

# INTRODUCING MORE PRINCIPLES OF DISCLOSURE:

## WILL THE POOR DISCLOSERS IMPROVE?

The IASB Research Forum 2017  
Brussels, November 28, 2017

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## BACKGROUND OF THE PAPER

- Disclosure requirements in IFRS Standards currently comprise a mix of principles and lists of specific requirements.
- Discussion paper on Principles of Disclosure published by the IASB in March 2017. Comments to be submitted on 2 October.
- Members of the EAA worked developing a comment letter and this working paper is one of the outcomes.
- Good timing for evaluating implications of adopting more principles of disclosure.

# PURPOSE & RESEARCH APPROACH

- PURPOSE OF THE PAPER

- The purpose of the paper is to evaluate the effects of introducing more high-level principles of disclosure in IFRS Standards

- RESEARCH APPROACH

- Review prior research on compliance with IFRS disclosure requirements in order to learn more about what works today in terms of disclosure requirements and compliance
- Literature review: search for prior research including the combination of 'disclosure' and 'compliance' in the title, keywords or abstracts in ABS journals ranked 2 or higher. 81 papers reviewed.



# PRINCIPLES-BASED STANDARDS IN THE AREA OF DISCLOSURES

- ‘Empirical research shows that principles-based standards work well in certain situations, in that they permit preparers to convey private information. On the other hand, in high-incentive situations, principles-based standards tend to perform poorly, especially in the absence of strong enforcement. This is troubling, since it is in high-incentive situations that financial reporting is most important.’
- ‘Empirical research indicates problems with principles-based accounting standards, while analytical research supports such an approach. It is important to note, however, that this research is mostly focused on measurement issues, not on disclosure.’
- ‘Arguably, principles-based regulation relating to disclosures is more difficult to achieve. It is harder to know whether a principle is followed properly relating to disclosures, as it is based more on qualitative judgement. Whether a certain note contains relevant information, and whether it is understandable for users is difficult to enforce and audit. Thus, having principles-based standards for disclosures is likely to be even more difficult than suggested by existing research.’

Source: Barker et al. (2013)



# PRINCIPLES-BASED STANDARDS IN THE AREA OF DISCLOSURES

- Principles-based standard setting implies a top-down, deductive approach. It will be important to also consider what works in practice.
- For example, a principles-based approach was applied in IFRS 7 (Financial Instruments: Disclosures), where a high-level principle of disclosure is set out in the beginning followed by a large number of specific requirements derived from the principle. This appears theoretically attractive, but has it worked out well in practice?
- Increased knowledge of what has worked out well in practice would seem important when considering increased reliance on general principles of disclosure as outlined in the Discussion Paper.



# PRINCIPLES OF DISCLOSURE VS. SPECIFIC REQUIREMENTS

- Let's first think about the disclosure requirements in four standards that have been subject to academic research: IFRS 3, IAS 36, IFRS 7 and IFRS 8
  - IFRS 3 – Disclosure objectives and list of specific requirements
  - IAS 36 – list of specific requirements – no principle provided
  - IFRS 7 – high-level principle of disclosure, specific requirements derived from the principle.
  - IFRS 8 – high-level principle of disclosure, very little mandatory specific requirements
- Do entities comply with these requirements? Both principles and specific requirements? What does academic research show?



# IFRS 3

## Business Combinations

### Disclosures

59 The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either:

- (a) during the current reporting period; or
- (b) after the end of the reporting period but before the financial statements are authorised for issue.

60 To meet the objective in paragraph 59, the acquirer shall disclose the information specified in paragraphs B64—B66.

61 The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period that relate to business combinations that occurred in the period or previous reporting periods.

62 To meet the objective in paragraph 61, the acquirer shall disclose the information specified in paragraph B67.

63 If the specific disclosures required by this and other IFRSs do not meet the objectives set out in paragraphs 59 and 61, the acquirer shall disclose whatever additional information is necessary to meet those objectives.

2 disclosure objectives

Specific requirements derived from the objectives

“Objectives override”

32 items specified

17 items specified

Source: IFRS 3, Business Combinations



# IAS 36

## Impairment of Assets

### Disclosure

example  
126

An entity shall disclose the following for each class of assets:

- (a) the amount of impairment losses recognised in profit or loss during the period and the line item(s) of the statement of comprehensive income in which those impairment losses are included.
- (b) the amount of reversals of impairment losses recognised in profit or loss during the period and the line item(s) of the statement of comprehensive income in which those impairment losses are reversed.
- (c) the amount of impairment losses on revalued assets recognised in other comprehensive income during the period.
- (d) the amount of reversals of impairment losses on revalued assets recognised in other comprehensive income during the period.

“only” specific requirements

46 “shall” items specified in 126-135

1 example of a weaker formulation in 132

132

An entity is encouraged to disclose assumptions used to determine the recoverable amount of assets (cash-generating units) during the period. However, paragraph 134 requires an entity to disclose information about the estimates used to measure the recoverable amount of a cash-generating unit when goodwill or an intangible asset with an indefinite useful life is included in the carrying amount of that unit.

Source: IAS 36, Impairment of Assets





## Compliance with IFRS 3- and IAS 36-required disclosures across 17 European countries: company- and country-level determinants

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In this study, we analyse compliance for a large sample of European companies mandatorily applying International Financial Reporting Standards (IFRS). Focusing on disclosures required by IFRS 3 *Business Combinations* and International Accounting Standard 36 *Impairment of Assets*, we find substantial non-compliance.

Compliance is measured on the basis of a checklist including 100 disclosure items from IFRS 3 and IAS 36.

The data comprise annual reports for 2005 of 357 leading European companies

Why do these poor disclosers appear?  
 Why is the minimum level so low

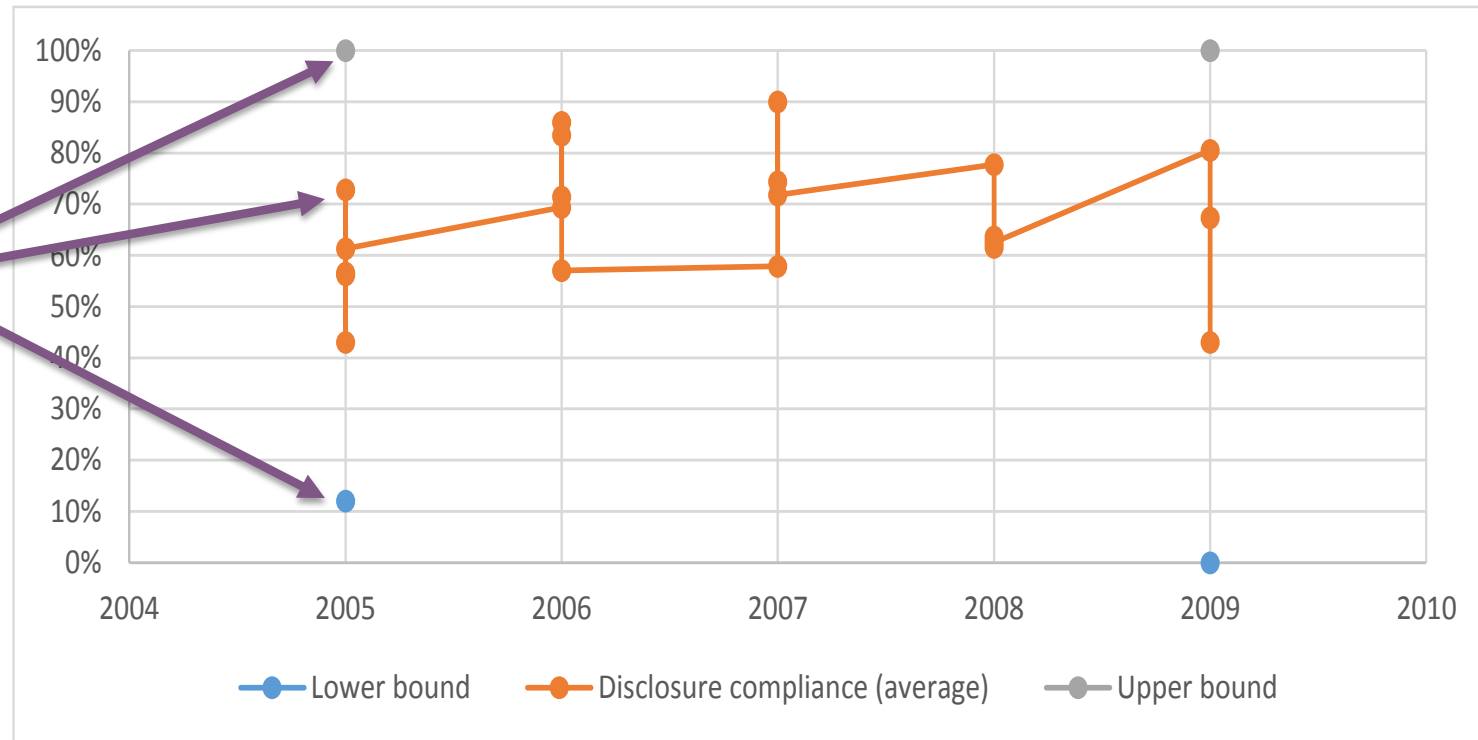
	Mean	Standard deviation	Median	Minimum	Maximum
Panel A: Dependent variable (level of compliance)					
COMPLIANCE	0.728	0.177	0.750	0.120	1.00
<i>By Country</i>					
Austria	0.563	0.137	0.539	0.333	0.837
Belgium	0.739	0.170	0.789	0.454	1.000
Czech Republic	0.582	0.191	0.607	0.238	0.807
Denmark	0.809	0.154	0.856	0.533	1.000
Finland	0.799	0.157	0.833	0.375	0.966
France	0.730	0.151	0.732	0.318	0.962
Germany	0.761	0.117	0.792	0.550	1.000
Hungary	0.603	0.191	0.519	0.444	0.894
Ireland	0.784	0.140	0.788	0.500	1.000
Italy	0.646	0.162	0.647	0.235	1.000
Luxembourg	0.579	0.270	0.608	0.222	0.879
The Netherlands	0.727	0.164	0.745	0.454	1.000
Poland	0.621	0.206	0.636	0.120	0.892
Spain	0.569	0.177	0.528	0.320	1.000
Sweden	0.817	0.142	0.857	0.360	0.966
Switzerland	0.849	0.114	0.888	0.558	1.000
UK	0.798	0.150	0.818	0.363	1.000

We found 21 studies measuring disclosure compliance with IFRS 3 and/or IAS 36.

Countries covered: European countries, Australia, Singapore, China

Average compliance across the 21 studies is 67%

Glaum et al. (2013)



There appears to be much variation in disclosure compliance behavior

Research focuses on compliance with specific requirements, not the objectives

# IS IT FAIR TO CONCLUDE THAT THERE IS NON-COMPLIANCE WHEN “SHALL DISCLOSE” ITEMS ARE NOT DISCLOSED?

- Companies may be compliant even though they do not disclose an item, because there may be circumstances unknown to the user that makes that disclosure immaterial.
- First, materiality refers to what is relevant when *users*, not preparers, make decisions, which means that when there is ‘...clear evidence of activity that would be expected to generate disclosure under IFRS’ (Pope & McLeay, 2011, p. 249), both the user and the researcher have good reason to believe this is non-compliance rather than lack of materiality. Researchers also put much effort into determining whether an item is applicable or not to the entity.
- Second, the poor disclosers do not appear randomly, but there are systematic patterns with the regard to what makes companies comply more or less with the specific disclosure requirements.



# Objective

- 1 The objective of this IFRS is to require entities to provide disclosures in their financial statements that enable users to evaluate:
- (a) the significance of financial instruments for the entity's financial position and performance; and
  - (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.

# IFRS 7

## Financial Instruments: Disclosures

### Significance of financial instruments for financial position and performance

- 7 An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.

135 "shall" items specified in 8-30

Specific requirements derived from the principle

BC13: "In the Board's view, entities could not satisfy the principle in paragraph 7 unless they disclose the information required by paragraphs 8-30"

### Nature and extent of risks arising from financial instruments

- 31 An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

109 "shall" items specified in 33-42

BC40:

- a) consistent requirements and comparable information
- b) should depend on the extent of an entity's use of financial instruments and the extent to which it assumes associated risks

BC 41: strike a balance between a and b – the standard sets out principles and minimum requirements applicable to all entities.

Source: IFRS 7, Financial Instruments: Disclosures



# The Effects of IFRS 7 Adoption on Bank Disclosure in Europe

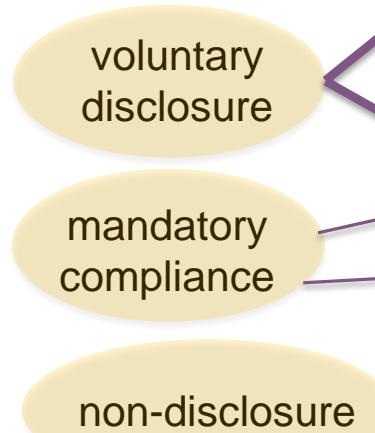
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Country	N	Total assets, million EUR		Return to equity		Risk report		Financial statement	
		2006	2007	2006	2007	2006	2007	2006	2007
Sample	171	148,188	170,290	0.154	0.134	13.9	20.1	69.4	73.7

The level of disclosure has significantly increased due to more extensive description of **accounting policies** and more elaborate **disclosure about exposures to significant risks**.

An analysis of information about selected details reveals that disclosures are **not only more extensive but also more profound**.



“Interestingly, an increase in the length of the financial statement (the risk report) could be observed for **only 73.20%** (89.54%) of the banks in the sample.”

“...companies are supposed to include information about the credit quality of financial assets in their financial statements. **28.0%** of European banks voluntarily disclosed the internal or external **ratings of their customers** before IFRS 7 adoption. In 2007, this proportion increased to **72.7%**. The same observation can be made for information about the **age of financial assets that are past due but not impaired** on the reporting date. The proportion of banks disclosing such information has increased from **8.3%** to **63.6%**. This sheds...some light on compliance... **27.3%** of the banks are withholding information about customer ratings, and **36.4%** do not provide information about loans in arrears.

## (Un)useful risk disclosure: explanations from the Italian banks

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Managerial Auditing Journal  
Vol. 29 No. 7, 2014  
pp. 621-648

**Purpose** – The purpose of this paper is to better understand how mandatory risk categories are disclosed and to provide a better understanding of the reasons why risk disclosure looks less useful than it ought to be.

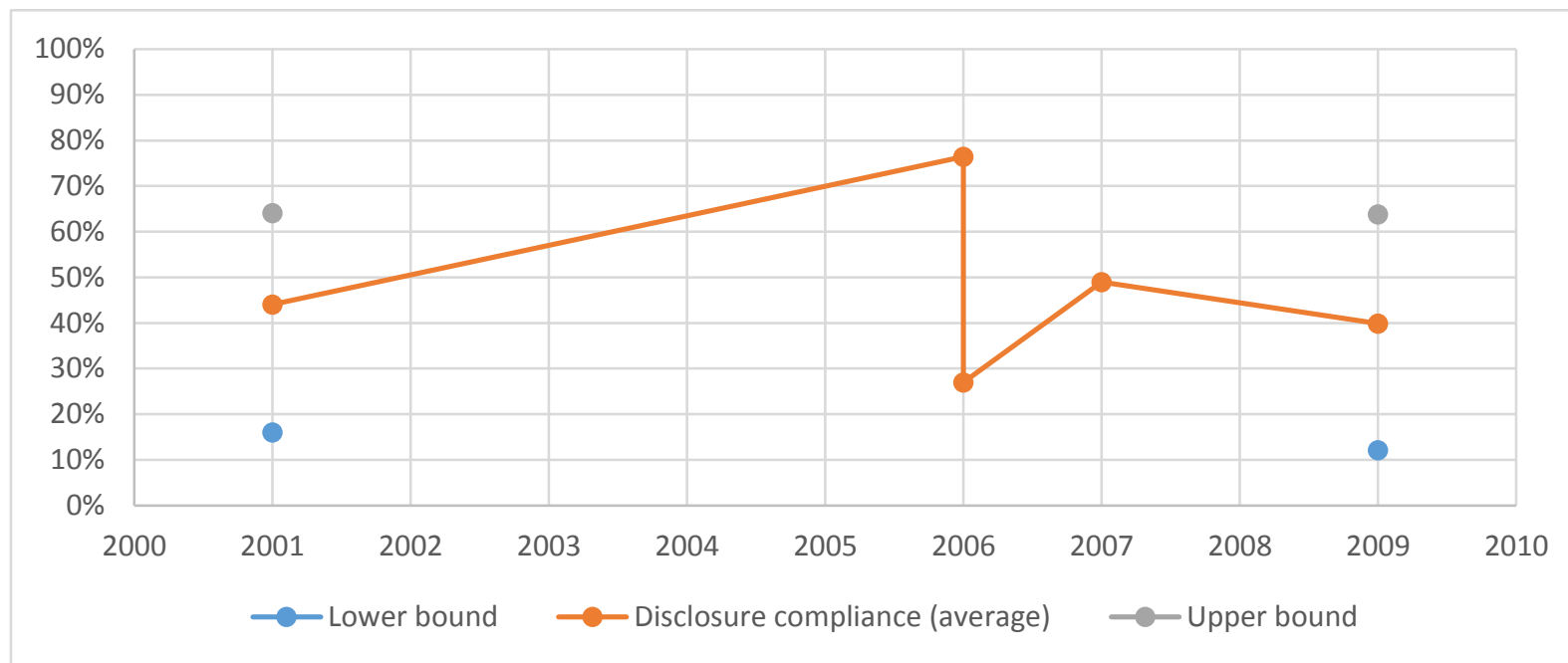
**Design/methodology/approach** – We analyze **how Italian banks provide risk information**, by focusing on its characteristics to find out any differences between the notes to the financial statements and the public report, both prepared in compliance with the instructions of the Bank of Italy. We assess the risk-related reporting practices of 66 Italian banks, based on a content analysis of the two mandatory reports, and verify whether bank-specific factors explain any differences.

The findings show that although Italian banks **formally comply** with the Bank of Italy's instructions, there is **room for them to choose the characteristics of the information**, with undeniable effects on the quantity of the disclosure provided in each report and for each risk category.

We found five studies measuring disclosure compliance with IFRS disclosure requirements

Countries covered: Portugal, Jordan, Malawi, Malaysia

Average compliance across the five studies is 47%



## IFRS 7 – WHAT ABOUT COMPLIANCE WITH THE PRINCIPLE IN PARAGRAPH 7

- According to our review, academic research has not focused on compliance with principles in IFRS 7, but on compliance with specific requirements. One reason for this may be that it is very difficult to measure such compliance with principles. However, if this is difficult for researchers it may perhaps be so for entities, auditors and regulators as well?
- A few years ago, ESMA published a report on compliance with IFRS 7 (ESMA, 2013) based on a study of 39 European financial institutions. The report was somewhat critical (ESMA, 2013, p. 4, emphasis added):
- Overall ESMA found that disclosures specifically covered by requirements of IFRS 7 – *Financial Instruments: Disclosures* were generally provided and **acknowledges the efforts made by financial institutions to improve the quality** of their financial statements. Yet, ESMA observed a **wide variability in the quality** of the information provided and identified some cases where the information provided was not sufficient or not sufficiently structured to allow comparability among financial institutions. Some financial institutions provided disclosures that were **not specific enough**, **lacked links between quantitative and narrative information**, or **provided disclosures that could not be reconciled to the primary financial statements**. ESMA urges issuers to take a step back and consider the overall objectives of IFRS 7 against their specific circumstances when preparing disclosures.



# IFRS 8

## Operating Segments

A high-level principle

Some specific requirements

## Disclosure

20

An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

Information about profit or loss, assets and liabilities

23

An entity shall report a measure of profit or loss for each reportable segment. An entity shall report a measure of total assets and liabilities for each reportable segment if such amounts are regularly provided to the chief operating decision maker. An entity shall also disclose the following about each reportable segment if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker, or are otherwise regularly provided to the chief operating decision maker, even if not included in that measure of segment profit or loss:

- (a) revenues from external customers;
- (b) revenues from transactions with other operating segments of the same entity;
- (c) interest revenue;
- (d) interest expense;
- (e) depreciation and amortisation;
- (f) material items of income and expense disclosed in accordance with paragraph 97 of IAS 1 Presentation of Financial Statements (as revised in 2007);
- (g) the entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method;
- (h) income tax expense or income; and
- (i) material non-cash items other than depreciation and amortisation.

Source: IFRS 8, Operating Segments



# Segment Disclosure Quantity and Quality under IFRS 8: Determinants and the Effect on Financial Analysts' Earnings Forecast Errors☆

Paul André<sup>a</sup>, Andrei Filip<sup>b</sup>, Rucsandra Moldovan<sup>c,\*</sup>

André et al. (2016) find that under IFRS 8, **more discretion can be exercised over the quality than the quantity of disclosures** and that incentives played an important role in the sense that managers with proprietary concerns tended to solve this by (p. 443): ‘...either deviating from the suggested line-item disclosure in the standard, or, if following standard guidance, by decreasing segment reporting quality.

These results suggest that **when management is given much flexibility in relation to disclosure in combination with low enforceability**, there will be **high variation in disclosure quantity and quality**

in practice, to some extent related to the incentive patterns of management.

270 multi-segment European firms applying IFRS 8 that report non-geographical segments

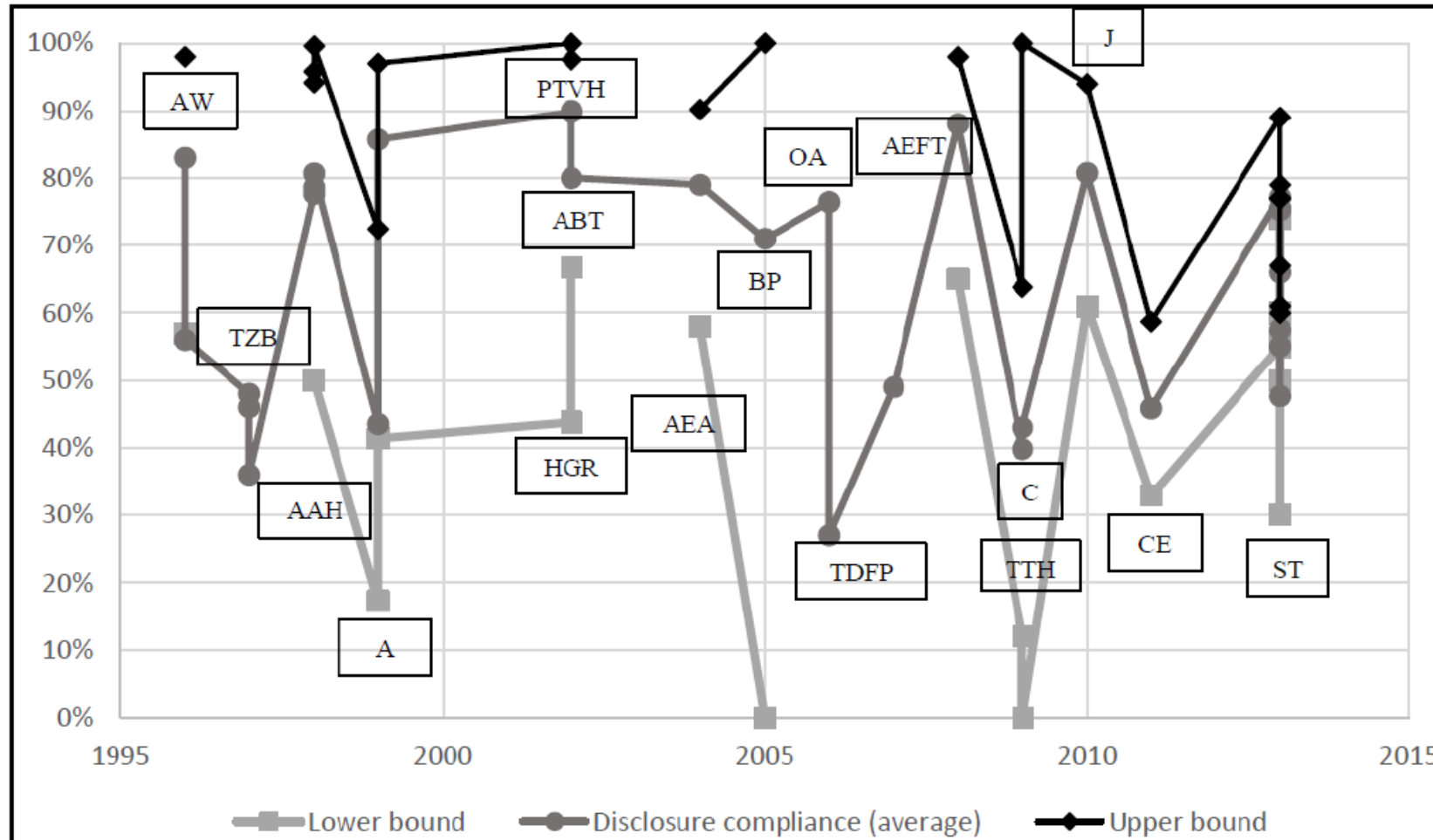
Table 2

Panel B: Distribution of sample into groups based on *SRQI* and *SRQt*

		<i>SRQt</i>			
		<i>Over-disclosers</i>	<i>Box-tickers</i>	<i>Under-disclosers</i>	<b>Total</b>
<i>SRQI</i>	<i>HighQI</i>	22 (8.15%)	31 (11.48%)	15 (5.56%)	<b>68 (25.19%)</b>
	<i>AvgQI</i>	39 (14.44%)	66 (24.44%)	30 (11.11%)	<b>135 (50.00%)</b>
	<i>LowQI</i>	14 (5.19%)	35 (12.96%)	18 (6.67%)	<b>67 (24.81%)</b>
	<b>Total</b>	<b>75 (27.78%)</b>	<b>132 (48.89%)</b>	<b>63 (23.33%)</b>	<b>270 (100%)</b>

This table presents the sample distribution into groups of *SRQt*, i.e., *Over-disclosers*, *Box-tickers*, and *Under-disclosers* against *SRQI*, i.e., *High*, *Avg*, and *LowQI* (percent of total sample in brackets). The sample contains 270 firm observations. Companies are split into groups based on whether their values for *SRQt* and *SRQI* are in the bottom, upper, and two middle quartiles. See variable definitions in [Appendix A](#).

# IAS/IFRS DISCLOSURE COMPLIANCE IN EMERGING-MARKET AND DEVELOPING COUNTRIES 1996-2013

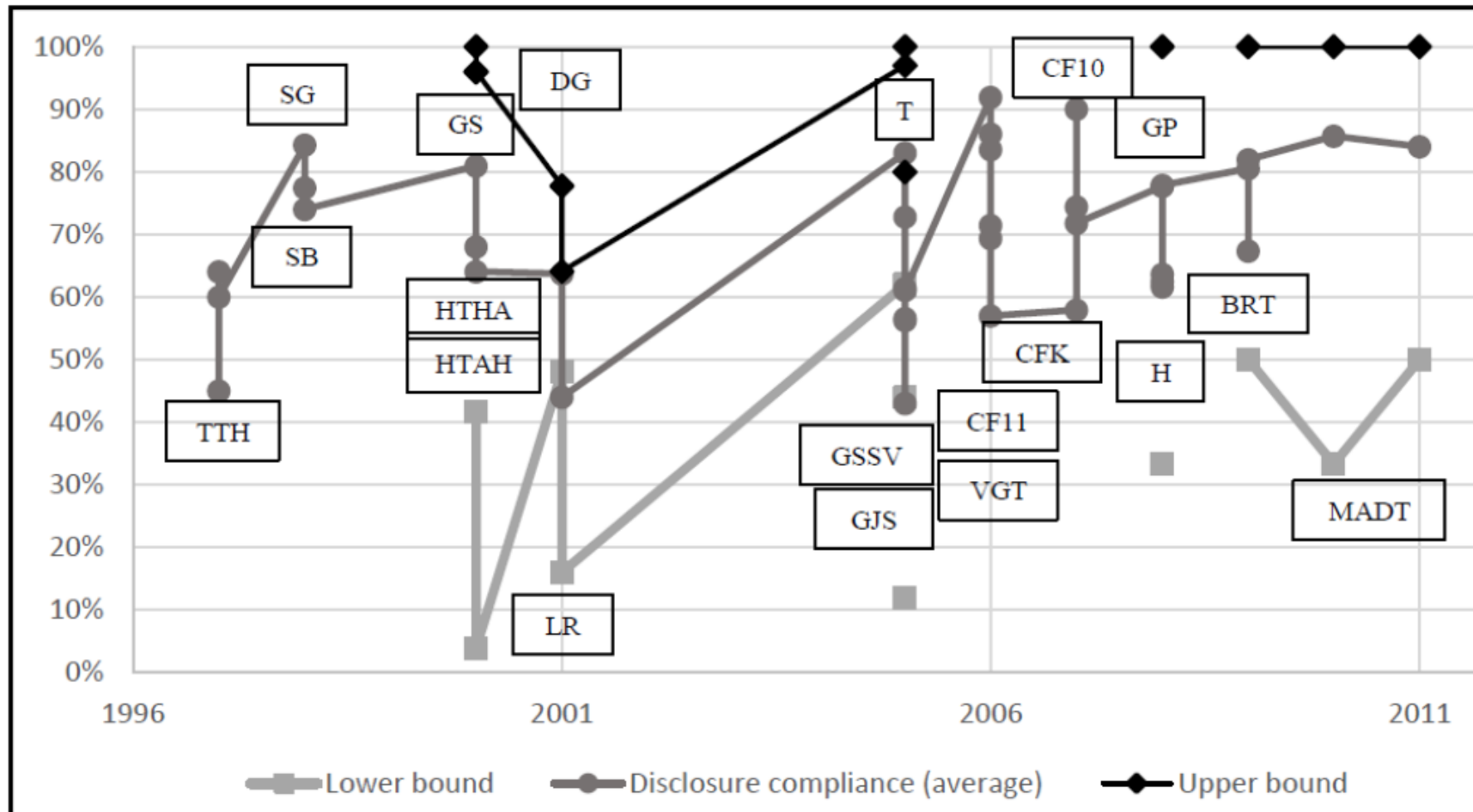


Average compliance across the 17 studies: 65%

Lower bound generally much below the average

Figure 1: Compliance with IAS/IFRS disclosure requirements in 17 studies of emerging and developing countries during 1996-2013. Each dot represents a country/region covered by a study in a particular year.

# IAS/IFRS DISCLOSURE COMPLIANCE IN DEVELOPED COUNTRIES 1997-2011



Average compliance across the 19 studies: 70%

Lower bound generally much below the average

Figure 2: Compliance with IAS/IFRS disclosure requirements in 19 studies of developed countries during 1997-2011. Each dot represents a country/region covered by a study in a particular year.



## SOME OBSERVATIONS BASED ON THE REVIEW

- Academic research has not addressed the issue of compliance with disclosure principles, only compliance with specific requirements.
- The results available suggest quite high levels of non-compliance on average and very low levels of compliance among the poorest disclosures.
- It remains unclear whether more principles-based disclosure requirements improve compliance as research has not explicitly addressed this issue.
- The number of academic studies on disclosure compliance seems to be decreasing over time.



## WHY IS DISCLOSURE COMPLIANCE SO LOW?

- Non-compliance does not appear randomly. If the risks of non-compliance are low (e.g., low risk of litigation) and there is absence of strong public enforcement, mechanisms related to environment and incentives can be expected to influence entities' behaviour more strongly.
- Factors explaining compliance levels include company size, listing status, enforcement-related, governance-related, country-/culture-related variables.
- Given that entity-specific disclosures appear to be very context-dependent, how should disclosure requirements be formulated in IFRS standards?

## IN THE NAME OF RELEVANCE...

- The DP describes the disclosure problem in terms of (i) not providing enough relevant information, (ii) providing irrelevant information and (iii) ineffective communication of the information provided.
- Information is defined as only being relevant if it is capable of making a difference in the decisions made by primary users. It is not possible to determine what information primary users will find irrelevant and what should therefore not be required by entities to disclose. As a consequence, the discussion would seem to focus on who can make the best 'second-guessing' by entities, auditors and regulators on what primary users consider relevant.
- The IASB's actions within the Disclosure Initiative (the principles of disclosures and the materiality guidance) seem to explicitly target the 'best-in-class' disclosers, rather than setting minimum requirements that would rely less on the entity's good intentions. Will the principles only work if managers are 'in good faith'?
- The DP: (IASB, 2017, 4.18, p. 41): 'If a principle is included in a general disclosure standard, it might be possible to delete the specific requirements in the Standards described...' Will fewer specific requirements still support the protection of investors from poor disclosers?



Thank you!  
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