BIN THE CLUTTER

The effects of clutter have typically come in for little consideration by the preparers of annual reports. However, the phenomenon is increasingly under discussion, with initiatives recently launched to combat it

It is unusual to think about the effects of ‘clutter’ but, increasingly, this phenomenon is being discussed. One prominent website describes clutter as follows: ‘Clutter invades your space and takes over your life. Clutter makes you disorganised, stressed, out of control. Clutter distracts you from your priorities. Clutter can stop you achieving your goals.’ This definition of clutter may not be completely applicable to annual reports, but it is possible to see certain aspects, which are applicable.

The UK’s Financial Reporting Council (FRC), among other organizations, has called for reduced ’clutter’ in annual reports. Additionally, the Institute of Chartered Accountants In Scotland (ICAS) and the New Zealand Institute of Chartered Accountants (NZICA) were commissioned by the IASB to make cuts to the disclosures within a certain group of IFRSs, and produce a report.

Clutter in annual reports is a problem, obscuring relevant information and making it more difficult for users to find the key points about the performance of the business and its prospects for long-term success. The main observations of the discussion paper published by the FRC were:

- there is substantial scope for segregating standing data, either to a separate section of the annual report (an appendix) or to the company’s website
- 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 the capital markets that annual reports do not contain unnecessary information. However, it is equally 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. A company, however, must treat all of its shareholders equally in the provision of information. 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.

A significant cause of clutter in annual reports is the vast array of requirements imposed by laws, regulations and financial reporting standards. Regulators and standard setters have a key role to play in cutting clutter both by cutting the requirements that they themselves already impose and by guarding against the imposition of unnecessary new disclosures. A listed company may have to comply with listing rules, company law, international financial reporting standards, the

corporate governance codes, and if it has an overseas listing, any local requirements, such as those of the Securities and Exchange Commission (SEC) in the US. Thus, a major source of clutter is the fact that different parties require differing disclosures for the same matter. For example, an international bank in the UK may have to disclose credit risk under IFRS 7, *Financial Instruments: Disclosures*, the Companies Acts and the Disclosure and Transparency Rules, the SEC rules and Industry Guide 3, as well as the requirements of Basel II Pillar 3. A problem is that different regulators have different audiences in mind for the requirements they impose on annual reports. Regulators attempt to reach wider ranges of actual or potential users and this can lead to a loss of focus and structure in reports.

There may a need for a proportionate approach to the disclosure requirements for small and mid-cap quoted companies that take account of the needs of their investors, as distinct from those of larger companies. This may be achieved by different means. For example, a principles-based approach to disclosures in IFRS, specific derogations from requirements in individual IFRS or the creation of an appropriately adapted local version of the *IFRS for SMEs*. Pressures of time and cost can understandably lead to defensive reporting by smaller entities and to choosing easy options, such as repeating material from a previous year, cutting and pasting from the reports of other companies and including disclosures of marginal importance.

There are behavioural barriers to reducing clutter. It may be that the threat of criticism or litigation could be a considerable limitation on the ability to cut clutter. The threat of future litigation may outweigh any benefits to be obtained from eliminating 'catch-all' disclosures. Preparers of annual reports are likely to err on the side of caution and include more detailed disclosures than are strictly necessary to avoid challenge from auditors and regulators. Removing disclosures is perceived as creating a risk of adverse comment and 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. Companies have a tendency to repeat disclosures because they were there last year.

Explanatory information may not change from year to year but it nonetheless remains necessary to an understanding of aspects of the report. 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. Even if the standing 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. A new reader may be disadvantaged by having to hunt in the small print for what remains key to a full understanding of the report.

Preparers wish to present balanced and sufficiently informative disclosures and may be unwilling to separate out relevant information in an arbitrary manner. The suggestion of relegating all information to a website assumes that all users of annual reports have access to the internet, which may not be the case. A single report may

best serve the investor, by having one reference document rather than having the information scattered across a number of delivery points.

Shareholders are increasingly unhappy with the substantial increase in the length of reports that has occurred in recent years. This has not resulted in more or better information, but more confusion as to the reason for the disclosure. A review of companies' published accounts will show that large sections such as 'Statement of Directors Responsibilities' and 'Audit Committee report' are almost identical.

Materiality should be seen as the driving force of disclosure, as its very definition is based on whether an omission or misstatement could influence the decisions made by users of the financial statements. The assessment of what is material can be highly judgmental and can vary from user to user. A problem that seems to exist is that disclosures are being made because a disclosure checklist suggests it may need to be made, without assessing whether the disclosure is necessary in a company's particular circumstances. However, it is inherent in these checklists 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 often this is not stated explicitly for users.

One of the most important challenges is in the changing audiences. From its origins in reporting to shareholders, preparers now have to consider many other stakeholders including employees, unions, environmentalists, suppliers, customers, etc. The disclosures required to meet the needs of this wider audience have contributed to the increased volume of disclosure. The growth of previous initiatives on going concern, sustainability, risk, the business model and others that have been identified by regulators as 'key' has also expanded the annual report size.

The length of the annual report is not necessarily the problem but the way in which it is organised. The inclusion of 'immaterial' disclosures will usually make this problem worse but, in a well organised annual report, users will often be able to bypass much of the information they consider unimportant, especially if the report is on line. 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.

IFRS requires disclosure of 'significant accounting policies'. In other words, IFRS does not 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. In many cases, it would not. Of far greater importance is the disclosure of the judgments made in selecting the accounting policies, especially where a choice is available.

A reassessment of the whole model will take time and may necessitate changes to law and other requirements. For example, unnecessary clutter could be removed by

not requiring the disclosure of IFRS in issue but not yet effective. The disclosure seems to involve listing each new standard in existence and each amendment to a standard, including separately all those included in the annual improvements project, regardless of whether there is any impact on the entity. The note becomes a list without any apparent relevance.

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. The drive by the IASB has very much been to increase the use of disclosure to address comparability between companies and, in the short to medium term, a reduction in the volume of accounting disclosures does not look feasible although this is an area to be considered by the IASB for its post 2012 agenda.

Written by a member of the Paper P2 examining team