

The financial reporting supply chain

Executive report



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The financial reporting supply chain

Introduction

Financial reporting has changed radically over the past ten years. New technology and more sophisticated performance metrics have increased the amount and quality of information generated by businesses. The accounting standards environment has become more international. And governance continues to be a major issue for management, shareholders and regulators, focusing them on the quality of corporate reporting.

At the same time, the pace and complexity of business activity has also changed. Companies need the freedom to move quickly in new and existing markets and to deploy appropriate financial instruments and business models. Accurately reflecting these complexities in relevant, understandable and reliable financial and narrative reports – produced in accordance with complicated reporting regulations – is a major challenge.

The International Federation of Accountants (IFAC) commissioned a project to discover the effects of developments in the financial reporting process over the past five years. Has it become better or worse? Have financial reports become more or less relevant, reliable and understandable? What should be done next? This research project was chaired by Norman Lyle, recently retired as group finance director of Jardine Matheson in Hong Kong and a former President of CIMA, the Chartered Institute of Management Accountants.

Its survey of 341 contributors to the financial reporting supply chain – the people who prepare, audit, disseminate and use these reports – revealed that governance has improved as a result of recent changes. Equally important, respondents said the balance between the cost of producing financial reports and their benefits has also shifted positively.

But there were warnings. Regulation is seen by many to have become too onerous; aspects of financial reports are thought by many to have become overly complex; worse, a 'checklist' mentality has crept into the financial reporting supply chain. This has created concerns about whether governance and financial reporting are well-served by the rules intended to guarantee their credibility.

This report summarises the findings of the IFAC survey and interviews. It also includes contributions by leading figures in the financial reporting supply chain (see appendix 1 for details) who attended a CIMA hosted round-table debate on the subject, chaired by Charles Tilley, Chief Executive, which covered the four key areas in the IFAC study:

- corporate governance
- the financial reporting process
- the financial auditing process
- the usefulness of financial reports.

In February 2008, the IFAC Board approved a new project that will analyse actions currently being taken to address the suitability of business reporting and identify areas for future development. This project will take the findings of the financial supply chain report to the next stage and deliver specific recommendations for further action. The project will be led by Charles Tilley.

The views of round-table participants bear out, and expand upon, the project findings. This report also includes CIMA perspectives on these four topics and relevant CIMA publications are listed in appendix 2.

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Introduction

CIMA, the Chartered Institute of Management Accountants, is the only international accountancy body with a key focus on business. It is a world leading professional institute that offers an internationally recognised qualification in management accounting, with a full focus on business, in both the private and public sectors. With 164,000 members and students in 161 countries, CIMA is committed to upholding the highest ethical and professional standards of its members and students.

CIMA is a member body of IFAC.

The International Federation of Accountants (IFAC) is the global organisation for the accountancy profession. It works with its 157 members and associates in 123 countries and jurisdictions to protect the public interest by encouraging high quality practices by the world's accountants. IFAC members and associates, which are primarily national professional accountancy bodies, represent 2.5 million accountants employed in public practice, industry and commerce, government and academia.

Through its independent standard setting boards, IFAC develops international standards on ethics, auditing and assurance, education and public sector accounting. It also issues guidance to support professional accountants in business, small and medium practices and developing nations. In addition, IFAC issues policy positions on topics of public interest.

To serve the public interest, IFAC will continue to strengthen the worldwide accountancy profession and contribute to the development of strong international economies by establishing and promoting adherence to high quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues where the profession's expertise is most relevant.

1 Corporate governance

After the accounting and reporting scandals of the early 2000s, corporate governance became a priority for the users and regulators of financial reports. Additional reporting requirements in areas such as board level remuneration, internal controls and management oversight have placed new burdens on preparers, albeit with some positive effects; and audit firms and their clients have faced far closer scrutiny on the sign-off of their financial reports and the related audit opinion.

Project findings

'The survey shows corporate governance has improved over the last five years – but there were still some concerns,' said Norman Lyle. 'If you get the right tone at the top in an organisation, leading to the right culture and behaviour throughout, corporate governance tends to work well.' It was felt by many respondents that a review of existing rules would be timely.

Lyle cites the Sarbanes-Oxley Act as an example of the difficulty in finding the right balance. Overall the Act was seen as positive. But some of the internal control provisions create too much work for those in the financial reporting supply chain, compared to the benefits.

IFAC's report, *Financial reporting supply chain: current perspectives and directions*, highlights several positive developments over the past five years: increased awareness that good governance counts; new codes and standards; improved board structure; improved risk management and internal control; and increased disclosure and transparency.

One respondent commented: 'Directors of listed companies and statutory bodies have become more knowledgeable about financial reporting, take their responsibilities more seriously and appear to be more independent in carrying out their fiduciary duties.' This 'heightened consciousness' regarding governance was mentioned by several members of the financial reporting supply chain.

The problems include: governance in name but not in spirit; over regulation; the development of a checklist mentality; personal risk and liability for directors and management; and some concerns over costs relative to perceived benefits.

One external auditor said: 'Directors [are] spending more and more time on compliance issues and losing sight of operational issues.' Another respondent recommended that boards 'review their agendas to see how much time they spend on compliance versus strategy – then find a balance.'

And despite the focus on governance, many respondents felt that executive remuneration issues had not been tackled successfully of late. Bonuses, for example, may be linked to activities that were not in the best long-term interests of an organisation.

'We're also seeing an issue around how to expand the system from straight compliance into business governance,' said Lyle. 'In other words, moving away from just looking at the financial controls to the broader strategic issues that businesses face.' This theme crops up in every area of the debate about the financial reporting supply chain.

1 Corporate governance

Where next?

The IFAC respondents were asked how to improve corporate governance in their own country and to prioritise measures that might achieve this goal. High priority moves include:

- Continue to focus on the behavioural and cultural aspects of governance – with a special emphasis on ethics in every part of the financial reporting supply chain.
- Review existing rules – because many were introduced as a response to crises, particularly in the US. In fact, several countries have already done this.
- Further improve the quality of directors – increasing the number and status of independent directors is also recommended.
- Better relate remuneration to long-term performance – and increase transparency in executive compensation.
- Expand view from compliance governance to business governance – with a focus on effectiveness and efficiency.

CIMA financial reporting supply chain round-table

A major issue for groups reporting in the UK is 'comply or explain' – the principle that a company can choose not to apply a particular aspect of governance reporting as long as it outlines its reasons for not doing so.

'From a corporate governance perspective, it is actually quite difficult to adopt the "comply or explain" route,' said Ken Lever, former CFO at Tomkins and chairman of the Financial Reporting Committee of the 100 Group of leading finance directors. **'In my experience on 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.'**

But good governance is at least in part about transparency. While specific governance measures might seek to enhance the openness of reports and compel companies to adhere to best practice in areas such as remuneration and risk management, lack of clarity in narrative reporting rules and complexity in financial statements is limiting the effectiveness of financial reports as a tool to monitor good governance.

'What are the barriers to change on the financial reporting side?'

Richard Ackland, Director at KPMG, explained. **'Companies see that the downside risk of getting financial accounting reporting wrong far outweighs the benefit of better [less boilerplate] corporate governance disclosure.'**

The other major issue is the way that governance reporting focuses heavily on senior management. Simply reporting remuneration arrangements doesn't appear to have tackled the problem of misaligned rewards for directors. And there is a perception that good governance demands more reporting on management remuneration below board level.

But there was also a feeling that some sense had prevailed around the more onerous governance rules relating to the accuracy of financial reports. **'Fear of liability was still a big factor in reporting, and that's an area where concessions have been made by the government in the shape of the safe harbour provisions, which now apply to the directors' report and indeed the directors' remuneration report,'** said Richard Slynne, Corporate Partner at Allen & Overy LLP.

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CIMA perspectives

An earlier IFAC/CIMA study on governance (see the 2003 report *Enterprise Governance: Getting the balance right*) – researched 27 international case studies in ten different countries and found four factors that underpinned both success and failure in corporate governance:

- culture and tone at the top – and the way that ethics and discipline are communicated and demonstrated throughout the business
- the chief executive – who sets the tone for probity and diligence
- the board of directors – it is essential for it to set – and demonstrate by example – an appropriate tone, reinforced by high ethical standards
- internal controls – which minimise the risk of governance failure or fraud.

But in the context of the current debate, the financial reporting supply chain also ought to take account of four specific developments.

1. The disclosure liability regime

In 2006, the arrival of a new European statutory liability regime for misstatements in periodic disclosures for companies whose securities are traded on regulated markets triggered concerns that long-standing common law principles about liability were under threat. The Transparency Directive 2004/109/EC included 'investor protection' as well as reporting stewardship as a purpose of disclosures.

The UK Treasury asked Professor Paul Davies of the London School of Economics to undertake an independent review on liability for misstatements to the market. The directive excluded liability for negligent misstatement except where the defendant knows a third party is likely to use the statement for a particular class of transaction. This led to a concern that the widely accepted Caparo rule – which defines the duties of care around disclosures and makes clear that the issuer is responsible to its shareholders, and advisors are responsible to an issuer – was under some threat from the directive.

1. Corporate governance

CIMA's view is that the protection for directors making statements in good faith is important and any liability regime must be unambiguous. Directors must be aware of the risks and consequences of their actions and regulation should encourage them to promote confident and candid disclosures. So any regime for disclosures of financial information should carefully identify the entire range of disclosure which might be affected in order to avoid the complication of alternative liability regimes applying to disclosures of a similar nature.

Davies' recommendations (which were to extend the liability regime) are currently under consideration by the Treasury. In July 2005, CIMA sought and published a legal opinion from Allen & Overy LLP on director liability for statements in the Operating and Financial Review and this may be updated when the UK Treasury publishes its proposals.

The UK regime should continue to place more weight on codes of practice and professional judgement, rather than develop into the more inflexible and litigious nature of the regime which applies in respect of corporate governance and financial reporting in the US. CIMA would strongly encourage all jurisdictions to put the emphasis on codes of practice and professional judgement where this is achievable.

2. Developments in the Codes

CIMA has been a strong advocate of a principles based approach to corporate governance and we have encouraged attempts to ensure that it is the spirit of governance that prevails, rather than a checklist or boilerplate approach. So we welcome the UK Financial Reporting Council's focus on the practical application of a largely unchanged Combined Code after its 2007 review. Change for change's sake would have undermined the current governance regime. But we would welcome development of the 'comply or explain' framework. Ideally, it would place as much emphasis on 'explaining' as 'complying' – giving more flexibility to both users and preparers.

CIMA also supports the UK Financial Services Authority's proposal to remove the first part of the corporate governance statement for listed companies, which has led to too much boilerplate. And we're encouraged by the move by the US Securities and Exchange Commission (SEC) to a more risk based approach to section 404 of the Sarbanes-Oxley Act, too.

Again, CIMA would strongly encourage all jurisdictions to use a principles based approach to corporate governance where this is achievable.

3. Governance and strategy

CIMA is concerned that boards are getting swamped by compliance issues – distracting them from the real work of management, strategy and performance. The CIMA Strategic Scorecard™ is a framework designed to help boards balance their governance duties more effectively between compliance and strategy.

4. Remuneration reporting

Investors want companies to clearly explain their strategic plans, then transparently report on how executive remuneration is linked to tangible execution of that strategy. The reporting should show how rewards are linked to success and the implications for failures.

This transparency should also be applied to the next level of management – commonly known as 'the marzipan layer' – which also has a significant influence on the ability of the company to achieve its strategic goals. Remuneration reporting for this layer should not be on an individual basis, but we would like to see clarity on the remuneration structure in aggregate.

CIMA is a founder member of the Report Leadership Group along with PricewaterhouseCoopers and Radley Yeldar. The Group has recently researched the reporting of executive remuneration and a best practice example is available at www.reportleadership.com This uses a 'three tier' approach which has the potential to be applied in most jurisdictions.

Again, CIMA would strongly encourage all jurisdictions to use a principles based approach to corporate governance where this is achievable.

Report Leadership is a multi-stakeholder group that aims to challenge established thinking on corporate reporting. The contributors to this initiative are the Chartered Institute of Management Accountants, PricewaterhouseCoopers LLP and Radley Yeldar.

The group believes that corporate reporting should be more relevant, informative and accessible. It should provide investors with what they want without inundating them with unnecessary detail. As part of the initiative, Report Leadership seeks to align external reporting more closely with management reporting, recognise the complexity of business today and provide reporting that will adapt readily to other media. It focuses on three areas of topical interest:

- effective communication through clear messaging and navigation
- modelling the future through the provision of contextual information that allows investors to assess the quality and sustainability of future cash flows
- rethinking the financials to provide greater detail on revenue, costs, segmental information, pensions and debt.

To bring its ideas alive, the group has demonstrated how these can be applied in extracts from the annual report of a fictitious company, Generico.

The group has also undertaken work on two key areas:

- executive remuneration – providing practical ideas for communicating one of the most complex areas of corporate reporting
- online reporting – including the publication of an online version of the Generico annual report.

For more information on the Report Leadership project, visit: www.reportleadership.com

PricewaterhouseCoopers www.pwc.com provides industry focused assurance, tax and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 146,000 people in 150 countries across its network share their thinking, experience and solutions to develop fresh perspectives and practical advice. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Radley Yeldar is a creative communications consultancy offering a range of specialist services including brand identity, corporate reporting, corporate responsibility, digital media, internal communications and marketing communications.

2 The financial reporting process

The most significant development in this area is the emergence of International Financial Reporting Standards (IFRS). While these more widely accepted standards are seen as crucial to support a global business environment, participants in every part of the financial reporting supply chain have expressed concerns about the complexity and clarity of financial reports, partly as a result of the transition to IFRS. There is also a perceived disconnect between reporting requirements and what really goes on within businesses.

Project findings

There was general acceptance that a move towards global financial reporting standards was a good thing. Boards of directors and management are taking more ownership of financial reporting, perhaps in response to the attention it received during the early 2000s.

Survey respondents also cited improved internal control over financial reporting systems as a major plus. Technology has played a big role in re-shaping the preparation of financial reports. That doesn't mean there aren't costs to collating financial information. 'Users – especially owners – need to set some priorities as to the information they need, while recognising that information is not a free commodity,' one respondent pointed out.

The introduction of IFRS is seen by many as a positive step, creating a 'level playing field'. One respondent added, 'Certain business transactions and accounting practices, not covered in great detail under (some local) GAAP(s), are subjected to more detailed analysis in IFRS, increasing the level of comfort provided to preparers, auditors and users.'

But reporting under IFRS is also seen as very complex. Some respondents think this has damaged the comprehension of financial statements. 'IFRS has been implemented in undue haste,' said one respondent. 'It would have been better if the implications had been thoroughly discussed by all participants – not only accountants – before it was implemented. Now it is something that is of no help to management and no help to investors either.'

And because many companies are using these standards for the first time, they've hit a very steep learning curve. 'Compiling and reconciling accounts for different financial reporting standards, where people still report to local GAAP as well as to IFRS, is also seen as an issue,' said Lyle. 'But this may only be a transition problem.'

The other major concern is that financial reporting standards sometimes drive businesses into a legalistic form of reporting that is not in the interests of the shareholders and other users. Like some of the concerns over corporate governance, this was perceived as a case of compliance outweighing the

reporting of the essence of the business. Lawyers and legislation took much of the blame. 'Boards feel that they should communicate more clearly and directly to their stakeholders,' said one respondent. 'But even a simple press release takes hours of lawyers' [time]. Why? A lot of businesses are afraid of liability.'

Where next?

Respondents prioritised the following measures:

- convergence to one global set of financial reporting standards – although local interpretations and over-complex standards stand in the way of a true global playing field
- simpler and clearer financial reporting standards focusing more on principles and less on rules – with an emphasis on plain language
- ensure that boards of directors pay attention to the quality of financial reports – and that audit committees are integral to the entire reporting process
- provide additional education and training for preparers – particularly around IFRS.

A Chair should be determined that he could show [the annual report] to his intelligent 20 year old son, who could read through it and say what it is all about. I am very struck still by how few annual reports really read that way.

CIMA financial reporting supply chain round-table

If the point of financial reports is to show how a company is performing and explain its strategy to investors and markets, complexity is a major problem. 'A Chair or management team shouldn't feel cynical about it,' said Sir Christopher Hogg, Chair of the Financial Reporting Council. 'A Chair should be determined that he could show [the annual report] to his intelligent 20 year old son, who could read through it and say what it is all about. I am very struck still by how few annual reports really read that way.'

Narrative reporting is essential because users of reports need to understand how the financials fit into a broader strategy. 'We have this great detail and are producing numbers crunched [in sophisticated ways]', said Michael McKersie, Assistant Director for capital markets at the Association of British Insurers. 'We need more of the quality, narrative stuff because that is what helps people to understand what companies are about.'

Ken Lever confirmed this was an issue for preparers, too: 'The most important thing about any financial reporting is transparency: it is trying to communicate how a business creates value. If people understand that, it gives them a better basis for assessing whether it is a good

or bad business to invest in. In a lot of reporting, because of the complexity introduced over time, the process of creating value in business is often disguised.'

But Lever also highlighted the problem of tailoring reports to different audiences. Many investors and other stakeholders focus on narrative reporting; but there are technical users who demand as much data as the standards allow. 'If you ask 50 users what sort of information they would like to take out of the reporting requirements of the business, you get 50 different answers,' he said. 'I don't think we can stop the process where the narrative is going to become more and more important; and the back end is going to be complex.'

Bill Hicks, Director of external reporting at AstraZeneca, was also concerned that this division would create a 'split' supply chain for reports. 'The future of compliance is the financial statements – which will be largely ignored; and the future of corporate reporting will be all the non-GAAP measures – the analyst presentations,' he said. 'I see [the disconnect] widening even further: the future of corporate reporting as we sit here now is not in financial statements. Should we be trying to stop it going in that direction? Yes, I think we should.'

2 The financial reporting process

Clearly it is not enough to simply take a printed report and put it on the web as a Acrobat file (PDF); companies need to provide richer, more usable and more readily accessible information.

Quite apart from the additional overhead 'split' reporting creates in the financial reporting supply chain (particularly for smaller companies), it hampers real understanding of management's contribution and the business' strategy. And there are still huge questions about whether one set of accounting standards or reporting requirements can cover all sizes of company in all sectors and regions.

The standard-setters and regulators are crucial players. Many in the financial reporting supply chain are still nervous about the extent to which regulators such as the SEC allow the use of non-GAAP measures and how seriously the standard-setters are tackling complexity – or even listening to the concerns of the rest of the financial reporting supply chain.

CIMA perspectives

1. Complexity

Radley Yeldar reports that the average length of annual reports in the FTSE100 has finally stabilised after years of growth. In 2006 the average was 136 pages, in 2007, 150 pages and in 2008, 149 pages. The longest annual report in the FTSE100 was HSBC Holdings of 476 pages in 2007. Additional complexity both increases the resources required by the financial reporting supply chain and in many cases decreases the usefulness of reports. Better alignment of statutory reports with internal management reporting practices and improved narrative reporting would help solve this problem. (See also section 4, pg16, on the usefulness of financial reports.)

2. Technology

Both retail and institutional investors show a real appetite for improvement in online financial reporting, according to research by the Report Leadership Group – although in the IFAC survey, UK respondents still had a more than average appetite for paper financial reports. Clearly it is not enough to simply take a printed report and put it on the web as a Acrobat file (PDF); companies need to provide richer, more usable and more readily accessible information.

Users should be able to bookmark and annotate pages, interact with charts and data and conduct sensitivity analyses, as well as using audio and video content to get the insight they want. Data suitable for downloading into a spreadsheet helps. Although the jury is still out on the eXtensible Business Reporting Language (XBRL), it would appear to be a viable solution; providing all members of the financial reporting supply chain engage in its development and adoption to prevent the system being shaped by regulators for regulators – a filing instrument rather than a communication tool.

3. Reporting for smaller entities

IFRS for SMEs, which should be published in its final form towards the end of 2008, is being eagerly awaited. The International Accounting Standards Board (IASB) wants to reduce the complexity of the financial reporting standards for many companies, and although CIMA thinks the proposals are still too complex, especially for the smallest of companies, many will be able to apply this simpler set of standards.

4. Narrative reporting

The content and presentation of management accounts is not prescribed by regulation, but by the need for clear, concise information to support management decision making. It's about driving performance, not complying with a bookshelf full of standards.

The same principle applies to narrative reporting in published financial statements. If you could compare management accounting information to the narrative information in the annual report (one rarely can: management accounts are often considered too commercially sensitive to be published), their relationship would be obvious. Narrative reporting is a selective summary of the information which has been reported to the board during the year, and on which the board has made its decisions. Management accountants typically play a major role in the presentation and interpretation of such information.

Hardly surprising, then, that CIMA is a natural and enthusiastic advocate of good narrative reporting; backs the principles based nature of narrative reporting requirements; and will contribute substantively to current international projects, such as the development of the IASB guidance on Management Commentary.

The content and presentation of management accounts is not prescribed by regulation, but by the need for clear, concise information to support management decision making. It's about driving performance, not complying with a bookshelf full of standards.

3 The financial auditing process

After the Enron disaster and the consequent collapse of Arthur Andersen, auditors have an increasingly important and high profile role in the financial reporting supply chain. They now hold management to account more firmly over their reports and play a critical part in ensuring companies comply with complex reporting rules. This has raised the quality of audit and, in many areas, the auditor's contribution to the financial reporting supply chain. But the same issues of complexity and inflexibility that dog the reporting process are also key factors for audit.

Project findings

The importance of audit is now appreciated much more widely. And thanks to the wide adoption of International Standards on Auditing (ISAs), there is an emerging consensus about what 'an audit' actually means around the world. 'Since the auditing firms are trying to apply ISAs, the quality of the audits is increasing day by day,' said one respondent. Another added, 'Preparers have become more diligent and audit committees are more aware of the importance of their role.'

Audit committees' enhanced status was highlighted by several respondents, particularly in relation to their ability to co-ordinate with the board. 'They are working together for common results – checking falsehoods don't creep through, that the company is not stretching the boundaries of risk, making sure the whole board understands risks and helping them to supervise management.' A broader remit for audit committees – taking in management and strategic risk – has been welcomed, as has greater independence for external auditors.

But current legislation around reporting also makes audit firms nervous. In the US, in particular, there is still a lot of 'box-ticking' rather than adding value to the financial reporting supply chain. Some criticised the usefulness of the audit report. 'The same opinion for a company that scrapes over the line versus a high-flying company that jumps ten feet over the bar? That can't be right.'

The new rules have also reduced scope for professional judgement by auditors, partly in response to the risk of failing to comply with regulations and standards; and partly because the larger audit firms want greater central control in order to guarantee service levels internationally. 'The audit partner is always checking treatments with the technical people, so we are moving away from the idea of an audit staff that can use judgement,' said one respondent.

'Over regulation may be necessary in the short-term, but I think people will live with that for now,' said Lyle. 'There are proposals to reduce the liability of auditors, and that is a good thing. If you read an audit report, it doesn't really tell you a lot. Auditors are reluctant to put information into the marketplace in case people rely on it and they are sued at a later stage.'

Choice in the audit market, particularly for large clients, is limited. The Big Four firms have a strong hold. This is often for perfectly logical reasons such as global reach and capacity. However, greater choice might be beneficial as some respondents expressed difficulty in finding suitable audit firms for non-audit work, such as due diligence, because of existing relationships with Big Four firms.



It is generally agreed that there is huge value for investors in the audit – and massively increased risk where discussion moves away from audited material.

Where next?

What course of action should be taken by the auditing profession, and others, to further strengthen the external audit and to preserve the public confidence that has started to return?

- Continue to focus on independence, objectivity and integrity.
- Converge to one set of global principles based auditing standards – although change must be gradual to embed these properly.
- Consistent use of audit standards and safeguarding of quality within audit firms – global firms should strive to offer uniform quality; regulators should focus less on paperwork and more on principles.
- Improve auditor's communication – which means moving away from a boilerplate report and possibly including more insight into the audit process. It also implies possible limits on, or proportionate, liability for auditors.
- Remove barriers that limit choice of auditor – both in terms of available competition and client sentiment.

CIMA financial reporting supply chain round-table

While the audit remains a vital part of the financial reporting supply chain – not least from a governance point of view – there is a danger that if the financials it oversees become less relevant to companies and their investors, the audit itself will lose relevance. 'Companies want to tell the users of accounts about non-GAAP measures, and that is what the users of accounts want to hear,' said Sarah Deans, Head of accounting & valuation research at JPMorgan Securities. 'There is a risk that this rather makes the audit profession irrelevant.'

Of course, if accounting and reporting standards evolve to cover more non-financial and non-GAAP information, the auditor's role changes radically. 'I would expect the analyst presentation to be based on how management runs the business and that that data will, in the very foreseeable future, be part of the audited financial statements,' said Ian Wright, Director of corporate reporting at the Financial Reporting Council. Segment reporting – which is more analogous to management's view of a business – has been one of IFRS's major successes and is an example of reports becoming more relevant for users.

In fact, many auditors are already happy for companies to clarify and expand

on the statutory reports. 'Providing companies have complied with what they have to, we are neutral on whether they add other things to the financial reports,' said Andy Simmonds, a Deloitte partner and member of the Accounting Standards Board.

The crucial point, he added, is that additional information should be reconciled to the accounts in a consistent way. But there is general agreement that auditors should also remain robust in their interpretation of the accounting principles to prevent obfuscation or cherry-picking of the most flattering interpretations of the numbers.

In fact the level of interpretation, in areas such as fair value accounting, does seem to lend weight to calls for a more explanatory auditor's report. 'One way or another there is that need for more qualitative information,' said the Association of British Insurers' Michael McKersie. 'If the "true and fair view" – which I emphasise is of utmost importance to investors – requires further disclosures on something, then we should have it.'

It is generally agreed that there is huge value for investors in the audit – and massively increased risk where discussion moves away from audited material.

3 The financial auditing process

CIMA perspectives

1. The Financial Reporting Council's (FRC) audit choice project

CIMA, a participant in the project, welcomes the FRC's proposals to increase choice in the UK audit market. But we recognise that this is a problem that will not be solved easily in the short term. It will also require international collaboration between regulators.

2. Liability

CIMA submitted a response to the FRC consultation on guidance on auditor liability limitation agreements, which are now permitted under the UK Companies Act 2006. We supported the view that, in general, such agreements should be based on proportionality.

CIMA's view is that the current principle of joint and several liability is inequitable in cases where one defendant – the auditor – has a much greater ability to pay damages than other defendants; the party with the deepest pockets suffers most. Statutory proportionality is the most just solution to this problem, so we welcome the provisions allowing auditors to limit their liability contractually with the board. The situation will need careful monitoring as proportionality is typically subjective and, in practical terms, may not be able to avoid the 'deepest pocket' issue.

3. The audit report

The call for more informative audit opinions is likely to be outweighed by the practicalities, costs and legal issues. If there are, for example, significant accounting judgements made, management should disclose them; auditors should then verify the statements for consistency with the financial statements.

John Griffith-Jones, Joint Chairman KPMG Europe LLP, recently proposed that the spirit of the audit report in the vernacular should be 'these accounts are about right unless the management have deliberately conspired to falsify them'. This is a laudable aim although practicalities suggest some of the legal boilerplate would still have to follow any such statement.

4. Complexity

Complexity in reporting is a key factor for audit and is being looked at by both the US (SEC) and UK (FRC) regulators. Some of this complexity is driven by increased sophistication in underlying business transactions – but corporate reporting needs to be made more informative and accessible.

If we can align external reporting more closely with management reporting, the whole process will become more relevant and accessible to the investment community – and would reduce complexity in the audit process.

Management spends significant time aggregating and recalculating data from internal sources to construct the information demanded by regulatory reporting. Too often this is then followed by considerable effort from users of the reports to deconstruct the data to fit their own requirements. If we can align external reporting more closely with management reporting, the whole process will become more relevant and accessible to the investment community – and would reduce complexity in the audit process.

4 The usefulness of financial reports

While the reliability and relevance of financial reports have improved, it seems that they haven't got any easier to understand over the past five years. Yet preparers want to communicate clearly and to articulate both upside and downside business risks to stakeholders; users are also keen to get more from financial reports. So it's important that participants in the financial reporting supply chain consider new technology and look beyond the traditional financial report formats and improve reporting on non-financial measures.

Project findings

Almost any information about companies is considered useful by users of accounts and the annual financial reports are still thought of as the most useful communication by users. That said, a minority of respondents thought the annual report itself is starting to look tired. 'Quarterly reports, investor meetings and other ongoing communications are much more important,' said one, 'and it is these communications that move the market.'

IFAC found that users aren't that interested in real-time information. One user commented: 'The ongoing business and the long-term results are essential. Over-emphasis on short-term reporting deteriorates long-term results and shifts management focus.'

Despite increased use of technology by preparers in the financial reporting supply chain, the IFAC study showed many users were less enamoured by the digital revolution. 'It was surprising to me that people still want paper financial reports,' said Lyle. Although eXtensible Business Reporting Language (XBRL) – a technology designed to tag financial data to make them easier to search and analyse – has great potential, 'I had a sense there wasn't a great degree of understanding exactly what XBRL meant, how it could actually be used within companies and also by users of accounts and stakeholders.'

Unsurprisingly, given the complaints about complexity from preparers, users also reported that financial reports are too complex now. 'There is a real desire to get more of the management information that was behind the financials,' said Lyle. 'People find narrative reporting useful and would like to see more information [of the type that] is used to run and manage a business. If you have got internal reporting information that is used to run the business, there was a sense that more of that should go out into the marketplace.'

Good communication remains essential to the financial reporting supply chain. But for preparers eager to make their financial reporting more usable, there's a problem. There is little consensus from investors about what they actually want to hear. For example, some like 'fair value' accounting; others think it's an ambiguous term or that it creates undue volatility in the accounts. 'If you had a tool like XBRL, then people could get out more of the information they wanted from reports,' said Lyle.

Should companies be concerned that too much competitive information would be revealed by reporting on internal metrics and allowing users of reports to slice and dice data for themselves? Lyle thinks not. 'My experience is that that competitive information is often in the marketplace anyway; companies in the particular industry have got a good sense of what is going on in that industry.'

4 The usefulness of financial reports

Where next?

Respondents suggested the following steps to improve clarity in the financial reporting supply chain.

- Determine what information should be reported – through better communication with all parts of the financial reporting supply chain and engaging users in both the preparation of reports and standard-setting.
- Include more business driven information – with a focus on narrative reporting, non-financial information and openness about strategy.
- Better align internal and external reporting – making it easier for preparers and more transparent for users.
- Deploy technology so that users can compile their own information – using XBRL, but also webcasting analyst and strategy presentations.
- Encourage short-form financial reporting on material issues – 'I want a shortened report containing key information with greater use of charts and pictures – that also should be audited – and less detailed commentary,' said one respondent.

CIMA financial reporting supply chain round-table

It would be wrong to suggest all of the newer accounting standards have had a negative effect on usefulness. 'If you look at segment reporting, we hear from a lot of investors saying, "we really get the useful numbers out of the segments; wouldn't it be good if there were more data on segments?"' said the FRC's Ian Wright (who is also deputy chair of the Financial Reporting Review Panel). 'But we come back to how we get management to communicate their picture of the business, how they actually manage in practice.'

From a preparer's perspective, this is the real key to 'usefulness'. 'One of the reasons why narrative reporting and the use of non-GAAP measures is actually growing is because directors believe they will help the investor understand how the business goes about creating value,' said Ken Lever.

He continued: 'We are trying to address the needs of so many different users, and over time we are going to get a divergence between the information to give a user a good feeling for how the business is creating value; and, for the technical people, all the detailed numbers. The challenge is to make sure it is even-handed and that it actually does tie in, reconcile to, the required financial information.'

But even if non-GAAP, easily understandable, statements can be reconciled to the accounts, complexity in standards and regulations is the biggest barrier to comprehension and usefulness.

'We are moving towards a disconnect in the financial statements: the auditors are looking at assurance and companies are moving towards non-audited measures to communicate with shareholders,' said AstraZeneca's Bill Hicks. 'Is that because preparers are naturally devious and untrustworthy? Probably not. Or is it because the direction of financial standard-setting has moved such that it is no longer a tool for effective communication?'

The onus is on members of the financial reporting supply chain to talk among themselves about what is considered 'useful' – and also to lobby the standard-setters in an attempt to keep the financials relevant to their needs. 'There has been a failing on the part of users to rise to this challenge and to make their voices heard on these sorts of issues,' said Paul Lee, Director of Hermes Pensions Management. 'Hopefully we are seeing that changing.'

The real test is to make financial reports, or rather the reporting process, universally useful. Many participants in the financial reporting supply chain cite analyst presentations as a 'useful' expression of financial reports, combining both detail on the financials and strategic direction. Some stakeholders also welcomed discrete strategy presentations from companies. But retail investors require different ways of accessing reports. This makes the web, in particular, an important part of the financial reporting supply chain.

CIMA perspectives

1. Aligned reporting

Management spends significant time aggregating and recalculating data from internal sources to construct the information demanded by regulatory reporting. But the users of the reports often deconstruct that data to fit their own information requirements. If we can align external reporting more closely with management reporting – and perhaps provide information in more easily re-configurable formats (see pg18, Online reporting), published reports will become more relevant and accessible for users.

2. Segment reporting

Information on performance by segment helps users see which areas of a business are most productive and where value is – or isn't – being added. So the IASB's recent standard (IFRS 8, *Operating Segments*) is a welcome development – particularly the requirement for reports on the segments that are typically used by management internally.

But there was considerable unrest in the European Parliament following publication of the final version of IFRS 8 because it allows management to define the segments. Members of the European Parliament also had concerns over the level of geographical information. Any delaying action at this late stage increases the risk of a 'European IFRS' developing – which will reduce the usefulness of financial reports in a global context.

Some stakeholders also welcomed discrete strategy presentations from companies. But retail investors require different ways of accessing reports. This makes the web, in particular, an important part of the financial reporting supply chain.

4 The usefulness of financial reports

3. Online reporting

Our research with both retail and institutional investors tells us that the usefulness of financial reports would be considerably increased by an improvement in online financial reporting that makes fuller use of the web's capabilities. And users want to be able to extract and analyse information without the need to re-key, for example. The eXtensible Business Reporting Language (XBRL) is potentially a great way to allow this to happen. However users and preparers need to play an active part in the development of XBRL otherwise we will end up with a system developed by regulators for regulators.

4. Narrative reporting

CIMA believes that the usefulness of financial reports is greatly enhanced when the bare figures are supplemented with insightful narrative – which demands the use of non-GAAP key performance indicators. These should be used alongside, and reconciled to, the IFRS/GAAP figures. They allow the company's financial story to be told through the eyes of management, helping to deepen investors' understanding of progress and position of the business.

5. Fair value

Current international accounting requirements relating to the evaluation of fair value are complicated: the chairman of the International Accounting Standards Board (IASB), Sir David Tweedie, has quipped that if you understand IAS 39, *Financial instruments: recognition and measurement*, then you haven't read it carefully enough. But at the same time, the existing standard appears to be the only viable option if we are to continue towards the goal of international convergence, which, to many, is the overriding priority. The balance sheet is supposed to be a snapshot of the state of a company's financial affairs at a specific point in time. Although there are shortcomings with the current mixed measurement model using both fair value and historic cost, in general, international standards are moving in the right direction.

The IASB recently issued a discussion paper, *Reducing complexity in reporting financial instruments*. This is the first step in the simplification of a standard inherited from its predecessor body. The current board believes that there are too many classes of financial instruments and too many methods for measuring them. Reducing complexity in the standard is a welcome move and a better way forward than proposals to completely ignore it.

Fair values and financial instruments are controversial issues and the endorsement process in relation to the European market has already become politicised.

Fair values and financial instruments are controversial issues and the endorsement process in relation to the European market has already become politicised. A dangerous precedent was set four years ago when the European Commission agreed to a watered down version of IAS 39 following vigorous lobbying from the banking sector. IFRS is now being or will soon be applied in many countries – possibly including the US. So any jurisdiction that chooses to break away from endorsing IFRS as they stand, risks losing out from the benefits of international convergence.

Appendix 1

Attendees at CIMA's financial reporting supply chain round-table, which took place at the Andaz Hotel on 16 January 2008 and was chaired by Charles Tilley, Chief Executive of CIMA.

Mr Andrew Carr-Locke	Former CFO	George Wimpey plc
Mr Andrew Jones	Partner, Head of Research	Makinson-Cowell
Mr Andy Simmonds	Partner Chair Member	Deloitte ICAEW Financial Reporting Committee Accounting Standards Board
Mr Bill Hicks	Director of External Reporting	AstraZeneca
Sir Christopher Hogg	Chair	Financial Reporting Council
Mr Edward Beale	Chief Executive Chairman, Corporate Governance Committee Member	City Group P.L.C. The Quoted Companies Alliance Accounting Standards Board
Mr Ian Wright	Director of Corporate Reporting Deputy Chair	Financial Reporting Council Financial Reporting Review Panel
Ms Jennifer Hughes	Financial Correspondent	Financial Times
Mr John Kellas	Chair	International Auditing and Assurance Standards Board
Mr John Plender	Chairman Columnist	Quintain plc Financial Times
Mr Ken Lever	Chair Former CFO	Financial Reporting Committee of the 100 Group Tomkins plc
Ms Liz Hickey	Director of Technical Activities	International Accounting Standards Board
Mr Mark Smith	Director External Reporting	Tomkins plc
Mr Mark O'Sullivan	Senior Manager, Corporate Reporting Group	PricewaterhouseCoopers
Mr Michael McKersie	Assistant Director	Capital Markets, Association of British Insurers
Mr Nick Topazio	Technical Specialist	CIMA
Mr Norman Lyle	Chair	IFAC Financial Reporting Supply Chain Project
Mr Paul Lee	Director	Hermes Pensions Management
Mr Richard Ackland	Director	KPMG
Mr Richard Slynn	Corporate Partner	Allen & Overy LLP
Mr Richard Leyland	Director, Corporate Law and Reporting	Department for Business Enterprise and Regulatory Reform
Mr Richard Carpenter	Development Director Board Member	Radley Yeldar Investor Relations Society
Mr Richard Mallett	Technical Director	CIMA
Ms Sarah Deans	Head of Accounting & Valuation Research	JPMorgan Securities Ltd
Mr Trevor Harrison	Chairman Advisor	Chelsea Building Society L.E.K. Consulting

Co-ordination team

Mrs Amelia Palmer	Project Co-ordinator	CIMA
Mrs Jane Lyons	Administrator	CIMA
Mrs Katie Scott-Kurti	Senior Press Officer	CIMA

Appendix 2

Further reading

CIMA/PricewaterhouseCoopers/Radley Yeldar/Tomkins (2006), *Report Leadership*, Executive Report. www.reportleadership.com

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CIMA (2005), *Maximising Shareholder Value: achieving clarity in decision making*, Technical Report. www.cimaglobal.com/technicalreports

CIMA published legal opinion from Allen & Overy LLP addressing Director's liability for statements in the OFR. www.cimaglobal.com/ofrlegalopinion

CIMA Professional Code of Ethics, which includes various types of support including the ethics helpline and the whistleblowing advice line. www.cimaglobal.com/ethics

CIMA Mastercourses, a programme of advanced training courses which includes accounting and financial reporting topics. www.cimaglobal.com/mastercourses

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