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Dear Ms Kerr

## Louder than Words: FRC Discussion Paper

Grant Thornton UK LLP welcomes the opportunity to comment on the Financial Reporting Council's Discussion Paper *Louder than Words*. Our comments are made in the context primarily of matching rules and good practice guidance for preparers with information needs of users. We believe that the FRC has made a very worthy start with this Discussion Paper. However, complexity in corporate reporting is a project worthy of a much deeper study, which would require input and resource from others, including the accountancy profession and international bodies. Areas not addressed in the FRC Paper that merit further study include consideration of future investor needs, risk management and the relevance of accounting to meeting investor needs. We would welcome a discussion with the FRC on how best to advance the debate in areas addressed by the FRC Paper and more broadly. Grant Thornton UK LLP is very interested in this project and keen to partner with the FRC as these issues are developed.

A key current issue is the perceived disconnect between the information needs of users and communication by preparers. Regulations themselves can never be the solution; they can only provide the framework within which management and business operate. Information needs are not always clear or consistent but messages we often hear from investors are that: the annual report is typically poorly structured; the complexity and volume of information in the annual report tends to obscure key messages; and management fails to tell the story because it does not put financial information in the context of business strategy and targets to measure implementation of that strategy.

We believe that the time is right to bring stakeholders together for in-depth and coordinated consideration of what should be the future corporate reporting model. In our view, the way to drive this forward and achieve coordinated actions is for the FRC to link up with other bodies. We recommend that FRC should partner with the profession, user groups and preparers in the UK to drive thought leadership for the future of corporate reporting and provide substantial input into the global debate on this issue. This would also offer the potential for enhanced interaction between investors and investees.

The FRC Paper has acted as a focal point for concerns on complexity and general obfuscation in corporate reports. The FRC has thereby brought the issue to the attention of a wider audience, but it would be unrealistic to expect individual organisations to cause change. The FRC has the potential to take a leading role as a sounding board and conduit for regulations that affect Financial Reporting in the United Kingdom and in challenging international bodies that develop regulations applicable in the UK. In a UK context, we believe that the FRC should be proactive and take a leading role in addressing key emerging issues relating to corporate reporting in the UK, for example narrative reporting and risk reporting. However, change at international level will, in our view, need to be driven by an international body or grouping. Identifying the best mechanism to achieve this is likely to be a key area for the FRC and other bodies to address.

We believe that the FRC should challenge regulators directly on 'why have you made it so complicated?' and 'why is it necessary to have **all** these requirements?' In our view, it will be more difficult to change the response of business, because they will be advised to say things a certain way in their corporate reports to minimise litigation risk.

We summarise below our key overall points in response to the FRC consultation:

- We support the key principles identified in the Paper for less complex regulation and for effective communication in reporting
- We agree that the primary purpose of corporate reports is providing investors with information that is useful for making their resource allocation decisions and assessing management's stewardship. Hence, corporate reporting should be focused on investors. However, it is vital that the preparers of reports and the standard-setters engage with investors to understand what their specific needs are and whether they are justified needs Identifying the core principles underlying investor needs is crucial to addressing this area
- Any reporting of wider issues should be restricted to those areas deemed material to investors. In this context, it is also necessary to consider the scope for differential reporting, eg delivering to all the basic information, with more detailed analysis (such as details of all share option awards, if that were required) made available outside the 'primary' document. Developing a better focussed, more relevant form of Summary Financial Statements would be an appropriate starting point
- Other stakeholder-driven reporting should be clearly signposted according to a hierarchy of reporting and a clear purpose for each report
- The role of XBRL and other advancements in information technology needs to be taken into account. XBRL may meet one need for information gathering but it does not address the communication needs themselves

Our detailed responses to each question within the consultation are set out on the following pages together with comments on other areas that we believe merit further consideration and action. If you have any questions on this response, please contact Steve Maslin (phone: 020 7728 2736; email: steve.maslin@gtuk.com) or Robert Carroll (phone: 020 7728 2210; email: robert.w.carroll@gtuk.com).

Yours sincerely

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## Responses to consultation questions

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

We agree that the principles for less complex regulation proposed by the FRC can help to reduce complexity. We do not identify other principles that should be considered.

We believe that the FRC has the opportunity to take a leadership role in promoting coordinated regulation that reflects the realities of business and meets important user needs. We also believe that the FRC should seek more input from investors and other users of corporate reports in the development of regulations.

In our view, the FRC needs to reach out with one voice and challenge other regulators, for example through commenting on draft regulations and other proposals, applying the targeted, proportionate, coordinated and clear principles.

We encourage the FRC, where practicable, to promote the approach of making as much use as possible of information already produced by entities for internal purposes in their external corporate reporting. We believe that this approach can help meet the principles of targeted and proportionate regulation and avoid requirements becoming unduly burdensome, thus enhancing the relevance of information to users of corporate reports and the efficiency of corporate reporting itself.

In furtherance of the principles for less complex regulation, we propose that the FRC should encourage and promote better dialogue between investors and standard-setters. At present, our perception is that standard-setters and other regulators are not sufficiently well informed about user needs and priorities and hence do not always focus their attention on developing regulations in the areas users regard as being most important, nor develop regulations likely to meet user needs. In this regard, we cite as a recent example the International Accounting Standards Board's (IASB) Exposure Draft of proposed changes to accounting for income taxes. In our view, this area is not a high priority for change and the IASB's proposals do not represent a significant improvement on current practice.

With regard to financial reporting regulations in particular, we observe that there are occasions when regulations are not expressed as clearly as they could be. One such example is IFRS 2 *Share-based Payment*, where numerous practical difficulties have arisen in interpreting and applying the standard's requirements. On the other hand, we note that the IASB's recent *International Financial Reporting Standard for Small and Medium-sized Entities* (IFRS for SMEs) was generally written in clear and straightforward language.

We believe that regulators have the opportunity to draw lessons from experience elsewhere. For example, the legal profession has, in recent years, made great progress in using more accessible language. Another example is the International Auditing and Assurance Standards Board's Clarity Project to improve its standards.

We believe that there is a risk of continual change in financial reporting regulations until the conceptual framework is more fully developed. We believe that the FRC should take a leadership role in encouraging the IASB to decide the conceptual framework as a matter of priority and avoid reactive amendments to numerous standards in the meantime. We further note in this regard that changes to IFRS have become so numerous and so frequent that it is becoming extremely challenging even for financial reporting technical experts to keep track of developments. In our view, such an approach to standard-setting risks impeding good corporate reporting and compliance with regulations. However, we support short-term revisions to standards where there are important issues that need to be addressed urgently, for example the current IASB project to revise IAS 39 *Financial Instruments: Recognition and Measurement.*

We challenge the FRC about the point made on page 20 of the consultation paper regarding IFRS 7 *Financial Instruments: Disclosures*. Whilst we acknowledge that many companies have found compliance with IFRS 7 to be a significant challenge, in our view the IASB was right in principle to set out minimum disclosure requirements as, without such requirements, we would question whether companies would provide any meaningful disclosures.

We commented recently to the Financial Services Authority in relation to governance standards that the solution rests not with the introduction of more detailed disclosure or even a shift to rules-based compliance, but rather through changing the working practices, behaviour and attitudes of those who effect the governance. We also noted that in our experience relatively few organisations truly have made the transition from risk management being a compliance process existing for the purpose of appeasing the audit committee to it being an embedded management tool critical to the effective management of the business. In our view, these are key points that regulators should keep in mind when developing and reviewing regulations. The regulations themselves can never be the solution; they can only provide the framework within which management and business operate.

### 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.

In the context of the question, cash flow reporting is part of financial reporting for external users. We believe that the IASB should remain the sole source of international financial reporting standard setting for general purpose financial statements. We are concerned that calls from other bodies for 'best practice' reporting will only add to complexity and risks reducing comparability.

We believe cash flow reporting is in need of improvement. In the current economic environment, cash is vitally important. An unsatisfactory standard on reporting cash flows does not encourage users or management to broaden their focus beyond reported profit, which is an inherently more subjective number. IAS 7 *Statement of Cash Flows* is an old standard and the disclosures it requires are, in our view, less informative than those required by the current UK standard FRS 1 *Cash Flow Statements*. We note in particular that FRS 1 requires a reconciliation of net debt, which many users of financial statements find informative. However, we observe that the current IASB project on financial statements presentation does not address the key issues identified by the FRC. We see a potential opportunity for the FRC to encourage the IASB to address this issue.

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

We believe that basing regulations on the information that management produces internally is a good starting point and is consistent with an objective of informing users about how the business is run, therefore minimising unnecessary complexity and cost. However, we believe that the needs of external users of corporate reports should take precedence. Thus, if information is particularly important to users, its disclosure should be required even if management does not produce that information internally.

Whilst it is useful to present information through the eyes of management in corporate reports, events over the last year or so have shown that management do not necessarily know or consider everything, nor do they always see things logically. Therefore, 'through the eyes of management' information should be balanced with specific disclosures that are required across the board.

We observe that an approach of basing accounting standards and other regulations more on the information that management produces internally may be difficult to operationalise. If regulations are very principles-based and flexible, what will be disclosed will depend on how management generates information to monitor its business. However, disclosures should address the principles in a way that users could challenge if the principles do not appear to have been adhered to. If regulations are more prescriptive but based on management information, there could be too much diversity and no comparability.

When responding to consultations on proposed regulations, we believe it would be helpful for preparers of financial information to consider whether the proposals reflect how they would record transactions and whether they would manage their business differently. Financial reporting should not drive business decisions other than insofar as it facilitates better informed decision-making. For example, a new standard on business combinations in principle should not alter the decision to buy. Such feedback to regulators should form part of a robust impact assessment which could help to avoid regulations becoming unnecessarily burdensome and reduce the risk of duplication of processes (ie management using one process internally then needing to rework information extensively for external reporting).

### 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 that a project on disclosures has the potential to help stem the constant growth of accounting disclosure requirements. We also believe that it could help regulators to identify which disclosures are the most important and give them appropriate prominence. It is important that regulators, preparers and auditors understand user needs. A project to review and challenge disclosure requirements could help to educate auditors and preparers to focus on disclosures that matter. However, we note that substantially all information currently included in financial statements is wanted by at least one stakeholder, so it may be difficult for such a project to reduce disclosures significantly. Furthermore, as the largest source of accounting disclosure requirements is IFRS, the IASB or the International Accounting Standards Committee Foundation will need to take a leading role.

We believe it is important for regulators, preparers and auditors to understand what is material. For example, some information required to be disclosed by IFRS 2 *Share-based Payment* may be material to users even if the expense recognised is not. This may be because of the potential dilutive effect of options or the potential cash inflow to the business on exercise of share options.

In our view, the IASB needs to set a minimum disclosure benchmark for financial reporting. This should be based on an underlying conceptual framework for disclosures. A guiding principle might be that disclosure should be required if it has the potential to result in a user undertaking a different action.

UK regulators such as the Audit Inspection Unit and the Financial Reporting Review Panel may be inadvertently encouraging provision of excess information, thus adding to the level of clutter in corporate reports. Their apparent focus on technical detail and desire to challenge auditors and companies respectively on often highly detailed points of marginal materiality may lead to increased volume of disclosures in corporate reports without a commensurate increase in the value of the information provided. A further driver in this area is the requirement of Auditing Standards for auditors to report all non-trivial misstatements to management, even if they are otherwise immaterial. We note in our other comments below that the issue of materiality merits further study, in particular in relation to disclosures.

### 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?

Subsidiaries are legal entities in their own right, usually with limited liability. Their accounts matter to a supplier to a subsidiary and are important to creditors in general. Groups generally structure themselves as a combination of legally separate entities for sound business reasons. We are aware that complex corporate structures are in some cases driven by taxation issues. If the taxation regime is the driver of complexity in corporate reporting in this area, the FRC should draw this issue to the Government's attention. However, there are unlikely to be easy answers. Simplification of the corporate tax regime has proved to be difficult and requires careful consideration to avoid the law of unintended consequences, such as reducing UK competitiveness with competing jurisdictions.

A further reason for complex group structures in many businesses is historical, related to acquisitions, joint ventures, and management of business sectors. When groups consider hive-ups and reorganisations, tax, insolvency and risk are factors that sometimes impede a more streamlined group structure because these factors are entity driven.

In our view, requirements for publication of accounts and for audit of subsidiaries are appropriate where groups structure themselves as a combination of legally separate entities. Businesses could, if they wished, choose to avoid these requirements by structuring themselves as single legal entities, but many choose not to do so.

We note that the UK Accounting Standards Board's (ASB) proposals for the future of UK GAAP would potentially allow subsidiaries of publicly traded companies to use the IFRS for SMEs unless those subsidiaries themselves have public accountability. Thus, subsidiaries would be able to prepare accounts with substantially fewer disclosures than would be the case under full IFRS. This would amount to a simplified regime for subsidiaries compared to full IFRS, which may be the only alternative in the medium term and beyond. The responses to the ASB's consultation may provide useful information for the FRC's complexity project in this regard.

We believe that there may be some merit in looking again at the existing opt-out of EC Directives if there is a parental guarantee. However, we doubt that many large groups would pursue such a route if it were to be available, as separate legal entities within a group are often established and maintained for risk management reasons, which parental guarantees would negate.

### 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?

See our answer to Question 5.

**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?**

A coordinated approach has some initial appeal. However, different viewpoints risk increasing complexity. Hence, any coordination needs to be done with the right objectives in mind. One of these should be to avoid gold-plating one another's regulations. Establishing some form of hierarchy of rule-makers and regulators, and of regulations, may be better than merely attempting to coordinate a diverse group of regulators. Coordination between regulators must have clear and widely accepted objectives and principles if it is to achieve anything positive.

For financial reporting regulation, we believe that the key standard-setter should continue to be the IASB. Widespread adoption of IFRS is leading to greater harmonisation of financial reporting. In this regard, globalisation may lead to less complexity in the longer term, though we acknowledge that unless the USA embraces IFRS there will continue to be two sets of financial reporting regulators.

In our view, the bigger question is what users want. Coordination between users and user groups internationally may be a better route than having a multiplicity of national and international regulators trying to work together. The risk of imported complexity could be mitigated by national regulators working together at international level to understand user needs.

There is also scope for better coordination in a UK context. For example, for listed companies there are currently two sets of regulations governing disclosure of directors' remuneration: regulations made under the Companies Act 2006 and the FSA Listing Rules. There is a large measure of overlap between the two but differences remain, meaning that companies have to apply two sets of regulations where one would suffice. Impending developments in narrative reporting also risk increasing complexity without a commensurate increase in the usefulness of information provided. Effective coordination between regulators is essential to mitigate this risk.

**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?**

Yes, see our response to Question 1.

There may be lessons to draw from recent attempts by individual regulators to reduce complexity, for example the IAASB Clarity Project mentioned in our response to Question 1.

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

We believe that the principles for effective communication have the potential to reduce complexity in corporate reporting. However, we believe that a revised conceptual framework for financial reporting itself is likely to make a more significant contribution to reducing complexity.

We observe that many companies currently view the annual report as largely a compliance document and a 'leave-behind.' Direct engagement between the company and investors and lenders, present and potential, is often seen by management as much more important that the annual report. Hence, placing emphasis on and directing effort towards enhancing the quality of the annual report is often not seen as an efficient use of management time. Rather, many businesses would favour less complex reporting requirements as this could save them time and money by easing the compliance burden. Developing a better focussed, more relevant form of Summary Financial Statements might be an appropriate starting point. We note that the Combined Code on Corporate Governance is principles-based. We support its 'comply or explain' approach but note that uninformative boiler-plating is not helped by Schedule A to the Code and narrative provided often does not add a great deal of value.

We believe that engagement between preparers, regulators and users of corporate reports has greater potential to improve the effectiveness of communication and reduce complexity than coordination amongst regulators.

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

We believe that a key barrier is a lack of communication between regulators, companies and users of corporate reports. Another barrier is the unwillingness of management to say anything meaningful when they do not see others doing so, or when they believe that the risk of litigation or shareholder criticism is greater than the potential advantages of clear communication. Management are often reluctant to be perceived as market leaders in this area, which leads to bland, unimaginative and therefore uninformative disclosure.

We also see lack of challenge at board level as a potential barrier. For example, non-executive directors may not be afforded the scope or not be strong enough to challenge whether communication is effective.

### 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?

In our view, the items listed on pages 54 and 55 all exist for a reason. For those matters relating to financial reporting, we believe that the IASB is the appropriate body to take action and it is essential to avoid proliferation of regulators or regulations. We note that the IASB has recently issued proposals to modernise and simplify requirements for financial instruments, which have the potential to address several issues mentioned. Better engagement between the IASB and users of financial statements will help to address many of the issues noted. In this regard, we commented recently to the Financial Services Authority on their Discussion Paper 09/2 A Regulatory Response to the Global Banking Crisis:

> "We believe it is vital that an effective balance be struck in respect of the IASB between improving the communication between the Board and stakeholders (for example investors and issuers) on the one hand, but avoiding regulatory capture by vested interests on the other. In this regard we support the development of the Monitoring Board and [Standards Advisory Council]."

For those issues not directly related to financial reporting, principally the CSR agenda and remuneration reports, there is a wider political dimension. For remuneration reports, the detailed requirements are set out in regulations made under the Companies Act 2006. Aspects of the CSR agenda are also addressed by statute, including carbon reporting in the Climate Change Act 2008 and various other areas in statutory requirements for the directors' report.

If action is necessary regarding these non-financial reporting areas, the Government will be a key player but will need to be properly informed by users, preparers and other regulators if any action is to be beneficial. In relation to carbon reporting, we note that this is a major business issue and should be addressed in corporate reporting in its broadest sense.

For remuneration reports, we believe that there is a need to restructure and rethink reporting as a subset of a wider discussion on remuneration. This is an area where we believe that the FRC could make a useful contribution, for example by conducting a review of reporting and making recommendations to Government.

We also note our surprise at the points made on page 54 regarding intangible assets. If the views of users and preparers referred to are genuinely and widely held, it suggests that the IASB has not been sufficiently well informed in its development of financial reporting requirements.

## Other comments

### Sustainability

There is a need to refocus on the investor. Some aspects of sustainability are relevant to investors, for example how major transactions relate to sustainability.

The challenge of reporting on sustainability information is how to report on issues that are material to the business and investors. Addressing this issue is one of the key aims of The Prince of Wales's Accounting for Sustainability Project, of which Grant Thornton UK LLP are strong supporters.

### Future of reporting

The role of XBRL and other advancements in information technology needs to be taken into account. XBRL may meet one need for information gathering but it does not address the communication needs themselves. Advances in technology and communication offer the opportunity for innovative reporting and providing a menu from which users can select what is relevant to them. There may be scope for a hierarchy of reporting, whereby there is a core level and layers or areas of detail appropriate to different user groups, each of which could be signposted to the detailed information likely to be of most interest to them.

### Regulators

Regulators are not the primary users of financial statements and calls for regulatory matters to drive the financial statements should be resisted.

### Long-form reporting and risk reporting

There may be a role for long-form reporting, such as reporting on issues discussed between the external auditor and the audit committee. There may also be a role for enhanced reporting of risks and how management have addressed those risks. Investors believe that useful information is discussed between these parties and would like some access to that information. This may be possible through better external reporting by the audit committee and chief risk officer. However, there is a risk of boiler-plating, which it may be possible to mitigate by some linkage with the IAS 1 *Presentation of Financial Statements* requirements to report on key judgements and estimates.

### Materiality

The concept of materiality and how it is defined merits further consideration, especially insofar as it relates to financial statements disclosures and to the annual report as a whole. At present, we believe that lack of focus on providing disclosures that are material and omitting those that are not contributes to the general clutter in corporate reports, thereby reducing the clarity of the key messages.

### Assurance

The FRC Paper does not address the issue of assurance on corporate reports. Assurance may develop in future as a menu rather than a one-size-fits-all approach. We observe that this is currently a matter of debate internationally.

### Risk-based concerns of preparers

The FRC Paper does not, in our view, give adequate weight to the effect of risk-based concerns of preparers on complexity and effective communication, ie companies may disclose more information than is needed 'to be safe', notwithstanding materiality considerations, or give boilerplate disclosures in sensitive areas, in an attempt to mitigate the perceived threat of litigation. We propose that the FRC should consider whether more 'safe harbours' could be created to encourage better quality communication, for example in the areas of forward-looking information, judgments and estimates, risk assessment and risk mitigation.