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Our ref: BT/FRC
Your ref: Discussion paper: Louder than Words

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26 October 2009

Dear Ms Kerr

Discussion paper: Louder than Words

We thank the FRC for the opportunity to comment on the FRC Discussion Paper Louder than Words.

We support the steps taken by the FRC to reduce complexity in financial reporting.

Any specific proposals for the simplification of accounting standards should take into account that the needs of users do not always correspond to the needs of preparers. There is clearly a difficult balance to strike, but the simplification of financial reporting must not be at the expense of ensuring that the preparation of financial statements is based upon objective measures of financial performance and financial position.

Whilst we welcome debate on all of the issues raised in the consultation paper, we are concerned that changing accounting standards so that they are based more on the information that management produces internally could reduce the comparability of financial statements.

Our responses to the specific questions raised by the FRC are included in the attached appendices, together with further detail on the above points.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

John Hudson
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Encls– Appendices A and B

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Appendix A

Detailed comments on 'Principles and actions for making corporate reports less complex and more relevant'

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

   Yes. We believe the principles proposed can reduce complexity. We do not believe there are any other principles to consider.

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.**

   Whilst we are generally satisfied with cash flow reporting we would support the inclusion of reconciliations of net debt in IFRS accounts.

   We are concerned that there are no exemptions from preparing a cash flow statement contained in IFRS or IFRS for SMEs. We note the position of the International Accounting Standards Board expressed in the IFRS for SMEs basis for conclusions (BC139):

   "if a comparative statement of financial position (with amounts for the beginning and the end of the reporting period) and an income statement are available, preparing a cash flow statement is not a difficult, time-consuming or costly task... the great majority of users of SMEs' financial statements who have communicated with the Board—including particularly lenders and short-term creditors—indicated that the cash flow statement is very useful to them."

   Whilst we acknowledge that cash flow statements can provide useful information to lenders, we believe that the requirement for all entities to prepare a cash flow statement would in certain cases impose an additional cost burden on the preparer for little or no benefit to the users of the financial statements, for example, where subsidiary entities are party to a group treasury function, the critical cash flows are those of the consolidated group.

   We support the consideration of the points in "Call for action one – Improve cash flow and net debt reporting", and would also encourage discussion amongst users as to whether there is a preference for the direct method over the indirect method of cash flow presentation. It is not difficult to prepare a cash flow statement using the indirect method and in many cases for smaller entities it is a simple arithmetic exercise. We consider more useful information would be presented via the direct method, as noted in IAS 7, paragraph 19:

   "19 Entities are encouraged to report cash flows from operating activities using the direct method. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method."

In summary, we believe that in addition to improving reporting of cash flows, consideration should be given to circumstances or principles which would warrant an exemption from the preparation of cash flow statements.

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

No. Accounting standards and other regulations should be based as far as possible on objective measures of financial performance and financial position. It is vital that accounting systems capture non-routine transactions and events which impact on financial reporting at the time they occur ensuring that reliable information is available to prepare the statutory accounts.

The information management prepares for internal use will vary from company to company depending on a number of factors including the choices made by management. The use of such information in external reporting is likely to result in a reduction in the comparability of financial statements, as observed following the implementation of IFRS 8 Operating Segments. The need to explain and justify the basis for the preparation of figures not defined in accounting standards could also lead to additional disclosure requirements thus increasing the complexity of financial reporting.

Management can reduce the cost of financial reporting and improve its quality by ensuring that the design of the company's internal information systems takes account of the financial reporting framework used by the company and by the group. Many groups reporting under IFRS find the preparation of financial statements to be a costly exercise because their management information systems are designed for UK GAAP reporting and this often results in a complex conversion process.

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?**

We believe a project on disclosures could help to stem the growth of disclosure requirements. We would encourage any forthcoming project to look at advice to preparers to ensure that key disclosures are given appropriate prominence thus ensuring that the accounts give a true and fair view.

There is scope for reducing the disclosures in respect of valuations made by independent experts. The most important disclosures are the figure arrived at, the method employed or basis of calculation, and the identity and qualifications of the independent expert. Detailed disclosures explaining how the expert arrived at the valuation figure such as volatility and prospective dividends are not necessarily helpful to the users of the financial statements.

In many corporate reports adjusted earnings figures are given greater prominence than the earnings figures that are required to be disclosed by the financial reporting framework, despite the unadjusted figures providing information that is more comparable over time and between companies.

We would support a standard to ensure non-GAAP measures of financial performance are presented consistently and reconciled to GAAP figures where appropriate.

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

The IASB framework identifies seven types of users of financial statements. The users of financial statements in general and the users of the financial statements of wholly-owned subsidiaries are essentially the same; the only significant difference is that in the case of a wholly-owned subsidiary there is only one investor. While group management ought to be able to satisfy its needs for financial information from subsidiaries by communication with the management of subsidiaries, a statutory audit might identify inaccuracies in the reporting of financial performance by subsidiary management. Potential investors in, and counterparties of, wholly-owned subsidiary companies will use the company's financial statements as one of their sources of information. Furthermore, UK Corporation Tax returns are based on entity level financial statements and therefore HMRC will be a user of the accounts of wholly owned subsidiaries.

It is important to consider why groups create and retain subsidiary companies. Often subsidiaries exist to reduce the group's exposure to risk and often there is a corresponding increase in the risks faced by external parties. We believe that these external parties have the right to reliable information about their own exposure to risk. Companies are legal persons whereas groups are not, therefore the activities and financial position of individual companies will be of interest to regulators, including HMRC, creditors and other users as noted within the IASB Framework. The cost of preparing and filing financial statements is part of the price an entity pays for the benefit of limited liability.

As the financial statements of wholly-owned subsidiaries are used in much the same way as company financial statements in general we believe management should prepare and file audited financial statements that show a true and fair view and this will inevitably mean that a number of disclosures are required. As noted previously we would encourage disclosure exemptions for cash flows where these are managed on a group basis, and can envisage the disclosure project highlighting other areas where disclosures could be reduced in consultation with users.

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?**

The EC Fourth Accounting Directive allows for an exemption to the requirement to prepare, audit and file subsidiary accounts in article 57 if specific conditions are met. One of the conditions is that the parent company must have declared that it guarantees the commitments entered into by the dependent company. This exemption has not been adopted in UK law. We believe that relatively few companies would be prepared to give a general and unlimited guarantee in respect of a trading subsidiary for risk-related reasons similar to those noted in 5 above.

Even in cases where a general guarantee of subsidiary's commitments was given we believe that many users would still be legitimately interested in the accounts of individual companies. There will always be a cost incurred in attempting to enforce a parent company guarantee and success would never be certain or instantaneous. HMRC would be a user of subsidiary accounts whether or not a guarantee was in place.

For the reasons given above we do not consider it to be desirable to eliminate the UK requirement to prepare, have audited, and file wholly owned subsidiary accounts even where there is a parent company guarantee.

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?**

Governments, regulators and standard setters working together in a more joined-up way nationally and internationally should reduce complexity overall. In the UK, we would encourage the Government, the FSA and standard setters to work more closely in order to avoid the overlapping of requirements which can increase the cost and complexity of corporate reporting for little or no benefit to the users of the reports.

There is a danger however that when two accounting standards setters decide to converge two accounting frameworks that the final outcome is a set of standards with significantly more requirements than either of the frameworks which it replaces. The risk can be reduced by agreeing principles of good regulation prior to convergence and testing each proposed requirement against the agreed criteria.

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?**

An emphasis on delivering regulations and accounting standards in a clear, understandable way would reduce complexity. Standard setters and legislators need to agree principles of good regulation and review existing requirements and proposed change against those principles.

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

We believe that a principles based approach would result in higher quality corporate reports which would be less complex and more relevant for users. We expect that preparers might have to invest more time in order to produce high quality reports which refer specifically to the risks and opportunities relevant to the company rather than containing generic statements.

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

The main barriers to effective communication are the existence of excessive disclosure requirements and a rules-based regulatory regime which can result in companies focussing more on compliance than on providing relevant high level information of genuine interest to users. At best this can result in long reports containing information that users are not interested in and at worst it can result in a "copy and paste" approach where preparers copy from the reports published by other companies without proper consideration of the specific circumstances of the company and its performance for the year.

The discussion paper refers to the fact that International Standards on Auditing require auditors to report all disclosure omissions identified to the appropriate level of management unless they are 'clearly trivial'. We agree with the suggestion that this requirement may result in an undue focus on immaterial items.

One of the challenges to simplifying corporate reporting is identifying changes which will be supported by both users and preparers of corporate reports.

There are also entity specific barriers which require to be overcome in many cases. We note with interest that the FRC discussion paper says users "do not consider them too complex overall", whereas "the preparers we interviewed almost unanimously believe the process of compiling a corporate report is too complex, and so are the reports themselves". One reason for this apparent discrepancy is that companies spend a disproportionate amount of time ensuring the completeness and accuracy of the figures in disclosures that are not material to the financial statements to the detriment of providing useful and qualitative narrative reporting.

As highlighted above, more time is required to prepare financial statements if the management information system is based on a different reporting framework than that used to prepare the group financial statements.

A layer of complexity is introduced by the fact that UK Company Law currently provides preparers with the option to prepare parent and subsidiary financial statements under UK GAAP, whilst requiring reporting of consolidated financial statements under IFRS. This would be removed if all related entities were required to apply IFRS, as noted by the ASB in *Policy Proposal: The Future of UK GAAP*. The downside is that IFRS requires significantly more disclosure.

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?

Our comments on the specific sources of complexity in corporate reports noted on pages 54 to 55 are contained in Appendix B.

We consider that the Auditing Practices Board, the International Accounting Standards Board and the Accounting Standards Board are best placed to take the necessary action to simplify corporate reporting.

Appendix B: Opportunities for further action

Opportunities for further action as identified on pages 54 and 55 of *Principles and actions for making corporate reports less complex and more relevant*	**Our comments**
(a) Acquisition accounting Users and preparers both say that valuation of acquired intangibles is unnecessarily complex because it is time consuming to do and does not result in useful information.	The recognition of intangibles such as customer relationships separately from goodwill is not simply a disclosure issue as it affects the post acquisition results of the group. Unlike goodwill, many types of intangibles have limited economic lives. We therefore consider such valuations to be essential.
(b) Capitalisation of research and development (R&D) costs Users say that capitalisation of R&D costs is confusing because no two companies make the same judgements and it reduces the ability to compare entities. Even within a single entity, it is difficult because it means that costs are not shown in one place.	The capitalisation of development costs in certain circumstances is consistent with the principles in the IASB framework. If it was decided not to capitalise development costs in any circumstances the definition of an asset in the IASB framework would have to be changed and such a change could have far reaching implications. It is certainly true that people can reach different judgements on future events but this permeates financial reporting, in particular such judgements are made as part of impairment reviews and when determining fair values on acquisition.
(c) Choices Users are concerned that choices in accounting standards reduce the ability to compare entities, particularly in relation to the choice of adoption dates for IFRS.	The main issue raised in the paper in relation to choices was the choice of adoption dates for IFRS. Companies have a choice as to how far back they wish to go in the retrospective application of IFRS 3 to business combinations occurring prior to the date of transition. The availability of this choice reduces comparability of financial statements but provides the means to address circumstances where an entity does not have sufficient historical information to apply IFRS 3 retrospectively to all business combinations. We do not see a practical alternative to the current approach of providing exemptions in cases where the available historical information would otherwise be insufficient to comply with IFRS.
(d) CSR agenda Many users and preparers say that CSR information can be important; but they are concerned that overloading reports with this type of information may make them cluttered.	We agree with the comments made by the users and preparers. The purpose of the annual accounts and report is to reflect the company's performance during the year and its position at the year end and in our view much non-financial policy matters will not normally fall into this category. We believe it would be more useful to employees and to the public if a company published its policies on employee involvement and disabled persons on its website and updated the site when policy changes were made rather than republishing the policies every year in the annual report whether or not they have changed. Similarly, a quoted company ought to have the option of publishing a separate annual environmental performance report on its website rather than as part of its financial reporting process. We believe further action in this area is warranted.
(e) Defined benefit pensions Both users and preparers say there is significant underlying complexity in relation to the valuation of pension plans. There is also a belief that pension disclosures should include future cash flows relating to pension scheme funding.	There may be scope for further action in this area, however we draw attention to the ASB best practice paper "Retirement Benefits - disclosures" which included 6 principles to provide clear disclosures in this area. We feel that this, combined with IAS 19, provides best practice, and covers the users concerns since the best practice paper recommends disclosure of the funding obligations, including how the entity will fund any shortfall and any payment plans agreed with Trustees.
(f) Discontinued operations Many users consider discontinued operations accounting complex because changes in plans often result in numerous restatements for each discontinued operation. Many favour a disclosure-only treatment.	We are in agreement with the comments made by users. Users only really require disclosures to indicate the future impact of the discontinuation of operations. We believe there is significant scope for improvement of *IFRS 5, Non-current Assets Held for Sale and Discontinued Operations* and that further action in this area is warranted.

Appendix B: Opportunities for further action

(g) Embedded derivatives Many preparers observe that the 'witch hunt' for embedded derivatives and the process of valuing them is complex and time consuming – and does not always yield a sensible result.	Many of the problems preparers experience in relation to embedded derivatives result from the fact that they have entered into transactions whose accounting effects they do not fully understand. Whilst the results of valuation exercises for embedded derivatives can yield results that are unpredictable and unexpected we do not share the view that the process does not always yield sensible results. Please see our comments on (j) below.

(h) Fair value Fair values are considered complex where there is an absence of a market for determining the value. In addition, the gain on write-down of own debt has sharply polarised opinion – with views ranging from 'inevitable' to 'absurd'.	There is scope for simplification in this area and we welcome the steps that are being taken to simplify IAS 39. Please see our comments on (j) below.

(i) Financial instruments: general Users and preparers are concerned about the significant underlying complexity of financial instruments as well as the very complex and detailed accounting standards that many consider add unnecessarily to complexity in this area.	There is scope for simplification in this area. Please see our comments on (j) below.

(j) Financial instruments: risk reporting/disclosures Both preparers and users are concerned that financial instruments disclosures made in accordance with the minimum requirements are not as useful as they could be.	We believe that disclosure of financial instruments should be risk based. The total number of disclosures could be reduced if the maximum exposure resulting from financial instruments was disclosed. We believe further action in this area is warranted.

(k) Hedge accounting Qualifying for hedge accounting treatment is time consuming for preparers. Both users and preparers have a preference for using hedge accounting treatment for economic hedges, even if they don't meet the strict requirements to qualify for hedge accounting.	We believe hedge accounting should normally be available as an option for entities that are genuinely hedging their exposure to risks. We believe that the current requirements are too strict. Provided preparers have set our their intention at inception we see no good reason why hedge accounting should not be used in more cases. It should be noted however that increased flexibility will reduce comparability and could result in increased disclosure requirements. There may be scope to reduce the disclosure requirements in relation to hedge accounting and focus on key issues such as whether the directors have decided to fair value hedge or to cash flow hedge. We believe further action in this area is warranted.

(l) Interpretive guidance Many preparers say the proliferation of interpretive guidance for accounting standards such as IFRIC interpretations and accounting manuals produced by audit firms adds to complexity.	We believe that accounting standards should be principles based and that the principles and requirements should be expressed as clearly as possible. We recognise however that there will always be a need to interpret principles and requirements and we believe that interpretive guidance helps to ensure reasonable and consistent interpretation, especially as guidance can include worked examples which would not be included in the standard. If interpretations and guidance were not published there would be a greater number of perceived choices available to preparers which would reduce the comparability of financial statements.

(m) Parent company financial statements Many users say that they do not use the parent company financial statements in annual reports.	Dividends to shareholders of the parent company can only be paid from the distributable reserves of that company. The parent company financial statements are therefore relevant to investors and potential investors in the parent company. We therefore believe it is right to continue including parent company financial statements in the annual report of the Group.

Appendix B: Opportunities for further action

(n) Remuneration reports Many users observe that remuneration reports are too dense to be useful. They want greater focus on important details such as how performance ties to remuneration, less boilerplate text and greater use of graphical displays of information.	We do not consider any of the disclosure requirements of the Listing Rules to be unnecessary in fact there is a strong argument for additional disclosure such as the share based payment charge for each director and more precise details of performance criteria linked to bonuses and share option schemes. We agree that such reports could often be more focussed on the important details.

(o) Segmental reporting Users are still looking for greater granularity and cash flow information at the segment level.	Recommending more detailed disclosure requirements would dilute the core message that reporting should be made simpler. In many cases more detail is already available in the accounts of subsidiary companies.

(p) Share-based payments Share-based payments are difficult for preparers. Because there is significant underlying complexity and the standard is very detailed and rules-based, they often need to employ an expert to help.	We find that in many cases share-based payments are relatively straight forward to account for but acknowledge that complexity arises due to the complicated drafting of the legal agreement with the employees. We believe that IFRS 2 is already based on a sound principle, although it could be presented in a simpler fashion and there is scope to reduce disclosure requirements.