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FINANCIAL REPORTING DISCLOSURES: A PROGRAMME FOR REFORM

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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.

A new report from the ICAEW Financial Reporting Faculty, *Financial Reporting Disclosures: Market and Regulatory Failures*, looks at the sources of this unhappiness and what can be done about it. The report argues 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. In this brief summary of the report, we concentrate on the regulatory issues.

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 regulatory 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.

There are broadly four ways in which the regulatory causes 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 so as 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.

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