The Corporate Reporting Users' Forum

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IASB/FASB Joint Board Meeting

Speakers

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- Peter Elwin, Head of Accounting & Valuation Research, Cazenove Equities
- Peter Reilly, Capital Goods Research, Deutsche Bank
- Sue Harding, European Chief Accountant, S&P Ratings Services
- At the table:
  - Nick Anderson, Head of Research, Insight Investment
  - Jed Wrigley, Fund Manager, Fidelity International

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- www.cruf.com
- Discussion forum founded in 2005 with the objective of influencing the future development of accounting standards (US and IFRS)
- Membership covers buy and sell side, equities and credit
- Members have global or regional responsibilities, located in UK, US, Germany, South Africa, & Australia
- No fixed chair and does not seek to achieve group-wide consensus prior to commenting
- We focus on what matters to us as users (only comment when a majority of members think it's worth it)
  - CRUF members act as individuals and do not necessarily represent the views of their organisations

CRUF comment letters

- Included in your pack:
  - To IASB and FASB - re the performance reporting project
  - Fair Value definition in existing standards (FAS 157)
  - Conceptual Framework (with a similar letter to EFRAG)
  - Intangibles
- Available on the website:
  - To SEC - supporting the removal of the reconciliation
  - To the FT - re pensions accounting
  - Business Combinations II
  - Performance Reporting (amendments to IAS 1)
  - Segmental Reporting
  - Pensions

Financial reporting - our overriding objective

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- We aim to understand and forecast business activity
  - operating flows are generally much more important than spot values
- We need
  - Financial information that presents business reality as seen by a rational external investor (not through the eyes of management)
  - Financial statements that reconcile to each other
  - Clear differentiation between operating/financing/investing
  - An underlying post-tax earnings figure (NOT Comprehensive Income)
- We need to be able to identify capital invested and how well management have used this capital (stewardship)
  - Not just “Buy/Sell”, but “Intervene” as well (e.g. private equity, loan finance, tracker funds)

Financial reporting - not the whole answer

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- We do not need (or want) financial reports to provide us with the answer
- But they should be a key source of comparable, reliable, consistent data

The rest of this presentation…

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- Peter Reilly will now provide a practitioner's perspective on several accounting issues
- Sue Harding will then summarise with some thoughts on the future direction of standard setting
- Q&A

The view from the front line

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- We have chosen to highlight four topics
  - A long-standing weakness that has never been addressed
  - A fundamental change that we regard as a major success
  - A recent development that is proving to be a retrograde step
  - A potential development that we have reservations about
- *Please note: these are the personal views of Peter Reilly*

Cash flow disclosure is wholly unsatisfactory

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- Some personal observations on cash flow:
  - Cash flow analysis is extremely important; cash flow is the ultimate driver of value
  - It is unnecessarily difficult to do in a coherent manner
  - I have never met an investor (or CFO) who regards current standard as satisfactory
  - Several major accounting implosions were linked to abuse of cash flow disclosure, yet there has been no real reform
  - Direct/indirect debate is not the issue
  - I think a well-structured overhaul would be enormously popular

Cash flow disclosure: what's wrong

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- Major things are missing or misleading:
  - No reconciliation between cash flow and net debt movement (this is by far the single biggest complaint)
  - Debt at acquired (and divested) companies is not disclosed, nor is currency impact on overall debt
  - Many cash flow items are not cash flow at all
  - Many headings are opaque, even to experienced investors
  - Extracting a satisfactory operating or free cash flow number can be very difficult
- It will be impossible to get consensus on the 'right' format. But it should be possible for users to rebuild the cash flow statement - in their preferred format - in a way that reconciles with the balance sheet

Stock option expensing was a major success

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- Stock option expensing was hugely controversial, especially in the US
- Classic conflict between shareholders and employees, who were trying to extract value from the company without proper disclosure of cost
- Both Boards took the moral high ground despite aggressive lobbying from CEOs
- A good test of a controversial standard is whether it is still controversial several years later; we think expensing is now generally accepted

FAS 142 / IFRS 3 is a retrograde step

- Most investors welcomed the demise of goodwill amortisation; it was usually stripped out anyway
- The creation of new intangibles on acquisition (customer lists, brands, developed technology etc) is a return to goodwill amortisation by the backdoor BUT:
  - It is even more arbitrary (choice of what to capitalise and amortisation period is highly subjective)
  - It is much harder to strip out (usually buried inside EBIT)
  - The problem is getting worse with time as acquisitive companies build up more intangibles
  - Provides no useful information
- *NB creating a new intangible can be very helpful in some cases, e.g. assets with definite fixed lives such as patents, licences*

FAS 142 / IFRS 3 – further observations

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- Writing up acquired inventory to fair value reduces reported profitability for 1-2 quarters after acquisition; this obscures flows and reduces comparability with history and peers
- The process of creating the new intangible assets takes time and reduces visibility during the integration period
- In our experience, investors are:
  - Stripping out PPA amortisation as they regard it as an unwelcome distortion
  - Becoming more unhappy as the problem mushrooms
- We think this is a classic case of a well-intentioned standard creating negative value:
  - extra expense and complication for preparers…
  - …without adding any value for users

Revenue recognition: please tread carefully!

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- Revenue recognition is not a major concern for most investors
- We do understand that current standards need tidying
- We would like any future standard to stay close to a customer consideration model
- We think that a radical re-think is both unnecessary and potentially dangerous
- We would like any new standard to also look at cost recognition, which is often of greater concern to investors

Future direction of standard setting

- Good standards
  - Result in less uncertainty – information risk reduced
    - Result in confidence in the system and facilitate efficient capital markets
  - Accounting/Disclosure provides clear information on
    - Business and financial transactions and risks
    - Accounting policies and choices, assumptions and estimates
    - Consequential assets, liabilities, earnings/OCI, and cash flow amounts
      - where, how much, and relationships between them
    - Estimation risk for numbers used in the accounting, and sensitivities and other information useful in predicting future changes (including those relating to off balance sheet contingencies)
  - Disclosure absolutely key – a single accounting number is not enough

Future direction of standard setting

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- Future changes – 'evidence based'
  - There is a need for the change
  - The change solves real problems
  - Not just to serve the pursuit of conceptual purity
- How can CRUF help provide evidence, based on practical analysis by parties involved in credit and equities?

Future direction of standard setting

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- The Standard Setting Agenda
  - A considerably lengthy agenda currently…
  - Focus on (for example)
    - Conceptual framework
    - Performance statement / cash flows
    - Income taxes
  - High priority, but don't rush
    - Insurance (and any related consequences for other standards)

Future direction of standard setting

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- The Standard Setting Agenda
  - Would not be upset if some projects were delayed (for example)
    - Liabilities and equity, consolidation/JVs, common control, non-financial liabilities, government grants - address after conceptual framework
    - EPS, SBP vesting
  - Other needs not on the agenda?
    - Reconciliation of net debt
    - Meaningful disclosure – better information on risk and risk management

CRUF Guiding Principles

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Principles based

Accounting standards that govern the preparation of corporate reports should be principles-based and comprehensible to the financially literate. These standards should not result in outputs that are at odds with economic reality.

Such standards should be based on the presumption that the stated principles are faithfully applied. Therefore standards should avoid unnecessary detailed prescription and not unduly restrict companies in presenting meaningful results that are in accordance with those principles.

Reality and substance

Corporate reports should report economic reality.

Accounting standards should require compliance with their spirit rather than their letter so that preparers are required to disclose economic 'substance' rather than accounting or legal 'form'.

Clear disclosure supports decision making

Users want transparent and comprehensive disclosures.

Corporate reports should be prepared with the objective of providing a fundamental source of information for investors and creditors on which to base their decisions.

Primaries + notes + extra info

Corporate reports should provide information that is clear, understandable, consistent and relevant.

No single primary statement should take precedence.

Not all information that is relevant for users of corporate reports has to be reflected in the primary financial statements. Some information, such as contextual and non-financial information may best be presented outside the primary financial statements.

Accounting standards should not discourage companies from presenting additional information that is useful to users.

Maintainable cash flow drivers trends

The purpose of the cash flow statement should be to identify and explain cash inflows and outflows over the period. Further, the cash flow and accompanying notes should provide insights into the drivers of maintainable cash flows as well as the trends over time of these drivers.

The cashflow should be capable of comparison and reconciliation with the profit and loss and balance sheet. The impact of acquisitions and disposals on these cashflows should also be clear.

Invested capital stewardship

The purpose of the balance sheet should be to reflect the capital invested in the business along with capital adequacy, compliance with legal covenants and stewardship.

The purpose should not be to determine the entity's fair value. Further information regarding the values of individual assets and liabilities (including assumptions and sensitivities), should be provided in the notes.

Returns Op/Fin/Inv

The purpose of the profit and loss statement should be to identify the returns generated from the capital invested in the business.

The profit and loss and the accompanying notes should clearly differentiate and analyse relevant information, such as: operating performance from financing activities; recurring from non-recurring activities; value changes from trading activities.