

Louder than Words (in short).

Principles and actions for
making corporate reports less
complex and more relevant



Financial Reporting Council

The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting confidence in corporate reporting and governance. For corporate reporting, the outcome we seek is this:

Corporate reports contain information which is relevant, reliable, understandable and comparable, and are useful for decision-making, including stewardship decisions.

For further information visit
www.frc.org.uk

Investigating complexity

Concerns about the increasing complexity and decreasing relevance of corporate reports have been growing in recent years. Many people point to the increasing length and detail of annual reports – and the regulations that govern them – as evidence that we have a problem. Others are more worried that reports no longer reflect the reality of the underlying businesses, with key messages lost in the clutter of lengthy disclosures and regulatory jargon.

We set out to investigate the complexity and relevance of corporate reporting. As we began, the unfolding credit crisis raised an additional issue: the risk of further complexity arising from uncoordinated responses to the crisis by regulators and standard setters. This emphasised the importance of the coordination advocated in this booklet.

Our discussion paper provides the results of our initial investigation and offers practical recommendations for improvement. We confined the scope of our activities to UK publicly traded companies to make the task manageable, but we hope that there are lessons here for all companies.

This booklet is a summary of the full paper which is available at www.frc.org.uk. The full paper is a first step towards reducing complexity, not the end goal. We will continue working towards implementation of our ideas after it is published. We also hope our work will stimulate productive discussions not only in the UK but around the world, and provide a platform for lasting improvement in corporate reporting.

To help frame the debate we have set out over the last few pages of this booklet a possible agenda for the items you might want to discuss – but please do not let that constrain you!



Concerns about the increasing complexity and decreasing relevance of corporate reports have been growing in recent years.



Understanding complexity

We have considered complexity in a broad sense, meaning anything that makes corporate reporting regulations or the reports themselves unnecessarily difficult to understand, implement or analyse. This includes missing information or irrelevant detail that obscures the overall picture.

Working with a wide range of people involved in regulating, communicating and using corporate reports, we set out to determine the causes of increasing complexity and decreasing relevance, and to develop recommendations aimed at improvement.

Corporate report preparers almost unanimously said the process of compiling a report is too complex, and so are the reports themselves. Users were not so sure, but sought a variety of improvements focused on relevance and better communication.

Focusing on the users

One widely acknowledged problem is that reports currently aim to please too many types of user. There is a need to refocus them on their primary purpose: providing investors with information that is useful for making their resource allocation decisions and assessing management's stewardship. We suggest that regulators and companies should reconsider how they address the needs of other stakeholders – for example, those with specialist interests in environmental and employee diversity issues.

Making change happen

Complexity in corporate reporting is a multi-faceted problem that will require changes in behaviour from all members of the corporate reporting community. Our research has convinced us that the best route to better reporting – and regulation of reporting – emphasises principles rather than rules.

So we recommend a commonsense approach based on *eight guiding principles* – four for regulation of reporting and four for effective communication in reporting.

We also make *five calls for action* in areas where it is clear that urgent change is needed.

Finally, we ask readers for their thoughts on how we can address other specific causes of complexity mentioned by interviewees that represent *opportunities for further action*.



Complexity in corporate reporting is a multi-faceted problem that will require changes in behaviour from all members of the corporate reporting community.



Principles for less complex regulation of reporting

In addition to principles for technical content *in* standards and regulations, we need some principles *for* those standards and regulations themselves.

Accordingly, to provide a toolkit for improving the quality and effectiveness of regulations, regulators and standard setters should all adopt a single set of principles that govern how they set and communicate regulations. We believe corporate reporting regulations should be:

1.

Targeted

Understand the problem

Regulations should focus on significant problems and be targeted to:

- Provide relevant information that meets important user needs
- Reflect the reality of the business while minimising unintended implementation consequences.

2.

Proportionate

Balance the costs and benefits of regulation

Regulators should limit constant change by intervening only when an area is high-risk and change will bring obvious benefit. Intervention should be as cost effective as possible – for example, by using management information already produced for internal purposes.

What do we mean by the term regulations?

All laws, accounting standards and other requirements that govern the content of corporate reports.

What do we mean by the term regulators?

All bodies involved in setting regulations.

3.

Coordinated

Consider what other regulators are doing

Regulators should understand what other national and international regulators are doing in a particular area. Wherever possible, they should be consistent with one another and work together in a joined-up way.

4.

Clear

Deliver an understandable solution

Being clear means keeping regulations simple and user-friendly. They need to be understood easily by those who will apply them and those who will benefit from them. Regulations should emphasise:

- A clear articulation of the desired outcome
- Principles and judgement where appropriate
- Plain language with well defined terms
- Consistent terminology
- An easy-to-follow structure.

Principles for effective communication in reporting

To reduce complexity, it is important to focus on good communication as well as simplifying regulations. The UK Accounting Standards Board's *Reporting Statement: Operating and Financial Review* (OFR) provides principles for writing the OFR that we think can apply throughout corporate reports to improve communication. We have modified these principles slightly to develop principles for effective communication. Corporate reports should be:

1.

Focused

Highlight important messages, transactions and accounting policies and avoid distracting readers with immaterial clutter.

2.

Open and honest

Provide a balanced explanation of the results – the good news and the bad.

What can preparers do to help?

We urge preparers to apply these principles now, to help reduce the complexity of their reporting without waiting for regulatory change.

3.

Clear and understandable

Use plain language, only well defined technical terms, consistent terminology and an easy-to-follow structure.

4.

Interesting and engaging

Get the point across with a report that holds the reader's attention.



Call for action one:
Improve cash flow and net debt reporting

The FRC should launch a project to further investigate users' needs for cash flow and net debt reporting with a view to better aligning reporting with these needs, possibly through producing best practice guidance.



Call for action two:
Ensure disclosure requirements are relevant and proportionate to the risks

We would like to see a project on disclosure which investigates the characteristics of useful disclosures and the main objectives of financial reporting disclosure. Further, a process is needed to review existing disclosure requirements regularly for continued relevance.

Ideally, we believe another organisation could constructively kick off this work with a view to providing recommendations to the relevant regulators, including the International Accounting Standards Board (IASB).



Call for action three:
Ensure requirements for wholly-owned subsidiaries' reporting are targeted and proportionate

We recommend further study of the costs and benefits of subsidiary reporting requirements to determine if we can better match requirements to user needs and reduce the overall burden on UK companies. Improvements could result in adjustments to GAAP or other legal requirements. If the study concludes that one of the steps necessary to reduce complexity requires changes in EU and/or UK law, the prospects for early change are limited and so may need to be pursued over a period of time.



Call for action four:
*Improve usability
of International
Financial Reporting
Standards (IFRS)*

The IASB should consider a project to reorganise its standards, accompanying documents and interpretations around accounting topics, using an easy-to-follow structure and clearly expressing the desired outcomes.



Call for action five:
Cut clutter

Clutter in reports is a multi-faceted issue that will be very difficult to resolve. To begin tackling clutter in reports we believe two steps are urgently necessary:

Step 1:

Preparers should remember that immaterial disclosures undermine the quality of reports and make a concerted effort to cut clutter.

Step 2:

We recommend an investigation into the way various sources of regulation are contributing to clutter in annual reports.

However, some action is already in hand. In order to help preparers make judgements and provide some examples of obviously immaterial disclosures, the FRC plans to conduct a review of 2008 annual reports during summer 2009. It will publish a short paper on its findings including, where possible, examples of how regulations may have contributed to clutter.

Opportunities for further action

In our face-to-face interviews, interviewees mentioned a large number of specific sources of complexity in corporate reporting. Each represents an additional opportunity to understand and address the issues that give rise to complexity in corporate reports. These are summarised below in alphabetical order:

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.

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.

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.

Corporate social responsibility (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.

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.

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.

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.

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’.

Opportunities for further action

Continued

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.

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.

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.

Interpretive guidance

Many preparers say the proliferation of interpretive guidance for accounting standards such as International Financial Reporting Interpretations Committee interpretations and accounting manuals produced by audit firms adds to complexity.

Parent company financial statements

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

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.

Segmental reporting

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

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.

Questions to consider

When you've read the full paper, we'd value your feedback. Is what we are suggesting a logical and sensible way forward? What are your suggestions on how to move this from a debate to actual change? Please be open-minded and frank, and send your thoughts by post or email to:

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We'd appreciate comments by 30 October 2009. To help frame the debate we suggest some points you might want to discuss – but please feel free to raise others.

- 1 Can the principles for less complex regulation we propose help reduce complexity? Are there other principles that should be considered?
- 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.
- 3 Proportionate: Should accounting standards and other regulations be based more on the information that management produces internally?
- 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?
- 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?
- 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?

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?

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?

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

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

11 Which opportunities for further action warrant follow-up? Which organisation(s) would be best placed to assist with the necessary action?

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