FINANCIAL REPORTING FACULTY

Information for Better Markets

DEVELOPMENTS IN NEW REPORTING MODELS

Information for Better Markets
An initiative from the ICAEW Financial Reporting Faculty

Developments in New Reporting Models addresses recent calls for a new reporting model for business and forms part of the *Information for Better Markets* thought leadership programme of the Financial Reporting Faculty of The Institute of Chartered Accountants in England and Wales (ICAEW).

In recent decades, there have been many calls for a new reporting model. We examined a number of them in an earlier report, *New Reporting Models for Business* (2003). Since then there has been no falling away in the frequency of such calls, though their criticisms of current practice have in some respects moved on. If anything, the demands for reform have been given renewed force by the financial crisis and its aftermath. This report looks at the calls for a new model in relation to both financial and non-financial reporting, and identifies underlying features of the development of business reporting. In the light of this analysis, it suggests a more realistic way of framing the debate on the future of business reporting.

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

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

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Executive summary

Business reporting has to change to reflect changes in business, in information technology, and in users' needs. This is a perpetual process. Business reporting cannot be static or it will fail. But how radical do changes in business reporting need to be? Should existing practices be thrown away so that a fresh start can be made? Or is a more evolutionary process of development needed?

In recent decades, there have been many calls for a new reporting model. We examined a number of them in an earlier report, *New Reporting Models for Business* (2003). Since then there has been no falling away in the frequency of such calls, though their criticisms of current practice have in some respects moved on. If anything, the demands for reform have been given renewed force by the financial crisis and its aftermath. Some of them focus on financial reporting, while others call for extensive non-financial disclosures. Some also demand less complexity in reporting. This report looks at the calls for a new model in relation to both financial and non-financial reporting, and identifies underlying features of the development of business reporting. In the light of this analysis, it suggests a more realistic way of framing the debate on the future of business reporting.

We consider some of the most important arguments that financial reporting information is not useful or is fundamentally misleading, and which might therefore justify calls for a new approach. However, there is no single financial reporting model, so criticisms of 'the model' need to be seen as referring to specific practices.

Financial reporting certainly has limitations, and these are widely acknowledged. But these limitations are also related to its strengths, especially in terms of its relevance and reliability. We find that there is ample evidence that financial reporting does in fact provide useful information. This does not mean that financial reporting cannot be improved. But it does mean that financial reporting should not be dismissed as useless or irrelevant.

The claim that the absence of many intangibles from the balance sheet shows that current financial reporting practices are inappropriate is not a credible one. Financial reporting does provide useful information on intangibles, though not all the information that users need. They also need and get non-financial information on intangibles. But while this reflects the limitations of financial reporting, it does not show the need for a new approach to it. The evidence suggests that if financial reporting attempted to reflect all intangibles at current values this would not provide useful information.

The financial crisis has sharpened and refocused older and sometimes conflicting claims that a new approach to financial reporting is needed. While it is too early to make confident assessments of the role of financial reporting in the crisis, at present the charge that financial reporting either caused it or made it significantly worse is not well supported. Most explanations of the crisis focus on other issues as being of far greater importance.

For non-financial reporting, practice has moved strongly in the direction called for by reformers, so that for many companies their non-financial disclosures are now longer than their financial reporting. But companies rarely follow any externally prescribed model that covers all their non-financial information. And there seems to be no realistic possibility of a prescriptive reporting model that would cover all non-financial reporting and provide a detailed blueprint applicable to businesses generally. The information that different businesses disclose and should disclose is too diverse to be captured by such a model.

Similar objections would not apply to high-level principles for non-financial reporting. Such principles would mean that businesses:

- disclose information that is relevant to their particular circumstances;
- vary their disclosures as circumstances change; and
- experiment in their reporting.

In deciding what to disclose, it is sensible for individual businesses to engage with their stakeholders and other users of their reports. In this way, they can judge what works and what does not, and where additional disclosures may be needed.

We argue that business reporting is best viewed, not in terms of models, but as a complex social institution, which constantly evolves in response to changes in its environment. It also needs to be seen in the wider context of the supply of information about businesses – in which it is just one source, competing with others, but with certain competitive advantages.

Market forces, regulation, ethical and emulatory motives, and pressure from participants in public debate all push business reporting to adapt to changing circumstances. So it would be surprising if, except on rare occasions, it could justifiably be said that 'the reporting model is broken'. Business reporting will always be controversial and there will always be a degree of dissatisfaction with it. But there are grounds for optimism that it should be reasonably well adapted to users' needs and, as long as it continues to evolve, should remain so in the future.

Sometimes there will be a need for radical change, but this will usually be when there have been radical changes in the context of business reporting. Moreover, if people are concerned that business reporting is not fit for purpose, it may be more productive to investigate the environmental causes of its problems, rather than simply to prescribe a new model.

Business reporting for many companies has indeed become long and complex, but this is a rational response to changing circumstances. While unnecessary length and complexity should be removed, the real issue is often 'How do we cope with length and complexity?' One way of doing so is to produce shorter and less complicated reports for those who want them. Another is to rely on intermediaries such as analysts and journalists who filter long and complex reports, and aggregate them with other sources of information, into forms that the ultimate consumers of information can digest.

Advocates of new reporting models are participants in a public debate in which there is a struggle for attention. And framing the debate in terms of the search for a new reporting model is a rhetorically attractive strategy. But it presents too dark a picture of the current state of business reporting and encourages unrealistic expectations of how much can be achieved.

The debate on the future of business reporting needs to be reframed – not as a stark choice between an old model and a new one – but in terms of the need for continuing evolutionary improvements. Proposals for reform have to be assessed on their merits and many of them will be justified. So a series of small debates on particular issues is more likely to be fruitful than a big debate on grand schemes of reform.

But precisely because business reporting evolves in response to its environment, it is also possible for that environment to push it in the wrong direction or to stunt its evolution. Excessive or misguided regulation, for example, or a defective legal framework that encourages a focus on liability problems rather than communication, may lead reporting astray. So the forces that shape reporting – as well as reporting itself – need to be kept under constant and critical review.

There is a need for further research on a number of matters, and the quality of the debate on the future of business reporting would be improved if more effort went into looking at how far proposals for change either are supported by existing research findings or can be tested by future research.

1. THE CHALLENGE

The financial crisis of 2008 and its aftermath have led to renewed calls for reform of corporate reporting. Some critics argue that the crisis could have been avoided or dealt with more promptly if only there had been a different reporting model for business.

Such calls for a 'new reporting model' are themselves far from new. They belong to a tradition that goes back to at least the 1970s. But how far is the rhetoric of dramatic change justified?

1.1 Summary

Business reporting has to change to reflect changes in business, in information technology, and in users' needs. This is a perpetual process. Business reporting cannot be static or it will fail. But how radical do changes in business reporting need to be? Should existing practices be thrown away so that a fresh start can be made? Or is a more evolutionary process of development needed?

In recent decades, there have been many calls for a new reporting model. We examined a number of them in an earlier report, *New Reporting Models for Business* (2003). Since then there has been no falling away in the frequency of such calls, though their criticisms of current practice have in some respects moved on. If anything, the demands for reform have been given renewed force by the financial crisis and its aftermath. Some of them focus on financial reporting, while others call for extensive non-financial disclosures. Some also demand less complexity in reporting. This report looks at the calls for a new model in relation to both financial and non-financial reporting, and identifies underlying features of the development of business reporting. In the light of this analysis, it suggests a more realistic way of framing the debate on the future of business reporting.

1.2 Calls for reform

It is only natural at a time of economic crisis that business reporting should come under critical scrutiny. The subprime crisis that first hit financial markets in the summer of 2007 turned into a major financial crisis in 2008 and has extended to affect the wider global economy, causing – at the time of writing – the worst recession since the early 1980s.[1] It is important that any criticisms of business reporting's role in these events should be carefully considered, so that if business reporting has indeed helped to cause the financial crisis, or made it worse, or failed to send warning signs when it should have done, these defects can be remedied for the future.

While this report is not aimed primarily at the specific criticisms of business reporting that have been raised as a result of the financial crisis, it is highly relevant to them. It focuses on calls for reform that have been made for some time, going back at least to the 1970s, but these calls have been given renewed force by the financial crisis. For example:

- 'Recent events on Wall Street have demonstrated the risks of a reliance on backward looking financial reporting.'[2]
- 'Can we understand corporate performance and the motivations of management by just focusing on financial information? In fact has the narrow focus on financial information been a contributing factor to the credit crunch?'[3]
- 'Given the cumulative societal cost of past scandals, restatements, the dot-com bubble, business failures and now the global credit crisis, a new, more transparent business reporting model just might contribute to restoring trust and confidence.'[4]
- 'The global financial crisis of 2007++ … would have been spotted and brought to heel before [it] reached such disastrous proportions if the wealth measurement model [of financial reporting] … had been in place before the problems started to fester.'[5]

Criticisms of this sort call for a very broad reform of business reporting, in most cases extending well beyond financial reporting, and fall within a tradition that we have characterised as calls for a new reporting model.

These calls for reform were examined in an earlier report in the ICAEW's *Information for Better Markets* thought leadership programme, *New Reporting Models for Business* (2003).

[1] For convenience, we refer to the whole episode as 'the financial crisis'.

[2] The Institute of Chartered Accountants in Australia, *Broad Based Business Reporting: The Complete Reporting Tool*, Sydney: ICAA, October 2008.

[3] David Phillips, 'Recasting the reporting model – a G20 priority', Corporate Reporting blog at www.pwc.blogs.com, 20 February 2009.

[4] Mike Krzus, '20/20 vision: tomorrow's business reporting', *CorporateGovernor*, spring 2009, www.grantthornton.com.

[5] David Mosso (a former vice-chairman of the Financial Accounting Standards Board [FASB]), *Early Warning and Quick Response: Accounting in the Twenty-First Century*, Bingley: Emerald, 2009.

This looked at 11 proposals for reform of business reporting that had appeared in recent years, analysed them from a change management perspective, and raised a series of questions for further discussion and research. The present report is a follow-up to *New Reporting Models for Business.*

Table 1.1: Proposals discussed in *New Reporting Models for Business*

- *The Balanced Scorecard: Translating Strategy into Action*, Robert S. Kaplan and David P. Norton.
- *Improving Business Reporting – A Customer Focus* ('the Jenkins Report'), American Institute of Certified Public Accountants.
- *Tomorrow's Company: The Role of Business in a Changing World*, Royal Society of Arts, and *Sooner, Sharper, Simpler: A Lean Vision of an Inclusive Annual Report*, Centre for Tomorrow's Company.
- *The 21st Century Annual Report/Prototype plc* and *Performance Reporting in the Digital Age*, ICAEW.
- *Business Reporting: The Inevitable Change?*, Institute of Chartered Accountants of Scotland.
- *Inside Out: Reporting on Shareholder Value*, ICAEW.
- *Cracking the Value Code: How Successful Businesses Are Creating Wealth in the New Economy*, Arthur Andersen.
- *Sustainability Reporting Guidelines*, Global Reporting Initiative.
- *Unseen Wealth: Report of the Brookings Task Force on Understanding Intangible Sources of Value*, the Brookings Institution, and *Intangibles: Management, Measurement, and Reporting*, Baruch Lev.
- *The Value Reporting Revolution: Moving Beyond the Earnings Game* and *Building Public Trust: The Future of Corporate Reporting*, PricewaterhouseCoopers.
- *The Hermes Principles: What Shareholders Expect of Public Companies – and What Companies Should Expect of Their Investors*, Hermes Pensions Management.

1.3 Business reporting and reporting models

It may be helpful to start by defining our terms – though the terms we define here are often used in different ways in the debate on the future of business reporting, and other participants in this debate may well disagree with our usage.

Businesses disclose a wide variety of information about themselves in a number of different ways, and we refer to all these disclosures as **business reporting**.

An important feature of business reporting is that it is reporting by **managers** – that is, by those who run the business. In law, this will often mean the board of directors as a whole, who may well include non-executives. In practice, the preparation and disclosure of information are often delegated – by the board to executives, and by senior executives to more junior ones. Law and practice vary among jurisdictions, from one business to another, and from one type of reporting to another.

We refer to all those who use business reporting as **users**. In this report, our main focus is on investors as users of business reporting. This is not intended to deny the importance of other user groups, including the business's own managers and, indeed, society as a whole.

Some of what managers disclose is accounting information and we refer to this as **financial reporting**. Everything else they disclose we refer to as **non-financial reporting**. The boundary between financial reporting and non-financial reporting can be a grey area, as non-financial reporting often summarises or discusses information drawn from financial reporting.

Some of these disclosures comply with rules or norms that govern what information should be disclosed and/or how it should be calculated. We refer to the key features of these rules or norms as **reporting models**. Much of the debate on the need for major reforms in business

reporting is framed in terms of 'models' and whether 'the current model' is broken or not. But, as we explain later, we do not think this is the best way to approach these issues. Also, only some of those who call for a major reform of business reporting talk in terms of a new model. And those who do may be using the term in a general way to indicate 'the way we do things now' or 'how we ought to do things in future'.

Research findings 1.1: Business reporting and reporting models

What is a reporting model?

Although the debate on the future of business reporting often focuses on the 'reporting model', this is not a term that figures significantly in the research literature, perhaps because it is commonly used in a rather loose way. Christian Nielsen, *Modelling Transparency: A Research Note on Accepting a New Paradigm in Business Reporting*,[6] takes a more rigorous approach to the term. He identifies four basic features of a business reporting model:

- an external communication purpose;
- a description of content;
- a structure for disclosing content; and
- a defined method of construction.

On this basis he concludes that only two of the eleven proposals for reform reviewed in *New Reporting Models for Business* (the Jenkins Report and GRI) actually put forward a new business reporting model.

1.4 Delivery and access

It follows from these definitions that when we refer to business reporting, we are not referring just – or even primarily – to the annual report. For many businesses, the annual report forms only a fraction of their total reporting and some of the most important information in it (profit for the year, for example) has already been disclosed by the time the annual report appears. The annual report nowadays is perhaps more a useful work of reference than a way of transmitting important new information to users, though it may still do that to some extent.

The annual report is just one way of delivering information to users and reading the printed version of it is just one way of accessing that information. A number of the reformers whose proposals we reviewed in *New Reporting Models for Business* focused on delivery and access issues as well as on the content of business reporting. In particular, high hopes were – and continue to be – expressed for XBRL.

XBRL is a method of electronically tagging financial reporting data. The US Securities and Exchange Commission (SEC) explains that the tags

> 'uniquely identify individual items in a company's financial statement so they can be easily searched on the internet, downloaded into spreadsheets, reorganized in databases, and put to any number of other comparative and analytical uses by investors, analysts, and journalists.'

XBRL therefore makes possible ways of accessing information that facilitate its manipulation by users.

Use of XBRL is growing. The SEC is progressively introducing requirements for US publicly traded companies to provide financial information in XBRL format, and these requirements are being applied to the largest companies first. In the UK, both the tax authorities and the public accounts filing system (Companies House) already use XBRL extensively, and it will become mandatory for all companies within a few years. It has been claimed by the CEO of XBRL International that, if its use had been even more widespread, it could have prevented the financial crisis.[7] So this is another respect in which the crisis has reinforced older calls for reform.

[6] Full references for items mentioned in the 'Research findings' panels are given in the Bibliography.

[7] Lesley Meall, 'XBRL "could have prevented recession"', *Accountancy*, April 2009.

This report does not look at means of access and delivery for business reporting information. But these are important issues and the potential role of XBRL specifically was considered in an earlier ICAEW report, *Digital Reporting: A Progress Report* (2004).

Research findings 1.2: Delivery and access

The annual report as a work of reference

Bill McInnes, Vivien Beattie and Jacky Pierpoint, *Communication Between Management and Stakeholders: A Case Study*, find that 'finance professionals' use the annual report and accounts as a reference source. It does not provide them with timely information. But for private shareholders, employees, suppliers and customers, the annual report and accounts are a timely source of information.

1.5 Criticisms of 'the current model'

Even before they were able to identify it as a cause of global economic crisis, the advocates of reform made forceful criticisms of business reporting. Two of them noted caustically that 'Every aircraft in the world would be grounded if air traffic control relied on the same type of system that companies use today to report their information.'[8] Another expressed concern that 'The lack of good information about the most important value drivers in individual firms … may … be producing a serious misallocation of resources'.[9] And more recently the CEO of one of the world's major accounting firms commented, on behalf of his fellow CEOs, that 'We all believe the current reporting model is broken.'[10] The financial crisis may seem to bear out such criticisms. But what is the reasoning behind them?

Many of those who call for reform of business reporting regard it as a major defect of financial reporting that it is 'backward-looking'. It is impossible to deny that financial reporting is reporting about the past. But as those who are interested in a business are usually interested in its future more than its past, many of the reformers argue that business reporting needs to be more forward-looking.

Financial reporting also undeniably, and inevitably, focuses on numbers and indeed on financial numbers (monetary amounts). Some of the reformers point out that much of what those who are interested in a business want to know about it is qualitative – its strategy, for example, or the calibre of its management. And where users are interested in quantitative information, much of what they want may be non-financial – eg, data such as key performance indicators (KPIs) on customer satisfaction or on sales volumes.

In *New Reporting Models for Business*, we noted that a number of those who called for extensive reform of business reporting took the absence of key intangibles from the balance sheet as their starting point. It is true that many important intangibles do not appear in corporate balance sheets and, on the face of it, this is a problem in itself. But the absence of intangibles is also a major contributor to the gap between the value of companies as shown in their balance sheets (net book value) and their value as measured by the stock market (market capitalisation). Until the financial crisis and the resulting fall in share prices, this gap had grown in recent decades, and for many commentators its existence seems to be proof that the financial reporting model is broken.

This aspect of the reformers' critique is often presented in the form of a simple historical analysis. Here is Kaplan and Norton's version:

> 'The financial-reporting process remains anchored to an accounting model developed centuries ago ... This venerable financial accounting model is still being used by information age companies as they attempt to build internal assets and capabilities … Financial measures tell the story of past events, an adequate story for industrial age companies for which investments in long-term capabilities and customer relationships

[8] Samuel A. DiPiazza Jr. and Robert G. Eccles, *Building Public Trust: The Future of Corporate Reporting*, New York: John Wiley & Sons, 2002.

[9] Margaret M. Blair and Steven M. H. Wallman, *Unseen Wealth: Report of the Brookings Task Force on Intangibles*, Washington DC: Brookings Institution Press, 2001.

[10] Quoted in Barney Jopson, 'Big Four in call for real-time accounts', *Financial Times*, 8 November 2006.

were not critical for success. These financial measures are inadequate, however, for guiding and evaluating the journey that information age companies must make …'[11]

While one or two of the critics call for reform of financial reporting so that it will reflect all intangible assets at their current values, most assume that this will never happen. Their emphasis instead is on extensive additional non-financial disclosures. These are often linked specifically to intangibles, but they are just as often calls for information about the business's success drivers or its business model. All these areas overlap, as the demands for information on intangibles, success drivers and business models are all ways of trying to understand how the business works – why it is, or will be, successful.

The call for a new reporting model is often therefore primarily for a non-financial model, which – taken together with financial reporting – would give investors and other stakeholders all the information they need to value a business or to assess its performance and future prospects. This is a call for radical change. In both its negative aspect (as a critique of financial reporting) and its positive aspect (as a demand for a non-financial reporting model), it poses major challenges.

1.6 Changing criticisms

In one respect, since we wrote our earlier report there has been a shift in perspective from some of business reporting's critics. This has appeared in growing criticism of the length and complexity of business reporting. The criticism is aimed at both financial and non-financial reporting, and has prompted a number of inquiries into complexity. There seems to be an assumption by some that a new model for business reporting as a whole would reduce its complexity.

A brief summary of some of the more important recent calls for reform of business reporting and proposed frameworks, which might provide new reporting models, is given in Appendix 2. The publications listed there are:

- KPMG's *Building a New Reporting and Communications Model* (2003), which states that 'a new reporting and communications model is needed'.
- The Value Measurement and Reporting Collaborative's *Re-discovering Measurement* (2005), which is part of its New Paradigm Initiative. This 'intends to open a debate on what lies beyond the boundaries of the traditional reporting paradigm, in the expectation that doing so will lead to a new global consensus on concepts and criteria for measuring value and performance'.
- The Enhanced Business Reporting Consortium's exposure draft, *The Enhanced Business Reporting Framework* (2005), which proposes a detailed structure for narrative disclosures.
- *Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks* (2006). This states that: 'The large discrepancies between the "book" and "market" values of many, if not most, public companies ... provide strong evidence of the limited usefulness of statements of assets and liabilities that are based on historical costs. Clearly, a range of "intangibles" that are not well measured, or not measured at all, under current accounting conventions are driving company performance.'
- The Report Leadership group's *Report Leadership: Tomorrow's Reporting Today* (2006), which provides 'a better blueprint for corporate reporting' and gives examples from an imaginary annual report to demonstrate its approach in practice.
- The Accounting for Sustainability Group's *Accounting for Sustainability* (2007). This includes a new Connected Reporting Framework, which 'presents key sustainability information alongside more conventional financial information to give a more rounded and balanced picture of the organisation's overall performance'.
- Tomorrow's Company's *The Future of Corporate Reporting* (2007), which urges companies to improve their reporting by focusing on the future rather than the past and by providing better non-financial information.
- The CFA Institute's *A Comprehensive Business Reporting Model: Financial Reporting for Investors* (2007), which calls for full fair value accounting and recommends that, in the long term, 'all intangible assets should be recognised at fair value'.

[11] Robert S. Kaplan and David P. Norton, *The Balanced Scorecard: Translating Strategy into Action*, Boston: Harvard Business School Press, 1996.

- The International Federation of Accountants' *Financial Reporting Supply Chain: Current Perspectives and Directions* (2008). This consists mainly of a summary of the findings of a global online survey. It notes that, 'According to many correspondents, financial reporting has become less useful because it has become too complex for the average reader to understand.' It calls for work to determine 'what would a more useful business reporting model look like?'
- PricewaterhouseCoopers' *Recasting the Reporting Model: How to Simplify and Enhance Communications* (2008). This states that 'The time has come for a new, market-driven blueprint for corporate reporting to be developed to reflect shortcomings in the current model and the growing challenge of climate change.'
- The World Intellectual Capital Initiative's WICI Framework (2008), which brings together new reporting models from other sources and provides an XBRL taxonomy for them.
- The Institute of Chartered Accountants in Australia's *Broad Based Business Reporting: The Complete Reporting Tool* (2008). Broad Based Business Reporting is an 'enhanced reporting mechanism increasingly used by business to better meet the information needs of their key stakeholders'. The report gives a pro-forma example of business reporting at an imaginary firm.
- The *ICGN Statement and Guidance on Non-Financial Business Reporting* (2008). This states that 'traditional accounting is ... ill-equipped to capture intangible drivers which in the modern economy increasingly underpin value creation. The so-called "value gap" between ... book value and ... market capitalisation ... suggests a need to go beyond conventional accounting.'
- The International Accounting Standards Board (IASB)'s exposure draft, *Management Commentary* (2009), which offers 'a non-binding framework which could be adapted to the legal and economic circumstances of individual jurisdictions'.

In addition to these proposals, Appendix 2 draws attention to other relevant developments:

- the implementation in the EU of requirements for a business review;
- the Accounting Standards Board (ASB)'s Reporting Statement, *Operating and Financial Review*, which is followed voluntarily by a number of UK companies; and
- the Global Reporting Initiative's *Sustainability Reporting Guidelines: Version 3.0*, which are also followed in varying degrees by a number of companies and other entities around the world.

The proposals for reform listed above are in the tradition of those we looked at in *New Reporting Models for Business*. A number of them continue to focus on intangibles as a problem and many call for extensive new non-financial disclosures. If there has been a change of emphasis it has been to draw attention to and deplore the complexity of business reporting and to call for it to be more closely aligned with businesses' internal reporting. For the most part, these reports do not yet reflect the impact on the debate of the financial crisis.

The developments in practice listed above reflect the move towards more (and more regulated) non-financial reporting.

1.7 Rhetoric and reality

A feature of the calls for reform that we considered in *New Reporting Models for Business*, and of subsequent calls, is that they stress the need for radical, even revolutionary, change. Some calls for change really are revolutionary. But often they are essentially drawing attention to some feature of current practice that could be improved.

The stress on dramatic change is understandable. The debate on business reporting is a public one, and those who wish to attract attention to what they have to say have to shout louder than everyone else in order to be heard. An announcement that 'we think some features of current practice could be usefully improved' is unlikely to attract attention. 'The reporting model is broken' stands a better chance of being noticed.

This element of hyperbole sometimes makes it difficult to judge how extensive the desired changes really are. When people say, 'the model is broken', it is possible that they have in mind something less drastic than a completely fresh start, and are merely doing their best to draw attention to a needed improvement. We may therefore seem to disagree more strongly than is really the case with those who appear to be calling for dramatic change.

The very language of 'models' tends to mislead. It suggests that business reporting is a mechanical construction and that progress in it is achieved by discarding old models and adopting new ones. It would be better to think of business reporting in evolutionary terms, to see existing practice as something that constantly needs to evolve in a constantly changing environment, responding to changes in business, in information technology, and in users' needs.

1.8 Different societies, different reporting practices

Reporting requirements and practices differ from one jurisdiction to another. This may be seen as simply the result of the existence of multiple jurisdictions. But an important implication of the evolutionary perspective on business reporting is that different reporting practices are likely to emerge in different social contexts, reflecting local cultures and needs and national legal and regulatory frameworks.

The criticisms of 'the reporting model' that we consider in this report could be seen as part of a debate within a predominantly English-speaking tradition of business reporting. This tradition gives priority to the needs of shareholders or investors, and emphasises the importance of transparency. The critics usually share these assumptions, but argue that current reporting practices fail to meet their purported objectives.

The growth of international capital markets has led to the investor-focused approach to business reporting being exported around the world. In this sense, in spite of its internal critics, it has been highly successful, and in many of the countries where it has been imported it is itself a 'new' reporting model and represents a radical change from past practice.

But there are critics who are opposed in a more fundamental way to the emerging global consensus on business reporting. These critics do not accept the priority given to investors and capital markets. They regard other stakeholders, and other social and regulatory objectives, as equally or more important. These criticisms often reflect broader objections to certain features and beliefs of the societies that have exerted most influence on the development of the investor-focused approach to business reporting.

We do not deal with these criticisms in this report. But their existence and character support one of the report's key themes: that business reporting is the product of its environment. Different cultures are likely to produce different approaches to reporting. So it is only to be expected that exporting the product of one cultural environment to another is likely to provoke resistance based on concerns that go much wider than business reporting itself.

1.9 Structure of the report

In the remainder of the report we:

- examine the charge that financial reporting is not useful or is fundamentally misleading (Chapter 2);
- look at whether current practices in accounting for intangibles are inappropriate (Chapter 3);
- look briefly at whether the financial crisis has exposed a need for radical change in financial reporting (Chapter 4);
- ask whether a detailed and prescriptive model is possible for non-financial reporting (Chapter 5);
- identify some underlying features of the development of business reporting (Chapter 6);
- comment on the question of complexity (Chapter 7); and
- suggest a more realistic way of framing the debate on the future of business reporting (Chapter 8).

In Appendix 1, we summarise the proposals for reform examined in *New Reporting Models for Business* and look briefly at later developments related to them.

In Appendix 2, we summarise other recent developments in the debate on new reporting models for business, including inquiries into complexity.

New Reporting Models for Business identified six underlying issues on which there was deep disagreement between the advocates of reform and supporters of the status quo. Can business reporting:

- meet all decision-making needs?
- benefit from a new conceptual framework?
- depend on the invisible hand?
- attach values to all intangibles?
- achieve transparency?
- serve multiple stakeholders?

In this report we are not focusing specifically on these six questions, but they remain relevant to the issues addressed here. We set out suggested answers to them in Appendix 3.

Since 2003 we have received a number of helpful comments on *New Reporting Models for Business*, commissioned research to help answer questions raised there, and looked at other relevant research findings. This research has significantly influenced our thinking, and key findings are summarised at relevant points in the report. To avoid overburdening the main text with a large number of footnotes, the full references for relevant research are given in the Bibliography, while Appendix 4 lists those items commissioned by the ICAEW.

Finally, Appendix 5 pulls together ideas for possible future research arising from this report. These are referenced to Appendix 5 at the points where they are raised in the body of the report.

2. FINANCIAL REPORTING FUNDAMENTALS

Critics of financial reporting sometimes give the impression that it is fundamentally misleading – an unsuitable product best avoided by those who wish to understand a business. Some critics are concerned because financial reporting is 'backward-looking', some because it is incomplete, others because it relies too much on historical information, and yet others because they fear it relies too little on historical information.

How much substance is there in these criticisms? And does financial reporting have strengths that are being overlooked?

2.1 Summary

We consider some of the most important arguments that financial reporting information is not useful or is fundamentally misleading, and which might therefore justify calls for a new approach. However, there is no single financial reporting model, so criticisms of 'the model' need to be seen as referring to specific practices.

Financial reporting certainly has limitations, and these are widely acknowledged. But these limitations are also related to its strengths, especially in terms of its relevance and reliability. We find that there is ample evidence that financial reporting does in fact provide useful information. This does not mean that financial reporting cannot be improved. But it does mean that financial reporting should not be dismissed as useless or irrelevant.

2.2 Criticisms of 'the financial reporting model'

There is no single, static model for financial reporting:

- Different jurisdictions have different requirements.
- Within jurisdictions it is common for different entities to be governed by different requirements – depending on their size, ownership or business activity.
- The requirements are liable to change from year to year.

'The financial reporting model' is therefore a moving target, which means different things at different times, in different places and for different businesses. And different critics of 'the model' have different features in mind. So criticisms of 'the model' usually need to be seen as referring to specific practices.

In this report, we cannot hope to address all the reasons why people have claimed that the financial reporting model is fundamentally defective or why a new approach is needed. There are important areas of controversy that we do not address here. However, in our view five lines of criticism merit further attention in this report, either because they underlie many of the demands for reform of business reporting that we examined in *New Reporting Models for Business* or because they are of particular relevance in the light of the financial crisis.

Fundamentally misleading. One line of attack occurs in a number of the proposals that we looked at in *New Reporting Models for Business*. This is that financial reporting is inherently misleading, or of no real value, because it is historical ('backward-looking'), quantified and financial. This is not really an attack on any particular set of practices, but on financial reporting as such, as the criticisms refer to inherent features of financial reporting.

Accounting for intangibles. Internally developed intangibles are not usually recognised in the balance sheet. This is because they typically fail to meet the tests that apply for the recognition of assets generally. For example, they may be inseparable from the business or it may not be clear until a late stage of their development (by which time most of the relevant expenditure has been written off) that there really is an asset that will generate income in the future. The first type of problem applies to intangibles such as the value of customer relationships. The second to intangibles such as those created through research and development spending on pharmaceuticals. This criticism of financial reporting underlies many of the demands for reform that we considered in *New Reporting Models for Business* and is still made, though perhaps less frequently.

Current value accounting. In the financial crisis and its aftermath, there has been heavy criticism of fair value accounting or mark-to-market accounting, which is not quite the same thing, but is often referred to as though it is. Fair value is a form of current value accounting. It is not the only one, and a number of its critics are advocates of alternative forms of current value. Fair value – especially in relation to accounting for financial instruments – is accused by some of causing or at least exacerbating the financial crisis. Those who object to increasing reliance on fair value usually call for a return to greater use of historical cost accounting.

Historical cost accounting. By contrast, there has also been persistent criticism of financial reporting for 60 years or more on the grounds that it relies too heavily on historical cost information. Critics who take this view argue that there should be a new approach based entirely on current values. What form of current value they ask for has varied over time and with the critic's personal views. But at present the demand is typically for a move to fair value accounting.

Recognition and disclosure. Some regard current recognition and disclosure practices as wholly inadequate. Again this is an area where, although the criticism is a longstanding one, it has been intensified in the context of the financial crisis.

For any of these reasons, critics are liable to claim that financial reporting is seriously misleading, that the model is broken and that we need a new one.

In this chapter we consider the criticism that financial reporting is fundamentally misleading. In Chapter 3 we look at accounting for intangibles, and in Chapter 4 we briefly review the other three specific charges against financial reporting, each of which has been given fresh life by the financial crisis.

2.3 Inherent limitations: is financial reporting useful?

2.3.1 The problem

It is true that financial reporting is historical, financial and quantified, and that such features impose limitations on what it can do. These limitations are widely acknowledged, and it is generally agreed that no one who wishes to understand a business should rely **solely** on financial reporting information.[12] Users of financial reporting also need to obtain information from other sources. However, there is a large gap between acknowledging the necessary limitations of financial reporting and accepting that it is not useful or is seriously misleading.

How can we judge whether financial reporting is inherently misleading or not useful? One approach is to see whether people actually use financial reporting information. If they do, this would provide a prima facie argument in its defence. They are unlikely to use information that is seriously defective.

Research findings 2.1: Inherent limitations: the problem

Users need to obtain information from other sources

Bill McInnes, Vivien Beattie and Jacky Pierpoint, *Communication Between Management and Stakeholders*, is relevant to the complex question of where users get their information from. The objectives of this study include:

- To establish the range of information sources and channels offered by a company to its stakeholder and information intermediary groups.
- To establish the range of information sources and channels from third parties available to stakeholder and information intermediary groups.
- To document and explore the uptake of these information sources and channels by each group.

2.3.2 Is financial reporting useful?

The evidence from those who are involved in either investing in businesses or advising those who do is that most of them regard financial reporting information as essential. This broad endorsement, however, needs to be understood in the light of how the information is used.

- Users do not say that financial reporting gives them all the information they need.
- Users are selective in their use of financial reporting information. Often, for example, they will pay more attention to profits than to balance sheet totals. And what they regard as important will vary from business to business and from time to time.
- For some businesses – early-stage businesses with high growth prospects, for example – financial reporting information is much less relevant. However, even in such cases investors have some interest in the historical record to date – even though it may well be one of losses and negative cash flows.

[12] See, for example, the IASB's *Framework for the Preparation and Presentation of Financial Statements* (paragraph 13): 'financial statements do not provide all the information that users need to make economic decisions'. Other conceptual frameworks make the same point. *The Report of the Financial Crisis Advisory Group* (2009) has useful comments on this issue.

- As far as possible, users anticipate financial reporting information before it is disclosed. Actual disclosure (reporting) is only significant to the extent that it either removes uncertainties (by confirming that the user's expectations were correct) or contains a surprise. The fact that an earnings announcement has no effect on the share price does not therefore mean that the business's earnings are irrelevant to how the business is valued by the market. It just means that there was no real news in the announcement, or possibly that the good news and the bad news were of equal weight.
- There are supply chains in the market for business information. Suppose an analyst uses financial reporting information as one of the inputs to the information he produces, and an investor then bases his decision on, among other things, the information produced by the analyst. Or suppose an investor buys shares after reading a newspaper article written by a journalist after he spoke to an analyst who has been studying the company's accounts. In each case, as far as the investor is concerned, he may think he is not using any financial reporting information, but he is an indirect consumer of it.

Because of these last two points, people who indirectly make constant use of financial reporting information are liable to say, quite accurately, that they never read the accounts or even that they don't see the point of them. In every economic process, including information production, the ultimate consumer is likely to be unaware of the significance of inputs at the various stages of the production cycle.

Critics of financial reporting might respond that analysts and others use financial reporting information because information based on a broken model is better than none at all. But the research findings summarised below suggest that analysts and other users disregard financial reporting information that they don't trust and that they do have other sources of information. Their use of financial reporting information should therefore be seen as a positive vote in its favour, rather than as a gesture of despair.

Research findings 2.2: Is financial reporting information useful?

Financial reporting information is essential

A series of reports by PricewaterhouseCoopers shows extensive investor interest in and use of financial reporting information: see, eg, *Measuring Assets and Liabilities: Investment Professionals' Views*, *Corporate Reporting: Is It What Investment Professionals Expect?* and *Performance Statement: Coming Together to Shape the Future*. While these reports reflect plenty of critical views on the content of financial reporting, suggestions for how it could be improved and concerns about how it might be made less useful, they do not indicate that users consider financial reporting unhelpful.

For individual analysts' insights on which financial reporting information is used, and how, see the practitioner commentaries given by Stephen Cooper, Sarah Deans, Peter Elwin and Jed Wrigley at ICAEW Information for Better Markets Conferences referred to in the Bibliography.

Users anticipate financial reporting information

The classic work of Ray Ball and Philip Brown, 'An empirical evaluation of accounting income numbers' (1968), concludes that '85 to 90 per cent of the net effect of information about annual income is already reflected in security prices by the month of its announcement'.

A more recent study finds that 'quarterly earnings announcements collectively are associated with approximately six to nine percent on average of the total information incorporated in share prices over the year. If extreme observations are deleted, this falls to approximately five to six percent': Ray Ball and Lakshmanan Shivakumar, 'How much new information is there in earnings?' (2008).

Such findings are sometimes cited as evidence of the irrelevance of financial reporting. They are nothing of the sort. They show that, at the time they are publicly announced, earnings figures tend not to be a surprise. How far financial reporting information is important in valuation and for other purposes are separate questions. Ball and Shivakumar draw attention to various functions of financial reporting announcements that are consistent with their findings, including disciplining prior information releases by managers.

2.3.3 Financial reporting and Keynesian beauty contests

A variant on the 'financial reporting is misleading' argument is that those who use financial reporting to help them value companies are participants in a 'Keynesian beauty contest'. The point of this particular argument is that it casts doubt on the proposition that, if investors use financial reporting information, this means that it really is useful.

The economist John Maynard Keynes drew an analogy between investing in the stock market and taking part in a competition to choose the six prettiest faces from 100 photographs.[13] In Keynes's day, such competitions were to be found in some newspapers. One way in which the newspapers organised these competitions was to award the prize to the entrant whose choice matched the most popular choices of other entrants. Assuming that entrants understood how the competition was decided, the winner was not picking what were really the prettiest faces, but picking the most popular choice for what entrants would expect to be the most popular choice for the prettiest faces.

It could be argued that successful investors in the stock market are like the winners of these newspaper competitions. They are not the investors who are best at spotting the real value of companies, but those who are best at guessing how other investors will expect other investors to value them. So if an investor knows that other investors are using financial reporting information to value companies, he will try to anticipate financial reporting news and investors' reactions to that news. In such a world, financial reporting information will be used not because it is in fact useful in helping to understand a firm's financial performance, position and prospects, but because people know that everybody else uses it.

How can we answer this point?

The problem with the 'beauty contest' argument is that participants in the stock market who think that financial reporting information is all that matters and that it can be used as the sole basis of a successful investment strategy, regardless of whether it is right or wrong, will find that reality keeps on breaking in. Expectations based on financial reporting information at a point in time are borne out or confounded by fresh information that emerges later. Financial reporting information is about the real world. And if it is misleading, that will come out sooner or later.

It is no doubt correct that an investor who can anticipate other investors' reactions to information will be able to make a profit, even if the information they are reacting to is of no inherent value. However, financial reporting is ultimately about the real world. So if people use financial reporting information, this is probably because they think it gives them some useful information about firms' real performance, position and prospects.

2.4 Financial reporting: the strengths of its limitations

Outsiders who deal with a business may well want information about it that depends on access to its records. Unless they are in a position to obtain privileged access, they have to rely on the business's managers for this information. Indeed, this is business reporting's competitive advantage, that it uses managers' unique access to a business's records and to what they themselves know, for example, about their own intentions as managers. But such information also has some inherent disadvantages.

- Managers tend to present past performance and future prospects in the best possible light.[14] The information they provide may therefore be less than objective.
- Managers typically have a more optimistic view than outsiders of their business's prospects. For example, if, in a competitive market, all the expected future sales of the competing businesses are added up, they are almost certain to exceed likely total sales for the market in question. An outsider will have a more objective view than insiders of which businesses are likely to realise their ambitions. This means that managers' reporting also tends to be unduly optimistic.

[13] John Maynard Keynes, *The General Theory of Employment, Interest and Money*, London: Macmillan, 1974 [1936], pp154-7.

[14] There are exceptions. Managers may favour lower income measurements (or higher losses) where competition is restricted (eg, because of a monopoly), to reduce taxable income, to load blame on predecessors where there has been a change of management, or to create hidden reserves to facilitate profit-smoothing in future (cookie-jar accounting).

- Managers have limited information. Even where they are reporting based on the business's records, they may be trying to report on matters where others are better informed or where putting together the full picture requires information from a number of separate sources.

It is human nature that managers tend to err on the side of optimism where their own projects are concerned, and this affects the objectivity of their reporting. This does not mean that they are dishonest. Indeed, preparers' basic honesty is one of the driving forces in the development of business reporting.

Current financial reporting practice is often criticised because assets are not usually written up to current values in the balance sheet, and profits are not usually recognised until they have been realised.[15] However, these features are important elements of 'conservatism' in financial reporting. Conservatism serves two complementary functions:

- It counters managers' tendency to over-optimism by restricting recognition of assets and gains to those evidenced by actual transactions. Another way of describing the current approach to financial reporting is to say that it is transaction-based, although not completely so.
- To the extent that it is transaction-based, financial reporting information can be independently verified and is capable of legal and regulatory enforcement, providing an obstacle not only to over-optimism but to potential dishonesty.

Of course, even a transaction-based approach involves many subjective judgements on matters such as the recoverability of expenditure, the allocation of costs, and the amount of provisions. Nevertheless, conservatism provides one protection against the risks of managerial optimism and incomplete knowledge. In addition, the key characteristics of financial reporting – its historical, financial and quantified nature – also provide protections.

- **Historical** – To the extent that financial reporting is historical, it does not depend on an ability to forecast the future[16] and there is an objective record against which it can be checked. To this extent, deliberate bias and managerial optimism can be guarded against. Also, management's knowledge of the business's past transactions should be complete.
- **Financial** – Financial reporting information emerges from a business's records of transactions with third parties. It therefore relies on an accounting system that has to be in place anyway for the business to function effectively. And because third parties are involved there is added potential for independent checks.
- **Quantified** – While many numbers in financial reporting are to some degree subjective, quantification can provide objectivity and the potential for verification. 'This asset was very expensive' is subjective and unverifiable. 'This asset cost £5m' is objective and verifiable.

Also, although financial reporting does not provide a simple read-out of a business's value, it does provide inputs to the valuation process – both directly and indirectly by 'disciplining' other sources of information. When people seek to value a business by going back to fundamentals, they often have to use 'soft' sources of information such as forecasts of future performance, claims about how new products will affect profitability and qualitative assessments of business strategy. Because these are often forward-looking, qualitative or subjective, they are difficult to evaluate at the time. Financial reporting information provides a way of checking how far expectations generated on the basis of soft information have actually been realised in practice. It therefore encourages both those who provide soft information not to misstate it and those who use it to have a greater degree of confidence in it.

So the inherent limitations of financial reporting are advantages in terms of the reliability, and even the relevance, of the information it provides. They provide it with a competitive advantage by comparison with softer forms of information, such as much qualitative, forward-looking and non-financial reporting.

[15] 'Realised' is a legal term with a complex meaning in some jurisdictions. We are not using it here in a legal sense.

[16] Although it does depend on an ability to predict the future in the sense that both assets and liabilities represent expected future cash flows. Perhaps because of this feature of accounting, its theorists are fond of quoting the remark, 'To know the past, one must first know the future': Raymond Smullyan, quoted by Yuri Ijiri, quoted in turn by Baruch Lev, 'Corporate earnings: facts and fiction', *Journal of Economic Perspectives*, vol 17, no 2, spring 2003, pp27-59.

Research findings 2.3: Financial reporting: the strengths of its limitations

Transaction-based approach: an obstacle to over-optimism and potential dishonesty

Ross Watts, 'What has the invisible hand achieved?', summarises the principal arguments on this question, which he has examined more fully elsewhere. He notes that: 'The manager has an incentive to recognise gains and defer losses until after he has left the firm to avoid being fired and to earn higher earnings-based compensation ... Conservatism defers recognition of the gains until there is verifiable evidence that the gains exist'.

Assets and liabilities represent expected future cash flows

Ray Ball, 'International Financial Reporting Standards (IFRS): pros and cons for investors', comments in passing: 'All accounting accruals (versus simply counting cash) involve judgments about future cash flows.' He goes on to point out that, 'Consequently, there is much leeway in implementing accounting rules.'

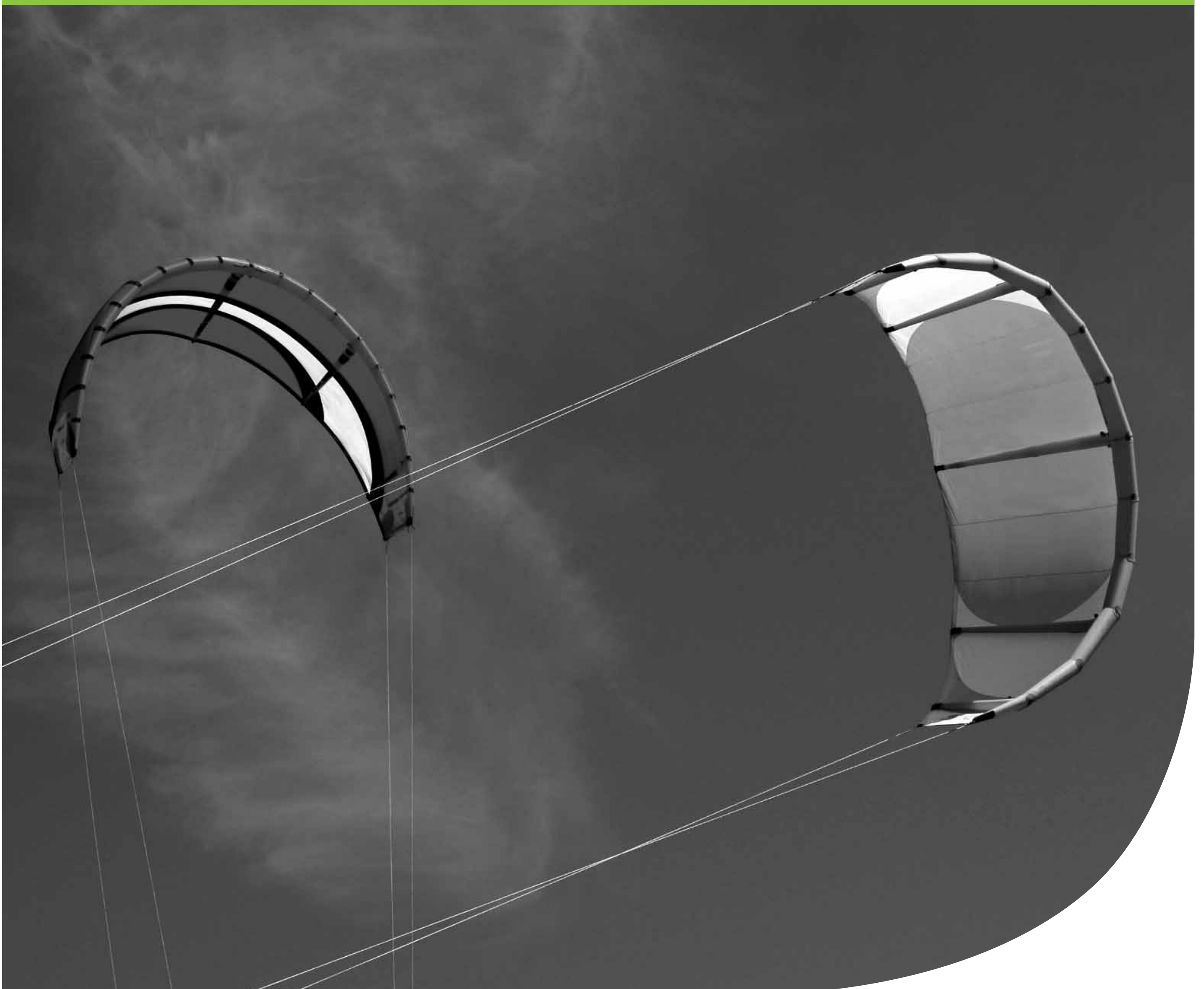
Financial reporting disciplines other sources of information

Again this is an issue that Watts has explored more fully elsewhere, but in 'What has the invisible hand achieved?' he notes that: 'The evidence suggests accounting's comparative advantage in supplying information to capital markets is ... to produce 'hard' verifiable numbers that discipline other sources of information.'

3. ACCOUNTING FOR INTANGIBLES

In the days of the 'new economy', one of the strongest criticisms of financial reporting was that it failed to reflect intangibles. While the craze for the new economy now seems to belong in the same category as tulipmania or the South Sea Bubble, this criticism of financial reporting has not gone away.

But is it sensible to focus exclusively on the balance sheet in trying to understand the contribution of intangibles? Or is the income statement also relevant?



3.1 Summary

The claim that the absence of many intangibles from the balance sheet shows that current financial reporting practices are inappropriate is not a credible one. Financial reporting does provide useful information on intangibles, though not all the information that users need. They also need and get non-financial information on intangibles. But while this reflects the limitations of financial reporting, it does not show the need for a new approach to it. The evidence suggests that if financial reporting attempted to reflect all intangibles at current values this would not provide useful information.

3.2 Relevance of the question

We devote more space in this report to the question of accounting for intangibles[17] than to other issues in financial reporting because, for a number of the critics of business reporting that we looked at in *New Reporting Models in Business*, it was an issue of fundamental importance. No other financial reporting issue has attracted so much attention from those who call for a general reform of business reporting. For various reasons, it has received less attention since 2003:

- It was a fashionable issue in the 1990s, partly because of the internet boom on the stockmarket.
- The discrepancy between firms' balance sheet values and their stockmarket values was seen by some as irrefutable evidence of the inadequacy of financial reporting's treatment of intangibles. This discrepancy has now diminished, though it has not gone away.
- For some people, the argument has moved on and the focus of criticism of financial reporting is now its alleged failures in the run-up to, and during, the financial crisis.

But the problem of intangibles has not disappeared, and it still generates criticism of financial reporting. It also provides a useful way in to some of the key features of business reporting that often escape attention in the broader debate on reporting models.

3.3 The charges

Those who argue that current financial reporting practices for intangibles are inappropriate focus on the absence of key intangibles from the balance sheet. They often describe this as an outcome of financial reporting's historical origins in a now bygone world when tangible assets were what mattered. They also claim that financial reporting's failure to reflect the new reality has a number of unfortunate consequences.

- Investors are misled. They do not know which businesses to invest in or at what price. As a result, resources are misallocated.
- In relation to intangibles specifically, because they are not reflected in accounts, some intangibles-rich companies will be undervalued and there will be some underinvestment in intangibles.
- Equally, because investors do not know what businesses' intangibles are worth, they will also overvalue some intangibles-rich companies and overinvest in intangibles, leading to stock market bubbles and excessive volatility.

We consider these criticisms in the remainder of this chapter.

3.4 The historical perspective

How far is it true that financial reporting reflects an old, outdated model of the economy, and is therefore no longer relevant to a new, intangibles-based economy?

For many critics, the decisive evidence on both the rise of intangibles and financial reporting's obsolescence is the growing disparity between market capitalisations and net book values in corporate balance sheets. But this is capable of a number of different interpretations, such as:

- **Growing investor optimism.** If, in otherwise identical circumstances, investors feel growing optimism about companies' future prospects, this will result in higher market

[17] Also referred to as 'intellectual capital', although sometimes this has a narrower meaning.

capitalisations and therefore a growing gap between capitalisations and net book values. There is some reason to believe that, until the financial crisis, there had been such increased optimism in recent decades.

- **The changing nature of companies seeking stock market listings.** There is evidence that companies have become more likely than in the past to seek a listing at an early stage before they have significant assets or even any earnings. This trend also would tend to open up a gap between net book values and market capitalisations, which for such firms are based on hopes for the future, rather than on existing assets or extrapolations of the historical record.
- **Changes in firms' business models.** One way of looking at firms is to see them as bundles of assets that add value through their joint use. This added value is reflected in the value of the firm, not in the value of the separable assets that compose it. Provided that the gap between the value of a firm and the value of its separable assets depends to some extent on the nature of its business model, it is reasonable to expect some correlation between growth in the complexity of firms and growth in the gap between market capitalisation and net book value.[18]

The evidence suggests that intangibles have always been important and have not suddenly become important since, say, 1980. Even in what is characterised as the industrial era, businesses succeeded through the strength of intangibles such as innovation, the skills of their workforce, intellectual property, relationships with suppliers, and their customers' goodwill. Possibly intangibles have become **more** important, but this is difficult to show, and there seems to be no credible case for the view that we now live in an intangible economy – in contrast to some imagined purely tangible economy of the past.

The view of history offered here – that intangibles have always been important – does not, of course, show that current financial reporting practices are satisfactory. Indeed, it draws attention to the fact that, even in the days of the 'old economy', financial reporting did not attempt to show all of a business's assets or to measure those assets that it did show at their current values. Critics might therefore argue that financial reporting has **always** been defective, and that the rise of intangibles (assuming that there has been such a rise) has merely highlighted problems that were already there. So it could be said that the question is not just 'Is the financial reporting model broken?' but 'Has it always been broken?'

Research findings 3.1: The historical perspective

Intangibles have always been important

To check whether the common assumption that intangibles have become significantly more important in recent times is correct, we invited Sudipta Basu and Gregory Waymire to investigate it. In 'Has the importance of intangibles really grown?' they argue that 'intangibles are ubiquitous to human economic interaction' and that tangible assets incorporate intangibles (so the distinction between the two is in that respect artificial). They note that 'academic accounting research provides little evidence to support the argument that the average value of accounting intangibles has increased disproportionately in recent years'.

3.5 Is financial reporting misleading investors about intangibles?

Critics might argue that, even if people are using financial reporting information, all this shows is that they are being misled. This is a difficult point to refute. It would, however, be extremely surprising if users were being systematically misled on the subject of intangibles. Many users, including those who have the most effect on market prices and investment decisions, are highly sophisticated and fully aware of how financial reporting deals with intangibles. It would be remarkable if investors were systematically misled by financial reporting in this respect.

The critics might respond that it is the uninformed investors who need protecting. Again this is a difficult point to deal with. What sort of conclusions do the critics think uninformed investors are drawing from financial reporting? Do they imagine that investors look at the net

[18] The significance of conducting economic activity through firms has been referred to in two earlier ICAEW reports, *Measurement in Financial Reporting* (2006) and *Measuring IT Returns* (2008).

assets figure in the balance sheet, compare it with the market capitalisation, conclude that the company is massively overvalued and promptly sell their shares? If so, the problem seems to be a self-liquidating one. If not, what exactly is the problem?

It does not appear that the absence of intangibles from the balance sheet has led to either underinvestment in intangibles or undervaluation of intangibles-rich companies. But this point is disputed among researchers and it does not seem possible to settle it conclusively. Those who defend the current approach to accounting for intangibles point to:

- heavy and increasing investment in intangibles; and
- the very high valuations (relative to both earnings and reported net assets) attached to many intangibles-rich companies.

But the critics may claim that both investment in intangibles and the valuations of many intangibles-rich companies would have been even higher had intangibles been properly reflected in the accounts.

A further argument for the inadequacy of the current approach to intangibles is that it allegedly promotes bubbles and volatility in stockmarkets. In a way, this stands the previous argument on its head. While defenders of current accounting practices point to heavy investment in intangibles and high market capitalisations as evidence that there is no problem, the critics can reply that sometimes both investment and valuations are **too high**, because investors are not properly informed and become excessively optimistic.

Again this is a point that it seems to be impossible to settle conclusively. While it may be true that overoptimism reflects inadequate information, it does not follow that business reporting potentially holds a remedy for it. Sometimes it may be possible to identify a specific information gap that business reporting can fill, but filling the gap (though worthwhile in itself) will not provide the final answer that people seek. The central problem is the inherent uncertainty of the relevant investments. The internet bubble of the late 1990s, for example, reflected excessive expectations of a range of business models based on radical new technology. These expectations were certainly not based on financial reporting information, which would, if anything, have provided investors with an anchor in reality. Moreover, it is unlikely that additional non-financial information would have dampened investors' enthusiasm, although it does not seem possible to prove the point.

A related argument is that investment in intangibles, though heavy, may not have been well-directed. If the reporting of intangibles had been better, critics argue, investments would have been better directed. This is yet another argument that appears to be impossible to refute, but equally there seems to be little evidence to support it. Investments in new products and services are inevitably risky. This is true of both tangible and intangible investments, and there are plenty of misdirected investments in tangible assets. There seems to be no reason to think that remediable deficiencies in financial reporting have led to misdirected investment in intangibles.

Our conclusion therefore is that it is unlikely that investors are being seriously misled by the financial reporting of intangibles.

Research findings 3.2: Is financial reporting misleading investors about intangibles?

No underinvestment in intangibles or undervaluation of intangibles-rich companies

We invited Douglas Skinner to examine the question of accounting for intangibles: see 'Accounting for intangibles: a critical review of policy recommendations', which includes evidence on the extent of investment in intangibles. For evidence of heavy and growing UK investment in intangibles, see HM Treasury, *Intangible Investment and Britain's Productivity*.

For a different view, see Baruch Lev, 'A rejoinder to Douglas Skinner's "Accounting for intangibles: a critical review of policy recommendations"'. Lev has a substantial body of research in this area, including *Intangibles: Management, Measurement, and Reporting* and (with various co-authors) 'Information asymmetry, R&D, and insider gains' (Aboody and Lev) and 'R&D reporting biases and their consequences' (Lev, Sarath and Sougiannis), as well as other papers investigating the financial and non-financial reporting (and non-reporting) of intangibles.

3.6 Intangibles: income v the balance sheet

One reason why users of financial reporting information are not misled about intangibles is that they are selective and ignore information that might be misleading. So, they do not assume that the figure for net assets on the balance sheet tells them the value of the business. They do not assume that the absence from the balance sheet of internally developed intangibles means either that the business has no internally developed intangible assets or that those it has are worthless.

By and large, those who wish to use financial reporting totals to help them value a business look to the income statement rather than the balance sheet. That is why the content of the income statement is such a sensitive issue for standard-setters. Earnings reflect the contribution of intangibles and so provide a basis for valuing a business even when it has valuable intangible assets missing from the balance sheet. Users can arrive at a valuation by capitalising earnings.

Where intangibles are not reflected in income because, for example, they are at an early stage of development, their valuation is also likely to be especially uncertain. So the problem of not knowing what they are worth is unlikely to be solved by putting an estimated value for them in the balance sheet. Where estimated current values for intangibles are included in the balance sheet, the information is often regarded as so subjective and unverifiable that users tend to ignore both the disclosed asset values and any charges to income based on them. In these circumstances, non-financial information is important, but even this will only provide material to assist the valuation process. The essential problem is that the value of intangibles in development is highly uncertain; no form of reporting can overcome that.

The gap between market capitalisations and the net assets shown in company balance sheets is therefore a red herring. No necessary connection is to be expected between the two numbers. If in the long run the gap between them has grown, this is not evidence of the growing irrelevance of financial reporting. As noted above, it might instead be explained by a shift in recent decades in the nature of companies seeking a listing: from relatively well-established companies to newer companies where growth options are more important. Or the gap might reflect investors' growing – and possibly excessive – optimism.

Research findings 3.3: Intangibles: income v the balance sheet

Users look to the income statement rather than the balance sheet

For evidence on this point, see Douglas Skinner, 'Accounting for intangibles: a critical review of policy recommendations' ('most approaches to equity valuation rely on information from the income statement') and Jed Wrigley's commentary on another paper, which refers to a strong relationship between earnings and the S&P index over 130 years. The emphasis on the income statement is broadly supported by all four of the analysts' commentaries referred to above (Research findings 2.2).

Users can arrive at a valuation by capitalising earnings

This point is made in Stephen Penman, 'Financial reporting quality: is fair value a plus or a minus?': 'current [historical cost] income forecasts future income on which a valuation can be made'. This approach is endorsed in Skinner, 'Accounting for intangibles'. Penman returns to the question in *Accounting for Intangible Assets: There Is Also an Income Statement*.

A shift in the nature of companies that seek a stock market listing

On this, see Skinner, 'Accounting for intangibles': 'firms that go public are increasingly less profitable with higher growth and lower survival rates than was the case before 1980'.

Users often ignore current values for intangibles in company accounts

Peter Elwin's practitioner commentary provides evidence on this point: '[Analysts] do not take account of the value of a customer list, partly because they know it is made up anyway and partly because it could disappear tomorrow… They will look at things like patents, R&D, etc, ie, intangibles where there is a reasonably clear … legal framework, and a clearly defined legal life, and where they can be transferred to somebody else – licences and so on.'

Jed Wrigley's commentary draws attention to managers' reluctance to write down the current values of intangibles. In effect, the stock market often writes them down well before managers do.

On the other hand, the European Federation of Financial Analysts Societies (EFFAS) and Jan Hofmann, an analyst at Deutsche Bank, both call for companies to report the value of their intellectual capital. See *Principles for Effective Communication of Intellectual Capital.*

3.7 Putting all intangibles on the balance sheet

If financial reporting were to be changed so that a business's balance sheet did show the value of all intangibles and net assets equal to the value of the business, what would that entail?

First, there is the problem of identifying the value of the business. Those preparing the accounts could take the business's market capitalisation where there is one. This does not in fact show the value of the business if it were to be sold, but it is an objective and verifiable amount. Alternatively, they could estimate what they think the business is worth and use that; this would be a subjective and unverifiable amount (though managers could disclose how they calculate it).

Either way, those preparing the accounts would now have a total that the business's balance sheet would have to add up to. Making the balance sheet do this would involve two processes:

- Identifying all of the business's currently unrecognised assets and liabilities and putting them in the balance sheet.
- Estimating the current value of all the business's assets and liabilities.

These are subjective and unverifiable processes.

- Currently unrecognised assets would typically be intangible assets such as employee skills, supplier relationships, customers' goodwill, and so on. Unfortunately, establishing the existence of such intangibles is not an objective, verifiable matter. Different people asked to identify a business's intangibles will arrive at very different conclusions.
- Even supposing all unrecognised assets could be identified, valuing them so as to show their contribution to the value of the business is also a subjective process. The values required are not 'fair values' in the sense of market values, but the present value of each asset's contribution to an individual business's future cash flows. But future cash flows are unknown, estimates of them will reflect the expected effects of growth options as well as of assets in place, the choice of a discount rate is subjective, and because assets produce cash flows jointly, attributing them to individual assets is an arbitrary process.

Would this exercise provide useful information in spite of the problems of subjectivity and verifiability? Although firms do not currently produce balance sheets that purport to add up to the value of the business, changes in the financial reporting of business combinations have led to the recognition of some previously unrecognised intangibles in companies' accounts and to their valuation at a current value at the time of acquisition. The evidence to date on this information is, as noted above, that it is often regarded as so subjective and unverifiable that users tend to ignore it. This suggests that a balance sheet that purported to add up to the value of the business would not in fact provide useful information. Also, when users are asked whether they want a balance sheet that adds up to show the value of the business, they typically say 'No'. Analysts, in particular, tend to consider that they can do a better job of valuing the business than its managers can.

The fundamental problems with financial reporting statements that purported to show the value of the business would be that managers:

- would not necessarily have a better view than the market on what their business is worth; and
- would be attaching values to assets that cannot be valued reliably.

Of course, if managers believe that they **do** have a better view than the market of what their business is worth, then it would be helpful for them to explain their view, which may provide the market with useful information.

Two of the issues that affect the financial reporting of intangibles are equally problematic when it comes to non-financial reporting:

- different people will identify a business's intangibles differently; and
- intangibles typically produce their benefits for a business jointly with other tangible and intangible assets.

Research findings 3.4: Putting all intangibles on the balance sheet

The asset values required to value a business are not market values

The point here is that, if the values of a business's assets (less its liabilities) are to add up to the value of the business, these values must reflect the cash flows that they will generate within that particular business. However, these values will in many cases not be the same as the assets' market values. Various researchers have drawn attention to this.

For example, Stephen Penman, 'Financial reporting quality: is fair value a plus or a minus?', writes: 'fair value accounting conveys information about equity value … by stating all assets and liabilities on the balance sheet at their value to shareholders… This idea is close to that of 'value in use' but with a focus on the shareholder rather than on the entity.'

And Mary Barth and Wayne Landsman, 'Fundamental issues related to using fair value accounting for financial reporting', write: 'Because value-in-use is the only measure that always captures total firm value associated with an asset and is consistent with the going concern tenet of GAAP, value-in-use should be the focus of fair value accounting.'

Managers do not necessarily have a better view than the market on what the business is worth

Ross Watts, 'What has the invisible hand achieved?', explains this point. In relation to managers providing a valuation of the company, he notes that a company's stock price 'contains more information than the information of any single investor. The accountant, or financial reporting in general, cannot hope to produce a range of information anywhere near what is in the price or to generate an estimate of a firm's equity value that captures much of the information that is in the market price.'

Managers would be attaching values to assets that cannot be valued reliably

Douglas Skinner, 'Accounting for intangibles: a critical review of policy recommendations', identifies economic characteristics of intangibles that are relevant to their non-recognition and non-valuation in financial reporting. These characteristics include:

- 'Many intangibles are not separate, saleable, or discrete items. As such, their value is intrinsically tied to the residual value of the firm. Examples of assets in these categories are customer satisfaction, employee loyalty, certain brand names, and so on. These resources increase in value as the result of many different and interrelated activities and expenditures, making it hard to uniquely identify the costs associated with these assets.
- The well-defined property rights associated with most tangible and financial resources currently recognized as assets often do not extend to intangibles. For example, it is often very difficult to exclude others from enjoying the benefits associated with these resources.
- Largely because of these characteristics, there are no liquid secondary markets for many intangibles, making it difficult to reliably measure the value of these resources. This means that it will be difficult to reliably estimate fair values for these types of resources.
- Because many intangibles are not separable and saleable, and because of poorly-defined property rights, it is often difficult to write fully-specified contracts for intangibles.'

Wayne Lonergan, 'Discussion of Bloom' (ie, a discussion of a paper by Martin Bloom on accounting for goodwill), also gives a useful analysis of the reasons why intangible assets are difficult to measure reliably.

Penman, in *Accounting for Intangible Assets*, argues that 'the term "intangible asset" can just be a cover for speculation or even fantasy' and refers to valuation in such cases as 'a conjectured value of a conjectured asset'.

3.8 Difficulties in the debate on intangibles

Our argument suggests that the absence of most intangibles from the balance sheet does not mean that financial reporting is fundamentally misleading, but in some important respects the argument is unsatisfactory or inconclusive.

- Part of the defence of the current approach to accounting for intangibles is that users are able to value a business even though its intangibles do not appear in the balance sheet. However, if this is the case, why is it not equally possible to value a business if **tangibles** are omitted from the balance sheet? This question does not imply that the balance sheet is being used to value the business. The point could equally well be expressed in terms of earnings. That is to say, if it is possible to value a business satisfactorily on the basis of earnings with expenditure on intangibles written off as it is incurred, why is it not equally possible to value a business with expenditure on tangibles written off as it is incurred? (Appendix 5, Question 1.)
- The use of fair values to measure certain financial instruments has been defended on the basis that historical cost for such items is wholly inadequate. Fair value information therefore has to be only a little bit relevant and a little bit reliable to be more useful. Why is the same not true of valuing intangibles in the balance sheet? Measuring valuable intangibles at zero is on the face of it wholly inadequate. Surely valuations that were even a little bit relevant and a little bit reliable would be more useful? (Appendix 5, Question 2.)
- There are a number of points where the evidence is disputed among researchers. This may reflect fundamental problems in knowing whether, eg, investment in one type of asset is too high or too low or whether at any given moment stock market valuations are too high or too low. It may be impossible to give conclusive answers to such questions, but how can we know, even with the benefit of hindsight, whether:

  – there is too much or too little investment in a particular class of asset; or

  – stock market valuations are too high or too low? (Appendix 5, Question 3.)

All these problems deserve further exploration.

3.9 Improving financial reporting for intangibles

The debate on intangibles is often framed in terms of fundamental questions that tend to produce polarised conclusions such as, 'The fact that most intangibles are not on the balance sheet means that the reporting model is broken' or 'It doesn't matter that most intangibles aren't on the balance sheet'. But there is a large area between these two poles where there are important, but less fundamental questions about how particular intangibles should be accounted for. Answers to these questions may provide ways of improving the reporting of intangibles in an evolutionary way.

Indeed, one of the key issues in the debate on reporting intangibles has nothing to do with putting intangibles into the balance sheet at their current values. It is about the absence from balance sheets, for many intangibles, of even their historical cost.

Aspects of reporting intangibles that require attention include:

- There is a lack of comparability on recognition of intangibles, many of which only appear on the balance sheet when there is a business combination. A discussion paper from the Australian Accounting Standards Board (AASB)[19] notes that many internally generated intangibles are now recognised in accounts following a business combination. It suggests that a similar approach to recognition and measurement might be appropriate for such assets even in the absence of a business combination. Views on this particular proposal will probably depend on how useful the intangibles disclosures resulting from business combinations are thought to be. Evidence to date is that the 'softer' valuations that emerge tend to be disregarded.
- There are doubts about the reliability of impairment measurements for intangibles, which depend heavily on management judgements.
- Even where intangibles are not recognised as assets in the accounts, it is possible that more information could usefully be disclosed on their market values, where such values exist.

[19] AASB, *Initial Accounting for Internally Generated Intangible Assets*, Melbourne: AASB, 2008.

More broadly, there are important questions as to what exactly is distinctive about intangibles in terms of requiring special provision in accounting standards. At first sight, it seems desirable that financial reporting requirements should not distinguish between the tangible and the intangible. But is this a sensible starting-point or are there relevant differences between the two types of asset that mean that different accounting approaches are appropriate? (Appendix 5, Question 4.)

Research findings 3.5: Improving financial reporting for intangibles

Historical cost accounting for intangibles

In *Intangibles: Management, Measurement, and Reporting*, Baruch Lev suggests changes to accounting standards to require 'recognition as assets of all intangible investments with attributable benefits that have passed certain prescribed technological feasibility tests'. Previously written-off R&D expenditure would then be written back and added to the asset. The intention is that, in this way, income and expenditure in relation to intangibles would be better matched.

4. FINANCIAL REPORTING AND THE FINANCIAL CRISIS

Some bankers have been quick to blame the financial crisis on financial reporting. They are not alone. A number of politicians, regulators, academics and others also appear to believe that financial reporting either caused the crisis or made it worse.

The views of these critics are often mutually incompatible – some calling for more current value in accounts, others for less. But what is the evidence on the causes of the crisis? Is financial reporting to blame?

4.1 Summary

The financial crisis has sharpened and refocused older and sometimes conflicting claims that a new approach to financial reporting is needed. While it is too early to make confident assessments of the role of financial reporting in the crisis, at present the charge that financial reporting either caused it or made it significantly worse is not well supported. Most explanations of the crisis focus on other issues as being of far greater importance.

4.2 Past and future work

Although we devote less space in this report to the financial reporting questions that emerge from the financial crisis than we do to intangibles, this does not mean that they are less important. But we have already looked at the general questions of current value and historical cost accounting in *Measurement in Financial Reporting* (2006). And the research available for a proper investigation of financial reporting's role in the financial crisis is still limited; much more needs to be done.

4.3 Current value accounting: a broken model?

It has been claimed that the use of fair values for certain financial instruments helped to cause the financial crisis or made it worse. This view is often shared by those who fear that there is a general move towards the greater use of fair values in accounting, and who believe that this is a change for the worse. We should emphasise that critics of fair value do not usually call for the abandonment of all current values in accounting. Under the historical cost approach it is normal for assets to be written down to a current value where their historical cost is considered to be irrecoverable. And it is not in dispute that certain assets (eg, foreign currencies or investments held by investment institutions) should be recorded at current values. The critics' argument is usually that the use of current values has gone too far and has already been damaging.

Although the role of fair value has become the focus of current criticisms of financial reporting, there is as yet no convincing evidence that its use for certain financial instruments either caused the financial crisis or made it worse. Most explanations focus on other factors as being of far greater importance. An SEC study on the role of fair value accounting, mandated by the US Congress, concludes:

> 'bank failures in the US appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence. For the failed banks that did recognize sizable fair value losses, it does not appear that the reporting of these losses was the reason the bank failed.'[20]

Some of the major US banking failures were of 'investment banks', which were outside the mandated scope of the SEC study. However, the SEC extended its conclusions so as to cover these institutions:

> 'Rather than a crisis precipitated by fair value accounting, the crisis was a "run on the bank" at certain institutions, manifesting itself in counterparties reducing or eliminating the various credit and other risk exposures they had to each firm.'

A later US report, by the Committee on Capital Markets Regulation, is critical of the SEC study in certain respects, but does not suggest that the crisis was caused by fair value accounting:

> 'In the housing sector, banks took advantage of low interest rates and securitization opportunities to institute relaxed lending standards that drove mortgage lending throughout the early part of the decade… Increased borrowing by US households was partially offset by climbing asset prices. However, the period of rising property values came to a close after reaching a peak in Q2 2006, with home prices eventually falling by 27% by Q4 2008…
>
> '… The wreckage in Wall Street and elsewhere [in the financial sector] stems in part from the explosive growth in complex and mispriced mortgage-related securities… As the housing bubble burst, the market for these securities dried up and their values have plummeted…'[21]

[20] Securities and Exchange Commission, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting*, Washington: SEC, 2008.

[21] Committee on Capital Markets Regulation, *The Global Financial Crisis: A Plan for Regulatory Reform*, Cambridge: Committee on Capital Markets Regulation, 2009.

A UK study, *The Turner Review*, is more critical of fair value:

> 'While it is difficult to quantify the effect, it is a reasonable judgement that the application of fair value/mark-to-market accounting in trading books, played a significant role in driving the unsustainable upswing in credit security values in the years running up to 2007, and has exacerbated the downswing.'[22]

The possibility that financial reporting has procyclical effects has been discussed for many years, and long before the rise of fair value accounting or the development of modern financial instruments. Indeed, in the past, critics sometimes alleged that procyclical effects were caused by the use of historical costs and could be remedied by the use of one form or another of current value accounting (of which fair value is one method). All forms of accounting show good results in the good times and bad results in the bad times. In doing so, they reflect reality, which is what people expect accounting to do. But, in an economy subject to economic cycles, it is quite possible that reflecting reality intensifies inherent cyclical tendencies. Another way of putting this is that it is possible that financial reporting that does **not** reflect reality could have countercyclical effects. However, this raises a number of questions about why people should place reliance on information that they know does not reflect reality, and whether this would in fact assist financial stability.

Another line of criticism is that fair values are misleading because they reflect market prices, which are in turn based on actual or offered transactions between marginal buyers and marginal sellers. They do not show values that could be realised if all holders of an asset decide to sell it at the same time. In relation to the financial crisis, the argument therefore is that, when asset prices were rising, fair values created an illusory optimism (thereby fuelling the bubble). However, historical costs also reflect market prices (at the date of acquisition rather than at the balance sheet date), and so it is quite possible that historical costs will also give a misleadingly high figure for what could be realised if all holders sold at once. Also, it is unusual for all holders of a particular asset to want to sell it at once unless someone is offering to pay **more** than the market price (as in a takeover bid for a business). In other cases, all holders of an asset may wish to sell if they find that it has been fundamentally overvalued. This may affect those who bought and recorded the asset at an inflated historical cost as much as, or more than, those who bought the asset at a lower cost, but show it in their balance sheet at a higher fair value.

There is also a deeper suspicion that market prices are often unreliable indicators of underlying value (of real, as opposed to accounting, 'fair value'). This reflects a view that markets are often irrational – either unduly optimistic or unduly pessimistic. We cannot address this issue here, but even if the suspicion is well-founded:

- As noted above, historical cost also uses market prices.
- It is not clear that superior sources of valuation – always rational, never unduly optimistic or unduly pessimistic – are available.

Enquiries into the causes of the financial crisis also make some positive comments on fair value. Both the SEC and Lord Turner note that businesses that used fair value for management purposes, because they registered falls in asset values before competitors, took earlier action to respond to the crisis, and so coped with it better.

The relationship between financial reporting and financial stability is an important question and one that needs to be thoroughly researched. (Appendix 5, Question 5.) But the charges made against fair value on this score do not seem to be proven, and indeed there is some evidence that fair value was useful in providing early warning of emerging problems.

Research findings 4.1: Current value accounting: a broken model?

No convincing evidence that fair value caused the financial crisis

There is an emerging literature on financial reporting and the financial crisis. For the lack of evidence that fair value is responsible for it see, eg, Ray Ball, *Don't Blame the Messenger … or Ignore the Message*, Christian Laux and Christian Leuz, 'The crisis of fair-value accounting: making sense of the recent debate', and Stephen G. Ryan, 'Accounting in and for the subprime crisis'. There is also a good deal of material on this question in the SEC's *Study on Mark-to-Market Accounting*.

[22] Lord Turner, *The Turner Review: A Regulatory Response to the Global Banking Crisis,* Financial Services Authority: London, 2009.

Research findings 4.1: continued

Past allegations that historical cost has procyclical effects

This subject goes back a long way. A well-known discussion is W. T. Baxter, 'The accountant's contribution to the trade cycle', which was published in 1955. Baxter refers to a number of earlier works, including Gottfried von Haberler, *Prosperity and Depression* (1937). Von Haberler, who in turn refers to even earlier German-language works, argues that (p 46): 'These paper profits [produced by historical cost accounting] are … likely to add to the cumulative force of the upswing, because they stimulate borrowers and lenders to borrow and lend more. They foster the optimistic spirit prevailing during the upswing, and so the credit expansion is likely to be accelerated. This phenomenon has its exact counterpart during the downswing of the cycle.'

Von Haberler argues for the use of replacement cost, rather than historical cost, which is also the point of Baxter's paper. An important feature of these criticisms is that they have in mind accounting for physical assets – fixed assets and stocks. They do not consider accounting for financial instruments, which is the focus of the contemporary debate on financial reporting and the business cycle.

4.4 Historical cost accounting: a broken model?

Historical cost accounting has been under attack for at least the past 60 years. At one time, the key motive for criticism was its apparent inability to cope with the effects of inflation, but this has never been the whole case against historical cost. And contemporary critics[23] pay little if any attention to inflation as an issue.

The key charge against historical cost is irrelevance. It uses out-of-date, historical values, when what users need, it is claimed, are up-to-date, current values. Also, historical costs for identical assets vary from one business to another, so arguably historical cost accounts are not comparable from one business to another. Some critics also argue that historical cost is more open to manipulation than fair value. Those who wish to replace historical cost with current value therefore argue that only in this way can the users of financial reporting obtain information that is genuinely relevant, reliable and comparable.

We do not in this report go into the arguments for and against historical cost accounting – an issue we considered in *Measurement in Financial Reporting*. Our focus is on the more limited question of whether historical cost is responsible, to a greater or lesser extent, for the financial crisis. The specific charge here is that, in the early stages of the crisis, historical cost led to overstated asset values and failed to give sufficient warning of the scale of the emerging problems.

The difficulty in assessing this charge is the lack of evidence. The early critics of financial reporting's role in the financial crisis concentrated on fair value, which it was claimed overstated profits in the upturn and **overstated** losses in the downturn. The critics of historical cost essentially claim that it **understated** losses in the downturn. On the face of it, there is a simple empirical question here. But because the charges against historical cost in the financial crisis are relatively new, they have been investigated even less thoroughly than those against fair value. More fundamentally, there is a knotty problem as to how it is decided whether profits and losses are understated or overstated, as it is the question of how profits and losses are to be measured that is the point at issue in the first place. In other words, any answer is likely to beg the question.

The charges against historical cost are as serious as those against current value, but it is possible at present to give only provisional and inconclusive answers to them:

- There is so far no convincing evidence that financial reporting, in any respect, either caused or significantly exacerbated the financial crisis.

[23] For example, the CFA Institute's *A Comprehensive Business Reporting Model: Business Reporting for Investors* (2007) states that 'Fair value is the most relevant information for financial decision making' and that 'Our goal is for fair value to be the measurement attribute for assets and liabilities.' David Mosso, *Early Warning and Quick Response: Accounting in the Twenty-First Century* (2009), argues that 'the accounting model' is 'broken beyond simple repair' and that 'all balance sheet assets and liabilities … must be measured at fair value'.

- However, the role of historical cost in the crisis is a question that deserves to be investigated, and we propose to return to it in our future work.

4.5 Recognition and disclosure problems

4.5.1 The charges

There are two other important allegations against business reporting in the financial crisis and the period that led up to it. It is claimed that:

- there was insufficient disclosure on certain financial instruments; and
- significant liabilities were hidden in off balance sheet vehicles.

Together with the criticisms of fair value (or historical cost), they add up to a case that the financial crisis has shown that the financial reporting model is broken.

As usual, neither of these criticisms is entirely new. Users have complained for decades that there is insufficient detail in financial statements and there have also been problems with off balance sheet items for many years. Again, the financial crisis intensified and refocused longstanding complaints.

There has also been criticism that there was inadequate disclosure of risk in the period leading up to the crisis and in its early stages. This is not entirely a financial reporting issue; risk disclosures are mainly found outside the financial statements. However, we mention it here for the sake of completeness and return to it below (Section 6.9).

4.5.2 Disclosure questions

It seems likely that, in the run-up to the financial crisis, disclosures for certain financial instruments could usefully have been more extensive. We note that financial reporting standard-setters have in fact extended relevant disclosure requirements in response to the crisis and are considering further changes.

While this seems to be one area where useful lessons have already been learnt, we do not see it as an issue that casts doubt on financial reporting as a whole. Disclosures in financial reporting are constantly expanding in a piecemeal way as new topics of interest or importance emerge.

4.5.3 Off balance sheet items

In Europe, publicly traded companies comply with International Financial Reporting Standards. And as far as we are aware, before and during the financial crisis, European companies reported in their balance sheets all the liabilities that they should have done.

It is possible that the position was different in the US. One of the issues that emerged from Enron was that the US rules on off balance sheet items were weak. While there were reforms in this area post-Enron, US requirements were still arguably significantly weaker than elsewhere. However, we do not know how far this accounting issue had any effect on the financial crisis. It should not be assumed that, because liabilities were off balance sheet, investors ignored them. In many cases there has been full disclosure, and it is known that investors, making use of these disclosures, have treated some off balance sheet items as though they were on balance sheet.

Research findings 4.2: Off balance sheet items

Investors treat some off balance sheet items as though they were on balance sheet

For evidence on this, see Wayne R. Landsman, Kenneth V. Peasnell and Catherine Shakespeare, ‘Are asset securitizations sales or loans?’ The authors find that the stock market views securitised assets and liabilities held off balance sheet in a special purpose entity (SPE) as though they were none the less on the balance sheet of the originating firm. This finding indicates that such securitisations are really a form of secured borrowing rather asset sales.

4.5.4 Conclusions

Recognition and disclosure seem to be the areas of financial reporting where it is most clear that there were remediable failures in and before the financial crisis. These are being addressed by standard-setters. However, it is not clear that these problems were significant causes of the crisis or made it significantly worse. Those who believe that the reporting model is broken because current disclosures are, in their view, grossly inadequate, will not change their minds because of the expansion of disclosures on financial instruments planned by standard-setters.

5. NON-FINANCIAL REPORTING

It may seem obvious that there should be a model for non-financial reporting by business. How else can we ensure that users get the information they want about the drivers of business success?

Unlike non-financial reporting, financial reporting is heavily regulated, and there are thousands of pages of requirements as to what should be disclosed, how it should be measured, and how it should be presented. Why should non-financial reporting be any different?

5.1 Summary

For non-financial reporting, practice has moved strongly in the direction called for by reformers, so that for many companies their non-financial disclosures are now longer than their financial reporting. But companies rarely follow any externally prescribed model that covers all their non-financial information. And there seems to be no realistic possibility of a prescriptive reporting model that would cover all non-financial reporting and provide a detailed blueprint applicable to businesses generally. The information that different businesses disclose and should disclose is too diverse to be captured by such a model.

Similar objections would not apply to high-level principles for non-financial reporting. Such principles would mean that businesses:

- disclose information that is relevant to their particular circumstances;
- vary their disclosures as circumstances change; and
- experiment in their reporting.

In deciding what to disclose, it is sensible for individual businesses to engage with their stakeholders and other users of their reports. In this way, they can judge what works and what does not, and where additional disclosures may be needed.

5.2 Is there a non-financial reporting model?

In one respect, the reformers have won the argument. No one now disputes the need for a significant degree of non-financial information in business reporting. Indeed, perhaps the most significant change in business reporting in recent years has been the explosion of non-financial information. For many companies, it now outweighs the financial reporting.[24]

HSBC Holdings' annual report provides a well-known example of the growth of business reporting generally and of non-financial reporting in particular.[25]

Table 5.1: HSBC Holdings: annual report and accounts

	Financial statements: pages	Financial statements: %	Other reporting: pages	Other reporting: %	Total pages
1999	61	49	63	51	124
2008	119	25	353	75	472

In less than a decade, while the volume of the financial statements has nearly doubled, other reporting has grown by a factor of almost six and now takes up three-quarters of the annual report. And the annual report is only a part of HSBC's total disclosures in the course of a year. This may be an extreme case in terms of the volume of information, but it is not untypical of the trend for publicly traded companies generally.

Although there is now a mass of non-financial reporting by companies, it does not follow any single model. It may therefore seem premature to ask whether we need a **new** non-financial reporting model when, arguably, we do not have a non-financial reporting model at the moment. In the absence of a widely accepted model for non-financial reporting, such as there is within each jurisdiction for financial reporting, there are none the less:

- some overriding rules for publicly traded companies, such as requirements to disclose any information that would be likely to have a significant effect on the share price;
- some high-level principles that apply to certain parts of business reporting, such as the business review in Europe; and
- more specific disclosure requirements on certain issues, such as information relating to the directors.

[24] Deloitte, *Write from the Start: Surveying Narrative Reporting in Annual Reports*, London: Deloitte, 2008, finds that for its sample of UK listed companies on average 54% of the annual report and accounts is now taken up with narrative reporting.

[25] The 'Other reporting' in the table includes some financial information that does not form part of the financial statements. The distinction is not, therefore, a clear-cut one between financial and non-financial reporting.

There is also a vast amount of voluntary disclosure that follows no clear pattern, but reflects a mixture of managers' wishes as to the messages they wish to get across to outsiders and their assumptions as to what is of interest to users. And all of this varies from country to country and within countries depending on the nature of the business (eg, whether it is a publicly traded company).

So it is misleading to talk of 'the' business reporting model in relation to non-financial reporting. But there are models (though not universal ones) designed for certain aspects of non-financial reporting and it is worth considering the case for developing a comprehensive and universal non-financial reporting model, if only to bring order to the mass of current disclosures.

5.3 The case for a non-financial reporting model

Why is it useful to have a model for any kind of business reporting? A model tells the preparers of information what they need to do, it tells the users of information what they can expect, it may well elicit more disclosures than would otherwise be provided, and (perhaps most importantly) it ensures a degree of comparability in the information disclosed. A model might therefore be expected to be as useful for non-financial reporting as it is for financial reporting.

Those who advocate a non-financial reporting model often start from the limitations of financial reporting and seek to compensate for them.[26] As financial reporting is historical, quantified and financial, their models typically seek to specify what forward-looking, qualitative and non-financial information businesses should disclose. The specific limitation of financial reporting that they most often seek to remedy is its failure to value intangibles. So the models are sometimes designed to address this particular issue, and to specify what should be disclosed in relation to intangibles, rather than to cover business reporting as a whole.

Two options therefore need to be considered:

- a narrower non-financial reporting model, which would just cover intangibles; and
- a broader model that would cover the whole of non-financial reporting.

Why might there be any objection to either of these types of model?

5.4 Problems with a non-financial reporting model

The central problem for any non-financial reporting model is whether it is possible usefully to specify in any detail the information that should be disclosed. If we start with the option of a narrower model, which would be restricted to intangibles, the evidence is that even for this limited objective it is impossible to specify what information should be disclosed. This emerges from:

- research that looks at what information on intangibles is found useful by markets; and
- critiques of existing models for detailed disclosures on intangibles.

The research on intangibles disclosures finds that relevant information is highly diverse, specific to particular businesses and particular circumstances, and changes in response to changes in markets and technologies. An added consideration is that, even for management purposes, managers have difficulty in knowing what non-financial information about intangibles is useful.

Critiques of the disclosure models for intangibles that have been produced to date[27] point out that they tend to require information that is:

- not on the face of it useful, eg, the ratio of PCs to employees; or
- too vague, eg, customer satisfaction; or
- too industry-specific to be appropriate for a general model.

[26] We should make it clear that those who advocate models for non-financial reporting do not assume that there will be no financial reporting. As far as we are aware, they all assume that there will be financial reporting as well. However, the models they propose are sometimes purely for non-financial reporting.

[27] The website www.intellectualcapital.nl provides useful links to material on this subject, including to the Danish Ministry of Science, Technology and Innovation, whose *Intellectual Capital Statements* (2003) gives a large number of potential non-financial indicators for different aspects of intellectual capital (or intangibles).

They also note that it is difficult even to identify a business's intangibles in an objective way; different people tend to come up with very different lists of any given business's intangibles. Also, intangibles (like other assets) work jointly to produce benefits for a business, so it is often impossible to say what contribution they make to a business's success.

Research findings 5.1: Problems with a non-financial reporting model (1)

Critiques of proposed models

Douglas Skinner, 'Accounting for intangibles: a critical review of policy recommendations', addresses the usefulness of proposed models for reporting intangibles: 'there are at least several practical/implementation concerns [relevant to the proposed models]:

> 'First, many of the measures would be industry or firm specific, and so not subject to standardization or comparison (e.g., order backlogs for Boeing).
>
> 'Second, from a reporting and assurance perspective, many of these measures will be difficult to verify in an objective way in part because they often differ across firms and industries and are not measured in a standardized way.
>
> 'Third, proprietary costs of disclosure are likely to be significant and will lead to preparer objections.
>
> 'For these reasons, I believe that such proposals will be difficult to implement as mandated disclosures and so are probably better understood as guidelines for structuring voluntary disclosures. Moreover, to the extent that investors find such disclosures useful, market forces will provide managers with incentives to disclose them if those disclosures pass the cost-benefit test.'

Useless disclosures

In relation to two such recommended disclosures – numbers of patents and numbers of clicks on a website – Wolfgang Ballwieser, 'The limitations of financial reporting', asks: 'What consequences shall we draw after getting such information? The number of patents does not say anything about the cash flows that result when the patents are used. The same applies to the number of "hits" on a website.'

Support for these criticisms seems to come from the fact that very little progress has been made in persuading businesses to adopt a common reporting model for intangibles, even though a number of models have now been available for some years. However, further research on this would be useful, to see exactly how far such models have been adopted and how useful the resulting disclosures are thought to be. (Appendix 5, Question 6.)

There are also problems that relate specifically to historical but forward-looking non-financial information: ie, non-financial data that is indicative of future financial performance.

- Often the time-lag between the non-financial phenomenon and its financial effects is very short. For example, if loss of customers' goodwill results in an immediate loss of customers, then non-financial data on customer satisfaction is hardly a forward-looking indicator at all. The effects will show through at once in the financial numbers.
- The relationship between the non-financial phenomenon and the financial effects is often unknown. In which case, disclosing the non-financial information will not help users in making financial forecasts.

If it is impossible to specify a model in relation to intangibles that would provide useful disclosures for all businesses, then it must on the face of it be impossible also to specify successfully a detailed model for the whole of non-financial reporting. Again, this conclusion seems to be supported by the lack of progress in practice in specifying such a model that is widely accepted by either users or preparers. The case may well be different for specific industries, where useful lists of disclosures are sometimes developed and agreed by the industry. But by definition these are restricted in their application – they do not provide a general model.

Research findings 5.2: Problems with a non-financial reporting model (2)

Relationship between non-financial phenomena and financial effects is often unknown

We invited Christopher Ittner to look at whether measuring intangibles helps improve business performance. His paper, 'Does measuring intangibles for management purposes improve performance?' draws attention to – among other things – the lack of 'causal modelling' in firms to link non-financial measures to financial performance and to firms' tendency to abandon non-financial measures within one or two years of their introduction.

Impossible to specify what information needs to be disclosed

We invited Anne Wyatt to look at what information on intangibles is value-relevant and Andrew Stark to give an overview of research on reporting intangibles. Wyatt, 'What financial and non-financial information on intangibles is value-relevant?', Douglas Skinner, 'Accounting for intangibles', and Stark, 'Intangibles and research – an overview with a specific focus on the UK', all comment on the diversity of information relevant to intangibles and express scepticism as to the value of mandatory frameworks. An interesting implication of Wyatt's study is that 'accounting regulators might better facilitate value-relevant disclosures on intangibles if they give discretion to management to report their firm's economic reality'.

Elisabeth Dedman, Sulaiman Mouselli, Yun Shen and Andrew Stark, 'Accounting, intangible assets, stock market activity, and measurement and disclosure policy – views from the UK', conclude that: 'it is difficult to see how a set of mandated disclosures could be arrived at' and that the research evidence from the UK 'suggests that the appropriate disclosure mechanism involves firms deciding on the content of any such disclosures judged relevant to market participants within a framework providing principles governing such disclosures'.

Vivien Beattie, Bill McInnes and Stella Fearnley, *Through the Eyes of Management: Narrative Reporting across Three Sectors*, also provide extensive evidence of the diversity of non-financial disclosures.

A study by the Organisation for Economic Cooperation and Development (OECD) , *Intellectual Assets and Value Creation: Implications for Value Reporting*, concludes: 'research suggests that any guidance about improved disclosure on intellectual assets should remain principles-based and voluntary. Given the wide range of intellectual assets held by firms in different industries, the principle-based approach allows companies flexibility in applying the guidance and addressing their own circumstances and risks as companies have unique stories with respect to their value creation processes. A more prescriptive approach could engender a box-ticking mechanistic approach to ensure compliance rather than allowing companies to produce meaningful reports tailored to their own circumstances.' The report adds, 'As experience develops, more harmonisation can be encouraged.'

Disclosure lists for specific industries

Stark, 'Intangibles and research', gives a UK example: the Bioindustry Association's *Best Practice Guidance on Financial & Corporate Communications* (2006).

While we are sceptical of the value of detailed general models for non-financial reporting, high-level principles may well be useful. In our view it is sensible to have high-level disclosure principles – such as requirements to disclose any information that would be likely to have a significant effect on the share price. It may also be sensible to have slightly more specific but still high-level guidance, such as in the IASB's *Management Commentary* proposals, or high-level rules such as the EU's requirement, which consists of a few sentences, for companies to prepare a business review. The full requirement in the EU Accounts Modernisation Directive reads:

> '1. (a) The annual report shall include at least a fair review of the development and performance of the company's business and of its position, together with a description of the principal risks and uncertainties that it faces. The review shall be a balanced and comprehensive analysis of the development and performance of the company's business and of its position, consistent with the size and complexity of the business;

(b) To the extent necessary for an understanding of the company's development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters;

(c) In providing its analysis, the annual report shall, where appropriate, include references to and additional explanations of amounts reported in the annual accounts.'

The EU Transparency Directive's requirements for management statements by publicly traded companies also take a high-level approach to defining what needs to be disclosed.

Alternatively, the principles could describe a process for how those preparing a report should consider what to disclose and how to disclose it. Even this sort of approach can become quite detailed, however (eg, the many references in the ASB's Reporting Statement, *Operating and Financial Review*, to what directors 'should consider', 'should [do]', 'should ensure', 'could do', 'may wish to consider' and 'might want to consider'). But a high-level process could be as effective as a high-level disclosure framework.

Provided the principles are at such a high level:

- they avoid the difficulties inherent in trying to design a model that meets all the specific needs of diverse businesses; and
- they also avoid requiring useless disclosures.

Such high-level principles would mean that businesses:

- disclose information that is relevant to their particular circumstances;
- vary their disclosures as circumstances change; and
- experiment in their reporting.

To test these proposals, it would be useful to have a research project to check how effective broadly-stated requirements are in eliciting disclosures. (Appendix 5, Question 7.)

On the question of experimentation, what is needed is not a temporary period of experiment to be followed after a few years by detailed rules once businesses have found out what disclosures are useful. The evidence suggests that the relationship between non-financial information and financial measures is inherently uncertain, and so what is needed is something that allows experiment on a permanent basis. Some stability in disclosures may usefully emerge, and this would aid comparability between businesses and over time, but a desire for comparability should not prevent the disclosure of relevant information.

In deciding what to disclose, it is sensible for individual businesses to engage with their stakeholders and other users of their reports. In this way, they can judge what works and what does not, and where additional disclosures may be needed.

5.5 A comprehensive model

A number of the advocates of a new reporting model have in mind something more comprehensive that would bring together not only all non-financial reporting, but all business reporting. What is sought is sometimes described as 'joined-up' reporting. This seems to imply a comprehensive framework or overarching structure, though those who call for joined-up reporting more often use a different metaphor and talk about 'telling a story' as a way to overcome the fragmented nature of business reporting.

While telling a story obviously makes reporting more readable, there are difficulties with it as a goal, as it implies a degree of selection and emphasis and even artistry that are probably inappropriate in business reporting. Professional users of business reporting tend to regard any 'story' as propaganda. Much of business reporting, if it is to be objective and comprehensive, may well need to be a purely factual matter of record that does not set out to tell a story. Warren Buffett's reports can be cited as evidence against this proposition, but it needs to be borne in mind that they constitute a small fraction of Berkshire Hathaway's total reporting. Most of it is as much a purely factual matter of record as anybody else's.

There is also a question as to how far business reporting needs to be joined up. If the point being made is that companies should not say one thing in the directors' report and something else in the accounts, then clearly this is correct, but it is not something that requires a

reporting model to stop it from happening. If the point is that companies are obliged to repeat the same information in different places in their reporting, then again it is a good point, but sounds like something that could be cleared up by improved regulation, rather than something that requires a reporting model.

It is equally legitimate to take the view that business reporting does in fact cover a number of discrete topics, which require to be reported on separately (though perhaps, for readers' convenience, within the same document), and attempting to join them up as though they were parts of a coherent whole would be an artificial exercise.

It would certainly be difficult to develop a coherent and detailed model that could be prescribed for the whole of business reporting. The type of high-level requirements we have described in the previous section might not even provide models for the whole of non-financial reporting, let alone for the whole of business reporting. The EU's business review requirement, for example, governs only a fraction of many publicly traded companies' non-financial disclosures.

Non-financial reporting has grown in an uncoordinated way because it has been a response to a series of uncoordinated demands for more information. These demands were outcomes of the concerns of the day. They were not such as would have been forecast by anyone sitting down in, say, 1990 and drawing up a schedule for what information people would want over the next 20 years. And disclosure has its own internal momentum. Once a new area for disclosure is opened up, users realise that what they have been told does not quite answer all their questions – or that it prompts new ones. Or circumstances change, and they find they need more information on something that they had not previously regarded as important.

A comprehensive model for non-financial reporting therefore seems to be a pipe dream. We cannot predict now what information people will want in the future. And there is no reason why those who want more information should feel constrained in demanding it because it does not fit into some pre-ordained model of disclosure.

And if there is no realistic prospect of bringing all non-financial reporting within a single comprehensive and prescriptive model, then a single model for business reporting as a whole (of which non-financial reporting forms a part) must also be unrealistic. Again, this is not an argument against high-level principles or guidance, or guidance limited to specific issues or industries for which it is possible to reach agreement.

Research findings 5.3: A comprehensive model

Professional users regard 'stories' as propaganda

See Bill McInnes, Vivien Beattie and Jacky Pierpoint, *Communication Between Management and Stakeholders: A Case Study*. They find that: 'finance professionals and private shareholders had different perceptions regarding the objectivity of the audited financial statements compared to the narrative sections. The finance professionals regarded the front end as propaganda. By contrast, several private shareholders considered that the audited accounting numbers could be manipulated, whereas the personal words of the chairman or CEO had credibility.'

5.6 Greenhouse gases: measurement and reporting

The measurement and reporting of greenhouse gas emissions provide an example of a specific issue on which it should be possible to develop agreed guidance. Currently, there are a number of alternative approaches in use, so there is a lack of comparability in reporting and an agreed approach would be desirable. Indeed, to the extent that it is a purely scientific or technological question, it may be easier to have objective and comparable measures of greenhouse gas emissions than of profits. However, many of the difficulties are essentially those of the allocation of responsibility for emissions.

Some of the problem areas mirror those in financial reporting, for example:

- What are the boundaries of the reporting entity?
- Should leased assets be included?

Other problems are equally difficult, but do not have obvious parallels in financial reporting:

- Which indirect emissions (eg, emissions caused by suppliers or customers) should be included?
- Which emission reductions (eg, purchased carbon offsets) should be recognised?
- Which gases should be treated as greenhouse gases?

And the methodology of measurement is also debatable, as many emissions are not measured directly, but in a conventionalised way: for example, by applying stipulated 'factors' to different types of energy consumption.[28]

In principle, it should be possible to agree on relevant conventions, even if there is no objective way of determining what the 'right' conventions should be. In this respect, measuring and reporting greenhouse gas emissions are analogous to profit measurement and reporting.

5.7 Mapping users' information needs

There is a consensus that business reporting should be designed to meet users' needs. While this may seem to be a statement of the obvious, within living memory it was a revolutionary idea, and advocates of reform may well argue that it is an idea whose consequences have still to be completely reflected in practice.

Some of the reformers take the view that, given the primacy of users' information needs, business reporting should be redesigned – more or less from scratch – to meet these needs. This approach sometimes involves asking users what information they use or would like to have. In the case of sophisticated investors, this often means what information they use (or would like to use) in their valuation models. The assumption is that, having mapped out users' information needs, these would be compared with what businesses actually provide. Businesses would then be required to provide information based on a revised reporting model that reflects users' ascertained needs.

While asking users what information they use and what information they would like are useful exercises and should influence reporting practice, we are doubtful how far this approach can be taken. Investment analysts' models are usually proprietary and this has two implications.

- They may not be completely open about what information they use or how they use it.
- They are proprietary because they are different. Different users use different information in different ways.

Users' needs also change over time. If, for example, assets whose market value is normally of little interest to users are about to be sold, then their market value suddenly does become of interest. The financial crisis has probably changed what information users want on certain types of businesses (such as banks). When things return to normal in the economy, users' focus will change again.

Perhaps more important than any of these points is the fact that analysts are unlikely, if they are doing their job properly, to use their own models in a mechanistic way. Business valuation is not an automated production process, where certain known data are input at one end of it and a standardised product emerges at the other end. Good analysts will take all relevant information into account and will not place predetermined limits on what information is relevant.

Users are therefore in a similar (but converse) position to managers. Just as the overriding rule for managers is to disclose what users need to know, and this cannot be defined in any detailed way in advance, so for users their overriding rule must be to take into account all relevant information. But they cannot know in advance exactly what this will be.

So while it is sensible to ask users about their information needs, it should not be expected that this will lead to a detailed map that can be used to create a reporting model to meet these needs.

[28] Such emissions are in the first place those of the energy supplier, and only indirectly attributable to the reporting entity. A useful guide to many of the issues involved is the UK government's *Guidance on How to Measure and Report Your Greenhouse Gas Emissions* (2009).

Even where users' needs can be identified, this does not necessarily mean that they should be met. There are always risks in asking people what they want if they assume that somebody else will be paying for it. The benefits of providing information need to be compared with its costs, and ideally the costs should be met – possibly indirectly – by those who receive the benefits.

5.8 Success drivers and business models

One of the most insistent demands for better non-financial disclosure is for businesses to disclose the drivers of their success. This is closely connected to the demand for more information on intangibles as it is often said that nowadays intangibles are the key drivers of success.

It is a proposal that, at first sight, it is impossible to disagree with. But one problem in practice is that those who call for their disclosure, and businesses themselves, have very different ideas of what drivers are in this context. The literature on the subject lists an extensive array of what are claimed to be drivers of business success. For example:[29]

- agility
- anxiety
- brand differentiation
- costs
- customer satisfaction
- growth
- human capital
- humane values
- innovation
- leadership
- marketing
- paranoia
- product
- quality
- strategy
- sustainability
- technology
- trust-based relationships.

And it may well be that all of these items are, in their different ways, drivers of business success.

At the same time, it is difficult to see what sort of useful disclosures could be made in relation to a number of them. While it may be true that only the paranoid survive, managers who report that 'paranoia is the key driver of our success' will probably reduce their chances of survival. Even anxiety, though less alarming, is something probably best not mentioned in the directors' report. On the other hand, managers may be only too happy to talk about their agility and humane values, but it may be doubted what useful disclosures would emerge.

Human capital, though almost universally identified as a key driver of business success, is a similarly dubious topic for disclosure. To say that 'our people are our greatest asset' says nothing useful. A number of more objective disclosures have been proposed (eg, ratio of male to female staff, other diversity indicators, expenditure on staff training, staff turnover, number of PhDs employed), but it is difficult to identify information on this point that will help investors to value the business. The key human resource that investors are usually interested in is the quality of top management. But this is something that cannot be assessed simply by referring to a few indices.

[29] This list is based on an internet search using the key words 'business success drivers', which leads to a number of prescriptions from authors and consultants, and, for perhaps the most unusual item, Andrew S. Grove's maxim (and book) that 'only the paranoid survive'.

Identifying business drivers and their contribution to the business faces similar difficulties to identifying intangibles and their contribution to the business. Different people, asked to explain what makes a business successful, will come up with very different answers. It is even possible – and perhaps not uncommon – that a business's own managers do not properly understand what drives their own success. And drivers of success, insofar as they exist at all, make their contribution jointly; it cannot be said – except in an arbitrary or subjective way – how much one driver rather than another contributes to a firm's success. Demand for this sort of disclosure sometimes seems to overlook what in fact makes one business succeed and another fail, which is often simply good management in the one case and bad management in the other. However, it is difficult to see what a business can usefully and objectively disclose on such matters.

Another frequent demand from the reformers is for disclosure of the business model.[30] This overlaps, and is often coupled with, the demand for disclosure of the drivers of business success (and hence with the call for more information on intangibles). In both cases, the request is essentially for managers to explain how the business works and why it is successful.

A business model 'represents an understanding of a business which is intended to show how it works. It simplifies complex relationships and dependencies to enable analysis and comparison.'[31] Such a model can be presented in various ways, depending on the depth of understanding it attempts to impart.

For example, there are high-level descriptions of models, which do little more than say what the business is. So, for example, a classic retailer's business model could be described as: to buy from wholesalers and sell to the public. A variant would be for the retailer to buy from manufacturers. A further variant would be for the retailer to manufacture itself. The disclosure could be given more specificity by saying what it is that the retailer sells, who it sells it to and how it sells it (eg, in shops or over the internet). Disclosure of this sort of high-level model seems to be essential if users are to understand a business, and it is difficult to see why anyone would invest in a business unless they knew at least this much about it.

A second way of presenting a business model is to provide a qualitative explanation of what makes the business successful. Demands for this sort of information are essentially the same as demands for a disclosure of business drivers, but expressed in a different way, and so face the same difficulties.

But a business model can also be presented as something more like an economic model. Here the intention would be to capture the financial essence of the business: to understand how key changes in the business itself or in its environment would affect its results. Disclosure of this sort of information is problematic as it might involve giving away what managers regard as proprietary information or because, as is often the case, it is difficult to know what the connections are between the different elements of business performance.

Although, therefore, the demand for information on business drivers and business models is central for many of those who propose reform of business reporting, it is not entirely clear what it means or whether it would really be worthwhile to meet it. Further work is needed to investigate what information on business drivers and business models could usefully be disclosed, what information is disclosed currently, and how useful it is. (Appendix 5, Question 8.)

[30] One recent call comes from the Accounting Standards Board in the UK. 'It is possible that explicit requirements for business model disclosure could drive better reporting overall as well as filling a gap in information brought to light by the credit crisis': *Rising to the Challenge* (2009).

[31] *Measuring IT Returns*, p 27.

Research findings 5.4: Success drivers and business models

Managers do not understand what drives their own success

Anthony Hopwood gives an example of this from his own experience in 'The economic crisis and accounting: implications for the research community'. He looked into a company that was proposing 'a considerable rationalisation of its information and IT systems', but which did not properly understand the reasons for its own success. When Hopwood examined the matter and mapped out the key information flows in the firm, it emerged that other significant changes that were proposed 'would have eliminated – or at least seriously damaged – the very flows of information that were now seen as being so instrumental in their survival and relative success.' With its improved understanding of the reasons for its own success, the firm was able to make appropriate changes to its plans.

Disclosing business models

Balanced scorecard measures are an instance of the type of 'business model' information that some reformers say should be disclosed. But Robert Kaplan and David Norton, the originators of the balanced scorecard, draw attention to some of the problems of reporting such measures externally:

> 'Executives are properly concerned that anything beyond minimal disclosure could benefit competitors more than existing shareholders. Especially if the Balanced Scorecard is a clear articulation of business unit and corporate strategy, its public revelation could enable competitors to sabotage a well-formulated and executed strategy' (*The Balanced Scorecard: Translating Strategy into Action*).

Similar concerns are noted by Jeffrey Unerman, James Guthrie and Ludmila Striukova in *UK Reporting of Intellectual Capital*. For example, one manager commented: 'It's a very fine line between saying "look this is how we operate and this is what we do, which drives the business", and giving away … the crown jewels of the business'.

6. THE DEVELOPMENT OF BUSINESS REPORTING

When people talk of the need for a new reporting model, it can give the impression that business reporting is an invented or designed product. If the current model doesn't do everything that we'd like it to, we just design a new one.

There are alternative ways of looking at business reporting. They are perhaps more subtle and complex, and they may promise less dramatic change. But they may also be more realistic.

6.1 Summary

We argue that business reporting is best viewed, not in terms of models, but as a complex social institution, which constantly evolves in response to changes in its environment. It also needs to be seen in the wider context of the supply of information about businesses – in which it is just one source, competing with others, but with certain competitive advantages.

Market forces, regulation, ethical and emulatory motives, and pressure from participants in public debate all push business reporting to adapt to changing circumstances. So it would be surprising if, except on rare occasions, it could justifiably be said that 'the reporting model is broken'. Business reporting will always be controversial and there will always be a degree of dissatisfaction with it. But there are grounds for optimism that it should be reasonably well adapted to users' needs and, as long as it continues to evolve, should remain so in the future.

Sometimes there will be a need for radical change, but this will usually be when there have been radical changes in the context of business reporting. Moreover, if people are concerned that business reporting is not fit for purpose, it may be more productive to investigate the environmental causes of its problems, rather than simply to prescribe a new model.

6.2 An evolving institution

While every proposal for reform has to be assessed on its merits, there are reasons for treating calls for a major overhaul of business reporting with at least a degree of initial scepticism.

People tend to think of business reporting as a tool or technique and, if we view it in this light, images of radical change – of outworn, broken models being replaced by gleaming new ones – are not inappropriate. In terms of the delivery of business reporting information, the model has indeed changed in this dramatic kind of way: the primacy of paper delivery has been superseded by electronic media – emails and the internet.

But although the medium of delivery may have an impact on information content, any model for the content of business reporting is likely to change more slowly. In this context, business reporting is best viewed as a complex social institution or body of practices, which constantly evolves in response to changes in its environment, and varies in different societies and in different circumstances. Seen in this light, dramatic change is unlikely to be needed unless there is an equally dramatic change in the surrounding environment. And such changes are likely to be rare – though they are not impossible, and we consider some possible instances of sudden environmental change below. Also, as business reporting is a social institution that varies from one society to another, it is unlikely that it will be equally well adapted in all societies, or that criticisms that are valid in one social context will be valid in others.

Our analysis focuses on individual firms. But individual firms' activities can have systemic consequences. So it is possible that the evolutionary forces that we describe in this chapter are less effective in ensuring that reporting reflects any systemic consequences. We discuss this point below (Section 6.9).

Our analysis also focuses on investors as the principal users of business reporting. But they are not its only users. So again it is possible that the evolutionary forces that we describe are less effective in ensuring that reporting meets other users' needs.

In understanding business reporting as an evolving social institution, various aspects need to be considered. Business reporting is:

- only one of a number of sources of information relevant to understanding a business;
- a market phenomenon, governed by the forces of supply and demand;
- an ethical endeavour, in which participants seek to comply with social norms;
- a source of emulation and prestige;
- a regulated activity; and
- the subject of public debate.

Research findings 6.1: An evolving institution

Business reporting is best viewed as an evolving social institution

The title of Gregory B. Waymire and Sudipta Basu's 'Accounting is an evolved economic institution' indicates the central thesis of their paper. They argue that: 'Accounting, like other economic institutions, has evolved through a path-dependent process over thousands of years wherein current practices are influenced by both the recent and the distant past… Yet, accountants almost exclusively use implicit theories of intentional design to analyze accounting practices'.

6.3 The wider context

Business reporting is one source of relevant information about businesses, but there are many others and the market is a very broad one. A wide range of information is needed to assess a business's prospects. An investor might want to know about, among other things:

- likely growth in the sectors and economies where the business operates;
- its competitors;
- any other factors – eg, changes in technology – that might affect the markets for its products or services.

An investor would also, of course, want information more specific to the business – about its past performance, its management, its plans, and so on.

In some ways, the market for information works like any other market. Where information can give an economic advantage, people will be willing to pay for it, and suppliers will emerge who are willing to provide it, as long as the gains from doing so exceed the costs.

Business reporting works within this broader market for information, and as we saw in Chapter 2, it both competes with and complements other sources of information. Its main competitive advantage is that it is prepared by managers who have unique access to the business's records and unique knowledge of their own intentions. In the case of financial reporting specifically, it has other competitive advantages in terms of its 'hardness'. But, as we also saw in Chapter 2, business reporting has inherent biases and limitations too, and these mean that it can never entirely displace other sources of information.

How does this relate to business reporting as an evolving social institution? As circumstances change and new types of information about a business become relevant, market opportunities emerge for information suppliers. These opportunities may be seized by the business's managers through their own disclosures. But there is also a chance for third party suppliers of information to fill the gap. The boundaries between what is reported by businesses about themselves and what is reported by third parties are fluid. Managers may respond to the emergence of new types of information from third parties (perhaps because the information is not of very high quality), by providing something better. Or they may accept the position and leave it to outsiders to provide the new information that users need. Each party's decisions are liable to change as circumstances change and they learn from experience.

In this way, the existence of a market for information, with a variety of different suppliers, ensures that the totality of information available constantly adapts in response to environmental changes. This is one of the ways in which business reporting is kept up to the mark – as part of a broader system of information provision.

Research findings 6.2: The wider context

Many other sources of information about businesses

Ray Ball and Lakshmanan Shivakumar, 'How much new information is there in earnings?, give a list of examples of information sources other than financial reporting. The third and last group in the list is partly what we would categorise as non-financial business reporting.

> 'Examples of aggregate-level information are statistical releases by the Federal Reserve, the Bureau of Labor Statistics and other Government agencies, prices from capital, foreign exchange and derivatives markets, and releases of survey data on macroeconomic expectations, consumer confidence and sentiment. Industry-level information includes industry association surveys and reports, sales data, prices, hotel occupancy rates, airline capacity utilization, etc. Firm-specific information includes changes in management, changes in strategies, mergers and acquisitions, restructurings, new products, product sales figures and forecasts, factor and product prices, labor negotiations, security analyst reports and forecasts, rating agency reports, and management forecasts.'

6.4 Business reporting as a market activity

To the extent that the information that businesses report about themselves is subject to the forces of supply and demand, one option is for them simply to provide it in return for payment, but in practice this is unusual. In general, where businesses make disclosures in response to a demand for information, they do so without charge and because the business gains if people understand it better.

Imagine, for example, that we have a choice between two businesses, one of which we understand because it is open about itself, and one which we do not understand because it is secretive. Other things being equal, we are more likely to:

- invest in;
- lend to;
- sell to;
- buy from; or
- work for

the business we understand. In dealing with the business that we do not understand, we are taking a greater risk, and we would expect to be compensated for this – by a higher expected return on our investment or a higher rate of interest on our loan, etc. And we may be unwilling to take the risk at all.

Firms therefore respond to market forces when they disclose information about themselves because in doing so they make it easier to do business, and they reduce the costs associated with non-disclosure, in particular the cost of capital. Indeed, there is a vast amount of voluntary disclosure by managers.

Research findings 6.3: Business reporting as a market activity (1)

Business disclosure responds to market forces

Martin Walker, 'How can business reporting be improved? A research perspective', explains the theory: 'If all firms are wealth maximising then they will choose a disclosure level for which the marginal cost of additional disclosure equals the marginal benefit.'

Research findings 6.3: continued

Improved disclosures reduce the cost of capital

Although it may seem obvious that improving disclosure should reduce the cost of capital, in fact, as Baruch Lev has pointed out, 'there is … only scant evidence of a link between improved disclosure and cost of capital, and the estimated reduction in cost of capital is very modest' (*Intangibles: Management, Measurement, and Reporting*).

We invited Christine Botosan to review this question. In 'Disclosure and the cost of capital: what do we know?', she concludes:

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

While this supports the case for more disclosure, it leaves a question, identified in Stephen Cooper's practitioner commentary, as to what types of information have an effect on the cost of capital.

Seth Armitage and Claire Marston, in *Corporate Disclosure and the Cost of Capital: The Views of Finance Directors*, note that managers do not necessarily think in terms of reducing the cost of capital. They may instead think of their objective as improving market confidence or corporate reputation.

There is a vast amount of voluntary disclosure

We invited Russell Lundholm and Matt Van Winkle to analyse why firms do or do not disclose information. In 'Motives for disclosure and non-disclosure: a framework and review of the evidence', they explain the theoretical case for full disclosure. They note that there is evidence suggesting that 'managers are already disclosing everything that they do know' or, to be more precise, suggesting that 'perhaps not much else is known by managers with sufficient certainty to be useful information for the market'. Looking at the flow of publicly disclosed information from IBM over a four-month period of 2005, they note that:

> 'IBM offered seven 'IR viewpoints' discussing strategic and operational aspects of their business, five 'Recent Events' announcements, … four podcasts discussing key business and technology topics, and two 'IR Corner' announcements of specific business developments. They also posted the audio recording and PowerPoint slides from four executive presentations during this period, as well as the extended response to an institutional investor's question about the strategic importance of microelectronics to IBM. Beyond the financial data in the required filings, these disclosures communicated facts about IBM's market share by product line, its estimates of growth in various markets, specifics on new contracts, the terms of an agreement to sell IBM's PC division, assorted legal settlements, hiring plans, plans to acquire software companies, and a refutation of the analysis in a negative analyst report. These disclosures are in addition to the four full time staff working in the IR department who handle personal contact with the 23 analysts covering IBM.'

Jeffrey Unerman, James Guthrie and Ludmila Striukova, in *UK Reporting of Intellectual Capital*, draw attention to the volume of intellectual capital disclosures outside the annual report, especially on websites.

The different types and sources of information about a business are complementary. Users rely on non-financial reporting to supplement financial reporting and on third party sources of information to supplement business reporting (ie, reporting by managers). Managers in turn respond to market and regulatory demands for information that are intended to compensate for gaps or weaknesses in one source of information by extending or strengthening another. The nature of the relationship between the different sources will vary from business to business and for individual businesses over time. In a well-established, predictable business, greater weight might be placed on financial reporting information and less on third party information. For a relatively new business in a market that is hard to predict, where the financial reporting record is therefore likely to be of much less use, the position might be reversed.

Market forces push business reporting to evolve in response to changes in its environment. If users' information needs change, managers have an incentive to meet them. This does not mean that businesses should disclose everything; there may be good reasons not to disclose certain information. Whether they respond to market forces in disclosing information – or how far they do so – depends on various factors, such as the costs and benefits involved and the responses of third party information suppliers.

Research findings 6.4: Business reporting as a market activity (2)

Businesses may have good reasons not to disclose information

Russell Lundholm and Matt Van Winkle, in 'Motives for disclosure and non-disclosure: a framework and review of the evidence', having explained the theoretical case for full disclosure, also explain the 'frictions' that lead to non-disclosure.

Much is not disclosed because it is immaterial. For example, Andrew Marshall and Pauline Weetman, in *Managing Interest Rate Risk and Foreign Exchange Risk*, find that 'on average companies disclose less than 50% of the information that they could provide on objectives, policies and processes for risk management'. But they comment that 'we did not feel that any company was concealing any material information'.

6.5 An ethical endeavour

It may be surprising to think about business reporting as an ethical endeavour, but unless we recognise that it has an ethical aspect, we will not fully understand it.[32] Any disclosure of information involves basic questions of honesty and integrity. Those making the disclosure could:

- be downright dishonest about simple matters of fact (by misrepresentation or omission);
- be careless in preparing it, so that it may be wrong by mistake rather than by design;
- be deliberately biased in making subjective judgements included in the information; or
- present the information in a misleading way.

In practice, most people who prepare business reporting information are honest and conscientious and take pride in their work. They do not set out to mislead, but to convey an accurate picture of what the information is intended to represent. In financial reporting, this objective is described in some jurisdictions in terms of requirements to 'give a true and fair view' or to 'present fairly', but clearly a similar objective is implicit in all business reporting. It could equally well be said that it is about telling the truth or, in terms of the preparer's work, doing a good job.

How does this relate to business reporting as an evolving social institution? Those who prepare business reporting information are aware of the environmental changes that surround their work. They know that what they have to report has to evolve to reflect changes in what is being reported on and changes in users' needs. They may be compelled by regulation to change what they report or be persuaded by market forces. But because they are trying to do a good job, honestly reporting what matters, they are in any case likely to adapt what they report so as to respond to changing circumstances.

This influence on business reporting is one that arguably depends on the individual preferences and attitudes of the managers responsible for a particular business's reporting as much as on enduring corporate cultures. And individuals who are in a position to affect the quality and content of corporate reporting may do so in more than one business in the course of their careers.

6.6 A source of emulation and prestige

It may also be surprising to think about business reporting as a source of emulation and prestige, but this aspect of it provides an important evolutionary mechanism.

Business reporting by publicly traded companies is a public activity. In certain respects (essentially disclosure and presentation), people are able to see who is doing it well and who

[32] On this subject, see the ICAEW report, *Reporting with Integrity*.

is doing it badly. When those engaged in business reporting encounter a new problem or want to rethink how they report or what they report, they look at how other people do it. They may do this by looking directly at other firms' reports or by consulting textbooks or by referring to sources of good practice examples (eg, www.corporatereporting.com or the work of the Report Leadership group: see Appendix 2). People will copy what seem to them to be the best examples, given their particular circumstances.

The large number of prizes that are given for outstanding annual reports or accounts and the considerable interest that such awards arouse among preparers are signs of the pride that they take in their reports. Relevant awards include the:

- Africa investor Financial Reporting Awards
- Australasian Reporting Awards
- BDO Stoy Hayward Property Accounts Awards
- Canadian Institute of Chartered Accountants' Corporate Reporting Awards
- Global Reporting Initiative's GRI Readers' Choice Awards
- League of American Communications Professionals' Vision Awards
- PricewaterhouseCoopers' Building Public Trust Awards.

Such awards are likely to have some effect in their own right. This will be partly through the inducement to excellence that they provide, but more importantly because the prize-winners provide models that other businesses are likely to use as a source of ideas. Awards are therefore a way of advancing and disseminating best practice – not just a way of recognising it.

The role of emulation and prestige in business reporting's evolution as a social institution is therefore a significant one. Preparers learn from other preparers who seem to be doing a good job. As this activity does not take place in a vacuum – what is 'best' is best in relation to a particular environmental context – it provides an adaptive mechanism of reporting evolution.

It would be useful to investigate this area further and to consider it in the context of the broader question: Why do businesses improve their reporting? Looking at specific examples of changes in reporting practice, how do they occur? How far do businesses learn from one another in reporting, and what role do awards play in this process? And bearing in mind our argument in the preceding section, how far can individual managers affect the development of business reporting? (Appendix 5, Question 9.)

6.7 A regulated activity

The information disclosed by businesses is heavily regulated – especially its financial reporting component. We may distinguish two purposes of regulating reporting:

- to produce information for the benefit of third parties; and
- to produce information that will be used by the regulators.

We consider these in turn below.

Information for third parties. Much information disclosed by businesses is in the public domain. This is partly because of regulatory requirements to publish information, but also because information issued privately by businesses – eg, to shareholders – often goes to so many people that it is effectively impossible to keep it private. In this respect, business reporting, like other forms of information, is not in a typical market as its output is frequently a public good, to which all interested parties have free (or nearly free) access. If matters were left purely to market forces, therefore, information production by businesses might well be less than optimal as they receive no payment for it from its consumers. This provides one argument for regulation of business reporting – to try to ensure that there is an optimal level of production of a public good. As the production of public goods has a cost, the objective is not to maximise them, but to increase their production to the point where the marginal cost equals the marginal benefit. This is the optimal level of production.

Another motive for regulation is to ensure fairness among interested parties. For example, one shareholder may be able to access information that is unavailable to others and so enjoy what might be seen as an unfair advantage (through insider trading). For this reason disclosures are often regulated to ensure that all interested parties are treated in the same way, which leads to requirements for public disclosure.

Other objectives of regulation include:

- reducing information asymmetries between insiders (eg, managers) and outsiders (eg, shareholders). In some circumstances, this may mean protecting investors and others from being defrauded;
- reducing the social and contracting costs of disclosure; and
- securing comparability of information and network effects from the use of a common 'language' of business reporting.

Whatever the justification for intervention, a good regulatory regime for business reporting will supplement and improve the working of the total market for information about businesses. In this way, it helps business reporting adapt to its changing environment.[33]

Information for regulators. The most common form of regulation of reporting so as to produce information that will be used by the regulators is in the field of taxation. In a number of jurisdictions, financial reporting has historically been shaped to a large extent by the needs of tax authorities. Indeed, as far as private companies and the accounts of individual companies within groups are concerned, the tax authorities are often seen as the principal users. However, industry regulators have also influenced reporting in specific sectors, such as banking and insurance. Both tax authorities and industry regulators may adjust financial reporting information for their own purposes or may demand completely different information. The influence of regulatory needs on financial reporting is perhaps less widely supported now than it was in the past, but this is an ongoing debate. In practice, there is no doubt that in many jurisdictions regulatory needs have influenced reporting requirements.

Research findings 6.5: A regulated activity

Justifications for regulation

On the advantages and disadvantages of standards, see Geoff Meeks and Peter Swann, 'Accounting standards and the economics of standards'. For a more sceptical view of regulation, which also distinguishes between voluntary and mandatory accounting standards, see Ray Ball, 'International Financial Reporting Standards (IFRS): pros and cons for investors'.

Reducing the social costs of disclosure

Robert Verrecchia points out that in practice 'public disclosure and private information-gathering are complements and not substitutes' ('Policy implications from the theory-based literature on disclosure'). Public disclosure therefore tends to raise social costs because it stimulates private information-gathering. 'Social costs' in this context cover both the preparers' costs of preparing and disseminating information and the users' costs of preparing their own private information based on the public disclosures.

6.8 Recent changes in the market for information

We mentioned earlier in this chapter that a significant change in recent decades has been the rise of electronic media to displace print as the primary medium for transmitting information. This, and other environmental changes, may well have been sources of radical change in the volume of business reporting.

- The IT revolution means that information is significantly cheaper to produce and disseminate and – on the user's side – to access and analyse than it was, say, 30 years ago. As the cost of information has therefore fallen significantly for both producers and consumers, we would expect both a rising demand for information and a growing willingness to provide it.
- There has been a huge growth in the scale of international capital markets – again by comparison with, say, 30 years ago even though they may have shrunk temporarily as a result of the financial crisis. Again this affects both supply and demand factors for information. As more money is available to invest, greater expenditure can be justified

[33] The regulation of business reporting is the subject of an ICAEW Information for Better Markets Conference in December 2009. Papers from this conference are expected to be published in the annual *International Accounting Policy Forum* special issue of *Accounting and Business Research* in 2010.

on research on where to invest it. And as more capital becomes available, and investors become more sophisticated in their use of information, the gains to business of attracting capital by better disclosure become more obvious.

- An important driver of the volume of information is that as businesses become bigger and more complex, and engage in new and more complex forms of transactions, there is more to disclose.
- Disclosure generates its own demand. As more information is disclosed, users invest more in analysing it and, through analysis, generate their own private information. This in turn generates more questions that users want answered and so leads to demands for greater disclosure.

When all these factors are taken into account, it is unsurprising that there has been a rapid growth in the volume and complexity of business reporting in recent decades. Businesses themselves see many of their disclosures as being purely for the purpose of meeting regulatory requirements, and there is no doubt that there has also been a steady growth in such requirements in recent decades. But it is an open question how far regulation has an effect that is independent of supply and demand. To some degree, it may well be merely codifying or anticipating developments that would – though with less uniformity – take place anyway. We return to the problem of length and complexity in the next chapter.

We have suggested that much of the increase in disclosure by businesses is a response to market forces rather than regulatory requirements, but it may be difficult to disentangle the effects of the two. Useful research questions on this subject would be: How much disclosure by businesses could be regarded as voluntary rather than regulatory, and how have the relative volumes of the two changed over time? How far does compliance with regulatory requirements lead to what are in effect voluntary disclosures through 'good' disclosers providing more information than 'poor' disclosers? (Appendix 5, Question 10.)

Research findings 6.6: Recent changes in the market for information

An open question how far regulation has an effect independent of supply and demand

Ray Ball, 'What is the actual economic role of financial reporting?', poses a number of questions about the relative roles of markets and the political/regulatory process and comments that 'accounting standards are shaped in large part by user demand'. Questions that he suggests for further investigation include:

- 'What is the dominant effect on financial reporting practice – markets or politics and regulation?'
- 'How different would financial reporting practice be without market regulators … and without the involvement of governments …?'
- 'To what extent are the accounting standards promulgated by the FASB a codification of what constitutes generally accepted accounting principles (a market-based common-law criterion, under which individuals are held to widely accepted standards of behavior) as distinct from Generally Accepted Accounting Principles (a fiat-based code-law criterion)?'

6.9 Systemic issues

We have already discussed some of the criticisms of financial reporting in the financial crisis (Chapter 4). However, they also raise wider issues that are relevant to this report.

- If business reporting has systemic impacts, how effective are the evolutionary forces that shape business reporting likely to be in addressing such impacts?
- How effective is business reporting in reflecting systemic risks and uncertainties?

The evolutionary forces that we have described above are mainly relevant to shaping business reporting for investors in individual firms. If reporting has systemic effects, then it is difficult to see how market forces are likely to make it address these consequences. On the other hand, governments and regulators are likely to be keenly interested in them. So regulators may well shape business reporting so as to address whatever its systemic effects are thought to be.

Whether this will make business reporting less useful for investors (something that might itself have systemic effects) is an important question.

As noted in Chapter 4, some critics of business reporting's role in the financial crisis claim that there was inadequate disclosure of risk by certain financial institutions. The ICAEW has for some time argued the case for better reporting of risk.[34] But we suspect that, in the run-up to the financial crisis, the primary failure in this respect was that managements (and almost everybody else in the market) underestimated certain risks, especially systemic risks, rather than that they knew about them and failed to report them. So the problem may be one of risk assessment, rather than risk reporting. However, this is an issue that needs to be properly investigated. (Appendix 5, Question 11.)

6.10 Reasons for optimism

There are therefore good reasons why we would expect business reporting to be responsive to changes in its environment. We would not expect it to become so divorced from users' needs that its critics can reasonably say that 'the model is broken' or that it needs a root and branch reform. This would imply a severe and concurrent failure of all the forces that push business reporting to adapt to its environment.

An example of significant, but evolutionary adaptation to changing circumstances can be seen in the recent development of financial reporting. Novel financial instruments became an increasingly important feature of business activity, especially in financial services, in the 1980s. From the 1990s onwards, financial reporting responded to this development by adopting a fair value measurement basis for many financial instruments. This has been a significant adaptation of reporting practices, but not a revolutionary one – most financial reporting remains on a historical cost basis. As we have seen, debate continues on whether there should be further moves towards or away from the use of fair value.

There are times when more radical change is needed. Again, this can perhaps be best seen in the case of financial reporting. One of the assumptions that underpin financial reporting is that there is a satisfactory reporting currency – ie, the currency in which the accounts are drawn up. The reporting currency is normally a firm's local currency, but when this is affected by hyperinflation it is no exaggeration to say that accounts drawn up using it are meaningless or that the reporting model is – in this respect – broken.

Hyperinflation of course has far more important effects than merely spoiling the work of accountants. Indeed, as business reporting is a social institution embedded in a wider network of institutions, including the legal framework and the rule of law, we might hazard a generalisation that it is unlikely that situations will arise where it can justifiably be said that the reporting model is broken unless other, more important, social institutions are broken too. This may be because of the pace of environmental change or because institutions have lost their capacity to adapt quickly enough.

Business reporting might also conceivably become incapable of responding adequately to environmental changes if regulatory controls or the legal framework inhibited or even prevented its evolution. For example, business reporting could become so heavily regulated by standard-setters and securities regulators that businesses lost all freedom to innovate, and the regulators themselves might fail to respond appropriately to changing circumstances. Or the regulation of financial reporting might have other objectives than the production of useful information for investors – for example, meeting regulators' own information needs. Or the legal framework could inject such a fear of litigation into those who prepare accounts that they are reluctant to say anything useful in case it exposes them to lawsuits.

But while financial reporting by publicly quoted businesses in the world's leading economies is now so heavily regulated that sclerosis is a risk, business reporting as a whole still leaves considerable freedom to businesses to decide what sort of information they will disclose (including non-GAAP financial reporting measurements). And while there are jurisdictions in which litigation is an ever-present threat, it is arguably as much an incentive to good reporting as a deterrent. For the time being, therefore, it remains a reasonable assumption that business reporting should be able to adapt successfully to changing conditions.

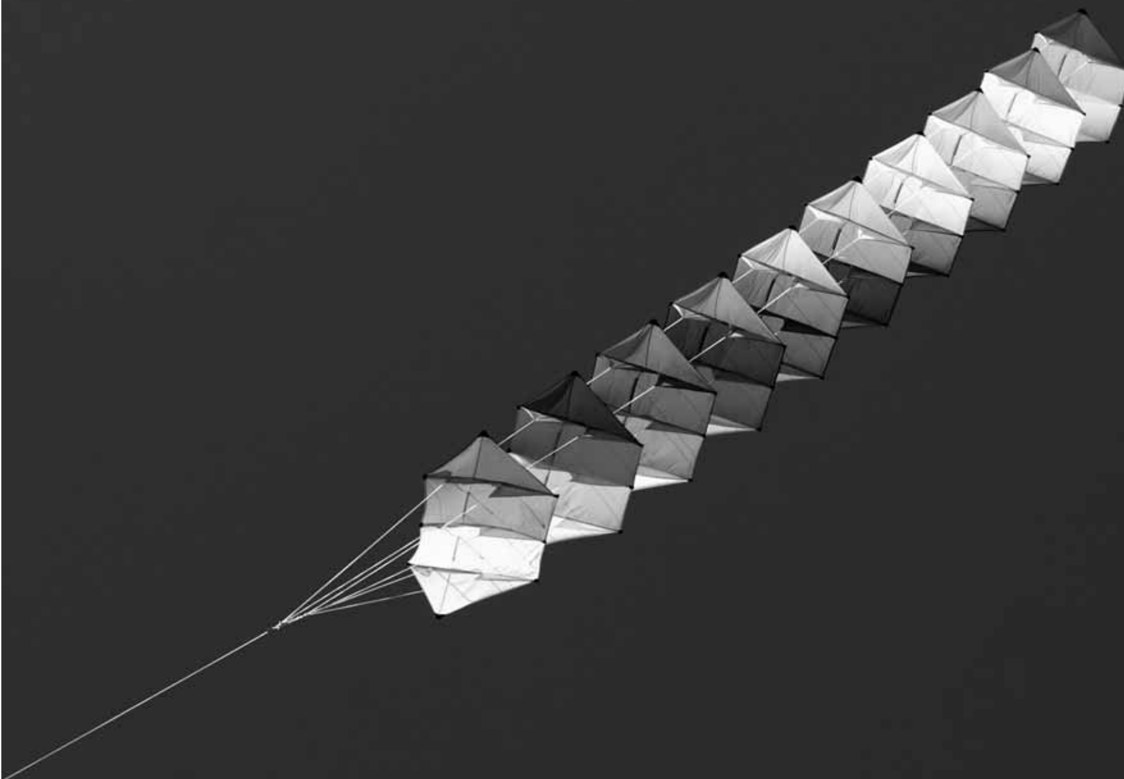
[34] ICAEW, *No Surprises: The Case for Better Risk Reporting*, London: ICAEW, 1999.

If people are concerned that business reporting is not fit for purpose, it may be more productive to investigate the environmental causes of its problems, rather than simply to prescribe a new model. The regulatory and legal frameworks should be examined to see why businesses are unwilling or unable to respond to legitimate demands for information. Unless the underlying causes of failure are addressed, the diagnosis may be mistaken and the prescribed cure is unlikely to work. And as regulatory and legal frameworks vary from one society to another, there is unlikely to be a uniform set of answers to such questions. What works in one society will not work in another, and different societies will have varying degrees of success in evolving appropriate business reporting practices.

7. LENGTH AND COMPLEXITY

When annual reports are liable to be 400 pages or more, it's no surprise that people begin to ask whether things have got out of hand. Managers feel that they have to devote too much time to preparing ever-longer reports that they suspect no one ever reads. And how are users to find their way around this mass of information? How can they see the wood for the trees?

But there are other, less gloomy, ways of looking at the issues of length and complexity.



7.1 Summary

Business reporting for many companies has indeed become long and complex, but this is a rational response to changing circumstances. While unnecessary length and complexity should be removed, the real issue is often 'How do we cope with length and complexity?' One way of doing so is to produce shorter and less complicated reports for those who want them. Another is to rely on intermediaries such as analysts and journalists who filter long and complex reports, and aggregate them with other sources of information, into forms that the ultimate consumers of information can digest.

7.2 The problem

Whatever the causes of reporting's recent expansion, there is a perception that reports are becoming too long and complex. Length and complexity are, in themselves, undesirable. Other things being equal, the shorter and simpler any communication can be, the better.

This is an area where a degree of scepticism may be appropriate. As we noted earlier (Section 6.8), there are good reasons why reporting has become longer and more complex: changes in IT dramatically reducing the costs of supplying and using information; the rapid growth of capital markets; the greater size and complexity of firms and their transactions. While we may sympathise with nostalgia for the lost brevity of a simpler past, longer and more complex reporting is not an arbitrary development. It is a rational response to a changing world. It is perhaps also worth noting that the expansion of reporting is not just a development of the past generation. In the UK, annual reports approximately doubled in length between 1920 and 1935 and doubled again by 1950 – to what at the time, no doubt, seemed the inordinate length of 15 pages on average.

It could also be argued that an annual report of several hundred pages is not disproportionate for a company whose market capitalisation may well be in the tens of billions. A visitor from Mars, with no preconceptions about the length of annual reports, might not find it incongruous that a highly valued company should have to produce a large amount of information. In business, it is not unusual for a single contract to be hundreds of pages long. Summarising a large multinational's entire performance, position and prospects in a few hundred pages is arguably a triumph of compression.

However, there is an argument that a long report makes it more difficult for the user to find the information that matters. In one respect this is unconvincing. It could be argued that what matters are the principal financial statements, and it is usually easy enough to find these. As for the rest of the information, what is important is a subjective judgement. Management almost invariably highlights the information that it considers most important. It could also highlight certain information as, in its opinion, unimportant, but some users will almost inevitably disagree – or have their suspicions aroused.

Users who claim that they receive far too little information note that while board members in a publicly traded company may receive a monthly report that is several inches thick, investors have to make do with about half an inch a year. These are the critics who think that the reporting model is broken because it discloses far too little. Significantly, there are few complaints from users that companies disclose too much information. Indeed, a recent report notes that:

> 'Not everyone agrees that the length of reports is a problem. Many large institutional investors say they are happy for reports to contain as much information as possible, and they will decide what they want to use.'[35]

Where length and complexity can be reduced without a loss of useful information, clearly they should be. It is sometimes said in relation to company reporting that 'nobody reads all this stuff'. If the point being made is that no user sits down and reads a set of financial statements from beginning to end, then this may not be a fair criticism. A set of financial statements could be seen as akin to a newspaper or a work of reference; nobody reads them from end to end, but this does not mean that there is something fundamentally wrong with either newspapers or works of reference. Most readers of accounts, for example, may skip the notes on pension costs or on financial instruments. But a few users may find that these provide

[35] Financial Reporting Council, *Louder than Words: Principles and Actions for Making Corporate Reports Less Complex and More Relevant*, London: FRC, 2009.

useful information. If the point being made is that there is some material in the annual report that nobody ever reads, then such material should of course be removed. It may be, of course, that the material that everyone ignores is what managers put in their reports voluntarily, to convey a particular image of the business.

It is also sometimes said that even all the directors do not understand everything in the accounts. At first sight, this is a more worrying claim. However, it depends what its factual basis is. Accounts have always included particular amounts whose calculation is probably more or less of a mystery to most directors. Manufacturers' costing systems, which underlie measurements of stocks and work-in-progress, are often extremely complex and few in the business may understand them fully. Actuarial valuations, which impact the accounts of both insurers and businesses with defined benefit pension schemes, require considerable technical skill and non-actuaries cannot be expected to understand them as well as an actuary can. Many financial instruments are inherently complex and it is quite likely that not all directors in a financial services business will understand all of them; their measurement for accounting purposes may in fact be easier to understand than the instruments themselves.

There is an important difference, of course, between understanding what figures mean and understanding how they are calculated. The basic concepts of accounting – income, cost, current value – are quite simple. Every director should understand them. But there is no need for them to understand exactly how the numbers are calculated. There is a legitimate division of labour within a business. Different people understand different aspects of preparing the accounts. As long as their work is properly supervised and coordinated, this should not be a problem. Accounting for large, complex businesses is in this respect no different from any other complex process (eg, manufacturing or design); people with different specialist skills contribute to different aspects of the process – nobody is a specialist in every aspect of it.

Research findings 7.1: Length and complexity: the problem

Annual reports doubled in length between 1920 and 1935 and again by 1950

For the evidence on this, see A. J. Arnold and D. R. Matthews, 'Corporate financial disclosures in the UK, 1920-50: the effects of legislative change and managerial discretion'. The authors note that during the period 1920-1950: 'The major companies became steadily more reliant on funds raised on the Stock Exchange and this tended to reduce the dominance of their founding families. Some companies began to think about making their financial reports more informative and interesting to readers and less legalistically minimal. Thus, an instinctive desire to keep information secret began to come into conflict with a more professional, managerial awareness of the importance of better public relations.'

7.3 Possible solutions

In considering what degree of length and complexity are appropriate in reporting, it needs to be borne in mind that the benefits of complex and extensive disclosures are likely to vary with the size of the company, whether it is publicly traded or privately held, and so on. Financial reporting requirements need to be proportionate, and jurisdictions reflect this in various ways. In the UK, for example, there is currently the *Financial Reporting Standard for Smaller Entities* (FRSSE). And internationally there is now the *IFRS for SMEs.*

The means of delivering and accessing information are also relevant. A 400-page printed report that arrives in the post is more burdensome than the same volume of information that can be selectively accessed online.

However, our analysis suggests that it is probably realistic to start from the assumption that the large, modern, multinational, publicly traded company is likely to have a large amount of information to report and that some of it will be quite complex. The question then is: How do we cope with this situation? In answering it, points to bear in mind include:

- Users of business reporting are not obliged to read everything businesses publish. Companies themselves recognise that users cannot be expected to read several hundred pages of annual report. So they publish a few pages of highlights at the front.

- Indeed, for many users, there is no compelling reason why they should read anything published by a business itself. Instead, they may get their information perfectly satisfactorily from third parties – newspapers, magazines, analysts' reports, and so on.

Possibly the presentation of financial reporting information could be improved by being structured better, with key messages shown briefly, clearly and prominently. Maybe this kind of structuring could be made part of the requirement to give a true and fair view or to present fairly. This sort of development assumes that it can be agreed what in the accounts is important and what is not important, which is likely to be difficult. It may, though, be worth at least investigating whether anything can be done to highlight the more important information in accounts and possibly this could involve updating the 'true and fair view' requirement. The Audit Quality Forum publication *Changes in Financial Reporting and Audit Practice* suggests:

> 'Arguably, the need to be clear and, where possible, concise, is an element of the true and fair view on which both preparers and auditors have to make a judgement. Perhaps it should be made more explicit, so that part of the job of management is to ensure that users of financial statements can see the wood for the trees.'

As noted above, many companies are already highlighting what they consider to be key points, so there is a question as to whether this kind of structuring would improve on or codify existing best practice. In order to pursue this idea, it would be helpful to make use of what is known from research in other fields on how readers (of printed texts or websites) process information, so that the presentation of financial reporting information can take advantage of current knowledge. (Appendix 5, Question 12.)

8. THE WAY FORWARD

Few people would regard business reporting as a suitable subject for rhetorical flourishes. But because it's a topic of public debate, there is a constant temptation to overstatement – on both sides of the argument. The common view seems to be that those who fail to exaggerate will simply be ignored.

Yet this cannot be the best of way of discussing the future of business reporting. Proposals for reform should be grounded in research, not rhetoric.

8.1 Summary

Advocates of new reporting models are participants in a public debate in which there is a struggle for attention. And framing the debate in terms of the search for a new reporting model is a rhetorically attractive strategy. But it presents too dark a picture of the current state of business reporting and encourages unrealistic expectations of how much can be achieved.

The debate on the future of business reporting needs to be reframed – not as a stark choice between an old model and a new one – but in terms of the need for continuing evolutionary improvements. Proposals for reform have to be assessed on their merits and many of them will be justified. So a series of small debates on particular issues is more likely to be fruitful than a big debate on grand schemes of reform.

But precisely because business reporting evolves in response to its environment, it is also possible for that environment to push it in the wrong direction or to stunt its evolution. Excessive or misguided regulation, for example, or a defective legal framework that encourages a focus on liability problems rather than communication, may lead reporting astray. So the forces that shape reporting – as well as reporting itself – need to be kept under constant and critical review.

There is a need for further research on a number of matters, and the quality of the debate on the future of business reporting would be improved if more effort went into looking at how far proposals for change either are supported by existing research findings or can be tested by future research.

8.2 The rhetoric of public debate

There are two perennial and apparently contrary features of business reporting:

- It constantly adapts to its changing environment, and it is unlikely except on rare occasions to be in a state where it can reasonably be claimed that 'the model is broken'.
- Although it adapts to its changing environment, the process is not instantaneous or automatic and it is usually far from obvious exactly how it ought to adapt. And when reporting does change, it is always open to argument whether it has changed in the right way or whether a different adaptation would have been better. This leaves room for public debate on business reporting, and an important role for those who engage in critical thinking and careful analysis – both of existing practices and of ideas for how they might be reformed.

So while there are reasons for optimism about business reporting, there will always be a degree of dissatisfaction with it. As there are few incentives for understatement in public debate, dissatisfaction and proposals for reform will often be stated in extreme terms – eg, 'the model is broken'. The same temptations to overstatement exist on the other side of the debate, and modest improvements are liable to be condemned as dangerous innovations that will put everything at risk. The rhetoric is just another factor in the evolutionary process.

As we noted earlier, one element of hyperbole is the use of the term 'model' in discussing business reporting, and in particular assertions that 'the model is broken' or that we need a 'new model'. The terminology seems to imply a black-and-white choice between static options. But, as we have argued in this report, it is usually more helpful to think in terms of evolutionary change. It is no mystery, though, why the rhetoric of broken models is more attractive, or why people think it is a better strategy to make public calls for revolution, rather than for evolutionary adaptations.

As long as business reporting matters, it will always be controversial. But we should not see the perpetual criticism of business reporting as something inconsistent with the reality that it is, to a large degree, well-adapted to its environment. The criticism and debate, and the proposals for reform, are among the forces that ensure that there is a process of adaptation and that the direction it takes is more likely to be a sensible one.

There are a number of respects in which, in the current debate, there is a tension between rhetoric and reality or a tendency to gloss over conflicts between competing demands.

1. **Do people want more information or less complexity?** Almost all demands for major reform of business reporting call for the disclosure of more information. Sometimes this is phrased as a call for added granularity or enhanced disclosure. While length and

complexity are not the same thing, the two issues are related, and those who complain about complexity often cite the length of reports as evidence of the problem. However, there is a tension between demands for greater disclosure and demands for less complexity.

2. **Do people want a 'management approach' or do they want comparability?** Some of the recent calls for reform have stressed the desirability of external reporting being better aligned with the information that managers use in running the business. There are advantages in this approach, but there is a tension between it and users' demand for comparability.

3. **Why do people seem to overlook the huge amount of non-financial reporting?** Businesses produce a great deal of information that is not financial reporting. For many companies, as we have seen, non-financial reporting now outweighs financial reporting – even in the annual report and accounts. Continued calls for more non-financial reporting sometimes seem to overlook this.

4. **Why do people think the market is obsessed with earnings numbers?** The market uses all the information available to it, and this includes a great deal of information that is not financial reporting (or even anticipations of financial reporting). Yet some advocates of more non-financial information continue to talk as though the opposite were true. (Appendix 5, Question 13.)

5. **Why do people think that managers should give investors all the information they need to value the business?** Managers have limited knowledge and certain inherent biases. It does not make sense for users to expect to obtain exclusively from a business's managers all the information that they need. Instead, reporting by managers has to be seen as part of a larger market supplying information relevant to the assessment of businesses. Yet some reformers seem to assume the opposite.

6. **Why do people demand information on success drivers and business models when it's not really clear what they are?** Investors would like to know what makes a business successful. This sounds like a reasonable demand. The problem is that no one yet has pinned down what it means in a way that could be translated into meaningful disclosure requirements or even principles.

Different calls for reform make different assumptions and probably no one makes all the dubious assumptions or overlooks all the conflicts that we have just listed. But they are all features of the debate, which would be raised to a higher level if, on these issues at least, there were a closer match between rhetoric and reality.

8.3 Reframing the debate

Continuing calls for a 'new reporting model' may be helpful as a way of attracting attention to important issues, but unhelpful as a way of understanding them. Those we have seen do not make a convincing case that there is a need for radical, rather than evolutionary, change. This does not mean that there is no need for change in business reporting. There is and probably always will be. We may say of business reporting – as the Red Queen says in *Through the Looking Glass* – that 'it takes all the running you can do, to keep in the same place'.

The changes that business reporting needs are unlikely to be capable of being labelled in a way that captures what they are all intended to achieve, as though they were all parts of a single grand project. The International Accounting Standards Board, for example, has nearly thirty distinct current projects. All that it can be said they have in common is that they are meant to improve financial reporting.

Framing the debate in terms of the search for a new reporting model has the rhetorical allure of revolutionary change. But it presents too dark a picture of business reporting now and encourages unrealistic expectations of how much can be achieved. The debate needs to be reframed, not as a stark choice between an old model and a new one, but in terms of continuing evolution through many, diverse changes.

Every proposal for reform has to be assessed on its merits and many of them will be justified. Claims that the reporting model is broken or that we need a new reporting model also, therefore, need to be assessed on their merits, but also deserve at least an initial scepticism.

But precisely because business reporting evolves in response to its environment, it is also possible for that environment to push it in the wrong direction or to stunt its evolution. Excessive or misguided regulation, for example, or a defective legal framework that encourages a focus on liability problems rather than communication, may lead reporting astray. So the forces that shape reporting – as well as reporting itself – need to be kept under constant and critical review. This is a task that each society has to undertake for itself. What is appropriate in one context may not be appropriate in another.

8.4 The importance of research

In preparing this report, we have relied heavily on the research that we commissioned as a follow-up to *New Reporting Models for Business*, and we believe that this has contributed significantly to our understanding of the issues. As we have noted, there is a need for further research on a number of matters (these are brought together in Appendix 5), and this may challenge the arguments we have put forward here. Also, there are questions where existing research findings or the conclusions to be drawn from them are disputed, so again there may be challenges to our own conclusions based on this research.

Nor do we claim to have seen more than a fraction of the very large volume of research relevant to the issues addressed in this report. We would therefore welcome information on relevant work that might lead to different conclusions.

One of the characteristics of the debate on the future of business reporting, however, is that there is often little or no attempt to base it on research. This may be because the participants in the debate see no need for research or are sceptical of its value. Yet those who contribute to the debate often make important assumptions about business reporting or its users and effects that seem to be at odds with what is already known about these things. In our view, the quality of the debate would be improved if more effort went into looking at how far proposals for change are either supported by existing research findings or can be tested by future research.

Appendix 1: Proposals discussed in *New Reporting Models for Business*

This appendix briefly reviews the 11 proposals for reform discussed in *New Reporting Models for Business* and subsequent developments in relation to them.

A1.1 The Balanced Scorecard

The Balanced Scorecard: Translating Strategy into Action (1996) by Robert S. Kaplan and David P. Norton expands on the ideas in the authors' well-known 1992 article in the *Harvard Business Review*, 'The balanced scorecard – measures that drive performance'.

The balanced scorecard is primarily about management and internal reporting rather than external reporting. However, Kaplan and Norton argue that the financial accounting model was designed for a world that is now past. In particular, it fails to reflect a company's intangible and intellectual assets – 'the very assets and capabilities that are critical for success in today's and tomorrow's competitive environment'. They argue that managers need a balanced scorecard of measures, with information from financial, customer, internal business process, and learning and growth perspectives.

While the balanced scorecard is not designed for external reporting, Kaplan and Norton suggest that there would be benefits if balanced scorecard information could be communicated to outsiders: 'the best financial reporting policies will eventually be derived from the best internal reporting policies'.

Since the original publication of Kaplan and Norton's ideas, balanced scorecard approaches have been adopted for management purposes by many companies. But few firms refer to the balanced scorecard in their external reporting. This will probably not surprise Kaplan and Norton as they identify a number of reasons why companies are unlikely to disclose balanced scorecard information publicly. In particular, 'executives are properly concerned that anything beyond minimal disclosure could benefit competitors more than existing shareholders'. However, firms are now disclosing far more non-financial information than they used to, and it is possible that this derives from data used in a balanced scorecard approach to management, even if it is not presented in that format publicly.

A1.2 The Jenkins Report

Improving Business Reporting – A Customer Focus ('the Jenkins Report'), was issued in 1994 by the American Institute of Certified Public Accountants. Its key demand is that 'Business reporting must keep up with the changing needs of users or it will lose its relevance.' By users, it means the providers of finance to business.

The report makes a number of criticisms of financial reporting and calls for extensive disclosures of non-financial and forward-looking information and better alignment of internal and external reporting. It also calls for the development of a comprehensive business reporting model and puts forward one such model itself.

The Jenkins Report led to a number of follow-up reports by FASB, but the last of these appeared in 2001. As with other proposals that we examined in 2003, it could be said that its calls for more forward-looking and non-financial disclosure have now to a degree been met. However, actual disclosures have not precisely matched the report's recommendations or followed the model that it recommended.

A1.3 Tomorrow's Company

Tomorrow's Company: The Role of Business in a Changing World was published in 1995 by the Royal Society of Arts. This report led to the setting up of Tomorrow's Company as an independent organisation and its publications have included *Sooner, Sharper, Simpler: A Lean Vision of an Inclusive Annual Report* (1998).

In these reports, Tomorrow's Company puts forward an inclusive approach to business and business reporting, in which there would be a broader focus on stakeholder relationships and less emphasis on financial measures. And although in *Sooner, Sharper, Simpler* the focus is on reporting, Tomorrow's Company's main emphasis is on how inclusiveness can improve business performance; better reporting is a means to that end.

Tomorrow's Company argues that there are critical limitations in financial reporting and that 'over-reliance on financial measures' has damaged British companies. Recommendations for non-financial reporting include a 'value chain report', a 'people document' and a 'sustainability document'.

Tomorrow's Company's work was influential in the subsequent UK Company Law Review, which led to major reforms embodied in the Companies Act 2006, and particularly in proposals, subsequently overturned, for a mandatory operating and financial review. The organisation remains active in 'creating a future for business which makes equal sense to staff, shareholders and society'. It also retains an interest in business reporting issues (see Appendix 2 below: *The Future of Corporate Reporting*). As with other proposals for reform, business reporting could be said to have followed the general direction indicated, without adopting the specific model suggested.

A1.4 The 21st Century Annual Report

The 21st Century Annual Report/Prototype plc and *Performance Reporting in the Digital Age* are two reports issued by the ICAEW in 1998. They propose that businesses publish a wider range of leading indicators of financial performance, take a more inclusive view of stakeholders, and harness advances in information technology in their reporting.

Speakers at the conference on which *Performance Reporting* is based, comment that:

- 'With technology, … we are in the world of á la carte with potentially infinite alternative menus of information available'; and
- 'The days when companies were judged solely in terms of economic performance and wealth creation have long disappeared'.

Both reports foresee a world in which communication with stakeholders will be primarily web-based, with more emphasis on forward-looking, non-financial measures.

Once again, it could be said that the world has indeed moved in the direction called for in these reports, though not yet to the extent predicted. The disclosure issues discussed in these reports have been followed up in *New Reporting Models for Business* and in this report. The technology issues have been followed up in the *Making Information Systems Work* thought leadership programme of the ICAEW's Information Technology Faculty, including *Digital Reporting: A Progress Report* (2004).

A1.5 The Inevitable Change

Business Reporting: The Inevitable Change? is a report issued by the Institute of Chartered Accountants of Scotland (ICAS) in 1999. It argues that 'Traditional financial reporting, developed for manufacturing companies with mostly 'hard' assets, and rooted in the periodic reporting of aggregated, historical, financial information, no longer satisfies users.' Business reporting at the moment, it claims, is producer-driven, rather than meeting users' needs.

To meet users' needs, the report proposes that businesses should use advances in information technology to make available a wider range of information faster than at present, rather more frequently, and recognising different stakeholders' differing requirements. In particular, it recommends an 'electronic library-type resource' for external users, with information layered, linked and pre-packaged for each stakeholder group.

As with the other reports examined, it could be said that things have moved in the desired direction, with an increasingly wide range of corporate disclosures and ever-growing use of the internet. But the particular proposals in the report have not been adopted. Subsequent research reports from ICAS have explored various aspects of internet-based communication and the measurement, management and reporting of intangibles.

A1.6 Inside Out

Inside Out: Reporting on Shareholder Value is a report from the ICAEW, published in 1999. It states that 'Investors today want information about a company's potential for creating shareholder value… The future is uncertain and cannot be reported as a matter of fact, but reporting the past is no longer enough.' It also draws attention to other problems with financial reporting.

To address these problems, the report proposes that publicly traded companies should disclose more about their strategies and value drivers, including the measures and lead indicators used at board level to manage the business.

Once again, there has subsequently been rather more disclosure of strategies and other non-financial information, including some KPIs, but not of the particular information proposed in the report. The questions explored in Inside Out have been pursued in later ICAEW reports, including *Prospective Financial Information: Guidance for UK Directors* (2003), *New Reporting Models for Business,* and this report.

A1.7 Value Dynamics

Cracking the Value Code: How Successful Businesses Are Creating Wealth in the New Economy (2000) was written by Richard E. S. Boulton, Barry D. Libert and Steve D. Samek of Arthur Andersen. Its central concept is Value Dynamics – an asset-based approach to business and value creation.

The authors argue that 'Old methods of managing and measuring are simply not up to the task'. Companies should be more transparent and user-driven in their disclosures; in particular, they should disclose the current values of all their assets, including intangibles not currently recognised in financial reporting. 'In the New Economy, it is intangible assets such as relationships, knowledge, people, brands, and systems that are taking center stage'. Greater openness will be rewarded by a lower cost of capital.

Judging from the increased volume of disclosures, there has indeed been greater openness since this book was published, but – as ever – it has not followed these authors' particular prescription. Arthur Andersen ceased trading in 2002 and there has therefore been no follow-up to Value Dynamics.

A1.8 GRI

The GRI's *Sustainability Reporting Guidelines* and their continuing evolution are referred to in Appendix 2. The GRI is unique among the proposals for reform that we have surveyed in providing a reporting model that organisations explicitly comply with.

A1.9 The Brookings Institution

In 2001 the Brookings Institution published *Unseen Wealth: Report of the Brookings Task Force on Understanding Intangible Sources of Value* and a book by Baruch Lev commissioned by the Task Force, *Intangibles: Management, Measurement, and Reporting*. The publications are focused on the problem of reporting intangibles and put forward proposals to allow companies to move towards systematic reporting of relevant information on these assets. The Task Force's report states that there is:

> '[a] large and growing discrepancy between the importance of intangible assets to economic growth and the ability to identify, measure, and account for those assets [and this] is a serious potential problem for business managers, for investors, and for government.'

Professor Lev's book includes a disclosure framework for intangibles: the 'value chain scorecard'.

Both publications call for action by the authorities – the US government, the SEC, FASB – to help develop standardised frameworks for disclosure. Compliance with these would initially be voluntary, but it is envisaged that as practice evolves some mandatory requirements would also be developed.

As far as we are aware, there has not been any follow-up by the relevant authorities to these calls to action.

A1.10 ValueReporting™

The ValueReporting™ Revolution: Moving Beyond the Earnings Game by Robert G. Eccles, Robert H. Herz, E. Mary Keegan and David M. H. Phillips of PricewaterhouseCoopers was published in 2001. *Building Public Trust: The Future of Corporate Reporting* by Samuel A. DiPiazza Jr and Robert G. Eccles of PricewaterhouseCoopers was published in 2002 and builds on the thinking in the earlier book.

The ValueReporting™ Revolution argues that 'the corporate reporting model has failed those whom it intends and ought to serve best… The model has not even begun to keep pace with the extraordinary changes in how executives manage their companies.' *Building Public Trust* comments that 'Every aircraft in the world would be grounded if air traffic control relied on the same type of system that companies use today to report their information.'

The key idea in *ValueReporting™*'s wide-ranging proposals to deal with these defects is greater transparency. This leads among other things to recommendations that businesses should report performance on all the measures they use internally and that industry-specific disclosure standards for non-financial information should be developed on a voluntary basis. It is envisaged, however, that as practice develops standards would become mandatory.

As ever, it could be said that there has been a substantial move in the direction of non-financial reporting, but that the particular prescription in *ValueReporting™* has not been adopted. PricewaterhouseCoopers continues to develop and actively pursue the ideas in *ValueReporting™*:

- through its publications, services and research, including the website www.corporatereporting.com;
- through *Recasting the Reporting Model* (see Appendix 2 below);
- through its Building Public Trust awards; and
- through its participation in a number of collective endeavours to reform business reporting, such as the Enhanced Business Reporting Consortium, the CEOs of the International Audit Networks, the Report Leadership group, and the World Intellectual Capital Initiative (for all of which, see Appendix 2 below).

A1.11 The Hermes Principles

The Hermes Principles: What Shareholders Expect of Public Companies – and What Companies Should Expect of Their Investors, a booklet by Tony Watson and David Pitt-Watson of Hermes Pensions Management, was issued by Hermes in 2002. *The Hermes Principles* gives an investor perspective on business reporting, emphasising the importance of open communication with shareholders on key issues. The booklet points out that financial reporting measures can be misleading and stresses the central role of discounted cash flows in assessing business performance.

Judging from the increase in the volume of reported information, companies are indeed displaying greater openness. But as with other reformers' proposals, it is doubtful whether the progress to date meets the demands of *The Hermes Principles.*

Appendix 2: Recent developments

The first part of this appendix (Section A2.1) summarises recent contributions to the debate on new reporting models for business. The second part (Section A2.2) refers to some recent developments in reporting practice. The third part (Section A2.3) looks at recent and current inquiries into complexity in financial reporting.

A2.1 Significant contributions to the debate

Significant contributions to the debate published since *New Reporting Models for Business* was written include:

- KPMG's *Building a New Reporting and Communications Model* (2003);
- the Value Measurement and Reporting Collaborative's *Re-discovering Measurement* (2005);
- the Enhanced Business Reporting Consortium's exposure draft, *The Enhanced Business Reporting Framework* (2005);
- *Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks* (2006);
- the Report Leadership group's *Report Leadership: Tomorrow's Reporting Today* (2006);
- the Accounting for Sustainability Group's *Accounting for Sustainability* (2007);
- Tomorrow's Company's *The Future of Corporate Reporting* (2007);
- the CFA Institute's *A Comprehensive Business Reporting Model: Financial Reporting for Investors* (2007);
- IFAC's *Financial Reporting Supply Chain: Current Perspectives and Directions* (2008);
- PricewaterhouseCoopers' *Recasting the Reporting Model: How to Simplify and Enhance Communications* (2008);
- the World Intellectual Capital Initiative's WICI Framework (2008);
- the Institute of Chartered Accountants in Australia's *Broad Based Business Reporting: The Complete Reporting Tool* (2008);
- the *ICGN Statement and Guidance on Non-Financial Business Reporting* (2008); and
- the IASB's exposure draft, *Management Commentary* (2009).

These are briefly outlined in turn below.

Building a New Reporting and Communications Model

Building a New Reporting and Communications Model: A New Source of Competitive Advantage was issued by KPMG Australia in 2003. It says that stakeholders do not currently receive the information they need:

> 'Current business reporting and communications do not facilitate precise stakeholder decision-making about business performance and sustainability, severely constraining investment optimisation… A new reporting and communications model is needed.'

It states that:

> 'The key to the new business reporting framework is a flagship performance report detailing the organisation's strategy, performance in implementing it, and insights about the performance outlook.'

This would be accompanied by 'aligned special purpose reports meeting all legitimate stakeholders' needs'.

The 'new look reporting and communications' would be underpinned by 'rigorous business modelling and business measurement methodologies'.

Re-discovering Measurement

Re-discovering Measurement was published in 2005 by the Value Measurement and Reporting Collaborative as part of its New Paradigm Initiative. The report draws attention to the limitations of 'traditional accounting', notably its inability to measure a business's 'future value

creation potential'. It argues that the defects of the traditional accounting paradigm are well known, just as the problems in the Newtonian paradigm in physics were well known by the end of the 19th century. However, 'there has as yet been no accounting Einstein to point us toward a new accounting paradigm'. The report states that the New Paradigm Initiative:

> 'intends to open a debate on what lies beyond the boundaries of the traditional accounting paradigm, in the expectation that doing so will … ultimately lead to a new global consensus on concepts and criteria for measuring value and performance.'

The report lists more than 80 value and performance measurement innovations produced in recent years, analyses them into different categories, and discusses criteria for assessing how far they succeed. It selects seven of these new measurement approaches and proposes further work on assessing them from different perspectives.

The Enhanced Business Reporting Framework

The Enhanced Business Reporting Consortium published an exposure draft of *The Enhanced Business Reporting Framework* in 2005 and a revised exposure draft (Version 2.1) in 2006. The introduction to the 2005 version states:

> 'The Enhanced Business Reporting Framework promotes greater transparency of corporate strategy and performance. The Framework also provides structure for the type of narrative discussion, eg, MD&A in the US and O&FR in the UK,[36] required in many countries. This structure makes it possible to create useful classifications, ie, taxonomies for value drivers, performance measures and qualitative information. Specifically, the EBR Framework enables a more robust use of XBRL taxonomies. Ultimately, companies adopting the Framework will provide the investment community and other stakeholders the information they need to make better decisions.'

Version 2.1 of the exposure draft provides a framework of 35 recommended disclosure categories under four headings – Business Landscape, Strategy, Resources and Processes, and Performance – and provides a short description of each one. For example, under Resources and Processes, there are 11 recommended framework disclosure categories:

1. Resources and Processes – Summary

Resource Form

2. Monetary Capital
3. Physical Capital
4. Relationship (Social) Capital
5. Organizational (Structural) Capital
6. Human Capital
7. Develop Vision and Strategy

Key Processes

8. Manage Internal Resources
9. Manage Products and Services
10. Manage External Relationships
11. Manage Governance and Risks

Global Capital Markets and the Global Economy

Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks was published in 2006. It focuses on publicly traded companies and their auditors and covers a wide range of issues: auditing, financial reporting, non-financial reporting, XBRL, liability, legal and regulatory frameworks, and accounting education.

[36] At the time the draft *Framework* was published, there were requirements for publicly traded companies in the UK to produce an OFR. These requirements were withdrawn shortly afterwards, before they came into effect.

On financial reporting, it comments:

> 'The large discrepancies between the "book" and "market" values of many, if not most, public companies … provide strong evidence of the limited usefulness of statements of assets and liabilities that are based on historical costs. Clearly, a range of "intangibles" that are not well measured, or not measured at all, under current accounting conventions are driving company performance.'

In addition to its comments on purely financial reporting issues, the report's main criticisms of current business reporting are that it:

- provides insufficient information to allow users to assess the value of intangibles such as employee creativity and loyalty and relationships with suppliers and customers;
- is insufficiently customised; and
- is only periodic (eg, annual or quarterly).

The solutions proposed are:

- more disclosure of non-financial information to allow users to assess the value of intangibles;
- customised reporting using XBRL; and
- more frequent, possibly daily, reporting.

The report calls for a 'new reporting model', which 'should be driven by the wants of *investors and other users of company information*, and the information produced should be forward-looking, even though it may be historical in fact.' It gives some examples of such information:

- numbers of patents recently awarded;
- measures of customer satisfaction, product or service defects or awards; and
- measures of employee satisfaction.

The report calls for a global conversation to develop the new reporting model and the CEOs say that their networks 'stand ready to host conversations among all the key stakeholders in business information about what a new reporting model should look like'.

This initiative has been pursued by the international audit networks in a series of round tables with interested parties around the world. An update was published in January 2008: *Global Dialogue with Capital Market Stakeholders: A Report from the CEOs of the International Audit Networks*. This states that 'a business reporting model that captures the realities of a firm's economics is clearly top-of-mind', but notes that 'there is little clarity [about what such a model should look like] beyond the desire for improvement'. However, the report expresses the CEOs' determination to press on with 'an ongoing dialogue to move these issues forward'.

Report Leadership

The Report Leadership group – comprising, at the time of the report referred to here, the Chartered Institute of Management Accountants (CIMA), PricewaterhouseCoopers, Radley Yeldar, and Tomkins plc – published *Report Leadership: Tomorrow's Reporting Today* in 2006. The group has subsequently published two further reports.

The 2006 report puts forward 'a better blueprint for corporate reporting that:

- Aligns external reporting more closely with management reporting
- Recognises the complexity of business today
- Will adapt readily to other media
- Is relevant and accessible to the investment community.'

The report says that it is 'the first salvo in what we hope will be a continuing debate'. As such, it focuses on just 'a few areas that are particularly topical and are widely seen as needing improvement', categorised under three broad headings:

- effective communication,
- modelling the future, and
- rethinking the financials.

For example, under the heading of modelling the future, the report discusses:

- value creation;
- forward-looking orientation;
- business environment;
- strategy; and
- key performance indicators.

For each of these topics, it briefly sets out what the problem is, 'what investors want', and 'what we've done to make it work'. This last point refers to a fictitious annual report for 'Generico' – a model report demonstrating the RL group's approach in practice.

In its submission (May 2009) to the Walker enquiry into the corporate governance of the UK banking industry, the RL group calls for 'a fundamental review of the reporting model' and says that 'the current reporting model [is] too dependent on financial aspects of reporting'.

Accounting for Sustainability

The Accounting for Sustainability Group was formed in 2006 as part of the Prince of Wales's Accounting for Sustainability Project. The project had two objectives:

- to embed sustainability in organisations' decision-making; and
- to improve organisations' reporting of their sustainability performance.

Reporting was therefore only one aspect of the project.

The group issued *Accounting for Sustainability* in 2007. The report includes a new Connected Reporting Framework, which 'presents key sustainability information alongside more conventional financial information to give a more rounded and balanced picture of the organisation's overall performance'.

The Framework has five key elements:

- 'An explanation of how sustainability is connected to the overall operational strategy of an organisation and the provision of sustainability targets.'
- 'Five key environmental indicators, which all organisations should consider reporting …: greenhouse gas emissions, energy usage, water use, waste and significant use of other finite resources.'
- 'Other key sustainability information should be given where the business or operation has material impacts.'
- 'Industry benchmarks for the key performance indicators when available.'
- 'The sustainability impacts of its suppliers and the use of its products or services by customers and consumers.'

A subsequent report, *Connected Reporting in Practice: A Consolidated Case Study* (2009), looks at the experience of six organisations that have adopted the Connected Reporting Framework. It 'highlights the main benefits arising from using the framework, as well as identifying some of the key challenges that participants have overcome'.

The Future of Corporate Reporting

Tomorrow's Company's *The Future of Corporate Reporting* was published in 2007. It follows two earlier relevant reports by Tomorrow's Company, both discussed in *New Reporting Models for Business*:

- *Tomorrow's Company: The Role of Business in a Changing World* (1995).
- *Sooner, Sharper, Simpler: A Lean Vision of an Inclusive Annual Report* (1998).

The Future of Corporate Reporting identifies three functions of communication in corporate reports:

- conveying information;
- building relationships; and
- the motivational/focusing effects on the reporter.

The report's emphasis is on the last two of these functions.

It urges companies to improve their reporting by focusing on the future rather than the past and by providing better non-financial information. It argues that:

> 'Communicating … forces the company to define what measures it is going to report on. This in turn forces it to be clear about what is its success model, and what are the key relationships that enable that model to succeed. This also forces the company to be clear about what it means by success: what it is setting out to achieve.
>
> 'This is why companies find non-financial reporting difficult – because it forces them to be explicit about the success they seek and what drives it.'

However, better reporting (ie, narrative or non-financial reporting) will 'improve relationships with key stakeholders' and 'can actually help to improve internal management and performance'. The report states that the reporting changes it envisages:

> 'Ultimately … will be about improving the board's understanding of its business model, improving its ability to manage that business model, and enabling it to develop more robust business models for the future.'

A Comprehensive Business Reporting Model

As its sub-title indicates, *A Comprehensive Business Reporting Model: Financial Reporting for Investors*, issued by the CFA Institute in 2007, is primarily concerned with financial reporting. However, it has some comments on other aspects of business reporting and its recommendations tackle intangibles, the principal point of deficiency alleged against financial reporting by many advocates of new reporting models.

The report recommends that, in the long term, 'all intangible assets should be recognized at fair value'. In the short term it recommends that managers disclose various items of financial and non-financial information, including:

- 'estimates of the fair value of identifiable intangibles not recognized in the financial statements';
- 'information about intangibles that are embedded in other tangible or financial assets, such as core deposit intangibles';
- 'the nature of the intangible assets that are important to the business and … what [they] do to develop, protect and exploit them'; and
- 'operating and financial measures to communicate to investors the value of intangibles to the company'.

On non-financial disclosures generally, the report argues against their being mandated by accounting standard-setters or being audited, and comments:

> 'In the current disclosure environment, if managers are compelled to comply with a standard for the disclosure of nonstandard information, the tendency will be for the disclosure to quickly devolve into boilerplate rather than to supply the candid, incisive, and informative disclosure that investors need.'

On the subject of transparency, the report states:

> 'Managers often claim that they must withhold information because of competitive disadvantage. Generally, we are skeptical of such claims because we believe that industry competitors generally know much more about each other than they share with investors… [H]owever, we do recognize that there are rare circumstances when disclosing information would be detrimental to a company's business strategies.'

Financial Reporting Supply Chain

Financial Reporting Supply Chain: Current Perspectives and Directions was issued by the International Federation of Accountants (IFAC) in 2008 as part of its Business Reporting Project. It consists mainly of a summary of the findings of a global online survey of 341 people involved at different stages of the financial reporting supply chain: including users, preparers, auditors, standard-setters and regulators. The survey asked respondents about their views on developments over the past five years. It found that, on balance, respondents believe that over this period:

- the relevance of financial reporting has improved;

- the reliability of financial reporting has improved;
- financial reporting has become more understandable; and
- the balance between the benefits and costs of the financial reporting process has improved.

However, the report notes that, 'According to many respondents, financial reporting has become less useful because it has become too complex for the average reader to understand.'

The report concludes:

> 'IFAC and its member bodies, working with the other financial reporting supply chain stakeholders, have an important role to play if financial reports are to become more useful… There needs to be a coordinated ongoing dialogue to address the concerns raised.
>
> 'The first step is to determine what should be done to make financial reports more useful to the various user groups; what would a more useful business reporting model look like?…'

In 2009 IFAC published a follow-up report, *Developments in the Financial Reporting Supply Chain: Results from a Global Study among IFAC Member Bodies*. As its sub-title indicates, this is based on information from IFAC's member bodies and associates: 74 of them responded to a questionnaire. In relation to the usefulness of financial reports, the study finds that satisfactory solutions are needed for:

> 'insufficient reporting on nonfinancial indicators, risks and sustainability performance; the unclear link between reporting and an organization's environment, its strategy, and the implications of that strategy ...'

Recasting the Reporting Model

Recasting the Reporting Model: How to Simplify and Enhance Communications was issued by PricewaterhouseCoopers in 2008. It states that:

> 'The time has come for a new, market-driven blueprint for corporate reporting to be developed to reflect shortcomings in the current model and the growing challenge of climate change…
>
> 'Today's corporate reporting … is too financially orientated, too technically complex and, critically, it ignores key elements of business performance including sustainability issues'.
>
> Important respects in which current reporting falls short include 'the explanation of strategy, the drivers of value and the key performance indicators … critical to understanding business success.'

It calls for, among other things:

- 'External reporting that flows from internal management information…
- 'Integration of financial, contextual and non-financial information so that investors have the complete information set needed to make informed decisions.'

The prize for successful reform will be 'enhanced yet simplified reporting, more effective and efficient capital markets and a major contribution to creating a more sustainable world.'

The WICI Framework

In 2008, the World Intellectual Capital Initiative (WICI) released its first version of a comprehensive information framework. At the time of its release, it was stated that:

> 'The WICI Framework is the first step towards development of an internationally recognized, voluntary framework for providing the information that investors and others need.'

The WICI Framework exists as an XBRL taxonomy. It incorporates:

- the Enhanced Business Reporting Framework;
- intellectual asset based management guidelines developed by Japan's Ministry of Economy, Trade and Industry;
- environmental, social and governance (ES&G) key performance indicators developed by the Society of Investment Professionals in Germany; and

- industry specific reporting frameworks and key performance indicators developed by PricewaterhouseCoopers.

The Framework is not, therefore, a new reporting model except in the sense that it brings together models from other sources and provides an XBRL taxonomy for them.

Broad Based Business Reporting

Broad Based Business Reporting: The Complete Reporting Tool was issued by the Institute of Chartered Accountants in Australia (ICAA) in 2008. It builds on the work of a number of earlier reports published by the ICAA:

- *New Directions in Business: Performance Reporting, Communications and Assurance* by Michael Bray (2002);
- *Extended Performance Reporting: An Overview of Techniques* by Wai Fong Chua (2006); and
- *Extended Performance Reporting: A Review of Empirical Studies* by Wai Fong Chua (2006).

The 2008 report explains that:

> 'Broad Based Business Reporting (BBBR) is an enhanced reporting mechanism increasingly used by business to better meet the information needs of their key stakeholders. Users require insight into a business' chosen strategy for business management and value enhancement. They also require properly aligned financial and non-financial performance information in order to build the models from which they make their varying decisions.'

The focus of BBBR is on the non-financial elements, particularly in relation to intangible assets and environmental, social and governance (ESG) responsibilities. The report comments that: 'BBBR is achieved through closer alignment of external reporting with internal management reporting.' And it warns: 'recent events on Wall Street have demonstrated the risks of a reliance on backward looking financial reporting'.

The report gives a pro forma example of non-financial reporting at a fictitious firm, Key Metric Enterprise, with disclosures on the following key risks: human capital, customer, product, reputation/brand, environment, and financial. For each category, the pro forma gives a statement of the firm's strategy, key performance metrics and a discussion of these metrics.

A follow-up report, *Broad Based Business Reporting: Supplementary Paper* (2009) 'expands on the original paper by placing BBBR firmly in the context of the global economic downturn and the ongoing tightening of capital'. It states that 'Financial modelling by sophisticated capital market players is forced to rely too much on extrapolation, assumption, industry-based input, and unaudited and inconsistent information.'

ICGN Statement and Guidance

The *ICGN Statement and Guidance on Non-Financial Business Reporting* was issued in 2008 by the International Corporate Governance Network.

The Guidance argues that:

> 'traditional accounting is … ill-equipped to capture intangible drivers which in the modern economy increasingly underpin value creation. The so-called 'value gap' between more traditional financial accounting measures of value, such as book value on the one hand and market capitalisation on the other, suggests a need to go beyond conventional accounting. Investors need to understand what drives value.
>
> 'Non-financial business reporting can help to inform the investment process by revealing in both quantitative and qualitative terms those drivers that increasingly shape company performance…
>
> '… It has an important role in mitigating the short-termism that currently afflicts financial analysis'.

The Statement says that non-financial business reporting should:

- be genuinely informative and include forward-looking elements where this will enhance understanding;
- be material, relevant and timely;

- describe the company's strategy, and associated risks and opportunities, and explain the board's role in assessing and overseeing strategy and the management of risks and opportunities;
- be accessible and appropriately integrated with other information that enables investors to obtain a whole picture of the company;
- use key performance indicators that are linked to strategy and facilitate comparisons;
- use objective metrics where they apply and evidence-based estimates where they do not; and
- be strengthened where possible by independent assurance that is carried out having regard to established disclosure standards applicable to non-financial business reporting, such as those issued by the IASB.

The Guidance adds that, 'Critically, businesses need to recognise the link between improvements in non-financial areas and in cash flow or the share price'.

Management Commentary

The International Accounting Standards Board's exposure draft (ED) of a non-mandatory statement, *Management Commentary*, was published in June 2009. The ED offers 'a non-binding framework which could be adapted to the legal and economic circumstances of individual jurisdictions'.

The ED states that:

> 'Management commentary should communicate information about an entity's economic resources, claims on those resources and the transactions and other events and circumstances that change them. It should also explain the main trends and factors that are likely to affect the entity's future performance, position and development.'

According to the ED, management commentary 'may help users of the financial reports to understand, for example:

(a) the entity's risk exposures, its strategies for managing risks and the effectiveness of those strategies;

(b) how resources that are not presented in the financial statements could affect the entity's operations; and

(c) how non-financial factors have influenced the information presented in the financial statements.'

The ED also states that 'commentary that is aligned with [the principles that underpin decision-useful management commentary]:

(a) provides management's view of the entity's performance, position and development;

(b) supplements and complements information presented in the financial statements; and

(c) has an orientation to the future.'

Comments on the ED were requested by 1 March 2010.

A2.2 Significant developments in practice

Significant developments in practice since *New Reporting Models for Business* was written include:

- the implementation in the EU of requirements for a business review;
- the ASB's Reporting Statement, *Operating and Financial Review*, which is followed voluntarily by a number of UK companies; and
- the Global Reporting Initiative's *Sustainability Reporting Guidelines: Version 3.0*, which is also followed in varying degrees by a number of companies and other entities around the world.

These are briefly outlined in turn below. The ICAA report, *Extended Performance Reporting: An Overview of Techniques*, also surveys international developments in this area, focusing on intangible asset and ESG reporting.

EU requirements for a business review

The EU's Accounts Modernisation Directive (2003: see Section 5.4 above) requires large and medium-sized companies to provide:

> 'a fair review of the development and performance of the company's business and of its position, together with a description of the risks and uncertainties that it faces.
>
> 'The review shall be a balanced and comprehensive analysis … consistent with the size and complexity of the business;
>
> 'To the extent necessary … the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters.'

This requirement was due to be brought into effect by EU member states for accounting periods starting on or after 1 January 2005.

In the UK, additional disclosure requirements have been specified for publicly traded companies, and the report is therefore known as an Enhanced Business Review (EBR). A review of 23 UK publicly traded companies' annual reports by the ASB, published in 2007, finds that 'Companies are in general complying with the legal requirements for the Business Review.'[37] A further review of 50 companies' reports, published by the ASB in 2009, finds 'significant opportunities for improvement' in certain areas of narrative reporting and 'immaterial clutter detracting from important information' in some cases.[38]

A 2007 review of 100 UK publicly traded companies' annual reports by Deloitte finds that:

> 'companies are writing to order. There is a certain consistent feel to the narrative sections in annual reports. Individuality is losing out against uniformity. This may be because companies, under constant time pressures and faced with complex rule books, are looking at model narrative reports… Alternatively, it may be the need to comply with the rules…'[39]

Operating and Financial Review

The ASB's Reporting Statement *Operating and Financial Review* (2006) says that it is a 'formulation and development of best practice'. It succeeds a considerably shorter and less demanding statement, also called *Operating and Financial Review*, first issued in 1993 and revised in 2003, and is essentially a non-mandatory version of a mandatory Reporting Standard, issued in 2005, which never came into effect.

The 2006 statement recommends that directors prepare an operating and financial review (OFR):

> 'which should be a balanced and comprehensive analysis, consistent with the size and complexity of the business, of:

a) the development and performance of the business of the entity during the financial year;

b) the position of the entity at the end of the year;

c) the main trends and factors underlying the development, performance and position of the business of the entity during the financial year; and

d) the main trends and factors which are likely to affect the entity's future development, performance and position, prepared so as to assist members to assess the strategies adopted by the entity and the potential for those strategies to succeed.'

The statement says that it 'has been written with quoted companies in mind, but is also applicable to any other entities that purport to prepare an OFR.'

[37] ASB, *A Review of Narrative Reporting by UK Listed Companies in 2006*, London: ASB, 2007.

[38] ASB, *Rising to the Challenge: A Review of Narrative Reporting by UK Listed Companies*, London: ASB, 2009.

[39] Deloitte, *Written to Order: Surveying OFRs, EBRs and Narrative Reporting in Annual Reports*, London: Deloitte, 2007.

Deloitte's 2007 review of 100 publicly traded companies' reports finds that the number of companies preparing 'formal OFRs' fell in two years from 41% to 10%.[40] The authors comment that this does not mean that the narrative content formerly in OFRs is disappearing: 'Companies are simply dropping the OFR tag to reduce the compliance burden'.

Sustainability Reporting Guidelines

The Global Reporting Initiative's *Sustainability Reporting Guidelines* were first issued in 2000. A revised edition appeared in 2002 and was discussed in *New Reporting Models for Business*. A third edition – the *G3 Guidelines* – was published in 2006. The *Guidelines* provide an evolving template for businesses to report information on their economic, social and environmental impacts, and accordingly G3 represents an evolution of the 2002 *Guidelines*, not a radically new approach.

The *Guidelines* 'consist of Principles for defining report content and ensuring the quality of reported information. [They] also include Standard Disclosures made up of Performance Indicators and other disclosure items, as well as guidance on specific technical topics in reporting.' Fourteen sector supplements have been issued with disclosure recommendations for particular sectors, such as 'Apparel and footwear', 'Automotive' and 'Electric utilities'. It is also intended to develop national annexes to address country and regional sustainability issues.

In *New Reporting Models for Business* we noted that in September 2003, 313 organisations around the world complied with the *Guidelines* at least to some extent. By October 2009, this had increased to 1,060 organisations (issuing reports for 2008: see www.globalreporting.org), many of them in the public sector or third sector. The GRI recognises differing levels of adherence to the *Guidelines* (A, B and C; and A+, B+ and C+ where the organisation has obtained external assurance), and most organisations state their level of compliance on this basis.

A2.3 Inquiries into complexity

The problem of complexity in financial reporting is the subject of recent and current inquiries in various countries around the world:

- The SEC Advisory Committee on Improvements to Financial Reporting (CIFR).
- The Global Accounting Alliance's *Getting to the Heart of the Issue: Can Financial Reporting be Made Simpler and More Useful?*
- In the UK, the Financial Reporting Council's *Louder than Words: Principles and Actions for Making Corporate Reports Less Complex and More Relevant.*
- The IASB's work on reducing complexity in reporting financial instruments.
- FASB's Disclosure Framework project.

The SEC

In the US, the SEC Advisory Committee on Improvements to Financial Reporting reported in 2008. In relation to complexity it recommended:

1. To reduce complexity caused by the use of different measurement bases (the 'mixed attribute model') the SEC should recommend that FASB should:

- 'be judicious in issuing new standards and interpretations that expand the use of fair value in areas where it is not already required' until it has 'a measurement framework to systematically assign measurement attributes to different types of business activities' and has developed and implemented 'a plan to strengthen the infrastructure that supports fair value reporting'; and
- 'consider the merits of', among other things, 'assigning a single measurement attribute within each business activity to the maximum extent feasible'.

[40] Deloitte's 2008 review states that the number claiming compliance has fallen to 9%. Its 2009 review finds claimed compliance has fallen to 4% and suggests that 'the ASB needs to take action to withdraw its Reporting Statement'.

2. The SEC and FASB 'should work together to develop a disclosure framework' to:

- 'integrate existing SEC and FASB disclosure requirements into a cohesive whole'; and
- 'require disclosure of the principal assumptions, estimates, and sensitivity analyses that may impact a company's business, as well as a qualitative discussion of the key risks and uncertainties that could significantly change these amounts over time.'

3. The SEC and FASB should 'establish a process of coordination … to regularly assess the continued relevance of disclosure guidance'.
4. 'Recognition guidance in US GAAP should be based on a presumption that bright lines should not exist.' Instead, the SEC should recommend FASB to adopt an approach based on 'proportionate recognition'. Where this is not feasible, FASB 'should provide qualitative factors in its recognition guidance'. CIFR uses the term 'proportionate recognition' to describe 'accounting for one's rights and obligations as a party to a contract' in contrast to 'the current all-or-nothing recognition approach in US GAAP'. For example, where a company takes out a four-year lease on a fixed asset expected to have a useful life of ten years, proportionate recognition would mean recognising as an asset the value of the right to use the machine for four years.
5. Investors, preparers, auditors and regulators should be 'better trained to consider the economic substance and business purpose of transactions in determining the appropriate accounting, rather than relying on mechanical compliance with rules.'
6. US GAAP should be 'presumptively based on business activities, rather than industries'. That is, the same activities should be accounted for in the same way by companies in different industries. At present, US GAAP includes a large volume of industry-specific guidance and requirements.
7. US GAAP should be 'based on a presumption that formally promulgated alternative accounting policies should not exist' – ie, options in standards should not exist – 'except in rare circumstances'.
8. US GAAP should be 'scoped with sufficient precision to minimize the use of scope exceptions'.
9. US GAAP should be 'based on a presumption that similar activities should be accounted for in a similar manner'.

The Global Accounting Alliance

In January 2009, the Global Accounting Alliance (GAA), an alliance of nine of the world's leading professional accounting organisations (including the ICAEW) published *Getting to the Heart of the Issue: Can Financial Reporting be Made Simpler and More Useful?* This addresses two issues: principles-based standards and complexity in financial reporting. It is based on interviews with a broad cross-section of financial reporting stakeholders.

The report states that:

> 'there have been increasing complaints from preparers and users of financial statements about the length and complexity of those financial statements. Yet many users have claimed that some of the most important information just isn't there, or isn't easily accessible or understandable.'

In relation to complexity, it notes that 'The key cause is complexity of business and transactions – and the need for explanatory narrative on complex items'. However, 'accounting standards also cause complexity'. Some interviewees quoted in the report connect the issues of complexity and principles-based standards. The implication is that principles-based standards would help reduce complexity, though the report does not state this explicitly.

The report poses 10 questions for consideration:

1. Should an agreed international framework for accounting standards be adopted with a clear hierarchy comprising (i) a conceptual framework; (ii) principles-based standards; and (iii) limited authoritative guidance?
2. Should guidance be provided for preparers and auditors on the exercise of judgement in the application of principles-based standards and on the documentation of reasons for the judgements made?
3. Should regulators be encouraged to accept a reasonable degree of variation in accounting treatments and to take a more effective, outcome-oriented approach to regulation?

4. Should a single definitive set of general purpose financial statements be retained?
5. Should standard setters be encouraged to drop requirements considered redundant?
6. How can company boards be encouraged to provide better quality communication?
7. Should an international framework for high-level summary financial statements be developed in order to provide information suitable for retail and less sophisticated investors?
8. Should general purpose financial statements be developed and published in XBRL format to allow users to drill down to whatever level of detail is required?
9. Should company communication be improved through the use of clearer language, less jargon and coded language, and a focus on clarity and transparency?
10. How has the recent financial crisis affected the debate on these issues?

A series of round tables to discuss these questions was held around the world in 2009.

The Financial Reporting Council

In the UK, in May 2009, the Financial Reporting Council published a discussion paper (DP), *Louder than Words: Principles and Actions for Making Corporate Reports less Complex and More Relevant*. This addresses 'concerns about the increasing complexity and decreasing relevance of corporate reports'. The DP considers complexity in the sense of anything that makes corporate reporting regulations or reports unnecessarily difficult. Necessary complexity is therefore outside its scope. It also focuses on annual reports and on UK publicly traded companies. It notes, on the basis of interviews conducted in preparing the report, that:

- 'preparers … almost unanimously believe that the process of compiling a corporate report is too complex, and so are the reports themselves'; while
- 'users … do not consider [annual reports] too complex overall'.

The DP proposes four principles for less complex regulation of reporting.

> 'To provide a toolkit for improving the quality and effectiveness of regulations, regulators and standard setters should all adopt a single set of principles that govern how they set and communicate those regulations. We believe regulations should be:
>
> - Targeted
> - Proportionate
> - Coordinated
> - Clear.'

The DP also proposes four principles for effective communication in reporting.

> 'The lessons learned from the UK ASB's work on the Operating and Financial Review (OFR) should be extended to cover corporate reporting in its entirety. Reports should be:
>
> - Focused
> - Open and honest
> - Clear and understandable
> - Interesting and engaging.'

Comments on the DP were requested by 30 October 2009.

The IASB

The IASB does not currently have a project on complexity, but the title and content of its 2008 discussion paper – *Reducing Complexity in Reporting Financial Instruments* – appear to show that it is a significant consideration in at least some of its work.

The discussion paper notes that 'the *many ways* of measuring financial instruments and the associated rules are one of the main causes of today's complexity'. It suggests that 'a *long-term* solution … is to measure in the same way all types of financial instruments' and argues that 'fair value seems to be the only measure that is appropriate for all types of financial instruments'. However, because of the 'issues and concerns' that such an approach would involve, the paper puts forward alternative medium-term solutions.

The Leaders of the G20, in their April 2009 *Declaration on Strengthening the Financial System*, 'agreed that accounting standard setters should take action by the end of 2009 to … reduce the complexity of accounting standards for financial instruments'. Responding to this and other points in the *Declaration*, the IASB and FASB announced plans to publish within six months (of 7 April 2009) proposals to replace existing financial instruments standards with 'a common and globally accepted standard'. At the time of writing (October 2009), the IASB and FASB are developing separate proposals.

FASB

In July 2009, FASB announced a Disclosure Framework project. Its objectives are:

> 'to (1) establish an overarching framework intended to make financial statement disclosures more effective, coordinated, and less redundant, and (2) seek ways to better integrate information provided in financial statements, MD&A, and other parts of a company's public reporting package.'

While the objectives do not refer to complexity, it seems reasonable to interpret them as being relevant to that, and the project is stated to be a response to recommendations 2 and 3 on complexity of the SEC Advisory Committee on Improvements to Financial Reporting set out above.

Appendix 3: Six underlying questions

The six underlying questions identified in *New Reporting Models for Business* remain important, partly in connection with the issues already discussed in the main body of this report, but also in relation to wider aspects of the debate. We set out below our suggested answers to the six questions.

A3.1 Can business reporting meet all decision-making needs?

We see business reporting as just one source – though a very important one – in the larger market for information. Even for help in valuing a business, which is generally seen as one of the principal functions of business reporting, it cannot provide all the information a user needs. Managers have only limited information, and where they have an information advantage because what they provide is based on their personal knowledge and access to the company's records, they are subject to incentives and biases that may well affect the reliability of the information they provide. These imply significant limitations in business reporting.

All that business reporting can do is help meet users' diverse information needs. To argue that because an identified need is not fully met, businesses must provide more information, is a recipe for an indefinite expansion of less and less useful and more and more costly disclosures.

The content of business reporting therefore needs to be determined in this larger context, recognising where business reporting is at a competitive advantage with other sources of information and where it is at a disadvantage. To try to shape and extend business reporting as though it were capable of meeting all decision-making needs is to risk requiring information beyond the useful scope of business reporting.

So our suggested answer to the question 'Can business reporting meet all decision-making needs?' is: 'No, and it would be unhelpful to behave as though it could'.

A3.2 Can business reporting benefit from a new conceptual framework?

We argued in Chapter 5 that, unless a model for non-financial reporting is at a high level of principle, it would probably be impracticable. Similar considerations apply to the question of whether there is a need for a conceptual framework for business reporting. Financial reporting already has one – or rather, several, as until now each major standard-setter has preferred to have its own framework. The leading versions, those of FASB and the IASB, are currently under review with the object of producing a common framework.

The question, therefore, is whether the conceptual framework for financial reporting should be extended so as to cover all business reporting or whether a separate framework should be developed specifically for non-financial reporting.

We see nothing to be gained either way from such a framework. If any requirements for non-financial reporting are kept, as we suggest, at a high level, then it would not seem to be a productive exercise to go to the trouble of establishing an even higher level of principles (the framework) that would in turn help to determine the principles that govern non-financial reporting. There is also the problem that it is not clear that a conceptual framework for disclosure, as opposed to a changeable list of headings for it, is really feasible.

Our suggested answer to the question 'Can business reporting benefit from a new conceptual framework?' is therefore: 'No, and it is probably unrealistic to imagine that one could be developed'.

A3.3 Can business reporting depend on the invisible hand?

Some advocates of new reporting models argue that, left to itself, the market will achieve an optimum level of disclosure by businesses – the 'invisible hand' of market forces will achieve the desired results. These arguments turn on the effect of improved disclosures in reducing a business's cost of capital. However, we are not convinced that purely market solutions are likely to achieve the best possible results. There are benefits from standardising disclosures and measurements, including benefits to the cost of capital, and standardisation would probably be either impossible or much less effective without a degree of regulation – both to set requirements and to enforce them.

This is not an enthusiastic endorsement of regulation. Regulation imposes costs, develops a dynamic of its own, and can easily lead to inappropriate requirements. The objective must be to ensure that regulation is seen as a way of helping the market for business information to operate effectively, not as an alternative to it. Regulation should be carefully scrutinised, based on research, and subject to post-implementation reviews and cost-benefit tests.[41]

Also, as we have emphasised, we do not see likely benefits from detailed regulation of the whole of non-financial reporting. Businesses already have strong incentives for disclosure, including the threats of regulatory penalties and civil suits from shareholders, and there is evidence that these work well for non-financial reporting within a broad regulatory framework.

So, in response to the question 'Can business reporting depend on the invisible hand?' our suggested answer is: 'The market plays a vital role in helping to maintain and improve the quality of business reporting, but it would not be sensible to rely on it exclusively'.

A3.4 Can business reporting attach values to all intangibles?

Financial reporting does not at present put balance sheet values on most intangibles, and we have argued in Chapter 3 that there are advantages in the current approach, which prevents it from doing so. But this leaves open the possibility that valuations of all intangibles could be disclosed in either financial or non-financial reporting.

The arguments on this point depend on the nature of the intangibles. Where a business holds intangibles that are separable from the rest of the business and for which a realistic market value can be obtained, it may well be useful to disclose what they are worth. And where this is the case, the disclosure might be made in either the financial or non-financial reporting. There may also be an equally strong case for information on the market values of tangible assets.

But many intangibles are not clearly separable from the business and there is therefore no realistic market value for them. This does not mean that values cannot be attached to them. It just means that the values are not likely to provide useful information.

Our suggested answer to the question 'Can business reporting attach values to all intangibles?' is therefore 'Not usefully for all intangibles, but current values may well be useful information where they reflect market prices'.

A3.5 Can business reporting achieve transparency?

There is an assumption in many proposals for business reporting reform that managers possess valuable information that they are failing to disclose. The purpose of the proposed reforms is to secure greater disclosure, and in some cases the reformers argue for a policy of full disclosure – complete transparency. A specific disclosure called for by a number of reformers is a description of the business model, and it is assumed that every business can be seen in terms of a model.

Businesses have good reasons to disclose information so that markets have confidence in them. This allows them to raise money or to do so at lower cost, and encourages other parties – potential customers, suppliers and employees – to do business with them. The argument for full transparency is that this will maximise the benefits from disclosure – in particular for the cost of capital.

But businesses also have good reasons not to disclose information. Disclosure may put them at a competitive disadvantage. For example, it may reveal too much about a product they are developing or about their acquisition plans or it may make their business model easier to replicate. In a competitive market it is unrealistic to expect businesses to be totally open about everything they do or plan to do. Competition in business assumes a degree of privacy. So transparency in this sense is not a sensible objective. Disclosure may also involve information that third parties regard as confidential, such as contract terms.

There are also concerns about disclosing business models. If we are talking about business models as articulated descriptions of how the business works financially, often there is a reluctance to disclose, because of a fear that the model will prove to be wrong. In practice it is very difficult to establish the financial relationships between inputs and outputs in a business, and even if management thinks it has identified them, they may well change. Some business

[41] These matters are discussed more fully in *Measurement in Financial Reporting.*

models are therefore more like working hypotheses – constantly being proved to be imperfect and constantly being amended to fit changing circumstances. Publishing information of this type, which might be instantly disproved by experience, could be embarrassing to managers and misleading to investors.

No doubt some managers have bad reasons for non-disclosure. They may be protecting their own interests (eg, they would prefer not to admit that an investment they are responsible for seems to be failing). Or they may be insufficiently motivated to disclose information that it would be to the business's advantage to disclose. Disclosure may reduce the company's cost of capital, but if the managers personally derive no benefit, why bother?

There is a large grey area between what are clearly good reasons for non-disclosure and what are clearly bad reasons. Management may, for example, be aware of an operational difficulty that it should be able to resolve but which, if disclosed, would undermine confidence in the business. The trend of reporting practice on such issues has been to move towards greater openness. But there is a genuine business case for giving managers some time to resolve a problem rather than instantly publicising it.

There are also grey areas in what managers do and do not know. Some things are certain, some are probable, some are merely suspected. Much management 'information' is really estimated data produced by managers, which the managers themselves regard as unreliable. So they may well have concerns about disclosing everything they 'know' when they are not sure themselves whether they really know it.

Transparency in the sense of honesty is a different matter.[42] All business reporting should be honest, and it is possible to be honest while making it clear that certain issues are not topics for full disclosure. If a business says, 'We never discuss our acquisition plans,' that is compatible with being perfectly honest.

Our suggested answer to the question 'Can business reporting achieve full transparency?' is therefore: 'It depends what you mean by transparency. If transparency is honesty, then business reporting should be fully transparent. If transparency is full disclosure of everything of which managers are aware, then it does not seem to be compatible with the workings of a competitive economy.'

A3.6 Can business reporting serve multiple stakeholders?

This question was raised in *New Reporting Models for Business* because of a view among some reformers that a reporting model could be devised that would meet the needs of all stakeholders. Alternatively, the reformers advocated a technological solution: all the information that anybody could want would be stored in corporate databases accessible via the internet and users would drill down to the specific information they need. In relation to sustainability reporting, reformers currently seem to be divided: some want it integrated with the rest of reporting to investors; some want it kept separate.

Business reporting already serves the needs of multiple stakeholders. It is in a business's interests to do so, as it depends on successful relationships with different groups: owners, investors, lenders, employees, customers, suppliers and others. But users have diverse needs for information. We cannot assume that management will have available all the information that would meet all these needs. As with information for investors, some of it will be best obtained from other sources.

Sometimes relevant information might be highly uncertain or against the business's interests to disclose. Also, businesses are not necessarily interested in meeting all stakeholders' information needs; they may not recognise all those who demand information as legitimate stakeholders.

To deal with this issue comprehensively, it would be necessary to know:

- what information not currently available would meet different stakeholders' needs;
- to what extent different stakeholders have a right to information about a business; and
- what the costs and benefits to the business would be of preparing and disclosing information to meet different stakeholders' needs.

[42] *Reporting with Integrity* notes that 'A distinction needs to be made between honesty on the one hand and full disclosure and transparency on the other'.

Our suggested answer to the question 'Can business reporting serve multiple stakeholders?' is therefore a conditional one: 'Business reporting already serves multiple stakeholders. But how much further it can do so in practice depends on stakeholders' needs, on their information rights, and on the relevant costs and benefits.'

Appendix 4: ICAEW-commissioned research

Since *New Reporting Models for Business* was published, the ICAEW has, with the financial support of its charitable trusts, commissioned a number of research projects – some specifically designed to explore the issues raised in the report, others focused primarily on other issues, but making points that are relevant to the debate on new reporting models.

All the following papers have been published in the *International Accounting Policy Forum (IAPF)* annual special issue of *Accounting and Business Research (ABR)*. With two exceptions, all of them were first given at Information for Better Markets Conferences at the ICAEW. The exceptions are the papers of Ray Ball, and Geoff Meeks and Peter Swann, which were first given at the ICAEW as P. D. Leake Lectures.

Table A4.1: ICAEW-commissioned research papers

- 'International Financial Reporting Standards (IFRS): pros and cons for investors', Ray Ball (*ABR, IAPF*, 2006, pp5–27)
- 'Disclosure and the cost of capital: what do we know?', Christine A. Botosan (*ABR, IAPF*, 2006, pp31–40)
- 'Motives for disclosure and non-disclosure: a framework and review of the evidence', Russell Lundholm and Matt Van Winkle (*ABR, IAPF,* 2006, pp43–48)
- 'What has the invisible hand achieved?', Ross L. Watts (*ABR, IAPF*, 2006, pp51–61)
- 'Does sustainability reporting improve corporate behaviour?: Wrong question? Right time?', Rob Gray (*ABR, IAPF*, 2006, pp65–88)
- 'How can business reporting be improved? A research perspective', Martin Walker (*ABR, IAPF*, 2006, pp95–105)
- 'Financial reporting quality: is fair value a plus or a minus?', Stephen H. Penman (*ABR, IAPF*, 2007, pp33–44)
- 'Has the importance of intangibles really grown? And if so, why?', Sudipta Basu and Gregory Waymire (*ABR, IAPF*, 2008, pp171–90)
- 'Accounting for intangibles: a critical review of policy recommendations', Douglas J. Skinner (*ABR, IAPF*, 2008, pp191–204)
- 'What financial and non-financial information on intangibles is value relevant? A review of the evidence', Anne Wyatt (*ABR, IAPF*, 2008, pp217–56)
- 'Does measuring intangibles for management purposes improve performance? A review of the evidence', Christopher D. Ittner (*ABR, IAPF*, 2008, pp261–72)
- 'Intangibles and research – an overview with a specific focus on the UK', Andrew W. Stark (*ABR, IAPF*, 2008, pp275–85)
- 'Accounting standards and the economics of standards', Geoff Meeks and G. M. Peter Swann (*ABR, IAPF*, 2009, pp191–210)

The following reports and briefings commissioned and published by the ICAEW are also relevant.

Table A4.2: ICAEW-commissioned reports and briefings

- *Through the Eyes of Management: Narrative Reporting across Three Sectors*, Vivien Beattie, Bill McInnes and Stella Fearnley (2004)
- *Corporate Disclosure and the Cost of Capital: The Views of Finance Directors*, Seth Armitage and Claire Marston (2007)
- *UK Reporting of Intellectual Capital,* Jeffrey Unerman, James Guthrie and Ludmila Striukova (2007)
- *Communication Between Management and Stakeholders: A Case Study*, Bill McInnes, Vivien Beattie and Jacky Pierpoint (2007)
- *Managing Interest Rate Risk and Foreign Exchange Risk: Disclosure of Objectives, Policies and Processes*, Andrew Marshall and Pauline Weetman (2008)
- *Digital Reporting Options for Europe: A Socio-Technical Analysis of Interactive Data from the Perspective of Non-Professional Investors*, Joanne Locke, Andrew Lymer and Alan Lowe (2009)

Appendix 5: Opportunities for further research

In the course of this report, we have identified a number of issues where there is a need for further investigation. This appendix brings them together.

Difficulties in the debate on intangibles (3.8)

1. Part of the defence of the current reporting model is that, using earnings figures, investors are able to value a business without intangibles in the balance sheet. However, this raises a question as to why we need **tangible** assets in the balance sheet. If it is possible to value a business satisfactorily on the basis of earnings with expenditure on intangibles written off as it is incurred, why is it not equally possible to value a business with expenditure on tangibles written off as it is incurred?

2. The use of fair values to measure certain financial instruments has been defended on the basis that historical cost for such items is wholly inadequate. Fair value information, it is argued, therefore has to be only a little bit relevant and a little bit reliable to be more useful. Why is the same not true of valuing intangibles in the balance sheet? Measuring valuable intangibles at zero is on the face of it wholly inadequate. Surely valuations that were even a little bit relevant and a little bit reliable would be more useful?

3. In the debate on accounting for intangibles, there are a number of points where the evidence is disputed among researchers. This may reflect fundamental problems, eg, in knowing whether investment in one type of asset is too high or too low or whether at any given moment stock market valuations are too high or too low. How can we know, even with the benefit of hindsight, whether:

   - there is too much or too little investment in a particular class of asset; or
   - stock market valuations are too high or too low?

Improving financial reporting for intangibles (3.9)

4. At present, financial reporting standards distinguish between tangible and intangible assets. Is this distinction justifiable? And if so, why?

Current value accounting: a broken model? (4.3)

5. It has been alleged during the financial crisis that financial reporting has had adverse systemic effects – essentially that it has intensified the business cycle, especially in the financial sector. This is an important question that needs to be carefully researched. Does financial reporting – or do certain approaches to financial reporting – have procyclical effects?

Problems with a non-financial reporting model (5.4)

6. Support for the criticisms of detailed models that have been developed for reporting intangibles seems to come from the fact that little progress has been made in persuading businesses to adopt any of them. However, further research on this would be useful. What use have preparers made of detailed models for reporting intangibles? Have users found the information they provide helpful?

7. We have expressed a preference for high-level principles for non-financial reporting, on the basis that detailed models are likely to be ineffective. However, the same charge might be levelled at high-level models. How effective are broadly stated disclosure requirements that leave significant discretion to preparers as to what exactly should be disclosed? Compliance with the EU's business review requirements may provide relevant data on this question. What disclosures are being made across the EU in response to these requirements? Have users found the information they provide helpful?

Success drivers and business models (5.8)

8. What information on success drivers and business models could usefully be disclosed? What information is currently disclosed on these matters? How useful is it?

A source of emulation and prestige (6.6)

9. We have suggested that business reporting evolves partly through imitation of best practice and that accounts awards play a role in this. It would be useful to investigate this further and to consider the broader question: Why do businesses improve their reporting? Looking at specific examples of changes in reporting practice, how do they occur? How far do businesses learn from one another in reporting, and what role do awards play in this process? How far can individual managers affect the development of business reporting?

Recent changes in the market for information (6.8)

10. We have suggested that much of the increase in disclosure by businesses is a response to market forces rather than regulatory requirements, but it may be difficult to disentangle the effects of the two. Useful research questions on this subject would be: How much disclosure by businesses could be regarded as voluntary rather than regulatory, and how have the relative volumes of the two changed over time? How far does compliance with regulatory requirements lead to what are in effect voluntary disclosures through 'good' disclosers providing more information than 'poor' disclosers?

Systemic issues (6.9)

11. The financial crisis has raised questions about the quality of risk reporting – especially relating to systemic risks – in the years leading up to it. Key questions here are: How do the risks reported by businesses before the crisis compare with the risks that became clear during the crisis? Where there is a gap between the two (ie, businesses did not report before the crisis risks that became clear during it), how far was this because these risks were unforeseeable, should have been foreseen but were not, or were foreseen but not reported?

Length and complexity: possible solutions (7.3)

12. We have suggested that financial reporting might be structured so as to ensure that key messages are shown briefly, clearly and prominently. In order to pursue this idea, it would be helpful to have a summary of what is known from research in other fields on how readers (of printed texts or websites) process information. A subsequent challenge would be to look at how this knowledge can best be applied to the presentation of financial reporting information.

The rhetoric of public debate (8.2)

13. There is a large body of research showing that financial reporting is just one source of information to which the market pays attention and that the next earnings announcement is not the exclusive focus of market interest. Yet many of those who participate in the debate on the future of business reporting seem to assume the opposite. It would be useful to summarise what is known on this subject and make it more widely available.

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