Disclosure Pilot Update

Executive Summary

Project Type	Influencing
Project Scope	Significant

Purpose of the paper

The purpose of this paper is to update the Board on the evidence gathered to date on the Disclosure Pilot, and seek its view on the approach to the final comment letter due to be approved at the December board meeting.

Summary of the Issue

The key themes from the stakeholder responses are:

- The advantages of the proposals are seen as providing a more principles based approach, with more information provided on the purpose of the disclosure and the related user needs which is considered helpful to improving disclosure.
- The disadvantages of the proposals are that they are seen as challenging and resource intensive for smaller preparers, that mandatory disclosure requirements created a shared single source of understanding of what is required by all stakeholders, and concern that the proposals create significant challenges for auditors and regulators.

The paper outlines three approaches to finalising the comment letter:

- Support the proposals.
- Hybrid approach, whereby the IASB maintains the current (mandatory) disclosure requirements but spends additional time understanding user needs when developing proposals and shares these user needs and objectives as contextual information rather than as compliance objectives.
- Do not support the proposals.

The paper asks the Board's views on the approach they wish to adopt when finalising the comment letter to the IASB.

Decisions for the Board

To decide on the approach to take in finalising the comment letter.

Recommendation

There is no recommendation for this session.

Disclosure Pilot Update

Background

1. The IASB Exposure Draft ED *Disclosure Requirements in IFRS Standards – A Pilot Approach* [1] ("the Disclosure Pilot") seeks to address the "the disclosure problem" of financial statements containing irrelevant information, insufficient relevant information, ineffective communication of the information provided and a checklist approach to disclosure used by some entities.

2. This IASB project forms part of IASB's Disclosure Initiative, a portfolio of projects exploring how to improve the effectiveness of disclosures in financial reporting. The IASB's ED was published on 25 March 2021 and the comment deadline, following extension, is 12 January 2022.

3. The ED proposes four actions.

   (a) Creates Guidance for IASB to use when developing and drafting disclosure requirements. This proposes to largely replace mandatory disclosure items with an objectives-based regime where entities can provide disclosure that satisfies the disclosure objectives.

   (b) Applies this Guidance to IFRS 13 *Fair Value Measurement* and proposes amendments to this standard developed using the new Guidance.

   (c) Applies this Guidance to IAS 19 *Employee Benefits* and proposes amendments to this standard created using the new Guidance

   (d) Proposes consequential amendments to IAS 34 *Interim Financial Reporting* and IFRIC 17 *Distribution of Non-cash Assets to Owners*.

4. The ED notes that in addition to the proposed amendments to IFRS 13 and IAS 19, the guidance may potentially be used in the future development of new standards and changes to existing IFRS standards.

5. Given the importance placed on disclosure by users of financial statements, the ED's proposals are expected to affect a large number of UK stakeholders, including IFRS preparers, users, auditors and relevant regulators. Ensuring the IASB has the opportunity to consider views of UK stakeholders during the standard's development is key to minimising new concerns being identified during the endorsement and adoption assessment process.

1 The ED, Basis for Conclusions and Illustrative Examples can be accessed here: https://www.ifrs.org/projects/work-plan/standards-level-review-of-disclosures/exposure-draft-and-comment-letters/

Key themes identified in the UKEB draft comment letter

6. The UKEB's draft comment letter was open for public consultation from 26 August – 1 November 2021. It:

   (a) supported the IASB's work to make financial statements more useful.

   (b) expressed concern about a number of practical aspects of the proposals. These included issues of comparability, digital reporting, audit and enforceability, the application of judgement. Certain drafting issues in IFRS 13 were also highlighted.

   (c) noted that in the process of developing specific disclosures co-ordination with the proposed International Sustainability Standards Board (ISSB) should be considered, and the proposals should build in sufficient flexibility to accommodate this.

   (d) expressed reservations about supporting the amendments to IFRS 13 and IAS 19 without first understanding whether the Guidance described in the ED will be adopted and applied to other existing or future IASB standards. The letter suggests IFRS 13 and IAS 19 would benefit from re-exposure once this decision has been made.

Emerging views on the exposure draft

7. At the time of publication the ED contained dissenting opinions from three IASB board members. The basis of the dissent was as follows:

   a) The proposals will **increase enforcement challenges**. One aspect of the disclosure problem is failure to provide enough relevant information. Enforceability is particularly important to address this, but concern was expressed that it would be difficult to assess and enforce objective based disclosure and that it would be difficult for regulators to assess during the exposure draft process how successful enforcement would be.

   b) The proposals will be **more burdensome for preparers** and **increase reliance on materiality** judgements. Good application will require the use of significant judgement by preparers. Poor application of materiality contributes to the disclosure problem and increasing reliance on materiality and judgement may exacerbate the problem.

   c) The proposals will **impair comparability** for users of financial statements.

8. In September 2021, the Australian Accounting Standards Board decided not to support the proposed disclosure approach. AASB acknowledged feedback from stakeholders that the proposed approach might not be operational in practice. It acknowledged IASB's efforts to solve the disclosure problem but concluded the suggested approach would not result in the desired outcome. During its meeting on 11 November, the AASB will consider the following three alternative approaches it may recommend to IASB:

   a) *Maintaining the current disclosure requirements and reaffirming the principle of materiality in each standard by referencing the relevant materiality guidance.* The staff paper notes that this approach is considered to address the objective of too much irrelevant information in financial statements, but it does not resolve the issues of insufficient relevant information, or the ineffective communication of information provided;

b) *Maintaining the current disclosure requirements and use the disclosure objectives as supporting guidance.* The staff paper notes that while this approach does not address the objective of too much irrelevant information in financial statements, it is expected to improve the issues of insufficient relevant information and the ineffective communication of information provided; and

c) *IASB using the proposed Guidance as a guide when developing future standards and reviewing detailed disclosure requirements, i.e. internal guidance only.* The staff paper notes that this approach would improve all three objectives, and this is the option recommended by AASB staff.

9. In addition, the AASB paper considers the potential impact of digital reporting, and questions whether this would make the three issues associated with the "disclosure problem" irrelevant, particularly the issue of too much irrelevant information. They imagine a future in which financial reporting consists of both a comprehensive digital financial data file to be read by robots, and a set of concise financial statements with reduced disclosures for human readers. They see benefit in a disclosure regime similar to today (mandatory disclosure) for such concise financial statements. This view is consistent with themes identified in the UKEB secretariat's work, including our discussion with a financial data provider.

Work undertaken by the UKEB secretariat

10. To date we have undertaken a blend of activities including roundtable events, one to one interviews, discussion with industry groups, field tests (3 FTSE100 companies, 1 FTSE250 company), a stakeholder survey and public consultation on a draft comment letter. In total, this has provided feedback from 46 stakeholders and three industry bodies, across 23 events.

11. At the time of writing stakeholder feedback is largely complete. The common themes are summarised in the following paragraphs. Based on this feedback we have concluded that it may be difficult to support the IASB proposals in their entirety. But given the conceptual nature of the Guidance it is not clear how these concerns are best addressed. They cannot be resolved by modifying or clarifying the wording of the proposals, rather they consider the potential consequences of the ideas at the heart of the proposals. We therefore include three potential options for responding to the IASB and ask the Board for direction as to how they would like to proceed.

Approach to the final comment letter

12. When drafting the comment letter to the IASB we had anticipated that stakeholders would broadly support the IASB proposals, subject to limited modifications to reflect certain practical difficulties. However, the feedback has not been as positive in reality and as a result we have identified three potential approaches when finalising the UKEB comment letter:

a) Support the proposals subject to:

i) certain specific changes to drafting to provide clarity, and

ii) the understanding that IASB will ultimately apply the proposed guidance to all accounting standards, not just IFRS 13 and IAS 19.

b) Recommend a hybrid approach, one that retains some elements of the IASB proposals but avoids the more challenging practical difficulties.

c) Do not support the proposals.

Option 1: Support the Proposals

13. Supporting the proposals can be split into two elements – the changes to IFRS 13 and IAS 19 and the proposed Guidance, .

14. Field test results demonstrate that, subject to certain drafting changes to improve clarity, the requirements proposed for IFRS 13 and IAS 19 can be successfully applied by participants, and participants consider the resulting disclosure to be an improvement on current practice. On this basis, there is no reason not to support the proposed changes to IFRS 13 and IAS 19, subject to the overarching questions of:

a) Whether the advantages of moving to an objectives based regime approach outweigh the disadvantages?

b) Whether these changes should proceed in isolation to making similar changes to other standards?

c) Whether the field test experience would produce similar results in mid-size and smaller companies. Discussion with several challenger accounting firms regarding their clients ability to apply the proposals suggest this would be problematic, and we would encourage IASB to consider carefully the field test results from smaller companies in jurisdictions where such testing took place?

15. Feedback on the Guidance in the proposals was more complex. We summarise below stakeholder feedback on the advantages and disadvantages of the proposals.

16. The advantages of IASB's proposals identified by stakeholders were:

a) The proposals provide a more principles-based approach, giving companies greater freedom to tell their own story in their own voice. This was considered to be inherently appealing.

b) The additional information on the purpose of the disclosure and user needs was widely welcomed and considered helpful to improving disclosure.

c) Users welcome better disclosure and, while issues are expected, users thought the proposals would result in better information than available today.

d) As noted above the field tests were largely positive and, overall, the participants were enthusiastic about the proposals. The information on objectives had provided a fresh perspective to consider their disclosures. Participants also noted that some or many of their identified improvements could be made under todays rules, and they will consider doing so in their next set of financial statements.

e) Several preparers noted that the implementation of a new/revised standard provides an "event" which would be a catalyst to make significant changes to disclosure. This can otherwise be difficult due to practical constraints (time and resources, audit) and behavioural constraints (lack of desire to fundamentally change something that is considered to work). It was thought that any significant changes would be made in or around the transition year then the disclosure would become stable again with relatively few changes year on year.

17. The disadvantages of proposals identified by stakeholders were:

a) Smaller preparers, and the accounting firms who work with them, told us that the proposals represent a substantial change in thinking that may be difficult to accommodate. Mid-size preparers highlighted resource challenges if too many standards changed at once. There is risk that the gap in disclosure quality between those with finance resources and those without will widen.

b) Many stakeholders highlighted the benefits of mandatory disclosure requirements, which would be lost under the IASB proposals. Mandatory requirements are said to create confidence by providing a shared understanding of what is required amongst all parties, and provide a useful framework for discussions between companies, auditors and regulators. Mandatory requirements create a single source of reference as to what is required and in their absence there is concern that further disclosure requirements are created "via the backdoor" by the preferences of individual audit firms and local regulators. This may lead to the inconsistent application of IFRS, both within and between jurisdictions.

c) Many preparers told us they use a checklist of some form (based on either IFRS disclosure requirements, prior year accounts or Big 4 Example account publications) as part of their process, but then move on to consider the question of what should be added/modified/removed in the current year. We understand accounting firms do the same. This is considered to assist in creating an efficient and robust process.

d) Stakeholders told us that barriers to removing irrelevant information from financial statements was often a behavioural issue. Adding further information to disclosures today is considered straightforward, however removing (irrelevant) information is considered difficult. This is often due to cultural barriers (audit committee taking a conservative view, finance teams perceived risk of audit dispute, pragmatic decisions to "give in" to the auditors as not enough resources to research and "argue back") rather than being IFRS rule based. Both preparers and auditors described the "safety" of including extra information when in doubt. As this behaviour is not driven by IFRS rules, changing those rules is unlikely to lead to a different outcome.

e) There is general agreement that the role of audit is critical to these proposals, and many stakeholders acknowledged the challenging audit environment in the UK at this time, with the profession currently facing intense media scrutiny and the Department for Business, Energy and Industrial Strategy (BEIS) review of the audit market and product. Preparers, particular those from mid-size and small firms felt strongly that, in the current climate, auditors would struggle to adapt sufficiently to make the proposals work. They thought audit firms would be reluctant to permit reduction of disclosure in the new regime, or support disclosure which was significantly different to the peer group. For many, this was a "deal breaker" for the proposals being workable in practice. Most attendees at the auditors roundtable agreed that while conceptually this is a step in the right direction, application in practice will be tough.

f) Many stakeholders raised comparability as a potential issue with the practical implementation of the proposals. However, both users and preparers suggested that industry norms may emerge over time, mitigating the comparability risk.

g) Stakeholders questioned whether regulators would be able to effectively carry out their role under the new regime. Some suggested the subjective nature of the proposals would make regulation less effective. As one preparer noted "who is to say we are wrong". It was noted a detailed knowledge of the company would be required to understand whether the disclosure was appropriate, and that regulators did not easily have access to such information. From a UK regulatory perspective, the FRC shared concerns as to the impact of the proposals on regulatory resources, noting it is likely more time will be needed to determine if the disclosures presented satisfy the disclosure objectives, and in forming a view and making enforcement decisions. This acknowledges that difficulties in enforcement may lead to a reduction in the quality and usefulness of information disclosed in financial statements, and could exacerbate the lack of comparability across companies.

h) As noted in the UKEB's draft comment letter, digital reporting has not been fully explored in these proposals. Discussion with a financial data provider revealed that machines value uniformity of information, tabular information over narrative, and do not mind excess (irrelevant) information. Research by the FRC Lab notes that "in the world of AI data has value, but structured data has even more value....to facilitate the use of corporate reporting information.....data that is required to be made publicly available could be done so in a way that is open, structured and allows for low cost aggregation and reuse"[2]. Research in US market[3] of those accessing financial information in the SEC EDGAR system has shown robot downloads substantially exceed human downloads and that this is a growing trend. There is therefore a balance to be explored and achieved between the differing disclosure needs of machine and human users.

18. In terms of the project objectives, supporting the IASB proposals may lead to more relevant disclosure and more effective communication of the information presented by some companies. However, it risks widening the gap in disclosure quality between companies with significant finance resources and those who lack such resource. It also risks losing the benefits of todays mandatory disclosure regime, reduces comparability, and poses practical challenges for auditors and regulators. The issue of too much irrelevant information in financial statements may not be addressed, as (other than in the transition year) our work indicated this was a behavioural issue and unlikely to be affected by changes to drafting in the standards.

[2] *Artificial Intelligence and Corporate Reporting, How Does it Measure Up*, January 2019, Financial Reporting Council Financial Reporting Lab.

[3] *The Use of EDGAR Filings by Investors*, Tim Loughran & Bill McDonald, Journal of Behavioural Finance, 2017, vol.18, issue 2, 231-248..

Option 2: A Hybrid Approach

19. An alternative to fully supporting the proposals may be to take a hybrid approach. The purpose of creating a hybrid approach is to retain many of the advantages noted above, including the improvement in disclosure desired by users, but to bypass the most challenging practical difficulties identified by stakeholders.

20. This could be achieved by maintaining the current (mandatory) disclosure requirements but supplementing these by (i) requiring IASB to spend more time in the standard setting process understanding user needs as proposed, and (ii) by providing this information on user needs and disclosure objectives as contextual information, rather than as compliance objectives. This could be achieved by, for example, including this information as application guidance, or by including the information in main standard as an introductory note to the disclosure section. This is consistent with feedback received in the field tests that, having used the information contained in the objectives to look at existing disclosures with fresh eyes, many of the changes identified could likely be implemented under today's disclosure regime.

21. This has the advantage of allowing preparers and auditors to better understand user needs and therefore make better judgments about the disclosure presented. This is likely to lead to improved disclosure. It also avoids the pitfalls described above, including the concerns of smaller entities, the loss of the shared understanding and confidence created by mandatory rules, the risks to audit and regulation described by stakeholders, and this approach enables comparability which may be otherwise lost under the IASB proposals. This approach could also potentially act as a bridge toward adopting the full IASB proposals at a future date when stakeholders are more familiar with thinking about objectives, and the information characteristics of digital reporting have been more fully explored.

22. In terms of the project objectives, this approach is more likely to lead to relevant disclosure and effective communication of the information presented. By retaining mandatory requirements the current benefits can continue, the gap in disclosure quality is unlikely to worsen, comparability issues are avoided, and the audit and regulatory challenges arising from the proposals are avoided. It may not address the issue of too much irrelevant information, as our work indicated this was a behavioural issue and unlikely to be affected by changes to drafting in the standards.

Option 3: Do not support the proposals

23. This approach has the disadvantage of ignoring user feedback that wishes to see improvement in financial statement disclosure, and preparer feedback that the objectives and other information on user needs were helpful to make changes and improve disclosure. There are no obvious advantages to this path, and we do not recommend it. If the proposals cannot be supported in full we consider the hybrid approach a more constructive way to engage with the challenges presented by the proposals.

Questions for the Board
a) Which of the three options outlined above would the Board prefer for its final comment letter on this project? b) If the preferred approach is to support IASB's proposals, how does the Board recommend that the disadvantages identified by stakeholders are positioned in the final comment letter?

Next Steps

24. The Secretariat will present a final comment letter for the approval at the December Board meeting.

25. The IASB's comment deadline is 12 January 2022.