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**For the attention of Melanie Kerr**

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Dear Sirs

We welcome the opportunity to comment on the issue of complexity in financial reporting as discussed in the "Louder than Words" discussion paper. We think it is good that the UK is taking a lead on this difficult but crucial issue. The need for international co-operation to achieve progress on a number of the issues raised in the document will create some difficulties but should not provide an excuse to delay the debate. Having arrived at a position where annual reports run to several hundreds of pages and the majority of companies produce lengthy disclosures on items such as share based payments and pensions, the need to reduce complexity in financial reporting has become an issue of real urgency.

In an environment that has become far more sophisticated and indeed litigious, the demands on and expectations of general purpose financial statements have never been greater. Businesses are larger and more complex – evidenced by the type of transactions they undertake and risks inherent in those transactions. Different users make competing demands for the inclusion of additional disclosures of matters of interest to them in the financial statements.

There is certainly room for improvement. We need to be smarter about what is disclosed and where. Transparency should continue to be the fundamental goal of financial reporting since it enables users to gain greater insight into the risks run by companies and facilitates comparability. Complexity may be here to stay but there is always scope for transparent, clear and concise disclosure so that business risks and other key issues are easier to understand. Mandatory detailed disclosure on certain topics has its merits but a user-friendly and suitably balanced overlay, demonstrating clear links between the narrative in the front end of the accounts and the financial statement disclosures, is vital.

We have in the past suggested that the development of a "disclosure framework" would obviate the need to look at disclosures on a piecemeal basis every time a new standard is published. Such a framework could establish principles as to how to determine what is and is not material, useful and necessary information. However, preparers will only be free to prepare their reports under the umbrella of such a framework if the risk of being "second guessed" by regulators and others is minimised. In our view, the way in which regulators police financial reporting is very

influential in determining companies' approaches. We see achieving consistency of approach amongst international regulators as important, albeit difficult to manage. Consistency of application within the UK should be a more achievable goal and any new proposals or developments should be reviewed in this light.

Some of the other key issues we discuss in our detailed response are:

- Reduced disclosures for subsidiary companies.
- Rationalisation of the front end of annual reports to avoid over lengthy, potentially confusing and sometime repetitive disclosures. Consideration should be given to putting more information on the website rather than in the annual report.

The speed of development of the financial reporting framework over the past few years, together with the business issues faced by companies on a daily basis, may make it difficult to get real focus on the big picture messages contained in the paper; indeed, the goal may seem somewhat intangible. It would be worthwhile to distinguish between changes that would be "nice to have" and those that are urgently needed in order to provide coherent information to stakeholders. Drawing that distinction is, in itself, a challenge. The document is a useful contribution to the debate. However, if it is to bring about change, momentum must be maintained by taking forward some of the specific initiatives discussed and identifying some "quick wins".

Our detailed responses are set out in the attachment to this letter. Our responses to the questions are included under the relevant call for action. If you have any queries in relation to this letter please contact Andrew Vials in the first instance

Yours faithfully



KPMG LLP



### *Call for action 1- Improve cash flow and net debt reporting*

*Question - Targeted: Is cash flow reporting in need of improvement? If so, what is the best means of achieving this improvement? Consider changes to IFRS, best practice guidance, publicity campaigns, other.*

We note that there is no requirement for companies to produce a net debt reconciliation. We agree with the users' comments that the cash flow reporting requirements could be improved by including an opening to closing net debt reconciliation.

Where management consider a net debt reconciliation to be necessary to gain a better understanding of the cash flow statement they can provide this information on a voluntary basis. However, in the absence of regulation, any voluntary disclosures provided may not be comparable. The FRC may wish to consider a move to a principle-based standard approach which either requires a net debt reconciliation or sets out the basis of any net debt reconciliation provided by management.

FRS 1 included the requirement for a net debt reconciliation at the request of users. If the decision were taken to change IFRSs, the disclosure requirements of FRS 1 or the responses that the ASB received when developing FRS 1 may provide a good starting point.

The Call for action notes that vague descriptions are often used and that recalculation of the cash flow statement from amounts disclosed in other primary statements is difficult. We agree that clear and concise language would be an improvement. However, this is an issue for each preparer. We appreciate that with the current disclosure requirements recalculation of the cash flow statement from the balance sheet and profit and loss may or may not be possible, depending on the complexity of the business - for example, whether it includes foreign currencies - as well as the level of detail provided in the primary statements and notes. As noted above management can provide additional disclosures that would enable the cash flow statement, or part of it to be recalculated. In some circumstances, especially those involving foreign currency transactions, the additional information required may be significant. Call for action 2 "Ensure disclosure requirements are relevant and proportionate to the risks" should be considered. We believe that disclosures should deal more with incremental needs rather than "re-performance" by the user. Management could give additional disclosures in this area if they believe that the information is significant to an understanding of the financial statements.

### *Call for action 2 - Ensure disclosure requirements are relevant and proportionate to the risks*

### *Call for action 3 - Ensure requirements for wholly-owned subsidiaries' reporting are targeted and proportionate*

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

While requiring disclosures based more on management information would result in obvious time and cost benefits, the requirements of the users must be considered. Although providing information as seen through the eyes of management can be beneficial, users expect consistency in financial reporting. Other issues include the need for a baseline minimum level of disclosure and the need for information disclosed to be able to be interpreted by the users. This is consistent with the directors' duty to prepare accounts which comply with GAAP and law which, in our view, is an important aspect of their stewardship of the company.

The primary user of management information - management - will have a detailed understanding of the business. Users of accounts cannot be expected to have the same level of knowledge of the business. A mix of transparent, open and honest management information, potentially supplemented by a minimum level of information, as is currently required by IFRS 7 for example, might be considered as the model most appropriate for disclosure requirements.

*Question - 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?*

Yes, we believe that a project on disclosures would be helpful. We have suggested to the IASB in the past that a disclosure framework would be desirable. The FASB's project on a disclosure framework may provide some helpful input into any project undertaken by the FRC. However, to get user buy-in would require preparers to provide disclosures in good faith giving sufficient, targeted, transparent, and relevant disclosures that deal with the key aspects of the financial statements.

The project the FRC mentions could consider looking at existing disclosure requirements, identifying areas where the "safeguarded minimum" can be reduced, as well as identifying principles that can be used in setting a disclosure framework going forward. A project to ask both preparers and users of financial statements to review some financial statements and specify the disclosures that they believe should and should not have been provided may help.

The trend towards long financial statements has been driven by both increasingly complex transactions and a litigious environment. Users continue to support inclusion or retention in the financial statements of disclosures that are of particular concern or interest to them. On this point we note that the DP itself calls for a number of further disclosures, both within the Calls for action and the Opportunities for further action sections.

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

The statutory audit is one key element of a corporate form – the limited liability company – that facilitates economic activity on a broad scale. Rather than being a regulatory burden, it positively enables the operation of a system that brings significant and widespread benefits.

General purpose financial statements are used by many stakeholders, including tax authorities, banks providing debt finance, potential and actual equity investors and, for statistical purposes, governments. Potential lenders often require financial statements for a number of earlier years; if not produced at the time, these could be difficult to produce later when information and accounting records may not have survived and personnel and systems may have changed. Although it can be argued that each user can make the investigations they require, separate exercises to gather information are likely to be more burdensome and less efficient. In addition, an audit provides management with an external perspective on the company's governance and its control environment.

Whilst many stakeholders may require audited financial statements they may be willing to accept a simplified reporting regime. An exercise to find out what information users find useful may be appropriate. Any exercise should have regard to the SME disclosure requirements.

However, there may be scope for allowing wholly-owned subsidiaries to enjoy reduced disclosure requirements, for example, the cash flow requirements. One option to reduce the complexity in subsidiaries' financial statements may be to allow, under certain circumstances, cross referencing to other publicly available financial statements in the group for certain disclosures, for example, pension and share-based payment disclosures related to group schemes.

*Question - Targeted and proportionate: Would it be desirable to eliminate the UK requirement to prepare, have audited, and file wholly-owned subsidiary financial statements in the case of a parent company guarantee?*

We are aware that certain jurisdictions, for example, Ireland and Australia, allow subsidiaries not to prepare financial statements if they form part of a cross guarantee group. As the DP notes the issue was discussed as part of the Company Law Review but no change resulted.



Whilst we agree that a parent company guarantee may provide some comfort to creditors, as noted above there are many users of the financial statements other than creditors. Even considering creditors alone, does a parent company guarantee solve the issues? The guarantor may be weak. Subsidiaries may be moved out of the guarantee group. It is not clear to us how the other users will get the information that they seek. For these reasons we do not believe that it would be appropriate to dispense with the requirement for subsidiaries to prepare financial statements. If the FRC were to pursue this issue further then it would clearly be necessary for wide consultation to ensure all interested parties can express their views.

*Question - Coordinated: Would it increase or decrease complexity if national and international regulators worked together in a more joined-up way? Is there a risk that international regulators working together might result in imported complexity for some jurisdictions? How do we mitigate this risk?*

We agree that the idea of national and international regulators working together within a standard disclosure framework producing a single set of disclosure requirements is attractive. However, as different jurisdictions are likely already to have different local requirements, for example, local GAAP and law, encompassing these existing requirements would likely increase the complexity in one or all jurisdictions. One suggestion may be for regulators to reduce the level of similar but subtly different disclosure requirements by working from a common principle-based disclosure framework.

We note the comment in the DP on the overlap between different regulators' requirements, for example, the various remuneration requirements. However, while we appreciate that the scope of the various regulations is different, for example Listing Rules and Companies Act, we believe that the various regulators have done well in some cases in not seeking different disclosures on the same area. The remuneration disclosures required by the Listing Rules and the Companies Act are, with the exception of one pension disclosure, exactly the same. If the regulators dropped the disclosures from either the Companies Act or the Listing Rules there would be some entities that would not be required to include these disclosures. We believe that it would be better to have some entities required to provide the same disclosures by two sets of regulation than not being asked at all. However, the slight dissimilarity between directors' pension disclosures in the Listing Rules and the Companies Act indicates that there still is scope for greater consideration by regulators, when drafting regulations, of other similar requirements already in issue.

#### *Call for action 4 - Improve usability of IFRS*

*Question - 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?*

We agree that clearer regulations and accounting standards would reduce complexity. The example provided, IFRS 2, illustrates well that regulations could be written in a much more user-friendly way. However, implementation would involve a substantial change both to existing regulations and the process for drafting regulations. In order to assess the potential benefit to be gained, we recommend the FRC reviews an existing standard with a view to reducing its level of complexity. The exercise we suggest would focus on style and language, not technical content, with the sole aim of reducing complexity and increasing clarity.

We have often said that the structure of accounting standards could be improved. Some standards are repetitive; requirements repeatedly expressed in different ways are particularly confusing for preparers. If the requirements of a standard are clearly articulated at the beginning and any necessary interpretation made clear in the standard with a view to minimising the amount of application or implementation guidance contained in appendices, standards would be easier to follow.

We believe that the codification concept addresses the symptoms of complexity rather than the cause. Some standards are too long and some poorly drafted in places, requiring frequent "corrections" shortly after publication. Post implementation reviews are a useful exercise but arguably should not be necessary. US GAAP requires a codification as the regulations are more numerous and disparate. We are not convinced that there is a need for codification in IFRS. An IFRS "current text" will not in itself

reduce complexity. However, we do support the concept of being able to find the currently applicable accounting standards in one place. The IFRS bound volume contains the *current version* of standards rather than *those standards that apply to the current accounting periods*. Old standards should not be removed from the text before the new ones are applicable.

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

Yes. We believe that the four principles proposed would help reduce complexity. However, the issue is how to put these principles into action. Regulations are not intentionally drafted in an uncoordinated or unclear way but it may be that regulators and preparers have a different understanding or interpretation of the issues, despite the consultation process. The issue may be one of time and resources; we should not easily accept that it is not possible to draft technical subjects in a simple manner.

#### *Call for action 5 - Cut clutter*

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

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

We agree that if corporate reporting followed the four principles for better communication then reports would be less complex.

Excluding unnecessary disclosures will make reports more focused and understandable. However, preparers would need sufficient guidance to know what can be excluded. The DP mentions a number of disincentives for preparers to reduce clutter. Preparers must be confident that regulators will not “second guess” their judgement.

The share-based payment example in the DP is a good one. We agree that if a share-based payment charge is immaterial to the financial statements its disclosure should be omitted. However, any omission would need to be reconsidered each year based on the facts and circumstances at the time. Removing, reviewing and potentially inserting disclosures in the following year, with comparatives, might be more difficult and time consuming than retaining the disclosures and updating them year on year. The FRC’s proposed project to review disclosures in published 2008 financial statements and identify immaterial disclosures should help in this respect.

The Companies Act requires a “balanced and comprehensive analysis of (a) the development and performance of the company’s business during the financial year, and (b) the position of the company’s business at the end of that year.” If there is deemed to be any widespread lack of adherence to these requirements then it will need regulatory action to drive home the message. An alternative suggestion to direct involvement could be the issue of an FRC sponsored publication that provides examples of best practice disclosures.

The use of alternative measures is another subjective issue. Do preparers believe that they are providing information that makes the results of the business more understandable and business-focused or are they presenting the information in a form that illustrates the entity in the best possible light? Evidence would suggest the former but whatever the reason, the use of varied measures of revenue and profit may confuse some readers. Should the use of alternative measures be regulated? We would support, for example, an explicit requirement, rather than the current “recommendation”, to reconcile, explain and be consistent in the use of alternative measures.

Making corporate reporting more interesting and engaging will be difficult. Again we agree with the principle but we have no simple suggestions for implementation. The diversity of disclosures required makes it difficult for the financial statements to be drafted in an interesting and engaging story-like manner.



We note the comment about starting out with a high-level summary in the annual report and progressively drilling down to more detail. Describing the same information with progressively more and more detail in various reports (Chairman, CEO, Directors report, CFO etc) adds length without necessarily adding interest or clarity. We consider that the structure of front end reports is an area where there is significant room for improvement. For example a brief Chairman's statement, another more detailed report from the executive and a separate report containing other various regulatory requirements might suffice. Risk and KPI disclosures should be positioned in a way that enables a user to make a clear link between them and the surrounding narrative. Furthermore, reports would be easier to read if they did not rely on extensive cross-referencing.

One method of making the front end reports more engaging or less cumbersome is to remove some of the content from the annual report, for example, much of the Directors' Remuneration Report or the Corporate Governance statement. The Annual Report could include a one-paragraph summary of the Corporate Governance statement (a compliance statement and any areas of non compliance and explanation) with the remainder of the content, for example, the number of meetings there were in the year and how many meetings the directors attended, given in a document that is required to be updated annually and available on the web. However, if this information were to be included other than in the annual report, the effect on auditors' responsibilities would need to be considered.

## Opportunities for further action

*Question - Which of the specific sources of complexity in corporate reports noted on pages 54 to 55 (below) warrant further action? Which organisation(s) would be best placed to assist with the necessary action?*

The DP lists 16 opportunities for further action. We note our comments on these below.

*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.*

We agree that the valuation of intangibles may be complex and believe that the separate reporting of some intangibles, e.g., customer relationships, could be re-evaluated. However, including information on intangibles does provide users with information on what has been acquired and the period over which it is likely to be recovered. Before any decisions are taken in this area we think that the users should be surveyed to determine the level and nature of information that should be given on intangible assets and whether they would be happy to receive less.

*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.*

This is an example of a judgement decision made by the entity. We agree that two companies may make different judgements but we do not believe that this should result in a requirement to write off all expenditure. This is an example of where more comprehensive disclosure of the judgements taken and the reasons for them, as required by IAS 1, should be given.

*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.*

We do not believe that all choices should be removed from regulations. The inclusion of many choices was at the suggestion of preparers. It is up to preparers to explain the rationale behind their choice.

*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.*

As discussed above, there is scope to reduce the level of information in the front end of annual reports. Much of the information included in this report is voluntary information". To this extent the issue therefore falls within the company's own hands.

*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 is a limit to the extent to which the calculation of an actuarial liability can be simplified. The disclosure of future cash flows would be useful but would, nonetheless, be more disclosure. The ASB's non-mandatory statement on pension scheme disclosures includes future cash flow disclosure requirements. If users would find this information useful it is in their hands to challenge the preparers of financial statements.

*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.*

Whilst we agree that IFRS 5 has flaws, IFRS 3 also required restatements in the same way.

*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.*

We agree that the area is complicated – perhaps overly so – and that some simplification of the rules could be looked into. The IASB has a major project to consider this issue, the first phase of which has resulted in the publication of IFRS 9. However, we believe that in principle if a normal commercial contract contains a significant and discretionary speculation feature then some appropriate accounting consequences should follow.



*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’.*

Fair valuing without observable market data will, by its nature, be subjective. However, we do not see this as a reason not to fair value in other cases. There has been much discussion on this issue both at the IASB, its Expert Advisory Panel, and elsewhere and it is clearly an area where additional disclosures are necessary to provide the reader with relevant information about key assumptions and sensitivities. The issue of fair valuing own debt is particularly contentious and we note is currently under consideration by the IASB.

*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.*

Complex transactions often lead to necessary complexity in financial statements. The IASB is undertaking a project to simplify the accounting for financial instruments.

*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.*

Is this suggesting more disclosure of information or possibly more appropriate disclosures? We believe that many of the disclosures required in this area could be considered excessive in some cases (for example, fair value of collateral) and that the disclosure requirements of IFRS 7 could be rationalised. Whilst it may be more appropriate to encourage companies to focus on explaining how they manage their financial instruments and the nature of the risks and strategies, there is a risk that companies would not provide sufficient information. We support a safeguard minimum level of focused disclosures with management requested to give additional information when the circumstances merit it.

*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.*

The IASB is currently considering hedge accounting as part of its Financial Instruments project. We would support simplification of the current detailed rules in some areas.

*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.*

There have been relatively few interpretations issued by IFRIC and we do not regard this as a problem. Furthermore, we believe that the IFRIC agenda decision process is a straightforward process that seeks to apply the “proportionate” principle in declining to take on to its agenda many of the issues it receives by way of submissions from constituents.

As regards accounting manuals, on the one hand some claim these manuals add to complexity and the volume of application guidance, on the other, many feel it appropriate that the views of the large firms are clearly expressed.

*Parent company financial statements - Many users say that they do not use the parent company financial statements in annual reports.*

As the parent financial statements often equate to only a few pages, removing them from a set of financial statements is unlikely to make much of a saving; in addition they are often presented separately so are easy for the reader to ignore. Parent company financial statements are required at present as UK distributions are based on distributable reserves as reflected in these financial statements. Any change to the requirement to publish the parent company financial statements would need to consider what consequential changes to the capital maintenance laws might be necessary.

*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 agree. This is another area where it is in the hands of the users to challenge the level of information given by preparers.

*Segmental reporting - Users are still looking for greater granularity and cash flow information at the segment level.*

If the disclosures give the information that management uses to run the business this ought to be sufficient for users. Additional information would of course increase the volume of disclosures.

*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 agree that something can and should be done in this area. We note that the IASB is due to carry out a post implementation review of IFRS 2.