ACCA

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Dear Ms Kerr

FRC discussion paper: Louder than words

ACCA (the Association of Chartered Certified Accountants) is pleased to have this opportunity to comment on this discussion paper (DP) which explores the complexity and relevance of current corporate reporting in the UK. The DP was considered by ACCA's Financial Reporting and Corporate Governance & Risk Management Committees. I am writing to give you their views.

General comments

We fully support this project and in particular commend the unique approach taken in the DP, the design and presentation of which are a welcome form of communication. It certainly adds constructively to the debate and thinking on reporting, while rekindling many previously recognised issues relating to the regulation of corporate reporting.

ACCA wholeheartedly supports the overriding sentiment of the DP and agrees that there is an overwhelming need for accounting standard setters and regulators to work together to simplify corporate reporting, both in the UK and internationally.

Complexity in financial reporting
As mentioned in the DP, ACCA conducted a survey of its international members in 2008 to investigate the main causes of complexity in financial reporting under IFRS[1]. The survey was solely aimed at preparers of annual reports and concentrated on six key areas of financial reporting which had been highlighted in the earlier phase of the FRC complexity project. Excluding the views on income tax accounting (which 69 percent of members still found complex), 90 percent of members found the other areas surveyed to be complex. Respondents acknowledged that some complexity was inherently a

[1] *ACCA Members Survey: Complexity in Financial Reporting*, ACCA, 2009

consequence of a more complex business environment but significant weighting was given to the difficulty in understanding relevant standards. With the time and monetary cost of fulfilling requirements in standards obviously a factor from a preparer perspective, there was a strong opinion that there is an element of avoidable complexity in financial reporting, which is a direct consequence of applicable accounting standards.

We agree with the DP that a fundamental restructuring of financial reporting standards is required. However, constant amendments to standards and regulations themselves exacerbate complexity for all stakeholders in the corporate reporting supply chain, so we would prefer an evolutionary restructuring and rewriting of the standards and regulations to an agreed format rather than a 'clarity' type project. The sensible approaches under the DP's principle 4 for less complex regulation of reporting provide a sound basis for clarity as and when new standards are developed or when significant amendments are considered.

IFRS are an increasingly fundamental part of the global corporate reporting landscape, and it is quite right that the DP demonstrates some of the issues of complexity through examples from IFRS. Indeed, in another major survey conducted by CFO Research Services in collaboration with ACCA[2], CFOs highlighted the fact that "the quality and depth of current reporting under IFRS are seen as needing improvement" and that IFRS were "currently used principally as a reporting tool (38 percent) and a compliance tool (29 percent)", the argument being that investors and other user groups desired better presentation and more comprehensive and in-depth analyses, among other things.

Focus on primary users
We also agree that annual reporting can be sharpened and streamlined by focusing on the primary users of financial reports. The DP appears to conclude that corporate reports should be prepared for the use of providers of capital (present and potential shareholders, lenders and other creditors) only. This is clearly consistent with the proposals made by the International Accounting Standards Board (IASB) in its 2008 exposure draft, *Objective of financial reporting and qualitative characteristics*. However, we believe that the objectives of financial reporting should also include the reporting of management's stewardship of the enterprise and a record of the performance and position for which they are accountable to the owners.

Indeed, as we noted in our response to that IASB exposure draft, undue emphasis on the provision of information which is useful as input to investing or

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[2] *A Climate of Convergence: Global Standards and the Modern Enterprise*, CFO Publishing Corp, 2008

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credit decisions is the source of much of the expansion of disclosure requirements that has rendered financial statements both lengthy and very hard to understand. It is also the source of much of the measurement complexity that has characterised recent developments in IFRS.

We therefore believe that the framework for financial reporting should have in mind a narrower primary group – equity shareholders - as there will necessarily be differences between the information needs of different capital providers.

Relevance of reporting
By keeping in mind primary users, the DP suggests that it might not be relevant to include specialist commentary on environment or employee diversity issues, for example. We believe that issues regarding sustainability and diversity reporting are increasingly important to equity shareholders as well as other users of corporate reports. Such information should therefore be provided within the broader corporate reporting framework, and where material to understanding the accounts and the business as a whole, should be included in the main annual report.

Where organisations feel additional information may be relevant to stakeholders other than the primary users of financial reports, these elements of reporting should be carefully analysed and made available independently. This will also allow the actual annual report itself to remain streamlined and focused, with that additional information available elsewhere. In this respect, businesses should look to embrace innovative methods of reporting, that enable different users to focus on areas of interest.

Clearly, many companies are using on-line reporting to enable this already, with many companies offering a range of services and reports in the 'investor relations' sections of their corporate websites. While most still tend to offer only PDF versions of the annual report itself, others offer interactive versions, which allow users to access relevant sections of the report as required. A prime example of this is the latest annual report of Commerzbank, which divides the annual report into a number of sections and sub-sections including, corporate responsibility, management reports, financial statements and additional information.

It is important for issuers to understand and fulfil the information of their wider stakeholders, but this should not be at the cost of complicating the annual reports for its primary users.

Below are our detailed responses to the specific questions raised in the DP.

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Specific points for discussion raised in the DP

1. Can the principles for less complex regulation we propose help reduce complexity? Are there other principles that should be considered?

We support the principles for less complex regulation of reporting as outlined in the DP, and believe that were they to be applied appropriately, this should result in simplified regulation.

Excessively prescriptive reporting can be costly and lead to complexity. This often results in more complex and lengthy regulations, where core principles are obscured by detailed bright lines. As well as being costly to apply, such regulation is vulnerable to financial engineering, which can lead to a vicious circle of constant amendments to those regulations and standards.

However, we believe that there is often a thin distinguishing line between principles based and rules based regulations. The DP does not fully explore what constitutes principles-based regulation (as opposed to rules based) and we believe that it is vital to ensure that this is set out from the outset.

In principle, we certainly agree that a coordinated, principles based approach to regulation and standard setting is an important factor in reducing complexity. We also fully support the DP's suggestion that while technical merit is important in setting standards and regulations, greater emphasis should be placed on 'understanding the problem being addressed' and therefore arriving at the most efficient and practicable solution.

If regulators and standard setters adhere to the principles of targeting significant problems and keeping in mind the wider objective of providing useful and readily useable decision-making information, resulting regulations should prove to be less complex. Such an approach should also ensure that a balance is struck between the needs of providing useful information to users of corporate reports, with the cost to preparers of producing that information.

2 Targeted: Is cash flow reporting in need of improvement? If so, what is the best means of achieving this improvement? Consider changes to IFRS, best practice guidance, publicity campaigns, other.

Although this question is dealing with a specific reporting area, unlike the other questions for debate, we appreciate that cash flows are vital in understanding the underlying viability and performance of a business and should therefore always be given prominence in line with the other primary statements. We do agree, however, that the current model (under IFRS) does fall short in terms of providing decision-useful information and that there is a need in principle to

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improve cash flow reporting. We therefore support additional research to investigate both what users need from cash flow reporting and also how compatible these are with requirements for internal management purposes. Recommendations on whether amendments or additional guidance is required should be based on the outcome of such a review.

The DP notes that users like to reconcile net debt, rather than opening and closing net cash. We believe that there is merit in being able to distinguish an organisation's ability to generate 'free cash' from its trading activities. We certainly believe that the cash flow statement should support the concept of 'free cash flow' by separating the operating cash flows from the results of all sorts of investing (PP&E, R&D, intangible assets). We also note in its recent discussion paper, *Preliminary views on financial statement presentation*, the IASB proposed reporting cash equivalents separately from cash. We believe that this has been a helpful treatment in UK standards, as have the additional headings used in them.

3 Proportionate: Should accounting standards and other regulations be based more on the information that management produces internally?

Clearly, for financial information to remain relevant, reliable and allow comparability between businesses, that information should be as objective as possible. However, we also firmly believe that in order to fully reflect the reality of the underlying business the information provided in corporate reports should incorporate internally used management information. This view mirrors the trend in standards, which are increasingly being based on such information.

As such, we do not believe that the question of whether information is based on that produced by management for internal purposes is necessarily a major issue in terms of adding complexity to reporting. We believe that it is optional accounting treatments in standards which results in complexity and reduced comparability, and believe that this is an issue which needs to be more pressingly considered.

4 Proportionate: Would a project on disclosures help stem the constant growth of accounting disclosure requirements? Could it also identify the most important disclosures, with a view to giving them greater prominence?

The DP calls for a project on understanding the main objectives of disclosure requirements in financial reporting. Clearly there are various uses of disclosure, but we would generally only support disclosure where it supplements the financial information in the accounts or when that information cannot otherwise be readily observed through the financial statements. We have previously raised

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our concerns to the IASB about the use of excessive disclosure requirements to mitigate concerns about the actual accounting requirements themselves.

5 Targeted and proportionate: Who are the main users of wholly-owned subsidiary accounts? Should subsidiaries be required to file audited accounts with full disclosures? Is a more simplified reporting regime more appropriate?

Other than the fact that investors may not be as interested in the separate accounts of wholly-owned subsidiary undertakings, we see no pressing argument for subsidiaries not to file audited accounts. All other user groups, such as lenders and tax authorities would be the same as for other entities, and we firmly believe that it is in the public interest for audited accounts to be filed. While we see no reason for the current requirement for subsidiaries of listed companies who prepare their group accounts in full IFRS, to also prepare their accounts in full IFRS, we do not believe that there is a strong enough case for them to have further simplified reporting. Indeed, we note that there are exemptions under UK GAAP for related party transactions and cash flow statements etc. and we believe that these are appropriate and proportionate.

6 Targeted and proportionate: Would it be desirable to eliminate the UK requirement to prepare, have audited, and file wholly-owned subsidiary accounts in the case of a parent company guarantee?

Where the parent company has offered a guarantee on behalf of a wholly-owned subsidiary, we would expect that any stakeholders would review the accounts of that parent company itself. Therefore, we would still require the preparation, audit and filing of accounts for the subsidiary, on the grounds noted in our response to Question 5, but with relief from full disclosure requirements.

7 Coordinated: Would it increase or decrease complexity if national and international regulators worked together in a more joined-up way? Is there a risk that international regulators working together might result in imported complexity for some jurisdictions? How do we mitigate this risk?

While it could be argued that it is the constant changes to regulation and standards that really cause much of the anguish for all stakeholders in the reporting supply chain, it is also clear that the abundance and various sources are burdensome. This is especially the case where there is overlap between the sources of those requirements, and the examples provided in the DP illustrate well, the need for greater coordination at the regulatory level.

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As noted in the DP, preparers tend to increasingly adopt a checklist approach to ensure compliance, and this can be at the cost of useful communication. Similarly, such an approach is increasingly being taken to assurance work, as auditors face similar regulatory demands.

We believe that coordination has to be a priority at the national level. However, with the increasing use of international standards for regulatory and financial reporting, there is a need to ensure that there is a level-playing field for organisations based in different jurisdictions – the US 20F report for UK companies issuing reports in the US is a good example of the burden of significantly differing reporting regimes.

While there are legitimate concerns about importing complexity from other regimes, we believe that internationalisation of standards on the whole does bring about simplification, through consistency.

8 Clear: Would an emphasis on delivering regulations and accounting standards in a clear, understandable way reduce complexity? How can we best move towards clearer regulations and accounting standards?

The DP notes a number of ways in which accounting standards in particular could be made clearer, both for those applying them and those interpreting the resulting information.

Articulating the desired outcome
This point is well made, and we certainly agree that many standards would be improved and become easier to understand were the desired outcome clearly stated at the beginning of the standard. The current 'objectives' sections of many standards do not do this adequately.

Plain language using well defined terms and easy to follow structure
We fully support the view that plain language wherever possible, with well defined and consistently used terms will have a significant effect on simplifying accounting standards. In ACCA's survey on complexity in financial reporting, preparers predominantly used the accounting standards themselves (as opposed to just application guidance). When asked about how complexity could be reduced in the specific areas of IFRS analysed, significant numbers pointed to 'improving the drafting of the accounting standard so it is easier to understand'.

As such, we would also fully support call for action four, to *improve usability of IFRS*, and believe that this is a realistic target. As we noted in our general comments, rather than burden stakeholders with a wholesale project of revamping existing standards, we would like to see a long term revision of standards to occur on a step by step basis, as and when major technical amendments are required.

9 Do you agree that principles for effective communication can reduce complexity in corporate reporting?

We agree that the proposed principles for effective communication in reporting can be acted upon immediately, and do not require any regulatory change. Indeed, to a large extent they represent good practice, which does not necessarily require changes to standards or regulation, and could be provided through supplementary guidance. Clearly, there is considerable benefit for users, were preparers to provide information that meets those principles and the arguments made in the DP supporting those principles are well founded.

However, it is not immediately obvious whether this will necessary reduce complexity itself – certainly from the perspective of preparers. Users would of course benefit from more focused, transparent, clear and engaging forms of reporting. However, we question how practicable it is to expect preparers to necessarily provide 'open and honest' disclosure, unless they believe it is likely to benefit them.

10 What are the barriers to more effective communication? How might these barriers be overcome?

As noted above, there is often an incentive for businesses to only provide 'good news' when communicating to outside user groups. While this can be overcome by more prescriptive requirements for narrative reporting to ensure all relevant information is presented, this can in turn simply lead to boilerplate disclosure, as businesses simply report these minimum requirements, without actually adding any decision-making value to potential users of that information.

In this respect we believe that additional research should be carried out to understand the disclosure needs of users, while assessing current requirements in financial reporting. Indeed, we note that the US Financial Accounting Standards Board (FASB) initiated a "*Disclosure Framework*" Project in July 2009, which aims to bring about more useful and consistent disclosure. We believe that the IASB and other standard setters should play an active role in this project.

11 Which of the specific sources of complexity in corporate reports noted on pages 54 to 55 warrant further action? Which organisation(s) would be best placed to assist with the necessary action?

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We agree that all of the issues raised as opportunities for further action warrant attention by standard setters. With the recent global financial crisis, it is clear that the reporting of financial instruments is a major issue. The IASB are in the process of addressing many of the related areas around financial instruments, prompted by concerns from issuing financial institutions and users of their financial statements. However, we believe that preparers from other types of organisations should also be consulted more widely in terms of how those proposed changes may impact them.

As was the case with our survey on complexity in financial reporting under IFRS (copy attached) ACCA would welcome the opportunity to assist the FRC in researching and assessing ways to improve corporate reporting. We see particular merit in pursuing projects on

- assessing user needs in relation to disclosure requirements
- choices in accounting standards
- developing the CSR agenda
- valuation of pension plans
- reliability of non-market based fair values and
- uses of parent and subsidiary accounts.

If there are any matters arising from the above which require further clarification, please contact me.

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