Corporate reporting is all about communication and accountability. Stewardship is an important anchor on which our current model is based, a model developed from within the context of company law. But in addition to stewardship, which involves looking backwards, investors increasingly demand fair and balanced forward-looking information, about strategy, business models, the value-creation process and related risks; and about performance on an integrated set of targets, not only financial but equally non-financial key performance indicators (KPIs).

Financial statements have traditionally been a key element in the corporate reporting chain. Will that still be the case in, say, 10 years’ time? The premise of this article is that they will not, unless we develop a new vision for corporate and financial reporting as well as for the related assurance the profession provides. The scope of corporate reporting should be extended to better support investors’ own assessment of business value and performance prospects, and to enable investors to make judgments about the sensitivity of their assessments to key risks and opportunities.

We understand that providing future-oriented information on the basis of clearly stated assumptions is an important part of this, while at the same time recognising the legitimate concerns that companies may have in doing this.

There is an increasing sense among stakeholders – boards, audit committees, investors and auditors alike – that traditional financial reporting, which for most large and listed companies in Europe is based on International Financial Reporting Standards (IFRS), is becoming increasingly less fit for purpose.

FINANCIAL STATEMENTS

There are various reasons why people criticise the relevance of today’s financial statements. Some feel that they have become overly complex; others that they are focused too much on technical issues and detail,
rather than on the big picture. Others say they are too voluminous in disclosure, and that the notes covering sensitive areas such as key judgments made, major estimate and assumptions underlying the numbers, as well as the risk exposures and sensitivities, are too often expressed opaquely, in too much boilerplate language. Moreover, they are not linked sufficiently with the overall strategy and business model of the entity as set out in the director’s report or management commentary.

Complexity has many causes. It is not only the growing volume of disclosure that leads to more complexity in financial statements. Obviously, the world of business and finance itself is more complex than it was a few decades ago, and this growing complexity is also reflected in financial reporting. However, financial reporting itself may at times also contribute to complexity, for example, where requirements in standards become overly anti-abuse driven, overly prescriptive or no longer reflective of the business model the reporting is set out to portray.

The result of increased complexity and volume in detail is that financial statements are increasingly seen as a compliance document, an exercise for the accounting experts only. Of course, if true, this is a worrying development.

If traditional financial statements are no longer being perceived by many stakeholders as doing what they should do, communicating about the entity’s performance, financial position and prospects, the value of the audit profession is also questioned. At the end of the day, this is all about relevance. The audit profession is being challenged for having been too passive for too long in terms of true innovation.

FRESH THINKING
To heed that call, now is the time to start thinking afresh, in new and bolder ways than we have done before. The good thing is that we are not alone. The International Accounting Standards Board (IASB) is consulting on its future agenda. The comment deadline closed in December 2011. Many of the respondents to this consultation commented on the need to improve future financial reporting.

Similarly, the International Integrated Reporting Committee (IIRC) issued a first global discussion paper, asking for views from the international business community about how to achieve better business reporting by focusing on ‘telling the story’ in an integrated way. This means that reporting would not focus, as is traditionally the case, on financial performance only, but much more broadly on an entity’s drivers for longer term value creation, including its strategy, business model, related risks and performance across a number of key performance indicators, including non-financial KPIs. First indications on the feedback to the IIRC also suggest a mandate for change.

SPEED OF CHANGE
The pace with which changes in corporate reporting should be made is one where views may differ. This should, however, not distract from the overall ambition to change.

Over the past year, a number of initiatives have emerged that are aimed at addressing disclosure burdens and improving the relevance of financial of financial statements. For example:

- the Financial Reporting Council’s (FRC) Cutting Clutter, aimed at making financial reporting more focused on the important issues, both under IFRS and UK GAAP, including working on behavioural changes at all stakeholder levels;
- the Scottish and New Zealand Institutes’
paper on Losing Excess Baggage, aimed at reducing disclosures under existing IFRS by some 30%;
- in France, the national standard-setter, Autorité des Normes Comptables (ANC), issued a similar discussion paper in late 2011 with proposals to reduce current IFRS disclosures for smaller listed entities;
- at a European level, the European Financial Reporting Advisory Group (EFRAG) is preparing a discussion paper for release in 2012. Proposals include a Disclosure and Presentation framework that in future can be used by both standard-setters and entities to decide which information to include in the note disclosures and which information to exclude from the financial statement and, where relevant, to put in other places, eg, in the management commentary instead. EFRAG is working on this project in cooperation with the US FASB;
- ESMA, the European market regulator, issued a consultation paper about the concept of materiality; and
- at international level, the International Audit and Assurance Standards Board (IAASB) issued a paper about Auditing Disclosures, which among others, investigates issues in relation to applying the materiality concept to disclosures.

The fact that we have all these initiatives emerging goes to show that there is a need for action. With respect to addressing the issue of disclosure overload and presentation, the IASB should take charge. There is a clear need for leadership to pull all the above initiatives together in a globally coordinated project, which may contain both short-term elements and working on medium-term solutions,

There is an increasing sense among stakeholders that traditional financial reporting, based on IFRS, is becoming increasingly less fit for purpose

Assurance Standards Board (IAASB) issued a paper about Auditing Disclosures, which among others, investigates issues in relation to applying the materiality concept to disclosures.
eg, a more conceptual basis for disclosure and presentation requirements in future standards.

This would be a welcome first step, but it is not enough. We also need to work on the longer vision for improved corporate reporting and the consequences for the assurance given about the information provided.

**BUILDING BLOCKS**

It may be useful to think about the corporate reporting content as consisting of three main building blocks, as illustrated in the box above.

At present, building block 1 is not integrated with building block 2 and 3, with the latter two forming the traditional financial statements as we know them today.

We believe that over time, building block 1 and 2 will become the prime focus for corporate reporting, ultimately all contained in one single new integrated report. Building block 3, the details which presently form part of traditional financial statements and director’s report, will decline in prominence, but will still be available to analysts and other users as a database for their research needs.

Over time, the information in building block 3 may easily be provided in electronic format, eg, on a corporate website, through reporting formats such as XBRL or through a combination of both, although for this to happen regulatory changes would be necessary.

**AUDIT AND ASSURANCE**

The role of the auditor, of course, interacts with the scope of information being reported. The further development of integrated reporting should be a fundamental step in enhancing the relevance of the audit as auditors’ assurance skills are applied to a wider range of relevant information.

In terms of assurance, the consequences of the future vision presented may entail significant change. More and different forms of assurance would need to be given over building blocks 1 and 2, depending on the scope of information being provided.

Where the information contained in those blocks is forward-looking, it will need careful consideration as to the limitations of what can be done, so as not to create new expectation gaps or undue exposure to liability.

With respect to building block 3, much of this information is currently subject to annual statutory audit as part of the financial statements’ note disclosures. We could envisage that at some future point, the need for having this information audited annually should be reconsidered.

Other alternatives that are worth exploring further would include in our view a system whereby the auditor provides assurance from time to time over the systems and processes that generate the details, but no longer over the output itself as part of the annual “true and fair” statutory audit requirement. Such alternative assurance could, for example, be based on a surprise inspection regime, with a deterring system for those entities whose information provision proves deficient when inspected.

Such a model would have as an advantage that the skills of the profession can be focused increasingly on the fair and balanced presentation of building blocks 1 and 2.

Of course, all this will not happen overnight. It will require a lot of intermediate experimental and, at the appropriate time in the future, regulatory changes to both facilitate and guide those new developments.

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