Think Ahead ACCA

FEE Cogito Paper 'The Future of Corporate Reporting'

Comments from ACCA to FEE

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The expertise of our senior members and in-house technical experts allows ACCA to provide informed opinion on a range of financial, regulatory, public sector and business areas, including: taxation (business and personal); small business; pensions; education; and corporate governance and corporate social responsibility. www.accaglobal.com

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SUMMARY

ACCA welcomes the opportunity to comment on FEE’s Cogito paper, ‘The Future of Corporate Reporting.’

The paper sets out very interesting and topical proposals about how corporate reporting can and should be made more decision-relevant for users. ACCA agrees that changes are needed to ensure that the annual report is relevant, understandable, and credible, and that technology provides excellent opportunities to bring about such changes.

We believe that any changes to the corporate reporting landscape need to be carefully prioritised. Before the audience of corporate reporting can be extended beyond the providers of financial capital, existing issues around conciseness, and the trade-off between the relevance and comparability of information, need to be resolved first. Likewise, before more timely reporting can be achieved, preparers need to become accustomed to the increased level of professional judgement that principles-based reporting frameworks require. Finally, changes to corporate reporting processes must be predicated on the need to preserve the credibility of the reporting package – whether or not independent assurance is obtained.

COMMENTS

Q1.1 Which are the steps in the reporting process that assist in ensuring that the stakeholder’s information needs are properly addressed?

Q1.2 Do you identify any impediments to reach a broader audience for corporate reporting?

> *Our response below relates to both questions 1.1 and 1.2.*
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> *The question of what stakeholder groups constitute the users of financial statements (or more widely, annual reports) is fundamental to any discussion of future developments in corporate reporting, and one that is often overlooked. ACCA believes that the scope of stakeholders in corporate reporting needs to be clearly defined.*
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> *We welcome the growing emphasis on making corporate reporting information more decision-relevant for stakeholders. However, legal and practical barriers currently exist to addressing the different needs of different stakeholder groups equally. In particular, existing company laws focus on the directors’ responsibilities to shareholders only. The inherent complexity of the annual reports also means that most stakeholders, including some shareholders, rely upon finance professionals and the media to interpret the information reported on their behalf.*
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> *ACCA believes that at this stage in the evolution of corporate reporting, the definition of the primary users of annual reports should not be extended beyond shareholders and providers of financial capital. In our opinion, in improving the quality of corporate reporting, the first step should be to improve the content and presentation of the reports, before seeking to address the needs of a wider range of stakeholders.*

Arguably, the interests of other stakeholders – such as suppliers, customers and staff – are aligned with the interests of shareholders in most cases. A high quality of reporting to shareholders should lead to better communication with other stakeholders.

Q2.2 Do you agree that financial statements have lost, or are losing, some of its significance?

ACCA's research and discussions with global experts show that the financial statements continue to be widely referenced by the majority of investors. While other sources of information, such as buy-side analyses, are relied upon, the financial statements continue to be a crucial source of confirmatory value.

However, the need to improve the decision-usefulness of financial statements is clear. A study carried out by ACCA in June 2013 showed that although the annual report remains by far the most cited source of input for making investment decisions, there a significant minority, 45% of the investors surveyed, expressed concerns about the quality and relevance of corporate reporting.

Q2.3 What are the key steps that should be taken by standard setters and policy makers to foster innovation and enable financial reporting to regain and enhance its relevance?

In our 2013 study, we suggested that standard-setters should:

- *address concerns about clutter;*
- *set appropriate boundaries for how and what management can report: this includes finding a balance between relevance and comparability on the one hand, and flexibility and relevance on the other;*
- *enhance assurance: rigorous assurance is sometimes valued more than the speed of reporting, but the practicality of providing assurance over interim reporting and real-time information should be considered.*

<u>Addressing clutter</u>

As far as the issue around clutter is concerned, we believe that the non-disclosure of material information is more detrimental to decision-making by the users of the financial statements than the disclosure of immaterial information. Over-disclosure is also more difficult for standards to address than under-disclosure, due to the clearly judgemental nature of determining what information should be omitted.

Looking at the financial statements first, complex accounting standards contribute to the length of annual reports. The extent to which this can be reduced is limited: most accounting complexities are driven by the complexities of business. Principles-based standards should help to put a brake on increases in technical complexity in the future. Calls for more consistent application of IFRS around the world are, on the other hand, pushing in the opposite direction. We recognise that principles-based standards do require judgment to apply and that in some countries, preparers and auditors have been used to working with more prescriptive rules. The issue might be overcome with more application guidance from the IASB, while keeping the standards themselves concise and principles-based. In addition, recognising that IFRS may be over-complex *for certain, simpler business operations or structures, the merits of differential reporting may also warrant further investigation.*

Looking beyond the financial statements, issues of conciseness are more acute for non-financial reporting, where disclosures are often of a narrative nature. How conciseness in non-financial reporting can be achieved may merit further research.

As we move away from the concept of a paper-based report of x pages, digital publishing in an online, interactive format will allow users to search a database of information for what they want to find. The CORE & MORE model proposed by FEE and the <IR> Framework are both predicated on the potential of digital technology. We would encourage FEE to further explore current innovative practice. In particular, the FRC's Financial Reporting Lab, which is in the process of launching the 'Digital Future: Data' project from July this year should provide valuable examples.

Appropriate boundaries

Limits of financial reporting

Looking just at the financial statements, profit as a widely-recognised benchmark GAAP measure of performance has a crucial status. If other measures are deemed significant for certain sectors and businesses, then those should be included, but reconciled to the benchmark profit number. The IASB needs to address issues in the measure of performance, most notably the distinction in principle between items in profit and those dealt with as other comprehensive income. Equally, net assets in financial statements and stock market values of companies have grown further apart. To maintain relevance of the financial statements the IASB will need to consider whether 'investments' being made in intangibles should not be better captured in balance sheets.

Financial performance is just one measure of company performance: other KPIs such as numbers of subscribers, pipeline of new products, or proven reserves are clearly vital for an overall coherent picture. A full assessment of financial performance also requires visibility over the risks and the strategy in the shorter and longer term that may impact the current business model and future performance.

Hence ACCA's strong support for Integrated Reporting (<IR>) as a framework which captures that and recognises that businesses need to consider a balanced scorecard of different capitals for their long term sustainability. The <IR> Framework also promotes a more future-looking focus to reporting

While initiatives such as Integrated Reporting improve the relevance of corporate reporting, this may compromise comparability. That is a real concern, but only within bounds. Investors may want to compare different insurance companies, but they expect less to compare an insurance company with a retailer.

Timeliness

The financial statements provide a record of the recent past so that others may use that information to evaluate the future. Some aspects of the financial statements have a limited degree of predictive value, such as some fair values, cash flow forecasts for *asset impairment or for provisions such as pension obligations. Even so, financial performance is generally a lagging indicator as compared to many of the non-financial KPIs noted above.*

The timely release of corporate reporting information as and when information becomes available should, in theory, facilitate more meaningful two-way communication between companies and their stakeholders. However, it could also give rise to significant issues.

Earlier research by ACCA showed that while CFOs voiced cautious support for real-time reporting, they were concerned about compromising competition-sensitive information, and increased risks of misstatement particularly given how difficult it is to implement effective internal control processes for this purpose. Investors have also told us that they value assurance as much as, if not more than, timeliness. How assurance can be provided over information in a CORE and MORE report is an area that FEE's report does not currently address adequately.

Finally, we have also noted concerns that real-time information could drive short-termism in the markets, with disproportionate attention being paid to interim results.

There is clear demand from investors for information with predictive value – such information, including sensitivity analyses and business intelligence, are typically provided by external analysts but there is a valuable opportunity for the company to provide its own perspective. Sensitivity analyses can be provided and updated in a dynamic way in the MORE portion of the corporate report.

Enhanced assurance

More tailored forms of reporting, however, carry a greater risk that is loss of neutrality. For all their faults, financial statements are a standardised form of reporting that allows less scope for manipulation by management. Some investors discount any other reporting and focus solely on the 'harder' financial numbers. Financial statements are a form of honesty check on what we traditionally call the 'front half'.

Forward-looking reporting poses a practical and legal issue for director responsibility and assurance. Frameworks such as <IR> have a more forward-looking stance, if only via risk and strategy disclosures. That may be as far as it can go, before laws and legislation find a way to delineate the limits of director and auditor responsibility – or an alternative way of ensuring the credibility of forward-looking information is found.

Q2.4 How could technology assist in innovation for financial reporting?

Our 2013 report 'Understanding investors: directions for corporate reporting' found that 45% of the investors surveyed were using financial statements in XBRL, although only half of these found it useful. Since then, progress has been made towards standardising the use of taxonomies. The recent IFRS Foundation's consultation on the IFRS Taxonomy Due Process sought to align the IFRS Taxonomy due process more closely with standard-setting. ACCA supports the proposed approach.

We agree with the Cogito paper's arguments that technology helps to improve the timeliness of reporting, enables innovative presentation methods for clearer disclosure, and makes corporate reports accessible to a wider audience. The main issue to be resolved is the definition of boundaries: defining the scope of directors' responsibility over the reported information, defining and disclosing the scope of assurance, and ensuring the neutrality and credibility of information, whether audited or not.

Q3.1 Do you believe that the proposed CORE & MORE model could be a way forward for corporate reporting in the future? If not, why not?

In order to evaluate whether the CORE & MORE model has the potential to transform corporate reporting in the future, more detail is needed about the types of information that the CORE and MORE portions of the report would contain. In particular, consensus between preparers, investors and regulators around the information that would be reported in the CORE portion is crucial.

Before the CORE and MORE model can be widely adopted, it will be necessary to consider how regulatory disclosures would fit within the proposed model. How changing landscape of regulatory requirements can be reconciled with the dynamic, periodic or ad hoc elements described in the Cogito paper is an important issue to address – a one-size-fits-all solution that applies to all regulatory disclosures is unlikely to be workable.

In principle, we welcome the flexibility of the 'layered' approach that the CORE and MORE model allows. This permits companies to adopt a broad principles-based approach, for example by applying the <IR> Framework, to their CORE report, and drill down into regulatory disclosures and specific comparable KPIs in the MORE portion.

One of the key qualities that investors and users appreciate from the current model is that the annual report and accounts package is one which is quite evidently the responsibility of the top management and signed off as such. The financial statements are audited and there are clear responsibilities of the auditors in relation to the other documents issued at the same time.

In regulating the future of corporate reporting, there is merit in retaining this package. Indeed, arguably, the full package should be released at the same time – earnings announcements, financial statements, management commentary/strategic/integrated report plus HSBC is an example of one company adopting this approach.

For the reasons set out above, we would propose that a specific package of periodic information should be published in a coordinated simultaneous release. This may include the earnings announcement, financial statements, management commentary and the integrated report. Dynamic information (ie. non-financial information, risk reporting, and forecasts) could separately and updated on a rolling basis, but such information should be reconciled and cross-referenced to the CORE information wherever possible.

Q3.5 How should policy makers and standard setters address the trade-off between standardisation versus innovation?

The recent trend in principles-based standards should aid innovation. Regulators have started to move away from disclosure requirements that are based on an annual reporting cycle, dictate the location of disclosure (ie. the Directors' Report in the UK), and follow a fairly standardised format. For example, the European Commission's non-financial reporting Directive extends the scope for more entity-specific narrative reporting. The judgement-based nature of these disclosures reduces the level of standardisation of these disclosures, favouring reporting that are more closely tailored to each company's specific circumstances.

At the same time, standardisation is important in maintaining neutrality and comparability in corporate reporting. The use of standard formats reduce the scope for manipulation, thus protecting the credibility of corporate reports. Comparability is paramount in making investment decisions in an environment where decisions have to be made increasingly quickly, although as discussed before, investors would tend to compare like-for-like, making across-the-board comparability less of a concern.

Another regulatory push for innovation comes from some regulators' demand for more timely and frequent reporting. To deliver a more concise report focussed on what is important and to deal with principles-based standards, judgment is required and judgment needs time to apply.

We would encourage regulators to make standards more principles-based. To ensure that reporting remains comparable, principles-based standards will need to be accompanied by clear examples-based application guidance. Particularly for non-financial reporting, in order to preserve the credibility of the information, regulators need to focus more on ensuring companies make transparent disclosures about the decision-making process around what and how to report. We believe that while timely information is important to the capital markets, regulators need to allow high quality reporting practices to be embedded before mandating more frequent reporting.

Q3.6 What are the main challenges and the key benefits of a parallel experimentation in the area of corporate reporting?

Experimentation with new reporting mediums pose particular challenges in terms of accountability and assurance.

Preparers, auditors, regulators and users will all be concerned about how the boundary of corporate reporting information is to be delineated. Investors will want to know:

- *What distinguishes information related to the financial statements – for which company directors are responsible – from pure PR or marketing information?*
- *Over what information is assurance provided by qualified independent third parties? What level of assurance is provided, and what criteria is applied?*

Our 2013 report 'Understanding investors: directions for corporate reporting' found that two thirds of our respondents have become more sceptical about the information that companies provide after the financial crisis. Unless the questions of accountability and assurance are resolved, it will be difficult to restore investor confidence.

Q4.5 Do you have any examples of policies that enable innovation from your country? Should these examples be replicated at a European or an international level?

The UK's Financial Reporting Lab (https://www.frc.org.uk/Financial-Reporting-Lab.aspx), launched by the Financial Reporting Council, provides an environment where investors and preparers can work together to test new reporting formats and share best practice in innovative reporting.