



The Hundred Group
of Finance Directors

The economic crisis

Assessment of the affects and implications by
The Hundred Group of Finance Directors

Autumn 2009

Introduction

- In observing first hand the impact of the credit crisis over the past year or so, the Hundred Group has followed the work of Regulators, Governments, Standard Setters and other Commentators as each has sought to identify the cause of the crisis and how to react to ensure such severe problems are not encountered again.
- In the immediate wake of previous crises such as the Enron and WorldCom failures, there was clear evidence of knee-jerk regulation and legislation in jurisdictions outside the UK (the largely mechanical approach in Sarbanes-Oxley failed to deal with some of the more substantive governance and accounting issues). The Hundred Group is pleased that the UK Government has adopted a more measured approach to regulatory reform.
- We as Finance Directors, have been keen to assess the affects and implications under three broad themes:
 - **The role of Financial Reporting** – Given the length and complexity of Annual Reports, can they be relied upon to provide meaningful information to users?
 - **The role of Accounting Standards** – Has the current economic crisis highlighted deficiencies in Accounting Standards and the Accounting Standard setting process?
 - **The role of Corporate Governance** – Would a different approach to Corporate Governance and Risk Management have helped avert the recent economic crisis?
- This paper outlines the Hundred's Group's hypotheses in relation to these questions and provides a summary of our findings. It is our intention to constructively add to the debate and call on stakeholders to remain focussed, measured and balanced in providing a regulatory framework that both protects stakeholders and encourages business growth and enterprise. The Hundred Group believes that there is a place for better, not more, regulation which focuses on the most important issues.
- In drawing our own conclusions, this paper asks the question "**what next?**" – what role should the Hundred Group play in influencing the debate over the coming months?
- The Hundred Group is a non political, not-for-profit organisation which represents the finance directors of the UK's largest companies, with membership drawn mainly from constituents of the FTSE100. Our aim is to contribute positively to the development of UK and International policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. Whilst we outline below the views of The Hundred Group of Finance Directors as a whole, they are not necessarily those of our individual members or their respective employees.

The role of Financial Reporting

QUESTION: Given the length and complexity of Annual Reports, can they be relied upon to provide meaningful information to users?

Hypothesis	Actions to test the hypothesis	Findings
<ul style="list-style-type: none">▪ Within the constraints of existing regulation, the Hundred Group believes that its members faithfully and appropriately report the financial results, financial performance and business risks to stakeholders.	<ul style="list-style-type: none">▪ The Hundred Group will leverage analysis undertaken elsewhere, in particular PricewaterhouseCoopers' ("PwC") Corporate Reporting Group, which annually surveys the Annual Reports of the FTSE 350, and the Financial Reporting Review Panel ("FRRP"), which annually regulates financial reporting through its independent review.▪ As appropriate, the Hundred Group will undertake its own analysis to confirm the work and conclusions of others.	<ul style="list-style-type: none">▪ We met with both PwC and the FRRP to discuss their reviews of Annual Reports.▪ We recognise that some improvements can be made to the extent and relevance of narrative and financial reporting, but neither party has identified fundamental flaws in FTSE 100 Annual Reports (see Appendix 1).
<ul style="list-style-type: none">▪ The current regulatory framework adds unnecessary complexity to financial reporting. The Hundred Group does not believe that the existing model is broken, but that a more pragmatic approach to reporting would lead to more useful financial information.	<ul style="list-style-type: none">▪ The Hundred Group is aware that a number of Complexity projects have already been undertaken by bodies such as the Financial Reporting Council ("FRC") and the Global Accounting Alliance. The Hundred Group will meet with the Financial Reporting Council to debate its findings.▪ The Hundred Group may meet with users to understand first hand how investors use financial information, whether an alternative approach to disclosure would be beneficial.▪ Finally the Hundred Group will meet with the International Accounting Standards Board ("IASB") and the FRRP to debate both the IASB's approach to disclosures within Accounting Standards and the FRRPs approach to its review of Annual Reporting.	<ul style="list-style-type: none">▪ We met with the FRC and support, in principle, its conclusions (see Appendix 1).▪ We continue to have constructive and open dialogue with the IASB and support their aim of delivering high quality, global accounting standards.

The role of Accounting Standards

QUESTION: Has the current economic crisis highlighted deficiencies in Accounting Standards and the Accounting Standard setting process?

Hypothesis	Actions to test the hypothesis	Findings
<ul style="list-style-type: none">▪ The current economic crisis has identified flaws in the IASB's accounting standard setting process. The IASB has been slow to react to emerging issues since its agenda is inappropriate and inflexible. Indeed certain convergence standards have jeopardised the quality of IFRS.	<ul style="list-style-type: none">▪ The Hundred Group will reconsider its "Statement of Principles" in order to re-establish the characteristics of good quality Standards.▪ The Hundred Group will measure a selection of recent Accounting Standards (or drafts) against its principles to assess whether the IASB is generating good quality Accounting Standards.▪ The Hundred Group will consider the IASB's agenda and provide its view of the projects that the IASB should focus on.▪ The Hundred Group will critique the IASB's process and provide views on how to structure a "fast-track" process.	<ul style="list-style-type: none">▪ Our new Statement of Principles is included in Appendix 2. It is our view that some of the IASB's more recent projects are not meeting these principles.▪ Our assessment of the IASB's Forward Agenda is outlined in Appendix 3, whilst Appendix 4 provides commentary on the IASB's standard setting processes. We believe improvements can be made.
<ul style="list-style-type: none">▪ Accounting standards have not been the cause of the recent economic turmoil, however the crisis has identified that the procyclical nature of IAS 39, in particular, has compounded some problems within Financial Institutions.	<ul style="list-style-type: none">▪ The Hundred Group will consider whether better Accounting Standards would have avoided some of the issues arising from the economic crisis, in particular:<ul style="list-style-type: none">▪ The use of fair value and the complexity of valuing in illiquid markets;▪ The impairment model; and▪ The consolidation model.▪ The Hundred Group will draw upon its own experiences (specifically the experiences of its Financial Services members) and consult with Big 4 technical departments and the FCAG as required.	<ul style="list-style-type: none">▪ The Hundred Group has identified some flaws with financial instrument standards and, more generally observes the complexity of accounting standards.▪ We support the IASB's review of IAS 39 and anticipate that simplification of this standard will lead to better, more decision-useful information.

The role of Corporate Governance

QUESTION: Would a different approach to Corporate Governance and Risk Management have helped avert the recent economic crisis?

Hypothesis	Actions to test the hypothesis	Findings
<ul style="list-style-type: none">▪ The Hundred Group believes that the existing Corporate Governance model (as set out within the Combined Code) is not fundamentally flawed nor that a different framework could have prevented the current economic crisis.	<ul style="list-style-type: none">▪ The Hundred Group will consider the Combined Code to assess areas that it considers may require attention.▪ The Hundred Group will meet with Sir Christopher Hogg from the FRC to exchange views.	<ul style="list-style-type: none">▪ We have not identified any areas within the existing Code that require urgent attention.▪ Appendix 6 provides a summary of our views.

The Hundred Group conclusions

THE ROLE OF FINANCIAL REPORTING

Initial conclusion: The Hundred Group believes that Annual Reports provide meaningful information to investors, but recognise that further improvements to corporate reporting can be achieved through a combination of supportive regulation and by increased effort by preparers. The Hundred Group supports the work of the FRC with regard to complexity, and more generally, other parties who are looking at longer-term proposals to enhance the totality of investor reporting.

What next?

- We will assist the FRC in working through its Complexity actions (see Appendix 1).
- We will consider voluntary changes to our approach to financial reporting and will seek to involve Investor Groups (such as CRUF), PwC, the ICAEW and the FRC as we develop “best practice Annual Reports”.
- We will encourage our members to take-on the outputs from the actions above.

THE ROLE OF FINANCIAL ACCOUNTING

Initial conclusion: The Hundred Group believes that the economic crisis has identified some deficiencies in accounting standards, notably the complexity of IAS 39, but that generally IFRS has stood up well to the test. The Hundred Group supports independent global accounting standards, but believes that the priorities, process and conclusions of the IASB should be improved.

What next?

- We will work with the IASB to support it in developing high-quality global accounting standards.

THE ROLE OF CORPORATE GOVERNANCE

Initial conclusion: The Hundred Group does not believe the Combined Code is fundamentally flawed and we believe that good governance is not about regulation, but about people, behaviours and culture. In our view further legislation would not deliver a “step-change” in governance. The Hundred Group recognises that, within the Financial Services sector, there is an opportunity to improve the role of the regulator and that the existing infrastructure should be used to deliver improvements. The Hundred Group observes that corporate governance reporting could be improved to provide better insight into its application within FTSE 100 companies.

What next?

- We will assist the FRC in assessing the existing Combined Code.
- We will consider improvements to Corporate Governance disclosures as part of the Financial Reporting work streams (above).

Appendix 1

Complexity of financial reporting

- The Hundred Group recognises that a number of parties survey Annual Reports and, accordingly, rather than undertake our own primary research, we have leveraged the work of others.
- The FRRP annually reviews Annual Reports, and publishes its findings¹. These reviews cover reports issued by the Financial Services Sector. Summary conclusions include:
 - The Panel reviewed more accounts in 2008/9 than in the previous year and wrote less letters to companies and on the basis of accounts reviewed, the Panel concluded that the standard of corporate reporting in the UK remains good. With regard to Bank accounts, the Panel observed the difficulty in meeting the needs of different stakeholders (including regulators) and the complexities of IFRS 7 disclosures.
 - 10 Financial Sector Annual Reports were reviewed in the period to 31 March 2008 (16 in the period to 31 March 2007), and no set was found to be deficient. The Panel found that whilst some refinement to disclosures would be taken on by those entities reviewed in 2009, there were no systemic weaknesses and no material issues regarding measurement or recognition. Such statistical analysis was not provided by the FRRP in its 2008/9 report, and the sector will remain a priority of the Panel in 2009/10.
- Furthermore, the FRC has met with PwC's Corporate Reporting Group and discussed its review of Narrative Reporting².
 - PwC notes considerable improvement in Corporate Reporting by the FTSE 100 companies over the past few years, with some very good examples of effective communication. It also recognises the investment applied by companies to deliver meaningful reports.
 - PwC is currently reviewing 2009 Annual Reports, noting improvements again. It does not believe that the 2009 round of reporting has cast doubt on the adequacy of reporting in prior periods.
 - More generally, PwC identify areas where Corporate Reporting could be improved, most notably around "joining the dots" between strategic priorities, management actions, remuneration and performance. It found that narrative reporting was improving across the FTSE 350 but that there was room for improving the effectiveness of reporting and the accessibility of relevant financial information. It believes that the Hundred Group has a role to play in delivering improvements.
- More generally, Annual Reports are getting longer, with research by Deloitte³ indicate a third longer than in 2005. The same Deloitte survey did not identify any systemic issues with IFRS 7 disclosures, although the report commented on differences in approach and location within the accounts.

References:

1. *FRRP Review Findings and Recommendations 2009, 2008 and 2007*.
2. *Joining the Dots, A summary of the narrative reporting practices of the FTSE 350, PricewaterhouseCoopers*.
3. *Right to the end: Surveying financial statements in annual reports, Deloitte*.

Appendix 1

Complexity of financial reporting (continued)

- The Hundred Group recognises that many stakeholders believe that Annual Reports are difficult to penetrate and are overly complex.
- We believe that the balance between meaningful and compliance based disclosure has shifted, with accounts passing the compliance test but including swathes of immaterial disclosures. We also observe that financial disclosure has been “added to”, rather than pulled together in a more strategic, coherent manner. We are concerned that Investor Relations has become a parallel process to financial reporting.
- We note that our conclusions are similar to those formed by the Global Accounting Alliance, the FRC and the Financial Crisis Advisory Group.
- The FRC (through its recent publication *“Louder than words”*) is calling for support to assist it in progressing its Complexity Project. It notes:

Less complex regulation	Effective communication
<ul style="list-style-type: none">▪ Improve cash flow reporting – It believes that cash flow reporting is not meeting the needs of investors (and that the IASB’s Financial Presentation Project is not providing a better model). It would like to launch a project to investigate the needs of investors with a view to providing best practice guidance.▪ Disclosure project – it would like an organisation to kick start a review of “useful disclosure”, and asks for a body to volunteer.▪ Wholly-owned subsidiaries – it questions the need for such onerous subsidiary reporting requirements.▪ Improve usability of IFRS – it asks the IASB to consider using “simple language” so that the standards are easier to use, easier to understand and are based upon principles.	<ul style="list-style-type: none">▪ The Financial Reporting Council believes that effective communication is based upon preparers being:<ul style="list-style-type: none">▪ Focused;▪ Open and honest;▪ Clear and understandable; and▪ Interesting and engaging.▪ The Financial Reporting Council asks that preparers to remember that immaterial disclosures undermine the quality of reports and that preparers should make a concerted effort to cut clutter.▪ It recognises that sources of regulation are contributing to clutter in Annual Reports.

- The Hundred Group supports the FRC’s project and has initiated its own Corporate Reporting project with the aim of meeting with auditors, regulators and users of accounts to assess what practical steps can be taken to improve the usefulness of Annual Reports.

Appendix 2

The Hundred Group's Statement of Principles

Refer to our website: www.100groupfd.co.uk



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Appendix 3

The Hundred Group's assessment of the IASB's agenda

- The Hundred Group has identified the following issues with regard to the IASB's standard setting agenda:
 - Incremental changes to accounting standards are unhelpful as they affect the stability and understanding of the capital markets. The IASB's limited resources should target those areas where more radical reform is needed;
 - Certain projects are focusing on areas which are not "broken". Whilst we recognise that convergence is an important aim, the haste to converge jeopardises the quality of IFRSs;
 - The IASB has decided to consider certain projects separately whereas addressing them together will engender more consistent standards; and
 - The IASB's agenda setting process is delivering an agenda that is not always relevant and is over-ambitious in its scope.

Priorities

- We believe that the IASB should focus wholly on financial crisis related projects, most notably its review of IAS 39. Other projects should be delayed to ensure that the Board allocates sufficient resource to delivering a high-quality standard that simplifies IAS 39, whilst meeting the needs of all businesses.
- The IASB's attention should then turn to completing the Conceptual Framework and improvements to Financial Statement Presentation (including discontinued operations). The Hundred Group recently commented on the IASB's Discussion Paper on Financial Statement Presentation, as we felt that it was missing an opportunity to deliver a better presentation model.
- A number of "convergence-critical" projects should also be considered by the IASB, but the Board should not compromise on the quality of standards to achieve convergence.
- We believe that the IASB should reassess its agenda setting process, to ensure it focuses on the matters that require urgent attention and meets the demands of all constituents. We are encouraged by the steps being proposed in the review of the IASC Foundation Constitution.

Appendix 4

The Hundred Group's “fast track” process

- The IASB's current standard setting process is set out in its Due Process Handbook (published in April 2006).
- The Hundred Group is satisfied that the current steps outlined in the Handbook and welcome the concepts of effect analyses, feedback statements and post-implementation reviews (though we have not yet had many instances of these concepts in action). We would encourage:
 - Clearer explanation of the problem that the IASB is attempting to address with its proposals, i.e. how its proposals will improve financial reporting;
 - Greater engagement with constituents before proposals are issued;
 - Open debate of different solutions in DPs (we are observing a worrying trend that only one option is put up for discussion);
 - Meaningful feedback statements, through identification of the common themes arising through the comment period and how these issues were addressed in the subsequent stage of the process;
 - More transparency concerning the field-testing of proposals that is being undertaken with both users and preparers; and
 - More rigorous cost/benefit analysis.
- We have yet to see evidence that the IASB's due process results in substantive changes to its proposals – this is the real test of whether a process is effective, after all, even the IASB cannot get things right every time. We are therefore sceptical as to whether the IASB's due process is effective or whether it is a way of paying lip service to consultation.

An increasing stakeholder group

- The IASB should be applauded for its progress in delivering global accounting standards. Over 100 countries adopt, or are committed to adopt IFRS's.
- With success comes greater challenge, and we would encourage the IASB to consider enhancements to all its processes so that the views of all constituents are considered equally, fairly and free of political bias.

Appendix 4

The Hundred Group's "fast track" process (continued)

When should the IASB use a fast track process?

- We understand the need for prompt action in unprecedented times, but we are concerned that if accounting standards are amended too hastily their quality may be undermined. It is our view that due process still needs to occur and that any "fast-track" procedure must therefore truncate, rather than omit, the key steps. Further, we believe that due process involves not only giving constituents sufficient time to submit their comments, but also allowing sufficient time for the IASB to give those comments full and proper consideration. We are concerned that if proposals are perceived to have been a "done deal", the effect will be to undermine confidence in the standard-setting process.
- With this in mind, the Hundred Group makes the following observations:
 - The IASB's forward agenda should consider emerging issues and predict the impact of macro economic issues. The IASB has been criticised in recent times for being reactive, rather than proactive. We would therefore encourage it to reassess the processes and procedures it has in place in setting the agenda;
 - Matters of interpretation should continue to be referred to IFRIC and minor issues should continue to be addressed by the Annual Improvements projects; and
 - A fast track process should only be used in exceptional circumstances and not be used for improper or inappropriate reasons.

What are the critical steps of a fast track process?

- As outlined above, the risk of a fast track process is that it impacts the quality of IFRSs and/or gives insufficient regard to the views of users and preparers of financial information. To this end, we would recommend the following:
 - Publication of an ED with a minimum comment period of 30 days;
 - During the comment period, the IASB should hold roundtables with the Global Preparers Forum, the Users Forum and the SAC to ensure it understands first hand the concerns of constituents;
 - Any new IFRS (or amendment) arising should incorporate an Appendix that outlines a summary of the public comments and how these have been addressed within the standard;
 - The process should allow for re-exposure, should the comments received warrant such action;
 - Fast track first time adoption rules should reflect the practical difficulties that may be incurred by preparers; and
 - Any issue subject to the fast track process should automatically be added to the IASB's forward agenda – either as a standalone project or a wider project – to test that full due process would have concluded in the same manner as the fast track process.



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Appendix 5

The Hundred Group's assessment of financial accounting implications

- The Hundred Group has considered whether the current economic crisis has highlighted deficiencies in Accounting Standards and the Accounting Standard setting process.
- In conclusion, we observe issues arising from:
 - Complexity (as addressed in Appendix 1); and
 - Financial instruments.
- We support the IASB's review of IAS 39 and anticipate a simplified approach to financial instruments will be welcomed by preparers and users (see comments in Appendix 3).
- In our recent comment letter on the IASB's proposals to changes to the consolidation model, we observed that off balance sheet issues appear to be arising in the US, and not with IFRS reporters. In our view there are no flaws in the existing IASB consolidation standards and interpretations.
- The Hundred Group concluded that no other specific accounting issues were identified as a result of the crisis.

Appendix 6

The Hundred Group's draft assessment of Corporate Governance

- There has been widespread commentary on the banking crisis and the causes thereof, and almost all commentators have identified some form of failure in Corporate Governance. However few commentators have gone as far as to say that there are fundamental flaws within the Combined Code.
- The Hundred Group observes that there was not one “root-cause” of the recent financial crisis and that isolating Corporate Governance is inappropriate. We do however note that the failings of some organisations, most notably in the Financial Sector, do put into question the effectiveness of risk identification, risk mitigation and risk reporting. However, structural factors beyond anyone’s control also played a significant role in the current financial crisis and few were able to comprehend the full spectrum of their corporate actions.
- We agree that a review of systemically important financial institutions is required, but within the framework of existing, rather than new, regulation. Sir David Walker’s findings may apply more broadly, but there is no evidence to suggest governance failure across the remainder of the business sector, nor has evidence emerged that an alternative governance model has proved more robust.
- The Hundred Group supports a Code that:
 - Is founded on *principles*;
 - Encourages diverse boards composed from a broad talent pool of executive and non-executive directors;
 - Recognises that the board is responsible for challenging business strategy, risk management and financial performance;
 - Continues with a *comply or explain* approach to compliance;
 - Recognises that institutional shareholders play an important role in challenging the effectiveness of boards and that these powers should be exercised in practice;
 - Encourages open and honest disclosure, by companies, of their approach to risk management; and
 - Encourages competitiveness and enterprise within the UK.
- In our view, the economic crisis may result in a change in behaviour, as we all now have relevant experience of “expecting the unexpected”. It is our belief that many of our members are already challenging the application of the governance framework within their organisations with changes to areas of focus and increased time being spent⁴ – reassessing their approach to strategy, risk management (identification, mitigation and reporting) and remuneration.

References

4. The Audit Committee Institute, sponsored by KPMG, International survey of audit committee members.