THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

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Our ref: ICAEW Rep 108/09

Your ref:

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Dear Melanie

LOUDER THAN WORDS

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on the discussion paper, *Louder than Words: Principles and Actions for Making Corporate Reports Less Complex and More Relevant*.

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

Yours sincerely

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW REPRESENTATION

ICAEW REP 108/09

LOUDER THAN WORDS

Memorandum of comment submitted in September 2009 by The Institute of Chartered Accountants in England and Wales, in response to the Financial Reporting Council discussion paper, *Louder than Words: Principles and Actions for Making Corporate Reports Less Complex and More Relevant*, published in June 2009

Contents	**Paragraph**		

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to comment on the discussion paper, *Louder than Words: Principles and Actions for Making Corporate Reports Less Complex and More Relevant*, published by the Financial Reporting Council.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 165 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

4. Our members occupy a wide range of roles throughout the economy. This response was developed by the Financial Reporting Committee of the Institute, which includes preparers, analysts, standard-setters and academics as well as senior members of accounting firms and public sector bodies.

MAJOR POINTS

Welcome for the initiative

5. We welcome this initiative from the Financial Reporting Council (FRC). It is important that, as far as possible, the complexity of corporate reporting should be reduced and its relevance increased. Complexity in reporting and regulation imposes costs on those who have to understand it. It means that considerable time has to be invested in understanding the rules and that there is a risk that important messages will not be understood. As far as possible, for the benefit of both those who prepare corporate reports and those who use them, a principles-based approach is preferable. We believe that the discussion paper (DP) provides a useful analysis of the issues and some interesting ideas for how progress can be made.

Relevance

6. Although the DP's title indicates that it is intended to cover both relevance and complexity, the emphasis seems to be more on the latter. So far as there is a relationship between the two issues it depends on the proposition that the inclusion of irrelevant information in reporting makes it more complex. It may be that this is the principal aspect of relevance that the FRC wishes to deal with. But if the FRC wishes to consider the question of relevance further it may be helpful to do so in a separate publication.

Follow-up

7. The DP's proposals for action should be followed up where appropriate in the light of comments received on the DP. Much of the potential for further action, where it is needed, seems to lie in the hands of third parties. So it will be useful, in due course, to know what the FRC itself plans to do. The ICAEW would be interested to be consulted on any follow-up projects and to assist in them where we can do so.

Users

8. We note that the users whom the FRC spoke to in preparing the DP ‘do not consider [annual reports] too complex overall’. On the evidence of the DP, concerns about complexity seem to lie much more with preparers. If this is correct, while it does not remove the problem, it does mean that the problem is perhaps rather different from what people have assumed it to be. It also needs to be borne in mind that users' requirements for relevant information are met in a variety of ways, and not just by annual reports. For example, timely information is obtained through the requirement to release price-sensitive information to the market as quickly as possible. Users also find that early but incomplete information in a preliminary announcement or earnings statement fulfils an important need. This information is subsequently confirmed and augmented by the annual report, which serves as a useful work of reference.

9. It is not clear from the DP whether the users consulted included private investors. We believe that it would be useful to investigate their views separately. One possibility is that they tend not to use the annual report directly, but prefer to use intermediary sources of information such as newspapers, magazines, analyst reports, online sources such as Google Finance, and so on. Information in annual reports may therefore reach private investors indirectly, and after filtering and analysis by third parties. Private investors may in this way overcome complexity through using alternative sources of information.

10. Even sophisticated, professional users of financial statements can be sub-categorised into distinct and important groups that may have very different needs. Not only are there different equity investors and their advisers – tracker and index funds, long-term value investors, day-traders/short-sellers and arbitrageurs, buy-side/sell-side analysts – but there are also important debt-related users, such as credit rating agencies and the like. The type, extent and complexity of information that these users may want from the annual report may vary considerably, and yet all are purported to be served by general purpose financial statements under the IASB Framework. So we believe the discussion (page 10) on ‘Remembering who the users are’ needs to be rather more sophisticated in terms of developing some insight into who the users are that have a legitimate interest in the annual report.

11. Having said that, we agree with the final paragraph on page 10, that annual reports should not be used for other types of reporting or other social policy objectives. There are other mechanisms whereby such information can be reported, particularly for listed companies, which in the UK must maintain a website, thus providing a channel through which information can be updated frequently and easily. The business review, under UK legislation, rightly deals with issues such as environmental matters only to the extent that they are relevant to the members of the company, who in law are the primary users of the financial statements.

Necessary and unnecessary complexity

12. The DP defines ‘complexity’ as ‘anything that makes regulations or the reports themselves unnecessarily difficult to understand, implement or analyse’. The restriction of ‘complexity’ to unnecessary complexity is an unconventional, but probably sensible approach – though it does risk some misunderstanding as to what can realistically be achieved. It may be, for instance, that most of what is conventionally regarded as complexity is in fact unavoidable complexity. In which case, putting the report’s proposals into effect will still leave most complexity in place.

13. It may be useful to investigate what has caused the growth in the volume of business reporting overall, which will have added to both necessary and unnecessary complexity. Possible causes include:

- the growing complexity of businesses and their transactions;
- the growing value of investments, which makes additional information costs worthwhile;
- the growing ability of at least some users to cope with the increased volume and complexity of information;
- persistent demands from users for more information; and

- falling costs of providing and accessing information (eg, on the internet).

14. For example, the report suggests (top of page19) that users 'find it less useful to see six pages on share-based payments', but the share-based payment number in the financial statements will have been calculated according to a complex model. Should users be able to see inside the ‘black box’ or are they happy to accept the number at face value? A similar argument would apply to defined benefit pensions inputs and models and complex financial instruments. Experience suggests that more sophisticated users want to see the model and its inputs so they can adjust assumptions and information. This inevitably leads to voluminous and complex disclosures. But it also probably leads to better user understanding of important figures in the financial statements.

15. It would also be useful to look at how different users cope with the growing volumes of information available, and the added necessary and unnecessary complexity that this entails. As we have suggested, private investors may well cope by using alternative sources of information and analysis, which in effect process corporate reporting information for their benefit. However, all users have diverse sources of information available to them, and we can correctly assess how they use corporate reporting only if we understand their overall approach to information and investment.

Is avoiding complexity a priority?

16. The evidence referred to in the report casts doubt on whether the current degree of complexity really is a major problem for users. It may be worthwhile going beyond this to consider in general how high a priority the avoidance of complexity is for them. Our experience is that those who want additional information to be disclosed by businesses are rarely put off by being told that it would add to the complexity of reporting.

Underlying complexity

17. We have suggested that one cause of growing complexity in reporting is the growing complexity of businesses and their transactions. It is perhaps natural to seek to report on this underlying complexity in as simple a way as possible. But there is also something to be said for the complexity of reporting reflecting the complexity of what it is reporting on. One of the disadvantages of underlying complexity is that the parties to transactions may be exposing themselves to risks that they do not fully understand. If the underlying complexity is apparent in the reporting, this may bring pressure from investors to avoid unnecessary complexity in the business and its transactions. We refer to an example of this below that relates to financial instruments.

Describing business reality

18. The DP talks about the view of some that 'accounting is becoming too theoretical' and no longer describes business reality (page 19). The restrictions on hedge accounting are given as an example of ‘theoretically correct’ requirements, which lead to reported results that do not match economic performance as perceived by management. But users surely would not want a complete free-for-all and so some level of restriction is required. If people do not know what the acceptable boundaries are, there will potentially be a need for more and more extensive disclosures in order to make up for distrust of figures prepared under lax rules. Restrictions on hedge accounting should not, therefore, be seen as the result of excessive theory, but as the result of the desire for a degree of standardisation in accounting practices. Whether the current hedge accounting requirements are the best possible is a separate question.

19. In terms of 'describing business reality' and perhaps describing underlying performance, it would have been helpful to have a more extensive discussion on non-GAAP measures. For example, it would be useful to consider whether and how these ought to be brought within the financial standards framework by requiring consistency over time and reconciliation to GAAP measures or whether they should simply be left to stock exchange regulators to deal with. An important aspect of this is how far non-GAAP measures should be brought within the scope of

audit requirements for the financial statements or whether alternative forms of assurance would be more appropriate.

Changing people's behaviour

20. As the DP points out, its proposals require people – regulators and preparers – to change their behaviour. This is always a difficult task. The FRC may wish to consider what the motivations will be for regulators and preparers to change their behaviour in the ways proposed. How will they will gain from making the proposed changes in their behaviour or lose from not making them?

Unintended consequences

21. We believe the discussion on unintended consequences (page 20) is a little unfair, in that it seems to assume that the standard-setter can always get things right first time. It should certainly aim to do so, and perhaps could do better, but we believe perfection is an unrealistic objective. It should be recognised that sometimes new standards will require adjustment in the light of experience – although not too much if their principles are properly articulated. Standard-setters should undertake post-implementation reviews to pick up such problems, and the IASB already does this.

RESPONSES TO SPECIFIC QUESTIONS

Question 1

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

22. We believe that the four principles proposed would help to reduce complexity if they were put into effect. The difficulty of course lies in putting them into effect. We suspect that most regulators would in fact be happy to subscribe to the four principles and may indeed believe that they already comply with them.

23. So why are there problems in practice? We have identified three sources of difficulty, and there may be others:

    - The regulator's perspective is usually significantly different from that of the regulated. For example, what seems unclear or disproportionate to the regulated may well seem perfectly clear and proportionate to the regulator.
    - Coordination among regulators may involve at least one of them achieving less than it wants. Why would any regulator accept this voluntarily?
    - Shortage of time or resources may add to regulatory complexity. Saying things clearly and simply takes time, effort and ability. These may not be available.

24. Also, perhaps above all, it needs to be recognised that a good deal of what is conventionally regarded as regulatory complexity may fall into the category of 'necessary complexity', which limits the potential effectiveness of the four principles.

25. The four principles proposed by the FRC are similar to the government's five Principles of Good Regulation by which the FRC is itself bound. 'Proportionate' and 'Targeted' appear in both lists. 'Clear' and 'Coordinated' in the FRC's list may be regarded as equivalent to 'Transparent' and 'Consistent' in the Principles of Good Regulation. However, the Principles of Good Regulation also include 'Accountable', which is missing from the FRC's list. Accountability seems to us to be an important principle for any regulator, and likely to lead to better regulation.

26. While this does not amount to a principle, we believe that the length (and therefore the complexity) of the printed annual report could be reduced if some of the information currently

included in it were made available purely on the company website. Any information put on the website should be properly structured so that users can navigate it effectively. Transferring information to websites would not reduce the volume (or complexity) of corporate reporting overall, but it would help address the problem that some people see with the length of the annual report. It should not be assumed that people want to read a report from beginning to end; rather, they will be interested in dipping in for specific pieces of information, so structure and searchability are likely to be most important when information is delivered electronically.

Question 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.

27. This is an important question, and the users' comments in the DP suggest that it deserves further work. We endorse the point made in the DP that there is a need for a reconciliation of opening and closing net debt, which would provide helpful information for users. It may be a useful exercise for the FRC to make available once again the responses received by the Accounting Standards Board when it consulted on the amendments to FRS 1, *Cash Flow Statements*, embodied in the 1996 revision of the standard. Comments at that time raised much the same issues that the FRC has highlighted now. The best way of making any changes would probably be through amendments to IFRS. Although of course there is nothing to prevent companies giving the relevant information on a voluntary basis, presumably some level of standardisation would be beneficial.

28. There is little discussion in the DP on whether sectoral changes could reduce complexity for some companies. It may be that cash flow/net debt reporting is of varying importance in relation to different industry sectors. For example, cash flow reporting for insurers may be much less important than for manufacturers. For some sectors, existing requirements – other than in relation to the reconciliation of opening and closing net debt – may be appropriate, in which case, for these companies they should be left in place.

29. Another area of reporting in need of improvement – and one that we would have expected to be raised by the DP – is the net income/other comprehensive income divide in the statement of comprehensive income. Users apparently do not understand that there is no underlying principle in the standards as to what is or is not in net income, in terms of recognised gains and losses.

Question 3

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

30. Other things being equal, the closer accounting requirements are to management practice the better. However:

    - What is appropriate for internal users will not always meet external users' needs.
    - What management produces for internal use quite rightly varies from company to company, and the object of standardisation is to reduce variation to an appropriate extent for the benefit of external users.
    - Sometimes externally imposed requirements can improve management's perception of an issue. Some would argue that this has been the case with, for example, defined benefit pension costs.

31. Under the 'proportionate' heading, the paper also states (page 23) that 'most users mentioned that they do not consider valuation of intangible assets acquired in a business combination useful.' While we have heard anecdotal evidence to the same effect, it would be helpful to understand why users take this view and what, if anything, they do use the information for. Some harder evidence would be helpful, particularly as there are those who would like to

extend considerably the number of intangibles, including internally-generated ones, that should be valued and put on company balance sheets.

Question 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?

32. We see great difficulty in stemming the constant growth of accounting disclosure requirements, which is mainly a response to demands from various users. The past two years, for example, have seen both:

    - a series of reports (including the FRC's) calling for shorter, less complex reporting; and at the same time
    - even more demands for greater disclosure in the light of the current financial crisis.

    We note that the FRC's own list of opportunities for further action includes calls for additional disclosures on some matters.

33. We believe that listed companies, the focus of the DP, often already do their best to highlight the most important financial reporting information. Going beyond this, and trying to establish in a standardised way what are the most important disclosures might well add to the volume of unnecessary regulation; what is important will vary from company to company and, often, from year to year.

34. Nevertheless, there may be scope to set criteria for standard-setters and regulators against which to judge whether disclosures should be mandated. Relevant criteria might include evidence as to the disclosures' use, whether they are required in order to understand other necessary disclosures, and so on. This approach could include sunset clauses on new disclosure requirements, thus requiring evidence for renewal. Experience to date suggests that it is very difficult to remove a disclosure requirement once it is in place. The Financial Services Authority (FSA) consultation on which disclosure requirements to drop from the Listing Rules following the implementation of the Disclosure and Transparency Rules provides an example. The FSA did not consider that those demanding the retention of disclosure requirements that it had suggested deleting had to provide evidence as to why the disclosures were important. Simply by objecting to their removal ('just in case') the objectors succeeded in retaining them. So if there is to be any reduction in requirements, a radically different approach will be needed.

35. We hope that the US Financial Accounting Standards Board's recently launched project on a disclosure framework will be able to develop a useful approach to these questions, which could then be considered by the International Accounting Standards Board (IASB).

Question 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?

36. We have not researched the question, but we suspect that the main users of the accounts of wholly-owned subsidiary companies are lenders, customers, suppliers, employees and tax authorities. While it is true that many very large groups can have hundreds of subsidiaries, whose financial reporting thus takes a great deal of time and effort, the decision to create such complex structures is presumably driven by considerations such as tax and liability management. It is not clear that financial reporting requirements should be simplified, potentially to the detriment of creditor users, where the group itself has chosen to expose itself in this way to additional complexity and volume of reporting.

37. While a simplified filing regime for wholly-owned subsidiaries may nevertheless be appropriate, we believe that further work needs to be done on this question first to ascertain users' needs and views. Only then should proposals for possible reforms be developed.

38. Although the question of assurance is outside the scope of the DP, in reconsidering the regulatory regime for wholly-owned subsidiaries, it would be sensible to look at the relevant audit requirements at the same time. Again, it will be important to understand users' needs and views first. The ICAEW Audit and Assurance Faculty report *Alternatives to Audit* (2009) is based on research into a parallel area, audit-exempt companies, and may be useful in considering alternative forms of assurance for wholly-owned subsidiaries. The FEE report *Survey on the Provision of Alternative Assurance and Related Services Across Europe* (2009) is also relevant.

Question 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?

39. This issue was considered not that long ago by the Company Law Review, which decided against any change of the type suggested in the DP. If there is a substantive demand to revisit the question, then we believe that further work is needed before proposals for reform can be made. It is possible that users are interested in information on wholly-owned subsidiaries even where there is a parent-company guarantee. This is partly because it may not be certain that the guarantee will be completely effective and there may be significant potential difficulties and costs in invoking it. Analysts also often use subsidiaries' accounts to help them understand the sectoral and geographical breakdown of a group's activities. If some simplification or reduction is permitted for wholly-owned subsidiaries, the quid pro quo may need to be more disclosure in the group financial statements about cross-guarantees, but also about the group structure generally, where the major assets and operations are legally held, and so on. Our initial view is that changes of the sort suggested in the DP are unlikely to achieve a great deal, because in many group situations parent companies will consider it detrimental to their shareholders to offer legally-binding parent company guarantees.

Question 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?

40. As the wording of the question indicates, working together by international regulators may import higher levels of complexity rather than reduce it. While we support increased working together by international regulators, and it would be good if this did indeed reduce complexity, we do not see any way of guaranteeing this outcome. In particular, different jurisdictions have very different histories of development of financial reporting and different legal approaches, including the penalties for misstatement and the ability of investors/market participants to gain redress. There is a risk of importing inappropriate approaches to regulation from regimes with very different legal environments.

41. In terms of overlapping regulations (page 28), we agree these are very frustrating and certainly unnecessary. We have, for example, been pressing the Department of Business, Innovation and Skills (BIS) and the FSA to deal with the overlap between the Companies Act and the Listing Rules on disclosure of directors' remuneration, but to no avail. Regulators have to step up to the mark when these things are pointed out to them, and that should be done first at a national level.

42. By contrast, we are not clear that the complaint about the confusion and overlap between quoted/listed/admitted to trading categories implied by the DP on page 29 is fully justified as

there is no discussion as to why these categories exist or what they are used for. In some instances, having separate categories is important to avoid the most complex and far-reaching requirements being applied to smaller entities with publicly traded shares. There has to be some level of categorisation in order to allow appropriate application of regulatory requirements, depending on risks and circumstances.

Question 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?

43. The DP includes an excellent example (drawn from IFRS 2, *Share-based Payments*) of how the drafting of standards could be improved. It is difficult to see, though, how improved drafting can be institutionalised. Poor or complex drafting is common in other areas of regulation and legislation, and the complaints about it there are just as loud. This seems to be a topic on which the users of regulation just have to keep pressing for improvement, including offering alternative drafting. As necessary complexity grows, this is likely to be a continuing struggle.

44. We know that standard-setters are aware of the problem of consistency of terminology and obviously it would be helpful if standards and other regulations were as consistent as possible – as long as this leaves standard-setters suitable freedom to define things properly. However, it should be recognised that consistency of wording is not the only problem. On pages 35-36 the DP talks about words such as 'remote', 'probable', and 'virtually certain'. It is interesting to note that the way similar words have been interpreted in the US in relation to SFAS 5, *Accounting for Contingencies*, is so far from their natural meaning that they are impossible to understand if taken at face value (so, for example, lawyers will advise that a loss is 'probable' only if it is a lost cause, not 'more likely than not').

45. In terms of improving the structure and usability of IFRS, the IASB has not been in existence for very long and there are gaps in the literature that still need filling. US GAAP is much longer established and this probably makes a codification project more straightforward (and necessary given the much greater volume of interpretation). While we would support an eventual codification of IFRS, we believe the IFRS canon needs to develop further, and the IASB has more urgent issues to deal with, before it should be contemplated. Given the varying sources of requirements for UK GAAP, there is perhaps a case for its codification, but it might be difficult to achieve. In practice, the accounting manuals produced by audit firms, which bring together the different requirements from various sources, provide a helpful way around the problem.

Question 9

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

46. We are sure that everyone would welcome corporate reporting that is focused, open and honest, clear and understandable, and interesting and engaging.

47. We believe that corporate reporting in the UK is honest and that cases of dishonesty are unusual. We also believe that managers are open in disclosing material information about their businesses; as indeed they are required to be by law in the case of listed companies. Increased openness will usually add to the length of reporting and, as the DP indicates, increased clarity can also have this effect. While length and complexity are not the same thing, we suspect that for many people increased length effectively means increased complexity.

48. Making corporate reporting interesting and engaging will always be a challenge. People pay to read things that are interesting and engaging, and it is difficult to see corporate reporting ever reaching this level of success. There is always likely to be a constraint on how well-resourced a financial reporting function will be and how much staff time will be available, particularly as

reporting deadlines have been substantially shortened, to rewrite material that is already in compliance with the relevant standards and regulations. By and large, users read corporate reports from financial motives rather than for entertainment, so it is in any case perhaps worth asking how much effort it is appropriate to devote to making them interesting and engaging. As already noted, it should not be assumed that people want to read a report from beginning to end; rather, they will be interested in dipping in for specific pieces of information, so structure and searchability not an engaging narrative read, are likely to be most important when information is delivered electronically.

49. The fact that it is difficult to disagree with the proposed principles may indicate why it is doubtful how effective they will be. Most preparers may consider that they already comply with them or that, where they do not, there are good reasons for this (see Question 10).

50. It has been suggested that one way in which preparers could reduce unnecessary complexity would be by removing unnecessary disclosures. However, preparers may not know which items in their disclosures are used or by whom. If it is desired to cut disclosures by listed companies, it would be helpful if the FRC could produce guidance for preparers on how they can decide which of their disclosures are useful. Or perhaps the FRC could initiate a project to identify useless disclosures in published reports.

51. One example of unnecessary complexity that we would like to draw to the FRC's attention is the requirement for disclosure of auditors' remuneration. While we agree that there is a need for disclosure of auditors' remuneration, this on the face of it relatively minor matter currently needs 29 pages of guidance so that people can understand and apply the rules. The FRC could usefully tackle this issue with BIS and the auditing profession, so as to improve the current requirements.

Question 10

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

52. We have identified four barriers to effective communication (there may be others): time, ability, motivation, and legal liability.

53. Typically, it takes more time to draft something clearly. As noted above, preparers may not have the time to do this or may consider the time it would take better spent on other things (eg, managing the business).

54. Drafting is a skill. Those who prepare corporate reports will not necessarily have it or even recognise that it is needed. It can be bought in, but preparers may not consider the gains to be worth the additional costs, which include the time-costs of briefing the external drafters and checking and revising their work.

55. The principal penalty for poor communication is a higher cost of capital. But, as noted earlier, those who bother to read corporate reporting are probably motivated to do their best to understand it by financial motives. So, as long as key users – ie, those who have an effect on stock prices – think that they understand the company's reporting, preparers will have little incentive to reduce complexity. It is of course possible that the complexity is necessary to meet key users' information needs, in which case it cannot be said that the communication is ineffective.

56. Preparers need to take care that they meet all legal and regulatory requirements, and failure to do so carries damaging reputational (and other) penalties. It is hardly surprising if preparers tend to give priority to ensuring compliance, rather than to the positive aspects of communication. The Financial Reporting Review Panel has, however, helped mitigate this problem by emphasising publicly that it is uninterested in investigating apparent cases of non-compliance with requirements where the item in question is immaterial.

57. It may also be worth looking at requirements placed on auditors. For example, ISA 260, *Communication of Audit Matters with those Charged with Governance*, requires the auditor to communicate 'all uncorrected misstatements other than those that the auditor believes are clearly trivial'. This encourages attention to immaterial items and seems to be a barrier to taking a more sensible approach to materiality issues.

58. Overall, though, we do not see a neat way to overcome these barriers to effective communication. In each case, the FRC will need to investigate the costs involved in the various ways that communication might be improved and assess how these costs compare with the benefits likely to accrue to those who incur them. In this way, it may become clearer which obstacles can be overcome or why they are not being overcome.

Question 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?

59. The DP lists 16 opportunities for further action. We discuss each of these in turn below and, where applicable, suggest which organisation would be best placed to assist with any further action.

Acquisition accounting. We agree that the usefulness of the current requirements on accounting for acquired intangibles is worth investigating. This is a matter for the IASB.

Capitalisation of research and development (R&D) costs. It is likely that different accounting decisions by different companies reflect different underlying circumstances. However, as users have expressed concern on this issue, we agree that the usefulness of the current requirements on capitalisation and disclosure of R&D spending should be investigated. This is a matter for the IASB.

Choices. The desirability of choices in accounting standards is a matter that needs to be assessed case by case. However, the complete elimination of choice in financial reporting would require a rule-book that has an answer for every conceivable eventuality that might arise. This is likely to add to the complexity of regulation.

While we understand that there may be some disadvantages to users in allowing early adoption of new requirements in standards, there are also advantages. Changes to standards should be improvements, so there is an argument that those who are able to adopt improvements early should not be discouraged from doing so. Also, within the financial reporting community as a whole there are – as with any activity – advantages in having pioneers so that others can learn from their experiences.

CSR agenda. So far as we are aware, any extensive CSR information in annual reports above and beyond that required by the business review requirements in the Companies Act is put there voluntarily by managers. We do not think they should be prohibited from doing this if they wish to do so, but it does tend to distract from the primary purpose of the financial statements. Readers who object to bulky printed reports can always go online for more targeted access. And as we suggested above, companies should perhaps be encouraged to provide more and better-structured online information rather than clutter up the annual report unnecessarily.

Defined benefit pensions. We agree that the case for disclosing future cash flows relating to pension scheme funding should be investigated. Such disclosures would of course add to the volume of reporting. This is a matter for the IASB.

Discontinued operations. We agree that the accounting requirements for discontinued operations should be investigated as we believe IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, is a deficient standard. This is a matter for the IASB.

Embedded derivatives. We are not sure what preparers have in mind when they say that the search for embedded derivatives does not always yield a sensible result. However, if preparers have these concerns they should be investigated. This is a matter for the IASB.

Fair value. We agree that fair value measurements can be complex where there is no market for the item in question. We are not sure what opportunity for action the FRC sees here. Is it suggesting that fair value measurements should only be used where they are Level 1 measurements? If so, this is a matter for the IASB.

We also agree that there are sharply differing views on gains on the write-down of own debt. But again we are not sure what the FRC is suggesting. Is it proposing that such gains should never be recognised? If so, this would be a matter for the IASB.

Financial instruments: general. We do not see what is to be done about the underlying complexity of financial instruments, other than for those who are troubled by it to avoid using them or to avoid investing in companies that use them. There is some evidence that companies are shying away from more complex instruments to 'vanilla' products, partly for their own risk purposes, but perhaps also because of likely market reaction. The problems of complexity in accounting for financial instruments are already being examined by the IASB. As we explained in ICAEW REP 100/08, responding to the IASB's discussion paper, *Reducing Complexity in Reporting Financial Instruments*, we do not think that the 'solution' to this problem that is sometimes suggested – ie, measuring all financial instruments at fair value – would be a good idea. We are continuing to respond to the IASB's further work in this area.

Financial instruments: risk reporting/disclosures. Again this matter is already being examined by the IASB.

Hedge accounting. We agree that it would be desirable for hedge accounting to be more closely aligned with economic hedges, but as already noted a complete free-for-all may not be in the interests of users and may militate against good financial reporting and reliable information. Again this matter is already being examined by the IASB.

Interpretive guidance. We are surprised that preparers object to interpretive guidance. The number of IFRICs issued is modest, and we doubt whether they add significantly to the complexity of financial reporting regulation. Also, they are usually only issued where there is a problem with the existing requirements. We have generally been pleased with the restraint shown by the IASB and IFRIC.

Accounting manuals produced by audit firms seem to us to be a useful way of helping preparers cope with complexity rather than a way of adding to it. What is the FRC's 'opportunity for action' here? That the firms should stop publishing accounting manuals? This would seem counter-productive when we know that preparers often want practical help, and not always in relation to very complicated issues.

Parent company financial statements. While many users do not use parent company financial statements, we are aware of some investors who do, and it would be useful to assess the extent of such usage. Once this is known, it can be assessed what the scope is for reducing existing requirements. This would be a matter for the BIS. However, unless distributions cease to be assessed by reference to financial statements, there would appear to be limits as to the ability to abandon parent company 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 DP whether the problem here is with the legal requirements or with how companies 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* (2007). As its title suggests, this report seeks to improve remuneration reporting, but working 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 already noted the overlap problem with the Listing Rules, and this should be tackled by the FSA and BIS together.

Segmental reporting. We agree that the possibility of further segmental reporting disclosures should be investigated. Such disclosures would of course add to the volume of reporting. This is a matter for the IASB.

Share-based payments. The DP notes that many interviewees consider IFRS 2 could be rewritten to emphasise principles. We do not know how beneficial this would be or how easy to do. While ultimately it would be a matter for the IASB, we understand that the French standard-setter is looking at the issue, under the auspices of EFRAG's Proactive Accounting Activities in Europe (PAAinE), and we assume that any relevant findings will be passed on to the IASB.

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