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Dear Ms Kerr

Discussion Paper: Louder Than Words - principles and actions for making corporate reports less complex and more relevant

We welcome the discussion paper from the FRC addressing the key issues of complexity, relevance and communication. The paper discusses a number of concerns that will be familiar to preparers and users of financial reports.

One of the key questions, where views will vary, is what is “unnecessary” as compared to “necessary” complexity. There are inevitably aspects of business activities and/or financial reporting where complexity is a fact of life. Nevertheless there are also aspects where, in reporting, simple concepts have become complex requirements and, in particular, there are concerns over some aspects of the impact of IFRS.

An underlying issue relevant to the future development of the ideas in the discussion paper and, more specifically to IFRS, is clarity over the term “users”. Which users are being referred to, what do they require which is significant to their decisions and how do the requirements vary between different users. Such clarity is important in attempts to reduce complexity and unnecessary costs in reporting

While it has to be recognised that taking forward many of the ideas in the discussion paper lies outside the control of the FRC, we see the paper as a useful document in raising the profile of this topic and generating debate.

We hope that you find our comments useful and thank you for the opportunity to be able to comment on this matter.

Yours sincerely

M S Hayes
Group Finance Controller

Encs/

Discussion Paper: Louder Than Words

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

Application of the principles would result in less complexity but the key question is how is this to be achieved in practice, especially in an international context. How do you persuade the various interested parties to work together to implement the principles, when those parties have somewhat different perspectives and some at least probably believe that they already apply the principles? As part of this can one get agreement on what is "unnecessary" as opposed to "necessary" complexity? It is also the case that complexity has a cost but it is shareholders who bear this cost not, at least directly, many of those who have a role in creating the level of complexity. However all of this is not to say that the FRC report is not a useful contribution to the debate, which over time may influence behaviour and moderate some aspects of the complexity of reporting that we are increasingly facing.

On some of the specifics, we would agree that the balance has swung too far from principles to rules. In practice some rules are needed and the real question is where the line is drawn, which has become a problem for various reasons. As long as standard setters give undue emphasis to the "anti-abuse" aspects of standards this will add to the complexity of standards, both through their content and their application. It is also the case that the basis for standards has become over theoretical. Some implications of this are covered in other answers below but it has impacted the resource needed to address standards for both users and preparers, while generating accounting that is not always in line with the way businesses are managed or the way we believe many users would like to view businesses. In this context it is also necessary for there to be more clarity over what "users" are being referred to in supporting new approaches in standards. There sometimes seems to be a disconnect between what, for example, the IASB quotes as users' views and what companies actually see in their relations with the market. This is aside from the obvious point that companies should be one of the users as well as the preparer of the financial information.

Change is also an issue in complexity as noted in the paper. It is not always easy to see the benefits that outweigh the costs in particular changes, where we believe the costs are also sometimes underestimated. The internal and external costs of getting companies and their auditors comfortable in areas such as financial instruments or share based payments can be large. Even just establishing that an IFRIC interpretation does not have a material impact has costs for a large multinational.

We would also agree that reports need to be more focussed and, for example, where companies want to provide other than a more than top line CSR information this should be done through other routes.

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.

We believe that cash flow reporting is one area where IFRS is clearly out of line with what both preparers and users want. A new standard is required although the early developments from the IASB were not reassuring. An approach is needed which is based on net debt flows (not cash or cash and cash equivalents), and is an indirect approach starting by reconciling operating profit to operating cash flow and ending with a reconciliation of net debt. This would be more in line with how most preparers would view cash flow and with the sort of information we understand many users would like to see.

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

We strongly believe that in developing reporting requirements more attention should be given to what businesses do internally, both from the provision of relevant information and from a cost/benefit perspective. While there should be some standardisation in external reporting, sometimes the requirements go too far by trying to fit all entities into one requirement e.g. IFRS 7. We would also not claim that management are always right but if most or all businesses take one line internally a standard setter needs to have an extremely strong case to mandate an alternative approach. It has to be said that the IASB has sometimes been dismissive of this by rejecting widely held views. We would also agree with the comments on intangibles in the discussion paper. Accounting for goodwill and other intangibles has become a more complex and costly exercise but it is unclear who benefits from this approach and what is actually achieved.

The greater the divergence between internal measures and externally required measures, then the more we will see the use of non-GAAP performance measures and the less attention paid to GAAP requirements. This adds to both the complexity and cost of the reporting exercise and the complexity of communication for users and preparers.

The concept of “the relevant information to meet important user needs” is a particular problem in an international environment, when even the basic approach to reporting performance can result in different views. When international standardisation is taken to the level of dealing with any problem that might be significant for one or two countries, or one industry, then we have detailed standards where at a minimum everyone has to address the relevance and possible disclosure in relation to many items that are not ultimately material. The question is whether we really need international standardisation of accounting requirements for all companies to the level that might be appropriate in a national environment. This is the route of IFRS to date but it comes at a cost that will increase as more companies come under IFRS unless there is a change in the direction and complexity of reporting.

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?

Over recent years the level of disclosures has expanded and the direction is always one way with every new IFRS or IFRIC seemingly adding to volume of detail in financial statements. This is usually supported by statements that the disclosures are needed by users and sometimes on the basis that users need all the detail behind the numbers so that they can make independent judgements or even adjustments (e.g. share based payments, financial instruments, post retirement benefits). We are not sure how a project on disclosure would be structured to actually moderate these developments. However, the IASB should be clearer on which users require something and why so as to avoid the perception that sometimes it is only driven by the standard setter and a limited range of users. The trade off between transparency and complexity needs to be less heavily weighted to the former principle.

Some of the implications of the ever expanding disclosure requirements could be moderated if there was a higher level of materiality applied in preparing reports but certain factors currently act against this happening. With the change to IFRS, the reporting climate has become more focussed on rules than principles and on literal interpretations rather than substance. This, coupled with the general approach of auditors, makes companies more likely to err on the side of caution and include disclosures that in earlier years they would not have considered on grounds of materiality.

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?

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?

We agree with the second paragraph of page 25 and it is difficult to see for many subsidiaries, especially wholly owned non trading subsidiaries, who benefits from full and/or audited GAAP financial statements. This aspect has also been instrumental in many UK groups not changing their subsidiaries to IFRS despite resolution of the distributable profit issue. Therefore this issue need to be reviewed with more understanding as to who, if anyone, benefits from various types of subsidiary financial statements. The work coming out of the ASB’s paper on the future of UK GAAP should provide input on this issue.

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?

Greater co-ordination between regulators would seem to have the obvious benefit of minimising problems of multiple, slightly different requirements. However, as recognised in the paper, there are also dangers in the degree to which this is done and how this could in practice increase complexity. Convergence is not an end in itself and, as we noted under Question 3, this can lead to a proliferation of requirements. These also then have to be addressed by companies worldwide when the original need for action was only relevant to a much more limited population of companies. In this context we would also note that the IASB is pursuing convergence with US GAAP when the majority of companies using IFRS have little interest in that issue and are primarily concerned with the content of the standards that they have to apply.

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?

It is unfortunately the case that technical experts sometimes struggle to understand what is really intended in IFRS and whether the words actually lead to that result. This is compounded by the problem, noted earlier, that in recent years it is the literal reading of the words in the standard which determines the accounting treatment not what would be the sensible answer based on the substance of the transaction. Moreover, because of their wider application, international requirements run a greater risk that words will lead to unidentified consequences because they were drafted without reflecting some situations.

There are many examples of such issues in IFRS. For example, IAS 39 is highly complex and rule driven, requiring input from highly technical experts in the field even when dealing with an entity that is not a financial institution and does not have very esoteric instruments.

This drafting issue is also relevant to the resource involved in entities that try to input to the process of developing IFRS/IFRIC e.g. the initial proposals leading to IFRIC 14 or the recent proposals on tax.

Plain and consistent language would of course help but it has to be recognised that the former will be difficult in some areas. Nevertheless the IASB has some way to go on this although they are not alone amongst regulators in having such problems. It is also the case that they do not help themselves by sometimes introducing new terminology when most people are comfortable with the existing terminology.

It is often said that it takes more time and resource to say things simpler but it is also the case that more time and resource also lead to more ideas and change, which is also more interesting for those involved. The IASB needs to pay more attention to the former, getting the wording right on what it issues as much as trying to develop new items. Could the words as well as the ideas be more tested with some preparers, who will use the requirements, before they are given wider circulation?

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

The principles set out are clearly ones that many would say are good and many would no doubt also say that they already follow them as far as they can. However in practice the principles may be somewhat conflicting. The increased length of commentary needed to be "open and honest" and "clear" may for example reduce the focus and understandability. The concept of “interesting and engaging” is also difficult in this context as, even without IFRS, we are not sure many people would find financial statements a good read! This is not to say that, as covered elsewhere, there are not things that could be done to make the financial statements more readable even if they are not interesting and engaging. If the concept of interesting and engaging has much of a role it is more in the areas of the OFR, Summary Financial Statements etc where communication of the key messages is the prime aim rather than detailed compliance with accounting standards.

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

As covered elsewhere there a number of aspects of IFRS which if addressed could improve the task of communicating e.g. cash flow reporting, the complexity of net finance cost notes even for relatively normal non financial institutions, volume of disclosures etc. Also, as mentioned elsewhere, over recent years we have created a climate where there is a natural tendency for preparers and auditors to play safe with very low levels of materiality, coupled with the literal application of the words in IFRS and IFRIC interpretations and pressure to cope with expanding requirements. All of this increases the volume of information in financial statements so potentially making the messages less clear. For any of these aspects to change it would necessary to review both IFRS and the auditing standards.

The drafting of information to communicate messages clearly can often be time consuming and somewhat of a specialised skill not always found in those whose main area of expertise is financial reporting. There is therefore a cost involved and inevitably there is both a resource constraint and a prioritisation of resources to where the benefits outweigh the costs. For the reasons noted in Question 9 above, such communication resource as is available is therefore focussed on the OFR etc.

However, even in these areas, care is needed that what has happened to some extent in financial statements does not feed through into these areas. Some guidelines and consistency is of course essential but we need to be careful that we do not have guidelines based on a narrow technical viewpoint which turn themselves into tramlines leading to boilerplate disclosures and unnecessary complexity of communication.

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?

The IFRS should address acquisition accounting. As a number of respondents pointed out during the development of the original IFRS 3, that it would result in accounting for goodwill and other intangibles that would be complex and time consuming without any commensurate benefit to the quality of the financial statements.

If there is an issue on R&D, with a wide range of users having significant concerns, then the IASB should address the issue.

Choices in IFRS need to be looked at in each particular circumstance and there will be cases where some flexibility is necessary if financial statements are to provide useful information. As regards adoption of new standards, assuming they are regarded as an improvement, it seems wrong to prohibit early adoption and we would assume users would not have a real problem given the disclosures which are required.

On CSR see our comment at the end of Question 1 above.

The IASB should look at future cash contributions for post retirement benefit schemes but this should be done as part of a review of all recognition, measurement and disclosure for such schemes bearing in mind the volatility of the numbers – more than many other numbers, any balance sheet position is a relatively subjective valuation which is likely to change materially in a short period of time.

Again if discontinued operations are regarded as a major problem area by a wide range of users then the IASB should address the topic.

Embedded derivatives are one of those areas where large multinational groups have incurred cost to arrive at amounts which are totally insignificant to their accounts. We have usually reached a sensible result but, as with some other aspects of IFRS, it is the cost of doing so that is the concern.

We have a general concern over the trend of the IASB to look for hypothetical fair values, often associated with exit values where such values are unlikely or never going to materialise. This is clearly an IASB issue and it will be interesting to see what transpires in the current review of financial instruments.

The IASB is already looking at complexity in respect of financial instruments, including hedge accounting, and elsewhere in this response we have touched on the issues raised. In particular the point for non financial institutions is often that significant time has been spent on issues which have not materially added to the usefulness of the resulting financial statements. Also the combination of financial institution disclosure with that of other corporates through the implementation of IFRS 7 has made reporting unnecessarily complex for the latter.

In respect of IFRIC interpretations, as noted elsewhere, these are often of very limited impact on most preparers as they are fairly specific issues but to establish that in each case in the current climate is a cost for large groups e.g. IFRIC 4. The real question is whether such standardisation at an international level yields benefits which outweigh those costs. As regards accounting manuals produced by audit firms, preparers often want help in dealing with IFRS and if it comes through such manuals that is good. However this should not spill over from advice into a position where the major audit firms are quasi standard setters with decisions taken without due process on what sometimes appears to be an arbitrary basis.

We do not see parent company financial statements as an issue and are more concerned with the issue of subsidiary financial statements.

There seems little doubt that remuneration reports are long and complex, while being one of the areas in reports that readers usually tend to look at. The current position is perhaps indicative of what happens with a rules based approach, where the disclosures to meet legal and other requirements are also prepared and reviewed from a legal perspective.

Any review of a requirement for segmental cash flows by the IASB should only follow once the total cash flow information has been changed to a more appropriate basis as noted in Question 2 above. We would also note that segmental disclosures such as these should clearly be based on what, if anything, is used internally. However, given the overall issue of complexity, we would also hope to see some simplification in some of the other areas mentioned in the paper.

There is no doubt that share based payments is an area which is complex, requiring expert technical input, and often results in disclosure out of proportion to the impact on the financial statements. However, given most preparers now have their models up and running, we would not see this area as a major priority for the IASB. In this context, however, we would note that we have been concerned by the extension of the standard to the accounts of subsidiaries (IFRIC 11).We think any users of such accounts (including minority shareholders) would be more interested in what that company has been charged by another group company rather than a hypothetical charge based on IFRS 2.