



**FINANCIAL
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FACULTY**

INFORMATION FOR BETTER MARKETS

AN INITIATIVE FROM THE FINANCIAL REPORTING FACULTY



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What information should companies disclose? How should they measure their profits and their capital? How should their reporting be regulated? Financial reporting by businesses is vital to the functioning of healthy markets, but dogged by numerous controversies.

As the laws, regulations and standards governing financial reporting become ever more complex, the ICAEW Financial Reporting Faculty helps members to keep up to date and to understand the implications of new requirements. The faculty also seeks to inform and influence regulators and standard-setters on financial reporting questions. The faculty's work on these public policy issues is informed by its *Information for Better Markets* thought leadership programme.

Our *Information for Better Markets* work subjects key issues in financial reporting to careful and impartial analysis. Better understanding of these issues will help achieve what the preparers and users of financial reporting both need – **practical solutions to complex problems**. In pursuit of this objective, the *Information for Better Markets* initiative tackles three broad themes in financial reporting:

- **disclosure;**
- **measurement; and**
- **regulation.**

Our *Information for Better Markets* work takes two principal forms. We write and publish reports. And we commission research by leading academics from around the world. The research is usually presented at one of two annual events – the P. D. Leake Lecture and the *Information for Better Markets* Conference – and published in the annual *International Accounting Policy Forum* special issue of *Accounting and Business Research*, a leading academic journal. Both the research and the events at which it is presented are financed by ICAEW's charitable trusts.

Our reports draw on the research that we commission as well as on other academic work. And the research explores the arguments and evidence on issues that we raise in our reports.

Disclosure

The disclosure theme focuses on what information businesses should disclose in their financial reporting.

We all know that markets flourish on information. It is a lot less clear exactly what information they need and who should provide it. Information itself is a product bought and sold in the marketplace. People buy newspapers, magazines and published reports, subscribe to websites and alerts, and commission their own third-party reports and investigations. Much of the information we have about companies is produced and distributed in this way, through the normal market process of supply and demand.

But companies also provide information about themselves free of charge. If we buy shares in a business, or lend it money, or work for it, we probably want to know a good deal about it, what it does and what its prospects are. So businesses willingly disclose information about themselves to attract and reassure shareholders, creditors, employees and other interested parties. A business that is open about itself has a competitive advantage over one that is secretive.

The relationship between managers and shareholders provides an especially powerful motive for disclosure – at least to shareholders – because managers act as their agents. And if the relationship between agent and principal is to work successfully, openness is essential.

Yet few businesses – perhaps none – are totally transparent. For most companies, there is a point beyond which it does not make sense to be open. There are good reasons not to disclose information that would help competitors or damage relationships with customers, suppliers or employees. There may also be grey areas where information is too uncertain to disclose or where premature disclosure could prejudice managers' ability to resolve a problem. Just how much companies should disclose is therefore inevitably controversial.

There has also been growing criticism in recent decades of the limitations of financial reporting information. This has prompted calls for increasing disclosure of non-financial, qualitative and forward looking information to compensate for financial reporting's supposed defects. But how real are these alleged defects? And how successfully can useful non-financial disclosures be specified?



Our *Information for Better Markets* work subjects key issues in financial reporting to careful and impartial analysis. Better understanding of these issues will help achieve what the preparers and users of financial reporting both need – practical solutions to complex problems.

We have already explored some of these issues in the *Information for Better Markets* publications *New Reporting Models for Business* (2003), *Developments in New Reporting Models* (2009) and *Reporting Business Risks: Meeting Expectations* (2011). Future work will continue to explore the principles that should govern disclosures by businesses. This work will build on the recognition that much disclosure is voluntary rather than mandatory, and that disclosure takes place within an environment in which there are many, competing suppliers of information.

Measurement

The measurement theme focuses on how businesses should measure the items they disclose in their financial reporting.

Perhaps the most difficult aspects of financial reporting involve measurement. This is hardly surprising. Reported profits affect managers' rewards and prospects, how much tax a company pays, what its dividends are, how the business is valued and its ability to attract investors. It is difficult to think of anything in business reporting more important for a company or its directors and management. And it is no wonder that changing how profit is measured can generate fierce debate.

There are valid arguments for widely differing views on such fundamental matters as:

- the definition of capital;
- whether costs or current values should be used;
- what type of current value is most useful;
- when revenue should be recognised; and
- how costs should be allocated.

And controversies continue about how to account for, among other things:

- pensions;
- taxation;
- intangibles;
- financial instruments; and
- extractive industries – from exploration to closure and rehabilitation.

We have already explored some of the fundamental issues in *Measurement in Financial Reporting* (2006) and *Business Models in Accounting: The Theory of the Firm and Financial Reporting* (2010). A particular concern for many of those involved in the financial reporting process is the use of fair value, a concept that only entered the debate on financial reporting relatively recently. Both these reports consider the proper use of fair value in financial reporting. And we have also looked, in various publications, at the relationship between financial reporting and financial stability, in which the role of fair value has been especially controversial.

Business Models in Accounting broke new ground for our *Information for Better Markets* work, drawing on economists' work on the theory of the firm and exploring its potential implications for financial reporting. We will continue to draw on relevant thinking in economics where this can contribute to the understanding of accounting problems.

Much also remains to be done in looking at specific measurement problems. Our *Information for Better Markets* conferences in 2007 and 2008 looked at, respectively, accounting for intangibles and accounting for pensions. Our 2011 conference considers accounting for financial instruments.

Regulation

The regulation theme focuses on how businesses' financial reporting should be regulated in laws and standards and how these requirements should be enforced.

The whole subject of how financial reporting is regulated calls for further investigation. Few areas of business activity are more heavily regulated than company financial reporting. Yet many questions remain as to how effective this regulation is and whether there are better ways of doing it.

The diversity of businesses is an important consideration in thinking about how best to regulate financial reporting. The costs and benefits of financial reporting are very different for, say, a large publicly listed company and a small owner-managed business. Arguably the objectives are different too. So different regulatory approaches may well be appropriate for different types of business.

At the same time, there are benefits in having a common language of financial reporting – both for all businesses within a country, and globally to promote international trade and investment. These are arguments for a standardised approach to financial reporting. But do the benefits of standardisation outweigh the costs of imposing a one-size-fits-all approach? And how should international standards be set?

There has been increasing recognition in recent years that the institutional framework is critical in determining the quality of financial reporting. This is not simply a question of what standards require, but also of how they are interpreted and enforced, what assurance arrangements are in place, the legal framework, corporate governance, education and training, and ethical codes and norms. These vary from country to country and also within jurisdictions, depending on factors such as the size and ownership of the business and the nature of its activities. We have already looked at these issues in the context of the implementation of IFRS around the world, and we will continue to work on this aspect of regulation.

Another important question for the regulation of financial reporting is: who is financial reporting for? Different regulatory authorities have different answers. Securities regulators usually see financial reporting as being for the benefit of investors in securities markets. Standard-setters focus on the providers of capital. Banking regulators think financial reporting should protect the interests of depositors and financial stability in general. Company law often gives priority to owners.

And so on. These diverse views on the purposes of financial reporting frequently overlap. But the financial crisis showed that they can also conflict – for example, where securities regulators and banking regulators differ on the proper role of fair value accounting.

This is an issue that we propose to explore in our future work, looking in particular at the different users of financial reporting and their different needs. How far are they really in conflict? To what extent can they all be met by financial reporting? This work will also have important implications for measurement and disclosure.

Our *Information for Better Markets* conferences in 2009 and 2010 looked at, respectively, the role of regulation in financial reporting and the international implementation of IFRS. Our 2012 conference considers the question: who is financial reporting for?

Bringing practice and research together

We believe it is important to bring together academics and practitioners (ie, non-academics) to examine public policy issues. In this way, we can ensure both that contributions to the debate are properly informed by the latest thinking and research, and that academics have access to people who can help give a practical perspective on the problems they are investigating. This isn't always easy. There are often barriers between the worlds of practice and research and it takes a deliberate effort to overcome them. We try to do this in various ways.

- We commission papers from leading international academics and we ask practitioners to provide commentaries at the events where they are presented.
- These events are aimed at both academic and practitioner audiences. Attendance is typically split about 50/50 between the two groups.
- We attend academic conferences around the world and take an active role at them in promoting discussions that address public policy issues.
- We reflect what we have learnt from both researchers and practitioner commentators in writing our own reports.

We will continue to do all these things as part of our *Information for Better Markets* work.



Our track record

ICAEW is a world-leading professional body, with over 136,000 members all around the world. Chartered accountants can be found in all sectors of the economy, have a wide range of expertise and work to the highest technical and ethical standards. This range of expertise and involvement is reflected in ICAEW's thought leadership programmes. These cover areas such as corporate governance, financial services, corporate finance, markets and regulation, assurance, and financial management.

ICAEW has a long and proud record of thought leadership on financial reporting questions. Over many years it has tackled difficult public policy issues that are relevant to its members, but also of importance for society more widely because of financial reporting's key role in helping to make markets work. Since 2003, this thought leadership activity on financial reporting issues has been brought under the banner of the *Information for Better Markets* campaign.

Invitation to participate

If you are interested in keeping in touch with our *Information for Better Markets* work, or contributing to it, please visit icaew.com/bettermarkets or email us at bettermarkets@icaew.com.



The ICAEW is a founder member of the Global Accounting Alliance, which represents over 775,000 professional accountants in over 165 countries worldwide, to promote quality services, share information and collaborate on important international issues.

ICAEW is a professional membership organisation, supporting over 136,000 chartered accountants around the world. Through our technical knowledge, skills and expertise, we provide insight and leadership to the global accountancy and finance profession.

Our members provide financial knowledge and guidance based on the highest professional, technical and ethical standards. We develop and support individuals, organisations and communities to help them achieve long-term, sustainable economic value.

Because of us, people can do business with confidence.

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