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Mr Bruce Donald
Secretary
Financial Reporting Council
c/ The Treasury
Langton Crescent
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Dear Mr Donald,

Managing Complexity in Financial Reporting

The Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) welcomes the opportunity to provide comments to the Financial Reporting Council (FRC) on the report *Managing Complexity in Financial Reporting* ("the paper").

HoTARAC commends the FRC for addressing complexity in financial reporting, a topic HoTARAC has previously suggested the International Accounting Standards Board (IASB) add to their list of projects.

HoTARAC agrees with the conclusions of the Task Force in respect of the sources of complexity in financial reporting and the strategies proposed for addressing it. Further, HoTARAC has identified additional strategies for the FRC's consideration.

The report addresses both short-term management of complexity and long-term strategies for reducing complexity. HoTARAC recommends the FRC's focus to be on the achievement of results in the longer term, the most important strategy being a greater FRC engagement with the IASB as soon as possible to urge the Board to complete the development of its conceptual framework project. This would assist in the development of robust, consistent and principle-based standards, which HoTARAC contends would likely result in a reduction of complexity in recognition, measurement and disclosure. Additionally, this would provide a mechanism for the framework for presentation and disclosure proposed by the Task Force.

HoTARAC further recommends the needs of financial report users be researched to determine the extent to which current accounting pronouncements meet those needs.

A number of topics identified in the report are also particularly pertinent to entities in the public sector and HoTARAC recommends the FRC give public sector issues further consideration. In particular, HoTARAC recommends that FRC's engagement with IASB include encouragement for IASB to liaise with the International Public Sector Accounting Standards Board, in addition to the Australian Accounting Standards Board, to ensure that the IASB is better informed and more able to consider the impact of its decisions on the public sector.

Notwithstanding its preferred approach of a greater focus on a long-term strategy, HoTARAC suggests, as 'quick wins', developing a practical and effective differential reporting framework for the Australian public sector and promoting independent education or training programs which aim to increase report users' understanding of financial information provided in the General Purpose Financial Reports.

Comments by HoTARAC on the Matters for Comment in the report are attached.

If you have any queries regarding HoTARAC's comments, please contact James Benson from the Australian Department of Finance and Deregulation on 612 6215 3775.

Yours sincerely

Grant Hehir
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

24 July 2012

Financial Reporting Council – Managing Complexity Task Force

Invitation to Comment - Managing Complexity in Financial Reporting

General Comments

HoTARAC appreciates the Financial Reporting Council (FRC) addressing the issue of complexity in financial reporting and inviting stakeholder comment on the *Managing Complexity in Financial Reporting* paper ("the paper"). HoTARAC is in general agreement with the Task Force, both in terms of identification of the causes of complexity and the possible solutions canvassed in the paper. However, HoTARAC would recommend FRC clarify its objectives in issuing this paper. For example, there may be merit in identifying whether the FRC would take an active role in progressing strategies to manage complexity in financial reporting.

HoTARAC agrees with the Task Force regarding the burden on preparers in respect of complexity driving reporting requirements and accompanying disclosures and the difficulties of users in understanding the resulting voluminous disclosures. However, complexity may also be perceived to be beneficial to some users. Some commentators, in particular market analysts and some regulators may argue that it may be necessary to reflect the complex environment in which an entity operates, provide additional information to improve understandability and comparability (e.g. valuation assumptions) and permit an entity to comply with its regulatory requirements. Consequently, HoTARAC recommends the Task Force consider providing further explanation as to why complexity in the context of financial reporting requirements is an issue. HoTARAC is of the view that complexity in financial reporting may impinge, not only on information consistency, as mentioned in the paper, but on other qualitative characteristics of financial reports, as outlined in the Australian accounting framework. HoTARAC expands on this idea in the response to Matter for Comment 6.

HoTARAC believes it is important to distinguish between short-term tactics for managing complexity and longer term strategies for reducing complexity in financial reporting. While the paper addresses both management and reduction of complexity, HoTARAC considers engagement with the International Accounting Standards Board (IASB) to be critical to the longer term goal. To a great extent, complexity in reporting could be mitigated through the finalisation of the IASB conceptual framework. HoTARAC contends that the application of high level principles or concepts, rather than rule-based requirements, would likely result in more relevant information rather than just a focus on compliance and/or onerous disclosures being provided. In particular, as per the Australian Accounting Standards Board's (AASB) suggestion raised in the paper on page 11, it is critical for the IASB to progress its presentation and disclosure conceptual framework project. HoTARAC would also strongly recommend the IASB be encouraged to consider public sector/not-for-profit (NFP) issues in developing its conceptual framework.

HoTARAC agrees that regulatory imposts are also a source of complexity in reporting. The regulatory function is often reactive to crises and scandals, and tends to set rules and compliance regimes to resolve the matter rather than applying a conceptual approach. Page

5 of the paper indicates that sometimes the General Purpose Financial Reports (GPFRs) are used by regulators to meet their special purpose needs, which is not the defined purpose of GPFRs, thus at times creating confusion and adding another layer to the information required by the standard setters. HoTARAC has further outlined its consideration on this issue in the response to Matter for Comment 3.

Complexity in financial reporting is an issue for all reporting entities, however HoTARAC notes the paper appears to focus on private sector reporting. HoTARAC considers a number of points raised by the FRC particularly pertinent to public sector entities. Therefore, HoTARAC would urge the FRC to take into account the interest of both for-profit and NFP reporting entities. For example, the operating result may not be the sole measure of performance for the public sector, particularly for those entities below the whole of government level, where the key indicators of performance are the delivery of services and its associated cost. Annual Reports in the public sector often highlight these performance measures, with the financial statements relegated to an appendix.

Matters for Comments

1. *Are there any additional sources of reporting complexity which should be considered by the Task Force and the FRC, and if so, what?*

As noted in the General Comments above, HoTARAC endorses the FRC's conclusions in respect of complexity in financial reporting. HoTARAC notes that a number of points raised by the FRC, particularly in respect of the mixture of rule-based and principle-based standards, the framework for presentation and disclosure, and the hybrid measurement framework at least partially arise from the lack of a current conceptual framework for International Financial Reporting Standards (IFRSs) to guide the development of principle-based standards. Ideally, standards should be developed or revised within overarching principles established under a conceptual framework. Developing or revising standards without a conceptual framework can lead to inconsistencies between standards, lack of understandability and proliferation of rule-based standards. The latter may also have been exacerbated by the IASB and the US Financial Accounting Standards Board convergence project.

Due to an arguable lack of engagement between standard setters and the primary users of GPFRs, standard setters (with input from regulators and preparers) make their own judgements about appropriate recognition, measurement and disclosure requirements, using their extensive conceptual expertise. HoTARAC is not aware of any evidence or research that confirms that the broad ranges of users actually require the sophisticated requirements in accounting pronouncements. Therefore, there is an argument that current accounting pronouncements may be more complex than they really need to be.

Decisions by standard setters are also leading to an increasing range of subjective judgements required of entity management in preparing general purpose financial statements. Increased disclosures and negotiations with auditors to explain the subjective judgements lead to difficulties for preparers and auditors in applying accounting pronouncements. It also may reduce comparability between entities.

As noted by the Task Force, the application of the full suite of IFRSs to all Australian reporting entities, including to the public sector, amplifies complexity for the Australian public sector entities (page 5 of the paper), particularly given the current focus of the IFRSs on the private sector and capital market users.

HoTARAC also agrees with the Task Force's comments on page 6 of the paper that reaction to financial crises and scandals have flowed into reporting requirements in ways that have added to complexity. This has led to changes that HoTARAC believes are inappropriate from a public sector reporting perspective for both users and preparers. At times, this has been identified by the national standard setter, the AASB. For example, the AASB is currently considering specific revisions to IFRSs for application to NFP entities.

Outside of the accounting framework, some HoTARAC jurisdictions have an additional layer of financial reporting issued through mandatory guidelines for public sector reporting entities under their control where the requirements of Australian equivalents to IFRSs do not fully address perceived public sector needs. For example, some State jurisdictions require Generally Accepted Accounting Principles – Government Finance Statistics harmonised reporting by certain public sector entities in their jurisdiction.

Further, market regulators such as the Australian Securities and Investments Commission have also requested additional information to be included in financial reports. Such requests are consistent with the Australian accounting framework as the accounting standards issued by the AASB only provide for the minimum requirements for GPFRs.

2. *Do you agree with the Task Force's conclusion that complexity is inevitable in the short-term and accordingly that efforts should be concentrated on strategies to assist stakeholders to better manage this complexity?*

HoTARAC agrees that complexity cannot be significantly reduced in the short-term because it is a product of the existing financial reporting frameworks which, itself, would be difficult to amend in the short-term. HoTARAC agrees that assisting stakeholders in managing complexity is the appropriate short-term strategy for coping with complexity. In addition, HoTARAC recommends that FRC focus on long-term strategies and solutions to reducing complexity in financial reporting, in particular the strategies for engagement with the IASB to ensure progress with its developing framework and to identify potential initiatives to reduce complexity in financial statements.

3. *Do you have any comments on the strategies to better manage complexity as suggested by the Task Force?*

HoTARAC endorses the strategies suggested by the Task Force for managing and reducing complexity. In respect of the framework for presentation and disclosure suggested under strategy 5 on page 11 of the paper, HoTARAC recommends presentation and disclosure requirements be developed as part of the IASB's conceptual framework projects. As well as addressing the rule-based and potentially onerous disclosure requirements, the IASB's framework could assist in delineating a clear goal for the development of principles-based standards that would also address the existing complexity in recognition and measurement. The IASB conceptual framework applying high level principles would provide general guidance that may be more easily applied with little or no modification for the NFP sector in Australia.

HoTARAC agrees with the FRC's observation that application of IFRSs to all reporting entities across Australia adds to reporting complexity. HoTARAC believes a solution would be for standard setters to focus on the development of principles that are genuinely suitable for and able to be applied by, a broad range of reporting entities, rather than just large corporations. On this point, standard setters should focus on the provision of adequate implementation guidance to accompany individual standards. This would also improve comparability between entities by reducing the likelihood of different interpretations by preparers and auditors.

Addressing public sector and other NFP entity issues at the IFRS level would reduce the imperative for the AASB and individual jurisdictions to tailor standards for those entities' use through the inclusion of Aus paragraphs from the AASB or additional reporting requirements by jurisdictions, or at least this would significantly reduce their scope and number. This would also lead to a number of desirable outcomes, such as increased comparability across reporting in different sectors, transaction neutrality in financial reporting and the freeing up of AASB resources currently dedicated to NFP issues. Transaction neutrality is particularly pertinent as it is desirable that similar transactions, regardless of the sector the entity belongs to, should be treated in a similar manner for accounting purposes. However, specific public sector issues need also to be addressed to ensure that GPFRs remain relevant and useful to the users of financial statements of those entities. HoTARAC would also recommend the FRC encourage the IASB to work collaboratively with the International Public Sector Accounting Standards Board (IPSASB) to promote consideration of public sector issues in standard development.

The FRC may wish to consider strategies to reduce complexity resulting from standard setters not meeting the users' needs. GPFRs are intended to meet the needs of a broad range of users who cannot themselves direct entities to prepare specific information to meet their individual needs. However, as mentioned in response to Matter for Comment 1, standard setters (with input from regulators and preparers) make their own sophisticated judgements about the minimum information that they consider users would need. One obvious, and arguably the most important, strategy would be to undertake research into the true information needs of the broad range of "general purpose" users, to determine the extent to which existing accounting pronouncements meet those needs. The fact that many entities choose to present a view of their financial performance and position outside audited financial statements (that is often not in accordance with accounting standards) may in part suggest that existing accounting standards do not always meet users' needs.

HoTARAC questions whether regularly commenting on standard setters' proposals automatically creates a professional relationship that facilitates an exchange of viewpoints. Increased cooperation between preparers, users, domestic standard setters and the IASB is likely to provide a more effective way to bridge the gap the Task Force identified between users, the individual preparers and the IASB (strategy 6 of the paper) for better ensuring future revisions to IFRS meet the needs of users to whom the changes are intended to affect. This engagement is critical and HoTARAC supports the IASB's current outreach initiative with the AASB being a key player in the Asian-Oceanian Standard-Setters Group. HoTARAC is interested in what role the FRC intends to play to facilitate the suggestions in strategy 6.

The FRC's second suggested strategy states that a reduction in the number and length of 'boilerplate' disclosures may result from strengthening the 'safe harbour' and 'business judgement' provisions in the *Corporations Act 2001*. HoTARAC believes the true driver for the number and length of disclosures by all reporting entities is the accounting standards issued by standard setters. This largely results from disclosures being developed by standard setters on a topic-by-topic basis, with the ultimate consequence that the perspective given to disclosures about some topics is arguably greater than it should be, relative to other topics.

Suggested strategy 5 in the paper refers to how this topic-by-topic approach to developing the current standards has led to a considerable volume of disclosure requirements. HoTARAC believes it should also be acknowledged that the topic-by-topic approach has also resulted in complexity in the recognition and measurement requirements that preparers and auditors have to apply.

Materiality is an over-riding consideration when determining whether or not to comply with associated disclosure requirements set by standard setters. Therefore, the issues discussed by the FRC in "cause 3" and "strategy 2" could be addressed if standard setters issued clear statements that preparers are always to consider the materiality of a matter when determining which disclosures should be included in financial statements. This would be particularly important if the AASB proceeds with its plan to withdraw accounting standard AASB 1031 *Materiality* (about which an exposure draft is planned to be issued over coming months). If AASB 1031 is withdrawn, HoTARAC expects that the standard materiality paragraph included in each Australian accounting standard would also be deleted.

HoTARAC generally supports differential reporting. HoTARAC agrees with the Task Force that applying a single set of IFRSs to all reporting entities adds to reporting complexity (page 5 of the paper). IFRSs are mainly directed to large companies with complex transactions, hence requiring detailed information that may not be necessary or relevant for smaller entities. The IASB has sought to reduce complexity of the application of the full suite of IFRSs through a self-contained set of standards tailored for small and medium sized entities (SMEs). The IFRS Foundation claims the IFRS for SMEs result in a 90% reduction in disclosures. The AASB has adopted these principles in developing its Reduced Disclosure Requirements (RDRs) for 'Tier 2' entities. While HoTARAC jurisdictions have not adopted RDRs at this stage as they have been assessed as not providing the same benefits as for the private sector reporting, differential reporting signposts future strategies for reducing complexity and merits further consideration by the FRC. For example, HoTARAC recommends the FRC give some consideration to introduce a third or fourth tier to extend the benefits of differential reporting.

HoTARAC welcomes the Task Force's comments on the role of integrated reporting and notes that this potentially draws on other information provided in Annual Reports. HoTARAC suggests this could be complemented by considering the role of information included in the broader IPSASB GPFRs definition, which encompasses information outside the financial statements. A common set of standards for information that sits outside the financial statements would assist entities in preparing such information and users in understanding this information and making comparison between entities. HoTARAC notes that IASB has gone some way to addressing this issue through the non-binding practice statement *Management Commentary* and that the IPSASB has commenced a process for developing reporting requirements for such information with their projects on reporting service performance information and financial statement discussion and analysis. HoTARAC recommends such projects be encouraged to identify relevant information to be included in the financial reports without adding additional layers and resulting complexity. HoTARAC also notes that guidance for information sitting outside financial statements would also be useful in curbing overly subjective management analysis of financial results.

One area that the FRC may wish to consider is whether there are alternatives to using GPFRs to meet the needs of regulators. For example, in relation to regulatory disclosures currently included in GPFRs, regulators could alternatively require separate audited special purpose reports to be prepared by the targeted entities. Related to this issue, standard setters should review the definition of the reporting entity, including the characteristics of the types of entities which should prepare GPFRs, to attempt to ensure the costs of preparation do generate significant benefits to users. Again, HoTARAC notes this is part of the IASB's conceptual framework project, which is currently held in abeyance.

Consistent with the Task Force's conclusion, in HoTARAC's view, one of the strategies to mitigate complexity in the short-term is assisting users in navigating through voluminous disclosures required under current financial reporting requirements. Accordingly, HoTARAC strongly endorses the Task Force's suggestions on embracing evolving technology in assisting users in navigating to the parts of the Annual Report that are most relevant. To be effective, the technology employed should be accessible by a wide range of users. For example, online reporting, with its inherent ability to 'layer' documents through hyperlinks, can be the ideal mechanism for navigating through complex documents. However, regarding the second last paragraph of strategy 1, HoTARAC questions the connection between companies putting governance policies and procedures on their web sites, and minimising boilerplate descriptions in Annual Reports.

4. *Do you have any suggestions for the financial reporting terms and definitions that should be encouraged for development (Suggested Strategy #4)?*

HoTARAC is unclear about the nature of any such terms and definitions, for example, whether these would be industry-specific or applicable by all entities, and therefore HoTARAC is unable to gauge how this suggested strategy would help. It is also unclear how such standard terms and definitions would work within a principles-based framework. Subject to these uncertainties, HoTARAC would suggest that the terms and definitions would ideally be promulgated through the accounting standards framework.

5. *Please indicate 'quick wins' that you believe could be achieved in managed complexity, which could be delivered within the current Australian legislative framework and IFRS.*

HoTARAC believes the FRC's efforts should be concentrated on developing long-term strategies for reducing complexity and the scope for improving short-term management is, by its nature, limited. Nevertheless, HoTARAC agrees with the strategy of using information technology to assist users in navigating through the complexity of financial reports as mentioned in the response to Matter for Comment 3 and also proposes below a couple of other 'quick wins' initiatives to address the complexity issue.

HoTARAC considers the Australian differential reporting regime could be enhanced in the short to medium term. HoTARAC is of the view that there is a pressing need for a practical differential reporting regime for the NFP sector, particularly in the public sector. Work has already been performed by the AASB through their differential reporting project and this needs to be capitalised on to move forward and achieve this goal. HoTARAC is progressing on its own project on this matter to inform discussion with AASB. The substantial benefits that would result are worth the extra effort by all parties. The FRC could assist in promoting this goal.

Educating or training users to assist their understanding of the information contained in the GPFRs may be worth further investigation. As identified in the paper, there is an information gap resulting from a lack of users' understanding of this information. This may be one of the reasons that many reporting entities in both the private and public sectors have been providing their own interpretation of their business financial results and position through additional communication to their financial statement users, including their shareholders. HoTARAC considers FRC may have a role in encouraging and promoting independent education and/or training of report users. This could curb and/or mitigate the opportunity taken by some entities to present their own subjective analysis and interpretation of their financial results.

Education and training may also be beneficial for users of more sophisticated information technology applications, such as XBRL, in accessing and interpreting data.

6. *Are there any other issues the Task Force should consider?*

HoTARAC appreciates the Task Force's comments that IFRSs generate complexity when applied to all reporting entities in Australia including the public sector. HoTARAC would recommend the Task Force further consider the public sector issues raised in this response.

HoTARAC commends the Task Force on the detailed analysis of complexity in presentation of results and the need for consistency of information (page 7 of the paper). HoTARAC recommends further consideration be given to other qualitative characteristics of financial reports, such as understandability, comparability, fair representation, materiality and relevance.

Again, HoTARAC notes that a conceptual framework that applies high level principles to recognition, measurement and disclosure would be useful in applying the qualitative characteristics in GPFRs. This would also assist in the application of IFRSs to the public sector, as opposed to the current IASB's approach which is generally more capital market specific and details based.

Transaction neutrality, noted in HoTARAC's response to Matter for Comment 3, is also important component of comparability.

HoTARAC recommends FRC consider the impact on audit arising from any agreed initiatives resulting from this review.