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Melanie Kerr
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30 October 2009

Dear Ms Kerr

Request for Comments on 'Louder than Words'

We have pleasure in responding to the FRC's discussion paper entitled 'Louder than Words'. Like the FRC, we also believe that enhancing the relevance, accessibility and understandability of the reporting model is critical to the effective working of the capital markets and the societies that rely upon them. We welcome the FRC's initiative in promoting the debate on these important matters and appreciate the opportunity that has been provided to stakeholders to provide their opinions.

The discussion paper sets out to describe principles and actions for making corporate reports less complex and more relevant. However, the focus appears to be more heavily on complexity. Whilst we do not deny the benefits of making annual reports more understandable and accounting standards less complex, the issue of relevance and the urgency with which action is required deserve at least equal attention.

> ***"...the issue of relevance and the urgency with which action is required deserve at least equal attention."***

We have included in Appendix 1 a response to the detailed questions raised in the discussion paper. We set out below certain key issues which we consider are important in assessing the findings of the FRC's study and the recommendations it has made for further action.

What is reporting trying to achieve?

As a major accounting and audit firm, we are directly impacted by the relevance and utility of the current reporting model. Our concerns about its current health stem from our knowledge of how company management and boards of directors relate to the current model, the manner in which investors use the information and the internal challenges we face in ensuring compliance with current regulations.

One of the important observations of the review is that reports currently aim to please too many types of user. The discussion paper suggests there is a need to refocus the reports on their primary purpose: providing shareholders and investors with information that is useful in making their resource allocation decisions and assessing management's stewardship. We agree with this positioning.

> ***"...there is a need to refocus the reports on their primary purpose..."***

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From our work over the past decade, we know that investors want to understand the market context in which a business operates, its strategy and how this links to key business activities, risks and performance indicators. Furthermore, they want to understand how growth is to be achieved and how this growth will be managed and funded. In understanding financial performance, they want to understand the underlying operational performance, separate from the impact of market changes and one-off events that often mask the real trend. A clear explanation of these components of business activity demands financial, non-financial and narrative information to be presented in a joined up way. Furthermore, it requires information that is both strategic and capable of presenting the big picture, but also sufficiently detailed to provide investors with the key data points they need.

> ***"A clear explanation of these components of business activity demands financial, non-financial and narrative information to be presented in a joined up way."***

Disproportionate focus on financial reporting

One of the major reasons for complexity in reporting is the disjointed way in which the current model has evolved and the fact that no single organisation has overall responsibility for its structure, relevance or development. Whilst the IASB is solely responsible for setting international financial reporting standards, the credit crunch has emphasised the importance of broader aspects of reporting, which financial reporting alone can never address. In particular, aspects of governance, explanations of the business model and the key risks and relationships to which it is exposed, and the impact of remuneration on culture and behaviours are all critical issues. But in reality, these aspects have not been approached in a logical and structured way, which has resulted in them receiving significantly less attention from those involved in the corporate reporting supply chain.

> ***"One of the major reasons for complexity in reporting is the disjointed way in which the current model has evolved and the fact that no one organisation has overall responsibility for its structure, relevance or development."***

Today, all these other aspects of reporting comprise approximately 50% of the volume of annual reports, but the quality, organisation, consistency and value of what is reported is variable and much of what is reported is ignored by investors. While the introduction of rigid standards to this element of reporting is not the answer, more regard should be given to what information has value and to how critical elements of information should be aligned – such as strategy, remuneration, key performance indicators and risks - if a company is well managed and well governed. In addition, the story told through these critical elements should be aligned clearly with the detailed financial information.

> ***"...more regard should be given to what information has value and to how critical elements of information should aligned – such as strategy, remuneration, key performance indicators and risks..."***

Delivery mechanisms

The current reporting model is built on the premise of a printed annual report. While legislative change may be required, it is critical that the delivery channels of corporate information adapt to advances in technology. There is much useful data contained in a printed annual report, however the volume can be intimidating and cumbersome. It is often difficult for users to locate the needed information. We believe these concerns could be greatly mitigated by the use web-based technology which would allow users to 'point and click' to drill-down to the needed information. If information is well organised such that relevant information can be located, the concerns of volume would be reduced.

> ***"...It is critical that the delivery channels of corporate information adapt to advances in technology."***

Technology such as the use of XBRL to enable tagging and searching may also be useful to enable users to locate, analyse and compare consistent data across companies.

Materiality

Materiality is a critical concept in reducing complexity. It is often something that standard setters will focus on in response to the challenge that financial reporting is becoming too complex. However, given the regulatory environment in which we operate and concerns that directors have over litigation, there is a risk that a mind set of 'unthinking compliance' may develop as the easy default option. The result is a reporting model which provides all the information demanded by regulation but in a form that is often difficult to understand and digest. This is an area which demands more consideration and we believe it is an area where the FRC can provide valuable leadership, for example by making it clear that non-disclosure of immaterial items is acceptable.

"Materiality is a critical concept in reducing complexity."

Actions to move this agenda forward

The challenge facing the FRC is to determine how to move this critical agenda forward in a global environment. The UK has traditionally been progressive in its thinking, as evidenced in areas such as governance, remuneration and narrative reporting. To allow this to continue, we would encourage the FRC to take the following actions:

1. **Help sponsor the creation of a strategic plan for the future development of reporting**. We believe the FRC has an important role in bringing key stakeholders together to agree actions to make reporting more relevant and to avoid added complexity as the model evolves. Arguably, insufficient strategic thought has been given to the overall development of corporate reporting and thus it has become overly complex, often organised in silos and difficult to navigate and understand. By creating a blueprint for the future of reporting that can be used to identify and avoid problems areas and actions that might increase complexity, we have an opportunity to make reporting more relevant and accessible.

2. **Promote the strategic plan internationally.** While it makes sense to create a new blueprint for reporting in the UK and to take actions to reduce complexity, the nature of reporting means that many of the priorities and challenges need a global solution. Accordingly, the FRC has a critical role to play in influencing global thinking on those issues which need convergence of thinking and consistent action.

3. **Support developments in market practice that can be made within the constraints of IFRS compliance, focusing on the structure of annual reports in their entirety and how financial information is organised and presented.** Much can be done to improve reporting within the constraints of IFRS and local regulations. However, this requires experimentation and new ideas. We believe the FRC can play an important role in establishing an environment where

change and new ideas are encouraged. In particular, the FRC should consider extending its role to the promotion of best practice and the sponsorship of activity to generate practical ideas to enhance access and understanding.

4. **Remove standing data from the annual report.** At a more micro level, we believe the complexity agenda could be assisted if the FRC could champion action to allow standing data and disclosures that do not change from year to year to be included on a company's website, for example, as opposed to the annual report.

If you have any questions on the content of this letter, please do not hesitate to contact Peter Holgate, Senior Technical Partner, (020 7213 5675) or Peter Hogarth, Technical Partner, (020 7213 1654).

Yours faithfully,

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

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Appendix 1 - Detailed responses

We set out below our responses to each of the detailed questions set out in the discussion paper

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

We believe the four principles proposed are sensible and would, if implemented, have a positive effect on reducing complexity. We do not have any particular general principles to add, but draw attention to our response to Question 8 where we set out six key elements to be taken into account when writing high-quality, principles-based accounting standards.

Drafting regulations and standards according to simple or broad principles is not necessarily easier than doing so on a 'rules' basis. It may actually take more time and thought to do so. It will also require a change in mind-set of all participants in the corporate reporting process. Principles require the exercise of judgment to apply them. Regulators, standard setters, preparers, auditors and users need to accept that some diversity may legitimately result from the exercise of reasonable judgment. There may be false comfort in a mechanistic approach to applying a rule, rather than taking a broader view to ensure that the reporting aligns with the business and the economics.

We consider the second principle proposed in the consultation document *'Proportionate: Balance the costs and benefits of regulation'* to be particularly important. Constituents will continually ask regulatory agencies and standard setters to refine, interpret and develop regulation and standards. We would like to see increased public input into the agenda-setting and cost/benefit factors being considered at an earlier stage in the development of work programmes and specific projects (rather than conducting impact analyses in the latter stages of a project). Items that are not serving an urgent need from the market to enhance regulation or standards should not be added to the agenda.

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.

We agree that cash flow reporting is in need of improvement. We are not alone in this view and note that user groups such as the Corporate Reporting Users Forum have highlighted concerns in comment letters to the IASB and other forums. It is evident that many users of financial statements are unable to obtain the information they require from the statement of cash flows. This is partially apparent from the increasing use of non-GAAP measures, such as EBITDA, in financial statements. In many cases, users defer to EBITDA or other derived measures as a means of estimating, analysing and projecting cash flows trends. The use of such non-GAAP measures is an indication that the GAAP financial statements are not meeting fully the needs of the users.

Many commentators consider that cash flow statements prepared in accordance with FRS 1 are more useful than those complying with the international standard (IAS 7). Some of the areas of difference include the former's distinction between cash and cash equivalents and its requirement to provide a net debt reconciliation.

The IASB has included cash flow reporting within the scope of its project on financial statement presentation. We believe that this is the right forum in which to debate changes to the cash flow reporting model and encourage the FRC to play an active role. We encourage the FRC, through the ASB, to revisit the comments that were previously analysed during the revision of FRS 1. This analysis, together with the responses to this discussion paper and those submitted to the IASB's financial statement presentation discussion paper, may position the FRC to propose specific, supportable improvements to the IASB.

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

Yes. In general, the more remote information becomes from day to day business activity, the greater the risk to its relevance. If management has to capture data that is not used in controlling and running the business, then it should be questioned whether that data is likely to be useful to investors and other users. We believe that the use of non-GAAP performance measures (that are considered important by management) can be useful to investors if they are balanced and clearly explained. If management abuses the use of non-GAAP measures by not properly balancing the 'good news' with 'bad news', this should adversely impact the investment community's view of management's credibility.

Our view is that accounting standards should result in clear and transparent financial statements that faithfully represent the economic consequences of transactions and set results in the context of the entity's business model. This is supported by the fact that many respondents to the IASB's recent exposure draft on classification and measurement of financial instruments indicated that the business model employed by a reporting entity should be the primary factor in determining how best to report the amount, timing and uncertainty of cash flows for financial instruments.

The detailed basis on which internal management data is prepared is likely to differ from company to company. In practice, regulation and accounting standards would need to establish broad principles with some limited flexibility for management to tailor and report data to reflect internal information. These principles should help to balance the need for management to have flexibility in their reporting with the need for consistency and comparability.

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 relevance of a disclosure will vary significantly, depending on the nature of an entity's business and transactions. It would be difficult to review the current list of disclosures and identify disclosures that would not be relevant to a user in any circumstances.

While we agree that the current disclosure requirements are voluminous and, in many cases, not relevant to a particular entity, our view is that principles should overlay the detailed lists of disclosure requirements. These principles should assist entities in determining which disclosures should be included with prominence and which may be excluded or reduced. The principles must also provide a framework for evaluating materiality. It is often difficult to evaluate the materiality of a disclosure, for example with respect to related party transactions or share-based compensation. Some may view materiality of a share-based compensation payment considering the size of the total expense as compared to the profit and loss of the group, while others may view materiality from the perspective of the employee. Others may view any share-based payment to a director or senior management to be material. Share-based payments is one area where disclosures can be quite lengthy. In some cases, this may prove very useful to the reader while in others, it may not. Principles would be useful to help preparers tailor disclosures to an appropriate level of detail. The IASB may address these questions during Phase E of its conceptual framework project, but work in this area has not yet commenced. This presents the FRC with an opportunity to develop a model for submission to the IASB.

Another consideration is the accessibility to and organisation of financial information. While an entity's annual reporting may contain very useful and relevant information, it can be difficult for users to locate the information they need. The Securities and Exchange Commission in the United States has been recently focused on XBRL reporting. This provides an electronic mechanism for extracting consistent and relevant information. While it is a significant undertaking, the use of electronic web-based links and search tools to drill down into information could make it much easier for users to locate necessary information, which can often become lost in lengthy printed documents.

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

The requirement to prepare audited subsidiary accounts should ultimately be driven by whether or not audited subsidiary accounts are needed by a shareholder, creditor, supplier or other party who has an interest in an entity. There are many situations where an entity may be wholly-owned with no creditors or suppliers requiring or using audited financial statements. In these situations, it is arguable that audited financial statements should not be specifically required, assuming the sole shareholder does not require such information. While Article 57 of the EU's Fourth Council Directive allows territories to exempt subsidiaries from preparing annual accounts in certain situations, the UK has historically not elected to allow this exemption. As part of the FRC's initiative, this may be an area worth revisiting.

Where subsidiary accounts are required, we believe that complexity could be reduced through the ASB's current proposal to replace UK GAAP with IFRS for SMEs. Given many subsidiaries have parents who are responsible for filing under full IFRS, they are required to produce full IFRS data for reporting to the parent. We believe complexity could be reduced if subsidiaries were allowed to prepare financial statements using the recognition and measurement principles of full IFRS, with significantly reduced disclosures. This will allow subsidiaries to maintain one set of financial information – and not IFRS for SMEs for its subsidiary accounts and full IFRS for its parent. This is a broad issue with significant implications which we are further analysing in conjunction with our response to the ASB on the future of UK GAAP.

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?

Refer to question 5.

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?

Complexity (and cost) will be reduced for multinational and other large companies if regulators coordinate their activities and do not demand different types of information in different jurisdictions. Similarly, investment activity will be facilitated if information is prepared and published in different markets according to the same standards.

The question asks whether there is a risk that international regulators working together might result in imported complexity for some jurisdictions. In our view the greater risk is that national regulatory agencies take the 'global' standard but then add their own 'bells and whistles'. The global economy will not benefit if each country reaches for domestic solutions. We are already seeing different sets of guidance emerging in a related area - on carbon measurement and disclosure. These are all intended to be helpful, but their variety is likely to create confusion and an unnecessary administrative burden on business at a time of economic challenge. The way to mitigate such risks is to encourage the maximum degree of coordination and dialogue between regulators and standard setters from different countries.

We appreciate that international coordination is a significant undertaking which will take time and the support of numerous global parties. While this coordination should be embraced, we also believe that the FRC should focus efforts on centralisation of regulation within the UK. Whilst IFRS is the sole source of guidance for financial reporting, the annual report of a listed UK company must draw on guidance from many other sources. The discussion paper cites the example of directors' remuneration, but there are other instances of overlapping or inconsistent regulation. We encourage the FRC to build on the analysis it has so far performed and publish clear guidance, highlighting where differences exist and suggesting how they may be overcome.

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?

We agree that it is desirable for regulations and accounting standards to be drafted in a clear and understandable way to help all participants in the financial reporting process. Reducing complexity should be one, but by no means the only, benefit of delivering regulations and standards in this way.

In January 2008 the Global Public Policy Committee of the large accounting network firms published a white paper[1] that explored the characteristics that the networks believe are the key elements of a high-quality, principles-based accounting standard:

- Faithful representation of economic reality
- Responsiveness to users' needs for clarity and transparency
- Consistency with a clear conceptual framework
- Based on an appropriately defined scope that addresses a broad area of accounting
- Written in clear, concise and plain language
- Allows for the use of reasonable judgment.

Though clearly oriented towards accounting standards, we believe some of these elements would apply equally to other types of regulations and standards.

We also consider it would be helpful in delivering clear regulations and standards if the different objectives and perspectives of differing types of reporting were better understood. For example, in the context of the financial crisis, there has been confusion in the marketplace regarding the differing objectives of financial and prudential reporting. Some have proposed including measures designed to build counter-cyclical reserves in the performance statements (income statement or other comprehensive income) of financial institutions. While well-intentioned in its aim of improving financial stability, we believe this confuses the picture of financial performance for investors and other users and adds to complexity.

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

We agree that it is useful to set out the principles for effective communication as a mechanism to help improve reporting. We also agree that the four principles set out in the discussion paper (focused, open and honest, clear and understandable, interesting and engaging) capture the high ground on which companies should be focusing in their endeavours to make their reports more

[1] White paper *'Principles-based Accounting Standards'* published January 2008 by the Global Public Policy Committee (GPPC) of the six largest international accounting networks. The GPPC comprises representatives of BDO International, Deloitte, Ernst & Young, Grant Thornton International, KPMG, and PricewaterhouseCoopers, and focuses on public policy issues for the profession.

informative and engaging. However, in the absence of a high-level structure which establishes the nature of the information that needs to be reported and how it should be organised, we believe the principles lose their value and impact. Furthermore, we would encourage more thought to be given to the behavioural reasons why these principles may not be embraced (refer to question 10) and what actions can be taken to encourage change.

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

A number of barriers exist to effective communication. Firstly and most importantly, the current reporting model has evolved in a piecemeal way. New elements (in the front and back half of the annual report) have been introduced at different times with little regard to how they should be integrated with existing requirements. The result is a document that often lacks a logical flow or organisation. Information can be difficult to locate. Related information often appears in different sections of the document and it can be difficult to differentiate the materiality and nature of the information being presented. Currently, there is no differentiation between standing data which does not change from year to year and performance data which explains what is currently happening in the business.

Secondly, because of the dynamic of modern reporting, the annual report is increasingly seen by many as a legal reference document, with the communication effort being committed to the preliminary announcement and analyst briefings. While this is understandable, there is a danger that the annual report becomes less relevant, particularly as much of the communication of financial performance is achieved through extensive use of non-GAAP information.

Breaking the mould is something that is difficult to do, given the primary motivation and starting point for the production of most annual reports is the need to comply with legal form and requirements. The substance of what is reported is often a secondary issue and, at times, is not even considered. The Report Leadership document, which we participated in creating, is a good example of an initiative to try to break the mould. While it was very well received by investors and companies, it is difficult to determine how much impact it has had in practice.

In considering how these barriers can be overcome, we would encourage more consideration be given by the FRC to the following:

- Promoting best practice, particularly which addresses some of the short-comings identified above.
- Developing guidance which helps to promote an environment in which experimentation to improve the communication qualities of reporting is encouraged in the UK market.
- Ensuring the opportunities and benefits that accrue from the use of XBRL are optimised. In particular, serious thought should be given to determining what information needs to be captured in the annual report and what information, for example standing data, could be retained on a company's website. In this context, we believe more thought needs to be given to the use of exception reporting, as would be used routinely inside business.
- Ensuring safe harbour protection for forward looking information.
- Identifying actions that can be taken to encourage shareholders and investors to promote approaches to reporting which they believe assist in the understanding of business performance and where appropriate, challenging those companies who do not adhere to such reporting.
- Promoting the connected reporting model developed by the Prince of Wales' Accounting for Sustainability project, which recognises the convergence that is taking place between mainstream and sustainability reporting.

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?

We agree that many of the areas identified by the FRC require further action. Many of these items are accounting-related matters which are currently prioritised by the IASB, particularly in the area of financial instruments. We have provided input to the IASB in relation to their discussion papers and exposure drafts and will continue to do so. The following matters, which fall outside the IASB's remit, should also be considered:

CSR agenda

So far as we are aware, any extensive CSR information in annual reports (above and beyond that required by the Companies Act to be included within the business review) is included voluntarily. We do not think companies should be prohibited from including CSR information, but it does tend to distract from the primary purpose of the financial statements. While readers who object to bulky printed reports can go online for more targeted access, companies should be encouraged to provide more and better-structured online information to enable users to readily access the needed information. This is consistent with our previous discussion of the need to better leverage advances in technology for delivery of information.

Parent company financial statements

While many users do not use parent company financial statements, it would be useful to know whether there are any who do. Once the extent of usage is known, the scope for reducing existing requirements can be assessed. This would be a matter for the Department of Business, Innovation and Skills (BIS). However, unless distributions cease to be assessed by reference to parent company financial statements, there would appear to be limits as to the ability to abandon such financial statements, or even reduce their comprehensiveness given that UK law requires distributions to be made by reference to 'true and fair' accounts.

Remuneration reports

It is not clear from the discussion paper whether the problem with remuneration reports is with the legal requirements or with how companies seek to comply with them. It would be useful to establish this first. One way of doing this would be to see whether users would be content with the recommendations of the Report Leadership group in *Executive Remuneration: Simple, Practical Proposals for Better Practice in Reporting Executive Reward.* As its title suggests, this report seeks to improve remuneration reporting, but works within the constraints of existing legal requirements. This is a matter on which the FRC could conduct research, but ultimately it would be a matter for the BIS. We have noted the overlap problem with the Listing Rules, and this should be tackled by the FSA.