting of risks with prospectus risk factors;

- the reasonable boundaries of disclosures on risk mitigation;
- the reasons companies adopt defensive and boilerplate risk reporting (a proper understanding of which is necessary before effective measures can be adopted to discourage its use).

Such a review would also usefully examine the extent to which it is appropriate to draw parallels between risk management and risk disclosure for financial institutions (learning the lessons of the financial crisis) and risk management and risk disclosure by non-financial companies. We are not convinced that those parallels are self-evident and believe this needs a proper examination.

- 22.4 **Standing data** – it is suggested that where certain information is unchanged, it should be included as "standing data" and the focus should be on current or future changes. See our comments in paragraphs 9.1 to 9.5 above. Such a proposal may suit readers of past reports who already have an understanding of such processes, but not the new reader whose search for the information may be made more difficult as a result. The fact that information has not changed does not make it any less material.

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