The City of London Law Society

4 College Hill
London EC4R 2RB

Tel +44 (0)20 7329 2173
Fax +44 (0)20 7329 2190
DX 98936 – Cheapside 2

mail@citysolicitors.org.uk

www.citysolicitors.org.uk

City of London Law Society Company Law Committee response to the Financial Reporting Council's discussion paper, *'Thinking about disclosures in a broader context'*

The City of London Law Society ("CLLS") represents approximately 15,000 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 19 specialist committees. This response in respect of the FRC's discussion paper, *'Thinking about disclosures in a broader context'* has been prepared by the CLLS Company Law Committee.

Introduction

We welcome the FRC's initiative in promoting discussion regarding a disclosure framework. In particular, we see significant benefits from a framework that will guide standard setters and regulators with a view to ensuring that obligations on preparers are consistent ("joined up"). The challenges of reaching agreement on a framework that will have validity and be useful across the range of contexts in which financial reporting operates should not be underestimated. As noted below ("Objective of financial reporting"), the legal framework within which disclosure obligations arise in the UK (Companies Act, Listing Rules, Disclosure and Transparency Rules, Corporate Governance Code) is complex, and each of these sources of requirements has differing objectives and standards. It will also be relevant to understand how a framework for disclosure in financial reporting would relate to prospectus disclosure. A coherent framework that recognises the different objectives and contexts of different types of reporting would be a useful step forward.

Your initiative comes at a time of change in the regulatory/legal environment in the UK, following a debate that has made clear the importance of high quality financial reporting as part of the drive for more corporate decision-making based on long-term considerations. That debate has examined the manner of reporting as well as the content. In particular, we note the enthusiasm of some users to have "reporting by exception" in some areas, with unchanging information published in a different form (e.g. on the preparer's website). We suggest that in seeking to establish a disclosure framework, it will be helpful if there is clarity over the interaction between content and manner of publication.

We have found it easier to provide comments on the different themes that emerge in the Discussion Paper rather than to respond to the specific questions. Where we have not commented, we agree with the comments in the Discussion Paper.

What is financial reporting?

We are not convinced that the distinction between corporate reporting and financial reporting is as clear as it is presented here. We would note that the obligations on preparers (if they are issuers of listed or other traded securities) to avoid selective disclosure of material information means that "corporate reporting" of financial information (e.g. in analysts' presentations) should only involve the communication of the information contained in the financial report and there should not be any material difference between the content of a company's corporate reporting and its financial reporting. In addition, financial reporting has a narrative element which can overlap with corporate reporting. As a result, the disclosure framework for financial reporting will have a direct bearing on "corporate reporting". We understand the concept of "corporate reporting" in the Discussion Paper to cover all communications by a company aimed at users; that is a broader meaning than we think is encompassed by the expression when used in the FRC's "mission statement" (as set out on the inside front cover of the Discussion Paper) and it might be helpful if a different term was used (perhaps "corporate financial communications").

Objective of financial reporting

Page 14 of the Discussion Paper identifies the purpose of financial reporting as being *"providing investors with information that is useful for making their resource allocation decisions and assessing management's stewardship"*. Page 7 of the Discussion Paper notes that *"disclosures that do not meet the objective of financial reporting should be excluded from the financial report"*. We would note that for UK companies there is an important distinction between the annual report and accounts produced in accordance with the Companies Act and the annual report required by the Disclosure and Transparency Rules. While a single report generally performs both functions, the purpose of each is different. The Companies Act annual report is to existing shareholders for the purpose of assessing management's stewardship while the annual report and interim reports required under the Disclosure and Transparency Rules are required for investors making their resource allocation decisions. A preliminary statement may be produced but is not required. If it is produced, its contents are regulated by the Listing Rules (see our comments below on Appendix B. These distinctions are important in the UK for determining potential liabilities (for companies, management and auditors) and we think it is important to ensure that the distinctions are not lost in the disclosure framework.

Appendix A proposes a different statement of the objective of disclosure. We agree that a disclosure framework should include a clear statement of the objective but we do not agree with the statement suggested. Specifically, we find the exclusion of information that is "generally known" from the scope of the objective is unhelpful. Financial report disclosure (and in particular the management commentary) will often have to include information that is "generally known" in order to give a true and fair view (required by the Companies Act) and to be "fair, balanced and understandable" (adopting the current Corporate Governance Code standard). We also note the statement has no reference to strategy or to prospects. These

are essential components of narrative reporting for UK companies and it would be surprising if the statement of the purpose of disclosure in the framework did not include them.

Content principles

We endorse the first principle for the content of disclosure, which requires the disclosure of information that provides *"context for understanding the performance position and development of the entity"*. But we note that in relation to the management commentary the principle is expressed differently elsewhere (e.g. on pages 16 and 21) as being to provide *"context for understanding the financial statements"*. We prefer the former and think the latter too limited.

Corporate governance

We disagree with the comment (on page 17) that corporate governance disclosures provide "information about the responsibilities of the board". We suggest that the scope of the corporate governance disclosure could be expressed as "information about the organisation of the board and its activities in discharging its responsibilities for governance".

The suggested content of the corporate governance report (on page 17) seems right to us although we question whether "related party disclosures" fits within this section (see the discussion on this below).

Non-financial information

We agree that there is a need for a debate about the types of non-financial information that users need to be included in the financial report. We think this debate is closely linked to the question of who is a "user" for this purpose.

Placement

We offer three comments in relation to the discussion of "placement". The first is to observe that one of the reasons for placing disclosures in different parts of the report is to assist in defining the information that is to be covered by external assurance and the nature of that assurance (see for example the different assurance standard required by the Companies Act to be provided by auditors in relation to the financial statements and the narrative report). The second is to suggest that it is also important to allow flexibility to ensure that preparers can decide where information may most effectively be disclosed. The third is that issuers may wish or need to include information in more than one place to ensure that a particular section is complete and not misleading or to avoid cross-references to another section of the report. Some users will only look at particular sections of the report and may prefer them to be complete in themselves.

Management commentary

We agree that there are different features of information contained in management commentary that distinguish the disclosures made there from other parts of the financial report. However, we do not see the distinction as being one of "management's view" in contrast with historical information but rather that the management commentary provides

“**explanations**” both of the historical information contained within the financial statements and of the future development of the issuer.

Risks and uncertainties

We notice that the discussion of risks and uncertainties on page 25 is focused on quantitative risk disclosures and not on the strategic or other risks with which narrative risk disclosure is concerned. It also ignores the “liability management” aspect of risk reporting as seen in US-style risk factors (and where the relationship with the prospectus regimes is important). This is an area where we expect continuing debate in the coming months and it will be important to ensure that the discussion of risk and uncertainties in the disclosure framework is consistent with conclusions reached in that debate.

Related party disclosures

While we agree that related party information is relevant to stewardship questions, it is also relevant to understanding the financial statements. This may be a case where separate disclosure of information covering similar ground is useful. The approach currently adopted of including quantitative disclosure in the notes and, if sufficiently material, an explanation within the management commentary may be the most useful to users. In addition, in some cases, the related party issues will be such that disclosure within the corporate governance report would also be appropriate.

Proportionality

We agree broadly with the approach to proportionality. In particular, the two drivers identified of relevance and cost/benefit seem to us to be correct. We would simply note, in relation to the table setting out different approaches, that there is a significant difference between narrative disclosure and financial statements. In financial statements, proportionality may be assessed simply on the basis of quantum, whereas in relation to disclosure relevance requires a broader assessment.

Materiality

We agree that there needs to be a debate regarding materiality. In particular, we would again observe that in narrative reporting (the management commentary) materiality is not simply a question of quantum. If that proposition is accepted, the discussion of the three different levels of materiality needs to be re-examined.

We agree that the ranking of different terms describing materiality reflects generally accepted usage, although we would note that the difference between “immaterial” and “insignificant” is in practice very hard to identify and wonder whether it is a useful distinction. We also note the importance of using words consistently in different requirements and would suggest that principle be included in the disclosure framework.

We are sceptical of the value of a “10-minute test” for materiality. In a complex world it does not serve users well to suggest that it is possible to provide meaningful information (e.g. for resource allocation decisions) in a 10 minute read. We would be very cautious of any suggestion that any part of the financial report must meet that standard.

The framework for disclosure obligations for listed companies incorporated under the Companies Act does not generally adopt an express standard of materiality in the same way:

- The Companies Act requirement for the business review (s 417) requires that it be "fair" and contain "a description of the principal risks and uncertainties facing the company"; it refers to a "balanced and comprehensive analysis…consistent with the size and complexity of the business" and requires explanations "to the extent necessary for an understanding"; materiality is defined in part by the purpose: "to help [members] assess how the directors have performed their duty under section 172.

- The Listing Rules and Disclosure and Transparency Rules require for all formal announcements, including preliminary announcements, that all reasonable care must be taken "to ensure that any information ….. is not misleading, false or deceptive and does not omit anything likely to affect the import of the information".

- The Disclosure and Transparency Rules requirements for annual reports adopt a similar approach to the Companies Act requirements (but without the same express purpose) but do require the disclosure of "important events" since the end of the financial year reported on.

- The requirements that apply for the prospectus regime are different again.

It will be important that a framework definition of materiality is consistent with these different requirements or that the framework leads to adoption of a general materiality standard. In the latter case there will be many different constituencies to satisfy.

Communication

We note the principle requiring disclosures to explain the substance of transactions contemplates going beyond what is required by IFRS. We think that IFRS often requires substance to be reported and not form and there is the potential for confusion if a disclosure principle in the framework suggested an obligation to go beyond the accounting treatment required by IFRS. If IFRS is considered inadequate it is IFRS that should be amended.

We note the comment (on page 43) that suggests it would be possible to require disclosures to be organised to emphasise that information can be based on which is the "most important". We are cautious about this as a mandatory standard. We see that it would give rise to many potentially difficult judgements. To take the example given of share-based payments, it is not at all clear how to judge which scheme is "the most important". Is importance in that context to be judged by reference to the amount that the CEO may earn, or the total impact of a share scheme on the share capital of the company or on some other basis?

Appendix B

We are not convinced that the review of preliminary announcements discussed in Appendix B provides an understanding of the needs of users. Generally, in our experience, preliminary announcements contain disclosures that will be published in the annual report, in the sections that comprise the "Business Review" and to that extent they reflect the requirements of the Companies Act, the Disclosure and Transparency Rules and the Corporate Governance

Code. There are two principal reasons for this approach: (i) the requirement that the preliminary announcement not be misleading, false or deceptive or omit anything likely to affect its import has the effect that any material information that will be in the annual report should be in the preliminary announcement and (ii) the annual report required by the Disclosure and Transparency Rules does not have to be published through a RIS if the management report has already been so published. Preliminary announcements do not, therefore, necessarily reflect user needs any more than does the annual report.

We also disagree with the proposition that the Listing Rules requirements are procedural. The preliminary announcement must comply with the content requirements applicable to interim reports. It must also "include any significant additional information necessary for the purpose of assessing the results being announced". There is also a general Listing Rule requirement that information must not be misleading, false, deceptive or omit anything likely to affect its import.

We suggest that a review of presentations delivered by management at the time the preliminary results are released would provide a more useful guide to user needs.

Appendix C

We do not agree with the categorisation in Appendix C of the two types of corporate governance disclosures. The first category suggests that disclosures are currently included to demonstrate compliance. We think that most disclosures are those expressly required by the Corporate Governance Code and other applicable rules (see Schedule B to the Code), including the Listing Rule requirement to include a description of how the company has applied the main principles of the Code. Within these required disclosures, some are amenable to the application of "materiality" and others are not. Accordingly, we do not find the distinction drawn between the two categories to be helpful.

We accept that the effect of the disclosure requirements is that annual reports on governance matters generally change little, as board practices and arrangements change little year by year. There may be a case therefore to limit the annual reporting to changes, with the detail included elsewhere. However, we think the disclosure framework must encompass the entirety of the disclosure.

Action points

We note the suggestion that IASB should develop the disclosure framework including providing guidance on materiality in all aspects of non-financial statements and financial reporting and provide overarching principles for disclosure. As it appears this goes further than disclosure in financial statements it will be important to understand how this framework, guidance and principles will fit with the legal and regulatory framework within which these broader disclosure obligations sit.

Questions

We have covered our views on Questions 1 to 6 above. Our response to Question 7 is to suggest that disclosures in financial reports would be improved if there was more helpful guidance on forward looking disclosures (including but not limited to profit forecasts) and this

might usefully form part of a disclosure framework. We think better forward looking disclosures would make an important contribution to the "long termism" agenda and to achieve that requires a review of the regulatory environment (in particular ensuring there is an appropriate liability regime (which ensures that preparers making such statements in good faith are not subject to liability based on hindsight judgements) and guidance that helps preparers produce useful disclosures and users to understand the limitations of those disclosures.

If you have any questions on this submission please contact William Underhill (william.underhill@slaughterandmay.com; 0207 090 3060).

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THE CITY OF LONDON LAW SOCIETY
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