Centre for Financial Market Integrity
CFA INSTITUTE

Melanie Kerr
Financial Reporting Council
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Dear Melanie Kerr,

Re: Response to consultation on making corporate reports less complex and more relevant

We laud the FRC for undertaking the consultation paper (CP) - '*Louder than words- Principles and actions for making corporate reports less complex and more relevant'*. The CP covers two primary themes namely a) less complex regulation of reporting and b) effective communication in reporting.

The focus on reducing complexity has been a recurrent theme in several recent standard setter financial reporting initiatives. Consistent with our previous commentary[1], we concur with a definition of complexity that focuses on the usability and interpretation of financial statements and therefore believe that the debate is in the right direction and to the interest of investors. However, we believe that the primary and overarching focus of reforms should be on relevance of information. A focus on relevance would be consistent with the raison d'etre of financial reporting information, which is to provide capital providers with decision useful information.

We fully support the proposals related to effective communication. The main comment is that these principles should also be extended to accounting standard setter language.

We have further specific comments below in relation to the regulatory framework.

[1] *'Despite the appeal of eliminating complexity, there is the danger of complexity being a catch all phrase resulting in different constituencies talking at cross purposes. Everyone is likely to agree with the goal of reducing complexity but there is a danger of such a goal meaning different things to different constituencies. Therefore, in its communication to its key constituencies, the IASB should disaggregate the category of complexity that it aims to resolve. The board and staff need to be clear whether what is being resolved is implementation, investor interpretation or volume complexity. There is also a need to distinguish between avoidable and unavoidable complexity. Complex arrangements and the ongoing innovation of financial instruments are part and parcel of modern finance. Managers need to fully convey the nature and the entire spectrum of risks associated with the complexity that they face. Hence financial reporting should efficiently and precisely convey the complexity. In other words, accounting should shed light on the complexity of financial instruments and it should neither exacerbate nor mask the complexity of such instruments. Overall, we support measures (i.e. fair value and improved disclosures) that reduce user interpretation complexity and provide a more accurate depiction of the economic reality of reporting entities*.'- CFA Institute comment letter to IASB on reducing complexity 19th September 2008

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Regulatory framework: principles for less complex regulation and calls for action

The CP proposes that regulations should be targeted, proportionate, coordinated and clear. It goes further to call for the following:

- Improved cash flow and net debt reporting
- Ensure disclosure requirements are relevant and proportionate to the risks
- Ensure requirements for wholly owned subsidiaries' reporting are targeted and proportionate
- Improve usability of IFRS

Principles of regulation

Broadly speaking, we support the notion of having targeted, proportionate, coordinated and clear interventions. We strongly support the idea of a coordinated approach by the regulatory and standard setting bodies. Further to the mentioned benefits, this will minimize stakeholder response burden and redundancies in request for views. It will further make the changes less disruptive for users.

Similar to any set of high level, qualitative principles, the challenge lies in enacting these and clearly a lot more work needs to be done than has been articulated in the CP. For example, in pursuit of proportionate reforms, the CP suggests that regulators should seek cues for reporting enhancements from internal management reporting practices. While we agree that information that is useful for management could be useful for investors, it is important not to lose sight of the differing information needs of investors and managers, taking into account the existing information asymmetry. Investors make judgments on earnings quality based on limited information, yet managers are likely to have insider views on the quality of reported earnings. Hence, the usefulness for management of particular information is not a sufficient criterion of evaluating its usefulness for investors. In other words, if managers consider certain information not to be useful, it should not mean that the same judgment on usefulness should be extended towards investors.

Business reality portrayal

The CP further postulates that corporate reporting is becoming disconnected from business reality largely due to ongoing accounting standard changes. However, it seems to be an iniquity to point the finger of blame towards either existing or emerging financial accounting regulation as being the primary inhibitor to the portrayal of business reality. While reporting requirements are less than perfect, corporate managers still have sufficient latitude to disclose a lot more meaningful information that can help in the interpretation of their business model reality than they currently do. Parallel to improving accounting regulation and communication styles, more regulatory effort needs to be directed towards reducing the inclination and incentive of managers to portray a rosier picture of their underlying risks and performance prospects, as this does influence the overall usefulness of corporate disclosures.

Furthermore, the briefly developed arguments in favour of hedge accounting as necessary to better convey underlying risk management effectiveness, fail to consider that hedge accounting is largely an artefact of shortcomings of the existing mixed attribute accounting. In this regards, the CP does not acknowledge the **extent to which mixed measurement attribute accounting is in fact a causal factor of financial reporting complexity**. There is need to elevate the need to reduce the existing mixed attribute related complexity and this will include improving the current financial statement presentation to a more disaggregated format as well as resolving the use of the other comprehensive income (OCI) statement.

Cost-Benefit

While we agree with the notion of accounting reforms needing to be based on an evaluation of costs versus benefits, the CP does not sufficiently acknowledge the difficulties of determining these costs and benefits on a holistic basis. Nor does it shed any light on how current practice of such an evaluation, could be enhanced. It is worth reiterating that investors bear significant costs due to poor information and these should not be excluded from any cost-benefit analytical framework.

Call for action-proposals

With regards to the calls for action, we strongly endorse the recommendations made towards improving the usability of IFRS. We also strongly endorse the notion of development of a disclosure framework that can help better map the supply and demand of disclosure requirements and allow a move away from the current pattern of piecemeal enhancements. We would encourage a collaborative effort between the regulatory bodies and this should be informed by an understanding of investor requirements. Hence efforts should be made to attain a broad based investor input to inform this process. The CFA Institute is willing to facilitate such input given the scale of our global membership.

Cash flow transparency

We support[2] the proposal to focus on improving cash flow transparency. However, our concern would be whether the specific proposed disclosures have been based on an exhaustive evaluation of all improvement options. There seems to be a quantum leap in the process of prescribing disclosures. Therefore, it will be most helpful if the FRC could provide more texture on the basis of all its conclusions towards specific disclosure proposals. For example, the basis of assigning priority to the provision of net debt to cash flow statement, given that what has primarily been under scrutiny by the IASB and FASB as a means of improving cash flow transparency, is the direct method cash flow statement[3]. This is not an argument against the specific proposal of net debt to cash flow statement but a recommendation for the coordinated and exhaustive evaluation of all options. By being selectively prescriptive there is a risk that the FRC may inadvertently conform to the pattern of pursuing uncoordinated piecemeal enhancements that the CP proposes should be avoided.

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[2] In a 2007 CFA Institute Corporate Disclosure Survey of members 97 % of respondents identified the cash flow statement as an integral part of their valuation analysis.

[3] A recent (July 2009) CFA Institute global membership survey of financial reporting users, which found that ***63% of respondent members either agree or strongly agree that direct cash flow*** relative to the IDM, would improve their ability to predict future cash flows and assess earnings quality

Conclusion

Overall, we applaud the FRC for initiating and stimulating this debate on financial reporting complexity. We strongly endorse the proposal to develop a disclosure framework, improve usability of IFRS and the proposed principles of improving communication. As a way forward we encourage the FRC alongside other standard setting bodies, to further develop the principles of regulation, paying particular attention on the extent to which the mixed attribute system is a contributory factor to current complexity and thereafter to base the call for action on an exhaustive evaluation of all improvement options. We also propose that, parallel to the objectives of the CP, more regulatory effort needs to be directed towards reducing the inclination and incentive of managers to portray a rosier picture of their underlying risks and performance prospects.

Sincerely,

/s/Charles Cronin

Charles Cronin,
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CFA Institute
EMEA Office

/s/ Vincent Papa

Vincent Papa,
Director, Financial Reporting Policy
CFA Institute,
EMEA Office

About CFA Institute

The CFA Institute Centre[4] represents the views of its members, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protection. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct*.

[4] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute, a global, not-for-profit professional association of 100,300 investment analysts, advisers, portfolio managers, and other investment professionals in 139 countries, of whom 88,210 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.