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FINANCIAL REPORTING DISCLOSURES: MARKET AND REGULATORY FAILURES

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Financial Reporting Disclosures: Market and Regulatory Failures forms part of the Information for Better Markets thought leadership programme of ICAEW's Financial Reporting Faculty.

There has been growing concern in recent years both at the problem of disclosure overload in financial reporting and that, in spite of the growing volume of disclosures, users still do not get all the information they need. This report argues that current concerns are largely a predictable outcome of the regulatory system, and it makes recommendations to address these concerns.

But it also points out that the current regulatory system is a response to market failures in financial reporting disclosures, that the recommended reforms all have their costs, that reform will require all interested parties to work together, and that there is a need for realism as to how much can be achieved by regulating financial reporting disclosures.

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The ICAEW Financial Reporting Faculty provides its members with practical assistance and support with IFRS, UK GAAP and other aspects of business reporting. It also comments on business reporting issues on behalf of ICAEW to standard-setters and regulators. Its *Information for Better Markets* thought leadership programme subjects key questions in business reporting to careful and impartial analysis so as to help achieve practical solutions to complex problems. The programme focuses on three key themes: disclosure, measurement and regulation.

We welcome comments and enquiries on this work and the other themes in the *Information for Better Markets* programme. To contact us, please email bettermarkets@icaew.com

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FOREWORD

While the focus of this report is on financial reporting disclosures and their regulation, it raises important issues that have a wider resonance.

The extensive regulation of disclosures can be seen as the outcome of developments initially prompted by dissatisfaction with a minority of firms that failed to meet investors' reasonable expectations. But once in place, regulation acquires a logic of its own and tends to be seen as the solution to every problem. Before long, the attitudes of those who contribute to the financial reporting process are changed, and instead of asking 'What do we have to disclose to give a true and fair view?', they are asking 'Where does it say I have to disclose this?'

This attitude is unprofessional, and it leads to the skills that should be devoted to ensuring that investors are properly informed being devoted instead to ensuring that the letter of the law is complied with. But in a highly regulated activity, where non-compliance has potentially serious consequences, such attitudes are understandable and perhaps inevitable.

Financial reporting is not unique in this respect. The same trends can be seen in other areas, such as taxation and financial services, for example. Again, the initial impetus for detailed regulation may come from the need to deal with those who try to take unfair advantage of a system that leaves scope for judgement and professionalism. But the cumulative tendency of ever-tighter regulation is to squeeze judgement and professionalism out of the system.

The public may feel that this is not something that a professional body such as ICAEW is morally entitled to criticise. If everybody involved behaved professionally in the first place, there would be less need for regulation. This is a fair point. But there is a trade-off between increasing regulation and reducing the scope for professional judgement, and when those in the financial reporting process stop asking what they need to do to give a true and fair view, then something valuable and essential to the success of the reporting process has been lost.

If progress is to be made in changing attitudes, so that there is less emphasis on detailed regulation and more emphasis on professional judgement, then all parties involved in the practice and regulation of financial reporting need to work together. There is no one group that can change things on its own. Preparers, users, auditors, enforcement agencies, standard-setters, governments and regulators will all have to agree that there is a need for change, and agree on what needs to be done. Such a fundamental shift will require a change in the climate of opinion, and this report is intended as a contribution to that.

In moving towards a new settlement for the regulation of financial reporting disclosures, it will be important to be realistic about the objective of the exercise. It should not be a single-minded pursuit of transparency. The regulation of financial reporting disclosures should instead be seen as a balancing of interests – between users and preparers, and between owners and managers.

There also needs to be realism about what the detailed regulation of financial reporting disclosures can ever achieve. It is impossible to specify in advance everything of significance that a business might need to disclose at one time or another. The list of disclosures is potentially endless. Ultimately, a space has to be found for professional judgement. And this means that those involved in financial reporting should not be faced with incentives that overwhelmingly deter them from exercising judgement.

EXECUTIVE SUMMARY

CHAPTER 1: PROBLEMS OF DISCLOSURE

There have been widespread complaints of information overload in financial reporting and there is a widely-held view that financial reporting disclosures need to be reformed. Views differ on what exactly the problem is, but few people seem to be happy with the current position.

In this report, we look at the sources of this unhappiness and what can be done about it. The report is international in its coverage, and although much of the evidence that we refer to comes from the US and the UK, the problems that we address are of concern in many countries around the world.

Our focus is on public companies – that is, firms whose shares or other securities are publicly traded. Financial reporting disclosures by private companies do not seem to be a major issue. And we do not address the problems of disclosure in non-financial or narrative reporting. To some extent these overlap with the problems of financial reporting disclosure, but in one respect the problems of non-financial reporting are worse. This is because, to a significantly greater extent than for financial reporting, there are often multiple authorities able to impose non-financial disclosure requirements in reporting to shareholders. These requirements are uncoordinated and often for the benefit of interest groups other than shareholders. This is a distinct problem that needs to be separately addressed.

As regards financial reporting disclosures, we argue that the current degree of dissatisfaction is to a large extent a predictable outcome of the regulatory framework. But this framework is itself a response to failures in the market for financial reporting information. And both market and regulatory failures in part reflect the inherent limitations of financial reporting.

We also argue that financial reporting disclosures need to be seen in the context of the larger corporate financial information environment. The present system of disclosures assumes a particular model of corporate governance. Within this model, the level of disclosure is effectively a compromise between owners and managers, and between preparers and users, and it therefore requires a balancing of interests, not a single-minded pursuit of transparency.

We identify a number of ways in which the regulatory framework should be changed to address current concerns. But we also suggest that there needs to be greater realism about what can be achieved by financial reporting disclosures and their regulation. In particular, there are three fundamental problems of financial reporting disclosure that no market or regulatory solutions can entirely remove:

- **Subjectivity.** Relevance and materiality are subjective judgements. There will always be occasions when some users will disagree with preparers' choice of what it is relevant and material to disclose.
- **Self-reporting bias.** Financial reporting is a product of managers who are reporting on their own performance. Even though the overwhelming majority of managers are honest, and even though their reporting is heavily regulated, a degree of bias is only to be expected.
- **Potential self-inflicted damage.** It is against firms' interests to be completely transparent. Some disclosures will give valuable information to their competitors or to those with whom they contract, which would be to the disclosing firm's disadvantage.

CHAPTER 2: MARKET FORCES

Firms would make financial reporting disclosures even in the absence of regulation because it is in their interests to do so. And it could be argued that, even in the absence of regulation, changes in markets and technologies in recent decades would have led to a significant increase in disclosures. But in important respects the market for financial reporting disclosures does not work like other markets.

CHAPTER 3: MARKET FAILURES

There are four main reasons why financial reporting disclosures are regulated, each of which represents a different type of market failure:

- **Underproduction of public goods.** Because the benefits of financial reporting disclosures cannot be restricted to those who pay for them, they are 'public goods', and therefore tend to be underproduced if their production is left purely to market forces.
- **Lack of comparability.** There are advantages in standardising financial reporting disclosures, and standardisation can be achieved more cheaply and effectively when it is done on a mandatory rather than a voluntary basis.
- **Lack of credible commitment.** Some of the benefit of financial reporting disclosures comes from knowing that they are reliable and some of it comes from having a credible commitment to disclosure. Regulatory regimes may be able to impose more effective enforcement than voluntary regimes, and so may produce both more reliable disclosures and more credible commitments.
- **Information asymmetry.** In the absence of regulated financial reporting disclosures, it is arguably easier for participants in capital markets to take advantage of those who are less well-informed, eg, by selling shares at more than they are worth, by buying them at less than they are worth, or even by committing outright fraud.

While these are all valid arguments for the regulation of financial reporting disclosures, they do not mean that it is an unmixed blessing. On the contrary, regulation does not necessarily achieve its objectives, and it brings fresh problems of its own.

CHAPTER 4: REGULATION AND INCENTIVES

Regulation changes the incentives of existing participants in the financial reporting process, and brings new participants, each with their own particular motivations.

- Legislators' and securities regulators' incentives push them to ensure that all users are treated equally, regardless of their needs.
- Standard-setters' incentives push them to meet the demands of users and to increase uniformity. And they demonstrate their effectiveness to stakeholders by making fresh requirements, not by allowing firms to disclose less. These incentives create a bias towards ever-increasing disclosure.
- Enforcement agencies need to show that they have ensured firms' compliance with disclosure requirements. They cannot do this so easily or effectively if firms are able to argue that information has not been disclosed because it is immaterial. Anything that allows judgement makes enforcement harder; a rule book is easier to enforce. Enforcement agencies therefore tend to treat non-disclosure as a problem, but do not treat disclosure of immaterial items as a problem. This creates a bias towards disclosure of immaterial items.
- Auditors need both to show that audited firms have complied with disclosure requirements and to provide a cost-effective service. They can achieve both these goals most easily if there is visible compliance with all relevant disclosure requirements. This also creates a bias towards disclosure of immaterial items.
- For preparers, regulation brings a compliance mentality. As there are greater risks in disclosing too little than in disclosing too much, they inevitably err on the side of over-disclosure.
- Regulation creates opportunities for some users – particularly users who are not themselves providers of capital, or capital providers who are not owners – to lobby for increased disclosures, whose costs they will not themselves have to meet.
- But regulation leaves the fundamental problem of users' incentives unchanged. Where there are a large number of users, the gains to any single user from participating in either market or regulatory processes for determining disclosures are outweighed by the costs.

CHAPTER 5: REGULATORY FAILURES

Regulation of financial reporting disclosures takes place principally through legislation, through the requirements of securities regulators, through accounting standards, and through the enforcement of disclosure requirements by various agencies. It can lead to too much disclosure, to too little disclosure, to the wrong disclosures, to too complex disclosures, and to poorly communicated disclosures.

There is a conflict between regulation and standardisation of financial reporting disclosures on the one hand and the diversity of firms and user needs on the other. This conflict underlies some of the most important concerns about financial reporting disclosures.

- For the sake of fairness, regulation requires firms to disclose the same information to all users, with the result that ordinary users are faced with reports designed for users who benefit from long and complex disclosures.
- For the sake of comparability, standardisation imposes uniform disclosure requirements on diverse firms, with the result that a proportion of disclosures may well be immaterial.

In addition, it is impossible to specify all relevant disclosures. This leads to an ever-growing list of required disclosures that have been recognised as important at one time or another for at least some firms.

Overall, it is a predictable result of the present system that it will lead to a proportion of disclosures that are irrelevant to particular firms and to particular users, and that, if it is left unchanged, the volume of irrelevant disclosures is likely to grow.

CHAPTER 6: RECOMMENDATIONS

Dissatisfaction with financial reporting disclosures is partly unavoidable and partly a product of their regulation. There are broadly four ways in which the regulatory side of the problem can be tackled: reform the process for setting disclosure requirements; change the requirements themselves; change the way in which the requirements are implemented; and place more reliance on non-regulatory solutions. We make recommendations in each of these four categories. The recommendations are interdependent. Also, no one group is in a position on its own to reform financial reporting disclosures and their regulation; a coordinated approach is needed.

Reforming the process for setting disclosure requirements

1. **The standard-setting process should be reformed so as to give more weight to the views of equity shareholders who as owners meet the costs of disclosure requirements.** There is a view that the standard-setting process focuses unduly on the needs of a small group of users who have an apparently limitless appetite for information, but who do not bear the costs of producing it. If standard-setters were to give more weight to the interests of those who ultimately meet the costs of their decisions, this would give greater legitimacy to the requirements that they impose.
2. **Standard-setters should establish a framework to provide a structure for setting disclosure requirements.** This should ensure that disclosures are only required when they are needed and that they are properly organised, and should recognise that disclosure requirements reflect a balancing of interests, rather than an unqualified commitment to transparency. The framework should form part of the conceptual framework for financial reporting.
3. **To the extent that firms comply with disclosure requirements even though the resulting information is immaterial, standard-setters should reflect this in deciding whether disclosure requirements are proportionate.** If standard-setters are able to assume that their disclosure requirements only lead to the disclosure of material information, when in fact they lead to a lot of immaterial disclosures as well, their calculations of the costs and benefits of disclosure requirements will be unrealistic.

Changing the disclosure requirements

4. **Disclosure requirements should allow firms to report separate information sets to different types of users.** At present the disclosure system fails to distinguish between the very different needs of the various users of financial reporting information. While some users may be happy with lengthy disclosures, the majority are sent information that is far longer and more complex than they can make use of. The information set for most users could be short and, beyond a minimal common core, decided by each firm to reflect its own particular circumstances. Regulation of disclosures in the common core should itself be minimal to allow for effective communication. Both information sets should be online and available for anyone who wants to access them.
5. **Standard-setters should regularly review their disclosure requirements to weed out unnecessary disclosures.** The IASB's first such review should be initiated as soon as it has finalised the conceptual framework on disclosure.

Changing the way disclosure requirements are implemented

6. **To reduce the incentives to provide immaterial disclosures, enforcement agencies should clarify that they will not take action against firms that omit immaterial disclosures, and they should encourage firms to omit immaterial disclosures.** As international firms make disclosures in more than one jurisdiction, this would require a common approach among enforcement agencies internationally.

7. **Auditors should refrain from encouraging firms to make immaterial disclosures and should encourage them to omit immaterial disclosures.**

8. **Once enforcement agencies and auditors have reformed their approach to materiality, firms should cut out disclosures that are clearly immaterial.**

Placing more reliance on non-regulatory solutions

9. **Preparers and users should engage directly to discuss voluntary public disclosure of information that is not currently provided, rather than rely entirely on standard-setters to introduce new disclosure requirements.**

These reforms would curb disclosures by ensuring that they are only required where those who benefit from them are also prepared to meet their costs. They would ensure that disclosure requirements are developed within a framework that recognises that the level of mandatory disclosures requires a balancing of interests between owners and managers, and between users and preparers. They would encourage firms to leave out immaterial information and allow them to structure their disclosures so as to reflect the very different needs of the different users of their financial reporting. They would allow and rely on greater use of professional judgement by all those involved in the financial reporting process. The overall result should be a better system of financial reporting, with more focused disclosures.

There is no solution to current problems that will guarantee that everyone gets what they want, and there are no improvements that will come without costs and risks attached. The question for those involved in the financial reporting process is therefore whether they are willing to bear the costs and increased risks of changes that could improve the system of financial reporting disclosures as a whole, or whether they prefer on balance to leave things as they are. If they prefer to leave things as they are, then the present feelings of disenchantment and alienation from the financial reporting process can only be expected to grow as mandatory disclosures continue to increase.

1. PROBLEMS OF DISCLOSURE

Everybody seems to agree that financial reporting disclosures need to be reformed, but there is no agreement on what exactly the problem is.

Is the problem information overload? Or is too little being disclosed? Or perhaps the problem is not one of volume, but that firms are making the wrong disclosures?

1.1 DISCLOSURE OVERLOAD?

In the past 20 years, as the result of a combination of technological changes and market forces, there has been an information explosion. It is not something that people usually complain about. The increasing availability of large volumes of information on almost any subject under the sun is generally seen as a welcome development.

Not so in financial reporting. Here, there are widespread complaints that there is too much information and a widely-held view that financial reporting disclosures need to be reformed. It is common for public companies' annual reports to be 100 pages or more, and they have doubled in length in recent years (see Panel 1.1).[1] Some are even longer and have grown even more quickly. HSBC Holdings' 2012 annual report is 546 pages; for 1999, it was just 124. Financial reporting disclosures seem to have been growing inexorably for as long as anyone can remember, and there is no obvious limit to their growth in future. It is said that nobody reads them all and that producing them is a waste of time and money.

Panel 1.1: The disclosure explosion

Deloitte, *Joined up Writing: Surveying Annual Reports* (2012), notes that 'the average length of annual reports has doubled over the past 16 years to a current 103 pages'. The survey covers 100 UK public companies. The trend is a long-term one. A.J. Arnold and D. R. Matthews, 'Corporate financial disclosures in the UK, 1920-50: the effects of legislative change and managerial discretion' (2002), find that the length of annual reports doubled between 1920 and 1935, and doubled again by 1950. Details of works cited are given in the bibliography.

If the law of diminishing returns applies to financial reporting, then there is a risk that growth in the volume of disclosures has not produced a proportionate increase in the value of the information disclosed. This inevitably prompts questions about how worthwhile it is to have financial statements of 50 or 100 pages or more. It is also said – though not in most cases by users – that users are either confused or distracted by the volume of disclosures. So large parts of financial statements, it is claimed, may be either positively unhelpful or at best useless.

The claim that financial reporting disclosures have become too long and complex is not a new one. In 1994 Ray Groves, then chairman and chief executive of Ernst & Young in the US, argued that 'Important information is getting lost in a disclosure forest, because our present system does not distinguish between information that's critical for decision making and nonessential data'.[2] That same year, the American Institute of Certified Public Accountants (AICPA) published *Improving Business Reporting – A Customer Focus* (usually known as 'the Jenkins Report'). Commenting on the significant increase in disclosures over the previous 20 years, the report called on standard-setters to 'search for and eliminate less relevant disclosures'. Eliminating less useful disclosures would, it said, 'reduce the need for users to wade through excess material'.[3]

In 1995, the US Financial Accounting Standards Board (FASB) responded to calls such as those from Mr Groves and the AICPA by issuing a prospectus, *Disclosure Effectiveness*, on which comments were invited. This initiative does not appear to have led to any further work by the FASB on the problem of disclosure in general, though it did prompt a revision of existing disclosure requirements in relation to post-retirement benefits.

Claims of excessive and over-complex disclosures have become more frequent since the 1990s and in recent years have even become the official view of regulators and standard-setters. In 2007 the US Securities and Exchange Commission (SEC) appointed an Advisory Committee on Improvements to Financial Reporting 'to make recommendations intended to increase the usefulness of financial information to investors, while reducing the complexity of the financial reporting system …' The committee's report, published in 2008, includes a recommendation for a 'disclosure framework' (see Appendix 4 at A4.2).

Panel 1.2: Sunlight – the pros and cons

'Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants …' – Louis D. Brandeis (1914)

'… in addition to being a disinfectant, sunlight can also be blinding' – Troy A. Paredes, 'Blinded by the light: information overload and its consequences for securities regulation' (2003). Professor Paredes was an SEC Commissioner from 2008 to 2013.

[1] For convenience, we refer to all firms with publicly quoted securities as 'public companies'.

[2] Quoted in Katherine Schipper, 'Required disclosures in financial reports' (2007). Schipper comments that Groves 'did not … provide criteria to be used in making that distinction', ie, between critical information and nonessential data.

[3] *Improving Business Reporting*, Chapter 6. It also called for extensive new disclosures.

Partly in response to the SEC committee's report, in 2009 the FASB attempted to tackle the issue again by setting up a 'disclosure framework' project. It was stated that the project 'aimed at establishing an overarching framework intended to make financial statement disclosures more effective, coordinated, and less redundant'. The first output from this project was published in 2012: *Disclosure Framework: Invitation to Comment* (see A4.5). In Europe, the European Financial Reporting Advisory Group (EFRAG), the French Autorité des Normes Comptables (ANC) and the UK Financial Reporting Council (FRC) set up a project in 2010 on 'A disclosure framework for the notes to the financial statements'. The first output from this project was also published in 2012: *Towards a Disclosure Framework for the Notes* (see A4.6). FASB and EFRAG/ANC/FRC have been working together on these projects.

Also in Europe, in the UK, the FRC (*Louder than Words*, 2009) and the Accounting Standards Board[4] (ASB) (*Cutting Clutter*, 2011) both identified reducing the length and complexity of corporate reporting as an objective. The FRC followed the EFRAG/ANC/FRC paper on disclosure with its own discussion paper, *Thinking about Disclosures in a Broader Context: A Road Map for a Disclosure Framework* (see A4.7). It has also set up a Financial Reporting Laboratory, one of whose objects is to help cut clutter in financial reporting.

And in 2012 Hans Hoogervorst, the chairman of the International Accounting Standards Board (IASB), commented that 'it has become increasingly clear that we are suffering from disclosure overload' and announced that the IASB would be embarking on 'a project to develop a new IFRS disclosure framework'.[5] Early in 2013 the IASB held a public forum in London to discuss disclosure overload, and it currently plans to deal with disclosure issues in a revised conceptual framework and through revisions to individual standards (see A4.8).

Yet claims that financial reporting disclosure is excessive and over-complex are controversial. Most users are not complaining about the 'excessive' volume of financial reporting disclosures. In some cases, this may be because they are not interested in reading the accounts in the first place. And if they do not want to read a full-length report, they are not compelled to. They can focus on the primary financial statements if they prefer to do so. Most public companies highlight what they regard as the key information in their reports, and users who do not wish to spend much time reading corporate reports can stick to that. Users are not obliged to 'wade through' disclosures; they can skip over them, and most probably do. And many 'users' rely on alternative sources of information – analysts or the media – to keep them informed about the companies in which they invest, so are not concerned about how long the financial statements are.

Panel 1.3: Shareholders' preference not to be informed

'The lack of active involvement in, and relative ignorance of, corporate affairs on the part of … shareholders is hardly accidental. It is exactly what the shareholders want and expect when they purchase the stock of a firm. Most shareholders have no desire to spend time or effort personally monitoring the performance of managers and other agents… They trade the loss of direct control of the firm against corresponding gains in the form of diversification of their investment portfolio across firms, saving in personal effort and freedom from the need for investment expertise' – Shyam Sunder, *Theory of Accounting and Control* (1997), p84.

But there is a wide range of users, with differing amounts of time to spend studying corporate reports. Some users, contrary to the conventional wisdom, say that they do read everything that is published. Others want to be able to refer to the full set of information that is currently disclosed, even if they do not expect to read it from cover to cover. Some do not see a 546-page annual report for an organisation as large and complex as HSBC as excessive; on the contrary, they see it as quite an achievement to keep it that short. Far from complaining that companies are disclosing too much, some users would like companies to disclose much more than they do now (see the examples in Appendix 4 at A4.1 and A4.9).

And there is abundant research evidence of the benefits of disclosure (which we discuss in Appendix 3).

Panel 1.4: Alternative views on overload

'[A] protest that is frequently launched, either when additional disclosures are sought by investors or when standard-setters propose to require them, is that investors are already overloaded with disclosures and cannot suffer the burden of any more. We would hasten to assure standard-setters that useful information is never overload' – CFA Institute, A *Comprehensive Business Reporting Model: Financial Reporting for Investors* (2007).

[4] The predecessor of the Financial Reporting Council's Accounting Council.

[5] Speech to the Consejo Mexicano de Normas de Información in Mexico City, 7 March 2012.

Panel 1.4: Alternative views on overload (continued)

'[T]he academic literature indicates that the market, as a whole, reacts positively to increased disclosure, notwithstanding that individuals may feel overloaded' – Richard Barker et al, 'Response of the EAA FRSC to the EFRAG/ANC/FRC discussion paper: *Towards a Disclosure Framework for the Notes*' (2013).

An IASB survey of users' and preparers' views on disclosure found that users think the problem is primarily one of 'poor communication' and 'not enough relevant information', while preparers think it is primarily one of 'disclosure overload' – IASB, *Discussion Forum – Financial Reporting Disclosure: Feedback Statement* (2013).

Sometimes, those who call for reduced disclosures call for additional disclosures at the same time; in fact, it appears to be almost obligatory to do so.

Panel 1.5: The Lex column

Two contrasting items in the Lex column in the *Financial Times* illustrate the different points of view in the disclosure debate. An article entitled 'Accounting disclosure' was published on 14 March 2012 and proposed six possible cuts as a start in reducing disclosures.

1. Accounting policy notes could be deleted unless they explain anything unusual.
2. Remuneration reports are too long. The pay of individual directors is immaterial in the context of a company's total pay bill.
3. Long disclosures on financial instruments could be reduced by using charts.
4. Tax disclosures could be cut: 'Most [investors] probably just want to know the amount and timing of the [tax] bill.'
5. Disclosures on assets held for sale should be cut as they can be too easily manipulated ('like play-doh').
6. '[M]ost sections on risk can be axed.'

This article appeared to conclude what Lex had to say on the matter. But the next day there was a second article. 'Accounting disclosure II' pointed out that 'a few added disclosures would help, too'. Specifically:

1. Companies should disclose product information in the same way they provide geographical segmental information. For example, Amazon should disclose whether Kindle e-readers make money.
2. Segmental disclosures should not leave any expenses unallocated.
3. Qualitative disclosures should be improved. For example, pharmaceutical companies should disclose patent expiry dates in different regions.
4. More detail should be provided on the calculation of goodwill.
5. Assumptions used in valuing other assets should also be stated.
6. There should be standardised charts for information that crosses time periods, such as debt and hedging profiles.
7. Five years of comparatives should be provided.
8. Earnings per share without share buybacks should be disclosed.

In conclusion, the article stated that 'the gap between what investors want and what companies provide remains too wide'.

Panel 1.6: The stickiness of disclosure requirements

In *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (2012) John Kay writes:

'The demand for more information has been an instinctive response to a wide range of problems that have emerged in the financial services sector in recent decades. Disclosure and transparency have become mantras in policy and in regulation … The outcome is a cascade of information, or at least data … Useful information may itself be buried by the sheer volume of data …

Panel 1.6: The stickiness of disclosure requirements (continued)

'And yet when we sought to shift complaint about the reporting burden to specifics, we encountered unease about the notion that we might dispense with any particular requirement. Recording or reporting has rarely been mandated without some valid purpose in mind, and people would recall that purpose. We received many submissions deploring the overall information overload but few proposing the deletion of any particular requirements: and at the same time, we also received many submissions demanding that new mandatory reporting requirements should be imposed.'

In *Discussion Forum – Financial Reporting Disclosure: Feedback Statement*, the IASB states:

'In 2012 the IASB discussed with the IFRS Advisory Council the possibility of undertaking a short-term project to improve disclosure requirements. The strong message that the IASB received was that there were unlikely to be many "quick wins". Previous attempts by standard-setters to review or rationalise disclosure requirements had more often than not resulted in additional disclosure requirements.'

Indeed, one point of view is that it is a mistake to focus on whether there is too much disclosure or too little – the real problem, it is argued, is that companies are not making the right disclosures. This is compatible with the position of those who call simultaneously for reduced disclosure requirements and for the imposition of fresh ones. Of course, if firms think that they are required to disclose the wrong information, they are always free to publish the right information voluntarily as an additional disclosure.

Another complaint is that disclosures are unclear or badly organised. While possible solutions to the problem of organisation include the imposition of a standardised order for the notes to the accounts, some would see this as making existing problems worse. More typically, proposed solutions put the onus on preparers to sort things out for themselves and to make sure that their disclosures are clear and well organised. Although better communication cannot on its own remedy all of the failures of financial reporting disclosure, some of the current unhappiness with disclosures is probably attributable to poor communication.

What almost everyone seems to agree on is that there is a serious problem with financial reporting disclosures – even if they cannot agree on precisely what it is.

In this report, we look at the sources of this unhappiness and what can be done about it. We argue that the current degree of dissatisfaction with financial reporting disclosures is largely a predictable outcome of the regulatory framework. But this framework is itself a response to failures in the market for financial reporting information. And both market and regulatory failures in part reflect inherent limitations of financial reporting. We identify a number of ways in which the regulatory framework should be changed so as to address current concerns. But we also suggest that there needs to be greater realism about what can be achieved by financial reporting disclosures and their regulation.

Panel 1.7: Making up users

In 'Making up users' (2006), Joni J. Young points out that standard-setters and others engaged in debates on financial reporting have made up an abstract category – users – 'to justify and denigrate particular accounting disclosures and practices'. We are constantly told, when fresh requirements are imposed, that users need a particular disclosure or would find it helpful. But it is not so clear what flesh-and-blood users actually want.

Claims of disclosure overload seem to rely on the same group of abstract users, who – we are now told – are 'confused' or 'overwhelmed' by disclosures, 'struggle' with them or are forced to 'wade through' them. Again, what flesh-and-blood users think is less clear.

1.2 THE BROADER CONTEXT

Although it is usual to consider the problems of financial reporting disclosure in isolation, they reflect wider social trends. Four in particular are relevant: the information explosion, changing expectations of transparency, the growth of regulation in society generally, and the growth of litigation. The regulation of financial reporting disclosures also needs to be seen in the context of market forces pushing firms towards greater disclosure.

1.2.1 The information explosion

We live in what is often called 'the information age'. This label reflects both the mass of information now available, either through the internet or in other ways, and the growing importance of information to economic activity. The explosion of publicly available information about firms has been matched by an explosion of information about public bodies, individuals, and the natural world. To a large extent this growth of data is attributable to changes in technology that make it easier to generate, disseminate and access information and to market forces that reflect these technological developments. But it is also attributable to another change – increased expectations of transparency.

1.2.2 Expectations of transparency

Although the growth of financial reporting disclosures seems to be an extreme case, it is a symptom of a broader trend towards greater mandated transparency in many diverse circumstances. For example:

- sellers of property have to make extensive disclosures to buyers;
- pharmaceuticals manufacturers have to disclose product information to consumers;
- schools have to disclose their pupils' exam results;
- politicians have to disclose their financial interests and sources of funding;
- in the UK, local authorities have to disclose payments to suppliers over £500; and
- academic authors have to make conflict-of-interest disclosures to peer-reviewed journals.

All of these requirements for increased transparency are either relatively new or have significantly expanded in recent decades. The motivations for requiring these (and other) disclosures resemble those for financial reporting disclosures. They are not mutually exclusive, and may be summarised as follows.

Risk warnings. An earlier Information for Better Markets report, *Reporting Business Risks: Meeting Expectations* (2011), noted a growing demand for 'more and better risk warnings on all kinds of products and services'. Many mandatory disclosures are intended to meet this demand; disclosures on retail pharmaceutical products are an example.

Levelling the playing field for buyers and sellers. To a large extent buyers and sellers are expected to look after their own interests (caveat emptor and caveat vendor), but certain transactions are regarded as of such importance that significant disclosures are required – usually by the seller. The information commonly disclosed on selling a property is a good example. In the absence of such disclosures, either buyers would incur higher costs in obtaining information for themselves, or property prices would be discounted to reflect the increased risks. Economists regard disclosures of this sort as a way of dealing with the problem of adverse selection (see Appendix 1 at A1.3).

Improving behaviour. There are a number of situations in which disclosure requirements are intended to improve behaviour. Financial and funding disclosures by politicians may be seen as an example of this. Economists regard such disclosures as a way of dealing with the problem of moral hazard (see Appendix 1 at A1.4).

Improving performance. People may perform better (not just in a moral sense) when their performance is observed or disclosed. This may be because disclosure makes them accountable or because their performance becomes a matter of pride or can be compared with others' performance; people can also learn lessons from observing others' performance if it is disclosed.

Better decision making. Information on school pupils' exam results may be seen as an example of mandatory disclosure to facilitate better decision making – in this particular case, by parents. This motive for disclosure overlaps with the others – understanding risks better, for instance, should also lead to better decisions. Equally, one could say that disclosure of school pupils' exam results helps parents avoid the risk of sending their children to the wrong school and is likely to encourage schools to improve their performance.

How can we explain this overall growth in transparency across a variety of activities?

- As educational standards rise, people have an increased expectation that they will be better informed on all sorts of matters.
- The same tendency arguably arises from a general decline in deference towards authority. As deference towards those who make decisions affecting us or on our behalf declines, we expect more information about their activities. This may also be a relevant factor in demands for corporate disclosure.
- There may also be a reduced level of trust of those in authority, including those in government, the professions and running businesses. Increased disclosure can be a way either of restoring trust or, perhaps more frequently, of removing the need for it. This could be seen as problematic when, in law, the roles of company officers such as directors and auditors are based on principles of trust.
- In some ways, society is increasingly competitive. Transparency promotes competition.

- People are far more transparent in what they reveal about themselves than in the past – whether in the media or via social networking. As they become more transparent themselves, they may find it less easy to understand why others, including firms, should not be equally transparent.
- Transparency is an ideal that seems to fit well with other ideals of modern society, such as freedom, democracy and justice. Free speech, freedom of the press, and freedom of information laws are more common in democracies than in autocracies. Withholding information seems to fit better with authoritarian, undemocratic and unjust regimes. In practice, no society is completely transparent, but people frequently invoke the ideal of transparency.

These forces create a self-perpetuating increase in expectations of transparency across society. The more openness there is, the harder it becomes to defend not being transparent.

An interesting feature of this explosion of information is that most of it is ignored by most of the people at whom is directed. Most people do not read conscientiously through all the information in a packet of pills. Most parents do not read all the information that is available about their children's schools. Most voters in the UK do not read through all their local authority's payments over £500. But the disclosures are still important. A few people will read through them all, and some will pass on the key points to others. People can refer to the full information when they want to. And knowing that the information will be disclosed will itself affect the behaviour of those whose actions are being reported on.

In debates on financial reporting disclosure, there sometimes seems to be an assumption that disclosures are not worth making unless most of those at whom they are directed actually read them. This is not an assumption that is made in other areas.

1.2.3 The growth of regulation

Regulation is a pervasive feature of modern societies:

> 'Today, we live in houses and apartment buildings whose construction – from zoning, to use of materials, to fire codes – is heavily regulated. We eat food grown with heavily regulated fertilizers and hormones, processed in heavily regulated factories with publicly monitored technologies, and sold in heavily regulated outlets with elaborate labels and warnings. Our means of transport, including cars, buses, and airplanes, are made, sold, driven, and maintained under heavy government regulation. Our children attend schools that teach heavily regulated curricula, visit doctors following heavily regulated procedures and paid government-controlled prices, and play on play-grounds using government-mandated safety standards.'[6]

The growth of regulation in part reflects the fact that, when defects in markets are identified, it is easy to conclude that regulatory solutions are needed to put them right. While sometimes this conclusion may be justified, it can also be an example of the 'nirvana fallacy'. We are guilty of committing this error whenever we compare an imperfect reality with an imagined ideal – for example, comparing imperfect markets with perfect regulation.[7] This not only biases policy prescriptions towards regulatory solutions, but also creates unrealistically high expectations for what regulators can achieve. As it is assumed that regulation can solve every problem, any remaining difficulties must be the regulators' fault. This leads to a schizophrenic mix of attitudes: a tendency to idealise regulation, but constantly to criticise regulators.

The rapid expansion of financial reporting disclosure regulation can be seen as part of the larger trend of increasing regulation. This does not show that the regulation of financial reporting disclosures is either right or wrong – merely that it is not unusual.

1.2.4 Litigation

While litigation affects some countries more than others, in many jurisdictions it has grown significantly in recent decades, sometimes fuelled by contingency fee systems for the payment of lawyers. Disclosures are often provided as a way of forestalling, or at least reducing the threat of, litigation, and so can become a defence mechanism rather than a means of communication.

1.2.5 Market forces

We look at the market forces that underlie increasing disclosures in the next chapter. At this stage we merely note that, even in the absence of regulation, firms would still make financial

[6] Andrei Shleifer, 'Understanding regulation' (2005). He is referring to the US, but other societies are almost as heavily regulated.

[7] Harold Demsetz, 'Information and efficiency: another viewpoint' (1969). Oliver Williamson, 'Transaction cost economics: the natural progression' (2010), points to a similar fallacy, which assumes that there are no transaction costs in the public sector. As a result, 'convoluted public policy prescriptions [are] often (unwittingly) anchored in asymmetric application of zero transaction cost reasoning, of which regulation is an example'.

reporting disclosures and changes in markets and technologies would almost certainly have led to significantly increased disclosures in recent decades.[8] While regulation may be responsible for disclosures that are excessive or misguided, the trend towards increasing corporate disclosure reflects powerful market forces.

1.3 FUNDAMENTAL PROBLEMS OF FINANCIAL REPORTING DISCLOSURE

While it is helpful to see the problems of financial reporting disclosure in a broader context, in some respects its features are distinctive. In particular, there are three fundamental problems of financial reporting disclosure that no market or regulatory solutions can entirely remove:

- **Subjectivity.** Relevance and materiality (see Panel 1.8) are subjective judgements. There will always be occasions when some users will disagree with preparers' choice of what it is relevant and material to disclose.
- **Self-reporting bias.** Financial reporting is a product of managers who are reporting on their own performance. Even though the overwhelming majority of managers are honest, and even though their reporting is heavily regulated, a degree of bias is only to be expected. This will partly reflect a necessary degree of managerial optimism about the firm's continuing projects and prospects.
- **Potential self-inflicted damage.** It is against firms' interests to be completely transparent. Some disclosures will give valuable information to their competitors or to those with whom they contract, which would be to the disclosing firm's disadvantage and that of its owners. Such information is 'proprietary', and the losses or reduced gains caused by its disclosure are often referred to as 'proprietary costs'.

Panel 1.8: What is materiality?

'Information is material if omitting it or misstating it could influence decisions that users make …': IASB, *The Conceptual Framework for Financial Reporting 2010*, paragraph QC11. An item may be material because of its size, its nature, or a mixture of the two.

1.4 THE CORPORATE FINANCIAL INFORMATION ENVIRONMENT

Financial reporting disclosures take place within a larger context that makes them more or less useful. This context has been called the 'corporate financial information environment'.[9] Panel 1.9 lists some of its key features.

Panel 1.9: The context of disclosure

In 'Financial accounting information and corporate governance' (2001) Robert M. Bushman and Abbie J. Smith give a list of nine factors that make disclosures more or less useful:

Auditing regime. Information that is rigorously audited is more reliable.

Communication infrastructure. The easier it is to access information, the more useful it is.

Financial analyst community. Information is more useful if there are analysts who use it. Alternatively, information disclosed by firms may reduce the need for analysts.

Financial system architecture. Public disclosures are more useful if firms are financed by public offerings rather than privately (eg, by bank debt).

Legal environment. Disclosures are more useful where the law allows effective protection of investors and of property rights.

Other corporate control mechanisms. The usefulness of disclosures is greater where there are, eg, management incentive plans and an active market for corporate control.

Industry concentration. The value of disclosure increases with the level of competition among firms, by informing firms of good and bad investment opportunities. This involves the imposition of proprietary costs on the disclosing firms.

Political influence over business activities. The incentives to use information profitably are reduced if gains are subject to political expropriation.

Human capital. The benefits of information increase as people become more educated and able to use it.

[8] 'Regulation of disclosure obscures the underlying supply and demand for accounting information … so the marginal effect of regulation is unclear': Ray Ball, *The Firm as a Specialist Contracting Intermediary: Application to Accounting and Auditing* (1989).

[9] The title of a current research project supported by the Economic and Social Research Council and ICAEW charitable trusts.

Another important feature of the corporate financial information environment is the availability of relevant information from other sources, such as government bodies, the media and investment analysts. Such features of the information environment vary from country to country, but also within countries and ultimately from firm to firm and over time.

The significance of this for our purposes is that there is no such thing as an ideal system of financial reporting disclosures, independent of the context in which it operates. The system of public company disclosures that we have at present assumes among other things a particular model of corporate governance, under which managers make truthful but not fully transparent disclosures to outsiders, and are to a large degree left to get on with their work without interference from owners. This system embodies compromises between owners and managers, and between users and preparers, and so reflects a balancing of interests, rather than a single-minded pursuit of transparency.

Moves towards full transparency for public companies would disrupt this model of governance, and would be likely to lead to changes in other aspects of the information environment – companies going private, for example, or not choosing to go public.

1.5 SCOPE AND PLAN OF THE REPORT

1.5.1 Scope

'Disclosure' is used in more than one sense in relation to financial reporting. Sometimes its meaning is restricted to disclosures in the notes to the accounts. This approach is based on a distinction between what is 'recognised' and what is 'disclosed'. But as recognised items are disclosed in the primary accounting statements (ie, the statement of financial position, the income statement, etc), this distinction can be misleading. Also, it is often a secondary consideration whether disclosure is made in or outside the financial statements, provided it is made somewhere. For this reason, we include all financial reporting disclosures within the scope of this report, regardless of where they are made.

We do not address the problems of disclosure in non-financial or narrative reporting. To some extent these overlap with the problems of financial reporting disclosure, but in one respect the problems of non-financial reporting are worse. This is because, to a significantly greater extent than for financial reporting, there are often multiple authorities able to impose non-financial disclosure requirements in reporting to shareholders. These requirements are uncoordinated and often for the benefit of interest groups other than shareholders. This is a distinct problem that needs to be separately addressed.

The focus of the report is on public companies – that is, firms whose shares or other securities are publicly traded. Financial reporting disclosures by private companies do not seem to be a major problem.

The report is international in its coverage, and although much of the evidence that we refer to comes from the US and the UK, the problem that we address appears to be a concern in many countries around the world.

1.5.2 Plan of the report

The remainder of the report is organised as follows.

- Chapter 2 looks at the market forces that underlie financial reporting disclosures.
- Chapter 3 explains the arguments in favour of regulating disclosures.
- Chapter 4 examines regulation's effects on the incentives of the various participants in the financial reporting process.
- Chapter 5 analyses the problems caused by regulating financial reporting disclosures.
- Chapter 6 makes recommendations for reform.
- Appendix 1 discusses in more detail various aspects of the supply and demand for information about firms referred to in Chapter 2.
- Appendix 2 reviews other options for tackling financial reporting disclosure problems, additional to those recommended in Chapter 6.
- Appendix 3 summarises some key findings of research on financial reporting disclosures.
- Appendix 4 lists existing proposals for a disclosure framework and similar suggestions.

2. MARKET FORCES

Firms will provide outsiders with information, even when they don't have to, because it's in their interests to do so. And changes in markets and technologies in recent decades would almost certainly have prompted a significant increase in disclosures, regardless of regulatory requirements.

Could market forces on their own deal with the problems of disclosure?

2.1 INFORMATION ABOUT FIRMS: SUPPLY AND DEMAND

2.1.1 Demand

Anyone who has significant transactions or a significant relationship with a firm is likely to want to know something about it. The precise motives for wanting the information, and exactly what information is relevant, will depend on the nature of the transaction or relationship. We look in more detail at the motives for this demand in Appendix 1.

2.1.2 Supply

Managers may supply information to outsiders when they are under no legal obligation to do so or they may voluntarily assume such an obligation. It makes sense for managers to do this because firms depend for their success on being able to undertake transactions with outsiders and to form relationships with them. Outsiders are more likely to agree to this when they know something about the firm. We explained the point in the earlier Information for Better Markets report, *Developments in New Reporting Models*:

> 'Imagine … that we have a choice between two businesses, one of which we understand because it is open about itself, and one which we do not understand because it is secretive. Other things being equal, we are more likely to:
>
> - invest in;
> - lend to;
> - sell to;
> - buy from; or
> - work for
>
> the business we understand. In dealing with the business that we do not understand, we are taking a greater risk, and we would expect to be compensated for this – by a higher expected return on our investment or a higher rate of interest on our loan, etc. And we may be unwilling to take the risk at all.'

A significant feature of financial reporting information is that it is prepared by insiders (managers) for the benefit of outsiders (including owners). Those who prepare the disclosures therefore have an advantage over those to whom they are reporting. As insiders they are better informed – ie, there is an information asymmetry. A second significant feature of financial reporting is that its preparers have a motive to bias the information they report because it may be used by owners in their decisions about whether to change managers, how to remunerate them, and whether to intervene in management decisions.

Economists have developed arguments to explain voluntary disclosure in situations where there are opportunities for managers to take advantage of outsiders' ignorance. Opportunities of this sort exist wherever there are information asymmetries. Economists have identified two specific problems created by information asymmetry: adverse selection and moral hazard. Adverse selection arises where one party to a transaction takes advantage of the other's ignorance to charge too high a price or to pay too low a price. Moral hazard arises where one party to a transaction or relationship can take advantage of the other's ignorance either by engaging in activities that the other would not have agreed to or by culpably failing to perform tasks that it is expected to perform. Adverse selection and moral hazard are explained in more detail in Appendix 1.

Both adverse selection and moral hazard are made worse by uncertainty about the reliability of information. Problems arising from information asymmetry and uncertain reliability create incentives for the parties to a transaction or relationship to secure fuller disclosures and to ensure and signal the disclosures' reliability.

2.1.3 Motives for withholding information

Firms also have motives for not supplying information even though there is a demand for it.

- The information may be costly to prepare or to disseminate.
- It may be considered to be too uncertain to be useful.
- Disclosure may have proprietary costs. This is often the case with detailed segmental and product information, which we discuss below.

Detailed segmental and product information is of value to users – including owners, suppliers, customers and employees – because it allows them to make more accurate forecasts and to question managers' decisions. Its disclosure is unattractive to preparers because there are proprietary costs in signalling to rivals, and to those with whom it is contracting, where exactly the firm is and is not making money.

Some commentators argue that the competitive element of proprietary costs ('competitive costs') is largely fictional because competitors usually know, through gossip, trade sources and illicit leaks of private information, how well their rivals' various projects are doing. The only people who do not know, it is said, are the shareholders. There may often be some truth in this, but companies go to considerable lengths to try to keep such information private, and they do not generally behave as though it is already in their competitors' hands. So the existence of competitive costs for public disclosures is real, although the actual costs may often be exaggerated.

Managers may have their own motives, which conflict with the interests of the firm's owners, for not disclosing information. For example, they may in rare cases prefer not to have disreputable or – perhaps more frequently – doubtfully competent conduct exposed. These are instances of self-reporting bias.[10] And complete transparency (on how particular products or projects are performing, for example) allows all their decisions to be questioned. But if outsiders knew as much as managers about the decisions a business faces, it is not clear what the point would be of employing managers to take the decisions.

There may also be occasions when the managers' interests are better aligned with the interests of the firm than the owners' are. Managers of a public company are more likely than owners to be sensitive to the proprietary costs of disclosure. Their careers are invested in the success of the particular business that they work for, while the owners are likely to have a diversified portfolio, so from the investors' point of view, the competitive costs to one business may be cancelled out by the competitive benefits to another. So when managers plead proprietary costs as a reason for non-disclosure of information demanded by users, this may be because their interests are better aligned with those of the firm itself. The owners' interests, if they have a diversified portfolio, may be better aligned with the overall efficiency of the market, rather than with the fortunes of any particular firm. Managers also sometimes claim that investors take too short-termist a view of the firms in which they invest.

We return to the conflict between managers and diversified owners regarding the proprietary costs of disclosure in Section 5.8.

2.2 CHANGES IN SUPPLY AND DEMAND

Changes in the corporate financial information environment are likely to have contributed to the growth in financial reporting disclosures. Some of them have shifted the supply curve to the right (meaning that more information will be supplied at a given cost); some have shifted the demand curve to the right (meaning that more information will be demanded at a given price).

Changes shifting the supply curve to the right include the following.

- Developments in IT mean that information is significantly cheaper to produce, store and disseminate than it was, say, 30 years ago. As the cost of information has fallen significantly for preparers, there should be an increased willingness to provide it.
- There has been a huge growth in the scale of international capital markets – again by comparison with, say, 30 years ago. As more capital becomes available, and investors become more sophisticated in their use of information, the gains to business of attracting capital by better disclosure become more obvious.
- As businesses become bigger and more complex, and engage in new and more complex forms of transaction, there is more to disclose.

Changes shifting the demand curve to the right include the following.

- Developments in IT also mean that information is significantly cheaper for users to access and analyse than it used to be, and indeed is capable of analysis in ways that were previously unknown. As costs for the consumers of information have fallen, and ways of using it have increased, there should be an increased demand for information.[11]
- The growth in international capital markets also affects the demand for information. As more money is available to invest, greater expenditure can be justified on research on where to invest it.

[10] Firms, as well as their managers, have a self-reporting bias. Ronald A. Dye argues that the central premise of the theory of voluntary disclosure is that 'any entity contemplating making a disclosure will disclose information that is favourable to the entity, and will not disclose information unfavorable to the entity': 'An evaluation of "essays on disclosure" and the disclosure literature in accounting' (2001).

[11] This reduction in costs could also mean that, in some circumstances, users produce more information themselves, reducing the demand for firms to provide it.

- Disclosure generates its own demand. As more information is disclosed, users invest more in analysing it and, through analysis, generate their own private information. This in turn generates more questions that users want answered and so leads to demands for greater disclosure.
- Developments in the nature of the measurements required by accounting standards may also have shifted the demand curve to the right. It has been suggested that the increased use of fair value, for example, has increased the amount of judgement involved in preparing accounts. As a consequence, it is argued, users want more supporting information so that they can understand the judgements that have been made by preparers.[12]

When all these factors are taken into account, it is not surprising that there has been a rapid growth in the volume and complexity of business reporting in recent decades. This would probably have occurred, though not to the same extent, even in the absence of regulatory requirements for financial reporting disclosures.

2.3 MARKET RESPONSES TO DIVERSITY

Firms are highly diverse. They have different activities, use different technologies, operate in different markets and under different jurisdictions, and organise and finance themselves in different ways. All these differences mean that what is a relevant disclosure for one firm may well be irrelevant for another.

As economic growth allows consumers to exercise a growing diversity of demands, as technological advance creates a growing diversity of techniques, as new financing and organisational techniques are devised, and as the expansion of markets permits a growing division of labour, it is likely that there will be continuing growth in the diversity of firms. We would expect that, as a result of this growing diversity, the information relevant to understanding particular firms would become increasingly diverse.

Users are also diverse and are interested in different types of information about firms. To take a simple example, shareholders may be most interested in the consolidated accounts of the group, creditors may be most interested in the accounts of a subsidiary that owes them money, and employees may be most interested in the accounts of the particular unit – not necessarily a legal entity – in which they work. Users also have very different resources of time and skill to apply to financial reporting disclosures. At one extreme, there are no doubt a proportion of users who have little time and no special understanding of financial reporting. At the other extreme are a small number of investment analysts who work full time on assessing particular businesses or sectors and who may well have a highly developed understanding of financial reporting or access to others in the firm who do. Users lie at every point on the spectrum between these two extremes. Changes in markets have accentuated the differences between users, as most users' capacity to cope with the growing volume and complexity of financial reporting information by reading it all themselves has not increased.

Panel 2.1: The average investor

'Realistically, few people expect the "average" individual investor to focus in any detail on the information that companies disclose. As a practical matter, a company's disclosures are largely "filtered" through experts – various securities professionals and financial intermediaries – who research and process the information and whose trades and recommendations ultimately set securities prices' – Paredes, 'Blinded by the light: information overload and its consequences for securities regulation'.

One research study finds that even those users who do read the accounts spend on average less than 15 minutes doing so and typically do not bother to look at the notes: Vicky Cole, Joël Branson and Diane Breesch, *Are Users of Financial Statements of Publicly and Non-Publicly Traded Companies Different or Not? An Empirical Study* (2009). No doubt some users spend far more time than this – possibly days – reading a set of accounts.

In a normal market, we would expect to see the emergence of products and services – sets of disclosures in this case – that reflect the differences among firms and the diversity of users. We would also expect firms to make a better job of communicating their disclosures, and that there would therefore be fewer complaints about excessive volume and complexity.

At the same time, there are market pressures for common approaches to disclosure to emerge. It would be impossibly expensive for firms to supply every user with the precise disclosure package that would suit them. Equally, it would make life difficult for users if every firm decided in isolation what to disclose, making no attempt to provide information that was comparable with other firms' disclosures.[13]

[12] Barker et al, 'Response of the EAA FRSC to the EFRAG/ANC/FRC discussion paper: *Towards a Disclosure Framework for the Notes*'.

[13] It would also make auditing more expensive, as auditors would need to give more time to considering what disclosures are appropriate for each firm, instead of being able to rely on standardised disclosure requirements.

Again, in a normal market, an equilibrium would be found that balanced the forces for diversity and the forces for uniformity. But the market for information is not like other markets. Once financial reporting information is disclosed it becomes a public good – freely available to all (see 3.2 below). So the option of selling different information packages to different users is not available for the firms that make the disclosures.

Market participants have not overlooked the problems caused by the diversity of firms, the diversity of users, and the interaction of these diversities with the uniformity imposed by regulators and standard-setters. We may guess that most investors are not particularly troubled by receiving more information than they want. They do not bother to read the accounts, but look instead to other sources of information about the firms in which they invest: analysts' reports, newspapers and magazines, TV and radio, the internet.[14] And although firms are required to provide the same information to all users, larger public companies – for which the problems of length and complexity are most evident – usually also provide highlights of key information at the front of the annual report.[15] Any user who wants to read only this key information or perhaps just the primary financial statements can do so without great difficulty (and does not usually have to wait for the annual report for it anyway).

So although the option of selling different information packages to different users is not available for the firms that make financial reporting disclosures, these firms none the less cater to the needs of ordinary users to some extent. And other participants in the market for corporate information edit and analyse public disclosures and tailor them to target particular groups of users. In spite of all this, some users complain of being overwhelmed by the volume or complexity of financial reporting disclosures and others are keen to complain on their behalf.

[14] A 1970s study suggests that different sources of information are complementary rather than alternatives. Investors who read the accounts are more likely to consult other sources of information as well. T. A. Lee and D. P. Tweedie, 'The private shareholder: his sources of financial information and his understanding of reporting practices' (1976).

[15] Deloitte's 2012 survey of UK public companies found that 91% of the companies in their sample 'included summary information in one form or another at the start of their annual report': *Joined up Writing: Surveying Annual Reports*.

3. MARKET FAILURES

The market for financial reporting disclosures does not function effectively. To start with, the product is one that users receive for free and its producers are not paid to produce, so it's a very strange sort of market.

Does this mean that disclosures have to be regulated?

3.1 FOUR ARGUMENTS FOR REGULATING DISCLOSURES

As the principal causes of current concerns about financial reporting disclosures are – we argue – regulatory, it may be asked why they are regulated in the first place. There are four main arguments that support the regulation of financial reporting disclosures.[16]

- **Underproduction of public goods.** Because the benefits of financial reporting disclosures cannot be restricted to those who pay for them, they are 'public goods', and therefore tend to be underproduced if their production is left purely to market forces (Section 3.2 below).
- **Lack of comparability.** There are advantages in standardising financial reporting disclosures, and standardisation can be achieved more cheaply and effectively when it is done on a mandatory rather than a voluntary basis (3.3).
- **Lack of credible commitment.** Some of the benefit of financial reporting disclosure comes from knowing that it is reliable and some of it comes from having a credible commitment to disclosure. Regulatory regimes may be able to impose more effective enforcement than voluntary regimes, and so may produce both more reliable disclosures and more credible commitments (3.4).
- **Information asymmetry.** In the absence of regulated financial reporting disclosures, it is arguably easier for participants in capital markets to take advantage of those who are less well-informed, eg, by selling shares at more than they are worth, by buying them at less than they are worth, or even by committing outright fraud (3.5).

3.2 PUBLIC GOODS

3.2.1 The nature of public goods

Goods and services that are non-rivalrous and non-excludable are public goods.

Something is non-rivalrous if the enjoyment of its benefits by one person does not reduce others' ability to enjoy them. A picture on the internet is non-rivalrous. If I look at it, this does not reduce your ability to look at it. Food is rivalrous. If I eat it, you cannot.

Something is non-excludable if others cannot be excluded from the enjoyment of its benefits. The picture on the website is non-excludable if it is on a free, public site. It is excludable if it is on a subscription-only site. If a good is non-excludable, this implies that its producer will not be paid for it by all – or, in some cases, by any – of those who enjoy its benefits.

A key feature of public goods is that their production is likely to be sub-optimal.[17] As the producer is not paid for them by all of those who benefit from them, it is likely to produce less of the goods than is socially desirable.

Public goods can also be private goods in the sense that the 'public' that benefits from them may be small – any group of two or more people with a common interest. For example, a benefit to all the shareholders in a particular company may be a public good. Public goods are not necessarily, therefore, in the public interest, as one group's public good may be at the expense of others' interests, and their costs may exceed their benefits.

3.2.2 Under-production of financial reporting disclosures

Financial reporting disclosures are public goods. If I use them, this does not reduce other people's ability to use them, so they are non-rivalrous.[18] And financial reporting by a public company is information in the public domain; anybody can access it, so it is non-excludable. Because it is non-excludable, it is not feasible to charge for it. It is therefore likely to be produced in lower quantities than are socially desirable.

One benefit of financial reporting disclosure as a public good is that its provision should reduce private information-gathering costs. We may expect for example that, in the absence of requirements for firms to disclose profits, third parties would produce estimates of profitability and sell or publish them. These estimates could involve unnecessary duplication of costs, with

[16] On this subject generally, see Robert Bushman and Wayne R. Landsman, 'The pros and cons of regulating corporate reporting: a critical review of the arguments' (2010), a paper commissioned by ICAEW. They note that the case for mandatory disclosure has been 'the subject of significant debate in the academic literature, much of it driven by law and economics scholars wherein the question of mandatory public disclosure is typically embedded in the larger issue of the role of securities laws and whether securities markets should in general be regulated.' For alternative lists of reasons see G. Meeks and J. G. T. Meeks, *Towards a Cost-Benefit Analysis of Accounting Regulation* (2001), a report commissioned by ICAEW, and Anne Beyer, Daniel A. Cohen, Thomas Z. Lys and Beverley R. Walther, 'The financial reporting environment: review of the recent literature' (2010).

[17] The 'optimal' amount of anything is the best amount, reflecting all the relevant costs and benefits.

[18] This statement needs to be qualified in some circumstances. For example, if I use financial reporting disclosures to inform my share trading, the disclosures may be useful to me in this respect only until the information is fully reflected in the share price. So, in these circumstances, the disclosure is useful to its first users, but (in an efficient market) quickly ceases to give an advantage. It may of course continue to be useful in other respects, and even for share dealing purposes it may continue to give an advantage if other market participants forget about it or fail to recognise its significance in relation to later events. Information continues to be useful after it ceases to be news.

various outsiders each making their own estimates when the firm itself could produce the information more cheaply – and presumably more accurately. Requiring the firm to publish the information may therefore be more efficient for society as a whole, removing the duplication of users' costs as well as giving users what should be more accurate information.

3.3 STANDARDISATION

Standardisation is also a public good. The classic case is standardisation of weights and measures, which is likely to happen to some extent even without government intervention, but – it is generally thought – is more likely to be achieved to an optimal extent when it is imposed and enforced by governments. Standardisation of financial reporting disclosures is arguably a similar case.[19] It produces positive benefits to users, because it makes comparisons easier, but also reduces preparers' and users' contracting costs because they do not need to enter separate agreements for every firm as to what should be disclosed and how.

Standardisation is likely to be most beneficial where it coordinates disclosures of a type that firms would make anyway, using information that they already have to hand. Where these conditions do not apply, standardisation can impose significant costs, especially where it requires the production of information that the firm would not otherwise generate.

The costs and benefits of standardisation arguably apply in a distinctive way to some types of information. For example, users of financial reporting disclosures may want to compare different firms, and this is most easily done where firms provide comparable information in a common format. For such users, it may also be helpful to disclose even immaterial amounts to facilitate comparisons with companies where the comparable amounts are material.

Differences in what firms disclose can raise questions about why they aren't all doing the same thing, which can damage the credibility of financial reporting. Many people – especially non-accountants – find it difficult to understand why different companies should account differently for the same item, and are liable to assume that any flexibility in the rules in this respect must be allowing companies to get away with something that they should not be allowed to get away with. So standardisation is also a way of enhancing the credibility of financial reporting and of those involved in the financial reporting process.

The argument for standardisation of disclosures is distinct from the argument for optimisation of the amount of disclosure, and the two objectives are likely to conflict for particular firms.

The demand for standardisation of financial reporting practices is sometimes primarily governmental or political. Government agencies and regulatory bodies prefer uniformity in the interests of fairness (eg, for taxation) and for their own convenience in processing information from a large number of firms. There is also a political demand for uniformity as the existence of different practices among firms becomes difficult to defend once financial reporting is regarded as a proper subject for political debate, rather than a private matter to be resolved by the parties involved. Though standard-setters have often been private sector bodies, they have also often either been set up at the behest of governments and regulators and/or received their authority from these higher powers.[20]

3.4 ENFORCEMENT

Reliable disclosures are more useful than unreliable ones. But it is difficult for users to judge in any particular case whether disclosures are reliable; they are forced to a large extent to depend on the enforcement regime to ensure reliability.[21]

It is possible in a voluntary disclosure regime to have enforcement procedures – for example, by appointing independent auditors and by making contractual disclosures that are subject to enforcement by the courts. But mandatory systems may have more effective enforcement regimes than voluntary systems – because they have a greater range of penalties available, or because they are cheaper for users than the courts would be, or because they are able to put efficient monitoring systems in place.

It is useful not only to have a particular item of information disclosed, but also to know with confidence that the item will be disclosed. For example, knowing what profit a company made last year is useful information and, other things being equal, an investor is more likely to put money in a company that has disclosed this information than in one that has not. But it is also helpful to know that the information will continue to be reliably disclosed in the future. This requires a credible commitment by the company.

[19] See Geoff Meeks and G. M. Peter Swann, 'Accounting standards and the economics of standards' (2009), a paper commissioned by ICAEW.

[20] See, eg, Stephen A. Zeff, *Forging Accounting Principles in Five Countries: A History and an Analysis of Trends* (1971).

[21] By 'reliability' we refer to the extent to which disclosures can be trusted by users. The concept of reliability is explored more fully in Audit Quality Forum, *Reliability Matters: Reliability and the Central Role of the Auditor* (2013).

Companies can give commitments voluntarily outside a system of mandatory regulation. But, again, mandatory systems may provide cheaper or more effective enforcement regimes than are available to voluntary arrangements, thereby facilitating credible commitments.

On the face of it, the enforcement argument could be used in favour of superseding a wide range of voluntary contractual relationships – not just those relevant to financial reporting disclosures – by regulation. Whether in any particular case regulation is actually better than voluntary arrangements must depend on the circumstances.

3.5 FAIRNESS

There are a number of situations in which it is thought desirable to protect the less well-informed against the better-informed; in particular, for financial reporting disclosures, by protecting:

- lenders against borrowers[22];
- ordinary investors against professional investors;
- owners against managers; and
- potential owners against existing owners.

Where information asymmetries exist in such relationships, it is possible for the better informed party to take advantage of the other, eg, by buying or selling shares at an unfair price or even by outright fraud.

Voluntary measures may provide appropriate protections to some extent, and some people would argue that voluntary measures are more appropriate for relationships that are entered into voluntarily. But it is usually considered that regulation is needed to protect the interests of what would otherwise be the weaker party. This is essentially a matter of fairness rather than of economic efficiency, although there may also be efficiency benefits from such regulation. There are potentially a number of such benefits.

- If relatively uninformed investors suspect that they are being taken advantage of, they will tend to stay out of the market or seek a higher rate of return to compensate them for the risk they are taking – the 'adverse selection' problem. It could therefore be argued that regulation of financial reporting disclosures is desirable to help the capital markets work effectively, providing capital for businesses and returns to savers. As the SEC's chairman has observed: disclosure that provides investors with the information they need 'makes it possible for [them] … to have the confidence to invest and, as a result, allows our capital markets to flourish.'[23]
- Alternatively, it could be said that for ordinary investors the cost of acquiring the information they would need to protect themselves is too high by comparison with their potential returns from investment in equity markets. Again, the effect will be that ordinary investors will tend to stay out of the market. Requirements for companies to disclose information solve the problem relatively cheaply, again helping capital markets to work effectively.
- There is also a perceived risk that capital markets in which a significant number of investors are not properly informed will run away with themselves, leading to a cycle of boom followed by bust when reality dawns.[24] It was the conviction that ordinary investors in the US in the 1920s had been misled, that this had contributed to the stock market boom, and that the ensuing stock market crash led to the Great Depression, which prompted the federal regulation of securities disclosures in the US and the establishment of the SEC to implement it.[25]

For all these practical benefits of removing information asymmetries between the well-informed and the less-well-informed the question arises of why markets do not provide a satisfactory solution. To answer this, we are driven back to the earlier points about public goods, standardisation and enforcement.

The arguments set out in this chapter all provide good reasons for the regulation of financial reporting disclosures, but they do not mean that it is an unmixed blessing. On the contrary, regulation does not necessarily achieve its objectives, and it brings fresh problems of its own. We consider these issues in the next two chapters.

[22] Conceptual frameworks usually treat lenders and other creditors as among the primary users of financial reporting. Securities regulators commonly regard public debt offerings as bringing companies within the scope of their regulation of disclosures and other matters.

[23] Mary Jo White, 'The path forward on disclosure': speech at a conference of the National Association of Corporate Directors, National Harbor, Maryland, 15 October 2013.

[24] Christian Leuz and Peter Wysocki, *Economic Consequences of Financial Reporting and Disclosure Regulation* (2008), suggest that 'financial reporting and disclosure regulation may stabilize financial markets by limiting asset bubbles'.

[25] On this see Tim Bush, *'Divided by Common Language': Where Economics Meets the Law: US versus Non-US Financial Reporting Models* (2005).

4. REGULATION AND INCENTIVES

Regulation is intended to make people behave better in some way. But regulation typically gives us all incentives to comply with the letter of the law and to game the regulatory system to our own advantage rather than to try to meet its objectives.

And the regulators have their own incentives, which may work against achieving the desired outcomes.

4.1 PARTICIPANTS IN THE FINANCIAL REPORTING PROCESS

In any market-based financial reporting process, the primary participants are preparers and users, and the interaction between the two plays a role in shaping financial reporting disclosures. In a regulated financial reporting process, preparers and users remain important participants, but their relationship becomes less important as the content of disclosures is increasingly determined by regulators, standard-setters and, indirectly, by enforcement agencies.

A secondary but important role is played by auditors and their professional bodies. In a market-based regime, auditors advise preparers on what constitutes accepted practice, and help ensure that preparers comply with it. Their professional bodies may to some extent codify what constitutes accepted practice. In a regulated regime, the professional bodies' role is usually superseded by the standard-setter, and the auditors become the front line of enforcement for mandatory disclosures.

Panel 4.1: The role of professional bodies

It is possible to coordinate disclosures among preparers even in the absence of regulation. Before the era of mandatory accounting standards, this was usually done by professional bodies of auditors. It is still done for some types of business by specialist trade bodies.

For an explanation, based on the economic theory of the firm, of why such coordination activities make sense, see Ray Ball, *The Firm as a Specialist Contracting Intermediary: Application to Accounting and Auditing*. For historical examples of professional bodies coordinating accounting practices, see Stephen A. Zeff, *Forging Accounting Principles in Five Countries: A History and an Analysis of Trends* and *Principles before Standards: The ICAEW's 'N Series' of Recommendations on Accounting Principles 1942-1969* (2009).

Even in a market-based regime there is usually a degree of regulation. Typically, a legislature or government will have established a framework for financial reporting – setting out who has to prepare accounts, who they have to be presented to, and some requirements as to their contents. And there is usually further government involvement through enforcement by the courts.

The distinction between market-based regimes and regulated regimes for financial reporting is not, therefore, a sharp one. All financial reporting regimes are regulated to some degree, and regulation never entirely removes the role of market forces – firms can continue to make voluntary disclosures. But the distinction, though fuzzy, is important and has significant effects on financial reporting disclosures. These effects arise in large part because the transition from markets to a regulatory regime changes the incentives of existing participants in the financial reporting process and introduces new participants with their own particular incentives.

4.2 REGULATORS

In markets, suppliers often distinguish between customers in various ways. This may be because different customers have different preferences, or can afford different products, or impose different costs on the supplier (eg, because of their location), or have different bargaining powers or negotiating skills. This is true in information markets as in other markets.

In market-based financial reporting regimes, although the framework for reporting may impose a degree of equality within particular classes of users (eg, all shareholders are entitled to receive a copy of the accounts), there usually remains significant scope for preparers to distinguish among different users in the information that they provide. And there is no group of regulators working full time on financial reporting. The framework may be revised from time to time, but otherwise legislators and governments have little interest in the subject.

In a regulated regime, there are usually full-time regulators, including standard-setters. They may not have been set up primarily to regulate financial reporting, but the power to do so may have been given to them so that they can achieve their primary objectives. A securities market regulator, for example, may be established to ensure that ordinary citizens participating in capital markets are not taken advantage of by other, better-informed market participants. The regulator set up to achieve this may be given power over financial reporting as well.

A regulator of this sort has incentives to certain kinds of behaviour.

- Most obviously, regulators demonstrate their effectiveness and earn a living by making regulations and enforcing them. New problems or the persistence of old problems are deemed to be evidence of the need for more regulations or tougher enforcement or both.
- Financial reporting typically serves diverse purposes. But where a securities regulator is given power over financial reporting, it is likely to want to ensure that the objective of information to support the fair pricing of capital market transactions is given priority.

- If the raison d'être of such a regulator is to ensure fairness between capital market participants, it may well see this as implying that all users should have equal access to financial reporting information regardless of their different skills and needs.
- Regulators may set financial reporting requirements themselves, but there is often an advantage to them in distancing themselves from the process, as it typically involves a degree of unpopularity as well as expense. They may therefore support a separate standard-setter, but retain the power to remove it or to veto particular decisions, if they do not like what it is doing.
- Regulators are not rewarded if firms' disclosures are good, but they face strong criticism or worse if firms' disclosures are thought to be deficient in some way. As we noted earlier (1.2.3), there is a tendency to have great faith in regulation, but to constantly criticise regulators. This inevitably makes them defensive.

This analysis reflects the fact that disclosure regulation may be presumed to carry the inherent defects that the modern economic theory of regulation tends to see in all regulation. While an older approach to regulation tended to assume that regulators are competent and altruistic guardians of the public interest,[26] the modern economics of regulation as it developed in the US in the second half of the 20th century seems to be largely concerned with pointing out the defects of regulatory solutions. Advocates of this approach may even argue that regulators are in fact 'generally incompetent', that their 'primary concern [is] their own wealth and power', and that they are 'often captured by those whom they are charged to regulate'.[27]

More recently, however, it has been pointed out that market solutions, like regulatory solutions, involve a role for government, and that the government institutions required for the operation of markets are as imperfect as those involved in regulation. Market solutions assume that, in the last resort, conflicts can be resolved and rights enforced by the courts. But 'courts around the world are more often than not highly inefficient, politically motivated, slow, and even corrupt'. In short, 'both judges and regulators are government agents, subject to political pressures, incentives, and constraints'.[28] The nirvana fallacy – usually attributed to those who compare imperfect markets with perfect regulation – is also committed by those who compare the imperfect reality of regulation with idealised markets. It is an open question whether in any particular case a regulatory solution is likely to be an improvement on a market one.

4.3 STANDARD-SETTERS

Standard-setters are a specialised type of regulator, and their incentives are in some respects similar to those of other regulators.[29]

- Standard-setters demonstrate their effectiveness, and the continuing need for their services, by setting standards. New problems, or the persistence of old problems, are deemed to be evidence of the need for new standards or tougher standards.
- People expect standard-setters' work to result in standardised outcomes. Differences in financial reporting practices are prima facie evidence of inadequate standardisation. So the standard setting process has an inbuilt bias towards ever-greater uniformity.
- Standard-setters have a limited range of tools at their command: more or less detailed rules on measurement, recognition, disclosure and presentation. One option for tougher standards is to make them more detailed. But there is a limited range of choices available on measurement, recognition and presentation; these are not promising avenues for producing ever-tougher standards. Disclosure is a different matter; disclosure requirements can be expanded indefinitely. So for standard-setters that need to demonstrate their effectiveness, the two most promising routes are ever-more detailed standards and ever-greater disclosure.
- Where standard-setters are set up with the goal of protecting investors – or meeting users' needs – they will have an inbuilt bias towards meeting their requests for disclosure. As there is no point short of complete transparency at which investors' information needs will be fully met, requests for disclosure can be expected to move progressively closer to this goal.
- Like other regulators, standard-setters are not rewarded if firms' disclosures are good, but they face strong criticism (or worse) if disclosures are thought to be deficient in some way.

[26] This school of thought is associated with the economist A. C. Pigou (1877-1959).

[27] Bushman and Landsman, 'The pros and cons of regulating corporate reporting: a critical review of the arguments'. The words quoted are from the authors' summary of one approach within the economics of regulation, not an expression of their personal views. Their paper gives references to the key works in the economics of regulation. The classic paper on regulatory capture, though the phrase does not appear in it, is George J. Stigler, 'The theory of economic regulation' (1971). This is concerned with the regulation of particular industries or professions, rather than activities – such as financial reporting – conducted across industries.

[28] Shleifer, 'Understanding regulation'.

[29] See Ross L. Watts, 'Corporate financial statements: a product of the political and market process' (1977), for an application of the modern economic theory of regulation to accounting standards.

4.4 ENFORCEMENT AGENCIES

To be seen to be effective, enforcement agencies need to achieve not only compliance with disclosure requirements, but visible compliance. From this point of view, it is unhelpful if firms omit disclosures on the grounds that they are immaterial, and so enforcement agencies have incentives to discourage such an approach.

- Where, on grounds of immateriality, items have not been disclosed, the enforcement agency cannot tell by looking at the accounts whether there has been compliance. Every item of non-disclosure is a potential case of non-compliance, which might require specific enquiries by the enforcement agency. This increases the costs of enforcement.
- Materiality is subjective and the enforcement agency may be criticised for failing to secure disclosures that the firm says are immaterial. Generally, anything that allows judgement makes enforcement harder; a rule book is easier to enforce.
- Like other regulators, enforcement agencies are not rewarded if firms' disclosures are good, but they face strong criticism or worse if firms' disclosures are thought to be deficient in some way.

Enforcement agencies therefore tend to treat non-disclosure as a problem, but do not treat disclosure of immaterial items as a problem. This creates a bias towards disclosure of immaterial items.

4.5 AUDITORS

Auditors need both to show that audited firms have complied with disclosure requirements and to provide a cost-effective service. They have better information than governmental enforcement agencies about whether a potential disclosure is material or not. But in their capacity as enforcers they face the same potential criticism as a governmental agency if a firm that they are reporting on fails to make a disclosure that others might regard as material. And, like regulators, they are not rewarded if the firms they audit are seen as 'good' disclosers. They also have the problem that non-disclosure may prompt governmental or regulatory enquiries about why the disclosure was not made, and they may face disciplinary action and/or litigation.

For self-protection, therefore, auditors may encourage firms to disclose items specified in standards even if they are immaterial. Auditing also costs less if less effort is needed to determine what should and should not be disclosed. Both factors create a bias towards encouraging disclosure of immaterial items.

4.6 PREPARERS

In a regulated reporting regime, preparers' priority is making sure that they have met all relevant requirements. It is important to avoid adverse regulatory findings and, preferably, to avoid enforcement agencies' enquiries in the first place. There may also be a threat of litigation if omitted items are subsequently alleged to have been significant. As there are greater risks in disclosing too little than in disclosing too much, preparers inevitably err on the side of over-disclosure.

Under a regulatory regime, decisions on whether or not to disclose information involve additional effort and expense, including the preparation of documentation justifying the decisions taken, so that the firm is able to defend itself in the event of a regulatory or legal challenge. Unquestioning disclosure is simpler and cheaper.

Nor is there any evidence that the market punishes 'excessive' disclosures. In effect, as far as the market is concerned, there is no such thing as excessive disclosure.

All these factors encourage a compliance mentality among preparers and a bias towards over-disclosure. Communication and meeting users' needs can easily become secondary goals.

Panel 4.2: Philosophical resignation

Ilia Dichev, John Graham, Campbell R. Harvey and Shiva Rajgopal interviewed a number of US public company CFOs in conducting the research for 'Earnings quality: evidence from the field' (forthcoming).

'Several CFOs say that they are resigned to financial reporting as a compliance activity where they just do what the regulators tell them to do … Typical of this perspective is the following CFO: "There are so many things that are ridiculous, but rather than saying oh this is ridiculous, we say OK. We just want to get it right." Another CFO's perspective: "… at the end of the day, how should I spend my time? Do I want to spend my time working on this? Or do I want to spend my time working on strategy and driving the business? We're not going to let the accounting wag the business here, so we're just going to comply."'

Panel 4.2: Philosophical resignation (continued)

CFOs in the UK probably feel much the same way. BDO, *The Future of Corporate Reporting: What Does 'Good' Look Like?* (2013), quotes one finance director: 'There's so much legal disclosure that it's complete rhubarb.'

CFOs may of course prefer to spend their time on strategy rather than financial reporting even when disclosures are lightly regulated.

Panel 4.3: An individual investor's view of preparers

'Whilst reading annual reports, I am left with the sense that preparers are box ticking to satisfy the regulators, but trying to avoid giving me any meaningful information' – Patrick Mulvey, individual investor, commenting on a draft of this report.

4.7 USERS

For users, the need to put their requests for disclosure to preparers individually – requests that may not be accepted in a market setting – is replaced by the opportunity to lobby for their wishes to be imposed on all companies through the standard-setting process. Where users are not themselves investors, or are capital providers but not owners, the costs of these disclosures are borne by other parties, rather than by those who call for them. So in theory a regulated regime gives at least some users incentives to lobby for ever-greater disclosure.

In practice, users do not typically call for long lists of specific additional disclosures, but set out general principles for disclosures (eg, A4.1 and A4.9 in Appendix 4), which may or may not imply extensive new disclosures, depending on how they are interpreted. Indeed, in practice, it is difficult to get users to participate in the standard-setting process. This seems to be because the gains to users from improved disclosures accrue to users generally, and the costs of participating in the process exceed the benefits to any particular user.

Where users do become involved in the standard-setting process, there may be a tendency for those who do so to reinforce a bias towards significantly increased disclosures. For example, if standard-setters find users who are willing to assist them in looking at, eg, pension disclosures, they are likely to secure the help of analysts who specialise in this subject because they focus on firms with large defined benefit pension schemes. The disclosures that they find useful will reflect their expertise, but may be disproportionate for firms that do not have significant defined benefit schemes. This could be seen as a materiality problem, rather than a problem with standards, but to the extent that it is a standard-setting problem, the involvement of knowledgeable users may well reinforce it.

Also, it is not clear that all users necessarily gain from improved disclosures. Users are in competition against each other to spot under- and overvaluations and to profit from them. Competitive advantage is gained by superior information or superior ability to analyse information. Competitive advantage is reduced if everybody has the same information. Alternatively, competitive advantage can be reinforced if disclosures are so complex that it requires special skills to interpret them. Some users, therefore, may have no incentive to lobby for improved public disclosures and, where they do lobby for them, may have no interest in ensuring that they are readily comprehensible to the ordinary investor.

Finally, passive investment strategies have become more important in recent decades. The investors who adopt such strategies have a strong interest in the effectiveness of the financial reporting and corporate governance systems as a whole. But they are unlikely to gain by taking an active interest in improving the financial reporting or corporate governance of individual firms.

So, while regulation creates opportunities for users to lobby for additional disclosures that would be helpful to them, the fundamental feature of users' incentives remains unchanged by the introduction of regulation. Where ownership is dispersed, users have inadequate incentives to become involved in either market or regulatory processes for determining disclosures because the resulting outputs are public goods from which all benefit.

4.8 THE EFFECT ON PROFESSIONAL JUDGEMENT

The incentives introduced by regulation change the nature of professional judgement. The objective of financial reporting is to give a true and fair view (or to present fairly) so as to provide investors with useful information. Preparers should be asking themselves, 'What do we have to disclose to give a true and fair view?' and 'Would this information be useful to investors?' These are subjective matters that require professional judgements from auditors as well as preparers.

Partly no doubt because some of those who should have been exercising professional judgement failed to do so properly, the scope for judgement has been progressively narrowed by regulation. It cannot be entirely eliminated. There is still an overriding requirement to give a true and fair view (or to present fairly), and participants in the financial reporting process – who in a regulated regime include enforcement agencies as well as preparers and auditors – should always bear this in mind. And there remain many subjective elements in financial reporting that require judgement; it is not as though the process has become automated. But the more reporting is regulated, the more judgement is directed towards compliance with checklists of specific requirements.

The effect on disclosure is therefore likely to be a focus on the detail of requirements even where the disclosures may not be material and, at least for some participants in the process, the application of as little thought as possible to what the disclosures are intended to achieve.

5. REGULATORY FAILURES

Regulation is introduced in an attempt to tackle market failures. But it introduces its own regulatory failures.

The key issue for financial reporting disclosures is that regulation imposes uniform requirements for firms whose activities are diverse, for the benefit of users whose needs are diverse. It should not be a surprise that this causes problems.

5.1 FUNDAMENTAL PROBLEMS OF DISCLOSURE REGULATION

In this chapter we identify the regulatory failures to which the incentives embedded in the current system give rise. But not all the problems of regulating financial reporting disclosures are about incentives. Some of its greatest difficulties arise from the nature of the task itself. In particular, the regulation of financial reporting disclosures is subject to a number of fundamental problems, which mean that standard-setters are not only unlikely ever to get it exactly right but are unlikely even to know whether they have got it right.

- There is no clear and practical objective for deciding which disclosures to mandate. Although standard-setters set out objectives for financial reporting in general, these are at too high a level to provide much help with specific disclosures.
- Arguably, decisions on disclosure requirements should be made on the basis of a cost-benefit test, but the benefits of particular disclosures are usually impossible to measure precisely. Direct costs can sometimes be measured, but proprietary costs are more speculative. Cost-benefit tests for financial reporting disclosures, which all accounting standard-setters endorse in principle, are inevitably subjective.[30] Such assessments remain subjective even when they are relabelled as 'regulatory impact analyses'; the change of name may be intended to acknowledge the difficulties in quantifying costs and benefits.
- Because, for the reasons just given, arguments on the merits of the case for any potential disclosure requirement are often inconclusive, decisions on disclosure requirements tend to have a political element. They are also inevitably political in the sense that they impose costs and benefits unevenly among different parties.[31]

Such problems are not unique to financial reporting; they are common to all decisions about the production of public goods. How can we know, for example, what is the optimal amount of money to spend on defence or public parks or the advancement of science, or what is the best way to spend it?

These difficulties reinforce the problems that arise from the pattern of incentives we identified in the last chapter. As a result, there may well be a tendency for disclosure requirements to be either sub-optimal (too little disclosure) or super-optimal (too much disclosure), but no one can be sure which is the current position. Indeed, there is a case to be made that standard-setters, by the nature of their task, always necessarily get it wrong for any particular firm. This is because differences between firms in the costs and benefits of particular disclosures 'are likely to make the optimal amount of disclosure specific to each firm'.[32] So regulation, it could be argued, inevitably produces the wrong disclosures.

As Ronald Dye has pointed out, 'the presence of an inefficiency or market failure does not necessarily signal the desirability of regulatory intervention, as whatever led to the market failure may also lead to regulatory failure'.[33] In Chapter 1 we identified three fundamental problems of financial reporting disclosure: subjectivity, self-reporting bias, and proprietary costs (potential self-inflicted damage). These do not disappear once financial reporting is regulated. Users may still disagree with preparers' subjective decisions about what needs to be disclosed. What is disclosed may still be biased towards good news. And disclosures may still be limited by proprietary costs. So there will still be frustrations and complaints that the 'wrong' information is being disclosed. As we note below, the solution to this is likely to be seen as more regulation.

In the remainder of this chapter, we consider how regulation might cause or contribute to the following problems: too much disclosure; too little disclosure; the wrong disclosures; too complex disclosures; and poorly communicated disclosures. Additional difficulties caused by the international dimension of regulation are noted. We also consider a group of conflicts at the heart of disclosure regulation: between winners and losers from the disclosure of proprietary information.

5.2 TOO MUCH DISCLOSURE

5.2.1 Four types of problem

If people consider that disclosures are excessive – that there is information overload – this could indicate any of the following types of regulation-induced problem or a combination of them.

[30] On this, see FASB, *Benefits, Costs, and Consequences of Financial Accounting Standards* (1991), Meeks and Meeks, *Towards a Cost-Benefit Analysis of Accounting Regulation*, and Katherine Schipper, 'How can we measure the costs and benefits of changes in financial reporting standards?' (2010), a paper commissioned by ICAEW.

[31] The political nature of accounting standard setting is discussed in Michael Bromwich, *The Economics of Accounting Standard Setting* (1985), Chapter 5.

[32] Leuz and Wysocki, *Economic Consequences of Financial Reporting and Disclosure Regulation.*

[33] 'An evaluation of "essays on disclosure" and the disclosure literature in accounting'.

- The disclosures required by standards are excessive (5.2.2).[34]
- The disclosures required by standards are not in themselves excessive, but in applying the requirements firms disclose too much (5.2.3).
- The disclosures required by standards are not in themselves excessive, and in applying the requirements firms do not disclose too much, but they communicate them poorly so that they seem excessive. We identify the regulatory causes of this problem at 5.6 below.
- The disclosures required by standards are excessive for some users, but not for others (5.2.4).

5.2.2 Excessive requirements in standards

Why might standard-setters' disclosure requirements be excessive?

Ideal of transparency. Transparency is often stated to be the goal of financial reporting. This sounds good and gives financial reporting an attractively idealistic character. There is no correspondingly attractive ideal of opacity to limit disclosures. The ideal of transparency therefore gives continuing impetus to requirements for ever-greater disclosure.

Cumulative growth. Once a requirement has been introduced, it is difficult to remove it. This means that disclosure requirements simply accumulate. As 'almost any piece of information can have value',[35] the list of potential disclosures is endless, and there is an ever-growing list of required disclosures that have been recognised as important at one time or another for at least some firms.

Priority for users. Standard-setters often state that their work is intended to meet the needs of the users of financial reporting information. As some users have an apparently limitless appetite for disclosure and many of them benefit from it without bearing its costs (ie, they are free riders), this introduces a bias towards ever-increasing disclosure.

Regulatory logic. There tends to be a characteristic logic to the development of regulation. Whenever there is an apparent failure or crisis, the assumption is that this indicates that there has not been enough regulation. People call for tougher rules or tougher enforcement. So, in financial reporting, each crisis or perceived failure leads to calls for more disclosure, not for less. This reinforces the cumulative-growth effect referred to above. And standard-setters demonstrate their effectiveness to stakeholders by making fresh requirements, not by allowing firms to disclose less.[36]

Panel 5.1: Being seen to be doing something

For any regulatory authority, where there are perceived problems there is a constant need to be seen to be doing something about them. And once a topic is under review, 'There is always the temptation … to make detailed changes to demonstrate that a thorough job has been done.'[37] Making additional disclosure requirements is often the easiest way to be seen to be doing something.

Political pressures. Users may lobby in favour of increased disclosures, and other bodies may reflect users' views in what they say. As users should arguably have the dominant voice in deciding financial reporting disclosure requirements, this could be seen as appropriate and in the public interest, but it is possible that standard-setters could defer unduly to them.

What we refer to as 'political' pressures typically have little to do with politics as it is usually understood. But sometimes such matters become political in the conventional sense. While it is possible to think of counter-examples,[38] financial reporting usually becomes a matter of national politics only when there is some accounting scandal – a great fraud, for example – or an economic crisis that for some reason becomes associated with accounting issues. The nature of these events is such that they are likely to lead to politicians demanding more disclosure rather than less. And sometimes they lead to the creation of institutions, such as the SEC, part of whose raison d'être is increased disclosure.

Incrementalism. Disclosure requirements are considered in isolation by standard-setters. It is not considered whether the total volume of disclosures is reasonable. It is widely assumed that if disclosures were considered in total rather than individually there would be fewer of them. If this is correct (which it may not be: see 5.3 below), it is another reason why disclosures would tend to be excessive.

[34] To simplify the argument in this chapter, we will assume that – except where otherwise indicated – disclosure requirements are imposed by standard-setters.

[35] Stephen A. Ross, 'Disclosure regulation in financial markets: implications of modern finance theory and signaling theory' (1979). The disadvantages of standardisation, including the risk that 'a flood of standards [might lead] to an indigestible quantity of details and notes', were identified by early critics of the process. See, eg, William T. Baxter, 'Accounting standards – boon or curse?' (1981).

[36] Disclosure regimes for smaller or private companies are sometimes an exception to this rule.

[37] Turnbull Review Group, *Review of the Turnbull Guidance on Internal Control* (2005), p3.

[38] For example, the debate in the US in the 1990s on how to account for stock options.

5.2.3 Excessive disclosure by individual firms

There are two main reasons why, even if the disclosure requirements in standards are 'right' and not excessive for firms in general, they might lead to excessive disclosures by the individual firm.

Standardised requirements. For the sake of comparability, standardisation imposes uniform disclosure requirements on diverse firms, but an appropriate disclosure for one firm may be superfluous for another. Indeed, unless disclosures are constrained by the application of materiality, standardised disclosure requirements could mean that the greater part of any single firm's disclosures are immaterial. One factor that might lead to over-disclosure is that, on any particular issue, standard-setters are likely to set requirements that reflect the position of those firms for which the issue is important. For example, in setting disclosure requirements for financial instruments (especially following the financial crisis of 2008) they probably have banks in mind. In setting disclosure requirements for leases, they inevitably have in mind firms for which leasing is significant. And so on.

Panel 5.2: Comparability – a user view

'There is a danger that reporting frameworks are … forcing [companies] to hack up their appearance or stretch themselves to fit, all in the name of comparability. There is a danger that this process of manipulation in order to fit the … reporting frameworks serves to mask the underlying realities of the companies. Comparisons can be made, but only between false versions of companies' – Paul Lee, *Procrustean Beds: Ensuring Reporting Standards for Companies Are Appropriately Flexible* (2013).

A second reason why standardisation is likely to lead to over-disclosure at the level of the individual firm is that standard-setters typically focus on public companies in setting their requirements. While the *IFRS for SMEs* has lower levels of disclosure appropriate to private companies, it could still be argued that, given that the standard is potentially applicable to even the smallest firms, for many private companies the requirements in the *IFRS for SMEs* would still be excessive. However, as we noted in Chapter 1, disclosures by private companies do not seem to be a major problem.

The central issue is that what is significant varies from one firm to another and from year to year. Standardised disclosure requirements are set to cast the net widely so that every firm, every year, discloses what is important. The result is that a mass of relatively unimportant information is liable to be caught up at the same time. It seems plausible that most firms could strike out at least some of their disclosures without materially misleading anybody.

Enforcement agencies and auditors. In theory, disclosure requirements in standards should not lead to immaterial disclosures because firms are only required to disclose what is material. In practice the materiality test seems to provide an ineffective screen, possibly because enforcement agencies and auditors push firms towards excessive disclosure. There are several possible reasons why enforcement agencies and auditors push firms towards more disclosure rather than less.

- They may believe that not disclosing something significant is more serious than disclosing something insignificant.
- Some users like full and predictable disclosures.

Enforcement agencies may fear that if firms are given discretion over what to disclose, they may use it to hide bad news rather than to cut out pointless disclosures.

- As noted in Chapter 4, the enforcement process is less costly if relevant agencies know what disclosures to expect and auditors know what disclosures are required.
- As also noted in Chapter 4, agencies' enforcement of compliance and auditors' effectiveness may be questioned if, on grounds of immateriality, items are not disclosed.

5.2.4 Differences among users

Standard-setters seek to meet the information needs of diverse groups of capital providers. They recognise that they cannot meet all of them, so they 'seek to provide the information set that will meet the needs of the maximum number of primary users'.[39] Even so, if the needs of the maximum number of primary users are to be met, there must be extensive disclosure requirements, many of which will be superfluous to the needs of any particular user.

In particular, standard-setters tend to focus on the small number of users who have the greatest demand for information. Meeting their needs necessarily results in disclosures that significantly

[39] IASB, *The Conceptual Framework for Financial Reporting 2010*, paragraph OB8. 'Primary users' are essentially capital providers.

exceed most users' needs, creating problems of disclosure overload. This is another aspect of the 'standardisation' issue. Yet for the sake of fairness, regulation requires firms to disclose the same information to all users, with the result that ordinary users are faced with reports designed for users who benefit from long and complex disclosures.

Panel 5.3: Diversity of demand

'[T]he value of information is personal and subjective and can vary across investors as their personal characteristics differ. This can lead to a heterogeneity in the demand for financial information among investors' – William H. Beaver, *Financial Reporting: An Accounting Revolution* (1989), p23.

Vicky Arnold, Jean C. Bedard, Jillian Phillips and Steve G. Sutton, in 'Where do investors prefer to find nonfinancial information' (2010), draw attention to the diversity of information that different investors choose to use. The article covers financial reporting information as well as non-financial disclosures. In 'Enhancing and structuring the MD&A to aid investors when using interactive data', the same authors (Sutton et al, 2012) explore differences in user preferences regarding MD&A (management discussion and analysis) disclosures.

5.3 TOO LITTLE DISCLOSURE

Why might standard-setters require less disclosure than would be optimal?

Incrementalism. Historically, public disclosure by firms started at a low level and, by comparison with the information available to management, remains at a low level. It could therefore be argued that the present incremental approach to adopting new disclosure requirements is too weak and that significant further growth in disclosures would be necessary to meet user needs as current and past levels of disclosure have been wholly inadequate. On the assumption that disclosures become individually less useful as they grow in volume, a marginal approach (which is the one currently employed by standard-setters) is a tougher constraint on new disclosures than one that considers the costs and benefits of disclosures as a whole when deciding on new disclosure requirements.

Political pressures. In most circumstances there is a constant pressure from preparers to moderate disclosure requirements because of the costs they impose on firms and their managers. Sometimes this pressure is mediated through the views of other groups, which may reflect preparer opinions. In a market economy, the general welfare depends significantly on the success of business, so it is in the public interest that the views of the business sector should carry due weight. But as it is difficult for standard-setters to determine what 'due weight' should be on any particular issue, they may end up, by accepting preparer views, setting disclosure requirements at a sub-optimal level.

Panel 5.4: Lobbying against proposed disclosure requirements

In the foreword to the FASB's 1991 report *Benefits, Costs, and Consequences of Financial Accounting Standards*, Dennis Beresford, the FASB chairman at the time, notes that 'a large portion of the costs [imposed by financial reporting standards] are incurred by a community of financial statement preparers that for the most part is relatively homogeneous, well organized, and articulate, but the benefits accrue to a very large, heterogeneous, and unorganized universe of users of financial information. In fact, one can argue that many of the benefits are enjoyed by society at large.' The implication is that preparers will be effective lobbyists against measures that are in the public interest.

In the same report, Diana J. Scott and Wayne S. Upton observe that 'A financial reporting standard represents a loss of management control over information – loss of the ability to decide whether, when, or how to present information.'

Ignoring some users. Standard setting focuses on the needs of certain users ('primary users', ie, capital providers), but ignores those of other user groups. Unless the needs of these groups coincide with those of primary users, disclosures that meet their needs are unlikely to be required.

Ignoring some needs. Even primary users' information needs tend to be ignored by standard-setters unless they concern information considered relevant in helping to forecast cash flows. Information needed purely for control purposes (see A1.1 below) is not regarded by standard-setters as falling within their remit. This may mean that it is relatively neglected. And even some information that is relevant to assessing future cash flows from an entity is liable to be regarded as outside the scope of standard-setters' work: for example, the disclosure of legally distributable profits – a relevant concept in some jurisdictions, such as EU member states – is not currently dealt with by accounting standards.

Standardised approach. Standard-setters necessarily treat unlike companies alike and while their standardised requirements may well be sufficient for most companies, there may be companies for which a standardised approach leads to too little disclosure.

Incomplete specification. As it is impossible to specify all the information that users might find useful, any approach that relies on specifying what should be disclosed will always fall short.

5.4 THE WRONG DISCLOSURES

As firms can make disclosures additional to those required by standard-setters, it could be argued that they have no excuse for not disclosing information that they consider relevant to investors, but which is not mandatory. If they believe that they are making the 'wrong' disclosures, they should do something about it.

But if standards lead systematically to what people regard as the wrong disclosures, this suggests either that the people making these claims have misguided expectations or that the standard setting process is defective. The most long-standing and insistent demand from investors for more information has been for better segmental information. The reason this information is never disclosed to the extent that at least some users would like is that it is claimed to be commercially sensitive, ie, its disclosure would impose proprietary costs.

Also, as noted above, because the range of information that is potentially relevant is limitless, it is impossible to specify comprehensively what firms should disclose. So in any system where disclosures are restricted to what the regulations specify, disclosures will always be 'wrong'.

5.5 TOO COMPLEX DISCLOSURES

Although the allegation of excessive complexity is sometimes made against current disclosure practices as a discrete charge, it is difficult to separate it in practice from other issues (eg, excessive volume of disclosures). In some instances perceptions of complexity may well be induced primarily by the volume of disclosures, in which case the regulatory causes of lengthy disclosures are also the prime causes of complexity. But users do sometimes query the complexity of required disclosures on particular matters: notably, stock-based compensation, defined benefit pension plans, and financial instruments. Poorly communicated disclosures can also exacerbate complexity, so the regulatory causes of this problem also need to be examined.

5.6 POORLY COMMUNICATED DISCLOSURES

There is a conflict between detailed regulation and effective communication. Communication is an art. It is not something that can be regulated in detail to achieve the desired results. We suspect that some of the current unhappiness with financial reporting disclosures is because they are poorly communicated. Managers are perfectly capable of communicating effectively when they are allowed to and have the incentives to do so. But detailed regulation of disclosures inevitably limits how well information can be communicated and shapes the behaviour of managers, who feel bound to give priority to compliance as an objective in its own right.

Panel 5.5: A preparer's confession

'I have worked on many 10-Ks during my career and I will admit that the notes, even mine, are not written to be read. They are written to comply with a lot of rules' – Arthur J. Radin, 'Have we created financial statement disclosure overload?' (2007).

Regulators and standard-setters, who may be seen as the main cause of these problems, have not been short of advice to preparers on how they can improve their communication skills. The three 2012 discussion papers on disclosure frameworks from FASB, EFRAG/FRC/ANC, and the FRC (see Appendix 4 at A4.5-A4.7), all have sections offering useful guidance on how to improve the communication of financial reporting information.

Some managers may even deliberately make their reports less readable in the hope of obscuring bad news. One research study suggests that this is not uncommon.[40] The same study, though, finds that the market is not fooled.

5.7 THE INTERNATIONAL DIMENSION

International disclosure requirements inevitably lead to disclosures that are more useful in some countries than in others. This is because the usefulness of a disclosure depends on the context in which it is made, and some of the relevant differences in context are ones that vary from country to country, such as those listed at Panel 1.9: ie, auditing regime, communication infrastructure, financial analyst community, financial system architecture, legal environment,

[40] Feng Li, 'Annual report readability, current earnings, and earnings persistence' (2008).

other corporate control mechanisms, industry concentration, political influence over business activities, and human capital.

If disclosure requirements are modelled on what is useful in certain countries, they are likely to lead to superoptimal or suboptimal levels of disclosure in other countries. Judging from the list of factors just mentioned, financial reporting disclosures are likely to be most useful in a country such as the US. Disclosure requirements modelled on what is appropriate for that market might, to varying degrees, be excessive in others.

Different jurisdictions also have different views on the function of financial reporting: for example, whether it is for valuation purposes, for control purposes, or both. Again, this implies that determining disclosures internationally on the basis of particular jurisdictions' preferences is unlikely to lead to universally-appropriate results.

5.8 PROPRIETARY INFORMATION AND CONFLICTS OF INTEREST

5.8.1 Transparency: winners and losers

It is conventional to think of transparency as a good thing and therefore to regard those who, on any particular issue, resist disclosure as clearly in the wrong. But it is arguable that a better way of looking at things would sometimes be to see transparency on any particular issue in terms of winners and losers. This is certainly the case in relation to the disclosure of proprietary information, where transparency imposes costs on some parties and bestows benefits on others, and it is by no means clear exactly where the public interest lies.

Below we discuss the conflicts of interest in relation to the disclosure of proprietary information between: pioneers and imitators, producers and consumers, firms and their contracting counterparties, preparers and users, and diversified and undiversified investors. We also look at how alternative forms of governance might avoid or mitigate these conflicts.

5.8.2 Pioneers v imitators

A firm's knowledge of what is profitable and what is not is a form of intellectual capital – akin to an invention, but often much more transient. If this information is disclosed, then the firm's competitors benefit as they learn which fields to move into and which to avoid, without having to incur the costs of being first movers. In this situation, the winners from disclosure are the imitators, and the losers are the pioneers.

In the short term, transparency may benefit the economy as a whole, as it promotes competition. But it also deters firms from undertaking projects that will create new information about what is profitable and what is not, as the information will quickly be shared.[41] As this reduces the benefits to being a first mover, it is also likely to deter entrepreneurial innovation, though we cannot say by how much.

It is considered in the public interest to allow firms exclusive use of their inventions for a limited period through the patent system. This gives firms an incentive to make inventions. But in the long run it is considered in the public interest to allow other firms to use these inventions, so patents have a limited life. Similar principles seem to be applicable to a firm's private information about what works commercially and what does not. The position is not quite the same, as patents actually prevent competitors from exploiting the new information even if they subsequently discover it for themselves. With commercial activities, any firm is (in general) free to imitate another's activities whether or not the results of the pioneer's venture are disclosed, so they can discover for themselves what works and what does not, and exploit this information.

5.8.3 Producers v consumers

Consumers benefit from competitive markets, so to the extent that the disclosure of proprietary information promotes competition, then it also benefits consumers. So in this situation, consumers are the winners, and producers (ie, those that disclose proprietary information) are the losers.

It is usual to think of what is best for the economy in terms of what is best for consumers, but producers will only innovate if they foresee a satisfactory return from innovation. Again – as with the patent system – it may be in consumers' long-term interests to allow innovative producers to have an exclusive right to their knowledge at least for a while. As noted above, this does not in fact prevent competition, it just increases temporarily the rewards to the pioneer producers until competitors decide to enter the market.

[41] So 'disclosure can have the effect of lowering the return to activities that generate information': Ross, 'Disclosure regulation in financial markets: implications of modern finance theory and signalling theory'.

5.8.4 Disclosing firms v counterparties

Firms enter into contracts with suppliers (including employees) and customers in relation to particular projects. In doing so, firms do not lay their cards face-up on the table. If the counterparties know how profitable a project is, they may bargain for a higher price – effectively demanding a share of the profits. If the counterparties know how unprofitable a project is, they may avoid it, as they might consider that from their point of view it involves too much risk. The arguments in favour of full disclosure at the project level are the same as those in favour of full disclosure at the firm level (see Chapter 2), but in practice firms do not regard full disclosure as being in their interests because they see it as imposing bargaining costs.

In this situation, the losers from full disclosure are the disclosing firms, and the winners are their contractual counterparties. It is not clear where the public interest lies here. But it is interesting that public policy traditionally sees a public interest in disclosure at the level of the firm (which is of most interest to investors in the firm), but not at the level of the project (which may be of most interest to the firm's other contractual counterparties).

5.8.5 Firms v users

Users' interest, in their capacity as users rather than investors, is in full disclosure of proprietary information so that they can make more accurate forecasts of future cash flows and assessments of the firm's value. Firms' interest – that is, the interest of disclosing firms with proprietary information – is in maximising the future cash flows. If there is full disclosure of proprietary information, forecasts of cash flows will be more accurate, but the cash flows to the disclosing firm will be lower. In this situation, users are the winners and firms are the losers.

Where does the public interest lie? Improved valuation and better forecasts of cash flows 'can facilitate the allocation of capital to the highest value projects'.[42] Better resource allocation should mean better performance for the economy as a whole. Yet this is at the expense of the firms making the disclosures. The question, again, is how far this acts as a deterrent to innovation. It is possible that there is a tension between facilitating efficient pricing by securities markets and promoting economic growth.

5.8.6 Diversified v undiversified investors

A diversified investor has no interest in particular financial reporting disclosures as they are firm-specific, and it has diversified away the risks (and opportunities) of its investments in any particular firm.[43] Its interest is in the efficiency of the market as a whole.

For an undiversified investor, the position is different. If it has an interest in a firm with proprietary information, then its interest is for that information not to be disclosed. As we noted earlier (2.1.3), a firm's managers are effectively undiversified investors as their human capital (and perhaps their financial capital as well) is likely to be significantly tied up in the firm.

In this situation, the winners from full disclosure are the diversified investors, and the losers are the undiversified investors. There are therefore potential conflicts of interest between diversified investors and the firms in which they invest (and with the undiversified investors and managers in those firms). Once again, it is unclear on which side the public interest lies. The answer may partly depend on whether it is wished to encourage forms of corporate governance under which owners take an interest in the firm in which they invest. Perhaps surprisingly, full disclosure may militate against such forms of governance.

5.8.7 Going private

Because of the costs of disclosing proprietary information, and as long as there is a difference in disclosure requirements for private companies and public companies, going (or staying) private is always an option if firms regard public company disclosure requirements as excessive.

5.8.8 Insider governance

Under the corporate governance system for public companies that exists in a number of countries there is in effect a deal between managers and investors. Managers are left to get on with running the business, but are accountable for their performance. Managers' freedom of action is constrained by non-executive directors and by the constant possibility that shareholders (including 'corporate raiders') may decide to make a strategic intervention, but within broad limits they are left to get on with it. In return, they are accountable for their performance and provide disclosures accordingly. These disclosures are truthful, but do not provide full transparency, because full transparency would interfere with managers' ability to run the business and would cause the business competitive harm.

[42] Bushman and Landsman, 'The pros and cons of regulating corporate reporting: a critical review of the arguments'.

[43] John Christensen, 'Conceptual frameworks of accounting from an information perspective' (2010), a paper commissioned by ICAEW.

Alternatively, a different system of corporate governance – 'insider governance' – could be adopted that would allow privileged investors access to inside information even though the company is publicly quoted. This is not uncommon in some countries and even in countries where it is unusual, it is sometimes found in public companies in which there is substantial family control. Under governance of this sort, private disclosure to insiders to some extent takes the place of full public disclosure, even for public companies, thereby avoiding competitive costs. Also, under this system, managers can expect more interference from owners – or they may be owners themselves.

Ray Ball, S. P. Kothari and Ashok Robin, in 'The effect of international institutional factors on properties of accounting earnings' (2000), note that insider governance becomes less feasible as a firm's significant investors become more diverse – numerically, geographically, culturally or linguistically. They find that, in countries with governance systems of this sort, stock market prices are not necessarily – as one might expect – based on less up-to-date information. This is because such jurisdictions usually allow insider trading; so the market is informed through insiders trading on private information, rather than through public announcements.

The nature of being 'informed' differs under the two systems. Under a system of private disclosure, the market is in effect informed that a company's value has changed and is left to infer the news underlying the change, which may prompt a further change in value. Under a system of public disclosure, the market is given the underlying news and is left to decide how this affects the company's value.

The ordinary investor is arguably in much the same position either way as, under both systems, keeping track of 'what the market knows' is a full-time job.

5.9 CONCLUSION

Overall, it is a predictable result of the present regulatory system that, while it no doubt leads to many useful disclosures, it also leads to a proportion of disclosures that are irrelevant to particular firms and to particular users, and, if it is left unchanged, the proportion of irrelevant disclosures is likely to grow.

At the same time, because it is impossible to specify in advance all relevant disclosures, and because regulation cannot eliminate the problems of subjectivity, self-reporting bias, and proprietary costs, users continue to receive the 'wrong' information.

6. RECOMMENDATIONS

The problems of financial reporting disclosure are partly unavoidable and partly the product of the current regulatory system.

This system can be changed for the better – if everybody is willing to take the risks and meet the costs involved. But people also need to be realistic about what can be achieved. And effective reform will require all concerned to work together to achieve it.

6.1 OVERVIEW

If, as we have argued, dissatisfaction with financial reporting disclosures – though partly unavoidable – is largely a product of their regulation, then there are broadly four kinds of ways in which the problem can be tackled:

- reform the process for setting disclosure requirements (6.2);
- change the requirements themselves (6.3);
- change the way in which the requirements are implemented (6.4); and
- place more reliance on non-regulatory solutions (6.5).

We set out below recommendations for reform in each of these four categories. A number of other possibilities are discussed in Appendix 2. The recommendations are interdependent. And no one actor or group of actors in the financial reporting process is in a position on its own to reform disclosures and their regulation; a coordinated approach is needed.

Several of the recommendations refer to standard-setters. While we primarily have the IASB in mind with these proposals, they may also be applicable to other, national standard-setters. But standard-setters operate in different ways, and each one is set up within a particular business, legal and institutional environment. What we envisage for the IASB will not necessarily, therefore, be appropriate for other standard-setters.

None of the proposed reforms is a panacea and none of them is cost-free or risk-free; there is a need for realism as to how much can be achieved (6.6-6.7).

6.2 REFORMING THE PROCESS FOR SETTING DISCLOSURE REQUIREMENTS

6.2.1 Reforming the standard-setting system

There is a perceived bias in the standard-setting process for disclosures, which it is sometimes suggested focuses unduly on the needs of a small group of users who have an apparently limitless appetite for information, but who do not bear the costs of producing it – ie, they are free riders. This problem is addressed by our first recommendation:

> **Recommendation 1: The standard-setting process should be reformed so as to give more weight to the views of equity shareholders who as owners meet the costs of disclosure requirements.**

Giving more weight to the views of shareholders would focus the attention of standard-setters on whether their proposals will be acceptable to those who ultimately pay for them and who are also their principal beneficiaries. While this would change how standard-setters approach their task, it is impossible to predict exactly what effect it would have on disclosure requirements.

- Shareholders have an interest in satisfying the information needs of other parties that contract with the firm, so other users' interests would not be left out of account.
- It seems unlikely that the information needs of sell-side analysts who are free riders are very different from those of buy-side analysts whose employers meet the costs of disclosure.
- While at the level of the individual firm there is a conflict of interests between existing shareholders and potential shareholders because existing shareholders might want potential shareholders to overvalue the firm, this is not true across the population of firms as a whole. Across the market, those who buy shares and those who sell shares are by and large the same people. There is no reason to think that existing shareholders as a group would have a bias against disclosures that are of benefit to potential shareholders.

Our initial assumption is that giving more weight to the views of shareholders would not lead to a dramatic reduction in disclosure requirements, which evidence suggests are generally supported by institutional shareholders who are able to make use of the disclosures they generate. Smaller shareholders may take a different view, but our proposals for differential disclosures (6.3.1 below) are designed to meet their needs. In the long run giving more weight to the views of shareholders would put a constraint on the indefinite expansion of disclosures that does not exist currently.

We should emphasise that this proposal is not a criticism of existing standard-setters, which make strenuous efforts to consult users and to appoint a number of them to standard-setting boards. But these efforts, though desirable in themselves, do not usually distinguish between sell-side and buy-side users, and we understand that in practice it often proves easier to involve sell-side users. While this implies practical difficulties in our own suggestion, it also helps explain why there is some scepticism among outsiders about how far standard-setters' proposals reflect investors' views.

6.2.2 A disclosure framework

It is sometimes suggested that the problem of disclosure could be significantly lessened if there were an agreed disclosure framework or set of principles to govern requirements for financial reporting disclosures. Such frameworks may well be useful in making standard-setters think more carefully about how they set disclosure requirements.

Recommendation 2: Standard-setters should establish a framework to provide a structure for setting disclosure requirements.

This should ensure that disclosures are only required when they are needed, and are properly organised. The framework should form part of the conceptual framework for financial reporting.[44] The level of disclosure is effectively a deal between owners and managers, and between preparers and users, and it therefore requires a balancing of interests, not a single-minded pursuit of transparency. This balancing of interests may be expressed as a cost-benefit test, although the costs and benefits will often fall to different parties. This is why the process is inherently one of compromise, and may be seen as essentially political.

If the framework forms part of the conceptual framework for financial reporting, this should ensure that as far as possible it is consistent with, and avoids overlaps with, the contents of the framework on questions of recognition, measurement and presentation.

However, the incentives that may lead to less than optimal results at the level of individual standards also apply to the conceptual framework setting process. Care will therefore need to be taken that the framework does not become an agenda for extensive new disclosures, as some of the proposals for such a framework listed at Appendix 4 seem to imply.

6.2.3 Standard-setters' assumptions on materiality

At present, standard-setters are able to assume that firms only make disclosures when they are material, and presumably their assessments of the costs and benefits of disclosure requirements are made on this basis. This is unrealistic.

A number of steps are needed to encourage a behavioural shift by preparers so that they omit immaterial disclosures. But there is no guarantee that these steps will be taken or that they will have the desired effect on preparers. Our next recommendation reflects this problem:

Recommendation 3: To the extent that firms comply with disclosure requirements even though the resulting information is immaterial, standard-setters should reflect this in deciding whether disclosure requirements are proportionate.

If practice changes, and immaterial disclosures do in fact disappear, then standard-setters should adjust their assumptions to reflect this.

This proposal may put standard-setters in a difficult position if they wish to impose disclosure requirements that are important for some firms, but immaterial for most others. Such an example goes to the heart of the issue. If standard-setters are able to impose requirements that are important for some firms, but disregard the fact that they will in practice result in immaterial disclosures by many other firms, then the problem of immaterial disclosures will simply get worse. Standard-setters may none the less conclude that the benefits of such a disclosure requirement in a particular case exceed the costs, but they should be realistic about what the costs are.

6.3 CHANGING THE DISCLOSURE REQUIREMENTS

6.3.1 Different disclosures for different users

At present the disclosure system fails to distinguish between the very different needs of the users of financial reporting information. While some users may be happy with lengthy disclosures, the majority are sent information that is far longer and more complex than they want. There is of course a spectrum of users, and to categorise them into just two groups is an oversimplification, but the information package sent to all users tends to focus on the needs of those at one end of the spectrum and so is unhelpful for those at the other end.

[44] *A Review of the Conceptual Framework for Financial Reporting*, a discussion paper issued by the IASB in July 2013, takes the first steps towards establishing a disclosure framework.

Panel 6.1: Two concepts of fairness

There is a tension between fairness as 'everybody gets the same information' and fairness as 'everybody gets the information they can use'. A common assumption of securities regulators is that everyone should receive the same information; otherwise there is a risk that the well-informed will take advantage of the poorly-informed. But investors do not all have the same time available to study financial reporting disclosures or the same skills in understanding them. In this situation, giving everyone the same information is arguably a source of unfairness, especially if the disclosures are tailored to meet the needs of those with ample resources to take advantage of them.

Research evidence supports what most people would assume anyway, that long and complex disclosures disadvantage private investors relative to professional investors (see Appendix 3). '[N]on-professional investors tend to read financial statements in the order presented and are therefore more likely to be affected by more complex reports than more sophisticated investors (analysts), who use directed information search strategies to analyse financial statements' – Brian P. Miller, 'The effects of reporting complexity on small and large investor trading' (2010).

However, useful information always gives an advantage to those who can understand it. While those who disclose financial reporting information should try to make it understandable to all, useful information cannot justifiably be withheld on the grounds that some people might not understand it. So we do not recommend reducing the total volume of disclosures purely because many of them will not be used by most investors.

It is sometimes suggested, though, that the burden of periodic reporting disclosures for the ordinary user could at least be reduced if they were restructured so as to place more information elsewhere on the internet. This could be done to varying degrees. One approach would be to put standing information, such as accounting policy notes that are unchanged from year to year, separately on the internet rather than in periodic reports. A more radical approach would be to include, as well as key non-financial information, only minimal accounting information – perhaps just the primary financial statements – in periodic reports, and leave it to users to look things up elsewhere on the internet (or to drill down) if they want anything more detailed (see eg, Panel 6.2). This approach appears to be the most promising way of achieving a major reduction in the length of periodic reports, although it would not in itself involve any reduction in the total amount of information disclosed.

Panel 6.2: 'The key numbers' and 'the detail'

In 'The future of financial reporting' (2012) Mark Vaessen and Oliver Tant suggest a division of corporate reporting between 'the story' and 'the key numbers' on the one hand and 'the detail' on the other. The first information set, which would include the primary financial statements, would form part of an integrated report that would be the key focus of corporate reporting. The second information set, which would include the notes to the accounts, could be disclosed on the internet. The authors suggest that 'the detail' might be outside the scope of the auditor's true and fair view opinion, though possibly subject to some other form of assurance. However, the true and fair opinion would perhaps be extended in another direction – though in a modified form – to encompass 'the story' and 'the key numbers' and whether they give a fair and balanced presentation.

On integrated reports, see the work of the International Integrated Reporting Council at www.theiirc.org

Recommendation 4: Disclosure requirements should allow firms to report separate information sets to different types of users.

The information set for most users would be short and, beyond a minimal common core, decided by each firm to reflect its own particular circumstances. Regulation of disclosures in the common core should itself be minimal to allow for effective communication. The information disclosed for users with an appetite for longer and more complex information would – like the shorter information set – be online and available for anyone who wants it.[45]

The financial reporting for ordinary users could include the primary financial statements – ie, the income statement, statement of comprehensive income, statement of financial position, statement of changes in equity, and statement of cash flows – and any other information that the directors consider to be material. The contents of the primary financial statements would

[45] This sort of restructuring is recommended in the ICAEW response (ICAEW REP 189/12) to the EFRAG/ANC/FRC discussion paper, *Towards a Disclosure Framework for the Notes*.

be governed by the requirements of accounting standards. The information for ordinary users outside these statements could be unregulated, except that it would be audited to ensure that it is not misleading.

This approach would have a number of advantages.

- Ordinary users would not receive an excessive amount of information. There would be no excuse for it to be too complex or badly organised.
- If ordinary users want more information, they can access it on the internet.
- Investment analysts and other users who like a full set of disclosures would still get the information that they do now, but without making life difficult for ordinary users.

One disadvantage is that, if a firm decides to make use of the option, it would involve extra work for it and its auditors. If the longer, more complex information set has to be prepared and audited anyway, the cheapest and easiest approach may be to send this to everyone. But if firms are happy to send all their shareholders the same information that they provide for investment analysts, they would be free to continue to do so.

The form of the audit report on either information set is a question that we do not address here.

Our proposed reform would allow firms to provide different audiences of users with different information sets. This will work only if firms think about how they communicate both with ordinary shareholders and with those who have an appetite for larger volumes of information, and tailor their disclosures and how they are presented to each group accordingly.

6.3.2 Remove unnecessary requirements

Disclosure requirements tend to stay in place once they have been established. They also tend to be set in isolation, issue by issue, so the standard-setter has no overall view on the level of required disclosures or how well they all fit together. This creates risks that disclosure requirements will stay in place through inertia or may become excessive overall.

Recommendation 5: Standard-setters should regularly review their disclosure requirements to weed out unnecessary disclosures.

The IASB's first such review should be initiated as soon as it has finalised the conceptual framework on disclosure. To avoid such reviews creating constant changes in requirements, they should not be frequent – perhaps once every seven to ten years would be about right. Such reviews would no doubt be subject to all the incentives that are liable to lead to suboptimal results in standard-setting in the first place, but they would at least create regular opportunities for change and a degree of pressure on standard-setters to show results.

6.4 CHANGING THE WAY DISCLOSURE REQUIREMENTS ARE IMPLEMENTED

6.4.1 Materiality: enforcement agencies

Information overload can occur even if all the information provided to a user is material.[46] But to the extent that standardised disclosure requirements lead to insignificant disclosures by individual firms, in principle the problem can be dealt with by applying materiality to remove the redundant disclosures. Unfortunately there are obstacles in the way of preparers who wish to take this route.[47]

There is a bias towards disclosure in legal and regulatory enforcement; action is more likely to be taken when information is not disclosed than when it is disclosed. As the question of what to disclose is often (and inevitably) a grey area, it is understandable that preparers should incline towards disclosure in doubtful cases rather than towards non-disclosure. Cutting disclosures on grounds of immateriality therefore creates risks for preparers. As an academic writer on this subject has recently commented, 'I am aware of no SEC action or investor lawsuit arising from excessive disclosure.'[48]

It is arguable, though, that it is quite right that the materiality test should be applied asymmetrically. For example, if I have important information that I do not give you, I am more likely to cause you significant harm than if, in addition to giving you the important information, I give you a piece of unimportant information. Viewed in this light, the present bias in applying materiality is entirely appropriate.

[46] This point is made by Paredes, 'Blinded by the light: information overload and its consequences for securities regulation'.

[47] Much of the material in this section is derived from ICAEW's response to the ASB report, *Cutting Clutter: Combating Clutter in Annual Reports*: ICAEW REP 90/11.

[48] Robert J. Bloomfield, 'A pragmatic approach to more efficient corporate disclosure' (2012).

In addition to these risks, there are costs involved in deciding what not to disclose, as removing immaterial items will involve an extra effort by preparers in terms of planning, reviewing and considering potential cuts. There may also be additional costs in terms of discussion with the auditors and taking legal advice.

It should not be assumed, therefore, that using materiality to cut disclosures will necessarily appeal to preparers when they take the costs and risks of this course into consideration. And if they do cut disclosures on the grounds of immateriality, some users may find it unhelpful because it reduces comparability between firms. Some users expect a high degree of comparability, even where the relevant items are individually immaterial. That is, they expect certain information to be disclosed by all companies and have a problem if they cannot find disclosures that match these expectations.

Disclosing quantitatively immaterial items may in any case be helpful to preparers. Disclosure of quantitatively immaterial items can be useful if it includes relevant information. For example, a company may wish to emphasise that it has only a small amount of derivatives (or none at all) or of specific classes of sovereign debt. Disclosing the amount draws attention to it and answers any questions that users might have if it were not disclosed.

An additional issue is that if items appear and disappear from year to year, depending on whether or not they are material, it would make it more difficult for users to know what to expect and for enforcement authorities to assess compliance.[49]

There will also be difficulties in agreeing criteria for deciding what is material. Both the FASB and EFRAG/ANC/FRC in their 2012 discussion papers on disclosure advocate potentially material impact on users' assessments of future cash flows as the test of materiality. This may be appropriate for information that has a valuation objective, but it does not seem to be a good test for information for control.

But even as regards information for forecasting future cash flows, impact is a problematic criterion for judging materiality. Research has found that the publication of annual reports typically has little impact on share prices; by implication, it therefore has little impact on users' forecasts of cash flows. This is not particularly surprising. For investment analysts, annual reports are primarily works of reference rather than ways of conveying news to the market. Indeed, in a number of jurisdictions there are continuous disclosure requirements for public companies, which mean that managers should publish price-sensitive information when they become aware of it – not wait until they can publish it in the annual report or an interim report (see Panel 6.3). And investors are constantly using information from many sources to update their expectations of firms' future cash flows; they are not totally dependent on firms' periodic reports.[50]

Panel 6.3: Disclosing price-sensitive information

As we noted in *Reporting Business Risks: Meeting Expectations*, rules on the prompt release of price-sensitive information 'could be seen as requirements that the annual report should not contain any significant new information, if significance is interpreted in terms of potential effects on the share price.' It could be argued, though, that information in the annual report may well have an impact on users' assessment of future cash flows once they have had a chance to digest it. But this takes time, and may not have an effect detectable by statistical research. See also Appendix 3 at A3.3.2.

The implication is that a 'potentially material impact on users' assessments of future cash flows' test, rigorously applied, might well end up deleting most of a company's periodic reporting. Some might welcome this conclusion and say that it is what they suspected all along. But in our view it is evidence that periodic reporting, particularly the annual report, is not primarily about changing investors' expectations of future cash flows.

If materiality is to be a useful weapon in the battle against disclosure overload, there will need to be a culture change in legal and enforcement systems, including the courts. This change would also have to be international to be fully effective, as there would be little point in international businesses cutting back on their disclosures in one jurisdiction only to find that they are then in trouble with another country's regulator. Such a change in enforcement would then allow a similar change among preparers.

[49] Arguably, materiality should also be considered across the business cycle. So it may be desirable to disclose some items, even though they are immaterial in particular years, so as to obtain an understanding of the firm across the business cycle.

[50] For evidence on this, see Russell Lundholm and Matt Van Winkle, 'Motives for disclosure and non-disclosure: a framework and review of the evidence' (2006), a paper commissioned by ICAEW.

Recommendation 6: To reduce the incentives to provide immaterial disclosures, enforcement agencies should clarify that they will not take action against firms that omit immaterial disclosures, and they should encourage firms to omit immaterial disclosures.

As international firms make disclosures in more than one jurisdiction, this will require a common approach among enforcement agencies internationally.[51]

It has been suggested that enforcement agencies should actually take action against firms that make immaterial disclosures. As materiality is a subjective judgement, and it is probably helpful to users to err more on the side of over-disclosure rather than under-disclosure, we do not think that firms should suffer penalties for disclosing immaterial information. The Audit Quality Forum (AQF), hosted by ICAEW, has suggested that it should be made more explicit that being clear and, where possible, concise is an element of the true and fair view requirement (and a similar view is expressed at Panel 6.4 below).[52] The AQF report suggests that it is 'part of the job of management … to ensure that users of financial statements can see the wood for the trees'. This involves consideration of the structure and clarity of disclosures as well as their overall understandability.

It would at least be helpful if enforcement agencies could:

- question firms that they consider are disclosing excessive immaterial information; and
- where they do not receive satisfactory explanations, publicise their concerns.

This would put pressure on firms to eliminate excessive immaterial disclosures, without penalising firms that err honestly on the side of over-disclosure.

6.4.2 Materiality: auditors

Auditors also respond to the incentives created for them by the enforcement regime, and they transmit these pressures to their clients. Auditors may well encourage firms to make immaterial disclosures, both for the auditor's safety and the client's, and for the same reasons they are unlikely to discourage immaterial disclosures. But if the changes in the enforcement regime that we suggest are adopted, then it should be possible for auditors to change their behaviour as well.

Recommendation 7: Auditors should refrain from encouraging firms to make immaterial disclosures and should encourage them to omit immaterial disclosures.

Panel 6.4: An audit firm's view on auditors

'Auditors should be aware that their behaviour is … playing a significant role in reinforcing the deadlocked [annual reporting] environment. They need to support … companies in making active materiality judgements without an overruling focus on defensive compliance. In this respect, auditors should keep in mind that they have an obligation to make sure that the annual report provides a true and fair view; ie, gives users information relevant to their decision-making. We argue that companies which include excessive immaterial disclosures … obscure what is actually important to the company and therefore most relevant to users' – KPMG and Copenhagen Business School, *Better Business Reporting: A Study into the Barriers to Improvements in Annual Reporting* (2012).

6.4.3 Materiality: preparers

Decisions on materiality are taken by preparers. But in taking these decisions preparers are constrained by the legal and regulatory environment and by their auditors. So the options that we have identified for changing the legal and regulatory environment and for changing auditors' approach are ultimately also means for persuading preparers to change their approach to materiality.

Recommendation 8: Once enforcement agencies and auditors have reformed their approach to materiality, firms should cut out disclosures that are clearly immaterial.

[51] An additional complication in achieving international harmonisation is that different jurisdictions may have different views of the function of financial reporting – laying more or less emphasis, for example, on its control function. As noted above, different views on the function of financial reporting imply different views on which items of information will be material.

[52] Audit Quality Forum, *Changes in Financial Reporting and Audit Practice* (2009), pp29-30.

Where there is any doubt as to whether a disclosure is immaterial, it would usually be safer for firms to leave it in, as otherwise there is a risk that enforcement agencies or the courts will take a different view.

A cost of this recommendation is that it would take time and effort by preparers to decide what to exclude on the grounds of immateriality and their decisions, where they might be challenged, would need to be documented.

6.5 PLACING MORE RELIANCE ON NON-REGULATORY SOLUTIONS

John Kay, who undertook a review of UK equity markets for the British Government, argues that the desire for comparability in disclosure has gone too far. He associates this with an ineffective model of ownership:

> 'There has been considerable progress in recent years in the development of international accounting standards. We question, however, whether this trend may have emphasised comparability at the expense of relevance… The search for comparability is the product of an environment which emphasises the role of anonymous markets, in which investment decisions can be made without specific knowledge of the companies in which funds are invested… [But] the nature of the information which is helpful in understanding the activities of a company will vary from business to business and time to time.'

Kay therefore proposes that disclosures should be negotiated between firms and investors:

> 'The ability easily to engage in such discussion is a primary strength of the model of internal allocation of capital within large firms with diversified activities, of private equity, and increasingly of debt finance.'[53]

If those who are interested in financial reporting disclosures are unhappy with the results of their increasing regulation, then – as Kay suggests – they could place more reliance on voluntary disclosures.

Recommendation 9: Preparers and users should engage directly to discuss voluntary public disclosure of information that is not currently provided, rather than rely entirely on standard-setters to introduce new disclosure requirements.

Such engagement might take place on a sectoral basis rather than firm by firm, and there may be a role in it for standard-setters if they see the encouragement of voluntary disclosures as within their remit. The 2012 report of the Enhanced Disclosure Task Force, *Enhancing the Risk Disclosures of Banks*, provides an example of how a sectoral approach can be implemented, though the banking sector has the advantages that it is well-defined (firms either are or are not regulated as banks) and it has international central bodies such as the Financial Stability Board that can facilitate dialogue.

Another sector where additional disclosures are already provided partly in response to user demand is life assurance, where embedded value disclosures (or their absence) to some extent reflect demand (or the lack of it) from investment analysts.[54]

Both preparers and users may see voluntary interaction as unduly burdensome. But they have a choice: if they do not regard agreement on disclosures at the firm or sectoral level as worthwhile, then they can rely on the standardised disclosures that regulation produces.

6.6 THE WAY AHEAD

If the package of reforms we propose were implemented, they would curb disclosures by ensuring that they are only required where those who benefit from them are also prepared to meet their costs. They would also ensure that disclosure requirements are developed within a framework that recognises that the level of mandatory disclosures requires a balancing of interests between owners and managers, and between users and preparers. They would encourage firms to leave out immaterial information and allow them to structure their disclosures to reflect the fact that different users of their financial reporting have very different needs.

Our proposals would also allow and rely on greater use of professional judgement by all those involved in the financial reporting process – preparers, auditors and enforcement agencies.

[53] *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report.*

[54] For evidence on this see George Serafeim, 'Consequences and institutional determinants of unregulated corporate financial statements: evidence from embedded value reporting' (2011).

Financial reporting is in important ways an inherently subjective process. Trying to pin down in ever-greater detail exactly how it should be done in a futile attempt to make it perfectly objective is like trying to nail jelly to a wall. The realistic approach is to recognise that the use of professional judgement is not only unavoidable, but to be encouraged if we wish disclosures to achieve their objective rather than merely to comply with specific requirements.

The overall result of our proposals should be a better system of financial reporting, with more focused disclosures.

6.7 THE NEED FOR REALISM

There is no solution to current problems that will guarantee that everyone gets what they want, and there are no improvements that will come without costs and risks attached. The problems of subjectivity, self-reporting bias and proprietary costs will always impose limits on the usefulness of firms' public disclosures. Preparing different information sets for different users means incurring additional costs. Giving owners greater influence over disclosure requirements would mean additional costs in the standard-setting process, and could disadvantage other groups with an interest in it. Applying professional judgement to weed out immaterial disclosures would impose additional costs on preparers, auditors and enforcement agencies, and would increase the risk of omitting information that someone could regard as material. Voluntary engagement to secure additional disclosures involves time and effort to secure benefits that will be available to all.

The question for those involved in the financial reporting process is therefore whether they are willing to bear the costs and increased risks of changes that could improve the system for financial reporting disclosures as a whole or whether they prefer on balance to leave things as they are. If they prefer to leave things as they are, then the present feelings of disenchantment and alienation from the financial reporting process can only be expected to grow as mandatory disclosures continue to increase.

APPENDIX 1: SUPPLY AND DEMAND ISSUES

A1.1 MOTIVES FOR THE DEMAND FOR INFORMATION

Because a firm's owners have a wide range of information needs and are potentially in a position to enforce their demands, we focus on why they might have a demand for financial reporting information about the firm. We identify five motives.

1. **Estimating wealth and forecasting income.** Owners may want to see how well the firm is doing so that they can make an estimate of what their investment is worth or what dividends they can expect from it. Such information may form part of an estimate of their own wealth or expected future income that will affect their personal financial planning.
2. **Making investment decisions.** They may want information that will assist their decisions on whether and at what price to buy, sell or hold the company's shares.
3. **Strategic interventions.** If they are in a position to do so, they may want to intervene (perhaps with other owners) in the management of the company. For example, it may have launched a new enterprise that has not been a success and that almost everybody apart from the company's managers agrees should be terminated.
4. **Governance decisions.** They may want to check on management's performance and rewards with a view to making decisions (perhaps with other owners) on whether new management is needed and on how managers should be remunerated.
5. **Contracting with third parties.** Financial reporting disclosures may facilitate contracting with the firm by third parties, such as lenders, customers and suppliers (including employees). In this case, the owners' demand does not relate to their own information needs, but to benefits that they can expect to receive by meeting others' needs.

Motives 1 and 2 lead to the 'valuation' function of financial reporting, sometimes, especially when there is an exclusive focus on 2, referred to as the 'decision usefulness' approach. Motives 3 and 4 lead to the 'control' function of financial reporting, sometimes referred to as the 'stewardship' approach. Motives 3, 4 and 5 together constitute the 'contracting' motive for disclosure; while 5 relates explicitly to contracting, 3 and 4 relate implicitly to the triangular contractual relationships between owners, the firm and its managers.

Other groups may have information needs that overlap with those of owners. Motive 2 is applicable to potential shareholders, and they have a contingent interest in 1, 3, 4 and 5 should they decide to become owners. Different classes of lenders may share in all these reasons for wanting information about a firm. For example, motives 1 and 2, appropriately modified, are relevant to lenders who wish to assess their present wealth and future income and to assess whether and on what terms to lend to a firm or to dispose of existing loans to it. Motives 3 and 4 will also be relevant where lenders have rights to intervene in a firm's management if certain conditions are met (or nor met) and have a say in whether incumbent managers stay in place. Motive 5 is clearly relevant to lenders. Other groups have other information needs.

A1.2 CONTRACTUAL DISCLOSURES

As a firm's owners have a common interest in obtaining information about it, they may collectively insist that the company's managers provide them with financial reporting disclosures. Other parties, such as lenders, may also be in a position to agree disclosures contractually.

Historically, whether owners do behave in this way is something that has varied strongly among jurisdictions. In the UK, company law has since 1856 suggested accounting requirements that can be adopted into a company's governing agreement. These requirements frequently were adopted and, before the statutory regulation of accounting developed, formed a costless contractual basis for financial reporting disclosures.

In the US, by contrast, states competed with one other to attract those who set up companies, and as a result shareholders' contractual rights to financial reporting information were minimal. The establishment of the SEC in the 1930s eventually did much to improve information to shareholders and others, but through a regulatory regime for financial reporting disclosures, rather than a contractual one, and only for public companies.[55]

Panel A1.1: The Joint Stock Companies Act 1856: contractual disclosures

In the UK the Joint Stock Companies Act 1856 provided at Table B model 'Regulations for the management of the company' that companies could adopt if they wished to do so. As adoption was voluntary, the Table's status in relation to any firm that adopted it was contractual rather than statutory. In subsequent Companies Acts, the equivalent of Table B appeared as Table A.

The model regulations of 1856 required an annual statement of income and expenditure to be presented to shareholders:

'The statement so made shall show, arranged under the most convenient heads, the amount of gross income, distinguishing the several sources from which it has been derived, and the amount of gross expenditure, distinguishing the expense of the establishment, salaries, and other like matters: every item of expenditure fairly chargeable against the year's income shall be brought into account, so that a just balance of profit and loss may be laid before the meeting; and in cases where any item of expenditure which may in fairness be distributed over several years has been incurred in any one year the whole amount of such item shall be stated, with the addition of the reasons why only a portion of such expenditure is charged against the income of the current year.'

The regulations also required a balance sheet and specified what it should disclose.

A1.3 ADVERSE SELECTION

Adverse selection arises where one party to a transaction takes advantage of the other's ignorance to charge too high a price or to pay too low a price. What is at issue is information about the characteristics of an item or a transaction.[56] Adverse selection is therefore essentially a problem about knowing what the facts are. But it is also forward-looking in the sense that better knowledge of recent facts allows people to make more reliable forecasts.

The concept of 'adverse selection' originated in insurance where it refers to the problem that arises if an insurer offers, eg, health cover at a uniform premium to all potential customers because it does not know what each potential customer's health problems are. The resulting information asymmetry means that the potential customers who are most likely to take up the offer are those with the most severe health problems. To cover its losses, the insurer has to raise the premiums it charges. But this will deter some potential customers – in particular those with the least severe health problems, who are the least likely to make claims. As the insurer has to raise its premiums again, it will lose another tranche of relatively healthy customers. And so on. In principle, a position could ultimately be reached where it becomes uneconomic to offer insurance at all.[57]

An illustration relevant to financial reporting would be that, where there is information asymmetry between corporate insiders and outsiders, the companies most likely to invite capital from outside investors are those where insiders see an opportunity for gain at outsiders' expense. To protect themselves against this risk, outside investors will demand a premium on the price they are to be paid for their investment ('price protection'). This makes it less attractive to raise capital from outsiders, so companies where insiders do not intend to profit at outsiders' expense are less likely to raise capital in this way. This increases the risk to outside investors, who will therefore demand a larger premium. This will make capital-raising unattractive for another tranche of companies, where insiders expect to make only modest gains at outsiders' expense. This further increases the risk to investors, who will demand an even larger premium. And so on. Again, in principle, a position could ultimately be reached where capital-raising from outsiders becomes uneconomic.

Adverse selection is also relevant to transactions and relationships with those other than capital providers. For example, employees, suppliers and customers may make significant investments in their relationships with a particular firm. These are not the sort of investments that appear on the investee firm's balance sheet. But employees make an investment of human capital

[55] On this see Tim Bush, *'Divided by Common Language': Where Economics Meets the Law: US versus Non-US Financial Reporting Models* (2005).

[56] Joseph E. Stiglitz, 'The contributions of the economics of information to twentieth century economics' (2000).

[57] George Akerlof, 'The market for "lemons"' (1970), uses this kind of analysis to explain – among other things – why people aged over 65 have great difficulty in buying medical insurance.

in the relationship with their employer, and may make significant property investments that assume a particular place of work, and suppliers and customers often make relationship-specific investments, such as plant that is specific to a particular customer's needs or training that is specific to a particular's supplier's products. All these parties face adverse selection costs when they transact with a firm about which they are not fully informed. They may therefore seek price protection or additional information or refuse to transact.

The risk of adverse selection can be reduced by disclosures that reduce information asymmetry. It therefore creates disclosure incentives for both preparers and users of financial reporting.

An assumption that underlies much discussion of disclosure by firms is that:

> 'a rational buyer interprets withheld information as information that is unfavorable about the asset's value or quality. Consequently, the buyer discounts the asset's value until the point at which it is in the seller's best interests to reveal the information, however unfavorable it may be.' There is thus 'a notion that withheld information can be "unravelled" by the behavior of rational buyers'.[58]

Information asymmetry can also be reduced by 'signalling', where information content is attributed to certain actions that the company takes or that its managers take personally. For example, if the directors decide to increase the dividend or increase their personal stake in the company, such actions can be interpreted as positive signals of the directors' expectations regarding the company's future performance. To be credible, such signals must be costly. That is, the person giving the signal must incur some cost in doing so. A director buying shares clearly incurs a cost. The cost of increasing the dividend is less obvious. But investors tend to assume that a dividend increase – unless it is announced as a special dividend – will be maintained. A company that unexpectedly cuts its dividend typically suffers a fall in share price and its directors' positions may be at risk. So an increased dividend in effect puts the directors' necks on the block. They are sending a message that they think the increase can be maintained; if it is not, they will have to suffer the consequences.

A1.4 MORAL HAZARD

Moral hazard arises where one party to a transaction or relationship can take advantage of the other's ignorance either by engaging in activities that the other would not have agreed to or by culpably failing to perform tasks that it is expected to perform. What are at issue are incentives to behave in particular ways.[59] Moral hazard is therefore, like all questions of incentives, a forward-looking problem.

The concept of 'moral hazard' also originated in insurance. For example, a driver who is fully insured may drive more dangerously than he would if he were uninsured, thereby causing losses to the insurer. An illustration relevant to financial reporting would be that, where there is information asymmetry, managers may award themselves disproportionately generous compensation. As with adverse selection, moral hazard is a risk that investors are likely to want to protect themselves against, either by not investing in firms where there are information asymmetries giving rise to moral hazard or by requiring a premium on the price at which they are prepared to invest or to lend. And as with adverse selection, it is possible in principle to imagine situations where moral hazard risks are so great that investment by outsiders becomes unfeasible.

As explained in Panel A1.2, in business the losses to owners from moral hazard and the costs incurred to guard against it, are commonly regarded as 'agency costs', which arise from the principal-agent relationship that exists between owners and managers. Moral hazard risks in business include the various forms of 'managerial appropriation of corporate resources', such as 'outright stealing of cash, the use of excess cash for "pet projects" from which the manager derives some private utility, lavish business trips, or simply excessive compensation'.[60] Other examples are 'special treatment of favoured customers [and] ease of consumption of leisure on the job'.[61]

[58] Robert E. Verrecchia, 'Essays on disclosure' (2001). The unravelling principle is explained in Russell Lundholm and Matt Van Winkle, 'Motives for disclosure and non-disclosure: a framework and review of the evidence' (2006). Verrecchia, 'Discretionary disclosure' (1983), points out that the existence of competitive costs of disclosure means that users cannot assume that withheld information is unfavourable. The principle also assumes that users know when relevant information is being withheld. Ronald A. Dye, 'Disclosure of non-proprietary information' (1985), notes this and several other qualifications to the unravelling principle.

[59] Stiglitz, 'The contributions of the economics of information'.

[60] Christian Leuz and Peter Wysocki, *Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Further Research.*

[61] Michael C. Jensen and William H. Meckling, 'Theory of the firm: managerial behavior, agency costs and ownership structure' (1976).

Panel A1.2: An analysis of agency costs

In 'Theory of the firm: managerial behavior, agency costs and ownership structure' Michael C. Jensen and William H. Meckling identify three types of agency cost. They define an agency relationship as one that exists where a principal engages an agent to perform some service on his behalf that involves delegating some decision making to the agent. Decision making in this context extends from, eg, major investment decisions to relatively minor matters such as how exactly the agent spends his time in performing the required service. The agency relationship with which Jensen and Meckling are mainly concerned is that between the owner and the manager of a company.

The three types of agency cost that they identify are:

1. monitoring costs, which are incurred by the principal in order to control the agent's actions;
2. bonding costs, which are incurred by the agent in order to assure the principal that the agent is acting in the principal's best interests; and
3. a residual loss to the principal, which is incurred to the extent that, in spite of monitoring and bonding, the agent does not act completely in the principal's best interests.

An important feature of this analysis is that it shows that it is in the interests of the agent – as well as the principal – to bear agency costs.

The disclosure of information to reduce moral hazard is relevant to other aspects of business activity. For example, corporate social responsibility reports may be expected to reduce socially irresponsible behaviour. Of more direct relevance to financial reporting, regulators and tax authorities may regard it as more likely that reporting to them will be honest if they can relate it to disclosed financial reporting information.

As moral hazard is a forward-looking problem, it may be avoided or reduced by the knowledge that there will in the future be full disclosure of relevant transactions. The threat of moral hazard also therefore creates disclosure incentives for both preparers and users of financial reporting.

In principle, the moral hazard aspect of information asymmetry can also be reduced by signalling, although it is difficult to think of specific examples.

A1.5 IMPLICATIONS OF ADVERSE SELECTION AND MORAL HAZARD

Most managers are not trying to take unfair advantage of outside investors (adverse selection) or to steal their money (moral hazard). They therefore have an interest in reducing information asymmetries so that they can secure capital from outsiders at a price that does not include a premium to reflect fears of adverse selection and moral hazard. They have a similar interest in reducing information asymmetries so that their contractual pay does not include a discount to reflect fears of adverse selection and moral hazard.

Investors want to make sure that their money is properly protected and so wish to reduce information asymmetries that might create moral hazard. They also want to have as many opportunities as possible for profitable investment. They therefore have an interest in reducing information asymmetries so that entrepreneurs are not deterred from bringing profitable opportunities to market. Removing the adverse selection and moral hazard premiums will mean that investors are offered a lower return on their investment, but if they are risk averse, they are likely to see this as a potentially beneficial trade-off. Investors will therefore demand information, even where there is no requirement to provide it, or will expect to be compensated (eg, by price protection) where it is missing.

Even in a world where managers would in no circumstances take advantage of outsiders' ignorance, they would still have an interest in promoting relationships with other parties that transact with the firm or have other forms of relationship with it, and financial reporting disclosures may be relevant to these objectives. Equity investors in a firm also have an interest in the firm paying for disclosures that will facilitate relations with other parties with which the firm contracts or has relationships, such as lenders, suppliers, customers and employees. This is reflected in Motive 5 at A1.1 above. Adverse selection and moral hazard therefore reinforce other motives for disclosure; they are not the only reasons for disclosure.

APPENDIX 2: OTHER OPTIONS FOR CHANGE

A2.1 INTRODUCTION

The recommendations in Chapter 6 are divided into four categories.

- Reforming the process for setting disclosure requirements.
- Changing the disclosure requirements.
- Changing the way disclosure requirements are implemented.
- Placing more reliance on non-regulatory solutions.

This appendix reviews some options for change not included in the recommendations at Chapter 6 in the first three of these categories.

A2.2 REFORMING THE PROCESS FOR SETTING DISCLOSURE REQUIREMENTS

A2.2.1 A sunset rule

A sunset rule for disclosure requirements[62] would mean that they have a limited life and that, at the end of the specified period, either they are renewed or they expire. It would not necessarily mean that disclosure requirements would be reduced, but it would place an administrative obstacle in the way of their endless expansion.

While this change in the standard setting process could work to reduce disclosure requirements, it is possible to imagine situations in which it would not work. Assuming standard-setters' default position would be to propose the renewal of all requirements approaching their sunset date, such a rule would significantly increase the burden on those involved in standard setting, including those who respond to standard-setters' proposals. A possible result would be that existing requirements are constantly renewed without being thoroughly assessed, while people devote their limited time and resources to thinking about proposals for fresh requirements, which are likely to seem more important.

One way of making such a rule more effective would be to require positive evidence that the required disclosures have actually been used.[63] This would tilt the balance against automatic or semi-automatic renewal of existing requirements.

A2.2.2 A one-in, one-out rule

There could be a rule that each additional disclosure requirement has to be accompanied by the repeal of an existing one. Such a rule would not reduce the volume of disclosure requirements, but it would restrict them to their existing level. As we explain below, it is a rule that would only work if the standard-setter abided by the spirit of the rule, rather than sticking to a literal interpretation of it.

A literal interpretation of the rule would make it ineffective. This is because what constitutes 'a' disclosure requirement is a subjective matter. Consider, for example, the disclosure requirements of IFRS 13, *Fair Value Measurement*. These include, at paragraph 93, nine sub-paragraphs and six sub-sub-paragraphs. So is paragraph 93 one disclosure requirement, or nine, or fifteen? Probably none of these is the right answer, as individual sub-paragraphs and sub-sub-paragraphs sometimes contain a series of separate requirements. Paragraph 93(e)(iii) requires, 'for recurring fair value measurements categorised within Level 3 of the fair value hierarchy, a reconciliation from the opening balances to the closing balances, disclosing separately changes during the period attributable to the following':

> '(iii) purchases, sales, issues and settlements (each of those types of changes disclosed separately).'

[62] As suggested by, eg, Arthur J. Radin in 'Have we created financial statement disclosure overload?'

[63] A suggestion in the ICAEW response (ICAEW REP 108/09) to the Financial Reporting Council's 2009 discussion paper, *Louder than Words: Principles and Actions for Making Corporate Reports Less Complex and More Relevant.*

Should (iii) count as four disclosure requirements?

To make things even more difficult, IFRS 13 is a standard whose provisions apply across other standards that require fair value measurements. Its requirements are in effect super-requirements, and should presumably count more heavily than single requirements in other standards. It is not clear just how heavily they should count.

However, a one-in, one-out rule if applied in the spirit in which it is intended would be a rough and ready way of putting a cap on disclosure requirements.

A2.3 CHANGING THE DISCLOSURE REQUIREMENTS

A2.3.1 Generalised disclosure requirements

In *Disclosure Framework: Invitation to Comment* (see A4.5 below) the FASB raises the possibility that it could impose general disclosure requirements rather than specific ones. This would leave it up to preparers to decide what disclosures are relevant in their own particular circumstances and would presumably avoid the problem that firms are currently required to disclose information that they regard as irrelevant or immaterial. EFRAG/ANC/FRC raise the same possibility in *Towards a Disclosure Framework for the Notes* (see A4.6 below). The two papers also note the disadvantages of this solution.

The main argument against this approach is that it would risk returning financial reporting to the era when some firms disclosed very little and disclosure by different firms had very limited comparability. It could also prove to be an unintentionally onerous regime for preparers, who will not know what they should disclose, but would have to make their own decisions line by line, and then be ready to justify them in the event of any subsequent legal or regulatory challenge. In practice, it may be expected that firms would initially at least publish much the same information as they do already, because existing requirements would give them the best indication of what users are likely to expect.

A2.3.2 Differentiated disclosure requirements

The FASB also raises the possibility in *Disclosure Framework: Invitation to Comment* that it could issue standards with different disclosure requirements for different types of firm. The requirements might be differentiated on the basis of the size of the firm or the nature of its activities. This should reduce the number of disclosures that are irrelevant to a particular firm or to the users of its accounts. Again, *Towards a Disclosure Framework for the Notes* raises the same possibility. And again, both papers draw attention to possible drawbacks of this approach.

This option is probably more attractive than generalised disclosure requirements as it would at least secure comparability among the firms that comply with a particular set of requirements. It is also an approach that is already adopted in practice by the IASB in its *IFRS for SMEs*, by those jurisdictions that distinguish in their disclosure requirements between public and private companies and between different sizes of firm, and by existing industry standards, such as those for insurers and for oil and gas companies. The question is therefore how far this existing approach could usefully be extended by standard-setters.

A2.3.3 Two-tier disclosure requirements

Another possibility would be to structure the disclosure requirements in standards in two tiers. The first tier would apply to those firms for which the relevant standard would produce material disclosures and would be more detailed in its requirements. The second tier would apply to those firms – perhaps the majority – for which the relevant standard would not produce material disclosures and would be less detailed in its requirements. A two-tier approach might involve the standard-setter specifying which firms would have to comply with the first-tier requirements. For example, it might be stipulated that banks have to comply with first-tier disclosures for financial instruments.

A2.4 CHANGING THE WAY DISCLOSURE REQUIREMENTS ARE IMPLEMENTED

A2.4.1 A safe harbour regime

Fear of litigation is seen as an important driver of uninformative disclosures. It is possible that firms would comply more with the spirit of disclosure requirements, and not just with their letter, if they were given some form of safe harbour protection. This has been used in the US to promote voluntary forward-looking disclosures. However, it would be less easy to apply to mandatory historical reporting, and it might conceivably create more problems than it would solve, as it would be difficult to have an effective safe harbour that did not also allow firms to reduce their disclosures of useful information. It may even be doubted whether it is possible to apply the safe harbour principle to non-disclosures rather than to disclosures.

A2.4.2 Better structured information

It has also been suggested[64] that disclosures could be better structured to make it easier to pick out important information. Sometimes this is seen as one of the roles of a disclosure framework. It is impossible to disagree with the proposition that, if information can be better structured, it should be. There are various ways in which information can be made easier to navigate.

- A table of contents is useful (not all companies provide one), especially if it lists all the notes.
- If a report is long enough, it may warrant an index.
- Cross-referencing information is helpful to users.

Demands for better structured information sometimes relate specifically to the notes to the accounts. At present, firms often structure the notes so as to link them where appropriate to items in the principal accounting statements. There is no obvious way of ordering notes that are not linked to items in the principal accounting statements, though a table of contents listing the notes – as suggested above – should help with this problem.

It has been proposed, though, that notes would be ordered better if the most important or relevant ones came first. Putting information in this order is generally considered the most effective way of communicating it. There would none the less be some disadvantages in this approach.

- It would make information in the notes harder to find in the case of those firms that currently order it based on the sequence of items in the primary financial statements or in some other logical manner.
- The order of items would vary from year to year as the importance of different issues changes. So comparisons between one year and the next would be made harder.
- Although some notes are relatively important and some relatively unimportant, such judgements are subjective and preparers risk misleading users if the two parties' views on importance do not coincide. Indeed, there may be a risk of litigation if subsequent events cast doubt on managers' judgements and investors can claim that important information was 'buried' in notes that were consigned to a relatively low place in the disclosure order. This risk would perhaps be all the greater because there would be an implication that the user really needs to read only the notes that come first and can afford to ignore the rest.
- Investment analysts will probably work their way through all the notes anyway, so there will be no gain to them, except that they will read things into management's choice of order that management does not necessarily intend.
- What is important for one purpose may not be important for another. Information on directors' remuneration, for example, may be immaterial for forecasting future cash flows, but important for purposes of control. Which purpose should predominate?

So there is a conflict between 'better structured' in the sense of drawing attention to what managers consider to be important and 'better structured' in the sense of helping users to find the information they want. In isolated communications that are intended to be news, drawing attention to what is considered important probably matters most. In communications that form both part of a time series and part of a greater body of similar communications from other firms, and which are more for reference than to convey news, a degree of consistency and predictability in structuring is likely to be more helpful. Unfortunately, different types of users use periodic reports in different ways. For investment analysts, they may be primarily works of reference. For ordinary readers – who do not know how much the market already knows – they may look like news.

While we do not recommend any mandatory requirements to improve the structure of disclosures, if firms are interested in communicating with users, it makes sense for them to consider how they present their information.

[64] Eg, in FASB, *Disclosure Framework: Invitation to Comment*, EFRAG/ANC/FRC, *Towards a Disclosure Framework for the Notes*, and FRC, *Thinking about Disclosures in a Broader Context.*

APPENDIX 3: THE FINDINGS OF EMPIRICAL RESEARCH

A3.1 OVERVIEW

The empirical research literature relevant to disclosure in financial reporting is immense, and this appendix is a highly selective summary and discussion of a relatively small number of publications that seem to be particularly relevant to the issues addressed in the report. For some elements of this survey we have relied primarily on a few papers that review different aspects of the available literature. We have not consulted all the works cited in the passages quoted from these surveys.

We look at empirical research on:

- the regulation of financial reporting disclosures (A3.2);
- the benefits of disclosure (A3.3);
- aspects of disclosure that limit its benefits – length, complexity and poor presentation (A3.4); and
- whether disclosure has already reached its useful limits (A3.5).

An obvious gap in this list is empirical research on the costs of disclosure to preparers, which seems to be a little-studied topic.

We have not examined the vast research literature on the value relevance of specific disclosures. This research looks at correlations between the information in particular disclosures and share prices or changes in share prices.[65]

Finally, we discuss what conclusions can be drawn from the research reviewed in this appendix (A3.6).

A3.2 THE REGULATION OF FINANCIAL REPORTING DISCLOSURES

Disclosure requirements are simply one aspect of the larger question of the regulation of financial reporting. What empirical research there is on the effects of regulating financial reporting tends not to separate out disclosure from other aspects.

In *Economic Consequences of Financial Reporting and Disclosure Regulation*, Christian Leuz and Peter Wysocki comment that 'there is limited research on the costs and benefits of financial reporting and disclosure regulation'. In particular, they find 'a paucity of evidence on market-wide and aggregate economic and social consequences of reporting and disclosure regulation'.

There has been some work on whether the new statutory disclosure regime introduced in the US in the 1930s, including the foundation of the SEC, had any effects. This regime was, at that stage, primarily applicable to capital-raising exercises rather than to annual or interim accounts. The main positive finding to emerge from the research seems to be that 'securities offerings are less risky' after the introduction of the new regime.[66]

Overall, in view of the lack of evidence on disclosure regulation's effects (beneficial or otherwise), Leuz and Wysocki regard it as puzzling 'why disclosure regulation is so pervasive'.[67]

Katherine Schipper, whose paper 'Required disclosures in financial reports' seeks to understand what standard-setters are trying to achieve when they mandate disclosures, as well as to assess the effects of their requirements, notes 'the dearth of analytical theories of required

[65] For opposing views on this, see Robert W. Holthausen and Ross L. Watts, 'The relevance of the value-relevance literature for financial accounting standard-setting' (2001) and Mary E. Barth, William H. Beaver and Wayne R. Landsman, 'The relevance of the value relevance literature for financial accounting standard setting: another view' (2001).

[66] Carol J. Simon, 'The effect of the 1933 Securities Act on investor information and the performance of new issues' (1989).

[67] An earlier survey, 'Information asymmetry, corporate disclosure, and the capital markets: a review of the empirical disclosure literature' by Paul M. Healy and Krishna G. Palepu (2001) makes similar points. The authors state that 'empirical research on the regulation of disclosure is virtually non-existent' and that 'little is known about why financial reporting and disclosure is regulated in the capital market'. Anne Beyer, Daniel A. Cohen, Thomas Z. Lys and Beverley R. Walther, 'The financial reporting environment; review of the recent literature', also observe that 'the reasons why disclosure regulation is so prevalent in advanced and developed economies such as the US' remain an unanswered question.

disclosures'. Part of the explanation for this, she suggests, is the problem that 'required disclosures are economy-level choices, affecting multiple firms that differ in terms of both economic circumstances and contracting arrangements and parties'.

Schipper concludes that:

> 'In the absence of conceptual guidance, two interrelated types of pragmatic considerations appear to determine standard-setting decisions about required disclosures. First, standard-setters appear to consider disclosure requirements after recognition and measurement decisions have been made, and in the context of those decisions. Second, standard-setters appear to make explicit and implicit assumptions about judgments and decisions financial statement users are likely to want to make, again, in the context of the standard… Given the number and variety of events and transactions that are subject to recognition and measurement guidance, as well as the number and variety of financial statement users' judgments and decisions, this pragmatic approach does not seem to place meaningful limits on the growth of disclosure requirements.'

A3.3 THE BENEFITS OF DISCLOSURE

A3.3.1 Different types of benefit

Researchers have found evidence of a number of different types of benefit that appear to be attributable to financial reporting disclosures:

- lower cost of capital (A3.3.2);
- improved liquidity (A3.3.3);
- reduced uncertainty (A3.3.4);
- improved predictive ability (A3.3.5);
- improved ability to calculate numbers on different bases (A3.3.6);
- reduced moral hazard (A3.3.7); and
- greater economic growth (A3.3.8).

Arguably there is a good deal of linkage and overlap between the items on this list. Improved predictive ability and improved ability to calculate numbers on different bases should both reduce uncertainty. If they do not, it is difficult to see in what respect they are benefits. Reduced uncertainty should lead to a lower cost of capital. Reduced moral hazard increases cash flows to shareholders and so should also lead to a lower cost of capital. Liquidity is usually measured by the bid-ask spread on a firm's shares (a reduced bid-ask spread is taken as evidence of increased liquidity). But a reduced bid-ask spread on a firm's shares should also mean, other things being equal, a lower cost of capital for the firm. And while a lower cost of capital is a benefit to the firm that has it, at the macro level the benefit of a lower cost of capital is that it promotes economic growth.

Although all these benefits of disclosure are arguably interrelated and in some cases overlapping, it makes sense to consider them separately as the evidence and arguments for each of them are distinct. We accordingly look at each of the different types of benefit in turn below.

It should be noted that the benefits of disclosure are not related only to the firm making the disclosures, as inferences may be drawn by users in relation to other firms.

Some of the research referred to below deals with voluntary disclosures, some with mandatory disclosures, and some with both. As there are significant elements of discretion in how preparers choose to comply with disclosure requirements, the distinction between voluntary and mandatory disclosures is in any case not always clear.

To the extent that disclosures are voluntary, it would be surprising if they did not have benefits as, otherwise, why would firms make them? Presumably firms make rational choices in what they do not disclose as much as in what they do disclose, so in principle it would be as useful to study the costs and benefits of non-disclosure as it is to study the costs and benefits of disclosure.

A3.3.2 Lower cost of capital

In *Intangibles: Management, Measurement, and Reporting* (2001), Baruch Lev comments: 'there is … only scant evidence of a link between improved disclosure and cost of capital, and the estimated reduction in cost of capital is very modest'. Some later studies of the question tend to be more positive, but researchers remain cautious in stating exactly what link, if any, there is between disclosure and the cost of capital. In 'The economic consequences of increased disclosure' (2000) Christian Leuz and Robert E. Verrecchia suggest that a possible explanation of why it has been difficult to show a relationship between increased disclosure and the cost of capital is that previous research on the subject had used US evidence and that 'the [US] disclosure environment is already rich'. That is to say, US disclosures are already so extensive – and already sufficiently credible – that additional disclosures cannot be expected to have a significant effect.

A similar point is made by Jerold L. Zimmerman in *Myth: External Financial Reporting Quality Has a 1st Order Effect on Firm Value* (2012). He argues that for US public companies it is inherently unlikely that differences between firms' external reporting have a significant effect on their share price. This is not just because all such firms operate under a well-enforced system where they have to make extensive financial reporting disclosures. It is also because – like companies under similar regimes around the world – they are required 'to release quickly to the public any news or information which might reasonably be expected to materially affect the market for [their] securities'.[68] Drawing on his personal experience of serving on the audit committees of US public companies, Zimmerman states:

> 'I have never once heard in over 100 board meetings, conference calls, and audit committee meetings a director, manager, investment banker, public accountant, or outside legal counsel assert, "Let's improve our external financial reporting quality to enhance shareholder wealth."'

Such issues may of course be discussed below board level, which is consistent with any effects being second-order ones.

In 'Disclosure and the cost of capital: what do we know?' (2006), a paper commissioned by ICAEW, Christine Botosan reviews the evidence and concludes:

> 'The sum total of the evidence accumulated across many studies using alternative measures, samples and research designs lends considerable support to the hypothesis that greater disclosure reduces [the] cost of equity capital.'

In *Economic Consequences of Financial Reporting and Disclosure Regulation*, Leuz and Wysocki list a number of papers that support a connection between improved disclosure and a lower cost of capital. Panel A3.1 includes extracts from their review.

Panel A3.1: Evidence on the cost of capital

From Leuz and Wysocki, *Economic Consequences of Financial Reporting and Disclosure Regulation*:

'[R]esearch documents a positive link between external capital raising activities and disclosure quantity and quality (eg, Frankel, McNichols and Wilson, 1995; Healy, Hutton and Palepu, 1999; Lang and Lundholm, 2000). More recently, there are also studies that document more extensive pre-IPO disclosures are associated with lower underpricing (eg, Schrand and Verrecchia, 2005; Leone, Rock and Willenborg, 2007).'

'Botosan (1997) … creates a self-constructed index of voluntary annual report disclosures for a sample of US manufacturing companies and links it to an ex ante imputed cost of capital measure. In her overall sample, she does not find a significant relation between voluntary disclosure and equity cost of capital. However, firms with low analyst following do exhibit the predicted negative relation between disclosure and cost of equity capital.'

'Follow-up research by Botosan and Plumlee (2002) finds a significant negative relation between cost of equity capital and annual report disclosures.[69] However, they find contradictory evidence suggesting that the cost of capital is higher for firms with more timely voluntary disclosures, and no association between the cost of capital and firms' investor relations activities.'

'Hail (2002) examines a sample of Swiss firms where mandated disclosure is low and there is large variation in firms' voluntary disclosure policies. He finds that more forthcoming firms enjoy around a 2.5% cost advantage over the least forthcoming firms. The considerable magnitude of his findings in a weak disclosure environment is consistent with the idea expressed in Leuz and Verrecchia (2000) that the magnitude of the relation may depend on countries' institutional factors.'

Mary E. Barth, Yaniv Konchitchki and Wayne R. Landsman, 'Cost of capital and earnings transparency' (2013) find evidence that firms with more transparent earnings enjoy a lower cost of capital. Firms with transparent earnings are defined as 'those whose earnings better reflect changes in the economic value of the firm'.

[68] Ray Ball, 'Infrastructure requirements for an economically efficient system of public financial reporting and disclosure' (2001), notes that: 'The low surprise content of earnings reports in US stock markets … is consistent with the United States being almost universally viewed as possessing a high-quality system of public financial reporting and disclosure.'

[69] A negative relation means that as disclosures increase, the cost of capital falls.

A point that Leuz and Wysocki make in relation to liquidity (Panel A3.2) may also be applicable to the cost of capital. That is, research based on studies of public companies that are all subject to the same disclosure regime may well exclude by definition those companies for which improved disclosures could have a significant effect on the cost of capital.

A3.3.3 Improved liquidity

Leuz and Wysocki also list a number of papers that support a connection between increased disclosure and increased liquidity in trading a firm's stock (or shares). Panel A3.2 includes extracts from their review.

Panel A3.2: Evidence on liquidity

From Leuz and Wysocki, *Economic Consequences of Financial Reporting and Disclosure Regulation:*

'Welker (1995) tests the liquidity impact of firms' voluntary disclosures using AIMR[70] disclosure rankings. He finds that firms in the lowest third of the disclosure rankings have about 50 percent higher bid-ask spreads than firms in the highest third of the rankings.'

'Healy, Hutton, and Palepu (1999) also use AIMR rankings to examine a sample of firms that exhibit a voluntary and sustained increase in their disclosures. They find these firms had a significant increase in their liquidity (bid-ask spreads and trading volume) after the perceived increase in their disclosure quality.'

'Leuz and Verrecchia (2000) examine a sample of German firms that voluntarily adopt more onerous disclosure requirements by switching from German GAAP to an international reporting regime (ie, IAS or US GAAP). [They] find that switching firms have smaller bid-ask spreads and higher trading volume following the switch and relative to German GAAP firms, consistent with the notion that a commitment to more disclosure reduces adverse selection'.

'However, in many instances, the economic significance of the liquidity effects in cross-sectional studies[71] of US firms appears to be small. One issue is that these studies analyse firms' disclosures within the rich and stringent US disclosure system where the effects of additional voluntary disclosures are likely to be small (Leuz and Verrecchia, 2000). Moreover, cross-sectional studies may understate the true liquidity impact of voluntary disclosures. For example, firms with non-existent or minimal disclosures do not appear in the samples, but are likely to have such large bid-ask spreads that there is little or no public trading … Consistent with this claim, Bushee and Leuz (2005) document that firms in the OTC markets have extremely low levels of market liquidity and Leuz, Triantis and Wang (2007) [see Panel A3.9] show that liquidity essentially "vanishes" if firms cease to provide public disclosures on a regular basis … In other words, these extreme cases are often missing from cross-sectional studies, and therefore the results may understate the true magnitude of the liquidity impact of public disclosure in share markets.'

Jerold L. Zimmerman, in *Myth: External Financial Reporting Quality Has a 1st Order Effect on Firm Value*, comments that while reductions in bid-ask spreads may be statistically significant (ie, the detected correlation is unlikely to be a matter of chance), they tend to be quite small.

A3.3.4 Reduced uncertainty

'The effect of mandated market risk disclosures on trading volume sensitivity to interest rate, exchange rate, and commodity price movements' (2002) is a paper by Thomas J. Linsmeier, Daniel B. Thornton, Mohan Venkatachalam and Michael Welker. It is based on the theory that when investors generally are better informed about the likely effects of an event on a firm's prospects, they will tend to trade its shares less than when they are poorly informed. The rationale behind this is that trading is more likely where there is uncertainty and therefore diversity of opinion. Improved information should reduce uncertainty and diversity of opinion, and so reduce the volume of trading.

The authors compare trading levels at the time of changes in interest rates, exchange rates and commodity prices before and after implementation of the SEC's Financial Reporting Release (FRR) 48, *Disclosure of Accounting Policies for Derivative Financial Instruments etc*, in 1997. They find that trading volume sensitivity to changes in interest rates, exchange rates and commodity prices declines after FRR 48 information becomes available. This is consistent with investors' being better informed on the likely effects of such changes.

Some of the papers on improved predictive ability (see below) also have evidence relevant to reduced uncertainty.

[70] The Association for Investment Management and Research – formerly the Financial Analysts Federation, now the CFA Institute. AIMR used to publish annual rankings of companies' disclosures.

[71] That is, studies that examine the evidence for all US-listed companies at a particular time.

A3.3.5 Improved predictive ability

There are a number of studies showing that increased disclosure either could increase the accuracy of forecasts or is associated with increased accuracy of actual investment analysts' forecasts. Some of these are referred to at Panels A3.3 (disclosure in general), A3.4 (segmental disclosures) and A3.5 (disclosure of accounting policies).

Panel A3.3: Increased disclosures and predictive ability

In 'Corporate disclosure policy and analyst behavior' (1996) Mark H. Lang and Russell J. Lundholm look at correlations between disclosure informativeness, the number of investment analysts that firms have following them and the accuracy of the analysts' forecasts. Disclosure informativeness is measured using the Financial Analysts Federation assessments from 1985 to 1989 (see note to Panel A3.2). They find that 'firms with more informative disclosure policies have a larger analyst following, more accurate analyst earnings forecasts, [and] less dispersion among individual analyst forecasts.'

In 'Disclosure practices, enforcement of accounting standards and analysts' forecast accuracy: an international study' (2003) Ole-Kristian Hope looks at disclosures by public companies in 18 countries for 1993 and 1995 and their correlation with investment analysts' earnings forecasts. He finds that 'firm-level annual report disclosure quantity is positively associated with forecast accuracy, which suggests that firm-level disclosures provide useful information to analysts.'

Panel A3.4: Segmental disclosures and predictive ability

From 1970, the SEC required segmental disclosures by US public companies, with retrospective data from 1967 onwards. Bruce A. Baldwin, 'Segment earnings disclosure and the ability of security analysts to forecast earnings per share' (1984) looks at analysts' published forecasts before and after the SEC disclosure requirements were introduced. He finds that 'security analysts were able to make more accurate earnings projections after segment reporting was adopted in 1970.'

Baldwin also quotes a 1972 survey of 270 directors of investment research by the Financial Analysts Association intended to find out whether the newly mandated disclosures were being used. The survey found that:

'(1) substantially all respondents used segment information in their work, (2) two-thirds said that these data improved their earnings projections in at least some cases, and (3) more than two-thirds said that these data changed their appraisal of a company to a significant degree in at least some cases.'

Panel A3.5: Accounting policy disclosures and predictive ability

In 'Accounting policy disclosures and analysts' forecasts' (2003) Ole-Kristian Hope looks at disclosures of accounting policies by public companies in 18 countries for 1993 and 1995 and their correlation with investment analysts' earnings forecasts. He finds that 'the extensiveness of accounting policy disclosure … is significantly negatively associated with forecast dispersion and forecast error, and that such disclosures have incremental explanatory power over and above all other information in the annual report.'

A number of papers show that disclosures by US public companies in their MD&As improve predictive ability.

There is also a significant body of research showing that financial reporting information can help to forecast default. This is based mainly on ratios derived from the primary financial statements, rather than on detailed disclosures. We are not aware of any research that shows a correlation between more extensive disclosures and the ability to forecast default.

A3.3.6 Improved ability to calculate numbers on different bases

In 'Required disclosures in financial reports' Katherine Schipper lists a number of papers that give examples of disclosures enabling researchers to undo non-comparable accounting or to create an alternative treatment. Panel A3.6 gives extracts from her review.

Panel A3.6: Evidence on improved ability to calculate numbers on different bases

From Katherine Schipper, 'Required disclosures in financial reports':

Dopuch and Pincus (1988) use disclosures 'to place LIFO and FIFO firms on the same accounting basis'.

Imhoff et al (1991, 1993) use 'required disclosures about operating lease payments to approximate the effects of treating those leases as capital leases'.

'With regard to nonhomogeneous unconsolidated subsidiaries, Wiedman and Wier (1999) show that disclosures of assets, liabilities, and operating results required by Accounting Research Bulletin No 51, *Consolidated Financial Statements* (para 51), could be used to compute as-if-consolidated leverage ratios.'

A3.3.7 Reduced moral hazard

A recent study on disclosure and moral hazard – 'Does enhanced disclosure really reduce agency costs? Evidence from the diversion of corporate resources' (2012) by Pinghsun Huang and Yan Zhang (Panel A3.7) – notes that 'empirical evidence about the monitoring effect of disclosure is fairly sparse'. The paper does not speculate as to why this might be the case, but some possible reasons are as follows.

- Researchers may consider it obvious that credible disclosure reduces the possibilities for managers to run off with shareholders' money (or to abuse their position in other ways), so the issue might be seen as an uninteresting one for empirical investigation.
- The problem of moral hazard is about preventing behaviour that is illegal, immoral or at least undesirable. Evidence for the existence of such behaviour is always likely to be difficult to find except in the relatively small number of cases where there are actual convictions.
- Much empirical research in financial reporting focuses on evidence for public companies in the US, where there is a relatively high level of disclosure, so it may be difficult to show the benefits of disclosure if all the firms in the sample are high-disclosers (see A3.3.2).

The research referred to in Panels A3.8 and A3.9 looks at possible connections between, respectively, moral hazard and segment reporting, and moral hazard and 'going dark', which is a way of significantly reducing public disclosures.

Panel A3.7: Public reporting and private benefits

Huang and Zhang look at correlations between firm characteristics (eg, cash holdings, capital expenditure), stock returns and AIMR disclosure rankings (see note to Panel A3.2) for US public companies (excluding financial firms and utilities) over the period 1987-1996. Their findings 'suggest that managers in firms with greater disclosure are subject to greater scrutiny and discipline imposed by the external market, and are less likely to use resources for rent-seeking'. They also find that 'major internal investment [ie, capital spending other than on acquisitions] … and external expansion [ie, acquisitions] … substantially destroy the value of the stock for opaque firms'. The implication is that the investments of such firms 'offer private benefits to the detriment of outside shareholders'.

Panel A3.8: Segment reporting and empire building

Ole-Kristian Hope and Wayne B. Thomas, 'Managerial empire building and firm disclosure' (2008), look at the effects of changes in the reporting of segment information by US public companies following the introduction of SFAS 131, *Disclosures of Information about Segments of an Enterprise and Related Information* (1997). SFAS 131 changed the primary basis for the reporting of segment information from a geographic one to an operating segments one. Disclosure of earnings on a geographic basis would be required, therefore, only where operating segments were also geographic ones, though some firms continued to disclose them voluntarily. Requirements for geographic disclosure of revenues and assets remained in place and were indeed tightened up in some respects.

The authors find that 'non-disclosure of geographic earnings is associated with higher foreign sales growth and a decrease in foreign profit margin… [W]e also note that firm values are consistently lower for firms that no longer disclose geographic earnings.' The authors interpret their findings as evidence of empire-building by managers who are taking advantage of the reduced geographic disclosures allowed by SFAS 131: 'As monitoring is reduced, managers are more willing to expand international operations even though it leads to lower profitability.' The authors warn that 'our findings should be interpreted cautiously. Most importantly, it is difficult to prove causality. That is, although we establish a strong case for a positive association between non-disclosure of geographic earnings and managerial empire building, our tests cannot prove that non-disclosure causes such managerial behavior.'

Panel A3.9: Why do firms go dark?

In 'Why do firms go dark? Causes and economic consequences of voluntary SEC deregistrations' (2008), Christian Leuz, Alexander J. Triantis and Tracy Yue Wang look at the 484 US public companies that 'went dark' between 1998 and 2004. SEC rules allow companies to deregister if they have a relatively small number of shareholders and a relatively low level of reported assets. Deregistration exempts them from SEC requirements, including disclosure requirements. Their shares may still be publicly traded, but not on a major exchange. This is 'going dark'. Non-US readers need to bear in mind that financial reporting disclosure requirements for public companies in the US are primarily imposed by securities market regulators, not by company law, though company law varies from state to state. Escaping securities market regulation can therefore have a greater effect on disclosure in the US than in countries where requirements are primarily imposed through company law – though often, as in the EU, company law distinguishes between firms whose shares are publicly traded and others.

The authors find evidence supporting two alternative explanations for why firms go dark: to reduce costs (which, in itself, should increase the value of the firm) and to allow managers to exploit increased information asymmetries (which should decrease the value of the firm) – an agency problem.

'Consistent with the cost savings rationale, going dark firms are smaller and have poorer stock market performance, higher leverage, and fewer growth opportunities than the population of firms that could but choose not to go dark. They also exhibit higher levels of distress and experience a decline in stock market interest. It is plausible that, for such firms, the cost savings from SEC deregistrations exceed the (presumably low) benefits of continued reporting, which is consistent with claims in companies' press releases that the decision to go dark maximises firm value and is in the interest of shareholders.'

'However, we also find evidence consistent with the agency explanation for going dark. We find that firms that go dark have on average larger (positive and negative) accruals relative to their cash flow from operations (consistent with poorer accounting quality and hiding motives), larger free cash flow …, and weaker board governance and outside monitoring. Our results suggest that … these proxies for agency conflicts play a larger role when governance is weak. We also document that firms that are subject to state provisions requiring some form of disclosure are much less likely to deregister and that few firms voluntarily provide financial statements (privately or publicly) following deregistration. While reporting costs could still play a role in the latter findings, they are also consistent with a desire to avoid outside scrutiny.'

Research on disclosure in other areas (see Panel A3.10) suggests that the expectation of disclosure has an effect on the conduct of those whose behaviour will be reported on. It would be surprising if the knowledge that their conduct will be reported on through financial reporting disclosures had no effect on managers' behaviour – unless the disclosures were poorly specified or unreliable.

Panel A3.10: The effects of anticipated disclosures

'[D]isclosers frequently anticipate rather than respond to user actions. Manufacturers promised to make drastic reductions in toxic pollution nearly a year before their toxic releases were first disclosed to the public. Food companies began introducing new lines of healthy products well before nutritional labels were required… Likewise, government officials have taken anticipatory action to improve schools, drinking water quality, or other services in anticipation of the public's response to new transparency systems' – Archon Fung, David Weil, Mary Graham and Elena Fagotto, *The Political Economy of Transparency: What Makes Disclosure Policies Effective?* (2004).

A3.3.8 Improved economic growth

Explaining economic growth is a complex problem and identifying the effects of any single cause in promoting or retarding it clearly poses challenges. One attempt to assess whether corporate disclosure plays a role in economic growth is 'Does corporate transparency contribute to efficient resource allocation?' (2009) by Jere R. Francis, Shawn Huang, Inder K. Khurana and Raynolde Pereira. This paper examines

> 'whether the country-level information environment is positively associated with the timely reallocation of resources in response to growth shocks (or changes in growth opportunities) by improving the transfer of resources from industries that experience negative growth shocks to those that experience positive growth shocks.'

'Growth shocks' are unexpected changes in technology or prices that affect the relative prospects of different industries.

The authors note that there are a number of reasons for thinking that greater disclosure tends to lead to higher economic growth:

> 'First, transparency improves firms' access to lower cost external financing. In the absence of transparency, higher cost external financing will impede firms' ability to take advantage of growth opportunities. Second, transparency contributes to more informative stock prices. Informed stock prices reflect greater firm-specific information and this ensures that prices remain close to their fundamental value and reflect available growth opportunities. Third, transparency plays an important governance role in that it allows greater monitoring by outside investors. This greater monitoring in turn ensures that managers take advantage of value enhancing growth opportunities and prevents diversion of firms' resources.'

They conclude that 'Overall, the evidence points to a first-order importance of corporate transparency … in the efficient allocation of resources and economic growth.' They warn, however, that their positive conclusion on the value of corporate transparency 'is contingent on the social benefits of improved resource allocations exceeding the private (firm-level) costs of better accounting systems and expanded public disclosures.'

Two further papers covered in Panel A3.11 also examine the connection between disclosure and economic growth.

Panel A3.11: Further evidence on disclosure and growth

In their survey paper 'Financial accounting information and corporate governance' Robert M. Bushman and Abbie J. Smith summarise two studies that look at economic growth and disclosure:

'Both Rajan and Zingales (1998) and Carlin and Mayer [2003][72] investigate the economic effects of financial accounting regimes by exploring the relation between the CIFAR index for sample countries and various aggregate measures of economic inputs and outputs. The CIFAR index represents the average number of 90 specific items disclosed in the annual reports of at least three companies per country, including items from the income statement, balance sheet, funds flow statement, accounting methods, stock price data, governance information …, and general information. The CIFAR index is interpreted as the quality of the financial accounting information available in an economy, where a large number of disclosures is a proxy for better financial accounting information.'

'Together the results of Rajan and Zingales (1998) and Carlin and Mayer [2003] are consistent with the interpretation that high-quality accounting regimes promote GDP growth and firm entry by lowering the cost of external financing. Furthermore, the lower cost of equity capital associated with high-quality accounting regimes is particularly useful for the stimulation of high-risk, long-term investments in R&D.'

These findings are of interest for our purposes because the researchers take a disclosure index as a proxy for accounting quality, so 'high-quality accounting regimes' are in fact high-disclosure regimes.

Because of the methodological difficulties involved in investigating this question, we should perhaps not attach great weight to the findings of a small number of research papers. But we are not aware of any studies suggesting that increased disclosures, through the costs they impose on preparers and users, have tended to retard economic growth.

A3.4 ASPECTS OF DISCLOSURE THAT LIMIT ITS BENEFITS

Different aspects of disclosure can limit its benefits to users. It may be badly presented or too long or inherently complex. These are overlapping problems. Presenting information badly can make it more complex for users. Length in itself is often taken to be an indicator of complexity. A number of studies have looked at different aspects of these problems.

A3.4.1 Poor presentation

Information can be made easier or more difficult to understand by the way in which it is presented. The same information presented to the market in different ways, therefore, can be expected to have different effects on different users depending on how well they understand it.[73]

[72] Bushman and Smith in fact cite an earlier, prepublication version of this paper from 2000.

[73] Robert Libby and Scott A. Emett, 'Earnings presentation effects on manager and user behavior' (forthcoming), a paper commissioned by ICAEW, reviews the existing research literature on presentation.

One aspect of presentation is readability, another is bringing related information together. There has been research on both aspects.

Research into the readability of annual reports goes back at least to the 1940s, when Siroon Pashalian calculated Flesch readability scores for a number of US public companies' 1948 reports. Flesch scores rely mainly on the average number of syllables per word and to a lesser extent on the length of sentences. Pashalian found that the reports' readability came on average into the 'difficult' category, considered typical for academic journals.[74]

In 'Readability and corporate annual reports' (1964), Fred J. Soper and Robert Dolphin, Jr, compared the Flesch scores of 25 US public companies' 1961 annual reports with the same companies' 1948 scores in Pashalian's research. They found that, on average, they had become less readable and now came into the 'very difficult' category, considered typical for scientific journals. They also tested whether Flesch scores did in fact correlate with how well readers understood the reports' contents and found that they did.

The research reported at Panel A3.12 shows that readability correlates with forecast accuracy, uncertainty, and changes in share prices.[75]

Panel A3.12: Readability, investors and analysts

In 'The effect of annual report readability on analyst following and the properties of their earnings forecasts' (2011) Reuven Lehavy, Feng Li and Kenneth Merkley measure the readability of the annual 10-K reports of US public companies and investigate its correlation with sell-side investment analyst behaviour. The measure of readability is the Gunning fog index, which is based on the number of words per sentence and the proportion of 'complex' words. This is similar in principle to the Flesch score, but more weight is given to words per sentence than under the Flesch method, and word complexity involves more than the number of syllables per word.

The authors find that reduced readability is correlated with increased analyst following, with analysts taking more time to issue their reports, with increased 'information content' in analysts' reports, and with more dispersed and less accurate analysts' forecasts. 'Information content' is measured by the correlation of changes in share prices with the issuance of analysts' reports.

The increased analyst following is interpreted as a sign of increased demand for analysts' services to understand the information disclosed, and the increased information content suggests that investors are using the output of these services. The increased time taken to issue reports is interpreted as evidence that the disclosures take longer to assimilate. The increased dispersion and reduced accuracy are interpreted as indications of increased uncertainty associated with the less readable disclosures. The authors also note that their findings 'provide indirect evidence to support the notion that the information contained in the 10-K filing is used by analysts'.

A study by Brian P. Miller also looks at readability (see Panel A3.14).

The study by D. Eric Hurst and Patrick E. Hopkins reported at Panel A3.13 looks at the effects of different ways of presenting the same information. It shows, perhaps unsurprisingly, that bringing relevant information together helps people to understand it.

Panel A3.13: Complexity and comprehensive income

In 'Comprehensive income disclosures and analysts' valuation judgments' (1998) D. Eric Hirst and Patrick E. Hopkins report on an experiment with 96 US buy-side investment analysts and portfolio managers. They gave the participants information on companies that had been cherry-picking asset sales so as to report higher profits; the cherry-picking was detectable from information reported about the firms' comprehensive income. Some participants were given the information on comprehensive income in the income statement, others in a statement of changes in owners' equity. The experiment found that clear disclosure of comprehensive income and its components in the income statement 'made earnings management more transparent and resulted in significantly lower stock price judgments'.

The Feng Li study referred to at Section 5.6 in the main report, 'Annual report readability, current earnings, and earnings persistence', measures readability using a mixture of the Gunning fog index and length. As indicated earlier, it finds evidence that:

> 'managers may be opportunistically choosing the readability of annual reports to hide information from investors… However, there is no apparent correlation

[74] Siroon Pashalian and William J. E. Crissy, 'How readable are corporate annual reports?' (1950), based on Pashalian's research for a master's degree thesis.

[75] John E. Core, 'A review of the empirical disclosure literature: discussion' (2001), suggests that readability measures might be used as relatively easily computable measures of disclosure quality.

> between annual report readability and future stock returns, suggesting that the stock market understands this implication.'

Michael J. Jones and Paul A. Shoemaker, 'Accounting narratives: a review of empirical studies of content and readability' (1994), provide a still useful survey of 68 studies on readability. They point to a general conclusion that accounting narratives are hard to read, but draw attention to several limitations of the literature, including the important point that readability is not the same as understandability, which is what matters.

A3.4.2 Length

In 'Blinded by the light: information overload and its consequences for securities regulation' Troy A. Paredes notes that:

> 'Studies have shown that as a decision maker is given more information, decision quality initially increases; once the information level reaches a certain point, however, the decision maker's decision quality decreases if she is given additional information.'

Of the two studies in the panel below, Brian P. Miller looks at both readability and length as elements of complexity, but finds that length dominates, while Haifeng You and Xiao-Jun Zhang measure complexity purely by looking at length. It seems reasonable therefore to regard these papers as primarily about length.

Panel A3.14: Length and investor reactions

Brian P. Miller, 'The effects of reporting complexity on small and large investor trading', looks at the complexity of annual 10-K reports of US public companies and its correlation with share trading by large and small investors. Complexity is measured by both length (number of words) and two measures of readability: the Gunning fog index and the StyleWriter style index. The StyleWriter style index was another technique similar to the Flesch score and the Gunning fog index, but involving a number of apparently subjective, though mechanically recognised factors such as 'overwriting', 'jargon' and 'abstract words'; it was a proprietary product (superseded by the StyleWriter bog index).

Miller finds that more complex reports are associated with lower levels of trading by small investors, but not by large investors. The evidence suggests that length is more important than readability in producing this effect. Miller also finds that trading by large investors 'is actually greater for firms with longer and less readable reports'. The author comments that 'The findings specifically challenge some long-standing regulatory assumptions that requiring more disclosure will not only aid investors in their trading decisions, but also help level the playing field between small and large investors.'

In 'Financial reporting complexity and investor underreaction to 10-K information' (2009) Haifeng You and Xiao-Jun Zhang look at the delay in share price reactions to information in annual 10-K reports of US public companies and investigate its correlation with the reports' complexity. Complexity is measured by the number of words in the report. The authors find that 'investor underreaction [to the information in 10-Ks] tends to be stronger for a group of firms with more complex 10-K reports. Firm-years with less complex 10-K filings show little, if any market underreaction.' They comment that 'Overall, our results indicate that the complexity of accounting information does affect the extent to which investors can incorporate such information into price. This lends support to making 10-K information more intelligible to the average investor.'

A3.4.3 Inherent complexity

A number of studies have looked at users' ability to cope with complex information and found that more complex information is less well understood and/or takes longer to assimilate:

> 'judgment/decision-making research consistently finds that higher task complexity leads decision makers to select analytically simpler strategies to complete a task, and analyst-related research finds that analysts fail to use all available information in forming their forecasts. If less complex information is less costly to use than more complex information (ie, it takes less time, effort, or training) and there are constraints on an analyst's time, effort, or ability, then, all else equal, the net benefit of incorporating information into a forecast should be a decreasing function of the information's complexity' (Plumlee 2003 – see Panel A3.15).

We summarise below two studies that look at complex disclosures in different areas of financial reporting.

Panel A3.15: Complexity: changes in tax law

In 'The effect of information complexity on analysts' use of that information' (2003) Marlene A. Plumlee looks at how analysts impounded the effects of six tax-law changes in the US Tax Reform Act of 1986 into the effective tax rate forecasts for US public companies. She finds that 'analysts' revisions of their [effective tax rate] forecasts appear to impound the effects of the less complex tax-law changes but not the effects of the more complex tax-law changes.'

Panel A3.16: Complexity: pensions disclosures

In 'The perils of pensions: does pension accounting lead investors and analysts astray?' (2006) Marc Picconi looks at defined benefit pension disclosures and their impact on analysts' forecasts and stockmarket prices. He finds that 'both prices and forecasts fail to reflect new pension information at the time it becomes publicly available and that it is gradually incorporated through its effects on quarterly earnings.' The author comments that 'future research needs to deal with the issues of current pension accounting complexity and the fact that most of the economically significant pension information is buried in lengthy footnotes.'

A3.5 HAVE WE REACHED FULL DISCLOSURE?

In 'Motives for disclosure and non-disclosure: a framework and review of the evidence', Lundholm and Van Winkle explain the theoretical case for voluntary full disclosure by firms. They note that there is evidence suggesting that 'managers are already disclosing everything that they do know' or, to be more precise, suggesting that 'perhaps not much else is known by managers with sufficient certainty to be useful information for the market'.

As noted above (A3.3.2), in 'The economic consequences of increased disclosure' Leuz and Verrecchia suggest that a possible explanation of why it has been difficult to show a relationship between increased disclosure and the cost of capital is that previous research on the subject had used US evidence and that 'the [US] disclosure environment is already rich'. They note that, by contrast, 'disclosure levels in Germany … have been characterized as being low'. They accordingly look at German firms that adopt IAS or US GAAP between 1993 and 1997, which involves a commitment to 'substantially increased levels of disclosure', and find 'evidence … consistent with the notion that firms committing to increased levels of disclosure garner economically … significant benefits'. While this finding is of interest, more to the point for our current argument is the speculation that even in the 1990s disclosures in the US were already so extensive that commitments to additional disclosures for US firms would be likely to produce little unambiguously detectable benefit.

According to Daniel Kahneman,

> 'the extensive research on insider trading shows that executives do beat the market when they trade their own stock, but the margin of their outperformance is barely enough to cover the costs of trading'.[76]

This suggests that while there would be something to be gained by additional disclosures, it would not be a great deal. If there were significant information asymmetries between insiders and outsiders, we would expect insiders to make significant gains when they trade. On the other hand, it is possible that the gains from insider trading understate the gains to be made by reducing information asymmetries (in terms of improved share valuations). While insiders know a lot about their own business, they may know less than outside professional investors about many other things relevant to their company's valuation and they typically have an overoptimistic view of their company's prospects. In short, for purposes of share valuation, outsiders might be able to make better use than insiders of the knowledge available to insiders.

Also of interest is the age of the studies referred to by Kahneman, of which the earliest dates from 1988. If the gap in useful knowledge between insiders and outsiders was already narrow in the 1980s, why has it been necessary to have such a dramatic increase in disclosures over the past quarter century? The answer to this may partly be that – for the reasons discussed in Chapter 2 – there has been a dramatic increase in the information available within businesses. Full disclosure is a moving target; there may be full disclosure now, but additional disclosures would still be required so as to keep pace with new types of information that need to be disclosed. It would be interesting to investigate how far external disclosures have kept up with the internal growth of information.

[76] Daniel Kahneman, *Thinking, Fast and Slow* (2011), p464, n207.

Contrary to the argument set out above, some recent evidence suggests that managers do possess valuable information that they are failing to report to market participants generally, but do impart – perhaps unintentionally – to selected investors. Investors are willing to pay up to $20,000 an hour to meet with corporate chief executives, which – unless the investors are stupid – implies that they get information worth at least that much from the encounters.[77]

And a research paper from the US[78] – based on one unidentified company's meetings with investors between 2004 and 2010 – finds 'evidence that investors who meet privately with management make more informed trading decisions in periods when they meet, increasing their position before periods of high returns and decreasing their positions before periods of low returns'. This evidence relates particularly to hedge funds; other investors do not seem to gain as much from their meetings with managers. The authors suggest that 'our results seem to be most appropriately interpreted as implying either that hedge funds are better able to utilize the information conveyed during private meetings or alternatively that they are better able to extract useful information from management'. So some investors are smarter than others.

It is possible, of course, that the information derived from meetings with management is 'soft' information about the ability and credibility of managers, rather than the sort of 'hard' information in financial reporting disclosures.

A3.6 DISCUSSION OF THE EVIDENCE

We may summarise the findings reported in this appendix as follows.

- There is some evidence that the regulation of disclosure benefits investors, but it is surprisingly slight, given the extent to which financial reporting disclosures are in fact regulated.
- There is good evidence that increased disclosure can reduce the cost of capital, but where disclosures have already reached a certain degree of openness and reliability (as in the US for public companies), any further reduction in the cost of capital may well be insignificant.
- There is good evidence that increased disclosure can increase liquidity, but this effect is subject to the same caveats as the cost of capital effect.
- There is good evidence that increased disclosure can reduce uncertainty.
- There is good evidence that increased disclosure can increase the accuracy of outsiders' forecasts. Much of the evidence here is in relation to segment and product information, which is precisely where managers and firms are often most reluctant to increase disclosures.
- There is good evidence that increased disclosures can improve outsiders' ability to calculate numbers on different bases, but this is another area where managers and firms are reluctant to disclose information, partly because the process is a potentially endless one.
- There is good evidence that increased disclosure can reduce moral hazard risk, but again much of the evidence is in relation to segment reporting.
- There is some evidence that increased disclosures improve economic growth, but there are so many institutional factors that influence economic growth that it may be difficult to be confident how much is attributable to disclosure as such. It can perhaps be said with greater confidence that institutional clusters that promote economic growth typically include a relatively open system of disclosures.
- There is some evidence that the disclosure system for US public companies has for some time – perhaps even since the 1980s – been sufficiently open that additional disclosures are likely to have little effect. Additional disclosures may of course be needed from time to time (or constantly) to keep the system an open one.
- There is good evidence that poor presentation, length and complexity can make it harder for users to understand financial reporting information. But this does not mean that additional information is useless, and some complexity may be inevitable given the subject matter. Also, even if some or most users have problems because of poor presentation, length and complexity, it is not clear – judging by share prices – that the market is affected by these problems.

Much of the research surveyed is subject to a number of inherent limitations.

- It cannot tell us what is the optimum level of disclosure, as this will vary from firm to firm, from user to user, and from year to year.

[77] Steve Johnson, 'FSA warns of cash for access crackdown' (2013).

[78] David Solomon and Eugene Soltes, *What Are We Meeting for? The Consequences of Private Meetings with Investors* (2013).

- It is useful to know that specific types of disclosure can be shown to have benefits. But unless there is a comprehensive research programme to examine separately the effects of every single disclosure requirement, such evidence is necessarily piecemeal. It does not, therefore, provide the data that would be needed to review disclosure requirements in general and to separate out the more useful from the less useful (or the useless).
- In any case, evidence that particular disclosures have benefits often relates to their news value. It does not usually show whether they are of continuing reference value.
- It is difficult to know how far the findings are generalisable to different contexts. Most of the research cited here is based on US public companies and, as it is easiest to assess the effects of a new disclosure requirement when it first appears, studies are often based on evidence from about the time a new requirement was introduced. So the findings of such research may not hold outside the US, or for private companies, or for later periods. Indeed, much of the research is now quite old – based on disclosures in the early 1990s, for example, or even earlier – and it would be interesting to know how far its findings are still applicable today in what is in important respects a changed corporate financial information environment.
- There is a natural bias in research towards doing and publishing work that has interesting results, and research finding that a particular disclosure has no effects might be regarded as uninteresting. There may therefore be a bias towards research studies that show that disclosure has beneficial effects rather than negligible effects.
- There is no reason to think that there would be a bias against research studies that show that disclosure has harmful effects rather than positive effects, but there is in general an absence of such studies, apart from those attributing the negative effects to length and complexity. This may indicate either that disclosure is generally not harmful, that firms find ways of not making disclosures that would be harmful, or that researchers have not yet found ways of detecting negative effects of disclosure other than those attributable to length and complexity.
- The benefits of non-disclosure may be difficult to research. To the extent that disclosures are voluntary, a decision not to disclose is presumably as rational as a decision to disclose, and so it seems reasonable to assume that such benefits exist. These benefits would of course include the avoidance of any costs that disclosure might entail.

APPENDIX 4: DISCLOSURE FRAMEWORKS AND OTHER PROPOSALS

A4.1 INVESTORS TECHNICAL ADVISORY COMMITTEE

The Investors Technical Advisory Committee (ITAC) is an independent committee set up by the FASB to give it advice from investor perspectives.

In December 2007, ITAC wrote to the FASB calling for a project to develop a disclosure framework. It proposed that 'the disclosure information requirements for a particular account (assuming it is material to the reader of the financial statements) will include:

- The accounting principles used to account for the item and activity in the account(s), and the basis for their selection.
- Sufficient detail about the account to permit a user to understand the composition and nature of the items included (and/or netted) within a specific caption.
- A roll-forward of the activity in the account balances from period to period showing gross (un-netted) changes by the nature of the change (eg, change in balance resulting from new issuances, repurchases, changes in interest rates and changes in credit quality).
- The principal estimates and assumptions used.
- The basis for selecting a particular assumption and any changes in assumptions that have a material impact in the determination of the underlying data and estimates.
- Risks and uncertainties related to the applicable account (unless immaterial or remote), including an estimate of the range of potential impact those items could have on the results of operations, financial condition, or liquidity, in either a favourable or unfavourable manner.
- The nature and magnitude of non-recurring transactions.
- For nondiscretionary or other commitments requiring use (or receipt) of resources (eg, capital commitments, on or off the balance sheet financings, and pensions) that are considered likely to occur, a disclosure of the best estimate of the amount of those commitments for each of the next five years and in the aggregate thereafter.
- A "catch-all" proviso mandating that, when a transaction is not covered by a specific accounting standard, if information regarding it is considered material to investors, disclosure of the nature and magnitude of the transaction is required to keep the financial statements from being misleading.'

ITAC complains that 'companies often still do not provide adequate information under today's prevailing piecemeal disclosure guidance'[79] and states that 'we view current disclosures as lacking or incomplete'. It says that 'preparers typically do not include additional information if not required to do so'. It recommends its comprehensive approach to overcome these problems. It suggests that the proposed disclosure framework 'could replace the disclosure guidance within existing individual standards and the need for specific guidance in new ones'.

A4.2 SEC ADVISORY COMMITTEE ON IMPROVEMENTS TO FINANCIAL REPORTING

In 2007 the SEC set up an Advisory Committee on Improvements to Financial Reporting (CIFR), which reported in 2008. CIFR's task was to make recommendations 'to improve the usefulness of financial information to investors, while reducing the complexity of the financial reporting system to investors, preparers, and auditors'.

The report states that:

> 'Historically, disclosure standards have developed in a piecemeal manner (ie, standard-by-standard). The lack of an underlying framework has contributed to: (1) repetitive disclosures that may disproportionately emphasise certain risks, (2) excessively detailed disclosures that may confuse rather than inform, and (3) disorganized presentations in financial reports.'

[79] Where the Committee refers to 'guidance' it in fact seems to have in mind mandatory requirements.

> '[T]he lack of a holistic approach to disclosures, the amount and timing of information, and the method by which it is transmitted, may result in complex and hard-to-navigate disclosures that cause investors to sort through material that they may not find relevant in order to identify pieces that are.'

However, it also says that 'The need for information varies by investor type', which is part of the reason why investors encounter information that is not relevant to them.

To address the problem that it has identified, CIFR recommends (Recommendation 1.2):

> 'The SEC and the FASB should work together to develop a disclosure framework to:
>
> - Integrate existing SEC and FASB disclosure requirements into a cohesive whole to ensure meaningful communication and logical presentation of disclosures, based on consistent objectives and principles. This would eliminate redundancies and provide a single source of disclosure guidance across all financial reporting standards.
> - Require disclosure of the principal assumptions, estimates, and sensitivity analyses that may impact a company's business, as well as a qualitative discussion of the key risks and uncertainties that could significantly change these amounts over time. This would encompass transactions recognized and measured in the financial statements, as well as events and uncertainties that are not recorded.'

CIFR acknowledges ITAC's contribution on this issue and envisages that the disclosure framework would work in the way that ITAC suggests, ie, the framework would establish fundamental principles, which would make disclosure requirements in specific standards unnecessary. 'Otherwise, disclosure standards will degenerate into myriad rules because standards-setters cannot envision all of the specific future disclosure requirements that would be necessary in different settings.' It proposes that the framework should be prepared jointly by the FASB and the SEC so that it also covers disclosures outside the financial statements.

CIFR states that:

> 'At a minimum, we believe an effective disclosure framework is comprised of three basic elements: (1) a description of the transactions reflected in financial statement captions, (2) a discussion of the relevant accounting provisions, and (3) an analysis of the key supporting judgments, risk, and uncertainties.'

A4.3 JOINT OVERSIGHT GROUP

In 2011, a Joint Oversight Group of the Institute of Chartered Accountants of Scotland and the New Zealand Institute of Chartered Accountants ('the Group') issued *Losing the Excess Baggage – Reducing Disclosures in Financial Statements to What's Important.* This report, commissioned by the IASB, reviews existing disclosure requirements in IFRS and suggests numerous deletions.

The report notes that 'the financial reporting community has become concerned about the increasing size of financial reports and the danger of readers being so blinded by so much data that the main messages are lost'. It says that financial statements are 'cluttered by excessive detail' and concludes that there is 'an urgent need to reduce financial statement disclosures so as to enable users to focus on the relevant information about the entity in a more accessible manner'.

The Group tested the impact of its proposed cuts on a set of model financial statements:

> 'The result for the disclosures required by the standards reviewed in this project [some were excluded] was a 37% reduction in the length of the financial statements. Looking at the financial statements overall, and thus including disclosures required by standards not included in this review, the impact would be a 30% reduction in length.'

As it is reasonable to expect that the standards excluded from the review would be susceptible to a similar scale of cuts to those included, the figure of 37% seems to be the relevant one. In other words, a set of accounts that now extends to 100 pages could be cut down to 63 pages if the Group's approach were adopted.

The effects of the cuts that the report proposes are not visible in the report itself as the model accounts exercise referred to above is not published. The report is a list of cuts to accounting standards rather than a list of cuts to disclosures. Many of the cuts to accounting standards are not cuts to required disclosures, but are instead deletions of:

- duplications within and between standards;

- cross-references;
- examples provided as guidance; and
- encouraged disclosures.

The figure of 37% is stated to be a reduction in the length of required disclosures, and presumably it therefore excludes any reduction that might arise from the removal of disclosures that merely follow guidance in the standards or that are encouraged, rather than mandatory.

The report stresses the application of materiality as a test to reduce required disclosures. It indicates that this contributes to the 37% reduction achieved in the model accounts exercise, but does not state how far it does so. To the extent that the reduction is due to a stricter application of the materiality test, then it would not need any cuts in disclosure requirements.

A4.4 FRS 101, *REDUCED DISCLOSURE FRAMEWORK*

In the UK, the Financial Reporting Council has for some years been developing a new financial reporting framework for entities that do not comply with full IFRS. This includes a 'reduced disclosure framework' that sets out reduced disclosure requirements for the individual accounts of certain entities: FRS 101, *Reduced Disclosure Framework: Disclosure Exemptions from EU-adopted IFRS for Qualifying Entities* (2012). Qualifying entities for this purpose are holding companies and subsidiaries whose financial reporting is included in consolidated financial statements that give a true and fair view and are publicly available. The consolidated financial statements would be prepared in accordance with IFRS.

The important part of the framework in the context of this report is the 'principles for determining which of the disclosure requirements in IFRS should be applied by qualifying entities'. The principles are:

> '1. *Relevance:* Does the disclosure requirement provide information that is capable of making a difference to the decisions made by users of the financial statements of a qualifying entity?
>
> '2. *Cost constraint on useful financial reporting:* Does the disclosure requirement impose costs on the preparers of the financial statements of a qualifying entity that are not justified by the benefits to the users of those financial statements?
>
> '3. *Avoid gold plating:* Does the disclosure requirement override an existing exemption provided by company law in the UK?'

Principle 3 is UK-specific, but the first two could presumably be applied by any standard-setter in determining which disclosures should be required.

A4.5 FINANCIAL ACCOUNTING STANDARDS BOARD

In 2012 the FASB published a discussion paper, *Disclosure Framework: Invitation to Comment*. The paper stresses that the ideas it puts forward for comment are not proposals, but 'a first step in developing a proposal'.

The paper states at the outset that:

> 'The objective and primary focus of this project is to improve the effectiveness of disclosures in notes to financial statements by clearly communicating the information that is most important to users of each entity's financial statements. Although reducing the volume of notes to financial statements is not the primary focus, the Board hopes that a sharper focus on important information will result in reduced volume in most cases.'

It also states, though, that 'limiting or reducing volume … is a highly desirable outcome to the extent that it enhances users' ability to find and understand relevant information'.

To achieve its objective, the paper puts forward possibilities 'intended to limit note disclosure to information with the following characteristics:

> a. It is unique to an entity or its industry.
>
> b. It is not already apparent from financial statements or readily available from public sources to which users could be expected to have access.
>
> c. It could make a material difference in assessments of future cash flow prospects.'

The paper identifies a number of 'decision questions', which are criteria to determine whether disclosures should be required. The FASB staff:

> 'informally tested the decision questions by applying them to various accounting topics and comparing the results to the current disclosure requirements. That testing indicated a few existing disclosure requirements that would not be indicated by the decision questions. Testing also identified some information not currently required to be disclosed that would be indicated by the decision process.'

Notwithstanding this ambiguous result, the paper states that 'the staff thinks that with a fully developed disclosure framework, disclosure requirements could be reevaluated and possibly reduced.'

One idea put forward is that:

> 'The Board might set different requirements for different entities … For example, differences [in requirements] might be based on the size of the reporting entity or the business in which the entity engages. The Board might also set different requirements for entities with particular types of asset mixes, leverage ratios, or other characteristics.'

A more radical idea already raised by ITAC and CIFR is that the FASB should abandon the practice of including detailed disclosure requirements in standards and instead establish a single overall requirement, leaving it to each firm to decide how best to apply this in its own particular circumstances. It is also suggested that there could be options between these two extremes. For example, the Board might 'provide a graduated scale of information requirements in each Topic'.

For any option that would involve firms using their discretion whether to make disclosures, firms 'would have to make an explicit decision about each disclosure' and 'would need to document the reasons for their decisions about which disclosures to provide'. This would involve evidencing the process by which they decide whether each potential disclosure 'would change users' assessments of cash flow prospects by a material amount'. If it would, the disclosure should be made. The paper points out that:

> 'permitting or requiring selectivity in the application of disclosure requirements … will not necessarily reduce the time and effort in preparing notes to financial statements. In fact, for many entities, more time and effort may be required, especially in the first year of application and in any year in which the entity's circumstances have changed significantly.'

The paper also discusses possible improvements to the format and organisation of note disclosures.

A4.6 EFRAG, ANC AND FRC

In 2012 EFRAG, the French ANC and the UK FRC issued a discussion paper, *Towards a Disclosure Framework for the Notes*. The paper states:

> 'There is a strong consensus in the financial community that disclosures in the notes to the financial statements have become unwieldy; the increasing length of the notes has done little to improve the quality of information, and may even have decreased it because of information overload… [T]here is now general consensus that something must be done.'

The paper states that the 'general objective of a disclosure framework' is 'to ensure that all and only relevant information is disclosed in an appropriate manner, so that detailed information does not obscure relevant information in the notes to the financial statements.' It suggests that 'there are two main areas for consideration to improve the quality of disclosures:

> a. avoiding disclosure overload, which may be caused both by excessive requirements in the standards, and by ineffective application of materiality in the financial statements;
>
> b. enhancing how disclosures are organised and communicated in the financial statements, to make them easier to understand and compare.'

The paper proposes seven general principles that standard-setters should follow in setting disclosure requirements:

> 'a. disclosure needs to be an objective distinct from other objectives within the Conceptual Framework, specifically from recognition, measurement and presentation;
>
> b. disclosure requirements should be developed and justified with the same level of depth and scrutiny as requirements for recognition and measurement;

c. consistency in the way disclosure requirements are set is necessary, including in the level of granularity;

d. disclosure requirements should be principle-based and detailed rules should be avoided;

e. disclosure requirements must achieve the appropriate level of proportionality to the entity's users' needs and meet a reasonable cost-benefit trade-off in all circumstances. Alternative disclosure regimes may have to be put in place to achieve proportionality;

f. disclosure should not be used to compensate for inadequacies in recognition, measurement and presentation requirements; and

g. it is necessary to consider the implications of recognition and measurement attributes on the disclosure requirements, so that, ultimately, the usefulness of information is assessed as a whole.'

The paper discusses the pros and cons of a spectrum of options for dividing between standard-setters and preparers the responsibility for deciding what should be disclosed. These are:

- 'What is disclosed depends upon the preparer: Preparers have complete discretion over the disclosure practices of their reporting entities.
- General disclosure objectives: Standard-setters define general objectives but preparers decide what to disclose to meet objectives.
- Industry level prescriptions: Standard disclosure tailored to needs and characteristics of a specific industry.
- Single set of requirements: A single set of requirements is provided for all items and transactions.
- Detailed requirements: Standards provide detailed requirements for each class of items and transactions.'

The paper stresses the importance of applying materiality to exclude irrelevant information. It also sets out a number of suggestions for improving the format and organisation of the notes to the accounts.

In 2013, EFRAG, the ANC and the FRC issued *Towards a Disclosure Framework for the Notes: Feedback Statement on Discussion Paper*, summarising the responses to the discussion paper.

A4.7 FINANCIAL REPORTING COUNCIL

In 2012 the UK FRC published a discussion paper, *Thinking about Disclosures in a Broader Context: A Road Map for a Disclosure Framework*. Although the FRC was one of the co-authors of the EFRAG/ANC/FRC discussion paper, *Towards a Disclosure Framework for the Notes*, the FRC disagreed with the limitation of the joint paper's scope to the notes to the accounts. The FRC paper therefore considers disclosures in 'the financial report as a whole'.

The paper states that:

> 'Disclosure overload can make it difficult to see the "wood for the trees". In our view, the "disclosure problem" is not just about quantity: the quality of disclosures, in terms of meeting the needs of users, is also an issue. Financial reports have become a disjointed collection of disclosures driven by different authoritative sources. The objective of financial reporting seems to have been forgotten as disclosures have become more about compliance than communication.'

Its aim is 'to develop a coherent framework within which standard-setters and other regulators can set disclosure requirements and preparers and auditors can apply them. We anticipate that this will improve the quality of information provided to users.'

The paper structures its road map for a disclosure framework around four questions, for each of which the relevant aim is set out:

1. 'What information do users need? Aim: to ensure that disclosures are relevant and targeted to meet the needs of users.
2. 'Where should disclosures be located? Aim: use placement criteria to provide a structure for the financial report so that disclosures are organised in a way that is more informative to the reader and can be consistently applied.
3. 'When should a disclosure be provided? Aim: to reduce the disclosure burden through the application of the concepts of proportionality and materiality.

4. 'How should disclosures be communicated? Aim: to develop a set of principles for good communication that will assist in improving the quality of disclosures.'

The paper sets out six principles for the content of disclosures. 'Disclose information that provides:

- Context for understanding the performance, position and development of the entity.
- The specific risks to which an entity is exposed, including their context as well as management's approach to these risks.
- An explanation of the corporate governance arrangements in place including setting out the responsibilities of the board.
- A disaggregation of amounts at a level that enables the key components of primary financial statements to be understood.
- An explanation of the basis for recognition and measurement of line items in the primary financial statements.
- Information relating to items not recognised in the balance sheet that, if or when recognised, would have a significant effect on future cash flows.'

The paper accepts that financial reporting disclosures will continue to be set by multiple regulators, but argues that 'it is essential that there is a principles-based disclosure framework, within which all regulators can operate'.

In 2013, the FRC issued *Feedback Statement: Thinking about Disclosures in a Broader Context: A Roadmap for a Disclosure Framework,* summarising the responses to the discussion paper, and a 'call to action for improving disclosures' (press release dated 29 October 2013). In its call to action the FRC recommends that:

1. 'Disclosures should focus on communication of relevant information to investors.
2. Core information that is relevant for investors is separated from supplementary information that only meets the needs of a wider stakeholder group.
3. Placement of information outside the annual report may be more appropriate for supplementary information, where the law permits this.
4. Immaterial information should be excluded.
5. Boilerplate language should be avoided with a focus on entity specific disclosures.
6. Related information is linked to tell the story of a company.'

The call to action also contains recommendations that the IASB:

7. 'Develops a disclosure framework that considers disclosures in the financial report as a whole.
8. Defines the boundaries of financial reporting.
9. Develops placement criteria.
10. Reduces and defines the "magnitude" terms used in IFRSs, such as significant, key and critical.'

A4.8 INTERNATIONAL ACCOUNTING STANDARDS BOARD

Early in 2013 the IASB held a discussion forum on financial reporting disclosure. A few months later it published *Discussion Forum – Financial Reporting Disclosure: Feedback Statement* in which it reports on the discussion at the forum, sets out its plans to deal with disclosure issues and publishes the findings of an opinion survey on disclosure, which it undertook ahead of the forum.

The feedback statement indicates that the IASB will:

- consider clarifying the meaning of the materiality requirement in IAS 1, P*resentation of Financial Statements*;
- start a research project to review and replace IAS 1, IAS 7, *Statement of Cash Flows*, and IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, 'in essence creating a disclosure framework';
- consider developing educational material or guidance on materiality;
- review the disclosure requirements in all standards in the light of the revised conceptual framework, which it is proposed would have a section on disclosure; and
- draft future disclosure requirements using less prescriptive language.

A4.9 CFA INSTITUTE

In 2013 the CFA Institute, a user body, issued *Financial Reporting Disclosures: Investor Perspectives on Transparency, Trust, and Volume.* The report is in essence a user response to some of the other initiatives on disclosure discussed above, in the development of which it is not always clear that user views have been strongly represented. The report is based to a large extent on a survey of CFA Institute members in which portfolio managers provided 48% of the replies and research analysts 42%.

The report states that: 'Investors believe the 2008 financial crisis – and the ensuing five years of economic uneasiness – plainly revealed the insufficiency of disclosures, especially those of financial institutions.' It also states that for 80% of the respondents to its survey, the volume of financial reporting disclosures is not a concern, and that 76% are not aware of the inclusion of obviously immaterial items in disclosures.

The report puts forward eight 'criteria for the development of effective disclosures' to be applied by standard-setters.

1. **Disclosure that complements recognition and measurement.** Disclosure is not a substitute for recognition and measurement, and recognition and measurement do not eliminate the need for disclosure.
2. **Concurrent development of recognition, measurement, and disclosure standards.** Standards for recognition and measurement of financial statement items and their related disclosures must be developed concurrently.
3. **Disclosure of judgements and choices.** Policy choices, assumptions, judgements, and methods must be fully and clearly disclosed.
4. **Disaggregation.** Disclosures should provide sufficient disaggregated information for investors to be able to fully understand and interpret the summary information in the financial statements.
5. **Disclosure of risks.** Investors require clear and complete disclosure of a company's risk exposures, its strategies for managing risks, and the effectiveness of those strategies.
6. **Disclosure of off-balance-sheet items.** Investors must have clear and complete disclosure of all off-balance-sheet assets, liabilities, and other financial arrangements and commitments.
7. **Disclosure of intangible assets.** Investors require clear and complete information about intangible assets held by a company.
8. **Disclosure of contingencies and commitments.** Investors require clear and complete information about a company's contingencies and commitments.

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ICAEW
Chartered Accountants' Hall Moorgate Place London EC2R 6EA UK

T +44 (0)20 7920 8466
E bettermarkets@icaew.com
icaew.com/bettermarkets

linkedin.com – ICAEW
twitter.com/icaew
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