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Ref: DAH

31 July 2012

Ms Lynn Wood, Chairperson
Financial Reporting Council
c/- FRC Secretariat
The Treasury

By email: frcsecretary@treasury.gov.au

Dear Ms Wood

MANAGING COMPLEXITY IN FINANCIAL REPORTING

We appreciate the opportunity to provide comments on this important topic. Pitcher Partners is an association of independent firms operating from all major cities in Australia. Our clients come from a wide range of industries and include listed and non-listed disclosing entities, large private businesses, family groups, government entities and small to medium sized enterprises. Consequently we apply the financial reporting requirements of International Financial Reporting Standards (IFRS) across a wide range of business structures and sizes.

In our experience our clients want relevant, reliable, consistent and comparable financial reporting information and consequently prepare their financial reports in accordance with accounting standards, even where there is no mandatory external reporting obligation. For example, where our clients' businesses operate in trading trusts which are not regulated under the Corporations Act 2001, their financial reports are ordinarily prepared in accordance with the measurement and recognition criteria of accounting standards.

There are three important issues worth noting:

i. Financial reports prepared in accordance with IFRS are ***not complex*** when ***business operations are not complex***;

ii. Complexity in business operations will result in equivalent complexity in financial reports;

iii. Complex transactions cannot be reported reliably using a simple historical cost basis of accounting.

We have also observed an increase in cross-border work across the range of our clients' businesses including privately owned business. While a lower cost of capital and issues of regulatory compliance might be objectives to promote the more efficient operation of capital markets, one set of global standards also enables common terms of reference when working across jurisdictions with private businesses.

Further, Pitcher Partner clients are generally ***growing*** businesses and therefore the nature of their businesses is dynamic. It is unlikely that they will remain in one sector during the course of their business evolution. We consider that one set of standards enables growing businesses to migrate from small privately owned family businesses to large publicly traded listed entities, using one set of consistent measures of performance during each transition.

On the basis of the discussion above, we support the FRC Task Force in its objective to ***manage*** complexity. We consider there is an urgent need to introduce measures to navigate the large body of requirements in the accounting standards and in financial reports, and especially for those entities that engage in complex transactions, and therefore produce complex, lengthy financial reports. We consider that these issues are particularly important for the Asia-Pacific region, where smaller growing businesses struggle with access to cost-effective technical expertise.

Our responses to your specific requests for comment are provided below:

1. Additional sources of reporting complexity which should be considered by the Task Force and FRC

The Australian Accounting Standards Board (AASB) introduced the reduced disclosure regime (RDR) in 2011, operative for annual reporting periods commencing on or after 1 July 2013 with early adoption permitted. This was a worthy initiative which has the ***potential*** to significantly reduce the number of extensive notes required when a business is privately funded. External stakeholders that do not contribute to the funding of a business will be more concerned with liquidity and going concern rather than the notes that relate to the internal management of the business.

Unfortunately the early adoption of RDR has been problematic. Firstly, the RDR standards were not published in time for reporting at 30 June 2011 and there was insufficient time to make amendments to reporting templates. Further, when the accounting standard handbooks were released for 2012, the RDR paragraphs were not shaded in the text and therefore accessing the RDR standards has been difficult and time-consuming via a separate section of the AASB web site. Presumably these difficulties will be addressed before 1 July 2013. If access to the RDR standards is difficult, then the objective of reducing complexity has failed. Many of our clients are not using RDR due to difficulties in access.

We understand the AASB may be researching the extent to which RDR has been used; however the lack of access is an important factor in understanding why adoption might be fairly limited.

2. Complexity in the short-term is *not* considered inevitable; efforts on strategies to assist stakeholders to better manage complexity should be implemented as a priority

Improving access to the RDR standards could significantly reduce complexity in the short-term. We consider that resources should be diverted to enable appropriate access to these standards as a priority. As the actual reduced disclosures have already been determined, this is now only an editorial function that should not be costly to implement. We consider that an assessment of the effectiveness of the RDR regime cannot be made properly until access is improved.

3. Comments on strategies to better manage information

We consider that improved presentation of financial reports is urgently needed.

More than forty years ago Marshall McLuhan introduced the term “the medium is the message” and a significant body of work has been conducted since that time about effective communications. Also, as noted by the Task Force, there have been significant developments in technology and especially in the last decade. Despite the progress in communications, annual reports are produced in a sequential format that is not easily navigated. The “message” that the coffee-table glossy printed annual reports convey, or their equivalent on-line PDF versions, has become a message that annual reports are lengthy, complex, wordy documents that often do not follow a logical order and are not easy to read.

The “message” conveyed as above is not consistent with the content. Annual reports contain a wealth of information about the financial performance and position of a business. Those involved in technical financial reporting are familiar with the requirements and can quickly navigate through the pages of content. However, those who are not closely involved in technical accounting concepts are faced with information overload. We need to have a mechanism where users can drill down through summarised financial information to find the content they are interested in quickly and easily. The *sequential presentation* of information is not the most user-friendly format. The technology is already available to use hyperlinks to make electronic access easy for the user. Solutions need to be researched to enable the identification and separation of audited and non-audited information presented to users.

In addition each accounting standard requires consideration of definitions, basis for conclusion, illustrative examples and information in other documents. Again, all this information is presented in paper or PDF documents, in a sequential order - perhaps the least user-friendly option. Technology should be used to facilitate the way financial reporting requirements are referenced and used. In turn electronic financial reports could link directly to electronic standards for an explanation of defined terms and accounting policies.

XBRL as a reporting language will enable computer assisted techniques to identify and evaluate the financial information produced. XBRL will provide an effective tool for users such as analysts, regulators and researchers. However, *a presentation format* that assists any stakeholder to access information, definitions, accounting policies and analysis about a single line item is a financial report, will be far more helpful than ploughing through pages of accounting policies and notes that are presented sequentially.

4. Development of a glossary to manage financial reporting terms and definitions

We consider that a glossary of defined terms would be beneficial to users and preparers of financial statements. There are a multitude of terms and definitions which have specific meaning and are separately defined in individual accounting standards. Currently, a user needs to know which accounting standard has been applied in order to access the individual standard to examine the definition. This is neither practical nor achievable – ordinarily users will not be not familiar with the detailed requirements of accounting standards and will not know which standard to access.

We consider that it would not be an overly onerous task in the short-term to extract copies of the definition section in each accounting standard to compile a glossary.

In the long-term, with better electronic presentation of financial reports, these terms could be hyperlinked from an electronic financial report to the glossary to facilitate user understanding. It should be noted that the Corporations Act 2001, in its online version, includes links to all definitions and other sections where they are mentioned, which has made it such a user-friendly electronic document. It would be beneficial to produce electronic financial reporting standards that included explanatory links in the same way.

5. "Quick wins" that could be delivered within the current Australian legislative framework and IFRS

We have three recommendations for "quick wins" to reduce complexity:

a) The timely availability of RDR standards and a glossary, in both printed and electronic formats (albeit without hyperlinks), would still improve access and hence reduce the time spent in searching for information.

b) The use of 'standard' reporting templates and example accounts that incorporate irrelevant disclosures should be prohibited or strongly discouraged. There are numerous examples of entities that include (for example) a full suite of accounting policy notes concerning (say) financial instruments, including accounting policies that relate to every classification of financial assets, financial liabilities and hedging transactions that the entity does not currently have and does not currently enter into. When this practice is extended across the full suite of accounting standards there are numerous additional pages of information included about the accounting policies that *might be adopted* if or when the entity enters into those types of transactions. This practice could quickly and easily be managed by directors and auditors, and perhaps through adverse publicity about companies that simply "pad out" their financial reports with unnecessary information.

c) Representation of a wider stakeholder group on boards and committees by the FRC would improve understanding of issues across a broader sector of the business community. This development should enable the FRC to promote good financial reporting disciplines providing information useful for decision-making by growing businesses in addition to the large corporates - thereby promoting future Australian economic prosperity. This issue is discussed further under item 6 below.

6. Other Issues

We have concerns about managing complexity in the following areas:

i. *Understand the financial reporting needs of the broader business community to understand how to manage complexity in the non-listed segment*

The Australian capital market comprises approximately 2000 listed companies, the majority of which (below the top 300) are relatively small businesses. Australia's top 500 businesses have been reported to contribute approximately 50% of gross domestic product. According to ASIC statistics there are nearly two million companies registered in Australia. There is a further an unknown number of businesses operating in non-corporate structures. These entities also contribute to the economic growth of Australia. We consider that future economic growth in Australia will stem from the innovation and entrepreneurship of growing businesses.

Growing businesses need reliable financial information for decision-making. This sector is not given adequate attention by the FRC and there is a lack of representation for this sector on boards and committees that influence the development of reporting requirements. Further, there seems to be minimal understanding of the way businesses may **transition** between market segments from (say) small family businesses to publicly traded listed entities. As the barriers to entry increase through regulatory compliance, we anticipate a decline in the number of entities seeking funds through fundraising on capital markets. There is a risk that the FRC is concentrating efforts into a market segment that may display limited growth in the future.

We consider that the FRC needs to take a more balanced approach to address the specific needs of the Australian business environment, rather than following global precedent.

ii. *Education in respect of how and why IFRS provides better quality information for decision-making*

Education is an important part of the application of IFRS recognition and measurement criteria, and it is disappointing that much debate revolves around compliance rather than how the information produced can be used more effectively for decision-making to improve business performance. At present the practice of reconciling not-IFRS information to IFRS information is gaining popularity – perhaps because there is a lack of understanding as to how IFRS information can be used more effectively. We consider that the FRC should actively encourage or participate in the development of educational materials for the business community that explain ***how*** and ***why*** IFRS information is useful for decision-making, rather than current guidance which tends to focus on ***what*** is required ***when***.

iii. *Pre-empting the complexity and confusion that is likely to arise through the presentation of IFRS and sustainability information side by side in integrated reports*

As noted by the Task force, the development of integrated reporting remains in its early stages. Integrated reports aim to link strategy, governance and financial performance in the context of social, environmental and economic impacts. We urge the FRC to consider how a stakeholder groups with significant divergence in their interest and capabilities will interpret the information presented side-by-side.
We are concerned as to how stakeholders with a primary interest in one dimension of the report will have an understanding of how information in another dimension is measured.

We currently observe reconciliations between non-IFRS and IFRS information. Consider for example how funds spent on social projects will be measured and compared to the economic value of assets held and used in a business. As accountants are still grasping the usefulness of economic value added information produced under IFRS, how will stakeholders with no financial reporting understanding evaluate the unrealised fair value measurements reported under IFRS, with historical cash flow values for environmental projects?

iv. *The timely development of financial reporting standards*

With the large number of countries now adopting IFRS and participating in the due process for their development, we have serious concerns that standard setting can no longer respond to emerging issues in the business environment on a timely basis. There is an increasingly long lead time between identification of an issue and the release of authoritative financial reporting requirements. For example, consider the complexity surrounding revenue recognition and the major debates that commenced with a discussion paper in December 2008. The final standard is not yet available and it is unlikely that the standard when issued will be operative before 2015. We consider that this period of time is far from satisfactory. In this interim period we have an accounting standard that is not complex, but we question whether it is fit for purpose.

Please do not hesitate to contact us if there are any matters arising from this submission that you would like to discuss further.

Yours sincerely

S D AZOOR HUGHES
Partner