

# **Issues arising from the ICAEW report: “What’s next for corporate reporting: Time to decide?”**

## **Comments from the British Accounting and Finance Association’s Special Interest Group in Financial Accounting and Reporting**

### ***Preface***

The Financial Accounting and Reporting Special Interest Group (FARSIG) is a special interest group of the British Accounting and Finance Association (BAFA). Its technical committee is charged with commenting on issues and proposals relating to financial accounting and reporting. Its views represent those of its members and not those of BAFA.

BAFA is the representative body for UK accounting academics and others interested in the study of accounting and finance in the UK. FARSIG is BAFA’s designated group specialising in issues relating to financial reporting. This response has been formulated by Mark Clatworthy, Omiros Georgiou, Lenka Krupova, David Oldroyd (editor) and Jason Xiao, with comments from Carol Adams and Mike Jones, and has been approved by the FARSIG Technical Committee.

We have necessarily been sparing with the literature we have cited in this response and if you need any supportive academic references we will be happy to supply them.

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## 1. Summary

We welcome this latest initiative by the ICAEW to influence the international debate on corporate reporting and are grateful for the opportunity to contribute to the discussions.

The report in question identifies a number of key areas affecting the future of corporate reporting, namely: 1) the objectives of corporate reporting, who is the user? 2) One report or many? The needs of investors v other stakeholder groups. 3) Consistency, credibility and the pace of change. 4) The intangibles problem. 5) Data and technology.

We shall comment on each of these areas in turn. Our main recommendations are summarised as follows:

- Corporate reporting needs to be considered in the wider context of all the information that is published about companies or which they publish themselves.
- The annual report to shareholders, and the financial statements especially, are but one of an expanding range information sources available to outside parties. Therefore, a clear distinction needs to be drawn between the audited financial statements and the rest in terms of the information provided.
- This is particularly relevant given the expansion of digital communication, which increases the possibilities for misinformation about organisations being spread.
- The distinguishing feature of the audited financial statements is they are subjected to verification by the auditors. It follows that audited financial statements should not contain information that is not susceptible to verification such as valuations based on estimates of long-term, uncertain future cash flows; or if they do, these should be accompanied by a clear warning of the uncertainty inherent in the estimates.
- Distinguishing the audited financial statements in this way would not preclude companies from publishing supplementary financial and non-financial information, the demand for which is increasing.
- The financial statements are of use to stakeholders in general, including investors, and the notion that their sole purpose is to inform the latter should be discarded.
- The degree to which standardisation of non-financial disclosures is practicable is necessarily limited owing to the incentives on companies to communicate additional information beyond that which at any point in time is mandated. Any such framework would therefore need to be principles-based.
- Long-lasting agreement on non-financial disclosures is most likely to come from a bottom-up approach to the development of practice.
- The difficulties associated with identifying, recognising and valuing intangibles, and the inconsistencies and uncertainties that result, highlight the impracticability of adhering to one over-arching theoretical approach to measurement.
- Information about intangibles is vital to understanding the nature of a company's operations. But owing to the uncertainties surrounding these assets that prevent them from being accounted for consistently within the audited financial statements, we recommend that they are dealt with outside, possibly in supplementary unaudited fair-value balance sheets or in a suitable narrative form.

- More research is needed on the impact of digitisation on corporate reporting in order to determine the way forward.

## **2. Objectives of corporate reporting, who is the user?**

We consider this to be a very important issue as it is always a starting point about thinking about corporate reporting. An important related question is ‘for what purpose is the information being used?’ These questions underpin all other issues when discussing the future of corporate reporting.

Restricting corporate reporting to servicing the information needs of investors is problematic because corporate reporting is used in practice for purposes other than investing decisions. It is important to debate the purposes different stakeholders read financial reports for. For example, evidence shows that investors also use annual reports to assess the performance of managers.<sup>1</sup> Annual reports play a vital role in the firms’ contracting with managers and debt-holders.<sup>2</sup> They also help to ‘discipline’ and confirm other relevant sources of information, such as direct contact with management. Restricting corporate reporting to the investment decision-making objective risks compromising the reliability of information needed for these other uses of financial reports.

There is also evidence that the current financial reporting model has limitations for meeting the needs of investors. For example, research shows that the increased use of fair values in financial reports, as promoted by IFRSs, detracts from informing investors about the performance of a business in certain areas.<sup>3</sup>

A better approach to the audited financial statements would not be to limit the objectives to facilitating investment decisions, but to restrict the financial information disclosed to what can be verified, thereby placing more emphasis on reliability. Verifiable accounting data is of use to stakeholders in general including investors, and the notion that the sole purpose of financial statements is to inform the latter should be discarded. In the event that less verifiable information is included in the financial statements on the grounds of relevance, accompanying disclosures should make clear the uncertainty inherent in the estimates.

An important issue to consider is the type of information reported. As the ICAEW report acknowledges, improvements in narrative reporting have brought about better understanding of companies’ risks and value. Disclosures can supplement more verifiable financial statements, so hard-to-verify fair-value information (i.e., where there are no observable inputs and/or prices), and non-financial capital information could be reported in the front end of the annual report. Companies could also include supplementary statements showing unrealised gains and ‘unrecognised value’, in like manner to the days of current cost accounting. Although this information may have the advantage of being inherently forward looking, it is also important to recognise its

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<sup>1</sup> Cascino, S., Clatworthy, M., García Osma, B., Gassen, J., Imam, S. and Jeanjean, T. (2016), *Professional investors and the decision usefulness of financial reporting*. ICAS (The Institute of Chartered Accountants of Scotland) and EFRAG (European Financial Reporting Advisory Group).

<sup>2</sup> Kothari, S. P., Ramanna, K., and Skinner, D.J. (2010), ‘Implications for GAAP from an analysis of positive research in accounting’. *Journal of Accounting and Economics*, 50 (2-3): 246-280.

<sup>3</sup> Georgiou, O. (2017), ‘The worth of fair value accounting: dissonance between users and standard setters’, *Contemporary Accounting Research*, epub ahead of press: <https://doi.org/10.1111/1911-3846.12342>.

limitations. In particular, forecast data are often lacking in usefulness when there is no tangible outcome against which the forecast can be evaluated. As discussed below, accounting for intangibles is a prime example of this.

### **3. One report or many? The needs of investors v other stakeholder groups**

The annual report is generally seen as a more trusted source of information than other sources. We agree that the linkages between different reports and information for different users will need careful consideration. We also agree that there is an inherent tension in expanding the scope of financial information as this potentially threatens the role of the audited financial statements. It is widely acknowledged in the academic literature that one information system cannot satisfy the needs of users with different objectives.<sup>4</sup>

Having said this, we consider that information currently reported outside the annual report, such as that listed in Table 1, is of relevance to stakeholders in general including investors. The key issue, therefore, is the *quality* of the information reported rather than its location. And perhaps information reported in both the annual report and in other places should be aimed at informing *all* stakeholders of a company.

We see three issues worthy of further debate in relation to including information that is currently reported separately in a single annual report:

1. The quality and properties of information in different parts of a single annual report. How is information not regulated (and possibly not audited) to be evaluated by the different users of the single annual report?
2. The extent to which managers are to be held responsible for the accuracy of the information in different parts of the single annual report. Should managers be responsible for all information in the single annual report?
3. The level and nature of independent verification of the information. Are auditors to be expected to report on the information outside the main financial statements? And if so, to whom should they be accountable? If auditors are not performing this role, what will the nature of regulatory oversight be?

If the acknowledged user-group is extended to those beyond providers of financial capital, narrative disclosures, rather than numerical data such as that included in the financial statements, will most likely fill the gap. This is because it is difficult to mandate standards across industries for many non-financial metrics (such as environmental performance) and independent verification of capital other than firms' financial capital is often difficult.

The limits of auditors' liability to outside stakeholders may inhibit the usefulness of many types of information to non-shareholders. Even creditors – who are among the target audience of existing financial reporting information – often find it difficult to obtain compensation for auditor negligence. Lack of liability to other stakeholders (contracted or non-contracted) for non-financial information may reduce auditor effort and attention, even in the presence of professional standards.

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<sup>4</sup> See for instance Demski, J.S. (1973), 'The general impossibility of normative accounting standards'. *The Accounting Review*, 48 (4): 718-723.

## *Time to decide?*

Should the trend for separate reporting outside of the annual report be encouraged, with appropriate safeguards, to minimise the risk of undermining the usefulness of the annual report to investors?

**OR**

Are the advantages of a single, comprehensive and trusted vehicle for corporate communication with a wide range of stakeholders more important?

To summarise, annual reports already exist within an expanding range of information sources about companies, and themselves contain a mix of mandatory and non-mandatory disclosures, not all of which is audited. It seems anachronistic and impracticable to curtail this.

The quality of the information reported is the key issue rather than its location; and we recommend that a clear distinction be drawn between the audited financial statements and the rest of the information provided, with the emphasis of the former being on reporting information that is capable of verification. Such information is useful to a wide range of stakeholders, in addition to investors.

## **4. Consistency, credibility and the pace of change**

The report raises the question of whether companies should be obliged to follow a standardised framework in the disclosure of non-financial information. To a large extent, whether such standardisation is possible in practice depends on whether the disclosures are mandatory or non-mandatory. Mandatory disclosures usually take a standardised form, whereas companies will always find incentives to communicate additional information to their significant stakeholders beyond what is mandated.<sup>5</sup> It follows that unless the full-extent of what companies communicate with the outside world is prescribed by regulators, standardisation of all non-financial and indeed financial disclosures is impracticable.

Therefore, whilst we agree that standardisation of non-financial disclosures would enhance the quality of corporate reporting by promoting consistency, any such framework would necessarily have to be principles-based to encompass all situations (though it could provide guidance on specific issues in like manner to the appendices to certain IFRSs).

The ICAEW report questions the viability of a voluntary approach to the development of practice in this area as opposed to a mandatory one. Studies suggest that where practice becomes mandatory, it is less likely to lead to misleading, biased and incomplete disclosures; also, that it results in better understanding by boards of directors of how the issues impact their businesses.<sup>6</sup> However, research also

<sup>5</sup> See for instance Friedman, A.L. and Miles, S. (2002), 'Developing stakeholder theory'. *Journal of Management Studies*, 39: 1-21.

<sup>6</sup> Adams, C.A. (2004), 'The ethical, social and environmental reporting-performance portrayal gap'. *Accounting, Auditing and Accountability Journal*, 17 (5): 731-757; Adams, C.A. (2017), 'Conceptualising the contemporary corporate value creation process'. *Accounting, Auditing and Accountability Journal*, 30 (4): 906-931.

indicates that making non-financial disclosures compulsory does not guarantee compliance;<sup>7</sup> and the associated costs of imposing additional regulation on business would need to be considered as well.

The choice between mandatory and voluntary practice is not a simple one as the long-term ability of standard-setters to impose standards without consensus is questionable.<sup>8</sup> We are therefore in favour of a bottom-up approach to the development of practice, such as the one mentioned in the report concerning the FRC's Financial Reporting Lab. The coalescing of social and environmental reporting practice that appears to be taking place around the six capitals of integrated reporting is possibly one such trend,<sup>9</sup> notwithstanding that scepticism remains over the ability of such initiatives to 'reconfigure the mainstream investment field'.<sup>10</sup>

We can see the advantages of a dedicated body to work with stakeholders in gleaning their views, carrying out experimentation, trying to establish consensus etc., as suggested in the report. However, given the tendency in corporate reporting of interested parties towards promoting political agendas,<sup>11</sup> such a body would need to be eclectic in its composition, and not dominated by particular lobbying groups.

### *Time to decide?*

Is a concerted international effort needed to encourage adoption of a consistent approach to non-financial reporting, perhaps through a high-level framework, developed and coordinated internationally by a global umbrella organisation?

*or*

Should we accept that, with non-financial reporting practice still emerging and evolving, initiatives designed to increase standardisation may at this stage inhibit all-important experimentation and innovation?

To sum up, the degree to which standardisation of non-financial disclosures is practicable is necessarily limited owing to the incentives on companies to communicate additional information beyond that which is mandated. Any such framework would therefore need to be principles-based. Long-lasting agreement is most likely to come from a bottom-up approach to the development of practice.

<sup>7</sup> EG) Adams, C.A., Coutts, A. and Harte, G. (1995), 'Corporate equal opportunities (non-) disclosure'. *British Accounting Review*, 27: 87-108.

<sup>8</sup> EG) Pong, C.K.M. and Whittington, G. (1996), 'The withdrawal of current cost accounting in the United Kingdom: A study of the Accounting Standards Committee'. *Abacus*, 32 (1): 30-53.

<sup>9</sup> EG) Adams, C.A. (2015), 'The International Integrated Reporting Council; a call to action'. *Critical Perspectives on Accounting*, 27: 23-28.

<sup>10</sup> Humphrey, C., O'Dwyer, B. and Unerman, J. (2017), 'Re-theorizing the configuration of organizational fields: the IIRC and the pursuit of "Enlightened" corporate reporting'. *Accounting and Business Research*, 47 (1): 30-63.

<sup>11</sup> Watts R.L. and Zimmerman, J.L. (1979), 'The demand and supply of accounting theories: the market for excuses'. *The Accounting Review*, 54 (2): 273-305.

## 5. The intangibles problem

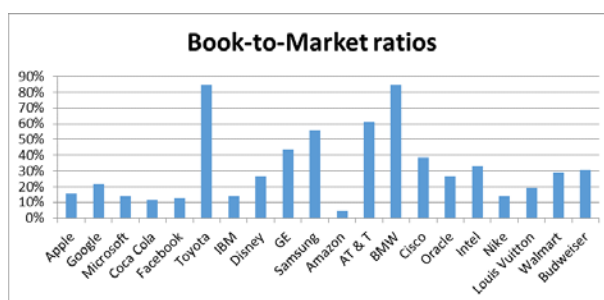
The ICAEW are correct in highlighting intangibles as the ‘Achilles’ heel’ of financial reporting given the size and significance of these assets, and the inherent difficulties in identifying and measuring them. The current accounting treatment under IAS 38 of recognising only those intangibles that have been acquired from other organisations produces inconsistent results.<sup>12</sup> Likewise, the two benchmarks for ascertaining the ‘recoverable amount’ when carrying out impairment reviews under IAS 36 are highly subjective given their forward-looking nature and the lack of an active market in most cases. This lack of susceptibility to verification is compounded in the case of goodwill, which is an asset that is hard to distinguish from other intangibles, cannot by definition be disposed of separately, and loses its original character following acquisition when the acquired business is integrated into the existing operations in pursuit of synergies. Finally, distinguishing when the trigger event occurs that differentiates research from development expenditure allowing the latter to be capitalised is also open to debate.<sup>13</sup>

Discussions about intangibles have appeared regularly (in ‘waves’) since as early as the 1950s, with the crucial research questions: how to account for intangibles in general and what is the best accounting treatment for internally generated intangible assets in particular, still unresolved.

The difficulties are compounded a) by differences in theoretical approaches to the phenomenon: and b) by accounting for intangibles being subordinated to the tax impacts in some national accounting jurisdictions, such as in the capitalisation of expenditures on research and development or advertising for tax reasons.<sup>14</sup>

Regarding theory, the balance sheet approach to income measurement has led the IASB towards recognising acquired intangibles in the balance sheet at a market

<sup>12</sup> The treatment of home-grown intangibles also contributes to the increasing gap between the book value of companies and their market capitalisation as illustrated by the book-to-market capitalisation ratios for 20 companies with the most valuable brand names in 2017 (listed in Forbes magazine), notwithstanding that is not the only explanation:



Source of data: Bloomberg, assessed November 1, 2017

<sup>13</sup> The degree to which the current accounting treatment adversely affects the capital markets is unclear. See for instance, Skinner, D. (2008), ‘Accounting for intangibles – a critical review of policy recommendations’. *Accounting and Business Research*, 38 (3): 191-204. However, accounting for intangibles is an example of what Lee (2006) describes as the ‘subjective, flexible, and inconsistent rules that permit the reporting of accounting numbers with ambiguous economic meaning’, enabling some corporate managers to engage in earnings management – ‘The war of the sidewardly mobile corporate financial report’. *Critical Perspectives on Accounting*, 17 (4): 419-455.

<sup>14</sup> Stolowy, H. and Jeny-Cazavan, A. (2001), ‘International accounting disharmony: the case of Intangibles’. *Accounting, Auditing and Accountability Journal*, 14 (4): 477-496, found considerable inconsistencies in their definition as well as their treatment between jurisdictions.

valuation. However, for this approach to work properly one would also need to be able to recognise internally generated intangibles, as well as being able to corroborate their future economic benefits, which in most cases is impracticable. This is aside from the difficulties in identifying and measuring goodwill separately from other intangibles and quantifying impairment. The alternative matching approach to income measurement yields more consistent results as the expenditure on creating and maintaining home-grown intangibles is matched to revenue in the income statement as it occurs, although this still leaves the problem over what period of time to match the cost of purchased intangibles.<sup>15</sup>

In other words, there is no ideal solution over how to account for intangibles following the conventional double-entry model, which has led some commentators to support the idea of voluntary disclosures outside the audited financial statements as the way forward.<sup>16</sup>

We echo this view, or as noted in Section 1 above, would permit companies to prepare alternate, unaudited supplementary financial statements showing unrealised gains and 'unrecognised value', which would allow them to include best-estimates of the value of all their intangibles, home-grown and acquired.<sup>17</sup>

### *Time to decide?*

Is it time for standard-setters, with the support and active assistance of other stakeholders, to rise to the challenge and prioritise ways and means of bringing a much wider range of intangibles onto the balance sheet?

*or*

Should it be finally accepted that the intangibles question will not be resolved through financial reporting change, with attention firmly focused instead on a broader approach to reporting that looks beyond historical financial performance?

Information about intangibles is vital to understanding the nature of a company's operations. But owing to the uncertainties surrounding these assets which prevent them from being accounted for consistently within the audited financial statements, we recommend that they are dealt with outside, possibly in supplementary unaudited financial reports.

## **6. Data and technology**

The answer to the question of whether to allow progress in the use of technology in corporate reporting to evolve naturally or to take a more proactive, interventionist

<sup>15</sup> Penman, S.H. (2009), 'Accounting for intangible assets: there is also an income statement'. *Abacus*, 4 (3): 358-371, suggests the focus on the balance sheet is overblown.

<sup>16</sup> See for instance, Basu, S. and Waymire, G. (2008), 'Has the importance of intangibles really grown? And if so, why?'. *Accounting and Business Research*, 38, (3): 171-190; Jenkins, E. and Upton, W. (2001), 'Internally generated intangible assets: framing the discussion'. *Australian Accounting Review*, 11 (24): 4-11; and Lev, B. (2018), 'The deteriorating usefulness of financial reporting information and how to reverse it'. *Accounting and Business Research*, 48 (5): 465-493.

<sup>17</sup> Although unaudited, such statements could receive independent verification from valuation professionals.



stance depends first on whether greater use of ICT is useful and cost-efficient to the constituents of corporate reporting. If greater use of ICT is not useful or cost-efficient, then it would be natural to let things evolve. Otherwise, the stakeholders in corporate reporting should make a concerted effort to promote and enable a greater use of ICT. More research is needed on this basic question as there is currently a lack of evidence.

The proposed decision issue is problematic in the sense that it does not distinguish between internal reporting and external reporting. There is much more use of ICT for internal accounting and reporting, e.g., ERP and stand-alone packages. The application of ICT for external reporting is currently more limited (apart from using the Internet for corporate disclosure including online databases such as EDGAR) because there are barriers or there is little demand. Also, we know little about what technologies would be useful for external information users and what and how such technologies could enhance the usefulness of accounting information to them. Again, more research is needed in this area before one could decide on how to achieve greater use of ICT in external reporting if desired.

The relationship between the annual report and other forms of reporting is a central theme running throughout the ICAEW report, in the section on non-financial disclosures, for example. Where the issue of ICT is distinctive is that it offers greater potential for customisation to meet the particular needs of users compared to hard-copy mediums.

A useful proposed model that describes this relation is *Customisation Around the Standard Report (CASR)*.<sup>18</sup> Under CASR, the general-purpose report can be seen as the standard report, which needs standardisation to maintain comparability, whereas customisation allows organisations to meet users' different information and presentation requirements. Customisation can be in many dimensions such as format of reporting, frequency of reporting (e.g., monthly and quarterly reporting) and content of reporting (e.g., social and environmental reporting).

Customisation can be done in two forms: customised reporting and customisable reporting. The former is a report tailored to meet the needs of specific users while the latter means that the user is provided with options to customise their own report. Both forms of customisation have the potential to increase the utility of accounting information to a wide variety of stakeholders, but more research is needed in this area not just in terms of future practice, but in terms of what is currently being achieved. For example, there is a need to give more exposure to and research on how investors currently manipulate data with their own software.

Allowing users to access raw data is an important way to achieve customisable reporting. However, one of the main barriers to the proposed provision of raw data to external users is the confidentiality concern, as well as data-protection issues. This point is missing from the report. Raw data contains detailed transactions, many of which are sensitive, involving external parties. When aggregated figures are reported, the confidentiality issue is reduced.

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<sup>18</sup> Jensen, R. and Xiao, Z. (2001), 'Customized financial reporting, networked databases and distributed file sharing'. *Accounting Horizons*, 15 (3): 202-222.

### *Time to decide?*

Should we accept that the pace of progress in the use of technology as a corporate reporting tool is likely to remain very slow, with no real impetus to change when investors already manipulate data using their own software and analyse data from a variety of sources?

***or***

Should stakeholders make a concerted effort to accelerate and coordinate progress, necessitating a new depth and breadth of collaboration between technology specialists and those with an interest in better corporate reporting?

In short, it is too early to answer the question raised, and we would agree with the ICAEW of the need for more research on ‘the likely impact of digitalisation in both theory and practice in this area’, as well as the costs and benefits. The ICAEW is well-placed to support research in this area. We suggest it should take a proactive approach – potentially with policy makers and government departments – to develop questions of interest and to solicit research.

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