



Getting to the Heart of the Issue

Can Financial Reporting be made
simpler and more useful?

**A report on research undertaken by the
Global Accounting Alliance**

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The report of this project undertaken by the Global Accounting Alliance (GAA) on the twin subjects of principles and complexity in financial reporting, is a timely contribution to worldwide developments. While the key stakeholders in financial reporting were being interviewed and the results of those interviews were being compiled into this report, major developments were taking place. The US Securities and Exchange Commission (SEC) announced its proposed road map for the adoption of international financial reporting standards (IFRS) for use by US companies. The US, often labelled as “rules based”, will now have good reason for increasing its influence over the International Accounting Standards Board (IASB) and the development of IFRS. The need for a consensus to be reached on principles based standards is more important now than it has ever been.

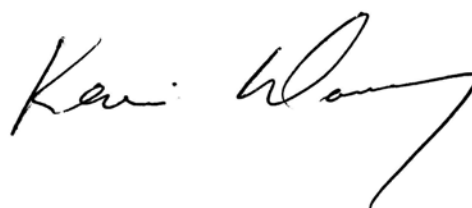
The UK Financial Reporting Council (FRC), and the US SEC’s Advisory Committee on Improvements to Financial Reporting have also been considering the complexity of financial statements. The FRC has sought views on the issue, in relation to broader corporate reporting requirements. To address the issue of complexity, the US Committee has made a number of recommendations including a new executive summary in company annual reports, and greater use of interactive data tagging financial statements.

Behind all these developments unrolled the financial crisis, which has changed

perspectives on the appropriate balance between market freedom, regulatory frameworks and government intervention. Our interviews were undertaken before the worst impacts of the financial crisis emerged, and it will be interesting to discuss the ideas emerging from this project in the light of these more recent developments.

The GAA would like to thank all the interviewees for agreeing to assist in this project, for sparing the time to be interviewed and for sharing their views with us. We would also like to thank Robert Bruce, the UK based financial journalist, for the preparation of key sections of this report.

The GAA looks forward to assisting in the debate on these issues with all stakeholders in the financial reporting community. We hope that this report, through the distillation of the views of a wide range of stakeholders and through discussion of the issues raised, is able to make a major contribution.



Kevin Dancey FCA
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Executive Summary

Over the last two or three years, a broad consensus of support seems to have emerged for “principles based standards”. However, there is a range of different interpretations as to what this term really means. There are also major and varying challenges faced in different jurisdictions by the implementation of principles based standards.

At the same time, there have been increasing complaints from preparers and users of financial statements about the length and complexity of those financial statements. Yet many users have claimed that some of the most important information just isn't there, or isn't easily accessible or understandable.

The Global Accounting Alliance (GAA) undertook this interview based thought leadership project to consider these two major topical issues in financial reporting. Its objective was to ascertain views from a broad cross-section of stakeholders in the international arena on the barriers to the practical application of a more principles based accounting regime, and how the current complexity and detail in listed company financial statements could be reduced, so as to focus on better communication with financial statement users.

As a result of the interviews undertaken between March and June 2008, the GAA proposes that a number of questions be considered by the key stakeholders in financial reporting, such that some agreed recommendations might emerge. The GAA is intending to facilitate a series of events internationally where these debates can take place. These questions are as follows:

1. Should an agreed international framework for accounting standards be adopted with a clear hierarchy comprising (i) a conceptual framework; (ii) principles based standards; and (iii) limited authoritative guidance?
2. Should guidance be provided for preparers and auditors on the exercise of judgement in the application of principles based standards and on the documentation of reasons for the judgements made?
3. Should regulators be encouraged to accept a reasonable degree of variation in accounting treatments and to take a more effective, outcome oriented approach to regulation?
4. Should a single definitive set of general purpose financial statements be retained?
5. Should standard setters be encouraged to drop requirements considered redundant?
6. How can company boards be encouraged to provide better quality communication?
7. Should an international framework for high level summary financial statements be developed in order to provide information suitable for retail and less sophisticated investors?
8. Should general purpose financial statements be developed and published in XBRL format to allow users to drill down to whatever level of detail is required?
9. Should company communication be improved through the use of clearer language, less jargon and coded language, and a focus on clarity and transparency?
10. How has the recent financial crisis affected the debate on these issues?

1. Call for Action

In early 2008, the debate on the place of principles and rules as the base for effective financial reporting seemed to be over – financial reporting needed more reliance on principles and fewer rules. This report details the consensus which seems to have emerged around the world that in future principles must hold sway. In the words of the Chief Accountant of the Securities and Exchange Commission, (SEC): “I grew up when we had principles. When I started in the profession, what we had was principles. And then it developed into a rules based profession. I do believe that principles based standards is the better of the two”.

What this report does, having underlined that finding, is describe the consequences of this apparent consensus and detail the actions which would be required within the financial reporting community around the world to bring it about. This is not a report just to sit on a shelf. It highlights the concerns of a wide range of stakeholders and the problems they identify with financial reporting. To provide value, this report needs to be the catalyst for discussion and debate on what needs to be changed and how such changes can be achieved.

Of course, in the middle and latter part of 2008, the financial crisis really started to bite, and the apparent consensus on principles which had been evident at an earlier stage may need to be reassessed. Paradigms have shifted, and the roles of governments, regulators, investors, financiers and companies have shifted. Different perspectives may be emerging on the balance between market freedom and regulation, and on the role and effectiveness of financial reporting.

Whilst accepting for the moment the broad consensus for principles based standards, the ensuing discussion and debate which the GAA seeks to initiate is likely to highlight whether there are different perspectives on the term “principles based

standards” and on the structure of the accounting and regulatory framework which is needed to support such standards. It will also highlight the extent to which views may have changed as a result of the recent financial crisis, market turbulence and looming recession. In any event, discussion and debate will be critical to agreeing whether a more principles oriented accounting regime is desirable, and how it can be brought about.

There is a clear consensus from the interviews on the need to establish a framework for accounting standards which will enable professional judgement to become the driving force in financial reporting statements. This would enable the creation of principles based standards which would focus on showing the economic reality of transactions and business events. This framework should provide guidance on the exercise of judgement in the application of these standards. The report also shows a consensus for the need for a hierarchy to be established which would create the circumstances in which the guidance would work.

Possibly the most important ideas to emerge from this report are that both culture and mindset must change within the accounting profession and business around the world if the goals of the consensus demonstrated in this report are to be put into place. As Jeff Willemain says in the report: “A student in an accounting program should be able to read a principles based standard and understand what it means. They should be able to understand how it relates to a conceptual framework and what it’s trying to accomplish, and therefore it ought to be written in clear, concise, plain language”.

The guidance also needs to concentrate on another element which comes to the fore in this report. The actions of regulators are crucial to the workings of what is being recommended. Regulators must accept that there will be variations

in outcomes as a result of judgement being used. And users and regulators must temper their desire to create precision in the comparability of financial statements. In Jeffrey Lucy's words: "Under a principles based system, regulators accept that differences in opinion between accounting firms, companies etc, may arise because each company has different circumstances".

A clear consensus was expressed that there was a need for greater protection around the exercise of judgement and a support mechanism to be set up to achieve this. John Carchrae says in the report: "The people who make the financial reporting decisions need strong support networks to protect them from strong business pressures that may drive them to do the wrong thing or not the best thing. That's reality. I don't pretend that those business pressures will go away, they won't. But if it's possible to try to provide stronger support mechanisms for people who are in difficult situations having to make difficult judgements, that could help the whole system".

The report also suggests that there need to be significant changes in the education of accountants, particularly in North America, to shift the emphasis away from the application of rules and towards a system where thinking their way through problems and issues is the natural route for an accountant to take.

There is certainly a consensus for the idea of changing the nature of financial statements, in an effort to combat their growing complexity. Those interviewed wanted the emphasis in the future to shift away from being dominated by compliance to a system where communication was the driving principle. Also, there should be an acceptance that different users have different needs, and encouragement for the greater use of XBRL to create an information database which would

allow those users greater flexibility in pursuing the information that they specifically require in a form which was useful to them.

Underlying all these elements in the efforts to reduce complexity was the desire for the use of clearer language, less jargon and coded language and a focus on clarity and transparency.

Although the interviews which form the basis of this report were undertaken in less turbulent times, the messages emerging are consistent and broadly supported. It is hoped that any changes in regulation or financial reporting arising from the financial crisis are well considered and that due process is adhered to. Knee-jerk reactions and unintended consequences should be avoided. The longer term issues which are discussed in this report remain important to the development and improvement of financial reporting. In an environment of trust, effective corporate governance and oversight, the objective is true and fair financial statements which take the communication of useful and understandable information as their priority.

2. Background

In early 2008, the GAA Board commissioned this research as an interview based thought leadership project to consider the following major issues in financial reporting:

1. The extent to which financial reporting should be governed by principles or rules; and
2. The increasing complexity and detail of financial statements (under International Financial Reporting Standards and US GAAP).

The objective of the project was agreed to be:

To ascertain views from a broad cross-section of stakeholders in the international arena as to:

- *the barriers to the practical application of a more principles based accounting regime;*
- *what practical steps are necessary to overcome these barriers and move to a more principles based accounting regime;*
- *how the current complexity and detail in listed company financial statements (both US GAAP or IFRS based) can be reduced, so as to focus on better communication with financial statement users; and*
- *whether a more principles based accounting regime could provide some or all of the solutions to the complexity issue, through a greater focus on the true and fair view/fair presentation and necessary supporting disclosure;*

- and thus to influence international standard setters, regulators and other stakeholders in financial reporting.

Interviews were undertaken between March and June 2008. Those interviewed in the course of the project are set out in Appendix 1.

It should be noted that the interviewees' views were provided in a personal capacity. Whilst the views of the organisations to which the interviewees belonged would have been reflected (to varying degrees) in the views presented, on many of these points there are no official views of those organisations, and seeking an official view would not have been feasible within the time constraints of the project.

The GAA took into account the following developments in pursuing its project:

- The Global Public Policy Symposium (GPPS) paper "Principles Based Accounting Standards", published in January 2008;
- The International Federation of Accountants (IFAC) report "Financial Reporting Supply Chain: Current Perspectives and Directions" of March 2008, which reports on the results of a global survey and a series of telephone interviews undertaken in late 2007. The principles/rules issue is raised in the report and the issues of understandability, complexity and disclosure overload are discussed;
- The UK Financial Reporting Council's project, commenced in 2008, looking at "the complexity and relevance of current reporting requirements" and "whether corporate reporting requirements are disproportionate to their intended benefits and whether there are opportunities for improvement." It is also addressing "the risk that these requirements, and related influential guidance, are contributing to the increasing complexity of corporate reports without making them more useful or understandable";
- Ongoing SEC considerations in developing a transition plan for the adoption in the US of IFRS, which was published as a proposed rule in November 2008; and

- The SEC's Committee on Complexity in Financial Reporting (CIFI^R) which presented its recommendations on 1 August 2008.

In pursuing this project, the GAA sought to make a meaningful contribution to the debate on these issues. In this respect, the GAA is pleased to build on the work of IFAC and others, and develop ideas and recommendations to address the problems identified - for further consideration and debate. It is also willing to liaise with bodies undertaking further work in similar areas.

The following two sections discuss the main conclusions emerging from the interviews, highlighting the areas of consensus and considering other interesting observations made.

3. The Implementation of Principles Based Standards

3.1 The Need for a Principles Based Standard-setting Framework

It is clear from the interviews which form the basis of this report that the debate over whether principles or rules should be the underlying concept in creating effective financial reporting is over. Principles have won the day. But there are many shades of debate and opinion within that consensus.

Principles involve the use of professional judgement from preparers, regulators and auditors. This should not present a problem if the judgement is exercised within the spirit of what was intended by the principle. It should not be difficult if we follow the "spirit" for an auditor or regulator to make a judgement as to whether the approach taken by the preparer was valid or a fraud.

Liu Yuting, Director-General in charge of accounting standards and regulation, Chinese Ministry of Finance

The concept of principles based standards is one which is almost universally supported in the abstract. Everyone agrees with and wants principles based standards, said one typical interviewee. There is no alternative, as rules based standards are not working. The perception is firmly embedded in the market that principles give you better and more realistic outcomes while rules bring you argument and outcomes which have much less connection with the underlying economic realities. But there are many different interpretations of quite what principles based standards would mean. It would mean a standard which would describe true north, said an interviewee. It would not be prescriptive in

nature. And probably it would include a lot more judgement as to whether or not the application of the standard was in the direction of the principle. Another suggested that principles based standards do not contain detailed, arbitrary rules. Rather, there is a principle or overall concept that the standard is driving to and all guidance falls under that umbrella. One American interviewee said: it means less form, fewer bright lines, fewer examples, and more focus on the economics of a business transaction.

It is hard to get useful business information from a set of US GAAP financial statements. In the UK, the situation is better, but is deteriorating. We support principles based standards, involving the application of judgements and common sense.

Jeremy Hand, Chairman, British Venture Capital and Private Equity Association

Another interviewee differentiated the two in this way: I think of a principle as a broad statement which relies on an understanding of the concept for its application to particular facts and circumstances. A rule, in contrast, is often a much more detailed, much more specific admonition that we will or we will not do a certain thing. Principles rely to a greater extent on the objective of understanding the spirit behind the principle, and a desire to conform to it, or at least to do the best one can.

What we want, said another interviewee, is a principle which goes to the substance of a transaction.

The biggest opportunity I think we have is to put in place a professional judgement framework that is accepted and recognized within the legal processes and by the regulators and that would allow companies and auditors to exercise professional judgement in the application of accounting. And I would argue that is essential for an effective implementation of a principles based accounting framework. That's the single biggest thing I think we can do to remove the obstacles to a movement in that direction.

Jeff Willemain, GPPC

One interviewee said that everyone agreed with the idea of principles based standards when it was obvious that there was no alternative, as rules based standards were patently not working. They went on to say that you could not really distinguish between principles and rules. The important point to him was the mindset involved. It was a choice of either regulating for every possible situation, or not. And emphatically the vote went for the mindset which avoided the prospect of burgeoning regulation. The focus, said another interviewee, should be on the desired outcome and how to achieve it.

Key points

- General support for principles based standards, but there are different understandings of what this means.
- Recognition that “principles vs rules” is a false distinction and that a balance is needed between principles and supporting guidance or “rules”.
- General support for allowing the use of judgement.

3.2 The Evolution of Guidance and Rules

The difficulty is the old one of starting out with the best intention of sticking to principles and becoming progressively boxed in as the business and market situation develops. The accounting keeps getting tested, said one interviewee, and it's always tested at the margin, and because it's tested at the margin interpretations are given. This gradually metamorphoses into what are effectively rules. Gradually there is a cumulative effect. And that is where the impossible complexity comes from. This was, said several interviewees, particularly the case in the US where companies had, in the past, persistently asked for more and more rulings until the whole system started to buckle. As a result, some said, it was much harder to get useful business information from a set of financial statements.

When the bans on solicitation and advertising were lifted in the 70s, that was the beginning of the end for principles based standards. As accounting firms started to solicit prospective clients and opinion shopping became more prevalent, companies would go to different accountants to find out if they would provide more favourable treatment for a transaction or an event. Then the accounting firms got together and said “Well here is the solution. We will develop the Emerging Issues Task Force.” In my cynical view, what happened was we, as a profession, set up a group to do what we couldn't do ourselves, which was to tell our clients and prospective clients ‘no!’.

Mike Starr, Grant Thornton

Another factor which interviewees mentioned was that directors, preparers and auditors wanted protection in their decision-making processes. They wanted someone to tell them that what they were doing was the right thing to do. The business environment, it was suggested, was one which lacked clarity and that those involved wanted to push for greater clarity as a result. That led to pressure on directors, preparers and auditors to cling to rules to back up what they felt was greater precision.

And there is no doubt that rules are needed. One interviewee recalled talking with a friend who had recently returned from having been driven along the autobahns of Germany. When the speedometer had topped 100 mph he had had what he described as an epiphany that in some cases there was a most definite need for rules!

Key points

- Guidance, often developing into rules, is sought for a variety of institutional, cultural, and behavioural reasons.
- Evolution results in accepted practice developing into guidance, then into formal interpretation, then into rules.

3.3 The Importance of Frameworks and Hierarchies

There was also, particularly from interviewees from North America, support for the idea that the terminology should be not be referred to as principles based. The description should be objective based standards rather than principles based standards. For them this removed the abstract nature of the definition. A different terminology should be used so as to emphasise the way they would work. The definition varied. 'Objectives based', 'objectives oriented' or 'outcome based' were favoured. It is better, said one interviewee, to set out desired outcomes, explain them, ensure there

are underlying principles to foster the outcomes, provide some guidance, and so ensure the desired outcome is achieved.

I think it's behaviourally better to set out desired outcomes, explain them and then you can have some principles underneath it that hopefully foster those outcomes.

Bob Herz, Chairman, FASB

So future effort should be devoted to creating a system which establishes a clear framework for accounting standards and which has a hierarchy which clearly learns from recent history.

All regulation, as one interviewee put it, is derived from some sort of conceptual analysis, from which principles are derived, and the rules are then based on those principles. You need the principles to understand why the rules are there. It was a question of seeking a balance between too principles based an approach where the application might be unclear, and too rules based which could obscure what was trying to be achieved.

But there has always been a dilemma in attempting to produce both effective standards to fulfil the demand from investors, preparers and the public interest along with a conceptual framework to underpin the standards being produced. The urgency of producing the standards has never allowed the luxury of getting the conceptual framework in position before the standard-setting process starts. Interviewees regretted that the discussion and development of a new conceptual framework could not happen wholly in advance of the new standard setting. Some felt that the former IASC/IASB conceptual framework had been imposed on IFRS users without effective consultation. But there was clearly a feeling also that the standard-setting world had to provide standards in a timely fashion and that the time to produce another fully-agreed framework ahead of a set of standards was unlikely to be available.

A clear hierarchy is needed, with the conceptual framework at the top. In the absence of a conceptual framework, accounting standards have to be longer and more detailed.

Patrice Marteau, Chairman of Business Europe Accounting Harmonisation Working Party

In any case, as one interviewee emphasised, conceptual frameworks already exist at both the IASB and FASB. Principles based standards would emphasize and draw directly out of a conceptual framework which gives you a way of understanding very clearly what the standard is trying to accomplish. A principles based standard would carefully lay out the scope which would cover a broad area of accounting. So, as one interviewee put it, you wouldn't expect a principles based standard to address, for example, accounting for a certain type of a device in a micro computer in the software industry. But it would cover, for example, revenue recognition. No one would have to be a deep expert to understand it. Instead it would be understandable by a broad range of users. Any accountant should be able to read a principles based standard and understand what it means.

A student in an accounting program should be able to read a principles based standard and understand what it means. They should be able to understand how it relates to a conceptual framework and what it's trying to accomplish, and therefore it ought to be written in clear, concise, plain language.

Jeff Willemain, GPPC

The question then is how much guidance should be provided. The big problem as I see it, said one interviewee, is that principles aren't consistently applied. There's a whole range of circumstances in which we create exceptions to the principles and

that's what drives the rules that then flow. As soon as you carve something out of a principle you have to establish clear lines around where the carve-out is. And every time you try to establish clear lines you have to be more and more explicit and you then find that people see a distinct advantage or disadvantage to falling one side or the other of a particular line and that drives even more rules as people try to fit themselves into one particular place.

This is where the commitment of preparers and users has to be solid. If you are going to establish a clear principle then you have to be willing to accept that you may not actually like the impact the principle has on your particular situation and you have got to be willing not to argue to carve out your situation because if you continue down that path of arguing to carve it out you will inevitably drive rules again, said the interviewee.

Key points

- US preference to focus on the desired outcome and have "objective oriented" rather than "principles based" standards
- Need a clear hierarchy of accounting pronouncements
- A conceptual framework is key, to set out the fundamental principles on which accounting standards can build

3.4 Litigation and Judgement

There was agreement that cultural issues, particularly involving regulators and auditors, need to be addressed. Partly this stemmed from the complexity of structured business transactions which in turn drive more complex standards, leading to greater length and attempts to deal with every possible situation. The complexity becomes embedded as long as people try to avoid the outcome that the standard setter is trying to

achieve. There is a big behavioural issue here, said one interviewee, in the form of a mindset which has developed over time. This, it was thought, stemmed in particular from the litigious culture of the US.

Take a look at FAS 133. Somebody one time said to me there's only seven air breathers who understand FAS 133, and I don't know any of them. The stuff is so complex, so dense.

Kenneth Daly, President and CEO, National Association of Corporate Directors

The answer, in part, would be for a greater acceptance from regulators in particular of variations in accounting treatment. One interviewee gave a leasing standard as an example. The truth of the matter, it was suggested, is that you could summarise leases in a few short pages if you went to a principles based approach. In practice you cannot envisage every type of transaction and every type of nuance that you will encounter and so in the end rules simply cannot cover it.

Regulators also accept that professional judgement exercised under a principles based accounting system may sometimes result in different views, provided that the accounting standards have been applied in good faith.

Jeffrey Lucy, Chairman of the Australian FRC

Another suggested solution was for the investment profession to help senior managements to be more relaxed about what was required of them. But this again assumed that the litigious culture could start to be reversed so that directors would feel less embattled and fearful of opening themselves to potential legal action following an attempt to be more open with investors.

Why is it that only the accounting profession can't have two answers? Look at the legal profession. You have prescriptive legislation yet business people regularly consult lawyers and get differing opinions. Look at the medical profession, dealing with life and death, yet you get different opinions re diagnosis and treatment.

Russell Loubser, CEO, JSE Securities Exchange, South Africa

Preparers and auditors could also do more to reduce what some felt to be the false search for comparability. This had also led to a demand for more and more detail. And another bar to change was the way the profession had allowed a myth to develop that accurate answers could be produced for balance sheets and profit figures. The reality was that a range of numbers is possible. The difficulty here was that the cultural change needed had to come from company chairmen and others conveying corporate performance. Companies, one interviewee pointed out, often treated reporting as a compliance exercise rather than a communication exercise.

The people who make the financial reporting decisions need strong support networks to protect them from strong business pressures that may drive them to do the wrong thing or not the best thing. That's reality. I don't pretend that those business pressures will go away, they won't. But if it's possible to try to provide stronger support mechanisms for people who are in difficult situations having to make difficult judgements, that could help the whole system.

John Carchrae, Chief Accountant, Ontario Securities Commission

But rules, of course, have their place. There is an obvious gut feel that, however much you may wish to pursue unfettered judgement, rules are not to be eschewed. The question is one of quite how many rules and what influence should they be allowed. People were wary of rules. They felt that they offered an illusion of certainty and would multiply in unhealthy numbers in uncertain circumstances.

This is what worried interviewees most about the perception of a rules-dominated financial reporting world. It was driving people into thought processes and decisions which eventually had more to do with the system of rules itself rather than the situation which they were trying to deal with. Where there are too many rules, reflected one interviewee, you can't see the real issues.

Part of the problem is the perception that the US system is built on a litigious culture which spawns rules. But this has not always been the case. I grew up when we had principles, said one interviewee. When I started out in this profession what we had was principles. And then it developed into a rules based standards profession. And I do believe that principles based standards is the better of the two.

In the UK, as long as one does not rush to judgement, has the full facts, and documents reasonable opinions, there are no major problems. The threat of litigation does not undermine the willingness of auditors and companies to exercise judgement in the UK, but any search for comfort in rules is likely to be unsuccessful.

Robert Overend, Audit/Technical Partner, Ernst & Young, UK

It is this gradual change in the culture which many interviewees, particularly from North America, pointed out. We have a very rules based society here, said one, and you can end up with rules right down to a gnat's eyebrow.

This, more than anything, was what brought about the real worries. The legal profession was felt to have a preoccupation with detailed rules to the extent that any overriding principle became either forgotten in the process or lost in the fog. This meant that people lost sight of the broader objective behind the rules and financial reporting became in danger of simply becoming a compliance process. Things wouldn't make much sense but they were done because that was what the rules said. This became a self-fulfilling process. As more and more problems were created by the emphasis on rules, more and more rules had to be created and introduced to try and correct the problems. More and more efforts would be made to circumvent those rules and more rules would have to be brought in to deal with that. The result was that the original broad principles are lost in the process and the accounting standards start to look, as one interviewee put it, like the Internal Revenue Code.

We are a heavily litigious society. We are a lawyer-laden society, and that manifests itself in a belief that piling on layers and layers of rules will somehow eradicate improper human conduct. Of course, nothing could be further from the truth. What influences human conduct is not simply rules, what influences human conduct is culture.

Michael Young, Willkie Farr & Gallagher

It was also felt that the emphasis on rules was damaging the credibility of the accountancy profession and its brand. Interviewees pointed out

that the restatements of accounts in the US were due, in the majority of cases, to what they described as the misapplication of rules based accounting. These restatements didn't change the stock price, nor did they change the cash within the company, but, as one interviewee put it: Every time there's a restatement the world says "there's another case of somebody doing something stupid". It was felt that the accounting profession was damaged by this. People didn't understand that restatements were often not very meaningful, and were simply the result of the misapplication of over-detailed rules.

The important thing is to recognise these problems and try and pull back from them. If you have rules based standards, said one interviewee, then you end up with very detailed, sometimes mathematical criteria such as in lease accounting, and in effect you incentivise companies and others to architect transactions to get around the rules. But it is not that black and white. There is a sweet spot on the continuum where you have pure principles on the left and rules on the right. That sweet spot needs to be drawn. We need to lay out some criteria that standard setters can follow that people understand and support and which will be used in designing standards that work better for everybody.

There has to be some kind of sense that the groups are all in this together and moving in the same direction, and if you had leaders from some of the top companies and auditors, and groups like ourselves saying this makes a whole lot of sense and reinforced a little bit, I think you could get somewhere. But if you get one group moving in one direction and another group chastising it or criticizing it, then I don't think that we can dance well.

Jeffrey Diermeier, President and CEO, CFA Institute

There was a general consensus on this point. Principles were not always good. Rules were not always bad. The focus, said one interviewee, should be on the desired outcome and how to achieve it. Sometimes a rule is required, sometimes a principle. It is a question of balance.

Many barriers to change were identified. One was the traditional complaint about the litigious nature of society in the US. A culture which respects transparency and integrity in financial reporting was required. One interviewee compared it to speed limits. If the US culture changed, if it became socially unacceptable to go faster than the speed limit, then you would find force behind the change.

Key points

- The credibility of the accountancy profession is being damaged by the emphasis on rules, and the number of accounting restatements in the US.
- Regulators need to accept some degree of variation in accounting treatments, allowing for greater use of judgement.
- A balance is needed between principles and rules, but an emphasis on rules leads to efforts to circumvent them and a need for yet more rules.
- A concerted effort from all players is required – to develop a culture of trust and integrity which fosters the exercise and acceptance of professional judgement.

3.5 The Role of the Accounting Profession

Some saw the attitude of auditors as a barrier to principles based standards. It was felt that all too often detailed rules provided comfort and protection from possible criticism whereas principles based judgements could be contested and criticised.

The key is trust in the audit profession; the profession, the European profession in particular, needs to take a leadership role, or the regulators will seize it.

Sir David Tweedie, Chairman, IASB

As a result of this desire for comfort and protection, there was a danger that the large audit firms would start to take collective decisions on the approaches to be taken where judgement came into play. This collective action might become an issue for regulators and legislators. As a result of these suspicions it would be important for the large audit firms to work in public and give reasons for their decisions.

Auditors often seem to favour detailed rules as these provide comfort and may protect from possible criticism. On the other hand, principles based judgements could be contested and criticized.

Jeroen Hooijer, Head of Accounting, European Commission

The education of accountants, particularly over the last two generations in the US, was seen to be another barrier. As a result of the growth

of a predominantly rules based environment accountants had become, it was suggested, very compliance oriented. The educational curriculum didn't stress critical thinking enough and there was not enough respect for the exercise of good judgement on the part of preparers. Audit failures, said one interviewee, usually don't come about because somebody forgot to follow a rule. They tend to occur because somebody didn't think.

I think there's been quite a shift towards training people to learn the rules and follow them and those reasoning skills that people need may not be as well developed as they could be or should be if you're going to have effective implementation.

John Carchrae, Chief Accountant, Ontario Securities Commission

There was doubt that the current generation of accountants had been trained to a level where they could take on the burden of working with principles based standards. There has been quite a shift, said one interviewee, towards training people to learn the rules and follow them. The reasoning skills that people need may not be as well developed as they could be. It was thought that it could require quite a bit of time in the US to develop the mindset that accountants would need to operate effectively.

The public interest is for good reporting that reflects the underlying economics and business and allows people to understand the performance of a company and to compare one company to another.

Bob Herz, Chairman, FASB

But overall it was agreed that the essential requirement to change the culture was to put a professional judgement framework into place which was accepted and recognised within the legal processes and by the regulators. That would allow companies and auditors to exercise judgement in the application of accounting. That, said one interviewee, is the single biggest thing I think we can do to remove the obstacles to a movement in that direction.

Regulators are happy to accept a reasonable diversity of practice in a principles based regime, so long as there are disclosures to help the users understand the accounting decisions made.

Michel Prada, President of the Autorité des Marchés Financiers, France and Chairman of the IOSCO Technical Committee

It was generally agreed that there would be huge advantages for the users of financial statements if true principles based standards were to become the norm. It allows you to get to the heart of the matter, said one interviewee. Currently the focus was on how a standard could be applied to a transaction rather than asking what the economic substance of the transaction really was and what result might best portray that economic substance. It would also improve the quality of both the auditing of information and the quality of that audit. Shifting the focus of auditors from compliance to the application of principles would enable reporting to better reflect economic realities.

The level of information required is a judgement call, and the auditors need to play a leading role in assessing what is appropriate. Beyond that, everyone involved needs to accept a degree of variability in the outcomes, accepting that in applying principles, decisions will be made that you don't always agree with. By way of analogy, if a class of school children were asked to produce a watercolor of a plant, there would be many different shades of colour – but all are likely to be accepted as true representations.

Paul Boyle, Chief Executive, UK FRC

These changes would significantly change the reporting culture for company management. Financial statements which were truly representative of the way management conducted and managed their business should allow analysts to link more readily what management says about its business with what's reflected in the financial statements. Currently, it was felt, managements often have to suggest that users look elsewhere to obtain a wider perspective on the business than the one which the financial statements alone are portraying.

Key points

- The attitude of auditors - toward rules and professional judgement - may represent a barrier to more principles based standards.
- Accounting education needs to foster the ability to make judgements.
- A framework for professional judgement could encourage cultural change.

4. Complexity and Detail in Financial Statements

4.1 Complex Transactions and Complex Reporting

In general the interviewees felt that financial statements had become more complex simply because they were trying to deal with businesses and a business world which had become much more complex. The major driver, said one interviewee, is the increasing complexity of business practice. Transactions had become enormously complex and then had to be captured in just a few pages of financial information. Several interviewees pointed to the growth in what they described as ‘exotic financial instruments’. There was a point in time, said one, when derivatives simply didn’t exist, hedges didn’t exist, interest rate swaps didn’t exist, and securitizations didn’t exist. They are all very complex and so some of the complexity in the financial statements is driven by real business complexity.

Complexity is a fact of business life; no 20 page summary will do justice to the complexity of, say, a large bank’s businesses, product lines, jurisdictions. And accounting specialists (like medical specialists) need to use complex, precise language when communicating with other specialists, who need a clear and detailed understanding if they are to act in the interests of investors, thereby ensuring that the share price is reasonably right.

Paul Boyle, Chief Executive, UK FRC

In some ways this was seen as inevitable. The main driver is the transactions, said one interviewee. We can’t expect the standards to simplify the accounting. It is evolution, so we can’t expect the standards not to become complex – due to the complex transactions.

The accounting standards themselves clearly have a role to play in increasing complexity in financial statements. ‘Some of it’s due to convoluted accounting methods’, said one interviewee, who then went on to mention stock options, pensions, and leases. Another suggested that accounting standards ‘do not provide the most transparent reporting. So in order to overcome this, additional disclosures are required.’

The world has become very complex – but we cannot go back. In some ways, accounting has become too complex, but the answer is not to reduce complexity – the answer is to be selective, tailoring information to meet the needs of different categories of users. There should be a financial hierarchy of information – more useful/essential information through to long-term trend information and complete legal/regulatory information.

Patrice Marteau, Chairman of Business Europe Accounting Harmonisation Working Party

It is the resulting detail in financial statements which gets in the way of understanding. One interviewee explained it this way: People talk about the number of pages that are given to the financial statements and then the number of pages that are given to explanations and footnotes, and the explanations and footnotes at times exceed the amount of space for the financial statements themselves. That’s fine if it improves transparency

and it improves clarity, but much of the detail does not do that. The same interviewee went on to say that one of the concerns about the greater detail is that it is designed by lawyers to limit the exposure of the company, rather than to add greater clarity.

You keep adding and adding, said another interviewee, and some of it may not be high risk, it may be low risk, and may not be important at all to that investor. But you have to analyze and go through all this information to try and come up with what is important. So having the right information is more important than having the length of it.

Whatever is done to reduce disclosures and move more effectively toward principles, accounts information will always be 'raw', portraying what's happened. For example, in relation to pension deficits, there will inevitably be volatility, and management need to explain the underlying reasons. Thus "narrative will be more and more important", including management commentary.

Sir David Tweedie, Chairman, IASB

But companies are sometimes their own worst enemies in this. Life is volatile, said one interviewee, and if financial information wants to capture what's going on in the life of a company then the result is going to be volatility. But there is some resistance to financial information which exacerbates volatility, particularly among the preparers of financial statements, and when you put in place things to siphon out information that will create volatility you can contribute enormous complexity.

Key points

- Agreement that financial statements are long and complex
- The key cause is complexity of business and transactions – and the need for explanatory narrative on complex items
- Accounting standards also cause complexity in the way something is accounted for or disclosed (eg stock options and pension costs)
- Concern on quantity replacing quality

4.2 Providing Users with the Information they need

Another interviewee simply stressed the urgency. The financial statements are incredibly long, incredibly detailed and they're a very tough read, said one interviewee. This is a big issue and a complex issue. But it's got to be addressed.

And there is the difficulty in reaching a judgement. The more burdensome the statements are, the more people may not pick them up and look at them. The simpler and shorter they are, the more likely people may read them. And there was a worry that shorter statements might open companies to legal action later when, with hindsight, they might be accused of withholding crucial data. One interviewee referred to a specific piece of arcane banking information. Many people, he said, would have not been remotely troubled by the absence of that information prior to the market seizing up. But when the market seized up you suddenly realized that this piece of data was quite crucial because you didn't know the risk which appeared to be associated with what appeared to be cash on the balance sheet. That's a tiny piece of data but when everything changes it suddenly becomes very significant, he said.

I don't see how the user understands all this information. So the recommendations from our advisory committee on improvements to the financial reporting system support this whole notion of trying to use more judgement because of the principles-based accounting that we should be using in the future.

Conrad Hewitt, Chief Accountant, SEC

The answer could well be different types of reports, which with technological change moving in the direction it is, would be much easier and more feasible than in the days of talking only in terms of huge paper documents. We have to recognize a fundamental fact, said one interviewee, and that is that our one size fits all reporting model simply doesn't work. We have different users, different needs, and we need a reporting model that addresses the needs or as many of the needs of as many of those investors as we possibly can. We need to report possibly even more information than we report currently but it doesn't have to be as complex as it is.

The answer, suggested one interviewee, depends on the presumed level of sophistication of the target audience: broadly: the 'Aunt Agathas', the average stockbroker, and the sector analysts. The accounts were always too complex for the first group; they have been for many years for the second; and the third cannot get enough of the detail.

And, of course, there are other burgeoning means of gaining an understanding of financial statements. Users, said one interviewee, will go to other means to try and understand the economics of a company, whether it is analyst reports, or newspaper reports, or an attempt to identify selected key performance indicators - there is always some information that rests outside the financial statements. He concluded that: complexity has

made the financial statements, the reporting model, less relevant than it was.

Key points

- Users find it difficult to identify the really important information or understand the "essence of the business" from the financial statements
- Some investors don't necessarily rely on the financial statements anyway
- It is difficult in some circumstances for preparers to judge what is important to users
- For individual shareholders, financial statements have always been too long and complex
- Professional analysts always want more information
- Information which could prove important may be inaccessible or even missing from the financial statements

4.3 The Value of XBRL to the Process

XBRL should enable users to source the quality information they require at speed and in the form they want it. The focus of the company is on day-to-day management, said one interviewee, which is not as relevant to the view needed by users. Operational managers focus on simpler metrics while professional investors prefer a more sophisticated approach. The solution to this need to recognize the different purposes and users of accounts may be XBRL. Then perhaps the different components of the information pack can be used for different purposes.

The new interactive data, which we call XBRL, will, I think, allow users to get more important information with less effort and on an easier, more timely basis. So I think that's very important. Maybe that'll help eliminate some of the unimportant information in our financial statements.

Conrad Hewitt, Chief Accountant, SEC.

Other interviewees also suggested XBRL as, in part, a solution. If you are a professional user, said one, you can look at the top line revenues and you can click and it might ask you if you wanted to see the company's six different revenue sources. Click. Then it might ask you if you would like to see the accounting policies for each. Click. And then it might ask you if you would like to see a comparison of the last three years in each of these products. Technology can do all this stuff and so cater for different levels of demand for detail, he said.

But there were also doubts from some over the ability of XBRL to provide sophisticated enough information. A challenge for XBRL's standard formats, suggested one interviewee, is that complex business details may be forced into a pre-determined matrix, which would be unhelpful for an innovative company within a sector

Key points

- Technology could provide the ability to "drill down" from summarised information.
- Consider different aggregation/layering/ tiering of information to different user groups – facilitated by XBRL.

4.4 Making Communication Simpler

There were many other non-accounting ways to improve the communication of company performance suggested by interviewees. Probably their essence could be summed up in one comment: We need to use more straightforward language in a simpler manner.

Financial statements and financial information ought – to a reasonably knowledgeable reader – to give them an indication of the extent to which the financials accurately reflect the condition and performance of the underlying business. And I would think that it would be that focus on clarity or transparency that could go a long way.

Mark Olson, Chairman, PCAOB

Interviewees were often quite apologetic about recommending ways of improving communications. It sounds trite, said one interviewee, but the quality of English that is used in drafting financial statement notes is often very poor and people don't focus on writing clearly and articulating points clearly. At the same time the interviewee recognized that sometimes people have an interest in obfuscating rather than clarifying, and that the notes are sometimes not produced to inform but as an attempt to provide some data while not really explaining fully what its implications are.

There are a lot of situations today where I think we see management saying, well that may be what the financial statements say but this is the picture you really should look at. If principles based standards help to move those two closer together, that should be a good thing for users.

John Carchrae, Chief Accountant, Ontario Securities Commission.

In some cases this was blamed, again, on the lawyers. Many people in the accounting community, said one, say that they write the management commentary and then the general counsel's office reviews it and there is a battle over all the things that the general counsel wants to pull out.

Overall there were calls to simplify the information, to be more flexible in meeting the needs of different constituencies, to place more emphasis on the 'true and fair' principle, to tailor disclosure to the needs of specific groups and overall to use better semantics and vocabulary. The profession, said one interviewee, uses words which are meaningless to many people. There were calls to rid the statements of jargon and standardized terms which were not understood in different jurisdictions.

If you simply take the current financial reporting model and conclude that is all you need to fix with the principles based approach, then you are going to fall short of providing information that is truly relevant. You will improve the standards, but you will fall short of improving the quality of the reporting.

Mike Starr, Grant Thornton

Several people cited the annual shareholder letters produced by legendary US investor Warren Buffett as an example of the style which people ought to seek to emulate. One interviewee suggested that maybe the best rule of all would be a rule which said "read Warren Buffett's annual shareholders' letters and try to write like that". Another interviewee put it succinctly: Narrative will be more and more important. Another concluded that he thought it was a long-term journey, not an immediate one. He thought that the best all

those involved could be doing today is to create the appropriate platforms and forums for the topics to move forward substantively because it would all take some time.

A more principles based framework allows you to get to the heart of the matter. Let me give a concrete example. Some of the best financial reporting I've ever seen is in Warren Buffett's annual letters to shareholders. You read the letters - and keep in mind you're dealing with a pretty dry subject - a large part of his business is insurance - but you read the letters and they're interesting and he focuses on what seems to be important, and by the time you're at the end you feel you have a pretty good sense of the business and how the business is doing.

Michael Young, Willkie Farr & Gallagher

But there was no doubt and a clear consensus that narrative reporting, management commentary and other non-financial information would help alleviate the problem which currently exists through so much complexity in financial statements.

Key points

- Praise for the Warren Buffett Letter to Shareholders – provide a good sense of the business and how it is going.
- Ideas for improvement include: more narrative reporting; a focus on straightforward language; less jargon and coded language.
- Concerns over legal exposure complicate the language.

5. Issues for Further Consideration

Based on the research, the GAA calls for the following questions to be considered by the key stakeholders in financial reporting:

1. Should an agreed international framework for accounting standards be adopted - with a clear hierarchy comprising (i) the conceptual framework which sets out the fundamental principles; (ii) outcome-oriented and principles based standards which establish how the fundamental principles are applied to particular subject areas; and (iii) sufficient additional guidance to facilitate practical implementation of the standards?
2. Should guidance be provided for preparers and auditors on the exercise of judgement in the application of principles based standards and on the documentation of reasons for the judgements made, for example by means of an internationally accepted professional judgement framework?
3. Should regulators be encouraged to accept a reasonable degree of variation in accounting treatments and to take a more effective, outcome oriented approach to regulating, engaging more experienced staff as necessary to support this approach? As a first step, should we encourage a debate with regulators as to what is a “reasonable degree of variation” in accounting treatments?
4. Should a single definitive set of general purpose financial statements be retained, or should we accept that it is impossible to fulfil the needs of all users with one set of financial statements?
5. Should standard setters, in conjunction with business, investors and other users, be encouraged to actively seek to drop requirements considered redundant or superfluous?
6. How can company boards be encouraged to focus on the communication value of the financial statements rather than the compliance aspects? Why are Warren Buffett’s letters regarded as so effective?
7. By reference to existing precedents and market practices in this area, should an international framework for high level summary financial statements be developed which can provide information suitable for retail and less sophisticated investors, encapsulating summary financial information drawn from the general purpose financial statements and balanced and informative narrative information?
8. Should general purpose financial statements be developed and published in XBRL format so as to form an information database which allows users to drill down to whatever level of detail is required?
9. Should company communication be improved through the use of clearer language, less jargon and coded language, and a focus on clarity and transparency?
10. How has the recent financial crisis affected the debate on these issues?

The GAA is undertaking a series of events at which these recommendations can be discussed between the relevant stakeholders.

INTERVIEWEES AND POSITION AT TIME OF INTERVIEW

Paul Boyle, Chief Executive of the UK Financial Reporting Council (FRC), and Chairman of the International Forum of Independent Audit Regulators (IFIAR)

John Carchrae, Chief Accountant, Ontario Securities Commission

Kenneth Daly, President and CEO, National Association of Corporate Directors, Washington

Jeffrey Diermeier, President and CEO, CFA Institute

Jeremy Hand, Chairman and Vincent Neate, Member of the Legal & Technical Committee, British Private Equity & Venture Capital Association

Bob Herz, Chairman, Financial Accounting Standards Board (FASB)

Conrad Hewitt, Chief Accountant, Securities & Exchange Commission (SEC)

Jeroen Hooijer, Head of Accounting and Ulf Linder, Deputy Head, European Commission

Russell Loubser, CEO, JSE Securities Exchange, South Africa

Jeffrey Lucy, Chairman of Australian Financial Reporting Council (FRC) and IASC Foundation Trustee

Patrice Marteau, Chairman of MEDEF; Member of IASB Standards Advisory Council and EFRAG Supervisory Board; Chairman of ACTEO and Chair of the Business Europe Accounting Harmonisation Working Party

Mark Olson, Chairman, Public Company Auditing Oversight Board (PCAOB)

Robert Overend, Audit/Technical Partner, Ernst & Young UK

Michel Prada, Chairman of the Autorité des Marchés Financiers (AMF) and Chair of the International Organisation of Securities Commissions' (IOSCO) Technical Committee and Sophie Baranger, Director of the AMF Accounting Division

Mike Starr, Chief Operating Officer, Grant Thornton International Ltd

David Tweedie, Chairman, International Accounting Standards Board (IASB)

Jeff Willemain, Global Managing Partner - Regulatory & Risk, Deloitte Touche Tohmatsu and Head of the Global Public Policy Committee (GPPC)

Mike Young, Partner, Willkie Farr and Gallagher

Liu Yuting, Director-General in charge of accounting standards and regulation, Chinese Ministry of Finance

INTERVIEW QUESTION FRAMEWORK

Practical Application of Principles

1. What do you understand by the term “principles based standards”? Is it worthwhile to distinguish between principles based accounting and rules based accounting?
2. In your opinion, what are the key reasons underlying the development of longer, more detailed accounting standards?
3. What do you see as the main barriers to the practical application of a more principles based accounting framework?
4. Is the accounting profession as currently constituted capable of operating within an environment of principles based accounting standards?
5. How are users of financial statements served by a move to principles based accounting?
6. Are regulators willing to accept a principles based approach to accounting, where the exercise of judgement could result in a range of accounting treatments of fairly similar items?
7. Are companies and auditors willing to accept a principles based approach to accounting and the exercise of judgement, which that requires?

Complexity & Detail in Financial Statements

1. To what extent do you feel that financial statements have become too lengthy/detailed/complex?
2. What is the impact on users of longer, more detailed financial statements?
3. In your opinion, what are the key reasons underlying the development of longer, more detailed financial statements?
4. How could the length and complexity of financial statements be reduced whilst giving users the key information that they need to know?
5. Could a more principles based approach facilitate the disclosure of key information for users, whilst dropping more detailed, less useful information?
6. Is there sufficient trust in company management and auditors to support a more principles based accounting regime to this degree?
7. More generally, how could the communication of company performance to a company’s stakeholders be improved?

THE GLOBAL ACCOUNTING ALLIANCE

The Global Accounting Alliance (GAA) was formed in November 2005 and is an alliance of leading professional accountancy bodies in significant capital markets. It was created to promote quality services, share information and collaborate on important international issues. The GAA works with national regulators, governments and stakeholders, through member-body collaboration, articulation of consensus views, and working in collaboration, where possible with other international bodies, especially the International Federation of Accountants (IFAC).

The Alliance facilitates a co-operation between nine of the world's leading professional accounting organisations:

- American Institute of Certified Public Accountants (AICPA)
- Canadian Institute of Chartered Accountants (CICA)
- Hong Kong Institute of Certified Public Accountants (HKICPA)
- Institute of Chartered Accountants in Australia (ICAA)
- Institute of Chartered Accountants in England and Wales (ICAEW)
- Institute of Chartered Accountants in Ireland (ICAI)
- Institute of Chartered Accountants of Scotland (ICAS)
- New Zealand Institute of Chartered Accountants (NZICA)
- South African Institute of Chartered Accountants (SAICA)

These organisations represent over 750,000 professional accountants in over 140 countries from around the globe.

The GAA was established to promote quality services, share information, and collaborate on important international issues, whilst operating in the interest of a quality accounting profession and the public interest. The overriding objectives of the GAA are those of operating in the interest of a quality accounting profession and the public interest.

In addition, the GAA has the objective of:

1. Enhancing the accounting profession and business through global leadership in the areas of thought leadership and research.
2. Assisting the development of national accounting institutes and their national qualifications
3. Promoting the brands represented by the member bodies through their linkages with the GAA, enabling growth for the member organisations.
4. Increasing advocacy leverage with national regulators, governments and stakeholders through member body collaboration, articulation of consensus views and working in collaboration with other international bodies such as IFAC.
5. Increasing member benefits through overseas support mechanisms and value adding services.
6. Promoting the international portability and recognition of the respective national qualifications, including specialisations, while ensuring that we always act in the public interest and do not set up any real or perceived barriers to other professional accounting bodies being able to conduct their business in any country.