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ACCOUNTING
ASSOCIATION

12 January 2022

Mr Andreas Barckow, Chair

International Accounting Standards Board

Columbus Building

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Canary Wharf

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United Kingdom

Dear Mr Barckow,

RE: Submission in response to the Exposure Draft ED/2021/3 – Disclosure Requirements in IFRS Standards – A Pilot Approach: Proposed Amendments to IFRS 13 and IAS 19

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The purpose of the EAA FRSC and the EAA members is to bring contributions of academic research to the standard-setting process related to Financial Reporting. In this comment letter, the authors aim to provide research-based input to the debate on the Exposure Draft ED/2021/3 – Disclosure Requirements in IFRS Standards – A Pilot Approach: Proposed Amendments to IFRS 13 and IAS 19. We do so by first discussing academic studies relevant for this Exposure Draft on the regulation of disclosures and companies' compliance with disclosures. Thereafter the authors zoom in on the academic literature in relation to disclosures in the context of IAS 19 Employee Benefits and IFRS 13 Fair Value Measurement. This comment letter compliments the input provided by EAA members and members of this author team during the 8th EAA's Financial Reporting Workshop organized together with the IASB on 1sth of July 2021.

With this letter the authors, on behalf of the EAA's FRSC, provide points of attention to consider in this pilot project related to disclosure requirements and inform the IASB and the project team working on this pilot project on additional references to relevant research, which the project team of the IASB could consider when delving deeper in the advantages and disadvantages of the suggested approach with respect to disclosure requirements included in ED/ 2021/3.

On the following pages we present our overview of the relevant academic literature. We would be pleased to answer any question you may have.

Yours sincerely

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Introduction

The IASB developed the Exposure Draft ED/2021/3 *Disclosure Requirements in IFRS Standards—A Pilot Approach: Proposed amendments to IFRS 13 and IAS 19* as part of its Disclosure Initiative—Targeted Standards-level Review of Disclosures project and wider work on 'Better Communication in Financial Reporting' as summarized below (IFRS June 2018).

The Disclosure Initiative project primarily focuses on improving the content and communication effectiveness of the notes to the financial statements. Completed projects include: Amendments to IAS 1 (Dec. 2014); Amendments to IAS 7 (Jan. 2016); Materiality Practice Statement (Sept. 2017) and definition of Material (Oct. 2018). The current ED is the result of a decision made by the Board, following the review of the March 2017 Discussion Paper: Disclosure Initiative—Principles of Disclosure, to prioritise the Targeted Standards-level Review of Disclosures project.

The purpose of financial reporting

The main theoretical framework that has guided the relation between managers of publicly held firms and their capital providers, particularly shareholders is conventionally the agency theory

(Jensen and Meckling, 1976). The purpose of financial reporting within this context is to reduce the information asymmetry between the firm and its financial capital providers particularly shareholders, ensuring that the firm is making investment and financing decisions in their interest. This information in turn is expected to be reflected in the market value of the firm – to date the key capital market barometer of business success.

However, the agency theory arguably, is no longer the sole theory that guides managerial decision-making and reporting behaviour. Post the financial crisis of 2007, and the risks posed by climate change, managers are increasingly taking into consideration the expectations of other stakeholders (as per instrumental stakeholder theory, Donaldson and Preston, 1995; Jensen, 2002). Firms are making financial resource-allocation decisions which are aligned with these stakeholder interests. Environmental expenditures or expenditures on employee benefits such as defined benefit pension schemes are a few such examples. As managers strive to balance financial capital provider interests with other stakeholder interests, what many corporations call earning 'profits with purpose', financial reporting - as well as the regulation of this reporting - needs to reflect these changing business realities.

The proposed guidelines (a) require entities to comply with overall disclosure objectives that describe the overall information needs of users of financial statements and (b) require entities to comply with specific disclosure objectives that describe the detailed information needs of users of financial statements. However, the guidelines never clearly define the 'users'. Are entities to limit themselves to only the so-called primary users as per its Conceptual Framework (2018), i.e., an entity's existing and potential investors, lenders, and other creditors? Should entities consider the financial information needs of a firm's primary stakeholder groups

(as defined by Clarkson, 1995, p.106: '*A primary stakeholder group is one without whose continuing participation the corporation cannot survive as a going concern'*)? These typically include shareholders, creditors, customers, employees, suppliers, governments, and local communities. There is a high level of interdependence between a business entity and these groups of stakeholders, an interdependency that has become even more pronounced in today's business climate. A broader view could assist entities in developing a more balanced approach to their financial reporting – enabling entities to articulate why and how resources are allocated across primary stakeholders. The rise in non-financial particularly environmental and social reporting is precisely the result of the need to articulate the firm behaviour. However non-financial reporting does not occur in a silo – there are inter-dependencies between financial and non-financial information just as financial decisions have non-financial impacts. Thus, by formally identifying and articulating the financial information needs of non-financial capital providers in financial reporting guidelines could help build clear links with non-financial reporting. This in turn can help reduce 'noise' that is the provision of irrelevant information and too much of it, what the IASB calls the 'disclosure problem'.

In the next section, we review current evidence on the role and effectiveness of IASB in regulating business reporting. This is followed by specific sections on IAS 19 and IAS 13 where we present our views/comments on the financial information needs of relevant primary users, the effectiveness of the current disclosure requirements in meeting these needs and suggestions for improvement.

Why regulate/mandate disclosures?

Following the IASB Board's 2013 discussion forum on financial reporting disclosure, it concluded that stakeholders have three main concerns about information disclosed in the

financial statements: 1) not enough relevant information; 2) too much irrelevant information and 3) ineffective communication of the information provided, collectively referred to as the ‘disclosure problem’.

For the IASB to take on the task of improving disclosure quality assumes on their part and on the part of a number of stakeholders that there is not a market solution to ensure the production of a socially desirable level of disclosure and that competition and private contracting cannot address the problem. Much of financial information is indeed costly proprietary information (Verrecchia, 1983). In the absence of regulation, not enough relevant information is likely to be disclosed. Also, Dye (1986) argues and theoretically shows that increasing mandatory disclosure requirements also increase a firm’s incentives for voluntary disclosures that support mandatory disclosures.

Leuz and Wysocki (2008, 2016), Enriques and Gilotta (2015) and Healy and Palepu (2001), among others, discuss a number of arguments to justify regulating firm’s disclosure activities which include: investor protection, agency cost reduction, existence of externalities, cost savings from standardization, increasing market efficiency, and better enforcement of sanction. The regulation of disclosure should also potentially lead to comparability of disclosures (across firms, especially when they operate in the same industry) and consistency of these disclosures across time (within the same firm), two desirable characteristics of information. This issue is discussed in detail in Abad et al. (2020).

Graham et al. (2005), based on a survey of some 400 financial executives, show that there are many drivers to voluntary disclosure by firms:

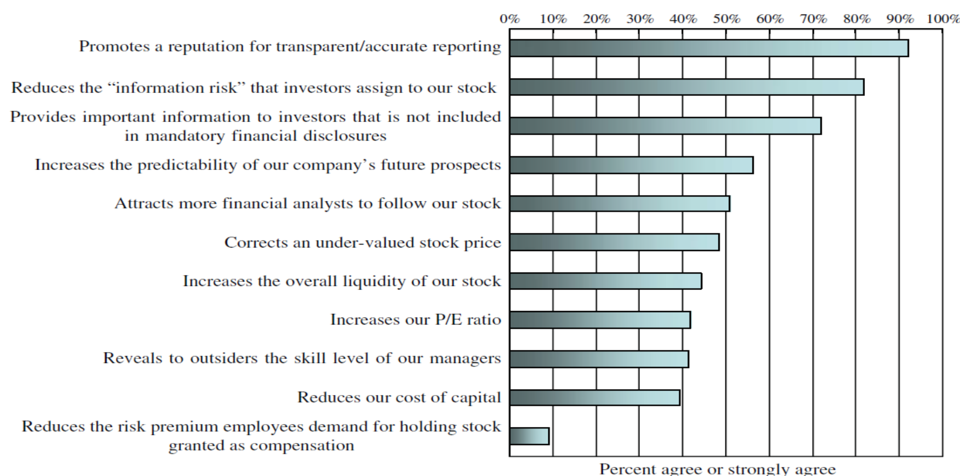

Fig. 10. Responses to the question: "Do these statements describe your company's motives for voluntarily communicating financial information?" based on a survey of 401 financial executives.

But they also document many constraints:

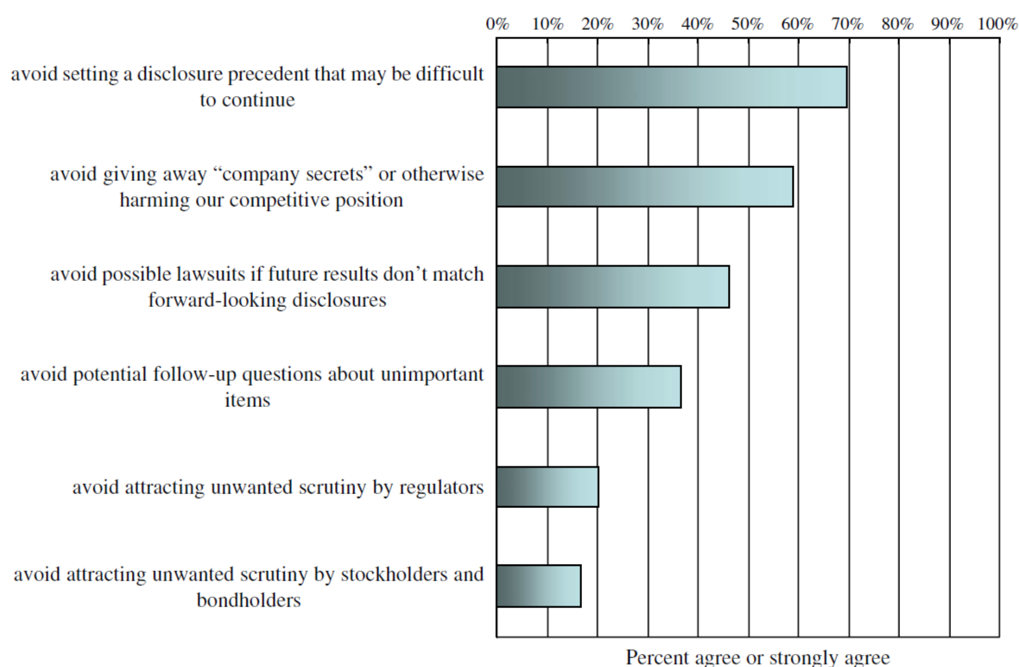

Fig. 11. Responses to the question: "Limiting voluntary communication of financial information helps…" based on a survey of 401 financial executives.

Nevertheless, regulators may easily over-regulate because it is relatively cheap to do so and because it obtains multiple stakeholder support while preparers may not have sufficient means to resist it. Further, regulation may not achieve the desired effects because (a) of user

and regulator limitations (biases, bounded rationality, information overload, …), (b) the fixed costs may disproportionately affect smaller firms, (c) of unexpected/unintended consequences, (d) of increased liability risk or proprietary costs or (e) of limitations to enforcement. The IASB thus has the challenge of justifying its intervention in the process.

Do firms comply with current requirements?

While the IASB does not wish to view firm's disclosure practices as a simple compliance exercise since they do not view it as a 'box ticking' exercise, we nevertheless have significant academic research that attempts to measure firms' compliance with current requirements. We discuss below two surveys of compliance studies.

Tsalavoutas, Tsoligkas and Evans (2020) survey 70 post-2005 IFRS compliance studies. Drawing inferences from such a collection of studies is challenging since they examine quite different settings, many focusing on a single country or small market or in contrast examining mostly large EU firms. Further, few of the papers properly consider materiality issues so they likely overstate the lack of compliance. Finally, most use a single scoring method, e.g., Cooke's method, but all scoring techniques have limitations, and we could argue that they mostly capture quantity but not quality of the disclosures.

Tsalavoutas et al. (2020) conclude that there are many standards that appear to have poor compliance, whether they are more principle or rule based. They list the following: IAS17, IAS21, IAS28, IAS31, IAS39, IAS41, IFRS6, IFRS8, IFRS7, IAS36, IAS12 and IAS19. They further note significant cross-country differences that are linked to enforcement, audit quality and firm size. Unfortunately, few of the 70 studies examine any market consequences and given the weak identification strategies, causal links are questionable.

Hellman, Carenys and Moya Gutierrez (2018) examine 81 papers published between 1998-2017. They also note that most studies suffer from methodological problems related to the indices used that mostly measure disclosure quantity. They further note that these studies rarely have any theory or expected benchmarks to measure their result against. They find that there is some indication of lower compliance in weaker legal and institutional settings. They also note that larger, listed and better governed firms are more compliant.

To the question 'is there too much irrelevant information', Hellman et al. (2018) suggest that some studies document positive effects of more information rather than less and that sophisticated users are likely able to decode. We must also recognize that the current trend to use machine-based methods to analyse the quality of corporate disclosures have no issue with quantity of information. As for 'is there enough information', the authors argue that disclosure needs to be more decision context specific. The board's decision to target specific standards, when it comes to disclosure requirements, will lead to the provision of more topic-specific information, which should support decisions that vary across contexts.

However, as noted by Cascino et al. (2014), the IASB faces some difficulties. One, there is a significant variety of key capital providers to large European public companies (professional equity investors; outside private/retail investors; inside equity investors; public and private debt providers and trade creditors) with a wide variety of informational needs. Further, objectives frequently compete (valuation vs. stewardship) and financial reports are only one of many information sources. They nevertheless argue that the competitive advantages of regulating financial reporting is to ensure verifiability, objectivity, regularity, and standardization.

Proposed amendments to Pension disclosures IAS 19

The Board proposes to replace the disclosure requirements in IAS 19 with a new set of disclosure requirements that would be based on the proposed Guidance. In this respect, the Board specified some overall and specific disclosure objectives and items of information to enable an entity to meet the specific disclosure objectives (IFRS Standards Exposure Draft, March 2021). Overall, the intention of the proposals seems to be to provide flexibility to companies and to allow them to take idiosyncratic factors into account when deciding what pension-related information to provide.

Prior academic literature on pensions provides useful insights in relation to pension-related disclosures. One group of studies has examined the value relevance of alternative pension cost components of defined benefit (DB) plans (e.g., Barth, Beaver & Landsman, 1992). The findings suggest that markets value alternative pension cost components differently. These findings are relevant in the context of this Exposure Draft as they indicate that disaggregated disclosures of pension cost components are useful and informative.

Other related studies have examined the ability of investors and analysts to process and incorporate pension information in prices and also earnings forecasts. Overall, the results reveal that prices and forecasts do not fully incorporate the anticipated future earnings effects emanating from changes in pension information. Rather, investors and analysts only gradually incorporate this information into prices and forecasts (Picconi, 2006). Further, Franzoni and Marin (2006) find that firms with severely underfunded plans are significantly overvalued. The findings suggest that investors do not incorporate the anticipated effect of pension liabilities on future earnings and cash flows, and they are surprised when the negative implications of pension underfunding become apparent. Prior literature has also examined the choice provided to

companies to present various components of pension cost in operating or financial income. In particular, Glaum, Keller and Street (2018) examine the choice firms sponsoring DB plans had in relation to presenting pension interest cost and expected return on assets / net interest cost in 2013 in operating or financial income. The findings show that the choice is driven by the anticipated impact on earnings before interest and tax figure.

Taken together, the findings of the studies discussed above suggest that even sophisticated financial statement users have difficulty processing and incorporating pension-related information into prices and forecasts, which may be explained by the complex nature of pension accounting involving making various actuarial and financial assumptions. The implications of these studies seems to be that providing information in a clear, balanced and transparent way is important even for sophisticated users of pension-related information. This is consistent with the overall disclosure objective to provide information that will enable market participants to evaluate the overall effect of DB plans on firm's financial performance and cash flows. It is also consistent with specific disclosure objectives in relation to the impact of DB plans on reported numbers in the financial statements and firm performance.[1]

In this respect, the Board's proposal to provide an executive summary and articulate how pension disclosures link with relevant items in the main body of the financial statements as well as cross referencing with relevant non-financial reporting is likely to be helpful. Allowing companies to exercise judgement and provide material and relevant information in relation

[1] Moreover, it could also be that providing information on pension related liabilities without linking it to pension related benefits such as articulating the need for generous pensions to motivate and retain high calibre employees, tends to present a one-sided picture. Firms may actually be less inclined to underfund their pension schemes if they can clearly specify how generous employee pension plans benefit the firm and serve its long-term interests. In fact, empirical evidence shows that high quality social disclosures including those related to employees increase a firm's market value. Further, this effect is driven by higher expected cash flows – suggesting such disclosures lead to reduction in transaction costs with firm's primary stakeholders (Qiu, Shaukat and Tharyan, 2016).

to their pension plan as per Board's suggestions also seems to be useful. However, the findings of the studies discussed above suggest that providing additional guidance to companies is perhaps necessary in order to ensure that comparability will be achieved. This is particularly important when firms have flexibility as to how and where to present pension-related information.

An overall comparability of the use of these disclosures may be threatened by the fact that adjusting for pension expenses is a regular practice when managers calculate their non-GAAP measures – also known as alternative performance measures (Black, Christensen, Ciesielski, and Whipple, 2021). Pensions expense are recurring items, as they are present in firms' financial statements across the years, and the literature tends to classify these adjustments as potentially misleading. However, Black et al. (2021) find evidence consistent with firms' non-GAAP adjustments enhancing the comparability of earnings metrics across sector peers. Thus, better disclosures on pensions should lead to a better understanding of the adjustments made and, consequently, of the earnings measures voluntarily disclosed by firms, at an industry level (but probably not across industries). The proposed changes included in the current primary financial statements project of IASB, which include the introduction of a single note to the financial statements for managers to explain the performance measures they create and disclose voluntarily, will further enhance transparency, when they are applied.

We also note that there is some evidence to suggest that firms only respond to detailed, specific disclosure requirements. In reviewing changes to executive remuneration disclosures over a period of significant reform in Australia, Clarkson, Van Bueren and Walker (2006) find that disclosures were only elevated to a desired level once detailed and prescriptive requirements were introduced in 2004. This is despite clear intentions and principles being introduced by earlier reforms in 1998. This is particularly the case when the disclosure relates to sensitive

items (Nelson and Percy, 2008). As pension fund deficits represent a potentially significant source of off-balance sheet risk, some firms may be reluctant to provide information that is not specifically required.

Other studies shed light on issues highlighted by the Board in relation to pension risk. Kalogirou, Kiosse and Pope (2021) examine the hidden pension deficits of French companies sponsoring DB pension plans using disclosures of early adopters of IAS 19. The findings suggest that financially risky companies that reported high pension deficits under IAS 19 subsequently reduced leverage and incurred higher costs of debt. The introduction of a more transparent regime allowed the credit market to correct estimation errors by considering information about actual pension deficits. The findings of this study imply that providing information about the actual pension deficits and hence the risk of DB pension plans in a clear and transparent manner is likely to be useful for creditors, consistent with the proposals put forward by the Board in relation to providing information about the riskiness of DB plans. However, these disclosures could also provide an explanation for the reasons of adopting DB plans in the first place and its potential benefits to the entity as well as its stakeholders (e.g., employee retention, attracting talent, good for business). Even though the above may be obvious, presenting this information would be in line with the principle of presenting a balanced view of costs and benefits of DB pension plans or indeed any other type of pension plan.

Balachandran, Duong and Vu (2019) document a positive relation between pension deficits and the cost of bank loans. Banks increase the number of loan covenants and shorten loan maturity for firms sponsoring DB plans with larger deficits. The findings are interpreted as being consistent with the notion that pension deficits are an additional source of risk. These

findings support the Board's proposals to make information about the risk undertaken by pension plans clear by providing information about pension riskiness in a prominent and transparent manner as this information is likely to be useful to market participants. This supports the overall and specific disclosure objective in relation to risks and uncertainties associated with the entity's DB plans.

Overall, the findings from some prior studies on pensions suggest that providing pension disclosures in a clear and understandable manner is very important, especially given that pensions is a very complex area requiring companies to make numerous actuarial and financial assumptions and also due to the highly regulated nature of pensions. There are at least two key issues to consider: first, it is important to consider the information needs of various stakeholders when providing guidance to companies as to what information to disclose. Second, in relation to the issue about judgement it seems that providing flexibility and allowing companies to exercise judgement when deciding what pension-related information to disclose is likely to be generally appropriate. However, it is important to provide detailed guidance to companies as to how to exercise judgement in order to ensure that companies indeed provide the information needed by various stakeholders to take effective decisions and that comparability is also achieved.

Proposed amendments to IFRS 13

IFRS 13 Fair Value Measurement was issued in 2011 following the aftermath of the financial crises. In short, the standard a) defines the notion of fair value; b) sets out a single framework for measuring fair value; and c) requires disclosures about fair value measurements.

In March 2018, the IASB completed its review of the findings from the Post-Implementation Review of IFRS 13 Fair Value Measurement and concluded that the standard is working as intended.[2]

The academic evidence gathered by the Board in the Post-Implementation Review of IFRS 13[3] identified 55 studies that relate to areas of focus and reflect a broad and comprehensive view, not restricted to particular methodologies and approaches. Three key takeaways arise from the review of these papers. First, the disclosure of the fair value hierarchy is beneficial to capital markets participants such as investors and financial analysts, allowing them to be more precise in their valuation of a firm and in the forecasting of its future earnings. Second, regarding the specific fair value relevance, the relative ordering of the value relevance of various levels seems to vary according to several factors, including the nature of the underlying assets, the market conditions, the institutional environment and managerial intent. Finally, there is evidence suggesting that managers take advantage of their measurement discretion either to inform financial statements users (and thus increase the quality of reporting) or to deceive them (e.g. to achieve some earnings targets) depending upon their incentives and the quality of the corporate governance.

A recent meta-analysis of these papers (Filip et al., 2021a) summarizes empirical findings. Overall, value relevance seems to be lower for level 3 than for levels 1 and 2, but it increases over time. The analysis also notes lower value relevance across all levels of fair value assets under IFRS when compared to U.S. GAAP. These time trends under IFRS and US

[2] The full report is available https://www.ifrs.org/content/dam/ifrs/project/pir-ifrs-13/published-documents/pir-ifrs-13-feedback-statement-dec-2018.pdf

[3] The academic review is available https://www.ifrs.org/content/dam/ifrs/meetings/2018/january/iasb/ap7b-ifrs-13-summary.pdf

GAAP have also been empirically investigated by Filip et al. (2021b). For both sets of standards, results provide evidence that is consistent with an increase and a convergence in value relevance across all three fair value levels over time. However, fair value levels exhibit systematically higher value relevance under U.S. GAAP compared to IFRS. The gap has closed to some extent since the enactment of IFRS 13. This evolution is likely due to learning about fair value accounting and changes in financial reporting regulations that increased disclosure requirements.

This evolving nature of disclosure and the market's ability to interpret this information also has relevance for the Board's proposed overall approach to disclosure requirements. Specific requirements can be quickly and easily incorporated into a firm's data collection processes. The increased application of judgement may mean that firms need a couple of years to interpret the disclosure objectives and consider how they apply to their organisation. The market, in turn, will also then require time to understand how those disclosures can be used. Overall, this suggests an extended period over which firms will apply new disclosure requirements and markets respond to improved information.

The academic evidence gathered by the Board in the post-implementation review of IFRS 13 suggests that investors may need a better understanding of the estimation process, which will allow them to adjust their reliance on fair value estimates. The proposed amendments to IFRS 13 intend to replace the disclosure requirements with a new set of requirements developed by directly applying the proposed Guidance. The proposal defines as an overall disclosure objective the investors' need to understand the company's exposure to uncertainties. As such, it introduces significant judgement in assessing the level of detail necessary to satisfy this disclosure objective. The main trade-off (and risk) of such an approach is that it may impair the comparability of the disclosures.

The level of judgement introduced in the proposed amendments also seems at odds with the fair value hierarchy. The categorisation of instruments into the three levels as prescribed by IFRS 13 is primarily a rules-based rather than principles-based approach. As a consequence, preparers find the distinction between level 1 and 2 fair values rather fluid and the market seems to make little distinction between them (Filip et al., 2021a). Given that the primary use of the fair value hierarchy is for disclosure, the Board should consider revising this part of IFRS 13 along with the disclosure requirements. This could allow for a more principles-based and company specific approach to the fair value hierarchy.

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