Reducing Complexity in Corporate Reporting: Louder Than Words

FRC Discussion paper

Response by the

Local Authority Pension Fund Forum

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David Sellors
Chief Operating Officer
LAPF Forum
Email: David.Sellors@lapfforum.org
Report Origination: PIRC Limited
Report Author: David Somerlinck

About LAPFF

The Local Authority Pension Fund Forum (LAPFF) was set up in 1991 as a voluntary association of 49 local authority pension funds based in the UK. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest. The Forum's members currently have combined assets of over £80 billion.

LAPFF´s interest in this topic arises from the effects of the financial reporting system on real economic decision-making. This impacts on business choices affecting job creation, working conditions, salaries and pensions, tax receipts, training and development, the environment and other issues across society.

Introduction

LAPFF supports the drive for more effective communication. It believes the FRC´s approach as set out will reduce complexity for the benefit of the producers of accounts. However, it also believes it will do this to the detriment of users and the financial reporting system as a whole.

LAPFF considers the following actions are required;

- Greater representation of users of accounts in the membership of the council of the FRC and its operating bodies. This will help the FRC to avoid being surprised by the views of account users in the future.

- Greater emphasis on effectively representing uncertainty in corporate numbers, rather than reducing complexity.

- Further research into the behavioural aspects of communication to avoid unintended and/or undesirable consequences of disclosure.

- Collaboration with a wider range of bodies to ensure that no one set of views is dominant in the FRC´s thinking.

- A UK equivalent of the SEC´s EDGAR database or similar to assist companies to comply with disclosure requirements at the lowest possible cost.

- A move away from regulation by compliance toward encouraging best practice with a focus on transparency.

- No change to reporting requirements for subsidiaries.

The Forum has taken the opportunity below to provide our view on those consultation questions, which we consider relevant to our activities.

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

1.1. There can be little doubt that "the challenge of giving a true and fair view of a company's financial position and results is an extremely demanding one."[1]

1.2. The survey in the FRC´s latest annual report shows investors far less inclined to respond as "very confident" than auditors or directors in any area the survey considered.

1.3. The FRC expresses "surprise" in finding users of accounts had "greater concerns about 'relevance' than 'complexity'". This reinforces our view that the regulator with responsibility for promoting confidence in corporate governance and reporting will benefit from connecting more with users. The membership of the council of the FRC (and its operating bodies) is heavily weighted to producers´ representatives. A rebalancing would appear in order to prevent similar surprises.

1.4. Rather than seeking to reduce complexity in reports, LAPFF believes the FRC should be seeking to increase transparency to satisfy users´ appetite for information. Technological improvements have delivered the computing power to analyse significant quantities of data to a wide audience. If this power can be harnessed increased scrutiny can act as a spur to raise standards; re-engage boards with their investors; and allow investors to fulfil their role in holding the board to account.

1.5. As part of our responses to the Company Law Review we called for the creation of a UK equivalent of the SEC´s EDGAR database. Mandating electronic filing, in our view, will make it easier for investors to find the information they deem relevant. The proliferation of web based services providing not only the numbers from the accounts but also ratios and peer comparison risks the "official" publication losing further relevance except for those who are prepared to undertake a time-consuming review of the various notes to ensure that they truly understand the numbers. Fundamental analysis is far more important to ensure that financial statements are useful for decision making and to hold boards to account.

1.6. Responsive boards will seek to understand, and where possible meet the information demands of their shareholders – whether they are required to do so by regulation or not. However, there are also boards that will rely on a certain interpretation of the letter of the regulations to their own advantage.

[1] "The Limitations Of Accounting Models And Their Impact On Decisions" Conference On The Future Of The Financial System 2 April 2009 Paul Boyle Chief Executive, Financial Reporting Council http://www.frc.org.uk/images/uploaded/documents/IEA%20Speech%20April%202009%20-%20published%20version.pdf

1.7. The FRRP only considers compliance with the law and accounting standards rather than being able to encourage continuing improvements in best practice. Investors are better placed to raise standards – but only if regulation is not an obstacle.

2. Is cash flow reporting in need of improvement?

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

3.1. At present the annual accounts provide a single figure based on management assumptions. Without the publication of those assumptions, the numbers produced by management are incapable of being properly scrutinised and held to account.

3.2. This is not a question of second guessing the board or management, but a necessary part of understanding, especially as it allows for comparability of varying views and to fairly reflect the possible uncertainties.

3.3. A reiterative process can assist in providing positive feedback to ensure that decision making is based on the best possible evidence. This will require a change in mindset from those boards that have treated shareholders´ views as an inconvenience rather than an opportunity.

3.4. Smith highlighted the difficulties that an audit committee can face in practice: "The audit committee has to pit its judgement against that of the 'experts', perhaps on a technically complex issue…The pressure on the audit committee [to concede] can be enormous." Responsible long term investors have less incentive to concede.

4. 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?

4.1. As supporters of transparency, LAPFF considers this to be less of an issue. Does the FRC have evidence from *shareholders* that this is in fact a problem?

4.2. LAPFF recognises the FRC´s desire for proportionate regulation, but at a time when investor confidence has been severely shaken, we consider the precautionary principle makes it incumbent on the producers of the accounts to demonstrate why the publication of information is not appropriate.

4.3. Instead we would recommend a project to share best practice to assist companies to develop tools to comply with the requirements at the lowest possible cost.

5. 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?

6. 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?

6.1. When Lehman Brothers collapsed, the bank was made up of more than 3,000 legal entities. This is an extreme example but there is a concern that corporate structures are unnecessarily complex as a means of creating opacity.

6.2. The creation and maintenance of significant numbers of wholly-owned subsidiaries may have a legitimate business rationale. However, lower reporting requirements create an incentive for greater corporate complexity as a means of avoiding transparency. It is incumbent on companies to demonstrate why wholly owned subsidiaries are required for the business models of their listed parents.

6.3. LAPFF does not consider the FRC has provided evidence to overturn the conclusion of the Company Law Review in 2001 “that there was not a solid case for changing the reporting requirements for subsidiaries”.

7. 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?

7.1. It is a matter for boards to decide whether the benefits of being in a particular market are in the interests of shareholders – regulation is the cost of doing business in a certain jurisdiction and will be only part of the decision making process.

7.2. Where two sets of national regulations are contradictory, this may reflect a difference in approach at the level of principle – or a particular set of historic circumstances in an individual market. If a board cannot explain the differences to shareholders used to both models has it really understood the local circumstances sufficiently well?

7.3. Complexity resulting from differing international regulations should not be simply removed by fiat. Over time users of accounts will decide what is useful or not – the market for ideas acting as a self-regulator. At no time will the balance be "perfect" for all, but the process should assist with ensuring that there is broad support.

7.4. Regulation takes time to catch up with market practice and there will be a certain amount of irrelevant information as a result of regulation that becomes outdated. But, as supporters of transparency, LAPFF considers this to be less of an issue than premature removal of data in the name of international consistency.

7.5. Our worry is that too much of the current corporate concern about complexity simply calls on the regulator to "dumb down" requirements to avoid inconvenient disclosures. This comes at the price of considering how business can deliver the information that shareholders believe is required, in the most cost effective manner. Such demands can only increase suspicion at a time when business legitimacy continues to be called into question.

8. 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?

8.1. It cannot be healthy for business regulation in the UK that company accounts are understandable by relatively few rather than subject to wider informed debate. This leaves the field open to those who would exploit it either to game the system for their own ends or those who see conspiracy at the heart of the current economic system.

8.2. Company Law is already perfectly clear. 'The directors of a company must not approve accounts… unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss …of the company.' For the listed companies that are LAPFF´s primary interest, the Combined Code provides that "The board should present a balanced and understandable assessment of the company's position and prospects. MAIN PRINCIPLE C.1"

8.3. For a director to decide whether a set of accounts meets these requirements is not as simple as a 30mph speed limit and clearly a "certain amount of elasticity is essential, if the system (of corporate law) is to work in practice."[2] In our view, shareholders are more prepared to listen to arguments as to why the board

[2] Company Law Amendment Committee 1925-26 Greene Committee

thought 25 or 40 mph was more appropriate in certain circumstances than a traffic policeman can or should be. In addition the UN Principles for Responsible Investment call on investors to be both informed and engaged.

8.4. Interest in accounting and auditing standards is caricatured as a technically arcane pastime rather than vital to ensuring capital is allocated efficiently for the benefit of the economy. Clear regulation is needed to support an education programme to ensure that all directors have an understanding of the issues involved – especially the impossibility of a simple “right answer”.

8.5. US statistician John Tukey claimed "Far better an approximate answer to the right question, which is often vague, than an exact answer to the wrong question, which can always be made precise."[3] The complexity of modern business and the impossibility of predicting the future make this a useful starting point.

8.6. The FRRP´s pro-active review of “high risk” sectors is no substitute for a diverse, informed population of engaged owners and stakeholders taking an ongoing interest in these matters. Publication of the FRRP´s basis for selecting these sectors would help to stimulate debate about the issues involved and widen the pool of interested parties.

8.7. Simpler regulation does not guarantee that companies will not simply adopt a box-ticking compliance approach rather than seeking to achieve best practice. The Forum would be interested to know how the FRC proposes to assess whether boards are taking reasoned decisions rather than simply following the letter of the regulation.

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

9.1. The principles of effective communication are universal.

9.2. As the FRC´s work revealed, users of accounts are more than willing to seek out the information that is important to them. This helps to ensure a vibrant market for ideas. Effective communication does not minimise complexity but seeks provide explanatory value from it.

[3] "The future of data analysis", *Annals of Mathematical Statistics* 33(1) 1962

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

10.1. LAPFF believes knowledge of the principles of effective communication are widely evident in corporate disclosures. We therefore believe room exists for board level education on this subject.

10.2. LAPFF concurs that good data graphics have significant value but they should "above all else, show the data"[4].

10.3. Writing in Accountancy Age in November 2008, Peter Wyman, global leader, public policy and regulatory matters, at PricewaterhouseCoopers claimed, “The fact that the response to [data under fair value accounting] has been for investors to sell, and to continue to sell as worsening conditions are reflected in each iteration of results, is testimony that financial reporting is working well…”

10.4. LAPFF considers such complacency a barrier to more effective communication. Earlier reporting failed to effectively warn of the risks that companies were taking. No doubt too many investors were equally complacent – but providing ”reliable intelligence for the purpose of enabling [shareowners] to scrutinise the conduct of the company’s affairs” requires this to be in a usable format rather than cluttered, opaque disclosure.

10.5. When considering “effective communication” it appears little account is taken of how the users of accounts attend to and process information. We believe biases in the way in which users of accounts access information should be addressed in the way in which reports are constructed. If this is not done the FRC risks that various financial scandals of recent years, where individuals were seduced into the misplaced belief that they understood what they were being shown, may be repeated.

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

11.1. The BBC Trust has published a report on “impartiality”[5]. In it, it talks of “Twelve bottles on the alchemist’s shelf: Accuracy, Balance, Context, Distance, Even-handedness, Fairness, Objectivity, Open-mindedness, Rigour, Self-Awareness, Transparency and Truth. It is the task of the alchemist, the programme-maker, to mix them in a complex cocktail.” Impartiality is a higher hurdle than the balance

4 Tufte (2001) "The Visual Display of Quantitative Information"

5 *From Seesaw to Wagon Wheel: Safeguarding Impartiality in the 21st Century* http://www.bbc.co.uk/bbctrust/assets/files/pdf/review_report_research/impartiality_21century/report.pdf

that is expected from company reports, but boards could do well to learn from the process that the BBC has undergone following various high profile scandals.

11.2. The sources for the discussion document draw heavily from research from the large accounting firms. Bodies such as The Royal Statistical Society would add intellectual rigour especially when it comes to consideration of risk. Having asserted that financial accounts are little different to statistics then the UK Statistics Authority could offer further insights into achieving the goal of effective, relevant communication.

11.3. Understanding of how users of accounts attend to and process information (and the pitfalls therein) is improving. Greater understanding by the FRC of the psychology involved would seem to be required to ensure that more easily approachable communication does not turn into a greater risk.

11.4. The public sector is also seeking to improve performance disclosure. The Department of Communities and Local Government has a website that seeks to encourage best practice and deals with similar issues, http://www.improving-visualisation.org/ .