



7 January 2013

**Response to the EFRAG Discussion Paper:**

***Towards a Disclosure Framework for the Notes***

The objective of the EAA FRSC is to identify and analyse research that is relevant to discussions surrounding current IASB and EFRAG issues. Our comments are based on a comprehensive review of the relevant literature, which includes research from European countries and also from the United States, Asia and Australia.

In developing this response<sup>1</sup>, we have identified research relevant to the questions raised by EFRAG. We discuss the research below in relation to the specific questions, but first wish to note some pervasive concerns about key assumptions made in the Discussion Paper. The first assumption is that information overload is a problem. The Discussion Paper refers to a number of studies by regulatory or professional bodies that indicate that the volume of existing disclosures may confuse rather than inform users of financial statements. In contrast, the academic literature indicates that the market as a whole reacts positively to increased disclosure, notwithstanding that individuals may feel overloaded. The second assumption is that there is a common desire across users, preparers, auditors and regulators to resolve the perceived problem, and to do so in a consistent manner. The academic literature, on the other hand, stresses that those parties are likely to have different information, incentives and

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<sup>1</sup> This response was prepared for the EAA's FRSC by a working group consisting of the following members: Richard Barker, Oxford University, UK (chairman of working group); Elisabetta Barone, Reading University, UK; Jacqueline Birt, Monash University, Australia; Ann Gaeremynck, KU Leuven, Belgium; Anne McGeachin, Aberdeen University, UK; Jan Marton, University of Gothenburg, Sweden; Rucsandra Moldovan, ESSEC Business School, France.

perspectives, that information in the notes is supplied in conjunction with other information, both within and outside the financial statements, and that these issues of context matter. The final assumption is that a principles-based approach will always be best. Academic research suggests that while principles-based standards work well in certain situations, in other cases they can perform poorly, especially in the absence of strong enforcement.

None of this implies that there is not a need for a disclosure framework. On the contrary, it highlights how important disclosure is. A coherent framework for making decisions about disclosure requirements is hence desirable. But the academic literature provides a counter-balance to set against at least some of the criticisms of the increased disclosures required by standard-setters.

In developing a disclosure framework, we share EFRAG's wish for coherence with the IASB's Conceptual Framework for Financial Reporting, which states that the fundamental qualitative characteristics that make financial information useful are relevance and faithful representation. It is important that both of these characteristics are applied in identifying information to be disclosed in the notes. One example is the use of fair value in IFRS. For recognised fair value estimates to be a faithful representation, they must be supplemented by disclosures about the estimation process, to allow users to assess their reliability. (Ryan, 2002; Barth, 2006; Bies 2004; Landsman, 2007; Blacconiere et al., 2011). Disclosures about reliability can be very diverse: disavowals of fair value disclosures in the notes (Blacconiere et al., 2011) as well as disclosures on the underlying parameters used to value investment property to overcome problems with the estimation accuracy of the fair value measurements (Vergauwe et al., 2012). Overall, disclosure has become more and more important in an IFRS (and US GAAP) context as measurement methods such as fair value demand more and more judgement from preparers. Users should be informed about judgements made to assess the reliability of the measurement choices made, which is a key characteristic in the decision process of different users. Technological advances such as XBRL can assist users in retrieving relevant information from the notes for decision making purposes.

The text below is structured as a direct response to the questions asked by EFRAG in the Discussion Paper. For each question, both analytical and empirical research may be included.<sup>2</sup> In analytical research, models of human behaviour are developed, based on certain

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<sup>2</sup> In this text we use the term 'literature' to refer to existing research.

assumptions. In empirical research testing is done in order to discover what is actually happening in practice. Sometimes this testing involves the models developed in analytical research. In general, we note that research is mixed on what is the optimal quantity of disclosures. Often the nature of research is such that it is difficult to deduce concrete recommendations based on it, but there are nevertheless many insights and related evidence that can contribute to the standard-setting process.

**Question 1.1: Do you agree with the key principles? If not, what alternative principles would you propose?**

A general comment is that the key principles are presented as a basis for the rest of the document, yet the principles themselves are not strongly supported or motivated. Not least, there is no principle setting out the *purpose* of disclosures, other than they should be ‘relevant’ (which itself is not defined in the key principles; see Q2.2 below). The purpose, and the consequential definition of relevance, is likely to be *context-dependent*. We acknowledge that the objective of financial reporting and the notion of relevance in that context are discussed in the Conceptual Framework and that this project is not the place in which to reopen that discussion. Nonetheless, we note below aspects of these issues that should inform any discussion of principles for disclosure.

Beyer et al (2010) point out that accounting information has both an *ex-ante* (valuation) role, and an *ex-post* (stewardship) role. In the first case, the literature is concerned with the role of information in capital markets, including the effects of information asymmetry and the role of information in asset pricing models. In the second case, the literature concerns the stewardship and contractual functions of financial reporting, with a focus on incentives of preparers and users, and how such incentives affect their behaviour. This includes research on agency issues (for example between management and owners of firms) as well as literature on accounting choices made by preparers. In both cases, the value of the firm can be viewed in simple terms as being determined by management effort and “luck” (random events outside the control of management). For valuation, information is needed about both, while for stewardship separate information about management effort is needed. Thus, for the latter function, disclosures should enable users to distinguish performance afforded by management effort.

Disclosure reduces the information asymmetry between the preparers of a company's accounts and the users. This can be important. For example, markets can break down when buyers and sellers have different access to information (Akerlof, 1970). Focusing more specifically on financial information in capital markets, Diamond and Verrecchia (1991) show analytically that reduced information asymmetry is beneficial, in that it decreases the cost of capital. This conclusion is supported empirically by a number of papers, for example Botosan (1997).

Implicit in the notion that the notes reduce information asymmetry is the idea that management has private information that can be conveyed to financial statement users. This would suggest that notes are important where private information exists, because the notes enable private information to become public. This supports principle 2.c, that information should be entity-specific. If it is not entity-specific, it should already be public information, and then there is no need to disclose it.

Easley and O'Hara (2004) analytically develop an asset-pricing model, where information asymmetry exists. This is an extension of previous models (such as the Capital Asset Pricing Model, CAPM), which assume there is no information asymmetry. Easley and O'Hara divide information into public and private. They show that private information represents a systematic risk that cannot be diversified away, i.e. investors have higher risk when there is private information. When investors see a higher risk, they will demand a higher return on their investment, increasing the cost of capital for firms. This is further support for principle 2.c, based on the reasoning given above.

Easley and O'Hara also show that firms with a higher proportion of private information will have a higher cost of capital. This suggests that disclosures are especially important for firms with a high level of private information. Francis et al (2008) suggest that complexity of operations is one factor which is positively associated with the level of private information. Further, real or measurement uncertainty is a possible driver of the amount of private information. This reasoning supports principles 3 and 4, that disclosures are contingent on the existing amount of private information, which in turn is contingent on operating complexity and measurement uncertainty in the balance sheet and the income statement.

It is important to note, however, that the relationship between disclosures and measurement uncertainty can be more complex than it appears at first glance. Francis et al (2008) test the relation between earnings quality (a measurement issue) and disclosures. There are two competing hypotheses for what to expect. First, based on Grossman and Hart (1980), Milgrom (1981) and Verrecchia (1983), lower earnings quality (caused, e.g., by higher measurement uncertainty) leads to more disclosures, as there is greater information asymmetry in such situations (as we suggested in the discussion above). Second, based on Verrecchia (1990), higher earnings quality leads to more disclosure, since financial statement users see such disclosures as more credible.

Findings by Francis et al (2008) lend support to predictions by Verrecchia (1990), with regard to voluntary disclosures. This can be interpreted as firms disclosing more when they have less reason to do so (as they have higher earnings quality, which suggests a lower level of measurement uncertainty). This last point relates to the behaviour of firms in relation to perceptions by users of financial statement information. It leads into a suggestion by Easley and O'Hara (2004), that the precision of information is perceived to be higher for older than new firms. As a consequence, disclosures are more important for new firms. This applies especially for IPO's. Thus, firm age could be a dimension worth considering in disclosure requirements.

Modeling by Easley and O'Hara (2004) and findings by Francis et al (2008) have implications relating to principles 8 and 9. Relating to principle 9, the need for disclosures are higher when there is a high proportion of private information, which can be measured as operating complexity and measurement uncertainty. It can be pointed out that this type of thinking is already manifest in for example IFRS 13 *Fair Value Measurement*, which requires substantially more disclosures for Level 3 items (that have a high measurement uncertainty) than for Level 1 or 2 items (which have lower measurement uncertainty). In addition, user perceptions also play a role, where the need for disclosures are higher when there is more perceived uncertainty (such as for new firms).

A further implication of Francis et al (2008) is that they indicate a possible difficulty with principles-based standards. Firms have incentives not to disclose when there is poor earnings quality, i.e. when there is high measurement uncertainty. It is precisely in such situations disclosures are needed the most. It could potentially be difficult to enforce principles-based standards when management incentives are going in the opposite direction. This points to a

problem relating to principle 8. It also points to an interaction between disclosure and audit, because the effect of audit can be to increase the credibility of financial statement data.

This issue of voluntary disclosure raises a question on which there is a considerable literature, namely the role of economic incentives and of associated actions by different actors in the financial reporting process. To some extent, this literature is more closely related to the stewardship function of accounting, in that it is partly about how financial reporting is used to evaluate management. A different way to describe this is to say that it has a contracting focus, since it is about how financial reporting is used in contracts, for example in those between a firm's owners and its management, or between a firm and its lenders. A large research area here is the accounting choice literature (cf. Fields, 2001), an example of which is studies of how firms implement a given set of accounting standards. Another large area of research concerns agency conflicts, which is focused on how owners (principals) can make management (agents) work in their best interests (cf. Beyer et al, 2010).

The accounting choice literature contradicts the point made in principle 14, which states that 'preparers, auditors and regulators, each in their specific role, have a shared interest in fostering the improvement of disclosures, through the application of all principles above.' This is an assumption, not a principle, and it is probably incorrect. If 'improvement of disclosures' here means providing better information to users of accounts, then the assumption appears to be that users, preparers, auditors and regulators have a shared interest, an alignment of incentives. In contrast, an assumption made in the literature (which is empirically supported) is that preparers' interests are not aligned with those of auditors and regulators. On a separate note, the key principles are silent on the issue of whether the notes should contain only information that has been audited.

In this context, disclosures could function as a form of enforcement of recognition and measurement by preparers. By increasing transparency, disclosures function as a deterrence of recognition and measurement manipulation. Such a relationship is suggested in Hope and Thomas (2008), for example, and is further discussed in Beyer et al (2010). This concerns several principles in the Discussion Paper, such as 1, 3, 4 and 10, which cover the relationship between notes and recognition/measurement in the primary financial statements; a deeper discussion of this relationship would be helpful.

An important principle in the Discussion Paper is the idea that disclosure standards should be principles-based rather than rules-based (principle 8). It should be noted that the dimension of principles- and rules-based standards is a continuous scale. It is not a matter of choice between either of the two regulatory approaches. The most extreme form of principles-based regulation would be to have no regulation of disclosures, or just a general rule requiring disclosures when relevant. This leads to an issue discussed in Beyer et al. (2010), which is the conceptual case that can be made for mandating disclosures through regulation. Beyer et al identify three possibilities: (1) financial or real externalities; (2) agency costs; (3) economies of scale.

Externalities relate to the fact that the actors getting the benefit of disclosures (e.g. users) are not the same as the actors paying for disclosures (e.g. firms and their current shareholders). Therefore, disclosures could be beneficial for the economy as a whole, even though no individual actor has an incentive to provide them. The existence of agency costs suggests that enforcement of disclosure regulation is important. For such enforcement to be possible, disclosure regulation is necessary. Economies of scale make it more efficient to have one entity (a regulator) developing disclosure requirements than if it is done by each individual user. Since all these three are assumedly present, disclosure regulation is assumed to be economically efficient. This supports the idea of having a framework for disclosure regulation.

The question that follows is to what extent such regulation (accounting standards) should be principles-based. Empirical research shows that principles-based standards work well in certain situations in that they permit preparers to convey private information. On the other hand, in high incentive situations, principles-based standards tend to perform poorly, especially in the absence of strong enforcement. This is troubling, since it is in high incentive situations that financial reporting is most important.

Ewert and Wagenhofer (2005) can be seen as supporting principles-based accounting standards. They show analytically that tighter accounting standards lead to less accounting earnings management, but also to more real earnings management. This is very costly since it leads to non-optimal action. Thus, this could support the use of a more principles-based approach.

Empirical research indicates problems with principles-based accounting standards, while analytical research supports such an approach. It is important to note, however, that this research is mostly focused on measurement issues, not on disclosure. Arguably, principles-based regulation relating to disclosures is more difficult to achieve. It is harder to know whether a principle is followed properly relating to disclosures, as it is based more on qualitative judgement. Whether a certain note contains relevant information, and whether this is understandable for a user, is difficult to enforce and difficult to audit. Thus, having principles-based standards for disclosures is likely to be even more difficult than suggested by existing research.

To some extent, the enforceability issue is already apparent in how current accounting standards are applied in practice. IAS 1 Presentation of Financial Statements, for example, states that specific disclosures required under IFRS do not have to be presented if they are immaterial (paragraph 31). Regarding disclosure of accounting policies, the standard says that they are especially useful when they relate to areas where there are alternatives within IFRS (paragraph 119), or for non-regulated areas (paragraph 121). In conclusion, IAS 1 encourages relevant, entity-specific information, and does not require standardized non-relevant information, yet in practice that is often not what is provided..

Thus, an important reason for the disclosure overload seems to be how IFRS is currently implemented, rather than the requirements in the standards. For example, enforcement agencies require the inclusion of many specific disclosure items, thus taking a rules-based approach in the enforcement action. A possible reason is that it is much easier to enforce such detailed requirements than more general disclosure principles. This, in turn, makes it very difficult for preparers to follow principle 12. Unfortunately there is not much existing research on such enforcement issues, even though it is suggested as an important future area by Beyer et al (2010).

In summary, we see considerable difficulties with a principles-based approach to disclosure regulation. If it is done, it probably has to be done in a way that differs from current practice in IFRS.

We can summarize our response to question 1.1 as follows. Principle 1 is a statement that is not supported or explained, making it difficult to discuss. Principle 2.c., that disclosure should

be entity-specific, is supported in research. Further, there is support for context dependency, both as it relates to financial reporting complexity (principles 3 and 4) and in terms of benefits to users (principle 9). Principle 12, although likely to be desirable, appears to be difficult to achieve in practice. Principle 14, on shared incentives, is not supported by research. This principle has more of the character of a political goal than a disclosure principle.

We see considerable difficulties with principle 8, that disclosure regulation should be principles-based. For this to work, principle 14 (a goal) must probably be accomplished first. Whether this will work in practice is far from clear, however.

**Question 1.2: Do you agree that these (disclosure overload and disclosure organization/communication) are the two main areas of improvement?**

In contrast with the assumptions that underpin the EFRAG report, *positive* market reactions to *more* disclosure have been extensively illustrated in the literature (Welker, 1995; Healy et al., 1999; Leuz and Verrecchia, 2000; Verrecchia, 2001; Tang, 2011; Smith et al., 2011; Davis et al., 2007); for reviews of this literature, see Healy and Palepu (2001), Core (2001), Leuz and Wysocki (2008) and Beyer et al., (2010). Providing value relevant information to otherwise uninformed investors enhances firm visibility and investors' willingness to invest in the firm (Diamond and Verrecchia, 1991; Chang et al., 2008). Evidence in Tang (2011) and Smith et al. (2011) support the importance of disclosures for investors, showing that disclosures assist with various types of investment decision making. For example, information risk is assessed differently by investors depending on the disclosures they have access to.

Disclosures also facilitate the placement and trading of shares at fair prices, improves the market liquidity and lowers the cost of capital (Diamond and Verrecchia, 1991; Kim and Verrecchia, 1994; Botosan, 1997; Piotroski, 1999; Li, 2010; Botosan and Plumlee, 2002). Gelb and Zarowin (2002) document a positive relation between voluntary disclosure and stock price informativeness, indicating the importance of providing sufficient information to investors. Vergauwe, Gaeremynck and Stokes (2012) find consistent evidence that more audit effort decreases the bid-ask spread when model inputs are used to value investment property in the balance sheet. However, they find no evidence that valuation-related disclosures increase the reliability of fair value estimates. High disclosure quality is associated with increased trading from both informed and uninformed investors, with evidence suggesting it reduces information searching costs (Brown and Hillegeist, 2007). Therefore, disclosure

quality appears to 'level' the playing field between privately-informed and uninformed investors. Furthermore, evidence also exists that investors punish firms for insufficient disclosure (Welker, 1995; Leuz and Verrecchia, 2000; Lambert et al., 2007) as they want to “price protect” themselves against potential losses from trading with better informed market participants; Schleicher, Hussainey and Walker (2007) found that narrative disclosures are more informative for loss firms compared to profit firms.

Previous research has also, however, found that the advantages of increases in disclosure come at a cost. Increases of required disclosures in a post-IFRS environment raise concerns related to proprietary costs. Katselas, Birt and Kang (2011) find that lobbying firms opposing the implementation of IFRS 8 Segment Reporting cited the threat of releasing sensitive information to the market (i.e. potential proprietary costs) as a disadvantage of the proposed standard. Further, Pisano and Landriani (2012) find that the actual implementation of IFRS 8 resulted in increases in disclosure in firms with higher levels of competition, supporting proprietary cost theory.

Moreover, as disclosures in annual reports have become longer and more complex in the past two decades, individual users of annual reports are increasingly likely to experience problems in searching and locating information (Smith and Taffler, 2000; Hodge et al., 2004). These problems are exacerbated to the extent that individual users have only limited time to absorb information for any given company. Cole et al. (2009) surveyed 849 stakeholders who use financial statements, including investors, suppliers, competitors, customers and consultants. The study found on average that respondents spend less than 15 minutes perusing the financial statements and do not look at the notes.

Problems of disclosure overload for individual users include the time associated with searching and locating relevant information (Janvrin and Mascha, 2010). Paredes (2003) gives a broad overview of the effect of information overload and implications for mandatory disclosure requirements, reviewing empirical evidence from investor psychology and behavioural finance fields. He points out that information overload can arise even if only material information is disclosed – simply having too much information can be detrimental. An obvious implication is the need to exclude immaterial information, which increases the overload without adding anything useful. There is also a further risk of an adverse effect on the quality of the information itself, with research indicating that the impact of relevant

information on auditors' judgements is weakened in the presence of irrelevant information about client characteristics (for example Glover, 1997; although there is no similar research in relation to the impact of immaterial information on investors' decisions). In general, less readable 10-Ks are associated with greater dispersion, lower accuracy, and greater overall uncertainty in financial analysts' earnings forecasts (Lehavy et al., 2011), supporting the idea that lower readability negatively affects even professional financial analysts. Miller (2010) finds that longer and less readable filings are associated with lower overall trading, mainly due to less trading activity from small investors. Moreover, two elements seem to be causing this association: disclosure (non-) comparability across firms, and variations in disclosure complexity over time (Miller 2010). Furthermore, evidence also shows that despite regulation, firms still aim to obscure negative news to investors. The evidence in Li (2008) discussed above points to managers misusing discretion allowed by the legislation to mitigate the adverse consequences of bad news. Using a measure of text readability to assess the complexity of disclosures in annual reports, Li (2008) finds that firms with easier to read annual reports have more persistent positive earnings, while firms with lower earnings have harder to read annual reports.

Overall, the literature supports the need for effective organization and communication of disclosures, while providing mixed evidence with respect to the question of disclosure overload, with a key consideration being whether the focus is on the individual investor or on the market as a whole. Many studies identify particular disclosure items, and show positive effects for firms providing the identified disclosures. This indicates that more disclosure is better than less. A word of caution is necessary however, as it is difficult to obtain "negative" findings in research, such as proving that a particular disclosure item is *not* useful. For this reason, such results are not seen in research, and conclusive evidence on disclosure overload is hard to find.

On a separate note, if a disclosure overload problem does exist, it may not be caused by the current standards within IFRS. Rather, it could be driven by the actions of enforcement agencies and preparers, as noted in the answer to Question 1.1 above.

**Question 2.1: Do you think there is a need to define the purpose of the notes? If not, please provide your reasoning.**

A definition is helpful for standard-setters, because otherwise there is no basis for determining a logically coherent approach to a disclosure framework. However, in formulating such a purpose, diversity in interests among stakeholders, and diversity in views of disclosures should be considered (cf. Question 1.1 above). Beyer et al (2010) point out that empirical accounting research often is focused on one issue at a time, leading to an underestimate of dynamics and complexity of studied phenomena. The same issue could apply in the development of a purpose for the notes. Similarly, we need to consider the two fundamental qualitative characteristics that make financial information useful i.e. relevance and faithful representation. As outlined in Chapter Two, both of these qualitative characteristics need to be applied when identifying the information to be recognised in the notes.

An important question is whether there is a purpose for the notes that is distinct from the overall purpose of financial statements, because if there is not, then there is no need for the purpose of the notes to be defined independently. On this view, an independent definition would either be superfluous or it would be incorrect: if the financial statements are designed to meet users' needs, then so too are the notes. An independent definition of purpose may be needed, however, to the extent that the different nature of the notes allows them to serve the broader purpose of financial reporting in a different way. In particular, clarity of purpose is required in two respects: first, in order to define the scope of the notes, for example whether they relate exclusively to the financial statements; second, in order to define the level of materiality that is applied.

**Question 2.2: Is the proposed definition of the purpose of the notes helpful in identifying relevant information that should be included in the notes? If not, how would you suggest it be amended?**

Chapter Two of the discussion paper contains two primary paragraphs with respect to definition of purpose. Paragraph 8 contains a direct definition of the purpose, while paragraph 14 gives a delimitation of the contents of the notes. Both paragraphs are commented on below.

In its current form, the proposed definition in paragraph 8 is not particularly helpful, primarily because it is logically circular. It is stated that the purpose of the notes is to provide a relevant description of the items presented in the primary financial statements and of unrecognised

arrangements, claims against and rights of the entity that exist at the reporting date. (Chapter 2, paragraph 8; a definition of the term 'unrecognised arrangements' needs to be provided.) Relevance is defined in terms of users' needs (Chapter 2, paragraph 9a). Users' needs are met by useful information (Chapter 3, paragraph 2). Useful information concerns the nature and amounts of the entity's economic resources and claims (i.e. the balance sheet, Chapter 3, paragraph 2) and the changes in the entity's economic resources and claims that result either from the entity's financial performance or other events (i.e. the flow statements, Chapter 3, paragraph 2). In other words, useful information is information about the primary financial statements, thus the defined purpose of the notes to the financial statements is to be the notes to the financial statements.

There is a need to break this circularity. The purpose refers to the Conceptual Framework, in that it uses the term 'relevance'. This term is defined in the Conceptual Framework as financial information having predictive value, i.e. that it is useful in making decisions that are based on future economic events. As such, the user and the type of information need to be specified. Examples are given in the answer to Question 1.1 above. Asset pricing models refer to investors, and they use financial information to predict future value creation, as well as systematic risk (cf. Easley and O'Hara, 2004). If the focus is on information asymmetry and agency conflicts, financial information may be used in various contractual situations. In order for the term relevance to be useful in formulating the purpose of the notes, both the setting and the type of information disclosed should be specified. Once that is done, research can provide guidance to the meaning of relevant information.

With respect to paragraph 14, it is not clear that the proposed definition successfully 'defines the boundary of the notes' (Chapter 2, paragraph 11). Several cases, including risk, are noted in paragraph 12, and we would agree that it is difficult to make a meaningful distinction between risk disclosures that relate to items on the face of the financial statements and those that do not. The problem of classification is probably greater, however, than the identified cases in paragraph 12 suggest. For example, much of the management commentary in an annual report is relevant to a users' understanding of the financial statements. In general, there are blurred distinctions between, on the one hand, a simple disaggregation of items of the face of the financial statements and a piece of information that constitutes a 'relevant description' and, on the other hand, between a relevant description that is confined to the financial statements and one that also concerns forward-looking information.

The delimitation of the notes is contextual, in that it depends on what is included in other parts of financial statements. For example, if there is substantial qualitative information in the MD&A, the need for such disclosures in the notes decreases.

The delimitation of the notes depends on the extent to which information in the notes is qualitatively different from other financial statement information. That is, if disclosure in the notes has a different effect on users than similar information elsewhere in financial statements, that is an important factor in delimiting the content of the notes. In this respect, research on differences in market reactions between information included in the income statement or balance sheet compared to disclosures in the notes is helpful.

**Question 3.1(a, b): Is the description of the approach (to meeting users' needs) clear enough to be understandable? If not, what points are unclear? If you do not support this approach (to meeting users' needs), what alternative would you support and why?**

Chapter 3 paragraph 4 of the Discussion Paper notes that a disclosure framework should indicate “what specific users’ needs are to be fulfilled by the notes” under the assumption that “disclosures are required only to provide supplementary information to the amounts reported in the primary statements.” This phrasing implies that there are some needs that can only be met by disclosure in the notes, and that these needs are, at least to a certain extent, incremental to those implied by the Conceptual Framework. However, the Discussion Paper does not directly identify users’ needs. Rather, it puts forth categories of disclosure (e.g. components of the line item, what the item is etc), yet it describes these as “categories of users’ needs.” Arguably, the actual line item being presented is not a need in itself. Instead, it responds to a need (i.e. for a certain type of information) that users have. The Discussion Paper then goes on to provide more details on what each of these categories means, and ends up referring to valuation (“help users assess the prospects for future net cash inflows to an entity”) and stewardship.

We are left wondering whether valuation and stewardship are too broad to efficiently serve as ‘users’ needs’ in a Disclosure Framework, especially given the argument put forth for the existence of a DF – that of providing incrementally relevant information, without simply duly repeating what is already in the main financial statements. The general view in the academic

literature is nicely summarized by Young (2006) who points out that our knowledge about the information needs and decision processes of actual users of financial statements is limited and that categories of users are mostly asserted rather than specifically identified and examined. A valuable contribution here is the literature survey in Clatworthy et al. (2013), which is the output of EFRAG's own initiative, conducted in partnership with ICAS.

Another possibility to help restrict the broad concepts of valuation and stewardship is to refer to the qualities of financial accounting information that responds to users' needs. To a certain extent, the Conceptual Framework has this same approach. Pike and Chui (2012) use structural equations modeling to analyze survey data on how individual's intention to use or rely on financial statements is influenced by the five qualitative characteristics of accounting information (understandability, relevance, reliability, comparability, consistency). They find that only reliability affects a person's intention to use financial statements. Interestingly, they also find that familiarity with accounting strongly affects the intention to use financial statements for decision-making purposes. This particular result emphasizes that the stated assumption that the general user has reasonable knowledge of accounting standards carries a lot of weight. Frederickson et al. (2006) consider the alternative possibilities for disclosing stock options compensation under US GAAP in a series of experiments. They find that users view voluntary footnote disclosure as the least reliable reporting alternative, compared to mandated income statement recognition and voluntary income statement recognition. In the light of this research, the Discussion Paper could focus on improving the reliability of footnote disclosure as a way to respond to the – more broadly conceived – users' needs.

Standard setters could also think of the role that accounting standards play for users of accounting and financial reporting disclosures. Recent research points to an expectation-defining role of accounting standards. Specifically, Clor-Proell (2009) investigates users' expectations about accounting choices in an experimental setting. She shows that when there is a mismatch between actual and expected choices, users are more likely to seek additional information that would explain the mismatch. Accounting standards can conceivably influence users' expectations of what they should find in footnote disclosures. In this sense, as long as the expectation has been formed, whether or not that information actually meets users' needs becomes of second-order importance.

The results of some research on financial analysts could inform standard-setters with respect to the nature of information predominantly used by analysts. Previts et al. (1994) argue that financial analysts' information needs exceed traditional, transaction-based reports. Rogers and Grant (1997) use content analysis of analysts' reports matched with the contents of the annual report to show that financial analysts appear to rely mostly on the MD&A, rather than on the actual financial statements or the footnotes. This finding speaks to the kind of information that analysts rely upon the most. Breton and Taffler (2001) take one step further in this direction, still using content analysis of analyst reports, to show that analysts rely crucially on non-financial, soft, qualitative and imprecise information in their primary task of making stock recommendations.

To sum up, the wording relative to users' needs in the Discussion Paper is rather imprecise. Standard setters should be aware of the expectation-defining role that accounting standards serve, and perhaps consider how the proposed framework would change already existing user footnote disclosure expectations. Other suggestions based on existing research would be to connect footnote disclosures more to a reliability characteristic of disclosure – which would serve both valuation and stewardship – when describing users' needs.

**Question 3.1 (c): Do you think that a category on “information about the reporting entity as a whole” should be included? If so, why?**

There are likely to be many advantages in providing a category on "information about the reporting entity as a whole". This could be included as an expansion in the "Statement of Significant Accounting Policies" section of the notes. This section already includes statements of compliance with IFRSs, basis of preparation, critical accounting estimates and judgements etc.

**Question 3.2: Are the proposed users' needs and indicators in chapter 3 helpful to identify relevant information? If not, how would you suggest amending them, or what other basis would you suggest to identify relevant information to be included in the notes?**

This table in paragraph 31 is currently confusing and not helpful to identify relevant information. The other problem with such a table is that it creates interpretation issues for preparers from non-English speaking countries. It would be more helpful to provide an example from an annual report (or fictitious company report) of relevant information compared to irrelevant information for users.

**Question 3.3: Do you agree with the way how risk and stewardship are addressed in the Discussion Paper? If not, what are your views about how risk and stewardship information that should be provided in the notes?**

Our response to this question is addressed in part by our response to question 1.1 above, where we discuss the nature of useful disclosure. We would add that Danckaert et al. (2012) investigate the usefulness of stock market risk disclosure regulation, for a sample of cross-listed firms on the NYSE. They examine the usefulness of (1) the total incremental risk disclosures made in Form 20-F in addition to those made in the annual report and (2) the required business and industry risk disclosures imposed by specific stock market regulation. Investigating the annual report as well as the Form 20-F of 318 firm-year observations over the period 2007–2008, they find that the incremental risk disclosures made in Form 20-F, and especially credit risk disclosures and business and industry risk disclosures, result in a decrease of the bid-ask spread. Moreover, their results also show that U.S. investors react stronger to bad-news and precise risk disclosures. Overall, these findings show that Form 20-F is a useful source for providing additional risk information and that additional stock market regulation is beneficial for stock market participants. Although there is already substantial risk information in the annual statements, the investors value the additional risk information demanded by the US market.

**Question 3.4: Do you think that standard setters should change their practice of mandating detailed disclosure requirements in each standard? If so, which of the alternative approaches discussed do you think will be the most effective in improving the quality of information in the notes?**

We agree that the disclosure requirements in different standards have been developed on an ad-hoc basis, implying the lack of a unified and consistent approach. The requirements could also have been influenced by current, transient economic, business, and social conditions. This suggests that the most efficient method of setting disclosure requirements would be to have a single, consistent disclosure set for all line items in the primary statements. Against this must be set the consideration that, for much the same reason that there exist individual, focused accounting standards in addition to the Conceptual Framework, so too there is a need for disclosure requirements specific to the distinctive context of the associated accounting standard.

**Question 3.5: Do you think that establishing alternative disclosure requirements is appropriate?**

Requirements for alternative disclosure regimes raise a number of questions that have been more or less debated in the academic literature. We have reviewed aspects of this literature in our response to Question 1.1. We focus here on a specific application suggested in Question 3.5, namely whether disclosure requirements should vary with entity size. The issues to address here are: why the standard setter should require alternative disclosure requirements; how and for whom those alternative disclosure requirements should be applied; and what consequences might be expected from this approach.

On the first of these issues, most proponents of alternative disclosure regimes argue that IFRS is too complicated for small firms, and compliance and preparation costs greatly exceed the benefits of reporting under a high-quality set of accounting standards. Therefore, the argument is made that small firms should be able to follow reduced disclosure requirements. There are two issues underlying this argument. First, do alternative disclosure regimes really lead to more efficient application of regulation? Second, will such requirements turn the tables on IFRS and transform it into a rules-based set of standards as industry-specific guidance has transformed US GAAP (Schipper 2003)?

Related to the first point, Bradford (2004) recognizes that due to regulatory economies of scale, the costs of regulation will invariably exceed the benefits for some size of businesses, but the fact that small business exemptions may be efficient does not mean they always are. This is because exemptions have their own costs, such as differential rule-making,

enforcement, and information costs. Bradford (2004) shows analytically that once these transaction costs are taken into account, the efficiency of small business exemptions depends on the particular regulation. Therefore, the increased efficiency of regulation compliance costs argument is less straightforward than it seems. On the second point, looking at the IFRS experiment with ‘little IFRS’ for small and medium-sized companies (SMEs) (e.g. Pounder 2009) the answer is ‘probably no’, but depends on the parties interested in reduced disclosures and their lobbying power.

On the issue of how, and for whom, alternative disclosure requirements should be applied, one approach is to set out a list of minimum disclosures required – as done in IFRS for SMEs (Grant Thornton 2010), while another approach is to provide a list of disclosures that could be eliminated. These approaches are quite different and yield different interpretations as to why a firm does not disclose something. For example, users can interpret non-disclosure as either non-compliance, or irrelevancy of the requirement based on the operations of the company. Considering these two possible views, the two approaches could trigger different interpretations. Joshi and Ramadhan (2002) survey 36 professional accountants working in small and closely held Bahrain companies on the adoption of IASs. The responses show that external auditors exerted the greatest influence on getting firms to adopt IAS, and that companies simply disregard requirements which are not applicable in terms of recognition, measurement and disclosure.

Who gets to apply reduced disclosure requirements is a more thorny issue. Gao et al. (2009) provide evidence on the unintended consequences of using ‘bright-line’ thresholds in regulation. They examine the consequences arising from small firms being granted exemptions from Sarbanes-Oxley Act of 2002 Section 404 requirements. In the SEC parlance, ‘non-accelerated’ filers are companies with public float less than \$75 million that were able to postpone compliance with Section 404 until 2008. Small businesses opposed this regulation because compliance costs disproportionately affected them relative to large firms (Eldridge and Kealey 2005). Using a carefully constructed control sample to account for company evolution, Gao et al. (2009) show that when small companies are exempted from costly regulations they have an incentive to stay small. This finding is robust to alternative explanations such as remaining small so as to maintain insiders’ private control benefits. In order to stay small, the exempted firms undertake less investment, make more cash payouts to shareholders, reduce the number of shares held by non-affiliates, make more bad news

disclosures, and report lower earnings compared to the control sample firms. This paper is a good example of how “bright-line” rules can distort behaviour (Hayes 2009).

The third, and final, issue concerns the consequences that might be expected from allowing alternative disclosure regimes. The main take-away from the scarce literature here is that disclosure exemptions/restrictions can create a vicious circle. Small firms with already reduced information environment report under reduced disclosure rules that may further restrict users’ access to information and, potentially, even damage firms’ disclosure reputation. While it could be argued that small *unlisted* firms that are closely held or managed by their owners do not in fact need a rich information environment, the case of small *listed* firms is different. Another issue is comparability to other entities. The general feeling is that IFRS is designed for *large listed* companies. What about *small listed* companies? Would we expect small listed companies to have less disclosure and would we allow them to have access to alternative disclosure requirements? This goes back to which entities will be allowed to apply alternative disclosure requirements.

There is some literature on how analysts regard small listed companies and their disclosure practices, but no relevant research on (non-)comparability caused by alternative disclosure requirements. For example, O’Shea et al. (2008) investigate the effect of information disclosure on daily stock price volatility of Australian metals and mining companies. They measure information disclosure by the number of announcements on the stock market. They find that the volatility impact of similar disclosures is greater for small and mid-sized firms than for large firms. Their explanation is that poor disclosure practices (i.e. repetitive, used as self-promotion tool) of small and mid-sized firms result in excessively volatile stock prices. The implication is that consequences related to disclosure may be larger for a small firm due to the lack of other information sources (i.e. fewer analysts following to produce/process and intermediate information between the firm and investors).

Fortin and Roth (2010) explore the relationship, for a sample of small US firms, between the number of analysts following a firm and various firm-level characteristics. This issue is interesting because small firms receive limited attention from the financial and business press, thereby making the role of analysts in mitigating information asymmetry all the more important. Fortin and Roth find that small firms with better corporate governance (superior shareholder rights) are followed by more analysts. This supports the view that analysts prefer

to cover firms with reduced agency conflicts and better information disclosure. The link between corporate governance and disclosures is supported by Griffin (2003). He finds that analysts decrease coverage of firms following corrective disclosures. The main implication is that analysts avoid firms with poor governance because they are more likely to produce incomplete or misleading disclosures.

One interesting capital-market setting requiring reduced disclosures, but which has not really been explored in the literature, is the Alternative Investment Market (AIM) part of London Stock Exchange. AIM is designed for small companies that want to list on a fairly liquid market with less stringent admission and on-going disclosure requirements. Mallin and Ow-Yong (1998) look at a sample of companies listed on this market. They find that companies that do not raise new capital upon admission to the AIM possess relatively weaker corporate governance structures, reinforcing the role of context and incentives in determining the optimal disclosure regime (Healy and Palepu 2001).

**Question 4.1 & 4.2: Do you think that a Disclosure Framework should reinforce the application of materiality, for instance with a statement that states that immaterial information could reduce the understandability and relevance of disclosures? Do you think that a Disclosure Framework should include guidance for applying materiality?**

We support the need for guidance on materiality, and suggest that the Disclosure Framework should provide an example to help guide the preparer in applying materiality to the notes. We note that research on materiality for disclosures is scarce, but that existing evidence suggests that the application and interpretation of materiality in the case of disclosures differs across firms. For example, in the context of postretirement benefits, Liu and Mittelstaedt (2002) find that the process of evaluating materiality for disclosures is inconsistent across firms. Szabo (2012) states that materiality plays a significant role in distinguishing between CSR information that is mandatory to disclose and that which is voluntary. Douppnik and Seese (2001) uncover differences in the way firms judge the materiality of individual countries to be disclosed in the segment information footnote, with firms moving away from the threshold provided by the relevant standard (i.e. SFAS 131). In some cases, managers prefer more stable measures of size (e.g. total assets) rather than current income to judge materiality (Gleason and Mills 2002).

**Question 4.3: Is the description of the approach clear enough to be useful to improving the application of materiality? If not, what points are unclear or what alternatives would you suggest?**

Liu and Mittelstaedt (2002), Szabo (2012) and Doupnik and Seese (2001) discuss concerns that material information may be excluded from the financial statements. There is little discussion in the literature of a key argument in the EFRAG paper, that immaterial information is being included in financial statements, to the detriment of users who then need to identify what is material. Exceptions can be found in the law literature. Hewitt (1976) notes that materiality is a necessary limit on full disclosure because full disclosure of every fact would result in too much information for any person to digest in a meaningful manner. He goes on to state that the manner of presentation of information may affect materiality so that even where all facts are fully disclosed, a material omission may occur. This can happen under the ‘buried facts doctrine’ if the most important facts are not sufficiently highlighted but are hidden in the document.

**Question 5.1: Would the proposed communication principles improve the effectiveness of disclosures in the notes? What other possibilities should be considered?**

We have largely addressed this issue in response to earlier questions, although a further, important point here concerns the discussion of technology in Chapter 5. Financial information in PDF or HTML form provides users with a wide availability of information, in a convenient manner (Lymer, 1999). However, as discussed in our response to question 1.2, the size of financial reports has increased over the years and there is the possibility of information overload. As a result, traditional format financial report users are likely to experience problems in searching and locating information presented in the notes (Hodge et al., 2004).

In Chapter 5, there is mention of XBRL and how it can assist in the way information is organised and accessed. We believe that XBRL has the potential to improve the effectiveness of note disclosures. This could also have consequences for future earnings as Li (2008) finds a positive relationship between easier to read financial reports and future earnings. XBRL is currently mandated in the US, with other countries likely to follow within the next 5 years. XBRL is derived from Extensible Markup Language (XML), which is a format that provides

major benefits in storing, exchanging and communicating financial information (Pinsker, 2004). The unique tags that characterise XBRL data enable efficient retrieval (Baldwin, Brown and Trinkle, 2006). Using an experimental approach, a study by Muthusamy, Bir and Birt (2012) compares the usefulness of the XBRL format financial report in comparison to PDF and finds that financial information presented in XBRL format is significantly more relevant, understandable and comparable to users. There is scope here to reconcile the conflict in the current environment, identified earlier, between information overload from the perspective of the individual with the demand for more information from the market as a whole.

**Question 5.2: Do any of the suggested methods of organising the notes improve the effectiveness of disclosures? Are there different ways to organise the disclosures that you would support?**

Different stakeholders appear to assign different importance to information presented on the face of financial statements compared with information disclosed in the notes. For instance, auditors are willing to tolerate more error in disclosed numbers than in recognized numbers (Libby et al., 2006), and loan officers put more emphasis on recognition of stock options in the income statement rather than on disclosure of stock options in the footnotes (Viger et al., 2008). In line with Maines and McDaniel (2000), who use an experimental design to show that nonprofessional investors are influenced by the format of disclosures, Bamber et al. (2010) find that managers indeed act as if they believe that the location of information matters. For example, the location of (other) comprehensive income is informative with respect to their overall earnings management and disclosure quality behavior (Lee et al., 2006).

Some papers investigate the consequences associated with the location of specific disclosures. The persistence of special items is higher for special items disclosed in the footnotes relative to special items presented in the income statement (Riedl and Srinivasan, 2010). The placement of an accounting restatement announcement in a press release is significantly associated with stock returns, such that firms with more visible announcements are penalized more by the stock market (Files et al., 2009). Therefore, information placement appears to be a pervasively important aspect in corporate disclosures. This line of findings stands in sharp

contrast with the ('rational') efficient market view, supported by, for example, Al Jifri and Citron (2009), who provide evidence that markets efficiently incorporate goodwill information regardless of its location for presentation.

On the question of what should be included in financial statements rather than elsewhere in a financial reporting package, there was research triggered by rising stock prices in the 1990s, on whether earnings and balance sheet information had become less value relevant, and what might be done to improve its value relevance (for example Lev and Zarowin, 1999, and Francis and Schipper, 1999). But these papers do not discuss whether there is some information that might be relevant for users making investment decisions but which does not belong in a set of financial statements. Some of the literature on conservatism implies that users do not find information about unverifiable gains helpful, and prefer 'hard' information they can trust and hence use to assess information from other sources (LaFond and Watts 2008). But that literature focuses on recognition, rather than specifically on disclosure.

Apart from note disclosures, a valuable source of information in financial reporting is the Management Discussion and Analysis (MD&A), which contains management's view on the company's operations and future prospects (Clarkson et al., 1999; Cole and Jones, 2004). In a recent study, Brown and Tucker (2011) find the primary users of the MD&A-schedules to be investors rather than analysts and also document stagnation in MD&A content. This suggests firms tend to 'copy-paste' the schedule with only minor changes between years, which results in restricted usefulness. However, the tone changes between subsequent MD&A filings do have an impact. Management's tone change adds to portfolio drift after taking into account accruals and earnings surprises (Feldman et al., 2010). The incremental value of the information conveyed by the tone change is stated to depend on the strength of the firm's information and disclosure environment. Li (2010) confirms the importance of tone in the MD&A, as well as the limited use analysts make of these schedules. MD&As are also evidenced to have an impact on a firm's cost of capital, stock return volatility and analyst forecast dispersion (Kothari et al., 2009).

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