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Dear Ms Kerr

Louder than words: Principles and actions for making corporate reports less complex and more relevant – response from Ernst & Young

INTRODUCTION

1. Ernst & Young LLP welcomes the opportunity to review and comment on the discussion paper entitled *Louder than words: Principles and actions for making corporate reports less complex and more relevant* ("the Discussion Paper") issued by the Financial Reporting Council ("FRC").

2. The financial crisis has highlighted the need to examine financial reporting and re-evaluate the role it plays in the global economy. At the same time, we recognise the risk of further complexity arising from uncoordinated responses to the financial crisis by regulators and standard setters.

3. We appreciate that the FRC acknowledge that the discussion paper is a first step towards reducing complexity in financial reporting. As such, we have answered the specific questions posed by the discussion paper in the appendix to this letter and have set out some areas for further consideration below. These areas focus around a wider review of the financial reporting model. We would be pleased to assist the FRC in exploring these areas further.

OVERALL OBSERVATIONS

Financial reporting and the global financial crisis

4. Global financial reporting is currently experiencing more scrutiny than it has since the ENRON affair. Whilst there is no suggestion that financial reporting actually caused the crisis, there is a broad spectrum of views on the role that it may or may not have played in the run up to the crisis.

5. Nevertheless, whatever the perception, it is clear that the complexity, relevance and value of financial reporting is now firmly in the spotlight. Questions need to be answered around why financial reporting did not provide an early warning of the impending crisis. Is it because this is not the purpose of financial reporting, or is it because modern day financial statements are too complex or is it because financial reporting has lost its relevance?

6. We are pleased that "Louder than Words" goes some way in trying to address some of these issues, although the "Calls for action" may have contributed more towards a step change to financial reporting. We say this because the financial crisis has presented us with a once in a lifetime opportunity to re-examine thoroughly the purpose, relevance and usefulness of financial reporting and the role that it plays in the global economy. As such, we would encourage the FRC to consider these wider aspects as they develop their thinking on the next steps in the objective to reduce complexity in financial reporting.

Objectives of financial reporting

7. We believe that greater importance should be placed on assessing the results of stewardship as an objective of financial reporting. It is clear that shareholders use accounting information to assess the stewardship of management, and we are concerned that not identifying this as a separate objective of financial reporting would compromise a basic purpose of financial statements.

8. The information that is required in order to assess the quality of management's stewardship – for example in relation to the management of risk, or compliance with laws and regulations – may well be different from the information about those matters that is required in order only to assess future cash flows and make decisions about whether to buy, sell or hold investments in an entity or to lend to an entity.

9. We therefore have some concerns around the IASB's latest thinking on the Conceptual Framework for financial statements, whereby the stewardship objective is viewed as a subset of decision usefulness. We have highlighted these concerns in our comment letter to the IASB (dated 7 November 2006) on the discussion paper "*Preliminary views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information.*"

10. We encourage the FRC to seek to influence the IASB and national standard setters in re-examining the objectives of financial reporting.

Financial reporting that is fit for purpose

11. In our view, establishing the objectives of financial reporting and the presentation and measurement alternatives best suited to meet those objectives serves as the foundation for financial reporting that is fit for purpose and less complex.

12. Decision usefulness is widely accepted as the primary objective of financial reporting. This could be regarded as a rather generic term that does not provide as much guidance as it could as to what financial reports should portray. We believe that there is scope for further debate with all market participants concerning the uses to which financial statements are put.

13. We believe that fair value, as a measurement, provides decision useful information in certain situations and is an important element of the assessment of an entity's future prospects. However, we do not believe that it provides the most decision useful information in all situations where IFRS currently requires (or permits) it as the measurement.

14. In our view, a fundamental objective of financial reporting should be to give a clear, unambiguous and understandable statement of the core activities of the business, based on the transactions it has made. We believe the focus of investors is on the transactions of the business and cash flows there from, rather than on the values of individual assets and liabilities of the business. We appreciate that changes in the economic position of an entity in relation to the market are an important element of the assessment of an entity's future prospects. However, we suggest that these should not obfuscate an appreciation of the real trading performance and sustainable cash flow of the business.

15. We believe that profits or losses based on real transactions that will be settled in cash are fundamentally different from valuation 'gains' or 'losses' and that a clear distinction needs to be made between the two. In addition, a distinction should be made between changes in fair value that are not caused directly by the entity's operating activities and those that are. Even more importantly, a distinction should be made between changes in fair value that may never become cash flows to the entity in contrast to those that will. This approach should be reflected in an income statement that clearly identifies the returns generated from the capital invested in the business and should clearly differentiate, for example: operating performance from financing activities and value changes from trading activities.

16. In considering the need to distinguish 'real' transactions from other transactions, there is also scope to consider the basic question of performance reporting and what is considered to be a 'real' transaction. For instance, if a company signs a major contract their share price may well go up. However, nothing is reported (or would be reported under the IASB's current thinking on revenue recognition) in the income statement until they perform under the contract. However, the sales effort expended has generated a contract which has a value. It could be argued that there is scope for wider examination of the basic question of performance reporting, what should be recorded and when.

17. In our view, financial reporting that is fit for purpose is key in reducing complexity. However, we recognise the limitations of financial reporting and recognise that it alone cannot fully meet the needs of users. As highlighted by the Financial Crisis Advisory Group in its recent report, financial reporting provides only a snapshot in time of economic performance. It cannot provide perfect insights into the effects of macro-economic developments. In addition, it is only as good as the underlying data used by preparers of financial reports. It is important that users recognise the limitations of financial reporting and do not rely exclusively on the information it provides in making resource allocation decisions.

18. We have raised our concerns around when fair value measures are used with the IASB in our comment letter on the Exposure Draft *Fair Value Measurement* dated 28 September 2009. We would encourage the FRC to raise this issue with the IASB as they address the use of various measurement alternatives, including fair value, in the *Conceptual Framework Project: Phase C – Measurements*. We would also support the FRC in initiating and facilitating debate with users of financial statements concerning the uses to which financial statements are put, whilst at the same time educating users as to the limitations of financial reporting.

Use of technology in financial reporting

19. The discussion paper identifies the fact that electronic media presents an opportunity to make corporate reporting easier to use. We strongly support this view. We have begun to see increased use of technology in financial reporting, through the publication of financial reports online and through the upcoming requirement for companies to file tax returns with accompanying accounts and computations in XBRL. We believe there is significantly more scope for technology to reduce complexity in financial reporting. We recognise that this process would be a significant undertaking, needing the input of standard setters and governments. We would support the FRC in adopting a leadership role in this area by providing new ideas and/or driving consensus.

20. Technology, such as XBRL, introduces the possibility for multi-layered and disaggregated financial reporting. Such an approach would recognise the fact that users of financial reports are an extremely diverse group that have different objectives, rights and obligations and therefore, different financial information needs and different levels of financial literacy.

21. This approach would allow clear distinctions to be made between objective and subjective figures, between realised gains and losses, gains and losses based on real and observable market prices and gains and losses based on hypothetical calculations. This would allow the central importance of reporting on core trading transactions, related cash flows and realised profits to be recognised and reflected in market communications.

22. In addition, where reliable current values are not readily available, ranges of possible current values, along with assumptions and sensitivity analyses, could also be provided in the form of note disclosure. The use of easily available technology would also allow users to test these sensitivities through changing the assumptions that have been used in the models, thereby determining the potential impact on the financial statements of a reasonable range of different judgements.

23. Technology would also allow far more frequent disclosures than currently made, although with different levels of assurance about its accuracy than for financial statements that are subject to regular audits.

RESPONSE TO SPECIFIC QUESTIONS

Our responses to the Discussion Paper's specific questions are set out in the Appendix.

CONCLUSION

We agree that the principles proposed by the FRC may go some way in reducing complexity in financial reporting. However, we believe that there is currently a significant opportunity for a wider re-examination of the purpose of financial reporting and the role it plays in the global economy. We recognise that this would involve engaging standard setters and regulators on a global basis. We would fully support the FRC in adopting a leadership role in this area and would be happy to assist in this process. We also recognise that such a re-examination may necessitate changes in regulations and accounting standards and that this would take some time to effect. As such, we think that improvement in this area will be an iterative process taking place over a number of years.

We are grateful to the FRC for publishing the Discussion Paper. We hope that you have found our comments helpful. If you would find it useful, relevant members of our firm are available to discuss further any of the points we have raised. Please contact Robert Overend on (020 7951 3050).

We wish you every success with the rest of the consultation process and encourage you to publish all non-confidential responses to the Discussion Paper in due course. We look forward to reading the results.

For the avoidance of doubt, none of the comments set out in this letter are intended to be confidential.

Yours sincerely

Ernst & Young LLP

Ernst & Young LLP

APPENDIX A
RESPONSE TO SPECIFIC QUESTIONS

Q1: Can the principles for less complex regulation we propose help reduce complexity? Are there other principles that should be considered?

We agree that regulations that are targeted, proportionate, coordinated and clear can help reduce complexity in financial reporting. Standard setters and regulators are currently trying to balance so many different considerations when issuing new standards / regulations that without a focus on these four principles, complexity is almost guaranteed. For example, the IASB considering a new or revised standard at the moment will have to consider, amongst other things: existing standards, the conceptual framework, views of the EC and SEC and comments from users and preparers during the comment period.

In our view, coordination is the most important of the four principles proposed. Whilst multiple regulators are responsible for setting regulation in a single area and are not acting in a coordinated manner, significant overlap and contradiction will continue to occur, even if each regulator is acting is a targeted, proportionate and clear way. We believe that, as far as possible, areas that are currently subject to regulatory overlap on a national basis, such as related party disclosures and remuneration reporting, should be either a matter for accounting standards or a matter for company law.

Once the boundaries of each regulators areas of responsibility are clear, that regulator should then focus on producing regulation that is targeted, proportionate and clear.

Where it is not possible to eliminate areas of regulatory overlap, we strongly support the need for greater coordination between regulators.

Q2: 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 support the proposal that the reporting of cash flow and net debt needs to be reviewed and improved. We believe that the cash flow statement and accompanying notes should provide insights into the drivers of maintainable cash flows as well as the trends over time of these drivers.

We believe that some improvement could be made in cash flow reporting through educating preparers to users concerns. One of the problems with cash flow reporting raised in the discussion paper is the need to reconcile the movement in net debt. We have seen examples of entities providing this voluntarily under IFRS where they consider it useful to users. In addition, the discussion paper has noted some issues with vague and ambiguous descriptions in the cash flow statement. In our view, this is largely driven by entities adopting the wording of the example operating, financing and investing cash flows given in IAS 7 *Cash Flow Statements* ("IAS 7"). However, IAS 7 is clear that the examples given are examples only, and does not mandate the descriptions to be used in the cash flow statement.

The problems that the discussion paper identifies with cash flow reporting could potentially be resolved to some extent by increased disclosures. For example, a reconciliation such as that proposed by the IASB's discussion paper *Preliminary Views on Financial Statement Presentation* between each line item in the statement of cash flows to the statement of comprehensive, would assist users in reconciling between the cash flow statement, income statement and balance sheet.

However, we encourage the standard setters to be mindful of the need to keep a balance between the costs to preparers of preparing additional disclosures and the benefit to users of the financial statements. Rather than adding to disclosure requirements in an effort to make financial reports meet all of the needs of all market participants, we would urge standard setters and governments to consider how the use of technology would allow financial reports to be tailored to the needs and disclosure requirements of individual users.

Q3: Proportionate: Should accounting standards and other regulations be based more on the information that management produces internally?

In our view, financial statements should reflect the reporting entity's underlying business model, although there is growing evidence to support the fact that financial reporting is becoming increasingly an exercise in regulatory compliance, as opposed a means of communicating relevant and reliable information about the business. Consequently, we believe that there is some scope for accounting standards to be based more on information that management produces internally. However, we recognise a number of difficulties in applying this approach:

- The difficulty of balancing accounting standards and regulations based on management information with the need for comparability between entities.
- The difficulty that some preparers have in complying with the 'through the eyes of management' approach. For example, the discussion paper highlights the propensity for preparers to comply with the specific minimum disclosure requirements of IFRS 7 rather than truly providing information through the eyes of management as the standard requires.
- The extent to which the approach should be adopted. Taken to the extreme, a small owner managed business may run their business on the basis of their cash book. However, we do not consider that this would support the use of cash accounting rather than the accruals basis in the entity's financial reporting. This would not provide the type of information about past transactions and other events that is useful to users in making economic decisions.

This is a difficult question to answer as it is drafted very widely. In order to answer this question, it is important to consider the specific areas where companies see a disconnect between their internal and external reporting and consider whether each of these can be bridged. In addition to the valuation of intangible assets example given in the discussion paper, common areas of disconnect in our experience include:

- Derivatives and hedge accounting: Where management consider fair value is irrelevant if the derivative will not be closed early and apply an 'old UK GAAP' approach to hedging.

- Share based payments: Where for equity settled schemes, the allocation of a charge is considered a non-cash item which does not aid management understanding of the company's performance.

- Pensions: Where regular assessment of the surplus / deficit would introduce volatility in the short term which is inconsistent with the approach taken to determine funding arrangements.

- Related party transactions: These may not be separately tracked for internal reporting purposes.

There may be some scope for accounting standards and other regulation to be based more on the information that management produces internally. We have seen this work well with IFRS 8 *Operating Segments* ("IFRS 8"). This standard can be viewed as improving financial reporting by allowing users of financial statements to review operations through the eyes of management whilst at the same time reducing costs for preparers. However, in certain areas, such as hedging, this may be more difficult to achieve. Whilst the IASB may, in time, make hedge accounting easier to achieve, we could not foresee a situation where an approach in line with that of old UK GAAP would be adopted by the IASB.

We therefore support a "business model" approach to financial reporting, but overlaid with principles that ensure comparability between entities. IFRS 8 attempts to do this by requiring certain reconciliations and disclosures.

Q4: 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?

We agree that existing disclosure requirements need to be edited and substantially reduced. Even if all the requirements could be justified individually, there comes a point at which their number and complexity begins to render them ineffective. Too many disclosures can add noise and complexity to financial reports. In our view, it is better to concentrate on the most effective disclosures in financial reports rather than legislate for every detail.

A project to reduce disclosures would have several benefits:

- The disclosures in an entity's financial report would be clearer and more informative if the rules were simplified. At the moment, users risk missing important information because it is obscured by less useful disclosures.

- The preparers of accounts would be able to focus more clearly on the essential purpose of the exercise: to present a true and fair view of the entity's performance, financial position and cash flows.

- Simplified rules would be easier to understand and more likely to be correctly complied with as a result.

In our view, a project on disclosures should consider, for each class of disclosure, who that disclosure is used by and whether it is still useful to them. The answers to which are the most important disclosures are likely to vary between different groups of stakeholders. Therefore it is important to involve all groups in the proposed project. If the disclosure is still useful to one or more groups of users, the project should then examine whether the financial report is the most suitable place for the disclosure to be made, or whether the information could be provided in an alternative way.

We recommend that disclosure requirements be reviewed on a regular basis. Whilst we do not think this would be an annual exercise, it would likely need to be repeated every two to three years in order to maintain the benefit of the initial project.

Q5: 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?

The benefit of the preparation and audit of subsidiary accounts highlighted in the discussion paper is creditor protection, which implies a view that the primary users of wholly-owned subsidiary financial statements are creditors. We would agree with this view. We also believe that the tax authorities are a primary user of subsidiary accounts. However, it would be useful to investigate the identity of other users of subsidiary accounts to clarify whether less onerous requirements could be as effective in meeting their needs.

It is necessary to understand whether users require subsidiary financial statements that give a true and fair view of an entity's performance, financial position and cash flows to comment on whether a simplified reporting regime is appropriate. If users of wholly owned subsidiary financial statements do not require financial statements to give a true and fair view, this gives the scope for a completely different reporting regime, such as that proposed in question six.

We believe there would be considerable benefits in a more simplified regime. For example, cost savings in preparation and audit, and allowing preparers to focus on those accounts that are of interest to the wider user group. However, such a proposal would be likely to have wider ramifications than just financial reporting. For example, such a proposal may face opposition from some audit practitioners who would see a decrease in subsidiary audit fees. In addition, under current rules, companies may only make distributions based on their most recent statutory accounts or by reference to interim accounts prepared in accordance with the statutory rules. A proposal to change the current reporting regime for wholly-owned subsidiaries may therefore also necessitate a change to the rules of distributable profits.

Q6: 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?

We see that there would be considerable benefit in such a regime provided that users of wholly owned subsidiary financial statements were found not to require financial statements that give a true and fair view.

Q7: 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?

We consider that there is a risk of imported complexity in national and international regulators working together in a more joined up way. However, the upside is a more consistent application of standards and regulations (e.g., of IFRS). Consistent application aids comparability for global users and hence helps to decrease complexity in financial reporting.

We believe that the risk of imported complexity could be mitigated to some extent through clarity as to each regulator's role. For example, we support the need for one set of global accounting standards, issued by the IASB. However, we also believe that there is still a role for local standard setters to play in implementing these international standards locally and addressing local idiosyncrasies, without making major amendments, additions or exemptions from those standards. We do not support local interpretations of IFRS as this detracts from the objective of one set of high quality standards consistently applied in all jurisdictions.

Once each regulator or standard setters' area of responsibility is clear, as long as each regulator and standard setter applies the 'proportionate' principle proposed by the FRC properly, we consider that this could avoid the risk of imported complexity.

Q8: Clear: Would an emphasis on delivering regulations and accounting standards in a clear, understandable way reduce complexity? How can we move towards clearer regulations and accounting standards?

We agree that, in theory, regulations should emphasise:

- Plain language with well defined terms;
- Consistent terminology; and
- An easy to follow structure.

However, the discussion paper appears to imply that regulators deliberately write regulations that are difficult for users to understand. In our view, complexity in regulations is driven largely by the complexity of the underlying transactions they are seeking to regulate. We agree to some extent that complex transactions can be explained more clearly than they are at present. However, in our view, a focus on delivering regulations and accounting standards in a clear, understandable way cannot reduce complexity in all circumstances.

We believe that the answer to regulations and accounting standards delivering a clear, understandable solution lies to a large extent in reducing the complexity and increasing the relevance of those regulations and standards, as discussed throughout this response.

Q9: Do you agree that principles for effective communication can reduce complexity in corporate reporting?

We agree to some extent. However, we also believe that the majority of preparers would agree with those principles proposed in the discussion paper. Most preparers of financial statements do not intend to write financial reports that are complex and difficult for users to understand. We therefore believe that the key to improving communication in financial reporting is combating the barriers to effective communication, rather than in educating preparers on the principles of effective communication.

We believe that the most important factor in effective communication is the need to write a compelling story of the business. It is clear when looking at an entity's narrative reporting if the preparer has set out with the objective of providing a clear narrative of the business, marketplace and strategy. The resulting report is easy to follow, with a clear overview of the business, strategic focus clear throughout the report and KPI's reported with context. Where preparers set out with the objective of complying with a disclosure checklist, the overall picture is often disaggregated and difficult to follow, and reflects the propensity to focus on compliance rather than getting a clear narrative hold.

Q10: What are the barriers to more effective communication? How might these barriers be overcome?

The discussion paper identifies a number of reasons for the 'kitchen sink' style of reporting that is synonymous with ineffective communication. We agree with the reasons identified. In our view, fear that missing disclosures will be challenged by regulators is one of the key drivers behind the volume of disclosures in corporate reports. We understand that the Financial Reporting Review Panel ("FRRP") needs to ask companies questions in order to monitor reporting effectively. However, questions regarding potentially missing disclosures drive companies and auditors to err on the side of caution and provide immaterial disclosures. We appreciate that the FRRP has changed the text of its letters explaining that immaterial disclosures do not need to be addressed. We believe that companies and auditors need to interpret such questions from the FRRP in the manner that they are intended and have the confidence to make judgements between disclosures that are material and those that are not.

In addition, as noted above, we also see the use of disclosure checklists as a reason for disjointed and ineffective communication. However, we recognise the need by preparers for such checklists given the huge amount of disclosure requirements with which they are expected to comply. As such, as discussed in question four, we believe that a project to reduce existing disclosure requirements would allow preparers to more effectively communicate useful information to users.

We would also emphasise that we see a huge range in the quality of communication of large UK companies, despite the fact that all of these companies operate under the same regime. It may be of some benefit to identify those companies where we see effective communication and understand what they are doing differently from their peers. This may provide some insight as to how they are overcoming the barriers to effective communication and whether this can be replicated elsewhere.

Q11: 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?

It could be argued that each of the areas identified warrants further action if there is sufficient concern amongst users and preparers that current regulations and standards are not meeting their needs. A key purpose of financial reporting is to provide decision useful information to users of financial statements. If users express a valid concern that standards and regulations are not meeting their needs in a particular area, this concern should warrant further investigation.

To this end, and considering the number of specific sources of complexity identified by users and preparers on pages 54 to 55 of the discussion paper, it is our view that there is a valid case for the IASB to review its current post implementation review procedures.

We believe that a post implementation review should gather input from both users and preparers. If users do not find information provided by a particular standard useful and preparers are finding the preparation of that information time consuming and costly (such as in the valuation of acquired intangibles for example) a thorough post implementation review should identify this. It should also facilitate debate between standard setters, users and preparers as to the merit of providing such information.