


Complexity, relevance and clarity of corporate reporting

The views of CIMA FTSE 350 Directors



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'The amount of information
that we have to provide now is
excessive.'

David Jeffcoat, Finance Director,
Ultra Electronics

1 Introduction

The Financial Reporting Council's (FRC) project to review the complexity and relevance of current company reporting requirements, is very timely. Over the past ten years, a raft of additional reporting burdens have been placed on businesses, and many of the existing requirements have also changed in that period.

We have seen the emergence of a *Combined Code on Corporate Governance*, International Financial Reporting Standards (IFRS), new disclosure rules on pensions and share-based payments, increased use of complex financial instruments – and rules to govern how they are reported – as well as a host of refinements to existing GAAP (Generally Accepted Accounting Principles).

For management accountants at all levels – but particularly for those holding the highest offices in business – these changes have created some stern challenges. Reconciling the information used to monitor, run and evaluate a business by its own management with the data required for published financial reports is harder than it has ever been.

CIMA recently conducted a straw poll of members, asking simply 'Do you think corporate reporting is more complex than it needs to be?' An overwhelming nine out of ten respondents said yes. (In fact, 94% also agreed that complexity has increased over the past five years, which suggests the problem is getting worse.) We also worked with IFAC on its survey into the financial reporting supply chain. According to the International Federation of Accountants (IFAC) report, 'complexity is one of the most mentioned words in the survey responses.'

Much of the complexity in financial reports is an inevitable result of the fact that we live in a more complex world. Technology, globalisation and complicated organisational structures demand more intricate rules for reporting. Global markets demand ever greater detail on companies in ever shorter timescales.

But the challenge for corporate finance functions remains the same: to communicate their organisations' current position and their future strategies as clearly, effectively and convincingly as possible. Articulating risks in such a fast moving business environment is a huge challenge. This means that the framework for describing them publicly must be flexible and clear.

CIMA strongly supports the notion that this framework should be based on principles, rather than tightly drawn and complex rules. The focus must be on information material to the business in question, not just information deemed 'important' for all businesses. We see an important role for narrative reporting in communicating this material clearly. We would also like to see a renewed focus on the importance of integrity in financial statements – creating a less paranoid environment for reporting.

The processes that companies use to deliver these reports should also be efficient and logical – and we welcome the FRC's clear intention to ensure that these broad aims are reflected in reporting rules.

'It is better to be roughly right than precisely wrong.'

John Maynard Keynes

Introduction

The need for reform

Some reform of statutory reporting is certainly warranted. CIMA's own research, based on a global International Federation of Accountants (IFAC) study into the financial reporting supply chain, concluded that while preparers of accounts are struggling to communicate the true drivers of their business through regulated financial reports, many users of those accounts are also finding them inadequate for their needs.

'A chairman shouldn't feel cynical about it,' Sir Christopher Hogg, Chair of the FRC, told a CIMA round table on the financial reporting supply chain last year. **'They should be determined that they could show (the annual report) to their intelligent 20 year old child, who could read through it and say what it is all about. I am very struck by how few annual reports really read that way.'**

The information typically imparted in analyst meetings, for example, is considered by the users of accounts to be more useful than the statutory accounts in evaluating management's performance and their business's strategy – crucial components of any assessment of value. Just as important, it's often easier for the preparers of accounts to generate that information, since it usually correlates more closely with their own internal management accounting.

Worse, while CFOs want to communicate this highly relevant material, many of them tell us that the time taken to conform to the statutory reporting requirements, often in less material areas, is preventing them from delivering better, more meaningful views on their businesses. The sheer time and effort required to assemble financial reports should be a key consideration of any review.

Any board of directors has a responsibility to provide clear and meaningful information to investors and other stakeholders. Our accounting and reporting rules should be detailed enough to ensure this is done consistently – but not so complex that the board finds it impractical to offer the appropriate information.

'I do not believe the purpose of accounting is to get to the best technical definition of the 'right answer', if such perfection even exists. Accounts exist to fairly present a picture of performance, resources and risk which leads to a more efficient allocation of resources by investors into competing claims for capital.'

Douglas Flint CBE FCMA
Group Finance Director of HSBC

CIMA welcomes the FRC's attention on the issue of complexity and relevance in financial reporting. We look forward to a shift towards a reporting environment that helps our members communicate more clearly; and users of accounts to better understand where management have applied sound and honest judgments to explain their performance and strategy.



Charles Tilley

Chief Executive, Chartered Institute of Management Accountants
February 2009

2 Broad themes and general conclusions

Broad themes

CIMA's concerns on complexity and relevance fall into four key areas.

Principles based standards

Firstly, to avoid setting rules too tightly to allow for the communication of genuinely useful and insightful information, we strongly urge an adherence to a principles based approach to drawing up reporting requirements.

The pressure to align IFRS with those of United States GAAP may have started to tilt the balance towards rules based standards. But this could only further complicate financial reporting and limit the ability of CFOs and boards to apply sensible judgments to how they translate practical management information into published reports and accounts.

Materiality

Secondly, we feel it is worth re-stating the importance of materiality in the rules governing financial reports.

Within an extremely broad skill set, CIMA members specialise in producing information that drives better decision making. We believe that it is this information, clearly presented, that is of most use to users and regulators of accounts – rather than disclosures that may have little or no bearing on value

creation or protection. Today's financial IT systems and more complicated business practices are capable of producing huge volumes of data. But we must remain focused on what really has a bearing on a company's performance and viability.

Narrative reporting

Thirdly, we should take care not to overcomplicate the management commentary. This is a crucial area of financial reporting, and one that has evolved considerably over the past few years. We believe that published financial reports, should communicate to a wide audience the kind of information usually imparted in analysts presentations – in other words, the data and assumptions that drive decision making, information which often fall outside the scope of GAAP.

While management should not be free to make misleading or inaccurate statements, their commentary is a fundamental part of the dialogue with stakeholders and should be as fulsome as possible.

Integrity

That leads us onto the final point: integrity and professionalism. These are the cornerstones of our profession and we expect our members to display these qualities at all times.

But excessive complexity in the accounting rules can actually make it harder for them to do so. It is absolutely right that failures of integrity by boards should be severely punished – as should any breakdown in the professionalism of auditors in providing assurance on financial reports. But it is not sensible to hold out the prospect of punishment for minor transgressions on complex or non-material disclosures. As HSBC's FD Douglas Flint explains, more use should be made of provisions allowing directors to express honest, clear judgments.

'We should go back to stressing accountability and responsibility with unambiguous 'safe harbour' protection for honestly produced complete and fair disclosure. We can then have a financial report that ceases to be disproportionately weighed down with technical warnings of what may go wrong.'

2 Broad themes and general conclusions

General conclusions

In short, we fear that statutory accounts limit the scope for describing what a business actually does, that audit now merely confirms that the technical accounting has been performed in line with the regulations, and that management has fewer opportunities to explain performance and strategy – with integrity – because they are bound by complex rules to report less relevant information in more detail.

'What I find frustrating about much of the governance around financial reporting now is there is an implication that nobody would tell the truth unless there was a rule that required them to do so,' says Douglas Flint. 'Any responsible management team would disclose information beyond that which is technically required if it gave greater clarity to a matter of interest or concern to stakeholders, because greater clarity brings confidence and confidence brings a higher market rating.'

Management teams spend significant time aggregating and recalculating data from internal sources to construct the information demanded by regulatory reporting. Analysts and investors then spend time deconstructing that information so that they can see the building blocks.

The process is wasteful and ineffective. It quite often leads to companies losing sight of the reason for publishing financial reports in the first place: communication.

This lesson about clear communication could be further applied to the use of over-technical or legalistic language in the drafting of accounting and reporting standards. The use of plain English in standards would have several beneficial effects. For example, Douglas Flint argued as early as 2006, that complex, rules-based standards were making it harder to train and retain accountants, especially for an organisation with staff speaking many different languages.

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Douglas Flint CBE FCMA
Group Finance Director of HSBC

At an event hosted by The Institute of Chartered Accountants of Scotland (ICAS), he cited IFRS 3 as an example of confused language: 'A business consists of inputs, and processes applied to those inputs, that have the ability to create outputs. Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business. Not one person can understand that,' said Flint. 'People with English as their second language have no chance.'

There is also some concern in both the preparers' and users' communities about the amount and speed of changes in the regulations governing financial reporting. CIMA appreciates this is hard for one body to manage – changes emerge from local regulators, legislation, international standard-setters and even market practice. But many of our members would welcome a sustained period of stability in order to fully come to terms with the reporting environment as it stands – hence the popularity of the IASB's two year moratorium on major new standards.

Common definitions, consistency between (and even within) standards, stability of regulations and straightforward, easily translated language are all a priority.

CIMA was a founding member of the Report Leadership Group which researched ways in which reporting could better serve both preparers and users of financial reports. The group includes PricewaterhouseCoopers, the professional services firm, and Radley Yeldar, specialist suppliers of corporate and business communication services. They concluded that corporate reporting should be more accessible and informative and picked out best practice examples of simple, practical, yet effective ways to improve narrative and financial reporting. The publications can be found at www.reportleadership.com including our latest, published in December 2008, *Report Leadership Tomorrow's Reporting Today: take a look at some examples*, which includes case studies using similar ideas to those advocated by Report Leadership.

3 Areas of concern

Through our own analysis of financial reporting, and after conversations with several senior, experienced CIMA members, we believe it is appropriate to flag up some key areas of concern within modern financial reports. In each case, there is a perceived problem with both relevance and complexity.

We feel that the FRC has an important role as a key contributor to the production and application of IFRS (particularly in light of the convergence project with US GAAP) to act as a catalyst to try and remedy the problems that have been identified.

Cash flow

Cash is one of the key metrics for any business and one of the few measures that is treated with equal reverence for both internal decision making and in published financial reports. Yet CIMA's members often complain that the reporting requirements now complicate its presentation for users of accounts.

'The way that the cash flow statements are now required to be presented is certainly not consistent with historic practice,' says David Jeffcoat, Finance Director of Ultra Electronics. **'It is not what the analysts are looking for in the results presentation. The formats that we use (are) more logical ... than the definition that applies for statutory reporting purposes.'**

That's a position reiterated by another FTSE350 FD we interviewed: **'we never use the cash flow statement when we talk to investors... we produce our own statement with the presentation at interims and full year. (The statutory statement) has no correlation at all with any internal reporting.'**

Andrew Carr-Locke, former FD of Wimpey and non-executive at Royal Mail, agrees: **'the cash flow statement is the most unintelligible and un-useful document in an annual report because firstly, most people reading it can't actually interpret what the headings are; and secondly, it ends on cash which is totally irrelevant. Most people want to understand cash and borrowings – your net debt position – and how that's moved. I've never known an analyst to use the statutory cash flow statement.'**

While CFOs and investor relations (IR) professionals have clearly developed work-arounds for cash flow reporting, bringing the standard more closely into line with common management practice for evaluating the cash position would be a welcome step to improve relevance – and remove one more level of complexity for preparers and users.

Financial instruments

Measurements

The recent global financial crisis has highlighted the difficulties in preparing accounts when companies hold assets and liabilities that are sometimes nearly impossible to value. **'Even in light of huge volumes of application guidance and examples, it is often difficult to find an answer to the proper accounting for increasingly diverse and innovative financial instruments,'** says Ahold CEO, John Rishton.

We appreciate that this is a thorny issue and one that has a significant political dimension at the moment. Nevertheless, several members point out that the volatility seen in the valuation of financial instruments does not translate well to a traditional balance sheet.

'The problem is that the economic measurement that now goes into accounts is based on an instant view of future value and that, itself, introduces a level of volatility in accounts,' says Geoff Cooper, Chief Executive of Travis Perkins. **'I don't think that inherent volatility has been adequately thought through by the people who (determine) how you value a company's balance sheet.'**

'The cash flow statement is the most unintelligible and un-useful document in an annual report'

Andrew Carr-Locke
Former FD of Wimpey and
non-executive Director at
Royal Mail

Disclosure

While some companies try to explain this volatility in conversations with analysts and investors – effectively explaining why the point-in-time value may be unclear or misleading – members also express concerns about the level of complexity in the disclosures around complex financial instruments. Even if we can generate reliable measures, those same point-in-time valuations tend to be presented in a way that obfuscates their true relationship to the management of the business.

Worse still, they feel there are too many obligations to disclose information that is, in any case, not material to the business. This complicates the financial report – in many cases needlessly.

'Disclosure of financial instruments is particularly poor in relation to derivatives,' says Geoff Cooper, Chief Executive of Travis Perkins. **'I can understand why it would be there for a company actually trading derivatives but, for most businesses, I think the disclosures are pretty meaningless and impenetrable.'**

Douglas Flint, FD of HSBC, cites an example from the oil and gas industry. **'You can have a gas contract where you're required to treat part of it as an embedded derivative,'** he says, **'It's not the way the business is managed and can produce hard to explain volatility in accounting numbers.'**

David Jeffcoat states:

'the whole area of reporting on financial instruments needs to be completely revised.'

Hedge accounting

Finally among the more esoteric aspects of financial reports, there is continuing disquiet about hedge accounting. Apart from its native complexity, members feel this is another area where reporting drives company decisions, not vice versa.

'Hedge accounting... has actually prevented us from undertaking a commercially beneficial transaction because of the accounting consequences,' explains Geoff Cooper. **'We all bravely say we should never let the accounting drive our commercial decision making. This is an example where it has done.'** Another FD adds: **'You put in place a set of rules that need to work for financial institutions as well – but the reality is it's out of all regard to the issues that interest our investors.'**

3 Areas of concern

Fair value accounting in general

Naturally, the debate on the measurement and disclosure of financial instruments has prompted a wider discussion on fair value accounting. While, as an institute, we accept that fair value is perhaps an imperfect method of accounting, we also acknowledge that it is the best option available given the alternatives.

'Fair value accounting is conceptually useful, but is difficult to apply in practice,' explains John Rishton. **'Should our instruments be based on today's market or exit value rates? Or on a more going-concern basis? There seems to be no consensus in this area and the confusion does not help in applying a principles based set of accounting standards.'** The recent and ongoing crisis in financial markets has also demonstrated the challenge of mark-to-market when market liquidity is close to zero.

Fair value also challenges the assumption that accounting should reflect a business, rather than drive its decisions. **'It's intellectually sound, but when you actually come to the practicalities, fair value can actually start to cause behaviour which causes movements in the markets and hence the fair value of the instruments being traded,'** says Andrew Carr-Locke. **'You almost get into a vicious circle.'**

So while we strongly reject the idea of suspending fair value accounting at times of crisis, we suggest this is an area that requires better underlying logic and more meaningful disclosures in financial reports.

Impairments

While there is some support for the newer applications of impairments – particularly around goodwill and other intangibles – there is also frustration that the standards seem inconsistent, making it harder for both preparers and users to see financial reports as a fair reflection of the business in question.

'In a retail chain, (after an acquisition) you might have to impair either the value of property or the goodwill – you write your balance sheet down,' says Geoff Cooper. **'However, if you create lots of goodwill by building a new store, you don't take it onto the balance sheet. So what does the figure in the financial statements actually represent?'**

John Rishton adds that impairments are an accounting concept that is not always reflected in changes to cash flows. **'It is difficult to explain how changes in the weighted average cost of capital (WACC) can result in increased impairments or impairment reversals,'**

he says. **'These changes often arise from market volatility or changes in the strength of our peer group – which affects our WACC rate – and may have little direct relationship to the performance of our assets. We disclose both impairments and reversals on a segment basis to allow the reader to adjust our earnings for these and arrive at a more predictable view of underlying operating performance.'**

This obfuscation is even more apparent in sectors such as financial services. **'A big problem can be the asymmetry of recognising an impairment loss on an asset that can recover with no recognition of that in the accounts,'** says Douglas Flint. **'It's a curious thing to have to reduce capital that you don't think is actually lost. So, if you had an equity stake which has experienced a 'significant or sustained' decline, you have to take the impairment to profit and loss; yet it goes up the following month, you can't take the impairment back. I don't understand the logic.'**

Pensions

Again, it is important to separate the problems companies are facing with pensions as a result of changed actuarial assumptions, poor returns and low interest rates from the issues concerning the reporting of their impact on company finances. But the relevance and complexity of those reporting requirements are still a concern for senior accountants.

'Pensions is another area which has become far more onerous and far more detailed and it seems every year we add on an extra half a page of disclosures,' says David Jeffcoat.

'The practice of having to disclose at a particular point in time the pension funding position – the deficit or surplus that exists – potentially drives the wrong behaviour in the short-term as opposed to taking a longer-term view in relation to contributions.'

Andrew Carr-Locke adds that the disclosures are often hard to follow through the accounts. 'Some better realisation of the exposures and the effective cost of pensions is called for,' he says. 'The actual implementation has been very complex because you now have parts going to the operating profit, parts going to the interest line and parts being taken into reserves.'

Deferred tax

Like many of our areas of concern, the complexity of deferred taxation and its lack of connection to the underlying performance of the business make reports much less relevant. We recognise that these requirements can be important for regulatory purposes, but this should not deter the financial reporting community from looking again at how they are reported. 'There is quite a lot of disclosure in deferred tax,' says another FD. 'I'm not sure who reads it, apart from the taxman. It's accountancy for accountancy's sake.'

'Pensions is another area which has become far more onerous and far more detailed.'

David Jeffcoat
FD of Ultra Electronics

3 Areas of concern

Length of disclosures in general

David Jeffcoat sums up many of these concerns: **'I have been doing this job now for nearly nine years and the length of the accounting section of the annual report has more than doubled,'** he says. **'My personal view is that the amount of information that we have to provide now is excessive.'**

According to research by Deloitte, the average listed company annual report now runs to 96 pages, an increase of 34% over 2005. In bigger companies, the problem is much more severe. Radley Yeldar reports that the average length of annual reports in the FTSE 100 has jumped by a quarter in just two years. Reports averaged 150 pages in 2007, but the longest was a massive 458 pages.

Clearly, addressing some of the other issues around complexity and relevance that we have highlighted could shorten the overall report. In particular, we see increased attention to materiality in the accounts – making sure they clearly reflect the metrics that drive decision making in a business – as an essential focus for any drive to bring report length down.

International Financial Reporting Standards (IFRS)

Anecdotally, we understand that most CFOs have not made radical changes to their internal reporting and management accounting as a result of the introduction of IFRS. But the international standards have, in many cases, fundamentally changed published financial reports. Ahold CEO, John Rishton's view is typical: **'the introduction of IFRS has had no impact on how we report internally, measure performance or make decisions,'** he says. **'The main differences internally include a greatly simplified and understandable cash flow statement and a natural focus on the future.'**

But like many CIMA members, Rishton also welcomes the IASB's two year moratorium on new pronouncements, to allow for the proper bedding-down of IFRS within Europe. IFRS for private entities is also being eagerly awaited, and although CIMA thinks the proposals are still too complex, especially for the smallest companies, this simpler set of standards is a welcome development.

And although many of the major concerns around complexity in IFRS are related to convergence with US GAAP, there remain general concerns about

comprehension. **'I was a great believer in the whole concept of having the world account in the same way,'** says Carr-Locke. **'Making a common language that everyone understood was great. But what I think we've done is actually made it a common language that no one understands.'**

Remuneration

Although remuneration reporting was broadly considered to be a lower priority for members than some of the complex rules around financial instruments or new standards, it remains an area with potential for reform. **'We spend far too many pages, in my view, disclosing the remuneration of half a dozen people out of 340,000 employees – but that's governance,'** says Douglas Flint, conceding that the depth of reporting reflects a wider social focus on executive pay.

In common with other areas of concern, some preparers feel that many of the disclosures are either unnecessary for their businesses or create confusion around the total remuneration for executives where they use complex reward mechanisms. Simpler narrative reporting around this section of the annual report may be called for.

4 Opportunities

Although there are clearly several aspects of financial reporting that could benefit from the FRC's attention to complexity and relevance, CIMA would also like to take this opportunity to highlight aspects of reports that make a positive contribution – and that perhaps should be protected from over complication.

Management commentary

Narrative reporting is a vital opportunity for management to explain their strategy to investors, to discuss the market environment in which they operate and to explain the context for their financial results. It is tremendously important as a means of providing a 'top slice' of the information regularly reported to company boards in a way that makes sometimes abstract numbers more relevant and less complex for users of accounts.

Interestingly, one new requirement – since rescinded, of course – has also helped management produce more relevant reports. 'On the Operating and Financial Review, the guidance that has been issued in this area generally is good and I think it has brought about an improvement in reporting,' David Jeffcoat adds.

Comply or explain

We recognise that 'comply or explain' has some weaknesses in practice. 'From a corporate governance perspective, it is actually quite difficult to adopt the 'comply or explain' route,' Ken Lever, then Chairman of the FRC's 100 Group of leading UK finance directors, explained at a CIMA round table in January, 2008. 'In my experience in public company boards, the tendency is not to want to explain; the tendency is to comply because you don't like to be singled out.'

'From a corporate governance perspective, it is actually quite difficult to adopt the 'comply or explain' route,'

Ken Lever,
Chairman of the FRC's 100
Group of Leading UK Finance
Directors

Nevertheless, it remains a valuable principle within statutory reporting. Extending the concept beyond corporate governance disclosures is no simple task. But in some of the more esoteric areas of reporting – particularly in relation to hedge accounting and derivatives, for example – it might allow management to cut non-material disclosures. In that sense, it is a logical extension of principles based standards.

If preparers can demonstrate that issues are not material – that they have no impact on management decision making and that they present no risk in the future – and therefore make no disclosures on them, they could focus instead on clear communication of their approach.

Short-form reporting

Deloitte's recent research in annual reports concludes that the high proportion (85%) of companies issuing a summary information page at the beginning of their annual report is a direct result of over complexity in the statutory accounts. In fact, such summaries are now a valuable tool for communicating clearly and companies should certainly be able to publish statutory reports in simplified form.

'We're getting to the point where annual reports and accounts going to shareholders are going to be very summarised documents and there will be a separate technical filing, a compliance document in effect, for regulators and those that want it,' says Douglas Flint, echoing our members' more general desire to limit shareholder reports to information generally of interest to and used by them.

Reporting for non-public interest entities

We have already noted the approval for IFRS for private entities, but results from our straw poll of members indicates that this is an opportunity to radically reduce complexity for the vast majority of businesses. There is, equally, a fear that this opportunity might be wasted by allowing poor definitions of those entities covered by the simplified standards or additional complexity to creep into these standards.

'Making a common language that everyone understood was great. But what I think we've done is actually made it a common language that no one understands.'

Andrew Carr-Locke
Former FD of Wimpey and
non-executive of Royal Mail

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